ASIAN DEVELOPMENT

Outlook 2002

SPECIAL CHAPTER

PREFERENTIAL TRADE AGREEMENTS IN ASIA AND THE PACIFIC

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FOREWORD

The *Asian Development Outlook 2002* is the 14th edition of the annual comprehensive economic report on the developing member countries (DMCs) of the Asian Development Bank (ADB). The *Outlook* provides a detailed analysis and assessment of macroeconomic trends, including fiscal, monetary, and balance-of-payments developments, for 41 Asian and Pacific economies for 2001, as well as projections for 2002 and 2003. It also provides a broad diagnosis of macroeconomic conditions and future growth prospects and progress in poverty reduction in the economies of the region. For the first time, the *Outlook* includes a section on Afghanistan.

The global economy weakened significantly through most of 2001. The United States economy, already slowing, contracted further in the third quarter largely as a result of the events of September 11th. However, the economy strengthened somewhat during the last quarter, and showed further strength during the first quarter of 2002. Output in Japan contracted in the latter part of 2001, and in Europe the growth that had started slowing after the first quarter weakened further toward the end of the year. In early 2002, amid indications of a recovery in the United States, most other industrial countries are expected to show some signs of strengthening over the course of the year.

As external conditions deteriorated in 2001, growth in most of the DMCs—particularly those in East Asia and Southeast Asia that are more open to international trade and that also depend heavily on electronics exports—slowed significantly during the year. Despite being affected by weak external markets, some economies such as the People's Republic of China, India, and Viet Nam maintained relatively robust growth. Overall, GDP growth in the DMCs fell from 7.0% in 2000 to 3.7% in 2001. With recovery taking hold as 2002 advances and some revival in exports appearing, growth in the DMCs is projected to record 4.8% in 2002, a rate well below the trend experienced before the Asian financial crisis. Growth will also be supported by rising domestic demand, already apparent in several DMCs in 2001.

This year's theme chapter looks at preferential trade agreements (PTAs), examining their role in determining trade flows within the Asia and Pacific region and between the region and the rest of the world. The global multilateral trading arrangement under the aegis of the World Trade Organization offers the best prospect for reducing barriers and achieving the greatest gains from trade liberalization. PTAs are a second-best means of achieving trade liberalization in a context where multilateral negotiations proceed slowly. Through their effect on trade and growth, PTAs have important implications for poverty reduction in the DMCs and the developing world more generally.

The preparation of the *Outlook* was made possible through the efforts of many individuals both inside and outside of ADB. The contribution of the economists from the Economics and Research Department, the five regional departments, and the resident missions is, in particular, acknowledged. The Regional and Sustainable Development Department, the Strategy and Policy Department, and the Regional Economic Monitoring Unit contributed comments on various drafts. The publication would not have been possible without the support of the Office of Administrative Services and the Office of Information Systems and Technology. Finally, the advice and assistance of the Office of External Relations in disseminating the *Outlook* are gratefully acknowledged.

Tadao Chino

TADAO CHINO
President

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In ERD, the *Outlook* team was led by J.P. Verbiest, Assistant Chief Economist, Macroeconomics and Financial Research Division, assisted by Cindy Houser, Charissa N. Castillo, and James P. Villafuerte. Cindy Houser contributed Part I; Christine Kuo prepared the country chapters on Hong Kong, China; and Singapore; Sailesh Jha contributed the country chapters on the Republic of Korea; Malaysia; and Taipei,China. The preparation of the theme chapter was coordinated by Christopher Edmonds, who drafted the chapter with Jessica Seddon, Ramon Clarete, and Kym Anderson. T. N. Srinivasan contributed a background paper for the chapter, which benefited from the review and valuable comments of Xianbin Yao and Jeffrey Liang. Other staff in ERD who contributed to the preparation of the *Outlook* are Yun Hwan Kim and Yeo Lin.

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ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
ADO	*Asian Development Outlook*
AFTA	ASEAN Free Trade Area
AICO	ASEAN Industrial Cooperation Scheme
AMC	Asset management company
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
CER	Australia-New Zealand Closer Economic Relations Trade Agreement
CGE	Computable general equilibrium
CIS	Commonwealth of Independent States
DMC	Developing member country
ECO	Economic Cooperation Organization
EFTA	European Free Trade Association
EU	European Union
FDI	Foreign direct investment
FTA	Free trade agreement
FY	Fiscal year
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
ICT	Information and communications technology
IMF	International Monetary Fund
Lao PDR	Lao People's Democratic Republic
LDC	least developed country
MFA	Multifiber Arrangement
MFN	Most-favored nation
MSG	Melanesian Spearhead Group
NAFTA	North American Free Trade Agreement
NIE	Newly industrialized economy
NGO	Nongovernment organization
NPL	Nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PRC	People's Republic of China
PRGF	Poverty Reduction and Growth Facility
PTA	Preferential trade agreement
RTA	Regional trading arrangement
SAARC	South Asian Association for Regional Cooperation
SAPTA	SAARC Preferential Trading Arrangement
SME	Small and medium enterprise
SOCB	State-owned commercial bank
SOE	State-owned enterprise
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
SREZ	Subregional economic zone
UK	United Kingdom
US	United States
WDI	*World Development Indicators*
WTO	World Trade Organization

DEFINITIONS

The classification of economies in the *Asian Development Outlook 2002,* by major analytic or geographic groupings such as industrial countries, developing countries, Africa, Latin America, Middle East, Europe, and transition economies generally follows the classification adopted by the International Monetary Fund (IMF). However, the IMF classification refers to Latin America as developing countries in the western hemisphere.

For purposes of *ADO 2002,* the following apply:

- **Developing Asia** refers to 40 developing member countries (DMCs) of the Asian Development Bank discussed in *ADO 2002,* in addition to East Timor.
- **East Asia** comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China.
- **Southeast Asia** comprises Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
- **Central Asia** comprises Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **Pacific developing member countries** comprise Cook Islands, East Timor, Fiji Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.
- **Euro area** comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.
- Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars. Currency abbreviations are given in Statistical Appendix Table A20.

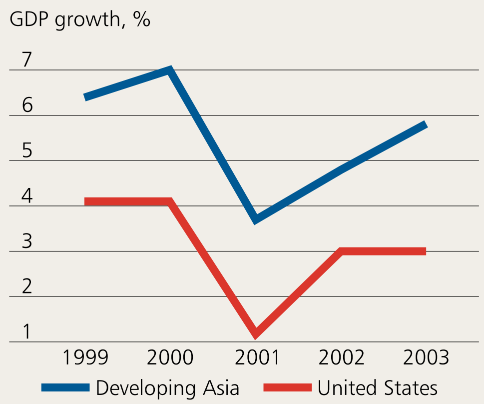
The *Statistical Notes* give a detailed explanation of how data are derived.

ADO 2002 is based on data available up to 15 March 2002.

DEVELOPING ASIA AND THE WORLD

In contrast to the deteriorating outlook of 2001, the encouraging economic news of early 2002 is forming the basis for stronger medium-term growth forecasts in the Asia and Pacific region (Figure 1.1). There are both external and internal reasons for renewed optimism. Externally, a strengthening United States economy, emerging from a milder than predicted recession, is proving beneficial to the outlook for other economies worldwide, including the euro area, Japan, and developing Asia. Internally, domestic demand in many of the Asian Development Bank's developing member countries is responding to macroeconomic stimulus and emerging as a source of growth. Moreover, falling risk spreads on Asian securities and, as of early 2002, strengthening equity markets reveal renewed investor interest in the region. A recovery in developing Asia is expected to build over 2002–2003, promising to be more balanced, though less intense, than the 1999–2000 expansion. However, the recovery is vulnerable to several risks, including rising oil prices.

FIGURE 1.1 **A recovery takes shape**



Sources: www.fedstats.gov; *Asian Development Outlook* database; staff estimates.

OVERVIEW OF 2001 ECONOMIC TRENDS IN DEVELOPING ASIA

As external demand receded in 2001, economic growth of the developing member countries (DMCs or developing Asia) of the Asian Development Bank (ADB) slowed to half its 2000 pace (Table 1.1). East Asian economic growth, high in 2000, was much lower in 2001 because an erosion of external demand sharply affected Hong Kong, China; Republic of Korea (Korea); and Taipei,China; while growth eased somewhat in the People's Republic of China (PRC). Southeast Asia was similarly affected by falling external demand, resulting in a pronounced drop in growth in 2001.

In contrast, South Asian growth accelerated as slowing export expansion was offset by improvement in agriculture. In Central Asia, growth was higher in 2001, in part because of heavy investment mainly in the energy sector. The recession in Papua New Guinea, political instability, and fiscal difficulties continued to affect overall 2001 performance in the Pacific DMCs.

The United States (US) dollar value of merchandise exports of developing Asia fell by 6.8% in 2001, a stark reversal from the 21.2% expansion in 2000 (Table 1.2). The loss of momentum in external demand was less severe in the South Asian subregion, for which information and communications technology (ICT) and nonagricultural commodity exports are less important and for which less volatile products such as textiles are more prominent exports. For East Asia and Southeast Asia, generally, the sever-

TABLE 1.1 Selected Economic Indicators, Developing Asia, 1999–2003

	1999	2000	2001	2002	2003
Change in Real GDP (%)					
Developing Asia	6.4	7.0	3.7	4.8	5.8
East Asia	7.6	8.3	3.9	5.2	6.2
Southeast Asia	3.8	5.9	1.9	3.4	4.3
South Asia	5.7	4.2	4.9	5.4	6.4
Central Asia	4.9	8.7	10.7	5.7	6.4
Pacific DMCs	6.6	-1.0	-0.8	1.9	2.6
Consumer Price Index Inflation (%)					
Developing Asia	0.8	2.3	3.0	3.1	3.3
East Asia	-0.7	0.7	1.4	1.5	2.3
Southeast Asia	1.0	2.5	5.2	5.7	4.4
South Asia[a]	4.2	6.2	4.6	4.1	4.8
Central Asia	15.5	16.9	13.7	10.0	5.6
Pacific DMCs	9.2	9.5	7.2	6.0	3.1
Current Account Balance (% of GDP)					
Developing Asia	3.9	3.2	3.0	1.9	1.1
East Asia	3.2	2.3	2.7	1.8	1.0
Southeast Asia	9.9	8.5	6.9	5.0	4.0
South Asia	-1.6	-1.0	-0.8	-1.7	-1.9
Central Asia	-4.4	0.3	-2.9	-4.5	-4.9
Pacific DMCs	1.8	4.3	2.2	0.2	3.0
Memorandum Items[b]					
US GDP growth (%)	4.1	4.1	1.2	3.0	3.0
Japan GDP growth (%)	0.7	2.2	-0.5	0.0	1.0
Euro area GDP growth (%)	2.6	3.4	1.5	1.7	3.0
US Federal Funds rate (%, end period)	5.5	6.4	1.8	3.0	—
Spot oil prices ($/barrel, Brent crude, end period)	25.7	22.4	19.8	25.0	—

— Not forecast. GDP = Gross domestic product, DMCs = Developing member countries.
[a] India reports on a wholesale price index basis. [b] Baseline assumptions for 2002–2003.
Sources: CEIC Data Company Ltd.; *Asian Development Outlook* database; staff estimates.

ity of the turnaround in the momentum of external demand stemmed from the collapse in ICT trade. Central Asia was affected by the decline in commodity prices, which deepened after September 11th 2001. Because the export decline was somewhat larger than the decline in imports, the 2001 current account surplus for DMCs as a whole shrank slightly in 2001, as it has done every year since peaking at 5.4% of aggregate gross domestic product (GDP) in 1998.

On the domestic demand side, the relatively stronger growth rates in some DMCs generally originated in the contribution of sustained or accelerating consumption growth, while investment growth tended to be somewhat weaker. In some cases, such as the PRC, this was partly the result of sustained fiscal deficit spending. In others, such as India and the Philippines, strengthening consumption arose from rising agricultural output and incomes.

In those cases of weaker or negative growth, DMCs often saw both slowing consumption growth—despite fiscal stimulus—and contracting investment. This, for example, included Korea; Malaysia; Singapore; and Taipei,China, for all of which the sharp deterioration in ICT exports fed through into investment in the ICT sector as a result of the deterioration in the outlook for sales. Some Central Asian countries were exceptions to this trend of relatively weak contri-

TABLE 1.2 Merchandise Exports, Developing Asia, 1999–2003 (% change in $ values)

	1999	2000	2001	2002	2003
Developing Asia	6.8	21.2	-6.8	5.5	9.2
East Asia	5.8	22.0	-5.8	5.0	8.7
Southeast Asia	8.9	19.6	-9.8	6.1	9.7
South Asia	4.4	17.3	0.5	7.2	12.9
Central Asia	6.4	49.1	-0.6	10.1	5.5
Pacific developing member countries	8.6	5.9	-9.1	8.5	6.5

DMCs = Developing member countries.
Source: Asian Development Outlook database; staff estimates.

butions to growth from investment in comparison with consumption. Fueled by rapid expansion of the oil and gas sector, Azerbaijan, Kazakhstan, and Turkmenistan experienced rapid growth of investment.

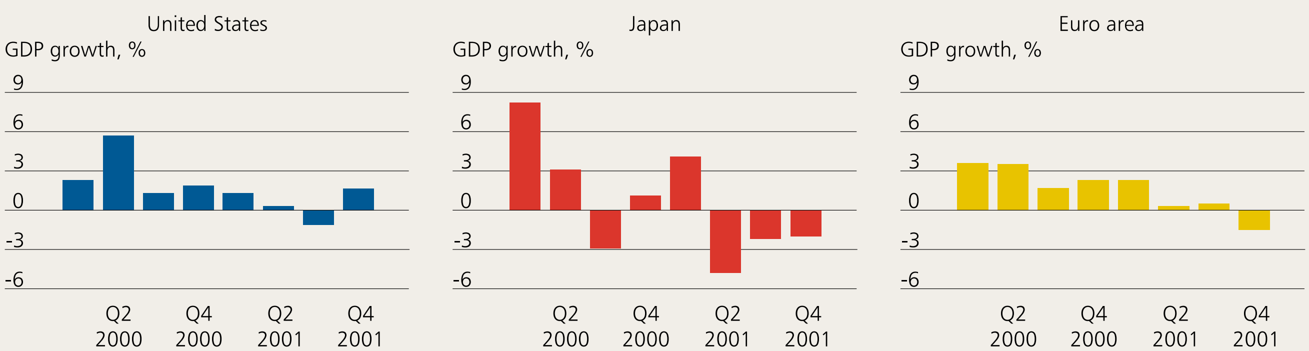
Despite generally weaker growth, inflation edged up in DMCs from 2.3% in 2000 to 3% in 2001. However, this level of inflation is still low by historical standards. Inflation was low despite significant monetary loosening across the region, particularly in East Asia and Southeast Asia, but this had only a limited effect because of weak credit expansion. Moderate exchange rate depreciation against the US dollar in much of developing Asia also had a limited effect on inflation because import prices were generally falling. Indonesia's inflation rate, however, accelerated from under 4% to over 11% partly because of increases in administered prices for fuel. Inflation continued its secular downward trend in Central Asia.

EXTERNAL CONDITIONS IN 2001 AND 2002

Macroeconomic Conditions in Major Markets for Developing Asia's Exports

The market for approximately one fourth of DMC exports—the US—is strengthening after a sharp mid-2000 deceleration that evolved into a mild recession by April 2001 and culminated in a GDP contraction in the third quarter of the year. With accelerating consumption and government expenditure growth more than offsetting double-digit contractions in private investment and exports, GDP growth reemerged in the fourth quarter of 2001 (Figure 1.2). Despite heightened uncertainty about economic prospects that characterized late 2001 and early 2002, the US economy returned to growth after only one quarter of economic contraction.

FIGURE 1.2 **A synchronized recovery?**



Note: Quarterly growth rates are seasonally adjusted and annualized.
Sources: www.fedstats.gov; www.stat.go.jp; www.ecb.int.

US consumption continued to grow, despite contracting investment, falling financial wealth, rising consumer debt, declining employment, the events of September 11th, and the Enron collapse.

A key element of this rapid rebound from the shallow recession was the behavior of consumption. Contrary to the typical experience of past recessions, US consumption continued to grow—by 3.1% in 2001—despite contracting investment, falling financial wealth, rising consumer debt, declining employment, the events of September 11th, and the Enron collapse. Factors that could explain this remarkable resilience include (i) low inflation—especially declining energy prices and steep discounts for automobiles and other manufactured goods; (ii) macroeconomic stimulus—particularly interest rate cuts that, together with substantial gains in home equity, initiated a boom of refinancing and home sales that was a significant source of funds for home owners; (iii) sustained productivity growth—itself unusual for a recession; and (iv) general optimism about long-run economic prospects in light of perceived efficiency gains from improved ICT and increased flexibility in product and financial markets.

There were indications in early 2002 that the US economy was gathering momentum for a further strengthening in the first quarter of 2002. The wholesale inventories-to-sales ratio fell to 1.3 months in January 2002, its lowest level since March 2000. Manufacturing output began to grow again in February 2002 after 18 months of contraction.[1] Seasonally adjusted employment, which fell in 5 of the 6 previous months, rose by 0.6% in February 2002. However, US economic growth in 2002 is expected to be moderate relative to past recoveries because the mild character of the recession and persistent weakness in fixed investment reduce the scope for a strong rebound. Elsewhere in North America, Latin America, and the Caribbean, most economies with important economic ties to the US experienced relatively sharp slowdowns in 2001. Those economies with no significant cyclical or structural imbalances should rebound with the US.

The pace of 2001 economic growth in the euro area, which absorbs about 15% of DMC exports, slackened and turned into a contraction in the fourth quarter. This downturn resulted from weak consumption growth and continued contractions in investment and exports. For 2001 as a whole, economic growth was relatively balanced across demand components—private and government consumption each grew at just under 2% but the drag from declines in both fixed and inventory investment more than offset the positive contribution from net exports.

The euro area economy was showing evidence in early 2002 of growth momentum. The purchasing managers' index for the euro area strengthened and business confidence rose for the second consecutive month in January. However, the seasonally adjusted rate of unemployment remained at 8.5% in December 2001, unchanged since September 2001. In addition, consumer confidence declined in January 2002. As a result, consumption growth is expected to be subdued in the early part of the year. Overall, euro area economic growth is expected to strengthen modestly in 2002 relative to 2001.

The United Kingdom expanded at a relatively strong 2.4% in 2001, as sustained consumption and government spending growth more than offset weak investment and export demand. This robust performance, especially in the context of a weak global economy, is expected to continue in 2002 because of ongoing strength in domestic demand and improvement in external conditions.

Japan, which is the destination for about 12% of DMC exports, slipped into an economic recession in the second quarter of 2001, shrinking for three consecutive quarters and posting negative growth for the year. This was because of a severe contraction in exports combined with falling public and private residential investment, which more than offset modest growth in business investment and government consumption, while private consumption stagnated.

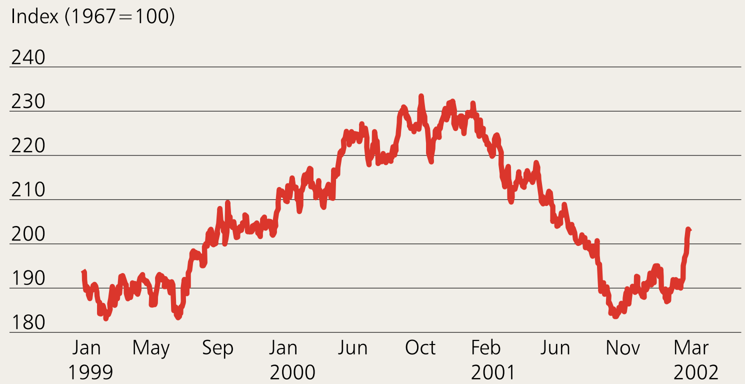
In early 2002, the prospects for a Japanese recovery were rendered unclear by conflicting influences. Low business inventories and a strengthening US economy indicated an improving outlook. Further, although consumer confidence in January 2002 was below its level of a year earlier, it rose relative to December 2001, after 3 consecutive months of weakening. Business confidence was similarly weak, although improving, and the fiscal stance was still restrained. Overall, domestic demand is forecast to contract in 2002 with, perhaps, sufficient offsetting improvement in the external sector to bring about zero growth in 2002. However, private sector-led corporate mergers and acquisitions are increasingly restructuring the manufacturing and finance sectors, which should provide some scope for increased efficiency and productivity

[1] This is based on a February 2002 reading of 54.7 for the purchasing managers' index of the Institute for Supply Management, compared with readings of below 50 for the previous 18 months. A reading above 50 is considered evidence of an expanding manufacturing sector, while a reading below 50 indicates a decline in manufacturing. *Source*: www.ism.ws.

growth. This, together with sustained strength in external demand, should result in an improvement in the investment outlook, contributing to a return to growth in Japan in 2003.

In the US, despite the surge in energy prices early in 2001, average annual consumer price index (CPI) inflation fell to 2.9%, from an already relatively low 3.4% in 2000 (especially in the context of rapid growth and very low unemployment), while it edged up by 0.3 percentage points to 2.7% in the euro area. In Japan, deflationary conditions persisted as average prices fell by 0.7%, compared with a drop of 0.8% in 2000. Overall, subdued inflation in advanced economies was matched in developing economies under the influence of falling prices for most commodities and some manufactured goods.[2] Several factors are cited as having triggered the trend toward lower inflation in recent years, including increased global competition in key commodity and manufactured goods markets, and the growing number of countries adopting inflation rather than exchange rates as their monetary targets. The outlook is for global inflationary pressures to increase somewhat relative to 2001 but to remain relatively low in 2002–2003 by historical standards.

FIGURE 1.3 **Commodity prices track pace of economic activity**



Note: Knight-Ridder Commodity Research Board Futures Commodity Price Index.
Source: www.economy.com.

World Trade in Goods and Services

The US, euro area, and Japan together account for over 50% of DMC exports (when total DMC exports are adjusted for reexports from Hong Kong, China and Singapore). It was largely double-digit growth in imports by these three economies that fueled high rates of economic growth in many DMCs in 2000 and it was the rapid reversal of that trend that led to sharply slower growth rates in the same DMCs in 2001. Although the most extreme swing from strong growth to steep contraction occurred in the ICT sector, the trend was generally evident, though to a lesser extent, across most merchandise products. This is apparent in the trends for prices of merchandise exports (especially commodity prices—Figure 1.3).

According to International Monetary Fund (IMF) statistics, advanced economies' import volumes of goods and services, which grew by an average 7.6% in 1995–1999, and reached 11.5% in 2000, are projected to have contracted by 0.3% in 2001. Because of the relatively modest nature of the economic recovery in the US, euro area, and Japan, and because the trade-dominating ICT sector will revive only slowly, trade is expected to rebuild to rapid growth only gradually. Single-digit growth is expected in advanced economies' import volumes of goods and services in the first half of 2002, as domestic demand expansion will be somewhat subdued because of lingering excess capacity and profit weakness in manufacturing, which will limit investment growth. Thus, in general, DMCs may see slowly improving external demand, with growth of merchandise exports expected to be less than 6% in 2002, but conditions may vary by subregion and by sector.

The US, euro area, and Japan together account for over 50% of DMC exports.

The value of world trade in manufacturing exports, which accounts for 75% of the total value of world trade in merchandise exports, is expected to have contracted in 2001 after rapid growth in 2000.[3] Of particular importance to DMCs are the ICT (specifically office machines and telecommunications equipment as defined in World Trade Organization [WTO] statistics) and the textile and clothing sector. ICT exports account for over 30% of DMC merchandise exports, and textile and clothing exports for over 8%.[4] The ICT sector experienced a major boom-

[2] International Monetary Fund, 2001, *World Economic Outlook,* The Global Economy After September 11, Washington, DC, December. The term "advanced economies" refers to 29 countries in North America, Europe, Asia, the Pacific, and the Middle East.

[3] World Trade Organization, 2001, *International Trade Statistics*, Geneva.

[4] The top seven DMC exporters of ICT products, by value (in descending order: Taipei,China; Malaysia; PRC; Korea; Singapore; Philippines; and Hong Kong, China) account for about 28% of world exports in the sector. The top eight DMC exporters of textiles and clothing, by value (PRC; Korea; Taipei,China; India; Pakistan; Indonesia; Thailand; and Hong Kong, China) account for about 45% of world exports in the sector.

bust cycle that carried the economic performance of many DMCs up in 1999–2000 and down in 2001. An indicator of this sector's health is the semiconductor chip market, which suffered a 31% decline in sales in 2001. Chip demand and the ICT sector as a whole are expected to recover relatively slowly in 2002, especially when compared with the rapid pace of expansion in 1999–2000. This is because retail sales of ICT products are expected to expand at a reasonable pace whereas corporate sales will be restrained by modest investment plans.

The growth of the value of world textile and clothing exports is expected to have slowed in 2001 from the 5% average pace of the previous decade as the rate of domestic demand growth slowed in major importing countries. Textile and clothing exports are expected to grow slowly in 2002 as world demand growth remains low relative to past trends.

Commodity exports are important to DMCs such as Indonesia, Viet Nam, and several economies in Central Asia. With falling demand, commodity prices fell in 2001, particularly in September 2001, reducing the value of such exports. The Futures Commodity Price Index of the Knight-Ridder Commodity Research Board fell by 16.3% during 2001, but this masks the beginning of a recovery late in the year. Commodity prices, which would generally be expected to continue to rebound with the pace of global economic activity, have experienced upward pressure.

BOX 1.1 Tourism Trends in Developing Asia

Tourism is an important and—prior to September 11th 2001—rapidly growing industry, both in the world generally and developing Asia specifically.[1] Indeed, because of its potential to provide foreign exchange earnings, fiscal revenues, services sector jobs, and backward linkages to industry, tourism is a prominent element of many DMC development strategies. The World Travel and Tourism Council (WTTC) estimates the total contribution of tourism in 2001 at over 10% of world GDP and nearly 8% of world employment (Box Table 1.1). Although tourism accounts for a slightly smaller share of GDP in developing Asia, nearly half of global tourism jobs are located in the region. Moreover, tourism grew at twice the world rate in developing Asia in 2000. Worldwide in 2001, it shrank as a result of the events of September 2001. In developing Asia, tourism growth fell significantly but remained positive.

By subregion, WTTC statistics indicate that Southeast Asia and the Pacific DMCs have the tourism industries with the largest shares of GDP, but absolutely East Asia's tourism industry is larger than that in the rest of developing Asia combined. The PRC is the fifth most visited tourism destination in the world with 31.2 million visitors in 2000.[2] The PRC has the largest number of jobs provided by tourism in the world, at over 50 million, followed by India, at over 23 million jobs. In relative terms, however, the Maldives is the most tourism-dependent economy in the region (and third in the world), with about 51% of total employment in tourism. The Pacific DMCs are also relatively dependent on tourism.

Tourism, being primarily service based, is typically less volatile than many other sectors. According to the World Tourism Organization, prior to 2001, international tourist arrivals had not declined worldwide since 1982. However, tourism is not immune to disruption. The September 11th attacks had an immediate and significant global impact on tourism. WTTC estimates that they caused a swing in tourism's 2001 contribution to world GDP from projected growth of about 3% to a contraction of about 1%. In addition, WTTC projects that the attacks will result in an overall contraction of the global industry of about 0.4% in 2002.

Although the largest absolute losses in tourism are being borne by the big markets such as the US and Europe, tourism in developing Asia is generally suffering more from the attacks in relative terms. This is in part because of perceived risk to the traveler, either from proximity to the fighting in Afghanistan or from internal security concerns. Destinations at a great distance from the traveler's home also tend to be harder hit. WTTC reports that tourism in Southeast Asia, projected prior to the attacks to grow rapidly in 2001, contracted by about 1.8% instead. Thus, the attacks resulted in a loss of more than 6% of tourism contributions to GDP in 2001. An additional factor was the reduction in visits home by overseas workers who were suffering from reduced job security because of poor general global economic conditions. The Pacific DMCs experienced a deeper contraction in tourism while tourism growth slowed significantly in East Asia and South Asia. WTTC reports that the DMCs with the largest projected job losses in 2001 and 2002, in absolute terms, resulting from the attacks are the PRC (1.8 million or 3.4% of total tourism employment), India (0.9 million or 3.7%), Thailand (0.5 million or 14.1%), and the Philippines (0.3 million or 10.5%).

[1] In this box, tourism is a set of direct and indirect economic activities associated with travel and tourism. The World Travel and Tourism Council (WTTC) refers to this measure, which captures the economic impact of tourism on GDP and employment, as the travel and tourism economy. The measure aggregates personal travel and tourism activities by residents and by international visitors, business travel, government travel and tourism expenditures, capital investment in travel and tourism, and exports of travel and tourism-related products. *Source:* WTTC, 2001, *Tourism Satellite Accounting Research*, available: www.wttc.org.

[2] World Tourism Organization, 2001, *World Tourism Stalls in 2001*, Press Release, 29 January, available: www.world-tourism.org. France, Spain, US, and Italy are the top four destinations, in that order.

Of particular importance, as a key barometer of energy market conditions and of business costs, the spot price of crude oil softened over the course of 2001. The spot price of Brent crude dropped by over 14% from end-December 2000 to end-December 2001 to under $20 a barrel, well below the Organization of Petroleum Exporting Countries' (OPEC's) target range of $22–$28 a barrel. This was despite announced OPEC production cuts totaling 5 million barrels or 20% of OPEC's daily output during the course of 2001. However, oil prices began to climb in early March 2002 because of renewed concerns about the stability of supply in the Middle East and because of a stronger outlook for global recovery. By 15 March 2002, the Brent crude spot price was at $23.79 a barrel, up by 20% since the beginning of the year. Prices are expected to continue to firm in 2002 but to stay within OPEC's target range.

The value of commercial services exports, about 20% of world exports of goods and services, grew by 6% in 2000 but is expected to have expanded at a slower pace in 2001, or perhaps even contracted. This is because of generally slowing economic activity throughout the year and disruptions to trade and travel from mid-September 2001. DMCs account for about 15% of the value of total commercial services exports. Of special importance to many DMCs is the tourism industry (Box 1.1). International tourist arrivals fell by 1.3% in 2001, compared with 7% growth in 2000, primarily because of a sharp

In many DMCs, governments and the tourism industry have taken steps to mitigate weakness in the industry, including security measures to restore consumer confidence and increased marketing activity and promotional deals, particularly aimed at local or regional tourists. As a result of these activities, and of generally improving economic conditions, tourism is expected to begin recovering in the second half of 2002 and rebound strongly in 2003. Thereafter it is forecast to settle into robust long-run growth of 3.6%. Developing Asia as a whole—the PRC and India particularly—is expected to enjoy buoyant growth in tourism. However, for those DMCs with continuing internal security concerns, recovery of the industry could take longer.

BOX TABLE 1.1 Economic Significance of Tourism in Developing Asia

	Share of Tourism in GDP, 2001		Real Growth of Tourism Value Added			Employment, 2001	
	$ million	% of GDP	2000	2001	2002	'000	% of Total
World	3,497,070	10.1	3.9	-1.1	-0.4	199,780	7.9
Developing Asia	262,750	9.2	8.2	1.7	1.8	100,414	6.9
East Asia	175,900	9.2	8.5	2.6	3.0	53,606	7.2
China, People's Rep. of	114,760	9.8	10.1	5.4	6.1	51,333	7.2
Hong Kong, China	18,060	11.3	13.7	-4.1	-2.3	272	8.4
Korea, Rep. of	31,450	7.5	2.1	-1.9	-3.8	1,426	6.7
Taipei,China	11,630	4.2	1.9	-1.5	-0.4	575	6.0
Southeast Asia	56,611	10.8	8.7	-1.8	-2.9	15,944	8.2
Cambodia	308	9.2	12.3	4.6	4.7	650	10.3
Indonesia	14,080	9.9	8.7	0.9	-6.6	6,098	6.7
Lao People's Dem. Rep.	174	9.7	2.4	-4.8	-0.6	187	8.3
Malaysia	10,140	11.5	17.3	-3.1	3.1	906	9.4
Philippines	5,690	8.0	3.9	-4.0	-3.4	2,835	10.3
Singapore	9,330	10.8	8.8	-5.4	-1.6	197	9.7
Thailand	14,770	13.0	4.8	-0.8	-4.9	3,223	10.1
Viet Nam	2,120	6.7	6.2	1.5	1.5	1,847	5.3
South Asia	29,242	5.8	5.6	2.6	3.3	30,569	5.6
Bangladesh	1,536	3.3	6.3	2.5	2.2	3,239	4.7
India	23,000	4.8	5.6	3.3	4.0	23,561	5.6
Maldives	347	82.3	-0.5	1.2	-0.1	52	51.0
Nepal	333	6.2	-1.2	-6.8	-0.7	728	7.1
Pakistan	2,728	4.9	7.5	-1.1	-0.3	2,482	5.0
Sri Lanka	1,298	8.4	6.2	-1.0	2.2	507	6.4
Pacific DMCs	997	22.2	7.6	-3.2	-1.4	295	12.8
Papua New Guinea	368	10.0	0.7	-3.7	-1.5	192	8.9
Fiji Islands	481	28.1	12.6	-3.5	-1.3	66	20.8
Vanuatu	103	42.6	11.4	-1.2	0.3	17	32.1

DMCs = Developing member countries.
Source: World Travel and Tourism Council, 2001, *Tourism Satellite Accounting Research*, available: www.wttc.org.

worldwide drop in tourism in the last 4 months of the year. However, the outlook for the industry is considerably less bleak than predicted in late September 2001. While global travel is expected to remain subdued in the first half of 2002, it should recover in the second half of the year as expanding global economic activity increases business travel and aggressive marketing campaigns emphasizing enhanced security measures and lower prices begin to have a positive impact on leisure travel.

Financial Markets

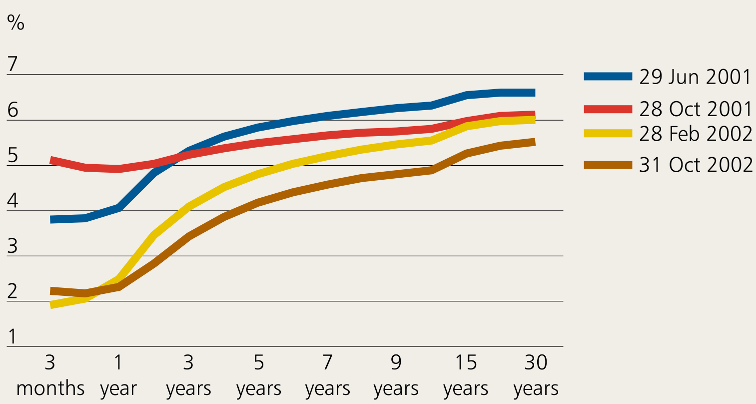
Global financial markets in 2001 were characterized by weakness in equity markets, lower interest rates, and steeper yield curves.

Global financial developments are of concern to DMCs both because international investors, banks, and corporations are sources of financial capital and because DMC financial market trends are heavily influenced by trends in major markets. Global financial markets in 2001 were characterized by weakness in equity markets, lower interest rates, steeper yield curves, and increased risk premiums for low-grade investments. They were also remarkably resilient: they suffered severe disruption in mid-September 2001, after which financial market turbulence dissipated rapidly. Moreover, while the global slowdown and the events of September 11th generally reduced portfolio flows to emerging markets, rising risk premiums on Argentina sovereign bonds in late 2001 did not lead to a global increase in sovereign risk spreads, as similar episodes had in the past.[5]

Worldwide equity markets were volatile in 2001 as sentiment about the expected duration of the economic downturn fluctuated between optimism and pessimism. Ultimately, markets worldwide lost value for the second year in a row, their worst performance since 1991, as the glowing corporate earnings outlook of the late 1990s faded amid a constant stream of announcements of downward earnings revisions. Morgan Stanley Capital International (MSCI) calculations show that most of the world's major stock markets posted double-digit losses in 2001. As a result, the MSCI World Index fell by nearly 18% in 2001.[6] Yet it is remarkable that, given severe post-September 11th disruptions (US stock markets closed for 4 days), losses were not more extensive. With substantial liquidity support from monetary authorities, coordinated efforts by market makers to avoid runaway sell-offs, and extensive corporate stock repurchases, stock markets in industrial countries (though not in emerging markets) returned to pre-attack levels by mid-October 2001. Because of evidence of improving conditions emerging in early 2002, most major stock markets had posted gains since the beginning of the year through 15 March 2002, and the MSCI World Index was up by 0.6%.

Bond market performance was a challenge to policymakers in 2001 as yield curves in major economies, such as the US, grew steeper during the year (Figure 1.4). In the first half of the year, US 90-day commercial paper rates fell by over 100 basis points but longer-term yields rose. This is attributable to the expectation throughout the first half of the year that a recovery would begin before the year was out. In contrast, the whole curve fell between end-June and end-October 2001. Despite further monetary easing, waning confidence in a quick recovery drove long-term rates down. However, in early 2002, the view that the period of monetary easing was nearing an end and the perception that the US fiscal budget would return to deficit, increasing the supply of government bonds, lifted the yield curve. Yield curve movements were more moderate in the euro area and barely perceptible in Japan because of less monetary easing.

FIGURE 1.4 **US Yield curves steepen as the rates drop**



Note: Yield curves are based on US swap rates.
Source: Bloomberg L.P.

[5] Emerging markets are loosely defined as developing economies in which governments and corporations have access to private international capital markets, or attract institutional portfolio investment, or both. Different institutions include slightly different sets of countries in the category but, for example, the Institute of International Finance includes 29 countries from Asia, Latin America, Europe, Africa, and the Middle East.

[6] The major indexes are Australia; Canada; France; Germany; Hong Kong, China; Japan; Switzerland; United Kingdom; and US. *Source*: *Asian Wall Street Journal*, 2002, Money and Investing, 2 January.

FIGURE 1.5 **Sovereign risk spreads diverge**

Note: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds.
Source: J. P. Morgan's Emerging Markets Bond Index, available: www.jpmorgan.com.

Despite across-the-board declines in debt issuance, particularly in the second half of 2001, as corporate financing needs fell, credit spreads—generally falling in early 2001—began to rise in the third quarter for both lower-grade corporate issues and the sovereign debt of more vulnerable emerging markets. Whereas investment grade borrowers enjoyed more favorable rates, speculative grade issuers were increasingly confronted with higher spreads and more difficulty in placing issues. These tendencies, present in all markets, were more pronounced in emerging markets. Nevertheless, when yield spreads on Argentina's sovereign debt began to rise sharply in late 2001, the effect on other emerging markets was limited (Figure 1.5). There are several factors that may account for this tendency for investors to focus on certain emerging markets, especially those with generally stronger fundamentals in some areas—including lower levels of short-term external debt, more flexible exchange rates, and, in many cases, current account surpluses.

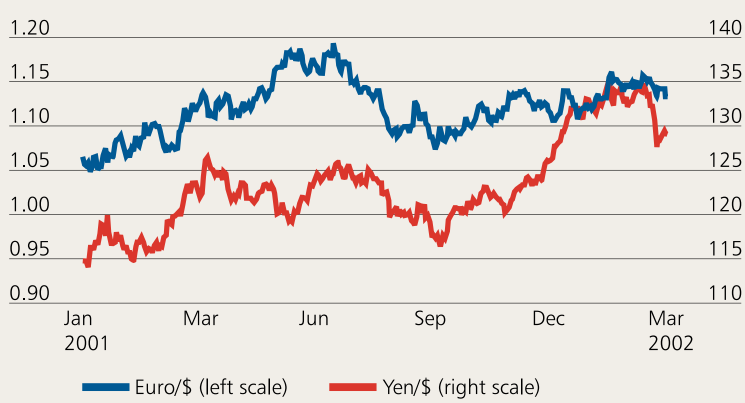
The increased occurrence of current account surpluses in several economies, notably emerging markets in Asia, was accompanied, naturally enough, by capital outflows. Generally, the trend after the Asian financial crisis of weak private capital flows to emerging markets continued in 2001. January 2002 statistics from the Institute of International Finance indicate that, excluding Argentina and Turkey, net external financing to emerging markets fell slightly from $141 billion to $133 billion.[7] In general, net private capital flows to emerging markets have been weak since 1998 at less than half the size experienced in the preceding 3 years. However, equity markets, particularly in East Asia and Southeast Asia, made some gains in the first quarter of 2002 as the global economic outlook improved. This trend should generally continue for all capital inflows (bank lending, portfolio flows, foreign direct investment) into emerging markets in Asia so that, overall, capital inflows into Asia are expected to increase in 2002 with the rebounding global economy.

The US dollar strengthened almost steadily throughout the first 6 months of 2001 against most major currencies (Figure 1.6). It began to soften in the third quarter, weighed down by evidence of a weakening economy, but recovered in the fourth quarter as investor flight to safe havens moved it higher against other major currencies. The US dollar ended the year slightly higher against the euro and significantly higher against the yen.

Macroeconomic Policy

As inflationary pressure dissipated and economic activity slowed rapidly in the US (and more gradually in the euro area over the course of 2001), monetary authorities took countercyclical action—aggressively so in the US. As the year wore on, and the global nature of the slowdown became more apparent, official interest rates fell worldwide. J.P. Morgan's GDP-weighted average official interest rate fell by 230 basis points from

FIGURE 1.6 **The US dollar appreciates in 2001**



Source: CEIC Data Company Ltd.

[7] International Institute of Finance, 2002, *Capital Flows to Emerging Market Economies*, available: www.iif.com.

end-December 2000 through 16 January 2002.[8] In the US, the Federal Funds target rate was reduced by 475 basis points to 1.75% between end-December 2000 and end-December 2001. Although this had limited effect on investment, as plummeting profits and excess capacity led corporations to slash investment budgets, it lowered mortgage rates. The ensuing wave of refinancing bolstered household disposable incomes and provided support to consumption.

With clear indications of economic recovery, particularly in the US, and some evidence of inflationary pressure, particularly in the euro area, further easing in official interest rates is unlikely in 2002. However, with unemployment likely to remain relatively high, particularly in the European Union (EU), in most of 2002, large increases in official interest rates are not anticipated during the year but some tightening of monetary policies is possible, perhaps as early as mid-year.

Countercyclical fiscal policy measures were also undertaken in 2001, although less aggressively and less uniformly. Predominantly automatic stabilizers reduced the US government surplus from 1.5% of GDP in 2000 to 0.3% in 2001. Despite the limits of the EU's Stability and Growth Pact, Germany's fiscal balance went from a surplus of 1.2% of GDP in 2000 to a deficit of 2.5% in 2001. The United Kingdom reduced its surplus from 3.9% of GDP in 2000 to 0.5% in 2001. Canada and Italy also followed expansionary policies while, notably, France and Japan tightened their fiscal budgets. Under current policies, there will be considerable fiscal stimulus over the next 3 years, particularly in the US. The combined effects of a June 2001 tax cut package and an emergency spending authority enacted after September 11th, totaling $375 billion over fiscal 2002 (ending September 2002) to fiscal 2004, are projected to further reduce the US fiscal surplus in 2002.

SUBREGIONAL TRENDS AND PROSPECTS

East Asia

Growth moderated in the PRC, decelerated rapidly in Korea and Hong Kong, China, and reversed into recession in Taipei,China.

East Asia, with a 58% weight in aggregate DMC economic activity, experienced a significantly slower pace of economic growth in 2001 than in the previous year (Figure 1.7). Growth moderated in the PRC, decelerated rapidly in Korea and Hong Kong, China, and reversed into recession in Taipei,China. Mongolia continued to struggle with low growth performance because of severe weather conditions and low commodity prices. The ability of the PRC, which carries a 26% weight in developing Asia's aggregate GDP, to sustain a relatively high growth rate resulted primarily from strengthening consumption and, to a smaller degree, the momentum of optimism surrounding WTO accession. This drove foreign direct investment 15% higher than in 2000 to $46.8 billion, which, together with stronger domestic debt-financed public investment, lifted fixed investment by over 11% to nearly 39% of GDP in 2001 from 37% in 2000. In contrast, Korea and Taipei,China suffered fixed investment contractions of 1.7% and 18.2%, respectively, partly because of the global correction in the ICT sector. Taipei,China's investment contraction was more severe because of a trend toward shifting production to the mainland in some industries. Hong Kong, China managed a 2.1% increase in fixed investment, based, in part, on an improvement in equipment purchases.

Diverse experience in domestic demand was similar to that in external demand. The growth in value of the PRC's merchandise exports decelerated from 27.9% in 2000 to 6.8% in 2001. In 2001, the value of merchandise exports in Korea dropped by 14%; in Taipei,China by 17.3%; and in Hong Kong, China by 5.9%, reflecting the varying degrees of concentration of ICT products in their export mixes. Hong Kong, China suffered the further blow of a steep drop in demand for commercial port services as world trade activity, and particularly the PRC's, slumped.

Finance sector performance also showed a divergence in 2001 among the East Asian economies. Korea's stock market performance was among the best in the world, with the Korean Stock Price Index surging by 32% in US dollar terms. In part, this was a consequence of the perceived long-run strength of the economy. The PRC's Shanghai B Index gained 91% on the year. However, this combined rapid gains immediately after the Index opened to domestic investors in February 2001 with a 21% loss in the second half of the year as enthusiasm waned because of poor corporate performance, increased regulatory oversight, and a controversial proposal to sell government shares in state-owned enterprises (SOEs), which would substantially increase the supply of equities in the market. Because of

[8] J.P. Morgan, 2002, *World Financial Markets,* available: www.jpmorgan.com.

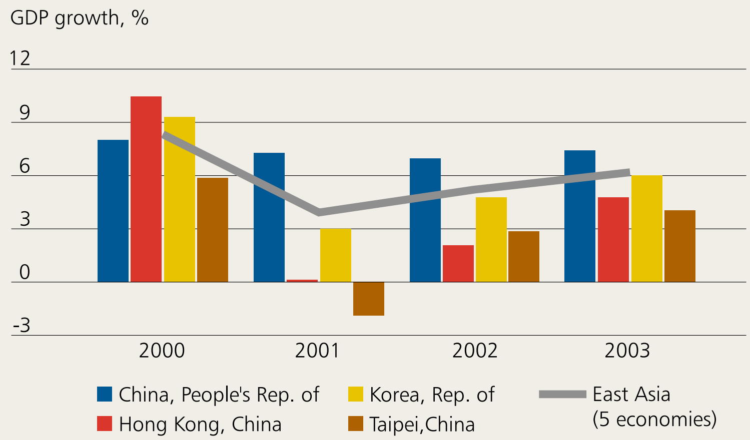
sharply decelerating growth and uncertainty about future prospects, Hong Kong, China's Hang Seng Index lost 25% of its value in 2001. Taipei,China's Taiwan Stock Exchange index, which had fallen by about 27% in US dollar terms through the third quarter of 2001, bounced back in the fourth quarter to improve by over 11% during the year.

With the pace of economic activity ebbing, inflation, at 1.4%, was slightly higher in East Asia in 2001 than in 2000, but still very low. Labor market conditions generally deteriorated in the subregion. Unemployment reached a record 5.3% in Taipei,China. In Korea, however, the unemployment rate fell over the course of 2001 as strong domestic demand propelled job creation in the services sector, particularly venture capital, more than offsetting job cuts in manufacturing, which registered a fall in employment during the year. In Hong Kong, China, the unemployment rate rose from 4.4% in 2000 to 6.1% in 2001. This was nearly as high as the record level experienced in 1999, when the economy grew slowly as it struggled to recover from a sharp, financial crisis-related contraction in 1998. Uniquely among DMCs, Hong Kong, China recorded price deflation in 2001, for the third year in a row, as property prices continued to decline and retailers offered large discounts to reduce inventories.

Under these conditions of low inflation and rising unemployment, there was mixed macroeconomic policy in East Asia. The PRC sustained a policy of deficit spending, but the deficit fell as revenues increased by more than public expenditures. With spending below target, Korea expanded the fiscal surplus from 1.1% in 2000 to 1.3% in 2001, despite tax cuts and a supplementary spending package in the third quarter. Hong Kong, China's fiscal deficit ballooned from less than 1% of GDP in 2000 to over 5% in 2001 as rapidly decelerating economic activity eroded revenues while expenditures rose by over 10%. Taipei,China marginally reduced its fiscal deficit in 2001 with a combination of higher revenues and increased spending.

In general, the economies of East Asia do not have large public debt burdens, as compared with Latin America and the Caribbean, or South Asia. However, there has been an increasing trend toward deficit spending in the last several years that is pushing up public debt. In the PRC, for example, government debt increased from about 10% of GDP in the mid-1990s to about 23% in 2001.

FIGURE 1.7 **East Asia gradually recovers**



Source: *Asian Development Outlook* database.

Monetary policy was accommodative in 2001 in Korea and Taipei,China, which made official interest rate cuts of 125 basis points and 250 basis points, respectively. But this had limited impact on credit expansion through much of the year, although retail lending began to pick up in the fourth quarter in Korea. Both economies experienced relatively mild exchange rate depreciation. In the PRC, interest rates on US dollar deposits were cut more or less in line with US official target cuts, leaving them lower than local currency deposit rates at the end of 2001. Similarly, Hong Kong, China lowered interest rates in parallel with the US cuts. The PRC maintained its de facto exchange rate peg to the US dollar and Hong Kong, China maintained its currency board arrangement.

The PRC and Taipei,China will feel the benefits of reforms associated with WTO membership over the medium to long term.

In terms of structural changes, the PRC and Taipei,China joined WTO, thereby committing to a wide range of reforms—key among them being in the finance sector. The benefits of these reforms will be felt over the medium to long term. In Korea, corporate and finance sector reform, which is still key to the medium- to long-run outlook, slowed in 2001 as political opposition mounted while Hong Kong, China temporarily suspended its Home Ownership Scheme (through mid-2002), under which low-income families can obtain subsidized housing, to allow conditions in the property market to improve. The major challenge for Hong Kong, China over the medium to long term is comprehensive tax reform to rectify persistent fiscal deficits.

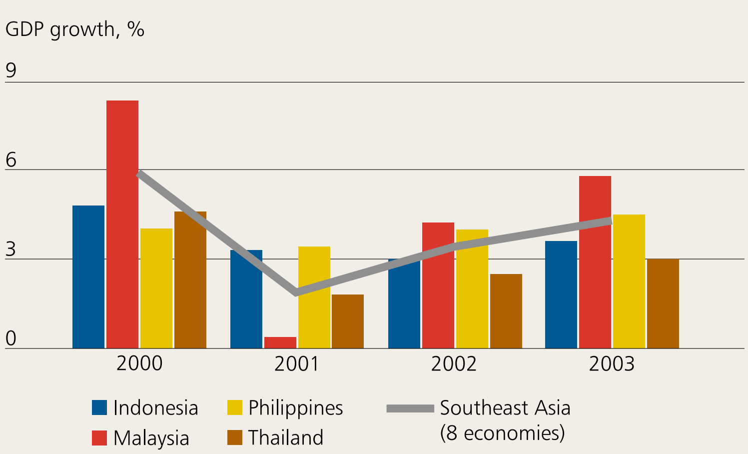
The outlook for Southeast Asia is for gradual strengthening of economic growth that will, nevertheless, stay below past performance over the medium term.

Over the next 2 years, economic performance is expected to strengthen in East Asia, with GDP growth rising to over 5% in 2002 and to over 6% in 2003. In part, this will come about because of an improvement in the external environment. The value of merchandise exports, which contracted in 2001, will grow moderately in 2002 before rebounding to nearly 9% growth in 2003. This should allow the PRC to boost growth modestly in 2003 after some slowing in 2002 as it begins to adjust to WTO membership. Korea should rebound moderately in 2002 as the US recovers, with further strengthening in 2003 as its other important market—Japan—strengthens. Economic growth in Hong Kong, China will improve but it will be limited by continued weakness in domestic markets—particularly real estate. Taipei,China will revive moderately from recession as a weak global recovery, uncertain investor and consumer confidence, and the structural challenge of WTO membership combine to limit a rebound. Mongolia, while still suffering from the devastating effects of severe winter weather on agriculture, should benefit from a recovery in commodity demand. In aggregate, growth in East Asia, while improving over the next 2 years, is likely to be below historical trends.

Southeast Asia

With nine members of the Association of Southeast Asian Nations (except Brunei), this grouping of countries, representing just under a quarter of DMC economic activity, slowed from nearly 6% growth in 2000 to below 2% growth in 2001 (Figure 1.8). However, there was a marked contrast between the performance of Singapore and four former crisis countries of Indonesia, Malaysia, Philippines, and Thailand on the one hand, and of the Mekong countries of Cambodia, Lao People's Democratic Republic (Lao PDR), and Viet Nam on the other. The former group generally suffered more severely from exposure to the global economy.

FIGURE 1.8 **Southeast Asia tracks the global recovery**



Source: *Asian Development Outlook* database.

Heavily dependent on ICT trade, Singapore's economy, after booming by 10.3% in 2000, contracted by 2.0% in 2001 as the value of merchandise exports shrank by 11.9%. Malaysia's economy, similarly ICT trade-dependent but with a smaller drop in domestic demand, decelerated from over 8% growth in 2000 to less than 1% in 2001. In Thailand, with a somewhat smaller export contraction, economic growth slowed from 4.6% in 2000 to 1.8% in 2001. In contrast, the Philippines, which suffered a 16.2% decline in exports, experienced only a modest slowdown in economic growth because of stronger domestic demand. With a relatively diversified export base, Indonesia's 2001 economic performance lagged behind only that of the Philippines in this group, because of less strength in domestic demand.

In contrast, Cambodia, Lao PDR, and Viet Nam all sustained growth rates of over 5% in 2001 with merchandise export value growth rates of 6–8%. This is, in part, because these economies have preferential (Cambodia) or improved (Viet Nam) access to markets in industrial economies, allowing strong growth of textile and clothing exports. Additionally, Viet Nam benefited from robust expansion in fisheries exports. Moreover, the agriculture sector, which is still large in these economies relative to the crisis countries, had a reasonably good 2001 in Cambodia and the Lao PDR. Viet Nam had healthy investment growth because of investor optimism generated by a bilateral trade agreement signed with the US in 2000.

The relatively slow growth rates in 2001 meant further delays in meaningful improvement of the welfare of the poor—particularly in Indonesia and Thailand, where the severity of the economic contractions associated with the crisis partially eroded past progress in reducing poverty—but also in the Philippines. In Cambodia, Lao PDR, and Viet Nam, steady growth performance and job-creating expansion of export manufacturing sectors in 2001 allowed poverty reduction progress to be sustained.

The direction of macroeconomic policy performance in 2001 was mixed in Southeast Asia, with Malaysia and Singapore adopting aggressive stimulus measures similar to those of the East Asian economies while other governments pursued less active countercyclical policies, in part because of limited capacity to do so. Malaysia expanded the fiscal deficit, relative to GDP, with supplementary spending. Singapore engaged in substantial off-budget fiscal stimulus in the face of rapidly slowing economic conditions. Indonesia's wider deficit arose from debt service and project-funding requirements. This wider deficit was thus planned, and Indonesia met its deficit target under an IMF agreement. The fiscal deficit in the Philippines contracted mildly to below 4% of GNP in 2001, an important accomplishment following the deterioration of fiscal performance in the latter part of the previous year. Thailand's deficit also fell by a full percentage point to 2.1% of GDP because of lower capital spending. In Cambodia and the Lao PDR, the size of fiscal deficits relative to GDP, which are mostly financed by official development assistance, were broadly stable in 2001. In Viet Nam, the deficit grew.

Monetary policy across the subregion was mixed as monetary authorities, with varying tools, straddled competing objectives. In the Philippines, interest rates have been lowered by more than 750 basis points since December 2000, at which time they were at high levels, having been raised to prevent capital flight. In contrast, Indonesia and Thailand have followed relatively tight monetary policies. In Indonesia, with inflation remaining in double digits, the exchange rate still weak, and the need to attract financing for public debt, interest rates have remained high. In Thailand, official interest rates were raised in mid-2001 because of concern about a weakening baht and capital outflows. This tightening of Thai monetary policy was partly reversed in early 2002 as the baht strengthened.

In the three Mekong countries, in which the dollar circulates widely and the banking sector is underdeveloped, money supply expansion supported financial deepening and exchange rate depreciation was mild. In Malaysia, which pegs the ringgit to the US dollar, the central bank made only one official interest rate cut, of 50 basis points in late September 2001. In Singapore, which does not directly influence interest rates but maintains an exchange rate band, this band was widened to allow the Singapore dollar more flexibility to adjust to external conditions.

The outlook for Southeast Asia is for gradual strengthening of economic growth that will, nevertheless, stay below past performance over the medium term. This is because, for Indonesia, the Philippines, and Thailand, external demand will only slowly recover and because domestic demand will remain weak over the medium term. To varying degrees, high levels of public debt, incomplete corporate and finance sector restructuring, investor caution, and weak political will to reform hamper each of these countries. Thus, each is expected to continue to make only very limited progress in reducing poverty. In contrast, Cambodia, Lao PDR, and Viet Nam are expected to continue to improve both economic performance and capacity to significantly reduce poverty over the medium term.

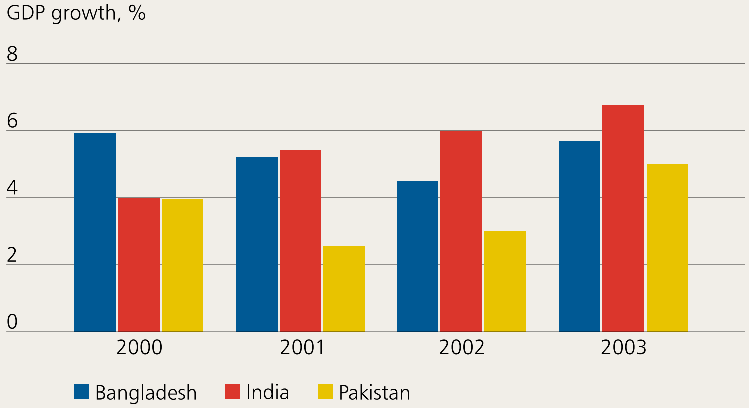
South Asia

South Asia accounts for about 17% of the DMCs' GDP, of which India represents 76% (Figure 1.9).[9] In India, with fiscal year 2001 closing at end-March 2002, substantially improved agricultural performance is projected to offset slowing industrial growth. Bangladesh, Nepal, and Pakistan, for which the fiscal year ended in mid-2001, experienced moderately slowing economic growth, primarily because of slowing agricultural growth in Bangladesh and Nepal—after bumper crops in the previous year—and because of a drought-related agricultural contraction in Pakistan. In the first half of fiscal year 2002 (the second half of calendar year 2001), these countries experienced further weakening in the pace of economic activity, in part because of slowing external demand and the disruptions of military operations in Afghanistan. For the economies reporting on a calendar year basis, Bhutan maintained strong economic growth based on expansion of the hydropower sector; performance in the Maldives deteriorated because of a severe drop in tourism in the fourth quarter; and Sri Lanka experienced a contraction because of

Although not so heavily dependent on the ICT sector as East Asia and Southeast Asia, South Asia experienced a drop in merchandise exports that was nearly as severe.

[9] The reporting of data in several South Asian DMCs on a fiscal year basis, which varies from country to country, complicates both comparison of performance between South Asian DMCs and comparison of aggregate South Asian performance with other subregions in developing Asia.

FIGURE 1.9 **South Asia is less exposed to global fluctuations**



Source: *Asian Development Outlook* database.

The outlook for South Asia is for further strengthening of growth over the medium term.

slowing external demand and drought, exacerbated by security problems.

Although not so heavily dependent on the ICT sector, the subregion experienced a drop in merchandise exports that was nearly as severe as in East Asia and Southeast Asia. India is expected to experience a contraction in merchandise exports in fiscal year 2001, in part because of a drop in demand for its computer and ICT-related services. In Bangladesh and Pakistan, export growth in 2001 strengthened relative to 2000. During 2001, exports of textiles and garments were relatively robust, benefiting in part from strong US consumption growth. However, in the first part of 2002, exports weakened. Nepal's exports growth settled back close to 4% in 2001 from extremely fast growth because of rapid expansion of carpet and garment exports in 2000. Sri Lanka suffered a sharp reversal in export performance, from double-digit growth to double-digit contraction, because of deterioration in external markets and internal disruptions, which raised shipping costs. In addition to weakness in merchandise exports, tourism suffered in South Asia. International tourist arrivals to the subregion are estimated by the World Tourism Organization to have fallen by over 6% in calendar year 2001 with the Maldives, Nepal, and Sri Lanka, where tourism is relatively more important, the hardest hit.

With rapid labor force growth in South Asia of 2% a year and significant underemployment or disguised unemployment, GDP growth of less than 5% for the subregion is probably insufficient to generate adequate job and wage growth for meaningful poverty reduction. Although strong agricultural performance in Bangladesh and India likely helped the rural poor subsist, weak industrial growth did not generate the higher incomes and lower-risk employment that can provide more secure graduation from poverty.

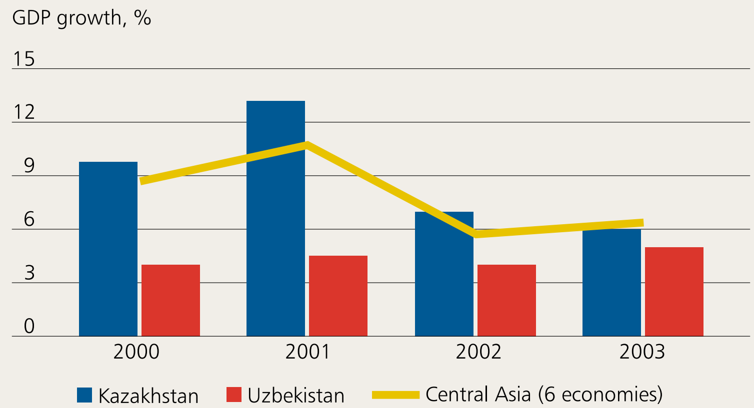
Fiscal policy was variable. India's fiscal deficit remained flat despite a combination of contracting imports, and hence low import-based revenues, and increased defense spending. Pakistan cut its fiscal deficit by more than 1 percentage point of GDP to 5.3% under an IMF standby arrangement, although this was accomplished primarily through expenditure cuts. Bangladesh had small reductions in the fiscal deficit as a proportion of GDP. Despite this progress, South Asia continues to be characterized by relatively high fiscal deficits and large government debt burdens. Yet, particularly in India, much of this debt is domestic debt, which means that it is much less vulnerable to external shock. However, it tends to crowd out more domestic private investment.

Against a backdrop of generally low or falling inflation, monetary policy in South Asia was moderately accommodative—India reduced the official bank rate from 7.0% to 6.5%, Pakistan from 12.0% to 9.0%—but with limited impact because of conditions of excess liquidity. Both Pakistan and Sri Lanka moved to more liberal exchange rate regimes. Pakistan moved from a managed float to a free float exchange rate system at the start of the fiscal year. Sri Lanka moved from a fixed rate to a float in January 2001 as reserves dwindled, and the currency depreciated. Bhutan and Nepal retained exchange rate pegs to the Indian rupee.

Perhaps the key constraint on development in the subregion is that structural reforms are either slowing or stagnant. In India, a combination of factors, including a relative lack of interest on the part of potential foreign buyers, complicates the related issue of privatization. Pakistan is having similar trouble finding buyers for some of its SOEs, given the current economic climate. In Bangladesh, the new Government intends to broaden market-friendly reforms, but concrete progress has yet to be made. Nepal's efforts to reform its troubled banking sector are moving ahead slowly, adjust a backdrop of political and economic turbulence.

The outlook for South Asia is for further strengthening of growth over the medium term. In part, this is a result of an improvement in external demand both because of a generally improving global economy and because of more stability in the subregion. Merchandise export growth should accelerate significantly. Tourist arrivals should rebound somewhat in the second half of calendar year 2002, although the subregion's tourism industry is expected to recover only slowly from the impact of September 11th and its aftermath. A general improvement in domestic demand is also forecast for the subregion. Based on the improvements in global economic conditions, internal security, and political stability, investment growth should improve. In Afghanistan and Pakistan, substantial inflows of official development assistance should support increases in public investment.

FIGURE 1.10 **Central Asian growth depends on commodities**



Source: *Asian Development Outlook* database.

Central Asia

Central Asia, benefiting from strong commodity demand in late 2000 and early 2001, and from rising investment in oil and minerals, enjoyed rapid growth in 2000. Growth further accelerated in 2001 despite slowing commodity demand and collapsing commodity prices in the fourth quarter of 2001 (Figure 1.10). In Azerbaijan, Kazakhstan, and Turkmenistan, where oil and gas accounted for over 80%, over 50%, and over 60%, respectively, of the value of exports in 2000, the volume of oil and gas exports continued to rise in 2001. Further, investment in the development of oil and gas fields continued to expand. In the Kyrgyz Republic, where gold mining dominates industrial activity, economic growth was sustained in 2001 largely by increased volume of gold production and strong agricultural growth, particularly grain production. In Tajikistan, aluminum, accounting for 50% of the value of exports, sustained industrial growth in 2001, which together with very strong agricultural performance, primarily in cotton, boosted economic growth that year. The performance of Uzbekistan, with the largest population among the Central Asian republics (CARs), has lagged behind that of the other CARs because of structural problems and weak exports.

Large structural distortions, off-budget spending, and inaccurate statistics make it difficult to interpret or compare developments in macroeconomic policies in the CARs. Nevertheless, some common features are apparent. Many CARs are dependent on taxes from commodity exports for revenues but otherwise have weak tax administration. Azerbaijan and Kazakhstan have set up national funds with oil sector receipts that can help cushion the budget in lean times. Both appear to have allowed fiscal deficits to widen somewhat in 2001, with increased expenditures on state payrolls in Azerbaijan and on defense in Kazakhstan. The Kyrgyz Republic recorded a slight increase in revenues as a proportion of GDP in 2001 because revenue collection efforts were enhanced by stronger tax measures. Uzbekistan, with low revenues and extensive off-budget subsidies to SOEs and favored sectors under import-substitution schemes, financed the deficit through borrowing from the central bank.

Central Asia enjoyed rapid growth in 2000, which accelerated in 2001 despite slowing commodity demand and collapsing commodity prices.

Rapid recent economic growth, fueled by commodity sector development, belies fundamental structural problems still confronting the CARs, including fixed exchange rates with active parallel exchange markets or multiple exchange rate systems, relatively high levels of inflation—particularly in Tajikistan and Uzbekistan—and continued high levels of state involvement in the economy. In addition, many CARs have yet to make significant progress in improving the climate for foreign investment.

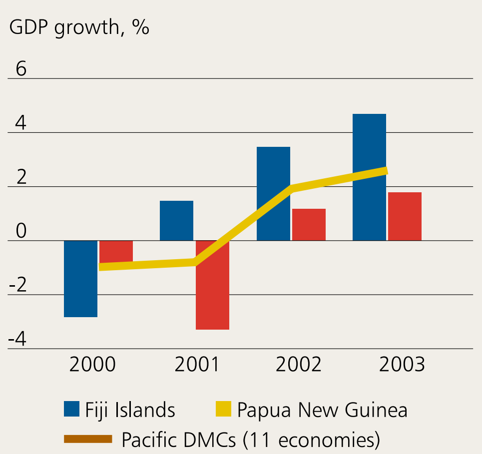
The outlook for the CARs is for economic growth to moderate somewhat from the rapid pace set in 2000 and 2001. Nevertheless, growth will still be in the double digits in Azerbaijan and Turkmenistan, and 6–8% in Kazakhstan and Tajikistan, as they continue to rebuild their economies on the basis of continued expansion of their export sectors. However, the Kyrgyz Republic and Uzbekistan will likely experience slower growth than other CARs over the next 2 years, reflecting weak export markets. Sustaining or improving performance in the subregion will depend primarily on structural reforms that address the weaknesses discussed immediately above and that allow diversification away from overdependence on commodity exports.

Pacific Developing Member Countries

A common theme among the Pacific DMCs is difficulty in fiscal management.

The economies of the Pacific manifested a mixed performance in 2001 (Figure 1.11). Papua New Guinea underwent a second year of economic contraction, in part because of a strong decline in mining and in part because commodity exports fell with weakening world demand. The Fiji Islands recovered from a political crisis-induced contraction of economic activity in 2000 to record growth of about 1.5% because of rebounding tourism. Samoa and East Timor (the latter is not included in subregional averages) experienced double-digit growth, the former because of reforms introduced in the 1990s, and the latter as conditions normalized and the country began to recover from substantial deterioration in 1999. The economies of Solomon Islands and Vanuatu both contracted, the former for the third straight year as a consequence of ethnic unrest and the latter because of cyclone damage to agricultural production. The Cook Islands sustained moderate growth based on strength in tourism while Tuvalu did so with higher public spending. While Kiribati emerged from recession based on expansionary fiscal policies, the Marshall Islands and Federated States of Micronesia (FSM) struggled, with growth of less than 1%.

FIGURE 1.11 **The Pacific outlook is improving**



Source: *Asian Development Outlook* database.

A common theme among the Pacific DMCs is difficulty in fiscal management because of the small size of the economies, exposure to external shocks, inexperienced civil services, dependence on external funding, and frequent episodes of political instability. In Papua New Guinea, with tax revenues declining in the face of a weakening economy, the Government was forced to shave expenditures because of a delay in accessing external funding that was contingent on the privatization of a public sector bank. The Fiji Islands ran a fiscal deficit of 4.9% of GDP, financed by an increase in Government debt to 43% of GDP, excluding contingent liabilities. Kiribati was able to draw on resources available through its Revenue Equalization Reserve Fund to replace a shortfall in revenues while Nauru has virtually depleted a similar fund, built on revenues from now depleted phosphate mines. FSM and the Marshall Islands each relies on US transfers under a Compact of Free Association, extensions to which are currently under negotiation. The Cook Islands made progress in reducing its large public debt through improved revenue mobilization. Solomon Islands and Tonga have deteriorating fiscal positions, leading to high debt and balance-of-payments pressure in both countries.

The Pacific DMCs are forecast to return to growth in 2002, with further strengthening in 2003, as Papua New Guinea emerges from recession into low growth because of a combination of modest improvements in agriculture and structural changes in the economy. Economic growth is expected to strengthen in the Fiji Islands, with generally broad-based growth led by improvements in tourism. In general, prospects for economic growth in the Pacific DMCs are clouded by a host of structural problems, including factor market rigidities, depletion of natural resources, the continued potential for civil unrest, and the domination of economic activity by the public sector.

MEDIUM-TERM OUTLOOK AND RISKS FOR DEVELOPING ASIA

Growth in developing Asia is expected to strengthen moderately in 2002, picking up further in 2003, as the region slowly returns to a more balanced and sustainable pace of development after a turbulent 1997–2001 period. Overall, aggregate growth for major DMCs will

TABLE 1.3 Changes in GDP: Outlook and Past Performance, 12 DMCs (%)

	1951 –2000	1981 –1990	1991 –1996	1997 –2001	2001	2002	2003
12 DMCs	6.6	7.7	8.1	4.6	3.8	4.9	5.8
East Asia (3 economies)	7.5	9.2	9.1	5.8	4.3	5.5	6.3
China, People's Rep. of	6.9	9.4	11.4	7.3	7.3	7.0	7.4
Korea, Rep. of	7.9	9.4	6.9	4.8	3.0	4.8	6.0
Taipei,China	8.2	8.0	6.6	3.8	-1.9	2.8	4.0
Southeast Asia (5 economies)	6.2	6.1	7.5	1.2	1.8	3.1	4.2
Indonesia	5.9	5.3	7.4	0.0	3.3	3.0	3.6
Malaysia	6.5	5.1	9.1	1.5	0.4	4.2	5.8
Philippines	4.1	1.0	3.5	2.6	3.4	4.0	4.5
Singapore	8.0	6.1	9.2	4.0	-2.0	3.7	6.5
Thailand	6.8	7.6	8.0	0.0	1.8	2.5	3.0
South Asia (4 economies)	4.3	5.4	5.7	5.4	4.8	5.4	6.4
Bangladesh	3.5	4.0	4.5	5.2	5.2	4.5	5.7
India	4.2	5.5	6.1	5.7	5.4	6.0	6.8
Pakistan	5.3	6.1	3.9	3.7	2.6	3.0	5.0
Sri Lanka	4.0	3.7	5.2	3.9	-1.3	3.5	5.5

DMCs = Developing member countries.
Note: Figures for multiyear averages are defined from a trend line.
Source: Staff estimates.

Aggregate growth in developing Asia, while improving over the next 2 years, is likely to be below historical trends.

stay well below its trend in the 1980s but draw within reach of its long-run (1951–2000) trend (Table 1.3). The major DMCs of South Asia are expected to sustain the growth performance achieved in the 1980s and 1990s, which was well above the long-run trend. The major DMCs of East Asia and Southeast Asia are projected to achieve growth performance over the medium term that is below long-run trend growth and well below growth performance over the 1980s. A critical question for these DMCs is whether, and how soon, they can return to the rates of growth approaching that long-run trend. Over the next few years, the answer rests, in part, on the strength of external demand. Ultimately, however, DMC growth performance will depend on domestic conditions. For those countries most affected by the financial crisis, weak financial and corporate fundamentals caused by high levels of nonperforming loans will inhibit long-run growth (Box 1.2).

Externally, the projections for 2002–2003 are contingent upon a sustained improvement in the global environment, although DMC export growth rates are not expected to return to the rate of over 20% seen in 2000. The US recovery that began in the fourth quarter of 2001 is expected to continue to build, although slowly by the standards of past recoveries. It should be accompanied by an improvement in economic conditions in the EU and Japan.

Other external conditions key to a sustained and robust revival of economic expansion in developing Asia include relatively low and stable oil prices and interest rates throughout 2002. Further, it is assumed that the major currencies will experience no major realignments in 2002. Moreover, a continuing trend of generally falling bond spreads in developing Asia will be important. Under these conditions, a gradual recovery in global trade and a moderate improvement in capital flows to DMCs should provide favorable conditions for economic growth to all the subregions of developing Asia.

Increased uncertainty over economic conditions has complicated the task of forecasting in recent years.[10] Thus, a careful assessment of risk factors is critical to an understanding of the com-

[10] The highest forecast of real 1999 US GDP growth reported at the end of 1998 by Consensus Forecast was 3.5%, compared with actual performance of 4.1%. The lowest forecast of real 2001 US GDP growth reported at the end of 2000 was 2.5%, compared with an estimated actual figure of 1.0%. *Source*: Hongkong and Shanghai Banking Corporation, 2002, *World Economic Watch,* 4 January, available: www.markets.hsbc.com.

BOX 1.2 Nonperforming Loans—A Lingering Issue

The ability of developing member country (DMC) governments to effectively use accommodative monetary policy to counter the economic slowdown in 2001 was partly determined by the strength of the finance sector. This was especially true for those economies most affected by the Asian financial crisis, which resulted in high levels of nonperforming loans (NPLs), or in loans on which payments have not been made for an extended period of time.

Many DMC governments undertook at least some official interest rate cuts during 2001 (although not Indonesia or Thailand, which both followed restrictive monetary policies). Yet the effectiveness of these policy moves to stimulate economic activity was hampered in some DMCs because the cuts did not trigger credit expansion due to a combination of supply and demand conditions. On the demand side, relatively strong corporations tended not to take advantage of readily available bank credit—either because they preferred to issue bonds at favorable rates or because they trimmed their investment plans. On the supply side, financial institutions were hesitant to lend to weaker firms, which increasingly faced worsening business conditions and liquidity shortages. The finance sector, hobbled by the lingering effects of the Asian financial crisis, was unable or unwilling to assume the associated risks.

Nearly 5 years after the start of the financial crisis, the five most crisis-affected economies show uneven progress in resolving the problem of high levels of NPLs in the finance sector (Box Table 1.2). Of the five countries, all except the Philippines adopted mechanisms for reducing the level of NPLs through the formation of asset management companies (AMCs) to buy distressed loans from financial institutions with public or publicly guaranteed funds. This was done to quickly restore the financial institutions to health so that they could focus on new lending to assist in bringing the economies out of crisis. By October 2001, AMCs in the four other crisis countries had purchased significant portions of NPLs, particularly in Indonesia, and the direct burden on the finance sector of NPLs had fallen. In the Philippines, which initially had a less serious problem, NPLs have been climbing as a result of economic weakness due to the financial crisis, political turmoil, and the global slowdown.

