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# CONTENTS

# ACRONYMS AND NOTES

| | |
|---|---|
| ADB | Asian Development Bank |
| *ADO* | *Asian Development Outlook* |
| ASEAN | Association of Southeast Asian Nations |
| CARs | Central Asian republics |
| CPI | consumer price index |
| DMC | developing member country |
| ECB | European Central Bank |
| EU | European Union |
| FDI | foreign direct investment |
| f.o.b. | free on board |
| FY | fiscal year |
| GDP | gross domestic product |
| IBRA | Indonesian Bank Restructuring Agency |
| IMF | International Monetary Fund |
| ICT | information and communications technology |
| NIEs | newly industrialized economies |
| NPL | nonperforming loan |
| OECD | Organisation for Economic Co-operation and Development |
| PRC | People's Republic of China |
| R&D | research and development |
| SBI | Sertifikat Bank Indonesia (Bank Indonesia Certificate) |
| SME | small and medium enterprise |
| SOE | state-owned enterprise |
| US | United States |
| VAT | value-added tax |
| WPI | wholesale price index |
| WTO | World Trade Organization |

Billion is 1,000 million.
Trillion is 1,000 billion.
Unless otherwise specified, the symbol $ means United States dollars; dollars are current US dollars.
— means that data are not available.
Quarterly growth figures are relative to the previous quarter on a seasonally adjusted annualized rate (unless otherwise specified). When rates relate to the same period in the previous year, they are denoted as year on year.

This *Asian Development Outlook 2001 Update* is based on the latest data made available at publication.

This *Update* does not cover all the developing member economies on the same chapter-by-chapter basis as was used in the *Asian Development Outlook 2001*. Hence, some of the smaller economies are dealt with in subregional overviews.

# FOREWORD

The economic outlook for developing Asia and the Pacific has changed significantly since the *Asian Development Outlook 2001* was published in April 2001. The 11 September terror attacks on the United States and the subsequent military response have exacerbated a global economic slowdown that was already more severe than was expected in April. Accordingly, this *Asian Development Outlook 2001 Update* reviews macroeconomic trends in the developing member countries of the Asian Development Bank (ADB) and revises April's economic forecasts for 2001 and 2002. An attempt has been made, in close cooperation with ADB staff in operations, to incorporate preliminary assessments of the economic impact of the attacks and the subsequent military response on the economies of developing Asia and the Pacific. However, events are still unfolding. There is a high level of uncertainty in the global environment and the economic outlook is changing by the day. The *Update* nevertheless is cautiously optimistic that, on the whole, developing Asia and the Pacific will continue to register healthy economic growth in 2001 and 2002 when compared with other regions in the world.

The *Update* was prepared by ADB's Economic Analysis and Research Division (EDAN), in collaboration with the Programs Departments and Office of Pacific Operations. The *Update* was put together by a team led by Brahm Prakash, Assistant Chief Economist (EDAN), comprising Cindy Houser, Sailesh Jha, Christine Kuo, Purnima Rajapakse and assisted by Charissa Castillo and James Villafuerte. Under the guidance of Charles Adams, the chapter "Outlook for Developing Asia and the Pacific" was prepared by Cindy Houser. Purnima Rajapakse processed and finalized the chapters on the subregions and individual economies. The contributors included Padmini Desikachar (Viet Nam), Yu-shu Feng (Thailand), David Green (Indonesia), Cindy Houser (Republic of Korea; Taipei,China; and the Newly Industrialized Economies), Sailesh Jha (Malaysia and Southeast Asia), Abid Hussain (Pakistan), Rezaul Khan (Bangladesh), Christine Kuo (Hong Kong, China; and Singapore), Xuelin Liu (Philippines), Elisabetta Marmolo (India), Long Yun Peng (People's Republic of China), Purnima Rajapakse (South Asia), Diwesh Sharan (Papua New Guinea and Pacific island developing member countries), and Tao Zhang and Masaaki Nagata (Central Asian republics, Azerbaijan, and Mongolia).

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I take this opportunity to thank all contributors, and earnestly hope that readers will find the *Update* useful. ADB welcomes feedback on the *Update* via telephone (++632 632 4444), fax (++632 636 2444), or email (ado2001update@adb.org).

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Manila
November 2001

# OUTLOOK FOR DEVELOPING ASIA AND THE PACIFIC

*The global slowdown in economic activity is turning out to be deeper, more synchronized across major economies, and more persistent than expected in April 2001 when the* Asian Development Outlook 2001 (ADO 2001) *was released. In addition, and beyond the immediate loss of life and property, the 11 September terror attacks on the United States and subsequent military actions have disrupted economic activity and adversely affected sentiment toward the economic outlook. Thus, this* ADO 2001 Update *(the* Update*) anticipates that the global recovery previously expected to begin in late 2001 will be delayed and only become firmly established by the middle of 2002. As a consequence, near-term projections for growth in developing Asia and the Pacific (the developing member countries of the Asian Development Bank) have been revised downward.*

*Against a background of considerable uncertainty, a number of significant downside risks to the economic outlook remain and may have intensified. These include those associated with the synchronized nature of the global slowdown, the current account imbalance in the United States, the fragile condition of the Japanese economy, and the possibility of further disruptions to economic activity in the aftermath of the 11 September attacks. The attacks added to an already uncertain outlook for global trade and have increased risk aversion, raising the cost of capital market access for some vulnerable countries. There are reasons, nevertheless, for cautious optimism related to the underlying strength and resilience of the global economy, the considerable macroeconomic stimulus already initiated, and the intention of policymakers to take additional measures as needed to mitigate the severity of the slowdown.*

*Based on this assessment, real economic growth in developing Asia and the Pacific is now expected to fall from 7.0 percent in 2000 to 3.4 percent in 2001, with a modest rebound in 2002 and stronger performance in 2003. Underlying the economic slowdown across the region in 2001 is a large diversity in economic performance, with the newly industrialized economies undergoing the sharpest slowdown, while the People's Republic of China and India sustain relatively robust growth.*

*The first part of this chapter appraises recent developments in, and the outlook for, the three major world economies. The second part reviews recent economic developments in the region, summarizes the current 2001-2002 forecasts—as revised from the* ADO 2001 *forecasts—and assesses the risks to those forecasts.*

# External Economic Developments and Outlook

## Introduction

The 11 September terror attacks on the United States (US) impacted a world economy in which the pace of activity was slowing to a surprising degree. The slowdown in global economic performance in the first half of 2001 was sharper and more synchronized across major economies than expected at the time of *ADO 2001*. The deterioration of the information, communications, and technology (ICT) sector that began in mid-2000 in the US broadened to other sectors by mid-2001 and deepened into a general demand-driven global cyclical slowdown. Aggressive monetary easing (especially in the US) as well as "new economy" relationships were initially expected to bring about rapid adjustments that would result in a relatively swift rebound in 2001 and a return to reasonably robust expansion in 2002. However, the magnitude of the reduction in US demand and its spillover effects to Europe and Japan were underestimated. Moreover, the extent to which world trade would be reduced was not anticipated. Then, amid signs of yet further weakening in the global economy, the September attacks abruptly disrupted US economic activity and significantly increased uncertainty over future global economic conditions. Box 1.1 reviews the global macroeconomic effects of the attacks.

Prior to the attacks, policymakers in the three major economies of the US, Japan, and the euro area (European Union members except Denmark, Sweden, and United Kingdom) had become increasingly confronted, as 2001 wore on, with negative economic news, such as deteriorating corporate profits, falling stock prices, rising unemployment, and faltering investor (and eventually consumer) confidence. Short-term interest rates began to fall in many economies as the focus shifted from inflationary pressures (which were ebbing) to the possibility of recession.

Optimism that US economic activity would rebound in the third quarter of 2001 had faded by midyear as did subsequent hopes for a modest US rebound in late 2001. Moreover, in the second quarter of 2001, economic conditions in Japan deteriorated significantly, and the pace of economic activity in the euro area slowed substantially. It is uncommon for these three major world economies—which together account for about 45 percent of world output and absorb nearly 50 percent of total exports from developing Asia and the Pacific—to be in simultaneous, mutually reinforcing slowdowns. Further, downward revisions to US productivity data (made before the attacks) reignited the debate about long-term trend growth prospects and further weakened the earnings outlook. With investor and consumer confidence then further shaken and financial markets falling sharply after the 11 September attacks, policymakers began to consider additional macroeconomic measures to preempt further weakening of the world economy. Together, these negative factors suggest that the slowdown in the global economy is likely to be sharper and more persistent than projected in *ADO 2001*, with recovery only beginning to take hold by the middle of 2002.

## Recent Developments in the Three Major World Economies

*Output and Employment.* The US economy was the first to slow, followed by Japan, and then the euro area. US real gross domestic product (GDP) growth, which fell to 1-2 percent, quarter on quarter, in the three previous quarters, further slowed to 0.3 percent in the second quarter of 2001. With US investment in a fourth (and exports in a third) consecutive quarterly contraction, consumption—which to that time had held up well—slowed to 2.5 percent growth in the second quarter of 2001, its smallest expansion in four years. As a consequence of these developments, manufacturing production shrank by about 4.0 percent in July 2001 relative to a year earlier, and shed over 860,000 jobs over the 12 months. This contributed to an increase in the unemployment rate from 4.0 percent in December 2000 to 4.5 percent in July 2001. In October 2001, with industrial production contracting for nearly a year, the unemployment rate jumped to 5.4 percent. According to data released by the Commerce Department on 31 October, because of the severe disruption to economic activity in September, the US economy contracted by 0.4 percent in the third quarter, year on year.

In Japan, the modest 2000 acceleration in growth had been expected to become a sustained, if mild, expansion that would bolster near-term economic prospects for developing Asia and the Pacific. Instead, economic activity weakened sharply in the first quarter of 2001, contracted by an annualized 3.2 percent, quarter on quarter, in the second quarter, and is expected to have contracted again in the third. The unexpected severity of the global ICT slowdown strongly affected the economy, which experienced double-digit contractions in export and private investment demand in the first and second quarters of 2001 after strong performance in the last quarter of 2000. Consumption sustained quarter-on-quarter growth of 2.0 percent in the second quarter but this is expected to have slowed to less than 1.0 percent growth in the third quarter as consumer confidence deteriorated along with the global outlook. With weak demand, industrial production has been on a downward trend for most of 2001, contracting by 11.7 percent in August 2001 from a year earlier. The unemployment rate reached a postwar high of 5.0 percent in the same month.

The euro area was expected to be relatively unaffected by the ICT correction in the US. However, real GDP growth, strong in the first quarter of 2001, slowed markedly in the second. This was due to slowing growth of exports to the US and Asia and to weakening domestic demand as high oil and food prices, slowing job growth, and declining equity values (particularly in telecommunications) impacted profits and real incomes. Consumption growth slowed from 3.2 percent, quarter on quarter, in the first quarter of 2001 to 2.4 percent in the second. Both gross fixed capital formation and exports contracted in the second quarter of the year after modest growth in the first. Annual industrial production growth, which slowed from 8.2 percent in December 2000 to 0.9 percent in April 2001, was negative by 1.1 percent in August 2001. The unemployment rate remained stable through July 2001 as slowing economic activity interrupted the gradual reduction in

Box 1.1 **Macroeconomic Effects of the 11 September Attacks and Related Events: A Qualitative Assessment**

The attacks on the US on 11 September 2001 and subsequent events, such as cases of anthrax contamination, warnings of possible further terror attacks, military actions in Afghanistan, and other related events have broad economic and noneconomic global implications. Focusing on the macroeconomic effects, it is difficult to disentangle the quantitative impact of the attacks from other influences on an already weakening world economy. However, it is possible to identify, qualitatively, direct and indirect channels of impact, identify policy responses, and assess the probable net effects on the world economy. Box 1.2 reviews the impacts of these events on developing Asia.

**Direct Effects**

- ***Destruction.*** Beyond the horror and tragedy of the attacks is a significant economic loss. Estimates of insurance losses, US government compensation to victims' families, and job losses at services catering to the World Trade Center area add up to perhaps as much as $100 billion. Yet this amounts to a relatively small impact on overall world productive capacity, which will disproportionately affect New York-based firms or branches in the finance sector.
- ***Disruption.*** In the weeks following the attacks, air traffic, financial market activity, entertainment events, retail business, and even manufacturing were curtailed for varying time periods. As a result, economic activity in the US and its main import markets will be reduced in the third and perhaps the fourth quarter of this year.
- ***Increased costs.*** Increased security and insurance costs may have a broader impact over a longer period. In many areas of government and business such as transport, postal services, retail trade, and hospitality services, increased security measures are adding to costs and slowing delivery. Airlines have reported 10-fold insurance premium increases but many are receiving some type of government assistance in meeting these and other costs. More generally, commercial insurance rates are rising. In the US, rates are increasing by about 75 percent on average for property insurance (particularly in urban areas), by 20-40 percent for workers' compensation insurance (particularly for workers in large office buildings), and by as much as 50 percent for large event insurance (such as sports and entertainment).

**Indirect Effects**

- ***Disruption to financial markets.*** Due to the attacks, global financial markets suffered immediate turbulence (resulting in large price swings for stocks, bonds, and currencies) and disruption (temporarily reducing the ability of governments and firms to issue new debt). Although the turbulence has abated somewhat, the lingering effects of fear of further attacks, concern about the ongoing military response, and the extent of damage to the US and world economies are elevating risk aversion, resulting in a shift to safe assets. This has, so far, lowered short-term Treasury bond yields, caused severe stock market corrections from which there has only been partial recovery in some cases, and increased the risk premiums for emerging-market borrowers. If these heightened concerns persist, capital flows to developing Asia and the Pacific, already slowing in the first half of 2001, may be further affected.
- ***Loss of confidence.*** Consumer confidence was weakening in many economies prior to the attacks. However, they appear to have caused significant erosion, globally, of confidence in certain sectors—such as travel due to security concerns—and to have caused a further general, global deterioration of confidence in near-term economic prospects. With global air travel down by as much as 30 percent since 11 September, the world's airline industry may be facing $10 billion or more in losses as a result. Hotel occupancy rates are down sharply worldwide. Retailers in the US are offering deep discounts to maintain sales volumes and predicting weak Christmas holiday sales. However, the magnitude and duration of a dampening effect on consumer spending from the attacks are unknown, particularly with lingering concerns over biological attacks and ongoing military operations.
- ***Downturn in business sentiment.*** Private investment, already contracting prior to the attacks in much of the world, is likely to suffer in the near term as businesses delay spending because of increased uncertainty and downward revisions to earnings projections. However, the attacks may also stimulate investment needs in certain areas, such as personal and corporate security. Yet it is unclear what the longer-term effects on business investment, particularly globally, will be.

**Policy Responses**

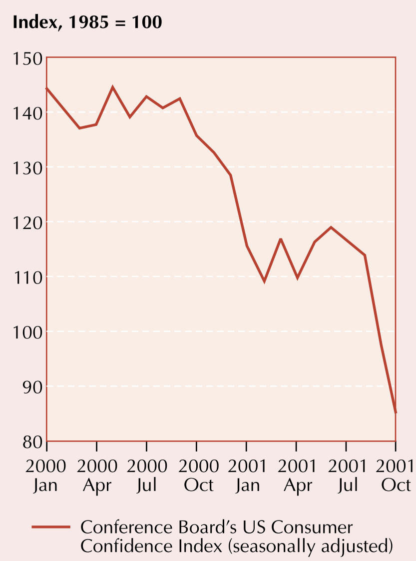
- ***Injection of liquidity.*** The US Federal Reserve, European Central Bank, Bank of Japan, and other monetary authorities provided much liquidity to financial markets to ensure continued settlement and other basic transaction functions immediately after the attacks. Traditional monetary stimulus, in the form of target interest rate cuts, was provided across the globe when the US financial markets reopened the week after the attacks. The US, for example, had cut the Federal Funds rate target by a full percentage point within a month of the attacks.

- ***Fiscal stimulus.*** Fiscal stimulus packages are still being developed, most notably in the US, where the Government, through mid-October, had provided about $45 billion in stimulus with additional tax and spending packages likely. Although fiscal responses in the euro area and Japan may be more limited, the authorities in several economies in Asia have passed or have proposed supplementary budgets since 11 September, including those of Hong Kong, China; Republic of Korea; Malaysia; Singapore; and Taipei,China. Many of them are also adopting elements of assistance to specific industries that include direct provision of funds and guarantees to reduce risk exposure for insurance providers.
- ***Increased international aid.*** Increased international aid funds are being made available to certain developing countries perceived as vulnerable to adverse impacts from the attacks and subsequent events.

Overall, in a macroeconomic sense, the attacks can be viewed as (i) causing a supply shock that was briefly severe in terms of disruption but that may have more moderate though longer-term consequences for transaction costs, and (ii) creating an additional demand shock in the midst of a preexisting global economic downturn. The indirect effects on aggregate demand have dominated the direct effects on aggregate supply with the result that the global disinflationary cyclical slowdown in economic activity has become more pronounced. An indication of this is the impact on oil prices, which initially surged after the attacks on fears of supply disruption but have since fallen to new lows for the year as signs of weakening demand became apparent, although an additional factor is the shift in the composition of spending away from energy-intensive activities such as air travel. Other commodity prices also weakened significantly after 11 September. In addition, job losses, particularly in the airline industry in the US, accelerated significantly in the wake of the attacks and expectations are that the unemployment rate in the US will soon reach around 6 percent, a level last seen in 1994.

There have been several preliminary attempts to provide quantitative assessments of the economic impact of the 11 September attacks, despite (i) the extraordinary level of uncertainty about the near-term global economic outlook, (ii) the difficulty in precisely separating the impact of the attacks from the underlying dynamics of the constantly evolving world economic outlook, and (iii) the ongoing nature of related events. An 11 October 2001 *Asian Wall Street Journal* article "Terror's Toll Continues to Mount," estimates that for the US alone, the direct and indirect effects (excluding loss of life and property) will cause the US economy, which had been expected to grow at an annual rate of 1.0 percent in the second half of 2001, to shrink at an annual rate of 1.0 percent. Hence the US recovery (and thus the global recovery), which had been expected in the fourth quarter, will be delayed. The baseline assumption of the *Update* is that the US recovery will be under way by mid-2002, a delay of two or three quarters, but it is difficult to attribute this delay entirely to the attacks since, immediately prior to them, there were indications that the US economy was weakening faster than expected. Nevertheless, it seems likely that the impact of the attacks on general global economic activity will last well into 2002, with significant costs in terms of lost output and income.

***Consumer confidence in the US plunged right after the terror attacks***




*Source: Bloomberg*

unemployment that was evident in 1999 and 2000. Overall, despite recent weakening of economic activity (particularly in tourism and travel as a result of the September attacks) and declining consumer and business confidence, it is likely that the euro area economy continued to grow, although at a low level, in the third quarter of 2001.

***By the second quarter of 2001, the three major economies were simultaneously weak...***

| | 2000Q4 | 2001Q1 | 2001Q2 |
|---|---|---|---|
| | | percent | |
| **Euro Area** | | | |
| Real GDP growth rate | 2.4 | 2.0 | 0.4 |
| Unemployment rate | 8.5 | 8.4 | 8.4 |
| Consumer price inflation rate | 2.6 | 2.6 | 3.0 |
| **Japan** | | | |
| Real GDP growth rate | 2.4 | 0.5 | -3.2 |
| Unemployment rate | 4.8 | 4.8 | 4.9 |
| Consumer price inflation rate | -0.6 | -0.9 | -0.7 |
| **United States** | | | |
| Real GDP growth rate | 1.9 | 1.3 | 0.3 |
| Unemployment rate | 4.0 | 4.2 | 4.5 |
| Consumer price inflation rate | 3.4 | 2.9 | 3.2 |

*Note*: GDP growth rates are seasonally adjusted annualized changes from the previous quarter. Unemployment rates are the average of seasonally adjusted monthly rates. Quarterly inflation rates are 12-month rates from the quarter's last month.

*Sources: European Central Bank, September 2001, Monthly Bulletin (online), available: www.ecb.int/pub/pdf/mb200109en.pdf; Government of Japan (online), available: www.stat.go.jp/English/19.htm; US Government, www.fedstats.gov*

As economic activity, particularly investment, slowed more than expected in the US, Japan, and the euro area, imports, especially of ICT products, shrank more rapidly than anticipated. The International Monetary Fund's October 2001 *World Economic Outlook (WEO)* projects that goods and services import volume growth in the seven leading industrial economies will slow from 11.5 percent in 2000 to 4.6 percent in 2001 rather than the 7.2 percent forecast in May 2001.[1] Overall, shrinking imports in these seven economies are matched in the developing world so that the October 2001

[1] International Monetary Fund, October 2001, *World Economic Outlook: The Information Technology Revolution* (online), available: www.imf.org/external/pubs/ft/weo/2001/02/index.htm. WEO uses purchasing power parity weights to aggregate individual country statistics into regional and world statistics. The seven economies are Canada, France, Germany, Italy, Japan, United Kingdom, and United States.

*WEO* projects that growth of the volume of world trade in goods and services will slow sharply from a quite rapid pace of 12.4 percent in 2000 to 4.0 percent or less in 2001. The October 2001 *WEO* also projects that, amid rising risk aversion, net private capital flows to all developing economies, shrinking since 1996 and at about zero in 2000, will turn slightly negative for the first time in over a decade.

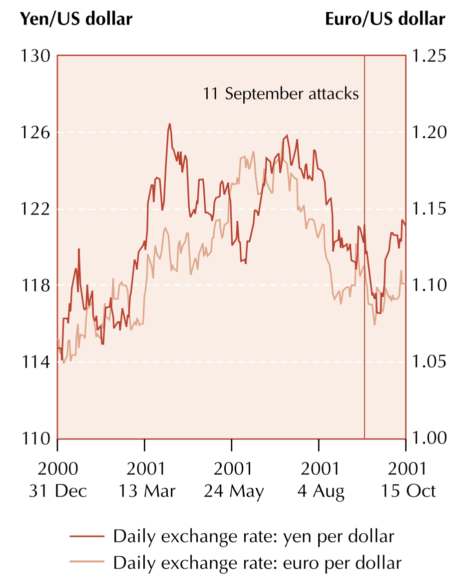
Despite reduced global trade and capital flows and a weakening US economy, the US dollar strengthened against many currencies in the first half of 2001, based on a favorable medium-term economic outlook, but it began to weaken in July 2001 as faith in a quick economic rebound faded. In the wake of the attacks, the US dollar depreciated against both the yen and the euro but subsequently rebounded. Overall, as of 15 October 2001, the dollar had appreciated by 5.5 percent against the yen and by 3.4 percent against the euro since end-December 2000.

***Inflation.*** Price pressures, still present throughout much of the first half of 2001, eased somewhat in the US and euro area in the third quarter. In the US, consumer prices rose by 2.6 percent in September 2001 from a year earlier, down from a 3.2 percent increase in June as falling energy prices offset somewhat rising food, housing, and medical costs. In the euro area, annual consumer price inflation eased from 3.0 percent in June to 2.5 percent in September 2001. In Japan, prices continued to drop—by 0.8 percent in September 2001 from a year earlier. US annual producer price inflation for finished goods fell from 4.8 percent in January to 1.6 percent in September 2001 while prices for crude materials, which rose by 35.5 percent in 2000, fell at a seasonally adjusted annualized rate of 29.9 percent in the first nine months of 2001, a larger swing in prices than in all of the 1990s.

Commodity prices, on a general downward trend throughout 2001, fell quite sharply after the September attacks. Oil prices in particular, which had eased only slightly in the first half of 2001, fell significantly in late September, having temporarily surged immediately following the attacks. The Brent crude spot price was up by about $2 per barrel (/bbl) to $29.55/bbl on 14 September 2001 from a week earlier, approaching highs seen earlier in the year but not the 2000 high of over $37/bbl. By 2 October, however, as expectations of world recession began to dominate fears of supply disruption, the Brent crude spot price had slipped to $20.40/bbl, rebounding slightly to $21.78/bbl by 15 October 2001, a drop of 26.3 percent from the previous month and 33.3 percent from a year earlier.

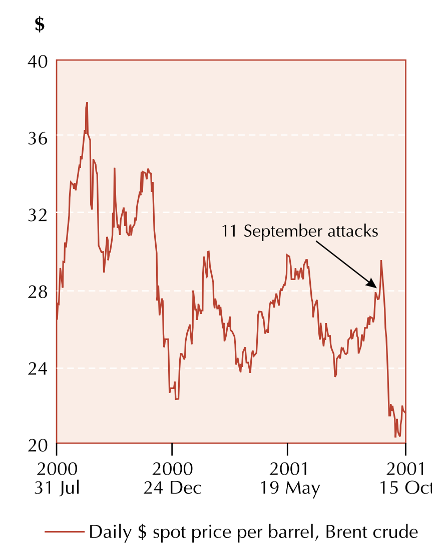
***Financial Markets.*** Stock prices in the US were generally falling through August 2001 after a rally in April and May 2001. With US corporate profits plunging by double digits for three straight quarters, productivity data being revised downward, and investor and consumer confidence faltering, expectations for future earnings and thus stock prices were subsiding. Then, amid increased uncertainty and heightened recession fears in the wake of the attacks on the US, stock markets underwent steep corrections in September while experiencing significant volatility. The Dow Jones Industrial Average,

***The dollar appreciated against the yen and the euro, recovering from a postattack fall...***




*Source: Datastream, Global Economics Database*

***...while oil prices fell to a new low, after a brief surge following the attacks***




*Source: Datastream, Global Economics Database*

***Major stock markets rebounded from steep postattack corrections...***

**Daily price movements ('000)**


*Source: Datastream, Global Economics Database*

which was down by 11.0 percent through 10 September 2001 from end-December 2000, reopened on 17 September and fell by 14.3 percent over the week to 21 September, representing a drop of 23.6 percent since end-December 2000. The Nikkei 225 Index fell by 30.7 percent and the Dow Jones Euro STOXX 50 by more than 39 percent through 21 September 2001 from end-December 2000. By 15 October, however, the Dow Jones Industrial Average had nearly regained its postattack losses while the Nikkei 225 and the Dow Jones Euro STOXX 50 had moved ahead of their pre-attack levels.

Short-term interest rates in the US started to fall from 2000 highs after the Federal Funds rate target was slashed, in a series of Federal Reserve actions, from 6.5 percent in January 2001 to 2.0 percent in early November. Rates on three-month Treasury securities have matched these cuts closely. In the aftermath of the September attacks, there was a flight to short-term Treasury securities, further driving yields down. The benchmark 10-year US Treasury note yield, however, rose from 4.8 percent in January 2001 to 5.4 percent in early July 2001 but then fell back by 21 September as confidence in a quick economic rebound slipped.

In Japan, short-term interest rates continued to hover above zero and 10-year government bond yields edged down by about 30 basis points from the beginning of the year to 1.3 percent in August 2001. In the euro area, short-term rates have dropped by much less than in the US as the European Central Bank (ECB) refrained from aggressive action both when the Federal Reserve was raising rates in 2000 and then cutting them in 2001. The ECB refinance rate was cut from 4.75 percent to 3.75 percent in three actions, the third in September 2001. However, long-term rates have not moved down.

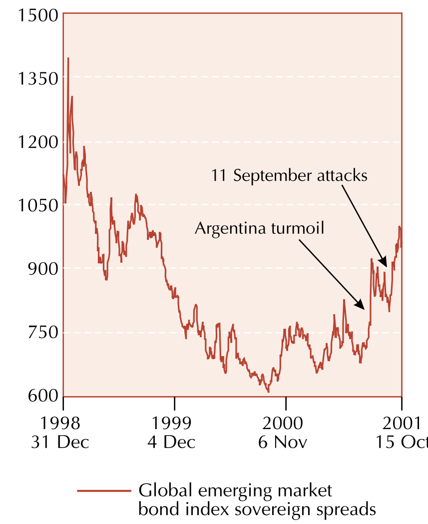
Although still below 1999 levels, sovereign debt risk premiums for developing countries, generally stable in early 2001, began to rise in the third quarter of 2001. These premiums (as measured by the difference or spread between the composite yield on sovereign debt instruments included in J.P. Morgan's Global Emerging Market Bond Index and the yield on US Treasury securities), increased by 20 percent in July 2001 as renewed fears about the weak fiscal position of the Argentine Government sharply increased interest rate spreads on Argentine sovereign debt (which holds a 20.4 percent weight in the Index) and had a contagion effect on other countries as well, particularly in Latin America. By comparison, the 10 percent increase in the composite spread in the month following the attacks was relatively modest. However, that trend has not reversed, unlike the brief surge in oil prices, the corrections in major stock markets, and the fall in the dollar immediately after the attacks.

*Policy Developments.* Except for US monetary policy, macroeconomic stimulus in the three major economies was modest through August 2001. However, with the terror attacks on the US impacting a weakening economy, officials moved more aggressively in September in an attempt to stabilize economic conditions. The Federal Reserve had begun to respond to evidence of a rapidly slowing economy in January 2001 with a cut of 50 basis points in the Federal Funds rate target. This was followed by a series of further reductions, the latest a 50 basis point cut on 6 November 2001. These cuts lowered mortgage rates, stimulating a refinancing boom that increased disposable income, but notably they have not boosted equipment investment—because of past overinvestment and excess inventories. The fiscal response in the US was initially more muted, consisting mainly of tax rebates in the second half of 2001. However, emergency packages totaling $45 billion in funds for relief to key businesses, infrastructure repair, enhanced security measures, and possible antiterrorism operations were put together in the second and third weeks of September 2001 and an additional package of about $75 billion-$100 billion was being debated in Congress in mid-October 2001.

In Japan, where policy rates were already near zero and past fiscal stimulus packages have burdened the Government with high debt levels, the authorities focused on structural reforms (including fiscal tightening) to address long-term economic weakness. However, having eased its monetary stance earlier in the year, the Bank of Japan took additional stabilizing measures, such as a 15 basis point cut in its overnight discount rate, an increase in its target for bank reserves, and interventions to stabilize the exchange rate, in the immediate aftermath of the September attacks.

In the euro area, where the economy only began to slow in the second quarter of 2001 and inflation remained above target, macroeconomic policy was less accommodative through August. The ECB eased its target rate by 100 basis points, most notably with a 50 basis point cut on 17 September, when the New York stock exchanges reopened. This action was taken the same day as actions by the Federal Reserve, the Swiss National Bank, the Bank of Canada, and was joined, a day later, by the Bank of England and others. While fiscal policy continued to evolve within the framework of the euro area's 1997 Stability and Growth Pact, there were indications in late September that France, Germany, and Italy might exceed their fiscal deficit targets.

***...but risk premiums were generally already rising***



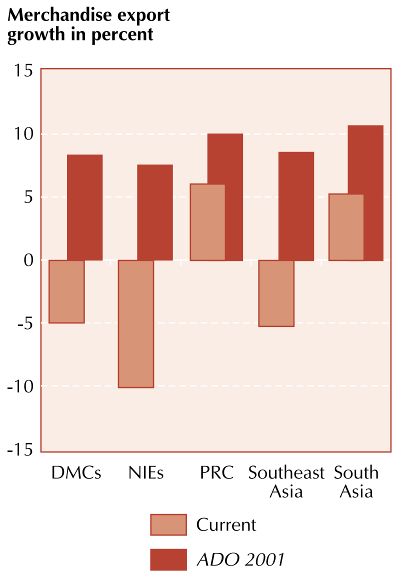

*Source: www.jpmorgan.com*

## Projections for 2001 and Outlook for 2002

Based on economic performance in the first three quarters of 2001, the baseline real GDP growth projections of the *Update* for 2001 and forecasts for 2002 have been adjusted downward to reflect a weaker than anticipated global economy. Economic activity is now expected to remain quite subdued in the near term with a global recovery beginning in 2002, perhaps as early as the second quarter. Conditions are expected to strengthen throughout the second half of 2002 and into 2003, when the effects of fiscal and monetary stimulus measures make themselves felt, investment (particularly in the ICT sector) rebounds, and global trade growth accelerates. Current expectations are for US GDP growth to be only 1.0 percent in 2001 and 1.0-1.5 percent in 2002. In Japan, a 0.5 percent contraction in 2001, and a similar contraction to zero growth in 2002, are expected. Euro area growth is expected to be 1.8 percent in 2001 and 1.8-2.3 percent in 2002.

The revised projections represent a fairly significant downgrade from *ADO 2001*. It should be noted, however, that the relatively low projections for year-on-year growth in 2002 mask a gradual pickup during the course of the year and that, by the second half, a strong recovery is expected to be

***Exports have been sharply weaker in 2001 than expected***




*Sources: ADO 2001, staff estimates*

under way that will continue into 2003. The forecasts do not incorporate the effects of any further policy measures that the three major economies may take to help mitigate the slowdown and short-run effects of the September attacks. Both through actions and words, policymakers in the three economies have indicated a clear intention to avoid a sharp and prolonged slowdown.

## Developing Asia and the Pacific

### Introduction

The terror attacks and subsequent actions are likely to have a significant impact on developing member countries (DMCs), which, to varying degrees, were already adversely affected by an unexpectedly strong drop in external demand (Box 1.2). As a result, real GDP growth in developing Asia and the Pacific is expected to slow from 7.0 percent in 2000 to 3.4 percent in 2001, a significant downward revision from the 5.3 percent projection given in *ADO 2001*. These aggregates mask different experiences, however, with the NIEs being marked down very sharply, Southeast Asia significantly, and South Asia less so, while the People's Republic of China (PRC) projection is unchanged.

The largest revisions to the *ADO 2001* forecasts involve projections of trade performance. This is because (i) the contraction of the global ICT sector—on which many DMCs are highly dependent—was sharper than expected; (ii) the US slowdown evolved into a deeper, wider, and more prolonged global slowdown—in part as a result of the attacks; and (iii) trade was disrupted by the attacks. The value of DMC exports, which grew by over 20 percent in 2000, was initially expected to slow to growth of just over 8 percent in 2001. Instead, it is now projected to contract by 5.0 percent before rebounding to growth of about 6 percent in 2002. Similarly, the value of merchandise imports, which grew by almost 25 percent in 2000 and was forecast at over 11 percent for 2001, is now projected to contract by more than 3 percent in 2001 before recovering to growth of 7.2 percent in 2002. Overall, the aggregate DMC current account, in surplus since 1997, is expected to remain positive but to fall as a share of GDP from 3.4 percent in 2000 to 2.3 percent in 2001 but to further erode in 2002 as recovery fuels import demand.

Financial market developments across the region have, with few exceptions, been influenced by the downward trend in US stock markets, by aggressive Federal Reserve interest rate cutting, by postattack volatility, and, to a more limited degree, by increased uncertainty and risk aversion. In addition, in some DMCs, internal political conditions and slow reform progress have, at times, adversely affected financial market performance. Many DMCs have undertaken expansionary macroeconomic policies in response to the slowdown in external demand, particularly after the 11 September attacks,

***Growth in developing Asia and the Pacific will slow significantly more in 2001 than originally anticipated...***

| | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|
| | | Current | *ADO 2001* | Current | *ADO 2001* |
| **Gross Domestic Product** (annual percentage change) | | | | | |
| Developing Asia and the Pacific | 7.0 | 3.4 | 5.3 | 4.5 | 6.1 |
| Newly Industrialized Economies | 8.4 | 0.1 | 4.3 | 2.7 | 5.6 |
| Central Asian Republics, | | | | | |
| Azerbaijan, and Mongolia | 7.8 | 7.7 | 3.3 | 5.5 | 4.8 |
| People's Republic of China | 8.0 | 7.3 | 7.3 | 7.0 | 7.5 |
| Southeast Asia | 5.2 | 2.4 | 4.0 | 3.3 | 4.8 |
| South Asia | 5.1 | 5.2 | 5.8 | 5.7 | 6.5 |
| India | 5.2 | 5.6 | 6.2 | 6.3 | 7.0 |
| The Pacific | -1.6 | -0.5 | 3.4 | 2.5 | 5.0 |
| Crisis-Affected Economies[a] | 6.9 | 2.1 | 3.9 | 3.4 | 5.1 |
| **Current Account Balance** (percentage of GDP) | | | | | |
| Developing Asia and the Pacific | 3.4 | 2.3 | 2.6 | 1.5 | 2.5 |
| Newly Industrialized Economies | 4.9 | 4.8 | 4.6 | 4.1 | 5.0 |
| Central Asian Republics, | | | | | |
| Azerbaijan, and Mongolia | 2.5 | 2.6 | 2.6 | 3.6 | 3.6 |
| People's Republic of China | 1.5 | 0.9 | 1.2 | 0.3 | 1.0 |
| Southeast Asia | 5.9 | 2.8 | 3.6 | 1.8 | 3.0 |
| South Asia | -1.1 | -1.6 | -1.7 | -1.9 | -1.5 |
| India | -0.5 | -0.9 | -1.2 | -1.0 | -1.0 |
| The Pacific | 5.4 | — | — | — | — |
| Crisis-Affected Economies[a] | 4.3 | 2.6 | 2.8 | 1.8 | 2.3 |

— not available.

[a] Indonesia, Republic of Korea, Malaysia, Philippines, Thailand.

but the magnitude of these measures varies widely across countries. It is expected that the modest impact of this stimulus will begin to be felt by early 2002, that the general level of uncertainty will fall, and that security concerns will ease as the ramifications of the attacks and related events unfold. As a result, tourism will slowly begin to rebound and risk aversion will begin to fall, leading to a gradual increase in capital flows. This, combined with a slow recovery in the ICT sector, is expected to initiate the modest beginnings of a regional economic recovery by the middle of 2002, which should be well under way in the second half of the year and continue to strengthen in 2003. Thus, forecast overall DMC growth in 2002, at 4.5 percent (down from 6.1 percent in *ADO 2001*), will be stronger than in 2001 but somewhat below potential.

## Recent Developments and Projections for 2001

*Output, Employment, and Inflation.* Recent economic performance in DMCs attests to their level of integration into the world economy, their diversity, and their postcrisis strength. After a year of relatively strong, primarily export-driven GDP growth, the region's economic expansion is proceeding at a slower rate than in 2000 and than expected in *ADO 2001*, in step with the major world economies. Unemployment is, thus, on the rise to varying degrees, notably in the NIEs, and inflation is generally weaker than was expected in *ADO 2001*, with deflationary conditions in some DMCs. Yet a sharp drop in exports, the main engine of growth for many DMCs, has not prevented the region from posting strong performance relative to other developing regions of the world, in part because of generally stronger macroeconomic fundamentals. This contrasts with 1998 when performance was, relatively, weak. The impact of the 11 September attacks on DMC output and employment in 2001, although not yet quantifiable, should be most significant in those economies with large tourism sectors such as Cambodia, Maldives, Nepal, and Thailand, and those for which the disruptions to trade would be most significant, such as Hong Kong, China; Pakistan; and Singapore.

DMCs are showing a wide range of trends that, to some extent, limits generalization. Although export performance is affected in most of the region, economic performance in the NIEs, which account for over 35 percent of GDP in developing Asia and the Pacific and are the most dependent on exports of goods and services, is deteriorating the most. The NIEs' real GDP growth, at 8.4 percent in 2000, is expected to be almost flat in 2001, revised down from the *ADO 2001* forecast of over 4 percent. This slowdown in the NIEs is at its most severe in external and investment demand, which are contracting overall, although consumption growth has generally slowed. Thus, output and employment have been hardest hit in manufacturing. The 2001 projection for Southeast Asia deteriorated less dramatically relative to 2000 and to the *ADO 2001* outlook (except for Malaysia) but was nevertheless significant, and this slowdown is broad based with export, investment, and consumption growth all slowing. Southeast Asia's real GDP growth is now expected to slow from 5.2 percent in 2000 to 2.4 percent in 2001 rather than to the 4.0 percent projected in *ADO 2001*. However, the Philippines, partly because of improved agricultural performance, and Indonesia, in part because of a peaceful change of government, have suffered less of a slowdown than Malaysia, where ICT exports are more important.

Although the 2001 projection is still for reasonably robust South Asian growth of more than 5 percent, this has been revised downward moderately because of weak export growth, adverse weather conditions, and the sharp negative impact on tourism of the heightened security concerns in the wake of the 11 September attacks. In contrast, the 2001 projection for the PRC has remained unchanged, despite weaker export growth, because of strong domestic demand and strong foreign investment in conjunction with imminent World Trade Organization accession. In the Pacific subregion, which experienced a contraction in economic activity in 2000 partly because of unrest

### Box 1.2 **Impact on Developing Asia and the Pacific of the 11 September Attacks**

There are two main avenues through which the effects of the terror attacks could be generally felt in developing Asia and the Pacific. First, global commerce could be affected. Trade in goods may be adversely impacted over a long period by increased transaction costs, although the magnitude of this effect is not expected to be large. However, trade in services (particularly tourism but also potentially banking) is being hit by security concerns. In addition, the general worsening of confidence might further dampen global commerce, placing additional downward pressure on export volumes and commodity prices. Indeed, commodity prices were sharply lower after the attacks.

Second, capital flows are likely to fall as risk premiums rise as a result of the attacks. Thus, businesses would be hit by reduced revenues and reduced access to capital at the same time, conditions that are likely to lead to the failure of weak companies. Although these trends were already evident in the global economic slowdown, availability and terms of financing have become even tighter after 11 September for both governments and private firms. Portfolio investment inflows were already sharply lower prior to the attacks but many DMCs that experienced steep stock market corrections immediately following them have had only partial recoveries. Foreign direct investment, which does not respond as quickly to changing conditions, is still expected to be higher for developing Asia and the Pacific in 2001 than in 2000, primarily because of flows to the PRC, but it may fall in 2002 because of the impact of uncertainty on current investment planning. Finally, although net loan repayments from DMCs since the 1997 financial crisis have substantially reduced external debt burdens, risk premiums have been rising in some countries in the wake of the attacks, although not to the same degree as other regions, such as Latin America.

The extent to which DMCs are affected will depend on (i) how much they depend on global commerce, and (ii) how much they are (or are perceived to be) vulnerable to heightened political uncertainty or the possible disruptive effects of actions related to the global antiterror campaign. For those economies with high merchandise exports to GDP ratios (such as the NIEs and Malaysia), the impact of the delayed recovery in global trade will mean a longer period of significantly lower growth. However, these are relatively high-income countries that are better able to cope with cyclical downturns. For those countries with relatively large tourism industries, however, the attacks represent a new and significant adverse shock. Anecdotal evidence suggests that there have been many cancellations across the region, particularly in DMCs with existing or previous security problems. Finally, risk premiums are rising on both sovereign and private debt in those countries that have relatively high debt burdens, particularly Indonesia, Pakistan, and Philippines.

| | **Tourism Receipts as Percent of GDP, 2000** |
|---|---|
| Cambodia[a] | 6.4 |
| Thailand | 5.8 |
| Malaysia | 5.1 |
| Hong Kong, China | 4.8 |
| Philippines[a] | 3.4 |
| Nepal[a] | 3.2 |
| Indonesia[a] | 2.9 |
| Singapore[b] | 2.0 |
| Sri Lanka[a] | 1.5 |
| People's Republic of China | 1.5 |
| Korea, Republic of | 1.5 |

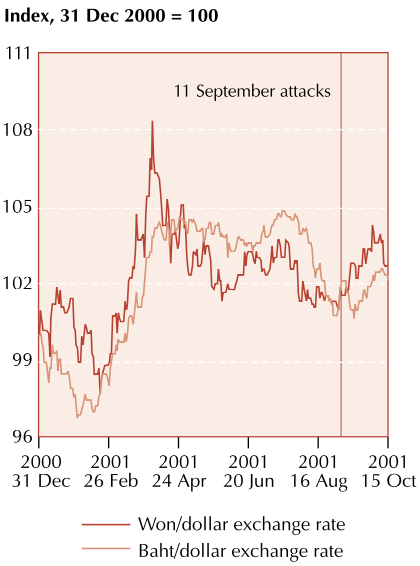
[a] 1999 data.
[b] Singapore tourist revenue refers only to official hotel receipts.

| | **Merchandise Exports[a] as Percent of GDP, 2000** |
|---|---|
| Singapore | 149.5 |
| Hong Kong, China | 124.6 |
| Malaysia | 109.9 |
| Taipei,China | 63.9 |
| Thailand | 56.7 |
| Philippines | 53.7 |
| Cambodia | 44.5 |
| Indonesia | 40.5 |
| Korea, Republic of | 38.4 |
| Sri Lanka | 33.5 |
| People's Republic of China | 23.1 |

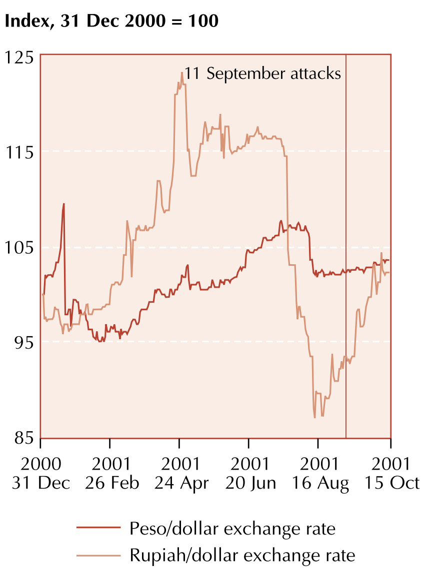
[a] Merchandise exports are customs trade data.

*Sources: IMF, IFS CD-Rom (October 2001); CEIC Data Company Ltd; ADB, Key Indicators 2001; World Bank, World Development Indicators 2001; www.cbc.gov.tw*

***The dollar appreciated against many Asian currencies in 2001 with the attacks having varying impacts...***




*Source: Datastream, Global Economic Database*




*Source: Datastream, Global Economic Database*

in the Fiji Islands and Solomon Islands, the 2001 real GDP projection has been revised downward to a contraction of 0.5 percent from the 3.4 percent forecast in *ADO 2001*. This is largely because of continued uncertainty in these two countries and in Papua New Guinea (which is expected to experience a second year of recession) and because of slower external trade in goods and services as a result of the global slowdown and the 11 September attacks. In the Central Asian republics (CARs) and Azerbaijan, the strong growth performance of 2000 is expected to be repeated in 2001 because of rising oil and gas production.

***External Sector.*** Although the 2001 slowdown in DMC economic activity of over 3 percentage points is sharper than expected, it is still less severe than the 5.7 percentage point drop during the crisis year of 1998. In contrast to the extreme corrections to domestic demand and substantial capital outflows suffered by many DMCs during that period, the current situation is better characterized as an ICT sector correction that deepened into a global cyclical slowdown. As such, the primary source of weakness lies in trade rather than capital flows, and the shock is global and more evenly spread among regions, rather than severe and concentrated in developing Asia and the Pacific. The additional impact of the terror attacks (Boxes 1.1 and 1.2) will be felt by most DMCs through external sector channels, such as slowing exports of goods and services (including tourism) and reduced private capital flows.

Within the context of aggregate DMC exports falling by 5.0 percent in 2001, the NIEs—heavily dependent on electronics exports—are expected to suffer a contraction of about 10 percent, whereas the exports of the PRC and South Asia—more diversified and more traditional—are expected to expand but at a significantly slower rate than in 2000. The CARs, Azerbaijan, and Mongolia will also see export growth slow, primarily because of slowing global commodity demand. However, similar to the NIEs, Southeast Asia is experiencing a projected contraction of merchandise exports of 5.3 percent in 2001 after growth of 18.6 percent in 2000. A similar picture emerges on examination of expected import performance. The NIEs—once again, the economies with the greatest reduction in import-intensive expenditures, investment, and exports—are unexpectedly seeing projected reductions in imports of over 10 percent this year, while both the PRC and South Asia are expected to record larger import levels than in 2000.

***Financial Markets.*** The US dollar has appreciated against most regional currencies through the first nine and a half months of the year. The exceptions are those with fixed or linked exchange rates such as PRC; Hong Kong, China; and Malaysia. Several regional stock markets have mirrored developments in the US, rallying in March and April, and generally falling thereafter, with particularly steep losses amid heightened volatility in September. Notably, the PRC's Shanghai A Share Index was down significantly through 21 September and even the B Share Index, which was opened to local investors in February 2001 and which rose quite rapidly through May, has since suffered a sharp correction. Interest rates are also generally falling, particularly short-term rates. The exceptions are Indonesia (where rates are rising) and the PRC (where rates are unchanged).

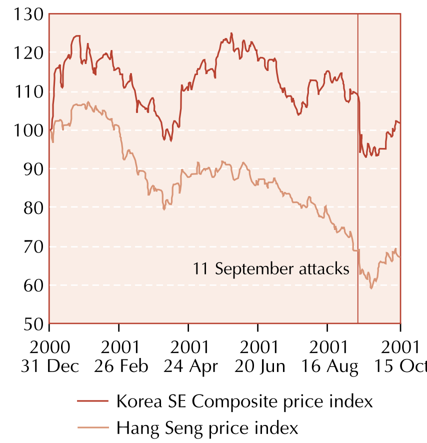
With greater uncertainty and risk aversion, some DMCs have seen net private capital outflows, because of portfolio investment outflows combined with weak foreign direct investment. In addition, as economic activity has slowed, demand for foreign credit has fallen while existing loans continue to be paid down so that many economies are making large net repayments of private credit. The crisis-affected economies of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand are expected to experience net private capital outflows again in 2001, having only returned to net inflows in 2000 after large net outflows in the wake of the financial crisis. However, net outflows are still well below levels experienced in 1998 and 1999. The PRC, in contrast, enjoyed an improved level of net inflows primarily because of increased foreign direct investment. Moreover, most DMCs have not witnessed significant increases in bond spreads. The DMCs that have been the most affected by the increased risk aversion in international financial markets are Indonesia, Pakistan, and Philippines.

***Policy Developments.*** In general, DMC macroeconomic policies have become more accommodative as economies have weakened and inflation has eased, particularly after 11 September. The largest total reductions in official interest rate targets since December 2000 have been in the Philippines (475 basis points), after a series of sharp increases in late 2000, and Hong Kong, China (400 basis points), due to the currency link. Rates are higher in Indonesia because of concerns about high inflation and in Thailand because of attempts to discourage refinancing of foreign debt in domestic markets. In most cases, monetary easing has not led to a significant expansion in credit. Many banks are still constrained by relatively high levels of nonperforming loans.

In terms of fiscal policy, the PRC may be the most aggressive and successful, having pursued an expansionary policy that is widely regarded as having helped buttress domestic demand during a time when export demand was weakening. The country perhaps hardest hit by the slowdown, Singapore, with a limited domestic sector, undertook very little monetary or fiscal stimulus prior to 11 September but announced in mid-October 2001 a second supplementary stimulus package, which amounts to about 7 percent of GDP. Malaysia also announced a second fiscal stimulus package in October of 1.3 percent of GDP. In other countries, such as India and the Philippines, fiscal constraints have limited the use of additional stimulus packages. For its part, the Republic of Korea has resorted to a mix of fiscal and monetary policy, and most significantly, to a series of efforts to safeguard its corporate sector by guaranteeing bonds and taking steps to facilitate additional credit extension to corporate debtors. In many economies, because of significantly weakening economic conditions, continued stock market corrections, and political uncertainty, progress in structural reform has been constrained as officials focused more on near-term stability. For example, asset management companies made little headway in 2001 in disposing of nonperforming loans.

***...whereas regional stock markets only partly recouped their postattack losses***

**Index, 31 Dec 2000 = 100**




*Source: Datastream, Global Economics Database*

**Index, 31 Dec 2000 = 100**


*Source: Datastream, Global Economics Database*

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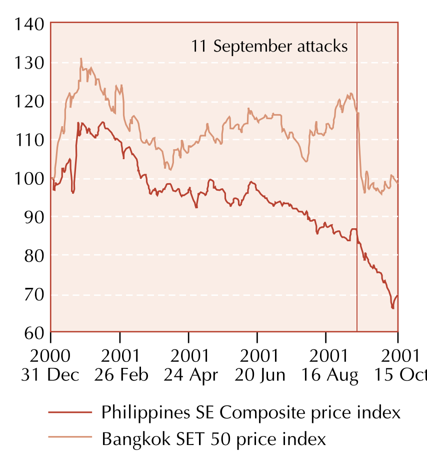
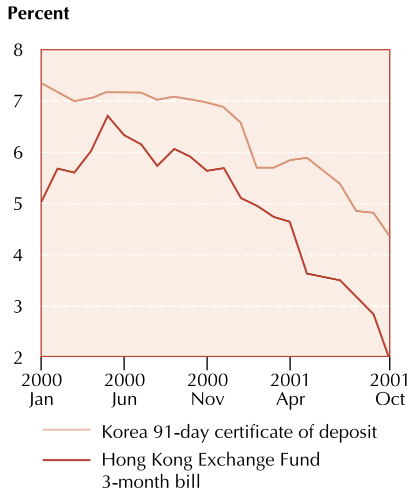



*Source: Datastream, Global Economics Database*

*Short-term interest rates generally fell...*

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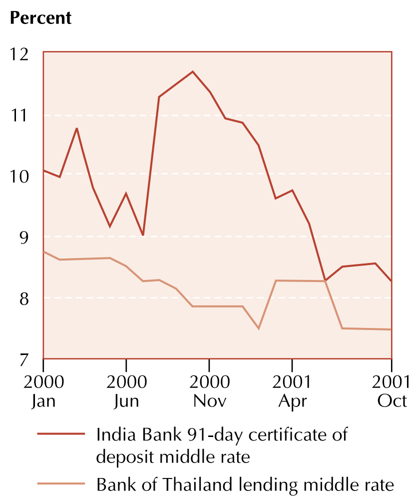
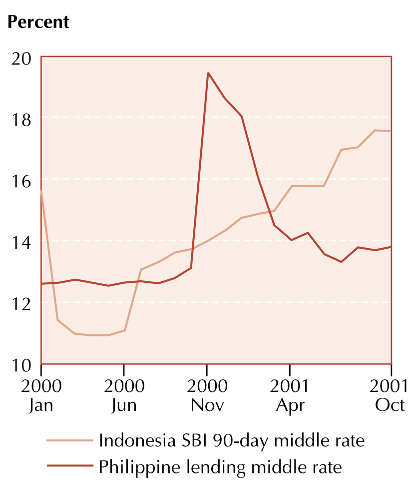



*Source: Datastream, Global Economics Database*




*Source: Datastream, Global Economics Database*

## Outlook for 2002: Assumptions and Risks

The forecasts assume a modest pickup in DMC growth performance from about 3.4 percent in 2001 to nearly 5 percent in 2002. This is based on the assumption that exports of goods and services (including tourism) will bottom out by end-2001 or early 2002, build slowly during the middle part of 2002, and show strong growth momentum in the latter part of the year so that, by 2003, expansion in exports from the region, and hence in GDP, will be robust. This is expected to be across all major subregions but strongest in the NIEs, which as a group should accelerate from virtually no improvement in 2001 to almost 3 percent growth in 2002. Southeast Asia is expected to see a more moderate pickup as exports recover in 2002 but, particularly for the economies of Indonesia, Philippines, and Thailand, domestic demand remains constrained. In contrast, PRC economic growth is forecast to moderate slightly under the assumption that lower net export earnings counteract the positive impact of continued macroeconomic stimulus. South Asia is forecast to experience a modest acceleration of growth as export expansion strengthens and agriculture recovers from drought conditions. The Pacific subregion should move from contraction to growth in 2002 on the strength of a global recovery and increased political stability. However, after the 11 September attacks, the CARs, Azerbaijan, and Mongolia may see growth slow in 2002 because of concern about stability in some countries.

In terms of external developments, DMC exports are expected to recover to close to 6 percent growth in 2002 as world trade, particularly in ICT

*In general, monetary policy in developing Asia and the Pacific has been accommodative...*

| **Official Interest Rate** | **Current (percent)** | **Change from December 2000 (basis points)** |
|---|---|---|
| Philippines Reverse Repurchase Rate | 8.75 | -475 |
| Hong Kong, China Bank Prime Rate | 5.50 | -400 |
| Singapore Three-month SIBOR | 2.28 | -411 |
| Taipei,China Official Discount Rate | 2.50 | -213 |
| India Bank Rate | 6.50 | -150 |
| Korea Overnight Call Rate | 4.00 | -125 |
| PRC One-Year Working Capital | 5.85 | 0 |
| Thailand 14-Day Repurchase Rate | 2.50 | 100 |
| SBI One-Month Rate | 17.58 | 316 |
| *Memorandum items:* | | |
| US Federal Funds Rate | 2.00 | -450 |
| European Central Bank Refinance Rate | 3.75 | -100 |
| Japan Overnight Call Rate | 0.01 | -24 |

*Sources: J. P. Morgan, 26 October 2001, Global Central Bank Watch, p. 5 (online), available: www.jpmorgan.com; www.mas.gov.sg* products, is fueled by the expected recovery in US consumption and investment demand. This should be accompanied by acceleration in DMC import growth of 7.2 percent as manufacturing rebounds. Because of a prolonged period of aggressive inventory corrections and capacity consolidations in the ICT industry (together with continued innovation), when retail sales begin to pick up (perhaps as early as the second quarter of 2002), DMC exports should begin to rise and investment in new capacity should reemerge. Although the pace at which the ICT sector will expand over the next few years is unlikely to match rates experienced in early 2000, it is still widely regarded as a growth industry for which expansion should be relatively robust over the medium term.

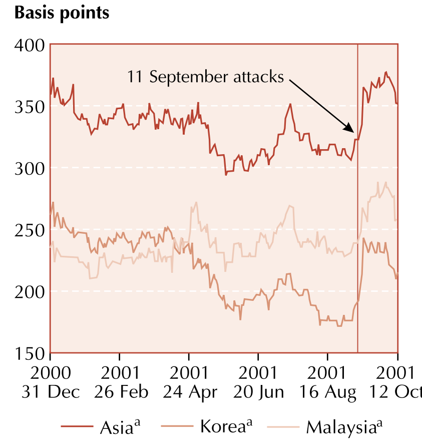
As the recovery begins in 2002, the overall DMC balance on current account is expected to remain in surplus, although it is likely to narrow as imports, particularly of capital goods, increase. The region should also see only limited increases in net private capital inflows in 2002 both because of debt repayments and because of a reduced global appetite for investment in emerging markets. This is a potential drag on long-term growth. Despite the expected pickup in economic activity, regional inflation is not expected to accelerate noticeably in 2002 relative to 2001 because world and regional GDP is still anticipated to be well below potential. Although some tendency toward expansionary policy may persist in the first half of 2002, as the recovery gets under way, governments will likely quickly shift to more neutral stances.

This outlook involves several key assumptions. First, whereas *ADO 2001* assumed a short, sharp, US economic slowdown, the current view is that the slowdown will be longer, deeper, and broader across sectors. The US economy is expected to stabilize in early 2002 but the recovery may not become firmly established until mid-2002. Second, Japan, which had been expected to expand slowly, will remain weak in the near term but will not significantly weaken further. Third, the euro area, which had been expected to remain strong, will experience an economic slowdown that will be relatively brief and shallow so that, as the US economy recovers, so will the euro area. Fourth, oil prices will remain stable, inflation will be subdued, and there will be no major exchange rate realignments. Fifth, despite recent disturbances, financial markets will continue to function in an orderly fashion and risk premiums will remain well below 1998 levels. Sixth, the level of uncertainty over the economic outlook will subside as current events unfold, volatility in market indicators subsides, and clear economic trends are reestablished. It is further assumed that macroeconomic policy will be further eased, particularly in the US, as needed to mitigate the effects of the slowdown.

As compared to the global environment at the time of *ADO 2001*, uncertainty over global conditions has increased sharply and significant downside risks are in evidence, although upside risks are present. The significant near-term risks are external.

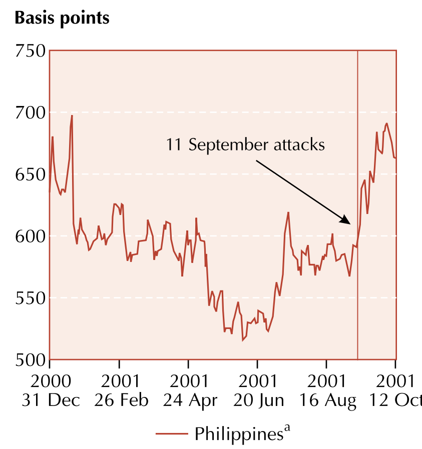
First, because of the synchronized nature of the downturns in the US, Japan, and the euro area, there is a risk that the three major economies will be in a downward spiral of shrinking trade and faltering confidence in which all the engines of growth stall. This could lead to a prolonged period of global

***...and risk premiums were moderately higher in general after the 11 September attacks***



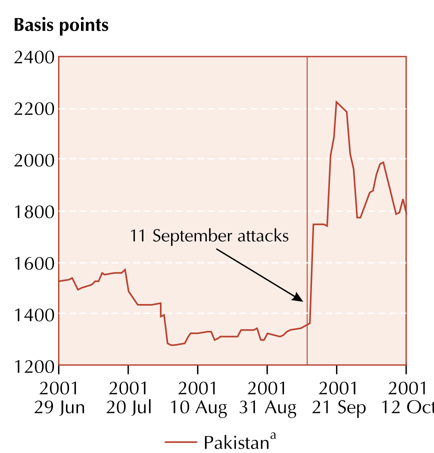

[a]Global emerging market bond index composite sovereign spreads

Source: www.jpmorgan.com




[a]Global emerging market bond index composite sovereign spreads

Source: www.jpmorgan.com




[a]Global emerging market bond index composite sovereign spreads

Source: www.jpmorgan.com

economic weakness. In fact, this risk is identified in *ADO 2001*. Conversely, because of the large amount of macroeconomic stimulus already present and the extended period of the slowdown, particularly in the US, it is possible that, once signs of a recovery appear, aggregate demand growth could rapidly accelerate to unsustainable levels. The risk of an extended period of global economic malaise is accentuated by the possibility of a prolonged period of turbulence caused by additional acts of terrorism (or the fear of them) or by protracted US military operations. This could further reduce consumer and corporate confidence, leading to prolonged weakness in global demand. This would, in addition, increase political risks to economic performance in several DMCs. Alternatively, a quick resolution to the conflict in Afghanistan and an abatement in the fear of terrorism would reinforce the possibility of a stronger than expected rebound in economic activity once a recovery is under way.

Second, uncertainty could graduate into sharp corrections. Doubt about the ability of the US to cope with prolonged crisis and conflict could adversely affect confidence in the US economy. This might lead to a reversal of financial flows, disruptive exchange rate corrections, and further reduce US import demand. Conversely, investors could continue to regard the US as a safe haven if instability were to rise in other regions, and pull funds out of emerging markets. Thus, either way, uncertainty, rather than decreasing, could increase because of security and stability concerns. This might also include oil price spikes. However, whereas some DMCs would be significantly harmed by high oil prices, others, as exporters, would benefit. In addition, developing Asia and the Pacific, because of recent reforms, is now better able to handle the adjustments required for the implied exchange rate and financial market corrections.

Third, the Japanese economy could weaken further, putting additional pressure on DMCs. Consumer and business sentiment was weakening significantly in October 2001, pointing to the possibility of a prolonged recession. If this triggers further losses on the Nikkei 225 Index, which was down by more than 20 percent in mid-October from its level at end-December 2000, it might cause balance-sheet difficulties for banks, which, since end-September 2001, must value stock holdings at market prices. This, in turn, could cause repatriation of Japanese bank holdings from abroad or reduce the activities of Japanese banks in other parts of Asia. However, in 2001, the Government has generally taken a more aggressive stance toward improving finance sector performance and is working toward a goal of eliminating nonperforming loans in three years. Possible actions include buying private sector debt and exercising shareholder rights to introduce management changes at banks that fail to pay dividends on government-owned stocks.

Finally, a medium-term domestic risk for several DMCs, notably in Southeast Asia, is the possible inability to generate higher levels of investment than over 1998-2001, a period generally characterized by weak domestic demand (particularly investment), slow domestic credit expansion, and net capital outflows. To reverse this will require a strengthening of the finance and corporate sectors, particularly through the reduction of nonperforming loans and improvements in corporate governance. These steps will be critical to reestablishing high long-run trend growth in developing Asia and the Pacific in 2003.

# NEWLY INDUSTRIALIZED ECONOMIES

*The trade-oriented economies of Hong Kong, China; Republic of Korea; Singapore; and Taipei,China—the NIEs—are suffering disproportionately from the current weakness in the world economy just as they were the big gainers from the 1999-2000 ICT boom. With global economic recovery delayed, in part because of the 11 September attacks on the US, growth performance for 2001 is now projected to be near zero with a softer rebound in 2002 than anticipated in* ADO 2001*.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -2.9 | 7.8 | 8.4 | 0.1 | 4.3 | 2.7 | 5.6 |
| Inflation rate | 4.6 | -0.1 | 1.1 | 2.1 | 2.2 | 1.9 | 2.5 |
| Export growth | -8.6 | 5.3 | 19.5 | -10.1 | 7.5 | 6.3 | 9.5 |
| Import growth | -19.5 | 7.5 | 25.0 | -10.6 | 7.3 | 6.8 | 10.7 |
| Current account/GDP | 7.4 | 6.3 | 4.9 | 4.8 | 4.6 | 4.1 | 5.0 |

*Economic Assessment.* With export demand weaker than anticipated, Hong Kong, China; Singapore; and Taipei,China are now expected to experience contractions in real GDP in 2001 rather than slowdowns in growth. The Republic of Korea (hereafter Korea) is expected to sustain positive, although lower, growth on the strength of domestic demand. The subregion will barely grow in 2001, in sharp contrast to 2000 when the NIEs were propelled to more than 8 percent real GDP growth on the back of rapid expansion of ICT exports. With weak economic performance, unemployment is rising in all the NIEs (apart from Korea), although rates are still below 1999 averages (except in Taipei,China, where seasonally adjusted unemployment was at a historic high of 5.3 percent in September 2001).