BOX TABLE 1.2 Selected Finance Sector Indicators
(end of period, %)

Date	Indonesia	Korea	Malaysia	Philippines	Thailand
Ratio of NPLs to Total Loans of the Finance Sector					
December 1998	49.2	—	13.6	11.0	45.0
December 1999	33.0	11.3	11.0	12.7	38.9
December 2000	18.8	8.1	9.7	14.9	17.9
September 2001	14.7	6.0	11.7	17.4	12.9
Share of NPLs Purchased by AMCs					
October 2001	85.3	72.6	38.8	—	50.7
Share of Purchased NPLs Disposed of by AMCs					
October 2001	6.3	54.7	85.2	—	—

— Not available.
NPLs = Nonperforming loans, AMCs = Asset management companies.
Source: Asian Development Bank, *Asia Recovery Information Center Indicators,* available: www.aric.adb.org.

However, particularly for Indonesia and Thailand, which initially had the largest ratios of NPLs, the effectiveness of the AMCs in restoring financial and corporate sector health has been inhibited by slow disposal of assets. Indonesia has been the slowest to dispose of AMC-held NPLs. Plagued by accusations of corruption and political opposition to the sale of distressed companies to foreign entities, the Indonesian Bank Restructuring Agency, formed in early 1998, had disposed of less than 7% of its NPL assets by the end of 2001.

Thailand has also struggled to accelerate resolution of its finance sector problems. The Thai Asset Management Company (TAMC) was set up only in mid-2001, after resolution of NPLs through judicial and administrative workouts proved inefficient. In early January, it reported that it had disposed of about $1 billion of $16 billion (or about 6.3%) in NPL assets, which were primarily acquired from state-owned banks. The private sector remains concerned about some legal and political aspects of TAMC operations, such as the level of transparency of debt resolution and the financial obligations of private sector participants in the process.

The overhang of NPLs held by the AMCs is one factor retarding economic recovery by delaying corporate restructuring. Thus, corporate sectors are clogged with inefficient companies (often state owned), with high debt, low profit, and little capacity to invest. Continued finance sector weakness, together with other structural problems, is resulting in relatively weak capital inflows and low levels of investment in Indonesia and Thailand relative to pre-1997 levels. These problems include slow progress in privatization and ineffective legal systems that leave foreign entities uncertain of the extent of legal protection they can expect. Both countries have been characterized by sluggish investment and economic growth compared with their pre-1997 averages.

plete picture of possible economic performance in developing Asia.

The major short- to medium-term external risks to the moderate recovery forecast for the region are that (i) export demand will be weaker than anticipated and (ii) disruptive global events or temporary bottlenecks will cause inflationary pressure for key commodities—particularly oil. The primary medium- to long-term internal risk to the ability of a large number of DMCs to generate high rates of sustained economic growth is that slow progress in structural reform will inhibit domestic demand expansion and productivity growth.

External Risks

A major risk that could result in slower region-wide economic growth in 2002–2003 than expected in the *Asian Development Outlook 2002* forecast is that the recovery in external demand proceeds at a slower pace than anticipated. This could occur for two reasons. First, the global trend of strengthening economic activity and trade could be slowed by prolonged weakness in investment. Second, a current account correction or increased transactions costs on international trade could reduce the US propensity to import goods for a given level of aggregate demand. Consequences for the Asia and Pacific region include (i) continued weakness in export markets, (ii) further erosion of corporate and finance sector health resulting from a prolonged period of weak earnings, and (iii) high unemployment or underemployment with continued fiscal constraint, implying slowing progress in poverty reduction.

A possible source of a faltering global rebound is the inability of the US economy to sustain its emerging recovery because consumption growth might slow or exports might stay sluggish (or both). This would likely result in generally weak earnings projections, which in turn, would prevent a recovery of investment demand. Thus, as the positive influence on growth from a fading inventory correction dissipates, momentum would falter. However, as evidence of economic strengthening continued to mount in late March 2002, this risk appeared to recede.

An adjustment to the US current account balance is of increasing concern because of the sheer magnitude of the deficit in recent years. After averaging zero in the 1970s, 1.7% of GDP in the 1980s, and 1.6% of GDP in 1994–1997, the current account deficit rose rapidly over 1998–2000, reaching 4.4% of GDP in 2000 as the gap between economic performance in the US and other economies widened.[11]

There is a fair possibility that, with the US poised to emerge from the global economic slowdown ahead of both the EU and Japan, the US current account deficit will widen further before it begins to shrink, increasing the chance of a sharp adjustment being precipitated by an event (or series of events) that erodes the global appetite for US financial assets. The fallout from the Enron debacle dampened US stock market performance in January and February in 2002 as the financial accounting of other corporations came under scrutiny.

However, the risk that the Enron contagion would spread across the corporate US seemed to have disappeared by March. The Government, accounting industry, and corporations in the US moved quickly to enact reforms and restore confidence, with some success as US equity markets moved into positive territory for the year in late February. Moreover, the trend toward tightening of accounting standards spread to Europe and Asia. Increasingly, institutional investors are putting pressure on countries and individual firms to improve financial reporting. An example is the announcement in late February 2002 that the largest US pension fund—California Public Employees' Retirement System—enacted new investment guidelines that include transparency, leading it to pull out of investments in several markets in developing Asia.

External risks to the recovery that is forecast for developing Asia include export demand that is weaker than anticipated and disruptive global events.

Although a current account correction would likely be gradual, it would tend to reduce the US propensity to import. A second factor that might reinforce this tendency is an increase in international trade costs associated with heightened security concerns at national borders and points of entry. This may, over the medium term, affect the optimum level of cross-border outsourcing by manufacturers.

A significant risk to the recovery that was of increasing concern in late March 2002, involves a reemergence of inflation. There are two possible sources. First, disruptive events in the Middle East could cause skittish oil markets to send prices higher. The price of Brent crude oil shot up by over 15% in about a week to $22.85 by 7 March 2002. If prices continue to rise, major oil import-

[11] For a fuller discussion of the current account imbalance, see IMF, 2001, *United States: Selected Issues,* Country Report 01/149, August.

ers such as Korea could be adversely affected by rising inflation and shrinking current account surpluses.

Second, the lagged effects of large doses of macroeconomic stimulus—combined with aggressive inventory corrections and massive layoffs—could create conditions of rapid demand growth in which bottlenecks occur, fueling inflationary conditions that lead to premature tightening by monetary authorities.

Domestic Risks

Because the outlook for external demand recovery remains relatively moderate, achieving and sustaining higher rates of poverty-reducing economic growth over the medium term rests, more than ever, on the strength and character of domestic demand expansion. DMCs, particularly those in East Asia and Southeast Asia (which have historically encouraged high savings rates and favored investment in export industries) are increasingly recognizing the critical contribution that a vibrant domestic market can make to a stable and balanced growth path in which all of the major sectors of the economy experience dynamic progress.

Thus, a significant risk on the domestic front for many DMCs is that they may fail to take the opportunity to use stronger growth performance over the next 2 years to move aggressively on structural reform. Renewed focus on domestic demand policies, including progress on corporate and financial restructuring, as well as competition policy and labor market reform, could provide the impetus for continued high rates of long-run growth. With slow progress on reform, DMCs risk a prolonged period of low growth because of increased global competition in traditional export markets and the likelihood of reduced import growth in industrial countries over the medium term.

ASIAN DEVELOPMENT

Outlook 2002

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

East Asia

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

PEOPLE'S REPUBLIC OF CHINA

In spite of the global economic slowdown, the People's Republic of China maintained its robust economic expansion in 2001, though some signs of slowing appeared in the second half of the year, due partly to a sharp deceleration in growth of external trade. Driven by domestic demand and supported by World Trade Organization accession, the macroeconomic outlook for 2002–2003 is bright.

MACROECONOMIC ASSESSMENT

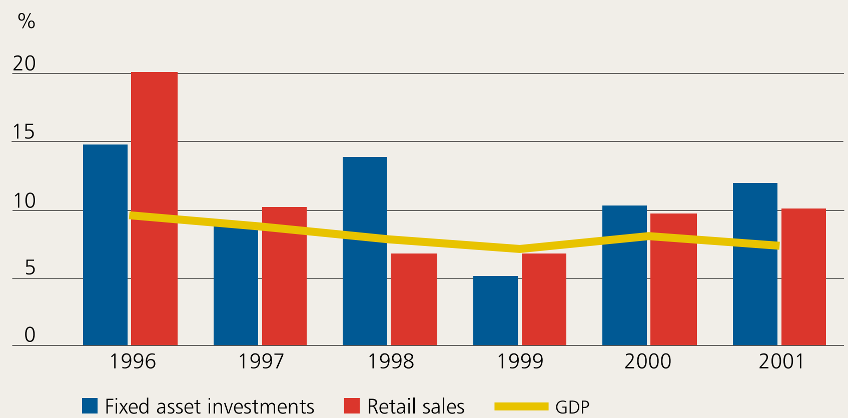
The People's Republic of China (PRC) remained one of the best-performing economies in the Asia and Pacific region in 2001, with GDP expanding at a rate of 7.3%. However, there were clear signs of deceleration in the second half of the year, with GDP growth slowing from a quarterly rate of 8.1% to 6.6% between the first and fourth quarters.

The industry sector posted a gain of 8.7%, led by the robust performance of foreign-invested enterprises. Their value added rose by 11.9% in the year, compared with 8.1% for state-owned enterprises (SOEs). The services sector grew by 7.4%, supported mainly by high growth in transport and telecommunications. Suffering from a severe drought and a decrease in the planted area, the agriculture sector grew by 2.8% in 2001. Grain output declined by about 2.1%, following a 9.1% drop in 2000.

Investment rose strongly by 12.1%, pushed by fiscal stimulus measures and accelerated foreign direct investment (FDI) inflows. However, momentum declined after August 2001, in which month investment had surged to 21% year on year, slowing to only 9.4% in November. One characteristic of investment during the year was a sharp rise in flows to the western region where economic development has lagged far behind that in the eastern and central regions: investment growth there was 5.1 percentage points higher than in the rest of the country. In contrast to high growth in public sector investment, that in the private sector stayed weak, partly because of a shortage of loanable funds available to the sector from the banking system and partly because of a generally cautious attitude toward lending to the private sector, especially to small and medium enterprises (SMEs).

Due to increasing incomes, retail sales strengthened by 10.1% in 2001, a slightly higher rate than in 2000 (Figure 2.1). Purchasing power stayed largely in the hands of urban residents, as the Government increased salaries for civil servants and pensions for government retirees twice during 2001. A large increase in automobile credit and housing mortgage lending also stimulated domestic consumption demand. Although rural income and consumption rose more rapidly in 2001 than in 2000, the rates of growth still trailed those in urban areas.

FIGURE 2.1 **Domestic Demand and GDP Growth, People's Republic of China, 1996-2001**



Source: National Bureau of Statistics.

TABLE 2.1 Major Economic Indicators, People's Republic of China, 1999-2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	7.1	8.0	7.3	7.0	7.4
Gross domestic investment/GDP	37.4	36.1	36.3	36.1	36.4
Gross domestic savings/GDP	39.4	38.9	38.1	37.9	37.6
Inflation rate (consumer price index)	-1.4	0.4	0.7	1.0	1.5
Money supply (M2) growth	14.7	12.3	14.4	13.0	14.0
Fiscal balance[a]/GDP	-2.9	-2.8	-2.6	-3.0	-2.8
Merchandise export growth	6.1	27.9	6.8	6.0	10.0
Merchandise import growth	15.8	35.4	8.2	10.0	14.0
Current account balance/GDP	1.6	1.9	1.7	1.0	0.4

[a] Central and local government.
Sources: National Bureau of Statistics; International Monetary Fund; staff estimates.

The PRC has significantly reduced rural poverty over the past few years. Sustained, rapid economic growth and targeted poverty interventions have brought down the number of absolute rural poor to below 30 million.

Inflation rose slightly in 2001, partly because of an upward adjustment in government-controlled prices of utilities and services. The consumer price index edged up by 0.7%, compared with 0.4% in 2000. However, some deflationary pressure built up as economic growth slowed in the latter part of the year, and prices fell slightly.

The official estimate of urban unemployment in 2001 was 3.6%, putting it slightly higher than in 2000. However, this does not cover workers who were laid off as part of SOE restructuring and who have not found new jobs. The reemployment rate of these workers, which has been declining in the past 3 years, is an important determinant of real urban unemployment.

The PRC has significantly reduced rural poverty over the past few years. Sustained, rapid economic growth and targeted poverty interventions brought the number of absolute rural poor in terms of the official poverty line down from 80 million in 1994 to below 30 million, or about 3% of the rural population, in 2001. However, the official poverty line was set in the mid-1980s and is substantially lower than the international standard of a dollar a day. About 213 million people, or 23% of the rural population, still live below that level.

During 2001, fiscal revenues increased by 22.2%, 5.2 percentage points more than in 2000. Fiscal expenditures grew by 18.6%, somewhat less steeply than in 2000. As a result, the fiscal deficit slightly declined to around 2.6% of GDP. However, these official figures give only a partial picture. If the Government's social security obligations and the costs associated with the nonperforming loans (NPLs) of the state-owned commercial banks (SOCBs) were included, the fiscal deficit would be significantly higher.

Monetary policy remained accommodative to stimulate domestic demand. Broad money (M2) increased by 14.4% in 2001, 2.1 percentage points higher than in 2000. However, M1 growth dropped in the second half of the year, reflecting slower economic activity. Interest rates remained unchanged in 2001, despite declining rates in many other economies in the region and in industrial countries. The asset market fluctuated sharply. Reflecting stronger domestic demand and a better economic outlook, the Shanghai and Shenzhen stock exchange indexes rose by 7% in the first half of the year. In February 2001, the B-share market, which used to be restricted to foreign investors, was opened to domestic investors with foreign currency. As a result, the B-share indexes on these two exchanges soared by about 200% in the first half of 2001, closing the price gap with the A-share market, which is open only to domestic investors. However, both markets experienced a sharp downturn in the second half of the year, triggered by plans to reduce state-owned shareholdings through increasing the volume of share offerings, restricting banks from injecting funds into the stock market, and punishing a number of listed companies for misconduct. Between June and December 2001, the A- and B-share indexes dropped by about 26% and 20%, respectively.

With the global economic slowdown, export growth decelerated sharply to only 6.8% from 27.9% in 2000. This was the result of lower import demand from the major trading partners—United States (US); European Union (EU); Japan; and Hong Kong, China. From 2000 to 2001, the growth rates of exports to these economies dropped from 24.2%, 26.4%, 28.6%, and 20.7% to 4.2%, 7.1%, 7.9%, and 4.6%, respectively. Import growth also slowed sharply, to 8.2% from 35.4% in 2000, largely reflecting a decline in demand for intermediate inputs by exporters. The current account surplus in 2001 dipped to $19.6 billion.

Robust economic growth and accession to the World Trade Organization (WTO) have made the PRC more attractive to foreign investors, and FDI regained its growth momentum in early 2001. Actual FDI inflows rose by 14.9% after 0.9% growth in 2000. Foreign exchange reserves stood at $212 billion at end-2001, or $43 billion higher than 12 months previously, and equivalent to about 11 months of imports of goods. The debt service ratio was 10%.

POLICY DEVELOPMENTS

To contain the effects of the Asian financial crisis, three fiscal stimulus packages were implemented in 1998, 1999, and 2000 (Y100 billion or 1.3% of GDP, Y110 billion or 1.3% of GDP, and Y150 billion or 1.7% of GDP, respectively). Such investment contributed to the construction of key infrastructure projects, including a rural power network, flood protection structures along major rivers and lakes, environment protection projects, and infrastructure in the western region. Expansionary fiscal policy continued in 2001: Y150 billion in government bonds were issued and a large proportion of the proceeds were targeted to support western region development.

While expansionary fiscal policy has contributed significantly to robust economic growth in recent years, the effectiveness of this kind of fiscal stimulus is probably declining. Furthermore, since a large volume of counterpart funds from commercial and policy banks were needed to match state investment, there has been some crowding out of other private sector investments. However, at the end of 2001, the Government announced that the expansionary fiscal policy would be continued into 2002 as growth in the world economy was expected to be slow.

On the monetary front, the Government focused attention on the performance of the finance sector. During the financial crisis, it intensified financial risk control, helping reduce the NPL ratio of all the commercial banks by 3.8% in 2001. To improve the quality of lending, the career path of bank staff was often tied closely to the quality of loans processed. As a result, commercial banks, particularly the four SOCBs (which still account for 71.8% of outstanding loans), tended to be very careful in making loans, particularly to SMEs in the private sector. It is the private sector though, consisting mainly of SMEs, that is very dynamic and has been growing quickly in recent years. The SMEs also provide the bulk of new employment opportunities. However, their development is seriously hindered by this lack of adequate financing. To encourage the commercial banks to lend to SMEs, more than 200 SME guarantee funds were established by local governments to enhance the credit of SMEs. The central bank also encouraged the commercial banks to increase their lending to SMEs.

More widely, there is a need both to improve the policy environment for supporting the private sector in general and SMEs in particular, and to strengthen the regulatory system (Box 2.1).

To minimize the adverse impact of the slowdown in the global economy, the Government adopted several measures in 2001 to encourage exports, such as speeding up export-tax refunds and customs procedures, and granting permission to private companies to engage in external trade.

To minimize the adverse impact of the slowdown in the global economy, the Government adopted several measures in 2001 to encourage exports.

In May 2001, the PRC adopted its new 10-year poverty strategy (2000–2010). In it, the Government designated 592 key counties for poverty reduction development work. The selection was based on income, social, geographic, and physical conditions. Priority was given to remote and mountainous areas and minority areas. Poor villages in non-key counties are also eligible for national poverty funding. The Government has placed a strategic priority on promoting development in the western region since 1999.

The PRC became a member of WTO at the end of 2001, and membership involves significant opportunities as well as challenges for the economy. Over the long term, PRC's accession and its commitments to cut tariffs, liberalize trade and investment, and open up domestic sectors to foreign participation should lead to significant efficiency gains. Hundreds of laws and regulations have to be revised to make them consistent

BOX 2.1 A Dynamic Engine for the Economy of the People's Republic of China

In the next few years, the PRC needs to create 8 million–10 million jobs annually for new labor market entrants and to find jobs for the more than 5 million workers who have been made redundant by SOE reform and not yet reemployed. A dynamic private sector is needed to serve as the engine for economic growth and employment generation. Official statistics show that the domestic private sector, consisting of formally registered private firms and small individual businesses, accounts for 13% of GDP.

However, if shareholding companies, foreign firms, private township and village enterprises, and private agricultural entities are included, the private sector generates more than 60% of GDP.

More than half the 200 million urban workers are self-employed, or are employed by private firms, privatized collective enterprises, foreign firms, or joint ventures. Private enterprises are also dominant in high-growth sectors, including services and the high-tech sector. Most private enterprises are SMEs, of which 8 million are in industry. An increasing number of state-owned SMEs are in the process of being privatized.

The Government has taken some steps to stimulate private sector development. In 1999, the National People's Congress amended the Constitution to recognize the private sector. A law on sole proprietorship, which became effective at the beginning of 2000, was the first law governing private investment in the PRC and protects the interests of investors and creditors. In 2000, the Government eased the registration rules for private businesses, and lowered their minimum capital requirement to one yuan ($0.12), doing away with the need to provide bank certificates and obtain bureaucratic approval. The Ministry of Foreign Trade and Economic Cooperation also issued import and export permits to 450 private companies, allowing them to conduct external trade. The scope of these permits has since been extended to all private firms with a certain scale of operation. Such trade was previously limited to government-approved medium and large SOEs. The China Securities Regulatory Commission recently announced that all qualified firms, including private firms and joint ventures, would be allowed to list on the A- or B-share market. This measure provides an opportunity for foreign joint ventures to access the domestic capital market and will improve the quality of listed companies on the domestic stock market. The Commission has also focused on promoting transparency, disclosure, and corporate governance, including the use of foreign auditors. These increasingly strict regulations and enforcement mechanisms should help in the sound development of the stock market in the long run.

While the PRC is making progress in these areas, more improvements are needed to develop the enabling framework for the private sector, including market entry, finance, land-use rights, and enforcement of private property rights. Private firms are still prohibited from operating in a number of sectors, while the legal environment affects private sector development. Enforcement of the rule of law, particularly of laws needed to resolve commercial conflicts, as well as legal recourse, is more difficult for private enterprises than for SOEs. Nevertheless, over the longer term, WTO accession is likely to help the economy build a rules-based system to facilitate the development of the private sector.

with WTO rules. All these changes will set a foundation for the country to be fully integrated into the world economy. By forcing the economy to reallocate resources in line with its comparative advantage (from capital- to labor-intensive sectors), membership should also generate more employment for a given rate of growth of the economy. It should further improve the country's export prospects. Many studies estimate that the economy's long-term gain from WTO membership will be equivalent to about 1–2% of GDP per year.

However, these positive effects will take time to make themselves felt. In the meantime, the Government's WTO commitments could pose adjustment challenges, especially in protected sectors such as agriculture, automobiles, banking, insurance, and telecommunications. To face these challenges, the Government needs to speed up economic reforms and create a more pro-business environment, including increasing the transparency of regulations, streamlining administrative procedures, and improving legal and accounting practices.

OUTLOOK FOR 2002–2003

Driven largely by domestic factors and supported by WTO accession, the PRC economy should continue to grow robustly over the next 2 years. Economic growth is forecast at 7% in 2002 and 7.4% in 2003, led by strong domestic consumption and investment. The industry and services sectors should grow by 7–9%, and the agriculture sector by 2–3%.

Domestic consumption and investment will remain strong in 2002–2003 with a growth rate of about 9–10%. Increased domestic consumption and continued solid economic growth will exert some upward pressure on prices. However, inflation should be moderate at 1–1.5% due to significant excess capacity in many industry subsectors, large unutilized supply potential of the agriculture sector, and cheap imports after WTO-related tariff liberalization.

The fiscal deficit will remain at around 2.8–3% of GDP in 2002–2003. Considerable public resources will be needed to reduce the NPLs of the SOCBs and to implement social security reforms. Substantial funding will also be needed to develop the western region, address poverty, and tackle environment and human resources development problems. Monetary policy is likely to remain accommodative. Money supply (M2) should continue growing by 13–14% in 2002–2003. In an attempt to stimulate the economy, the central bank reduced the interest rate for savings by 25 basis points and for lending by 50 basis points in early 2002.

Assuming that the global economy begins to recover in 2002 and gathers further momentum in 2003, exports are forecast to grow at the rate of 6% and 10%, respectively. With WTO accession, imports will continue to grow faster than exports, and the trade and current account surpluses will gradually decline. However, the decline in the current account surplus will be partly offset by foreign investment inflows as the Government further opens up the economy to fulfill WTO commitments. It is expected that the economy will post a current account surplus of $12.6 billion, or 1% of GDP, in 2002, which will likely fall to about $5 billion, or 0.4% of GDP, in 2003. The official foreign exchange reserves will be close to $230 billion by 2003, while the debt service ratio should fall to below 10%.

The external risks facing the PRC relate mainly to the prospects for global economic recovery, the speed and depth of which remain uncertain. If the improvement in external conditions is much less pronounced than expected, the Government may further strengthen its expansionary fiscal and monetary policies.

Driven largely by domestic factors and supported by WTO accession, the PRC economy should continue to grow robustly over the next 2 years.

HONG KONG, CHINA

Hit by the slowdown in industrial countries, GDP growth collapsed to 0.1% in 2001. Assuming a modest recovery in the US and in other key trading partners, the economy is forecast to gradually strengthen over 2002. The effects of globalization and of accelerating integration with the mainland will require the economy to make changes in its institutional and production structures if it is to remain competitive in the long term.

MACROECONOMIC ASSESSMENT

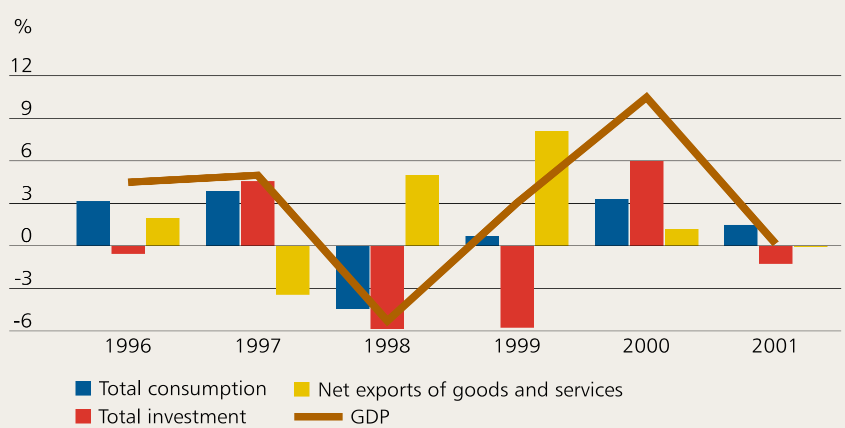
The economy of Hong Kong, China suffered a sharp slowdown in 2001, with GDP growth decelerating to a virtually stagnant 0.1% from 10.5% in 2000. The major contributing factors were a drop in exports and a weakening of consumer and business sentiment, stemming from the difficult economic environment worldwide (Figure 2.2).

Domestic demand growth slumped to 0.2% in 2001 from 10% in 2000. Expansion in private consumption fell to 2% from 5.4% over this period, reflecting consumer sentiment that was undermined by a drop in asset prices and rising uncertainty over employment. Given the bleak business outlook, gross fixed capital formation averaged a 2.1% increase, compared with a 9.8% rise in 2000. Slower growth in capital expenditure was mainly due to a sharp slowdown in the growth of spending on new machinery and equipment in 2001 as corporations cut their investment in information and communications technology upgrades. Expenditure on building and construction declined further by 2.5%, the fourth year of contraction. Private sector developers remained cautious in view of the overhang of supply in the residential property market while residential public sector projects were also scaled back. With the weakening demand in the economy, inventories underwent a modest depletion in 2001 after a substantial buildup in 2000.

Labor market conditions deteriorated during the year. The seasonally adjusted unemployment rate, having trended downward from a peak of 6.4% at the beginning of 1999 to 4.4% in the fourth quarter of 2000, edged up to 6.1% by the fourth quarter of 2001. The rise was attributed to increased corporate downsizing and layoffs in the context of slowing aggregate demand and the skills mismatch caused by ongoing economic restructuring.

Partly as a result of a sustained fall in import prices, a depreciation of regional currencies against the US dollar, and a benign external inflationary environment, deflation took hold, as the consumer price index fell by 1.6% in 2001. Fierce retail price competition and a weak property market that resulted in falling property rentals also put downward pressure on prices.

FIGURE 2.2 **Contribution of Demand Components to Change in GDP, Hong Kong, China, 1996-2001**



Source: Census and Statistics Department, 2002, available: www.info.gov.hk.

TABLE 2.2 Major Economic Indicators, Hong Kong, China, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	3.0	10.5	0.1	2.1	4.8
Gross domestic investment/GDP	25.0	27.6	25.8	28.0	27.7
Gross domestic savings/GDP	30.4	32.3	31.1	34.9	34.7
Inflation rate (consumer price index)	-4.0	-3.8	-1.6	-0.8	0.6
Central government budget/GDP	0.8	-0.6	-5.2	-3.5	-3.0
Money supply (M2) growth	8.1	8.8	-2.9	4.0	5.3
Merchandise export growth[a]	3.7	17.1	-3.0	2.5	7.5
Merchandise import growth[a]	0.1	18.1	-2.4	2.8	8.5
Services export growth[a]	5.7	14.1	3.5	4.0	13.0
Services import growth[a]	-3.0	2.1	0.1	2.2	8.0

[a] Based on GDP series, in real Hong Kong dollars.

Sources: Census and Statistics Department, 2002, available: www.info.gov.hk; Hong Kong Monetary Authority; staff estimates.

Under the currency link to the US dollar, the Hong Kong dollar strengthened against most regional currencies in 2001. Money market interest rates fell, due to aggressive monetary easing by the US Federal Reserve and to excess liquidity in the domestic market. Notwithstanding the economic slowdown and difficult operating environment, the profitability of the retail banks (locally incorporated banks plus a number of the larger foreign banks which operate a branch network and which are active in retail banking) held up well, recording only a moderate decline. With low interest rates making debt servicing more affordable, the overall asset quality of the retail banks continued to improve. Preliminary figures indicate that the consolidated capital adequacy ratio of locally incorporated authorized institutions remained strong at 16.8% at end-2001.

The Hang Seng Index fell in 2001, on concern about the global economic outlook as the external environment deteriorated. Share prices plummeted to a near 3-year low of 8,934 in the wake of the September 11th events in the US, but recovered to over 10,000 in October, as anxieties surrounding the likelihood of future attacks subsided. Mirroring the strength of the US stock markets, the Index subsequently rose, to 11,397 at end-December, though this was still 24.5% below the level of a year earlier.

Amid the deterioration of global growth, total exports of goods and services dropped by 2.1%, reversing a 16.7% surge in 2000. Merchandise exports contracted by 3% from 17.1% expansion in 2000. Within this total, domestic exports tumbled by 11%, in contrast to a 7.5% rise in the previous year, and reexports registered a 2% decrease, after soaring by 18.5% a year earlier. Domestic exports of electronic components registered a marked fall, while reexports of consumer goods, raw materials, and semimanufactures also slumped. The growth in services exports moderated to 3.5% from 14.1% in 2000, largely on account of a fall in tourist arrivals and a deterioration of regional demand for trade-related and other business services. Total imports of goods and services likewise fell, by 2.2% from a robust 16.7% growth in 2000, in tandem with slower reexports and a worsening of domestic demand. The combined visible and invisible trade surplus, nevertheless, widened slightly by $0.8 billion to $8.6 billion in 2001, as the fall in imports outpaced the decrease in exports.

POLICY DEVELOPMENTS

The volatility of fiscal revenues and the faster growth of recurrent expenditures over recurrent revenues in the past decade have raised concerns about the tax system.

The volatility of Hong Kong, China's fiscal revenues and the faster growth of recurrent fiscal expenditures over recurrent revenues in the past decade have raised concerns about the tax system. The authorities have been running operating deficits since fiscal year (FY) 1998/99 (1 April 1998–31 March 1999). On the revenue side, while a significant amount of total revenue is derived from nontax sources, the tax base is narrow, with nearly 93% of income tax coming from 15.6% of the employed workforce and 60% of profit tax

Enhancing human resources to support the transition to a full-fledged knowledge-based economy is at the top of the policy agenda.

from 1% of the registered corporations. In addition, revenues have fallen, reflecting the slump in the property market. On the expenditure side, the growth in government spending has exceeded revenues at an average rate of 8% a year since 1998. Moreover, social expenditures, including social welfare, health, and education, are expected to grow over time, in response to an aging population and the need to upgrade human capital.

Against this background, in 1999 the authorities enacted the Civil Service Reform to enhance the efficiency and cost-effectiveness of the civil service. In 2001, a 3-year Training and Development Program was introduced, to upgrade staff capabilities in providing an effective service. Two reviews by the Task Force on Review of Public Finances and the Advisory Committee on New Broad-Based Taxes were conducted. The Task Force assessed the nature of the operating deficit and concluded that the public finances were confronted with structural problems. The Advisory Committee suggested that a goods and services tax be adopted over the longer term to broaden the tax base. To address the issues, the 2002 budget sets out a 5-year plan to restore the operating and consolidated accounts to balance and reduce public expenditures as a proportion of GDP to 20% or below by 2006. While the budget will be countercyclical, expansion in government expenditures over the medium term will be below GDP growth. In light of the economic slowdown, the authorities are unlikely to introduce any new taxes but will need to make good any shortfall by raising additional revenues or reducing expenditures in the medium term to sustain healthy public finances.

Against the backdrop of a worsening economic outlook, the authorities, in the Chief Executive's October policy address, proposed HK$15 billion-worth of measures to relieve economic difficulties faced by the community. Enhancing human resources to support the transition to a full-fledged knowledge-based economy is at the top of the policy agenda. Aimed at improving labor flexibility and upgrading the labor skills required for technological development and application, reforms of basic and tertiary education will be continued. The measures include updating the school curriculum, strengthening the preservice training and professional development of teachers, and increasing the allocation of secondary school places to improve accessibility of educational resources. The authorities are pushing ahead with large-scale infrastructure projects, including both roads and railways linking with the Pearl River Delta, to enhance the transport network and economic cooperation between Hong Kong, China and neighboring provinces in the PRC.

Measures to improve the business environment were also emphasized in the policy address, involving financial assistance to SMEs and investing in the construction of a new exhibition center. Finally, the policy address emphasized both reinforcing the comparative advantage in tourism and in transport and logistics, and tapping the opportunities brought about by the new knowledge-based economy and economic growth in the PRC.

OUTLOOK FOR 2002–2003

GDP is projected to grow by 2.1% in 2002. A moderate economic recovery by the second half of the year is forecast, following an anticipated gradual firming in external demand and some stabilization in domestic sentiment. Exports are expected to pick up, particularly in the second half of the year, as the world economy strengthens further. Imports are expected to grow at a modest rate in 2002. Private consumption will probably remain lackluster, dragged down by high unemployment rates and the uncertain outlook for the property market. Machinery and equipment investment by the private sector will stabilize and begin to improve in late 2002, along with the gradual upward trend of exports. The trade-related services sector is expected to register growth again in 2002, reflecting the recovery in exports, while the banking sector will continue to be weighed down by the supply overhang in real estate.

Over the near term, the economy will continue to suffer the restructuring pains of intensifying integration with lower-cost production centers in the PRC. While economic growth is expected to pick up in the second half of the year, structural unemployment will likely remain high as displacement of employees in traditional manufacturing and low-end services continues. Unemployment, coupled with subdued consumer sentiment and ongoing supply and demand integration with the Pearl River Delta, will exert a downward pressure on prices, maintaining deflation for yet another year in 2002. As global economic growth gathers momentum, the economy is forecast to strengthen by 4.8% in 2003.

REPUBLIC OF KOREA

The Republic of Korea performed better than most economies in the region in 2001. This was largely due to the resilience of domestic demand, which arose from significant progress in restructuring the corporate and finance sectors after the Asian financial crisis. More diversified exports also contributed to relatively sustained growth. Strong domestic and external demand is expected to continue over 2002–2003.

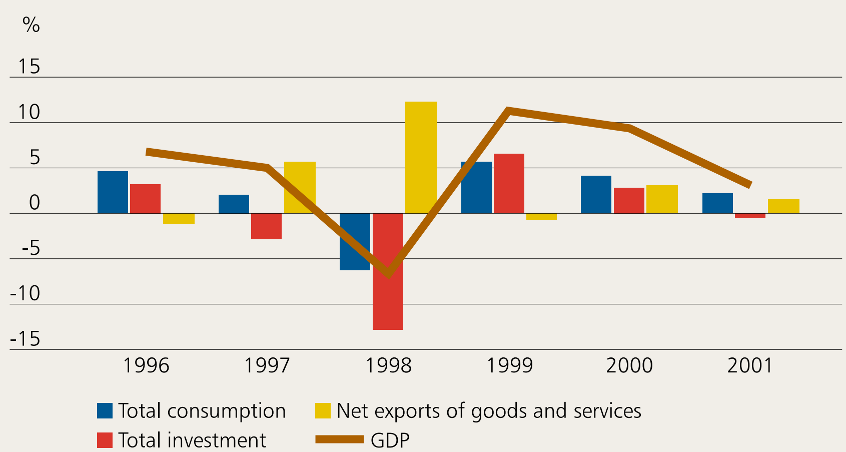
MACROECONOMIC ASSESSMENT

The Republic of Korea (Korea), although hit hard by the global economic downturn in terms of a large deceleration in export growth, did not experience as severe a shock as economies that are heavily dependent on exports of information and communications technology (ICT) products. This was because Korea has a more diversified industrial base and because its domestic market, though having significant linkages to the export sector, did not suffer as big a drop in private consumption. As a result, GDP growth decelerated to 3% in 2001 from 9.3% in the previous year (Figure 2.3). This modest expansion was driven mainly by private consumption, in contrast to the broad-based domestic and external demand expansion in 2000. Gross fixed capital formation increased in 2000 by 11.4% but declined in 2001 by 1.7%. Because of the weak earnings outlook in the ICT sector, and sluggish private spending, companies had little incentive to invest in new plant and equipment in 2001. Export growth began to slow in the first quarter of 2000 and continued decelerating through the middle of 2001, bottoming out in the fourth quarter of the year.

Consumption increased in 2001 by 3.7%, a much lower rate than in 2000. This helped support the labor market, and unemployment fell by December 2001 to a seasonally adjusted rate of 3.3%.

One reason for the relative strength of consumption in 2001 was the fact that the corporate sector had, after the financial crisis, generally engaged in significant cost cutting as part of the restructuring process. As a result, firms were not forced to make large-scale layoffs during this downturn. Also, negative wealth effects were weaker due to the solid performance of the stock market (albeit artificially supported by the Government to a degree). In addition, a high level of liquidity in the financial system, along with low loan demand from the corporate sector, led to increased credit availability for consumers in the fourth quarter, part of which was used for buying houses and other real estate. Furthermore, a drop in the savings ratio after 1998, combined with a rising debt-to-asset ratio among households, suggests that the propensity to consume may have risen. These factors may partially explain the pickup in retail sales toward the end of 2001.

FIGURE 2.3 **Contribution of Demand Components to Change in GDP, Republic of Korea, 1996-2001**



Source: Bank of Korea, 2002, available: www.bok.or.kr.

TABLE 2.3 Major Economic Indicators, Republic of Korea, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	10.9	9.3	3.0	4.8	6.0
Gross domestic investment/GDP	26.7	28.2	26.7	29.0	30.7
Gross domestic savings/GDP	33.5	32.6	30.1	30.5	31.0
Inflation rate (consumer price index)	0.8	2.3	4.1	3.5	4.0
Money supply (M2) growth	27.4	25.4	13.2	20.0	25.0
Fiscal balance/GDP	-2.7	1.1	1.3	1.5	1.6
Merchandise export growth	9.9	21.2	-14.0	7.0	10.0
Merchandise import growth	29.1	36.2	-13.3	12.0	14.0
Current account balance/GDP	5.8	2.7	2.0	1.9	0.7

Sources: Bank of Korea, available: www.bok.or.kr; National Statistics Office, available: www.nso.go.kr; Asian Development Bank Statistical Database System; staff estimates.

After the Asian financial crisis, the corporate sector had generally engaged in significant cost cutting as part of restructuring. As a result, firms were not forced to make large-scale layoffs during this downturn.

On the supply side, manufacturing growth decelerated sharply as a result of weaker orders for ICT products, which account for roughly half the exports of goods and services. As a result, industrial production growth slowed in the first half of 2001. In the second half of the year, external demand led to stronger growth in the automotive sector, helping offset some of the weakness in demand for ICT products. With a substantial depletion of inventories over much of the year and some improvement in domestic demand conditions, industrial production showed an upturn in the second half of 2001. Growth in the construction sector returned, to around 3.5%, from a 3.7% contraction in 2000. This was due to public spending on ports and roads as well as an upswing in residential building construction. Growth in the services sector remained resilient in 2001, although it was slower than in 2000, due to fairly brisk demand for recreational activities, hotel and restaurant services, communications services, and increased trade in construction materials.

Due to a large surplus in the National Pension Fund, the government surplus rose to 1.3% of GDP in 2001. A supplementary budget worth W1.5 trillion was introduced in June, mainly to provide local government subsidies and to improve education facilities. The Government also directed state pension funds worth W2 trillion toward share purchases in the aftermath of the September 11th events. This was done to support equity markets specifically and the economy generally. In November, it announced a reduction of sales taxes on a wide array of luxury goods to boost consumption. With regard to monetary policy, the Bank of Korea had to balance the risks of lowering interest rates to stimulate the economy versus the prospect of sparking inflation through a more accommodative policy stance. Inflation picked up in 2001 due to an escalation in services charges in the form of housing rents. To stimulate economic activity, and recognizing that interest rates were lowered throughout the year in industrial countries, the Bank of Korea cut policy interest rates by 125 basis points in 2001. Real short-term interest rates dropped close to zero. Monetary aggregates rose strongly, as did other indicators, such as the ratio of consumer lending to total bank assets (which underpinned consumer spending) in the second half of the year.

On the external front, ICT exports slumped in 2001, after double-digit expansion in 2000, due to the contraction in the ICT sector worldwide. This caused overall merchandise exports to fall by 14%, compared with 21.2% growth in 2000. Imports also contracted, by 13.3%, due to softer demand for oil, capital goods, and intermediate materials. As a result, the merchandise trade surplus declined to $13.4 billion in 2001. This combined with worsening deficits in travel and other areas of the services sector to narrow the current account surplus to $8.6 billion. The external debt position improved due to the early repayment of an IMF program loan and to a buyout by domestic creditors of Daewoo Motor's $55 billion debt from foreign creditors at a 60% discount. As a result, official reserves increased to over $100 billion at the end of the year from $96 billion at the end of 2000. The debt service ratio was around 14.1%.

POLICY DEVELOPMENTS

The Government's traditional focus on supporting exports and investment may shift toward consumption in the medium term. Manufacturing is now highly export oriented as well as cyclical in nature, and most investment is concentrated in this subsector. As a result, the past decade has been marked by increased volatility in both the finance and real sectors.

In response, and for the first time, the Government has begun to utilize tax policy to stabilize consumption. Less dependence on export industries and on investment in plant and equipment will have an impact not only on the composition of GDP but also on the volatility of the equity market. Since the early 1990s, there has been a significant increase in listings of capital-intensive companies with an export orientation, and these companies tend to be cyclically volatile. A move toward domestic demand would help reduce this volatility and indeed, the tax cuts in 2001 could be the first steps in implementing such a longer-term policy of diversifying the economy into domestic demand-related activities.

Korea's high savings ratio is partially grounded in the country's inadequate social welfare and pension systems, although benefits and national pension coverage have increased since early 1998. A corporate pension scheme may be introduced soon, possibly resulting in some of these savings being used for consumption. In addition, the Government may make more funds available to shore up the National Pension Fund, which is expected to face insolvency issues within the next 2 decades due to large benefit payouts resulting from changing demographic profiles. One proposal to address this concern is limiting the Fund's benefits at current levels or reducing them and introducing corporate pensions to cover some of the living costs of retirees. Since 2002 is an election year, any government impetus in this direction will likely be seen only in 2003.

OUTLOOK FOR 2002–2003

On a quarter-on-quarter seasonally adjusted basis, private consumption and gross fixed capital formation seem to have bottomed out in the fourth quarter of 2001. Private consumption growth is expected to be stronger in 2002–2003 since liquidity conditions are forecast to remain favorable, consumer and business sentiment should improve, and tax cuts will have multiplier effects on consumption and income. Fixed investment is expected to improve moderately. Given that a significant inventory correction took place in 2001, inventory investment is likely to gain momentum in the first half of 2002 and continue to do so for the rest of the year.

On the supply side, industrial production rose strongly in the second half of 2001, and, under the influence of restocking and improving domestic demand conditions, it should continue its recovery in 2002–2003. Furthermore, Korea is well placed to benefit from a recovery in the world economy since it has a diversified economy, a sound structural base (after significant postcrisis restructuring), and a low level of nonperforming loans. These factors suggest that economic growth will accelerate in the next 2 years.

Korea is well placed to benefit from a global economic upturn since it has a diversified economy, a sound structural base, and a low level of nonperforming loans.

There are, however, two concerns. The first is whether domestic demand will remain resilient, given the uncertainty of the timing of a strong recovery in export growth, as well as the absence both of strong social welfare and pension systems and of other automatic stabilizers. The second is how rapidly the global economy will recover and how this will impact on the demand for Korean exports. On the first point, the shift in emphasis toward an expansionary fiscal policy that began in 2001 is likely to continue, although at a somewhat subdued pace, and this should help support consumption demand. On the second, since Korean exports and US imports of ICT products are closely correlated and since US new ICT orders appear to have stopped declining in the fourth quarter of 2001, prospects are for a gradually strengthening rebound in ICT exports in 2002. On this basis, GDP growth is forecast at 4.8% in 2002 and 6% in 2003. Inflation should remain at about 4%. As economic activity improves, the current account surplus will rise slightly to about $8.8 billion in 2002 but fall to about $4 billion in 2003. As GDP growth picks up in 2002–2003 and as government revenues rise with an expanding tax base, the fiscal surplus is projected to increase to 1.5% and 1.6% of GDP, respectively.

MONGOLIA

Despite growing inflationary pressure, Mongolia has achieved some macroeconomic stability. This contributed to a positive environment for stronger private sector-led growth, particularly in the services and industry sectors, which offset the impact of a severe contraction in agricultural output due to a harsh winter. Future economic growth will depend on how quickly the economy can diversify so as to reduce its vulnerability to external shocks. Until then, growth will remain below potential.

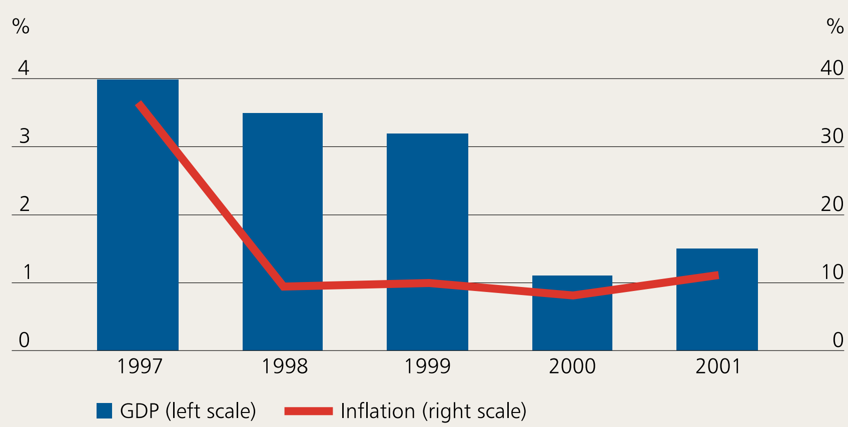
MACROECONOMIC ASSESSMENT

In 2001, the economy continued to be affected by exogenous factors, mainly severe natural shocks and declining exports, which kept its performance below potential. As a result, GDP grew at a moderate 1.5%. This growth was due primarily to the expansion of the industry sector that helped cushion a sharp drop in agricultural output. The losses in the livestock sector in 2001, still reeling from the ill effects of two successive harsh winters (*dzud*) and the outbreak of foot-and-mouth disease, were estimated at 10% of the country's total herd, or about 4 million animals. As a result, agricultural output, which still accounts for about 30% of GDP, posted an alarming 16% decline. The industry sector grew by 11.8%, driven by its main components, namely mining and manufacturing, which grew by 10% and 23%, respectively. The services sector, accounting for about half of GDP, registered 9.2% growth due to the buoyant outcome of the wholesale and retail trade, financial services, and transport and communications. While domestic investment reached 28% of GDP, savings remained low at 18%, and this gap contributed to the current account deficit and the external debt.

Growing unemployment, with only a poor social safety net, remains the Government's main concern and a primary cause of poverty. The extreme severity of the last two winters revealed the vulnerability of the rural economy and accelerated the migration of people seeking better access to social services and employment opportunities from remote to urban areas, particularly to Ulaanbaatar. Strong growth in the non-agriculture sectors has resulted in urban employment recovery. However, national unemployment, as measured by international standards, stood at 17% in 2000; 60% of the unemployed were under 35 years of age. To enhance the pro-poor orientation of wage policies, the Government announced a 6.1% increase in public sector wages and pensions on 1 October and raised the minimum monthly wage from MNT18,000 ($16) to MNT25,750 ($23).

Mongolia achieved some progress in restoring macroeconomic stability by reducing the budget deficit from 6.8% of GDP in 2000 to 5.1% in 2001. The key macroeconomic assumptions underlying the initial 2001 budget changed significantly as the impact of the second

FIGURE 2.4 **GDP Growth and Inflation, Mongolia, 1997-2001**



Source: National Statistical Office.

TABLE 2.4 Major Economic Indicators, Mongolia, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	3.2	1.1	1.5	3.0	4.9
Gross domestic investment/GDP	27.0	29.0	28.0	29.0	31.0
Gross domestic savings/GDP	20.0	18.0	18.0	19.0	21.0
Inflation rate (consumer price index)	10.0	8.1	11.2	6.0	5.0
Money supply (M2) growth	31.7	17.5	27.9	17.0	15.0
Fiscal balance/GDP	-12.2	-6.8	-5.1	-4.5	-4.0
Merchandise export growth	-1.7	18.2	-17.4	9.4	7.7
Merchandise import growth	-2.6	21.2	-9.7	4.9	6.2
Current account balance/GDP	-13.7	-17.2	-16.7	-14.7	-13.4
Debt service ratio	9.3	6.0	7.0	5.3	5.4

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

dzud was harsher than expected, leading to amendments to the budget in June 2001. The enhanced revenue collections generated from an introduction of temporary excise taxes and an increase in VAT from 13% to 15% (both measures were budget amendments) permitted a slight expansion in the provision for selected social programs without putting greater pressure on the overall deficit. A privatization scheme scheduled for 2001 was postponed to 2002–2003, removing from the budget the potential benefits of the sales of the major SOEs.

A tighter monetary policy was implemented to limit the effect of inflationary pressure stemming from large price rises for meat, energy, and fuel. However, the effect of this policy was partially offset by an expansion in wages and pensions. The result was an inflation rate of 11.2% (Figure 2.4). Broad money (M2) increased by 27.9% and commercial credit doubled due to the entry of new banks and expanded lending facilities supported by some multilateral and bilateral donors. Real rates on Bank of Mongolia bills fell sharply and remained negative through the first half of the year, but in the second half the Bank of Mongolia took decisive steps to increase the placement of these bills, allowing interest rates across all maturities to rise toward positive levels in real terms. The central bank's flexible exchange rate policy, applied through recourse to intervention, proved successful in avoiding excessive fluctuation in the exchange rate. Hence the national currency, the togrog, showed no significant deviations from the average level of MNT1,097 to the dollar during 2001.

The current account deficit increased from $167 million in 2000 to $170 million in 2001, or 16.7% of GDP. Total exports decreased by 17.4% as a result of a decline in the international price of export commodities, particularly copper—copper concentrate accounts for nearly 40% of total exports—and cashmere. The volume of cashmere exports also dropped, under the impact of the severe winter. Purchases of capital equipment and the need for imports related to *dzud*-relief kept imports relatively high, although 9.7% lower than in the previous year. There was a large inflow of external assistance. This led to an increase in the level of international reserves to $209 million from $191 million in 2000, equivalent to about 15 weeks of imports. External debt has doubled since 1996, and is about 90% of GDP. Consequently, debt service obligations have risen, to 7% of exports from 6% in 2000.

A tighter monetary policy was implemented to limit the impact of inflationary pressure. However, its effect was partially offset by an expansion in wages and pensions.

POLICY DEVELOPMENTS

The Government followed its strategic objectives within the context of the Action Program of the Government of Mongolia for 2000–2004. The Action Program emphasizes promotion of sustained higher economic growth and the improvement of living standards by strengthening economic reform, enhancing the provision of social services, narrowing income disparities, and ensuring good governance. The Government is committed to its Poverty Partnership Agreement with ADB. An interim poverty reduction strategy paper, prepared with assistance from the donor community, identified three pillars in the country's poverty reduction strategy: macroeconomic stability, private sector-led and outward-oriented growth, and more equitable distribution of the benefits of growth. However, the Government had limited success in achieving these strategic objectives.

Poor fiscal data quality and lack of proper accountability were the main factors in unrealistic 2001 budget planning that required subsequent amendments. In spite of that, the stronger revenues resulting from higher VAT and excise taxes financed the increases in social expenditures and permitted a budget deficit of about 2% below the 2001 target. Failure to privatize large SOEs, including Gobi Cashmere, the Trade and Development Bank, Mongolian Civil Air Transport, and the oil importer Neftimport Concern, meant the loss of a substantial funding source.

Restraining monetary measures were insufficient to contain the inflationary forces arising from the sharp rise in credit, higher wages, and increased pension benefits that were introduced in the second half of the year to bolster domestic demand. As a consequence, the inflation rate exceeded the original target by more than 3 percentage points. Policymakers have paid attention to maintaining an appropriate structure of interest rates, thereby fostering confidence in the domestic banking system through protection of the liquidity and solvency of the major state-owned banks.

The global economic slowdown made it difficult for the trade targets to be met. With exports declining faster than imports, the current account deficit widened beyond target and increased the stock of foreign debt. Further efforts to keep the exchange rate stable through central bank intervention, and preliminary steps to bolster domestic savings helped slow the rate of growth of foreign debt by the end of the year.

OUTLOOK FOR 2002–2003

Unless measures are taken to diversify the economy and reduce its vulnerability to external shocks, prospects for growth will remain below potential.

Unless measures are taken to diversify the economy and reduce its great vulnerability to external shocks, prospects for growth will remain below potential. Projections show moderate but rising rates of growth of 3% and 4.9% over 2002–2003, sustained by a more stable macroeconomic environment. Official projections for the period are for inflation to fall below 7%, and the fiscal deficit to shrink to under 5% of GDP. A growing demand for capital goods to meet the needs of the modernization of the economy will put the current account under pressure and generate a deficit of about 14% of GDP. However, this imbalance should be matched by expected greater inflows from international donors, a sign of their rising confidence in the economy, based on the Government's commitment to structural reforms. This is likely to result in an expansion of international reserves to 16 weeks of imports.

Sustainable economic growth and poverty reduction in the coming years will be possible only if concerted efforts are made to further develop and strengthen the private sector in a stable macroeconomic scenario. Fiscal policy has to shift its focus toward fiscal accountability and transparency and ensuring a more efficient allocation of public expenditures. Comprehensive public sector reform is vital to rationalize the tax system for achieving higher revenues and better public expenditure management. This remains key to the future expansion of social programs. Additional measures are needed to continue the progress made in developing the private sector, which currently accounts for about 60% of GDP, and to ensure a subsequent reduction in unemployment. In this regard, more decisive steps are needed, targeting (i) banking sector reform, including indirect monetary management, increased bank supervision, restructuring of the state-owned banks, and greater independence of the central bank from the Government; (ii) reform of nonfinancial public enterprises; (iii) strengthening of an open trade and investment system, including the energy sector; (iv) reinforcement of a market-oriented regulatory framework; and (v) progressive reduction of the public sector arrears and removal of indirect subsidies.

Progress in poverty reduction over the medium term will depend crucially on the Government's success in generating faster and more equitable economic growth. The most vulnerable layers of Mongolian society—small livestock herders, the urban poor, and street children—remain highly vulnerable to even minor external shocks, adverse weather patterns, and the ongoing reform process. Hence, a social safety net for the very poor needs to be built as a matter of urgency. While recognizing the need to address urban poverty through employment generation, policymakers should place strong emphasis on improving the provision of basic social services and infrastructure in rural areas.

TAIPEI,CHINA

After a recession in 2001 induced by an export slump in the ICT sector, economic growth is expected to resume in 2002. Restocking and some support from a moderate upturn in exports in the second half of 2001 will help stimulate GDP growth in the medium term, but structural unemployment will remain a concern as elements of the manufacturing base continue to move offshore.

MACROECONOMIC ASSESSMENT

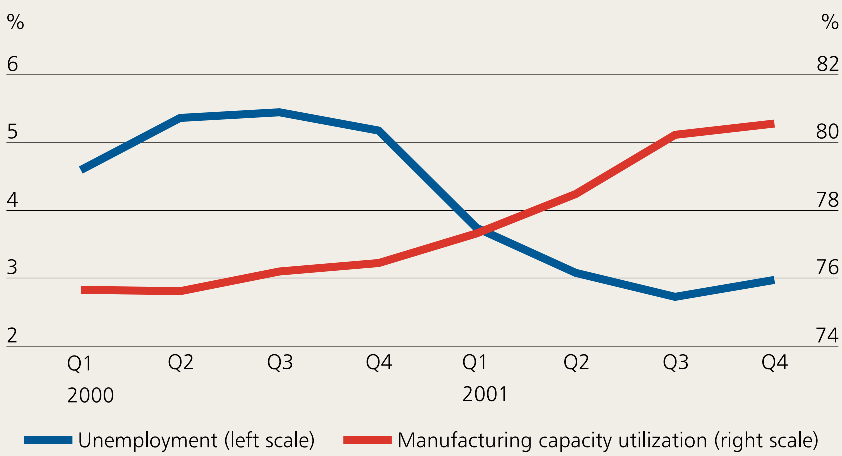
Economic growth decelerated rapidly in 2001 to register a contraction of 1.9%, representing the worst economic performance in 30 years. Much of the slowdown stemmed from the slump in exports of ICT products and the transmission of the export slowdown to private consumption and gross fixed investment. The economy's ICT exports account for more than 50% of exports of goods and services. The poor trade performance and associated recession in manufacturing pushed all components of domestic demand growth into negative territory in the second half of the year.

Taipei,China faced substantial spare capacity in manufacturing in 2001. Partly due to this, unemployment reached a historic high of 5.3% during the year (Figure 2.5). Combined with rapid worsening of the economic outlook, firms moving production to the mainland to cut labor costs, declining consumer confidence, and a negative wealth effect from a falling stock market, private consumption and fixed investment contracted in 2001. Adding to the downward pressure of falling investment, overdue loans reached a high of 7.5% of total loans. The severity of the downturn was exacerbated by a rising inventory-to-shipment ratio, indicating that the downward adjustment of stocks had not been large enough to adjust to falling sales. This partly explains why industrial production contracted over most of 2001. In the services sector, employment relative to that in industry increased by roughly 2% of the total labor force. However, employment growth in services did not fully offset the shrinkage of employment in manufacturing.

Price pressures remained subdued in 2001 with a negligible inflation rate as measured by the consumer price index, compared with 1.3% in 2000. Weakening domestic demand and a sharp fall in food and oil prices were the main factors. A 1.3% fall in the wholesale price index helped moderate the effect of the downturn by reducing the costs of production.

On the external account, the trade surplus rose in 2001, to $20 billion from $14 billion in the previous year, reflecting the adjustment of imports to slowing demand conditions. Merchandise exports

FIGURE 2.5 **Unemployment and Capacity Utilization Rates, Taipei,China, Q1 2000-Q4 2001**



Source: CEIC Data Company Ltd.

TABLE 2.5 Major Economic Indicators, Taipei,China, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	5.4	5.9	-1.9	2.8	4.0
Gross domestic investment/GDP	23.4	22.9	18.2	18.7	23.0
Gross domestic savings/GDP	26.1	25.2	23.5	24.1	25.5
Inflation rate (consumer price index)	0.2	1.3	0.0	0.7	2.1
Money supply (M2) growth	8.3	6.5	4.4	5.8	6.4
Fiscal balance/GDP	-1.3	-4.8	-4.3	-4.2	-4.0
Merchandise export growth	9.9	21.8	-17.3	5.5	8.0
Merchandise import growth	6.2	25.9	-23.8	8.0	10.0
Current account balance/GDP	2.9	2.9	6.7	3.9	3.4

Sources: Central Bank of China, available: www.cbc.gov.tw; Directorate-General of Budget, Accounting, and Statistics, Executive Yuan, available: www.stat.gov.tw; and staff estimates.

The two key concerns for the authorities are their ability to use fiscal policy as a countercyclical measure and the growing level of nonperforming loans.

contracted by 17.3%, after 21.8% growth in 2000. Toward the end of 2001, on a year-on-year basis, merchandise exports and imports showed some signs of recovery. The sharp decline in trade flows was accompanied by a drop in services imports of insurance and transport-related items, in addition to an overall drop in services imports, which were hit by the collapse in domestic demand. As a result, the current account balance rose to $19 billion in 2001.

On the fiscal policy front, the public debt-to-GDP ratio of around 28% of GDP has become a concern. (This figure does not include other contingent liabilities related to health care and pension funds.) Therefore, rather than cut taxes to stimulate demand, the authorities relied on expenditure policy in the form of a supplementary fiscal package of NT$111.5 billion. They also considered tax cuts, but eventually decided that such cuts would be difficult to phase out once a sustainable recovery took hold. In addition, tax cuts are limited by a prescribed link between revenues and spending: new government borrowing cannot exceed 15% of the total budget (which includes debt repayments and contingent liabilities).

The discount rate was cut by 250 basis points in 2001 to 2.13%. However, monetary policy has proven to be rather ineffective as bank lending and monetary growth were low in 2001, in spite of falling interest rates. The banks are reluctant to lend, due to the high and increasing level of nonperforming loans (NPLs) and to concerns over corporate creditworthiness.

POLICY DEVELOPMENTS

The two key concerns for the authorities are going to be the ability to use fiscal policy as a countercyclical measure and the growing level of NPLs. On the first point, the authorities' freedom to maneuver will be restricted due to the 15% ceiling on new borrowing and a high public debt-to-GDP ratio. This will be a particular concern in 2002 since domestic demand conditions are expected to remain quite weak until the economy makes a significant export rebound. A proposal to change the 15% limit (of the total budget) to 3% of GDP was considered by both the Legislative Yuan and the Economic Development Advisory Council in 2001, but was defeated. This proposal may be reconsidered in 2002. If it is approved, it is estimated that borrowing can be increased by roughly 1% of GDP.

On the second concern, if economic contraction continues in the first half of 2002, banking sector balance sheets could deteriorate further and NPLs may rise. The authorities have already put together an asset management company, the Financial Rehabilitation Fund, to transfer NPLs from banks, extend the coverage of deposit insurance schemes, and set up universal banks. However, the experience of Indonesia and Thailand suggests that the sale of these distressed assets by asset management companies would be difficult without the authorities engaging in at least a partial bank recapitalization to improve asset quality. This bailout would be possible without putting pressure on the fiscal balance only if the limit on new government borrowing was relaxed. Otherwise, banks' continuing weak balance sheets will hamper credit growth and prospects for economic recovery. Consequently, the authorities have little scope to use fiscal or monetary policy for countercyclical measures.

The investment outlook is constrained by uncertainty over ICT exports and the movement of production to the mainland. Both components of domestic demand should rise as external demand conditions improve, but the relocation of investment to the mainland and associated high unemployment rates are structural features of the island's economy that restrict growth potential in the medium term. Reflecting pressure to relax trade and investment relations with the PRC, the upside for domestic demand is quite limited over this period. The process of restructuring will require Taipei,China to become a provider of high value-added services to the region, rather than a manufacturing hub. Furthermore, greater integration with ASEAN economies and, possibly, the countries of South Asia may open up new markets for Taipei,China, and this may be a more fruitful approach than exclusive reliance on the PRC, where it faces stiff competition from Hong Kong, China.

The investment outlook is constrained by uncertainty over ICT exports and the movement of production offshore.

OUTLOOK FOR 2002–2003

The strength of recovery in 2002 and early 2003 will be determined by domestic demand conditions and the pace of recovery in industrial countries. So far, the backdrop for an upturn in private consumption and investment looks quite weak. Private consumption is unlikely to stage a sustained recovery since broad monetary aggregates have yet to show signs of an upturn, unemployment remains at historic highs, and spending continues to be sensitive to wealth effects. Some boost to inventory investment may take place in the second half of 2002 due to the low-base effect of 2001; a more sustained restocking may be seen in 2003 if exports show strong growth. This assumes that the inventory-to-shipment ratio finally starts dropping significantly in the first half of 2002.

Consequently, GDP growth is forecast at 2.8% in 2002 and 4.0% in 2003. With weak domestic demand conditions, the cyclical situation should allow interest rates to remain low for the whole of 2002 without running the risk of a sharp spike in inflation. The consumer price index is forecast to rise by 0.7% in 2002 and 2.1% in 2003. Assuming that the 15% limit on new government borrowing remains in place, the fiscal deficit as a proportion of GDP is forecast to stay at around 4%. The trade balance will stay positive, although import growth will exceed export growth in both years. This will result in a decline in the current account surplus to a projected 3.4% of GDP in 2003 from 6.7% in 2001.

ICT exports are an important component of overall exports, and the US is their most important market. Thus, US new orders of the product lines in which the economy specializes, such as personal computers and office equipment, and semiconductors and components, are crucial. Together, they account for 57% of exports of goods and services. Analysis of trends suggests that the island's exports lag US new orders of ICT equipment by one quarter. The recovery of Taipei,China's exports to the US will therefore likely be slow, given the current outlook for the ICT industry in the US. This could be followed by a moderate rise in the second half of 2002 as US (and EU) growth accelerates further. On the basis of these elements, exports are forecast to grow by 5.5% in 2002 and 8% in 2003, and imports by 8% and 10%, respectively, over these years.

ASIAN DEVELOPMENT

Outlook 2002

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

Southeast Asia

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

CAMBODIA

Despite some signs of economic slowdown, the economy continued to register strong growth in 2001. Exports, particularly garments, increased rapidly and made a major contribution to economic expansion. Fiscal and monetary policies have been well managed, and both prices and the exchange rate remained stable. One of the Government's main challenges is to convert strong macroeconomic performance into increased poverty reduction.

MACROECONOMIC ASSESSMENT

Despite severe flooding that hit the country in the last quarter of 2000, Cambodia saw reasonably strong economic expansion in 2001, when GDP was estimated to have risen by 5.3%. This was slightly below the rate in 2000, and below the Government's target of 6.1%, but still a strong performance given the global slowdown. In 2000, the industry sector (and in particular the garments subsector) led economic growth because agriculture suffered from the flooding, and growth in services was muted.

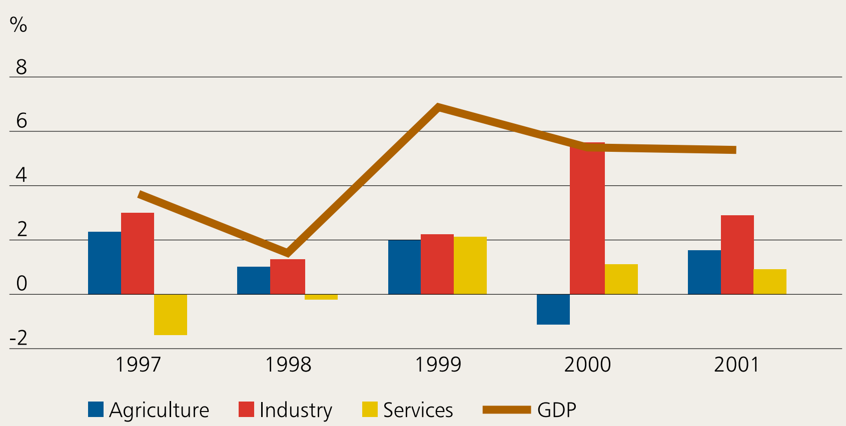
In 2001, economic developments were more balanced (Figure 2.6). The agriculture sector, accounting for 32% of the economy, expanded by 5%, despite localized flooding along the Mekong River and droughts in the north and northwest. Growth in industry, recently dominated by garments, slowed to a rate of 12%. The services sector registered an increase of 1.9%, with tourism continuing to play an important role. The annual growth rate in 2000–2001, above the 4% average in the previous 4 years, is laudable. Nevertheless, per capita incomes are still only rising by around 2% a year. The rate of expansion in the agriculture sector is of particular concern, given that over 80% of the population live in rural areas and depend largely on agriculture for their livelihoods. Labor market statistics collected by the Cambodia Development Research Institute show that wages for unskilled workers in Phnom Penh were stagnant or declining in 2001, highlighting the difficulty that the labor market faces in absorbing new entrants.

For the third year in a row, prices were stable. Before 1999, Cambodia suffered from inflation that was often in double digits. With low inflation, the exchange rate against the dollar has been stable.

The fiscal deficit remained largely unchanged in 2001, at 5.6% of GDP. Revenues accounted for 11.5% of GDP and total expenditures for 17.1%. Virtually the entire deficit is financed through grants and concessional lending.

Cambodia's trade deficit continued to narrow, to an estimated $225 million in 2001 from $263 million in 2000. Total exports grew to $1.35 billion from

FIGURE 2.6 **Sector Contribution to GDP Growth, Cambodia, 1997-2001**



Sources: Ministry of Planning; staff estimates.

TABLE 2.6 Major Economic Indicators, Cambodia, 1999–2003 (%)

Item	1999	2000	2001[a]	2002	2003
GDP growth	6.9	5.4	5.3	4.5	6.1
Gross domestic investment/GDP	17.0	14.1	16.2	17.0	17.4
Gross domestic savings/GDP	11.8	6.9	9.6	11.1	12.3
Inflation rate (consumer price index)	0.0	0.5	0.0	2.0	3.0
Money supply (M2) growth	17.3	26.9	18.0	16.0	14.0
Fiscal balance/GDP	-4.2	-5.8	-5.6	-4.5	-3.9
Merchandise export growth[b]	17.9	53.2	7.7	7.6	7.8
Merchandise import growth[c]	27.0	37.1	3.4	6.0	6.5
Current account balance/GDP	-8.4	-8.3	-6.6	-5.9	-5.1
Debt service ratio	1.7	4.2	4.0	3.9	3.0

[a] Preliminary estimates. [b] Refers to domestic exports. [c] Refers to retained imports.

Sources: National Bank of Cambodia; Ministry of Economy and Finance; National Institute of Statistics; International Monetary Fund; staff estimates.

Cambodia is still recovering from more than 20 years of war and international isolation.

$1.26 billion over this period. While this growth rate is less than in 2000, it still reflects healthy external demand for Cambodian exports, led by strong growth in garments. The current account deficit of 6.6% of GDP is financed through official transfers and capital inflows in the form of concessional loans and FDI. FDI was estimated to be $120 million in 2001.

POLICY DEVELOPMENTS

Public finances are weak as the Government makes the transition between taxes on international trade to broader measures such as VAT. Concessional loans and grants are widely used to finance the capital needs of the country, which are extensive given two decades of war and neglect by the international community. The Government is committed to maintaining fiscal stability with both revenues and expenditures scheduled to increase gradually as a proportion of GDP. It is also taking further steps to reorient spending toward the priority sectors of health, education, agriculture, and rural infrastructure, while reducing the share of expenditures on the military. By 2003, revenues should increase to around 13% of GDP with expenditures expected to rise to 17%. The share of recurrent expenditures in the budget is also expected to grow. Cambodia has a relatively liberal trade policy and is open to both imports and exports. The Government is also taking steps to align its trade policies with those of the ASEAN free trade area and WTO.

The dollar circulates widely and is freely used for many domestic transactions, while the financial system remains quite weak, together limiting the capacity of monetary policy to influence the real economy. The central bank may keep its conservative stance with continued careful management of the money supply. It is likely to intervene in a limited fashion to maintain stability and liquidity in the foreign exchange market. One key development is finance sector reform. The Government, with the support of ADB, prepared a finance sector blueprint that serves as a guide for medium-term reform in the sector. In January 2001, a number of unviable banks were closed and warnings issued to other banks. Further reforms in the medium term include the establishment of interbank payment systems and improved supervision of banks.

Cambodia is still recovering from more than 20 years of war and international isolation. It has made significant progress in improving the quality of life of the population in the past decade. For example, primary-school enrollment rates are now much higher at around 78%, and the population's health has improved. However, the Government—together with donors—needs to do more. Some indicators are still among the worst in Asia. For example, the infant mortality rate was estimated to be 95 per 1,000 live births in 2000. An estimated 36% of the population still live below the poverty line. Poverty remains concentrated in rural areas, where an estimated 90% of poor people live. Economic expansion in recent years has centered on rapid growth in textile production and exports, mainly in urban areas. For the benefits of this growth to reach the rural poor, significant investment is necessary to restore the physical infrastructure and to improve the quality and quantity of the country's human capital.

OUTLOOK FOR 2002–2003

The outlook for 2002–2003 is positive, with the economy expected to grow at about the same pace as in 2000–2001. In 2002, growth is forecast at 4.5%, a decline from current levels, but in 2003 it will likely pick up to 6.1%, in line with the Government's targets. Garments and tourism will continue to be the most dynamic areas. Exports will benefit from increased external demand in 2002–2003, as growth in the world economy strengthens. Nevertheless, the country will face growing competition in external markets, particularly in garments. Although the domestic cost of labor is quite low, exporters are often at a disadvantage due to the high costs of doing business, the country's poor infrastructure, and the strong dollar (since most costs are denominated in dollars).

Tourism will make an increasingly important contribution to the economy and the current account. The recent opening of Siem Reap airport to international flights has boosted the flow of visitors to the country. Additional investment is needed, however, to ensure that Siem Reap has sufficient public infrastructure to meet growing demand.

Inflation will remain subdued, given the central bank's recent history of responsible monetary management. Although increased demand should lead to some upward pressure on prices, the outlook is for inflation to remain below 5% in 2002–2003. The exchange rate will depreciate in line with the increase in inflation. Continued reforms in the finance sector will help improve the investment climate and lead to gradually higher savings and investment rates.

Poverty remains concentrated in rural areas, where an estimated 90% of poor people live.

INDONESIA

Economic growth slowed in 2001 as investment spending and exports reflected weaker external markets and continued internal political uncertainties. The ongoing conflicts in different regions of the country, burdensome public sector debt, and lack of progress on necessary economic reforms are constraining higher growth rates. Growth is expected to continue at a moderate rate in 2002–2003, sustained by private consumption spending and the anticipated recovery of international markets.

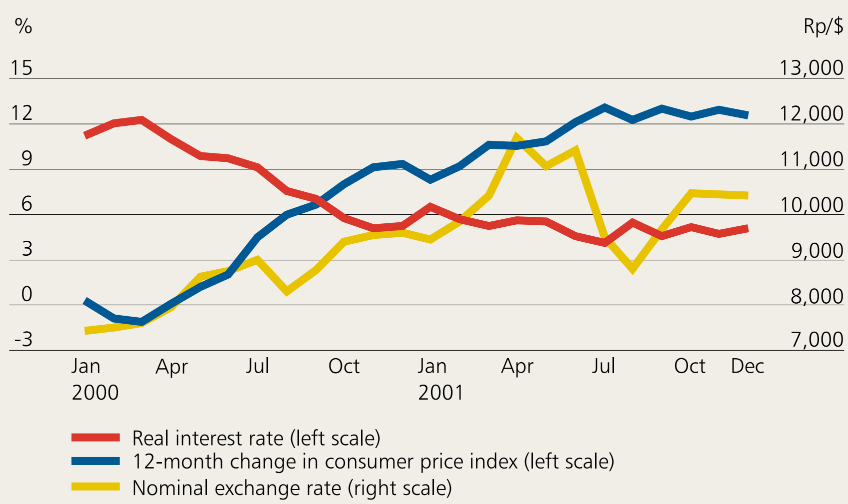
MACROECONOMIC ASSESSMENT

GDP growth in 2001 at 3.3% was considerably lower than the strong 4.8% expansion in 2000. The 2000 experience represented a delayed rebound from the Asian financial crisis, but this relatively good performance could not be maintained given investor uncertainty and weakening external markets. Strong growth in private consumption and public expenditures accounted for most of the growth in 2001. Business spending was muted in response to recurrent political difficulties, although the relatively peaceful change in the presidency in July provided for a moment of calm before the events of September 11th in the US and the subsequent rise in tension that again unnerved businesses. Investment in plant and equipment in the first two quarters of 2001 grew at an average rate of just under 18% (on a four-quarter basis). Though spending declined thereafter, the year as a whole showed only a 4% increase. The figures for exports and imports displayed a similar pattern of growing weakness during 2001. On a national accounts basis, net exports were down 26% during the year.

Private consumption rose by about 6% in 2001—the sharpest rise since 1997—with consumers responding to income increases in 2000 and early 2001. Although consumer spending remained strong throughout 2001, it is unlikely that this trend can continue as spending increased faster than overall income during the second half of the year. Likewise, the 8.2% growth in general government expenditures seen in 2001 is probably unsustainable, given the size and recent expansion of the public debt burden. Last year's deficit spending partly reflected efforts by the central Government to ensure a smooth transition under the decentralization process initiated at the beginning of the year.