Indeed, whereas the 2001 slowdown for Korea, which accounts for about 50 percent of the NIEs' real GDP, is much more muted than in the 1998 financial crisis, the contraction in Taipei,China, which accounts for more than 25 percent of the NIEs' real GDP, was unexpected and represents the worst economic performance in two and a half decades. In Korea, domestic demand strengthened somewhat in the first half of 2001, in part because of fiscal stimulus measures. In contrast, domestic demand in Taipei,China weakened over the same period due to significant political and economic uncertainties. Hong Kong, China and Singapore—small, open economies for which exports (including reexports) are over 200 percent of real GDP—face double-digit percentage point swings from strong GDP growth in 2000 to a contraction in 2001.

Alongside weaker economic activity, inflationary pressures are easing, although only in the third quarter in the case of Korea, where inflation is higher than was expected in *ADO 2001* and higher than in 2000 because of stronger domestic demand. In Singapore and Taipei,China inflation is lower than in 2000 and lower than expected in *ADO 2001*. In Hong Kong, China, instead of the anticipated inflation, the deflationary conditions of 2000 remain in place.

Korea is faring somewhat better than the other NIEs because, as a larger economy, it has a larger domestic market and a more diversified export sector, whereas the other NIEs are somewhat more dependent on the hard-hit ICT sector or trade-related services. However, all are feeling the adverse effects of the sharper than expected correction in the global electronics industry. This impacted both demand and investment in the NIEs' export-driven electronics sectors. In addition, as the global slowdown became deeper, longer, and broader, trade in all sectors began to slow sharply. In 2000, the growth of merchandise export values ranged from 16.0 percent in Hong Kong, China to 21.8 percent in Taipei,China. Instead of a mere slowing of export growth momentum in 2001 as anticipated in *ADO 2001*, severe export contractions are now expected, ranging from 5.9 percent in Hong Kong, China to 16.0 percent in Taipei,China.

Gross fixed investment growth is forecast to remain positive but low in Hong Kong, China—propped up by public infrastructure spending—but to be negative in the other three economies. The overall 2001 NIEs' current account surplus is expected to be wider than was forecast in *ADO 2001* because imports are contracting more rapidly than exports. However, with somewhat stronger net capital outflows, the pace of reserve accumulation is slowing in Korea and Taipei,China. More recently, the 11 September attacks and subsequent events have eroded consumer and investor confidence, which is delaying the global economic rebound that would restore export demand, which, in turn, would revive investment in export-driven sectors.

Finance sector performance was weak among the NIEs in the first three quarters of 2001, although Korea fared a bit better. The Korean won, which had depreciated by about 10 percent in 2000 against the US dollar, depreciated by a further 2.2 percent through 15 October 2001. The Hong Kong dollar remained linked to the US dollar but the New Taiwan and Singapore dollars, which had depreciated by about 5 percent and 3 percent, respectively, in 2000 against the US dollar, each fell further by about 4 percent through 15 October. Similarly, Korea's stock market, which experienced the largest correction in 2000, posted a modest gain of 1.9 percent through 15 October 2001 whereas the other stock markets followed the NASDAQ further down. The NIEs all experienced sharp stock market corrections after the September attacks but had rebounded somewhat by 15 October.

In credit markets, official interest rates were cut to varying degrees in the NIEs through early October 2001. However, with finance sector weakness in Korea and Taipei,China and high levels of uncertainty over the business outlook, these cuts had a very limited impact on credit expansion. In Hong Kong, China, policy rate cuts matched the Federal Reserve's 400 basis point cuts from end-December 2000 through early October 2001, lowering the prime rate to 5.5 percent. In Singapore, which uses exchange rate adjustments to achieve its inflation target, the overnight repurchase agreement rate fell by 158 basis points to 0.90 percent from December 2000 through 15 October 2001. Korea and Taipei,China cut official rates by 125 and 213 basis points, respectively, through early October. In Korea, historically low interest rates have ignited a real estate boom while corporations struggle to obtain new lending. In Taipei,China, bank claims on the private sector fell in the first three quarters of the year. However, in both economies the total value of bonds outstanding rose over the same period.

Each of the NIEs has also undertaken fiscal and other stimulus measures, including tax cuts and rebates as well as supplementary budgets. The packages are expected to provide some cushion against the economic slowdown. The actions of the Government of Korea to ensure the bond market's smooth functioning by guaranteeing some corporate debt falling due and in need of refinancing in early 2001 were critical to short-run macroeconomic stability there.

***Forecast.*** Global economic conditions deteriorated significantly in the third quarter of 2001. The September attacks accentuated the downward trend in the subregion's exports, adversely affected tourism, provoked sharp stock market corrections, and led to additional monetary and fiscal stimulus in the four economies. The anticipated global turnaround, which was receding even before September, is now expected to begin only in 2002, and may further delay recovery in the electronics sector. *ADO 2001* expected this recovery to be evident in the second half of 2001 but it may not now appear until the middle of 2002. Consequently, the contraction of exports (and therefore manufacturing) is not expected to bottom out until late 2001 or early 2002 and only slowly gather momentum thereafter. In addition, tourism may be weak for at least several months, which will particularly affect the economies of both Hong Kong, China and Singapore. Even with fiscal stimulus measures already in place in the NIEs, domestic demand—particularly investment—is expected to have only limited strength until mid-2002. Thus economic performance is expected to be very weak in 2001, improve moderately in 2002, but strengthen significantly in 2003.

# HONG KONG, CHINA

*Although the economy is less reliant on electronics exports than the other NIEs, the export sector still suffered from the impact of weaker than anticipated external demand, leading to a downward revision of near-term growth forecasts. A recovery in the near term will depend on a rebound in global economic activity and on steady expansion in the PRC.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -5.3 | 3.0 | 10.5 | -0.4 | 4.0 | 2.0 | 5.5 |
| Inflation rate | 2.8 | -4.0 | -3.8 | -1.4 | 1.0 | 0.3 | 4.0 |
| Central government budget/GDP | -1.8 | 0.8 | -0.6 | -1.9 | -0.2 | -1.0 | -0.1 |

*Economic Assessment.* Amid a global economic slowdown, GDP of Hong Kong, China in the second quarter of 2001 contracted by 1.7 percent on a seasonally adjusted quarter-on-quarter basis, following flat growth in the first quarter. As a result, year-on-year growth in the first half of 2001 moderated to 1.4 percent as against a 10.5 percent increase in 2000. The stronger than expected deceleration stemmed mainly from a pronounced slackening in merchandise exports and a weakening of domestic demand.

Private consumption grew by a modest 3.8 percent in the first half of 2001, supported by higher labor income. Nevertheless, a rising unemployment rate, depressed asset prices, and a weak property market undermined consumer confidence and slowed consumption growth from its pace of 5.5 percent in 2000. With the deteriorating business outlook, gross fixed capital formation averaged 5.8 percent expansion year on year during the first two quarters of 2001, compared to a 9.8 percent increase in 2000. The moderation was attributed mainly to a sharp slowdown in the growth of machinery and equipment acquisition during the second quarter of 2001, relative to the first. Expenditure on building and construction registered a 0.1 percent rise in the second quarter of 2001, after 11 consecutive quarters of contraction. However, the pace of inventory buildup slowed from the substantial accumulation in 2000, as a result of weakness in demand.

Manufacturing contracted by 0.1 percent in volume during the first half of 2001 compared to a year earlier, with a marked falloff in fabricated metal and plastic products, and a further decline in the consumer electrical and electronics industry. Growth in the dominant services sector moderated, with all segments posting lower growth. Expansion in the import/export trade and in transport slackened amid sagging global trade, while the nonbanking finance sector was dampened by a slowdown in stock market activity. The communications sector contracted by 11.3 percent in value terms in the first two quarters of 2001 from a year earlier, having increased by 8.7 percent in the previous year. In value terms, in the first half of 2001 real estate contracted by 22.9 percent, while banking slipped to 1.3 percent growth, over the corresponding period of 2000, due to the weakening of the property market and of banks' loan business.

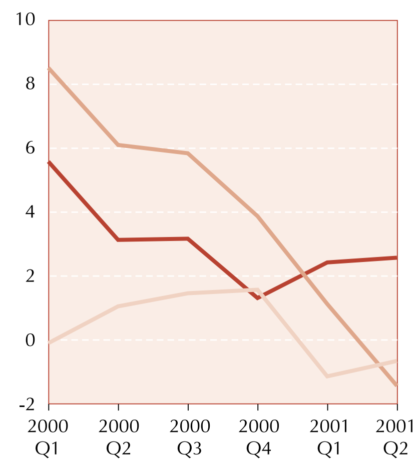
With the downturn in economic activity, the seasonally adjusted unemployment rate, having trended downward from 6.3 percent in the first quarter of 1999 to 4.4 percent in the fourth quarter of 2000, edged up to 5.3 percent in the third quarter of 2001. The steady decline in consumer prices since 1999 leveled off to an annual rate of 1.5 percent in the first nine months of 2001. However, deflationary pressures persisted, reflecting the effects of the current economic slowdown.

The slump in global demand, accompanied by a falloff in regional trade and the strengthening of the Hong Kong dollar along with the US dollar, hampered the economy's exports. Year-on-year growth of merchandise exports in the first six months of this year decelerated sharply to 1.0 percent from 17.1 percent in 2000. Domestic exports tumbled by 10.7 percent, reversing a 7.5 percent increase in 2000. Reflecting the export capability of the PRC, reexports, which accounted for 90 percent of the total value of merchandise exports over the period, posted a 2.8 percent rise, after soaring by 18.5 percent in 2000. Mirroring sluggish reexports and lackluster domestic demand, imports of goods slowed to 2.1 percent growth during the first half of 2001, against a surge of 18.1 percent in 2000. The growth in services exports decelerated to 5.7 percent in the first half of 2001, on account of the slackening in exports of trade-related and other business services, while that in services imports recorded a 3.0 percent rate in the same period. Taken together, the combined visible and invisible trade surplus narrowed from HK$14.5 billion in the first half of 2000 to HK$11.3 billion in the corresponding period of this year, equivalent to 1.8 percent of GDP.

Under the currency link to the US dollar, the Hong Kong dollar appreciated against most major currencies during the first nine months of 2001. Money market interest rates fell considerably in the same period, in response to aggressive monetary easing by the US Federal Reserve and to excess liquidity in the domestic market. In line with the movements in the major global stock markets, the Hang Seng Index tumbled to 10,131 by 15 October 2001.

***The components of demand act in different ways***

**Year-on-year percent change**




Contribution of demand to GDP growth

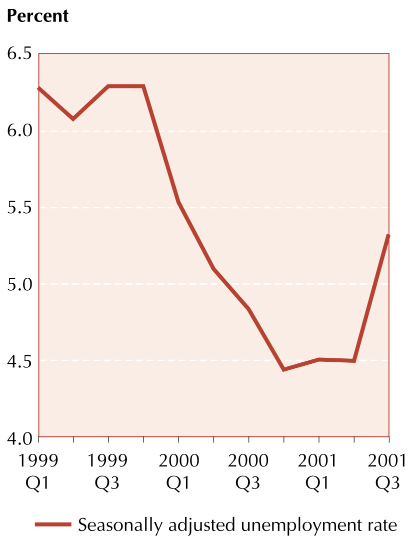
Investment
Consumption
External

*Source: www.info.gov.hk/censtatd*

*Economic Management Issues.* The authorities have been running operating deficits since fiscal year 1998/99 (ending 31 March 1999). The operating deficit is projected to reach HK$16.6 billion in fiscal year 2001/02 and to gradually fall over the medium term. The sources of fiscal revenues, some one fifth of which are projected to rely on land sales and investment returns, have fallen along with the slump in the property market. Moreover, social expenditures, including social welfare, health, and education, are expected to surge over the longer term, due to an aging population and the need to upgrade human capital. In an attempt to contain public expenditures, the fiscal year 2001/02 budget includes a proposal to increase private sector involvement in the delivery of public services. To improve economic efficiency and long-term development prospects of public finance, the authorities will have to undertake further efforts to broaden the tax base, optimize the revenue structure, and reform the allocation of resources.

In August 2001, the authorities outlined a HK$18 billion investment package over the next five years to promote tourism and contribute toward economic growth. Some HK$16 billion of the stimulus package, designated for the Disney Theme Park, had been included in the budget plan of March 2001. As the economic outlook worsened, and to sustain the long-term development of Hong Kong, China the Chief Executive's October policy address proposed measures worth HK$15 billion to provide tax relief, to support small and medium enterprises, to develop professional services, to promote continuing education and social services development, and to invest in the construction of a new exhibition center. Other plans involved the creation of additional job opportunities in the short term. Moreover, the authorities announced a capital expenditure program on infrastructure projects of over HK$400 billion.

***After falling, unemployment begins to rise again***




*Source: www.info.gov.hk/censtatd*

*Forecast.* Given gloomier trade prospects with the delayed recovery in the global economy and the fallout of the 11 September attacks on the US, real GDP is forecast to contract by 0.4 percent over the whole of 2001. In spite of continuing infrastructure investment, domestic demand will remain subdued for the rest of the year, with private consumption moderating as a result of the weak stock and housing markets and further easing in local employment. Trade- and travel-related services sectors, such as transport and tourism, will be hit hard by the recent fall in confidence and the increases in transaction costs in industry. Domestic exports are estimated to fall by 5.9 percent this year, as the US economy, a key export market for Hong Kong, China, slackens amid a protracted downturn in the ICT sector and faltering household spending. Due to the deterioration in the trade balance, the current account surplus is expected to narrow further. Corporate streamlining, resulting from a further fall in profits, will weigh continually on the labor market. Rising unemployment, coupled with depressed consumer sentiment, will hinder general price recovery, keeping annual inflation in negative territory in 2001.

With the cyclical downturn expected to be over by mid-2002, the economy is projected to recover to 2.0 percent growth in 2002. The current account balance is expected to improve, along with a gradual recovery in exports. Prices will likely firm up, on the back of an improvement in external demand and price increases in the PRC, the main supplier of goods imported for local use. Growth in private capital investment will probably be sustained, based on expected opportunities related to the PRC's accession to WTO. In the medium term, the stimulus to liberalization and better corporate governance in the PRC after WTO accession will expand and deepen its demand for high value-added financial, technical, and professional services from Hong Kong, China. Nonetheless, competition resulting from the increased integration of the PRC into the world economy will pose a challenge to Hong Kong, China's transshipment trade and manufacturing activities.

# REPUBLIC OF KOREA

*Having decelerated sharply in the first half of 2001, GDP growth is expected to remain weak in the second half of the year. Considerable uncertainty exists about the duration of the slowdown and the ability of the economy to quickly resume long-run trend growth above 7 percent.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -6.7 | 10.9 | 8.8 | 2.0 | 3.9 | 3.6 | 5.5 |
| Inflation rate | 7.5 | 0.8 | 2.3 | 4.2 | 3.0 | 3.0 | 2.5 |
| Current account/GDP | 12.7 | 6.0 | 2.4 | 2.7 | 1.9 | 1.7 | 1.1 |

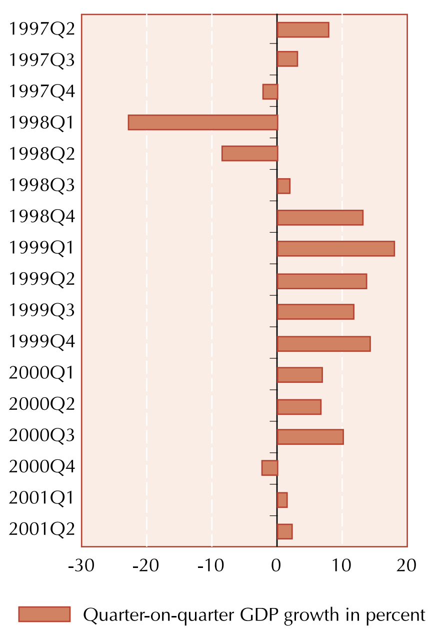
***Economic Assessment.*** Following the collapse of global ICT demand in the fourth quarter of 2000, the economy grew at rates below 2.0 percent in the first two quarters of 2001. This sluggish performance is in sharp contrast to the two-year recovery boom from the fourth quarter of 1998 to the third quarter of 2000, when exports expanded rapidly to over 50 percent of GDP. With export demand declining by 22.0 percent in the second quarter of 2001 (and imports by 29.0 percent), investment stabilizing, and consumption growing robustly, this quarter was the first one since before the Asian financial crisis in which domestic demand (having contracted in four of the previous five quarters) was the sole engine of growth.

With the plunge in external demand, manufacturing activity faltered. Following nine consecutive quarters of growth averaging 20.0 percent, real value added in manufacturing contracted by 10.5 percent in the fourth quarter of 2000, and averaged a 0.7 percent contraction over the first two quarters of 2001. In contrast, reemerging strength in domestic demand growth revived nonmanufacturing activity. Construction, which shrank in 11 of the 12 previous quarters, averaged 7.1 percent growth over the first two quarters of 2001. Similarly services, which accounted for around 57 percent of 2000 GDP and which grew by 4.0 percent at the most over the last three quarters of 2000, accelerated to an average of 7.2 percent growth over the first two quarters of 2001.

In addition to boosting nonmanufacturing activities, higher domestic demand contributed to a fall in unemployment. While the unionized manufacturing sector shed jobs only slowly, services sector jobs were being added quickly with the net effect that almost 900,000 jobs were created in the first half of 2001, lowering the seasonally adjusted unemployment rate from 3.9 percent in December 2000 to 3.6 percent in June 2001 and further to 3.3 percent in September. Reflecting this, the consumer expectations index rose from 82.2 to 100.3 over the same period, despite rising inflation and slow nominal wage growth. Consumer price inflation rose from 3.2 percent to 5.2 percent over this period because of rising energy prices and a depreciating won (which fell by 2.9 percent against the dollar during this period), but it fell back to 3.2 percent in September 2001 as energy prices eased.

The most striking feature in 2001 thus far has been the unexpectedly sharp drop in exports. The decline has been seen in nearly all sectors, reflecting the breadth of the global slowdown. The drop in electronics exports, which began in October 2000, was the steepest, accounting for 75 percent of the fall in export value between the second half of 2000 and the first half of 2001. The value of semiconductor exports in June 2001 was half the level of September 2000. Despite a significant rise in volume, semiconductors dropped from 13.0 percent of exports to less than 8 percent during this period because of an 80 percent drop in the semiconductor export unit price over the same period. Total merchandise exports were not as hard hit as the electronics component: in the first six months of 2001 their value contracted by about 5 percent compared to the first half of 2000, and by about 12 percent compared to the second half. Merchandise exports continued to weaken in the third quarter of 2001 and were down by about 10 percent through the first nine months of the year compared to a year earlier.

*With collapsed global ICT demand in the fourth quarter of 2000, the economy grew at rates below 2 percent in the first two quarters of 2001*




*Source: Bank of Korea*

Despite the slump in exports, the current account remained in surplus in the first half of 2001, rising significantly from the level of a year earlier, though falling slightly compared to the second half of 2000. With a shift away from import-reliant exports and investment demand, there was a sharp decline in imports of 11.4 percent in the first half of 2001 compared to the second half of 2000, particularly in electronics (down 21.8 percent) and capital goods (down 18.4 percent). Total external reserves declined to $94.3 billion by end-June 2001 from $96 billion at the end of 2000. This was mainly due to a sharp increase in net loan repayments, including a prepayment of $3.4 billion to IMF, which significantly reduced total external debt.

In the financial markets, the Korea Composite Stock Price Index (KOSPI) bucked the global trend, rising by 17.8 percent through June 2001, after a 50.1 percent drop in 2000. However, after falling by 8.4 percent in July and August and by another 12.0 percent in September, the KOSPI was down by 5.0 percent from its end-December 2000 level at the end of September. In addition, average daily trading values and volumes, new corporate stock issues, and foreign net purchases ebbed through much of 2001 as declining interest from global investors in emerging market equities combined with falling interest rates to shift corporate fund-raising activities to the bond markets. With the yield on three-year corporate bonds declining from 8.1 percent in December 2000 to 6.6 percent in August 2001, corporate bonds outstanding rose by 4.3 percent over the period.

*Economic Management Issues.* As global economic conditions continued to deteriorate in the third quarter of 2001, particularly after the 11 September attacks on the US, external demand, economic growth, and financial market conditions worsened; the Government countered with a mix of monetary and fiscal stimulus. Despite inflation running higher than its target of 4.0 percent, the central bank cut the overnight call rate by 125 basis points through 19 September. Through the first quarter of 2001, fiscal revenues were above, and fiscal expenditures below, target, resulting in an increase in the fiscal budget surplus from 1.0 percent to 2.0 percent of GDP rather than the planned small fiscal budget deficit. The Government took some modest steps in the third quarter to provide fiscal stimulus by cutting taxes and accelerating planned expenditures, as well as pushing through a $3.9 billion supplementary budget.

The Government's most significant steps to sustain economic activity have involved attempts to avoid capital market turmoil while working out high-profile corporate restructuring deals in an increasingly difficult economic environment. It made efforts to ensure the smooth functioning of capital markets both by guaranteeing new bond issues through its Quick Underwriting Program and its Korea Credit Guarantee Fund (KCGF) and by helping large creditors broker debt workout deals through the provisions of the Corporate Restructuring Promotion Law. These efforts have been successful in heading off a looming crisis in the bond and credit markets resulting from a large volume of total corporate debt reaching maturity this year. In addition, the KCGF and state pension funds will channel over $5 billion into efforts to boost demand for equities.

With elections due in 2002 and a slowing economy increasing labor resistance to job-cutting reforms, the Government is making some progress on major corporate restructuring deals such as those involving Hynix Semiconductor, Daewoo Motors, and Hyundai Securities. This is important since, over the medium term, weaknesses in the corporate and finance sectors could remain a drag on domestic investment. Although investment may have been unsustainable at 38 percent of GDP in 1996, it has since declined to 26 percent in 2000 and to less than 24 percent in the first half of 2001. In addition, debt-equity ratios, on the decline since 1997, have begun to rise again while corporate profits have started to deteriorate.

***Forecast.*** The Republic of Korea, with a strong external position, is not particularly vulnerable to adverse effects from the 11 September attacks. However, consumer and investor sentiment worsened in the third quarter of 2001, reflecting concern over a sharply deteriorating global economy, rising uncertainty in the wake of the attacks, and disappointment about the pace of corporate restructuring. The Government's efforts to stimulate domestic demand are expected to sustain real GDP growth of around 2 percent in 2001. Growth will improve modestly in 2002, as the global recovery remains subdued in the first half of the year. However, relatively robust export demand and GDP growth are expected in the second half. With inflation expected to continue falling through the second half of this year and 2002, the central bank may consider further rate cuts, but there is concern that low interest rates, already at 1998 levels, are feeding a real estate boom. The current account surplus is expected to be marginally wider overall in 2001 than in 2000, because imports are contracting faster than exports, but to narrow with economic recovery in 2002.

# SINGAPORE

*With continued worsening of the global economy, domestic economic weakness will likely persist in the second half of 2001, resulting in a considerably worse full-year economic performance compared to both 2000 and earlier expectations for 2001. Given the magnitude of the external slowdown, the Government's fiscal stimulus measures and the neutral exchange rate policy will help tide over the economy but not reverse the downturn.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | 0.1 | 5.9 | 9.9 | -3.0 | 5.0 | 1.0 | 6.0 |
| Inflation rate | -0.3 | 0.1 | 1.3 | 1.1 | 1.5 | 0.5 | 2.0 |
| Current account/GDP | 24.8 | 25.9 | 23.6 | 24.0 | 24.0 | 22.5 | 25.0 |

*Economic Assessment.* Given its dependence on external demand, the economy was hard hit by the deeper than expected global slowdown and electronics slump. Year-on-year GDP growth slipped to 1.9 percent in the first half of 2001, from 9.9 percent in 2000. The severity of this drop is revealed by the seasonally adjusted second quarter contraction of an annualized 10.7 percent, following a 10.8 percent decline in the first quarter.

With a sharp downturn in global demand for electronics, the manufacturing sector slowed markedly. Manufacturing production fell by 3.5 percent during the first six months of 2001 from a year earlier, following eight consecutive quarters of expansion averaging 14.3 percent, year on year. The commerce sector decelerated sharply across all segments, to register a year-on-year contraction of 3.3 percent in the first half of 2001 compared to a 14.3 percent increase in 2000. The slowdown was broad based, on account of a fall in tourist arrivals and slower entrepôt trade and retail sales. Growth in transport and communications moderated to 3.7 percent, despite the liberalization of the telecommunications industry. The finance sector grew at a slower pace of 2.5 percent over the period, reflecting weakness in a stock market hit by the sharp correction in global technology stocks. The construction sector, however, showed a year-on-year 0.9 percent increase, after 10 quarters of contraction. The improvement was based on the growth in civil engineering work and nonresidential public sector projects.

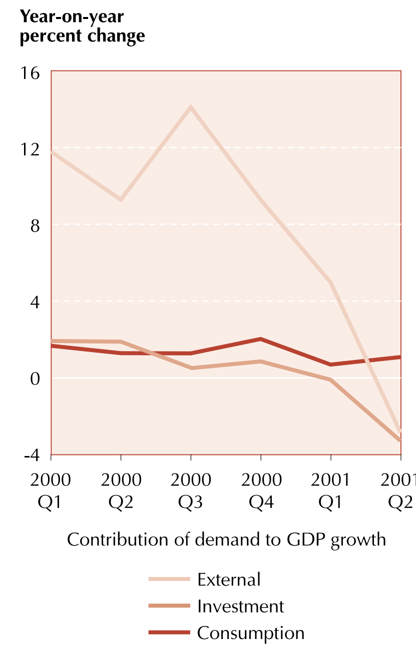
Amid deteriorating economic prospects, domestic demand contracted by 3.4 percent in the first half of 2001 over the corresponding period of 2000. Private consumption declined to 5.1 percent year-on-year growth during the first half of the year, as slower income growth and weaker asset markets took their toll. Gross fixed capital formation slowed to 4.1 percent year-on-year growth in the first two quarters, with an increase of 19.6 percent in public investment partially offset by a 13.7 percent decline in machinery and equipment acquisitions, as well as nonresidential buildings. In tandem with weakening demand, inventories slipped by 6.7 percent in the first half of the year compared to the first half of 2000.

On the trade front, total year-on-year export growth slowed sharply to an average of 4.1 percent in the first two quarters of 2001, from 22.4 percent in 2000. Non-oil exports, the key segment that accounts for 44.5 percent of exports, recorded a steep year-on-year decline of 9.4 percent in the second quarter, following a 3.6 increase in the first quarter and double-digit growth in 2000. The contraction was largely attributable to the weakness in electronics exports, which dipped by 8.9 percent in the first half of this year. Nonelectronics exports also contracted, declining by 1.6 percent in the second quarter of 2001, as slower regional expansion began to affect sales of petrochemical products and some machinery items. As a result of reduced demand for consumer goods and manufacturing inputs, total imports grew at a marginal rate of 0.7 percent in the first half of 2001, down from 23.5 percent growth in 2000. Taken together, the surplus of trade in goods rose to S$12.2 billion in the first two quarters of 2001 from S$8.5 billion in the same period of the previous year, with weaker exports counterbalanced by a more acute slowdown in imports. This was accompanied by a slightly reduced surplus of trade in services of S$4.4 billion. Thus, the current account surplus widened marginally to S$20.0 billion in the first half of 2001, equivalent to 25.7 percent of GDP.

Against the backdrop of slowing economic growth, the seasonally adjusted unemployment rate edged up to 2.6 percent in the second quarter of 2001, from 2.4 percent in the previous quarter. The demand for labor weakened sharply, with manufacturing and construction shedding 12,347 workers in the first two quarters and employment creation in services falling by more than half from the first quarter to 12,321 in the second. Consumer price inflation in the third quarter moderated to 0.5 percent year on year from 2.0 percent in the fourth quarter of 2000, due to subdued consumer demand and more stable oil prices.

In the financial markets, the Singapore dollar depreciated by 2.9 percent against the US dollar during the first three quarters of 2001, affected by the persistent weakness in regional currencies and ongoing US dollar demand to fund mergers and acquisitions in the banking sector. It nevertheless strengthened against many currencies in the region. Domestic interest rates trended downward, on the back of global monetary easing, the absence of inflationary pressures, and the sagging economy. The local stock market was volatile. Despite interest rate cuts by the US Federal Reserve, the Straits Times Index fell amid concerns over the extended slowdown in the global technology sector, to 1,421 by 15 October 2001, or 25.1 percent lower than at the start of the year.

*External demand has fallen sharply for three quarters*



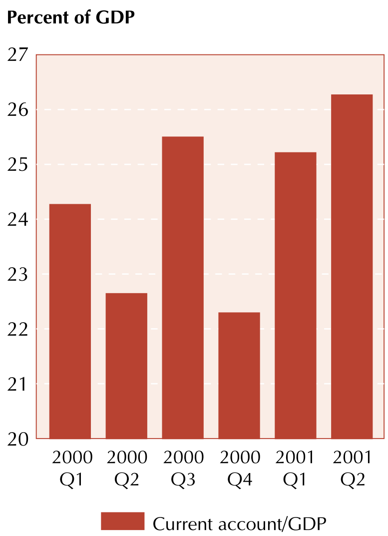

*Source: www.mti.gov.sg*

*Economic Management Issues.* As the global downturn became deeper and more protracted, in July 2001 the Government announced modest business cost-cutting and expenditure pump-priming measures. The off-budget measures, amounting to S$2.2 billion, included postponing scheduled increases in employers' contributions to the pension fund and foreign worker levies, extending property tax and rental rebates, and accelerating expenditure on infrastructure projects and retraining schemes for retrenched workers.

Further, in October, a more substantial off-budget stimulus of S$11.3 billion was introduced. The key features of the package were tax rebates and fee reductions for businesses and households, infrastructure spending increases, New Singapore Shares (providing a guaranteed investment return and a bonus tied to the economy's GDP growth), and employment assistance programs. Taken together, the two packages add up to 8.4 percent of GDP, and are estimated to result in a government budget deficit of S$4.0 billion in 2001. Nevertheless, given the severe global slowdown that will weigh on the economy, the measures will help it tide over but cannot by themselves reverse the downfall.

The Monetary Authority of Singapore refocused its monetary policy in July 2001, from a tightening stance on a trade-weighted basis that sought to achieve a gradual and modest appreciation of the Singapore dollar and contain inflation, to a neutral stance. Furthermore, the policy band was widened in October to permit greater flexibility in managing the exchange rate. However, an increase in the nominal trade-weighted exchange rate, coupled with a rise in unit labor costs, led to a persistent appreciation in the real exchange rate over the first half of 2001. The terms of trade for machinery and transport equipment had been on a declining trend throughout the previous two years. With a deteriorating outlook for exports, further policy intervention to dampen the (trade-weighted) strengthening of the currency might be needed.

*The current account surplus widened marginally to around 26 percent of GDP in the first half of 2001*




*Source: www.mti.gov.sg*

*Forecast.* With the worsening external environment, real GDP is expected to contract by 3.0 percent in 2001. The manufacture and export of electronics, the main drivers of economic growth in the past, are projected to decline further in the second half of the year, reflecting persistent weakness in global electronics demand. The slowdown in export growth will also feed through via lower freight and tourism incomes, as the region is hit by deteriorating world trade growth and the collapse in confidence in the global transport industry following the 11 September attacks on the US. Private consumption is expected to decline from the third quarter of the year, as consumer sentiment further weakens and labor continues to be retrenched. Gross fixed investment is expected to fall along with adjustments in inventories and lower investment in the ICT-related export sectors. The current account surplus will likely remain high for the whole of 2001. Given weak demand for imports, an increase in the trade surplus in goods will counterbalance a decline in services exports. Prices will be subdued in both the rest of 2001 and in 2002, reflecting lower regional inflation and slower domestic wages growth.

On expectations of a modest global electronics upturn, a weak economic rebound of 1.0 percent in 2002 is projected, supported by a gradual recovery in exports. Under the assumption of an improved external environment and strengthened import demand, the trade surplus will narrow, resulting in a decline in the current account surplus in 2002. Past investments in capacity expansion of the manufacturing and transport sectors will allow the economy to capitalize fully on the anticipated global recovery in 2002.