By sector, manufacturing output grew by 4.3% in 2001, and utilities and some services sectors also showed strong

FIGURE 2.7 **Inflation, Real Interest Rates, and Exchange Rates, Indonesia, January 2000-December 2001**



Sources: Bank Indonesia, *Indonesian Financial Statistics,* various issues; Central Bureau of Statistics, *Official Releases,* various issues.

TABLE 2.7 Major Economic Indicators, Indonesia, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	0.9	4.8	3.3	3.0	3.6
Gross domestic investment/GDP	12.2	17.9	17.0	17.0	17.0
Gross domestic savings/GDP	20.2	25.7	25.5	23.0	21.0
Inflation rate (consumer price index)	-1.9	3.7	11.5	13.1	7.7
Money supply (M2) growth	11.9	15.6	17.5	18.0	18.0
Fiscal balance/GDP[a]	-2.8	-1.6	-2.3	-2.5	-0.5
Merchandise export growth	1.7	27.6	-9.8	10.5	8.0
Merchandise import growth	-4.2	31.9	-12.2	10.0	10.0
Current account balance/GDP	4.1	5.2	3.1	1.5	0.7

[a] For 1999, the ratio of the fiscal balance relates to 1 April–31 March. For 2000, the ratio is estimated on an annualized basis for 1 April–31 December. Thereafter, the ratio refers to calendar year data.

Sources: Bank Indonesia, *Indonesian Financial Statistics,* various issues; Central Bureau of Statistics, *Official Releases*, various issues; Ministry of Finance; International Monetary Fund, *International Financial Statistics,* various issues; staff estimates.

growth. Manufacturing benefited from a high level of investment early in the year as well as sustained consumer spending. In contrast, agriculture continued to reflect weak productivity growth and other problems in the rural sector, and managed less than 1% growth in 2001.

Preliminary data for 2001 show a softening in labor market demand resulting from slower economic growth. Employment edged up by 1.1% in 2001, but this rise was insufficient to offset the population increase and the labor force participation rate. Increased employment was reported mainly in the formal sector, which accounts for about one third of the economy, while little jobs growth was reported in the informal sector, which depends heavily on employment in the poorly performing agriculture sector.

Real wage data support the above picture, with significant increases seen in manufacturing but stagnation in agriculture. Administratively mandated rises in the minimum wage may have been important in manufacturing wage movements late in 2001. Real wages in manufacturing appear to have risen enough to make up for the declines that occurred during the financial crisis.

In 2001, total government revenues equaled 20.3% of GDP, slightly under the 20.7% in 2000. (The 2000 figures are estimated on an annualized basis because the fiscal year ran from April to December to allow for the transition to a calendar-based fiscal year in 2001. Therefore, comparisons between the 2000 and 2001 fiscal years are uncertain due to seasonal factors that may differ in the two periods.) Revenues from public activities in the oil and gas sector rose from 6.9% to 7.1% of GDP despite a softening of international prices, while tax collections fell by roughly 1 percentage point of GDP in 2001. The inability of the Government to meet targets for its privatization activities hindered revenue enhancement efforts. Total government expenditures rose by more than 1 percentage point to 22.6% of GDP. An important component of this was the increase in interest payments on public debt: these payments equaled 5.9% of GDP in 2001 and were the single largest line item in the central government budget.

The external debt had ballooned during the financial crisis, rising from less than one half of GDP in 1996 to 88% of GDP at the end of 2001. Domestic debt increased likewise, rising from 21% of GDP in 1998 to 80% in 2001, largely due to bank recapitalization and refinancing exercises. Another large item in the routine budget—subsidies for energy and other services and operations by SOEs—fell from 6.4% of GDP in 2000 to 5.2% in 2001. This reflected the Government's moves to increase final consumer prices, especially for electricity and petroleum products.

The rupiah weakened during 2001, depreciating by roughly 8.3% against the dollar. Political events appeared to dominate exchange rate movements during the year.

On an annual basis, the consumer price index rose by 11.5% in 2001, a sharply higher figure than the 3.7% rate of inflation recorded in the previous year. The increase in aggregate demand during 2000 and early 2001 underlay much of the price movement, but the depreciating currency, increases in administered energy prices, and accommodative monetary policy were also important general factors in rising inflation. Transport prices in particular rose by over 15% during 2001. Food prices were quite volatile from month to month and increased by 12% over the year.

Interest rates increased on a nominal basis in 2001, though the rise in inflation held real rates roughly constant for key rates (Figure 2.7). The central bank's 1 month rate (on the Sertifikat Bank Indonesia) moved from an annualized rate of 14.5% at the end of 2000 to 17.6% at the end of 2001. Adjusting for the 12-month change in the price level, the real rate stayed fixed at a relatively high 5%. Central bank interest rates did rise relative to international money rates: the spread of the 3-month Sertifikat Bank Indonesia over comparable US treasury bills widened from 8.5% at the end of 2000 to more than 15% at the end of 2001. While central bank interest rates paced inflation, commercial time-deposit rates were little changed overall in 2001, as banks struggled to improve profitability. Since time-deposit rates were little different from actual inflation, the real interest rate on commercial bank deposits was close to zero, discouraging saving.

The banking system showed some improvement over the year as a result of continued closures and reorganization.

Monetary policy was relatively accommodative and broad money supply grew at an annual rate in excess of 17.5% for the year. At the very end of the year, growth in money supply aggregates appear to slow. Even with slowing monetary growth at the end of the year, the money supply was considerably above target levels set in the Government's macrostabilization program agreed with IMF.

The Jakarta Stock Exchange ended 2001 down only a slim 5.9% from the end of 2000. The gain in the index in the middle of the year, reflecting the relatively peaceful changeover in the presidency, was lost following the attacks in the US in September and renewed political turmoil in Jakarta.

The banking system showed some improvement over the year as a result of continued closures and reorganization. The number of banks fell from 151 at the end of 2000 to 145 in November 2001. Nonperforming loans fell in 2001, to 13.6% in November 2001 from 18.8% at the end of 2000. At the same time, intermediation activity appears to have picked up, with banks making more loans as a fraction of their deposit base and reducing their dependency on government bonds for income. However, these changes are small, and the banking system's role in corporate finance is still a lot less important than before the financial crisis.

Although national accounts data suggest that the real value of both exports and imports rose in 2001, preliminary data suggest that both flows fell in 2001 when measured on a balance-of-payments (dollar) basis, implying a weakening of prices during the year. On such a basis, merchandise exports showed a 9.8% decline through 2001, while merchandise imports dropped by 12.2%. For the first time since the financial crisis, oil and gas trade fell with both exports and imports shrinking during the year. Although price declines largely account for the slip in dollar inflows from oil and gas trade, production problems also hampered supplies and exports.

Net services flows, which had been negative for several years, became more so in 2001. Inflows from tourism finally showed a definite recovery from the impact of the financial crisis and coincident political unrest in the country, but fell off after September 11th. Protests and threats to foreigners by extremist groups, which were widely reported in the global media, had a strong negative impact on tourism. Heightened concerns over travel safety also raised costs for insurance.

With declines in both exports and imports, the net merchandise trade surplus narrowed to $23.6 billion in 2001 from $25 billion in 2000. With continued higher net outflows from services, the current account surplus narrowed to $5.1 billion or 3.1% of GDP.

On the capital account, inflows of official assistance, which were prominent in the rescue effort after the financial crisis, fell in 2001, reflecting a decline in disbursements from policy-based adjustment loans. The net resource transfer from official creditors persisted in its steady fall from its peak in 1998 and is projected to become negative if current trends continue. Private capital continued to flow out of the country, as both FDI and other investments were strongly negative. Private capital outflows were larger than official net inflows, and as a result the balance-of-payments position turned slightly negative in 2001. The country's net reserve position fell by approximately $1.9 billion to $28 billion at the end of the year.

POLICY DEVELOPMENTS

In 2001, fiscal and monetary policymakers faced the difficult task of encouraging economic recovery without jeopardizing a somewhat fragile macroeconomic stability. This challenge is likely to remain difficult in the coming years as fiscal freedom remains constrained and competing reform needs restrict monetary policy options.

Fiscal policy operates under increasingly tight constraints dictated by large debt service obligations and the transfer of one quarter of total public revenues to local governments under the ongoing decentralization process (Box 2.2). Domestic resource mobilization is hindered by relatively low tax collection efforts, with the tax-to-GDP ratio remaining at 12–13%, considerably below that of neighbors such as Malaysia. Improvements in tax collections can come only with across-the-board improvements in governance. Civil service and administrative reforms are necessary in tax collection agencies, but this is unlikely to have much impact until there is a concurrent strengthening of the legal and judicial system. A commitment to change is clear at the highest level of Government, but experience in other countries suggests that reform will not come quickly.

Sources of nontax revenue are also constrained, due in part to continued dependency on somewhat volatile oil- and gas-related revenues and because of difficulties that the Government faced in public asset sales and in privatization. In the fallout from the financial crisis, the Government took on a large debt burden, particularly in the finance sector as a result of bank recapitalization. The banking system as a whole was essentially nationalized as the Government assumed control and ownership of most of the banking sector that had previously been privately controlled and owned. With the government bailout, enterprise assets and outstanding loans were transferred to government asset-management agencies. Although some progress was seen in late 2001, entrenched political interests and concerns within the Government over the impact of privatization on equitable growth and economic security have obstructed asset sales and privatization efforts.

The 2002 budget, passed in October, calls for lower expenditures as a share of GDP than in 2001, although development spending financed by the central Government will remain steady at 3.1% of GDP. Overall, the Government's fiscal policy stance in 2002 is little different from that in 2001, with the budget targeting a primary fiscal surplus equal to about 2.5% of GDP (primary fiscal balance is defined as total revenues less all expenditures except interest payments). The Government has also announced that it will con-

BOX 2.2 Decentralization in Indonesia

As part of the momentous political changes under way in Indonesia, an ongoing decentralization program has transferred approximately one quarter of total central government revenues to local—particularly district—governments. Local governments were simultaneously given responsibility for public sector activities in health, education, and rural and urban infrastructure, along with authority over more than 2.3 million former central government staff.

The process was adopted to generate local responsibility for local problems, and to encourage participation and regional relevance of public sector services and initiatives. Set against a backdrop of several decades of increasing central government authority, decentralization is a radical move. Redistributing administrative power and public revenues offers the hope of moderating long-term political problems, including those that have led to intercommunity violence. Government estimates of the huge number of 1.3 million people displaced from their homes as a result of internal violence testify to the scope of these problems in some parts of the country.

Despite widespread concerns, the formal process of decentralization has proceeded relatively smoothly—few service disruptions or staff problems were reported and local governments made considerable efforts to meet their new responsibilities. However, major deficiencies remain in operating guidelines for local service providers, particularly in introducing minimum service standards and ensuring compliance and consistency between local regulations and national policies. In addition, with decentralization and the added responsibilities given to district governments, local governments have made many attempts to increase their revenues by raising taxes and fees. Many of these measures threaten to discourage trade, transit, and business activities across regions. To ensure that the promise of decentralization is fully met during implementation, the central Government is addressing this and related problems.

Brighter prospects in external markets in 2002–2003, continued incremental progress in economic reforms, and a prudent fiscal and monetary policy stance should provide scope for a modest pickup in GDP growth in 2003.

tinue with plans to increase electricity prices to reduce operating losses by the state electricity company. The 2002 budget assumes that the Government will win further debt relief from the Paris Club of government creditors and that next year's negotiations will bring a rescheduling both of interest payments and principal repayments.

Fiscal conservatism is dictated by the necessity to meet debt obligations. As noted above, public sector debt ballooned as a result of the financial crisis. With prudent debt management, including successful Paris Club renegotiations, the outlook is that the debt burden will gradually diminish. However, debt service will remain the largest single item on the public sector books in light of moderate economic growth and limited repayment capacity.

Monetary policy has been hampered by both difficult circumstances and weak political support for a tight monetary policy stance. The emerging threat of double-digit inflation has been difficult to confront through monetary instruments for fear of stifling business and consumer spending. An added constraint has been that a number of banks that received government support or rescue were dependent on fixed-income certificates. The balance sheets of these banks would suffer in a higher interest environment. Finally, political disagreements between the central bank and former President Wahid clearly undermined the central bank's ability to impose policies likely to be unpopular.

Spurred by rising exports, increased investment was one of the factors that helped pull the economy out of recession in 2000 and early 2001. However, FDI inflows faded as global markets weakened in 2001. More important to longer-term prospects, there has been a widespread perception that the policy environment for investment in Indonesia has turned harsh and unsupportive. In the first 10 months of 2001, only $6 billion of FDI projects were approved, roughly equal to one third of the total approved during the comparable period in 2000. Because the fall in investment predates the September attacks on the US, it would seem to be part of the broader, longer-term problem of capital flight seen in Indonesia since the financial crisis. Continuing problems of financial governance, lack of credibility of the legal and judicial system, and political uncertainty have all discouraged investors from making longer-term commitments. The Capital Investment Board noted that only about 10% of previously approved projects—both domestic- and foreign-sponsored—were likely to be realized this year. The political problems hindering attempts to sell state-controlled assets are one of the symptoms of the broad negative investment sentiment. Successful execution of planned privatization of major banks and SOEs would be helpful both in restoring investor confidence by signaling the Government's commitment to encouraging private sector development, and in convincing the investment community that needed changes will be made so that future investments are warranted.

OUTLOOK FOR 2002–2003

There will likely be a modest weakening of growth, from 3.3% in 2001 to 3% in 2002, as demand falters in the early part of the year before an expected recovery takes hold in the second half. Brighter prospects in external markets in 2002–2003, continued incremental progress in economic reforms, and a prudent fiscal and monetary policy stance should ensure that the risks of recurring recession are minimized and should provide scope for a modest pickup in GDP growth in 2003. However, there seems little prospect that the economy will again experience the rapid economic growth of the order of 7–10% annually that it experienced during the decades prior to the financial crisis.

A recent poverty monitoring report, covering January–October 2001, suggests that there was no poverty reduction in this period. Basing its assessment on trends in real wages in the formal and informal sectors, including agriculture, the report found that real wages in the informal sector were steady, although this average trend hid considerable variation across regions. Real agricultural wages increased by up to 10% in four provinces, and declined by up to 10% in five other provinces. Real wages in the formal and construction sectors registered significant increases (10–12%) largely as a result of legislatively mandated increases in the legal minimum wage. However, any beneficial effects that these increases had on the poor are unclear as changes in employment levels caused by the wage rises are unknown, as is the extent of participation of the poor in formal sector employment.

Growth in the 7–10% range is necessary to reduce poverty in a sustainable fashion and to meet the Government's long-term development goals. Looking back, poverty decreased from 40% in 1976 to just over 11% in 1996. At the

3–4% GDP growth rate currently anticipated, average income can be expected to rise by only 1–2% per year, i.e., far too little to materially affect the bulk of population that is poor or near poor. To regain high growth rates, it will be important for policymakers to work hard to convince both domestic and international investors that reforms are effectively reducing corruption and weaknesses in the legal and judicial system.

The IMF-supported program for macrostabilization calls for more aggressive targeting of inflation. However, the weaknesses of the central bank, a lack of political consensus on the advantages of higher interest rates, and the need to continue to raise energy and utility costs will mean that inflation will come down only relatively slowly. Exchange rate movements appear to follow current inflationary expectations, a trend that is likely to continue. Banking sector reforms, including privatization of banks, could provide additional scope for lowering inflation.

Although the external sector is likely to grow at higher rates in the future, current trends suggest that the large current account surpluses that have cushioned the economy from the effects of low growth and capital outflows (by providing foreign exchange for debt repayment) are likely to decline in 2002. Tightening current account surpluses means added risks from external shocks, such as dampening inflows from tourism or further capital flight. Active pursuit of government policies to improve peace and security and to encourage investment, as well as prudent debt management, will become more important .

LAO PEOPLE'S DEMOCRATIC REPUBLIC

Continued macroeconomic stability was accompanied by moderate economic growth in 2001 as the benefits of past reforms became evident. Inflation was significantly lower than in previous years and the fiscal situation began to improve. The outlook is positive, with continued prudent macroeconomic management and potential large-scale investment contributing to the overall picture.

MACROECONOMIC ASSESSMENT

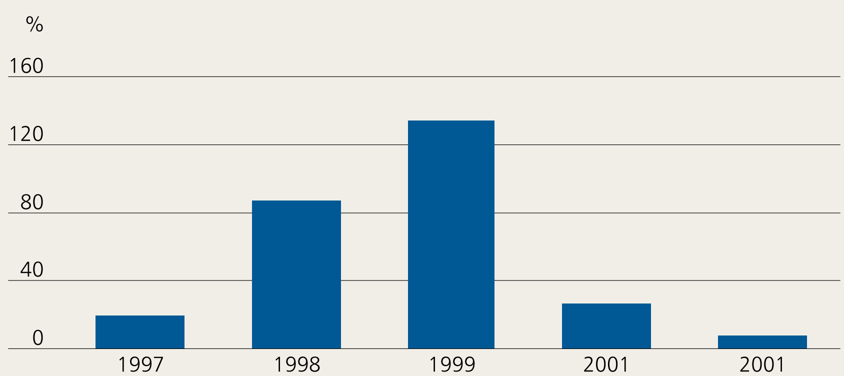
Economic performance in the Lao People's Democratic Republic (Lao PDR) remained steady in 2001 in the face of slower global and regional economic growth. GDP growth was estimated at 5.5%, a decline from 5.9% in 2000. Slower export and agriculture sector growth and limited FDI offset the benefits of a substantial drop in inflation, greater macroeconomic stability, and a strong improvement in tourism.

Growth in 2001 was well balanced as agriculture, industry, and services all reported moderate rises in output. Agriculture, which employs around 85% of the population and accounts for about half the economy, grew at an estimated rate of 3.9% during the year. This represents a slowdown after several years of strong expansion, led by extensive investment in irrigation and increased (albeit informal) cross-border trade in agricultural commodities with neighboring Thailand. Industry remained the fastest-growing sector, with construction and garments playing a key role. The services sector, which accounts for about a quarter of the economy, also saw steady growth of around 6% in 2001. Tourism continued to play an important role, contributing both to GDP growth and the balance of payments. Tourism has strengthened steadily every year since the mid-1990s.

As a result of continued sound macroeconomic management, prices became more stable. Inflation was reported at 7.8% in 2001 (Figure 2.8), below the Government's target of 10%. This represents a significant reduction from the very high inflation rates in 1998 and 1999 and is one of the lowest rates of price increases since the economy reopened to the outside world in 1986. The kip depreciated by 13.7% against the US dollar in 2001 from its level in 2000.

The external front was stable: the trade deficit remained constant at about 13% of GDP, while the current account deficit increased slightly to 7.2%. Exports remained firm at around $425 million. Leading exports included timber and wood products, electricity (from hydropower plants), and garments. Unregistered cross-border trade in agricultural commodities with Thailand was also significant. In 2001, foreign investment was estimated at $30 million, below the levels in previous years, which often exceeded $100 million a year.

FIGURE 2.8 **Inflation Rate, Lao People's Democratic Republic, 1997-2001**



Source: National Statistical Center.

TABLE 2.8 Major Economic Indicators, Lao People's Democratic Republic, 1999–2003 (%)

Item	1999	2000	2001[a]	2002	2003
GDP growth[b]	7.3	5.9	5.5	5.8	6.1
Gross domestic investment/GDP	22.7	20.5	21.0	22.0	22.0
Gross domestic savings/GDP	16.4	14.7	13.8	14.0	14.0
Inflation rate (consumer price index)	134.0	27.0	7.8	6.5	6.0
Money supply (M2) growth	78.3	45.8	20.0	18.0	16.0
Fiscal balance/GDP[b]	-8.8	-7.9	-8.0	-6.1	-6.0
Merchandise export growth	7.7	8.3	8.1	8.5	8.5
Merchandise import growth	0.3	6.6	10.5	11.0	11.0
Current account balance/GDP	-6.3	-5.8	-7.2	-8.0	-8.0
Debt service ratio	11.4	10.1	10.5	9.8	9.2

[a] Preliminary estimates. [b] Constant factor cost. [c] Central government balance ending 30 September.

Sources: Bank of the Lao PDR; National Statistical Center; State Planning Center; International Monetary Fund; staff estimates.

Growth in 2001 was well balanced as agriculture, industry, and services all reported moderate rises in output.

Foreign currency reserves remained steady in 2001 and at the end of the year were sufficient to cover 2.5 months of imports.

The Lao PDR is officially classified as a heavily indebted poor country, though official statistics overstate the seriousness of the country's foreign debt problem. Approximately half the debt is owed to the Russian Federation. This debt is carried on the books at an unrealistic exchange rate and is not currently being serviced. The governments of the Lao PDR and the Russian Federation are renegotiating the terms of the debt, which will lead to a significant reduction in its book value.

POLICY DEVELOPMENTS

Until a few years ago, weak fiscal policy resulted in large fiscal deficits. In recent years, this issue has been partially addressed, though the fiscal deficit remains substantial at 8% of GDP. Current revenues amounted to around 15% of GDP in 2001 and total expenditures to around 23% of GDP. In the medium term—by 2005—the Government is committed to increasing its revenues to around 18% of GDP. It is also determined to increase the share of spending in the social sector relative to GDP. In 2001, the deficit was almost entirely financed through grants and concessional loans from abroad. This trend is expected to increase in the future, although with price stability, the Government may be able to finance its deficit through domestic bonds as well.

Despite the rise in government spending in recent years, further action is needed to improve the balance between capital and recurrent outlays. In fiscal year 2001, capital expenditures accounted for around 65% of the total. As a result, spending in the social sector (which relies heavily on recurrent expenditures) has suffered. Fiscal decentralization has also raised uncertainties about the role of the provinces in determining spending and in collecting revenues.

The inflationary bout of 1998 and 1999 was largely caused by the Bank of the Lao PDR monetizing the Government's budget deficit. As part of the program to reduce inflation, the Bank stopped purchasing government bonds, effectively ending central bank financing of the budget deficit. The large volume of dollars and baht circulating in the country limits the role of monetary policy. Foreign currency deposits account for at least 75% of total liquidity and foreign currency is widely accepted for domestic transactions.

Finance sector reform remains a priority for the economy. Currently, the system is dominated by three state-owned commercial banks (SOCBs) and the Agriculture Promotion Bank, although foreign banks and joint ventures also operate, primarily in Vientiane. In the past, SOCBs focused on lending to SOEs and the percentage of nonperforming loans is quite high. The Government is in the process of reforming the finance sector,

The gains that the poor might have expected to see from economic growth have been reduced due to increased inequality.

with the support of ADB, IMF, and the World Bank. SOCBs have largely stopped lending to the Government. This reform will help the finance sector direct its lending to projects on the basis of their economic efficiency and contribution to GDP growth. It will also force SOEs to further commercialize their operations, as it will reduce their reliance on easy credit from the SOCBs.

In 1998, 39% of the population lived below the poverty line, determined by an estimate of minimum caloric needs. Poverty is not evenly distributed: in the north, 53% of the population are poor compared with 12% in Vientiane prefecture. Evidence suggests that economic growth has had a positive effect on poverty reduction, not equitably though: between 1993 and 1998, while per capita income grew by 25%, the proportion of poor people dropped only by 7 percentage points. The gains that the poor might have expected to realize from economic growth have been reduced due to increased inequality. New investment will have to concentrate more on providing physical and social infrastructure and to adjust the macroeconomic policy environment so that the poor are able to better capture the benefits of growth.

OUTLOOK FOR 2002–2003

The outlook for 2002–2003 is generally positive due to the anticipated economic recovery of the region and increased investment in the hydropower and mining sectors. GDP growth is expected to pick up, reaching 6.1% in 2003.

Recent efforts to reduce inflation have been successful and this downward trend should persist. With sustained prudent monetary policy, inflation should reach 6% in 2003. Several years of relatively low inflation should help stabilize fluctuations in the kip and may increase its use for domestic transactions. Exports are expected to increase by around 9% in both 2002 and 2003. Tourism is also likely to continue growing.

Both government revenues and expenditures are expected to rise modestly in the medium term, with revenues reaching around 15% of GDP by 2003, given ongoing reforms in tax collection and improved coordination with provincial tax authorities. Expenditures are forecast to rise to 22.8% of GDP by 2003. Further reforms in public expenditures should improve their quality, with a greater share going to recurrent expenses and human resources development.

MALAYSIA

GDP growth decelerated sharply in 2001 on the back of an export slowdown and weak domestic demand conditions. A surge in public spending in tandem with positive private consumption growth, over most of the year, averted a recession. Prospects are for a modest acceleration of growth.

MACROECONOMIC ASSESSMENT

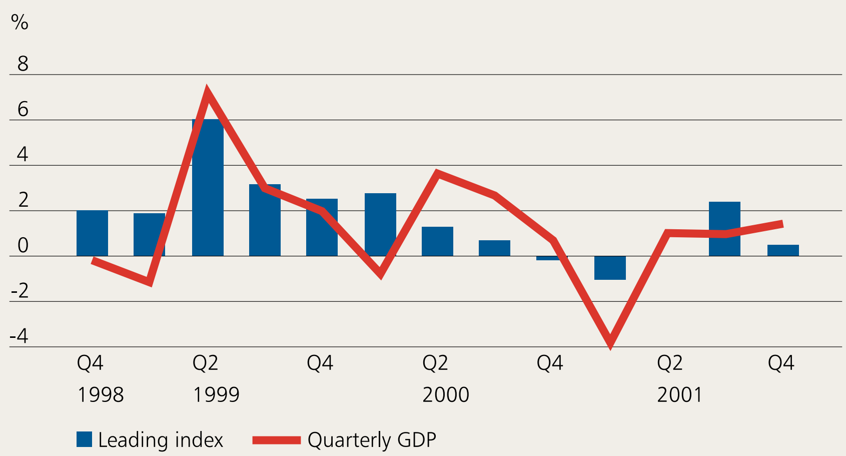
The year 2001 was difficult economically for Malaysia, as it experienced its second major slowdown in 4 years. While policymakers were still grappling with the consequences of the Asian financial crisis that began in 1997, a series of shocks prevented the economy from achieving a full recovery. In the first half of the year, the global plunge in demand for ICT products, which led to a protracted and synchronized slowdown in the world economy, contributed to slow domestic GDP growth of under 1%. While early signs of a leveling off started to emerge during August–September, hopes of a turnaround were dashed by the events of September 11th in the US. With the potential to cause another downward adjustment in export earnings, particularly from trade and tourism, these events further weakened the Malaysian economy.

Nevertheless, compared with some other regional economies, Malaysia was better able to deal with weakness of activity in the industrial economies. Important contributory factors were the resilience of private consumption and the beneficial effects of the Government's policy actions.

Among major expenditure categories, consumption spending grew, propped up by a surge in public spending. Given that total consumption accounts for about 60% of GDP, its resilience helped absorb some of the contractionary forces resulting from the collapse in external demand. While a fall in disposable income and a sluggish labor market exerted downward pressure on consumption spending, this was cushioned by retail discounts, tax deductions, a turnaround in palm-oil prices in the middle of the year, low interest rates, and a sharp increase in public spending. Private consumer spending growth, accounting for about 80% of total consumption, fell to 2.4% in 2001 from 12.2% in the previous year. Public consumption spending accelerated to 14.1% from 1.7% in 2000, as the Government adopted stimulus measures.

Stronger public investment could not prevent total investment from shrinking by 5.3% in 2001. Private investment was severely affected by the sharp contraction in manufacturing and the export slowdown. On inventories, it is encouraging to note that downward adjustments have been ongoing since the fourth quarter of 2000.

FIGURE 2.9 **Change in Leading Index and Quarterly GDP, Malaysia, Q4 1998-Q4 2001**



Source: CEIC Data Company Ltd.

TABLE 2.9 Major Economic Indicators, Malaysia, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	6.1	8.3	0.4	4.2	5.8
Gross domestic investment/GDP	22.3	26.8	24.8	25.9	26.4
Gross domestic savings/GDP	47.3	46.8	42.3	41.8	41.0
Inflation rate (consumer price index)	2.8	1.6	1.4	2.3	2.8
Money supply (M2) growth	13.7	5.2	5.3	6.9	8.5
Fiscal balance/GDP	-3.2	-5.8	-6.7	-5.2	-3.0
Merchandise export growth	16.8	17.0	-8.8	7.0	11.9
Merchandise import growth	12.8	26.2	-7.6	10.0	16.1
Current account balance/GDP	15.9	9.4	7.8	5.3	2.6
Debt service ratio	5.6	5.4	6.0	6.3	6.1

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

The main drag on the economy in 2001 was the export sector, which was hit by the slump in global demand for manufactured goods, particularly ICT products.

The main drag on the economy in 2001 was the export sector. The slump in global demand for manufactured goods, particularly ICT products, led to a sharp contraction in demand for Malaysia's exports, starting in the fourth quarter of 2000. In the weakening global economy, prices of some of Malaysia's primary commodity exports, including crude oil, were also softer, exacerbating the fall in nominal exports. Owing to the heavy import-dependent nature of exports and the decline in overall economic activity, import demand also fell sharply. The slump in imports was seen mainly in capital and intermediate goods; imported consumer goods experienced only a modest decline.

On the production side, manufacturing suffered a sharp contraction of 4.8% in 2001, from 21% growth in 2000. Within manufacturing, while domestic-oriented industries recorded growth of 8% in 2001, this did not fully offset the contraction in export-oriented industries. The agriculture sector was the only area, apart from construction, where growth actually picked up—to 2.3% from 0.6% in 2000. This was mainly due to the bumper harvest of palm oil. The services sector grew by 3.9%, primarily due to the resilience of finance, insurance, real estate, and business-related activities. A low interest rate environment was a catalyst for these activities.

At 1.4%, inflation in 2001 remained subdued due to weak domestic demand, a stable ringgit, and low inflation abroad.

The economic slowdown, apart from the inevitable loss of income and employment, did not impact on social conditions too severely, thanks to the Government's actions. Though the main thrust of fiscal policy was to soften the impact of the slump in external demand, the Government, in addition to offering tax relief, continued to spend heavily on health, education, and social protection. Monetary conditions remained accommodative. In fact, a low interest rate regime was already in place prior to 2001, as a result of the Government's desire to encourage more investment. Hence, the central bank made only a 50 basis point interest rate cut in 2001.

The merchandise trade balance remained in surplus, at $18.2 billion. This was despite the export contraction of 8.8%, and was mainly due to the similar fall in imports. The continued trade surplus helped the economy maintain a sizable current account surplus of $6.8 billion in 2001, as well as ward off pressures on the ringgit in the first half of the year. It also contributed to a steady rebound in foreign reserves from June, which ended the year at a comfortable $30.8 billion. The reserve position covered 5.2 months of retained imports and was six times the level of short-term external debt.

POLICY DEVELOPMENTS

Fiscal pump priming will continue in 2002 to act as a very important driver of growth, especially in the first half of the year when export expansion is expected to be moderate. Following the Government's low level of usage of the fiscal stimulus packages announced in 2001—it managed to spend only 50% of these funds—it has introduced a number of administrative measures to speed up project implementation. Apart from giving ministries greater financial authority, project management consultants will be appointed to supervise projects, which are awarded on a build-own-operate basis. Work will be required to start immediately after the award of a tender and once the tendering procedures have been simplified. A special committee in the Treasury Department has also been set up to monitor the project implementation process.

The 2002 budget cut the individual tax rate in the top bracket marginally from 29% to 28% and increased government salaries by 10%. On the corporate front, the Government extended the reinvestment allowance from 5 to 15 years and implemented tariff concessions for a wide range of intermediate products. These measures were designed to boost domestic demand directly, rather than letting it rely on the traditional multiplier effects emanating from public infrastructure projects.

Despite an expansion in the fiscal deficit in recent years, Malaysia's national debt at 50% of GNP remains manageable: its debt service ratio is only about 6%.

In the finance sector, the proportion of nonperforming loans picked up marginally to roughly 16.3% in 2001, primarily due to the deterioration in economic conditions. The credit intermediation channel remains effective through bank lending to households for mortgages and consumer loans. Companies have been tapping into a growing corporate bond market for financing on back of spread compression. It is expected that improved liquidity conditions and relatively low nonperforming loan levels will continue in the short to medium term and this should help stimulate consumption and investment-related activities in 2002 and 2003.

Malaysia's economic slowdown has highlighted the problems associated with overreliance on an export-led growth strategy. Both the intensity of the financial crisis and the speed with which the slump in the US economy has been transmitted to trade- and finance sector-related activities have prompted policymakers to look for alternative means of promoting economic growth. While maintaining an open economy, they have started to look for untapped potential at home, especially in services (ports and tourism), agriculture, and resource-based industries to improve the economy's resilience to shocks.

OUTLOOK FOR 2002–2003

The outlook is predicated on the following assumptions. A modest recovery in the US will be seen in the first half of 2002 and will be followed by a stronger pickup from the second half of the year and into 2003. The stimulus packages implemented in the second half of 2001 and new policy changes in 2002 via lowering of personal and corporate tax rates are expected to have significant spin-off effects on domestic demand in the short to medium term. Destocking was quite significant by the fourth quarter of 2001 and inventories are likely to follow the expected upward trend in the US business inventory-to-sales ratio in 2002. US new orders of ICT products will probably stage a modest upturn in the second half of the year and this will lead to a moderate recovery in Malaysian exports.

The stimulus packages implemented in the second half of 2001 and policy changes in 2002 are expected to have significant spin-off effects on domestic demand in the short to medium term.

Economic growth in the first half of 2002 is likely to be restrained, driven mainly by domestic demand underpinned by expansionary fiscal policy and a rise in inventory investment. The leading index rose in the third quarter of 2001 and is expected to continue to do so in 2002 (Figure 2.9). The recovery is likely to gather pace in the second half of 2002 as export demand accelerates. GDP growth is forecast at 4.2% and 5.8% in 2002 and 2003, respectively.

The outlook for inflation depends primarily on the speed and strength of the economic recovery. Prices should increase moderately as demand conditions improve, since some excess capacity may remain for much of 2002. The inflation rate for the year is projected at 2.3%, accelerating further to 2.8% in 2003.

The fiscal deficit is expected to narrow to 5.2% of GDP in 2002 due to stronger revenues stemming from an expansion of the tax base as GDP growth accelerates and as capital expenditures fall. In 2003, as the Government becomes less reliant on pump priming, the fiscal deficit is forecast to further narrow to 3% of GDP.

On the balance of payments, merchandise exports are forecast to register 7% growth in 2002 as the global economy strengthens. However, a stronger surge in imports, due to the replenishment of low inventories and to higher demand for intermediate inputs from ICT exporters, will likely reduce the merchandise trade surplus to $17.4 billion. With a forecast net services deficit of around $10 billion, the current account is expected to register a smaller but still considerable surplus of 5.3% of GDP in 2002.

MYANMAR

Economic expansion in Myanmar is likely to have slowed in 2001 as a consequence of tougher economic sanctions and slower domestic agricultural growth. Over the long term, prospects for growth and for lasting poverty reduction remain uncertain in a context where macroeconomic and structural distortions are acute.

MACROECONOMIC ASSESSMENT

For 2000, GDP growth is officially estimated to have been 13.6%. However, independent estimates suggest that growth was much more modest, possibly 6%. Official estimates of growth for 2001 are, as yet, unavailable but the pace of economic activity in Myanmar, as in other countries of the region, is likely to have slowed. In addition to depressed external demand conditions, economic sanctions are likely to have held economic expansion in check. Moreover, agricultural output, which contributes substantially to aggregate activity, is likely to have been adversely affected by rains that hindered dry-season rice cropping.

In 2000, inflation, which had averaged over 25% a year for more than a decade, dropped sharply. Consumer prices are estimated to have fallen by 1.7%. This dramatic reversal in trend was caused by a decline in the cost of food (mainly due to a bumper rice harvest in 1999/2000), which weighs heavily in the consumption basket. However, price stability was also helped by the creation of "tax-free markets," which lowered distribution and marketing costs, and by the slower growth of central bank credit. Although no official inflation data are yet available for 2001, the latest indications are that price stability was short lived, and inflation may have averaged somewhere around 20% in 2001. Central bank credit growth resumed and the kyat depreciated sharply in the parallel market.

Over a protracted period, the public sector has run substantial fiscal deficits. To cover the losses of state economic enterprises (SEEs), direct financial transfers are made by the Union Government. SEE expenditures account for about 75% of all public expenditures and, historically, SEEs have been responsible for the bulk of public sector deficits. In 1999, the consolidated budget deficit was estimated at about 5% of GDP. However, significant off-budget spending and the subsidies implicit in the application of the official exchange rate to SEE transactions mean that the true public sector resource gap could be much larger. Poor prospects for improved revenue mobilization and a large increase in public sector pay (in April 2001) imply that the public sector deficit persisted through 2000 and 2001.

Monetary policy in Myanmar has traditionally been captive to the financing needs of the public sector. Deposit and lending rates are administratively determined. Between 1999 and 2000, the central bank reduced its discount rate from 15% to 10%; the discount rate remained at this level through 2001. While real interest rates turned positive in 2000, accelerating inflation in 2001 is likely to have eroded the value of monetary assets.

Perhaps surprisingly, given depressed regional and global demand, available data suggest that Myanmar enjoyed fast export growth over the first half of 2001. Exports of garments grew strongly, as did exports of gas and metals, reflecting earlier investments in these sectors. Commodity exports also performed well. Exports of pulses surged, due both to an expansion of the area under cultivation that boosted supply and to rising international prices. Despite a variety of measures intended to contain imports, these also rose in 2001, largely as a result of increased fuel imports. While trade data are incomplete and may be subject to measurement error, it seems that the trade deficit narrowed in 2001. However, on the services account, reduced receipts from tourism and a decline in remittances from overseas workers may have resulted in a deficit.

Despite an increase in approvals, there was a sharp fall in disbursed FDI in 2001. In the first half of the year, inflows were down by about 50% over the same period in 2000. International sanctions and consumer boycotts are

2001 refers to fiscal year 2001/02, ending 31 March.

deterring investors. Other than limited flows for humanitarian needs, official development assistance to Myanmar has also largely ceased. Foreign exchange reserves remain meager, and in the first half of 2001 provided cover for about 1 month of imports. It is estimated that Myanmar had an external debt of $5.6 billion in 2000.

There is only one estimate of the headcount index of poverty in Myanmar. Based on a national poverty line, it puts the incidence of poverty in 1997 at 22.9%. This is very low compared with countries at similar levels of per capita income. While a low incidence of poverty may reflect Myanmar's rich agricultural legacy, it is also possible that these data are subject to error. A variety of other social indicators, including those for child malnutrition, is cause for serious concern.

POLICY DEVELOPMENTS

Severe macroeconomic imbalances threaten any sustained growth prospects. Perennial government deficits and their financing through central bank credit expansion act as implicit taxes on the private sector, distort resource allocation, and underpin the sustained depreciation of the domestic currency. Distortions in the foreign exchange market have reached unprecedented proportions with the ratio of the parallel to the official exchange rates now about 100:1. At the root of the economy's fiscal problems is a poor record on domestic resource mobilization. At 2.3%, the tax-to-GDP ratio is grossly inadequate and a wide range of basic needs remains unmet. The rationalization and strengthening of the tax system should be a matter of urgent government consideration as should the removal of subsidies from a wide range of goods and services. Equally, moribund SEEs strain the public purse.

The country faces a huge range of development problems. Its physical and social infrastructure is extremely inadequate and an increasing incidence of HIV/AIDS and drug-related problems are adding to social stress. Productivity in several sectors, particularly agriculture, is low and opportunities are impaired by a variety of policies and procedures that unnecessarily regulate and impede commerce. In sectors where SEEs benefit from large exchange rate subsidies, it is impossible for the private sector to compete. The reform process that was started over a decade ago has effectively stalled.

Productivity in several sectors, particularly agriculture, is low and opportunities are impaired by policies that impede commerce.

In a context where there is so much that now needs to be done, it is difficult to prioritize. Nevertheless, deficits in the provision of basic education and health services stand out. In terms of the public sector budget, each receives less than 0.5% of GDP in terms of recurrent and capital expenditures. Yet from the perspective of promoting both durable and equitable growth, international experience attests that investments in these sectors are crucial. A realignment of priorities in this direction, combined with policies that promote the liberalization of agriculture, could do much to help reduce poverty.

OUTLOOK FOR 2002–2003

Over the short term, economic prospects are uncertain, largely because the Government's reform agenda remains limited. Inflation may accelerate through 2002, and the exchange rate is at risk of depreciating further. It is unlikely that pressures on international reserves will be relieved. Economic outcomes in 2002 are, as in the past, likely to depend substantially on weather-related agricultural performance. While growth remains constrained, the prospects for a large headway in poverty reduction are minimal.

PHILIPPINES

The economy grew by 3.4% in 2001, spurred by the agriculture and services sectors and continued robustness in private consumption spending. Intense efforts to trim public expenditures, together with steps to improve tax collection, enabled the Government to contain the fiscal deficit. Inflation remained moderate during the year. Reduced global demand for electronic goods, lack of investor confidence, and ongoing political and security challenges are expected to continue to limit economic growth in 2002.

MACROECONOMIC ASSESSMENT

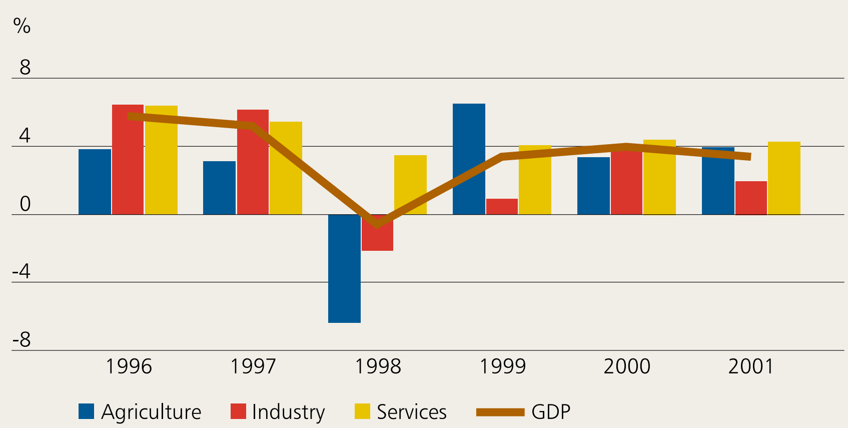
Despite the global economic slowdown of 2001, and security issues in Mindanao in the south, the country registered GDP growth of 3.4% in 2001. The services sector displayed the strongest expansion during the year, rising by 4.3% relative to the previous year (Figure 2.10). The sector's output contributed 1.9 percentage points of overall GDP growth in 2001. Expansion was also fueled by favorable performance of the agriculture sector (up by 3.9%), which benefited from good weather and some improvements in infrastructure. Agriculture remains important to the economy both because of its contribution to production and employment, and because agricultural products are important inputs to many manufacturing and services sector activities. An increase in both the harvested and irrigated areas as a result of investment to rehabilitate irrigation systems in some regions also helped in agriculture's improved performance.

The industry sector expanded by only 1.9% year on year in 2001, largely as a result of sluggish performance in manufacturing. This subsector accounts for 71.1% of industry's output, but grew by only 2.2%, or roughly a third of the increase registered in 2000. The electronics subsector was particularly hard hit by low global demand; electronics exports declined by 17% in 2001 compared with 3.9% growth in 2000. Garment exports, which represent about 8% of total exports, also fell in 2001. The construction sector stagnated, growing at an estimated rate of only 0.7%.

On the demand side, buoyant private consumption helped sustain economic growth. Government consumption expenditures bounced back from a 1.1% reduction in 2000 to a 0.1% increase in 2001. A large level of remittances, estimated to be over 8% of GNP, is one reason why consumption spending in the country held up so well, even though domestic income growth was weak.

Investment in the economy fell as a proportion of output, from 16.9% of GNP to 16.6% over the same period. Investment was particularly sluggish in

FIGURE 2.10 **Aggregate and Sector Change in GDP, Philippines, 1996-2001**



Sources: National Statistical Coordination Board, 2002, *National Accounts of the Philippines*; staff estimates.

TABLE 2.10 Major Economic Indicators, Philippines, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	3.4	4.0	3.4	4.0	4.5
Gross domestic investment/GNP	17.8	16.9	16.6	18.0	18.5
Gross national savings/GNP	18.7	21.0	22.1	20.2	19.5
Inflation rate (consumer price index)	6.7	4.4	6.1	5.0	6.0
Money supply (M3) growth	19.3	4.6	6.8	10.0	11.0
Fiscal balance/GNP	-3.6	-3.8	-3.8	-3.2	-3.0
Merchandise export growth	19.1	9.0	-16.2	3.0	6.0
Merchandise import growth	4.2	3.8	-6.2	2.5	4.0
Current account balance/GNP	9.2	10.7	6.0	2.0	1.5
Debt service ratio	13.4	12.7	16.4	15.0	15.0

Sources: National Statistical Coordination Board, 2002, *National Accounts of the Philippines,* January; Bangko Sentral ng Pilipinas, available: www.bsp.gov.ph; Bureau of Treasury, available: www.treasury.gov.ph; staff estimates.

the construction, durable equipment, and fixed capital subsectors. The low level of investment resulted from the unstable political and economic situation that has undermined investor confidence, and from poor incentives for capital investment in light of the depreciation of the peso and high investment costs.

The fiscal deficit in 2001 equaled P147 billion or 3.8% of GNP, or slightly above the Government's target of P145 billion. Public revenues for the year totaled P563.7 billion, while public expenditures amounted to P710.8 billion. The tax revenue target of the Bureau of Internal Revenue (BIR) was achieved, though it was reduced from P408 billion to P388 billion at mid-year. The deficit would have been larger in the absence of the Government's rigorous tax collection efforts during the year. Nevertheless, shortfalls in tax revenues are still a serious problem in public finance, as tax revenues declined as a proportion of GNP from 16.3% in 1997 to 12.7% in 2001. The Government made great efforts to keep fiscal expenditures within its target by trimming public expenditures, which mainly involved reducing expenditures on capital and infrastructure investments. The fiscal deficit in 2001 was financed through borrowing, and total public debt was estimated to be P1.2 trillion at the end of 2001, about P90 billion higher than at the end of 2000.

Prices rose by 6.1% in 2001, 1.7 percentage points higher than the historically low rate in 2000, though there was some evidence that inflation decelerated toward the end of the year. Slow growth in aggregate demand and decreases in the seasonally adjusted consumer prices for food contributed to this moderate rate.

Though inflation increased relative to 2000, sluggish economic growth prompted the central bank to pursue an expansionary monetary policy in an effort to spur economic recovery in 2001. Over the course of 2001, the central bank lowered its overnight borrowing rate from 13.0% to 7.5% and its lending rate from 15.25% to 9.75%. Interest rates on treasury bills experienced corresponding falls during the year. Domestic liquidity (M3) increased by about 6.8%, compared with the 4.6% rate of expansion in 2000. However, the slowdown in the economy, banks' cautious lending stance, and weak corporate demand for new debt in light of existing production overcapacity (particularly among manufacturing firms) all contributed to sluggish bank lending. Domestic credit to the private sector contracted. In contrast, domestic credit to the public sector rose by around 16%.

Total external merchandise trade fell by about 12% in 2001 compared with the prior year, reflecting the impact of the global economic slowdown. Orders from the country's principal export markets were weak and, as a result, exports declined by 16.2%. Imports shrank by 6.2%, reflecting a weakening in demand for intermediate inputs by export industries. As a result, the trade surplus fell by about $4.2 billion, a drop of over 60% from the 2000 level. The current account surplus is estimated to have fallen to about

In October 2001, the Government signed a Poverty Partnership Agreement with ADB to help the country in its poverty-reduction efforts.

$4.5 billion, or 6% of GNP, in 2001, and the overall balance of payments to have run a deficit of $0.2 billion, or 0.3% of GNP.

The country's outstanding external debt of about $52.4 billion was slightly above the level recorded at the end of 2000. The latest available figures show that external debt increased from 65.9% of GNP at the end of 2000 to 69.2% of GNP at the end of 2001. External debt is now well above its level prior to the Asian financial crisis. The maturity structure of the debt has been shortened and the level of external debt has been reduced. Debt obligations of the public sector constitute 64% of total external debt. Debt securities, such as bonds and notes that are generally traded in offshore capital markets, represent about a quarter of the total, while 22% pertain to obligations to private foreign banks and other financial institutions. External debt service payments in 2001 amounted to 16.4% of total exports of goods and services. In December 2001, gross international reserves were $15.7 billion, slightly higher than the $15.0 billion level in 2000, and provided import cover for 4.8 months.

While commercial banks had lower levels of bad debt in the aftermath of the financial crisis than banks in other crisis-affected economies, the share of nonperforming loans has been rising in recent years. In 2001, this share rose from about 16% in January to 17.3% in December. While the increasing nonperforming loan ratio was mainly attributable to shrinkage of banks' total loan portfolios, this increase still raises concerns about progress in cleaning balance sheets to clear the way for renewed and stronger lending to support needed investment by the industry sector.

Capital markets suffered from the global downturn and from the continued effects of lost confidence emanating from corruption scandals in recent years. The index for the Philippine Stock Exchange reached a new 10-year low in October, although stocks did recover some of their lost value later in the fourth quarter.

In 2001, the unemployment rate held steady at around 11%, but remained among the highest in the region. This was partly the result of slow job creation combined with a large increase in new labor force entrants associated with the continued high population growth rate. High unemployment and population growth, combined with low economic growth, suggest that the incidence and severity of poverty in the country remained relatively unchanged in 2001. The latest estimates of poverty incidence cover 2000 and show that over 39% of the total population have incomes below the national poverty line, representing an increase of 2.6 percentage points from the level recorded in 1997. Poverty incidence is higher in rural areas than in urban areas (46.9% and 19.9%, respectively) and increased more in rural areas between 1997 and 2000 (2.5 percentage points compared with 2 percentage points). In October 2001, the Government signed a Poverty Partnership Agreement with ADB that set goals and outlined a strategy for reducing poverty in the country, paving the way for greater development assistance to aid the country in its poverty-reduction efforts.

POLICY DEVELOPMENTS

In early 2001, the Government was hampered in its efforts to carry out economic reforms due to more pressing political concerns. Once the new administration's political position was consolidated, an ambitious program of economic reforms outlined in the President's July state of the nation address was initiated. One of the major policy initiatives of the Government in 2001 was to reduce the fiscal deficit and government debt by cutting expenditures, strengthening the tax collection system, and improving revenues, so as to allow greater expenditures for infrastructure investments and social development. The tax system is being simplified and the BIR is being reformed to improve its efficiency. The Government seeks reform in four key areas: simplify the current tax structure, including a proposal to abolish the existing system of exemptions and move to a gross tax system; increase the use of Internet or computer technology in tax collection to simplify and improve collection; reorganize the BIR to reduce corruption and improve its standing among the public (at the moment, the Government is seeking to increase the BIR's autonomy and eventually create a new revenue authority); and improve professional staff capacity at the BIR by improving human resources training, raising low salaries and benefits, and eliminating political intervention in BIR hiring.

Other major policy initiatives of the Government include efforts to curb money laundering, sell state-owned assets in power and construction enterprises, increase foreign and domestic investment in the economy, foster greater competition in domestic markets (e.g., shipping), and modernize the country's agriculture sector.

The Anti-Money Laundering Act of 2001 is considered insufficient by the Financial Action Task Force of the Organisation for Economic Co-operation and Development, and the Government is working on revising it.

There were a number of significant developments in the energy sector, including the opening of the country's first natural gas facility in October 2001 about 100 kilometers south of Manila. The Government is looking to open bidding on the construction of an overland pipeline to bring the gas to Manila. The state-owned energy company and two foreign energy enterprises jointly operate the facility. The new source of power promises to reduce the country's energy deficit, lower energy imports, and could help bring down the domestic cost of electricity (which is above the regional average). The Electric Power Industry Reform Act was approved in June 2001. To enforce the Act, many critical interventions are necessary.

The Act proposes privatization of the sector and a major strengthening of transmission, subtransmission, and distribution systems, which are weak at present. In the process of privatization, crucial transmission and subtransmission projects will have to be implemented by the public sector to avoid another power crisis. The restructuring of the sector is expected ultimately to lower electricity costs, and put them on a par with those in neighboring countries. However, limited progress was made in the planned sale of state-owned assets of the main power retailer in the country.

In 2001, the Government pledged to invest P2 billion on implementing the Agricultural and Fisheries Modernization Act, which was passed some years ago and set an ambitious range of measures to boost low farm productivity.

OUTLOOK FOR 2002–2003

GDP is expected to expand by 4% in 2002, with higher private consumption and improved exports. Achieving a higher rate will require sustaining growth in the agriculture sector, a recovery in industrial exports, and an improvement in the level of (and environment for) investment. GDP is expected to increase by 4.5% in 2003, as a foreseen global economic recovery takes place and the economy begins to reap the returns from ongoing economic and fiscal reform efforts. Investment is expected to improve to 18%–18.5% of GNP in 2002–2003.

Improvement of physical infrastructure is an important component of the measures needed to raise investment in the economy. A 19% spending increase for infrastructure construction is planned for 2002, which should help stimulate investment and broaden economic activity. The uncertain outlook for ongoing privatization efforts increases the difficulty of achieving deficit targets. Progress in the privatization program would foster higher growth and investment in the economy, increase revenues in the short run, and lessen expenditure demands on the Government in the long term.

Inflation should remain stable at 5–6% in 2002–2003. Domestic liquidity (M3) is expected to expand at a higher rate in 2002–2003 than in 2001. Interest rates are now low, having followed the recent worldwide trend down. However, rates are not expected to go any lower in 2002 and could rise slightly later in the year.

In 2002, the Government is expected to continue its ongoing efforts to reform the tax collection system, and to maintain the fiscal deficit to within its target of P130 billion. It is expected that the deficit will be further reduced to below P100 billion in 2003. The challenge of improving tax revenues remains. Strong support for reform from the tax authorities will be essential for enhancing collections and curbing the Government's growing debt service payments.

The trade balance is expected to maintain a small surplus in 2002. However, the current account surplus is expected to continue its recent decline and shrink to $2.0 billion, or 2% of GNP, in 2002, and to $1.5 billion, or 1.5% of GNP, in 2003. The overall balance of payments is expected to run a deficit in 2002–2003, largely because of continuing net capital outflows (first seen in late 2000). Reforms in the finance sector hold the promise of slowing and eventually reversing these outflows. Government efforts to rehabilitate infrastructure augur well for lowering production costs and enhancing the competitiveness of Philippine enterprises.

To improve employment opportunities and reduce unemployment, underemployment, and poverty, it is vital that domestic and foreign investment be encouraged. Reforms to improve both the investment environment and the operating environment for labor-intensive domestic and foreign businesses should be continued. Between 1985 and 1997, the incidence of poverty in the Philippines was reduced from 44.2% to 31.8%. There was some erosion in these gains

Improvement of the physical infrastructure is an important component of the measures needed to raise investment in the economy.

during the following 3 years as a result of the Asian financial crisis. There is, therefore, an urgent need to recover lost ground and to make further gains in reducing poverty. To do this, significant economic momentum will have to be maintained. GDP growth of 4% or more, if sustained, could result in progress in achieving the Government's objectives of reducing poverty.

This is particularly true if institutions are reformed in favor of the poor by redistributing economic opportunities, protecting the vulnerable, and enhancing the capabilities of the poor to participate in decision making. Such socially inclusive development would require the provision of an enabling environment for poverty reduction through macroeconomic, political, and institutional reforms as well as the development of programs that will equalize access to economic resources and social opportunities. Further, the human potential of poorer members of society can be nurtured via (i) providing better educational facilities, (ii) reducing the transport cost of isolated communities, which have become "poverty traps," through investments in infrastructure and agricultural development, and (iii) strengthening democratic institutions at various levels of government. Such policies have the potential to spur pro-poor growth in the economy.

SINGAPORE

The economy contracted in 2001 amid a difficult external environment, despite fiscal stimulus measures and a move to a neutral exchange rate policy. Given Singapore's high dependence on external demand, trends in the global economy are a key determinant of domestic economic activity.

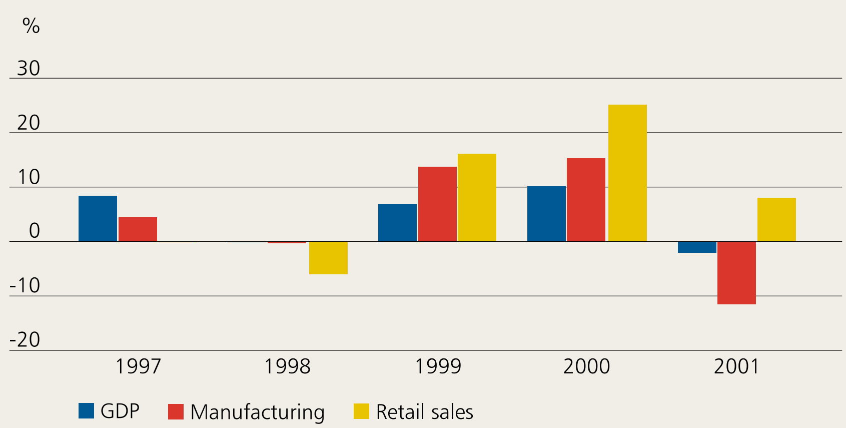
MACROECONOMIC ASSESSMENT

The deterioration of economic conditions worldwide and a severe downturn in global electronics demand exerted a strong drag on the Singapore economy in 2001. The slowdown was broad based, reflecting a sharp drop in international trade and a weakening of consumer and business sentiment. Electronics exports fell steeply, and GDP declined by 2% during 2001, down from growth of 10.3% in 2000. The pace of the fallout, nevertheless, showed signs of moderation in the last quarter as reflected in a revival of manufacturing, particularly electronics. After contracting for the first three quarters, GDP posted 4.3% quarter-on-quarter growth in the fourth quarter of the year.

The manufacturing sector bore the brunt of the slowdown, contracting by 11.5% in 2001, compared with 15.3% growth in the previous year (Figure 2.11). The contraction was mainly due to a double-digit decline in electronics, pulled down by a plunge in output of semiconductors, telecommunications equipment, and computer peripherals. This also reflected a drop in the segments supporting electronics production, particularly fabricated metals and machinery, as well as printing and publishing. With a substantial drop in private construction activity and cutbacks in public sector residential projects, the construction sector further declined by 2.1% in 2001, following a 1.7% fall a year earlier. The services sector recorded slower expansion, given reduced international trade flows. Growth in transport and communications moderated to 2.7% in 2001 from 8.5% in the previous year, on account of falls in tourist arrivals and the volume of air and sea cargo handled. The retail and wholesale sector fell by 2.8% compared with 15.2% growth in 2000, dragged down by weak consumer sentiment and a deteriorated economic situation. The financial services sector decelerated to 2.2% growth in 2001 from 4.6% in 2000, as a result of weak equity markets and reduced regional demand for insurance and investment advice.

Overall domestic demand fell by 8.7%, compared with 11.8% expansion in 2000. Rising uncertainty over employment and wage cuts undermined consumer confidence and helped lower the rise in household consumption to 0.5% from 9.9% in 2000. In spite of a substantial growth in government spending on civil engineering works and nonresidential construction, gross fixed capital formation posted a 4.6%

FIGURE 2.11 **Change in GDP, Manufacturing, and Retail Sales, Singapore, 1997-2001**



Source: Ministry of Trade and Industry of Singapore, available: www.mti.gov.sg.

TABLE 2.11 Major Economic Indicators, Singapore, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	6.9	10.3	-2.0	3.7	6.5
Gross domestic investment/GDP	31.9	31.6	24.3	23.6	24.1
Gross domestic savings/GDP	48.8	49.3	45.8	44.5	45.7
Inflation rate (consumer price index)	0.1	1.3	1.0	0.4	1.4
Money supply (M2) growth	8.5	-2.0	5.9	5.9	6.5
Fiscal balance/GDP	2.6	3.5	1.9	-0.5	1.2
Merchandise export growth	4.5	20.4	-11.9	5.0	10.0
Merchandise import growth	9.0	22.2	-14.0	6.0	11.1
Current account balance/GDP	20.0	17.2	20.9	19.8	19.0

Sources: Ministry of Trade and Industry; staff estimates.

The contraction in exports was caused mainly by the collapse of electronics-related shipments and by a significant drop in sales of petrochemical products and machinery inputs.

decrease, having increased by 6.3% in 2000. This was due mainly to a double-digit drop in private investment in machinery and equipment, as firms, faced with slackening external demand, cut back on capital expenditure and suspended investment plans. Reflecting the adjustment in production by manufacturers, inventories dropped at a rate of 6.7% in 2001, down from 2.4% growth in the previous year.

The sharp downturn in the global ICT industry severely affected Singapore's trade performance. Total exports, which grew by a hefty 20.4% in 2000, shrank by 11.9% in 2001. Non-oil exports, the key segment that accounts for 44% of exports, contracted by 14.5% in 2001, reversing the double-digit growth of the preceding year. The contraction was caused mainly by the collapse of electronics-related exports and by a significant drop in sales of petrochemical products and machinery inputs as a result of weak regional growth. Exports of oil products declined by 5%, as world oil prices fell in the final months of the year. In tandem with lackluster domestic demand and sluggish manufacturing activity, total imports contracted by 14% in 2001, after a surge of 22.2% in the previous year. The surplus of trade in goods rose to $12.9 billion in 2001 from $11.6 billion in 2000, accompanied by an increased surplus of trade in services to $5.7 billion from $5.1 billion. The current account surplus widened to $17.9 billion in 2001, equivalent to 20.9% of GDP.

The labor market eased considerably, reflecting the economic downturn and a consolidation in the banking sector following the liberalization of financial markets. The seasonally adjusted unemployment rate rose broadly across sectors, from 2.9% in December 2000 to a 15-year high of 5.3% in December 2001. Demand for labor worsened markedly, with manufacturing and construction shedding 33,200 workers in 2001 and employment creation in services falling to 36,800 from 80,500 in the previous year. Nominal wages growth moderated to 2.3% in 2001, down from 8.9% in 2000.

Consumer price inflation trended downward to 1% in December 2001 from 1.3% a year earlier. The decline reflected mainly the deflationary effects of intensified deregulation and consolidation of the domestic services sector in banking, telecommunications, and energy, as well as keen competition in retail markets and a sustained drop in the prices of oil-related items.

In the financial markets, the Singapore dollar depreciated by 6.7% against the US dollar during 2001, and weakened marginally against the Thai baht and Korean won. Domestic interest rates softened over the year, in light of monetary easing in the major economies and low inflationary pressure. While growth of commerce and manufacturing loans slackened in line with the deterioration of the overall business outlook, overall commercial bank lending increased by 3.3% in 2001, supported by growth in loans to the transport and communications sector. The Straits Times Index lost over a third of its value in the year to late September 2001, weighed down by a protracted downturn in technology, media, and telecommunications stocks, and by substantial selling after the September 11th attacks in the

US. The Index made up some ground in December, in light of better than expected month-on-month industrial production figures during the last quarter of the year, and ended 2001 at 1,624, or 14% below its level at the start of the year.

POLICY DEVELOPMENTS

With worsening economic conditions both worldwide and domestically, the Government enacted a series of off-budget measures to support the economy and help households and local companies over the severe slowdown. The first off-budget package, unveiled in July 2001, amounted to S$2.2 billion. It included measures to accelerate expenditures on economic and social infrastructure projects, and to cut business costs through property tax and rental rebates. The package was followed by S$11.3 billion-worth of stimulus measures in October, involving a range of corporate and personal income tax rebates; cuts in utilities, education, and hospital costs; the distribution of "New Singapore Shares" to citizens (providing a guaranteed investment return and a bonus tied to the economy's GDP growth); further assistance to SMEs; and expansion of the social safety net program.

Taken together, the two packages added up to 8.4% of GDP. Given the severe external slowdown weighing heavily on the domestic economy, the measures helped market demand, but could not reverse the domestic downturn and its effects.

In view of low inflation and declining exports, the Monetary Authority of Singapore adjusted its monetary policy in July 2001. It moved from a tightening stance that sought to achieve a gradual and modest appreciation of the Singapore dollar, to a neutral stance that targeted a constant trade-weighted nominal effective exchange rate. With the intensified uncertainties in the global economy after September 11th, its target band was widened in October to permit greater flexibility in managing the exchange rate. The trade-weighted nominal effective exchange rate weakened in the fourth quarter.

The Government continued restructuring and revitalizing the economy to retain its competitiveness globally. Key economic sectors, particularly financial services, telecommunications, energy, and the media were liberalized to enhance efficiency and competitiveness. In particular, as part of the comprehensive reform of domestic banking announced in 1998, the retail and wholesale banking markets were further liberalized in 2001, to allow foreign banks to engage in broader business in these markets. Reforms of the regulatory and supervisory environment to enhance the safety and soundness of the financial system were also implemented in 2001, and included setting guidelines on the issuance of new capital instruments for Singapore banks, and revising the framework for valuation and capital adequacy requirements for insurance companies, licensed securities dealers, and futures brokers.

Singapore continued to build up the capabilities of SMEs and to invest selectively in priority areas, such as ICT infrastructure, and research on biotechnology and life sciences. The Government also emphasized assistance to the workforce to upgrade skills and knowledge. These measures were intended to reduce the economy's vulnerability to external shocks related to electronics exports and to continue its transformation from a manufacturing to a knowledge- and skills-intensive economy, as well as to a regional service hub for health care, education, finance, logistics, media, information, and communications. Linked to this approach, in 2001 the Government established an Economic Review Committee to conduct a thorough analysis of Singapore's areas of comparative advantage and to work out a comprehensive development package.

The corporate landscape is characterized by high-profile multinational enterprises and government-linked companies. For years, companies in the latter group have been granted certain privileges and some monopoly power, but returns were poor. In the future, cultivating an entrepreneurial and less risk-averse business culture will be necessary for the development of high-value, knowledge-driven industries. To assist local enterprises overcome shortages of skilled workers, research and development capacity, and capital, the Government will need to take a less interventionist approach to industrial management and further reduce its participation in private firms.

With worsening economic conditions both worldwide and domestically, the Government enacted a series of off-budget measures to support the economy.

OUTLOOK FOR 2002–2003

The substantial amount of government infrastructure expenditure in the off-budget packages is expected to provide some support to the economy. In addition, the tax rebates and transfers, such as the New Singapore Share scheme, are expected to cushion the slowdown in private con-

GDP is forecast to return to growth and average 3.7% over the whole of 2002, supported by a gradual uptake in exports.

sumption through relief measures to liquidity-constrained households. Nevertheless, with exports accounting for 143% of GDP in 2001, the revival of the economy depends on the upturn in the global electronics cycle and on the economies of the US and other key trading partners. Inventory destocking is at an advanced stage, which, together with improved microchip sales and new electronics orders in the US, points to some bottoming out of the global electronics cycle. This will, in turn, buttress Singapore's electronics manufacturing and exports. Growth in trade-related transport services should also improve, in line with an expected moderate revival in regional trade.

On expectations of a modest recovery in external electronics demand during the second half of 2002, GDP is forecast to return to growth and average 3.7% over the whole year, supported by a gradual uptake in exports. However, with uncertain economic growth prospects and a weak employment market, private consumption is expected to remain depressed in the first two quarters of 2002, and then to rise moderately when the improvement in manufacturing production begins to feed through into employment. Corporate fixed investment is likely to turn around only toward the end of 2002, as business sentiment strengthens. With the Government's scheduled infrastructure and housing spending more than counterbalanced by a moderation in private sector investment, gross fixed investment is likely to decline throughout the year.

Under the assumption of an improved external environment and increased import demand, the trade surplus will narrow, resulting in a slight decline in the current account surplus in 2002. Reflecting the weak outlook for employment, partly as a result of the restructuring process in the financial services sector, the unemployment rate is forecast to edge up in the second quarter of 2002, before declining to 3.4% toward the end of the year. Prices, which normally lag behind economic expansion, will be subdued in 2002, due to low regional inflation, slow domestic wages growth, and the Government's cost-cutting measures.

The economy is forecast to strengthen by 6.5% in 2003. Anticipated buoyant external demand will reduce excess industrial capacity and improve investor sentiment toward the domestic ICT industry, while an expected recovery in asset values and wages growth will support private consumption.

Inflation is expected to creep up to 1.4% in 2003, based on a strengthening economy alongside a decline in unemployment. The trade surplus is projected to fall further in 2003. As a result of the import-dependent nature of exports and higher demand for capital goods, the rise in imports will likely outpace the increase in exports, in light of stronger trade flows.

THAILAND

Economic growth moderated in 2001, primarily as a result of the impact of the global slowdown on the industry sector and on exports. The deceleration was exacerbated by sluggish investment and banks' reluctance to lend, given the high level of nonperforming loans and slow progress in corporate and financial restructuring. Somewhat more rapid GDP growth is projected in 2002 as the world economy recovers. A strengthening of investor confidence is crucial to sustaining a faster rate of expansion in the medium term.

MACROECONOMIC ASSESSMENT

The global economic slowdown in 2001 had a significant impact on the Thai economy. GDP grew by 1.8%, considerably less than the 4.6% rate in 2000, while average unemployment increased to 3.9%, from 3.6% in 2000, based on the quarterly labor force survey by the National Statistics Office.

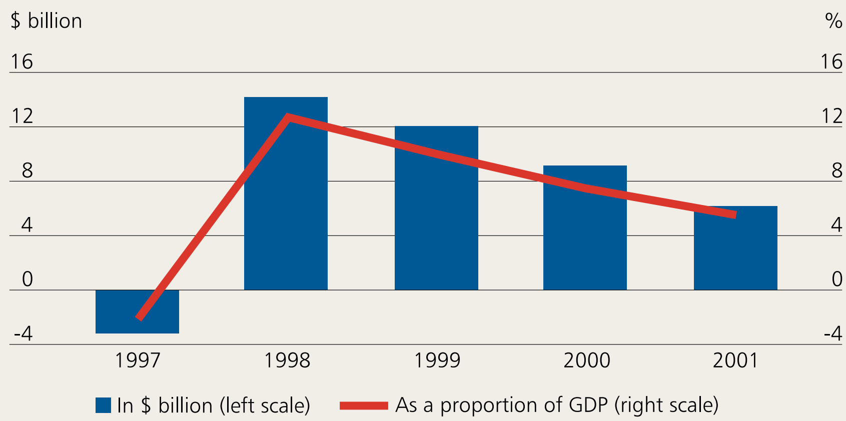
On the supply side, the pace of growth slowed in all sectors. Expansion of industrial output (which accounts for about 44% of GDP) decelerated to 1.3% in 2001 from 5.3% in 2000. The manufacturing production index, which covers about 63% of overall value added in manufacturing, rose by only 1.1%, a decline from 3.3% in 2000. The capacity utilization rate slipped to 53.3%, from 56% in 2000. The slowdown in activity was most evident among export-oriented industries, including electronics. However, domestic-oriented industries, such as vehicles and parts, beverages, and ornaments, fared somewhat better.

Growth in services (accounting for about 48% of GDP) moderated to 2.3% in 2001 from 4% in 2000, and was broadly in line with the general pace of economic activity. Virtually all subsectors experienced difficult conditions. Tourist arrivals dropped in the wake of the September 11th events in the US, and a moderation in consumption spending was felt in the retail segment and in other services activities. Growth in the agriculture sector (which accounts for about 8% of GDP) fell to only 1.5% in 2001, from 4.8% in 2000, partly due to the sluggish performance in production following a reduction in the area planted to rice and cassava.

On the demand side, real consumption growth slowed to 3.2% in 2001 from 4.6% in 2000. In a context of increased uncertainty, private consumption growth fell to 3.4% in 2001, from 4.9% in 2000. Investment, which has been the slowest component of demand to recover in the wake of the Asian financial crisis, remained sluggish in 2001. Excess capacity and obstacles to corporate restructuring held it in check.

In fiscal year 2001 (ending 30 September 2001), a consolidated central

FIGURE 2.12 **Current Account Balance, Thailand, 1997-2001**



Sources: Bank of Thailand; staff estimates.

TABLE 2.12 Major Economic Indicators, Thailand, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	4.4	4.6	1.8	2.5	3.0
Gross domestic investment/GDP	19.9	22.7	22.0	22.2	22.5
Gross domestic savings/GDP	29.9	30.2	27.5	26.3	25.5
Inflation rate (consumer price index)	0.3	1.6	1.7	2.0	2.2
Money supply (M2) growth	2.1	3.7	4.2	6.5	5.0
Fiscal balance/GDP[a]	-11.2	-3.2	-2.1	-3.8	-3.0
Merchandise export growth	7.4	19.6	-7.0	4.0	9.0
Merchandise import growth	16.9	31.3	-2.8	5.0	9.2
Current account balance/GDP[b]	10.0	7.5	5.5	4.1	3.0
Debt service ratio	19.4	15.4	17.4	15.0	15.5

[a] Excludes grants. Central government balance ending 30 September. [b] Excludes official transfers.

Sources: Bank of Thailand, Ministry of Finance; National Economic and Social Development Board; International Monetary Fund; staff estimates.

On a variety of indicators, the economy's external financial vulnerability is improving.

government deficit of B109.4 billion, or 2.1% of GDP, was registered, compared with B154 billion, or 3.2% of GDP, in fiscal year 2000. This reduction resulted largely from shortfalls in disbursements on capital projects. The rise in government revenues, mostly in the form of increased excise taxes, also contributed to the deficit reduction. The deficit was financed mainly through the issuance of domestic debt securities.

Money supply (M2) growth rose slightly to 4.2% in 2001 and short-term interest rates remained low throughout the year in a context of ample liquidity, but, despite these two factors, nominal net domestic credit continued to contract by 6.2% during the year. In particular, credit to the private sector (in nominal terms) dropped by 7.5%. This was the fourth year of the domestic credit decline, largely reflecting commercial banks' unwillingness to lend in the face of high credit risks, weak balance sheets, and sluggish domestic demand. Consumer price inflation stayed virtually unchanged at 1.7%, mainly due to weak demand, a stable exchange rate, and a moderation of fuel prices.

In 2001, exports shrank by 7%, as a result of reduced external demand and the downturn in the electronics business cycle. Import demand also contracted but by less than exports, causing the trade and current account surpluses to contract. Reduced demand for intermediate goods for exports and lackluster growth in consumer demand were largely responsible for this import demand shrinkage. The trade surplus narrowed to about $2.5 billion in 2001 from $5.5 billion in 2000, as the current account surplus narrowed to 5.5% of GDP from 7.5% (Figure 2.12).

The overall balance of payments was in surplus in 2001. However, the capital account remained in deficit, mainly due to the continued payment of foreign loans by private commercial banks and nonbank financial institutions. Official international reserves continued to accumulate, reaching $33 billion as of December 2001, up from $32.7 billion in 2000. This is more than twice the level of short-term debt and equivalent to around 6 months of imports. Currently, free international reserves, as defined by the gross reserves net of swap obligations and IMF package liabilities, are estimated at about $18 billion–$20 billion.

On a variety of indicators, the economy's external financial vulnerability is improving. By the end of 2001, total external debt had fallen to $69 billion, from $80 billion at the end of 2000. The reduction in debt was largely due to the liquidation of private sector foreign exchange liabilities. The external debt service ratio stood at about 17%. The baht depreciated from an average of 40 to the dollar in 2000 to an average of 44.5 to the dollar in 2001, which was broadly in line with the depreciation of other regional currencies against the dollar.

POLICY DEVELOPMENTS

In the face of the weakening external demand, domestic demand recovery is crucial to economic growth. In this context, the Government plans deficit-spending measures to support domestic demand. For fiscal year 2002, a budget deficit of B199.5 billion is targeted, or 3.8% of GDP, representing an increase of B90.2 billion, or 1.7% of GDP, over the budget for fiscal year 2001. The measures include higher spending on a public health program, a village and urban revolving fund, a tourism promotion program, a debt-suspension program for farmers, and housing credit support for government officials. The deficit will be financed mainly by the issuance of government bonds to the public.

As a result of successive deficit-spending measures to stimulate the economy and support finance sector restructuring, public debt has risen substantially. Total public debt outstanding amounted to about B2.9 trillion at the end of 2001, equivalent to around 57% of GDP. In 1996, prior to the financial crisis, the ratio of public debt to GDP was 15%. If debt continues to escalate, it could pose risks over the medium term, as an increasing debt service burden will constrain public expenditure options. Rising debt levels may also eventually force up domestic interest rates and have an adverse effect on perceptions of sovereign creditworthiness. In an attempt to alleviate these concerns, the Government has imposed a ceiling of 60% on the ratio of public debt to GDP.

In June 2001, the Bank of Thailand raised its 14-day repurchase rate by 100 basis points to 2.5%. In a low inflation setting, this move was intended to support the income of deposit holders and to deter capital outflows through the refinancing of foreign currency debt in baht. Late in 2001 and early in 2002, the Bank of Thailand partially reversed its earlier stance by lowering the repurchase rate by 50 basis points, in two 25 basis point steps. Accumulating international reserves and an appreciating baht over the last 6 months of 2001 suggest that monetary policy may have been too restrictive.

The proportion of nonperforming loans (NPLs)—defined as loans for which payment is at least 3 months overdue—decreased to about 10% of the total, or B478 billion in December 2001, from about 18%, or B858 billion in December 2000. Although this sharp reduction was partly the result of debt restructuring, the main reason was the transfer of NPLs to asset management companies (AMCs), since assets with these AMCs are not counted in the NPL ratio.

To overcome a variety of obstacles to debt restructuring and to promote efficient management of NPLs, the Government established the Thai Asset Management Company (TAMC) in June 2001. The TAMC plans to acquire and manage about B1.3 trillion (about $30 billion) in book value of distressed assets. Over 80% of these assets consist of NPLs held by state-owned entities. The bill empowering the TAMC was approved in September 2001. In bypassing the existing slow judicial and administrative procedures, it is hoped that the TAMC, with its special legal powers, will speed up the debt-restructuring process. By January 2002, the TAMC had taken over more than B700 billion (approximately $16 billion) in NPLs, mostly from state-owned banks. By the end of 2002, the TAMC is expected to have restructured about 70% of this debt. Under the approved bill, the TAMC is empowered to restructure debt through debt and debt service reductions, debt for equity swaps, transfer of collateral through the reorganization of businesses, and the foreclosure and disposal of collateral. Resolving the corporate debt problem definitively is a crucial issue for the economy, in view of difficulties with earlier restructuring arrangements.

Thailand has made substantial progress in reducing poverty over the last 2 decades, though the financial crisis in 1997 interrupted this momentum and had a severe impact on the poor.

Thailand has made substantial progress in reducing poverty over the last 2 decades. However, the financial crisis in 1997 interrupted this momentum and had a severe impact on the poor. Poverty incidence increased to about 15.9% in 1999 from 11.4% in 1996 and may have risen further by the end of 2001. In the Ninth National Economic and Social Development Plan (2002–2006), the Government has committed to intensifying the fight against poverty and has set a target of reducing the poverty incidence to less than 10% by 2006. Achieving this target is likely to require much faster economic growth than currently anticipated and/or the concerted application of pro-poor redistribution measures. In particular, the prospects for sustained poverty reduction will hinge on reversing current trends toward growing income inequality. Rural regions have not benefited from growth to the same extent as Bangkok. In addition, national educational attainments compare unfavorably with those of other middle-income developing economies. Measures to bridge education gaps deserve priority attention from the Government, as do initiatives to promote greater geographic balance in the creation of economic opportunities.

OUTLOOK FOR 2002–2003

Growth prospects will be influenced significantly by the evolution of global economic trends over the next 2 years. The economy is relatively open, with aggregate trade (defined as the ratio of exports plus imports to nominal GDP) of 111% of GDP. Thailand's ICT exports constitute about 60% of total exports. The major export markets are the US and Japan, which account for about 21% and 15% of total exports, respectively. In addition, with the economy a large net importer of fuel, oil price movements can have a pronounced effect on domestic income.

With the external outlook uncertain and domestic private demand still constrained by a large debt overhang, GDP growth in 2002 of 2.5% is projected. Economic momentum is expected to strengthen in late 2002 with the expected acceleration in recovery of global demand. In the absence of unanticipated adverse shocks, growth in 2003 should be in the range of 3–3.5%. Over the medium term, the prospects for growth will remain crucially dependent on continued progress in finance sector reform and corporate debt restructuring. Without significant advances in these two areas, it is unlikely that the recovery of investment needed to propel activity will materialize.

Inflation is projected to rise to around 2% in 2002 and to edge up to about 2.2% in 2003 as a result of the widening fiscal deficit supporting domestic demand. The scheduled increase in VAT from 7% to 10% in October 2002 will also act as a one-off boost to inflation, though it should provide a much-needed fillip to fiscal revenues.

The current account surplus is projected to narrow further to 4.1% of GDP in 2002 and then to about 3% in 2003. As economic growth begins to accelerate, import growth is expected to slightly outpace that of exports. Overall external debt is projected to decline in 2002–2003.

VIET NAM

GDP growth slowed moderately to around 6% in 2001, due to weakening exports and agricultural output. In spite of this, the economy remained fast growing, with stable prices and solid indicators of public finance and external debt. Steadier progress in state enterprise and banking sector reform is needed for the economy to maintain its international competitiveness, while policymakers should pay more attention to balanced regional development to consolidate past achievements in poverty reduction.

MACROECONOMIC ASSESSMENT

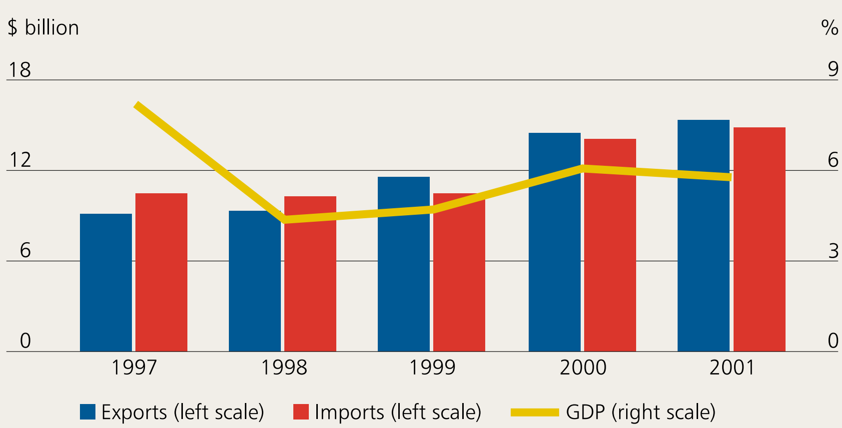
Despite the slowdown in the global economy, preliminary staff estimates for 2001 suggest that GDP in Viet Nam grew by 5.8% (6.8% according to preliminary official estimates), representing one of the highest rates of expansion in the region. As external demand weakened throughout the year, particularly in the aftermath of the events of September 11th, domestic demand—mainly investment—became the main source of growth.

On the supply side, the agriculture sector recorded weaker growth than the government target. The moderate 2.3% increase was due to a 1.7% decrease in rice output, a fall in the price of agricultural goods, and estimated growth of 5% in fisheries, the best-performing subsector.

However, the deceleration in agriculture was more than offset by a strong performance in industry and construction. Growth in industry was estimated at 9.7% in 2001, on the back of manufacturing and construction strength. Manufacturing is estimated to have increased by 9.2% while construction recorded a robust performance of 13%, due to the implementation of infrastructure projects, urban development projects in major cities, particularly Hanoi and Ho Chi Minh City, and a real estate boom. Within industry generally, the foreign-invested subsector grew at its lowest rate in recent years, namely 12.1%. Nonstate activities grew by 20.3% in 2001, partly due to the vigorous impact of the Enterprise Law, which streamlined administrative procedures for doing business. The Law abolished 145 out of 400 licenses in 2000, and government decree no. 30 issued that year required 60 licenses to be abolished in 2001. Registration requirements were also simplified. As a result, the number of private enterprises surged in both 2000 and 2001. In the improved business environment, capital investment also increased.

In 2001, services sector growth was estimated at 4.4%. Wholesale and retail trade maintained its modest improvement of 3.3%. Real estate services were

FIGURE 2.13 **Exports, Imports, and GDP Growth, Viet Nam, 1997-2001**



Sources: General Statistical Office; State Bank of Viet Nam; staff estimates.

TABLE 2.13 Major Economic Indicators, Viet Nam, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	4.7	6.1	5.8	6.2	6.8
Gross domestic investment/GDP	22.2	23.9	25.9	26.8	28.0
Gross domestic savings/GDP	26.3	25.5	27.4	27.1	27.8
Inflation rate (consumer price index)	0.1	-0.6	0.8	3.0	4.0
Money supply (M2) growth	39.3	39.0	23.2	25.0	26.0
Fiscal balance/GDP[a]	-2.8	-3.0	-4.9	-5.4	-6.5
Merchandise export growth	23.2	25.2	6.5	8.5	12.0
Merchandise import growth	1.1	34.5	6.0	10.0	13.0
Current account balance/GDP	4.1	1.6	1.5	0.3	-0.2
Debt service ratio	12.8	11.2	10.2	8.3	6.8

[a] Excluding grants and including net lending.

Sources: General Statistical Office; Ministry of Finance; State Bank of Viet Nam; staff estimates.

Domestic demand was the main source of economic expansion in 2001, led by strong growth in investment.

the leading area, strengthening by an estimated 8% due to the buoyant real estate market. The easing of procedures for issuing land-use certificates, the granting of permission to buy land to overseas Vietnamese, and the recognition of Viet Nam as one of the safer countries in the region all promoted land transactions. As a result, land prices in major urban centers such as Hanoi and Ho Chi Minh City increased by three or four times during the year.

On the demand side, domestic demand was the main source of economic expansion in 2001, led by strong growth in investment stemming from low interest rates, the continuing creation of a large number of SMEs, an increase in government capital spending, and a rise in FDI inflows. Investment's strong growth offset the deceleration in consumption, which rose by only 4.9% in 2001, due to declining rural incomes resulting from the weakening performance of the agriculture sector.

Official data based on the new national poverty line introduced in 2001 by the Ministry of Labor, Invalids, and Social Affairs show a further decline in poverty to 16% by end-2001, from 17.2% at end-2000. While these data are not internationally comparable, the draft Comprehensive Poverty Reduction and Growth Strategy released in January 2002 suggests that poverty—as measured by an international poverty line developed by the General Statistical Office and the World Bank—has also continued to decline since the last household survey, from 37% in 1998 to about 32% in 2000. Given the emerging disparities between urban and rural areas and among regions, the Government will need to ensure equitable distribution of the benefits of growth. The urban unemployment rate fell somewhat from 6.4% in 2000 to 6.3% in the first 7 months of 2001. The gradual shift in labor from agriculture continued, and was directed mainly toward the services sector.

The fiscal deficit in 2001, including onlending, was estimated at 4.9% of GDP, lower than budgeted because revenues strengthened more than expected, to 21.2% of GDP. On the expenditure side, the fiscal stimulus stance translated into higher capital spending, primarily on infrastructure projects. Overall expenditure was estimated at 25.6% of GDP in 2001.

The consumer price index remained fairly stable over the year with a slight increase of 0.8% by end-December 2001 on a year-on-year basis. Food prices fell through the first half of the year due both to the fall in world prices of agricultural commodities, particularly rice, and to 2 years of bumper rice harvests at home. Food prices recovered in the second half of 2001, and the food price index rose by 6% by the end of the year, reversing the downtrend of the previous 2 years. The transport and communications price index declined by 4.7%, reflecting, among other elements, lower Internet and telephone prices, as the market became more competitive and tariffs were reduced. So that trends in the prices of non-food goods and services could be more fully captured, the weighting of food items in the consumer price index basket was reduced from 60% to 47% in July 2001.

Though interest rates fell during 2001, it is estimated that credit growth to the economy decelerated from a high 38.1% in 2000 to 21% in 2001. Credit growth to SOEs slowed significantly, while accelerating by 27.5% to other sectors. This partly reflects the impact of the ongoing restructuring of the SOE sector on lending decisions by commercial banks. Broad money (M2) expanded by 23.2%. Within M2, the increase in foreign currency deposits fell by more than half to 27.7% from 60.5% in 2000. This reflects the disincentive to holding foreign currencies as opposed to local currency, as the interest rate spread between foreign currencies and dong deposits widened significantly in favor of the dong due to the fall in global interest rates.

The number of companies listed on the stock exchange increased from five in 2000 to 11 by the end of 2001. The market is still at a very early stage of development. Share trading constituted almost all transactions in the market; bond trading accounted for only 6.4% of the total. The stock exchange market was volatile as the index soared to 500 by mid-2001 and then fell sharply to 235 by the end of the year.

Since, during the early months of 2001, currencies of other countries in the region depreciated against the dollar even faster than did the dong, in real terms the dong appreciated against them. In view of this, attempting to accelerate export growth, the Government allowed foreign exchange management to become progressively more flexible, and the dong depreciated more rapidly in the second half of the year. Just before the events of September 11th, the dong was trading at 15,150 to the dollar. It then appreciated slightly, and remained at the 15,130 level until the end of 2001. This represented a depreciation of about 4% during the year.

In 2001, export growth was estimated at 6.5% compared with 25.2% in the previous year (Figure 2.13). The fall in international crude oil prices accounted for a large part of this deceleration. However, non-oil export growth was also slower than in 2000. Agricultural exports remained depressed, particularly rice and coffee, whose higher volumes were insufficient to offset declining world prices. Manufactured exports fared relatively poorly, with slowing export growth of footwear and garments due to subdued demand from within the region and from the EU. Against a broad-based weakening in export performance, marine products were among the few strong performers. Import expansion too was sluggish at 6%. Petroleum import growth was slower, due in part to the decline in world oil prices but also to the slowing domestic economy, which also accounted for the decline in imports of machinery and equipment.

On the current account, foreign exchange remittances surged in 2001, reflecting the impact of liberalization of regulations on foreign currency accounts and the permission granted to overseas Vietnamese to buy land. Current official transfers have remained broadly constant over the last few years. The current account surplus, excluding official transfers, was estimated at 1.5% of GDP in 2001.

On the capital account, FDI commitments rose. During 2001, 458 foreign-invested projects were licensed with a total registered capital of $2.2 billion, representing an increase of 12% over the 2000 level. The pickup in FDI commitments reflects the improved climate for foreign enterprises following amendments to the Foreign Investment Law and the successful conclusion of prolonged negotiations on a number of large energy projects. Another positive trend was the increasing share of FDI in light industries and agriculture, as these are more labor intensive and have export potential. For 2001, the surplus on both the current and capital accounts contributed to a rise in official reserves from $3.3 billion in 2000 to $3.5 billion in 2001, representing 11 weeks of imports.

A fall in international crude oil prices accounted for a large part of the deceleration in export growth in 2001, though non-oil export growth was also slower than in 2000.

POLICY DEVELOPMENTS

The lower fiscal deficit than earlier projected in 2001 gives room for phasing in some of the costs of implementing SOE and banking reforms in 2002. By some estimates, the capital cost of such reforms could come close to 3-4% of GDP this year. The Government also took steps to strengthen expenditure management, by endorsing, in September 2001, the Master Plan of Public Administration Reform for 2001-2010, which includes suggestions for public finance reform. In this regard, in an initial trial, the Government plans to replicate the success of a pilot scheme of lump-sum allocations for operational costs of administrative agencies to major cities such as Hanoi and Ho Chi Minh City. In addition, to enhance predictability and strengthen budget allocation for operation and maintenance, multiyear expenditure programming for education and transport was piloted in 2001, as opposed to the usual annual expenditure budgeting.

The Government has been gradually moving toward market-determined interest rates. The base rate, which replaced the ceiling on dong borrowings, is based on information on lending rates collected from nine commercial banks. Since June 2001, banks have been able to set dollar lending rates in line with the international market. Further, on 1 August 2001, the State Bank of Viet Nam liberalized its policy on the rates at which locally based companies may borrow from overseas lenders. This practice will require close monitoring, however; the experience of several countries during the Asian financial crisis demonstrated its potential dangers.

Viet Nam's medium-term growth is expected to remain sustained and robust as domestic demand continues to improve.

The State Bank of Viet Nam responded to the fall in global interest rates by lowering its base rate on dong loans on four occasions, from 0.75% to 0.6% per month. To increase banks' liquidity of dong holdings, currency swap operations between dollars and dong were reintroduced in August 2001. Reserve requirements on foreign currency holdings were raised from 12% to 15% in May 2001, but were lowered to 10% in November.

The Government adopted an overall reform framework for SOCBs in March 2001 and developed restructuring plans for individual SOCBs. The main challenges in this area are twofold: implementation of financial restructuring plans through resolution of nonperforming loans and recapitalization, and operational restructuring to strengthen corporate governance and risk management. Resolving the nonperforming loan problem is related to SOE reform in that much of the bad debt is owed by loss-incurring SOEs. With regard to developing the nonbank financial sector, the Government has broadened the scope of financial leasing and strengthened regulations to improve the business environment for domestic and foreign leasing companies.

The Government initiated, also in March 2001, a 3-year SOE reform framework that provides for the equitization, liquidation, and merger of around 1,800 small and medium SOEs, but progress in implementing plans and achieving targets has been slow. Against the 2001 target of 450–500, only 113 enterprises were equitized in the first 8 months of the year. Factors accounting for the slow pace include problems in resolving inter-enterprise debt; valuation of land, buildings, and equipment; decisions over the management structure of equitized enterprises; and difficulties in handling redundancies. There is a risk that the larger and more capital-intensive SOEs, which account for 90% of the SOE debt, will remain largely untouched by the reforms.

Significant progress was made in trade reform in 2001. Among the various measures introduced were lifting quantitative restrictions on all but a few items, abolishing quota allocations for rice exports and fertilizer imports, further liberalizing trading rights, and lowering the foreign exchange surrender requirement from 50% to 40%. The bilateral trade agreement with the US was ratified, and active preparations started toward the goal of WTO accession by 2004.

OUTLOOK FOR 2002–2003

Viet Nam's medium-term growth is expected to remain robust and sustained, as domestic demand continues to expand. GDP is projected to rise by 6.2% in 2002 and by 6.8% in 2003. The lagged impact of the fall in interest rates in 2001 and possibly in the first half of 2002, as well as the improvement in the business environment, should provide impetus for further development of the private sector.

As public sector debt is manageable, it is expected that, to ease the impact of the global slowdown on export demand and to accelerate SOE and banking reforms, the Government will continue its cautiously expansionary fiscal stance. Consequently, investment is likely to increase in all subsectors—namely private, foreign-invested, and public. Gross domestic investment is projected to reach nearly 27% of GDP in 2002 and 28% in 2003. Consumption is forecast to continue growing moderately at about 4.5%, as incomes in rural areas remain depressed due to the weak prices of agricultural commodities projected for 2002.

On the supply side, industry and construction together are projected to grow at about 10% annually in 2002–2003, acting as the main drivers of growth. Construction is expected to continue performing strongly in the medium term due to ongoing infrastructure projects, such as the Truong Son highway and urban development projects in major cities. The services sector, which is still dominated by the more traditional wholesale and retail trade and by transport services, is expected to post moderate growth of

5–6%—a rate somewhat higher than in recent years—in spite of a more steady increase in tourism.

It is expected that the Government will continue its cautious fiscal stimulus. Revenues are projected to grow, reflecting broadly stable but slightly rising oil prices in 2002. Given the higher rates of expenditure, and the implementation costs of some of the proposed reforms in the areas of public administration, SOCBs, and SOEs, the overall government deficit may increase to 5–6% of GDP in 2002–2003. Inflation rates are expected to increase, but to remain below 4%. Given the attempt to reduce nonperforming loans and to strengthen risk management by banks, credit restraint is expected to continue over the period.

Viet Nam's already rather high level of trade as a proportion of GDP is expected to rise further as a result of the bilateral trade agreement with the US and diversification toward manufactured exports. This should bring higher growth but also greater exposure to the risks and fluctuations of the external environment. External demand is anticipated to strengthen modestly in 2002, when the global economy is expected to gather momentum for a more robust expansion in 2003. The expectation of stable oil prices with an upward bias projected throughout 2002 and a projected increase of exports to the US and EU, particularly of footwear and garments, will support export growth in 2002–2003. Exports are forecast to increase to $16.7 billion in 2002 and to $18.7 billion in 2003, representing growth of 8.5% and 12%, respectively.

The recent trade liberalization measures and the expected rise in goods and machinery imports for the implementation of FDI projects approved in the oil, gas, and power sectors will result in medium-term import growth, projected at 10% in 2002 and 13% in 2003. The current account surplus, excluding official transfers, is projected to narrow to 0.3% of GDP in 2002 and move to a deficit of 0.2% in 2003, as imports pick up along with the expected economic recovery.

ASIAN DEVELOPMENT

Outlook 2002

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

South Asia

Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

AFGHANISTAN

The events of 2001 were the culmination of a period of hostilities in the country, ongoing since 1979, which devastated social and economic structures and institutions. Physical infrastructure and social services have collapsed. The population has been decimated, and virtually all skilled professionals have either fled the country or perished in the hostilities. Many cities and villages are in rubble, and the makings of a formal economy beyond subsistence farming and animal herding are all but nonexistent. The majority of the population remains extremely poor, lacking food, clothing, housing, and medical care. Afghanistan today has one of the highest infant, child, and maternal mortality rates, and one of the lowest literacy and life expectancy rates, in the world. It also has one of the highest proportions of disabled people in the world. Disruption to transport and communications has fragmented the economy and society. Delivery of social services has ground to a halt; women and girls were forbidden an education and prevented from working in many places during the Taliban regime. The severe drought over the past 3 years, coming on top of the hostilities, has substantially reduced food availability further; there is mounting evidence of famine conditions and forced sale of livestock. Renewed fighting after October 2001 triggered a population exodus from major Afghan cities. Some 2 million Afghan refugees are living in Pakistan and about 1.5 million in Iran, while there are an estimated 1 million–1.5 million internally displaced people. However, a new administration is now in place, and the task of rebuilding the economy has begun. With substantial commitments for international assistance, the economy is in a position to make rapid progress over the medium term. Nevertheless, a daunting range of constraints must be overcome to sustain a long-run development drive.

MACROECONOMIC ASSESSMENT

Any assessment of recent economic performance is necessarily tentative since the underlying information base is extremely weak. Prior to the recent conflict that ousted the Taliban regime, an ADB estimate placed Afghanistan's per capita income at about $300, for a population of 23 million, giving an aggregate GDP of about $6.9 billion. However, this is likely to have declined substantially during the past year. Current assessments of assistance needs start from the assumption of a per capita GDP of only $200 in 2001. According to the latest available estimates, the bulk of national production consists of agriculture and forestry products (53%), followed by mining and light industry (28%), trade (8%), and construction (6%). Transport, communications, and services account for the remaining 5%. These estimates exclude the illegal cultivation of poppy and the production of narcotics, which are known to be major sources of income.

Agriculture is the mainstay of the economy. Most Afghans used to be settled farmers, herders, or both. In recent years, opium replaced wheat as the country's main crop. Recent information suggests that poppy cultivation fell significantly over most of 2001 but may have resumed in recent months. Meat and fruits are the other main products. Traditional production of food crops, primarily wheat and livestock products, has been severely affected by 3 consecutive years of drought, which has considerably reduced irrigation coverage. Agricultural production has also been affected by the shortage of quality seeds and fertilizers. The restoration of traditional agriculture and food security over the medium term will be difficult. Extensive demining and rehabilitation of irrigation systems will have to be combined with mobile livestock extension, the rehabilitation of the road system, and a policy regime that encourages traditional agriculture.

Mining and light industry constitute the second major sector of the economy after agriculture. Afghanistan is believed to have substantial hydrocarbon reserves, both oil and gas, in the north. Exploration started in 1967 with collaboration from the former Soviet Union, but ended with the Soviet withdrawal in 1989. With the restoration of peace, prospects for the resumption of hydrocarbon exploration are good , as well as for the transit flow of oil and gas from the Central Asian republics to India and Pakistan, on the basis of foreign capital. Among manufactured products, carpets, leather goods, and gold and silver jewelry are the main items. With the restoration of political and economic stability, production of these goods should recover fairly quickly.

Large-scale rehabilitation programs will be required for the restoration of transport, power, and communications systems, as well as social services.

Large-scale rehabilitation programs will, however, be required for the restoration of transport, power, and communications systems, and social services, including education and health. Afghanistan has a road infrastructure of about 21,000 kilometers, of which only 13% were paved in 1991. There are also nearly 50 airports, half of which have paved runways. However, roads and airports have suffered considerably from the hostilities of the past decade, and especially from the heavy aerial bombardment of the Taliban forces in late 2001. Similarly, a telephone and telegraph network that linked the main towns has been destroyed and will have to be redeveloped. Power generators and transmission systems that provided electricity to the main towns are heavily damaged. The immediate policy priority is to restore the major transport links and power and communications systems in the towns, based on a decentralized structure with, to the extent feasible, full cost recovery, to make them self-sustaining without undue pressure on the budget. Over the longer term, cross-border transmission grids may have to be developed with the help of Afghanistan's neighbors, within the framework of regional cooperation.

Rebuilding the country's devastated human resources base is a prerequisite to long-term recovery. The restoration of the destroyed education and health services is an urgent economic management priority. Prior to 1979, Afghanistan had a school system that made primary education accessible to at least half the under-12 population, and included secondary schools in most provincial towns, as well as universities in Kabul and other major towns. After the occupation of 1979 by the former Soviet Union, the system eroded, especially during the civil war and under the Taliban interdiction on education for women. Today, the literacy rate is only around 31%, and is significantly biased toward men. However, universities in Kabul and at least five other towns are now in the process of reopening. Furthermore, there are plans to open community colleges to provide demand-based posteducation services.

Health services collapsed in the last 2 decades, especially in the 1990s due to the Taliban ban on women in the workplace, including most hospitals and health clinics. The World Health Organization ranks Afghanistan 173 out of 191 countries in terms of health care.

On the external front, the latest available trade statistics, for 1999, indicate a total export volume of $235 million. Fruits and nuts are the main exports, followed by carpets. Wool, sheepskin, and cotton are other important exports. Belgium, Germany, India, Pakistan, and the Russian Federation are the main destinations. The total volume of imports in 1999 was $900 million, implying a trade deficit of about $665 million or close to 10% of estimated GDP. The major imports include capital goods, food items (including sugar and edible oils), textiles, petroleum products, and tires. The main sources of imports are India, Japan, Kenya, Korea, Pakistan, and Turkmenistan.

Once again, the trade data exclude the large illegal trade in narcotics. A very rough estimate by the Economist Intelligence Unit placed the country's total debt at about $5 billion in the 1990s, or 72% of GDP, with the bulk of it ruble-denominated debt to the former Soviet Union, and mostly on concessional terms. Arrears to preferred creditors are estimated at $50 million, including $15.3 million to ADB.

POLICY DEVELOPMENTS

The public sector used to consist of the central Government, provincial governments, municipalities, and public enterprises. In the early 1990s, public expenditures were about 13% of GDP while recorded revenues (which excluded levies on opium and other illegal traffic) had declined to 3% of GDP. The 10% fiscal deficit was covered mainly by external assistance. Since then, the budgetary system has broken down and public finance has taken place off-budget. The budget itself has been supported principally by aid from Pakistan, a few minor tax revenues, and aid from Saudi Arabia, which was suspended in 1998. Following the collapse of the Taliban regime in December 2001, the interim administration discovered that the treasury was virtually empty. The budgetary system is now being restored with technical assistance from IMF as part of efforts to establish a credible macroeconomic framework, restore the revenue system, and enable the country to qualify for substantial external assistance.

Alongside the fiscal system, the interim administration also needs to immediately review its monetary and financial systems. The finance sector used to comprise a central bank, established in 1938, and four commercial banks, which were all nationalized in 1975. Financial intermediation has largely been conducted through “money bazaars,” which engage in both money lending as well as foreign exchange transactions. The local currency is the afghani (Af), earlier pegged to the dollar, and floated in 1996. It was trading at almost Af80,000 to the dollar in October 2001, but had appreciated to Af30,000–40,000 by January 2002, when the interim administration had succeeded the Taliban. While this is a mark of confidence in the system, the authorities now need to quickly reestablish regulation of both financial intermediation and foreign currency transactions to stabilize the afghani. Its rapid appreciation has already upset the basis on which external aid flows were calculated. The United Nations had initially appealed for a “start-up” fund of $20 million to enable the interim administration to start functioning. However, by underestimating the size of the civil service, and given the appreciation of the afghani, the interim administration requires start-up funding equivalent to $100 million, including $70 million to cover back pay owed to civil servants. An initial inflow of $7 million was almost all liquidated immediately by a first back-pay installment of $6 million for the period 16 December 2001–15 January 2002.

OUTLOOK FOR 2002–2003

At the Second Meeting of the Afghanistan Reconstruction Steering Group, concluded in Tokyo in early 2002, the international community addressed the country’s urgent development needs, pledging a total of $4.5 billion in external assistance, including $1.8 billion for 2002. However, a system of internal governance and a financial system need to be quickly established to absorb and deploy such assistance effectively. With this level of aid and progress in achieving internal security, Afghanistan will likely experience rapid growth over the next few years as rehabilitation, renewed confidence, and reestablished external economic relations quickly boost productive capacity.

Moreover, if these quick gains can foster a favorable environment of willingness to tackle the huge constraints faced by the country, long-term development prospects are good. The Preliminary Needs Assessment—jointly prepared by ADB, United Nations Development Programme, and World Bank at the initiative of the Steering Group—estimated that reconstruction requirements are $1.7 billion in the first year and about $5 billion in the first 2.5 years—the period spanning the current interim administration and the transitional government due to follow that. Part of the $5 billion will have to cover the interim administration’s recurrent costs, estimated at about $1.8 billion, as it is unlikely to be able to collect taxes in the foreseeable future. These costs include the salaries of civil servants who lost their jobs in the Taliban era and whom the interim administration plans to rehire. The 10-year figure for reconstruction is estimated at $15 billion.

In early 2002, the international community addressed the country’s urgent development needs, pledging a total of $4.5 billion in external assistance.

BANGLADESH

Based on a record crop harvest and an industrial recovery, the economy maintained steady growth, despite external economic and internal political pressures. A deteriorating external environment is likely to pull down GDP growth a little in 2002. The economy should then pick up in 2003, reflecting a rise in both domestic and external demand. The Government needs to address structural issues in the external sector, in public finance, and in banking, if the economy is to achieve sustained growth over the medium term.

MACROECONOMIC ASSESSMENT

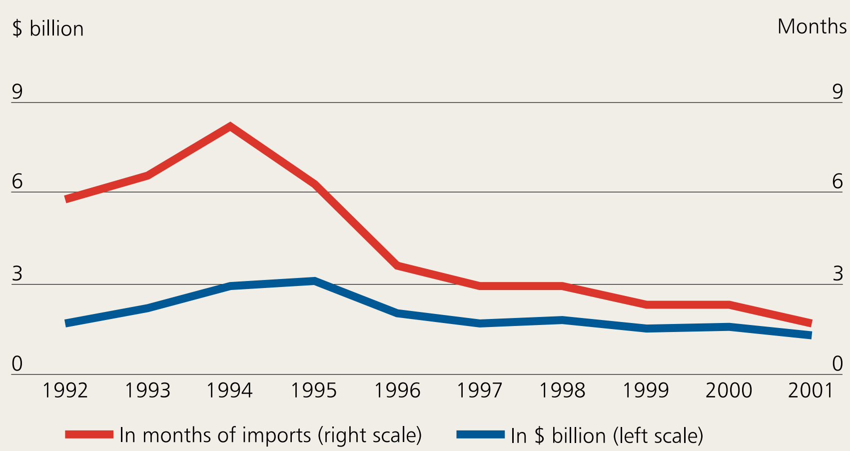
Despite lingering external pressures and political disruptions, the economy achieved steady growth during 2001 with GDP expanding by 5.2%, compared with 5.9% in 2000. This performance was underpinned by an exceptional crop harvest and a rebounding industry sector.

Favorable weather, the increased use of high-yielding varieties of crops, extended irrigation, and the ready availability of agricultural inputs such as seeds, fertilizer, and fuel at lower prices contributed to a record 26.8 million tons of food grain production. This represents a 7.6% increase over the previous year and was over 2 million tons more than domestic requirements (calculated at 455 grams per person per day). Despite the record, the overall growth rate of the agriculture sector declined to 3.1% from 7.4% in 2000, due to a high base for comparison following several years of successive bumper crop harvests.

Industry sector growth improved to 7.2% in 2001 from 6.2% in 2000, due mainly to stronger manufacturing. Increasing to 6.3% from 4.8% in 2000, manufacturing expansion was underpinned by a rise in domestic demand and a rapid strengthening in the export-oriented garment industry. The output of domestic market-oriented industries, including food processing, chemicals, cement, and small-scale industries, also rose considerably. Greater availability of bank credit to the private sector and higher imports of raw materials and machinery also supported manufacturing growth. Value added in 2001 in electricity, gas, and water supply together grew by a robust 7.4% compared with 6.8% in the preceding year, partly reflecting greater manufacturing activity. Growth in construction, however, rose marginally to 8.7% from 8.5% in 2000 because of an oversupply of commercial buildings and apartments. Services sector expansion was sustained at about

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

FIGURE 2.14 **Foreign Exchange Reserves, Bangladesh, 1992-2001**



Source: Bangladesh Bank.

TABLE 2.14 Major Economic Indicators, Bangladesh, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth[a]	4.9	5.9	5.2	4.5	5.7
Gross domestic investment/GDP	22.2	23.0	23.1	23.2	24.0
Gross national savings/GDP	20.8	22.0	21.0	20.7	21.9
Inflation rate (consumer price index)	8.9	3.4	1.6	2.4	2.6
Money supply (M2) growth	12.8	18.6	16.6	16.0	17.0
Fiscal balance/GDP	-4.8	-6.2	-6.1	-6.0	-5.8
Merchandise export growth	2.9	8.2	12.4	-8.0	10.0
Merchandise import growth	6.6	4.8	11.4	-5.0	6.0
Current account balance/GDP	-1.4	-1.0	-2.1	-2.5	-2.1
Debt service ratio	7.0	7.2	7.5	8.0	7.5

[a] Based on constant 1995/96 market prices.

Sources: Bangladesh Bank; Bangladesh Bureau of Statistics; World Bank; staff estimates.

5.4%, due to notable progress in the transport, communications, and financial services sectors.

Public investment growth is provisionally estimated to have slightly decreased to 7.3% of GDP, from 7.4% in 2000. In contrast, private investment activity strengthened somewhat, from 15.6% of GDP to 15.9%, reflecting increased domestic economic activity, lower interest rates, and buoyant export demand during the first half of 2001. Overall investment activity rose only slightly to 23.1% of GDP from 23% in 2000. Gross national savings, on the other hand, declined to 21% of GDP—about 1 percentage point lower than in the preceding year—due mainly to a decline in overseas workers' remittances. In terms of consumption expenditure, both public and private consumption broadly maintained their respective shares of GDP. Robust growth in exports was readily matched by import growth due to the import-dependent nature both of exports and of domestic market-oriented manufacturing activity.

The country faces a huge challenge to absorb some 2 million people entering the labor force annually, on top of the large number of existing underemployed. The only avenue of employment for this growing labor force, which is currently expanding at almost twice the population growth rate, is self-employment in the low-productive segments of the nonformal sector. Declining population growth has been more than offset by women's increased labor force participation rates. According to the 1995/96 Labor Force Survey, the unemployment rate in Bangladesh was estimated at only 2.5%. This is widely believed to grossly underestimate the true figure and to overlook the large number of underemployed. According to some estimates, the unemployment rate in the country is over 25%. The garment industry, which had absorbed a large proportion of the population entering the labor market, especially females, seems to have become oversaturated. In recent years, the overseas job market employed about 250,000 Bangladeshis annually, and their remittances constituted about 4% of GDP. However, overseas job opportunities seem to be declining, with only around 230,000 leaving for jobs abroad during 2001. According to the latest Household Income and Expenditure Survey of the Bangladesh Bureau of Statistics, 49.8% of the population lived below the poverty line in 2000 (based on the cost of basic need method). It shows that, over the course of the last decade, income poverty declined by 1 percentage point a year due to the overall increase in employment and decrease in real food prices during this period.

Although the wage level in Bangladesh is low, increases in real terms have been maintained in recent years. Nominal wages during 2001 went up by 4.2% from the 2000 level; in real terms, this was a 3.3% rise.

In 2001, the Government's revenues improved to 9.6% of GDP from 8.5% in 2000, due to an increase in import taxes and strengthened tax administration. Nontax revenues, how-

The country faces a huge challenge to absorb some 2 million people entering the labor force annually, on top of the large number of existing underemployed.

ever, remained depressed as a result of losses incurred by SOEs. Despite the overall improvement in revenue performance, the budget deficit declined only marginally to 6.1% of GDP from 6.2% in 2000 due to expenditure overruns. In the wake of declining availability of external resources, domestic financing of the budget deficit stayed at 3.6% of GDP. This is a cause for concern, as domestic borrowing is costlier than foreign financing. As a result of this high level of domestic borrowing, the Government's domestic interest payment obligations as a ratio of revenues—reflecting debt service capacity—rose to 13.6% in 2001.

The Government aims to improve the efficiency of tax administration, modernize the tax collection process, ensure closer monitoring and supervision, and expand coverage.

Although money supply (M2) remained expansionary to accommodate fiscal spending, growth eased to 16.6% in 2001 from 18.6% in 2000. This was due to a decline in the net foreign assets of the banking system and a moderation in credit expansion to the central Government. Nevertheless, the growth rate of government borrowing from the banking system remained at a high level of 19.7% in 2001, with the bulk of the borrowing coming from the central bank. Credit growth to the private sector also climbed, from 10.7% in 2000 to 16.9% in 2001. This stemmed from the pickup in private sector economic activity, as well as from measures taken in 2000 to reduce the bank rate and reserve requirements, and to abolish the interest rate bands applicable to agriculture and SMEs.

Consumer price inflation dropped from 3.4% in 2000 to 1.6% in 2001, due mainly to increased production of food grain. Food inflation declined from 4.1% to 0.9% over this period, while nonfood inflation remained unchanged at around 2.7%. The value of the taka was adjusted twice against the dollar, in August 2000 and May 2001, resulting in a cumulative devaluation of 10.5%. This, together with lower domestic inflation, led to a depreciation of the real effective exchange rate to a level similar to that prevailing at the beginning of 1998.

Over the course of 2001, the Dhaka Stock Exchange's all-share price index increased by 27.6%. The capital market is still, however, at a nascent stage, with market capitalization amounting to only $1.27 billion at the end of 2001 (and $1.05 billion at the end of 2000). Despite some progress in reducing nonperforming loans, the finance sector remained under stress, with the proportion of such loans in the banking system amounting to around 34% at the end of 2001.

The export growth rate accelerated from 8.2% in 2000 to 12.4% in 2001, though it decelerated sharply as 2001 progressed because of the global economic slowdown. This affected apparel exports particularly, which, together with knitwear, have accounted for about three quarters of total exports in recent years. Import growth picked up from 4.8% in 2000 to 11.4% in 2001, due mainly to increased imports of intermediate and capital goods from the import-dependent domestic and export-oriented manufacturing sectors. A higher trade deficit was accompanied by a decline in overseas workers' remittances of 3.4%. These developments led to a widening of the current account deficit (excluding official grants) from 1% of GDP in 2000 to 2.1% in the following year.

Despite a mild improvement in the capital account, the overall balance deteriorated, resulting in an erosion of foreign exchange reserves from $1.6 billion (2.3 months' equivalent of imports) at the end of 2000, to only $1.3 billion (1.7 months' equivalent of imports) at the end of 2001 (Figure 2.14). The country's outstanding external debt was around 34% of GDP at the end of 2001, while the debt service ratio crept up from 7.2% in 2000 to 7.5% in 2001.

POLICY DEVELOPMENTS

The 2002 budget projects a revenue target of 9.8% of GDP, or 0.3 percentage points higher than the figure achieved in 2001. In the absence of significant new revenue-raising measures, the Government aims to achieve the higher target by improving the efficiency of tax administration, modernizing the tax collection process, ensuring closer monitoring and supervision, and expanding coverage. After exceeding the revenue collection target in 2001 by 2%, the revenue intake during the first half of 2002 was 2.4 percentage points lower than the target set for the period. This was due mainly to a significant reduction in import-based taxes and to relatively subdued domestic economic activity. Despite a number of initiatives to reduce costs, such as upward adjustments in administered prices, cancellation of a summit of the Non-Aligned Movement, limiting contracts under suppliers' credit, and freezing government recruitment, the Government will remain under pressure to contain the fiscal deficit. It continues to subsidize loss-incurring SOEs and its revenues are below target. Given these developments, the Government's original budget deficit target of 5.4% of GDP for 2002 appears difficult to attain. Moreover, the Government is also unlikely to be able to reduce domestic financing of the budget from 3.5% to 2.6% of GDP, between 2001 and 2002, unless it takes steps to curtail unproductive and low-priority public expenditures, improve utilization of foreign aid, and privatize SOEs.

As the prospect of a lower than expected revenue outcome in 2002 unfolds, the expansionary trend in monetary policy is likely to continue to accommodate increases in government borrowing from the banking system. This has resulted in a crowding out of private investment. The growth of credit from the banking system to the Government has accelerated considerably, from 21.4% in July 2001 to 27.1% in October. The growth rate of broad money (M2) on a year-on-year basis, however, declined marginally from 15.1% in July 2001 to 14.1% in October. To encourage lending to the private sector, the central bank reduced the bank rate from 7.0% to 6.0%, also in October. Monetary policy is likely to remain expansionary for the duration of the forecast period.

The policy stance on exchange rate management remains unchanged with periodic adjustments in the exchange rate of the taka against the dollar as the main vehicle of management. In January 2002, the taka was devalued by a further 1.6% against the dollar as foreign exchange reserves came under heavy pressure. External reserves declined to only $1.1 billion (1.5 months of imports) during early January 2002 after two Asian Currency Union payments were made. The Government recently imposed regulatory duties on nonessential imports and enhanced margin requirements for letters of credit to ease pressure on foreign exchange reserves. These measures are not, however, consistent with the spirit of past trade policy reforms and may introduce new distortions. As the probable range within which the taka needs to be adjusted to maintain competitiveness is likely to be quite small, the Government needs to consider other trade policy reform measures that remove distortions on the tariff front.

OUTLOOK FOR 2002–2003

The global economic slowdown and developments following the events of September 11th in the US have considerably undermined the country's growth prospects for 2002. The resulting setback in export-oriented manufacturing and loss of investor confidence are also adversely affecting key production and services sectors such as trade and transport, banking, insurance, ports, and shipping. Moreover, the sharp deceleration in export growth over recent months is also leading to considerably slower import growth, with negative consequences for the Government's revenue intake. The loss of employment in the sectors immediately affected by the global slowdown, including garments in particular, is likely to be substantial with adverse consequences for poverty reduction. Between July and December 2001, about 1,200 garment factories closed and an estimated 350,000 workers in the garment industry lost their jobs. Higher unemployment will also make it harder for the Government to achieve its goal of reducing income poverty by 25% in 2005, from the levels that prevailed in 2000.

Between July and December 2001, about 1,200 garment factories closed and an estimated 350,000 workers in the garment industry lost their jobs.

The GDP growth rate for 2002 is expected to decline to around 4.5%, due to a more subdued performance of export-oriented manufacturing and services, and lower agricultural growth. Based on the index of industrial production, manufacturing output declined by 0.02% during the first 3 months of 2002 (July–September 2001) compared with the corresponding period of 2001. There appears to be a discernible downward trend with manufacturing output declining by 2.3% in September 2001 compared with a year earlier. GDP growth is likely to pick up in 2003 to 5.7%, due to a measured recovery in external demand, particularly in the US and EU, and to progress with the country's structural and economic reforms.

During the first 5 months of 2002 (July–November 2001), year-on-year export earnings fell by 10.9%, with all major export categories registering declines. The granting of duty- and quota-free access to the US market to garment exports from 72 Caribbean and Sub-Saharan African countries has disadvantaged the country's garment exporters. Imports, in terms of letters of credit opened, declined by 7% during the first 5 months of 2002 over the corresponding period of the previous year, as exporters' demand for industrial raw materials dropped. The current account deficit in 2002 is projected to widen to 2.5% of GDP on the assumption of an 8% decline in exports, a 5% decline in imports, and a gradual tapering off in remittances. Foreign exchange reserves are likely to be under mounting pressure from the expanding current account deficit. In 2003, the deficit is likely to decrease to around 2.1% of GDP, aided by stronger export performance and an increase in workers' remittances as the world economy recovers.

The budget deficit is expected to remain high in 2002 at 6% of GDP, mainly on account of a shortfall in revenue collections. The annual average rate of inflation remained broadly stable between end-June 2001 and end-October 2001. On a point-to-point basis, however, consumer prices rose marginally over this period due to a pickup in prices of nonfood items. The inflation rate is expected to increase to 2.4% in 2002 due to a further rise in administered prices and slower growth in crop production. This will, to some extent, be offset by relatively subdued domestic demand. In 2003, consumer prices are likely to edge up to around 2.6% as the Government's expansionary fiscal and monetary policies contribute toward demand-pull inflation.

BHUTAN

Close ties to India helped protect Bhutan from the slowdown of the global economy in 2001. The country's medium-term prospects are good, provided that the Government achieves greater fiscal discipline. Construction of hydropower plants and power exports to India will continue to play a key role in GDP growth.

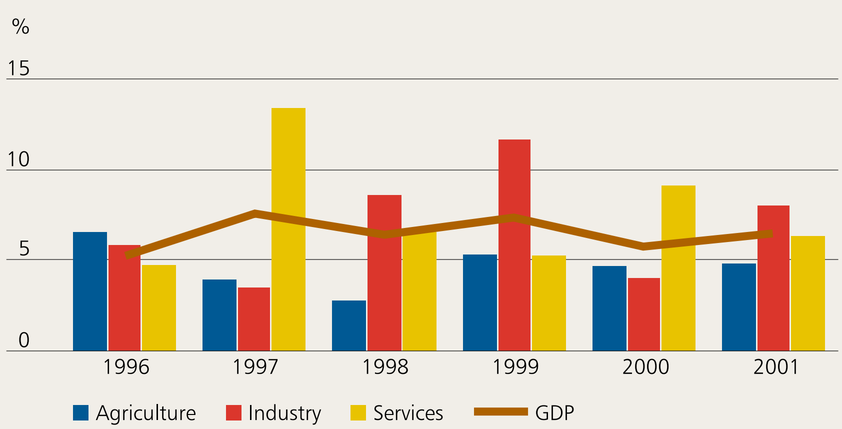
MACROECONOMIC ASSESSMENT

Economic activity, vigorous for the past few years, was robust in 2001 when GDP grew by 6.5%, compared with 6% during the 1990s and 5.7% in 2000 (Figure 2.15). The economy's close ties to India helped Bhutan avoid the direct impact of the global economic slowdown, though the main driving force behind economic growth was, in fact, the construction of hydropower plants to serve the Indian market. Accordingly, the industry sector grew by 8%, despite a disappointing performance by mining and manufacturing. The services sector grew by 6.3%, buoyed by the transport and communications subsectors. However, tourism, which registered double-digit growth in the 1990s, performed poorly as a result of slower tourist arrivals following the events of September 11th, poor weather conditions earlier in the year, and logistics difficulties with air transport from overseas. Agriculture, traditionally the slowest sector, stayed at 4.8% growth due to stable livestock production and to strong forestry output offsetting disappointing crop production and exports of fruits and horticultural products.

The fiscal deficit expanded to 5.1% of GDP in 2001 from 4.1% in the previous year because of increased capital investments on large projects, including a housing project, an expressway project, and a renovation project for a former capital city. Broad money supply growth decelerated to 5.5% from 21.4% in 2000, reflecting a deceleration of external assistance, which has a direct impact on money creation. Inflation has traditionally run in parallel to inflationary trends in India in view of the porous nature of the border with that country, and the existence of the ngultrum-Indian rupee peg. As measured by the consumer price index, inflation fell substantially in 2000 and remained low at 3.6% in 2001, largely due to declines in food prices. Interest rates also fell, reflecting low domestic inflation.

The trade account deficit increased from 16.7% of GDP in 2000 to 22.6% in 2001. However, the improvement of services and transfers helped narrow the current account deficit from 30.6% of GDP in 2000 to 27.5% in 2001. Capital inflows in the form of grants and loans, primarily to fund the power sector, con-

FIGURE 2.15 **Aggregate and Sector GDP Growth, Bhutan, 1996-2001**



Sources: Central Statistical Organization, 2001, *National Accounts Statistics Report*, October; staff estimates.

2001 refers to fiscal year 2000/01, ending 30 June except in the case of GDP, which is on a calendar year basis.

tinued to exceed the current account deficit by some margin, despite the lack of FDI. Grants, having surged in 2000, returned to the 1999 level in 2001, while the volume of loans increased. The net effect was to keep foreign exchange reserves at a level equivalent to 16 months of merchandise imports. In 2001, India accounted for 94% and 74% of total exports and imports, respectively, and 70% of total grants and loans. Total external debt increased by 37%, largely in response to loans from India for the new hydropower projects. The debt service ratio declined marginally from 5.7% of GDP in 2000 to 5.6% of merchandise exports in 2001.

POLICY DEVELOPMENTS

The prospects for agriculture largely depend on the Government's decentralization drive and the development of domestic and external markets for farm products.

The Government used to pursue a prudent fiscal policy, maintaining current expenditures at a level that could be completely financed by domestic revenues. However, the fiscal deficit rose steeply in recent years and reached over 5% in 2001, though some favorable factors are expected to mitigate the fiscal constraints. These include the fact that domestic revenues will probably strengthen as a result of the commissioning of major hydropower plants over the coming months, the likely upward revision of power export tariffs, and the introduction of a personal income tax this year.

Given that monetary policy has to be geared to supporting the exchange rate peg with the Indian rupee, inflation and interest rates have to be kept in line with those in India and therefore the scope of monetary policy is substantially limited.

A high level of excess reserves in the banking system persisted for many years. It was regarded as the result of the banks' low capacity for selective lending and the lack of domestic investment opportunities that are, in turn, due to the weakness of the private sector. The overall situation with respect to strengthening the domestic banking system is being addressed with assistance from ADB and IMF.

OUTLOOK FOR 2002–2003

Bhutan's medium-term economic prospects are good. Beginning this year, the Government will pursue a policy of maximizing "gross national happiness". This balances growth in GDP with environmental and cultural protection as laid out in the Ninth Five-Year Plan (2002–2006). Such a strategy could, though, make it difficult to achieve very rapid economic growth. The Government will also move toward a holistic approach to development and poverty reduction, with a greater focus on those living in rural areas. The economy is, other than tourism, relatively well insulated from the direct effects of global economic volatility, although it is vulnerable to the effects of major developments in India.

GDP growth of 6–7% a year over the medium term can be achieved, in particular if hydropower generation and power exports come on line as scheduled. The prospects for agriculture largely depend on the Government's decentralization drive initiated under the Ninth Five-Year Plan, starting in July 2002, as well as the development of domestic and external markets for farm products. Electricity and related construction will continue to boost the industry sector, while private sector development will determine the prospects for mining and manufacturing. The services sector will also benefit from an expected recovery in tourism.

It is projected that the Government will manage fiscal policy prudently, and that the overall fiscal deficit will be confined to about 3% of GDP. Monetary conditions are expected to remain more or less unchanged. Inflation will continue to reflect Indian price movements primarily, rather than domestic conditions, and is expected to remain moderate.

Despite generally good medium-term prospects, however, risks could arise from both external and internal forces. If India's fiscal situation worsens, hydropower projects could be delayed. Given the importance of external finance to Bhutan's development plans, it is important to maintain the flow of resources, since a reduction in these flows could reduce the development plan implementation rate and the Government's financial room for maneuver. Of more significance, perhaps, are the risks of not achieving rising living standards and adequate job creation, which could lead to growing unemployment.

INDIA

Economic growth improved in 2001, despite deteriorating external demand. While industrial expansion slowed, agriculture recorded a marked improvement due to a favorable monsoon, and services registered accelerated growth. Inflation fell and a comfortable level of foreign exchange reserves was built up. In 2002–2003, a more favorable external environment and stronger domestic demand due to a revival in agriculture should lead to faster economic growth which, to be sustained, must be supported by fiscal and structural reforms.

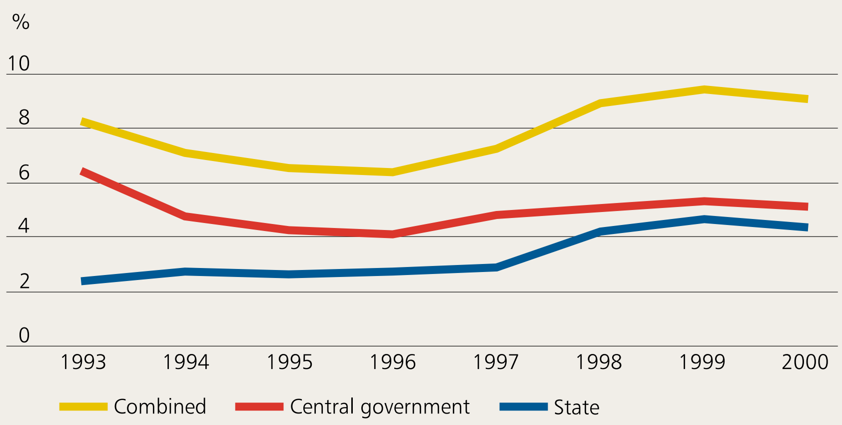
MACROECONOMIC ASSESSMENT

GDP growth in 2001 is estimated at 5.4%, somewhat stronger than the 4% in 2000 but below the 6.5% average of the previous 5 years. Several factors prevented the economy from achieving growth rates comparable with those of the mid-1990s. The global economic slowdown impacted negatively on exports, which contracted after growing at double-digit rates in 2000. Domestic demand growth remained weak, despite some strengthening in 2001, partly reflecting poor performance in the agriculture sector in 1999 and 2000. These two elements, plus a perception among the business community of slow progress in reforms, eroded business confidence and slowed the pace of growth in fixed investment.

Due to relatively favorable weather conditions, the performance of agriculture is projected to have improved significantly to 5.7% growth in 2001 after a contraction of 0.2% in 2000. This raises expectations of a possible demand-led pickup in economic performance, fueled by higher rural incomes. However, prospects for a continued sustainable agricultural improvement over the medium term depend on investment both to ease infrastructure bottlenecks (irrigation and rural electrification, in particular) and to modernize the sector.

As export demand shrank in 2001, industrial growth slowed significantly. In the first 9 months of the year, the index of industrial production rose by 2.3% compared with 5.1% in the comparable period in 2000. Manufacturing, accounting for the bulk of industrial output, expanded by a mere 2.3% in both the first and second quarters of 2001 after showing growth of 8.1% and 7.1%, respectively, in the corresponding quarters in 2000. However, moderate signs of improvement in growth momentum were evident from the second quarter of 2001 in other subsectors, such as electricity, gas, water supply, and construction. Industrial growth for the whole of

FIGURE 2.16 **Gross Fiscal Deficit as a Proportion of GDP, India, 1993-2000**



Sources: Ministry of Finance, *Union Budget 2002-2003*; Reserve Bank of India, *Finance of State Government 2000-2001*; Reserve Bank of India, *RBI Bulletin* (various issues).

2001 refers to fiscal year 2001/02, ending 31 March.

TABLE 2.15 Major Economic Indicators, India, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth[a]	6.1	4.0	5.4[b]	6.0	6.8
Gross domestic investment/GDP	24.3	24.0	24.0	24.5	24.9
Gross domestic savings/GDP	23.2	23.4	23.0	23.6	23.8
Inflation rate (wholesale price index)	3.3	7.2	4.7	4.0	5.0
Money supply (M3) growth	14.6	16.7	11.2	14.0	15.0
Fiscal balance/GDP	-5.4	-5.7	-5.7[c]	-5.3[d]	-4.8
Merchandise export growth	9.5	19.6	-1.0	11.0	14.0
Merchandise import growth	16.5	7.0	-0.9	13.0	14.5
Current account balance/GDP	-1.1	-0.6	-0.5	-1.0	-1.5
Debt/GDP	22.2	22.3	22.0	21.0	20.0

[a] Based on constant 1993/94 factor cost. [b] Advance estimate by the Government of India.
[c] Revised estimate by the Government of India. [d] Budget estimate.

Sources: Central Statistical Organisation, *National Accounts Statistics 2001*; Ministry of Finance, *Union Budget 2002–2003*; Reserve Bank of India, *RBI Annual Report 2000–01*; Reserve Bank of India, 2002, *RBI Bulletin,* February; staff estimates.

Stronger agricultural performance is likely to have improved rural labor market conditions and helped reduce poverty.

2001 is estimated at around 3.3%, the lowest rate in 5 years.

The performance of the services sector improved moderately in 2001, but fell short of the outstanding growth rates recorded in the 1990s. The sector recorded year-on-year increases of 6.7% and 7.4% in the first two quarters of 2001, respectively, with the figure for the whole year estimated at 6.5%. This represents a substantial improvement over 2000's 4.8% growth rate and reflects more robust performance in the financial and business services segment, particularly the key ICT and software services sector, which, after growing by a disappointing 2.9% in 2000, expanded by 25% during the third quarter of 2001 compared with the same quarter in 2000.

During 1992–2000, employment growth in the organized private sector averaged 1.3% a year compared with 0.2% in the public sector. In 2000, employment in these sectors rose by 0.6% and 0.5%, respectively. The largest contribution to employment generation is likely to have come from the informal sector, for which data are not available. Stronger agricultural performance is likely to have improved rural labor market conditions somewhat and helped reduce poverty (Box 2.3), while slower growth in industry and a retrenchment in the public sector have likely resulted in a deterioration of labor market conditions in the urban sector (though data are not yet available for 2001).

A low inflation environment accompanied a modest improvement in domestic demand. The annual average inflation rate measured in terms of the wholesale price index (WPI) declined from 7.2% in 2000 to 4.7% in 2001. The drop in WPI inflation stemmed from lower fuel and power prices. However, inflation, as measured by year-on-year variations in the consumer price index for industrial workers, was higher in December 2001 than a year earlier. This resulted from increases in prices of some primary articles, such as fruits and vegetables. However, as long as prospects of agricultural growth are positive, inflation should stay within moderate levels.

In terms of fiscal performance, falling imports and slowing industry hurt central government tax collections, which were down by about 8% through the first 9 months of 2001 relative to the previous year. Overall, revenues, budgeted to increase by 21%, were at about the same level as in 2000 through December 2001 because of better than expected nontax revenues. In order to contain the fiscal deficit, the Government took steps to curtail nondefense expenditure growth, including reducing the size of the civil service through attrition and reductions in capital expenditures. Despite these measures, the central Government is likely to miss its fiscal deficit target of 4.7% of GDP with an actual deficit projected at 5.7%. However, with some improvement in fiscal performance at the state level, the com-

BOX 2.3 Socioeconomic Development and the *Approach Paper to the Tenth Five-Year Plan (2002–2007)*

Throughout postindependence planning experience spanning the last 50 years, policymakers have considered economic growth a tool to achieve the wide and equitable access of India's citizens to necessary economic and social resources. Results, however, have been mixed. While poverty and social indicators have improved, they have done so at a slower pace than in other developing countries originally in a comparable position (e.g., the PRC and the economies of East Asia and Southeast Asia). Also, within India, outcomes have diverged with some states—Gujarat, Goa, Kerala—achieving substantial progress and others—Bihar and Orissa—lagging behind.

Overall, data show that poverty has been reduced the most, and the most quickly, during periods of faster economic growth. For example, the post-1991 reform period, during which economic growth accelerated significantly, witnessed a relatively rapid drop in poverty incidence. Thanks to fairly strong economic growth in a conducive reform environment, India reached some important socioeconomic and development milestones during this period, including:

- a reduction of 10 percentage points in poverty incidence, from 36% in 1993 to 26% in 1999;
- a deceleration in population growth to 2% (for the first time in four decades); and
- an increase in literacy of 13% during the 1990s (to 65% in 2001).

The *Approach Paper to the Tenth Five-Year Plan (2002–2007)* sets an 8% GDP growth target for India over the plan period. Achieving this goal would contribute substantially to further reducing poverty in the subcontinent.

The *Approach Paper* also sets some explicit goals, both in terms of poverty reduction and of social development, which would, if achieved, enable India to contribute substantially to the realization of the Millennium Development Goals as outlined in the Millennium Declaration, which was adopted by 191 nations in September 2000. For India, this would mean:

- a reduction of the poverty ratio by 5 percentage points by 2007 from the current level;
- all children to be in school by 2003 and an increase in literacy rates to 75% by 2007;
- a reduction in gender gaps in literacy by at least 50% by 2007 from the current levels; and
- a reduction of the infant mortality rate to 45, and of the maternal mortality ratio to 2, per 1,000 live births by 2007.

If India is to achieve these development goals, public policy will need to actively address other aspects of human deprivation alongside a reduction in income poverty.

In particular, the historical declining trend of health and education expenditures as a proportion of total public expenditures will need to be reversed. Finally, issues of access of the disadvantaged—in particular the poorest of the poor and women—to key basic services and goods will need to be tackled with greater vigor.

bined government fiscal deficit may not worsen significantly.

The central Government's lack of progress in reducing its deficit meant more domestic borrowing. Through the first 8 months of 2001 (through November 2001), the market borrowings of the central Government reached Rs719.3 billion, or 93% of the budgeted Rs773.5 billion for the whole fiscal year. This large volume of government borrowing continued to impart an upward bias to the interest rate structure and to increase the complexity of monetary management.

Monetary and financial developments were characterized by relative stability. Nonfood bank credit decelerated considerably in the last quarter of 2000, mirroring the slowdown in economic activity. In the first 9 months of 2001, broad money (M3) growth slowed to 10.5% from 13.2% in the comparable period of the previous year. On an annual basis, M3 growth slowed to 11.2% from 16.7% in the previous year. Bank deposits surged in response to adverse developments in other segments of the financial market, presenting the banking sector with the challenge of deploying these resources in a context of low credit and investment demand. Financial markets experienced some turbulence due to a domestic stock market scandal in March 2001 and the September 11th events in the US, but recovered quickly. Mindful of maintaining price and interest rate stability, the Reserve Bank of India (RBI) took limited countercyclical action. In October 2001, it reduced the bank rate from 7.0% to 6.5%, its lowest level since May 1973. It also reduced the cash reserve ratio in a staggered manner down to 5.5% in December 2001.

Exceptionally strong export performance, together with moderate import growth and a stable capital account, underpinned the attainment of a balance-of-payments surplus in 2000. In contrast, export growth collapsed in 2001 because of the protracted global economic slowdown, while import shrinkage reflected sluggish industrial activity and a substantial easing in oil prices compared with 2000. The trade deficit is projected to record a moderate improvement for the whole of 2001, and the invisibles account is expected to maintain a surplus in line with the 2000 outcome. Overall, the current account deficit is likely to have narrowed slightly to remain less than 1% of GDP in 2001.

The capital account strengthened in the first 8 months of the year (April to November 2001), reflecting mainly an increase in foreign investment inflows: FDI increased by over 61% compared with the same period in 2000, to $2.4 billion from $1.5 billion. This surge can be explained by the delisting of many foreign companies on the Indian bourses, as the money brought in by foreign companies for the purposes of delisting is considered as FDI. In light of these developments, the balance of payments is expected to register a moderate surplus for the sixth consecutive year in 2001.

Proposed finance sector reforms include establishing a pilot asset reconstruction company, allowing foreign banks to establish subsidiaries in India, and reforming pensions.

India's external debt position is expected to remain manageable in 2001. As of September 2001, external debt rose marginally to $100.4 billion, a 2.1% increase from the previous quarter's figure of $98.3 billion. The debt service ratio declined from the peak level of 35.3% in 1990 to 17.1% in 2000 as the Government continued to pursue a prudent external debt management strategy. The external debt-to-GDP ratio dropped to 21% in September 2001 from 22.3% in 2000. By the end of September 2001, the share of short-term debt in total debt had declined to 2.8% from 3.2% in June and the ratio of short-term external debt to foreign exchange reserves had fallen to 2.8%.

POLICY DEVELOPMENTS

In the 2001 budget, the Government announced a comprehensive program of second-generation reforms aimed at fiscal consolidation. The 2002 budget seeks to build on this platform through a two-pronged approach comprising both revenue-generating measures, including a 5% surcharge on all taxpayers, and expenditure-management measures, such as containing growth in public sector employment and reducing subsidies. At the same time, the budget made significant provisions for investment in infrastructure. Consolidating on earlier initiatives such as the State Fiscal Reform Facility, the budget sought to encourage the states to move toward better fiscal management by linking financial assistance to progress in implementing reforms, particularly in the area of tariff adjustment. It also took some steps toward the creation of a nationwide integrated market for goods and services, by presenting a reform framework for the agriculture sector.

Proposed finance sector reforms include implementing measures to strengthen creditor rights, establishing a pilot asset reconstruction company, allowing foreign banks to establish subsidiaries in India, and reforming pensions. The budget also introduced implementing measures to link administered interest rates to the market interest rates on government securities of equal maturity, in a move that should bring down the overall level of interest rates in the economy. With respect to capital markets, sector caps on portfolio investments made by foreign institutional investors were eased. India's economic prospects depend largely on the extent to which the Government will succeed in implementing these reforms, and particularly on its ability to achieve fiscal adjustment. They will also depend on the enactment of reforms to eliminate existing distortions in the factor market, including the reform of labor laws, as earlier recommended by the Council of Economic Advisors.

While there was some success in addressing fiscal problems in 2000, the deterioration of the fiscal situation in 2001 is a cause for concern. Large fiscal deficits are a chronic condition in India (Figure 2.16) and the cumulative debt burden of central and state governments is substantial. The fiscal situation has clear implications for the performance of the economy and for overall development. The Fiscal Responsibility and Budget Management Bill, under discussion in Parliament, contains a medium-term program of fiscal discipline, which would allow the debt path to converge toward a more sustainable trajectory.

The quality of fiscal deficits has been worsening. The large component of relatively rigid current expenditures—interest payments, subsidies, and public sector salaries and pensions—has risen over time and now accounts for a disproportionately large portion of the gross fiscal deficits at both the central and state levels. As a consequence, there is little money left for development and capital expenditures in physical and human infrastructure. Rationalization of public expenditures is required, but fiscal correction will require stronger revenues and an improvement in the overall efficiency of the tax system as well. In this respect, it is regrettable that the date of one of the key measures, the introduction of VAT, originally planned for 1 April 2002, has now slipped to 2003.

The Government cannot cut fiscal deficits substantially without reducing public sector subsidies, a large share of which is accounted for, directly or indirectly, by public sector undertakings (PSUs). For example, some estimates indicate that power sector subsidies and losses alone are equivalent, on average, to 50% of the states' deficits. Clearly, reforming PSUs and embracing decisively a disinvestment and privatization program would go a long way toward improving fiscal performance. In the context of the states' fiscal reform facility (2000–2004), power sector reforms are a key component of the states' medium-term fiscal reform programs and are included in memorandums of understanding between the central and state governments.

However, progress in disinvestment and privatization has been limited, for two main reasons. First, political economy factors tend to delay the process of PSU reform and results have been slow. Of a targeted disinvestment of Rs100 billion in 2000, only Rs25 billion were realized, while a similar outcome appears likely for 2001. However, the elevation of the Minister of Disinvestment to a cabinet position in October 2001 suggests greater government commitment.

Second, the economy will need the private sector to step in as the Government moves out of certain critical areas. A substantial share of private sector resources will need to come from outside the country. However, as the Enron-Dabhol case shows, the path to successful project implementation based on FDI is fraught with risk. Here, again, the precarious state of public finances, particularly at the state level, plays a role in the dynamics related to specific deals. But fiscal profligacy is also among the factors that contribute to creating an overall investment climate that is not conducive to FDI or to private investment in general. A recent study by the Confederation of Indian Industries and the World Bank found that significant disadvantages in power costs, interest rates, customs delays, infrastructure bottlenecks, and regulatory encumbrances far outweighed the marginal advantage that the economy has in terms of value added per unit of labor cost vis-à-vis other emerging economies.

Increasing the operational efficiency and transparency of the finance sector is also important to the creation of a supportive investment climate. To respond to concerns about the vulnerability of the sector, the financial reforms in 2001 continued to focus on strengthening both banking and nonbanking sector prudential standards. This meant upgrading norms for capital adequacy, income recognition, provisioning for nonperforming assets (NPAs), disclosure and transparency in accounting, and risk management. Specific proposals included new prudential norms for cooperative banks on lending against shares and on access to call money, and an apex supervisory body for the urban cooperative banking sector. RBI examined possible measures to strengthen the supervisory role of the boards of banks and of other financial institutions. Reforms also aimed at developing or strengthening linkages among the various segments of the financial market and at upgrading market practices and technologies. Guidelines were introduced in October 2001 for conversion of commercial paper from physical into dematerialized form. Steps were taken to develop government securities markets further, including measures to facilitate the availability of treasury bonds of varying maturities in the secondary markets, and the introduction of a negotiated dealing system. The amendment of the Securities Contract (Regulation) Act of 1956 better defined the supervisory and regulatory role of RBI with respect to government, money market, and gold-related securities, and related derivatives transactions.

The overhang of NPAs remained a factor in structurally high intermediation costs in the banking and nonbanking sectors, and, together with the high cost of funds and noninterest operating expenses, somewhat limited the downward flexibility of interest rates and, therefore, the effectiveness of monetary policy. Over the period 1996–2000, average gross NPAs as a share of total assets were 6.6% for public sector banks, 4% for private sector banks, and 2.9% for foreign banks. RBI is now moving toward the adoption of international norms for classifying loans as performing and nonperforming by 2004. RBI issued new guidelines for the recovery of NPAs in 2000, which were operative until June 2001. Under these guidelines, public sector banks recovered Rs22 billion. In addition, banks were mandated to include the risk-weighted assets of their subsidiaries in their consolidated balance sheets on a notional basis and to make adequate provisions.

The Government cannot cut fiscal deficits substantially without reducing public sector subsidies, a large share of which is accounted for by public sector undertakings.

As the economy approaches full capacity utilization and investment demand recovers, structural impediments may become binding constraints.

The limits of bank exposure to individual or group borrowers and to capital markets were made more conservative. Prudential norms introduced for banks were, in many cases, extended to nonbank financial institutions as well, in the context of a move toward the consolidated supervision of the whole finance sector. New norms were set for entry of new private sector banks and for eligibility criteria of banks and nonbank financial institutions to enter the insurance business.

The strengthening of prudential and disclosure norms and of supervision remained a major plank of the capital market reforms. Following turbulence in the equity markets in March 2001, a series of capital market reforms was announced in May, including a code of conduct against insider trading.

OUTLOOK FOR 2002–2003

During 2002, a moderate pickup in domestic demand as well as a rebound in global markets should provide sufficient stimulus for India's economy to grow at around 6%. Export growth in particular, should return to a double-digit rate, even though it is unlikely to reach the exceptional level of 2000. The current account deficit is expected to remain moderate, under the assumption of fairly stable oil prices, at around 1% of GDP. On account of substantially unutilized industrial capacity, industry sector activity will be able to respond quickly to the increase in demand, without undue inflationary pressure in the short term. Downward pressures on the price level may, in fact, be accentuated by the availability of cheap imports, provided that the positive impact of the removal of quantitative restrictions in compliance with WTO obligations is not offset by other forms of protection. With a stable rupee around the current level of Rs48 to the dollar, inflation is forecast at about 4% in 2002.

However, as the economy approaches full capacity utilization in 2003, and as investment demand recovers, structural impediments, such as high fiscal deficits and high real interest costs, may become binding constraints to economic performance if they are not dealt with. Assuming that visible and effective interventions are made both to address the structural fiscal deficits and to facilitate a further reduction in interest rates, the economy will grow at 6.5–7% in 2003. This requires a solid performance in the agriculture sector, as supported by the effects of reform and modernization. The projected improvement in growth performance also rests on the assumption of continued industrial recovery and strong services sector performance, in a favorable external demand environment. Inflation should still be moderate at around 5%, with the current account deficit in the range of 1–2% of GDP, to the extent that high export growth largely offsets an increase in imports.

Further liberalization of FDI may be required, but for Indian producers to compete effectively with foreign producers both at home and abroad, restrictions on key entrepreneurial decisions concerning scale and factors of production need to be removed. These include small-scale industry reservations that preempt the adoption of the optimal scale of production, and archaic labor laws that substantially hinder the ability of producers to retrench and restructure their businesses when market conditions require them to do this. Only if these necessary policy actions are undertaken can the higher projected growth rate of 2003 be taken as an indicator that the economy is moving onto a higher and sustainable growth path.

MALDIVES

The economy came under stress after the September 11th events, due to a fall in tourist numbers. The prospects are for continued weak performance in 2002 and beyond. Progress in accelerating growth will depend to some extent on developments in the global economy and on security conditions in South Asia.

MACROECONOMIC ASSESSMENT

The economy performed quite well during the first 8 months of 2001. However, particularly after the events of September 11th, it faltered, with the result that full-year growth fell from 4.6% in 2000 to 2.1%. Tourism—which accounts for more than one third of GDP and is the largest source of foreign exchange earnings—stagnated, due primarily to concerns over travel safety, as well as to declines in global consumer spending and confidence. In October and November 2001, tourist arrivals dropped off by 20.1% and 22.2%, respectively, compared with the corresponding months in the previous year (Figure 2.23). Overall, the tourism sector, which had shown annual growth of about 6% in recent years, declined by 0.5% in 2001. The downturn of the sector had spillover effects on the rest of the economy. Wholesale and retail trade contracted by 0.4% during the year. Transport and communications, the second largest sector, grew fairly strongly at 6.3%, but even this was significantly lower than the double-digit annual rates in 1996–1999. Other sectors, including fisheries, financial and business services, real estate, and retail trade, were weak, growing at 1% or less.

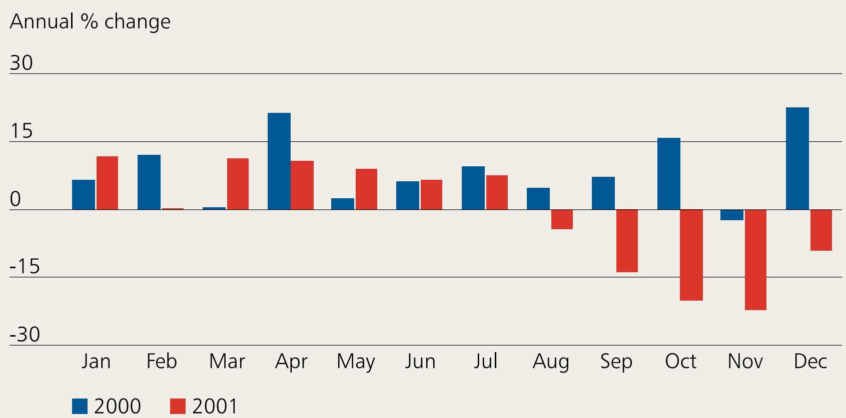
The fiscal deficit widened from 4.9% in 2000 to 5.3% in 2001, largely due to a rise in government expenditures to 41.3% of GDP from 40.8% in 2000. Monetary policy was more expansionary than in 2000, with money supply growth rising to 9% in 2001 from 4.1%. However, the consumer price index rose by only 0.7%, reflecting the sluggish economic performance.