# TAIPEI,CHINA

*With exports and investment contracting sharply, Taipei,China experienced its weakest economic performance in two and a half decades in the second quarter of 2001 and faces its first recorded yearly contraction in GDP in 2001. A modest rebound is forecast for 2002.*

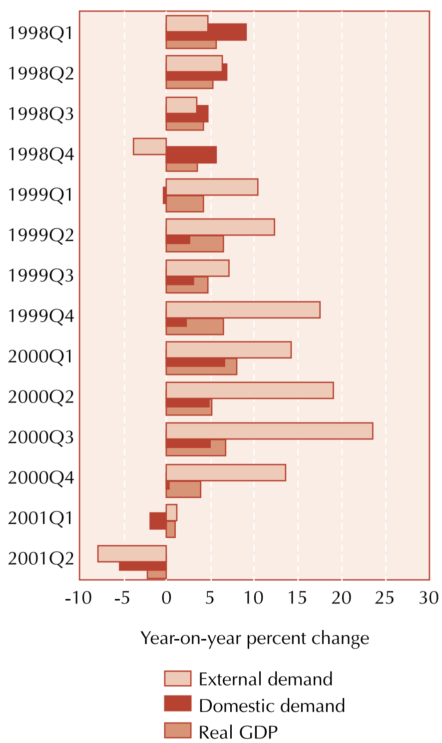
| Economic Indicator (percent) | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|
| | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| GDP growth | 4.6 | 5.4 | 5.9 | -2.0 | 5.1 | 2.0 | 5.8 |
| Inflation rate | 1.7 | 0.2 | 1.3 | 0.3 | 1.7 | 1.0 | 1.8 |
| Current account/GDP | 1.3 | 2.9 | 2.9 | 3.4 | 2.5 | 2.7 | 3.0 |

*Economic Assessment.* Economic performance was substantially weaker than expected in the first half of 2001: real GDP grew by less than 1.0 percent in the first quarter and shrank by 2.4 percent in the second quarter compared to the same quarters of the previous year. Domestic demand growth stalled in the fourth quarter of 2000 with a double-digit contraction in investment, and demand then began to shrink in the first quarter of 2001 as investment continued contracting and consumption growth decelerated to 0.6 percent. This deterioration in domestic demand worsened in the second quarter of the year, at a time when export demand, which had been growing for nine quarters, contracted by nearly 8 percent year on year. The collapse in domestic investment was partly the result of the falloff in worldwide demand for ICT products and partly the result of an accelerating trend in the relocation of manufacturing operations to the PRC to cut costs. Consumption growth slowed as the global economic downturn heightened uncertainty about the political and economic outlook, and rising unemployment eroded consumer confidence.

Growth of value added in services (services accounted for two thirds of GDP in 2000) slowed from 4.7 percent year on year in the fourth quarter of 2000 to 0.1 percent in the second quarter of 2001, with contractions in commerce and finance. Manufacturing, which expanded by 2.6 percent in the fourth quarter of 2000, shrank by over 2 percent in the first quarter of 2001 and by over 7 percent in the second quarter. The contraction in construction, ongoing since 1998, worsened to over 11 percent in the second quarter from 3.2 percent in the fourth quarter of 2000.

With the downturn in economic activity, unemployment worsened significantly from already historically high levels. The number of unemployed rose by 136,000 from end-December 2000 to end-July 2001, pushing up the seasonally adjusted rate from 3.3 percent to 4.7 percent. Average monthly earnings fell by 1.3 percent in the first half of 2001 compared with the same period in the previous year. Although employment picked up slightly in the services sector during these six months, this was more than offset by job losses in manufacturing and other industry sectors. In the third quarter, labor market conditions continued to deteriorate as unemployment hit another record of 5.3 percent in September. With regard to inflation, consumer prices, which rose by 1.3 percent in 2000, were 0.1 percent higher in July 2001 than a year earlier, or 0.8 percent higher if food and energy are excluded. Import prices increased by 0.9 percent year on year in July 2001 as the New Taiwan dollar, which had declined by 4.8 percent against the US dollar in 2000, depreciated by another 5.1 percent through July 2001. With domestic demand continuing to weaken in the third quarter, consumer prices fell by 0.5 percent in September from a year earlier.

*The deterioration in domestic and external demand worsened in the second quarter of 2001*




*Sources: Datastream, Global Economics Database; www.stat.gov.tw*

Because external demand conditions deteriorated much more severely in the first half of 2001 than anticipated—despite the depreciating local currency—the US dollar value of exports (in f.o.b. terms) declined by 10.6 percent year on year from January to June. As in other NIEs, the drop in exports occurred in almost all sectors but was most severe in machinery and electrical equipment. Accounting for 55.7 percent of 2000 exports by value, exports from this subsector fell by 10.5 percent year on year in the first half of 2001. However, because of the rapid fall in import-intensive investment and export demand, the US dollar value of imports (in f.o.b. terms) declined more rapidly, by 17.0 percent over this period. Consequently, the current account surplus, at $7.7 billion at end-June 2001, was three times higher than 12 months previously. However, with net financial inflows reversing from $6.3 billion over the first half of 2000 to an outflow of $2.0 billion over the first half of 2001, primarily because of net banking sector outflows, reserve accumulation slowed from $9 billion to $5.1 billion over these two periods. As external conditions deteriorated further in the third quarter of 2001, exports fell by 18.5 percent and imports by 23.7 percent in the first nine months from year-earlier levels, although this includes disruptions associated with the 11 September attacks and a severe typhoon on the island.

In line with regional trends, stock prices and interest rates fell, corporate debt levels rose, and bank lending slowed. Through end-July 2001, the Taiwan Stock Exchange Weighted Index declined by over 8 percent, after a 44 percent drop in 2000. After strengthening in August, the index fell by 19.3 percent in September as turbulence from the attacks on the US buffeted regional markets. The central bank lowered the discount rate from 4.63 percent in December 2000 to 2.50 percent in October 2001. Secondary market interest rates on 31-90 day commercial paper fell by an average of 174 basis points to 3.54 percent, three-year corporate bond rates fell by 206 basis points to 3.60 percent, and 10-year government bond rates dropped from 5.10 percent to 3.85 percent over the first eight months of 2001. The total value of bonds outstanding (covering government, corporate, and bank debentures) increased by 17.1 percent during the eight-month period. However, the prime lending rate declined only marginally from 7.7 percent to 7.6 percent, claims on the private sector contracted by 2.0 percent, while the past-due loan ratio of domestic banks rose from 5.3 percent to 6.5 percent during this period.

***Economic Management Issues.*** In response to weakening economic conditions and falling global interest rates, the central bank cut the discount rate eight times in the first nine months of the year. However, this has had little impact: while deposits at financial institutions grew by 6.3 percent year on year in August 2001, total loans showed no growth at all and portfolio investments of financial institutions expanded by 8.3 percent. The authorities have also adopted an expansionary fiscal policy. With the June 2001 passage of a supplementary budget of NT$61.1 billion, expenditures are expected to grow from about 24 percent of GDP in 2000 to about 26 percent in 2001, accompanied by a higher budget deficit. This should provide some cushion to the impact of the downturn in economic activity by boosting public infrastructure investment and thus providing additional jobs in construction.

In addition to these short-term measures, the authorities are taking steps to ensure medium-term growth prospects and sustained long-term development. In June 2001, hoping to develop a more efficient finance sector, the Legislative Yuan passed measures to allow greater flexibility for financial firms both to merge and to provide a wider range of services. An NT$140 billion resolution trust fund was also created to help restore to financial viability a group of credit cooperatives. Because this program covers only a small portion of the banking sector, many observers expect the authorities eventually to increase the size of the fund and to expand its scope. In August 2001, the Economic Development Advisory Committee made several policy recommendations intended to enhance Taipei,China's long-term development opportunities. Chief among them is the easing of restrictions on dealing with the PRC.

***Forecast.*** The deterioration of economic conditions in the first half of 2001 in Taipei,China, became even more pronounced in the third quarter. A significant worsening of external conditions, exacerbated by the September attacks and the typhoon, overshadowed Taipei,China's imminent WTO membership. The global economy and export demand are expected to remain weak through the rest of 2001. Hence, an unprecedented yearly contraction in GDP is expected for 2001. However, if the global economy slowly gathers momentum in 2002 and the authorities' economic stimulus packages and structural reforms provide a further boost, the economy should return to positive, although relatively modest, growth in 2002. With demand slack, inflation is likely to moderate for the whole of 2001 compared with 2000 but is expected to pick up in 2002 as demand starts to rise. Because imports are expected to remain weaker than exports, the current account surplus will probably widen in 2001 but begin to narrow again in 2002 as imports recover, reflecting a quickening pace of economic activity.

# CENTRAL ASIAN REPUBLICS, AZERBAIJAN, AND MONGOLIA

*Rising oil and gas production in the first three quarters of 2001 have contributed to stronger than expected growth. However, with uncertain agricultural prospects, emerging external and fiscal imbalances in some economies, softening oil and gas prices, and increasing concern about regional instability following the 11 September attacks on the US, growth in the Central Asian republics, Azerbaijan, and Mongolia is expected to slow in 2002.*

| **Economic Indicator** (percent) | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|
| | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| GDP growth | 2.1 | 4.9 | 7.8 | 7.7 | 3.3 | 5.5 | 4.8 |
| Inflation rate | 7.9 | 20.7 | 26.6 | 9.5 | 10.6 | 9.9 | 10.0 |
| Export growth | -16.2 | 1.4 | 31.0 | 4.1 | -0.3 | 10.8 | 10.7 |
| Import growth | -11.1 | -12.8 | -6.4 | 31.2 | 24.4 | 11.7 | 11.8 |
| Current account/GDP | -5.5 | -1.3 | 2.5 | 2.6 | 2.6 | 3.6 | 3.6 |

*Economic Assessment.* The economies of the Central Asian republics and Azerbaijan have maintained strong growth so far in 2001. Preliminary figures indicate that real GDP grew by about 7.0 percent in the first quarter of the year, compared to 6.5 percent in the corresponding period of 2000. The subregion's growth in the first quarter was due in large part to buoyant world oil prices. Recoveries in gold and aluminum production is also a contributing factor, which helped the Kyrgyz Republic and Tajikistan register GDP growth of 6.6 percent and 7.6 percent, respectively. Kazakhstan achieved 13.0 percent growth in the first three quarters of 2001, primarily on account of new pipeline capacity coming onstream, enabling a sharp increase in oil exports. In Tajikistan, where aluminum production has picked up strongly and economic rehabilitation has begun to bear fruit, GDP growth was officially reported to be 12.1 percent from January to September 2001. These two factors have contributed significantly to the high aggregate GDP growth for the subregion in 2001. However, widespread drought has adversely affected agricultural performance. Policy slippage and a decline in investment in Uzbekistan reduced its GDP growth to 2.8 percent in the first quarter of 2001 from 3.0 percent in the same period in 2000. Losses in the livestock sector, resulting from two consecutive severe winters and from a recent outbreak of foot and mouth disease, took a heavy toll on Mongolia's output in 2000 and early 2001. With GDP growth of 1.1 percent in 2000, Mongolia's real growth is expected to recover moderately in 2001.

The impact on the subregion of the 11 September attacks on the US has yet to be fully felt. However, additional public expenditures on domestic

The Central Asian republics comprise Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

and border security as well as an adverse impact on export earnings due to a softening of commodity and hydrocarbon prices and lower tourist arrivals have been reported. These will put the already fragile fiscal and external balances in the subregion under pressure, necessitating enhanced concessional financial inflows.

As the economies of the Central Asian republics have continued to grow, the unemployment situation appears to have improved in some countries. In Kazakhstan, for instance, the officially recorded unemployment rate declined to 3.8 percent of the total workforce during the first quarter of 2001 compared with 4.5 percent a year earlier. Similarly in Tajikistan, the official unemployment rate dropped to 2.5 percent by March 2001 from 3.0 percent a year earlier. In the Kyrgyz Republic, however, the official unemployment figure went up to 6.0 percent by the end of April, possibly as a result of the slowdown in agricultural growth. The actual unemployment situation, however, is less clear than implied by these official statistics as they at best reflect broad trends. In Mongolia, results of the 2000 Population Census showed an unemployment rate of 17 percent, against the official statistic of 4.6 percent for the same period. Data from the National Statistical Office for September 2001 shows an unemployment rate of approximately 4.7 percent.

A tight monetary policy stance has continued. Broad money supply grew more slowly in the first quarter of 2001 than a year earlier in Azerbaijan, Kazakhstan, and the Kyrgyz Republic. Year-on-year consumer price inflation fell significantly in Kazakhstan to 8.9 percent in March 2001 from 20.2 percent a year earlier. However, increases in public sector wages and higher energy and food prices have contributed to rising inflation in Tajikistan and Uzbekistan.

The year-on-year inflation rate in Mongolia fell to 8.0 percent by end-2000, but accelerated again in the first half of 2001 partly due to higher electricity tariffs and a decline in domestic meat supplies due to severe winter weather. The seasonal increase in meat supplies has since, however, helped reverse some of the earlier rise in food prices, easing inflationary pressures from mid-2001. Current monetary policy in Mongolia is geared to reducing inflation to about 8 percent by the end of 2001.

Fiscal balances have continued to improve in the subregion, benefiting from increasing oil and gas revenues and improved tax collection. According to government statistics, four countries registered a fiscal surplus in the first quarter of 2001: Azerbaijan (1.1 percent of GDP), Kazakhstan (7.6 percent), Kyrgyz Republic (2.4 percent), and Turkmenistan (0.7 percent). In Tajikistan and Uzbekistan, however, fiscal accounts remained marginally in deficit at 0.5 percent and 0.4 percent of GDP, respectively. Mongolia's revised budget for 2001 plans to keep the fiscal deficit at about 7 percent of GDP to reverse the buildup of the debt-to-GDP ratio.

The subregion's external sector performance so far in 2001 has been encouraging. Exchange rates have tended to stabilize, although some currencies have experienced marginal depreciation. Tajikistan introduced a new national currency, the *somoni*, in October 2000 to replace the Tajik rouble. The transition was smooth but the new currency had depreciated by 4.7 percent against the dollar by March 2001. The trade balance in the Central Asian republics has also strengthened during 2001. Trade surpluses were recorded in Azerbaijan, Kazakhstan, and Turkmenistan due to strong oil and gas exports. The Kyrgyz Republic also posted a trade surplus in March 2001, as a result of stronger gold exports and weaker imports due to import compression. The trade performance of Tajikistan and Uzbekistan has, however, lagged behind because of slow export growth that, combined with rising import costs, generated a trade deficit for both these countries. The continued high levels of external debt have remained serious concerns in the Kyrgyz Republic and Tajikistan.

*Economic Management Issues.* Azerbaijan and Tajikistan have achieved some progress in structural reforms, along with implementation of IMF-sponsored programs. Nevertheless, it will be some time before the impact of these reform efforts will be felt. In the Kyrgyz Republic, the IMF reform programs, under the Poverty Reduction and Growth Facility that had fallen behind by the end of the second quarter, were revived in September. The lack of private sector development in the non-oil sector remains a particular concern in Azerbaijan and Kazakhstan, where levels of poverty remain high despite significant GDP growth. Both these countries have established state oil funds to better manage their increasing oil revenues. The persistence of multiple exchange rates in Turkmenistan and Uzbekistan has caused concern in some quarters, as they generate wide-ranging distortions and rent-seeking practices. Although the Government of Uzbekistan announced some significant measures in July 2001 toward currency unification and further trade liberalization, significant steps still remain to be taken to create a favorable policy regime for the expansion of competitive manufacturing and export capacities. Much of the desired improvements in the economic outlook depends on the Government's commitment to effectively implement its planned stabilization and reform measures. At the subregional level, progress remains limited in developing a more integrated market through economic cooperation. In fact, barriers to flows of trade and services within the subregion appear to have increased.

*Forecast.* Average growth for the Central Asian republics and Azerbaijan is expected to be 7.7 percent in 2001, which is marginally below the growth rate of 7.8 percent achieved in 2000. This estimate for 2001 growth is significantly higher than the 3.3 percent projected in *ADO 2001* in April this year. The better economic prospects for 2001 are primarily the result of the much stronger growth performance in Kazakhstan due to the buoyant oil and gas sector that has benefited from new pipeline capacity. Turkmenistan is also expecting larger exports of gas with more pipeline capacity being made available by the Russian Federation, while rising aluminum production has stimulated growth in Tajikistan. At the same time, however, the adverse impact of the drought, occurring for the second year running, will likely pull down growth rates in Uzbekistan in 2001.

The 11 September attacks are likely to adversely impact fourth quarter economic performance in the subregion; their effects are likely to be more pronounced in the short to medium term. This is on account of a probable slowdown in export earnings as oil, cotton, and other commodity prices remain depressed as a consequence of slower global economic activity. The business sentiment has worsened and investment activity, both foreign and domestic, is expected to decline over the rest of 2001. Fiscal balances are also likely to come under pressure with higher outlays on security and on coping with the anticipated influx of refugees.

Therefore, 2002 GDP growth in the Central Asian republics and Azerbaijan is likely to be marginally slower than in 2001 in view of the international prices for oil and gas remaining depressed until the global economic recovery takes hold in the latter half of 2002. The estimated growth rate of 5.5 percent in 2002 is lower than the 7.7 percent in 2001 in view of the longer and deeper slowdown in the global economy and the adverse impact of the 11 September attacks. GDP growth in Mongolia for 2001 is expected to be modest, followed by a marginal improvement in 2002. The possibility of a third severe winter could also be a negative factor.

Subregional inflation in 2001 is likely to remain under control, although higher inflationary pressures may emerge in Uzbekistan due to a possible currency devaluation and rising food prices. The average consumer price inflation rate in the subregion is expected to be 9.5 percent in 2001, lower than the 26.6 percent in 2000. Average inflation in 2002 will likely increase marginally to 9.9 percent. The fiscal stance could become further strained, as a result of reduced revenues and the greater need for public spending on securing borders, maintaining domestic security, and meeting refugee costs. The subregion's external balances will remain highly dependent on global demand and international prices for its major exports of primary commodities and energy products. With limited improvement in the trade and current account positions expected in 2001 and 2002, debt servicing is likely to become more difficult in already highly indebted countries, such as the Kyrgyz Republic and Tajikistan.

# PEOPLE'S REPUBLIC OF CHINA

*The global economic slowdown has led to a sharp decline in demand for exports from the People's Republic of China, but a strong recovery in domestic demand has largely offset this. Although the 11 September terror attacks on the US have worsened the near-term external outlook, the economy is expected to maintain robust growth over the rest of 2001 and 2002. The Government's challenges are to manage the reform process after accession to the World Trade Organization and to reduce poverty by promoting development in the poorer provinces, as well as in the private sector.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | 7.8 | 7.1 | 8.0 | 7.3 | 7.3 | 7.0 | 7.5 |
| Inflation rate | -0.8 | -1.4 | 0.4 | 1.0 | 2.0 | 0.8 | 2.5 |
| Current account/GDP | 3.1 | 1.6 | 1.5 | 0.9 | 1.2 | 0.3 | 1.0 |

*Economic Assessment.* The sharper than expected global slowdown led to a steep decline in demand for exports from the People's Republic of China (PRC) during the first nine months of 2001, though this was largely offset by a strong recovery in investment and consumption. GDP growth declined somewhat to 7.6 percent over this period compared to 8.2 percent in the same period of 2000. The industry sector (including construction activity) expanded by 9.3 percent, led by strong domestic demand, with value added in heavy industry increasing faster than that of light industry. The services sector grew by 7.0 percent in this period, mainly due to rapid growth in the transport and telecommunications sectors. The agriculture sector expanded by only 2.4 percent, partly because more than 20 of the 31 provinces and municipalities were hit by serious drought. The yields of summer crops fell by 4.6 percent, following a 9.1 percent decline in total crop production in 2000.

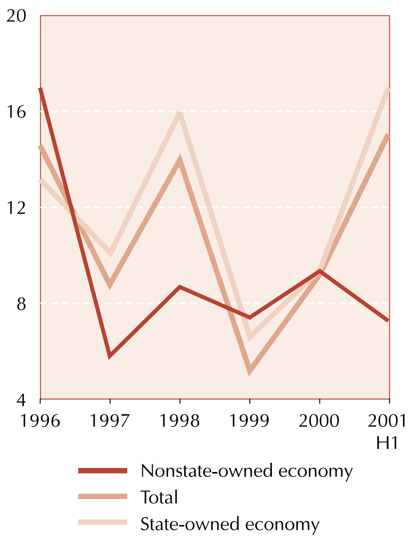
During the first nine months of 2001, investment growth remained healthy due to increased public investment and FDI inflows. Reflecting the Government's "go west" policy, the investment growth rate in the western region was twice as high as that in the eastern and central regions. However, investment growth in the nonstate sector, including collective and privately owned businesses, declined, stemming from an underdeveloped base and the narrowness of the investment opportunities available to this sector. The Government is aware of these limitations, and has taken steps to encourage nonstate-sector investments, such as establishing a credit guarantee scheme for SMEs and reducing barriers to accessing credit for the nonstate sector.

Robust economic growth and imminent accession to WTO have made the PRC more attractive to foreign investors. Both contracted and actual FDI grew strongly in the first eight months of 2001. Contracted FDI was $43.7 billion, a 31.6 percent increase compared to the first eight months of 2000. Actual FDI reached $27.4 billion, a rise of 20.4 percent over the same period of 2000. There are, however, some signs that, due to the rapid deterioration in the global corporate environment, FDI inflows into the PRC in July and August eased somewhat.

Consumption maintained its double-digit growth rate in the first nine months of 2001. Policies such as wage increases for civil servants and measures to facilitate the purchase of automobiles and housing have stimulated demand. However, income disparities between the rural and urban sectors widened in 2000: rural residents' incomes increased by only 2.1 percent compared to 6.4 percent for urban residents. Retail sales to rural residents in the first nine months of 2001 increased by 7.8 percent, whereas retail sales to urban residents increased by 11.5 percent. Moreover, the per capita cash income of rural residents increased by 5.2 percent in the first nine months of 2001 while the per capita disposable income of urban residents rose by 7.4 percent. Because the majority (64 percent) of the population live in rural areas, raising farmers' incomes has become a top priority for the Government. Recently, about 10 items of fees collected from farmers, including those relating to land use and farmers' dwellings, were eliminated. The Government is also conducting a fiscal reform experiment to reduce the tax burden on farmers by converting approved fees into an agricultural tax and abolishing other arbitrary forms of fees imposed on farmers. This policy reform will have a pro-poor impact because the system of imposing fees on poor farmers is a regressive method of taxation. It will also improve governance by bringing these funds into the budgetary framework. This will strengthen oversight and accountability for the management and expenditure of these funds.

*The first half of 2001 saw robust investment growth...*

**Annual percent change in nominal fixed investment**




*Source: National Bureau of Statistics*

The official estimate of urban unemployment at the end of 2000 was 6 million, about 3.1 percent of the urban labor force. However, the estimate does not cover urban *xiagang* workers, who are unemployed but are not registered with the Ministry of Labor and Social Security. There are still about 9 million *xiagang* workers who were laid off as part of the SOE reforms at the end of 2000. Including these *xiagang* workers, urban unemployment stood at about 15 million, or some 8.2 percent of the urban labor force, at the end of 2000.

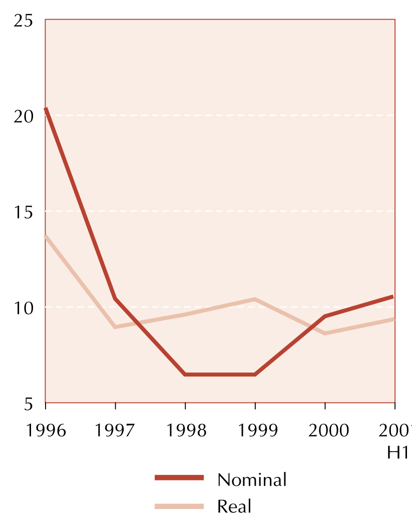
The CPI rose by 1.0 percent in the first nine months of 2001 from 0.4 percent for the whole of 2000. Housing and services prices rose moderately, while food and traded goods prices declined. In relation to traded goods, due to weak foreign demand, manufacturers have been cutting prices and diverting stocks intended for exports to the domestic market.

From January to September 2001, export and import growth decelerated to 7.0 percent and 11.2 percent, respectively, from 33.1 percent and 38.7 percent in the corresponding period of the previous year. While slower export expansion mirrored the slowdown in world trade, the import-dependent nature of exports meant that import growth also decelerated during this period, notwithstanding relatively high imports of investment and consumption goods. As a result, the trade surplus narrowed marginally to $13.6 billion, from $14.0 billion in the corresponding period of 2000.

*Economic Management Issues.* In the wake of sharply slower export growth, monetary policy remained accommodative to stimulate domestic demand and boost GDP. By the end of September 2001, outstanding broad money (M2), narrow money (M1), and money in circulation (M0) were higher by 13.6 percent, 12.3 percent, and 8.4 percent, respectively, over September 2000 levels. The aggregate loan balance of all financial institutions at end-September 2001 was also 12.3 percent higher than 12 months earlier. The increase in loans in 2001 consisted mainly of consumer credit and agriculture loans. Interest rates remained stable in the first nine months of 2001, after seven reductions in rates beginning in May 1996. The domestic one-year bank deposit rate was 2.25 percent and the prime lending rate of financial institutions was 5.85 percent. Some liberalization of foreign lending and deposit rates has taken place, marking the early steps in reform of the administrative system for setting interest rates that began in September 2000. Liberalization of domestic currency lending rates will follow, and the freeing up of domestic currency deposit rates will be the last stage of this reform.

*...while consumption demand was relatively stable*

**Annual percent change in retail sales of consumer goods**



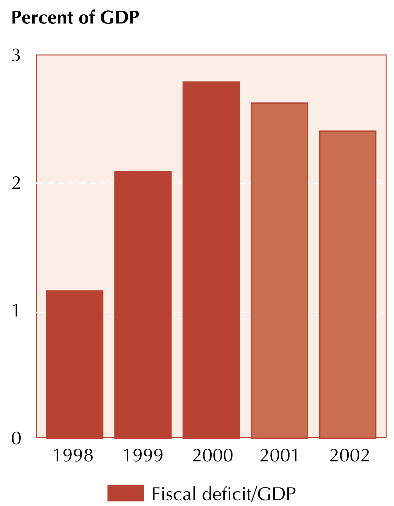

*Source: National Bureau of Statistics*

The expansionary fiscal policy that was begun in 1998 in the wake of the Asian financial crisis is being gradually phased out. Although an additional Y150 billion in bonds will be issued in 2001—with Y50 billion for the central government budget, Y50 billion for on-lending to local governments, and Y50 billion to support the Government's "go west" policy—the fiscal deficit for 2001 was originally planned at 2.7 percent of GDP as against 2.8 percent of GDP in 2000. Better than expected revenue collection in the first half of 2001 suggests that the actual fiscal deficit will be lower than the planned budget figure. During the first six months of 2001, tax revenue increased by 27 percent over the same period in 2000. Revenue from VAT and consumption tax rose by more than 40 percent, while revenue from individual income tax and enterprise income tax, taken together, improved by 36.2 percent.

The main external risk facing the PRC relates to the prospects for recovery in the US economy, the country's largest export market. Although it is anticipated that the US may gradually recover toward the end of the first half of 2002, the speed of this recovery remains uncertain—an uncertainty increased by the 11 September attacks on the US. The PRC's exports will likely see a more pronounced contraction and the growth rate of foreign tourists may drop somewhat in the next few months. Further volatility in the stock market, which declined sharply in the aftermath of the 11 September attacks, cannot be excluded as events unfold. There is also concern over the economic slowdown in Asia and the pace of recovery. To minimize the adverse impact of the sharper and more protracted slowdown in the global economy, the Government recently adopted several measures to encourage exports, such as speeding up export-tax refunds and customs procedures, and granting permission to nonstate-owned companies to conduct external trade. Such trade was previously limited to government-approved medium and large SOEs. Despite these measures, the Government needs to make more effort to increase trade with countries that are less dependent on the US economy. If the external conditions deteriorate further, it will have to place greater emphasis on targeting a proactive fiscal and monetary policy for private sector activity in general and small and medium enterprises in particular. There is also a need for improving the business environment. This will require better governance to improve the legal regulatory framework, increase transparency and disclosure, strengthen auditing and accounting, protect intellectual property rights, reduce corruption, and ensure that contracts can be enforced.

The country's fight against poverty, in spite of significant achievements, has a long way to go. A Ten-Year Poverty Reduction Strategy (2000-2010) was formally announced in June 2001. A "key county" poverty system will be used to focus assistance for the remaining 30 million rural people with incomes under the official poverty line of Y625 per capita annual income. Poor villages in non-key counties will also be eligible for national poverty funding. Given that almost all the poor live in the central and western parts of the country, the Government will have to mobilize more resources to promote development there. And since a dynamic private sector will be an engine for economic growth and employment generation, it must also work to create a pro-business environment that provides the private sector with the same access to markets, finance, and land, and enforcement of property rights, as the public sector.

***Expansionary fiscal policy is gradually being phased out***




*Sources: National Bureau of Statistics, staff estimates*

Accession to WTO will result in consumers having a wider choice of products while some goods and services will be sold at lower prices. Even though the welfare effects of WTO membership are positive in the long run, adjustments to be made in the short term will have social costs. WTO accession is likely to produce significant competitive pressure on the agriculture sector, as well as on the telecommunications and automobile industries. New studies show that the PRC's banking sector, one of the most protected in the country, is particularly vulnerable. In the short to medium term, local banks' net interest margins will narrow and profitability will be squeezed. Weak banks with low capital bases and poor asset quality may have to exit the market, possibly upsetting the stability of the domestic banking system. Consequently, to face the challenges from international banks after WTO accession, finance sector reform must be accelerated. The key challenge for the Government is to strengthen domestic banks by tackling the problem of nonperforming loans and to establish an effective corporate governance system. Domestic financial institutions must work to develop new areas of business and improve economic efficiency. Better human resources management systems, more generous compensation and incentive packages, and more appropriate staff training and career development, are also required.

***Forecast.*** The 11 September attacks on the US, in the context of an already weakening global economy, have worsened the near-term external environment for the PRC. The country is, however, likely to be less affected by these events than many other countries in the region due to its relatively low dependence on exports and its strong domestic demand. GDP growth is now expected to grow by 7.3 percent and 7.0 percent in 2001 and 2002, respectively. Although economic growth is likely to slow during the remainder of this year, rising domestic consumption and investment will for the most part make up for the negative impact of slower export growth. Investment will likely remain strong due to the large public investment program and the consolidation of FDI inflows at a high level. Consumption growth will also remain buoyant, due to rising incomes, including civil servants' salary increases. With inflation subdued, the Government is likely to maintain an accommodative monetary policy during the remainder of 2001 and 2002.

Export growth is forecast to fall to 6.0 percent for the whole of this year before declining further to 4.0 percent in 2002 due to a more prolonged global slump and softer rebound in 2002 than previously anticipated. Imports will also grow more slowly in 2001 and 2002 but faster than exports due to WTO accession and the liberalization of trade policies. Tourism is also likely to be affected for the rest of 2001 due to heightened security concerns. As a result, the current account surplus will come down to 0.9 percent of GDP in 2001 before narrowing further to 0.3 percent in 2002. However, this decline will be offset by foreign investment inflows, as the economy opens up further to foreign participation to fulfill WTO commitments. Official foreign exchange reserves will be about $195 billion and $210 billion in 2001 and 2002, respectively. With strong domestic consumption growth, there will be some pressure on prices, but given significant excess capacity in many industry subsectors, large unutilized supply potential in agriculture, and imports of cheap goods due to WTO-associated tariff liberalization, inflation is forecast to average 1.0 percent in 2001 before declining marginally to 0.8 percent in 2002.

# SOUTHEAST ASIA

*Economic performance varied considerably across Southeast Asia in the first half of 2001. Indonesia, Philippines, and Viet Nam outperformed other countries in the subregion due to resilience of domestic demand conditions. In Malaysia and Thailand, the global slowdown negatively impacted both the domestic and external sectors significantly. In 2002, exports are expected to stage a rebound in the subregion, with Malaysia and the Philippines the main beneficiaries.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -9.1 | 3.2 | 5.2 | 2.4 | 4.0 | 3.3 | 4.8 |
| Inflation rate | 33.4 | 2.8 | 4.7 | 5.9 | 5.4 | 5.3 | 4.4 |
| Export growth | -4.7 | 11.0 | 18.6 | -5.3 | 8.6 | 5.8 | 12.1 |
| Import growth | -26.2 | 7.0 | 23.5 | 0.5 | 16.1 | 7.7 | 19.1 |
| Current account/GDP | 4.7 | 6.7 | 5.9 | 2.8 | 3.6 | 1.8 | 3.0 |

***Economic Assessment.*** On average across the subregion, the deceleration of the global economy, which turned out to be steeper than expected at the time of *ADO 2001*, led to a worse drop in GDP growth in the first half of 2001 than anticipated. This was due primarily to the small, open-economy characteristic of the ICT-dependent economies of Malaysia, Philippines, and Thailand, which together account for the majority of the subregion's real GDP. The slowdown has spread to most sectors across the subregion, except in Viet Nam. In fact, just as the subregion's growth in 2000 was generally broad based, so was the slowdown in the first half of 2001. This development is consistent with the views expressed in *ADO 2001*, which anticipated that income effects from the export sector would permeate to other sectors during the course of this year.