On the external front, the trade deficit, already at over 40% of GDP, deteriorated by 3.6% from $233.3 million in 2000 to $242 million in 2001. The current account deficit worsened to $62 million, or 10.9% of GDP, in 2001 from $53 million, or 9.5% of GDP, in the previous year. Net nonmonetary capital inflows in 2001 amounted to $36 million, a 20% decline from the 2000 level. While inflows of official assistance increased, private capital inflows and net errors and omissions declined. In aggregate, the balance-of-payments deficit surged to $26 million in 2001 from $7.9 million in 2000. Foreign exchange reserves declined to $94.3 million at the end of 2001, sufficient to cover 2.9 months of imports.

POLICY DEVELOPMENTS

The Government made some important economic policy changes in 2001. First,

FIGURE 2.17 **Tourist Arrivals, Maldives, 2000-2001**



Source: Ministry of Tourism.

The health of the tourism sector will depend on recovery in the EU and Japanese economies.

the rufiyaa, pegged to the dollar under a de facto fixed exchange rate policy, was devalued on 25 July 2001 by 8% to Rf12.80 to the dollar from Rf11.77. A major reason for the devaluation was to respond to accumulated stresses in the foreign exchange market, including a premium of about 10% in the parallel market over the official exchange rate, a decrease in foreign currency deposits, and undue delays in traders obtaining foreign exchange for international transactions. The devaluation successfully eased pressure on the rufiyaa, resulting in the elimination of the parallel market.

Second, the Maldives Monetary Authority further liberalized financial markets, through measures such as the withdrawal in July of the bank-specific credit ceiling that was imposed on banks in 1995; the introduction in August of a Lombard facility (an emergency facility to provide liquidity in the interbank market) for commercial banks; and the elimination, also in August, of the 7 percentage point maximum spread between the rufiyaa deposit and lending rates.

OUTLOOK FOR 2002–2003

In view of the slow growth in the global economy, especially in the main tourism markets after the September 11th events, the Government's earlier projected 6% growth rate of GDP for 2002 is unrealistic. The health of the tourism sector will depend on recovery in the EU and Japanese economies, which are the major markets for Maldives tourism, and on an improvement in the security situation in South Asia. The tourism sector is unlikely to fully recover in 2002, though it has made some headway in the early months of the year. Initial projections indicate GDP growth this year of around 2%, with some upside potential, and inflation at around 1%.

The Government's budget for 2002, approved by the People's Majlis (or Parliament), was developed with balancing in mind, through streamlining nonurgent expenditures in light of an expected government revenue constraint stemming from a shortfall in tourism tax receipts.

On the external account, the services balance will weaken due to lower receipts from tourism, contributing to a worsening of the current account. However, a significant increase in the disbursement of official assistance is expected, which will help offset the weakening current account. Therefore, while tourism will remain under pressure in 2002, an immediate and acute deterioration of the balance of payments or the foreign exchange reserves is not currently foreseen. However, a close monitoring of the situation is warranted.

The recent completion of the Government's Sixth National Development Plan should facilitate the process of poverty reduction, though an immediate reduction in the numbers of poor people may be difficult because of slow economic growth. For the long run, government initiatives to reduce poverty include establishing regional growth centers on the key atolls, promoting electrification on the outer islands, expanding education in the atolls, and developing SMEs. These measures are expected to have a significant impact on improving living conditions on the atolls and on reducing regional disparities between Male and the atolls.

NEPAL

Overall economic performance remained generally favorable in 2001, though the economy experienced a sharp downturn in the first part of 2002 following both internal and external shocks, including the deaths of members of the royal family in June 2001 and a rise in insurgency. The outlook for 2002 has been further clouded by the impact of the September 11th events in the US.

MACROECONOMIC ASSESSMENT

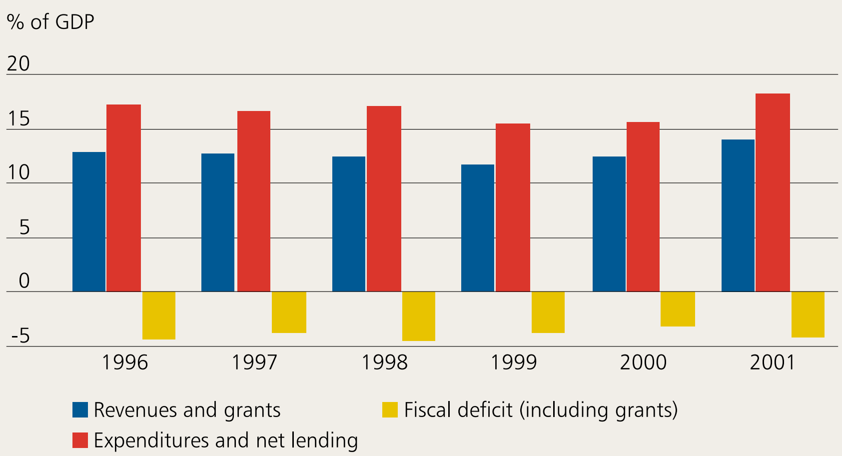
GDP growth slowed to 5% in 2001 from 6.1% in 2000, mainly because of agriculture's slightly weaker performance after an exceptional year in 2000, a sharp deceleration in manufacturing, and continued weakness in tourism. Agricultural output slowed to 4% growth in 2001 from 5% in 2000, while industry sector growth fell to 2.5% from over 8% during the same period. Tourism-related services were hit by the escalating insurgency and the shocking circumstances surrounding the deaths of members of the royal family. These factors contributed to a 21% drop in tourist arrivals by air during the year. Labor market conditions, characterized in 1999/2000 by a 47% underemployment rate and a 7% urban unemployment rate, likely deteriorated somewhat in 2001, given the slowing pace of urban expansion and the rapid enlargement of the labor force.

The budget deficit widened to 4.2% of GDP in 2001 from 3.3% in 2000 (Figure 2.18). Domestic revenue collections recorded a 16% gain due to improved tax administration. However, this was more than offset by a 26% rise in expenditures, resulting mainly from higher spending on security, a salary increase for civil servants, and the implementation of a voluntary early retirement scheme.

Broad money supply (M2) showed slower growth of 14.9% in 2001, down from 21.8% in 2000; a sharp slowdown in the rise of net foreign assets was a key factor. Because of the exchange rate peg to the Indian rupee and the active trade across the relatively open border between the two countries, inflation in Nepal generally tracks India's. It was low at 2.4% in 2001—the lowest rate in more than 20 years—compared with 3.5% in the previous year. Increased agricultural production, due to a balanced monsoon, kept prices of food items in check and helped counteract rising prices in the nonfood and services group, including fuel, power, water, and education.

Growth in merchandise exports fell sharply to 3.7% in 2001 from the substantial rate of 42% in 2000. Most of the decline was due to the sharp drop in the

FIGURE 2.18 **Government Revenues, Expenditures, and Fiscal Deficit, Nepal, 1996-2001**



Source: Ministry of Finance, *Economic Survey 2001*.

2001 refers to fiscal year 2000/01, ending 15 July.

TABLE 2.16 Major Economic Indicators, Nepal, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth[a]	4.4	6.1	5.0	3.5	5.0
Gross domestic investment/GDP	20.5	23.3	24.4	22.0	22.0
Gross domestic savings[b]/GDP	13.8	15.0	16.0	13.0	13.0
Inflation rate (consumer price index)	11.3	3.5	2.4	5.0	5.0
Money supply (M2) growth	20.8	21.8	14.9	12.0	12.0
Fiscal balance/GDP[c]	-3.9	-3.3	-4.2	-6.0	-6.0
Merchandise export growth	18.2	42.4	3.7	5.0	10.0
Merchandise import growth	-10.3	20.2	-0.9	5.0	5.0
Current account balance/GDP	-3.3	-4.5	-4.4	-5.0	-5.0
Debt service ratio	6.1	5.9	3.9	5.5	5.5

[a] Constant 1984/85 factor cost. [b] Data on savings were derived as a residual. [c] Includes grants.

Sources: Central Bureau of Statistics; Nepal Rastra Bank; staff estimates.

Further development of the market for government securities is required to break the link between budget deficits and monetary expansion.

growth rate of exports of ready-made garments and woolen carpets. Imports, meanwhile, declined by nearly 1%, following expansion of 20% in 2000. The poor import performance reflected a deceleration of growth in manufactured imports. The current account deficit remained at 4.4% of GDP in 2001. While net services receipts continued to fall that year, this was offset by an increase in net transfers, mainly due to rising remittances from overseas workers.

At the end of 2001, foreign exchange reserves amounted to $1 billion, or sufficient to cover more than 7 months of imports of goods and services. Dependence on foreign assistance became more pronounced in 2001, with foreign grants and loans financing 58% of development expenditures, a sharp increase from the 47% level of the previous 5 years. External debt as a proportion of GDP declined to less than 47%. The debt service ratio also fell and, due to the concessional nature of Nepal's external debt, was at a manageable 3.9% of exports in 2001.

POLICY DEVELOPMENTS

Although the 2002 budget is not as ambitious as 2001's, it is still expansionary, with a total outlay of NRs90.1 billion, representing an increase of 22% over an estimated NRs74 billion in the previous year. The budget calls for a 27% increase in development expenditures to be financed in greater part by grant assistance. Nevertheless, the budgetary target will be very difficult to achieve.

While the Middle Marshyangi hydropower project and the Melamchi water supply project entail a high level of investment and resource transfers, development spending is likely to be severely curtailed due to increasing expenditures on security operations and the adverse impact of the insurgency on development projects and programs. The Government has recently indicated that about 25% of the 2002 development budget will be reallocated to additional security expenditures. Estimates for domestic revenues in the 2002 budget, with a projected growth rate of 22%, also appear optimistic, given the sharp downturn in the main tax sources of manufacturing and services.

To support the central bank's efforts to control inflation and maintain the exchange rate peg, further development of the market for government securities is required to break the link between budget deficits and monetary expansion. Moreover, the Government needs to keep its overdraft with the central bank within prudent limits.

OUTLOOK FOR 2002–2003

The underlying assumptions of the following projections are that (i) the recent resurgence in domestic political unrest will stabilize somewhat, (ii) the global economic slowdown and the impact of the events of September 11th on the global economy will be modest and relatively short-lived, (iii) the Indian economy will grow at about

5.6% in 2002 and 6% in 2003, and (iv) the weather in Nepal and neighboring regions in India will be normal. On this basis, economic growth is projected to slow further to 3.5% in 2002, but to pick up to about 5% in 2003.

Growth in the agriculture sector may decline somewhat to about 3% because of the uneven monsoon from June to August 2001 in the Eastern Region, which will adversely impact agricultural growth in 2002. Growth in the industry sector may slightly increase to 3.5% in 2002, before further strengthening to 5.9% in 2003 as prospects for exports improve. The services sector is projected to decline sharply to 3.5% in 2002, but may strengthen in the following year to 5.5%, boosted by a recovery in tourism. In the absence of any external shocks to the economy, inflation is likely to be moderate over the next few years, and in 2002 and 2003 is projected at 5%, despite rising nonfood prices.

As a result of the anticipated sharp downturn in the economy in the early months of 2002 and the increase in security expenditures associated with the insurgency, the budget deficit in 2002 is likely to widen to 6%. Monetary policy will be geared to supporting the exchange rate peg with the Indian rupee. Continuing monetization of the economy will provide some leeway in monetary policy, but the 20% annual money supply growth rates in some recent years cannot be repeated without fueling inflation. Given projections for GDP growth and inflation, targets for broad money supply growth need to be in the range of 12–14% in the medium term.

While the recent renewal of the 1996 bilateral Trade and Transit Treaty with India in March 2002 has revived export prospects to India, the global economic slowdown will continue to undermine Nepal's exports. Among exports to other countries, garments, carpets, and *pashmina* shawls used to be strong, but exports of these products have sharply declined and will be further subject to a gradual removal of quotas in the US as part of WTO's Agreement on Textiles and Clothing. As a result, the trade and current account deficits should rise.

Continued efforts are required to mobilize domestic resources and reduce the fiscal deficit.

Historically, high population growth rates and low economic growth rates have limited progress in poverty reduction. To achieve the level of growth necessary to reduce poverty in the country, Nepal needs to restore law and order. It must also accelerate the reforms that began in the early 1990s and were agreed on during the National Development Forum in 2000 to provide an environment conducive to private sector development.

Given the fiscal problem that the Government is now facing, public resource management reform is needed both to ensure macroeconomic stability and to effectively use the limited public resources. It will require major improvements in budget planning, in domestic and external resource management, and in expenditure management. These improvements should begin with redefining the role of the Government versus the private sector in the economy. Prioritization of development expenditures and civil service reform is also vital, while to reduce dependence on foreign assistance for the country's development expenditures, continued efforts are required to mobilize domestic resources and reduce the fiscal deficit.

PAKISTAN

Economic growth slowed in 2001. A severe drought caused the agriculture sector to contract, though the rest of the economy registered strong expansion. The outlook for the medium term is for continued low growth, because of drought-induced weak agricultural performance and because industry will remain affected by weak external demand in a context of a slow improvement in the world economy and continued economic and political uncertainty.

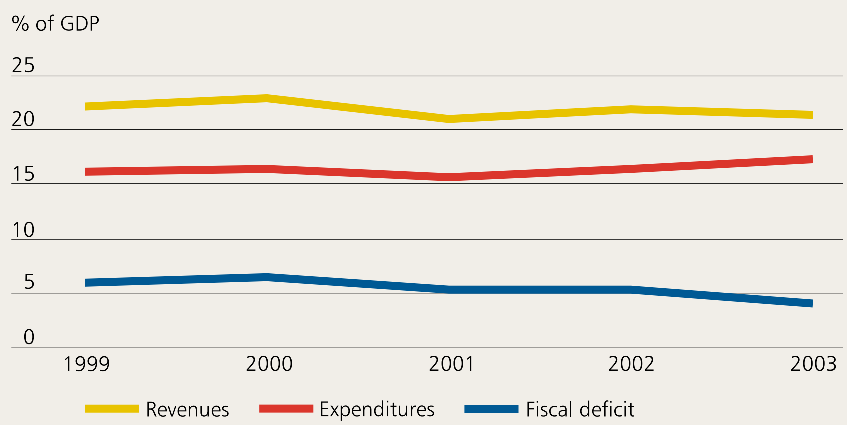
MACROECONOMIC ASSESSMENT

Economic growth in 2001 is estimated to have fallen to 2.6% from 3.9% in the previous year. This was primarily due to a drought-induced contraction in the agriculture sector, which posted a decline of 2.5% compared with growth of 6.1% in 2000. The output of major crops fell by 10.5%, the most significant drop since 1993. The drought also had adverse impacts on hydropower generation, while value added in the power and gas distribution sector declined by 3.1%. Overall, non-agriculture GDP growth improved slightly to 4.3% in 2001 from 3.1% in the previous year. The drought is estimated to have caused a loss of about 2% in national income.

The large-scale manufacturing sector grew by an impressive 7.8% in 2001, as against a 0.2% decline in 2000, because of strong external demand, in part arising from exchange rate depreciation. This was the highest rate of expansion since the 1980s, and was significantly higher than the annual sector average of 4% posted in the 1990s. The performance of all major industry groups was good in 2001, but some of the better growth rates were recorded in paper and board (24.9%), automobiles (23.3%), and petroleum (16.6%). Growth in the services sector declined marginally in 2001, to 4.4% from 4.8% in 2000. The decrease was due mainly to a slowdown in the finance and insurance subsector, as well as to a reduction in the growth rate of the public administration and defense subsector from 7% to 3% over the period.

Despite a moderate rise in public investment, total investment fell to 14.7% of GDP in 2001 from 15.6% in 2000, because of a fall in private investment. This can be attributed to a range of factors, including the short-term impact of an anticorruption campaign and changes in the foreign exchange regime that eliminated subsidies, and the persistence of excess capacity in key industries, such as cement, sugar, and power, which served to retard private investment in the industry sector.

FIGURE 2.19 **Government Revenues, Expenditures, and Fiscal Deficit, Pakistan, 1999-2003**



Source: International Monetary Fund, 2001, *Pakistan: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility (PRGF)*, Country Report 01/222, December.

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

TABLE 2.17 Major Economic Indicators, Pakistan, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth[a]	4.2	3.9	2.6	3.0	5.0
Gross domestic investment/GDP	15.6	15.6	14.7	15.2	16.2
Gross national savings/GDP	11.4	13.5	12.8	14.6	14.7
Inflation rate (consumer price index)	5.7	3.6	4.4	5.0	5.0
Money supply (M2) growth	6.2	9.4	9.0	9.1	—
Fiscal balance/GDP[b]	-6.1	-6.5	-5.3	-5.3	-4.1
Merchandise export growth	-10.7	8.8	9.0	-0.3	7.6
Merchandise import growth	-6.7	-0.1	5.9	0.2	6.2
Current account balance/GDP[c]	-4.1	-1.9	-0.9	-3.6	-3.1
Debt service ratio	41.2	38.4	32.1	32.0	28.1

— Not available.
[a] Based on constant 1980/81 factor cost. [b] Excludes grants. [c] Excludes official transfers.

Sources: International Monetary Fund, 2001, *Pakistan: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility (PRGF),* Country Report 01/222, December; State Bank of Pakistan, 2001, *Annual Report 2000–2001*.

National savings slipped from 13.5% of GDP in 2000 to 12.8% in 2001. Public savings showed exceptionally high growth, and their ratio to GDP increased to 1.2% in 2001, up from 0.3% in 2000. This improvement came about as a result of a decrease in the budget deficit and improved management of SOEs. However, private savings declined by an estimated 6.5% from the 2000 level, falling to 11.5% of GDP. The continuing low levels of private savings are the result of various factors, including a high dependency ratio, low and fluctuating growth rates of per capita income, and low investment returns. Corporate savings also moved lower in 2001, partly due to high cotton prices, which reduced profit margins in the textile sector.

The annual population growth rate in Pakistan is estimated to be 2.2%, while the labor force is estimated to be growing at 2.4% a year. The unemployment rate (among those aged 10 and above) was 7.8% in 2000—6.1% for men and 17.3% for women—but underemployment is likely to be pervasive. In general, the economy's absorptive capacity is estimated to have declined over the last few years, given low GDP growth of an average of 3.6% during 1999–2001, and increasing capital intensity in the commodity-producing sectors. Unemployment is estimated to rise by an average of 0.5 million every year.

The fiscal deficit fell from 6.5% of GDP in 2000 to 5.3% in 2001, the lowest level in 23 years (Figure 2.19). This decrease is entirely due to the Government's reduction in public expenditures to meet its fiscal target under an IMF standby arrangement. Public revenues edged down from 16.5% of GDP in 2000 to 15.7% in 2001 because of weak tax collections. The composition of deficit financing marked a significant shift from domestic to external sources in 2001, with the proportion of funding from external sources more than doubling to 69% of the total deficit, from 33% in 2000. This was a result of higher inflows from international financial institutions.

The continuing low levels of private savings stem from a high dependency ratio, low and fluctuating growth rates of per capita income, and low investment returns.

Despite a slight rise to 4.4% in 2001 from 3.6% in 2000, inflation remained low. Contributory factors included low growth rates of the money supply (largely due to the decline in budgetary support) and lower international commodity prices. Weighted average lending rates were 13.1% in June 2001, down from 13.5% in June 2000. Real interest rates remained high, although they declined slightly from 9.9% in 2000 to 8.7% in 2001.

At the beginning of 2001, the State Bank of Pakistan (SBP) replaced the managed float exchange rate system with a market-based, free-float system. The currency subsequently came under speculative attack on several occasions during the year, and depreciated by 18.6% against the dollar. Because of the low rate of domestic inflation, this resulted in a real depreciation of over 10% in 2001, providing a much-

The response of the donor community to the country's increased economic vulnerability since September 11th has been positive.

needed boost to exports, which were close to $9 billion for the first time. Exports expanded by 9%, with eight out of the top 10 export items recording double-digit growth rates—particularly raw cotton, leather, and synthetic textiles. The trade deficit improved, from $1.4 billion in 2000 to $1.2 billion in 2001, as did the current account deficit, from $1.1 billion to $0.5 billion over the same period. If proceeds from the Saudi Oil Facility were to be categorized as official transfers, the current account deficit would, in fact, be a surplus of $331 million.

The improvement in the current account deficit came primarily from a reduction in the trade deficit, increased workers' remittances, and higher foreign exchange purchases by SBP on the open market, which show up in the current account under private transfers. Foreign exchange reserves rose to $3.2 billion by end-June 2001. Net public debt as a proportion of GDP increased to 95.4% in 2001. Public or publicly guaranteed external debt, valued at $32.8 billion, accounted for 58% of the total public debt and was equivalent to 55.1% of GDP. At the end of June 2001, the net present value of Pakistan's public external debt was estimated at about 260% of the value of exports of goods and services, far in excess of the commonly accepted benchmarks for sustainability, which fall in the range of 150–200%. After the debt rescheduling granted by the Paris Club in December 2001, however, this ratio fell to below 200%.

POLICY DEVELOPMENTS

The Government's attempts to rectify macroeconomic imbalances and stabilize the economy in 2001 were fairly successful, and the country's macroeconomic indicators showed significant improvement. Prudent fiscal and monetary policies succeeded in reducing the budget deficit significantly and in containing inflation. However, the reduction in the deficit was achieved at the expense of development spending, which in 2001 was at its lowest level ever recorded. Given the country's high and rising levels of poverty and its low level of human development, the Government should significantly increase development spending and focus on revenue enhancement, including reforms to improve revenue collection by broadening the tax base and strengthening tax administration. In addition, the authorities need to urgently improve the management of public sector financial resources and to stop the considerable drain of public resources to loss-incurring SOEs.

The structural changes in the exchange rate regime at the start of the year had implications for monetary policy, as SBP was forced to restrict the money supply and raise interest rates to defend the rupee against speculative attacks. SBP concentrated on reducing liquidity from the market in 2001, and replaced the system of predetermined open market operations with discretionary open market operations, depending on the prevailing conditions in the money market.

The Government continued with its structural reform agenda in 2001, including trade and tariff reforms (further reduction of the maximum tariff from 35% to 30% and of the number of tariff categories), finance sector reform (strengthening SBP and the Securities and Exchange Commission as well as deregulation of the insurance sector), and reform of public resources management (separation of government audit and accounts functions).

The response of the donor community to the country's increased economic vulnerability since September 11th has been positive. Pakistan's case for increased assistance was strengthened by its successful completion of a standby arrangement with IMF in September 2001. In addition, on 6 December the same year, IMF approved a 3-year arrangement for Pakistan under the Poverty Reduction and Growth Facility (PRGF), totaling about $1.32 billion.

The PRGF commits the Government to a number of performance criteria and indicative targets, including a reduction in the budget deficit to 3.2% of GDP by 2004, in addition to implementation of key sector- and governance-related reforms. The successful negotiation of the PRGF set the stage for negotiations with bilateral creditors for the long-term rescheduling of external public debt, and on 13 December, the Paris Club comprehensively restructured Pakistan's debt. The Government estimates that the Paris Club agreement will lead to cash-flow savings of $2.7 billion during the 3-year PRGF, with further significant savings in the following decade. International sanctions against Pakistan have been largely removed or suspended, and the country has received bilateral grant pledges of $1.16 billion. In addition, the EU has pledged to ensure increased market access to Pakistan's exporters through a combination of lower tariffs and higher quotas with a view to mitigating the fall in exports.

OUTLOOK FOR 2002–2003

Large-scale manufacturing grew at a rate of 2.9% in the first 6 months of 2002, compared with growth of 2% recorded in the corresponding period of the previous year. However, it is too early to comment on how manufacturing growth in 2002 will compare with 2001 given the high variability in production of agro-based industries due to seasonal fluctuations. When the sugar industry is excluded from the analysis, for example, growth in the first 6 months of 2002 was 3.8% compared with 6.7% in the first 6 months of 2001.

In the first half of 2002, exports registered a decline of 0.5% compared with the same period in the preceding year. Imports contracted by 9.6% over the period, with the major falls seen in food items (down by 36%) and petroleum and petroleum products (down by 26.7%). The trade deficit fell by more than half to $425.4 million during July–December 2001, from $921.7 million in the corresponding period of the previous year.

The value of the rupee appreciated by about 10% in October–December 2001 as a result of the US Government's announcement of its intention to monitor monetary transfers through informal channels, prompting a greater inflow of transfers through the banking system. This was reflected in the large increase in remittances through banks, to $982.3 million in the first half of 2001 from $609.2 million in the first half of the previous year. Foreign exchange reserves rose to $4.8 billion by end-January 2002—the highest level ever—as a consequence of the increase in remittances, higher inflows of foreign assistance, and purchases of hard currency by SBP in the interbank market to prevent the rupee from appreciating further. Revenue collections were adversely affected in the first half of 2002, mainly because of the decline in imports and slow growth in industrial production. Inflation registered 2.6% during this period compared with 4.9% in the corresponding period in 2001. This was primarily due to low food inflation and the decline in petroleum prices in the international market.

This review of the data from the first 6 months of 2002 suggests that GDP growth is likely to be only slightly higher for the whole year than it was in 2001. The short-term effects of the military action in Afghanistan on the balance of payments have been particularly adverse, as export orders were rescinded and shipping and insurance costs increased. Manufacturing has also been hit by the fall in export demand. The prevailing uncertainty led to a further deterioration in the investment climate, and effectively forestalled the proposed privatization of Pakistan Telecommunications Corporation. Growth in the agriculture sector is likely to remain slow as cotton and rice production is expected to be lower than last year due to pest attacks and an expected 51% shortfall in irrigation water. (The effects of the last 2 years' drought are persisting in that water flows from snowmelt remained low in the winter of 2001/02, and winter rainfall was lower than expected.) The GDP growth rate in 2002 is projected to be in the range of 2.5–3%. Also, in light of the adverse expenditure and revenue impacts of the post-September 11th events, the fiscal deficit in 2002 is expected to be at least 5.3% of GDP, if not higher.

The Government has had to face a number of policy challenges in the wake of the September 11th events. At the same time, Pakistan's support to the international community in the fight against terrorism has provided it with an immense opportunity. If the Government continues to follow sound macroeconomic policies and to implement the planned economic and governance reforms, it could fairly quickly achieve rapid and sustainable economic growth and poverty reduction. However, if increased aid flows are used to postpone the necessary reforms and macroeconomic developments, as happened in the 1980s, Pakistan will be unable to break out of the existing vicious circle of low growth and rising poverty.

The Government has an immense opportunity to fairly quickly achieve sustainable economic growth and poverty reduction.

SRI LANKA

After a year marred by security problems and the worst economic performance ever recorded—in which the currency peg was abandoned, inflation picked up, and foreign finance became scarce—Sri Lanka is poised for a modest private sector-led recovery in 2002. However, the new Government must provide a stable macroeconomic environment if the turnaround is to take on substance and sustain itself.

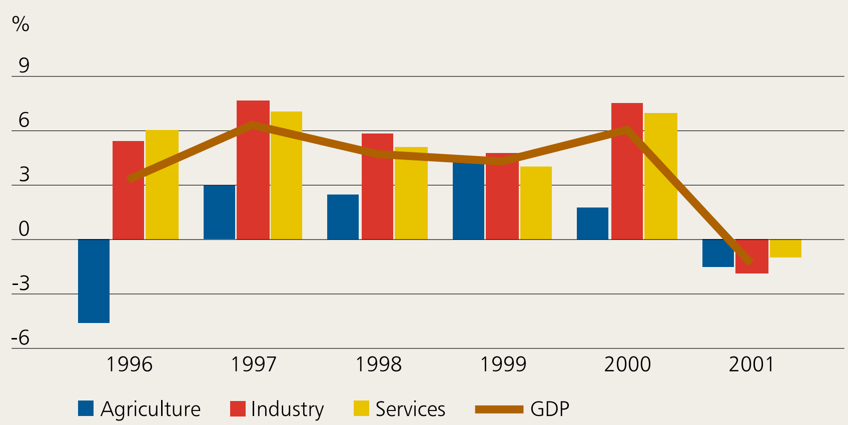
MACROECONOMIC ASSESSMENT

Sri Lanka's economy suffered a serious setback in 2001. In the first half of the year, GDP grew by less than 1% over the corresponding period in 2000. This poor performance was largely due to external factors, with the slowdown in global growth dampening demand for the country's manufactured exports, high oil prices increasing the costs of production and shipping, and a serious drought lowering agricultural yields and hydropower generation. On 24 July, the Liberation Tigers of Tamil Eelam (LTTE) attacked the country's only international airport. Consequently, tourist arrivals plummeted, while a hefty war-risk insurance surcharge on ships docking at the country's ports damaged the shipping industry, leading to a contraction of GDP in the second half of the year. Overall, real output declined by 1.3% for the year, the worst performance since the compilation of national accounts (Figure 2.20). This stands in marked contrast to the previous year when the economy achieved 6% growth. Early indicators suggest a rising level of unemployment, particularly in manufacturing and tourism-related services.

Savings and investment rates suffered, mainly due to actions in the public sector. The suspension of Parliament in July and its dissolution in October adversely affected the public investment program, as insufficient funds were available to support many ongoing projects, while the political instability was detrimental to private sector investment. The weak position of the Government also impeded commitments for new public sector projects, particularly those accompanied by strong sector reforms. The run-up to the December elections saw the Government approving a number of costly measures—such as increases in civil service allowances and cuts in taxes—that reduced public saving. Consequently, as a proportion of GDP, fixed capital investment fell from 28% in 2000 to 25.1% in 2001, while the savings rate remained at 17.3%.

Despite the Government's agreement with IMF to reduce the budget deficit, fiscal performance in 2001 was worse than in 2000. Current revenues remained at around 17% of GDP, even though the Government added a 40% surcharge to import duties and

FIGURE 2.20 **Aggregate and Sector Change in GDP, Sri Lanka, 1996-2001**



Sources: Central Bank of Sri Lanka, *Economic and Social Statistics of Sri Lanka;* Central Bank of Sri Lanka, *Annual Report 2000;* staff estimates.

TABLE 2.18 Major Economic Indicators, Sri Lanka, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth[a]	4.3	6.0	-1.3	3.5	5.5
Gross domestic investment/GDP	27.3	28.0	25.1	27.5	29.0
Gross domestic savings/GDP	19.5	17.3	17.3	17.5	18.0
Inflation rate (consumer price index)	5.9	1.2	11.0	8.5	6.0
Money supply (M2) growth	13.3	13.0	11.4	12.0	11.5
Fiscal balance/GDP	-6.9	-9.5	-10.0	-8.5	-7.5
Merchandise export growth	-3.9	19.8	-12.8	7.0	15.0
Merchandise import growth	1.5	22.4	-18.4	15.0	14.0
Current account balance/GDP	-3.6	-6.5	-3.4	-6.5	-7.5

[a] Based on constant 1996 factor cost.

Sources: Central Bank of Sri Lanka; Ministry of Finance; staff estimates.

increased the National Security Levy—a turnover tax applied to certain goods—by 1 percentage point for most of the year. Current expenditures continued to rise, to nearly 22% of GDP from 20.3% in 2000. This expansion in current spending was partly offset by poor performance in capital expenditures. The overall deficit, including grants and privatization proceeds, worsened from 9.5% of GDP in 2000 to 10% in 2001. When grants and privatization earnings are excluded, the deficit is in excess of 11% of GDP.

Receipts from privatization increased for the year, but this is due to the Government's receiving the second $25 million installment from Emirates Airlines for its stake in Sri Lankan Airlines in early 2001, rather than a reflection of progress in the privatization program. In fact, the budget had included the planned sale of a 20% stake in Sri Lanka Telecommunications that was expected to raise $250 million, but this did not push through due to globally depressed telecoms prices and the uncertain domestic political climate. Local events also adversely affected the Government's ability to attract foreign financing. The Government was preparing a syndicated loan of $200 million in the international market, but increased country risk following the LTTE airport attack prevented this deal from being concluded. Although a dollar-denominated development bond issue was floated at the end of the year, the financing of the overall gap was still heavily dependent on the issuance of domestic bonds and bank financing.

Growth in the money supply (M2) slowed in 2001 to 11.4% from 13% the year before. While the banking system raised its holdings of foreign assets, the bulk of the monetary expansion came from an increase in domestic credit. Due to the large fiscal deficit, domestic credit to the public sector rose by 14%. Following 2 years of reserve losses, and as it could no longer provide a defense against attacks on a fixed rate, the central bank floated the rupee in January 2001, when official reserves had fallen to $918 million, or only about 5 weeks of import cover. Although the exchange rate spiked immediately, the trend became less volatile, with the local currency depreciating by 16% over 2001.

Consumer prices rose by 11% in 2001, up from 1.2%, despite the drop in world oil prices toward the end of the year. The acceleration in inflation was driven by increases in key administered prices (diesel and power in particular) and the depreciation of the rupee, with poor weather also generating high domestic food prices. However, the continued high rate of monetary expansion paints a worrying picture for future inflation.

Sri Lanka's export performance paralleled the slowdown in the global economy. The country's largest source of foreign exchange, the textile and garment industry, experienced a drop in volume and earnings from May 2001, mainly due to lower demand from the US and EU. Tea exports, the country's third largest generator of foreign exchange, were affected by a drought in the first half of the year and a drop in international prices.

The country's largest source of foreign exchange, the textile and garment industry, experienced a drop in volume and earnings from May 2001, mainly due to lower demand from the US and EU.

Export earnings contracted by nearly 13%, from $5.5 billion in 2000 to $4.8 billion. The decline in imports was even more dramatic—from $7.3 billion to $5.9 billion—in part because the slowdown in exports reduced the demand for imported intermediate and investment goods. Consequently, the trade deficit narrowed to 7.5% of GDP from 11% in 2000. Although the tourism sector, the second largest source of foreign exchange, was on track for a record year, the LTTE attack caused tourist arrivals to plunge such that full-year tourism earnings fell by 15.5%. However, the initial tranche release of an IMF standby arrangement helped boost the level of official reserves to $1.3 billion, compared with $1 billion at the end of 2000, or about 2.7 months of import cover.

The most promising postelection development has been the ceasefire signed between the Government and the LTTE.

POLICY DEVELOPMENTS

To support the transition to a floating currency regime in January 2001 and to bolster official reserves, the Government negotiated a standby arrangement with IMF. Conditions for the support focused on the underlying factors placing pressure on the exchange rate, namely the fiscal deficit and losses of key SOEs.

The 2001 budget targeted a reduction in the overall deficit, excluding grants and privatization proceeds, to 8.5% of GDP from nearly 10% in the previous year. To reach this goal, expenditure growth generally was to be slowed and defense expenditures were to be reduced. Revenue measures included increases in customs duties and the National Security Levy as well as an ambitious target for privatization receipts. Although this target was agreed with IMF, the budget became a victim of politics in the latter part of the year. In the run-up to the elections, the Government instituted a series of costly measures, such as increasing public sector allowances, reducing administered prices, and regularizing temporary public employees. The cost of these measures in 2001 was around SLRs10 billion, or nearly 1% of GDP, but the bulk of the impact will be felt in future budgets. Moreover, the Government's inability to sell part of its holding in Sri Lanka Telecommunications left a large gap in its financing plan. As a result, the deficit actually increased from the 2000 level, violating the standby arrangement with IMF, which then put the arrangement on hold.

The elections brought in a new administration, led by the former opposition United National Party. Its platform is more pro-business than that of the other parties, and should therefore be a positive influence for reform in the areas of labor legislation, tax administration, and infrastructure investment. The most promising postelection development has been the ceasefire signed between the Government and the LTTE. Both parties are now working toward a negotiated settlement, with the Government of Norway acting as mediator.

OUTLOOK FOR 2002–2003

With improvements in the external environment, the economy is likely to turn around in the second half of 2002, but the key for the first half of the year is to stop the decline in macroeconomic performance and to focus on stability. Export production will continue to sag for the first half of 2002, as the country's main foreign markets emerge from the current economic downturn. The expected break in the drought should lead to improved performance in the agriculture and hydropower sectors. For the year, the recovery should be modest, with GDP expanding by 3.5%, and with potential for higher growth in 2003 if a stable macro environment is in place. While increases in some administered prices—notably power—will raise inflationary pressure, stable food and oil prices will mitigate the effect, bringing inflation down to 8.5%. The recent adoption of an automatic pricing formula for petroleum products means that price changes for such goods will evolve more smoothly over time.

Slower money supply growth is needed to contain inflation, a key factor in which is controlling the fiscal deficit, to eliminate pressure for monetary expansion to fill the financing gap. Lower interest rates and the current ceasefire will help keep recurrent expenditures in check, but for the sake of medium-term growth, public investment in basic infrastructure needs to be accelerated. While revenues will likely grow more slowly, the Government's commitment to privatization of SOEs will help bring the overall deficit down to 8.5% of GDP in 2002, which should fall further in 2003. A stable macroeconomic environment should attract higher rates of investment, leading to a widening of the current account deficit as capital import growth accelerates. The recovery in exports, which are forecast to grow by 7% in 2002, will be more than matched by import growth to support the higher investment rates.

Looking beyond the short-term stabilization issues, Sri Lanka needs to achieve high and sustainable rates of growth in per capita income to make substantial inroads in reducing poverty and to provide new jobs for entrants to the labor force. The private sector will need to take the lead in realizing more rapid economic expansion, with the Government providing an appropriate legal and regulatory environment. To this end, reforms in land and labor markets are needed to free the flow of these critical factors of production and to increase economic efficiency. Eliminating market distortions will also entail a reduction in the Government's direct involvement in commercial activities.

In the medium term, the Government needs to strive for a more commercial orientation in the remaining SOEs, reversing the losses in some cases and preparing the way for their eventual transition to private sector operations. The Government faces many challenges ahead, and it will need to prioritize its reform agenda to optimize the use of its scarce planning and management resources.

ASIAN DEVELOPMENT

Outlook 2002

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

Central Asian Republics

Azerbaijan
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

AZERBAIJAN

With improved performance in the non-oil sector, the economy maintained strong momentum in 2001, but overall GDP growth fell slightly as world oil prices declined. Growth prospects remain positive for 2002–2003 as major investments in the oil and gas sector are expected. Policy commitment to developing the non-oil sector through deepening structural reforms remains key to achieving sustained growth and poverty reduction.

MACROECONOMIC ASSESSMENT

GDP growth for 2001 is estimated at about 9.9%, a slight decrease from the 11.1% in 2000 (Figure 2.21). Agriculture increased by around 11% because of higher grain production resulting from an expansion in the area under cultivation. The oil and gas sector, the most important part of the economy and accounting for almost 30% of GDP, continued to grow only slowly, due mainly to a sluggish rise in production.

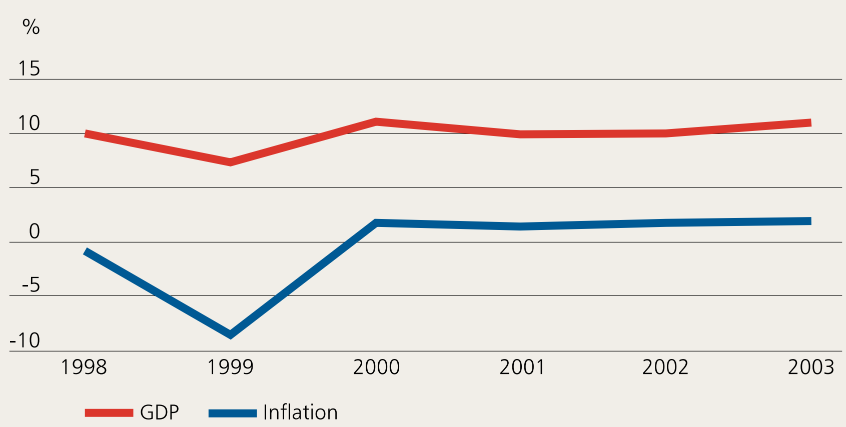
Domestic investment recovered in 2001. Preliminary data point to improved foreign investment. Foreign investment inflows (primarily in the oil and gas sector), which currently account for 56% of total gross domestic investment, are estimated to have climbed to about $700 million, or 13% of GDP, during the year. Despite strong economic growth and improved investment, there is no indication of improvement in the employment situation: unemployment is now estimated to have risen to 18%, because much of the economic growth has been in capital-intensive areas that create few jobs.

Government revenues (excluding the State Oil Fund), which rose in nominal terms on account of the strong GDP growth, still fell short of budget targets. As a result, revenues relative to GDP declined to 18% in 2001 from 18.6% in the previous year. Although government expenditures rose by 10% in nominal terms, the expenditure-to-GDP ratio fell to 20.1% from 20.8% in 2000. As a result, the fiscal deficit slightly improved from 2.2% of GDP in 2000 to 2.1% in 2001. Foreign capital remained the major source of deficit financing.

Broad money supply increased by 9.7% in 2001. Much of the increase was due to financial deepening, as total money supply, including foreign currency deposits, is currently only 12% of GDP. Annual inflation, measured by the consumer price index, remained modest at 1.5%. The exchange rate depreciated by 4.4% against the dollar to AZM4,748 by the end of the year.

Exports strengthened by 7.9% in 2001, lifted by strong oil exports. With falling imports, this resulted in an improved trade balance and a surplus equivalent to 9.6% of GDP. As a result, the current account deficit narrowed to 2.3% of GDP from 3.4%, despite

FIGURE 2.21 **GDP Growth and Inflation, Azerbaijan, 1998-2003**



Sources: Asian Development Bank *Country Strategy and Program Update (2002-2004)*; State Statistical Committee.

TABLE 2.19 Major Economic Indicators, Azerbaijan, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	7.4	11.1	9.9	10.0	11.0
Inflation rate (consumer price index)	-8.5	1.8	1.5	1.8	2.0
Money supply (M2) growth	15.2	18.3	9.7	—	—
Fiscal balance/GDP	-4.5	-2.2	-2.1	-2.0	-2.0
Merchandise export growth	51.5	83.6	7.9	—	—
Merchandise import growth	-16.6	7.5	-5.4	—	—
Current account balance/GDP	-13.1	-3.4	-2.3	-3.0	-5.0

— Not available.

Sources: Asian Development Bank, *Country Strategy and Program Update (2002–2004)*; State Statistical Committee.

The Government has demonstrated a renewed commitment to structural and institutional reform.

the growing deficit on the nonmerchandise account.

On the capital account, gross foreign investment recovered, mainly in the form of FDI in the oil and gas sector. Despite rising debt repayments and growing funds in the State Oil Fund, gross international reserves improved from $680 million in 2000 to $744 million at the end of 2001, or equivalent to about 5 months of non-oil imports of goods and services. Total public and public-guaranteed external debt rose from $1.16 billion in 2000 to about $1.27 billion in 2001, but as a proportion of GDP remained stable at 22%.

POLICY DEVELOPMENTS

A mix of a tight fiscal policy and a looser monetary stance was pursued in 2001. In view of the growing accumulation of spending arrears and worse than expected revenue performance, the fiscal deficit target of 2% of GDP was not met. The loosening of the monetary stance reflected the policy intention of supporting the development of the non-oil sector. But credit availability in this sector remained limited because of the underdeveloped banking sector and poor financial intermediation. The Government continued with its flexible exchange rate policy with the objective of maintaining currency stability and of supporting the non-oil sector.

The Government demonstrated a renewed commitment to structural and institutional reform, including the launching of a new privatization program and the streamlining of governnment organization. Preparation of a national program for poverty reduction, which emphasizes non-oil sector development, also began.

A new reform program—introduced with the assistance of IMF—aimed at deepening trade liberalization; promoting good governance, especially financial discipline in the energy sector; and improving the legal and regulatory environment for private sector development.

OUTLOOK FOR 2002–2003

The growth prospects for 2002–2003 are positive, provided that, as expected, oil investments increase and the world economy begins to recover in the second half of 2002. With agricultural performance likely to be stable, overall economic growth is forecast at around 10% in 2002 and 11% in 2003. Some major investment activities are expected to begin in 2002, which will help boost economic activity. They include the start of phase one of the full development of the Azeri-Chirag-Guneshi oil field and the construction of the Baku-Tbilisi-Erzurum gas pipeline. The inflation rate is expected to be fairly stable at 1.8% and 2.0% in 2002 and 2003, respectively.

The Government's current tight fiscal and looser monetary policy mix is expected to continue. However, a challenge for the Government is to increase much-needed social expenditures while keeping the fiscal deficit under control. Higher investment, which is closely associated with oil equipment imports, is expected to increase pressure on the current account, which is projected to swing to a deficit of 3% of GDP in 2002 and to 5% of GDP in 2003. To promote non-oil trade activities, the Government will likely allow a quicker depreciation of the manat. Debt service is expected to rise, reaching about 8.5% of exports of goods and services in 2003.

KAZAKHSTAN

Economic growth improved in 2001 to over 13%. Manufacturing performed well while production and exports of oil and other minerals were buoyed by high prices in the first three quarters of the year. However, the economy, dependent on a narrow range of exports, remains vulnerable to external factors. The medium-term outlook hinges on the pace of structural reform, economic diversification, and commodity prices, particularly those of oil.

MACROECONOMIC ASSESSMENT

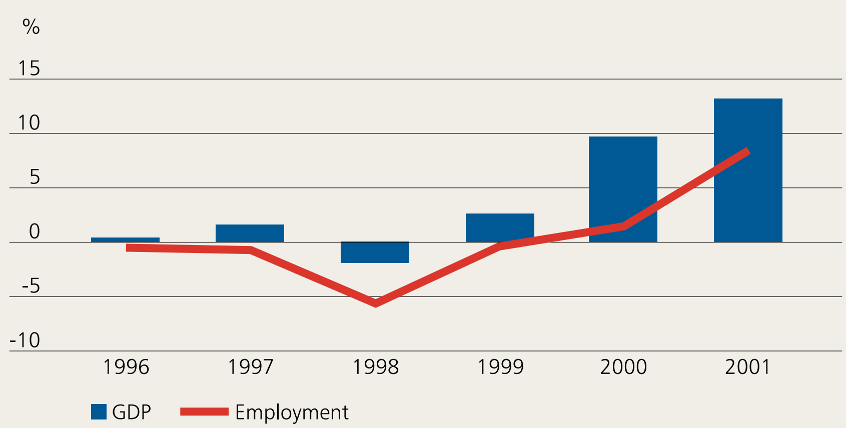
Economic performance in 2001 remained strong, with real GDP growth accelerating to 13.2% from 9.8% in 2000. Continued rapid growth was driven by buoyant world oil and other mineral prices (until the fourth quarter of 2001), robust regional demand for exports, and strong investment. The pace of growth, however, slowed to 11.7% in the fourth quarter from 16.6% in the second due to the softening of prices for oil and other minerals and uncertainty following the September 11th attacks in the US.

The easing of these prices was largely responsible for a slight deceleration in industrial output growth to 13.5% in 2001 from 15.5% in 2000. Manufacturing output rose by 14.8%, benefiting from strong regional demand for Kazakhstan's machinery, textile, leather, and chemical products. Agricultural output grew by 16.9%, compared with a contraction of 3.3% in 2000. Aided by good weather and an extension of the sown area, grain production increased by 37% to 15.9 million tons from 11.6 million tons in 2000. Cotton production rose by 45% in 2001, also partly because of an extension of the sown area. The services sector accelerated to 13.6% growth in 2001 from 9.3% in the previous year as private sector activities in wholesale and retail trade, hotels, restaurants, and housing continued to expand.

Capital investment remained strong, rising by 21%. More than half the total capital investment went to the oil and gas sector, followed by manufacturing, transport and communications, and construction. Major sources of capital investment were private domestic and foreign investment, which accounted for 58% and 30% of the total, respectively, while public investment made up the balance.

Rapid economic growth contributed to an improvement in the population's standard of living. Per capita income rose by over 10% relative to 2000. Average nominal monthly wages in 2001 were T17,258 (equivalent to $117), a 25.4% rise over the 2000 level. In real terms, average monthly wages went up by 9.5%. As a result, the share of the population living below the subsistence minimum of T4,637 (equivalent to $31 a month at the end of 2001) declined from

FIGURE 2.22 **Change in GDP and Employment, Kazakhstan, 1996-2001**



Source: Staff estimates.

TABLE 2.20 Major Economic Indicators, Kazakhstan, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	2.7	9.8	13.2	7.0	6.0
Gross domestic investment/GDP	17.8	17.9	23.0	16.9	16.8
Gross domestic savings/GDP	16.0	22.9	22.3	23.5	24.7
Inflation rate (consumer price index)	8.3	13.2	8.4	6.6	5.6
Money supply (M2) growth	84.4	44.9	40.2	27.0	22.4
Fiscal balance/GDP[b]	-3.5	-0.1	-0.6	-2.3	-2.0
Merchandise export growth	2.0	60.6	-3.5	11.6	5.2
Merchandise import growth	-15.3	21.3	23.5	11.7	15.3
Current account balance/GDP	-1.4	4.1	-4.6	-4.5	-4.7

[a] Annual average. [b] Fiscal balance for 2001–2003 includes transfers to the National Fund.

Source: Asian Development Bank Kazakhstan Resident Mission datafile.

The fiscal position remained stable, supported by continued growth as well as by enhanced tax collection and the expansion of the tax base.

31.8% in 2000 to 28% in 2001. The actual unemployment rate fell to 10.4% from 12.8% in 2000, but despite the decline, unemployment is still a major problem in rural areas and among women (Figure 2.22).

The fiscal position remained stable, supported by continued growth as well as by enhanced tax collection and the expansion of the tax base. Total government revenues rose to 24.2% of GDP from 22.6% in 2000, as a result of strong receipts from income and social insurance taxes and from VAT. Nontax revenues, accounting for roughly 10% of the total, rose by 88%, largely due to the rent paid by the Russian Federation for use of the Baikonur space complex. In contrast, capital revenues amounted to only 49% of the target due to slow progress in privatization. In line with total revenues, government expenditures increased to 24.7% of GDP from 23.1% in 2000. The Government raised spending for the social sectors and capital investment, which accounted for 46.4% and 11.5%, respectively, of total government expenditures. Overall, the budget deficit widened to 0.6% of GDP in 2001 from 0.1% in 2000, due to the sharp expansion of public spending and budgetary transfers to the National Fund. The transfers totalled 3% of GDP in 2001, and the Fund had accumulated nearly $1.24 billion by the end of 2001 (equivalent to 6% of GDP). The Fund was established in May 2001, both to reduce the volatility of budgetary revenues caused by fluctuations in world oil prices and to consolidate savings for future generations. Budgetary contributions to the Fund are made if the price of Kazakhstan oil exceeds $19 a barrel (or $23 a barrel for Brent crude).

The central bank followed a somewhat expansionary monetary policy, keeping pace with the liquidity demand of a rapidly expanding economy. The refinancing rate was reduced from 14% in 2000 to 9% in 2001, the lowest level since independence in 1991. This led to a cut of the average weighted interest for the corporate sector from 18.8% in 2000 to 16.3% at the end of 2001, and consequently a rise in commercial bank lending by 77.3% compared with the previous year. A capital amnesty, announced by the central bank in 2001 to encourage money illegally transferred to foreign banks to return to the country tax free, brought over $500 million back into the banking sector. As a result, money supply grew by 40.2% over the course of 2001, but the sterilization efforts of the central bank, continued monetization of the economy, and increased productivity helped keep inflation under control. Slower increases in the prices of nonfoodstuffs and services (4.5% and 3.5%, respectively) and a 15.5% decline in the price of gasoline contributed to lower inflation, which, as measured by the consumer price index, fell to 8.4% in 2001 from 13.2% in 2000. The tenge remained fairly stable in 2001, with a depreciation of 3.2% against the dollar in nominal terms.

Lower prices of oil and other minerals in the international markets, together with rapidly increasing imports, reduced the size of the trade surplus, which shrank to about 4% of GDP from 15.2% in 2000. Exports—almost 90% of which were oil and other minerals—declined by 3.5% in 2001 from the prior year level, while imports surged by 23.5%, mainly due to rising capital goods imports. As a result, the balance of payments suffered, with the current account recording a deficit equivalent to 4.6% of GDP. Nevertheless, the heavy presence of oil multinationals in the country ensured a steady inflow of FDI to cover the current account deficit. The sharp rise in gross FDI to $3.6 billion in 2001, contributed to an increase in the capital account surplus, from 5.6% of GDP to about 7% over the same period. International reserves of the central bank rose by 22% to $2.56 billion, while gross official reserves (including the National Fund) soared by 79% to $3.75 billion (equivalent to 4.2 months of imports of goods and services). Total public external debt continued to fall, from $4 billion (21.9% of GDP) in 2000 to $3.4 billion (16.6% of GDP) in 2001 due to limited new borrowing by the Government and its continued repayments of the outstanding external debt. The public debt service ratio declined to 17.3% from 24.6% in 2000.

POLICY DEVELOPMENTS

The Government continued its efforts in 2001 toward fiscal sustainability. A new tax code designed to broaden the tax base was approved by Parliament in June 2001 and became effective on 1 January 2002. A number of tax exemptions were abolished and fiscal stimulus was provided through a lowering of the social insurance tax and VAT rates. In April and November 2001, the Government revised the state budget and increased revenues and expenditures: revenues mainly as a result of improved tax collection and buoyant prices for the country's major exports; expenditures because of the Government's decision to clear wage and pension arrears accumulated from previous years.

As budget revenues remain sensitive to oil and other mineral prices, the Government needs to restore fiscal balance in the coming years by expanding the tax base through diversifying the economy and accelerating privatization. Despite the adoption of a new tax code, it needs to strengthen the tax and customs administration by introducing simplified declarations and completing the computerization of the system. In addition, it needs to enhance the administration of transfer pricing, rationalize public spending, and prioritize capital expenditures.

Monetary policy developments were encouraging in 2001. A decline in inflation allowed the central bank to cut the refinancing rate to 9%, below its target of 11%. As a result, the primary lending rates by commercial banks were reduced to the lowest level since independence. Because of sterilization of capital inflows, the central bank was able to maintain a relatively stable exchange rate and to avoid an overappreciation of the tenge, which could have had an adverse effect on the non-oil sector.

Finance sector reform continued, with a focus on strengthening the banking sector. A sound regulatory system and a fairly stable national currency are contributing to the stability of the banking system, while the deposit insurance system, banking secrecy, and confidentiality of the capital amnesty all helped increase household confidence in the system. As a result, public deposits rose to T185.5 billion (or $1,223 million), as against the 2001 target of T135 billion (or $890 million).

To provide long-term financing to the corporate sector, including SMEs, the Government established the Kazakhstan Development Bank in July 2001. The development of nonbank financial intermediaries continued, since pension funds account for almost 6% of GDP. However, little progress was made in relaxing strict regulations on pension fund investments and diversifying investment instruments. In view of the weak domestic stock market, investment regulations should be amended, allowing pension funds to invest some of their assets abroad.

The Government maintained its liberal trade policy, as accession to WTO remains a priority. Selected customs tariffs were abolished, and further simplification of the tariff system is expected.

As budget revenues remain sensitive to oil and other mineral prices, the Government needs to expand the tax base through diversifying the economy.

OUTLOOK FOR 2002–2003

The economic prospects for 2002–2003 remain positive, though GDP growth is expected to slow to 7% in 2002 and to 6% in 2003, mainly due to moderate world prices for oil and other minerals. However, the impact of low oil prices will be mitigated by the expected growth of oil production due to the recent opening of the Caspian Consortium Pipeline. In addition, a new pipeline linking the North Caspian oil field to this pipeline is to be completed by 2005. Therefore, the oil sector and continued FDI inflows to the development and exploitation of hydrocarbon resources will con-

Greater efforts are needed to raise the competitiveness of industry through accelerating privatization, restructuring or closing nonperforming enterprises, and improving the legal and business environment.

tinue to drive medium-term growth. Projected strong regional demand is also likely to boost GDP growth as the other economies in the Commonwealth of Independent States increase their imports of manufactured goods, including machinery, textile, and leather products.

A deterioration of the fiscal situation is expected in 2002–2003 as the Government will raise its budgetary spending to ensure a 25% increase in public sector wages and large external debt repayments in 2002 (mainly due to a $350 million eurobond redemption). Under the assumption that the oil price for Brent crude stays at $23 a barrel, the budget deficit is projected at 2.3% of GDP in 2002 and 2% of GDP in 2003. Nonetheless, if oil prices decline further, the National Fund will be able to provide some offset and support for the fiscal position. In 2002–2003, monetary policy should be expansionary in support of continued robust economic growth. The central bank has announced a medium-term monetary policy that focuses on inflation targeting rather than currency devaluation. It is likely to pursue a reserve money management regime to keep inflation in the 4–6% range in 2002–2003. Interest rates are expected to decline in line with the fall in inflation.

The trade balance is likely to remain positive over the next 2 years as oil production increases. Exports are expected to rise, reflecting an anticipated moderate global economic recovery in the second half of 2002. The current account deficit is projected to increase to about 5% of GDP in 2002–2003, as imports are likely to grow faster than exports. However, the expected increase in FDI inflows in the near term will likely cover the current account deficit. External public debt is projected to decrease, in view of the fact that the Government is committed to repaying its outstanding external debt and to limiting new external borrowing.

Despite recent achievements, the economy faces some major development challenges on two main fronts. On the first, limited economic diversification and high dependence on oil and other minerals make the country vulnerable to volatility in prices of these commodities. In addition, structural reforms have been very slow because privatization and restructuring of the corporate sector have been at a virtual standstill. Economic diversification is important for sustainable development. Equally, greater efforts are needed to raise the competitiveness of industry through accelerating the privatization process, restructuring or closing nonperforming enterprises, improving the legal and business environment, and building a system of good corporate governance. These measures will encourage greater investment in the non-extractive sector. On the second front, while projected strong growth is likely to further improve living standards, the Government needs to ensure that it benefits the whole population.

The Government is giving high priority to poverty reduction, and a comprehensive medium-term poverty reduction program for 2003–2007 will be developed by May this year. The realization of the Government's commitments to increase public sector wages and to introduce a mandatory social insurance system in 2003 will also contribute to enhanced living standards. However, additional efforts need to be made in addressing regional inequality, particularly in rural areas where poverty is more prevalent.

KYRGYZ REPUBLIC

The macroeconomic situation stabilized in 2001 as the Government pursued prudent fiscal and monetary policies and implemented key structural reforms. The recently concluded Paris Club meeting has addressed the short-term problems of debt burden and bunching of debt service payments. Long-term prospects depend on further debt rescheduling by bilateral creditors in 2004.

MACROECONOMIC ASSESSMENT

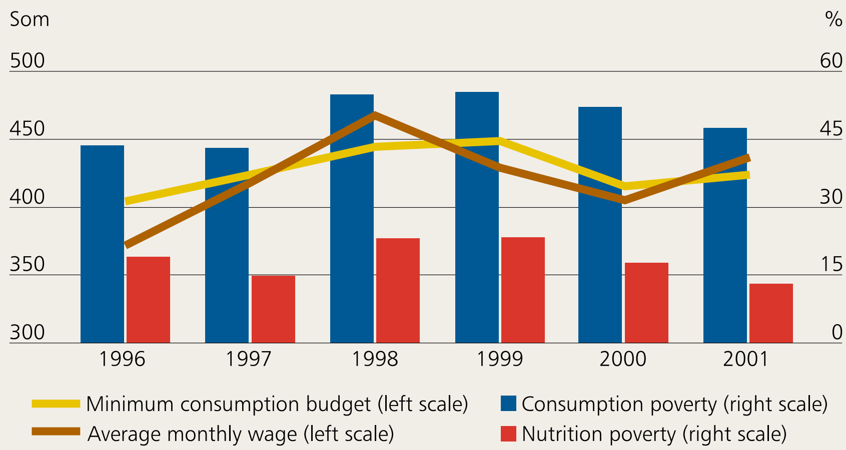
In 2001, GDP grew by 5.3%, a rate slightly lower than in the previous year. In agriculture, which expanded by a healthy 6.8%, productivity growth and an expansion in the area under cultivation generated a large food grain harvest of 1.8 million tons. This was 16.3% higher than 2001's output and 12% more than the previous peak. However, the output of animal husbandry, important for the poorer mountainous regions, rose by only 2.2%. Though the industry sector grew by 5.4%, growth was uneven and masks the decline in the output of several subsectors. Excluding the metallurgical sector, whose gross production increased by 13.8%, industrial output fell by 1.6% in 2001 due to a significant decline in the output of power generation, agroprocessing, oil refining, and pharmaceuticals. A sharp drop in transport services restricted growth in the services sector to a modest 2.4%, reflecting the decline in both industrial and foreign trade activity.

Gross domestic investment fell from 18% of GDP in 1999 to about 16% in 2000 due to a fall in the Public Investment Program (PIP), from 9% of GDP to 7% over this period. In 2001, the rate of investment declined further, by about 35%. A heavy external debt repayment burden, caused by the bunching of debt service requirements, pulled down the PIP to 4.4% of GDP in 2001.

The unemployment rate increased from 5.9% of the labor force in 1998 to 7.5% in 2000. The level of unemployment is not officially available, but on the basis of estimates of the registered unemployed, it seems that there has been very little reduction in unemployment in spite of robust growth in the last 2 years. However, poverty incidence has dropped, from 52% at the end of 2000 to 47.4% in September 2001, as a result of higher agricultural growth and stable food prices (Figure 2.23). This suggests that the insensitivity of the unemployment rate to significant growth may be the result of an increase in labor force participation rates.

Under IMF's new Poverty Reduction and Growth Facility (PRGF) program, the Government embarked on an ambitious fiscal compression program,

FIGURE 2.23 **Real Wages and Poverty Incidence, Kyrgyz Republic, 1996-2001**



Source: National Statistical Committee.

TABLE 2.21 Major Economic Indicators, Kyrgyz Republic, 1999–2003 (%)

Item	1999	2000	2001[a]	2002	2003
GDP growth	3.7	5.4	5.3	4.5	4.5
Gross domestic investment/GDP	18.0	16.0	—	16.1	15.8
Inflation rate (consumer price index)	35.9	18.7	6.9	7.5	5.5
Money supply (M2) growth	33.9	12.4	11.3	13.5	—
Fiscal balance/GDP	-12.7	-10.0	-4.0	-4.9	4.3
Merchandise export growth	-13.5	10.4	-6.0	2.8	3.4
Merchandise import growth	-27.6	-8.2	-14.4	4.8	5.9
Current account balance/GDP	-14.4	-5.6	-0.7	-6.3	-6.5
Debt service ratio	26	25.7	29.4	30.7	31.0

— Not available.
[a] Preliminary data.

Sources: National Statistics Committee; National Bank of the Kyrgyz Republic; Ministry of Finance; International Monetary Fund (for 2002–2003).

A high burden of public debt prevented the Government from devoting more resources to consumption and investment expenditures.

cutting its fiscal deficit from 10% of GDP in 2000 to 4.4% in 2001. Current revenues increased by 1.2 percentage points of GDP while public spending fell by 4.3 percentage points, and the PIP recorded a sharp fall. Parliament reviewed the budget in the middle of the year and amended certain tax measures to enhance the revenue-to-GDP ratio. It also increased user charges on many paid services to improve nontax revenues.

Continuing a policy begun in 2000, the central bank restricted monetary growth to 10–12%. However, it relaxed the reserve requirements of the commercial banks in June, resulting in an easing of the banking sector's liquidity position. Tight monetary policy and solid performance of the agriculture sector sharply reduced the monthly average rate of consumer price inflation to 6.9% in 2001 from 18.7% in 2000, while the year-on-year rate of inflation fell sharply to 3.6% from 9.6% in the previous year. Increases in the administered prices of utilities and in user charges represented the main source of inflation, as nonfood consumer goods prices registered a modest increase of 1.4% and food prices did not rise at all.

The foreign sector contracted in 2001. Exports fell by 6% due mainly to lower exports of power, food products, and nonprecious metals, while imports shrank by 14.4% due to a fall in public investment. This resulted in a positive trade balance of $50.5 million, which helped limit the current account deficit to about 0.7% of GDP. The som depreciated by about 1.5% against the dollar in 2001.

POLICY DEVELOPMENTS

Under IMF's PRGF, the Government will adopt a three-pronged approach to mitigate the medium-term risks to the economy and to improve economic performance. The PRGF takes into account some of the important structural adjustment reform programs of ADB and the World Bank. The key components of the program are: implementation of a credible debt strategy, continued pursuit of prudent fiscal and monetary policies to maintain macroeconomic stability, and implementation of structural reforms.

The high burden of public debt prevented the Government from devoting more resources to consumption and investment expenditures. Total external debt was estimated to be about $1.7 billion (112% of GDP) at the end of 2001, of which 55% was multilateral and 29% bilateral (owed mainly to Japan, the Russian Federation, and Turkey), and the rest commercial debt. The debt service burden is high at around 30% of exports of goods and services, and until recently, the Government had to face the looming problem of bunching of debt over 2002–2004. A large part of the nonconcessional debt (representing about one fifth of the total) was due for repayment, with grace periods for many concessional loans coming to an end. However, in March this year, agreement was reached at the Paris Club whereby debt servicing during 2002–2004 was rescheduled favorably with the possibility of debt stock restructuring in 2004, provided that the ongoing PRGF is implemented successfully. In addition, the Government has adopted a debt reduction strategy that, among other things, stipulates lowering the PIP to 3% of GDP by 2005.

The main objective of the fiscal stance for 2001–2004 is to achieve a turnaround in the budget, securing budgetary savings of 2% of GDP by 2004 from dissavings of 2.5% in 2000. This requires an increase in fiscal revenues of about 3.5% of GDP and rationalization of government consumption expenditures. The Government proposes to cut direct tax rates in 2002. Several measures have been put in place to compensate for the potential short-term loss of tax revenues. Further reforms to customs; VAT; and turnover, property, and land taxes are envisaged to improve revenues, and a 10% tax on interest incomes is to be introduced. Tax administration will be modernized and streamlined with a special focus on the customs department. On the expenditure side, the burden of fiscal adjustment will fall mainly on the PIP.

The Government undertook several structural reform measures in 2001 in an attempt to create a conducive environment for the private sector to function efficiently and to improve public sector governance. In the finance sector, it took steps to liquidate four nonviable banks. It also purchased the largest commercial bank—Kairat—from the central bank, augmented its capital, and has taken steps to improve its management with a view to eventual privatization. The regulatory capacity and powers of the central bank are being strengthened further. The Government has also initiated measures to strengthen the legal framework for the debt restructuring agency. Other notable structural reform measures include the introduction of international accounting standards, preparation of a blueprint and a time-bound implementation plan for judicial reform, and steps to facilitate rapid implementation of public enterprise reforms.

OUTLOOK FOR 2002–2003

GDP is expected to grow at 4.5% in each of the next two years. This is lower than the 5% target set under the interim National Poverty Reduction Strategy (NPRS), which charts the development approach for the 3 years 2001–2003. The lowering of the growth target reflects the constraints imposed by a gradually declining public investment program and the difficulties in attracting private investment to fill the gap. Achieving even this lower growth target depends on several important factors: substantial easing of the debt repayment burden this year; continued pursuit of tight fiscal and monetary policies to maintain macroeconomic stability; prompt implementation of key structural reforms in a number of areas, particularly in banking, agriculture, energy, and infrastructure; public sector governance and adjudication processes; and a favorable external environment for the economy. Under these assumptions, consumer price inflation is expected to have fallen to 5.5% by 2003 (after reaching 7.5% in 2002). Although the current account deficit in 2001 fell sharply due to a trade surplus and a squeeze on public investment, it is expected to rise to over 6% of GDP in the next 2 years as investment activity reverts to normal levels.

The recent restructuring of external debt is likely to prove critical for ensuring sustainability of public finances and for maintaining even the gradually reduced levels of spending on the PIP.

Recent developments indicate that the general business environment is still not supportive of the private sector.

Recent developments, such as declining production in several industry subsectors including food processing, a fall in commercial credit in the banking sector, low levels of private investment, and subdued inflows of FDI indicate that the general business environment is still not supportive of the private sector.

Economic prospects depend to a large extent on the urgent implementation of structural reforms under a tight fiscal regime, limited implementation capacity, and political difficulties in implementing stringent measures to improve public sector governance. Fortunately, though, the aftermath of the events of September 11th and the conflict in Afghanistan did not have the feared major adverse impact. Nevertheless, political uncertainty in the region could make Central Asia a less attractive destination for FDI. Therefore, any deterioration in the political situation in Afghanistan could impede inflows of FDI and the long-term prospects for economic growth and poverty reduction in the Kyrgyz Republic.

TAJIKISTAN

The economy in 2001 fared much better than forecast, with GDP growth reaching double digits, though this is expected to slow somewhat as capacity constraints are reached in aluminum smelting. External developments will also be critical, since exports, primarily cotton and aluminum, amount to about 70% of GDP. The situation in neighboring Afghanistan and developments in the Russian Federation, the country's major trading partner, will be particularly important to watch.

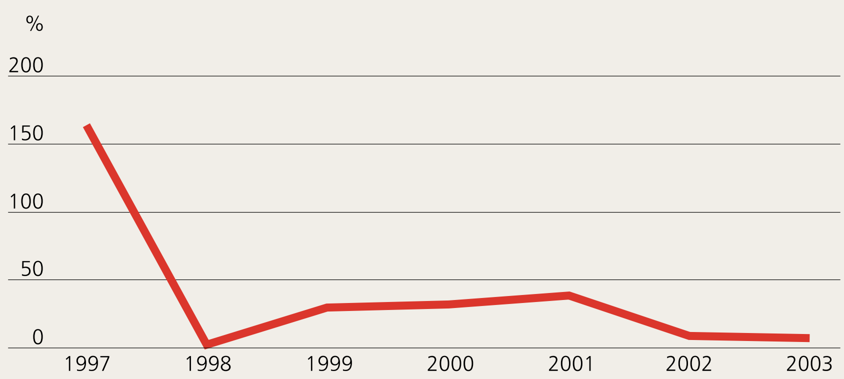
MACROECONOMIC ASSESSMENT

With the conclusion of the peace process in 2000, Tajikistan embarked on rebuilding an economy ravaged by civil war. In 2001, contrary to all expectations, economic growth accelerated to 10%, up from 8.3% in the previous year. As in 2000, it was led by a substantial increase in aluminum production. However, other industry subsectors languished, so while overall industrial production rose by 14.1%, industrial output (excluding aluminum) shrank by 5%. The agriculture sector, which contributes around 20% of GDP and accounts for more than half total employment, performed very well. Despite continued drought, it recorded an 11% expansion, fueled mainly by a 35% increase in cotton production, which stemmed from an increase in both planted and irrigated areas and from the low-base effect of low output in 2000.

Economic growth, in which the driving force is rising capital-intensive aluminum production, has so far failed to have much of an impact on formal sector employment or the level of poverty. While the official unemployment rate fell to 2.8% in 2001 from 3.3% in 2000, unofficial estimates put the unemployment or underemployment rate much higher at over 30%. An estimated 200,000 people left the country in 2001, more than in the previous year, most of them to the Russian Federation in search of work. Some emigrated permanently, and some left for seasonal work. Further, about one third of the labor force is estimated to be working abroad. (Even during the Soviet era, Tajikistan was a major supplier of labor within the Soviet Union.) Such population movements should be seen against a background in which almost 80% of the population continue to live in poverty.

The Government derives its main revenues from sales taxes on cotton and aluminum (37% of the revenue base), as well as from excise and customs duties. The tax base of the private sector is very narrow, and neither personal nor corporate income tax yet plays a significant role. The budget deficit fell by half to 0.2% of GDP in 2001, and showed a primary surplus of 0.4% of GDP, a switch from a 0.3% deficit in 2000. This surplus was attained mainly by higher than expected revenue collections, but excludes

FIGURE 2.24 **Change in Consumer Price Index, Tajikistan, 1997-2003**



Source: Staff estimates.

TABLE 2.22 Major Economic Indicators, Tajikistan, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	3.7	8.3	10.0	6.0	5.0
Inflation rate (consumer price index)	30.1	32.9	38.5	8.9	7.6
Fiscal balance/GDP	-2.3	-0.4	-0.2	-1.0	-1.0
Merchandise export growth	13.7	18.9	1.8	8.8	8.7
Merchandise import growth	-5.2	21.1	8.0	4.5	6.8
Current account balance/GDP	-3.2	-5.9	-7.7	-6.2	-5.5
Debt service ratio	5.1	10.0	18.0	43.0	38.0

Sources: International Monetary Fund; Government of Tajikistan; staff estimates.

the largely externally financed Public Investment Program, which accounted for 3% of GDP in 2000 and 4.1% in 2001. The greatest strain on, and danger to, the economy derive from the high levels of external debt repayments, both in terms of the principal and debt service. For 2001, over 1.7% of GDP was scheduled for servicing the external debt, up from 0.3% in 2000. Despite some successful bilateral negotiations, the grace period for some loans expired, and substantial repayments were due to IMF.

In 2000 and 2001, social spending accounted for 48% of government revenues and this has resulted in a squeeze on other essential expenditures, because of the Government's aim that over 40% of the budget should go to providing essential social services. Capital expenditures invariably suffered.

The Government continued its tight monetary stance in 2001. In the past, much of the inflationary pressure in the country was generated by exchange rate movements, the high costs of key imports from the Commonwealth of Independent States, and bad harvests that drove up food prices. Overall annual inflation was 38.5% in 2001, about 6 percentage points higher than in the previous year (Figure 2.24). The currency is stronger while the impact of the ongoing drought has diminished as a result of imports.

Burdened by many nonperforming loans, mostly extended in the form of direct credits to SOEs, or privatized enterprises with strong state connections, the banking sector remains paralyzed. Lending to the private sector is at a virtual standstill. If banks extend loans at all, they are short term and intended for trade finance only. Indeed, the largest sources of credit to the private sector are the nonperforming loans of commercial banks that are rolled over.

The economy is highly dependent on foreign trade, with exports equivalent to 70% of GDP. Cotton and aluminum are responsible for over 80% of export earnings, rendering the economy extremely vulnerable to terms-of-trade shifts caused by fluctuations in international prices and, indeed, the prices of these two major exports deteriorated considerably in 2001: cotton, for example, fell by 35%. In addition, production of goods for export was severely hampered by a 2-month closure of the railway connection between Tajikistan and the Russian Federation—the country's major trading partner. Some conservative estimates put the loss of export earnings at about $8 million, approximately 1% of total exports. Imports increased, but at a slower rate than in 2000. Wheat and power imports rose as a result of the drought. Thus, the current account deficit widened from 5.9% of GDP in 2000 to 7.7% in 2001.

The balance of payments is shored up by international donors. In 2001, additional donor transfers increased reserves and resulted in import cover of 2.3 months at year-end, compared with 2.1 months 12 months earlier. External debt stood at 113% of GDP at the end of 2001.

The greatest strain on the economy derives from the high levels of external debt repayments.

POLICY DEVELOPMENTS

The external debt burden is the most pressing economic problem that the Government will face over the next decade. It has therefore agreed to a debt reduction strategy with IMF, which includes making fiscal adjustments. To broaden the tax base, the Government now plans to strengthen the Large Taxpayers Inspectorate and to computerize the tax system. This is crucial, if it wants to offset the effects of the reduction to 5% in the cotton sales tax by end-2002. It also plans to earmark privatization proceeds for debt reduction, as well as to continue bilateral debt restructuring, for which purpose it is negotiating with the Russian Federation, its largest creditor. Although in 2001 the two governments agreed to reduce Tajikistan's debt stock by $49.5 million, the remaining discussions will be more controversial as both parties disagree on the exchange rate for valuing the remaining debt and on the question of debt-equity swaps. However, even the more optimistic debt scenarios conclude that the fiscal burden of servicing the debt will become unsustainable, and that debt rescheduling through an approach to the Paris Club in the near future will be necessary. The Government hopes to reschedule its debt under Naples terms (i.e., a debt reduction of two thirds of the net present value of eligible debt).

The financial market is hampered by the public's lack of trust in the banking sector.

Since 2000, foreign exchange has been traded in the relatively competitive interbank currency market, and the authorities aim to intervene only to smooth out short-term volatility. The financial market itself is still undeveloped, hampered by an almost complete public lack of trust in the banking sector. This is reflected in the very low deposit-to-GDP ratio of below 5%. To revitalize the banking sector, the Government has embarked on a reform program. In 2000, the largest four commercial banks signed restructuring agreements, which include submitting business plans and undergoing financial audits. Two have already published audit results and the others are expected to follow soon. Five banks that did not comply with minimum capital requirements are now being liquidated. The Government is also working on changes to the legislative framework and tax system, including making loan losses 10% tax deductible.

Agriculture sector restructuring still presents a major hurdle to economic growth. The Government is undecided between safeguarding a minimum number of large-scale, industrialized, agricultural complexes to produce cash crops such as cotton, or allowing privatization and agricultural reform (to which it officially pledges its commitment). The process of privatization itself has been slowed by allegations of corruption and by a lack of the necessary skills in government to deal with such an ambitious undertaking. In addition, agriculture suffers from both a lack of credit in the noncotton sector and overindebtedness in that sector. It is thus crucial that the Government develop mechanisms to support the provision of rural finance for noncotton activities. This will decrease dependence on cotton and help diversify agriculture. Private farms are keen to expand production of high value-added crops, such as fruits and vegetables. In turn, this could stimulate growth in agroprocessing industries. Several international nongovernment organizations are providing microfinance services in rural regions, and beginning this year, the Government is planning to foster growth of viable microfinance institutions through creating a supportive regulatory framework.

OUTLOOK FOR 2002–2003

After 5 consecutive years of economic growth, the outlook continues to improve, but significant risks remain. The main factors affecting stability are the high debt burden, the volatility of the external sector, the monolithic nature of industrial and agricultural production, and developments in Afghanistan. In addition, the price of aluminum will continue to weaken due to global oversupply. On the other hand, though, growth in the Russian Federation is expected to remain fairly constant and oil prices are projected to remain relatively stable.

Under these broad assumptions, GDP growth is expected to taper off. The only aluminum smelter is already operating close to full capacity and productivity gains of newly privatized farms will only be realized gradually. In monetary policy, the Government will keep a tight stance to reduce inflation to around 9% in 2002, and ensure fiscal discipline. The budget deficit is not expected to exceed 1% of GDP. The forecast for the debt service ratio has worsened in comparison with previous estimates made in 2001, as Tajikistan has to repay newly called-in government guarantees. However, the current account will likely improve as forecast increases in wheat and power production will reduce the need for such imports.

Whether economic growth finally succeeds in bringing down poverty levels depends crucially on the nature of that growth. There is an urgent need to diversify the economy and encourage manufacturing and small-scale enterprises. However, the Government's focus has so far remained on increasing power, cotton, and aluminum production, none of which is labor intensive.

TURKMENISTAN

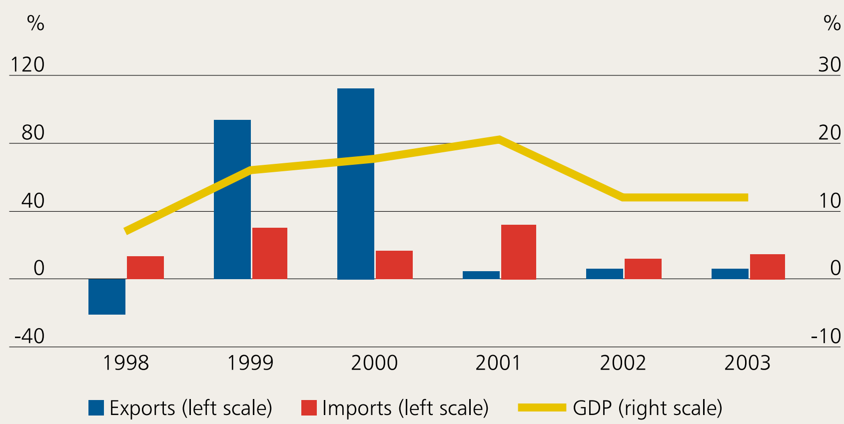
With a third successive year of around 20% rates of growth, GDP in 2001 recovered to above pre-independence levels. Economic prospects, however, remain strongly linked to export earnings from natural gas, oil, and cotton. While industrial and agricultural diversification policies have had some success, policy distortions in the foreign exchange regime discourage private sector growth and inflows of FDI.

MACROECONOMIC ASSESSMENT

With GDP growth in 2001 officially reported at 20.5%, the economy registered the third year in a row of around 20% expansion. Turkmenistan has benefited from positive developments in external circumstances, which, to a large extent, determine the economic performance and prospects of its export-dependent economy. The continued economic upturn in the Russian Federation and the Ukraine, which together absorbed 88% of total natural gas exports, and in other Commonwealth of Independent States (CIS) economies sustained export demand. Natural gas exports rose because of fuller capacity utilization of a new pipeline to Iran and a larger offtake by the Ukraine and other CIS importers via the Russian Federation. Nearly 7 billion cubic meters (bcm) of gas were exported in 2001 through the pipeline. Natural gas production increased to 51.3 bcm, a rise of 9% over the 2000 level. Of this, 37.3 bcm were exported, 11% more than in the previous year. Oil production also rose, by 12%. The value of industrial output, which consists mainly of oil and gas production, registered an impressive growth rate of 27%. However, transport bottlenecks continued to impose a binding constraint on further expansion of energy product exports.

Cotton exports, the other major revenue earner for the economy, also increased, in their case by 7%, and were helped by a 10% larger harvest than in 2001 (according to official figures). The superior quality of Turkmenistan's cotton fiber and the higher share of processed and value-added cotton exports partly mitigated the impact of a fairly sharp decline in average international cotton prices. Aided by favorable weather conditions and continued policy support, wheat production registered growth of 18% and contributed to a 23% rise in agricultural output. The emergence of a small export surplus in cereals testified to the success of the Government's policies to diversify agriculture away from a cotton monoculture and to generate self-sufficiency in grain production. The services sector has lagged behind industry and agriculture, as a result of weak development in private financial and retail trade activities. Transport and construction, which

FIGURE 2.25 **Change in GDP and Merchandise Trade, Turkmenistan, 1998-2003**



Sources: Asian Development Bank, 2001, *Economic Report and Interim Operational Strategy for Turkmenistan*, December; National Institute of Statistics datafile.

TABLE 2.23 Major Economic Indicators, Turkmenistan, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	16.0	17.6	20.5	11.0	11.0
Inflation rate (consumer price index)	23.5	7.4	6.0[a]	8.5	7.5
Fiscal balance/GDP	0.9	0.3	—	—	—
Merchandise export growth	93.3	111.7	5.0	6.0	6.0
Merchandise import growth	30.0	16.6	32.0	12.0	15.0
Current account balance/GDP	-18.0	-13.0	—	—	—

— Not available.
[a] January to June.

Sources: Asian Development Bank, 2001, *Economic Report and Interim Operational Strategy for Turkmenistan,* December; National Institute of State Statistics and Information of Turkmenistan datafile; staff estimates.

Turkmenistan has benefited from positive developments in external circumstances.

remain largely in government hands, showed growth of 4% and 7%, respectively, during January–October 2001, compared with the same period in 2000.

A tight monetary policy stance brought down inflation further to about 6% during the first 6 months of 2001, from an average level of 7.4% in 2000. The banking sector, dominated by public sector banks and government control over all foreign exchange transactions, remains underdeveloped. Essentially, the Government is operating a directed banking sector with public sector commercial banks having very limited autonomy and scope for credit management. The differential between the market and official exchange rates was unchanged over the year, with the market rate depreciating by less than 1% (to 21,500 manat to the dollar) and the official rate remaining pegged at 5,200 manat to the dollar. The huge differential between the two rates has generated widespread rent seeking and distortions that effectively discourage private sector growth.

The state budget recorded a deficit of 291 billion manat (1.2% of GDP) during January–October 2001. Revenues, at TMM5.37 trillion, were 14% short of the annual target and expenditures were 15% below target at TMM5.66 trillion. The true state of the fiscal balance, however, remains unclear because of the large number of off-budget accounts, including the foreign exchange reserve fund, which is managed directly by the President's office and which absorbs a substantial share of foreign exchange revenues from exports.

Foreign trade turnover, equivalent to nearly 80% of GDP, increased by 16% from the 2000 level and was estimated at $4.49 billion. Despite a 32% rise in imports—a result of capital goods imports for the Turkmenbashi oil refinery and other projects in the petrochemical and textile sectors—compared with only a 5% rise in exports, the trade balance still generated a small surplus of $275 million. While details of invisible trade flows are not available, there are significant outflows of foreign exchange on this account, leaving the external current account with only a marginal surplus.

Poverty incidence in Turkmenistan is perhaps the lowest among the transition economies of Central Asia. Extensive subsidies—the sustainability of which, however, remains questionable—in the provisioning of basic goods and services for the entire population have helped shelter people from price increases. Nearly 80% of total annual public expenditures are directed toward social and public services. The high GDP growth rates achieved in the last 3 years, combined with the Government's scheme for subsidized availability of basic commodities and services, has brought down the level of absolute poverty to negligible levels. Relative poverty, defined as the proportion of the population living on less than 50% of the country's average per capita income, is estimated at 15.9%.

POLICY DEVELOPMENTS

The Government has adopted a three-pronged overall economic policy framework: a transition strategy that accords to the state the leading role in economic development, a gradual approach to economic liberalization and privatization, and a special emphasis on minimizing social costs by subsidizing the provision of basic necessities and services. Within this framework, the Government is also pursuing the twin goals of industrial diversification and self-sufficiency in food and other basic goods.

As part of the diversification strategy, some public sector investment and foreign exchange earnings have been used for establishing textile and garment manufacturing plants, often in collaboration with Turkish partners. These joint ventures are now exporting to the US and Europe. As a result, the share of the textile sector in total industrial production increased from 10.4% to 26% during 1995–2000 while the share of cotton processed domestically in total cotton fiber production rose from 3% to 35% over the same period. However, given the multiple exchange rates and hidden subsidies available to these firms, their financial and economic viability cannot easily be ascertained.

The Government is also attempting to raise the output of processed oil and petrochemical products, and thus achieve higher value-added exports. In pursuit of this, it is undertaking a $1.5 billion upgrade of the Turkmenbashi refinery and developing an associated petrochemicals complex, which is expected to come into operation later in 2002. Another smaller refining and processing facility is being built near Atamurat, in Lebap province, to supply neighboring countries such as Afghanistan and Uzbekistan.

OUTLOOK FOR 2002–2003

The economic outlook over the next few years remains strongly linked to the export prospects for natural gas, cotton, and—to an increasing extent—crude oil and refined oil products. The country currently produces 51 bcm of gas, representing the utilization of only half its installed production capacity. In 2002, the production target for gas is 72 bcm, a near 40% increase over 2001's level. Similarly, with expanded capacity coming onstream at the Turkmenbashi oil refinery in 2002, a marked increase in production and exports of refined oil products can be expected. Moreover, exports of natural gas, oil, and other basic commodities to the northern and western regions of Afghanistan, which border Turkmenistan, are likely to strengthen over the medium term.

The economic outlook over the next few years remains strongly linked to export prospects.

Based on these outcomes, GDP growth is expected to be around 11% in both 2002 and 2003 (Figure 2.25). The official target for GDP growth in 2002 is 18%, which could be achieved if some of the more ambitious (but less likely) export contracts for natural gas materialize, and if exports of textiles and garments are substantially larger than in 2001. On the other hand, there is a risk that, because of the Government's inflexible policy stance with respect to the dominant role of the state in the economy and its maintenance of an extensive system of regulations and controls over trade and industrial activity, the economy may become increasingly isolated from global trade, investment, and financial flows. This could pull down future rates of economic growth.

The risk of an externally induced significant economic downturn, however, may be quite weak, for several reasons. These include the dependence of some CIS economies on energy supplies from Turkmenistan; the emergence of import demand from reconstruction activity in neighboring Afghanistan (the two countries already have extensive trade and commercial links); and the ready market for the country's high-quality cotton fiber in industrial economies, with which strong export links have been established since independence.

UZBEKISTAN

GDP grew by 4.5% during 2001, despite soft international prices for the country's main exports and a second consecutive year of drought. For sustaining long-term growth with macroeconomic stability, the Government needs to persevere with the major economic and structural reforms that were initiated in 2001.

MACROECONOMIC ASSESSMENT

GDP growth of 4.5% in 2001, marginally higher than in 2000, pushed national income to 3% above its pre-independence level in 1991 (Figure 2.26). This reflected reasonably strong growth in industrial output and in agriculture, despite continuing drought conditions. The agriculture sector, the largest employer and exporter, recovered after a poor performance in 2000, when the cotton crop was the lowest since independence. The sector registered an expansion of 4.5% in 2001, as cotton yields increased by nearly 10%.

Growth of industrial output accelerated to 8.1% in 2001 from 5.8% in 2000. Production of automobiles surged, mainly as a result of better capacity utilization at UzDaewooAuto, a joint venture. Production of natural gas and ferrous metals also rose, while output of oil and gas condensate decreased.

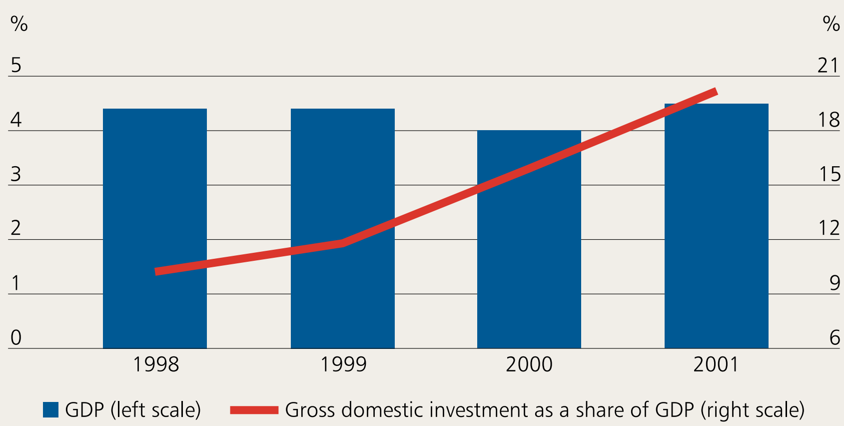
Due mainly to growing private activity, the services sector strengthened by 14.2% in 2001, marking a slight improvement on 13% in 2000. Retail trading, restaurants, and ICT have contributed noticeably to the expansion of the sector over the past few years as a result of small-scale privatization. This growth was achieved despite government restrictions on consumer goods imports.

A slump in international cotton and gold prices in 2001 hurt export earnings, exposing the vulnerability of the economy to fluctuations in commodity markets. The fall in commodity prices forced the Government to continue its policy of import compression and import substitution, to prevent external financing requirements from rising further. Despite these measures, a current account deficit of 0.5% of GDP emerged in 2001, compared with a surplus of 0.8% of GDP in 2000.

The fiscal deficit stayed at 1% of GDP in 2001. The shortfall was financed by central bank credits, the issuance of treasury bills, and proceeds from the sale of SOEs. The central bank's benchmark refinancing rate was 26.8% in 2000 and 2001 on an annual compound basis. The policy of keeping interest rates low can be attributed to the desire of the Government both to prevent its borrowing costs from increasing and to avoid bankruptcies among loss-incurring SOEs.

Consumer price inflation stood at 26.6% in 2001. However, IMF estimates put the inflation rate much higher, as the official data understate the true level of inflation, mainly because of shortcomings in the methodology by which consumer price data are collected.

FIGURE 2.26 **GDP Growth and Gross Domestic Investment Ratio, Uzbekistan, 1998-2001**



Sources: Government of Uzbekistan; staff estimates.

Exchange rate reforms and an effective depreciation of the commercial exchange rate, along with a rise in fuel prices and public sector wages, were the main sources of inflation in 2001. Despite the foreign exchange reforms, the market rate stayed at about 2.5 times that of the official rate at the end of 2001, about the same level as at the end of 2000. Exchange rate controls continued to stifle domestic investment activity and flows of FDI into the oil and gas sector.

Official statistics show that registered unemployment at end-2001 was the same as 12 months earlier, namely 0.4% of the workforce. Actual unemployment, however, is estimated to be much higher, and hidden unemployment in the rural sector has been rising.

POLICY DEVELOPMENTS

With the objective of pursuing a tighter monetary policy and making real interest rates positive, the central bank raised its monthly refinancing rate to 2.5% on 1 January 2002, or to 34.5% on an annual compound basis; the rate in 2001 was 26.8%. This should help bring down inflation and enable the Government to achieve the macroeconomic targets established toward the end of 2001 under an IMF staff-monitored program. The central feature of the IMF reform package is the commitment to initially reduce the differential between the market and official exchange rates to less than 50% by end-March 2002 and to unify the exchange rates by July.

The banking sector and financial markets are still at an early stage of development. This is reflected in the low level of financial intermediation in the economy. Moreover, the banking sector is highly concentrated, with the larger banks remaining in the public sector and facing limited competition. There is a need to facilitate market-oriented reforms, dismantle administrative controls on bank operations including the removal of restrictions on withdrawals, and strengthen public confidence in the banking system. This would allow the banks to increase their deposit base, raise the level of financial intermediation in the economy, and improve the environment for private sector development by ensuring greater access to commercial bank credit.

The 2001 budget targeted a fiscal deficit of 1.5% of GDP, with revenues at 30.1% of GDP and expenditures at 31.6%, based on government growth forecasts. According to official figures, the deficit in 2001 stood at about 1% of GDP. However, this could understate the true figure somewhat because transfers to loss-incurring SOEs were made as directed credit from the banking sector, not as allocations from the budget.

OUTLOOK FOR 2002–2003

Prospects for 2002 hinge on the policy stance of the Government. Exchange rate unification could dampen short-term growth prospects by restraining consumption and making imported capital goods more expensive. In the medium to long term, however, its positive effects will far outweigh any short-term negative impact. This necessary policy advance will significantly improve the investment climate in Uzbekistan.

In the medium to long term, the positive effects of exchange rate unification will far outweigh any short-term negative impact.

The Government envisages growth of 5.1% in 2002. This may not be realized given the global economic environment, continuing softness in international commodity prices, and the short-term impact of the policy changes. A GDP growth rate of 4% is more realistic. With the positive effects of policy measures likely to come through during 2002, higher GDP growth of 5% could be expected for 2003. Inflation by the end of 2002 is forecast to fall to 18%, but the actual figure may be higher because of upward pressure on prices due to exchange rate depreciation. Inflation will tend toward low double-digits in 2003 as the impact of depreciation works its way through the system and supply conditions improve.

Parliament has endorsed the 2002 state budget, which envisages a fiscal deficit of 2% of GDP, to be financed from privatization revenues, short-term government bonds, and credits from the central bank amounting to 0.5% of GDP. The budget includes social assistance to support vulnerable population groups that are likely to be affected by the liberalization measures.

The positive stimulus from exchange rate depreciation may encourage nontraditional exports and help the economy diversify its export base away from cotton and gold. However, a current account deficit of 1–2% of GDP is forecast for 2002–2003, as imports are likely to rise faster with investment activity picking up in response to an improved policy environment. The deficit is, however, likely to be fully financed by larger concessional and private foreign capital inflows, provided that the program of structural reforms is implemented in line with the Government's plans for exchange rate unification and for further liberalization of price and procurement policies in the cotton-growing sector.

ASIAN DEVELOPMENT

Outlook
2002

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

The Pacific

Cook Islands
East Timor
Fiji Islands
Kiribati
Marshall Islands
Federated States of Micronesia
Nauru
Papua New Guinea
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

COOK ISLANDS

GDP increased by an estimated 3% in 2001, and tourism was again the leading sector. Medium-term growth prospects have been clouded by the loss of some international air services in late 2001. The major policy issues are devolution of power to the outer islands, development of human resources, environmental management, and infrastructure development.

MACROECONOMIC ASSESSMENT

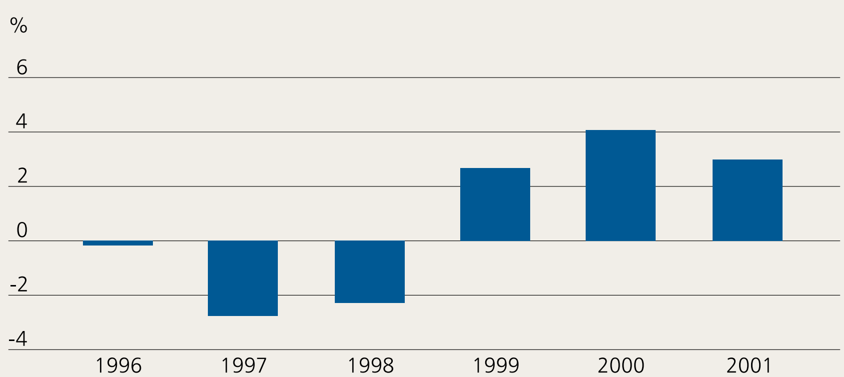
GDP in 2001 grew by an estimated 3%, after strengthening by slightly over 4% in 2000 (Figure 2.27). Tourism continued to be the leading sector, though the events of September 11th had a dampening effect on tourism growth in the last quarter of the year. International air services were curtailed for some airlines and visitor numbers fell by 17% in November 2001. Black pearl production fell from 2000's record high, with exports in the first three quarters of 2001 down 17.6% on the corresponding period in 2000. Commercial agriculture and fishing activity also declined from 2000's levels. In contrast, the finance and business sector grew rapidly, with gross turnover in the first three quarters of 2001 rising by 17.6% from the corresponding period in 2000. The inflation rate accelerated from 3.2% in 2000 to 8% in 2001.

The operating budget surplus in fiscal year 2001 was NZ$6.9 million, or 4.2% of GDP, compared with an original budget estimate of NZ$1.4 million. This outcome reflected unexpectedly strong revenue growth at 10.6% above the budget estimate. Continued economic and import expansion led to increased receipts of VAT and import levies. Expenditures were kept close to the budget estimate, which allowed for a 14.4% rise compared with the previous fiscal year. The Government increased its spending on physical infrastructure to support tourism, education, health, welfare, cultural development, and environment protection. Net debt stood at NZ$128.7 million, or about 72% of GDP, with the Government maintaining a reserve for future debt repayment. This represented a fall from 77% of GDP in fiscal year 1999 and 76% of GDP in fiscal year 2000.

The budget for fiscal year 2002 estimated that revenues would be relatively static at around NZ$64.7 million, but that expenditures, would rise by 12.2% to NZ$64.2 million, leaving a modest operating surplus of NZ$0.5 million. The outstanding debt was projected to rise to NZ$129.9 million, but to fall as a proportion of GDP to approximately 68.3% by the end of fiscal year 2002.

A drop in pearl exports in the third quarter largely accounted for a decline in total merchandise exports in 2001. Imports grew by 14% during the first 9 months compared with the corresponding period in 2000. Consequently, the trade deficit rose from NZ$58.7 million in the first three quarters of 2000 to NZ$71.2 million in the corresponding period of 2001. Tourism growth, supplemented by private remittances and offi-

FIGURE 2.27 **Change in GDP, Cook Islands, 1996-2001**



Sources: Government of Cook Islands, *Cook Islands Half-Year Fiscal Economic Update FY 2001/2002*; staff estimates.

cial transfers, ensured that the current account remained in surplus. The use of the New Zealand dollar as the domestic currency and its 8.5% depreciation against the US dollar in 2001 enhanced international competitiveness, though the acceleration in inflation eroded some of this gain.

Net foreign assets in the banking system at the end of September 2001 were 41.6% higher than at the end of 2000. Net domestic credit grew at the more modest rate of 6.5%, but this aggregate concealed the fact that government deposits with the banking system had increased and that credit to the private sector had grown by 11.3%. The latter was concentrated in tourism, agriculture, and fisheries. On 1 July 2001, the Cook Islands Development Bank and the Cook Islands Savings Bank merged to form the Bank of the Cook Islands, becoming the third commercial bank in the banking system. Nominal interest rates on deposits ranged from 1% to 2%, and were thus significantly negative in real terms. Nominal lending rates were in the range of 9.25–19%, with the new Bank of the Cook Islands adopting a higher interest rate structure.

A major policy issue arising in the context of public service reform is the need to improve service delivery.

POLICY DEVELOPMENTS

The principal issue of economic management is to consolidate and build on recent improvements in fiscal governance, in order to maintain a stable macroeconomic environment that supports private sector growth.

The budget policy statement for 2002 stressed five strategic priorities: economic sustainability, outer island empowerment, social cohesiveness, infrastructure advancement, and good governance. It also affirmed the Government's commitment to fiscal responsibility, including meeting all debt obligations, and to building an enabling environment for private sector development. Formulation and implementation of this budget was disrupted somewhat by a period of political instability in the latter half of 2001, beginning with the dismissal of the deputy prime minister in early July. Resolution of political uncertainties is essential for effective continuation of the economic, public sector, and governance reform process begun in 1996. A new Government was formed in February 2002.

A major policy issue arising in the context of public service reform is the need to improve service delivery, both on the main island of Rarotonga and on the outer islands. Public service downsizing in the late 1990s was successful in aggregate terms, but led to migration to New Zealand of some skilled and qualified workers. The outer islands were particularly hard hit by emigration. Implementation of the Government's devolution policy is crucial to reversing the decline in service delivery. This involves assigning greater service delivery responsibility to outer island administrations, capacity building in these administrations, and improving the provision of technical support from the central administration.

The devolution policy is to be complemented by public investment in roads, ports, and airstrips, and in health and education. Human resources development, in both the public and private sectors, is essential if the country is to improve the match between the skills needed in the civil service and the economy, and the skills available. Another major issue is the need to improve environmental management, particularly waste management on Rarotonga, as this is fundamental to sustainable tourism development.

OUTLOOK FOR 2002–2003

The official medium-term economic forecast made prior to the events of September 11th was that GDP would grow at annual rates of 3.3% in 2002–2003, with tourism and black pearl production acting as the primary drivers. The gloomier global economic outlook after September 11th, the loss of some international air services to the Cook Islands, and recent concerns over pearl oyster mortality rates call for a downward revision to these forecasts. In addition, continued emigration would further reduce the domestic economically active population. On the other hand, growth could be boosted by several large aid-funded infrastructure projects that were not factored into the official forecast, and by the fact that the Cook Islands retains its appeal as a safe tourist destination. Overall, GDP can be expected to grow at an annual rate of around 2.5% in the next few years. Inflation could fall back to the 2–3% range.

EAST TIMOR

Economic growth continued at a rapid pace in 2001 as the economy maintained its recovery from the devastation that occurred following the referendum on independence in 1999. A gradual transition to greater self-reliance has begun, although substantial international assistance is expected to continue in the medium term.

MACROECONOMIC ASSESSMENT

Agriculture has been recorded as the main source of income in nearly all of East Timor's approximately 500 villages, and most of them consume their agricultural production—only a small proportion of them sell a significant amount of their rice or maize harvest. During 2000 and 2001, rebuilding of seed stocks and irrigation systems, improved access to fertilizer and transport, a reduced threat of violence, and high demand resulting from the large international presence contributed to expansion in the agriculture sector. Estimates put GDP growth in 2001 at 18% (Figure 2.28), which compares with 15% growth in 2000 and a contraction of 34% in 1999. The strong growth in the services sector in Dili to meet the needs of international staff and reconstruction activities also helped lift overall output to close to precrisis levels by end-2001.

The large international presence, the reconstruction program, and the ongoing development of a large oil project in the Timor Sea led to a very high level of imports and a large current account deficit in 2001. The deficit was estimated at approximately $470 million that year, and is forecast to rise to about $662 million in 2002. However, the start of oil production in 2004 is expected to improve the current account balance.

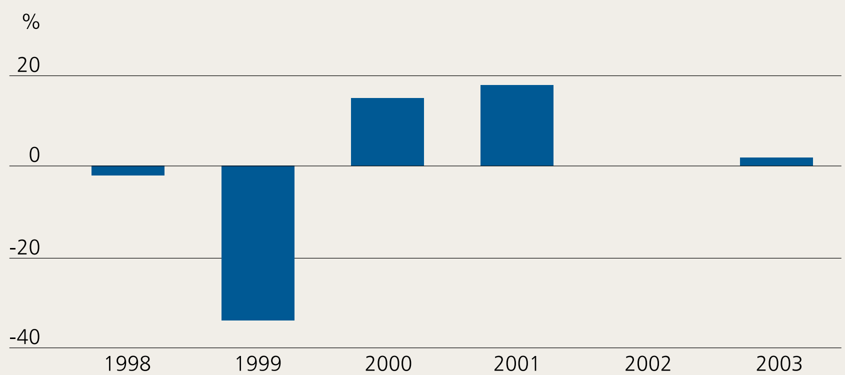
Meaningful monetary statistics are not yet available. The annual inflation rate was estimated at only 3% in 2001, compared with 140% in 1999 and 20% in 2000. The finance sector is very small, consisting largely of informal lenders, two operating branch offices of overseas banks, and a limited central bank role played by the Banking and Payments Authority (formerly the Central Payments Office).

A presidential election is scheduled for April 2002. UNTAET, the United Nations Transitional Administration in East Timor, is to complete its term at independence and a much smaller successor mission has been approved by the United Nations Security Council. There is a corresponding downsizing in international staff numbers.

POLICY DEVELOPMENTS

The future budget position rests heavily on accessing revenues from petroleum projects in the Timor Sea. Production in the first project, a gas recycling project in the Bayu Undan offshore gas field, is

FIGURE 2.28 **Change in GDP, East Timor, 1998-2003**



Source: Staff estimates.

The territory of East Timor is under the supervision of the United Nations. A Trust Fund for East Timor was established in 1999 with support from international donors. Grant projects under this Fund are formulated and supervised by ADB and the World Bank.

There is some risk of recession, depending on the extent to which the private sector can adjust to the decline in the size of the public sector.

expected to begin in fiscal year 2004. There is the prospect of revenues being earned from additional projects once a range of fiscal, legal, and market issues is resolved. By fiscal year 2006, revenues are projected to flow in, but they will begin to fall off by the end of the decade. The Government has announced its intention to save some of the earnings in high-revenue years, and invest the funds. The Government will have to make up the short-run revenue shortfall either through borrowing against future oil income or continued funding from the international donor community.

One consequence of the absence of a financial market and the use of the US dollar is that many poorly educated rural dwellers are required to revise the basis of their trading arrangements. This imposes new transaction costs at a time when the rural economy is generally weak and reestablishing itself after the violence.

A second consequence is that the exchange rate cannot be used as an instrument for increasing the competitiveness of the non-oil private sector. Public sector wages that are well above previous levels may create artificially high reservation wages in the non-oil private sector and cause serious market distortions. At the same time, the essential physical, legal, and social infrastructure is generally in a poor condition. In such an environment, the private sector faces significant hurdles to expansion.

One of the pressing constraints for East Timor's development effort is its limited human capacity. Many East Timorese worked in the previous administration but, frequently, the more senior positions were held by non-East Timorese and many of the important policy, expenditure, and administrative decisions were made outside East Timor. Consequently, the human resources required to manage all facets of government need to be built up. It is also clear that the development needs, especially in basic social services such as health and education, remain very high.

OUTLOOK FOR 2002–2003

The gradual reduction in international support is expected to see GDP growth slow considerably to zero and 2% in 2002 and 2003, respectively. There is some risk of recession, depending on the extent to which the private sector can adjust to the decline in the size of the public sector. Domestic revenues are growing, but the need for international support remains substantial and is estimated at $150 million–$170 million over the 3 years to fiscal year 2005. Local revenues are expected to outweigh international funding after fiscal year 2005 as the Timor Sea oil project enters production and this should help establish a stronger fiscal environment. For non-oil exports to be competitive, inflation will have to remain low given that the currency is the US dollar.

FIJI ISLANDS

The economy grew slowly in 2001. A new administration is adopting a more interventionist approach to economic management to address the long-standing problems of weak employment growth and poverty, low levels of private investment, and restructuring of the sugar industry. The official medium-term outlook is for growth of 3.5% or more.

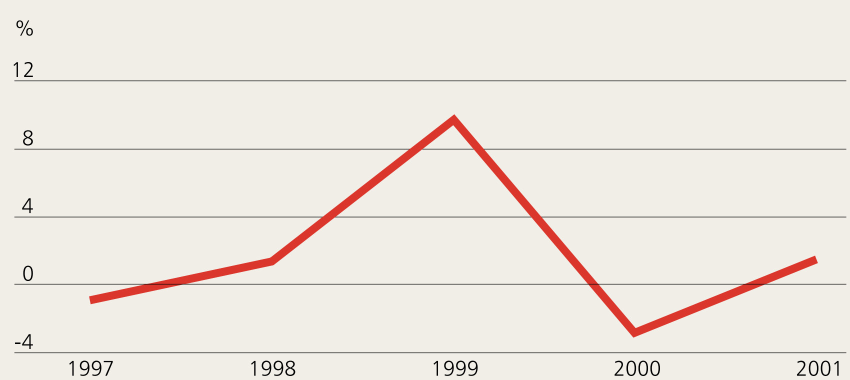
MACROECONOMIC ASSESSMENT

After falling by 2.8% in 2000 due to political instability and civil disorder, GDP increased by an estimated 1.5% in 2001 (Figure 2.29), largely reflecting the partial recovery of the tourism sector (and despite a temporary decline following the events of September 11th). The trade, restaurant, and hotel sector, and the transport and communications sector expanded by 4.2% and 7.3%, respectively. Mining and quarrying activity rose by 2% due to improved gold ore extraction, while the community, social, and personal services sector also registered modest growth, of 2.2%, mainly because of increased civil service employment. Construction activity grew by 2.9%, primarily as a result of public investment projects completed during the year, while the electricity and water sector strengthened by 3.5%. The primary sector as a whole contracted by 0.5% in 2001, largely due to a 10.2% drop in sugarcane production, reflecting transport problems and underlying uncertainty over the renewal of land leases. Aggregate manufacturing output fell by 5.5%. The finance, insurance, real estate, and business services sector declined by 3.1%, mirroring weaker business and consumer confidence.

The labor market remained sluggish in 2001 as a result of the slow economic growth. In the period from May 2000 to the end of 2001, an estimated 9,000 workers at least were laid off, of whom 2,700, or 30%, were in the garment industry. Further, skills shortages became more apparent in both the public and private sectors, as qualified and skilled citizens emigrated.

In 2001, the nominal and real effective exchange rates of the Fiji dollar remained relatively stable. The average inflation rate in 2001 was 4.3%, following one-off rises in transport and postal charges and reinstatement of VAT on basic food items. There were no demand-side pressures on the price level. These developments permitted progressive relaxation of exchange controls during the year. Monetary policy continued to focus on maintaining low inflation and ensuring adequate foreign reserves, but it was eased over the year to stimulate aggregate demand. The Reserve Bank of Fiji's minimum lending rate fell from 8.0% in January to 1.75% in October. The commercial banks' weighted average lending rate fell slightly, from 8.38% in January to 8.21% in November, while rates on savings and time deposits fell more—to 0.77% and 2.43%, respectively. The central bank undertook an initiative intended to stimulate export growth. From 1 August 2001, commercial banks

FIGURE 2.29 **Change in GDP, Fiji Islands, 1997-2001**



Source: Ministry of Finance and National Planning.

TABLE 2.24 Major Economic Indicators, Fiji Islands, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth[a]	9.7	-2.8	1.5	3.5	4.7
Inflation rate (consumer price index)	2.0	1.1	4.3	3.0	—
Merchandise export growth	19.2	-0.7	-17.2	7.7	12.8
Merchandise import growth	25.1	-5.4	-12.8	2.7	6.1
Current account balance/GDP	-4.1	-3.6	-4.4	-2.4	0.0
Budget balance/GDP	-6.4	-3.4	-4.9	-6.0	-3.7
Central government debt/GDP	38.2	40.9	42.7	46.0	46.2

— Not available.
[a] Constant 1989 factor cost.

Sources: Ministry of Finance and National Planning; staff estimates.

Despite a substantial improvement in VAT collection, operating revenues declined due to a sharp drop in direct taxation receipts, reflecting the lagged effect of the 2000 recession.

were required to lend a minimum amount to eligible exporters. The lending rate of the existing Export Finance Facility was also reduced from 3.0% to 2.0%.

Money and credit growth in 2001 continued to reflect slow economic growth, and weak consumer and business confidence. Broad money supply contracted by 1.5% as net foreign assets dropped by 11% and total domestic credit declined marginally. Within the latter area, credit to the Government, albeit a small share of the total, increased by 79.5%, while official entities reduced their borrowing by 20.3% and lending to the private sector contracted by 3.8%.

Despite a substantial improvement in VAT collection, operating revenues declined due to a sharp drop in direct taxation revenues, reflecting the lagged effect of the 2000 recession. Revenue arrears were also substantial. On the other hand, operating expenditures rose because of higher personnel spending, transfer payments, and interest payments on public debt. The outlay on general elections in September 2001 also pushed up total spending. Thus, the budget deficit in 2001 of 4.9% of GDP exceeded the target because of supplementary appropriations and a delay in asset sales of the Colonial National Bank. The underlying deficit (excluding asset sales) was 7% of GDP in 2001. Central government debt increased to 42.7% of GDP at the end of 2001. In addition, the Government confronted significant contingent liabilities, largely in the form of loan guarantees for public enterprises, which rose to over 60% of GDP at the end of 2001.

The 2002 budget stated that the Government was committed to a more interventionist role in rebuilding the economy. Priorities include a strong redistributive spending policy aimed at addressing people's basic needs; improving economic efficiency and international competitiveness; and reforming the civil service, public enterprises, and public financial management. The budget proposed an expansionary fiscal policy along with a deficit of 6% of GDP (with the underlying deficit at 6.3% of GDP) and a rise in public debt to 46% of GDP. It emphasized strengthening tax compliance and arrears collection. Operating revenues were projected to climb by 15.4% from the 2001 level, primarily as a result of higher direct taxation revenues. On the expenditure side, a shift toward capital spending, from 20% to 24% of the total, was projected. Operating expenditures were projected to rise by 3.7%, involving a reallocation away from personnel spending toward transfer payments. Planned spending on poverty reduction and rural development, education, health, and infrastructure development was raised significantly. The risks to these projections arise from their assumptions of continued political stability, nominal GDP growth of 6.1%, and success in substantially improving compliance and recovery of arrears in the area of direct taxation.

Compared with the previous year, exports declined by 17.2% in 2001. (A notable exception was fish, exports of which rose by 6%.) Total imports fell by 12.8%, largely reflecting the decline in imports of intermediate goods due to the contraction of garment production. Tourism earnings improved the services account balance, but net investment income outflows increased, as did private transfers. Official transfers (mostly

EU sugar transfers) declined. The current account deficit widened to 4.4% of GDP. The capital account surplus continued to fall as direct investment inflows and government net loan drawdowns fell. The overall outcome on the balance of payments was a deficit of $29.8 million and a lower foreign exchange reserve level of about $360 million, or 4.4 months of import cover. The external debt in mid-2001 totaled F$532.8 million, of which 58% was owed by the private sector. Interest payments on this debt were equivalent to about 1% of merchandise exports.

POLICY DEVELOPMENTS

The Government is making an effort to stimulate aggregate demand through an expansionary fiscal policy and an accommodative monetary policy. While emphasis on public investment in basic infrastructure and in health and education is appropriate, the crucial issue is ensuring that these efforts do not raise the already substantial public debt burden and threaten macroeconomic stability and growth.

In the 2002 budget, the Government announced its intention to support the implementation of a performance management system in the civil service, and to coordinate this implementation with financial management reform. A key component of the latter is a commitment to greater fiscal transparency. This will involve strengthening the financial management information system, reconsidering the 1999 Public Financial Management Act with a view to ensuring greater accountability, adopting the IMF Code of Good Practices on Fiscal Transparency, and reintroducing an internationally reputable official credit rating for the country.

Since the coup of 1987, the levels of total and private sector investment have steadily declined. Insecurity of property rights remains the major reason for the low level of investor confidence. The maintenance of political stability and consistency in policy implementation are also critical for rebuilding investor confidence. Another important issue relates to public enterprise reform, given the low return on investment. In view of the large public debt, the Government needs to be cautious in extending guarantees for public enterprise loans and in incurring contingent liabilities. It should encourage these enterprises to improve performance and borrow on the strength of their balance sheets.

The resolution of the difficult issue of land tenure arrangements is a major task for the Government. Thirty-year leases for farmers began expiring in 1997 and most have not been renewed, which is a cause for concern over the future of sugarcane production. The Government also needs to reform transport, sugar-milling infrastructure, and industrial relations in the sugar industry. The potential for crop diversification needs to be investigated in this context, given the long-term prospect of losing preferential access to EU markets.

OUTLOOK FOR 2002–2003

The official forecast is for the growth rate to accelerate to 3.5% in 2002 and to exceed 4% in the subsequent 2 years, notching up to the Government's long-term target of 5%. This is expected to generate employment growth of just under 2% a year. Based on such growth and targeted interventions, the Government aims to steadily reduce poverty. While growth is expected to be broad based, tourism is the leading sector in this drive. The agriculture, forestry, and fisheries sector is projected to grow at rates of 4–5% after 2002, assuming that sugarcane production recovers, strong growth in forestry resumes, and fisheries expansion continues.

Since 1987, the levels of total and private sector investment have steadily declined. Insecurity of property rights remains the major reason.

Inflation is projected to be about 3% in 2002–2003. Annual export growth rates of 7.7% and 12.8%, respectively, are forecast for 2002 and 2003, while import growth rates are projected to be 2.7% and 6.1%. As a result, the current account deficit will become negligible by 2003. The capital account surplus is projected to decline further as FDI inflows weaken, but the overall balance of payments should move into surplus by 2003. Import cover is projected to hold at 4 months.

After the expansionary budget of 2002, the budget deficit is projected to decline to 3.7% of GDP in 2003, primarily because the absolute levels of both operating and capital expenditures are reduced. Central government debt is projected to rise further to 46% and 46.2% of GDP, respectively, in 2002 and 2003. Assumptions about a significant rise in the investment-to-GDP ratio may not be realistic, especially when it is explicitly forecast that direct investment inflows on the balance of payments will fall during 2002–2003. However, given the small base and gradual return to normalcy, an annual GDP growth rate of 3% seems achievable in the medium term.

KIRIBATI

The economy strengthened during 2001 as government expenditures grew and copra production recovered. The economy is dominated by the public sector and is likely to remain reasonably stable over the medium term given the anticipated continued high level of government expenditures. Key emerging issues are the shift to an expansionary fiscal stance and an apparent change in attitude to the use of earnings of the country's trust fund.

MACROECONOMIC ASSESSMENT

Kiribati's economy grew by 1.5% in 2001, after a contraction of 1.7% in 2000. The improvement was attributed to a large increase in recurrent government spending, a recovery in copra production, implementation of a number of development projects, and increased private sector investment.

The inflation rate in 2001 rose to 7.1%, from 0.9% in 2000. Most of the increase was attributable to a depreciation of the Australian dollar (used as the domestic currency) and a delayed increase in local oil prices (in response to higher international oil prices) that fed into higher prices for food, drink, electricity, and local transport services.

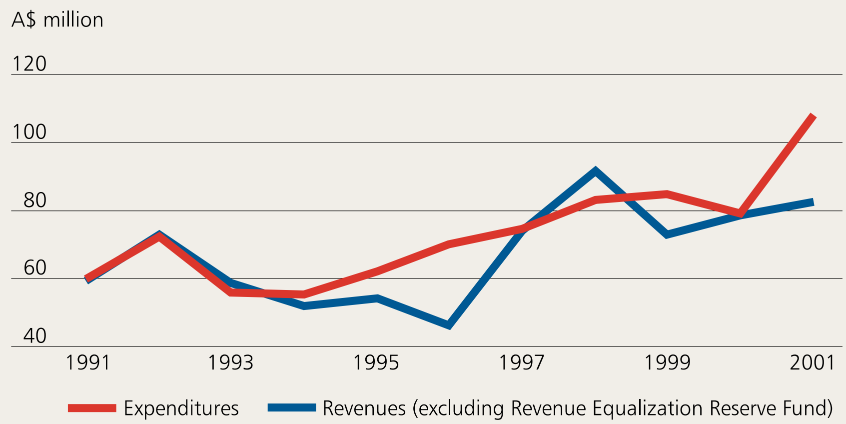
The 2001 fishing season turned out much better than initially expected, and license fees reached a record level of US$22 million, representing more than half the revenues raised locally over the year.

The Revenue Equalization Reserve Fund (RERF) has almost tripled in value over the past 10 years and, by the end of 2001, stood at US$329 million. All funds are currently invested in offshore markets, and so declined in value a little during 2001 due to the downturn in world equity markets. The RERF is designed to maintain its real per capita value over time, but good returns over recent years allowed a US$7 million drawdown of income—the first since 1997—to fund government expenditures during the year.

Fiscal management has tended to be conservative in Kiribati but has now shifted to an expansionary stance (Figure 2.30). The deficit, very small in 2000, grew substantially in 2001 to 37.5% of GDP. A large part of the additional expenditure in 2001 was attributed to a higher wages and salaries bill, higher subsidies to government-owned businesses and the copra industry, payments for landing craft, and a large contribution to development projects.

Kiribati holds a small level of external debt, in the order of US$7.6 million. But the large holding of the RERF

FIGURE 2.30 **Government Revenues and Expenditures, Kiribati, 1991-2001**



Sources: Asian Development Bank estimates based on Kiribati Statistics Office, *Government Finance Statistics, 1985-2000*; Republic of Kiribati, 2002, *Budget Papers*.

means that it has a large positive net external asset position.

The balance of payments was expected to be close to balance in 2001. Despite sizable imports and a trade deficit of some US$28 million, large inflows from fishing license fees, investment income from the RERF, and seafarers' remittances are expected to have resulted in a small current account surplus.

During the year, ownership of the sole commercial bank, the Bank of Kiribati—changed hands. The Australia and New Zealand Banking Group now owns 75% of it, with the Government owning the rest.

POLICY DEVELOPMENTS

The Government projects public sector deficits of a similar magnitude to that seen in 2001 for the medium term, and expects to finance them by higher drawdowns from the RERF, surplus funds accumulated in previous years, and loans. Important elements in the ongoing deficits are continuing increases in the wages and salaries bill and sustained subsidies and higher contributions by the Government to development projects. The use of the Australian dollar as the local currency means that this expansionary stance will have limited effect on inflation. It is likely to be felt mainly as a slowdown in the rate of growth of the country's external assets held in the RERF.

One of the key contributory factors to the strong growth in the value of the RERF over the 1990s was the policy of investing all funds offshore through professional investment managers. The 2002 budget speech foreshadowed a potential revision to this policy. The Government is studying the prospect of using some of the RERF to boost the performance of public and private enterprises via cofinancing or provision of capital for viable enterprises. Such a policy needs to be approached with considerable caution as it could lead to the erosion of the long-term benefits offered by the RERF. It could also see an increasing role for the Government at a time when the contrary approach, namely, of an increased role for the private sector, is being targeted through the country's National Development Strategy.

Nearly 20% of the formally employed labor force work on foreign merchant or fishing vessels and generate a substantial amount of factor income. This is an important source of income, particularly for people from the outer islands where poverty levels are higher and opportunities for formal employment are very limited. The copra industry too provides an important source of income on the outer islands. For many years, funds from Stabex—an EU scheme to stabilize export earnings—have been used to subsidize the copra price but these funds were largely exhausted in 2000. The Government has since pledged to fund the subsidy itself, which amounted to US$2 million in 2001. In addition, it has committed US$2 million to build a copra mill. The mill, to be operated by a private firm, is intended to increase value added from Kiribati's copra and reduce the subsidy required.

Large inflows from fishing license fees, investment income from the RERF, and seafarers' remittances are expected to have contributed to a small current account surplus in 2001.

OUTLOOK FOR 2002–2003

GDP is officially projected to increase by 2–3% in 2002–2003. The development of major public projects—including a power generation plant, sewerage project, sports complex, satellite project, rural electrification project, copra mill, and, potentially, an outer-island water supply project—are key components in the outlook.

However, the projected overall decline in government expenditures of almost 20% in 2002 (in real terms) will tend to weaken demand, and the full effect of this may not have been factored into the outlook. The growth outcome will ultimately depend on the actual government expenditures during the year.

A reduction in donor projects is foreshadowed in 2003 and locally financed development expenditures are projected to remain at 2002 levels. If total expenditures do fall as projected, economic activity may soften. However, the projected development budget for 2003 can be expected to build over the year as additional donor projects are committed to.

Inflation is expected to ease over 2002 due to lower oil prices.

The current account may move into deficit over the medium term due to high imports of materials and equipment for the sizable donor-funded projects scheduled for 2002. However, as they are donor funded, an offsetting capital inflow will help preserve the overall balance-of-payments position.

MARSHALL ISLANDS

Growth in the economy was minimal in 2001, and was based largely on limited expansion in private sector activity. A temporary increase in funding through the Compact of Free Association with the US is likely to result in some economic growth in the near term.

MACROECONOMIC ASSESSMENT

The economic difficulties of recent years continued into 2001, with estimated GDP growth slowing to only 0.6% from 0.7% in 2000. A contraction in government expenditures was brought about by the need to adjust to a downward trend in revenues and to repay the high debts accumulated over the 1990s. A positive factor was some, though limited, expansion in private sector activity due to a small rise in copra exports and the first full year of operation of a tuna processing plant. Consumer price inflation was relatively stable over the year at an estimated 2%, and is largely attributable to the low level of inflation in the US. (The US dollar is the country's currency.)

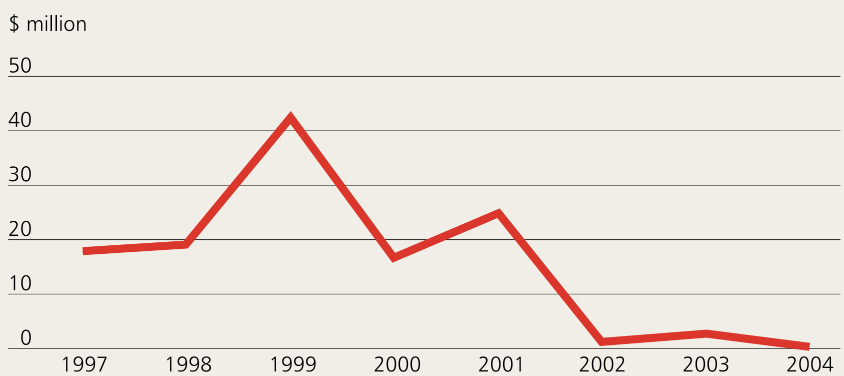
Total revenues and grants are estimated to have grown by over 13% in fiscal year 2001 while expenditures rose by just under 2%. This resulted in a budget surplus of about 17.5% of GDP, and marks a continuation of recent trends. The large surplus was required to meet large principal repayments that peaked in fiscal year 1999 at $42 million and were estimated at $25 million in fiscal year 2001 (Figure 2.31). This compares with total revenues and grants of $66 million and $84 million in fiscal years 1999 and 2001, respectively.

The Marshall Islands' export base is very narrow, with estimated exports of $8 million in fiscal year 2001 heavily outweighed by projected imports of about $60 million. Such a high level of imports is made possible by the provision of substantial financial assistance by the US under the Compact of Free Association.

Copra provides the main source of exports and of income on the outer islands. It also supports a small manufacturing operation in Majuro where it is processed into coconut oil and other products. Despite a government price subsidy, exports have trended downward in recent years. The income gained from the sale of fishing rights provides the main source of nontax revenues, amounting to approximately $3 million in fiscal year 2001. Tourism numbers are very small at around 2,000–3,000 visitors a year, and make little contribution to foreign exchange earnings.

The formal finance sector consists of two foreign commercial banks, one domestic commercial bank, and one national development bank. Local conditions determine interest rates despite the use of the US dollar and the absence of exchange controls. Commercial bank reserves are ample at around 44% of assets. Nonperforming loans are not a major issue for the commercial banks but are a problem for the development bank, which has suffered in the past from political interference and poor management.

FIGURE 2.31 **Principal Repayments, Marshall Islands, 1997-2004**



Sources: International Monetary Fund, 2001, *Staff Report for the Article IV Consultation*; staff estimates.

POLICY DEVELOPMENTS

External debt repayment requirements will fall substantially in fiscal year 2002 and remain considerably lower than in recent years. The Government intends to allocate at least 60% of the resources freed by the decline in external debt servicing to the Marshall Islands Intergenerational Trust Fund, which is also intended to receive contributions from the US and other donors in the future. The Government allocated $14 million to the Fund in 2001; and, under one scenario, the Fund would reach $750 million within 20 years and thereafter provide a regular income flow of around $30 million–$40 million a year (in nominal terms). This compares with a GDP of about $100 million in 2001.

Tax revenues have fallen in recent years following the reduction in fiscal year 1998 of general import duties from 10–12% to 5%. Total import duties have fallen by around $3 million a year. The potential exists to replace these lost revenues through a broad-based sales tax as a substitute for an existing turnover-type tax. A simple VAT was proposed for implementation in 1996 but this did not materialize. Other reasonable means for strengthening the fiscal position include the reduction of subsidies to government-owned enterprises, the adoption of (means-tested) copayments for overseas medical referrals, and the collection of unpaid social security taxes.

OUTLOOK FOR 2002–2003

The pace of growth in 2002 will be about the same as in 2001, while the outturn for 2003 will depend upon Compact negotiations. Inflation in 2002 will remain about the same as in 2001.

The Marshall Islands receives considerable direct US assistance, currently averaging around $35 million a year, the vast majority of which is in the form of direct budget support under the Compact. The availability of such support over many decades, combined with limited local resources, has created a heavy economic dependence on the Government. This dependence has inhibited the development of the fundamentals required for economic growth, from education attainment to entrepreneurial drive. Autonomous expansion of the private sector is very unlikely. Developments in the public sector, notably the future level of US funding, will continue to drive the economy over the medium term.

Compact support over many decades, and limited local resources, have created a heavy economic dependence on the Government.

The financial arrangements contained in the Compact were to be revised by October 2001. However, the Compact provided for a 2-year extension and this has secured a higher level of assistance than in the last 5 years, known as "bump-up" funds. This will increase direct budget support to $37 million annually in fiscal years 2002–2003. Assisted by this, the 2002 budget provides for an increase in expenditures from $66 million in fiscal year 2001 to $74 million. This can be expected to help sustain economic activity over the year.

Negotiations on the future level of support are continuing and the extent of adjustment that will be required post-October 2003 is unclear at this stage. In light of this impending change in revenues, it is important that expenditures, particularly recurrent expenditures, are kept to long-run sustainable levels. However, the 2002 budget provides for an increase in recurrent expenditures to $59 million from $55 million. Fiscal responsibility will probably require this to be reversed over the medium term.

The Compact provides the Marshallese with the right to work in and emigrate to the US, and there has been a steady outflow of citizens during the 1990s for this reason. While emigration will tend to encourage the most qualified people to leave the country and so depress economic activity, the option at least provides a safety valve and safeguards the quality of life for the remaining Marshallese, even if a large contraction in the public sector becomes inevitable.

FEDERATED STATES OF MICRONESIA

The economy grew at a modest 0.9% in 2001, helped by a temporary increase in funding from the Compact of Free Association with the US. Prospects depend largely on future funding under the Compact and on how these funds are used to increase economic efficiency and production in the private sector.

MACROECONOMIC ASSESSMENT

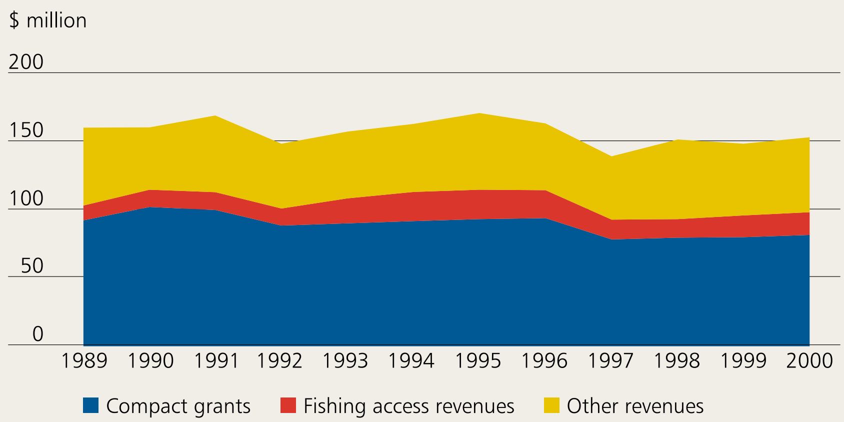
Fishing is the primary industry in the Federated States of Micronesia (FSM), followed by tourism and a modest level of manufacturing and construction. However, the economy has been highly dependent on funds from the US under the Compact of Free Association. In recent years, the Compact has provided a total of around $80 million annually in budget support for the national and four state governments (Figure 2.32). US funding reached almost $85 million in 2001, compared with an estimated GDP of $240 million for the year. The level of funding provided under the Compact has been stepped down twice since 1986, and this has required a contraction in the size of the public sector. The adjustment to the second step-down in the mid-1990s was a key factor behind 3 years of falling GDP at that time.

Current levels of Compact funding were to have ceased in September 2001 and to be replaced by a new negotiated level. In anticipation of a potentially protracted negotiation and approval process, the current agreement was extended for a further 2 years, during which time funding was set at the average rate of the 15 years of the agreement. This amounted to a temporary increase of about $17 million a year, known as "bump-up" funds. The additional funds allowed for an increase in government expenditures, mainly on development projects and wages. This helped boost economic activity over the last quarter of 2001, leading to marginal GDP growth for the year estimated at 0.9%.

Marine products generate almost all export revenues. Foreign fishing companies, operating mainly offshore, dominate the fishing industry. While fish exports have grown considerably, the industry has created relatively few jobs or profitable business opportunities for locals. The main impact of the fishing industry is via the payment of fish license fees to the national Government. With a small export base, the private sector is dominated by production for domestic consumption. Most nongovernment market activities are in services and the retail and wholesale trade, which are substantially dependent on the demand generated by government spending.

Within the private sector, the tourism industry has the best potential.

FIGURE 2.32 **Government Revenues, Federated States of Micronesia, 1989-2000**



Source: Department of Economic Affairs.

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

However, visitor arrivals declined from 16,500 in 2000 to 15,250 in 2001, with the fall concentrated among visitors from Japan and other parts of Asia. For the full year, the number of visitors from the US (accounting for around half the total) increased slightly, but this includes a decline immediately after the September 11th events.

In 2001, total formal employment (employing only about 16% of the population) fell by around 7%. Most of the decline came from cutbacks in the government sector. The annual inflation rate (for Pohnpei only) was estimated at 2.6% as of end-June 2001. The low rate reflects both the stagnant economy and low inflation in the US—the major source of imports.

Total loans from commercial banks amounted to just over $50 million at end-June 2001, or equivalent to about one fifth of GDP. Reflecting the low level of private sector activity, only $18 million were lent for commercial purposes, and the volume of these loans had declined over the 12 months to June 2001. This led to a high level of excess liquidity in the commercial banking sector.

POLICY DEVELOPMENTS

The availability of the bump-up funds has tested the fiscal credentials of the national and the four state governments. The state governments of Pohnpei and Yap, and the national Government, committed themselves to putting 50% of the additional funds into a special stabilization account of the FSM Trust Fund. This was intended to promote fiscal discipline by avoiding an increase in expenditures to likely unsustainable levels after September 2003. In contrast, Chuuk state government proposes to save the bump-up funds only for 2003, while fully spending the funds for 2002 on additional development projects and higher wages. Kosrae state government intends to use the funds to increase its wages by 20%. The risk, though, is that these two states may find it difficult to cut back the public sector if Compact funding declines after September 2003.

The Government has the potential to raise more revenues domestically, and one option is to replace an existing turnover tax. Improved tax administration is also required.

The external debt-to-GDP ratio was estimated at 24% in 2001. The national Government is committed to maintaining the debt at no more than this level through 2004. This represents a substantial reduction from a peak of 66% in the early 1990s. Given the prospect of declining revenues once Compact support is renegotiated, it is important that current debt levels remain manageable.

OUTLOOK FOR 2002–2003

Given the uncertainty of the amount of future Compact funding, it is difficult to judge how fast the economy will grow after September 2003. However, it is projected to strengthen by 3.3% in 2002, supported by the temporary increase in Compact funding, before falling to 0.7% growth in 2003. The uncertainty over the future size of the public sector is deterring private sector investment and the potential for economic expansion. It is difficult to expect much new activity prior to the finalization of negotiations with the US. Over time, national and state governments will be required to reduce expenditures or introduce new revenue-raising measures (or a combination of the two), either of which would tend to have an adverse impact on the private sector.

The international donor community has extended considerable support to strengthen fiscal management and improve the enabling environment for private sector development. Some achievements have been realized, but these need to be consolidated in Pohnpei and Yap states, while fiscal responsibility is not yet ensured in Chuuk and Kosrae states.

One consequence of large external flows has been that public sector pay rates have risen substantially above (to around double) those of the private sector. The resulting high reservation wage causes labor market distortion in the form of an excessively high cost of domestic labor to the private sector. It is very difficult to see this sector substantially reducing its dependence on the public sector as a source of demand. This factor will tend to continue to influence the prospects for private sector development over the medium term.

The international donor community has extended considerable support to strengthen fiscal management and improve the enabling environment for private sector development.

NAURU

While the economy was boosted toward the end of 2001 by external financial support, the medium-term outlook is weak, given the adverse effect of declining phosphate reserves and many years of poor fiscal management. The provision of basic public services is regularly disrupted and is at serious risk over the medium term.

MACROECONOMIC ASSESSMENT

The economy is dominated by the public sector. Power, water, telephone, post, banking, and air transport services are all provided by SOEs. The Government also owns the country's main on-island income-earning activity, a phosphate mining operation. The private sector is very small and consists largely of trade stores, an offshore banking sector, and some fishing operations. Phosphate output dropped off sharply in the early 1990s and is now at around a quarter of the levels seen in the late 1980s. This decline has led to economic activity becoming increasingly dependent on the government wages bill, compensation and royalty payments to landowners, and other initiatives as the main stimulus to demand, and this trend continued over 2001.

The state of government finances is difficult to assess. But it is clear that the Government faced serious cash constraints in 2001. This was due mainly to the suspension of phosphate exports in the second half of the year caused by the blockade of a processing plant as landowners sought additional compensation for the land occupied by the plant. By early 2002, government payrolls and payments to several creditors were delayed. The Government continued to rely heavily on the practically insolvent Bank of Nauru to help fund its budget deficits and royalty payments.

As Nauru uses the Australian dollar as its currency, inflation often follows the Australian inflation rate. However, the significant transport element (due to distances from major markets) and a lagged effect of oil price rises led to higher inflation in Nauru than Australia during the year.

In the second half of 2001, the Government of Nauru agreed with the Government of Australia to house and process over 1,000 asylum-seekers transferred from Australian waters. In return, Australia has agreed to fund a range of Nauru's equipment, material, and services needs as well as all costs of caring for the asylum-seekers. These payments will both enhance government service delivery and provide an injection of demand into the economy that will help support economic activity in 2002 and, potentially, beyond. In total, Australia's net contribution to Nauru's economy is expected to be substantial.

A pressing problem for the economy is the frequent disruptions of supplies of food, fuel, equipment, and materials. Air Nauru, the only airline servicing the country, faced repeated interruptions in 2001 due to a shortage of funds for lease payments, fuel, maintenance, and other running costs. Prior to Australian support, fuel supplies on the island had frequently been exhausted before the next shipment arrived. Public services, notably power, telecommunications, water, and health care also faced increasing problems over the year.

POLICY DEVELOPMENTS

It is expected that government revenues from phosphate mining will continue to weaken over the medium term: primary phosphate resources are largely exhausted and difficult to access; much of the mining operation's equipment is in a poor state; there is gross overstaffing; and plans to mine secondary deposits are not well developed. This decline in revenues will place considerable pressure on the budget.

Over time, the Government has faced fewer options to fund its continuing deficits. In the past, loans were acquired from official bilateral sources, overseas corporations, or the local bank, and deficits were also funded by drawdowns from the Nauru Phosphate Royalties Trust (NPRT). However, the ability to secure new deficit funding is seriously impaired by the absence of adequate collateral, local liquidity, or future revenue sources. For fiscal year 2002 (ending 30 June 2002), a deficit of A$40 million–A$50 million is budgeted, but it is unclear how this can be fully funded.

An ADB-sponsored reform program that began in 1998 was intended to promote an orderly adjustment process through fiscal and financial reforms and a one-third reduction in the civil service headcount to around 1,200. However, the retrenchment program was largely reversed in early 2000 with the appointment of up to 500 additional employees to the mining operation. At the same time, the net worth of the NPRT is believed to have seriously eroded due to the financing of continued large government deficits and poor investment of the Trust's assets.

Improved fiscal discipline would require streamlining the civil service, reducing subsidies to government services, and adopting a more appropriate tax regime (few taxes are currently levied in Nauru). The Government also needs to consider further reform to its offshore banking sector.

OUTLOOK FOR 2002–2003

Despite the short-term boost provided by the financial assistance received for housing the asylum-seekers, the medium-term outlook for the economy is weak. Per capita income is estimated to have fallen from A$9,000 in fiscal year 1988 to around A$4,600 in fiscal year 1998. It is likely that the trend continued since then. The very real risk of a crisis over the medium term exists if there is a substantial shortage of public funds, which would further impair the provision of basic public services and the import of essential goods. This would have a significant adverse impact on efforts to reduce poverty.

An important step toward bottom-up reform was made in 1999 through a National Economic Summit; however, the proceedings of the Summit were not made public. There is a need to improve transparency. The true debt position of the Government and its instrumentality, the net worth of the NPRT, and the reasons for the substantial decline in its value are not fully known. The economy's eventual adjustment will be made more difficult by its limited human resources base and, as the funds to employ such labor diminish, Nauruan workers will have to seek employment in the private sector. However, their weak education background limits their ability to undertake technical tasks, or to migrate as economic conditions deteriorate.

Economic adjustment is likely to exacerbate existing social problems. In the late 1990s, the unemployment rate of those aged 15–19 was estimated to be 33% for males and 52% for females. This situation will worsen as employment opportunities in the public sector and the very small private sector decline; replacement jobs will be very difficult to generate. There is a high incidence of gout and diabetes, because of poor dietary habits, and the incidence of these and other health problems can be expected to rise as incomes decline and funding tightens for health care and other public services.

There is a very real risk of crisis over the medium term if there is a substantial shortage of public funds.

PAPUA NEW GUINEA

The combination of a sharp decline in mining, weak domestic demand, and poor industrial profitability kept the economy in recession in 2001. There may, however, be some improvement in economic growth in 2002 as agriculture expands, though it may take longer for economic fundamentals to improve and for growth to be sustained.

MACROECONOMIC ASSESSMENT

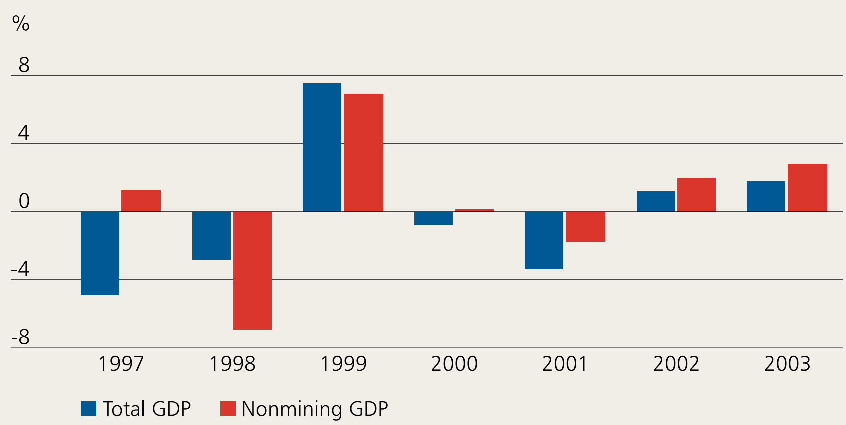
GDP contracted in 4 of the 5 years 1997–2001, the key contributors being poor macroeconomic management, drought, the Asian financial crisis and, most recently, slower growth in the world economy and low commodity prices. Earlier expectations of growth in GDP in 2001 did not materialize, partly due to delays in starting a gas pipeline project and a nickel-cobalt project in Ramu. In 2001, total and nonmining GDP contracted by 3.3% and 1.8%, respectively (Figure 2.33). The largest contractions by sector were seen in construction (9.3%); mining (9%); and transport, storage, and communications (7.4%). Sectors estimated to have expanded over the year are electricity, gas, and water (7.9%); finance, real estate, and business services (3.8%); and agriculture, forestry, and fisheries (0.9%).

A general decline in world commodity prices constrained most sectors over 2001, notably the mining and oil sector. World prices of coffee and copra fell by about 30%, and of copper and oil by about 10%. As a result, the export sector failed to realize the full potential benefit of a weaker kina.

The Government faced major difficulties in managing its finances in the first half of 2001. This was due to repeated problems in accessing all the external extraordinary financing from various donors due to a delay in meeting a major milestone for readying the country's largest bank—the Papua New Guinea Banking Corporation—for privatization. At the same time, tax revenues were lower than expected due to continuing problems with the implementation of VAT, falling oil prices, and a weak domestic economy. The Government had to cut back expenditure and put tight controls in place in the middle of the year. Overall, the budget recorded a deficit equal to 1.8% of GDP in 2001, which was mainly funded by an eventual drawdown on the external extraordinary financing in the second half of 2001. Foreign debt rose by 5.6% in 2001.

Despite the poor growth outcome, there were some important achievements in 2001. By the end of the year, inflation had fallen to below 10% due to tight monetary policy and weak demand. This was reflected in the movement of interest rates as inflationary expectations subsided. The official interest rate was reduced to 10%, a fall of about one third over the previous year's level. The weighted average of commer-

FIGURE 2.33 **Change in GDP, Papua New Guinea, 1997-2003**



Sources: Government of Papua New Guinea, 2001 and 2002, *Budget Papers*; International Monetary Fund, 1996 and 1999, *Staff Report for the Article IV Consultation.*

TABLE 2.25 Major Economic Indicators, Papua New Guinea, 1999–2003 (%)

Item	1999	2000	2001	2002	2003
GDP growth	7.6	-0.8	-3.3	1.2	1.8
Inflation rate (consumer price index)	14.9	15.6	9.8	8.3	5.0
Money supply (M2) growth	8.9	5.4	10.0	9.3	—
Merchandise export growth	9.1	7.3	-6.3	10.9	1.9
Merchandise import growth	-0.1	-7.0	-2.2	26.0	-6.1
Current account balance/GDP	4.2	10.1	7.5	2.7	5.7
Debt service ratio	7.5	6.7	6.8	6.8	9.1

— Not available.

Sources: Government of Papua New Guinea, 2001 and 2002, *Budget Papers;* Bank of Papua New Guinea, *Quarterly Economic Bulletin;* staff estimates.

cial bank lending rates also dropped from 16.9% in June to 14.7% in November 2001. The weighted average term deposit rate was 4.5% at the end of November 2001. Broad money supply (M2) rose by about 10% over 2001, with increases of 13.0% and 15.3% in net credit to the private sector and net foreign assets, respectively. Net credit to the Government climbed by about 4.5%.

Exports and imports declined by 6.3% and 2.2%, respectively, in 2001, reflecting weak global and domestic activities. As a result, both the trade and current account surpluses shrank, the latter from $352.6 million in 2000 to $221.3 million in 2001. The capital account deficit also fell from $234.7 million to $115.5 million in 2001, reflecting the large inflow of external extraordinary financing. The overall balance-of-payments surplus declined from $130 million in 2000 to $105.8 million in 2001. At the end of 2001, gross international reserves were around $400 million, sufficient to cover more than 5 months of imports or about 7 months of nonmining imports.

The annual average exchange rate of the kina against the dollar depreciated by about 20% in 2001 from the previous year's level. Due to the continuing long-term downward trend in the kina exchange rate, the business sector experienced pressure on profit margins due to the higher costs of imported inputs. The fall in the kina is triggering structural change as new operators emerge or as businesses seek to increase local content and find cheaper sources of production inputs.

POLICY DEVELOPMENTS

A continuation of the decline in GDP and per capita income has increased social tensions and unrest. This was reflected in a series of events during 2001, including student protests against privatization and temporary halts in production at important mining and oil projects caused by landowners' actions. Increased political activities in the run-up to the elections in mid-2002 have made the situation more volatile. This is adversely affecting business and investment activities, as businesses adopt an extremely cautious attitude to expansion. Such an attitude can be expected to last at least until a new government is formed in the second half of the year.

A feature of the Government's medium-term projections is an increase in the budget deficit to 2% of GDP in 2002, before a turnaround begins in 2003. While revenues and grants are projected to remain fairly stable, a cut in government expenditures is assumed after 2002. Privatization is expected to provide the main source of financing this year. However, the Government's domestic debt will have to rise thereafter, as increased domestic financing is required to offset rising external obligations. Risks to the 2002 projections arise from the possibility that the baseline assumptions on expenditure cuts, privatization receipts, correction of VAT implementation problems, continued high revenue collection from the forestry sector, and growth of personal and company tax payments may not hold good. If

The fall in the kina is triggering structural change as new operators emerge or as businesses seek to increase local content and find cheaper sources of production inputs.

the hoped-for turnaround in the budget deficit does not materialize, reliance on domestic financing may be even greater than currently predicted, adding to the potential for renewed macroeconomic instability.

Over recent years, the main role of monetary policy has been to compensate for the expansionary fiscal policy. Since 2000, the Bank of Papua New Guinea has had a legislated obligation to target price stability and has enjoyed greater independence from the Government in meeting this objective. In the past, the Bank adopted a policy of tightening the money supply as the exchange rate fell with a view to controlling inflation and curbing import demand. This approach will likely continue over the medium term, so as to break down inflationary expectations.

The Government's forecast for economic expansion rests on growth in the agriculture sector.

Many of the ongoing externally supported adjustment programs closed in 2001. Thus, the management of the balance-of-payments account and the maintenance of stable or orderly movements of the kina will be a major challenge in the medium term. The medium- and long-term prospects of the economy depend on how quickly the fall in the kina brings about structural change, thereby building the capacity to export and replace imports.

Major adjustments are required in the economy, which faces the grim prospect of substantial depletion of mining and oil resources within a decade. Continuing weaknesses in physical and social infrastructure add to the adjustment difficulties. It is important that the Government address these two areas. In addition, adoption of an acceptable reform of the land laws is critical as the present situation underlies both the social unrest and business risk perception in the country. Improved availability of credit through expansion of the capital market in rural areas is also crucial for long-term growth and poverty reduction prospects.

OUTLOOK FOR 2002–2003

The Government expects the economy to rebound moderately in the medium term, with GDP growth of 1.2% and 1.8% in 2002 and 2003, respectively. The strongest expansion is expected in agriculture, forestry, and fisheries, at 5.1% and 3.6%, respectively, in these two years. The contribution of the mining and oil sector to GDP is projected to weaken over the medium term as mining and oil resources are depleted. Inflation is projected to fall to 8.3% and 5%, respectively, in 2002 and 2003, while the current account surplus is forecast to stay at about 2.7% of GDP this year, widening to 5.7% in 2003.

The Government's forecast for economic expansion rests on growth in the agriculture sector. The projected growth for 2002 is mainly attributed to non-export activities, which largely means expansion in the domestic economy, particularly agricultural production. By 2003, improved exports are projected, with an expansion in output volumes of all major tree crops.