As envisaged in *ADO 2001*, intraregional trade has not provided a cushion against the slowdown in the industrialized economies and the consequent effect on the subregion. Much intraregional trade consists of exports and imports of electrical and electronic products, and so any slowdown in final demand for ICT products in the US, Japan, or Europe adversely affects this channel. The negative effect on export growth was seen in the fourth quarter of 2000 for most ICT products as new US orders for these products had started to tail off in the third quarter of the year.

The policy response to the slowing external environment across the subregion has been mixed. In Indonesia, the weak rupiah and high fiscal deficit have constrained the use of monetary and fiscal policy. In Malaysia, the Government has introduced a fiscal stimulus amounting to 2.3 percent of GDP for 2001 (in the form of infrastructure spending) while the central bank made a 50 basis point policy rate cut in September. In Thailand, the corresponding amount was 0.7 percent of GDP (in the form of tax cuts and support for SMEs), while perversely, in light of the slowing growth environment, the 14-day repurchase rate was raised by 100 basis points in June 2001. As in Indonesia, the Philippines' large fiscal deficit has limited the use of fiscal policy, while monetary policy has brought the reverse repurchase rate down by 475 basis points since December 2000.

GDP growth performance varied considerably across the subregion. Growth in Indonesia, Philippines, and Viet Nam remained resilient, while in Malaysia and Thailand quarterly rates slowed markedly in the first half of 2001. Malaysia and Thailand bore the brunt of the effects of the slowing global economy because of their higher export-to-GDP ratios and relatively high concentration of ICT products in their exports. The Philippines shares these characteristics, but is an anomaly among the ICT export-dependent economies because of its relatively stable private consumption growth performance—due largely to agriculture—which, along with public sector construction spending, has somewhat compensated for its larger than anticipated export slowdown. In Indonesia, pent-up demand dating back to the crisis years, along with a resolution of the political crisis, has led to a pickup in investment and consumption spending. In Viet Nam, growth remained firm as the industry and services sectors held up, while performance of the agriculture sector fell slightly.

In 2000, private consumption had already returned to precrisis levels in Malaysia and the Philippines, hence further growth in the first half of 2001 was limited. In Thailand, private consumption has yet to reach its precrisis levels and the first half national income accounts data imply little prospect of a rebound in the second half of the year. Private consumption remained robust in Indonesia in the first half of 2001, due primarily to the strength of the rural economy.

Fixed investment, however, remains below precrisis levels in most subregional countries. Much of the pickup in investment in Malaysia, Philippines, and Thailand in 2000 was due to increased machinery and equipment investment, primarily in the electrical and electronic goods sector. Therefore, the decline in fixed investment in the first half of 2001 in Malaysia and Thailand can be explained by rising excess capacity stemming from a slowdown in the export sector. In the Philippines, public construction spending programs boosted investment in the first half of 2001. Fixed investment spending in Indonesia remained healthy over this period due to rising capacity utilization rates and the upgrading of plant and equipment to compensate for the negative investment rates of 1998 and 1999.

***Forecast.*** GDP growth in 2001 has been revised downward to 2.4 percent from the 4.0 percent forecast in *ADO 2001*. The primary reasons for this are the unanticipated weakening of the global economy in the third quarter (reflecting US economic data); the 11 September attacks; continued weakness in the subregion's export sector and few prospects of a pickup until the first half of 2002; and the feedback effects of the export weakness on the domestic sector in Malaysia, Philippines, and Thailand. The larger than anticipated weakness of the external sector has also led to a downward revision of GDP growth in both Indonesia and Viet Nam. In early 2002, weaknesses in the external sector are expected to remain in all sectors, as domestic demand conditions are unlikely to stage a strong recovery in the industrialized countries or other DMCs until the second half of the year. The subregion is expected to record GDP growth of 3.3 percent in 2002. For the less export-dependent countries, Indonesia and Viet Nam, GDP growth is forecast to outpace that of its neighbors in 2002, supported by favorable domestic demand conditions. In Malaysia, Philippines, and Thailand, the risks of a further delay in a pickup of global demand, along with the uncertainty created by the 11 September attacks, remain severe. These risks may weigh on the growth rate forecasts for 2002. Their effects are exacerbated by the economic structure of these three economies, which have limited autonomous drivers of growth.

# INDONESIA

*During the first seven months of 2001, policymakers in Indonesia were distracted from economic matters by an extended conflict between Parliament and then President Wahid and by the program of decentralization initiated on 1 January. The deteriorating world economic climate, especially after the attacks on the US on 11 September, will limit short-term economic prospects. The installation of President Megawati in July 2001 now frees the Government to focus on economic issues. A substantial reform agenda needs to be addressed.*

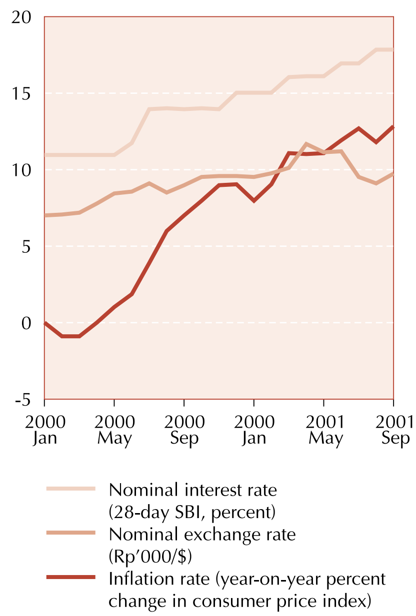
| **Economic Indicator** (percent) | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|
| | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| GDP growth | -13.2 | 0.9 | 4.8 | 3.2 | 4.2 | 3.9 | 4.5 |
| Inflation rate | 77.6 | 2.1 | 9.3 | 11.0 | 9.0 | 9.0 | 6.0 |
| Current account/GDP | 4.3 | 4.1 | 5.2 | 2.1 | 2.9 | 0.6 | 1.3 |

*Economic Assessment.* In the first half of 2001, GDP growth slowed to 3.4 percent from 4.8 percent in the same period in 2000 mainly because of continued household and public sector spending and a modest recovery in private investment. Government expenditure—although hampered by debt-repayment needs—rose by an average of 5.9 percent in the first two quarters (relative to the respective year-earlier period) and household spending grew by 5.3 percent. By sector, growth was most striking in manufacturing—averaging 4.2 percent in the two quarters—as well as in some services, particularly utilities and transport. The improvement in manufacturing was relatively broad based, following moderate increases in demand from households, businesses, and the external sector. Financial services showed only modest expansion, reflecting the still weak financial capacity of most banks. Offsetting some of this relatively good performance, imports were 34.6 percent higher than in the same two quarters of 2000, accelerating at more than twice the pace of exports, which rose by 14.3 percent. The import surge represents some rebound in consumer and business demand after income and production recovered somewhat in 2000 from the Asian financial crisis. Assuming a reasonable performance in the agriculture sector (on the basis of normal weather conditions), but faced with a more protracted global slowdown and uncertainties generated by the attacks on the US, the economy could show 3.2 percent growth for the whole of 2001, compared with the earlier forecast of 4.2 percent made at the time of *ADO 2001* in April this year.

The 2001 inflation rate is higher than called for under the previous IMF agreement and recommitted to as late as 15 June 2001 in the revision to the 2001 budget. Inflation moved to double digits after February 2001 and continued to run at 10 percent or more on an annual basis through September, when the 12-month price change was 13.0 percent with relatively large increases in housing and transport services. A weaker domestic currency, accommodative monetary policy, and increases for price-administered goods and services, such as oil and electricity, all contributed to increased inflation. The new IMF-supported macro-stabilization program, finalized in September 2001, targets lower inflation and calls for a more anti-inflationary monetary policy.

The rupiah weakened significantly in the first six months of the year, and by June 2001 stood at Rp11,400/$, or 30.6 percent weaker than in June 2000. Political uncertainties at the end of April briefly forced it to below Rp12,000/$, but it recovered significantly in early August to Rp8,400/$ as the political situation appeared to stabilize. After this brief spike, continued expectations of depreciation, due to the corporate sector's need to service external debts and to pay for imports in the coming months and the international uncertainties beginning in September, caused the rupiah to fall again. On 24 October, it stood at Rp10,245/$. Continued weakening of the rupiah, as seen in the third quarter of 2001, will complicate the monetary authorities' task of meeting the inflation commitment.

*A weaker currency and an accomodative monetary policy contributed to increased inflation*




*Source: www.bi.go.id/bank_indonesia2*

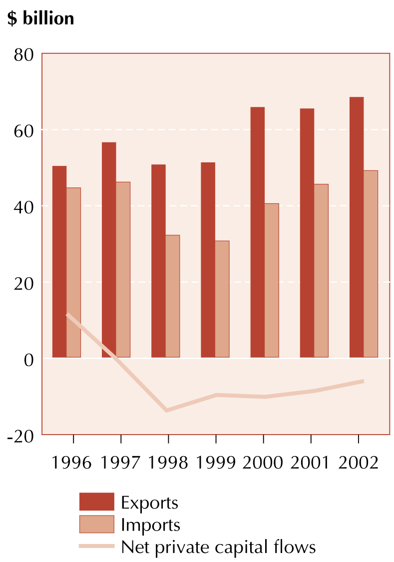
Indonesian exports rely heavily on Organisation for Economic Co-operation and Development (OECD) markets. Exports to the US and Japan will likely account for approximately 35 percent of total exports in 2001. Any further slowdown in the OECD economies will have a strong impact on the external trade balance. While monthly movements have been somewhat hard to interpret because of the extreme volatility of the oil and gas components, overall recent export levels are little different from those of a year earlier, suggesting that the export surge in early 2000 has not continued into 2001. Import growth has, on the contrary, shown some pickup as repressed household demand and some strength in investment occurred in late 2000 and early 2001. Exports fell by 0.3 percent in the first six months of 2001 while imports grew by 28.4 percent. As a result, the merchandise trade surplus fell by 25.6 percent in the first half of 2001 relative to the same period in 2000.

The shrinking trade surplus constitutes a clear risk for any strong recovery of the economy. After the emergence of the financial crisis in 1997, exports rebounded faster than imports, providing a positive trade balance and cushioning the economy against continued private capital outflows and a deficit on the services account. The events of 11 September are likely to have an impact on Indonesia's service flows in the near term as tourism has fallen off due to heightened security concerns, insurance payments have increased, and risk premiums on both sovereign and private debt have risen. With the changing trade figures, the current account surplus as a whole fell by approximately 25 percent on a year-on-year basis in the first half of 2001. This decline is expected to continue with the moderation in the trade surplus, which is likely to end the year at around $3.5 billion, down from $8.0 billion in 2000.

Unlike other crisis-affected economies, Indonesia's foreign investment flows have not recovered from the collapse in 1997/98. Unresolved political uncertainties have discouraged capital inflows, while foreign investor confidence is low due to perceptions that the country is suffering from political or governance problems. This year, foreign investors have noted, in particular: security problems affecting mining and oil and gas companies, such as

ExxonMobil in Aceh; political interference in the asset sales process of the Indonesian Bank Restructuring Agency (IBRA); and an uncertain judicial environment as shown in the Manulife case (which involved officials from the police and judiciary conniving in attempted extortion against a foreign-owned subsidiary during a sale of government assets). A slowdown in official development assistance, reflecting especially the end of the crisis programs, is an additional factor in the balance-of-payments picture. Finally, the negative publicity resulting from political demonstrations in Indonesia related to ongoing world political tension and military conflict in Afghanistan will likely further reduce the potential for investment flows into Indonesia and perhaps exacerbate capital flight from the country.

***Exports rebounded faster than imports after the 1997 financial crisis, cushioning the economy against continued private capital outflows***




*Sources: Bank Indonesia Annual Report 2000, World Bank Consultative Group on Indonesia document for 2000, staff estimates*

Besides political and security concerns, a more demanding labor movement might be another factor behind capital outflows. Labor unrest in mid-June 2001 convinced the Government to rethink its plans to implement administrative decrees relating to severance or termination pay by private employers. These decrees aimed to reverse an earlier decree that mandated payouts upon severance. The business community regarded these payouts as unreasonably high—yet labor in their turn considered the subsequent plans unreasonable.

Indonesia's external debt increased in early 2001. At the end of April, total external debt was estimated to be $139.1 billion, with the public sector accounting for just over half.

Privatization and asset sales are expected to contribute Rp34.4 trillion in calendar year 2001, or 12.0 percent of total government revenue, a target that will be a challenge. In the past, opposition from political groups and vested interests has combined to frustrate public asset sales. By 31 July this year, IBRA had realized only 50 percent of its planned asset sales and the Government had not begun the planned but difficult process of privatizing 16 SOEs.

As well as encouraging asset sales, the Government needs to continue to strengthen the banking system—it was the risk of systemic failure in the banking system that led to the Government's assumption of debt and assets during the financial crisis. As part of the present moves at strengthening the system, Bank Indonesia has mandated that, by the end of 2001, banks meet (i) an 8.0 percent capital-adequacy ratio target and (ii) a ceiling on maximum nonperforming loans of 5.0 percent. Through the transfer of troubled loans to IBRA, the aggregate nonperforming loans of all commercial banks fell to 23 percent by the first quarter of 2001 from 50 percent at the beginning of 1999, still far above the 5.0 percent target. In October 2001, Bank Indonesia and IBRA took the step of closing one bank because its capital-adequacy ratio was negative; they were also likely to merge another four banks.

*Economic Management Issues.* Domestic economic weakness resulting from the financial crisis has limited the extent to which the authorities can use fiscal and monetary policy to boost domestic demand in the wake of the current slowdown in export growth. A relatively loose monetary stance has aggravated the inflationary and exchange rate picture. Bank Indonesia has moved to limit international transactions of the rupiah (other than those related to trade and payments) but this measure is unlikely to have much impact by itself. The basic problem has been relatively rapid growth in the monetary aggregates. From August 2000 through August 2001, narrow money grew by 22.2 percent and broad money by 12.9 percent. Although volatile on a month-to-month basis, the overall results are above government targets. Interest-rate movements might seem to indicate some evidence of tighter monetary policy. The central bank's one-month bill rate in August 2001 was more than 316 basis points higher than in December 2000. However, real interest rates showed no definite increase in the first half of 2001 and, as a result of the more rapid price increases in June and July, real interest rates fell during those months.

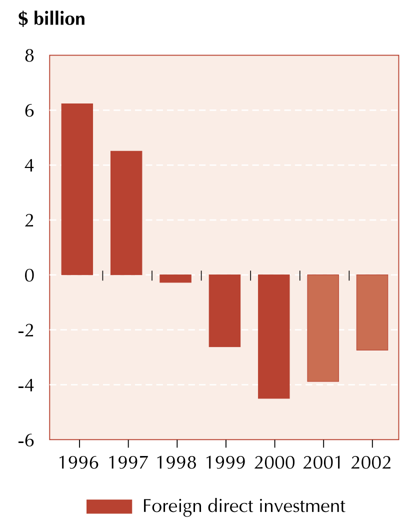
The 2001 budget has been revised several times as economic conditions have changed, particularly as regards the weakening rupiah and higher domestic interest rates. The latest budget revision, approved on 15 June 2001, targeted a 3.7 percent budget deficit. Central government spending is limited by large foreign and domestic public sector debts and softening world oil and gas prices. The very large domestic debt resulted from bank restructuring and associated public sector costs in the wake of the financial crisis. To meet deficit targets in the face of slack revenue mobilization, targeted current expenditures in 2001 were lowered in June 2001 from 17.9 percent of 2000 GDP to 14.5 percent. More than 91 percent of current expenditures are allocated to interest payments (6.1 percent of GDP), subsidies (4.5 percent), and public sector personnel expenditures (2.6 percent). Development expenditures are limited to 3.1 percent of GDP; approximately 90 percent of these are to be financed by official development assistance loans. As part of the revised 2001 budget plan, the Government increased the VAT rate from 10 to 12 percent, widened the tax base, and increased luxury and excise taxes.

The revised 2001 budget and the easing of political uncertainties in August paved the way for a new agreement with IMF over a stabilization program. The delay in this had heightened investor concerns and put at risk last year's Paris Club agreement. IMF had postponed the third disbursement under its extended fund facility to Indonesia, originally planned for September 2000. The IMF executive board reviewed the program in September 2001 and approved the disbursement of $395 million in new lending.

Through the end of August 2001, the Government has been quite careful in its fiscal affairs. Revenue collections are slightly ahead of targets, and expenditures close to targets. A report by the Ministry of Finance to Parliament revealed that 62.7 percent of expected total revenues and 55.0 percent of planned expenditures for the calendar year were realized by 31 August 2001. The actual budget deficit for the period was Rp7.8 trillion or 14.5 percent of the total planned deficit for the year (Rp54.3 trillion).

The 2002 budget was approved on 23 October after a six-week review by Parliament. The 2002 budget calls for total expenditures to fall from 23.2 percent of GDP in the 2001 budget to 19.6 percent. Development spending, still wholly financed by the central Government, will fall from 3.1 percent of GDP in 2001 to 2.8 percent in 2002. In her budget speech to

***Foreign investment flows have not recovered from the collapse in 1997/98***




*Sources: Bank Indonesia Annual Report 2000, World Bank Consultative Group on Indonesia document for 2000, staff estimates*

Parliament, President Megawati noted the importance of decreasing public subsidies for fuel by raising retail fuel prices. The Government has also announced that it will continue with plans to increase electricity prices in order to reduce the operating losses by the state electricity company. The overall government budget deficit is projected to fall to 2.5 percent of GDP in 2002 from 3.7 percent in 2001. Foreign funding is expected to account for 52 percent of next year's budget gap.

The installation of a new government and a new economic team must now be accompanied by efforts to stabilize the economy and relaunch reforms. Failure to meet the privatization and asset sales targets will jeopardize recovery prospects and further restrict development investment. To meet nontax revenue targets, many aspects of IBRA operations need attention, including a conflict of interest among IBRA employees who are also commissioners in companies to be restructured by the Agency. This is one aspect of the difficulties in overcoming vested interests in public sector privatization cases. Another is that there is no widespread political support for privatization, and outright opposition ranges from nationalist factions to those who resent the low postcrisis prices that might be attached to the many publicly held assets.

An important goal for the new Government is to improve governance generally, but specifically to make the legal and judicial system more effective in the context of the ongoing decentralization process. The commitment of the Government, at the highest levels, to address issues of corruption, collusion, and nepotism, known widely in Indonesia by the local-language abbreviation KKN, is strong. However, it is proving quite difficult for the authorities to show clear and significant progress.

*Forecast.* In 2002, GDP growth is likely to pick up to around 3.9 percent on the back of a gradual global recovery. Realization of this forecast would depend on an oil price of around $20 a barrel in 2002, and on prices of non-oil commodities staying at similar levels to 2001. Higher growth would be possible with significant improvements in political and security conditions.

Scheduled increases in administered prices of goods and services, plus the growing introduction of regional taxes, will put upward pressure on prices. Against this, the agreement with IMF on a more aggressive anti-inflationary stance for monetary policy calls for inflation in 2002 to be below double-digit levels. Success in this will require somewhat aggressive tightening of monetary policy, continued reforms in the banking sector, and some stabilization of the exchange rate. Continued slow growth of the global economy and the moderate economic recovery in Indonesia will reduce the trade surplus—higher import growth will likely accompany lower export growth. A smaller merchandise trade surplus plus the scheduled payment of external debts will virtually dissipate the current account surplus.

# MALAYSIA

*GDP growth decelerated sharply in the first half of 2001, as reflected across a wide array of sectors apart from services. Before the 11 September attacks on the US, the decline in industrial production seemed to be bottoming out, but given weaker than expected recent US economic data, economic growth may decelerate further over the rest of the year. Significant public infrastructure spending in the 2001 budget and further pump-priming measures announced in September may boost GDP growth in early 2002.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -7.4 | 6.1 | 8.3 | 0.8 | 4.9 | 3.1 | 6.0 |
| Inflation rate | 5.3 | 2.8 | 1.5 | 1.7 | 2.6 | 2.0 | 2.8 |
| Current account/GDP | 13.2 | 15.9 | 9.4 | 5.2 | 5.5 | 4.7 | 3.2 |

*Economic Assessment.* The broad-based growth that began in 2000 decelerated sharply in the first half of 2001 on a year-on-year basis to 1.7 percent, from 9.7 percent in the second half of 2000. On the demand side, much of the slowdown is explained by the drop in exports of electrical and electronic products and the knock-on effect on private consumption and gross fixed investment. Given that Malaysia's ICT exports account for more than 60 percent of total exports and that the US is its second largest market after the DMCs, the faster deceleration in US growth than expected at the time of *ADO 2001* has led to worse than expected export performance. Although Malaysia is diversified both in its range of ICT exports and its direction of trade, the secular downturn has occurred across most exports. In addition, the assumption in *ADO 2001* that intraregional trade might provide some cushion against an external shock from interregional trade has not held, because about 40 percent of Malaysia's total imports are electronic parts and components. Of this amount, close to 45 percent come from DMCs. The import concentration of ICT products ranges from 15 to 50 percent across the PRC, NIEs, and Southeast Asia. In addition, the export concentration of ICT products to DMCs from these economies ranges from 20 to 45 percent. Hence, any shock to regional ICT sector performance is immediately transmitted through intraregional trade.

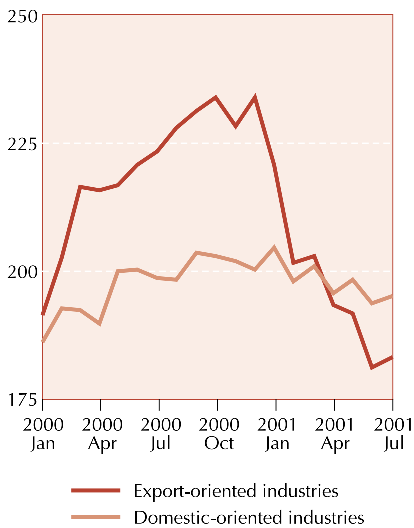
In terms of domestic demand, the expectation that the economy's diversity—consumption and investment account for roughly 36 percent and 20 percent of GDP, respectively—would mitigate any slowdown in exports has not held up that well either in the first half of 2001. Much of the high rates of fixed investment, which recorded a year-on-year increase of 24.1 percent in 2000, were in the ICT sector, contributing to a deceleration to 4.3 percent growth in the first half of 2001. Private consumption growth slowed to 2.9 percent in the first half of the year from 14.0 percent in the second half of 2000. Rising concerns about wage cuts and retrenchment, as reflected by a

4.0 percent unemployment rate in the first quarter of 2001, from an average of 3.1 percent in 2000, explain much of the downturns in private consumption and the consumer sentiments index.

In response to weakening aggregate demand conditions, and because domestic demand conditions are intricately linked to the external sector, manufacturing activity, which accounts for 29.6 percent of GDP, contracted by 6.7 percent year on year in the second quarter of 2001. The services sector, which accounts for 49.1 percent of GDP, expanded by 6.2 percent over this period, after 3.2 percent growth in the first quarter, supported by resilience in the finance, insurance, real estate, and business subsectors on the back of low interest rates.

*The falloff in electrical and electronic products has strongly affected industry...*

**Seasonally adjusted industrial production index (1993 = 100)**




*Sources: Bank Negara Malaysia (July 2001) Monthly Statistical Bulletin, CEIC Data Company Ltd.*

Price pressures remained subdued in the first half of 2001 with the CPI rising by 1.8 percent compared to the corresponding period of 2000. Weakening domestic demand and inventory correction were the major factors.

The trade surplus on a customs basis continued to narrow in the first and second quarters of 2001, reflecting the inadequate adjustment that imports have made to slowing demand conditions, in spite of severe falls in both capital and intermediate goods imports in the second quarter of 2001 of 11.2 percent and 11.0 percent, respectively, over the corresponding period of 2000. The trade surplus stood at RM12.5 billion in the second quarter of 2001 compared to RM13.3 billion in the previous quarter. The current account surplus widened from RM7.6 billion in the last quarter of 2000 to RM8.2 billion in the first quarter of 2001 due to a narrowing of the deficit in the services and income accounts, stemming from a large increase in freight charged and tourist inflows, as well as from lower dividend outflows from multinational corporations. The balance-of-payments deficit deteriorated in the first quarter of 2001 to RM10.3 billion from RM9.2 billion in the previous quarter. Much of the deterioration is on account of weakness in the capital account emanating from debt repayment, offshore asset acquisitions, and a rise in net external assets of domestic banks.

In response to the slowdown in global economic activity and negative repercussions for the economy, the Government has promoted public spending targeted at consumption and investment. Federal government expenditures rose by 43.4 percent and 59.1 percent in the fourth quarter of 2000 and the first quarter of 2001, respectively, although the impact on growth in the first half of this year seems limited. In August 2001, the Government announced a new fiscal package to be introduced in October's budget. In September, it stated that it would spend $1.1 billion to stimulate the economy. The total stimulus package announced through September, including a $790 million stimulus package of March 2001, was 2.3 percent of GDP. However, the effects of these measures are as yet unclear because only 6.7 percent of the March package has been spent. It is possible that the spin-off effects may be felt in the first half of next year, and may help support a modest recovery of domestic demand.

In September, the central bank cut the policy rate by 50 basis points to 5.0 percent, the first interest rate cut since August 1999. There is some room for monetary policy flexibility as external reserve positions have stabilized, some further US dollar weakness may be evident, and global easing of interest rates continues.

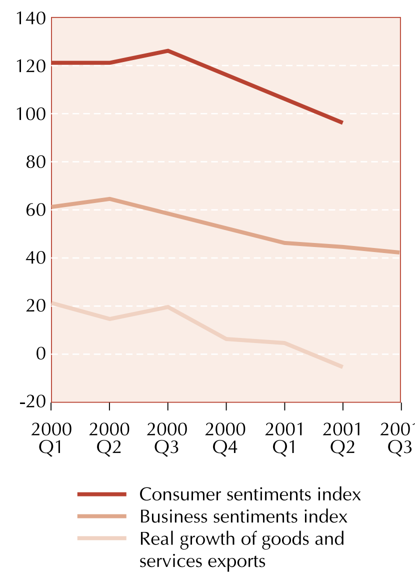
*Economic Management Issues.* In the short to medium term, Malaysia will remain affected by the cyclical nature of global ICT product demand, given its small economy. In particular, its current heavy reliance on exports of electronic parts and components may soon become a liability as lower-cost economies in Asia compete for market share of these low-end and low-skill products. As part of the Government's fiscal stimulus package, improvements of technical skills and infrastructure in the ICT sector would help move the economy up to more sophisticated product lines where it may face less competition from regional rivals. In addition, regulations have to be devised to encourage local competition in the ICT sector and consolidation of weak firms. In the telecommunications sector, for example, where fixed-line services are still dominated by the state monopoly—Telekom Malaysia—weak wireless operators survive in spite of high debt loads, and network quality requires significant improvement.

*Forecast.* GDP growth forecasts for the remainder of 2001 and 2002 depend on the extent of the US economic recovery, the effect of ongoing domestic fiscal stimulus packages, the extent of the continuing inventory adjustment process in the country, and the timing of the pickup in new US orders for ICT products, which are highly correlated with Malaysian exports of ICT products. On this basis, GDP growth is forecast at 0.8 percent and 3.1 percent for the whole of 2001 and 2002, respectively.

Price pressures are expected to remain subdued for the rest of this year, while a slight rise in the CPI is expected next year as domestic demand conditions improve, suggesting increases of 1.7 percent and 2.0 percent, respectively, for 2001 and 2002.

The current account surplus is expected to narrow to 5.2 percent of GDP in 2001 due to the delayed downward adjustment of capital and intermediate goods imports, in spite of a significant contraction in manufacturing. In 2002, on the back of a solid pickup in manufacturing, a modest improvement in exports, and greater demand for inputs (which have a high import concentration), the current account surplus is expected to further narrow to 4.7 percent of GDP.

***...while general sentiment turns gloomier***




*Sources: Bank Negara Malaysia (July 2001) Monthly Statistical Bulletin, CEIC Data Company Ltd.*

# PHILIPPINES

*The global economic slowdown has led to a sharp decline in exports, although relatively robust domestic demand has partially offset this fall in the Philippines. GDP growth over the rest of the year is likely to be weighed down by continued external sector weakness. Decisive measures are needed to improve public finances if growth is to be sustained in the medium term.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -0.6 | 3.4 | 4.0 | 2.7 | 3.1 | 3.0 | 4.2 |
| Inflation rate | 9.7 | 6.7 | 4.4 | 6.3 | 7.0 | 5.5 | 6.0 |
| Current account/GDP | 2.4 | 10.0 | 12.5 | 4.9 | 8.0 | 4.5 | 5.0 |

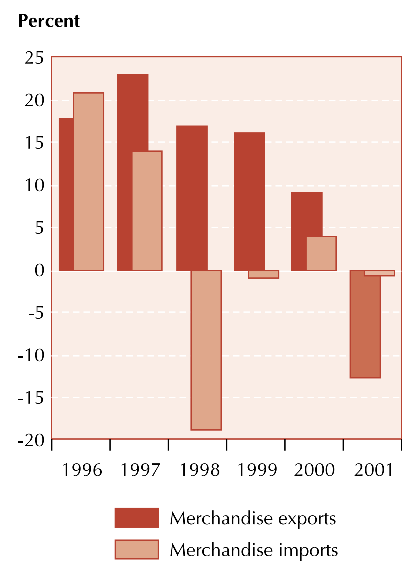
*Economic Assessment.* The global slowdown, which has been more pronounced than expected at the time of *ADO 2001*, has led to a steep decline in demand for exports from the Philippines. However, firm domestic demand has largely offset this weaker export growth, resulting in a year-on-year GDP growth rate of 3.3 percent in the first half of the year compared to a corresponding figure of 3.8 percent growth in the same period of 2000. On an expenditure basis, exports contracted by 4.1 percent year on year in the second quarter of 2001 after rising by 5.4 percent in the first. Although import growth has outpaced that of exports so far this year, continued weakness in the import-intensive export sector has led to a slowdown in imports in recent months. The weakness in net exports has been balanced to some extent by a pickup in public investment and continued steady growth in private consumption. The former is due to considerably higher government spending on construction activity, and the latter is due largely to higher agricultural incomes.

On a production basis, GDP growth was led by the services sector, especially in trade and private services, reflecting quite robust domestic demand. In the industry sector, growth averaged 2.7 percent year on year in the first half of 2001, compared to 3.9 percent growth in the corresponding period of 2000, reflecting a steep fall in manufacturing output due to the global economic slowdown. Favorable weather, the rehabilitation of irrigation canals, and the continuing adoption of better technology led to a year-on-year 3.0 percent increase in agricultural output in the first six months of the year, compared to 2.3 percent growth in the first six months of 2000. Against this backdrop of steady growth, the unemployment rate fell to 10.1 percent of the labor force in July 2001, from 11.2 percent in July 2000.

For the first nine months of the year, inflation averaged 6.6 percent. Although considerably higher than the 3.7 percent recorded in the corresponding period of 2000, inflation remained within the Government's target range of 6.0-7.0 percent for 2001. Generally stable food prices, due to sufficient supplies from domestic farmers and ample imports of rice, compensated for the rise in nonfood prices caused in part by the peso's depreciation against the dollar. In September 2001, year-on-year inflation at 6.1 percent was markedly below the year-on-year rate of 6.8 percent in July, due to an easing of food prices—after earlier typhoon-related disruption to production—and greater exchange rate stability.

During the first eight months of the year, merchandise exports posted a year-on-year decrease of 13.0 percent, due to the slowdown in the US and the slump in global electronics demand. Although merchandise imports have declined in recent months, reflecting slower export growth and domestic demand, for the first eight months of 2001 year-on-year imports declined by only 0.8 percent. As a result, the trade surplus fell to $704 million from $3.7 billion in the corresponding period of 2000. Data for the first seven months of this year indicate that the services and income surplus also declined, due to fewer tourist arrivals and lower worker remittances from abroad. As a result, in the first seven months of 2001 the current account surplus fell to $1.2 billion from $4.4 billion in the corresponding period of 2000.

***Merchandise exports switched from growth to contraction in the first eight months of 2001...***




*Source: www.census.gov.ph*

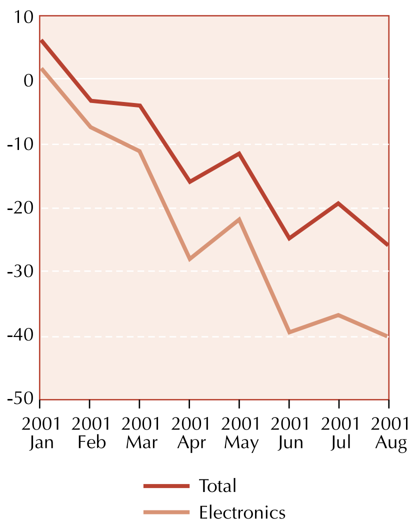
*Economic Management Issues.* Fiscal and monetary policies will be used to support domestic economic activity, but a large public debt burden, relatively high inflation, and exchange rate volatility constrain the extent to which countercyclical policies can be used to stimulate domestic demand. After two years of budget deficits exceeding P100 billion, the Government has committed itself to a deficit-reduction program, which should lead to a balanced budget by 2006. For 2001, the budget deficit has been set at P145 billion, or 4.0 percent of GDP. Although the deficit in the first seven months of the year was P11 billion better than target, this was achieved almost entirely by reduced expenditures since revenues remained below target.

The aim for 2002 is for the fiscal deficit to be further reduced to P130 billion (3.3 percent of GDP). Consistent with the Government's objective of maintaining lower interest rates and preventing crowding out of the private sector, a higher proportion of budgetary financing in 2002 is to come from foreign sources. While a greater emphasis is to be placed on concessional official development assistance, the Government will nevertheless continue to rely heavily on market sources. This, together with rising yield spreads, raises some concern over the sustainability of external borrowing as a means of financing. In the medium term, fiscal consolidation will only be sustainable if it is based on enhanced revenue-raising measures. Expenditures will remain severely constrained by existing debt service obligations (amounting to over 30 percent of expenditures in 2000), limiting the extent to which resources can be used for social and infrastructure investment.

Having raised interest rates sharply in 2000 to defend the peso, the central bank has steadily lowered policy rates this year mirroring, to a degree, rate cuts by the US Federal Reserve. By 18 May 2001, the central bank's overnight borrowing and lending rates had come down to 9.0 percent and 11.25 percent, respectively, from 13.0 percent and 15.25 percent in January 2001. However, following a sudden depreciation of the peso in June and July, monetary policy was tightened to stabilize the currency. With this achieved, a

***...largely due to declining external demand for electronic products***

**Percent change in exports, year on year**




*Source: www.census.gov.ph*

relatively moderate inflationary outlook for the rest of the year and a continued easing bias of the Federal Reserve have once again provided the central bank with greater flexibility to reduce interest rates. On 2 October, it cut interest rates by a further 25 basis points. Lower rates will ease pressure on the commercial banks that face a rising incidence of nonperforming loans. As of July 2001, the ratio of nonperforming loans to total loans had increased to 17.7 percent from 14.0 percent in early 2000. This has put a drag on loan growth as risk-averse banks generally choose to invest in Treasury securities rather than to lend.

*Forecast.* Given the sharper than expected global slowdown, together with the loss of confidence and heightened uncertainty generated by the recent terror attacks on the US, GDP growth for 2001 is expected to slow to 2.7 percent compared to the forecast of 3.1 percent made in *ADO 2001*. In 2002, GDP growth is likely to pick up to around 3.0 percent on the back of an anticipated gradual recovery in global growth. Although domestic demand will remain relatively robust, government consumption will slow in line with a planned reduction in the fiscal deficit. For 2001, inflation is likely to average 6.3 percent (under the assumption that oil prices do not increase in the fourth quarter). In 2002, inflation is likely to come down to around 5.5 percent, assuming that weather patterns are normal, oil prices remain at $22-$28 per barrel, and the exchange rate is fairly stable. On the external front, the current account surplus is expected to narrow to 4.9 percent of GDP in 2001 due to a smaller trade surplus, reduced numbers of tourists due to security concerns, lower worker remittances, and higher net interest payments. In 2002, the current account surplus is forecast to narrow further to 4.5 percent of GDP as import growth continues to outpace export growth.

# THAILAND

*GDP growth is expected to slow in 2001 due to considerably weaker export growth coupled with sluggish domestic demand. Growth is likely to pick up in 2002 on the back of a gradual global recovery and the Government's planned fiscal stimulus measures. Sustained growth will, however, depend on continued progress in finance sector reforms and corporate debt restructuring to improve profitability and investor confidence.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -10.8 | 4.2 | 4.4 | 1.5 | 3.5 | 2.5 | 4.5 |
| Inflation rate | 8.1 | 0.3 | 1.6 | 2.3 | 2.0 | 2.6 | 2.6 |
| Current account/GDP | 12.7 | 10.0 | 7.5 | 3.8 | 6.5 | 2.3 | 5.6 |

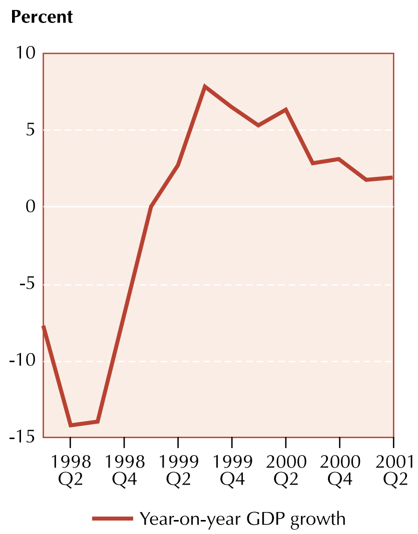
***Economic Assessment.*** The global economic slowdown is having a more significant impact on the Thai economy than expected at the time of *ADO 2001*. In the first half of 2001, considerably weaker export growth, together with sluggish domestic demand, led to a GDP growth rate of 1.9 percent year on year, compared with a year-on-year growth rate of 5.8 percent in the first half of 2000 and 3.0 percent in the second.

On a production basis, two key indicators of growth during the first half of 2001 were below the level of a year earlier. The manufacturing production index rose by only 1.4 percent year on year, compared to 3.0 percent in 2000, with major declines in electrical and electronic appliances and tobacco production. The industrial capacity utilization rate was 55.5 percent in the first quarter of 2001, but dropped to 51.9 percent in the second, compared with an average of 56.0 percent in 2000. Following an increase in crop and livestock production, the agriculture sector expanded by 1.9 percent in the first half of 2001, a slight rise from the 1.3 percent growth in the first half of 2000. The growth of government consumption expenditure remained broadly flat, reflecting a lack of fiscal stimulus, while private consumption expenditure continued to improve partly due to strengthened agriculture output and an increase in civil servants' salaries in April 2001. The decline in exports was, however, offset in the first half of the year by an even sharper decline in imports, owing to the import-dependent nature of exports and depressed investment activity.

For the first nine months of the year, inflation averaged 1.9 percent, compared to 1.5 percent in the corresponding period of 2000. This was mainly due to baht weakness feeding through into higher prices. Since August, however, the rate of inflation has remained flat due to excess capacity and weaker domestic economic activity.

In the first eight months of 2001, merchandise exports contracted by 3.7 percent (in dollar terms) compared to the corresponding period of 2000. The decline in exports was seen across the board, reflecting the breadth of the global slowdown. Import growth over this period represented a 2.4 percent increase compared to January-August 2000. However, due to the fall in export demand and domestic economic weakness, the demand for imports appears to have weakened considerably in recent months with year-on-year contractions of 8.2 percent, 3.8 percent, and 16 percent in June, July, and August, respectively. As a result, the trade surplus narrowed to $1.2 billion in the first eight months of 2001 from $3.8 billion in the corresponding period of 2000. This was partly offset, however, by a surge in tourism arrivals stimulated by the steady weakening of the baht. Nevertheless, the current account surplus narrowed to $3.8 billion in the first eight months of 2001 from about $6.5 billion in the corresponding period of 2000.

*The global economic slowdown accentuated declining GDP growth...*




*Source: National Economic and Social Development Board*

The capital account remained in deficit as banks and nonbanks continued their scheduled debt-servicing obligations, leading up to an overall balance-of-payments deficit in the first eight months of 2001. Total external debt dropped to $73.0 billion at the end of July 2001, from $79.7 billion at the end of 2000. International reserves eased to $32.6 billion in August 2001 from $32.7 billion at the end of 2000.

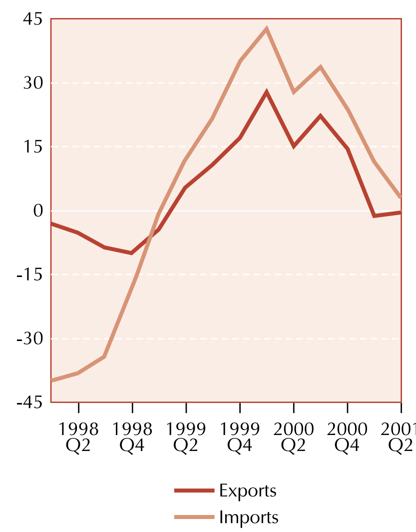
*Economic Management Issues.* Given weakening external demand, domestic demand recovery is crucial to economic growth that is hampered by incomplete restructuring. The Government's planned deficit-spending measures will provide some support for domestic demand. For fiscal year 2002 (ending 30 September 2002), the budget deficit is envisaged at B200 billion, or 3.7 percent of GDP, an increase of B95 billion over the estimated budget for fiscal year 2001. The higher budget deficit reflects increased spending on public health care, a debt moratorium for farmers, a "village fund" to stimulate economic activity. The revenue intake for fiscal year 2001 is projected to remain flat due to cuts in the corporate tax rate and a deferment of a proposed increase in VAT from 7 percent to 10 percent to 2002. To finance the projected fiscal deficit, the Government plans to borrow mainly from the domestic capital market through Treasury securities, because private commercial banks have high levels of liquidity and domestic interest rates are at low levels.

On 8 June 2001, the Bank of Thailand raised its 14-day repurchase rate from 1.5 percent to 2.5 percent, causing other money market rates to rise accordingly. The adjustment of the 14-day repurchase rate is intended to discourage refinancing of foreign debts in domestic markets and to increase consumption among those receiving bank interest. However, commercial bank rates have not moved, with the three-month time deposit and minimum lending rate of the five largest banks remaining at 2.5 percent and 7.5 percent, respectively. The Bank of Thailand is confident that moderate inflation and falling US interest rates will allow it to maintain an accommodative stance without risking a further significant fall of the baht.

Nonperforming loans (NPLs) of the banking system were reduced to B614.8 billion, or 12.5 percent of total outstanding loans, at the end of August 2001 from B863.7 billion, or 17.7 percent, at the end of 2000. The reduction was mainly due to the transfer of NPLs to bank-owned asset management companies, and only partly due to the progress of corporate debt restructuring, which has slowed, to some extent due to an inadequate legal framework. There has also been some concern over the quality of financial restructuring as reentry NPLs—restructured loans reverting to NPL status—have been on the rise. To promote the efficient management of NPLs and enhance corporate restructuring, the Government established the centralized Thai Asset Management Corporation (TAMC) in June 2001. TAMC plans to acquire and manage B1.35 trillion in NPLs, the overwhelming majority of which belong to state banks. The Government has granted TAMC special legal powers, enabling it to bypass the existing slow court procedures in order to expedite the restructuring process. However, given the limited participation of private banks in TAMC, legal and judicial reforms will need to be accelerated to support debt restructuring outside the TAMC framework.

*...as export demand fell and import demand weakened*

**Percent change in year-on-year merchandise trade**




*Source: Bank of Thailand*

*Forecast.* The 11 September attacks on the US, against a backdrop of an already weakening global economy, have further worsened the outlook for the Thai economy in the short term. GDP growth is now estimated to slow to 1.5 percent for the whole of 2001, compared to the *ADO 2001* forecast of 3.5 percent, due to considerably slower export growth and investment activity. In 2002, GDP growth is likely to pick up to around 2.5 percent on the back of an expected gradual recovery in global growth and planned fiscal stimulus measures for fiscal year 2002. Growth also remains highly dependent on continued progress in finance sector reforms and corporate debt restructuring to improve profitability and investor confidence. During the remainder of 2001, inflation is likely to pick up somewhat, largely on account of the continued depreciation of the baht. The postponement of the increase in VAT will help contain domestic inflation. Inflation is projected to rise to around 2.3 percent in 2001 and further to about 2.6 percent in 2002 as the widening fiscal deficit stimulates domestic demand. The current account balance is expected to narrow to 3.8 percent of GDP for the whole of 2001 due to a contraction in exports and reduced tourist arrivals during the remaining months of the year owing to heightened security concerns. The current account will narrow further to 2.3 percent in 2002 as import growth continues to outpace export growth.

# VIET NAM

*Growth in 2001 is expected to slow as the external environment worsens and agriculture sector performance weakens. In an attempt to boost the economy, the Government has allowed faster depreciation of the dong, focused its fiscal stimulus on reviving rural demand, and liberalized interest rates. However, a more potent source of higher growth would be the removal of distortions in the economy.*

| **Economic Indicator** (percent) | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|
| | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| GDP growth | 4.4 | 4.7 | 6.1 | 6.0 | 6.4 | 6.2 | 6.9 |
| Inflation rate | 7.9 | 4.1 | -1.7 | 0.5 | 3.0 | 3.0 | 5.0 |
| Current account[a]/GDP | -4.6 | 4.1 | 1.7 | 2.0 | -0.1 | -3.0 | -1.9 |

[a] Excludes official transfers.

*Economic Assessment.* The 11 September terror attacks on the US, compounding the effects of an already weakening global economy, have worsened the near-term prospects for Viet Nam. The sharp downturn in the US and the worldwide slump in the ICT sector are, however, likely to have a less direct impact on Viet Nam than on some other regional economies because its trade with the US is currently at a low level and its ICT sector remains undeveloped. However, these factors have indirect effects on the economy, which is experiencing slower trade with Asian economies (other than the PRC), particularly those that depend on trade with the US and on ICT exports. Moreover, the economy of Japan—the country's largest trading partner—continues to stagnate, affecting Viet Nam's economic performance. Expectations of a prolonged global slump weakening commodity and oil prices, and a softer rebound in 2002 than previously anticipated are also likely to hit the more cyclical exports.

GDP growth is now projected to slow to 6.0 percent in 2001, from 6.1 percent in 2000, and compared with the forecast of 6.4 percent in *ADO 2001*, due to the worsening external environment and weaker than anticipated performance of the agriculture sector. Low world prices of agricultural commodities have affected the sector's growth, which is expected to slow from 3.9 percent in 2000 to 3.5 percent in 2001. The strong recovery in industrial growth seen in 2000 is likely to moderate to 9.4 percent in 2001, reflecting slackening domestic demand and the slowdown in external demand. Although services sector growth has so far been sustained, this may not continue over the rest of the year as receipts from tourism are adversely affected due to heightened security concerns.

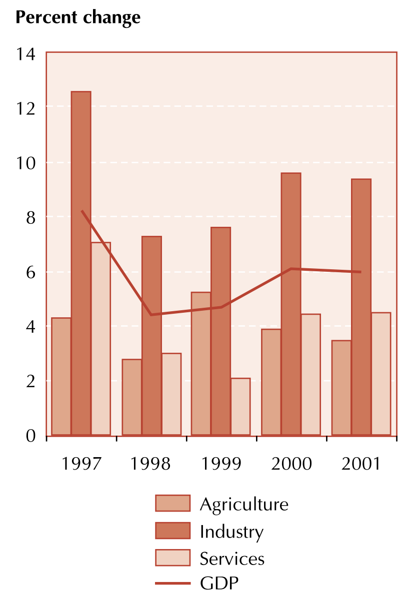
On the demand side, the resilience of domestic demand has so far counterweighed weakening external demand for Viet Nam's exports. While private consumption remained strong in the first half of 2001, weak rural demand due to the slump in agricultural prices is likely to dampen domestic demand over the year. The recovery in investment continues, led by domestic investment; the many new enterprises registered under the Enterprise Law bear witness to this. Although FDI commitments from Japan; Korea; and Taipei,China remain strong, realized investments are likely to be adversely affected by the economic slowdown in these three economies.

Export growth decelerated in the first half of 2001, in both oil and non-oil exports. The dip in crude oil prices has checked the surge in oil revenues that dominated export performance in 2000. Growth in the value of agricultural exports remains sluggish, particularly for rice and coffee, where higher export volumes have hardly offset declining world prices. Manufactured exports have also fared poorly, with slowing export growth of footwear and textiles due to subdued demand from the region and Europe. Against this broad weakening of export performance, marine products have stood out as strong performers. Merchandise export growth for the whole year is projected at around 12 percent. Compared to the strong recovery of imports in 2000, growth in 2001 has, thus far, been relatively modest; for the full year it is estimated at 10 percent. As a result of slower import growth, the current account balance is likely to remain in surplus in 2001. On the capital account, FDI inflows strengthened in the first half of 2001. Medium- and long-term loan disbursements have also risen, reflecting credits under IMF's Poverty Reduction and Growth Facility (PRGF), and the World Bank's Poverty Reduction Support Credit (PRSC). Due to these increased capital flows, gross reserves are expected to rise from $3.4 billion at end-2000 to $3.9 billion at end-2001, providing 12.6 weeks of import cover.

Consumer price inflation continued to fall in the first half of 2001 due to the decline in food prices, which dominate the CPI basket. It is, however, likely that inflation will rise in the latter part of the year as nonfood prices rise and the effect of faster dong depreciation feeds through to domestic inflation. After rapid expansion in 2000, credit growth slowed in the first half of 2001. The dong, relatively stable in the first quarter of 2001, began to depreciate faster in May. By end-August, it was trading at 14,980/$, down by 3.2 percent from the beginning of the year.

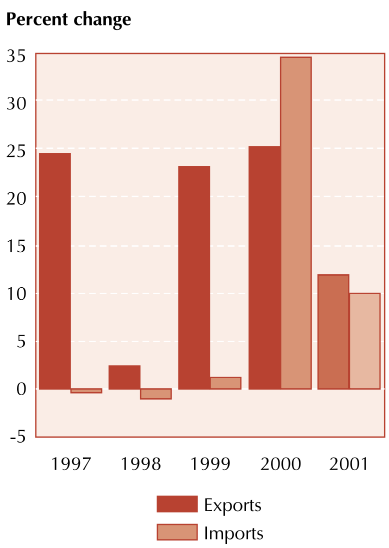
The Government's response to slower economic growth has been to maintain its fiscal stimulus and cut interest rates to buttress domestic demand, and allow a faster depreciation of the dong to boost external competitiveness. As part of the stimulus, to support farmers and exporters hurt by the slump in agricultural prices, the Government has stepped up public spending on rural infrastructure projects. In addition to lowering interest rates—on 1 May 2001 the State Bank of Viet Nam (SBV) reduced its prime monthly rate to 0.65 percent from 0.75 percent—the Government has further liberalized interest rate policies. Since 1 June, banks have been able to set dollar lending rates in line with the international market. On 1 August, the SBV relaxed its policy on the rates at which locally based companies borrow from overseas. To enhance export competitiveness, the Government has allowed the dong to depreciate since May 2001. However, the effects of the Government's announced intention to allow greater flexibility to SBV in managing the currency's crawling peg are likely to be tempered by its preference to minimize the dollar-denominated

***Sectoral growth begins to moderate***




*Sources: General Statistical Office, staff estimates* debt burden of SOEs. In another liberalization measure, and a further step toward current account convertibility, the SBV lowered the foreign exchange surrender requirement on export proceeds from 50 percent to 40 percent. As a result of the fiscal stimulus, the fiscal expenditure to GDP ratio (including on-lending) is expected to rise to 25.0 percent in 2001. Revenue growth in 2001 is forecast to slow, reflecting lower oil revenues and tax collection (income tax rates for professionals are being cut). The revenue to GDP ratio is estimated at 19.8 percent for 2001. Given these expenditure and revenue trends, the fiscal deficit is expected to widen to 5.3 percent of GDP in 2001.

***Export growth will decelerate sharply in 2001***




*Sources: State Bank of Viet Nam, www.undp.org, staff estimates*

*Economic Management Issues.* The above measures are expected to help sustain growth. However, a more potent source of higher growth would be the removal of distortions in the economy, including those in the key areas of banking, SOEs, trade, private sector development, and FDI. The Government's commitment to the removal of some of these distortions has recently been underscored by the successful conclusion of its four-year negotiations with IMF and the World Bank, which centered on a program of structural reforms. The program, to be supported by concessional assistance under the PRGF and PRSC, encompasses these key areas. The plans for banking sector restructuring include phased recapitalization of state-owned commercial banks conditional on improvements in their performance and greater transparency in policy-based lending. SOE reform plans include equitization/restructuring of around one third of the SOEs. They also call for strengthened financial discipline of SOEs through curbing credit to loss-incurring enterprises and monitoring the credit use of large SOEs that are targeted under the program. Trade reform plans are based on the implementation of commitments under the US Bilateral Trade Agreement and the ASEAN Free Trade Area and on the removal, on a multilateral basis, of quantitative restrictions on six out of the current 11 items by the start of 2003. Private sector development and FDI are to be promoted through easing barriers to entry and liberalizing the business environment for both domestic and foreign investors, and through improving policy transparency. It is estimated that the structural costs of reform could be as high as 12 percent of GDP. However, sustaining high growth will depend crucially on effective implementation of these reforms.

*Forecast.* The GDP growth rate in 2002 is likely to pick up slightly to 6.2 percent, in part due to a projected boost to exports, imports, and FDI induced by the US Bilateral Trade Agreement. This will, however, be partially offset by a delayed recovery in the US. The recovery in international rice prices will likely revive agriculture sector performance, but also lead to higher domestic inflation. It is anticipated that the fiscal deficit will widen further as the pace—and concomitant increase in fiscal costs—of implementing structural reforms increases. It is, however, likely to remain manageable. The current account balance will probably shift into deficit as import growth accelerates due to the greater volumes of intermediate goods imports that are needed to underpin higher investment. However, external borrowing and foreign investment will finance it comfortably.

# SOUTH ASIA

*Prior to the 11 September terror attacks on the US, South Asia had been less affected by the global economic slowdown and the downturn in the electronics cycle due to its relatively closed economies. The attacks, however, worsened the external outlook for the subregion. Domestic constraints, including adverse weather, widening fiscal deficits, political uncertainty, and lagging structural reforms, also continue to hinder subregional prospects.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | 5.8 | 5.9 | 5.1 | 5.2 | 5.8 | 5.7 | 6.5 |
| Inflation rate | 6.3 | 4.2 | 6.4 | 4.8 | 5.4 | 4.8 | 4.8 |
| Export growth | -0.1 | 4.4 | 17.2 | 5.2 | 10.6 | 5.9 | 12.4 |
| Import growth | -5.7 | 10.5 | 7.3 | 5.3 | 6.8 | 6.7 | 8.3 |
| Current account/GDP | -1.4 | -1.7 | -1.1 | -1.6 | -1.7 | -1.9 | -1.5 |

*Economic Assessment.* Weaker growth in the US and EU, South Asia's main export markets, has led to a deceleration in India's exports of software and cut diamonds, Pakistan's exports of cotton, and subregional exports of textiles and ready-made garments. The events of 11 September, coming on top of this global slowdown, have further weakened the outlook for the subregion in the short term. An immediate consequence has been to increase freight charges to and from Pakistan due to its perception as a war zone. At the same time, Pakistan textile and garment manufacturers have seen cancellations of export orders and a sharp drop in new orders because importers feel that they will be unable to maintain their existing production schedules due to uncertainty about current US actions in neighboring Afghanistan and the resultant impact on Pakistan. The prevailing uncertainty is also having an adverse budgetary impact, with the Government of Pakistan having to incur additional expenses associated with an increased number of refugees, and maintaining law, order, and defense preparedness. More generally, subregional exports and investment inflows are likely to be negatively affected by more subdued global demand and a loss of investor confidence. Heightened security concerns have already affected tourism arrivals in India, Maldives, Nepal, and Sri Lanka. Recent events are also likely to hurt remittances from South Asians working in the Middle East and the US. Although both India and Pakistan are likely to benefit from increased access to concessional aid and foreign investment inflows following the recent removal of the remaining sanctions imposed on them after their 1998 nuclear tests, the near-term economic impact is unlikely to be significant.

On the domestic front, bad weather in India, Nepal, Pakistan, and Sri Lanka led to depressed agricultural activity and private consumption growth earlier in the year. Manufacturing output in India, Pakistan, and Sri Lanka has been affected by the slowdown in exports and a shortage of power caused, in part, by a drought-induced fall in hydropower generation.

In Bangladesh and Nepal, manufacturing activity has also been affected by work stoppages and strikes. Slower export growth is likely to hold back domestic consumption, and domestic and foreign investment, in the subregion. Investment has also been affected by political uncertainty and lagging structural reforms. Weaker economic growth and reduced international trade flows are leading to shortfalls in revenue collections and to pressure on fiscal balances. This is likely to constrain the extent to which fiscal policy can be used to stimulate domestic demand and offset export deceleration. As a result of these developments, GDP growth in the subregion is likely to slow to 5.2 percent in 2001, from the *ADO 2001* forecast of 5.8 percent.

In 2001, subregional export growth (in US dollar terms) is expected to decline to 5.2 percent from 17.2 percent in 2000. The slowdown in exports has, to some extent, been offset by a relatively modest slowdown in imports arising from weaker domestic demand and the import-dependent nature of exports. As a result of slower export growth, reduced inflows of worker remittances, and lower earnings from tourism, the current account deficits of subregional economies are likely to widen somewhat in 2001.

Higher subregional inflation during the first half of 2001—stemming from poor agricultural harvests (India and Pakistan) and higher administered prices (Pakistan and Sri Lanka)—is likely to ease during the rest of the year due to an expected recovery in the agriculture sector and restrained domestic demand. In Pakistan and Sri Lanka, downward pressure on inflation will, to some extent, be balanced by currency depreciation and the removal of subsidies.

*Economic Management Issues.* Fiscal imbalances continue to be a drag on economic growth throughout the subregion. Despite recent efforts at restructuring state and central government finances, fiscal deficits remain large and are continuing to rise. Near-term prospects are for a further deterioration in these deficits as slower economic activity leads to revenue shortfalls and increased pressure for fiscal stimulus. In addition, greater political opposition to the proposed widening of tax bases and the selling of public assets in some South Asian countries will reduce prospects for significant revenue enhancement. Fiscal discipline, however, remains critical for both domestic and foreign investor confidence and for sustaining private sector activity. While depressed domestic economic activity would suggest that the costs of borrowing and crowding-out effects associated with large fiscal deficits are not the main reasons for current weak levels of private investment, such considerations will nevertheless be more important as subregional economic activity picks up. High fiscal deficits, however, affect private investment through the quality of public expenditure and its impact on the overall environment in which businesses operate. With public debt rising significantly, a large and increasing portion of government revenue goes toward interest payments—a situation in recent years that has led to smaller fiscal space for development and infrastructure expenditures.

Partly as a consequence of this, persisting infrastructure bottlenecks are preventing subregional economies from reaping the benefits that are offered by market reforms and trade liberalization. For example, transport sector bottlenecks and power shortfalls are proving to be a constraint on sustained economic growth. Faced with severe budgetary constraints, subregional governments need to encourage foreign investment in infrastructure, and to implement appropriate regulatory policies governing the relationship between private and public provision of infrastructure services. Although governments in the subregion are now more aware of what needs to be done to overcome infrastructure constraints, the political economy of these reforms is very complex and, consequently, progress to date has been slow.

Another challenge facing the subregion, and one that has failed to generate sufficient attention in the current global electronics-led slowdown, is the need for export diversification, both of products and export markets. Although South Asian countries are not as dependent on electronics exports as their Southeast Asian and East Asian counterparts, they depend heavily on textile and garment products, as well as on the US market. As a share of total exports, individual country exposure to textile and garment exports varies from over 25 percent for India to around 75 percent for Bangladesh, whereas exposure to the US varies from over 20 percent for India and Pakistan to over 30 percent for Bangladesh and Sri Lanka. The subregion as a whole needs to continue making progress in trade liberalization, labor market reforms, and human resources development to provide the greater flexibility for it to take full advantage of opportunities that the globalized economy provides.

***Forecast.*** In 2002, the dampening effect on external demand of a deeper and more protracted global slowdown is likely to be offset to some extent by a pickup in domestic demand if expectations of stronger agricultural performance materialize. Revival of agricultural growth will be accompanied by a moderate improvement in the industry and services sectors. The latter sector is also likely to benefit from further subregional efforts to liberalize the services sector. As a result, subregional GDP growth is projected to increase moderately to 5.7 percent in 2002.

The overall current account deficit for the subregion is likely to deteriorate further in 2002, as subdued export growth is accompanied by faster import expansion due to a pickup in domestic economic activity. Imports of investment goods are, however, likely to be contained due to significant excess capacity in India. Under the assumption of normal weather conditions, subregional inflation is likely to remain broadly stable in 2002. Low food-price inflation, due to the availability of ample food supplies, will be offset by demand-related inflationary pressures resulting from increased economic activity and utility price increases imposed by governments in the subregion, in an attempt to rein in higher fiscal deficits.

# BANGLADESH

*During fiscal year 2001, Bangladesh posted figures for robust economic growth and low inflation, due mainly to a bumper harvest and a revival of growth in the industry sector. However, a deteriorating external environment and mounting fiscal imbalances could undermine economic growth over the short to medium term.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | 5.2 | 4.9 | 5.9 | 6.0 | 5.7 | 5.5 | 6.0 |
| Inflation rate | 7.0 | 8.9 | 3.5 | 1.5 | 3.0 | 3.0 | 5.0 |
| Current account/GDP | -1.1 | -1.4 | -1.0 | -2.0 | -1.5 | -2.5 | -1.8 |

***Economic Assessment.*** The GDP growth rate in 2001 is now estimated at about 6.0 percent compared with a forecast growth rate of 5.7 percent made at the time of *ADO 2001*. Another bumper crop and a rebound of the industry sector contributed to this strong growth performance.

Foodgrain production in 2001 topped 26.8 million tons, representing growth of 7.6 percent over the preceding year. Favorable weather, expanded cultivation of high-yielding varieties, and improved availability of inputs at reasonable prices were all factors in another record harvest. However, despite the agriculture sector's large production increases, year-on-year growth was modest due to a high base for comparison, following record harvests in both 1999 and 2000.

Despite sporadic political unrest and mounting infrastructure constraints in the country, industry sector growth is estimated at 8.7 percent in 2001, compared with 6.2 percent in 2000. Higher growth was due mainly to a surge in output of export-oriented industries, namely garments, processed foods, and chemicals. Small-scale industries also registered an upturn in output. However, the traditional jute industry stagnated and construction growth slowed. Growth in the services sector was sustained by notable improvements in catering, telecommunications, and finance.

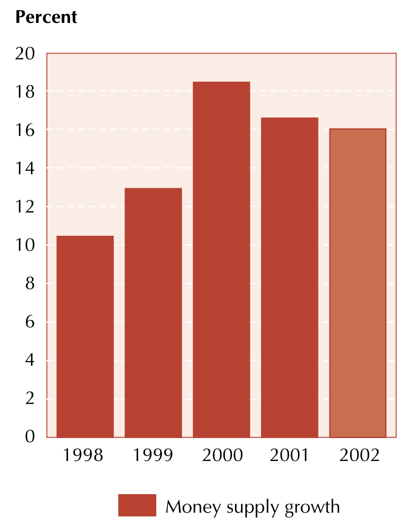
In 2001, investment activity increased moderately to 23.6 percent of GDP from 23.0 percent in the preceding year. Despite an increase in domestic savings, gross national savings declined to 21.6 percent of GDP in 2001 due to a decline in remittances from overseas workers. The country is yet to establish a well-functioning finance sector to mobilize domestic savings effectively.

The Government's revenue collection improved to 9.4 percent of GDP during 2001, compared with 8.5 percent in 2000. Despite this improvement, the revenue/GDP ratio continues to be one of the lowest among developing

2001 refers to fiscal year 2000/01, ending 30 June.

countries. An increase in imports, the introduction of a compulsory pre-shipment inspection scheme, and strengthened tax administration contributed to increased revenue collection. However, the budget deficit remained high at 6 percent of GDP on account of a sharp surge in expenditures. The fiscal deficit would have been substantially higher if quasi-fiscal activities, such as deficits among SOEs outside the annual development program, had been taken into account. A trend toward increased reliance on domestic borrowing, which amounted to some 3.5 percent of GDP in 2001, to finance the budget deficit remains a cause for concern because this is costlier than foreign financing. As a result of increased domestic borrowing, the Government's interest payment liabilities are rising. The ratio of interest payments on domestic debt to revenues rose from an already high 12.0 percent in the original 2001 budget to 13.6 percent in the revised 2001 budget estimates.