Palm-oil production is rising strongly, but other agricultural exports are suffering from a number of structural problems, which could derail the forecast expansion over the short to medium term. For example, the coffee harvest has been constrained by a deteriorating road network (attributable to a long-term shortfall in the funding of road maintenance) and law and order problems. Growth of the copra industry is limited by a poorly managed statutory market authority. Low world copra prices are further hampering incentives for farmers. Although a moratorium on the release of new timber areas was lifted in late 2001 and the 2002 budget reduced export taxes by around 13%, most logging operations will continue to suffer losses due to current low world timber prices. Much of the logging industry's heavy equipment is reaching the end of its useful life, and the industry is probably not making enough profit to encourage the reequipment required to meet even the minor expansion slated in government forecasts. Should the fiscal position not stabilize as projected, macroeconomic instability—including high inflation—is a possibility. Thus, there are major risks to the Government's medium-term projections and, while the economy is better placed now than it was 12 months ago, structural adjustment is still in its infancy, and the economy remains weak and very exposed to macroeconomic shocks.

SAMOA

The growth rate of the Samoan economy increased substantially to about 10% in 2001 as manufacturing, construction, private services, and fishing all continued their rapid expansion. Macroeconomic developments therefore need to be monitored closely to avoid inflationary and balance-of-payments pressures. The medium-term outlook is for economic growth to decline to the 4–5% range, avoiding overheating of the economy.

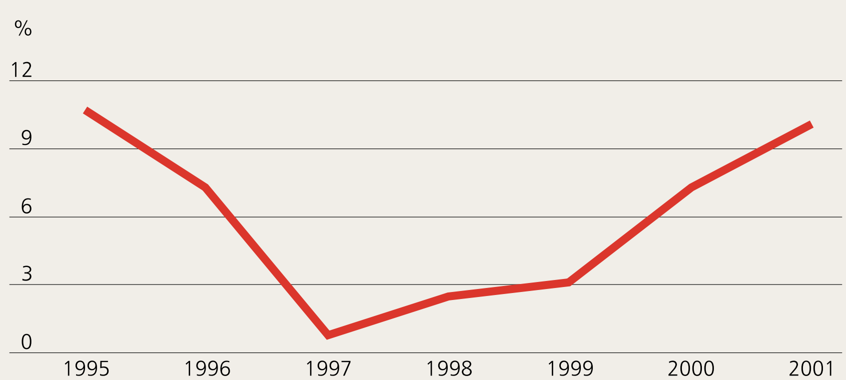
MACROECONOMIC ASSESSMENT

Economic performance has benefited in recent years from reforms introduced in the 1990s. In 2001, GDP growth accelerated to about 10% from 7.3% in 2000 (Figure 2.34). Manufacturing, construction, transport and communications, electricity and water, and hotels and restaurants all did well. However, agriculture declined by about 16% as subsistence production fell and efforts to diversify production for export remained unsuccessful. Fishing continued its expansion with the introduction of new, larger fishing vessels. In contrast, tourist arrivals were down somewhat because of the impact of the September 11th events. For example, September arrivals were nearly 12% lower than the corresponding monthly arrivals in the previous year, but because spending per tourist was higher, gross tourism earnings strengthened. The acceleration in the rate of output growth was accompanied by an increase in the inflation rate from under 1% in 2000 to 4% in 2001, above the central bank target of a maximum of 3%.

Total export revenues strengthened by about 20% in 2001 due to a surge in fresh fish exports and further growth in garment exports. Imports were about 31% higher than in 2000, with non-oil private sector imports accounting for most of the rise. The merchandise trade deficit fell to $79.8 million from $90.8 million. Despite the stronger earnings from tourism, and increased private remittances, the current account surplus as a share of GDP declined slightly. So, even with a higher surplus on the capital account, the balance of payments was in overall deficit. Foreign exchange reserves dropped and provided about 4.8 months of import cover at the end of the year, compared with 6.4 months in the previous year. As a proportion of GDP, external public debt declined from 64.8% to 60.2% at the end of fiscal year 2001 (ending 30 June). Debt service costs amounted to 18.5% of merchandise exports. During 2001, the effective exchange rate of the tala remained stable in nominal and real terms.

The budget deficit widened to 2.3% of GDP in fiscal year 2001 from 0.7% in the preceeding year. Tax revenues rose by 11.5% compared with the previous year as a result of continued rapid GDP and import growth. External grants increased by 15%. Current expenditures declined by 3%, with the wages bill falling, despite a 5% civil service salary increase from 1 January 2001. There was a reallocation away from general ser-

FIGURE 2.34 **GDP Growth, Samoa, 1995-2001**



Source: Treasury Department, *National Accounts Tables*, Table 1, September, 2001.

With rapid economic expansion in 2001, careful monitoring is needed to avoid undesirable pressures on the balance of payments and inflation.

vices toward education, pensions, and public works. A current surplus equivalent to 3.2% of GDP was recorded. Development expenditures rose by 53.6% from the fiscal year 2000 level, and the overall deficit in fiscal year 2001 was financed about 30% externally (through soft loans) and 70% domestically. This quite heavy reliance on domestic financing resulted from disbursement delays in external loans.

Broad money supply increased by about 14%. Since net foreign assets declined, an expansion in net domestic assets accounted for the growth. The Government reduced its net deposits with the banking system, while credit to the private sector and public institutions increased by almost 19%. The weighted average lending rate of commercial banks fell from 12.1% at the end of 2000 to 11.8% in September 2001, and the average deposit rate rose slightly to 4.45%, narrowing the interest rate spread. The central bank continued to use the issuance of its own securities as the main monetary policy instrument.

POLICY DEVELOPMENTS

The Government's major short-term policy challenge is to ensure macroeconomic stability while facilitating growth-promoting structural change and investment. An expansionary fiscal policy and an accommodative monetary policy stance were major factors in the rapid economic expansion of 2001, and careful monitoring is needed to avoid undesirable pressures on the balance of payments and inflation. The central bank considered tightening the money supply in the second half of the year but deferred this step in view of the events of September 11th. It also lowered its target for foreign exchange reserves to 4 months of import cover from about 6 months in 2000.

Implementation of the economic and public sector reform program continued in 2001, and the Government's commitment to ongoing reform was reaffirmed in the Strategy for the Development of Samoa 2002–2004, which emphasizes the theme of opportunities for all through sustained economic growth, better education and health, and revitalized cultural and traditional values.

A new Public Finance Management Act 2001 provided the legal framework for improved fiscal governance, and the Public Bodies (Performance and Accountability) Act 2001 likewise proposed a legal framework for better corporate governance of SOEs. A major issue in the latter context was the performance of Polynesian Airlines, which had begun to incur operating losses and was provided with a capital infusion of ST20 million in fiscal year 2001 and in the 2002 budget. Additionally, the first step in improving the commercial legal environment was taken with the passing of the Companies Act 2001, which replaced the outmoded Companies Act 1955. In the area of finance sector reform, the Financial Institutions Act was amended to place nonbank financial intermediaries under central bank supervision. The Government also moved to improve regulation and supervision of Samoa's offshore financial center by introducing amendments to the Offshore Banking Act 1997.

The process of achieving full compliance with the requirements of WTO and the Pacific Island Countries Trade Agreement continued, as did that of improving delivery of public services through performance-oriented planning and management.

OUTLOOK FOR 2002–2003

Provided that the economy does not receive severe external shocks, the outlook is for annual growth in 2002–2003 of 5%, driven mainly by ongoing and new construction projects. The expansion of the fishing fleet and of agricultural production will also contribute. Stronger agriculture will have a beneficial impact on the poor, who reside mainly in rural areas. Manufacturing will continue to register strong growth as garment production strengthens further, and copra-processing activity recovers somewhat. However, a slowdown in tourism-related sectors is expected. Annual inflation is forecast to be around 3% in 2002–2003. Stronger exports and private remittances are expected to prevent any deterioration in the current account balance as a result of import growth.

In fiscal year 2002, an overall deficit of 1.5% of GDP is budgeted as the Government continues to implement a strategy of current surpluses and development expenditures funded by external concessional loans. Total revenues and grants are projected to rise by 3.2% compared with 2001, while current expenditures are budgeted to be 9.7% higher. The current surplus is projected to fall to 1.7% of GDP, while development expenditures are projected to remain close to the 2001 level.

SOLOMON ISLANDS

The economy is still suffering from the aftereffects of recent ethnic tension. Weak management of the economy and subdued private sector activity have led to a sharp deterioration in government finances and pose a serious threat to the trade and current account balances. The Government needs to quickly adopt sound and credible socioeconomic policies.

MACROECONOMIC ASSESSMENT

After the Townsville Peace Accord in October 2000, the Solomon Islands had an opportunity to recover from the adverse effects of ethnic unrest. However, poor economic management and delays in starting the reconstruction process kept the economy depressed in 2001. GDP is estimated to have declined by about 5% following a much sharper decline of 14% in 2000. Thus the economy's output level declined by almost one fifth in two years, along with a larger decline in per capita income. The contraction in 2001 was broad based.

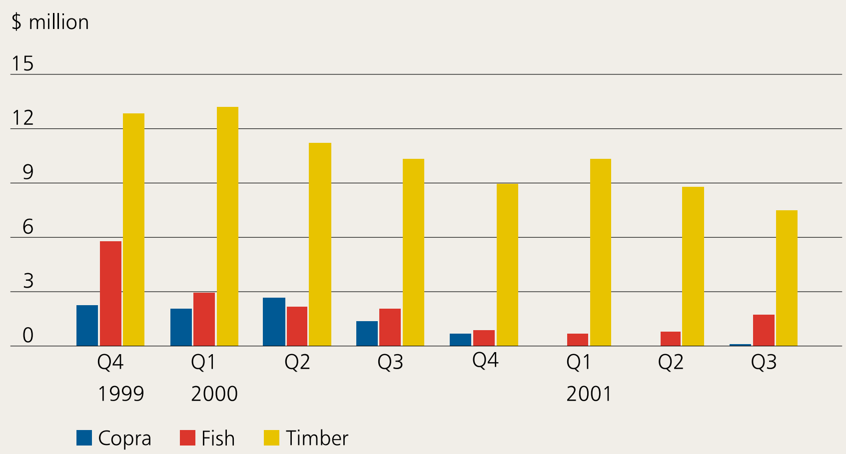
The Peace Accord led to substantial compensation payments. Faced with very tight budget constraints, the Government secured a $25 million concessional loan, $15 million of which were disbursed during 2001, helping maintain consumer spending. Domestic demand was also supported by a government payroll increase of around 30% from the 2001 level. Inflation declined marginally to about 8% in 2001, despite subdued economic activity and a decline in the money supply.

The Government's fiscal position deteriorated greatly in 2001, resulting in a deficit of about 8% of GDP. This was caused mainly by the rise in the number of government employees, the adverse impact on general revenue collections of a weaker economy, and import duty and tax remissions. By the end of 2001, payments to public servants, transfers to provincial governments for education and health, and payments to utilities were all delayed. Repairs to infrastructure damaged during the ethnic tension could not be started. No employee contributions were made to the Solomon Islands National Provident Fund (NPF) for the year. In addition, the Government defaulted on international debts and domestic debts held by local commercial banks and the NPF.

The Government exceeded the statutory limit on borrowing from the central bank. According to an official report, total government debt reached 115% of GDP in December 2001. Further, most key public enterprises also faced cash-flow problems, which were reflected in the delivery of services.

In line with declining economic activity, broad money supply and credit to the private sector contracted by about 12.5% and 21.5%, respectively, in 2001. However, a large level of excess liquidity built up in the banking system—three times the minimum liquid asset ratio set

FIGURE 2.35 **Principal Exports, Solomon Islands, Q4 1999-Q3 2001**



Source: Statistics Division, Ministry of Finance, as cited in Central Bank of Solomon Islands, *Quarterly Review*, various issues.

by the central bank at the end of September—while the demand for loans remained low due to weak business confidence.

Major export-oriented business related to fisheries, copra, cocoa, palm oil, and gold remained closed in 2001. Timber exports increased for the first three quarters of 2001, before stalling after exporters and the Government disagreed over log valuations. These supply disruptions, together with generally weaker world prices, led to a substantial fall in exports during the year (Figure 2.35), which was a major factor behind the decline in GDP. Imports, on the other hand, declined only marginally due to the compensation payments under the Peace Accord, the government payroll, and the import duty and tax concessions. Consequently, the trade deficit widened considerably in 2001. Gross external reserves at end-2001 were sufficient to cover only about one month of imports.

In recent years, the Solomon Islands adopted an exchange rate policy that was relatively inflexible, with some controls on capital movements. In mid-2000, further exchange controls were put in place to prevent capital outflows in the wake of lower deposit rates and concerns about capital flight following the ethnic conflict. By the end of 2001, the central bank decided on a more flexible exchange rate regime.

POLICY DEVELOPMENTS

A new Government was elected in December 2001, and faces the challenge of rebuilding an economy that is almost devastated. Further, the incomplete collection of weapons and insecure law and order conditions are serious concerns. Compensation has also been a major burden on government finances since last year. One of the first initiatives of the new Government was a decision on the cessation of the duty and tax remissions. However, sustainable fiscal consolidation will require further large cuts to the government payroll, strict controls on other expenditure items, and, possibly, the introduction of new revenue measures. There are indications that the Government will consider measures along these lines in the new budget.

It is important that the infrastructure is quickly restored. Special efforts are needed to restore business in the main export-oriented areas. Such initiatives, along with firm commitments to wide-ranging reforms, are likely to generate a more positive and critically needed response from the global donor community.

The finance sector is under great strain due to increased nonperforming assets. Maintenance of stable and efficient financial intermediation will remain crucial during the reconstruction period for sustainable economic development. The financial position of the NPF is also of particular concern as it has a bearing on financial market instability. It already faces large arrears, mainly from the Government, and almost its entire investment portfolio is held domestically.

OUTLOOK FOR 2002–2003

The formal sector of the economy faces major challenges due to damaged plant and equipment, financial difficulties, and the high cost of rehabilitation.

The formal sector of the economy faces major challenges due to damaged plant and equipment, financial difficulties, and the high cost of rehabilitation. Insurance will be very difficult to obtain for any future venture, particularly in mining, and this will create an added hurdle to investors seeking to restart closed operations. However, some encouraging recent economic developments should be noted, notably in the recommencement of fresh fish exports and sales of tinned fish.

Any forecast for the medium term is severely constrained by the lack of adequate economic data, as the country's statistical capacity was greatly damaged during the ethnic conflict. However, based on the assumption of substantial positive measures by the Government, an official report expects the contraction in the economy to halt by the end of 2002. Accordingly, GDP is projected to decline by 5% in 2002 and to stagnate in 2003 before growth begins. These projections are realistically achievable given that the economy's base is already very low.

Inflation is unlikely to change significantly in the medium term since domestic demand is expected to be restrained along with the fiscal deficit, and the supply position is likely to improve. Officials project the current account deficit to decline further to SI$85 million in 2002 before turning into a surplus of SI$40 million in 2003. The overall balance of payments is expected to show a surplus of SI$70 million and SI$192 million, respectively, in 2002 and 2003. The major risks to these projections stem from the possible continuity of weak fiscal management, and from sagging business confidence because of the security conditions.

TONGA

The economy expanded by a slower rate of 3% in 2001, led by the government administration and community services subsector. Medium-term prospects are for growth to remain at around this level. Key policy issues include the need for short-term tightening of fiscal and monetary policies, and effective implementation of a public sector reform program.

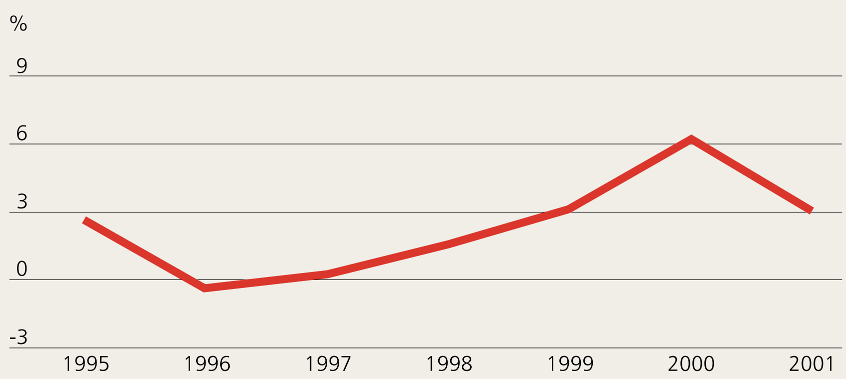
MACROECONOMIC ASSESSMENT

GDP growth decelerated to 3% in 2001 (Figure 2.36), largely reflecting slow growth in agriculture and tourism. Although there was a sharp slowdown in primary sector growth to 1.3%, the secondary sector grew by 5.4%, largely reflecting increased handicrafts manufacture, breadfruit production, and processing of agricultural products. Activity in the construction and quarrying subsectors was also up by 9% as a result of several large aid-funded and private sector projects. The services sector as a whole expanded by 3.8% in 2001, but the performance of the subsectors displayed considerable variation. The commerce, hotels, and restaurant subsector contracted by 2%, after significant expansion in 2000 due to millennium celebrations and conferences. The government administration and community services subsector, which accounts for some 18% of GDP, increased by 10% as a result of a 20% pay rise for civil servants. Most other services subsectors recorded modest growth. The inflation rate accelerated to 6.3% due to expansionary fiscal and monetary policies and substantial currency depreciation.

The fiscal situation deteriorated in 2001, largely due to the civil servants' pay rise, a shortfall in nontax revenues, and substantially increased spending to support certain ailing public enterprises. The wages share of current expenditures reached 57% and the current budget was in deficit at about 0.5% of GDP. The overall budget deficit was 2.6% of GDP, financed largely by advances from the domestic banking system and by some bond issues. Public domestic debt outstanding rose to T$32.5 million in 2001, to which must be added an estimated T$32 million in unfunded liabilities arising from a retirement scheme for civil servants introduced in 1999. As of mid-2001, the assets of the Tonga Trust Fund, which is held offshore and maintained separately from the budget and official foreign reserves, had fallen steeply due to weak management.

Broad money supply rose sharply by 26.5% in 2001. Domestic credit expanded by 31.3%, with private sector credit rising by 24.8% (partly reflecting a large loan for imports of telecommunications equipment), and net credit to government increasing more than five-fold in line with the financing of the fiscal deficit. Credit to nonfinancial public

FIGURE 2.36 **Change in GDP, Tonga, 1995-2001**



Sources: International Monetary Fund, 2001, *Statistical Appendix*, September; International Monetary Fund, 2001, *Staff Report for the Article IV Consultation*, October.

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

enterprises more than doubled. The effectiveness of monetary policy remained constrained by the weakness of the balance sheet of the central bank, which placed increased reliance on credit ceilings. The weighted average deposit rate dropped marginally to 4.7% in 2001. The base lending rate was stable at 9.0%, so that the interest rate spread widened slightly. With higher inflation, the real deposit rate became negative.

The trade deficit shrank to approximately one third of GDP in 2001 as merchandise exports, primarily squash and fish, increased by 3.7%, while imports declined by 4.3%, due to weak domestic demand. Net private transfers from Tongans living abroad continued to be the major source of foreign exchange, at about four times the value of exports. However, the services account turned negative due to payments made to Australia in connection with aircraft leasing arrangements; net investment income flows were also negative. The current account recorded a deficit equivalent to 8.2% of GDP. The capital account surplus fell further from its historically low level in 2000 due to a rise in Tongans' overseas investments. Consequently, the level of official foreign reserves dropped to US$12 million, or equivalent to about 2 months of imports of goods. The official external debt (including that of public corporations) stood at 44.6% of GDP. The debt service ratio was 19.5% of exports of goods and services. The pa'anga depreciated by 11% in nominal effective terms and by 6.8% in real effective terms.

The major impediment to private sector growth and foreign investment is the lack of transparency and predictability in the regulatory mechanism.

POLICY DEVELOPMENTS

The rise in substantial unbudgeted expenditures poses a risk of even higher inflation as well as a risk to the balance of payments. In addition, the Government needs to direct public spending away from wages toward operation and maintenance. To improve fiscal performance, the Government has already begun to consider the extensive range of tax and tariff exemptions granted under the Industrial Development Incentives Act. The issue of capturing a reasonable share of the resource rent in the fast-growing fisheries subsector also needs to be addressed. A large public enterprise sector has been a drain on the public purse and is still in need of major reform.

The most promising industry in the country is tuna fishing, primarily for export, with more modest prospects in agriculture and tourism. The major impediment to private sector growth and foreign investment is the lack of transparency and predictability in the regulatory mechanism. Other hurdles include an inefficient tax system and a costly public sector. These are being addressed through an economic and public sector reform program approved in principle by the Cabinet in early 2002.

OUTLOOK FOR 2002–2003

The outlook is for marginally slower GDP expansion in 2002 of 2.9%, and higher inflation at 10%, since monetary expansion may be used to finance the fiscal deficit. A stimulus to growth is expected from a rapid rise in production of fish for export and a modest expansion in agricultural production, with the primary sector growing slightly faster at 3%. However, secondary sector growth is projected to slow to 4% as expansion in construction, mining, and quarrying decelerates. Slower tertiary sector growth of 2.5% is projected. A strong recovery in tourism-related services is unlikely given the events of September 11th 2001, which are also expected to reduce remittance flows, as about 60% of these flows were from the US, where many Tongans worked in the airline industry and faced job losses. A slowdown in the dominant government services subsector is likely as long as a hiring freeze, introduced by the Government in mid-2001, remains in place.

Growth in 2003 is projected at 2.6% as a result of slightly slower expansion in all sectors, except for commerce, restaurants, and hotels, and private services, which are forecast to pick up as the tourism sector shows additional strength. Inflation is projected to moderate to around 5% as macroeconomic policy tightens following the implementation of a major economic and public sector reform program. In late 2002 and in 2003, the current account balance is expected to improve as somewhat faster export growth combines with slower import growth. A rise in net official capital inflows and an overall improvement in the balance of payments are forecast.

The 2002 budget anticipates substantial rises in nontax revenues and in external grants. Current expenditures are projected to rise by 8%. The overall budget deficit is projected at 2.3% of GDP. However, the revenue outlook appears overoptimistic, and unbudgeted expenditures are likely to cause the actual spending level to substantially exceed estimates. An overall budget deficit of over 4% of GDP seems more likely.

TUVALU

GDP expanded by 4% in 2001, led primarily by the public sector. Major policy issues include the sustainability of recent increases in public spending and public sector management. The medium-term outlook is for growth of 3%.

MACROECONOMIC ASSESSMENT

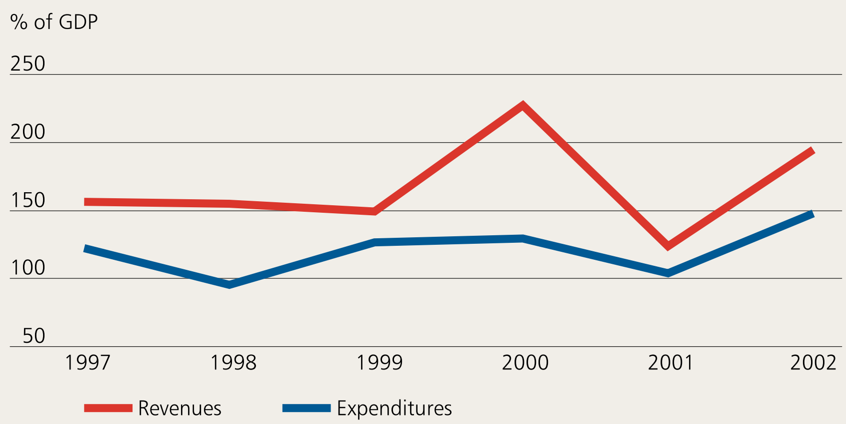
The economy grew by approximately 4% in 2001, following 3% expansion in 2000. Growth was led by the public sector, with public administration rising by close to 5% and construction continuing its recent expansion due to government- and donor-funded projects. Road improvement on the main island of Funafuti was the most significant of these projects and stimulated growth in mining and quarrying. Other sectors grew at more modest rates of around 2%. GNP in 2001 substantially exceeded GDP because of estimated remittances from Tuvalu's seafarers of $2.6 million, fishing license fees of $6.1 million, telecommunications license fees of $0.31 million, and revenues from leasing out Tuvalu's Internet domain address (".tv") of $1.6 million.

Prior to 2001, net income from overseas had been augmented significantly by returns from the Tuvalu Trust Fund (TTF), but these returns were smaller in 2001 due to weakness in overseas financial markets. In 2000, a windfall of $14.5 million in revenues from .tv Corporation International, the company leasing the Internet address, supported a substantial rise in government spending while maintaining the large budget surplus (Figure 2.37). The expectation of further windfall gains encouraged a 2001 budget that explicitly broke with the post-independence tradition of fiscal prudence by planning operating expenditures of $2.3 million in excess of estimated sustainable (or "core") revenues. The Government's special development expenditures were projected at $6.5 million. An estimated $5.7 million in the windfall revenues were intended to fund such special expenditures resulting in an overall budget deficit of $3.1 million. Extrabudgetary development expenditures are entirely financed by external capital grants and were projected at $6.5 million in 2001.

The actual budget outcome for 2001 was estimated to yield an overall budget surplus of $2.5 million, equivalent to about 20% of GDP. Total revenues were 11% above the original budget estimate because of unexpectedly high tax and fishing license revenues. However, revenues from interest, dividends, and telecommunications license fees were lower than the budget estimate.

Total expenditures were 44% below the estimate because of below-budget spending on all current and capital expenditure items. During the year, the Government drew down on the Consolidated Investment Fund (the B account) of the TTF and borrowed from the state-owned National Bank of Tuvalu to buy shares in Air Fiji. The opening of a permanent mission to the United

FIGURE 2.37 **Government Revenues and Expenditures, Tuvalu, 1997-2002**



Source: Ministry of Finance and Economic Planning.

The sustainability of recent increases in government spending is a major emerging policy concern.

Nations in New York added $370,000 to expenditures; subsidies to copra growers and public corporations also continued.

The inflation rate in 2001 fell to 1.8%, from 5.3% in 2000, reflecting falls in textiles and clothing prices, and in costs of miscellaneous items. The National Bank's lending rates for house and personal loans were 8% and 11%, respectively. The rate on savings deposits remained at 2% and offered little incentive to potential depositors.

Imports in the first three quarters of 2001 were $5.3 million, approximately double the level of the corresponding period in 2000. The substantial trade deficit continued to be financed by remittances, investment income, fishing and telecommunications license fees, and official transfers. Net foreign assets, inclusive of the TTF, were adversely affected by weakness in global financial markets, but still underpinned a sound external position. The market value of the TTF at 30 September 2001 was $32.6 million, equivalent to around 5 years of import cover.

POLICY DEVELOPMENTS

The budget for 2002 set a core operating spending ceiling of $11.6 million, special development expenditures at $2.5 million, and capital spending at $5.6 million. Revenues and grants were projected to total $26.1 million as a result of higher interest income and dividends and $10 million from another installment on the sale of the Internet address. An overall budget surplus of $6.4 million, or 47% of GDP, was projected.

The sustainability of recent increases in government spending is a major emerging policy concern. The balance of the B account needs to be raised toward the target level of $18.9 million (as determined by the Government and external consultants) to protect public expenditures against revenue volatility and possible decline. This will require better public financial management based on timely preparation of a realistic budget, which involves line ministries, and on sound budget execution, which in turn requires good cash management and an operative accounting and reporting system.

A related policy issue is the desirability of establishing a formal, arms-length relationship between the Government and the National Bank, to minimize the risk of improper political influence on bank management and to ensure appropriate regulation of a profitable monopoly. One recommendation is that regular and independent prudential supervision be arranged with donor assistance, and that an experienced overseas bank executive be appointed as a visiting bank director.

The management of public enterprises needs to be improved to reduce the drain on the public purse and to improve service delivery, following the example of the Tuvalu Maritime School, which has been commercialized into the Tuvalu Maritime Institute.

In an effort to reduce the disparity between household income in Funafuti and the outer islands, the Government is implementing an Island Development Program. This aims to decentralize administration, improve public service delivery, promote small business development, and encourage the sustainable augmentation of financial resources for outer island development through the Falekaupule Trust Fund. In 2001, the Fund reached a capital base of $8.2 million and the first distribution of earnings of $318,000 was made to island councils for development expenditures and $104,000 was placed in a buffer account modeled on the B account of the TTF. Continued implementation of the Program and of the associated Falekaupule Trust Fund is necessary if internal migration flows to Funafuti are to be reversed.

OUTLOOK FOR 2002–2003

Annual growth in 2002–2003 is projected to be around 3%, with inflation stabilizing at 1.5% in 2002 and 2.1% in 2003. Activity in the market economy will remain concentrated in Funafuti and will be dominated by the public sector. In 2002, the construction of a new $7 million government office building and a new hospital is scheduled to begin, while road reconstruction continues. New school classrooms are to be built on two of the outer islands. A slight increase in public sector employment is projected as existing vacancies are filled. These developments will stimulate private sector activity, which is otherwise constrained by remoteness from markets and poor international transport links. Given the projected state of the global economy and financial markets, no automatic distribution from the TTF is likely in either 2002 or 2003. Following the windfall gain in 2002, revenues from the marketing of the Internet address are projected to be lower in 2003, in the range of $1 million–$2 million, while fishing and telecommunications license fees are expected to be stable.

VANUATU

The economy contracted slightly during 2001, a key factor being the loss of agricultural production following two damaging cyclones early in the year. Over the medium term, a tighter fiscal stance will be necessary to avoid macroeconomic instability and to underpin efforts to promote a favorable investment climate.

MACROECONOMIC ASSESSMENT

GDP is estimated to have declined by 0.5% in 2001 after a 3.7% expansion in the previous year (Figure 2.38). Much of the decline is attributed to a contraction in agriculture, forestry, and fisheries. Tourism also performed poorly, particularly in the last few months of the year. Two cyclones that hit Vanuatu early in 2001 led to considerable destruction of coconut palms, and copra exports fell by nearly 50%; exports of kava and beef also weakened.

Government revenues fell below forecast levels in 2001 as the economic slowdown reduced import duties and VAT collections. Revenues from Internet gambling and the Asset Management Unit's sale of public assets failed to live up to expectations. As a result of the deteriorating fiscal position, the Government reduced spending on recruitment of new staff and introduced other restrictions. These controls were projected to have lowered total expenditures to 7.4% below the original appropriation and to have kept the budget deficit for the year to within 1% of GDP. However, the actual outcome for the year showed that total recurrent expenditures exceeded the budget by 4%. Due to the weakening fiscal position, the Government resorted to net domestic market borrowing of approximately US$4.3 million, mostly accounted for by an increased overdraft with the Reserve Bank of Vanuatu.

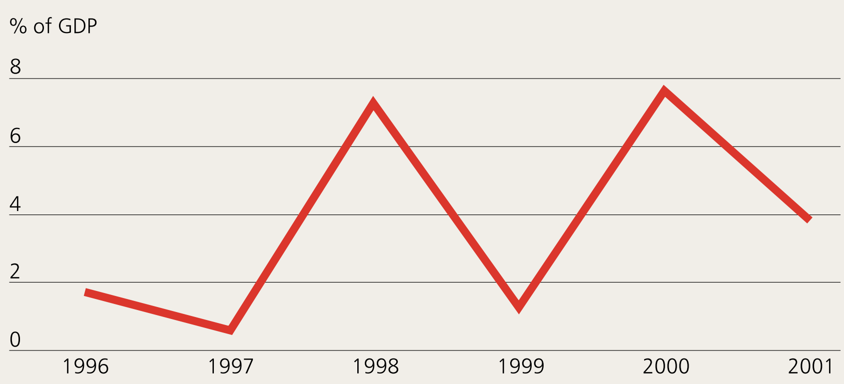
Private sector credit grew from US$81 million at the end of 2000 to US$85 million at the end of 2001, due to increased borrowing by construction, distribution (wholesale and retail), transport, manufacturing, and tourism. Broad money supply expanded by 5.5% over the year. Interest rates remained well above international levels during the year.

Poor export performance resulted in a deterioration of the trade balance. Nevertheless, international reserves remained comfortable, covering about 5.7 months of imports at the end of September. Inflation accelerated to 3.6% from 2.5% in the previous year, mainly because of higher prices for housing and utilities, and for transport and communications.

The vatu depreciated slightly against the US dollar in 2001. The annual average exchange rate in 2000 was 137.8 to the US dollar, but it fell to 147.0 by the end of 2001. Against the Australian dollar, the vatu showed a slight appreciation over the year.

Public debt surged in the 1990s, from 16% of GDP in 1990 to more than 40% in 2001, partly due to the need to fund losses by the National Provident Fund. The increased debt led to higher

FIGURE 2.38 **Fiscal Deficit, Vanuatu, 1996-2003**



Source: Vanuatu Statistics Office, 2001, as cited in Reserve Bank of Vanuatu, 2001, *Quarterly Economic Review*, March.

debt service costs, which rose by 13% in 2001. Around 80% of the public debt is external.

To look at ways of broadening the tax base, a Revenue Review Committee has been established.

POLICY DEVELOPMENTS

The Vanuatu Public Finance and Economic Management Act restricts the level of external debt and debt service costs to "prudent" levels, defined as an external debt-to-GDP ratio of 40% and a ratio of debt service costs (excluding principal repayments of domestic debt) to domestic revenues of 8%. External public debt is currently 33% of GDP and so well within the limit set. Annual debt service costs are anticipated to rise to 7.4% of domestic revenues in 2003 and to reach their ceiling in 2007.

The Government has responded to the situation by planning for small budget deficits over the medium term. Domestic debt incurs a higher interest cost than concessional external loans, and domestically financed deficits run the risk of deteriorating the exchange rate and increasing inflation.

To strengthen the fiscal position through a broadening of the tax base, the Government recently established a Revenue Review Committee to prepare a strategic tax policy framework. The intention was to lift the ratio of revenues to GDP from the current level of 22–23% to 27%. However, none of the major recommendations made by the Committee in mid-2001 has yet been implemented.

The fiscal position could also be improved through better revenue administration, and additional resources are now being allocated to both the Department of Customs and Inland Revenue to improve compliance. Unfortunately, the resources required to administer VAT, which was introduced in 1998, meant that the collection of import duties and other revenues suffered.

OUTLOOK FOR 2002–2003

The Government is aiming to achieve GDP growth of 4.5% over the medium term by encouraging private, including foreign, investment. Accordingly, the Foreign Investment Act was amended in 2001 to promote investment from overseas. The reform efforts pursued since 1997 under the country's Comprehensive Reform Program also remain important in improving the climate for the private sector.

However, the budget forecasts recognize the difficulties that will be faced in rapidly building economic activity, and project GDP growth of only 0.7% in 2002 and 1.9% in 2003. A budget deficit equal to 1.5% of GDP is projected for 2002, but the Government will find it hard to achieve this unless it significantly improves current revenue collections and expenditure control.

There is some risk of a further increase in inflation if fiscal policy loosens over the medium term or if external shocks lift import prices. The Reserve Bank of Vanuatu views the current level of inflation of 4% as a critical level, and any further increase may trigger a tightening of monetary policy. The high level of international reserves and prospects of a rebuilding of export revenues during 2002 mean that a stable exchange rate and a sustainable balance-of-payments position should be achievable over the medium term.

PREFERENTIAL TRADE AGREEMENTS IN ASIA AND THE PACIFIC

Global multilateral trading arrangements offer the best prospect for reducing barriers to trade and achieving the greatest gains from trade liberalization. Preferential trade agreements (PTAs) are a second-best means of achieving trade liberalization in a context where multilateral negotiations proceed slowly. There is considerable variation in the efforts undertaken by PTAs in different parts of the world. As institutions for international cooperation, PTAs in the Asia and Pacific region are relatively advanced and have served as vehicles for fostering regional cooperation in other economic and non-economic issues, though they have been less active than PTAs in other regions in altering tariffs. The diversity of PTAs highlights the need to avoid discussing them in general terms, and greater nuance in their portrayal can aid in understanding the types of PTAs that can serve as useful components of a multitiered international trading system. Empirical research shows that PTAs have generally increased trade both among members and between members and nonmembers, but also supports the conclusion that the effects of PTAs vary significantly, depending upon their particular institutional characteristics.

INTRODUCTION

Trade openness is widely recognized as a cornerstone of economic development and growth, and, ultimately, poverty reduction. Open borders have been linked with the stimulation of economic growth, with microeconomic improvements in the efficiency of resource allocation, and with increases in the level of competition among industries. Trade increases the variety of intermediate products and capital goods that are available and opens up communication channels for exchange of production methods and business practices. Economic integration has also been shown to have an important impact on reducing corruption, increasing government responsiveness, and improving the quality of economic policies.

Although there is substantial debate over the extent of the short-term adjustment costs of reducing barriers to trade, there is near unanimity that increased trade openness has had a significant long-term positive impact on economic development. In this context, developments in preferential trade agreements (PTAs) and multilateral trading arrangements carry important implications for future economic growth and prospects for reducing poverty in the developing world.

There are many reasons to be optimistic about increasing global trade and the trend among economies in the Asia and Pacific region toward greater integration, including the expansion of PTAs in the region. The volume of trade globally has risen steadily in recent decades, and the increase was particularly

TABLE 3.1 World Trade Organization and Preferential Trade Agreements, Membership Status of Developing Member Countries, 2001

Developing Member Country	World Trade Organization Membership Status (Date of Membership or Date Working Party Established)	AFTA (Jan 1992) [a]	APEC (1989)	CIS (Dec 1994)	ECO (Jul 1992)	GSTP (April 1989) [b]	MSG (July 1993)	SAARC (Dec 1985)	SAPTA (Dec 1995)	SPARTECA (Jan 1981)
	Date of Establishment									
Afghanistan					●					
Azerbaijan	Applicant (16 July 1997). Submitted a memorandum on its foreign trade regime in April 1999. A first set of questions concerning the memorandum was circulated in July 2000 and a second set in December 2001.			●	●					
Bangladesh	Member (1 January 1995).					●		●	●	
Bhutan	Applicant (15 July 1999). Not submitted a memorandum on its foreign trade regime. The working party has not yet met.							●	●	
Cambodia	Applicant (21 December 1994). Submitted a memorandum on its foreign trade regime in June 1999. Replies to questions concerning the memorandum were circulated in January 2001. First meeting of the working party took place on 22 April 2001. The next meeting is planned for the first quarter of 2002.	●								
China, People's Rep. of	Member (11 December 2001).		●							
Cook Islands										●
Fiji Islands	Member (14 January 1996).						●			●
Hong Kong, China	Member (1 January 1995).		●							
India	Member (1 January 1995).					●		●	●	
Indonesia	Member (1 January 1995).	●	●			●				
Kazakhstan	Applicant (6 February 1996). Last meeting of the working party was in October 1998. Bilateral market access negotiations in goods and services commenced in October 1997, and are continuing based on a revised goods offer and the existing services offer. Working party last met in July 2001.			●	●					
Kiribati										●
Korea, Republic of			●			●				
Kyrgyz Republic	Member (20 December 1998).			●	●					
Lao People's Dem. Rep.	Applicant (14 April 1999). Memorandum on its foreign trade regime was circulated in June 2001. The first meeting of the working party is expected to take place in the first half of 2002.	●								
Malaysia	Member (1 January 1995).	●	●			●				
Maldives	Member (31 May 1995).							●	●	
Marshall Islands										●
Micronesia, Federated States of										●
Mongolia	Member (29 January 1997).									
Myanmar	Member (1 January 1995).	●				●				
Nauru										●

TABLE 3.1 (cont'd.) World Trade Organization and Preferential Trade Agreements, Membership Status of Developing Member Countries, 2001

Developing Member Country	World Trade Organization Membership Status (Date of Membership or Date Working Party Established)	AFTA (Jan 1992) [a]	APEC (1989)	CIS (Dec 1994)	ECO (Jul 1992)	GSTP (April 1989) [b]	MSG (July 1993)	SAARC (Dec 1985)	SAPTA (Dec 1995)	SPARTECA (Jan 1981)
	Date of Establishment									
Nepal	Applicant (21 June 1999). The first meeting of the working party took place in May 2000. Market access negotiations commenced in September 2000. The next meeting of the working party is expected to be held in 2002.							●	●	
Pakistan	Member (1 January 1995).				●	●		●	●	
Papua New Guinea	Member (9 June 1996).		●				●			●
Philippines	Member (1 January 1995).	●	●			●				
Samoa	Applicant (15 July 1998). Memorandum on its foreign trade regime was circulated in February 2000. Replies to a first set of questions concerning the memorandum were circulated in August 2000, and replies to a second set are pending. The first meeting of the working party may take place in the first half of 2002.									●
Singapore	Member (1 January 1995).	●	●			●				
Solomon Islands	Member (26 July 1996).						●			●
Sri Lanka	Member (1 January 1995).					●		●	●	
Taipei,China	Member (1 January 2002).		●							
Tajikistan	Applicant (18 July 2001). Not yet submitted a memorandum on its foreign trade regime. The working party has not yet met.			●	●					
Thailand	Member (1 January 1995).	●	●			●				
Tonga	Applicant (15 November 1995). A memorandum on the foreign trade regime was circulated in May 1998 and replies to questions concerning the memorandum were circulated in November 2000. The first meeting of the working party was held in April 2001.									●
Turkmenistan					●					
Tuvalu										●
Uzbekistan	Applicant (21 December 1994). Submitted a memorandum on its foreign trade regime in September 1998. Replies to questions concerning the memorandum were circulated in October 1999. Bilateral market access contacts have been initiated. The first meeting ofthe working party may take place in the first half of 2002.			●	●					
Vanuatu	The final meeting of the working party was held on 29 October 2001.						●			●
Viet Nam	Applicant (31 January 1995). Topics under discussion in the working party include agriculture, the customs system, import licensing, national treatment, sanitary and phytosanitary measures and technical barriers to trade, state trading, trading rights, and trade-related intellectual property rights.	●	●			●				

AFTA = ASEAN Free Trade Area; APEC = Asia-Pacific Economic Cooperation; CIS = Commonwealth of Independent States; ECO = Economic Cooperation Organization; GSTP = Global System of Trade Preferences among Developing Countries; MSG = Melanesian Spearhead Group; SAARC = South Asian Association for Regional Cooperation; SAPTA = SAARC Preferential Trading Agreement; SPARTECA = South Pacific Regional Trade and Economic Cooperation Agreement.

Notes: [a] Viet Nam joined in 1995, Lao People's Democratic Republic and Myanmar in 1997, and Cambodia in 1999. [b] Thailand joined in 1990, the Philippines in 1992, and Myanmar in 1997.

Sources: World Trade Organization, 2001, *International Trade Statistics 2001*; official websites of the preferential trade agreements.

Box 3.1. Terminology of Preferential Trade Agreements

Preferential trade agreements (PTAs) are agreements between two or more countries in which tariffs imposed on goods produced in the member countries are lower than on goods produced outside.[1] In the literature, PTAs also refer to preferential trading arrangements or areas. This chapter defines PTAs broadly to include a host of trade arrangements made outside of the multilateral trading system, including PTAs notified to the World Trade Organization as well as looser arrangements such as APEC. The multilateral trading system represents the global effort to achieve trade liberalization across all countries carried out under the aegis of the World Trade Organization.

PTAs include regional trading arrangements (RTAs), which are PTAs where countries come from the same geographic region. Because existing PTAs among DMCs include a number of arrangements with countries from outside of the region (e.g., APEC and SPARTECA), the term PTA is generally used in this chapter.

There are several types of PTAs, in terms of their level of trade and economic integration. The most modest form of PTA involves preferential tariffs—but not eliminated tariffs—between two or more countries on certain goods. This contrasts with most-favored nation (MFN) trade liberalization, which occurs when each country lowers its trade barriers for all of its trading partners, regardless of the other countries' trade policies. Free trade agreements (FTAs) are PTAs in which tariffs are eliminated entirely on the goods produced in member countries, but countries maintain their own tariff structures with nonmembers. Customs unions are PTAs in which all members adopt a common external tariff structure. Consistent with the common external trade policy, customs unions generally act as a single body in all trade negotiations with nonmembers.

[1] Panagariya (2000). The definitions used in this chapter are generally based on the discussion in this paper and in Appleyard and Field (1998).

The volume of global trade has risen steadily in recent decades, and the increase was particularly sharp in the 1990s.

sharp in the 1990s. This growth has enabled Asian economies to increase the per capita income of their populations and to achieve significant reductions in the incidence and severity of poverty. Although in the late 1990s, the Asian financial crisis had a restraining effect on aggregate growth rates, on the negotiation of new PTAs, and on the expansion of existing PTAs in the region, export growth during the decade as a whole was strong. Export growth was strongest among manufactures while exports of agricultural products—the sector least liberalized in the existing multilateral and regional trading arrangements—actually fell as a share of total world trade. Trade in services also increased rapidly in the 1990s, while the share of services trade across sectors moved away from transport and travel toward other commercial services.

Debate Over Merits of PTAs

The debate over the relative merits of PTAs is pertinent for DMCs for several reasons. (Box 3.1 discusses some of the terms used in this chapter and Table 3.1 lists the membership status of the World Trade Organization (WTO) of the developing member countries [DMCs] of the Asian Development Bank [ADB]). First, the number of PTAs in the region is growing. The Association of Southeast Asian Nations (ASEAN) and the South Asian Association for Regional Cooperation (SAARC) have formed PTAs—the ASEAN Free Trade Area (AFTA) and the SAARC Preferential Trading Arrangement (SAPTA). Australia and New Zealand have deepened the Closer Economic Relations Trade Agreement (CER) and, via the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), extended preferential trade to their Pacific island neighbors. Several Pacific DMCs have joined the Melanesian Spearhead Group (MSG) and the Asia-Pacific Economic Cooperation (APEC) continues to evolve. The Economic Cooperation Organization (ECO) is the grouping in which the Central Asian DMCs participated, after the fall of the Soviet Union disrupted existing patterns of trade among themselves and with the Russian Federation. A Japan-Singapore trade agreement was signed in January 2002. There are other PTAs on the agenda. For example, an East Asian Free Trade Agreement, an expansion of ASEAN, and bilateral agreements between Japan and the Republic of Korea (Korea), are currently being discussed.

Second, PTAs outside of the region as well as preferential access agreements such as the "Everything But Arms" initiative[1] of the European Union (EU) and the phasing out of the

[1] This EU initiative, adopted on 5 March 2001, provides duty- and quota-free access to EU markets for exports of all merchandise except arms to United Nations-designated "least-developed countries". The initiative received in-principle, best-endeavors endorsement by other developed countries at the Third WTO Ministerial Meeting in Doha in November 2001, but without any specific timetable for implementation.

Multifiber Arrangement (MFA) will affect DMCs' export prospects. Regional PTAs have been seen as a defensive response to regionalism (i.e., the formation of regional trade blocs) elsewhere. Third, DMCs need to address the relationship between PTAs and multilateral trade negotiations under the Doha round of WTO negotiations.

The political dimension of PTAs, at both the domestic and international levels, seems to explain their popularity more than their economic advantages. PTAs can be more palatable domestically than multilateral arrangements, as they allow countries to clarify sensitive sectors while integrating with countries that will not create strong competitive pressures for economic restructuring.

On the international front, PTAs can be a forum for improved diplomatic relations and increased nontrade economic integration. Some argue that PTAs can serve as "commitment mechanisms" for policy reform, particularly nontariff reform, such as investment policies or regulation. They are often cited as quicker mechanisms for bypassing the complicated multilateral negotiations that occur in WTO.

In terms of economic performance, the evaluation of PTAs relative to broader liberalization is less clear. There is no strong empirical evidence that they have been harmful to broader trade in the Asia and Pacific region. Although clearly inferior to a multilateral trading arrangement in reducing the barriers to trade on a global scale, PTAs represent a second-best means of promoting trade liberalization in a context where multilateral negotiations proceed slowly. In such an environment, openness via PTAs can create some of the same institutional and competitive pressures as increased openness via multilateral negotiations. However, opinions vary regarding how effective PTAs are for creating incentives for efficient allocation of resources.

Opponents of PTAs point out that patterns of specialization in PTAs are not necessarily those that would occur if a country had opened its borders to the world economy. They also point out the potential that PTAs create for a complicated network of overlapping rules and trade restrictions that will limit trade between PTAs. From the critics' perspective, the political attractiveness of PTAs is cause for fear that trade agreements negotiated outside of the WTO could lead to a less important role for WTO and prevent the realization of global free trade.

The operational question now facing policymakers is how to achieve fuller benefits of increased openness to trade. Although PTAs involve a measure of controversy—particularly within the economics profession—they are, at the moment, a popular means of liberalization in the face of domestic and international constraints. There has been a substantial increase in the formation of regional PTAs in the past decade. It is in this context that this chapter looks at PTAs in the Asia and Pacific region, and at the effect, on countries in the region, of PTAs in other regions.

Chapter Overview

This chapter extends the discussion from the special chapter in *Asian Development Outlook 2001*, which examined international integration of markets and economic activities, and considered the impact of changes in technology and institutions that have underpinned globalization. It also builds on the *Asian Development Outlook 1997 and 1998* special chapter, which considered regional cooperation and highlighted the economic benefits of trade liberalization when accompanied by the development of efficient domestic factor markets. While this current chapter updates the *Asian Development Outlook 1997 and 1998* special chapter, it differs from it by adopting a more narrow focus on PTAs as institutional mechanisms for fostering freer trade and improved economic conditions in the region. It also devotes greater attention to the implications of recent theoretical and empirical work in economics for crucial policy questions on PTAs.

The question facing policymakers is how to achieve fuller benefits of increased openness to trade.

The 5 years since that chapter was written have been economically turbulent, with the experiences of the financial crisis and the subsequent global recession bringing to the fore concerns about increasing international economic integration and its impact on developing countries and the world's poor. These and other developments—such as the People's Republic of China (PRC) joining WTO and the expiration of the MFA—over these 5 years have prompted renewed consideration of multilateral trading arrangements, including PTAs.

This chapter focuses on identifying the characteristics of PTAs that are likely to maximize short-term economic and political benefits for member countries and minimize the potential risks that PTAs present to the longer-term goal of global free trade. Although the multilateral trading system remains the backbone of progress toward the realization of this goal, it is clear that the current impetus for PTAs has gained momentum. Consequently, this chapter has had to identify the specific features of PTAs that are worrisome and those that are more likely to contribute to improved economic performance. In particular, this chapter highlights ways to minimize conflict between PTAs and the WTO multilateral trading arrangements and identifies ways in which PTAs can be a neutral—if not complementary—means of trade liberalization.

The chapter has five main sections. The first reviews trends in regional and world trade and in the expansion of the number of PTAs worldwide. The next section discusses the diverse characteristics of existing PTAs, highlighting the distinct path that PTAs have followed in Asia and the Pacific relative to other regions. It stresses that it is difficult to argue about PTAs in general, and, specifically, that characteristics that may hinder free trade are found in some agreements but not all.

World trade has grown faster than GDP in the last 50 years as the world economy has become more open.

The third section reviews the main theoretical arguments for and against PTAs as institutional mechanisms for fostering trade and broader economic cooperation between nations. The fourth section provides a short quantitative evaluation of the effects of PTAs on Asian and world trading patterns using results drawn from econometric techniques. The results also provide some insight into the effects that major PTAs outside of the region have on trade flows to and from Asian economies. The conclusions summarize some major policy questions and developments.

TRENDS IN TRADE AND THE EXPANSION OF PTAs

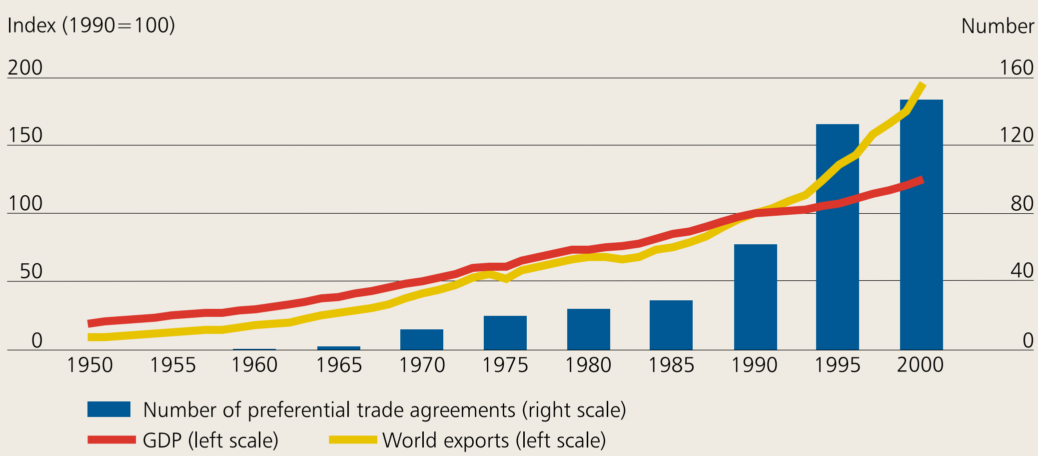
Trends in World and Asian Trade Flows

Overall Trade. World trade has grown faster than gross domestic product (GDP) in the last 50 years as the world economy has become more open (Figure 3.1). The average annual growth of exports was 6.5%. This was nearly 3 percentage points higher than the GDP growth rate of 3.8% (Table 3.2).

Growth in the exports of manufactured products has consistently surpassed growth in exports of agricultural and mining products as manufacturing goods' share in total merchandise exports increased. The share of manufactured exports in total merchandise exports rose from 70% to 75% in the 1990s, while the share of agricultural and mining exports fell from around 26% to 22% (Table 3.3). Exports of telecommunications and office equipment surpassed those of automotive products in the decade, growing from a little less than 9% of total exports to 15%, while automotive sector exports remained relatively constant at just over 9%. Exports of garments and textiles slowed in the 1990s, with textiles in particular growing at a slower rate than total merchandise exports.

This variation in the rate of growth of exports across categories of goods is due, in part, to differences in trade regimes. Rapidly growing telecommunications and office equipment ex-

FIGURE 3.1 **World Merchandise Exports, GDP, and Number of PTAs, 1950-2000**



Sources: World Trade Organization, 2001, *International Trade Statistics 2001;* World Trade Organization website, available: www.wto.org.

TABLE 3.2 Global Average Annual Growth, Exports and GDP, 1951–2000 (%)

	Exports				
	Agriculture	Mining	Manufacturing	Total	GDP
1951–2000	3.5	3.9	8.0	6.5	3.8
1951–1960	5.0	8.3	8.9	7.8	4.5
1961–1970	2.9	3.9	10.5	8.6	5.4
1971–1980	3.6	1.9	7.2	5.4	3.9
1981–1990	1.6	1.1	5.6	4.0	3.2
1991–2000	4.5	4.1	7.8	7.0	2.3

Source: World Trade Organization, 2001, *International Trade Statistics 2001,* Table II.1.

ports that were critical components of the information and communications technology revolution of the 1990s have been subject to low or zero duties and taxes, while slower-growing trade in garments and textiles, on the other hand, is managed under the MFA, which operates under a quota system. Other manufactured exports, such as iron and steel, machinery and transport

TABLE 3.3 World Merchandise and Services Exports, 1990, 1995, and 2000

	1990	1995	2000
World Merchandise Trade ($ billion)	3,388	4,934	6,186
Share in World Merchandise Trade (%)			
Agricultural products	12.2	11.7	9.0
Food	9.3	9.0	7.2
Raw materials	2.9	2.7	1.9
Mining products	14.3	10.6	13.1
Ores and other minerals	1.6	1.2	1.0
Fuels	10.5	7.2	10.2
Nonferrous metals	2.1	2.1	1.9
Manufactures	70.5	73.8	74.9
Iron and steel	3.1	3.0	2.3
Chemicals	8.7	9.4	9.3
Other semimanufactures	7.8	7.9	7.3
Machinery and transport equipment	35.8	38.6	41.5
Automotive products	9.4	9.2	9.2
Office and telecoms equipment	8.8	12.2	15.2
Other machinery and transport equipment	17.6	17.2	17.1
Textiles	3.1	3.0	2.5
Clothing	3.2	3.2	3.2
Other consumer goods	8.8	8.6	8.8
Total Merchandise Exports[a]	100.0	100.0	100.0
Commercial Services ($ billion)	845.3	1,246.5	1,435.0
Share in World Exports of Commercial Services (%)			
Transport	28.5	25.2	23.0
Travel	33.9	33.6	32.4
Other commercial services	37.6	41.2	44.6

[a] Includes unspecified products accounting for 3% of world merchandise exports.

Source: World Trade Organization, 2001, *International Trade Statistics 2001,* Tables IV.1 and IV.2.

equipment, chemicals, other semimanufactures, and consumer goods are governed by a variety of trade rules, including PTAs. The growth of trade in most of these goods, while still substantial, has been slightly below the growth rate of overall merchandise exports.

Geographic Concentration of Trade. North America, Western Europe, and Japan have consistently been the top three trading regions or countries. Together they accounted for 64.3% of world exports and 68.6% of imports in 2000, up from, respectively, 59.2% and 61.2% in 1948 (Table 3.4). In the 1990s, the share of the PRC in total world trade rose. Like the PRC, the share of the grouping comprising Central and Eastern Europe, the Baltic States, and the Commonwealth of Independent States (CIS) expanded in the 1990s.

As exports and imports have increased in importance in the world economy, greater attention has been given to PTAs in Asia and the Pacific.

Developing Asia, defined as the DMCs of ADB, nearly doubled its share of world merchandise exports over the past 50 years, while its share of world imports increased by about 50%, making the continent a net exporter of goods. Seven economies (PRC; Hong Kong, China; Korea; Malaysia; Singapore; Taipei,China; and Thailand) in 2000 accounted for 84% of developing Asia's exports as well as 84% of its imports. This is a sharp rise from the 64% and 61% shares they accounted for in 1960.[2] There were also important changes in the direction of exports of the DMCs from 1980 to 2000.

Increase in world trade and number of PTAs. As exports and imports have increased in importance in the world economy, greater attention has been given to the PTAs in the Asia and Pacific region (Figure 3.2). As more and more countries enter into negotiations to join WTO, the same countries have often simultaneously turned their attention to creating even closer trading ties with their neighbors. At present, about 97% of total global trade involves countries that are members of at least one PTA, compared with 72% in 1990.[3]

Generally, international trade is more important to smaller economies than to larger ones (Figure 3.3). Yet a few large industrial countries and regions dominate world trade. This asymmetry may help explain why some smaller economies have looked to PTAs to represent their interests in a broader international trading system.

The number of PTAs is expanding as well as the number of members of existing PTAs. Looking at the expansion of members of several of the PTAs in the Asia and Pacific region, one notes that APEC membership has grown rapidly. When founded in 1989, membership consisted of the ASEAN member states, as well as Australia, Canada, Japan, Korea, New Zealand, and the United States (US). The PRC joined in 1991, and Viet Nam in 1997, as their commitment to market opening and international integration became more certain. Hong Kong, China and Taipei,China joined in 1991. Chile, Mexico, Papua New Guinea, Peru, and the Russian Federation joined subsequently.

ASEAN's expansion to Viet Nam, Cambodia, and Myanmar was alternately interpreted as a move toward "natural trading partners," an effort to bring transition economies into the market system, and an effort to secure preferential access by existing members to the new members' rich natural resources.

PTAs in East Asia and Southeast Asia have generally been less active in carrying out effective trade liberalization than PTAs in other regions. As a result, although PTAs have existed for some time in these two subregions, the economies have remained highly export oriented and include many economies where exports represent a large share of GDP. The rapid growth of PTAs demonstrates the attractiveness of the larger regional markets, created by the PTAs, which can be accessed by joining an existing PTA. It may also reflect the sense of insecurity felt by smaller nations dependent on export earnings.

DIVERSITY OF PTAs

In themselves, PTAs are not necessarily either beneficial or harmful, nor are they unavoidable stumbling blocks on the way to the eventual achievement of global free trade. While many of the participants in the debate over PTAs lump them together as either "good" or "bad," it is important for policy purposes to look more carefully at the details of the existing arrangements before making any recommendations. This section describes the diversity of PTAs and considers the distinct characteristics of PTAs in terms of their likely economic and broader effects on members and nonmembers alike.

[2] The export and import shares in 2000 are estimated using the *Asian Development Outlook* database; the data for 1960 are estimated using the World Bank's *World Development Indicators 2001.*
[3] PTA membership is identified using WTO notifications as reported on the WTO website. The share of total world merchandise trade is estimated using *Direction of Trade Statistics* current export data with a sample of 168 countries in 1990 and 204 countries in 2000.

TABLE 3.4 World Merchandise Trade by Region and Selected Economy, 1948–2000

	1948	1953	1963	1973	1983	1993	2000
World Exports ($ billion)	58	84	157	579	1,835	3,641	6,186
				Share (%)			
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Asia and Pacific	13.6	13.1	12.4	14.9	19.1	26.3	26.7
Asia and Pacific developing economies[a]	9.5	8.4	6.5	6.4	9.7	14.8	17.8
China, People's Rep. of	0.9	1.2	1.3	1.0	1.2	2.5	4.0
India	2.2	1.3	1.0	0.5	0.5	0.6	0.7
Japan	0.4	1.5	3.5	6.4	8.0	10.0	7.7
Australia and New Zealand	3.7	3.2	2.4	2.1	1.4	1.5	1.2
North America	27.3	24.2	19.3	16.9	15.4	16.8	17.1
Latin America	12.3	10.5	7.0	4.7	5.8	4.4	5.8
Western Europe	31.5	34.9	41.4	45.4	38.9	43.7	39.5
Central and Eastern Europe, Baltic States, CIS[b]	6.0	8.1	11.0	9.1	9.5	2.9	4.4
Africa	7.3	6.5	5.7	4.8	4.4	2.5	2.3
Middle East	2.0	2.7	3.2	4.1	6.8	3.4	4.2
World Imports ($ billion)	66	84	163	589	1,881	3,752	6,490
				Share (%)			
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Asia and Pacific	14.2	15.1	14.2	15.1	18.5	23.4	22.8
Asia and Pacific developing economies[a]	10.6	9.8	7.8	7.0	10.4	15.5	15.7
China, People's Rep. of	1.1	1.7	0.9	0.9	1.1	2.8	3.5
India	3.1	1.4	1.5	0.5	0.7	0.6	0.8
Japan	1.0	2.9	4.1	6.5	6.7	6.4	5.8
Australia and New Zealand	2.6	2.4	2.3	1.6	1.4	1.5	1.3
North America	19.8	19.7	15.5	16.7	17.8	19.8	23.2
Latin America	10.6	9.3	6.8	5.1	4.5	5.2	6.0
Western Europe	40.4	39.4	45.4	47.4	40.0	42.9	39.6
Central and Eastern Europe, Baltic States, CIS[b]	5.8	7.6	10.3	8.9	8.4	2.9	3.7
Africa	7.6	7.0	5.5	4.0	4.6	2.6	2.1
Middle East	1.7	2.0	2.3	2.8	6.3	3.2	2.6

CIS= Commonwealth of Independent States.

[a] Asia and Pacific developing economies includes developing member countries plus Brunei Darussalam and Macau, China, but excludes the Central Asian republics, Cook Islands, East Timor, Marshall Islands, Micronesia, and Nauru.

[b] Figures are significantly affected by: (i) changes in the country composition of the region and major adjustment in trade conversion factors between 1983 and 1993; and (ii) the inclusion of the Baltic States and the CIS mutual trade between 1993 and 1999.

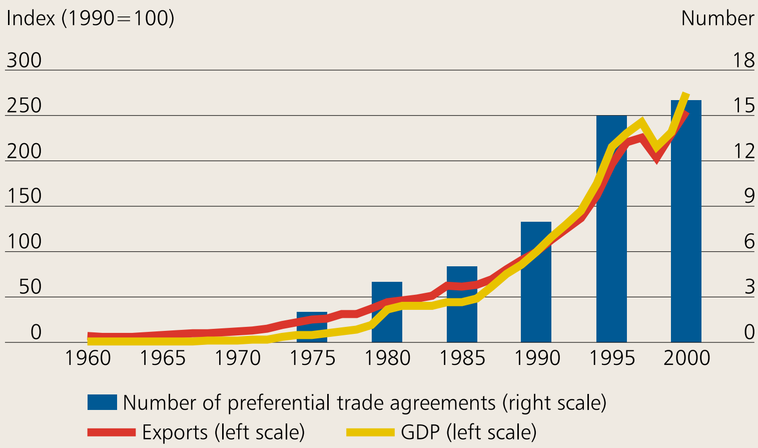
Notes: The figures reported include all exports and imports from countries, including within-region trade. Between 1973 and 1983 and between 1993 and 1999 export and import shares were significantly influenced by oil price developments.

Source: World Trade Organization, 2001, *International Trade Statistics 2001,* Table II.2.

Origins of PTAs

It is beyond the scope of the present chapter to fully compare and contrast all the international trading arrangements in the Asia and Pacific region. Instead, this chapter restricts itself to briefly reviewing the contrasts between Asian PTAs and the major PTAs in other regions. WTO has received notification of 30 multilateral PTAs and 58 bilateral arrangements in the past three decades. Most of these are between neighboring countries. Most are currently PTAs aspiring to evolve into free trade agreements (FTAs), rather than customs unions. Possibly this is because the formation of a customs union and agreement on a common external tariff structure are more demanding than the formation of an FTA. The degree of internal free trade varies highly, as does the breadth of the agreements beyond tariff reductions for goods trade. Agriculture is commonly excluded from the list of sectors where trade is liberalized. Most PTAs explicitly

FIGURE 3.2 **Asian and Pacific Merchandise Exports, GDP, and Number of PTAs, 1960-2000**



Sources: International Monetary Fund, 2001, *Direction of Trade Statistics* CD-ROM, October; World Bank, *World Development Indicators 2001*; World Bank website, available: www.worldbank.org; World Trade Organization website, available: www.wto.org.

PTAs vary widely in the degree of institutionalization.

recognize the need for facilitating trade, harmonizing quality and other regulatory issues, building infrastructure, and streamlining customs procedures, but activity in these areas tends to be limited in all but a few PTAs. Liberalization of trade in services is comparatively rare, although investment policies are more common.

PTAs vary widely in the degree of institutionalization. The majority are based on reciprocal trade concessions and thus require some sort of forum for negotiations, but the frequency of negotiations varies from several times per year to once every few years. Dispute settlement mechanisms frequently specify some sort of bilateral negotiation; only a few agreements have set up a multinational court to arbitrate on disagreements between members and have established the administrative agents to oversee implementation of agreements. Many of the PTAs are more ambitious in aspiration than implementation.

The group of PTAs involving DMCs varies widely.[4] AFTA, MSG, and SAPTA—as agreements between several neighboring countries to extend reciprocal preferential treatment to the others' exports for many sectors—are three typical PTAs in the region. AFTA and SAPTA were outgrowths of regional cooperation bodies (ASEAN and SAARC, respectively, which were formed for largely political reasons). They encompass a wide range of cross-national interactions in cultural, health, environmental, and other areas, in addition to trade. AFTA, in particular, has been active in drawing up a timetable whereby tariffs are to be reduced in progressive steps, leading eventually to an FTA.

MSG and SPARTECA involve groups of Pacific island countries (the latter in association with Australia). Trade volume among member countries remains low and these economies remain oriented toward the larger Australian and New Zealand markets. Another recently approved PTA in the Pacific is the Pacific Island Countries Trade Agreement (PICTA), which involves 14 countries, including several DMCs. The agreement is expected to come into force in 2002, once it is ratified by at least six countries. Its implementation is planned in stages leading to full trade liberalization within 8 to 10 years. PICTA aims to generate employment and other economic benefits through increased trade and investment opportunities in the larger market that it creates.

ECO involves much weaker arrangements than most PTAs,[5] and appears to have a greater focus on broad background institutions and arrangements for bilateral agreements (and even an attempted customs union) than on PTAs as such. In general, formal diplomatic arrangements for trade agreements have been offset by unilateral policy barriers and unpredictable changes, such as exchange controls. Two examples are Uzbekistan's imposition of exchange controls in October 1996 after a decline in cotton prices triggered a balance-of-payments crisis, and the Russian Federation's imposition of special tariffs after its economic crisis in 1998 (Pomfret 2001).

CER, an industrial-country PTA, has the institutional format of a generic PTA but is one of the most advanced free trade areas in terms of implementation: it has removed nearly all policy barriers to trade in both goods and services. CER not only eliminates tariffs but also contains provisions for customs harmonization and common product standards.

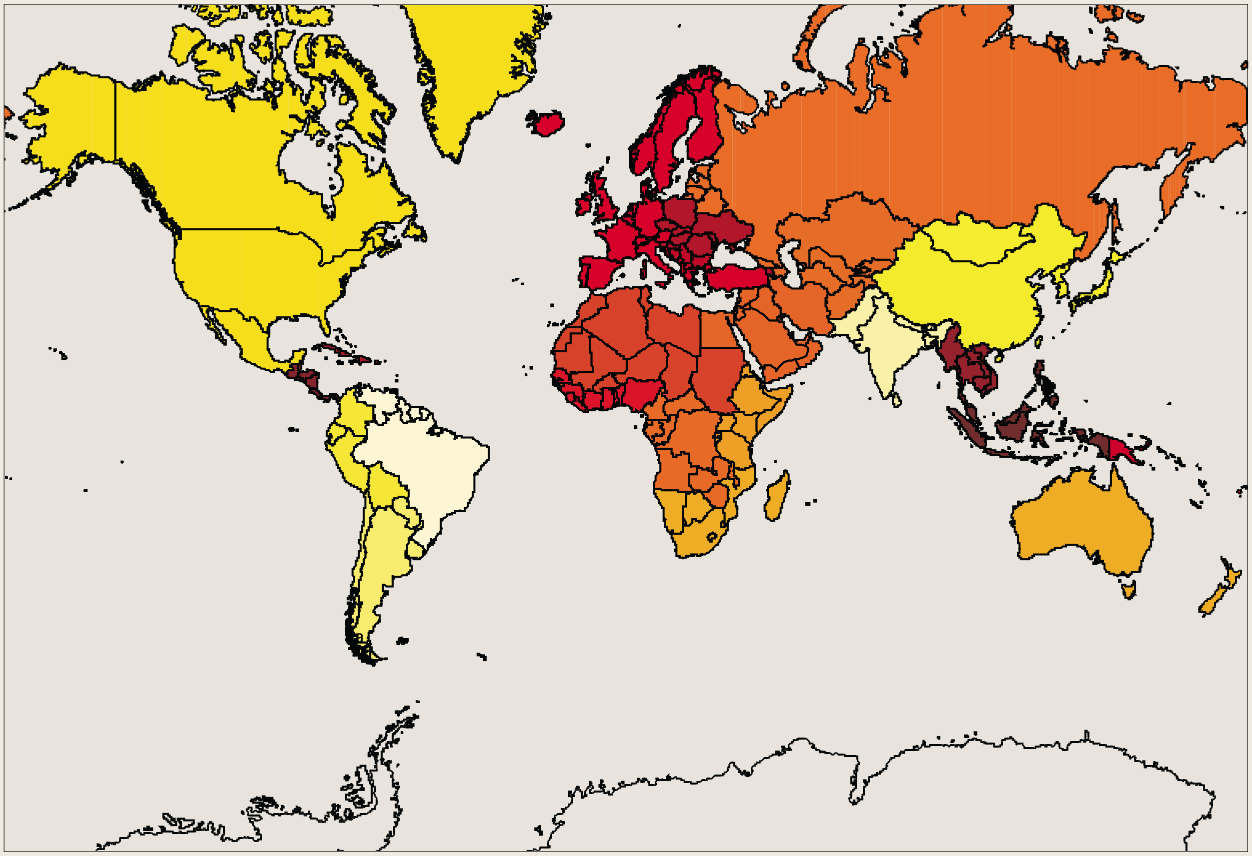
Institutional Characteristics of PTAs

PTAs in Asia and the Pacific are more loosely institutionalized than those in Europe, Latin

[4] APEC is not discussed here because it includes both DMCs and industrial countries.

[5] Trade between the newly independent states is estimated to have dropped by as much as 50% in volume terms.

FIGURE 3.3 **Importance of Exports across Geographic Regions, 2000**



Proportion of Exports to Gross Domestic Product (%)

- Brazil[a] (10.4)
- South Asia (11.7)
- Southern Cone (11.9)
- Andean Countries (13.7)
- East Asia (13.9)
- North America (14.0)
- Oceania (17.5)
- Southern Africa (19.7)
- East Africa (20.7)
- Russian Fed. & Baltics (22.0)
- Central Africa (22.0)
- Middle East (22.4)
- Central Asia (24.4)
- Saharan Africa (24.9)
- West Africa (28.6)
- Western Europe (29.2)
- Pacific Islands (30.0)
- Balkans (41.4)
- Eastern Europe (43.2)
- Caribbean (43.9)
- Mekong Countries (46.6)
- Central America (54.3)
- Southeast Asia (70.4)

[a]Includes Brazil and six other South American countries bordering the Caribbean Sea.

Sources: Base map from Environmental Systems Research Institute CD-ROM, 1999; data calculated for GDP and exports in nominal US dollars from World Bank, *World Development Indicators 2001* CD-ROM.

The delineation of countries, territories, or regions does not imply any judgment by the Asian Development Bank as to the legal or other status of any territorial entity.

TABLE 3.5 Institutional Arrangements Under Existing Preferential Trade Agreements

PTA	Member Countries[a]	Date of Entry into Force[a]	Supranational Institutions (including meeting frequency)[b]	Provisions beyond Tariff Reduction[b]
Asia and Pacific Region				
AFTA	Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam.	28 Jan 1992	ASEAN institutions include a central secretariat. For the FTA, no separate supranational institutions. Dispute settlement by bilateral negotiation, with presentation of case before a "senior economic officials meeting" as a means of resolving impasses. No standing body for investigating disputes; panels of experts appointed as needed. ASEAN economic ministers serve as final arbiters. Decision making at annual meetings of heads of state.	Trade facilitation, investment, industrial cooperation, services trade. FTA is part of larger regional cooperation plans under ASEAN.
APEC	Australia; Canada; Chile, China, People's Rep. of; Hong Kong, China; Indonesia; Japan; Korea, Rep. of; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; Philippines; Russian Federation; Singapore; Thailand; United States; Viet Nam.	1989	APEC Secretariat. Annual meetings of heads of state, ministers. Provisions are not binding, so no mechanisms for dispute settlement.	Trade facilitation, services, investment, intellectual property rights.
CER	Australia, New Zealand.	1 Jan 1983	Australia-New Zealand Affairs Secretariat under the control of the ministries of foreign affairs (oversees implementation). Dispute settlement by bilateral negotiations. Annual meetings of economic and foreign affairs ministers.	Trade facilitation, services, investment.
ECO	Afghanistan, Azerbaijan, Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan.	1991	ECO Secretariat, Regional Council, Council of Permanent Representatives, regional technical agencies. Annual ministers' meetings, biennial meetings of heads of state.	Investment, trade facilitation. Coordination of market-oriented reforms.
SAPTA	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka.	7 Dec 1995	SAARC institutional structure includes Secretariat, regional centers for research, Standing Committee of Foreign Secretaries, standing committees on technical issues. Most decisions made at annual meetings of heads of government. No separate institutions for SAPTA.	FTA is part of larger cooperation plans of SAARC.
SPARTECA	Australia, New Zealand, Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Micronesia, Nauru, Niue, Papua New Guinea, Solomon Islands, Tonga, Tuvalu, Vanuatu, Western Samoa.	1 Jan 1981	Forum Secretariat, Australian and New Zealand customs agencies oversee agreement, primarily assessment of origin of goods traded.	Services, migration, investment, some foreign policy, trade facilitation.