*Monetary policy remained expansionary*



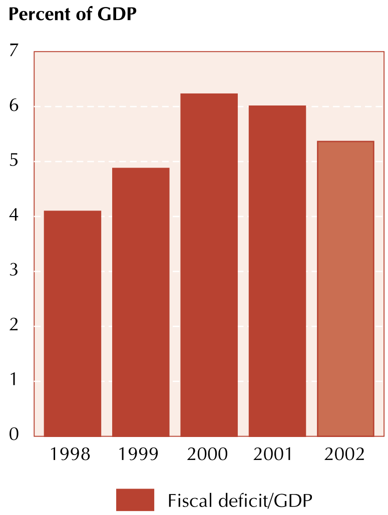

*Sources: Bangladesh Bank, staff estimates*

Although monetary policy remained expansionary to accommodate fiscal spending over the full year 2001, money supply growth slowed to 16.6 percent in June 2001 from 19.3 percent in December 2000. The main factor was the decline in net foreign assets in the banking system. The growth of credit to the private sector edged up from 13.7 percent to 16.9 percent, due to the revival of the industry sector.

The inflation rate fell further in 2001, to 1.5 percent from 3.5 percent in the preceding year, mainly because of successive record crop harvests and resulting deflation of foodgrain prices. It appears that any inflationary impact that the growth in money supply may have had was outweighed by the decline in food prices.

After two years of sluggish growth, exports grew by 12.4 percent year on year in 2001. Their base, however, remained narrow and undiversified, with ready-made garments and knitwear accounting for 75 percent of the total. While the overall annual growth rate of exports in 2001 was impressive, exports fell substantially during the latter half of the year from a 25 percent year-on-year growth rate in the first half. The major reason for the deceleration was the slowdown in the US economy and continued sluggish growth in Japan and the EU. Other important factors were continuing political disruptions and strikes, and infrastructure bottlenecks at the ports and in the supply of electricity. Imports picked up notably, due particularly to higher imported volumes of capital goods, and oil and oil products. The current account balance weakened in 2001 due to a deteriorating trade balance, a drop in overseas worker remittances, and higher payments for supplier credit. Foreign exchange reserves declined from $1.6 billion, or 2.3 months of imports, at the end of 2000 to $1.3 billion, or 1.6 months of imports, at the end of 2001. To address declining remittances, decelerating export growth, and falling foreign exchange reserves, the Government devalued the taka by 5.5 percent on 25 May 2001. The devaluation restored the real effective exchange rate to its early 1997 level; it also narrowed the gap between the official and informal-market exchange rates.

***Fiscal management is still a key challenge for the Government***




*Sources: Bangladesh Bureau of Statistics, staff estimates*

*Economic Management Issues.* Fiscal management remains a key challenge for the Government in the near and medium term. Although the 2002 budget projects that the revenue/GDP ratio will increase by 0.4 percentage points and that the expenditure/GDP ratio will decline by 0.3 percentage points, it lacks, however, any substantive new measures to strengthen tax administration or to expand tax coverage. On the other hand, projected expenditures seem to be on the low side. The continued reliance on high-cost domestic borrowing is detrimental to domestic investment and could impair macroeconomic stability. To manage its fiscal deficit, the Government needs to exercise the utmost restraint in public spending, take measures to cut SOE losses, and strengthen tax administration.

Against a background of a further decline in foreign exchange reserves to $1.25 billion, or less than 1.5 months of imports, at the end of August 2001, the Government has taken various steps to increase foreign exchange inflows including increasing punitive measures against illegal foreign exchange transactions; introducing incentives to encourage overseas workers to send their remittances through official channels; closer monitoring of imports to discourage the practice of overinvoicing; and encouraging repatriation of export earnings. To increase reserves in the future, the Government also needs to undertake urgent measures to improve the use of concessional funding, manage the exchange rate more flexibly, and initiate measures to diversify exports. This last measure would also require progress both in implementing reforms in the finance sector and in addressing mounting infrastructure constraints.

*Forecast.* For 2002, GDP growth is projected to decline to 5.5 percent due to more subdued export growth and investment stemming from the sharper than expected global slowdown and the loss of confidence and uncertainty generated by the recent terror attacks. Recent events are also likely to adversely affect remittances from migrant workers in the Middle East and the US. As a result of slower export growth and reduced remittances, the current account deficit is expected to widen. Higher public expenditures and the lagged effect of monetary expansion are likely to generate stronger inflationary pressures in 2002.

# INDIA

*The slowdown in global and domestic demand has taken its toll on the Indian economy, which is now expected to grow at below 6 percent during the current fiscal year. Supply-side structural constraints continue to hamper economic performance and to affect the medium-term prospects for the economy. Progress on fiscal consolidation and an accelerated pace of structural reforms may help move the economy toward a higher growth path in 2002.*

| **Economic Indicator** (percent) | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|
| | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| GDP growth | 6.6 | 6.4 | 5.2 | 5.6 | 6.2 | 6.3 | 7.0 |
| Inflation rate | 5.9 | 3.3 | 7.2 | 5.0 | 5.5 | 5.0 | 4.8 |
| Current account/GDP | -1.0 | -1.0 | -0.5 | -0.9 | -1.2 | -1.0 | -1.0 |

***Economic Assessment.*** The global economic slowdown has had a more significant impact on the Indian economy than expected in *ADO 2001*. Official estimates now place GDP growth in 2000 at 5.2 percent, as against the estimate of 6.0 percent reflected in *ADO 2001*. At the end of 2000 and in the first quarter of the current fiscal year, depressed global demand—reflected in the sharp decline of India's exports—contributed to a deceleration in economic growth. Given the relatively low level of openness of the economy, however, domestic demand and supply-side factors have played the key roles in constraining performance. With weaker growth in agricultural incomes, domestic consumer demand has remained subdued. Investment demand has also been weak in the face of structural bottlenecks and uncertainties related to the economic reform process. Inadequate and unreliable infrastructure has continued to constrain industry. High and chronic fiscal deficits and the resulting debt burden, both at the central and state levels, have limited the Government's ability to undertake development expenditures needed to spur growth in the medium term and to realize the economy's long-term potential.

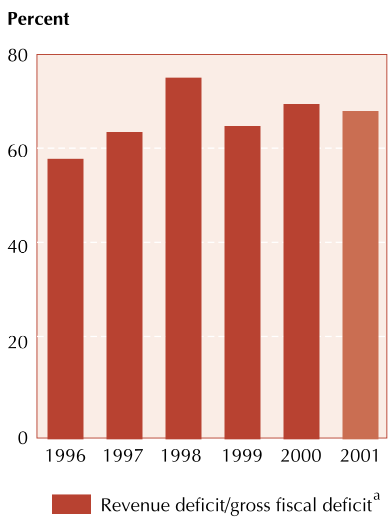
A review of the real economy reveals a continuing lackluster performance of the agriculture sector, which accounts for about one fourth of India's GDP. Value addition in agriculture contracted by 1.4 percent in the last quarter of 2000, a marginally worse performance than during the same period a year earlier. However, the monsoon this year has been above normal and overall rain distribution has been good, with adequate rainfall in the drought-affected states of Gujarat, Madhya Pradesh, and Rajasthan. With agricultural output depending heavily on weather conditions, this encourages expectations for better agricultural performance in the latter part of the current fiscal year.

Low levels of domestic and external demand and weak business confidence kept industrial growth sluggish, at 2.7 percent in the last quarter

2000 refers to fiscal year 2000/01, ending 31 March.

of 2000. Manufacturing, which alone accounts for roughly 60 percent of industrial output, grew by 3.5 percent, less than half the rate of growth during the same quarter in 1999. Nonmanufacturing industry grew by around 1.4 percent compared to 7.2 percent in the same period of the previous year. The mediocre performance of the industry sector extended into the first five months of fiscal 2001. The index of industrial production dropped to 2.2 percent during April–August 2001 from 5.4 percent in the same period of the previous year. The drop in growth was particularly steep in power, as well as in manufacturing.

*The revenue deficit remains high as a share of the fiscal deficit*




[a]Gross fiscal deficit excludes capital expenditure arising from the interest and management cost of the National Savings Fund's investments in states' securities.

*Source: Reserve Bank of India Annual Report 2000-01*

In 2000, growth in the services sector decelerated to 7.7 percent from growth rates exceeding 8.0 percent in the latter half of the 1990s. This may in part be correlated with the industrial slowdown. Growth in services was 6.9 percent during the last quarter of 2000.

Exports, which recorded double-digit growth rates in 2000, are now down to single-digit levels. During the first quarter of 2001, they grew by 1.8 percent in dollar terms compared to an increase of 26.6 percent in the same quarter of the previous year. This reflected a decline in both May and June 2001. Mirroring below-expectation industrial performance and low investment demand, imports declined by 1.9 percent in the first quarter of 2001 compared to an 18.1 percent increase in the previous year. The net result was a trade deficit of $1.9 billion for the first quarter of 2001 compared to a deficit of $2.4 billion in the same period of the previous year.

As of 12 October 2001, foreign exchange reserves were at a comfortable level of $44.9 billion. After weakening substantially to Rs48.43/$ following the 11 September attacks, the rupee has been fluctuating around Rs48/$. Capital flows remained stable during the first quarter of 2001, with a marginal decrease in FDI at $608 million balanced by higher foreign institutional investment at $632 million.

The annual rate of inflation as measured by year-on-year variations in the WPI stood at 5.2 percent in early July 2001 compared to over 6.0 percent in the previous year. Lower inflation reflects the easing of administered fuel prices due to softer international crude oil prices and low domestic demand. The CPI for industrial workers recorded an annual inflation rate of 2.5 percent in May, indicating relatively stable prices of most essential commodities. The Reserve Bank of India continued its flexible stance aimed at providing sufficient liquidity to the economy while warding off inflationary pressures. The year-on-year growth of broad money (M3) in July 2001 stood at 17.6 percent. This reflected a higher growth in commercial bank credit to the Government, though commercial bank credit to the private sector decelerated.

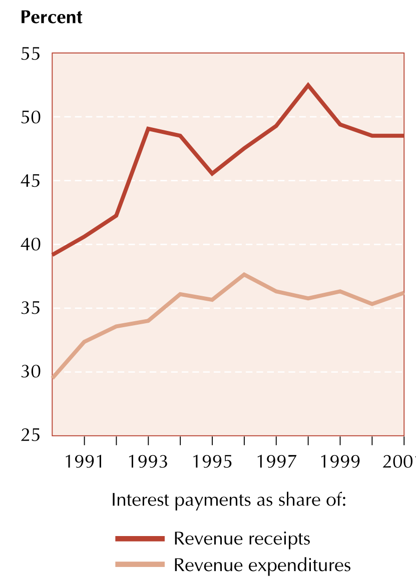
*Economic Management Issues.* The economic slowdown resulted in lower than expected tax collection. Only 14.0 percent of tax revenues per budget estimates were realized in the April–June 2001 period, compared to almost 19.0 percent during the same quarter of the previous year. Combined with measures to pump-prime the economy through accelerated public spending, this has led to higher government borrowing. Roughly 60 percent of the public borrowing program was completed after only one third of 2001.

In April–June 2001, the gross fiscal deficit was over 68 percent, and the revenue deficit roughly 100 percent, higher than their respective levels in the same quarter of 2000. These figures pose a challenge for the Government in realizing its fiscal deficit target of 4.7 percent of GDP as set out in the 2001 budget. Overall fiscal discipline is also critically dependent on performance by the states. Improvements in state finances may be encouraged by the state fiscal reform facility (2000–2004) as recommended by the Eleventh Finance Commission. This facility links the states' access to an incentive fund to their performance in reducing the revenue deficit as a percentage of revenue receipts. The incentive fund is financed by a withholding of 15.0 percent of the yearly grants that the Finance Commission assigns to the states to cover their revenue deficits, and a matching contribution from the central Government.

Fiscal discipline is crucial for investor confidence and for sustaining growth in the private sector. Together with the increase in consumer demand that is expected from improved performance and higher incomes in agriculture this year, an improved fiscal position is a precondition for stronger and more sustainable economic performance. There are two main channels through which high and chronic fiscal deficits affect investments in the economy. The first is high interest rates and crowding out. Although at present, lack of investment demand may be better explained by factors such as low consumer demand, the existence of substantial excess capacity, structural bottlenecks, and the slow pace of reforms, the cost of borrowing considerations will, however, become more significant as economic recovery gains momentum.

The second channel is the quality of public expenditure and its impact on the overall environment in which businesses operate. With total outstanding liabilities of the central Government amounting to roughly 60 percent of GDP, a large and increasing portion of the government budget goes toward interest payments.

*More and more of the government budget goes on interest payments*




*Source: Reserve Bank of India Annual Report 2000-01*

The passage of the Fiscal Responsibility and Budget Management Bill, expected this year, should provide a positive signal to the financial markets and help restore business confidence. The Bill provides for a reduction, over the next five years, of the revenue and fiscal deficits of the central Government by 0.5 percent of GDP each year. The revenue deficit of the central Government would be eliminated, and the fiscal deficit reduced to 2.0 percent of GDP, by 2006. The fulfillment of these commitments, and their impact, however, will depend on the extent to which efforts to rationalize expenditures and increase revenues are successful. Downsizing and achieving cost reductions in the large public bureaucracy, along with containment of the total subsidy bill, which amounted to roughly Rs270 billion and constituted 9.5 percent of revenue expenditures in 2000, will be central elements in these rationalization efforts.

On the revenue side, the Government has room for further improving the tax system and its administration. For direct taxes, revenue improvements are possible through the abolition of exemptions and securing higher compliance levels. For indirect taxes, after the introduction of value-added tax (VAT) at the national level, the establishment of uniform VAT in all states (planned for 1 April 2002 in major states) will be a positive development that is likely to boost revenue collection and limit scope for corruption. Further, the Government needs to make substantial progress in its program of divestiture and privatization of public sector undertakings, both for additional revenues and direct efficiency gains.

While the overall policy and development issues facing the Indian economy have remained the same over the past few months, some areas of policy reform have acquired additional urgency in the face of the current slowdown.

First are agricultural reforms (including liberalization of agricultural prices and exports), removal of licensing requirements, and de-reservation of agroprocessing from the small-scale industry list. Amending the Essential Commodities Act and reviewing the inefficient and costly targeted-foodgrain public distribution system are key to this process, and would have a positive impact on the budget by reducing the costs of food subsidies. To be effective, these reforms should be accompanied by efforts to reduce the dependence of Indian agriculture on weather patterns and improve productivity, through the provision of irrigation and other basic infrastructure services.

Second, the power sector requires reform. Inadequate power infrastructure is a binding constraint on sustained economic growth. Power sector reforms and privatization are needed to ensure that the increase in capacity in the sector takes place in a sustainable manner over the medium term. The burden that the power sector imposes on public sector finances is enormous. It is estimated that the hidden subsidy resulting from lower than economic pricing of power to the agriculture and domestic sectors is Rs250 billion a year. This is roughly equivalent to 1.2 percent of 2000 GDP at current market prices and to 17 percent of the gross (central and state) fiscal deficit in 1999 (based on the budget estimate for the gross consolidated fiscal deficit).

Finally, factor market distortions need to be removed. As trade is liberalized, distortions and inefficiencies in factor markets due to labor, land, and bankruptcy laws hamper the creation of an environment in which Indian businesses can compete with foreign producers.

***Forecast.*** Expectations of a prolonged global economic slump and a softer rebound in 2002 than previously anticipated have implications for India's economic outlook. Indian services sector exports—software and tourism in particular—are likely to suffer from the drop in external demand and heightened security concerns. ICT exports have played an important role in sustaining the current account, and, if they fall, could deprive the Indian economy of a buffer mechanism to counterbalance external shocks such as sharp increases in oil prices. Worker remittances from the Gulf countries may also be negatively affected. Further, political uncertainty in the subregion could deter foreign capital flows. These factors may contribute to a further weakening of the rupee. The stock market, which took a dip in the immediate aftermath of the attacks, appears to have stabilized, albeit at lower levels, but further turbulence cannot be excluded as events unfold.

Given the still limited openness of the Indian economy, however, the possible negative impacts on the balance of payments are unlikely to be very significant, especially when considered in the present context of comfortable foreign exchange reserves and a low current account deficit. Further, the dampening effect on external demand of a deeper and more prolonged global slowdown is likely to be counteracted by a pickup in domestic demand if expectations of a strong performance in the agriculture sector materialize. Revival of agricultural growth would be accompanied by a moderate improvement in industry and services sector performance in the latter part of fiscal year 2001. However, given the increased uncertainty of the global economic scenario, India's GDP growth rate is projected in the range of 5.3 to 5.8 percent in 2001 as against a growth rate of 6.2 percent in *ADO 2001*.

For 2002, GDP growth is projected in the range of 6.1 to 6.5 percent as industry and services sector growth gain further momentum. Realization of the high-end forecast in 2002 would depend, on the one hand, on an improved global environment, and on the other, on the Government's accelerating the pace of reforms necessary both to improve fiscal performance and to address structural issues in the economy. In a domestic environment characterized by stronger fiscal discipline, inflationary pressures might be managed effectively. Under this assumption, inflation would remain moderate, at around 5.0 percent in 2002.

With subdued export and import growth, the current account deficit may be below 1.0 percent of GDP in 2001. Stronger external demand and initial improvements in export competitiveness, due to the progressive removal of factor market distortions, are likely to improve export performance to some extent in 2002. As increases in industrial output may be realized initially through employing the current sizable excess capacity in the industry sector, import growth may be contained during 2002 and, with a stable invisibles account, the current account deficit is likely to be maintained at about 1.0 percent.

# PAKISTAN

*GDP growth slowed in fiscal year 2001, largely due to a drought-induced decline in agriculture sector output, and exogenous factors such as high oil prices and the slowdown in global economic activity. Nonetheless, the Government continued to undertake far-reaching structural reforms whose impact will be apparent in the near term. Tax administration and balance-of-payments vulnerability remain areas of concern. The current political uncertainty in the subregion is likely to have serious implications for near-term growth prospects.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | 2.0 | 4.2 | 3.9 | 2.6 | 3.8 | 3.0 | 4.7 |
| Inflation rate | 7.8 | 5.7 | 3.6 | 4.7 | 6.0 | 5.1 | 4.5 |
| Current account/GDP | -3.0 | -3.6 | -2.1 | -2.2 | -1.7 | -2.5 | -1.0 |

*Economic Assessment.* Overall economic growth in 2001, now estimated at 2.6 percent, was lower than the 3.8 percent projection of *ADO 2001* as well as the 3.9 percent expansion in 2000. This is explained primarily by a prolonged drought, increased world oil prices, and the slowdown in global economic activity. The drought adversely affected agriculture sector output and hydropower generation. The agriculture sector posted a contraction of 2.6 percent in 2001 compared to 6.1 percent growth in 2000, while nonagricultural GDP improved to 4.3 percent growth from 3.1 percent expansion in the previous year. Performance of the large-scale manufacturing sector was impressive, recording a growth rate of 7.8 percent after a contraction of 0.2 percent in 2000. This was, however, due mainly to a rebound in sugar production. The services sector also grew in 2001, by 2.6 percent.

During 2001, public investment rose by 4.6 percent in nominal terms, while private investment remained unchanged from its 2000 level. The latter has stayed low due to a lack of confidence among investors that the Government will persist in its economic reform policies. Private consumption also remained subdued due to the impact of stabilization policies aimed at curtailing aggregate demand and negative agricultural growth, which depressed rural incomes. Continuing—but smaller—fiscal deficits led to a higher rate of public consumption.

At 4.7 percent, full-year inflation was lower than the 6.0 percent projection made in *ADO 2001*, but higher than the 3.6 percent of the previous year. Higher inflation was attributable mainly to rises in oil and oil-product prices. During 2001, despite recessionary trends, the central bank pursued a tight monetary policy, principally to defend the exchange rate, which depreciated by 22.0 percent against the dollar over the year. Money supply

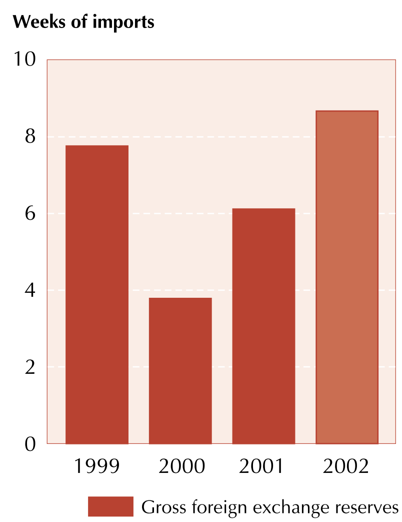
2001 refers to fiscal year 2000/01, ending 30 June.

(M2) growth in 2001 of 7.1 percent was significantly lower than the 11.3 percent projection of *ADO 2001* and the actual growth rate of 9.4 percent in 2000. Net budgetary borrowing in 2001 declined to PRs21.0 billion, from PRs40.0 billion in 2000, while credit to the nongovernment sector rose by 110 percent. The large increase in private sector credit offtake was due both to rationalization of the domestic interest rate structure, which resulted in a decline in interest rates, and to confidence of the private sector in the Government's economic reform program.

The slowdown in global economic activity and falling commodity prices adversely affected Pakistan's export performance. However, higher oil prices in the international market contributed to an increase in import values over 2000 levels. Export growth of 9.0 percent was significantly lower than the *ADO 2001* projection of 14.6 percent. Due to lower domestic economic activity, import growth of 5.9 percent was also lower than the *ADO 2001* projection of 9.3 percent. The resulting improvement in the trade deficit, together with workers' remittances—higher by $232 million than the previous year—helped offset a sharp deterioration in the services account.

The current account deficit of $1,340 million remained essentially unchanged in 2001, at 2.2 percent of GDP, from $1,128 million in 2000 (2.1 percent of GDP). Weakening global economic activity and the lackluster performance of Asian financial markets had a negative impact on net foreign private investment in 2001, which amounted to just $104 million ($232 million in FDI and an outflow of $128 million in portfolio investment). Reserves in 2001 were boosted by the central bank's purchase of $2.1 billion from the open market, an increase of $560 million over the 2000 level.

***Gross foreign exchange reserves were boosted in 2001***




*Source: Government of Pakistan*

In 2001, revenue collections (tax and nontax) increased by 6.0 percent over 2000 levels. The tax revenue target was, however, frequently revised downward during the year, and actual collections were considerably below earlier projections. Government expenditures in 2001 were 2.3 percent below target, which, coupled with nontax revenue-enhancement measures, resulted in a budget deficit of 5.2 percent of GDP—the lowest fiscal deficit in the last 18 years. The Government plans to further reduce the fiscal deficit to 4.9 percent of GDP by the end of 2002—but given the events of 11 September, this may prove difficult to achieve.

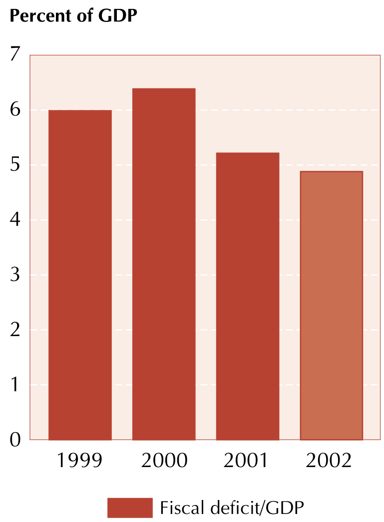
Under the 2002 budget, defense expenditures have been kept constant at the previous year's level while development expenditures are projected to increase to 3.4 percent of GDP from 2.9 percent in 2001. However, the shortfall in revenue collections for the first two months of 2002 has led the Government once again to lower the tax collection target. Based on past experience, this suggests that actual development expenditures are likely to be reduced once more, in an attempt to meet the fiscal deficit target.

The 2002 budget represents the first year of a Medium-Term Budgetary Framework (MTBF), worked out with IMF under a standby arrangement agreed to in November 2000. Beginning in 2002 and ending in 2004, the MTBF envisages (i) an increase in the growth rate from 4.0 to 5.5 percent; (ii) increases in investment as a percentage of GDP from 15.2 to 16.5 percent and national savings from 13.0 percent to 15.0 percent; (iii) a reduction in the budget deficit from 4.9 to 3.6 percent; and (iv) a decline in the current account deficit from $1.3 billion to $1.0 billion.

*Economic Management Issues.* The attainment of the MTBF targets will depend on the success of current measures to improve the efficiency of the economy, its market orientation, and the role of the private sector. The Government is constrained in its ability to increase development expenditures due to mounting public sector debt, from 88 percent of GDP in 1997 to 107 percent in 2001. Further problems have also been created by the recent changes in the composition of external debt from long-term, to medium- and short-term debt. The latter is due to the difficulties that Pakistan has faced in obtaining longer-term debt on concessional terms following the imposition of sanctions after the nuclear blasts of May 1998, and the need to make short-term borrowings to pay off existing debts. Against this backdrop, the slow pace of the Government's privatization's program, the inadequate performance of the tax administration regime, and subdued domestic and foreign investment are areas of concern.

IMF's standby arrangement ended on 30 September 2001. The Government has begun preliminary negotiations with IMF for longer-term financing under the Poverty Reduction Growth Facility, which it hopes to conclude by November 2001. In this context, the Government has prepared an interim poverty reduction strategy, which includes yearly expenditure targets for poverty reduction programs. Meanwhile, it plans to jump-start the economy by initiating large infrastructure projects in the roads and water sectors.

***The Government plans to further reduce the fiscal deficit by the end of 2002***




*Source: Government of Pakistan*

*Forecast.* Before early September, the Government projected GDP growth for 2002 at 4.0 percent on the basis of a modest recovery in agricultural output and related improvement in private consumption. More recent data, however, suggest that this winter season's wheat crop could be adversely affected by a shortage of irrigation water supply. The attacks on the US on 11 September, coming on top of an already weakening global economy, are also likely to have significant negative implications for Pakistan's economy in the short term. An immediate consequence of the attacks has been to increase freight charges to and from Pakistan due to the perception that the country is in a war zone. Several airlines have also stopped services to the country, leading to a reduction in available air cargo capacity. At the same time, domestic textile and garment manufacturers have suffered cancellations of export orders and a sharp drop in new orders stemming from weaker external demand, partly based on importers' anxieties that manufacturers will be unable to maintain their existing production schedules. The Ministry of Commerce has estimated that if Pakistan does not receive more favorable access to the US and EU markets now for its exports, the loss of export earnings (stemming from current events) could amount to $1.5 billion.

The atmosphere of uncertainty is also having an adverse budgetary impact, as the Government has incurred additional expenses associated with an increased number of refugees, with maintaining law and order, and with defense. Risk premiums have also increased sharply on sovereign debt in the aftermath of the 11 September attacks. The ramifications of these attacks have also led to a shortfall in revenue collections due to a slowdown in imports. For the month of September alone, the shortfall is estimated at PRs5.0 billion. Loss of investor confidence and the depressed state of the domestic stock market have led the Government to defer its privatization program, which was expected to bring in $500 million in 2002. Actual private capital inflows are also now expected to be considerably below the Government's initial projection of some $600 million. Although the economy is likely to gain from the recent removal of the remaining nuclear test-related sanctions, enhanced debt relief, and increased access to concessional aid, these are likely to be felt only with a lag.

While it is too early to gauge the full impact of the events of 11 September, under the assumption of a full-year loss to the economy of $1 billion, GDP growth in 2002 is projected to slow to around 3.0 percent from earlier government projections of 4.0 percent. The current account deficit is also likely to widen somewhat in 2002 owing to more subdued export growth and reduced inflows of worker remittances and other private transfers. Even in the event that exports are granted free access to the US and EU, this is likely to be partly offset by reduced import demand resulting from depressed consumer sentiment in these markets. Inflation during 2002 is expected to pick up somewhat on account of rupee depreciation and an increase in utility prices.

# PACIFIC ISLAND DEVELOPING MEMBER COUNTRIES

*The growth forecast for 2001 has been revised downward due to continuing economic weakness in the Fiji Islands and Solomon Islands, and a sharper than expected slowdown in the world economy. Further delay in a return to normalcy in these two countries, and a general weakening of commitment to prudent economic management among governments, pose a risk to future economic prospects.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | 0.7 | 5.6 | -1.4 | 1.2 | — | 3.9 | — |
| Inflation rate | 5.1 | 2.5 | 2.1 | 3.7 | — | 3.2 | — |

— not available.

***Economic Assessment.*** According to revised estimates, real GDP of the 11 Pacific island developing member countries contracted by a weighted average of 1.4 percent in 2000. This nevertheless represents a significant improvement over the *ADO 2001* estimate of a 1.8 percent contraction, due largely to the recent revision in the official figures for the Fiji Islands from a contraction of 9.3 percent to 2.8 percent growth in 2000. The overall decline in 2000 was a reflection mainly of crises in the two largest economies—Fiji Islands and Solomon Islands—arising from political instability and ethnic unrest. Other economies generally recorded positive growth during the year. In particular, the performances of Cook Islands, Samoa, and Tonga were robust.

Except for higher fish production, the two crisis-affected economies experienced weak demand and generally subdued or declining economic activity in the first half of 2001. During this period, both countries faced uncertainties due to pending elections. The other nine economies also recorded weak economic activity, largely reflecting the weakness of the world economy and depressed commodity prices. Positive developments were attributable primarily to a variety of country-specific factors, such as enhanced activity in construction, public investment, and fisheries.

Inflation generally rose during the first half of 2001 due to the lagged effect of higher global oil prices and increased costs of domestically produced food items. This has led to upward revisions of annual inflation projections for most countries as well as the group as a whole. The Fiji Islands recorded a rise in inflation, though this is expected to stabilize over the rest of this year due to significant excess capacity and weak wage growth. There was no official reporting of inflation in Solomon Islands for the first half of 2001. Across the

The Pacific island developing member countries comprise Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Papua New Guinea is discussed in a separate chapter.

11 economies generally, money supply growth showed no discernable trend during the first quarter of 2001: there was a decline in the Fiji Islands and Solomon Islands, a rise in Samoa, and a modest decline in Vanuatu. However, an expansionary monetary stance is likely in most of these countries over the rest of 2001 due to the authorities' efforts to spur economic growth.

During the first half of 2001, sluggish external demand for the 11 economies' exports was only partially offset by a modest decline in imports stemming from weaker domestic demand. As a result, most economies experienced a deterioration in their trade account and a weaker overall balance of payments. There were, however, significant variations in individual country performance. For instance, while the Fiji Islands and Solomon Islands had worsening trade accounts during the first quarter of 2001, for the former this was due mainly to a sharp decline in traditional exports, while for the latter this was attributable to a steep rise in imports, leading to its highest quarterly trade deficit in 10 years. In Vanuatu, substantial capital account outflows were responsible for a deterioration in the balance of payments.

Most of the larger economies saw weakening fiscal balances during the first half of 2001 due to higher expenditures and lower revenues—though once again a certain amount of diversity can be seen. Deteriorating fiscal performance was attributable to tax breaks and expenditure measures to spur investment and growth in the Fiji Islands, and to an eroded tax base and high expenditures in Solomon Islands. In most of these larger economies, recurrent expenditures were on the rise, particularly in Vanuatu. No discernable trend was evident in Kiribati, Federated States of Micronesia, or Tuvalu, which have a large share of nontax revenues in total revenues.

*Economic Management Issues.* Deteriorating exports and tax revenues associated with the less hospitable external environment pose risks to fiscal and external balances. Thus the main economic management issues are (i) the maintenance of growth without creating macroeconomic instability and (ii) a continued commitment to reform despite current difficulties. Another major factor is the early return to normalcy and rehabilitation in the Fiji Islands and Solomon Islands, as several factors associated with political instability and ethnic conflict continue to plague these countries. This has kept business and investor confidence low and economic activity subdued. The stability of the new governments following elections, as well as their commitment to reform and good governance, is critical for the two countries' recovery prospects. However, unless economic management in Solomon Islands improves significantly, the country may face increased risk of another economic crisis, as suggested by the continued deterioration in its fiscal and external positions in recent months.

One of the constraints facing economic growth and private sector development in the Pacific island economies relates to property rights, in which some of the recent ethnic conflicts are rooted. It is important that this problem is addressed quickly in a manner acceptable to all parties. Diversification of production and exports is another important issue for the subregion, so as to reduce vulnerability to external economic shocks. Recent developments in Samoa and the general structure of the precrisis Fiji Islands economy serve as good models for this.

The June 2001 Forum Economic Ministers' Meeting addressed a range of crucial issues, including land matters, strengthening compilation and reporting of statistics, governance and accountability, finance sector reforms, commercial law, and dispute resolution. The Meeting's adoption of the Guidelines for Good Land Policy, which could form the basis for national consideration of issues such as land leasing, dispute resolution, and use of land as collateral, was a major step in addressing the issue of property rights. Further progress in these areas is needed. Another recent major development has been the signing of the Pacific Agreement on Closer Economic Relations (PACER) in Nauru in August 2001 by many Pacific island developing member countries. As an initial step under the PACER, a free trade agreement—the Pacific Island Countries Trade Agreement (PICTA)—was signed and will come into force next year.

***Forecast.*** Near-term prospects remain weak because of a lack of rebound in the Fiji Islands and Solomon Islands, and a sharper than anticipated slowdown in the global economy. As a result, the forecast for the 11 economies in 2001 has been revised downward to a modest weighted average growth rate of 1.2 percent, reflecting small, but positive, growth in almost all the countries during the year. Projected weighted average inflation for 2001 has been marginally revised upward to 3.7 percent. A general deterioration in the balance-of-payments position is also expected during the rest of 2001, due to more subdued international demand for exports and low earnings from tourism resulting from heightened security concerns following the 11 September attacks on the US. While 2002 prospects remain uncertain, the weighted average of GDP growth is likely to pick up to 3.9 percent, reflecting a gradual recovery in the world economy and an economic rebound in the Fiji Islands and Solomon Islands. Inflation is likely to moderate as a result of lower food prices. The fallout from the events of 11 September has yet to settle and is adding uncertainty to these projections. Generally, the main areas of concern for the 11 economies are tourism, transport services, external trade, returns on official trust funds, and fiscal and external imbalances.

# PAPUA NEW GUINEA

*Despite substantial external assistance and improvements in macroeconomic stability, the economy contracted in 2000. Its near-term prospects remain weak, and the Government needs to address basic development constraints as well as diversify the production and export base to move to a sustainable growth path.*

| **Economic Indicator** (percent) | **1998** | **1999** | **2000** | **2001** | | **2002** | |
|---|---|---|---|---|---|---|---|
| | | | | **Current** | ***ADO 2001*** | **Current** | ***ADO 2001*** |
| GDP growth | -3.8 | 5.4 | -1.8 | -2.0 | 3.1 | 1.5 | 5.7 |
| Inflation rate | 13.6 | 14.9 | 15.6 | 10.0 | 11.6 | 6.0 | 6.2 |
| Current account/GDP | 0.6 | 1.4 | 7.8 | 3.8 | -3.5 | 3.5 | -3.4 |

*Economic Assessment.* Economic activity remained depressed in the first half of 2001 following disappointing growth in 2000. According to revised estimates, GDP contracted by 1.8 percent in 2000, even though stabilization measures and reform efforts generally continued on course. Production of crude oil and most major agricultural commodities declined in the first half of 2001.

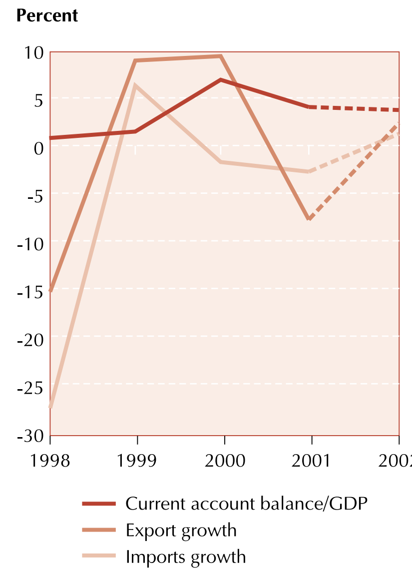
The maintenance of a tight monetary policy stance led to a gradual easing of inflation in 2000, which continued to decelerate into 2001. The average second quarter year-on-year rate of 7.9 percent was the lowest quarterly rate since the first quarter of 1998, which reflected weak aggregate demand and lower inflationary expectations.

Total government revenue and grants of K1.1 billion in the first half of 2001 amounted to only 34.6 percent of the Government's annual budget target, reflecting weak economic activity, civil unrest, and weak performance of revenue administration. Total government expenditure of K1.1 billion during this period was also low, pointing to financial constraints and tight expenditure controls. In particular, development expenditure, at about K99 million in the first half of 2001, represented only around one tenth of the budgeted amount for the full year. Delay in bringing the Papua New Guinea Banking Corporation to the point of sale—due to employee resistance—has deferred the release of $20 million under a structural adjustment loan from the World Bank by about six months. This caused serious cash management difficulties for the Government in the first half of 2001, but despite these, the Government succeeded in meeting its debt service obligations.

The decline in inflation in the last few months of 2000 allowed the central bank to begin a measured easing of monetary policy in 2001. In February, it introduced a new price-based signaling mechanism to announce a "kina facility rate" (KFR) at the start of every month as a benchmark rate for interbank trading. Treasury bill rates moved in line with the gradual reduction in the KFR from 15.5 percent to 13.0 percent from February to July. However, commercial bank rates stayed firm, indicating a hardening of real interest rates. Bank lending to business also remained low during this period.

In the first half of 2001, merchandise exports in kina terms increased by 4.2 percent compared to the corresponding period of 2000, due to the higher value of major exports except agricultural products. In the agriculture sector, rubber exports increased, reflecting better export prices, while coffee and palm oil exports declined due to weak international prices and a poor harvest. During this period, merchandise imports recorded a year-on-year increase of 2.2 percent, due to higher capital goods imports in the minerals sector. The current account recorded a surplus of K599 million in the first half of 2001, stronger than the corresponding figure in 2000 as a result of the higher trade surplus and transfer receipts. The overall balance of payments improved to a surplus of K183 million in the first half of 2001 despite a deficit on the capital account due to net official capital transfers and higher capital transfers by mineral companies to their offshore accounts. The level of foreign exchange reserves at the end of the first half of 2001 was K1.1 billion, sufficient to cover 4.6 months of imports. External public debt as of end-June 2001, at K4.2 billion, was 23.8 percent higher than one year earlier. The kina recorded wide fluctuations in 2001, and at the end of July 2001 had depreciated by about 10 percent since December 2000 against the dollar.

*The current account is likely to continue posting surpluses*




*Source: Staff estimates*

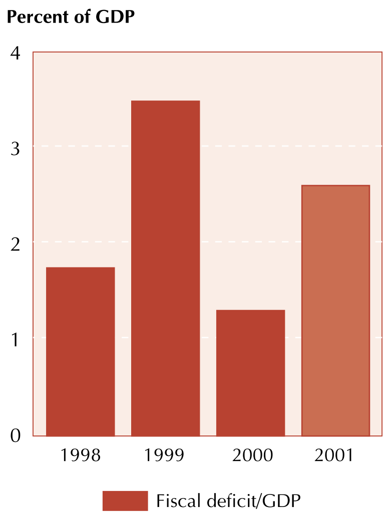
*Economic Management Issues.* The main economic management issues facing the country are (i) tight management of government finances, (ii) stabilization of the kina, (iii) reduction in inflation and interest rates, and (iv) generation of economic growth. Despite the Government's reasonable success in meeting most of these objectives in the recent past, economic growth remains elusive. The sharp slowdown in global growth and weaker trade flows are adding to the country's woes, and is testing national commitment to reforms. The situation has been exacerbated by increased political agitation in the early days of the run-up to elections in July 2002. The first half of 2001 witnessed major civil disorder and unrest.

While the 2001 budget anticipated and relied on a pickup in revenues from nonmineral activities, this has not materialized. The Government has proposed revising downward its revenue estimates for the year, reducing expenditure outlays, and increasing its reliance on nontax revenues. The 2001 agenda of reforms includes finalization of a new regulatory framework and competition policy, continuation of the privatization program, and completion of the functional and expenditure review of government departments.

The prime monetary policy target will be to keep inflation under control so as to weaken inflationary expectations and achieve a reduction in interest rates. The flexible exchange rate regime will be continued and central bank interventions will be restricted to smoothing short-term foreign exchange market volatility, which is a continuing problem and poses a serious threat to macroeconomic stability.

The country has a high population growth rate of about 3.0 percent, with a population of about 5.1 million in 2000. The fundamental development constraints of the country include rugged terrain, linguistic diversity, and

*The Government aims to limit the fiscal deficit to 2.6 percent of GDP in 2001*




*Source: Staff estimates*

isolated pockets of population. These hinder growth of the domestic market and extension of public services. The economy needs to diversify its production and export base and develop an integrated domestic market. Continuous underinvestment in rural areas, infrastructure, and human development is resulting in a society manifesting disparities in socioeconomic conditions and poverty, and significant gaps in skilled human resources. Investments in infrastructure, health, and education, and improvements in law and order will significantly help address these constraints and put the country on a long-term sustainable growth path.

*Forecast.* The growth estimate for 2001 and forecast for 2002 have been substantially revised downward since *ADO 2001*, largely reflecting a worsening outlook for the secondary and tertiary sectors, continuing difficulties in the coffee industry, and a secular decline in crude oil production. The economy is forecast to contract by 2.0 percent in 2001 due to a sharp fall in mineral extraction, construction, wholesale and retail trade, and activities related to transport, storage, and communications. A modest recovery of 1.5 percent is expected in 2002, on the back of more broad-based growth (excluding the minerals sector). The annual average inflation rate for 2001 is forecast to be 10.0 percent. On the expectation of greater exchange rate stability, inflation is expected to fall to 6.0 percent by 2002. The current account is projected to post a surplus of 3.8 percent and 3.5 percent of GDP in 2001 and 2002, respectively, due to an anticipated increase in the prices of agricultural commodities and slower imports associated with the minerals sector. The Government is aiming to limit the fiscal deficit to 2.6 percent of GDP in 2001. To achieve this, some expenditures that were supposed to have been made by the second quarter of this year will be deferred to 2002.

# STATISTICAL TABLES

## Table 1. Growth Rate of GDP

(percent per year)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| Newly Industrialized Economies | 6.3 | 5.8 | -2.9 | 7.8 | 8.4 | 0.1 | 4.3 | 2.7 | 5.6 |
| Hong Kong, China | 4.5 | 5.0 | -5.3 | 3.0 | 10.5 | -0.4 | 4.0 | 2.0 | 5.5 |
| Republic of Korea | 6.8 | 5.0 | -6.7 | 10.9 | 8.8 | 2.0 | 3.9 | 3.6 | 5.5 |
| Singapore | 7.7 | 8.5 | 0.1 | 5.9 | 9.9 | -3.0 | 5.0 | 1.0 | 6.0 |
| Taipei,China | 6.1 | 6.7 | 4.6 | 5.4 | 5.9 | -2.0 | 5.1 | 2.0 | 5.8 |
| People's Republic of China | 9.6 | 8.8 | 7.8 | 7.1 | 8.0 | 7.3 | 7.3 | 7.0 | 7.5 |
| Central Asian Republics, Azerbaijan and Mongolia | 0.6 | 1.8 | 2.1 | 4.9 | 7.8 | 7.7 | 3.3 | 5.5 | 4.8 |
| Southeast Asia | 7.4 | 3.5 | -9.1 | 3.2 | 5.2 | 2.4 | 4.0 | 3.3 | 4.8 |
| Indonesia | 7.8 | 4.7 | -13.2 | 0.9 | 4.8 | 3.2 | 4.2 | 3.9 | 4.5 |
| Malaysia | 10.0 | 7.3 | -7.4 | 6.1 | 8.3 | 0.8 | 4.9 | 3.1 | 6.0 |
| Philippines | 5.8 | 5.2 | -0.6 | 3.4 | 4.0 | 2.7 | 3.1 | 3.0 | 4.2 |
| Thailand | 5.9 | -1.4 | -10.8 | 4.2 | 4.4 | 1.5 | 3.5 | 2.5 | 4.5 |
| Viet Nam | 9.3 | 8.2 | 4.4 | 4.7 | 6.1 | 6.0 | 6.4 | 6.2 | 6.9 |
| South Asia | 7.0 | 5.0 | 5.8 | 5.9 | 5.1 | 5.2 | 5.8 | 5.7 | 6.5 |
| Bangladesh | 4.6 | 5.4 | 5.2 | 4.9 | 5.9 | 6.0 | 5.7 | 5.5 | 6.0 |
| India | 7.5 | 5.4 | 6.6 | 6.4 | 5.2 | 5.6 | 6.2 | 6.3 | 7.0 |
| Pakistan | 6.8 | 1.9 | 2.0 | 4.2 | 3.9 | 2.6 | 3.8 | 3.0 | 4.7 |
| The Pacific | 5.7 | -2.9 | -1.9 | 4.3 | -1.6 | -0.5 | 3.4 | 2.5 | 5.0 |
| Pacific Island DMCs | — | — | 0.7 | 5.6 | -1.4 | 1.2 | — | 3.9 | — |
| Papua New Guinea | 7.7 | -3.9 | -3.8 | 5.4 | -1.8 | -2.0 | 3.1 | 1.5 | 5.7 |
| **DMCs** | **7.6** | **5.9** | **0.2** | **6.4** | **7.0** | **3.4** | **5.3** | **4.5** | **6.1** |

— data not available.

## Table 2. Change in Consumer Prices
(percent per year)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| Newly Industrialized Economies | 4.3 | 3.5 | 4.6 | -0.1 | 1.1 | 2.1 | 2.2 | 1.9 | 2.5 |
| Hong Kong, China | 6.4 | 5.8 | 2.8 | -4.0 | -3.8 | -1.4 | 1.0 | 0.3 | 4.0 |
| Republic of Korea | 4.9 | 4.5 | 7.5 | 0.8 | 2.3 | 4.2 | 3.0 | 3.0 | 2.5 |
| Singapore | 1.3 | 2.0 | -0.3 | 0.1 | 1.3 | 1.1 | 1.5 | 0.5 | 2.0 |
| Taipei,China | 3.1 | 0.9 | 1.7 | 0.2 | 1.3 | 0.3 | 1.7 | 1.0 | 1.8 |
| People's Republic of China | 8.3 | 2.8 | -0.8 | -1.4 | 0.4 | 1.0 | 2.0 | 0.8 | 2.5 |
| Central Asian Republics, Azerbaijan and Mongolia | 41.5 | 31.2 | 7.9 | 20.7 | 26.6 | 9.5 | 10.6 | 9.9 | 10.0 |
| Southeast Asia | 6.2 | 7.1 | 33.4 | 2.8 | 4.7 | 5.9 | 5.4 | 5.3 | 4.4 |
| Indonesia | 6.5 | 11.0 | 77.6 | 2.1 | 9.3 | 11.0 | 9.0 | 9.0 | 6.0 |
| Malaysia | 3.5 | 2.7 | 5.3 | 2.8 | 1.5 | 1.7 | 2.6 | 2.0 | 2.8 |
| Philippines | 9.1 | 5.9 | 9.7 | 6.7 | 4.4 | 6.3 | 7.0 | 5.5 | 6.0 |
| Thailand | 5.9 | 5.5 | 8.1 | 0.3 | 1.6 | 2.3 | 2.0 | 2.6 | 2.6 |
| Viet Nam | 5.6 | 3.1 | 7.9 | 4.1 | -1.7 | 0.5 | 3.0 | 3.0 | 5.0 |
| South Asia | 5.8 | 5.3 | 6.3 | 4.2 | 6.4 | 4.8 | 5.4 | 4.8 | 4.8 |
| Bangladesh | 6.6 | 2.5 | 7.0 | 8.9 | 3.5 | 1.5 | 3.0 | 3.0 | 5.0 |
| India | 4.6 | 4.4 | 5.9 | 3.3 | 7.2 | 5.0 | 5.5 | 5.0 | 4.8 |
| Pakistan | 10.4 | 11.3 | 7.8 | 5.7 | 3.6 | 4.7 | 6.0 | 5.1 | 4.5 |
| The Pacific | 8.9 | 3.9 | 10.2 | 9.6 | 9.8 | 7.6 | 8.3 | 4.8 | 5.0 |
| Pacific Island DMCs | — | — | 5.1 | 2.5 | 2.1 | 3.7 | — | 3.2 | — |
| Papua New Guinea | 11.9 | 3.9 | 13.6 | 14.9 | 15.6 | 10.0 | 11.6 | 6.0 | 6.2 |
| **DMCs** | **6.1** | **4.4** | **9.4** | **0.9** | **2.6** | **3.1** | **3.4** | **2.8** | **3.3** |

— data not available.

## Table 3. Growth Rate of Merchandise Exports
(percent per year)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| Newly Industrialized Economies | 4.6 | 4.7 | -8.6 | 5.3 | 19.5 | -10.1 | 7.5 | 6.3 | 9.5 |
| Hong Kong, China | 4.0 | 6.3 | -8.5 | -0.6 | 16.0 | -5.9 | 5.3 | 4.5 | 8.5 |
| Republic of Korea | 4.3 | 6.7 | -4.7 | 9.9 | 21.1 | -11.5 | 9.0 | 7.0 | 10.5 |
| Singapore | 6.4 | -0.2 | -12.1 | 4.5 | 20.3 | -8.2 | 5.0 | 6.5 | 10.0 |
| Taipei,China | 3.8 | 5.4 | -9.5 | 9.9 | 21.8 | -16.0 | 11.8 | 8.0 | 9.8 |
| People's Republic of China | 17.9 | 20.9 | 0.5 | 6.1 | 27.8 | 6.0 | 10.0 | 4.0 | 15.0 |
| Central Asian Republics, Azerbaijan and Mongolia | 4.1 | 7.4 | -16.2 | 1.4 | 31.0 | 4.1 | -0.3 | 10.8 | 10.7 |
| Southeast Asia | 5.9 | 7.5 | -4.7 | 11.0 | 18.6 | -5.3 | 8.6 | 5.8 | 12.1 |
| Indonesia | 5.8 | 12.2 | -10.5 | 1.7 | 27.6 | -0.7 | 8.1 | 5.0 | 11.2 |
| Malaysia | 6.9 | 1.0 | -7.3 | 16.8 | 17.0 | -8.8 | 11.8 | 6.5 | 14.8 |
| Philippines | 17.7 | 22.8 | 16.9 | 16.0 | 9.0 | -12.5 | 3.0 | 4.0 | 8.0 |
| Thailand | -1.9 | 4.1 | -6.8 | 7.4 | 19.6 | -4.5 | 7.0 | 4.0 | 11.0 |
| Viet Nam | 41.2 | 24.6 | 2.4 | 23.2 | 25.2 | 12.0 | 12.0 | 15.0 | 13.0 |
| South Asia | 6.5 | 4.9 | -0.1 | 4.4 | 17.2 | 5.2 | 10.6 | 5.9 | 12.4 |
| Bangladesh | 11.8 | 14.0 | 16.8 | 2.9 | 8.2 | 12.4 | 15.0 | 3.0 | 15.0 |
| India | 5.6 | 4.5 | -3.9 | 9.5 | 19.6 | 5.5 | 12.0 | 8.8 | 13.0 |
| Pakistan | 7.1 | -2.6 | 4.2 | -10.7 | 8.8 | 9.0 | 14.6 | -4.8 | 14.1 |
| The Pacific | 4.1 | -14.1 | -17.2 | 11.2 | 1.5 | -8.0 | -3.4 | 3.5 | 1.3 |
| Pacific Island DMCs | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Papua New Guinea | -8.0 | -16.0 | -15.4 | 9.2 | 9.7 | -8.2 | -2.3 | 2.3 | -0.4 |
| **DMCs** | **6.8** | **7.8** | **-5.9** | **6.6** | **20.8** | **-5.0** | **8.3** | **5.7** | **11.2** |

— data not available.
... data not applicable.

## Table 4. Growth Rate of Merchandise Imports
(percent per year)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| Newly Industrialized Economies | 5.2 | 3.2 | -19.5 | 7.5 | 25.0 | -10.6 | 7.3 | 6.8 | 10.7 |
| Hong Kong, China | 3.0 | 5.2 | -12.3 | -3.1 | 18.6 | -4.8 | 4.7 | 3.5 | 9.0 |
| Republic of Korea | 12.3 | -2.2 | -36.2 | 29.1 | 36.3 | -12.0 | 8.0 | 8.0 | 13.0 |
| Singapore | 5.4 | 0.7 | -23.1 | 9.0 | 22.2 | -8.4 | 8.0 | 8.0 | 13.0 |
| Taipei,China | -0.1 | 10.1 | -7.4 | 6.2 | 25.9 | -20.0 | 10.8 | 10.0 | 9.5 |
| People's Republic of China | 19.5 | 3.7 | 0.3 | 15.8 | 36.8 | 10.0 | 20.0 | 8.0 | 15.0 |
| Central Asian Republics, Azerbaijan and Mongolia | 16.6 | 0.8 | -11.1 | -12.8 | -6.4 | 31.2 | 24.4 | 11.7 | 11.8 |
| Southeast Asia | 2.7 | -0.4 | -26.2 | 7.0 | 23.5 | 0.5 | 16.1 | 7.7 | 19.1 |
| Indonesia | 8.1 | 4.5 | -30.9 | -4.2 | 31.9 | 12.4 | 15.4 | 8.0 | 17.3 |
| Malaysia | 1.4 | 1.5 | -26.6 | 12.8 | 26.2 | -7.6 | 23.7 | 8.5 | 27.5 |
| Philippines | 20.8 | 14.0 | -18.8 | -0.9 | 3.9 | -0.5 | 5.0 | 5.0 | 5.0 |
| Thailand | 0.8 | -13.8 | -33.8 | 16.9 | 31.3 | 1.0 | 13.0 | 5.0 | 14.0 |
| Viet Nam | 25.5 | -0.2 | -1.1 | 1.1 | 34.5 | 10.0 | 16.0 | 18.0 | 17.0 |
| South Asia | 12.4 | 3.4 | -5.7 | 10.5 | 7.3 | 5.3 | 6.8 | 6.7 | 8.3 |
| Bangladesh | 17.9 | 4.1 | 5.1 | 6.6 | 4.8 | 11.4 | 8.0 | 5.0 | 9.0 |
| India | 12.1 | 4.6 | -7.1 | 16.5 | 7.0 | 8.0 | 10.0 | 9.1 | 9.5 |
| Pakistan | 16.7 | -6.4 | -8.4 | -6.7 | -0.1 | 5.9 | 9.3 | 0.8 | 8.8 |
| The Pacific | 23.8 | 6.2 | -23.2 | 5.5 | -12.5 | -9.5 | 8.7 | 0.3 | -3.1 |
| Pacific Island DMCs | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Papua New Guinea | 16.9 | 10.1 | -27.7 | 7.0 | -1.5 | -2.4 | 36.6 | 1.4 | -3.9 |
| **DMCs** | **6.9** | **2.4** | **-17.3** | **8.7** | **24.7** | **-3.2** | **11.4** | **7.2** | **13.1** |

— data not available.
... data not applicable.

# Table 5. Balance of Payments on Current Account
($ million)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| Newly Industrialized Economies | 740 | 16,811 | 64,136 | 54,612 | 42,157 | 41,709 | 40,036 | 35,626 | 42,960 |
| Hong Kong, China | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Republic of Korea | -23,005 | -8,167 | 40,365 | 24,477 | 11,044 | 11,452 | 8,697 | 7,617 | 5,806 |
| Singapore | 12,822 | 17,927 | 20,334 | 21,751 | 21,797 | 20,758 | 23,600 | 19,753 | 26,850 |
| Taipei,China | 10,923 | 7,051 | 3,437 | 8,384 | 9,316 | 9,499 | 7,739 | 8,256 | 10,304 |
| People's Republic of China | 7,243 | 36,963 | 31,472 | 15,667 | 20,519 | 10,567 | 12,000 | 3,881 | 10,000 |
| Central Asia Republics, Azerbaijan and Mongolia | -2,268 | -1,550 | -1,914 | -464 | 765 | 812 | 812 | 673 | 673 |
| Southeast Asia | -34,310 | -21,072 | 27,056 | 38,815 | 34,686 | 16,304 | 24,822 | 10,470 | 19,176 |
| Indonesia | -7,801 | -5,001 | 4,097 | 5,783 | 7,992 | 3,458 | 4,550 | 1,077 | 2,550 |
| Malaysia | -4,455 | -5,942 | 9,539 | 12,606 | 8,401 | 4,758 | 5,162 | 4,536 | 3,274 |
| Philippines | -3,953 | -4,351 | 1,546 | 7,910 | 9,349 | 3,500 | 7,726 | 3,500 | 7,571 |
| Thailand | -14,692 | -3,022 | 13,847 | 12,069 | 8,673 | 4,248 | 7,690 | 2,673 | 6,819 |
| Viet Nam | -2,580 | -1,839 | -1,238 | 1,154 | 505 | 625 | -20 | -993 | -716 |
| South Asia | -11,715 | -10,739 | -6,751 | -8,313 | -5,376 | -7,743 | -7,757 | -9,198 | -6,740 |
| Bangladesh | -1,636 | -909 | -470 | -653 | -442 | -1002 | — | -1,299 | — |
| India | -4,619 | -5,500 | -4,038 | -4,698 | -2,579 | -4,642 | -5,972 | -5,798 | -5,590 |
| Pakistan | -4,348 | -3,557 | -1,701 | -2,235 | -1,128 | -1,340 | -1,025 | -1,564 | -613 |
| The Pacific | 425 | -215 | 75 | 131 | 320 | 163 | -80 | 146 | -96 |
| Pacific Island DMCs | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Papua New Guinea | 289 | -263 | 23 | 53 | 282 | 118 | -125 | 112 | -130 |
| **DMCs** | **-39,885** | **20,198** | **114,074** | **100,449** | **93,071** | **61,812** | **69,833** | **41,599** | **65,973** |

— data not available.
... data not applicable.

## Table 6. Balance of Payments on Current Account
(percent of GDP)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Current | *ADO 2001* | Current | *ADO 2001* |
| Newly Industrialized Economies | 0.1 | 1.9 | 7.4 | 6.3 | 4.9 | 4.8 | 4.6 | 4.1 | 5.0 |
| Hong Kong, China | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Republic of Korea | -4.4 | -1.7 | 12.7 | 6.0 | 2.4 | 2.7 | 1.9 | 1.7 | 1.1 |
| Singapore | 14.1 | 19.0 | 24.8 | 25.9 | 23.6 | 24.0 | 24.0 | 22.5 | 25.0 |
| Taipei,China | 3.9 | 2.4 | 1.3 | 2.9 | 2.9 | 3.4 | 2.5 | 2.7 | 3.0 |
| People's Republic of China | 0.9 | 4.1 | 3.1 | 1.6 | 1.5 | 0.9 | 1.2 | 0.3 | 1.0 |
| Central Asian Republics, Azerbaijan and Mongolia | -5.8 | -4.5 | -5.5 | -1.3 | 2.5 | 2.6 | 2.6 | 3.6 | 3.6 |
| Southeast Asia | -5.4 | -3.5 | 4.7 | 6.7 | 5.9 | 2.8 | 3.6 | 1.8 | 3.0 |
| Indonesia | -3.4 | -2.3 | 4.3 | 4.1 | 5.2 | 2.1 | 2.9 | 0.6 | 1.3 |
| Malaysia | -4.4 | -5.9 | 13.2 | 15.9 | 9.4 | 5.2 | 5.5 | 4.7 | 3.2 |
| Philippines | -4.8 | -5.3 | 2.4 | 10.0 | 12.5 | 4.9 | 8.0 | 4.5 | 5.0 |
| Thailand | -8.1 | -2.0 | 12.7 | 10.0 | 7.5 | 3.8 | 6.5 | 2.3 | 5.6 |
| Viet Nam | -9.9 | -6.5 | -4.6 | 4.1 | 1.7 | 2.0 | -0.1 | -3.0 | -1.9 |
| South Asia | -2.3 | -2.2 | -1.4 | -1.7 | -1.1 | -1.6 | -1.7 | -1.9 | -1.5 |
| Bangladesh | -4.0 | -2.1 | -1.1 | -1.4 | -1.0 | -2.0 | -1.5 | -2.5 | -1.8 |
| India | -1.2 | -1.3 | -1.0 | -1.0 | -0.5 | -0.9 | -1.2 | -1.0 | -1.0 |
| Pakistan | -7.3 | -5.9 | -3.0 | -3.6 | -2.1 | -2.2 | -1.7 | -2.5 | -1.0 |
| The Pacific | 5.0 | -2.7 | 1.1 | 2.0 | 5.4 | — | — | — | — |
| Pacific Island DMCs | ... | ... | ... | ... | ... | — | — | — | — |
| Papua New Guinea | 5.5 | -5.3 | 0.6 | 1.4 | 7.8 | 3.8 | -3.5 | 3.5 | -3.4 |
| **DMCs** | **-1.4** | **0.8** | **4.2** | **3.7** | **3.4** | **2.3** | **2.6** | **1.5** | **2.5** |

— data not available.
... data not applicable.

# STATISTICAL NOTES

Summary tables on output, inflation, and components of the balance of payments are presented for 14 developing member countries and five subregions of the Asian Development Bank (ADB). These tables contain historical data from 1998 to 2000, preliminary estimates for 2001, and forecasts for 2002. Most historical data are obtained from ADB's statistical database system, official country sources, statistical sites on the Internet, and online data service providers. Statistical publications of the International Monetary Fund (IMF) and World Bank are also used. Estimates for 2001 and forecasts for 2002 are based on available quarterly data. Data refer to calendar years, except for Bangladesh, India, and Pakistan, where fiscal year data are reported.

Subregional averages have been computed for output growth, inflation, and the ratio of the current account balance to gross domestic product (GDP). Subregional averages of output growth and inflation are weighted arithmetic means of the individual country data using the average of 1995-1996 nominal GDP in US dollars as weights. This weighting system has been adopted in order to assign a more realistic share to the crisis-affected countries as compared to using contemporaneous nominal GDP in US$. The subregional average of the current account to GDP ratio is based on the ratio of the overall subregional current account balance to the overall subregional nominal GDP in US dollars. Except for the Central Asian republics and Azerbaijan, which have a variable country coverage depending on the specific data, all the subregional averages are computed based on the complete enumeration of countries included in the *Asian Development Outlook 2001*.

For the Central Asian republics, Azerbaijan, and Mongolia, the coverage for the subregional averages varies depending on the availability of data. For GDP and inflation, the averages cover CARs and Azerbaijan but exclude Mongolia; the comparative figure from *ADO 2001*, however, includes Mongolia but not Azerbaijan. For the components of the current account, the averages exclude Azerbaijan and the Kyrgyz Republic but include Mongolia.

Subregional averages for output and inflation are also presented for Pacific Island DMCs (which excludes PNG). However, due to data limitations, subregional averages for the components of the balance of payments are not presented.

**Growth rates of GDP** are valued at constant market prices except for India and Pakistan where GDP at constant factor cost is used. For Papua New Guinea, the growth rate is based on GDP at constant purchaser's value.

**Inflation rates** are generally based on the consumer price index (CPI) and reflect period averages except for Indonesia and Viet Nam with end-of-period inflation rates. The inflation rate for Hong Kong, China; Pakistan; and Singapore are fiscal year; while that for India is also fiscal year based on the wholesale price index (WPI).

**Growth rates of merchandise exports and imports** are derived from the balance-of-payments accounts for which data are from official sources. These figures are on a free-on-board (f.o.b.) basis. For Hong Kong, China the export and import growth figures in the text refer to growth of exports obtained from the national income accounts at constant market prices. This are different from the growth of merchandise exports and imports in the tables, which are in nominal US dollar terms.

**Current account balance as percent of GDP** is the ratio of the current balance in US dollars to nominal GDP in US dollars. The current account balance is the sum of the balance of trade, net trade in services and factor incomes, and current official and private transfers. In the case of Bangladesh, the current account balance does not include official transfers.

**Tables and charts for the chapter "Outlook for Developing Asia and the Pacific"** were generated using data obtained from the following sources: CEIC Data Company Ltd.; *Global Data Watch* of J.P. Morgan (August-October 2001); Global Economics Database of Datastream; *International Financial Statistics* of IMF (October 2001); *World Development Indicators* 2001 of the World Bank; *World Economic Outlook* of IMF (October 2001); and official sources. Other data are staff estimates. Short-term interest rates give the yield of three-month certificate of deposits or government bonds (whichever is available). Exchange rates are average of period market exchange rates. Stripped spreads are the rate differentials between the rate of return of private placements and the rate of return of corresponding government bonds. The following websites were also used as data sources: www.cnn.com; interactive.wsj.com; www.iif.com.

**Charts for individual country chapters and subregional overviews** were computed or generated from data obtained from CEIC Data Company Ltd.; *IMF Article IV* (various issues, several countries); Global Economics Database of Datastream; and official sources. Except for Papua New Guinea (which uses IMF data), the data on GDP growth are obtained from official sources. Data on the components of domestic demand (investment and consumption) for the PRC, Indonesia, and Malaysia are obtained from official sources. Data on fiscal deficits for Bangladesh, India, Pakistan, and PNG are obtained from official sources. Data on capital flows for PRC, and data on the stock market for the Republic of Korea are obtained from IMF. Unemployment rates for Hong Kong, China are obtained from official sources.