America, or North America (Table 3.5). There are no customs unions in the region, thus there is no need to negotiate a common external tariff structure. Dispute settlement mechanisms tend to be based on bilateral negotiations, with some provisions for resolution of disagreements. Much of the implementation of the PTA regulations, such as application of rules of origin, takes place subnationally according to commonly agreed standards. The political history of the PTAs also partly explains the lack of accompanying institutions. The two PTAs that are offshoots of larger organizations (AFTA and SAPTA) do not require much additional institutional structure to admin-

TABLE 3.5 (cont'd.) Institutional Arrangements Under Existing Preferential Trade Agreements

PTA	Member Countries[a]	Date of Entry into Force[a]	Supranational Institutions (including meeting frequency)[b]	Provisions beyond Tariff Reduction[b]
Other Regions				
Andean Pact	Bolivia, Colombia, Ecuador, Peru, Venezuela.	25 May 1988	Court of Justice (dispute settlement). General Secretariat (administers integration), Andean Parliament (deliberating body). Also annual meetings of Andean Council of Presidents and Council of Foreign Ministers.	Trade facilitation, migration, investment.
EFTA	Iceland, Liechtenstein, Norway, Switzerland.	3 May 1960	EFTA Secretariat. Standing Committee of EFTA States, various advisory committees. Parliamentary Committee (representatives from members' parliaments) meets four times a year, ministers meet twice annually.	Trade facilitation, services, investment, migration, common market, common currency.
EU	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.	1 Jan 1993	EU Commission, European Parliament, Council of the European Union, European Central Bank, various committees.	Trade facilitation, investment, maintenance of democracy.
Mercosur	Argentina, Brazil, Paraguay, Uruguay.	29 Nov 1991	Secretariat, Mercosur Trade Commission. Council of the Common Market, Common Market Group. Primary dispute settlement by bilateral negotiation; referred to Common Market Group then Council of the Common Market in case of impasse.	Trade facilitation, investment, labor, environment.
NAFTA	Canada, Mexico, United States.	1 Jan 1994	Free Trade Commission, NAFTA Secretariat (dispute settlement). Periodic meetings of heads of state.	

Sources: [a] World Trade Organization, 2001, *International Trade Statistics 2001,* except for APEC data, which is available at: www.apec.org.
[b] Clarete, Edmonds, and Seddon, forthcoming, *Asian Regionalism and its Effects on Trade in the 1990s*.

ister themselves. CER is a bilateral agreement so that administration does not require strong supranational agreements. APEC, the largest trading arrangement in which DMCs are involved, has few institutional structures, in keeping with its overall philosophy of loose cooperation and open agreements.

The European PTAs, in contrast, involve substantial international institutionalization. The EU has a powerful commission to oversee a wide range of common market policies.

The Latin American PTAs, particularly the customs unions of the Andean Pact and Mercosur, have intermediate levels of institutionalization. The Andean Pact is modeled on the EU and has some of the same permanent institutional elements. The Andean Court of Justice is unusual, as most PTAs specify bilateral negotiations as the primary means of dispute settlement. Mercosur's trade commission, a multilateral body that resolves disputes only after negotiations have reached an impasse, is a more common institutional format. NAFTA involves the least supranational institutionalization of the agreements in the Americas.

There are several PTAs that stand out with respect to nontrade provisions. Mercosur's attention to democracy is unusual, while NAFTA's provisions for labor and environmental regulation are also uncommon.

Most PTAs involving DMCs have provisions for trade facilitation and investment policy. SAPTA is an exception, as additional nontariff measures, such as trade facilitation and investment cooperation, are deemed priorities, although member governments have not formally agreed on such additional measures. Liberalization of trade in services among SAPTA members is also on the agenda. SPARTECA, mainly focused on providing market access as a kind of development aid, has no provisions beyond those for trade.

PTAs as Mechanisms for Regional Cooperation

PTAs in the Asia and Pacific region have made some progress in achieving their non-economic policy agenda. Frequent meetings among heads of state, trade officials, and other ministers suggest that they provide important opportunities for increased communication among member states, but these often fail to provide concrete measures to institutionalize reforms, while the lack of strict dispute settlement mechanisms detracts from the PTAs' ability to serve as "commitment mechanisms" for member countries.

PTAs in Asia and the Pacific generally lack institutionalized dispute resolution mechanisms.

Arenas for Communication. AFTA and SAPTA are both embedded in larger efforts that provide a strong background for regional communication at both political and technical levels. ASEAN's institutional structure is centered on ensuring frequent contact among member countries' heads of state as well as among trade specialists. Meetings of the heads of state (the ASEAN Summit) are held annually, as are the ministerial meetings. The annual summits of SAARC are an opportunity for informal political consultation. The Council of Foreign Ministers, which meets twice a year, is charged with reviewing goals and identifying new areas for cooperation. Similarly, CER provides a forum for exchange of information and has proven adept at advancing free trade into new areas over the years. Much of the interchange takes place at the ministerial level or below, with planned twice-yearly meetings of ministers switching between the nations' capitals and a range of ad hoc and scheduled specialist meetings.

The level of leadership commitment in APEC is also relatively high, with meetings attended by heads of state as well as senior trade officials since the mid-1990s. It would be logical to assume that the frequency of these meetings has increased the information flow among members and has contributed to the coincident expansion of intraregional trade and investment flows; it is, though, difficult to demonstrate a clear causal link.

PTA Membership as Commitment to Free Trade. The effectiveness of the dispute settlement mechanism and the strength of the threat of exclusion are the two features of PTAs that determine the "commitment value" of member countries. A PTA with a multinational court to resolve disputes impartially and a credible sanction (such as exclusion) make it difficult for member countries to slacken on their PTA commitments. Member countries can then point to the difficulty of reneging on their commitments as evidence that they will fulfill the promises that they have made. The value of a PTA as "insurance" in the case of a trade war also depends on the mechanisms for punishing nations that go back on their promise of market access.

PTAs in the Asia and Pacific region generally lack institutionalized dispute resolution mechanisms, preferring instead that remedies be negotiated informally. For example, CER leaves dispute settlement to negotiations. While it is unlikely that Australia and New Zealand will dissolve the agreement and impose high trade barriers, there is no obvious institutional reason for their mutual commitment to free trade. Disputes in AFTA are resolved by bilateral negotiations with several levels at which appeals can be made.

Asia and Pacific PTAs and the World Trade Organization

The Asia and Pacific region's involvement in PTAs does not seem to have affected countries' levels of participation in the larger multilateral trading system. WTO obligations have taken precedence over prospective PTAs in the region, and efforts to liberalize trade via WTO appear to have been more successful than the region's PTAs. For example, in Central Asia, policymakers appear to be looking outward rather than inward in their approach to regional integration efforts, and efforts to form Central Asian PTAs have generally given precedence to WTO participation. Kazakhstan abided by a WTO commitment for external tariffs rather than simply joining the proposed customs union of Belarus, Kazakhstan, Russian Federation, and Tajikistan. The Kyrgyz Republic joined WTO in 1998, and Georgia in 2000. Among DMCs in Central Asia, Azerbaijan, Kazakhstan, Tajikistan, and Uzbekistan are negotiating for WTO accession.

Similarly, all SAPTA members are full WTO members except for Bhutan and Nepal, currently observers negotiating for accession. The original

ASEAN members as well as Myanmar have joined WTO, while Cambodia, Lao PDR, and Viet Nam are observers. MSG members Fiji Islands, Papua New Guinea, and Solomon Islands are members of WTO while Vanuatu is an observer.

APEC appears particularly conducive to broader efforts to achieve global free trade. In the recent past, agreements negotiated under APEC have been influential in spurring trade reform outside of the PTA. For example, commitments made at the Bogor meeting of APEC influenced the CER's reductions of third-country tariffs on a most-favored nation (MFN) basis (Garnaut 2000). ASEAN members' plan to expand the scope of free trade via MFN liberalization is in part linked to member countries' efforts to meet APEC commitments. ASEAN also has a permanent budget to spend on technical assistance (used mainly to finance policymaker seminars and educational meetings) for WTO-related matters.

Income Characteristics of PTAs

PTAs involving DMCs vary greatly with respect to level of income and economic development. Some have members whose level of development is at a fairly uniform level with per capita incomes in a narrow range. Others have a wide dispersion in standards of living. ECO and SAPTA have the lowest average per capita incomes; CER and SAPTA have the smallest variations in per capita incomes (among PTAs involving DMCs). Other PTAs in the region have higher average per capita incomes and there is substantial variation in income levels among members. AFTA and SPARTECA have the highest variation in GDP across the member countries. AFTA brings high-tech industrial Singapore together with primarily rural Cambodia, Myanmar, and Viet Nam. SPARTECA's high coefficient of variation is due to the dispersion between the Pacific DMCs on the one hand, and Australia and New Zealand on the other (Table 3.6).

The European PTAs—the European Free Trade Association (EFTA) and the EU—are two of the richest of the PTAs with per capita incomes of about $27,500 and about $20,800, respectively. They are currently two of the more homogenous agreements, with coefficients of variation in per capita income of 0.2 and 0.3. This situation will likely change as the EU expands eastward.

Among PTAs in the Americas, the Andean Pact and Mercosur are in the middle to lower ranges of worldwide average per capita incomes, while the coefficient of variation in per capita income is slightly below average. The North American Free Trade Agreement (NAFTA) stands out as the only PTA outside of Asia between major industrial countries and a less developed neighbor.

Overlapping Memberships in PTAs and Multilateral Trading Arrangements

Within the Asia and Pacific region there is no common pattern to the extent of overlapping PTA membership. This is a concern, given fears concerning the debilitating effect that complex sets of overlapping regulations will have on future efforts to liberalize trade. Aside from common membership of APEC, most of the other common memberships involve bilateral agreements. This contrasts with the situation in most other regions, where overlapping membership is more common. SAPTA and SPARTECA members have relatively few commitments to other

PTAs involving DMCs vary greatly with respect to level of income and economic development.

TABLE 3.6 Per Capita Gross Domestic Product of PTAs, 2000

Preferential Trade Agreement	Per capita GDP ($)	Coefficient of Variation
Asia and Pacific Region		
AFTA	1,975	1.6
APEC	7,408	1.2
CER	19,283	0.3
ECO	1,220	0.9
SAPTA	461	0.8
SPARTECA	15,195	1.6
Other Regions		
Andean Pact	2,469	0.7
EFTA	27,468	0.2
EU	20,747	0.3
Mercosur	4,171	0.6
NAFTA	27,171	0.7
Average	7,235	

Source: Calculated using nominal GDP data from World Bank, *World Development Indicators 2001.*

TABLE 3.7 Selected Characteristics of Preferential Trade Agreements, 2000

Preferential Trade Agreement	Average number of PTAs per member[a]	% of members belonging to other PTAs[a]	% of members belonging to WTO[a]	Average % exports/GDP of members[b]	Average % trade within PTA[b]
Asia and Pacific Region					
AFTA	4.3	100.0	100.0	52.3	24.5
APEC	4.2	100.0	100.0	47.8	75.2
CER	4.5	100.0	100.0	20.8	9.2
ECO	5.4	80.0	100.0	36.3	6.6
SAPTA	2.5	71.4	100.0	25.7	4.8
SPARTECA	1.9	40.0	55.6	33.5	12.3
Other Regions					
Andean Pact	4.4	80.0	89.5	22.1	10.8
EFTA	15.7	100.0	33.3	34.1	11.8
EU	3.6	20.0	100.0	36.8	66.9
Mercosur	4.3	100.0	83.3	14.5	22.3
NAFTA	5.3	100.0	66.7	25.6	58.8

Sources: [a] Generated using data from World Trade Organization, 2001, *International Trade Statistics 2001*. [b] Generated using data from World Bank, *World Development Indicators 2001*; International Monetary Fund, 2001, *Direction of Trade Statistics* CD-ROM, October.

PTAs in Asia and the Pacific tend to be fairly outward looking.

PTAs, most likely because these two agreements involve least-developed countries. The other PTAs in the Asia and Pacific region have a higher number of other commitments because of the extent of bilateral agreements among member countries and the AFTA countries' membership of APEC.

Open Regionalism. APEC's adherence to the principle of "open regionalism"—reliance on unilateral trade liberalization extended to members and nonmembers and on open membership—while sometimes criticized as being unrealistic, offers a unique policy orientation for a trading arrangement.[6] While the exact nature of APEC's trade liberalization agenda has been unclear, some analysts credit its efforts with contributing to the formation of FTAs among some of its member countries.

The PTAs in Asia and the Pacific tend to be fairly outward looking, with a large percentage of members' trade going to nonmember countries. This reflects the region's strong ties to the US, Europe, and some Latin American markets. Of all the PTAs reviewed, AFTA and APEC members have the strongest links to the international economy as reflected by the ratio of exports to GDP. Among regional PTAs, CER, SAPTA, and SPARTECA have relatively low ratios of exports to GDP (Table 3.7).

Bilateral PTAs. Bilateral PTAs are also common among DMCs, especially among India and its neighbors and among the Central Asian DMCs. India gives duty-free access to products from Bhutan, Nepal, and concessionary customs duties to products from Bangladesh. The list of Central Asian bilateral agreements is quite long (the following include only those that involve WTO countries and have thus been notified to WTO). Bilateral agreements between Azerbaijan and Georgia, and Kazakhstan and Turkmenistan were negotiated in the second half of the 1990s after the goal of CIS-wide economic cooperation failed to materialize. The individual agreements borrow from the CIS institutions—rules of origin, for example, are based on CIS guidelines. The Kyrgyz Republic was also highly involved in bilateral agreements and has reported PTAs with Armenia, Kazakhstan, Moldova, the Russian

[6] See Garnaut (1994).

Federation, Tajikistan, Ukraine, and Uzbekistan.[7] Other bilateral arrangements in the region include PTAs between the Lao People's Democratic Republic (Lao PDR) and Thailand, and between New Zealand and Singapore, as well as CER.

Subregional Economic Zones. While the formal national-level trade agreements have attracted the most attention, significant efforts have been made to facilitate trade via subregional economic zones (SREZs) and infrastructure policies. SREZs generally consist of parts of several countries and most of the emphasis is on building infrastructure, reducing "red tape," and harmonizing standards between the subnational regions considered.

There are two main kinds of SREZ in the Asia and Pacific region: growth zones, and corridors. The general aim of a growth zone is to take advantage of the differential mobility of capital and labor to reduce the cost of manufacturing. Participants come together by geographic proximity so that there are low transport costs, but they are separated by policy barriers so that there are wage differentials to be exploited. The focus is on streamlining the movement of capital and of raw inputs to take advantage of the differences in labor endowments (Yuan 1997). The Johor-Riau-Singapore growth zone, for example, brings together semiskilled labor from Malaysia, low-cost land and labor from Indonesia, and capital from Singapore. The Brunei-Darussalam, Indonesia, Malaysia, and Philippines East ASEAN Growth Area (BIMP-EAGA) focuses on sector cooperation in mineral, forest, and marine resources. The Tumen River Area Development, consisting of parts of the PRC, Democratic People's Republic of Korea, and the Russian Federation, centers on the development of a free trade zone.

The principle behind the corridor concept is that it is important to create infrastructure links to bring together areas with economic complementarities between labor, land, and other factors. In the case of the four-country East-West Economic Corridor, for example, the Thai subregion is relatively abundant in skilled labor, while southern Myanmar, Savannakhet in the Lao PDR, and central Viet Nam have a scarcity of skilled labor but an abundance of natural resources. Wood processing and wood-based manufacturing have been identified as industries that could grow and be profitable if the two factor pools were joined. The potential gains from the SREZs are quite high. Analysis of the determinants of trade flows within Bangladesh, Bhutan, and India shows that attention to trade and facilitation measures in the South Asian Special Economic Zone (SASEZ) growth quadrangle is as important as further policy liberalization for increasing the flow of goods between these countries (RISNODEC 2001).

THE ECONOMIC AND BROADER EFFECTS OF PTAS: THEORETICAL ARGUMENTS

Are PTAs building blocks or impediments to the realization of global free trade?

Despite the rapid growth of PTAs over the past few decades, the theoretical debate over their role in increasing trade openness is far from over. Significant disagreement remains as to whether PTAs are building blocks or impediments to the realization of global free trade, and there is a variety of opinions over whether and how PTAs can coexist alongside the existing multilateral trading arrangements. Authors on both sides of the debate tend to focus on and critique different aspects of PTAs. The extent of trade liberalization within a PTA, the treatment of nonmembers, the harmonization of a range of policies linked to trade, the dispute settlement mechanisms, and the characteristics of members are just a few of the aspects of PTAs that have been analyzed (Table 3.8). This section focuses on extracting concrete and realistic policy guidelines from the theoretical analysis, after a discussion of the economic effects of PTAs, their broader noneconomic effects, and the long-term role of PTAs in the multilateral trading arrangements.

Economic Effects of PTAs

The PTA-general liberalization debate centers on two questions: the short-term comparison of the two forms of liberalization and the longer-term equivalence of the two paths to increased world trade. One viewpoint, associated with Summers (1991) and Lawrence (1991) is that trade liberalization is trade liberalization, no matter what the route. Reducing trade barriers for one's neighboring countries or other selected countries creates competitive pressures as well as the potential for technology transfer. Both

[7] Agreements involving Georgia are based on "Communication by Georgia to the Committee on Regional Trade Agreements," and agreements involving the Kyrgyz Republic are based on "Communication by the Kyrgyz Republic to the Committee on Regional Trade Agreements." *Source*: www.wto.org.

TABLE 3.8 Main Features of Preferential Trade Agreements

Feature	Importance for Outcomes
Membership	
Diversity in members' level of development	More diverse PTAs increase the potential for technology transfer and for increasing efficiency by specialization.
Combined size of members' economies	A larger combined economy is more attractive for investment and creates more potential for trade.
Members' resources and economic structures	Differences in the structure of the members' economies and resources determine the extent of trade within the PTA and individual countries' incentives to specialize.
Policies	
Extent of tariff preference	Less tariff preference for members versus nonmembers reduces the potential for distortion of trade flows. A common external tariff reduces possibility of distorting trade flows among members.
Sectors covered in agreement	Closer approximation of free trade creates more incentives for specialization and creates more competition for domestic industries. Greater sector coverage increases the potential welfare gains.
Nontrade and trade-facilitating policies covered	Agreements regarding policies other than trade allow countries to commit to domestic reforms and further lower the transactions costs of trade.
Rules of origin	Simple and transparent rules of origin minimize the potential for unproductive rent seeking and corruption.
Institutions	
Mechanism for dispute resolution	Mechanism for dispute resolution affects the PTA's ability to reduce conflict between members. The ability to impose stronger sanctions increases the commitment value of the PTA.
Frequency of meetings	Meetings are an opportunity for exchanging information, and for coordinating strategies for negotiation in other settings such as WTO. Interaction of higher levels of policymakers is likely to have the greatest benefits for policy coordination.

Source: Clarete, Edmonds, and Seddon, forthcoming, *Asian Regionalism and its Effects on Trade in the 1990s*.

lead to productivity gains and a restructuring of the economy toward its comparative advantage. Trade opening also increases the effective size of the market, which can attract foreign direct investment (FDI) from companies seeking to serve the consumer base. Therefore, runs the argument, joining a PTA will create more trade with at least some countries and thus contribute to development, and allow both member countries and some nonmember countries to obtain the benefits of increased openness. Critics of PTAs, on the other hand, focus on the degree to which the trade enhanced by PTAs distorts trade patterns between members and nonmembers, and creates the incentives for inefficient specialization. Various models of the political economy of trade policy also demonstrate that PTAs can increase opposition to more general liberalization and thus stall movement toward global free trade. These arguments are now discussed in greater detail.

Fostering Competition. One of the significant benefits of trade liberalization—general or PTA-induced—is the increased efficiency of domestic enterprises that has been prompted by greater competition in domestic markets that in turn has been brought about by the entry of foreign competitors in previously trade-protected sectors. Most economists argue that such efficiency gains generated by PTAs are smaller, though, than those stemming from multilateral trade liberalization.

Empirical studies generally find quantifiable dynamic efficiency gains associated with trade from PTA-induced trade liberalization (Tybout and Roberts 1996; Horn, Lang, and Lundgren 1995; Tybout 1999), but the static effects of PTA-enhanced trade are less well documented. The estimated effects of the EU, for example, in increasing competition are found to be secondary to the effects of increased liberalization in general (Jacquemin and Sapir 1991). Simulations of the effects of PTAs usually find large potential effects of integration between members (for example, Hunter, Markusen, and Rutherford 1991 in the case of NAFTA), but it is unclear whether these effects are ultimately realized.

At worst, PTAs may even generate new incentives for noncompetitive behavior for two reasons. First, they may leave out certain sectors. In many cases, the sectors where the effects of import competition could be greatest are not included in PTAs. Agriculture, for example, is commonly excluded from PTAs. As was the case with WTO, extending trade liberalization to these sectors has also been difficult under multilateral trading arrangements. Second, PTAs allow producers in member countries preferential access to markets in the group, thereby changing or distorting the assessment of returns on investment. The first of these concerns is clearly common to both multilateral arrangements and PTAs, while the second is particular to PTAs and is of greater import.

The specialization patterns among members of PTAs depend on the difference in the comparative advantage that the economies have relative to each other and to the rest of the world. An individual country gains most if it joins a PTA in which its comparative advantage relative to the other members is similar to its comparative advantage relative to the rest of the world. One proxy often used as a measure of how likely economically efficient specialization is, within a given PTA, is the proportion of world GDP accounted for by the sum of the PTA members' GDP. The assumption is that larger PTAs are more likely to have the least-cost producer of a given item within their boundaries (Panagariya 1994). The worst-case scenario occurs when a member of a PTA has a comparative advantage relative to other members that is different from its comparative advantage relative to the rest of the world. In this case, the patterns of specialization that regional, as opposed to multilateral, liberalization create can be harmful in the long run for the member country. PTA specialization can lock a country into inefficient production patterns and handicap its ability to adjust to a production structure that would be most competitive under global free trade. In some cases, PTAs could also be impediments to the structural transformation of an economy from lower to higher value-added production (Waltz 1997). A country that enters a PTA in which it has a comparative advantage in low-skills manufacturing, for example, may find itself specializing in this sector rather than moving resources into higher-technology sectors.

Trade opening increases the effective size of the market, attracting foreign direct investment.

Institutional features, such as the rules for determining the origin of goods traded among members, are also an important determinant of specialization patterns (and thus a potential source of distortion) in PTAs. Efforts to maintain the effectiveness of a PTA's various external tariffs increase the importance of rules of origin to prevent nonmembers' goods from entering the PTA via the member country with the lowest trade protection (discussed further below). Efforts to follow these rules can in turn affect firms' decisions on production and location. A firm might locate in Nepal, for instance, and use local components to access the Indian market even if a better, cheaper version of the product could be made in another country with other inputs. The administration of rules of origin can also create incentives for rent seeking and corruption.

Market-Size Effects of PTAs. Estimates of the benefits of increased market size within a PTA depend on the size and structure of the members' economies. The combined size of the consumer base as well as the combined size of the suppliers affect the degree to which the larger market of a PTA benefits any given country's manufacturers. Madani (2001) finds that industries in ASEAN members, on average, have not achieved significant scale effects from regional arrangements. Industry-level scale effects are significantly heterogeneous, suggesting that the "large-market" benefits of regional integration vary significantly across countries.

Another market-size effect of PTAs, namely, how membership affects countries' ability to attract FDI, depends on the extent to which the PTA addresses deeper trade and economic integration issues. PTA membership can positively affect members' ability to attract FDI in two ways: first, by reducing internal barriers to trade as much as possible by leaving few exceptions to open trade, and second, by maintaining high external tariffs that generate a premium on preferential market access (creating opportunities for "tariff jumping") (Heinrich and Konan 2001). The first option has very few negative consequences, but the second—as discussed later—can have significant negative economic consequences, including distortion of trade flows.

Research suggests that the welfare consequences of PTA liberalization tend to be positive.

PTAs appear to have encouraged FDI flows into member countries, although not all the rise in investment can be attributed to the large-market effect. FDI inflows increased with the implementation of the EU's single market program. The share of FDI flows from the US into Mercosur countries rose from 3.9% in 1992 to 4.4% in 1995 after the PTA came into force (World Bank 2000). A large part of the substantial increase in FDI to Mexico was due to firms in non-NAFTA countries taking advantage of Mexico's preferential access to the US market (Blomstrom and Kokko 1997).

Level of Trade. Regardless of the extent of benefits of increased trade for members of PTAs, trade liberalization through PTAs has consequences for the world economy, and these are different from those of multilateral liberalization. Trade diversion offsets trade creation within a PTA as member countries start to import goods from each other that they could have imported at lower cost from other countries in the absence of a preferential tariff. The potential for trade diversion increases as the difference between intra-PTA tariffs and external tariffs grows.

Rules of origin in PTAs (except for customs unions) create another incentive for trade diversion. It is often profitable, for example, for the country with the lowest external tariff to meet its own requirements for a product with imports from the rest of the world and export the corresponding amount to fellow members. Imports effectively enter the PTA through the country with the lowest external tariff schedule, a phenomenon known as "indirect trade deflection" (Robson 1998).

Considerable research has been focused on the balance between the welfare loss from trade diversion and the welfare gain from the additional trade that is created among member countries. Overall, research suggests that the welfare consequences of PTA liberalization tend to be positive. In theory, it is possible to create a customs union that maintains net external trade while building up internal trade and that leaves members (as well as the rest of the world) at least as well off as before (Kemp and Wan 1976). Likewise, a PTA with rules of origin that allow all final and intermediate goods produced by member countries to be freely traded can also be a Pareto improvement (Krishna and Panagariya 2001). Both of these results are demonstrations that Pareto improvements can exist, not that they will exist.

The general consensus of theoretical work in economics is that PTAs—when evaluated in purely economic terms related only to the changes in trade flows—are welfare reducing for the world as a whole (de Melo, Panagariya, and Rodrik 1992; Bhagwati and Panagariya 1996; Schiff 1997).

Distribution of Welfare Gains. The distribution of world welfare gains from trade creation via PTAs on the one hand, and via general liberalization on the other, is quite different. The protected internal market created by a PTA allows firms in member countries to gain a first-mover advantage that can be difficult for newcomers to overcome. Fruend (2000) suggests that PTAs may give this advantage to firms in member countries. Firms that anticipate access to foreign markets as the result of bilateral negotiations invest in distribution networks; this investment is irreversible and commits the original countries to trading with each other. Using trade data from the EU, Fruend shows that the countries that joined later, as the membership of the trade bloc expanded, received smaller benefits than earlier-joining members and ended up with smaller market shares in the countries to which they exported.

A greater distributional concern for most countries is that those remaining outside of a PTA suffer clear losses in the form of reduced exports or worsened terms of trade (Chang and Winters 1999). A country's welfare loss from reduced exports depends on the country's characteristics, specifically the difference in the income it can generate from its resources under the tariff structure that exists under the PTA, relative to the tariff structure that would exist with no PTA in existence.

The terms-of-trade effect, on the other hand, varies with the size of the PTA. Larger PTAs are likely to have greater effects on tradable goods' prices in general, though small PTAs can affect prices if markets are segmented. The Andean Pact, for example, affected cattle prices in Latin America, as the excluded Argentine producers had to lower their prices to access the Andean Pact market (Gupta and Schiff 1997). Exporters in excluded countries are generally unable to differentiate between buyers within the PTA and outside, so such price shifts apply to all sales and can be an important revenue loss.

PTAs as Institutional Mechanisms for Broader Cooperation

Complementarity or Destructive Competition? PTAs involve fewer nations—and usually nations from a single region—than can be readily accommodated within WTO. Also, PTAs offer a potentially stronger forum for negotiation of deeper integration and wider policy reform. Many argue that they complement WTO by helping members coordinate for negotiations and, in the case of developing countries, build capacity for broader international trade negotiations. Once formed, PTAs have the potential to foster the provision of regional or international public goods and yield positive externalities stemming from their efforts in trade liberalization and related policy areas.

PTAs' smaller size and resulting easier coordination between members are viewed as characteristics that give them an advantage in achieving deeper integration, and in harmonizing standards, regulations, and financial structures (Laird 1999). The logic behind this is that a PTA's smaller grouping of countries is more likely than all the members of WTO to have similar interests and needs, so that joint regulatory and monitoring institutions can be created and the institutions' startup costs shared. Deeper integration can be an important efficiency gain, as differences in cross-border standards are costly. Hoekman and Konan (1999), for example, estimate that the bureaucracy involved in satisfying Egypt's import product standards imposed an effective tax of between 5% and 90% of the value of shipments into the country.

There is one significant caveat to this view of PTAs as potential trade-facilitating complements to WTO. Proliferation of PTAs that involve nontrade integration could preclude common international standards as small groups of countries take different paths. From the perspective of world welfare, moves toward small-group harmonization are less favorable than agreements that foster common standards across a wide range of trading partners. PTAs are also sometimes seen as creating potentially destructive competition to WTO. Bagwell and Staiger (1997), for example, find that the advent of a PTA obscures the transmission of clear information about tariff rates and makes it more difficult for countries adversely affected by tariffs to impose reciprocal tariffs. (The threat of reciprocal tariffs can deter countries from imposing tariffs initially.)

Deeper integration can be an important efficiency gain, as differences in cross-border standards are costly.

Enhanced Regional Security. The traditional evaluation of gains from trade overlooks the fact that, for a country, trade with some countries might be more valuable than with others because it decreases the risk of conflict. The trade creation aspect of PTAs, particularly regional PTAs, is seen as a contribution to increased security. Intuition as well as empirical evidence indicate that increased trade among nations reduces the chance of military conflict (Polachek 1992, Irwin 1993). Schiff and Winters (1998) suggest that increased trade among members of PTAs—particularly PTAs involving deeper integration—can increase intragroup "trust" and thereby reduce tensions. Anwar (1994) argues that ASEAN lessened military tensions between members. Pomfret (1996) suggests that the ASEAN background may have contributed to the political stability and trust that allowed the formation of cross-border growth zones such as the Singapore-Johor-Riau growth zone, in spite of historical tensions.

The trust-building effect of increased trade, however, will be lessened if there are no previously agreed-on rules for distributing benefits, transferring income, and resolving latent conflicts. Indeed, some older regional agreements have at times contributed to intragroup tensions. For example, the United Republic of Tanzania and Uganda, members of the East African Common Market, were dissatisfied with the income transfers that the common external tariff on manufactures created, which prevented them from providing additional protection to their industry sectors and catching up with fellow member Kenya's more advanced manufacturing

Membership of PTAs can foster improved technology transfer and information sharing between members.

capacity. The ensuing arguments about compensation for the effects of imports on the various countries' manufacturing sectors contributed to the collapse of the common market and eventual conflict between the United Republic of Tanzania and Uganda in 1979. Similarly, Honduras' complaints about the distribution of benefits in the Central American Common Market were a factor in its 1969 conflict with El Salvador. The EU and its predecessors, on the other hand, have helped lessen tensions among member states, and it has itself benefited from a lowering of tensions, to the point where future European conflict is now, for many, inconceivable. In fact, in the 1950s, conflict prevention was the vision behind the establishment of the institutions and PTAs that evolved into the current EU.

However, the mixed performance of PTA-enhanced trade for lessening conflicts among members suggests that the trading arrangements cannot be seen as more than a supplement for an already concerted effort to resolve conflict via negotiation. Preferential treatment may create trade, but trade links alone are not likely to outweigh existing grievances.

Regional security can also be understood in economic terms. PTAs can be more valuable for trade purposes if future market access is considered more certain. PTAs with large markets can be seen as a form of insurance in the case of a global trade war (Perroni and Whalley 2000). WTO, in principle, provides the same kind of insurance, as members are sanctioned for violating commitments to bring down trade barriers. A PTA can also impose stringent restrictions on the imposition of nontariff barriers to trade. NAFTA, for example, created a multinational court to review antidumping cases levied by one member against another. A PTA that provides increased security of market access also encourages firms to specialize more narrowly and efficiently. From this perspective, the expected future gains from trade under a PTA can be larger relative to the expected gains from broader liberalization.

Technology Transfer. Membership of PTAs can also foster improved technology transfer and information sharing between members. The extent of gains from trade due to technology transfer in a PTA clearly depends on the characteristics of the other member countries. Exchange of production techniques is more likely to occur in PTAs covering economically varied countries, as such PTAs will generally encompass a wider range of technologies. Since much technology transfer takes place through multinationals that have a variety of manufacturing platforms in different countries, PTAs can attract FDI from them by facilitating internal manufacturing, assembly, shipping, and marketing.

Commitment to Reform. Policymakers often view joining international agreements as a way for their nations to demonstrate their commitment to economic reform. Either by allowing another country or supranational body to punish them for noncompliance, or by creating a situation where defection from the policy would be an explicit public breaking of trust, membership of a PTA can commit policymakers to reform and prevent them from backtracking on reforms once they are implemented. Fukase and Winters (1999), for example, argue that ASEAN membership is likely to be useful for locking in and accelerating the economic reforms of more recent member countries as well as enhancing their external credibility. The accession of Cambodia, for example, is cited as ASEAN's recognition of the country's political stability.

Both WTO rules and PTA reciprocal market access provide a way for countries to restrict their ability to raise tariffs and thus have a more credible trade policy. This external commitment can support more efficient specialization, reduce resources wasted on rent seeking, and limit the delay in adjustment to competitive pressures (Maggi and Rodriguez-Clare 1998). However, PTAs have a potential comparative advantage vis-à-vis multilateral arrangements such as WTO as regulations can be written more tightly. This creates an opportunity for members to commit to nontrade policy goals such as liberalization of investment or political reform. The implied commitment from a country to a PTA can be greater than that from a WTO member to WTO if the PTA has a stricter enforcement mechanism or if it includes more auxiliary provisions.

Long-Run Concerns: The Role of PTAs in the International Trading System

A number of the characteristics that distinguish PTAs and WTO have the potential of making PTAs a useful component of a larger multitiered international trading system, which can speed up the eventual development of a global system for open trade.

Opportunities for Experimentation and Testing of Trade Liberalization. It is clearly important for WTO to expand its treatment of trade barriers to include nontariff barriers, but it is unclear how best to set the rules to identify and sanction these forms of restricting trade. PTAs provide members with a short-term opportunity to experiment with different sets of rules relating to nontariff barriers.

Antidumping is still a large lacuna in the WTO framework for reducing trade barriers, and PTAs may offer an easier forum for developing the solutions to dumping that have eluded multilateral arrangements. Article VI of the General Agreement on Tariffs and Trade (GATT) defined dumping as having occurred if the product of a country is sold in another country for less than its "normal value." Unfortunately, the rule for calculating the normal value was not well specified. There are also no clear guidelines for establishing the "material injury" that is the basis for imposing an antidumping duty. The Uruguay Round Antidumping Measures Code clarified the method for calculating the normal value, defined standards for determining material injury, and imposed limits on how long antidumping measures could be imposed, but these stipulations were weakened by various other provisions and exceptions (Abbott 1995). Although resolution of antidumping cases is an important unresolved issue under WTO, PTAs provide added opportunities for finding solutions under conditions that may be more conducive to the negotiation of antidumping disputes.

Practice for Multilateral Negotiations. PTAs can be both a training ground and an information-sharing opportunity so that developing countries, particularly smaller countries, can be better prepared for negotiations in the multilateral setting. The process of accession to WTO is very difficult, particularly for transition economies and least-developed countries (Michalopoulos 1999). Regional PTAs can help countries prepare for accession through learning together and by pooling resources.

Continued interaction and the flow of information among member countries of PTAs can facilitate global trade negotiations by allowing each group to agree in advance on a negotiating position by working out compromises among themselves. Customs unions, by definition, are required to participate as a unit in tariff negotiations. There is obviously no guarantee, however, that regional groupings leading to two-stage negotiations (first among themselves, then in the larger WTO forum) will generate a more liberal trade policy than the single-stage negotiations in which all countries negotiate within WTO. The costs of within-group reconciliation of interests to achieve any kind of group unity may outweigh the benefits that the group's increased bargaining power can bring (Wang and Winters 1998; Andriamananjara and Schiff 2000; Mendoza et al. 1999). Nevertheless, APEC, for instance, has facilitated participation of its members in WTO negotiations. It is widely recognized to have contributed to negotiating the close of the Uruguay Round, and is generally involved in building capacity for implementation of WTO measures among its members.

The advantages of PTAs outside of areas directly related to trade liberalization—including nontariff barriers and the provision of a forum for smaller developing countries—seem to explain their popularity more than their economic benefits, both domestically and internationally. PTAs can be more palatable domestically in political terms than multilateral arrangements, as they allow countries to reserve sensitive economic sectors and to integrate with countries that will not create strong competitive pressures for restructuring.

PTAs are often seen as a means to bypass WTO's complicated multilateral negotiations.

Internationally, PTAs can be a forum for improved diplomatic relations and increased nontrade economic integration. Some argue that PTAs can serve as commitment mechanisms for policy reforms, particularly nontariff reforms such as investment policies or regulation. They are often seen as a quicker means to bypass WTO's complicated multilateral negotiations.

PTAs and the Development of a Broader Multilateral System for Open Trade. Although it is clear that PTAs and WTO are potentially complementary mechanisms, there is disagreement over whether this potential will be realized. An alternative scenario is that the proliferation of PTAs may damage the credibility of existing multilateral global trade negotiation frameworks if WTO does not improve its ability to police the agreements and ensure that they are compatible with the framework set out in its charter.

Although a PTA's charter may be in compliance with WTO rules, it is unclear that PTAs are monitored well enough, in practice, to ensure that they actually follow these rules (Box 3.2). Neither has there been a way to enforce the

Box 3.2 Preferential Trade Agreements and the World Trade Organization[1]

Nondiscrimination among members of WTO is the foundation of WTO agreement. Under WTO's charter, MFN treatment requires that any member granting any advantage, favor, or privilege affecting customs duties, charges, rules, and procedures to another member shall extend unconditionally such advantages to all members. Articles under GATT—the forerunner of WTO whose provisions were largely incorporated in the rules establishing WTO in the Marrakesh Agreement in 1994—permitted exceptions to the MFN treatment for PTAs. Some PTAs predated GATT. For this reason, exceptions to MFN were permitted under such special circumstances, because prohibiting the member countries of these PTAs from entering into such agreements would likely have led to their not signing GATT.

GATT specified a tariff-averaging procedure to enable a comparison of pre- and post-PTA tariff barriers. It required that the PTA be implemented within a "reasonable time." An understanding reached in the Uruguay Round set this "reasonable time" at 10 years, but otherwise the rules governing PTA-WTO interaction were not substantially changed.

There are two main routes by which WTO members can take part in PTAs.[2] One is by conforming with the provisions of Article XXIV. Under the article, a PTA can be granted a waiver from MFN obligations when any barriers to trade with nonmembers are not on the whole more restrictive than those that members had prior to their membership of the PTA. The second, available only to developing countries, invokes the authority of the enabling clause of the Tokyo Round Agreement, which permits qualified countries to exchange virtually any trade preference to which they agree. Any proposed PTA must be promptly notified to WTO for examination by a working party.

To date, 220 PTAs have been notified to GATT/WTO, including 109 that were notified during the GATT period. Of these, only 11 were justified under the enabling clause while 98 agreements were notified under Article XXIV. On notification, a working party is established to examine PTAs notified to WTO. Among working parties formed during GATT, 15 had not completed their examinations as of the end of 1994 and five did not report for various reasons.

Sixty-nine of the working parties initiated during GATT submitted reports, but only six explicitly acknowledged conformity of the PTAs considered with Article XXIV. Two of the six are still active, while the remainder did not make an explicit ruling in their reports (WTO 1995, p.16). The Committee on Regional Trade Agreements also reviews PTAs. Of the notified agreements presented to the Committee, 86 PTAs were still under examination at the end of 2000.

Recently, WTO (2001, p. 41) admitted "WTO does not have rules and procedures for examining RTAs that function adequately…the unsatisfactory experience of the GATT process on examining RTAs continues to be the same in the WTO." There are several reasons for this "unsatisfactory experience," apart from the consensus needed to rule on the compatibility or conflict of a PTA with WTO. Most importantly, difficulty arises from the vagueness of the wording of Article XXIV itself. In particular is the lack of a precise definition of "substantially all trade" in the requirement for liberalization within a customs union or an FTA, and the lack of a well-specified procedure for determining whether the post-union FTA barriers on trade with nonmembers are not "on the whole higher or more restrictive" than those that member countries had prior to their forming or joining a PTA. The absence of any explicit attempt to ensure consistency of the approach to permitted deviations from MFN under Article XXIV helps explain why WTO working parties have been unable to form the consensus needed to issue rulings of PTA compliance with WTO standards.

In fact, no agreement has ever been reached on the compatibility of the Treaty of Rome (which, in March 1957, established the European Economic Community [EEC], the forerunner of the EU) with Article XXIV, and the contracting parties agreed that because "there were a number of important matters on which there was not at this time sufficient information to complete the examination of the Rome Treaty...this examination and the discussion of the legal questions involved in it could not be usefully pursued at the present time. The examination of the EEC agreement was never taken up again" (WTO 1995, p.11).

The main reason for failure to pronounce on compatibility was that required consensus to decide on the issue of compatibility could not be reached, with often strong opposition against declaring the notified agreements to be compatible with Article XXIV.

[1] For a more complete discussion of this issue, see Panagariya (2000) or Srinivasan (2002).
[2] A third route, which has not been applied, would invoke Article IX of the Uruguay Round Agreement that allows waivers from normal WTO rules when the waiver has the support of three quarters of the country members of the organization. Also, Article V of the General Agreement on Trade in Services governs the conclusions of PTAs in the area of trade in services for both developed and developing countries.

obligations on PTAs or to punish those in violation (Laird 1999).

An area of the debate concerns the dynamic path of PTAs, more specifically the effect of development of PTAs on eventual achievement of an all-inclusive multilateral free trade arrangement. The most optimistic view of PTAs, associated with Baldwin's (1993) domino theory, is that PTA membership will gradually expand to cover all nations as the promise of access to the PTA market will attract applicants for membership. Critics of PTAs envisage a future in which the world has divided itself into several large trade blocs with little incentive for further reduction of trade barriers to create global free trade.

The efforts of Central and Eastern European countries to fulfill the requirements of EU membership can be seen as an example of the attractive power that a large regional organization can have. Similarly, some political-economic analyses argue that liberalization via PTAs can have a demonstration effect and create a demand for further liberalization. Fernandez and Portes (1998), for example, argue that PTAs serve as a focal point for the often dispersed domestic beneficiaries of liberalization to coordinate and offer strong political support for continued trade reform.

In general, the predicted outcomes for the dynamic path of PTA evolution are hard to test, as there has not been enough time to watch this path, since many PTAs were formed in the 1990s. The early stages of the domino theory and the fear of evolution of several major trade blocs are identical. In both cases, nations want to join existing PTAs. ASEAN's rapid expansion to include Cambodia, Lao PDR, Myanmar, and Viet Nam could, for example, be seen as either evidence for the domino theory or the precursor to an Asian bloc.

Most political economy theory suggests that PTAs will reduce rather than increase demands for liberalization (Krugman 1991). The way this works is that trade opening via PTAs will be enough to satisfy groups that benefit from freer trade and access to greater product variety. These pro-trade groups will lessen their lobbying efforts at further liberalization and the country will have little incentive to pursue further multilateral liberalization. Levy (1997), for example, shows how bilateral trade negotiations may alter domestic interest groups' payoffs and make them more likely to block further multilateral liberalization. PTA liberalization can also create interest groups opposed to further liberalization. Krishna (1998) points out that preferential access to large markets can create excess profits for producers in member countries. PTAs thus create a new interest group opposed to further multilateral liberalization. Andriamananjara (1999) demonstrates how a PTA shrinks the export sectors of the nonmember countries, which in turn, leads to an expansion of these countries' import-competing and lobbying sectors. Therefore, nonmember countries respond by becoming more protectionist and, in the process, undermine efforts to liberalize the multilateral trading system.

Scollay and Gilbert (2001) point out the possibility that PTAs will allow countries with like-minded protectionist policy outlooks to acquire greater bargaining power in the multilateral framework. PTAs, and particularly customs unions, can attract the support of protectionist interests in prospective member nations due to the opportunity they offer to raise domestic tariffs to the level of the highest tariff applied by any member. This creates an opportunity to pursue the elevation of trade barriers under the guise of trade liberalization through a PTA. Andersen and Eliassen (1991), for example, note that the number of lobbyists in Brussels, the seat of the EU, grew 10-fold between 1970 and 1990.

A pessimistic long-run scenario is that PTAs will proliferate and overlap such that countries become embedded in a "spaghetti bowl" of mutually inconsistent trade restrictions (Krueger 1997). The complexity of exchanging goods between countries will increase, lessening the incentives to trade. Trade routes will also be affected as producers take market barriers into account when planning exports. This is a particular concern for PTAs with complicated rules of origin.

In summary, although welfare consequences of PTA liberalization tend to be positive, it is generally acknowledged that PTA liberalization of trade does not compare favorably with multilateral liberalization if gains from trade alone are considered. The contribution of PTAs to the efficiency-improving expansion of world trade can be maximized if PTAs develop so that the comparative advantage of countries relative to each other is similar to that with the rest of the world. This is more likely to be the case when a PTA accounts for a large share of world GDP—but not when it consists of several very poor countries. The same argument applies to the size of the market and the ability to attract FDI: PTAs encompassing a small market cannot take advantage of the scale economies of a wider grouping of countries nor can they attract inflows of foreign capital as effectively as a more diverse set of countries. Furthermore, PTAs can foster competition by making industry coverage as comprehensive as possible and by minimizing the dispersion of external tariffs within the PTA in order to reduce the amount of trade diversion through indirect trade deflection.

Policy Guidelines for Asian PTAs

In terms of achieving the welfare gains and competitive effects associated with free trade in economic terms alone, PTAs are a second-best means, after general liberalization. The main debate is over the size of the gap between the "first" and "second" best ways to liberalize. Some policymakers seek to minimize this gap; others argue that it is too wide to close and that there is no reason to deviate from the first-best path. The nontrade effects of PTAs further complicate the debate when one considers the wide range of potential gains from PTAs that might offset the economic costs.

PTAs with a small market cannot take advantage of the scale economies of a wider grouping of countries.

The cost of a PTA to a country, relative to multilateral liberalization, depends on the characteristics of the other member countries as well as the institutional design of the PTA. For a country to realize its potential trade gains from a PTA, it needs access to a large market as well as incentives to specialize in the industry in which it has a comparative advantage. To achieve its potential nontrade benefits from a PTA, institutional features, such as the breadth of policies covered, the frequency of negotiations, and the mechanism for settling disputes, are more important.

PTAs as Trade Facilitation Mechanisms. For DMCs, trade liberalization via PTAs is no substitute for broader trade liberalization, for several reasons. First, there are economic limitations on the extent of gains from trade that can be achieved from trade within regional PTAs. The PTAs within the region tend to encompass countries with relatively similar resource bases, manufacturing capabilities, and economic structures, such that there is not much scope for expanding trade within the existing agreement. The prospects for trade-enhanced technology transfer are also limited for trade within most of the region's PTAs. (APEC, the only organization that does not seek to lower barriers to trade among members more than barriers to all trade, is an obvious outlier in terms of diversity of the member economies, potential for technology transfer across states, and importance of existing trade links among members.)

Second, the institutional features of the region's PTAs are not the most conducive to achieving gains from trade. All are basically FTAs, but, as mentioned above, the extent of free trade varies widely. The agreements retain protection for sectors that would potentially be most affected (and, in the long run, made more efficient) by external competition. Rules of origin, prominent in these agreements as in all FTAs, are a potential source of distortion in trade flows.

Third, the aggregate economic size of some PTAs tends to be small, such that any possible large-market effects of economic integration are limited.

Trade within the PTAs in the region is generally not free. AFTA members' lists of items to which preferential tariffs are applied, for example, tend to exclude sectors with significant domestic production (USTR 2000). Automobiles and most agricultural products are notable exceptions to the items slated by AFTA for free trade, which is targeted for 2010.

SAPTA has encouraged tariff concessions, but significant nontariff policy barriers remain in place. Antidumping investigations continue to be a major barrier to trade in the South Asian subregion. Bangladesh and Nepal have called for resolution of these disputes under SAARC/SAPTA. India, in particular, restricts imports of consumer goods by requiring special import licenses. The states in India can also impose separate taxes on imports that raise their price in the market. Member states have been reluctant to liberalize trade restrictions on the categories of items with the highest potential in their market. There are also hidden policy barriers that inhibit trade, including cumbersome bureaucratic procedures. In addition, the tariff rate alone can be misleading. For example, government values of goods for calculating tariffs are often much higher than the market value of the cheapest source of imports.

APEC's method of encouraging member economies' trade liberalization by peer pressure has shown mixed results. The Bogor Declaration states the ultimate goal, i.e., that members are to reduce tariffs to zero by 2010, or by 2020 for developing countries, but it is unclear exactly how this will be implemented and there have been difficulties in agreeing to strategies (Elek 1995). Australia and the US pushed for binding targets, as they were worried that the developing countries would be "free riders" on their market openings (Gallant and Stubbs 1997). Asian members wanted to follow "concerted unilateralism" to liberalize at their own pace, while developing countries wanted to ensure that they would not be forced to liberalize before they were ready. These differences of opinion were highlighted at the Osaka Summit: the PRC; Japan; Korea; and Taipei,China wanted to continue protection of their agriculture sectors despite pressure from the US. The resulting strategy was the Early Voluntary Sectoral Liberalization (EVSL), in which each country developed individual action plans. These plans generally did not move beyond existing commitments to liberalize politically sensitive sectors where the gains from liberalization would, perhaps, be the highest.

The potential gains from trade from any PTA, however, depend heavily on the extent of liberalization. The simulations of Anderson (1997) on the impact of APEC shows, for example, that welfare gains for APEC members depend heavily on whether agriculture is included in the list of liberalized sectors.

All PTAs in the region have similar forms of rules of origin based on the percentage of inputs from member countries. For example, AFTA's rules of origin allow a good to be considered as originating in a member country (i) if it is wholly produced in a member country or (ii) if the value of the materials from a member country makes up at least 40% of the free on board value and if the final manufacturing process takes place in a member country. CER's rules of origin specify that 50% of the factory or works costs of the goods should be made up from expenditure on inputs or contents originating in the area. They impose the additional restriction that the last process of manufacture should have occurred in Australia or New Zealand. SPARTECA's rules of origin are unusual in that excess local content from some SPARTECA qualifying goods can be transferred from goods with over 70% local content to help otherwise nonqualifying goods (between 35% and 50% local content) to meet the 50% local content requirement. SAPTA's rules of origin, though still based on the percentage criterion, are slightly more complicated with provisions varying by product and special concessions for the least-developed countries.

Verification of origin is generally done at the national level in accordance with guidelines agreed on as part of the charter for (or as an appendix to) the PTA. This mechanism creates several sources of rents, as there is no single acceptable way to calculate the value of a product. The guidelines for valuing the final product and the domestic inputs are generally vague and can thus be manipulated and interpreted differently by national authorities, which have wide discretion in applying these rules, and can do so arbitrarily. The same criticism applies to the guidelines for valuing inputs.

The Asian PTAs' level of cooperation in trade facilitation and in nontrade policy areas has generally been quite high. AFTA, in particular, is part of a wide range of trade facilitation and deeper integration policies among ASEAN countries. The ASEAN Industrial Cooperation Scheme (AICO) encourages technology investments in the ASEAN area by reducing tariffs on goods produced by companies that are partially owned by ASEAN citizens (30% equity), incorporated, and operating in member countries and cooperating or sharing resources (such as sharing technology or consolidating raw materials purchases) with another company in the region. The ASEAN Agreement on Customs lays the groundwork for regionwide harmonization of tariff nomenclature at the 8-digit Standard Industrial Trade Classification (SITC) level. The ASEAN Customs Vision 2020 also aims to streamline customs procedures for examination of goods and to simplify customs clearance for home use as well as the formalities of goods declaration for exporters.

Asian PTAs' cooperation in trade facilitation and in nontrade policy has generally been quite high.

CER's charter places many nontrade areas of domestic policy under its purview. A proposal to harmonize quarantine systems was one of the earlier agreements, while later cooperation included industry assistance, government purchasing, business law harmonization, export restrictions, and further harmonization of customs policies and procedures. A 1990 plan to avoid double taxation and income tax evasion is another example of a trade-supporting policy. The two governments also signed an agreement on common accreditation and quality standards in October 1990. A joint regulatory agency for food quality certification was established in 1995.

This attention to augmenting tariff reductions with further attempts to reduce internal barriers is important, given that the small market size created in most of the PTAs imposes an upper bound on the market size gains possible. Khanna's (2001) survey of exporters in Bangladesh and Nepal highlights some of the potential nontariff barriers that can impede trade if they are not explicitly considered in a PTA. The high tariffs on the consumer products that Bangladesh's manufacturing sector is currently capable of producing are the main obstacle to cross-border trade for Bangladesh exporters. While transit in India is relatively free for carriers from Bhutan and Nepal, those from Bangladesh are subject to more restrictions. On the other hand, transit in Bangladesh is severely restricted;

goods moving into Bangladesh from Bhutan, India, and Nepal are required to be transshipped at the border.

The limited number of trade routes, sparsely staffed customs stations, and a multiplicity of customs forms have also been documented as prohibitive barriers to trade (World Bank 2001). Finally, continuing differences in product quality standards, quarantine restrictions, and accepted certification have restricted trade even when there are significant production cost differentials between countries.

Given the limitations of the Asian PTAs in terms of market size and lack of diversity in many cases, these PTAs can best contribute to the building of a multitiered international trading system by continuing to put stress on lowering both internal and external tariffs. Aside from APEC, none of these PTAs can risk the trade diversion effects of bringing down internal tariffs without offering some tariff reductions to its other trading partners outside of the PTA. In fact, many countries in AFTA have already adopted MFN in adjusting their tariffs.

Aside from tariff policy, Asian PTAs can also focus on ways to boost joint security, reduce political tension, and improve conflict resolution. They can also address other measures to facilitate trade, such as harmonizing cross-border standards, facilitating the flow of labor between countries, and reducing bureaucracy.

EFFECTS OF PTAs ON TRADE IN ASIA AND THE PACIFIC: SOME EVIDENCE

The proliferation of various types of PTAs reflects the growing importance and complexity of trade networks.

The proliferation of various types of PTAs reflects the growing importance and complexity of trade networks. This section assesses the impact of PTAs on trade within and outside of Asia and the Pacific on the basis of earlier research as well as recent estimates made at ADB. The empirical research considered draws on two distinct methodologies: one applies econometric estimation to examine trade flows between countries using historical trade data, and the second relies on a simulation modeling approach to analyze the impact of policy changes (including trade liberalization under PTAs) on trade flows. As noted above, the volume of trade expanded rapidly in the 1990s and this rise was coincident with the surge in the number of PTAs. Whether existing PTAs have been trade augmenting or trade diverting is explored here using a *gravity model* of bilateral trade flows and examining results from global computable general equilibrium models. Before considering these results, the section first assesses the changing flows of world trade.

Trends in Intrabloc Trade

One way to examine the tendencies for trade to flow among members of a given group or region is by examining intrabloc trade shares. Numerous factors influence trading patterns and PTA membership is only one of them. If the share of intrabloc trade were to increase dramatically after the formation of a PTA, it would be plausible to conclude that this may come at the expense of nonmembers through trade diversion. On the other hand, PTAs could, by facilitating trade, bring about an increase in trade with nonmembers as well as within the bloc.

Table 3.9 compares intrabloc trade flows of PTAs over the last 20 years, and shows that PTAs in the Asia and Pacific region are highly diverse. The region includes the PTA with the highest intrabloc trade share—although APEC's large shares predate the formation of the arrangement and can be attributed to the large size of the countries involved—as well as some of the PTAs with the smallest intrabloc trade shares, such as CER, ECO, SAPTA, and SPARTECA. These results are not particularly surprising, given the looser nature of PTAs in the region as well as the member countries' strong trade links with the US, Europe, and Japan. The outward orientation of other Asian PTAs is even higher. The slow implementation of intragroup trade preferences in ECO, for example, has contributed to the outcome that around 7% of members' trade in 2000 was with other member countries, while CER's and SPARTECA's low degree of trade with members is most likely driven by Australia and New Zealand's extraregional links. The smaller member states of SPARTECA appear to take advantage of their preferential access to Australian and New Zealand markets and are regionally oriented in their trade flows. The high percentage of intrabloc trade in APEC is an exception for the region, but this is obviously a consequence of the fact that the agreement includes Asian countries' major extraregional trading partners.

The EU has fairly high intrabloc trade flows. In contrast, only around 12% of EFTA members' trade was between members in 2000. The Andean Pact and Mercosur PTAs trade predominantly with countries outside of the PTA, which reflects the importance of the US as a trading partner in that region. In contrast, trade between NAFTA member countries is larger than trade with nonmembers. The intrabloc trade shares of PTAs worldwide—particularly AFTA and APEC—generally increased until the late-1990s and have leveled off since. One would typically expect moderate changes over time in the intra-PTA trade shares, and sharp changes in shares can usually be attributed to changes in the composition of the PTA. For example in 1994, Mexico joined Canada and the US in NAFTA; Cambodia, Lao PDR, Myanmar, and Viet Nam joined ASEAN between 1995 and 1998. In each of these cases, expanded membership of the PTA led to sharp increases in the within-bloc trade share.

There have been instances where intrabloc trade shares fell (e.g., ECO, Andean Pact, and Mercosur between 1998 and 2000) as a result of external shocks and institutional changes within the PTA. Political instability and economic restructuring in Central Asia combined with the lack of integration of ECO countries in the world economy explain the fall in the ECO trade share.

Trade Intensity Indices

Frankel (1997) notes a limitation in comparing trade shares across PTAs to consider the trade-distorting effects of PTAs, namely that the intrabloc trade share tends to be higher the larger the size of the PTA. Trade concentration ratios or trade intensity indices overcome the limitation of intrabloc trade shares as measures of trade distortion by dividing the intraregional trade share by the share of the region to total world trade. If the ratio is one, the intraregional trade share is the same as the trade share of the region with the world. In this case, the PTA has a neutral effect on trade. If the trade intensity index is greater (less) than one, then there is trade diversion (creation) as a result of the PTA. Analysis of 5-year averages of the intensity indices for 11 PTAs from 1980 to 2000 shows that indices are greater than one (Table 3.10). The bigger PTAs (e.g., APEC, EU, and NAFTA) have indices close to one while smaller PTAs generally have larger indices. Interestingly, the Andean Pact and Mercosur trade blocs have the highest trade intensities, an observation also reported by Frankel (1997). The Asian PTAs tend to have lower trade intensities. AFTA members appear to have become more outward oriented and the intensity index figures fell steadily in the 1990s.

AFTA members appear to have become more outward oriented in the 1990s.

Gravity Model Estimation

Gravity model estimation provides a useful multivariate framework for assessing the impact of

TABLE 3.9 Intrabloc Export Shares of Selected Preferential Trade Agreements, Five-Year Averages, 1980–2000 (%)

Preferential Trade Agreement	1980–1984	1985–1989	1990–1994	1995–1999	2000
Asia and Pacific Region					
AFTA	20.8	18.9	22.5	24.8	24.5
APEC	66.3	72.2	73.1	74.3	75.2
CER	8.0	8.4	9.1	10.7	9.3
ECO	9.3	7.3	6.4	8.4	6.6
SAPTA	6.3	4.9	4.4	5.1	4.8
SPARTECA	11.9	11.4	12.8	14.2	12.3
Other Regions					
Andean Pact	5.0	4.8	9.1	13.2	10.8
EFTA	16.5	16.4	13.7	12.6	11.8
EU	62.0	65.1	66.5	65.1	66.9
Mercosur	9.9	8.5	15.9	24.8	22.3
NAFTA	41.3	46.7	48.2	53.2	58.8

Source: Generated using data from International Monetary Fund, 2001, *Direction of Trade Statistics* CD-ROM, October.

TABLE 3.10 Trade Intensity Indices of Selected Preferential Trade Agreements, Five-Year Averages, 1980–2000

Preferential Trade Agreement	1980–1984	1985–1989	1990–1994	1995–1999	2000
Asia and Pacific Region					
AFTA	4.2	4.8	3.8	3.7	4.0
APEC	1.6	1.6	1.6	1.5	1.5
CER	4.1	4.6	5.8	7.1	6.8
ECO	5.5	5.2	4.2	5.7	4.7
SAPTA	4.1	3.5	3.9	4.2	4.1
SPARTECA	5.8	6.0	7.7	9.0	8.7
Other Regions					
Andean Pact	3.6	5.4	10.9	15.7	16.6
EFTA	2.3	2.1	2.0	2.1	2.2
EU	1.5	1.5	1.6	1.7	1.7
Mercosur	5.6	7.5	11.7	13.2	14.3
NAFTA	1.8	1.8	2.0	2.2	2.2

Source: Generated using data from International Monetary Fund, 2001, *Direction of Trade Statistics* CD-ROM, October.

PTAs on the level and direction of trade.[8] Gravity models estimate the level of trade between two countries and assess the impact of policy characteristics—such as membership of a given PTA—on trade flows. The model is based on the idea that trade between two countries, like the gravitational force between two objects, is a function of the countries' "mass" (in this case population size and GDP) as well as the distance between them. While lacking microeconomic foundation, the basic gravity model has been widely applied as a predictive model for estimating the level of trade between two countries—particularly when other control variables such as measures of the country's remoteness from major trading centers—are added.

The model used in the present research included an important innovation that distinguishes it from other attempts to use gravity models to explore the effects of PTAs on trade. Extending the model of Soloaga and Winters (2001), the new model is able to capture the specific effects of PTAs on trade in the Asia and Pacific region. Its estimates can determine whether PTA membership influences a given country's trade with Asia in a different way from the way in which it affects its trade with the rest of the world.

It is beyond the scope of this chapter to discuss the estimates in detail, and instead this section will summarize the main results of the estimates and indicate the policy implications of the results.[9]

Data Issues. Eighty-three countries are included in the gravity model estimates. Bilateral exports for every pair of these countries are extracted from the IMF *Direction of Trade Statistics* database from 1980 to 2000. The number of observations varies per year. The export values are expressed in real terms based on a merchandise price index (base year 1990) obtained from WTO's *International Trade Statistics 2001*. Estimates were made using single-year cross-sectional data, as well as panel data constructed at 5-year intervals (1980, 1985, 1990, 1995, and 2000).

Basic Determinants of Trade Flows. The estimation results for the basic variables identified in the gravity model as driving trade flows—namely GDP, distance between capitals of trad-

[8] The authors associated with building the theory underlying the gravity model include Deardorf (1984), and Helpman and Krugman (1985). Frankel (1997) credits Helpman and Krugman as the source of the standard gravity model.

[9] For further details, see Clarete, Edmonds, and Seddon, forthcoming.

ing partners, physical area, and sharing a common border—have the expected signs and are highly statistically significant. This supports the validity of the gravity model, and model estimates generally explain cross-country trade flows well. Distances, the size of the economy, and whether countries share a common border all exert a statistically significant influence over trade flows in the direction expected. Between 68% and 73% of the variance in trade flows was explained by the basic gravity model across the various new estimates.[10]

Effects of PTAs on Intrabloc Trade. PTAs can be categorized into three groups based on whether they tend to foster intrabloc trade, to foster greater trade with trading partners worldwide, or to reduce trade with the rest of the world while leaving trade within the bloc unchanged. Estimates of the effects of different PTAs on the trade flows between members vary substantially across PTAs.

PTAs fostering intrabloc trade, except APEC, had positive and statistically significant coefficients for intrabloc trade, had hardly any change in their overall imports, and increased their exports to the world over the period covered in the data. The Andean Pact, ECO, Mercosur, and SPARTECA had the largest effects on intrabloc trade and on trade between the PTA-member countries and the rest of the world. In the Asia and Pacific region, ECO, SAPTA, and SPARTECA had the largest effect in increasing intrabloc trade, while AFTA and CER showed no significant intrabloc trade effect.

ECO countries tended to trade more intensely among themselves at the expense of trade with the rest of the world. Estimates showed that intrabloc trade was higher at a statistically significant level in 1995 and 2000 than would be expected if the countries were not members of ECO. However, it must be recognized that after SAPTA, ECO had the lowest intrabloc trade share of the PTAs considered as its historical orientation was to export to the Russian Federation and, despite the adoption of market-oriented policies, the subregion has not yet become well integrated into the world economy.

The large intrabloc trade effect estimated for SPARTECA can be attributed to the heterogeneity between Australia and New Zealand on the one hand, and the rest of the members in this PTA on the other. Trade tends to flow more intensely among SPARTECA's smaller member economies, but the potential for more trade among them is limited by the small size of their domestic markets. SAPTA and EFTA are also included in this category, even though these PTAs have lower gross intrabloc trade effects than the other PTAs.

This strength of the intrabloc trade effect is evidence of the size of the trade-diverting effects of PTAs and this evidence is generally in line with the results reported by Soloaga and Winters (2001). The effects of SAPTA membership on intra-SAPTA exports calculated in the estimation model are all statistically significant and positive. At the same time, it should be recognized that trade levels between some members of SAPTA are extremely low. For example, Frankel and Wei (1998) showed that India and Pakistan are trading at a 70% lower rate than would be expected given their size and proximity. In general, though, the estimates are merely indicators of how much more trade there is among SAPTA members than would be expected if SAPTA did not exist. It does not necessarily mean that overall levels of intraregional trade are high. The share of intra-SAPTA exports was only 4.8% in 2000, the lowest of any of the PTAs considered in this chapter.

Estimates of the effects of different PTAs on the trade flows between members vary remarkably across PTAs.

Mercosur appears to be the PTA that has had the greatest effect in stimulating intrabloc trade and trade between its members and the rest of the world. This effect is brought out by the "trade multiplier," which captures the extra trade associated with members of a given PTA. Across all PTAs, the trade multiplier averaged 7.8, compared with 20.8 for Mercosur. Preusse (2001) observed that intra-Mercosur exports expanded by 28.4% between 1995 and 1998. He attributes this outcome to the increasing significance of regional production. The effects of the Asian financial crisis and sociopolitical problems in the region cut short the impressive gains made following the formation of the customs union in 1995. Yeats (1998) noted that intrabloc trade in Mercosur increased at the expense of trade with nonmember countries and caused significant trade diversion. This stemmed from the group's "discriminatory tariffs against nonmembers, which are four to six times higher" than those in other major PTAs. The trade bloc appeared to reinforce the inward orientation of Mercosur's economies, enabling inefficient domestic producers to expand markets within the bloc while

[10] These percentages are based on the adjusted R-square of the different estimates.

Estimation results suggest there was increasing trade openness in the economies of countries joining APEC.

remaining uncompetitive on the wider international scene. The decline in Mercosur's trade (both within and outside of the bloc) in the late 1990s reflects the impact of accumulated inefficiencies sustained through relatively high discriminatory protection. The Mercosur case highlights the importance of examining broader economic policies—rather than just looking at trade flows—when analyzing the impact of PTAs.

Andean Pact countries also exhibit strong tendencies to trade among themselves. Although there seems to be no evidence that this came at the expense of any particular trading partner of the Andean Pact members in the 1980s, there is evidence that trade diversion at the global level increased in the 1990s.

In terms of PTAs fostering greater trade with trading partners worldwide, membership of APEC and the EU was estimated to significantly expand trade both to other members of the PTA and to the rest of the world. The finding for APEC confirms results obtained in Frankel and Wei (1998) and Soloaga and Winters (2001). APEC is built on the principle of open regionalism, and estimation results for the PTA suggest there was increasing trade openness in the economies of countries joining APEC. Increases in exports or imports appeared to reflect rising trading activity; this was also noted by Frankel (1997). Expanded intrabloc trade was accompanied by strong tendencies for APEC members to increase trade with the rest of the world. However, Frankel also cited the large size of the trade bloc as explaining the strong effect of PTA membership on intrabloc trade.

The EU is sometimes considered to be trade diverting, but the estimates from the gravity model showed EU members as associated with increased intrabloc and total trade. Soloaga and Winters' (2001) results indicate that EU membership has reduced the member countries' imports from non-EU members although Sapir (1997) attributed this to the increase in the number of member countries in the EU during the 1990s.

As regards PTAs that reduce gross trade with the rest of the world while leaving intrabloc trade unchanged, Frankel (1997), Frankel and Wei (1998), and Soloaga and Winters (2001) found that AFTA expanded intrabloc and total trade. However, the estimation results showed that AFTA reduced trade outside of the trade bloc and did not change intrabloc trade relative to the level expected in the absence of the PTA. A possible reason why these results differ from those of earlier researchers is that these estimation results include data that cover ASEAN's newest members—namely Cambodia, Lao PDR, Myanmar, and Viet Nam. Furthermore, the data include the period of the Asian crisis and subsequent recovery. Both could have had a possible impact on the trade-creating effects of AFTA. These newest members are economically less developed than the founding ASEAN countries and are, on average, less integrated into the world trading system. Their inclusion in the gravity model estimates may have diluted the effect of ASEAN on its trade within and outside of the PTA. Furthermore, during the Asian crisis the rate of growth in external trade of ASEAN fell significantly, creating a downward bias to the contribution of external trade in the estimates.

PTAs' Contribution to Asian and World Trade. When PTAs are considered as a whole, empirical estimates show that PTAs both within and outside of the region have augmented trade in the Asia and Pacific region. Estimation results provided little support for the assertion that PTAs have diverted trade to member countries at the expense of non-PTA trade. The general effect of PTAs on Asia and Pacific trade is quite small compared with the effect of non-Asian PTAs in other regions. Overall, PTAs appear to have increased aggregate trade flows worldwide, and gravity model estimates provide evidence that PTAs create rather than divert trade globally.

The effect of the EU on Asian trade suggested by the estimates indicates a more complicated picture. The EU was found to have a strong positive effect on trade flows between member countries and the rest of the world—which includes greater trade to Asia. However, the specific effect of the EU on Asian trade was found to be negative and significant. Overall, the total world trade effect dominates the Asia-specific effect, making the net effect of the EU on Asian trade positive. The Everything But Arms initiative for EU member countries to grant nonreciprocal trade preferences toward least-developed countries could carry some negative consequences for the EU's trade with a number of DMCs excluded from the initiative.

Beyond Gravity Models: Computable General Equilibrium Models

The gravity model estimation results can help explain bilateral trade flows and the effect of PTAs on flows, but reveal little or nothing about the effects of changing trade flows on the size and distribution of aggregate real income of economies. Broader econometric analyses of trade, growth, and increased national income provide evidence that higher levels of trade are associated with higher growth rates and improved national standards of living. This literature dates from the 1970s and includes several empirical studies of the relationship between trade and income, the results of which suggest that higher volumes of trade facilitate growth and higher income.[11] However, growth and higher income could, in turn, drive variations in trade flows. Indeed, trade and economic performance affect each other and it requires a more complete description of an economy to evaluate causal linkages and feedback mechanisms in and among the economies of the world.

Computable general equilibrium (CGE) models provide a framework that can detail how the extra trade translates into improved economic performance. They also suggest why the growth process can be faster for one subset of countries but slower for another. In CGE models, analysts assemble the relevant economic structural features and behavior of agents and, using the framework, simulate the economic effects of existing or proposed PTAs. The analytical design of the model drives the results of the empirical analysis and establishes the model's credibility.

Results from some CGE studies, such as Robinson and Thierfelder (1999), show that PTAs create trade rather than divert it. In particular, this study found that PTAs increase intrasector trade between countries by expanding market size and by enabling individual economies to benefit from increased specialization and division of labor. Frankel and Romer (1999) point out that trade provides countries with the opportunity to exploit their respective comparative advantage and achieve cost efficiencies through the larger markets offered to their domestic industries. It also enables countries to reduce resource wastage due to rent seeking, and to increase investment. However, this finding is questioned by Andriamananjara (1999), who developed a CGE model showing that PTAs tend to reduce the export markets of the nonmember countries and lead them to expand their import-competing sectors. Supporting this result, Scollay and Gilbert (2001) argue that effective PTAs tend to lead to a greater number of trade conflicts as a result of their negative impact on nonmembers.

A number of CGE-based studies note that larger PTAs have superior positive welfare effects (Scollay and Gilbert 2001, Wang and Schuh 2000), particularly if these PTAs liberalize their trade in a nondiscriminatory manner. The results of the study by Gonzalez-Vigil (2000) acknowledge the merit of open regionalism, as represented by APEC. This provides support for the proposition that APEC conforms with the multilateral trading system because its nondiscriminatory nature avoids marginalizing nonmembers. Scollay and Gilbert (2001) note that global liberalization remains the first-best option. The aggregate gains under global liberalization both for the world as a whole and for the APEC members together are about 50% higher than under the next most favorable multilateral trading arrangement simulated.

General equilibrium model simulations of the effects of PTAs suggest that aggregate trade creation dominates trade diversion.

General equilibrium model simulations of the effects of PTAs suggest that aggregate trade creation dominates trade diversion. Most models show that current and potential welfare changes for member countries are generally positive, especially when the possibilities of technology transfers and increased competition are included in the simulation (Robinson and Thierfelder 1999). Fukase and Winters' (1999) elaboration of the potential benefits for the Lao PDR, Myanmar, and Viet Nam of ASEAN accession is a typical example of the empirical literature on the subject. Their findings are generally positive, but the authors are quick to caution that "there is little evidence that dynamic gains always occur with regional integration especially in the case of integration schemes between developing countries. The existence of such gains depends heavily on the specific models used, and is very sensitive to the characteristics of the regional integration and the members' economic policy" (p. 3). The consensus view of economists is that PTA liberalization likely yields lower welfare gains than does multilateral liberalization.

CGE analyses enable consideration of the crucial policy question concerning the effect of PTAs on eventual achievement of broader multilateral trading arrangements. Scollay and Gilbert (2001) find that PTAs can be building blocks to broader multilateral trading arrangements

[11] For example, Michaely (1977), among the first researchers who assessed the empirical linkage between trade and economic growth. In the 1980s, additional empirical work was carried out by Feder (1982), Balassa (1985), and the World Bank (1987). More recent empirical work in this area includes Easterly (1993), and Frankel and Romer (1999).

provided that they improve the economic welfare of their members as well as nonmembers, and leave open the door to future negotiation. Foroutan (1998) found that the acceptance of a liberalized trade policy may be a condition for the survival and strengthening of PTAs, but that membership of a regional bloc is neither a necessary nor a sufficient condition for liberalization.

Several other studies offer more critical assessments of the effects of PTAs on prospects for eventual multilateral trade liberalization. Bagwell and Staiger (1997) are more skeptical concerning the effects of PTAs on prospects for a global open trading arrangement. They argue that PTAs obscure the transmission of externalities across countries and thus prevent the reciprocity principle from conveying efficient multilateral results for members. They also establish that externalities are transmitted efficiently across countries only if tariffs are in accord with the principle of nondiscrimination. Andriamananjara (1999) mentions a number of barriers to multilateral trade introduced by PTAs. In summary, CGE models have proven useful in improving the understanding of the sources of trade expansion brought about through PTA-based trade liberalization and income growth, as well as greater appreciation of the interaction between such liberalization and income growth.

CONCLUSIONS

The pace of growth in international trade accelerated in the 1990s. Simultaneously, there was a rapid increase in the number of international trading arrangements, including PTAs. This suggests that the growing importance of international trade in the determination of economic growth, both globally and at individual country level, has been leading nations to devote greater energies to develop PTAs while negotiating global trade agreements under the auspices of WTO.

Most empirical and theoretical work indicates that the effects of PTA-enhanced trade are not as beneficial for welfare as more general trade liberalization. PTAs have generated an increase in market size and resulted in an increase in the variety and availability of new products. Nevertheless, when compared with multilateral trade liberalization, PTAs are limited vehicles for enhancing welfare. First, the product variety among PTA members is obviously lower than the product variety in the world. Second, a PTA-created market, as the product of an agreement among a few countries, is obviously smaller than the world market.

The productivity- and efficiency-enhancing effects of international competition are likely to be qualitatively different in PTAs than in multilateral arrangements. Competition from other PTA members may, for instance, push countries into specialization that does not reflect their comparative advantage relative to the rest of the world. Domestic producers that make adjustments to serve the PTA market are likely to oppose further liberalization that would create pressure for reallocation of resources away from their sectors. The trade diversion that stems from preferential treatment for PTA members can manifest itself in inefficient specialization in member countries. A PTA member may be able to produce and sell goods in other member countries more cheaply than a competitor in a nonmember country can, even if the competitor's production costs are lower. A PTA can also create an incentive to specialize in the use of tariff differentials to import nonmembers' products and then resell them as local goods after some processing, so as to take advantage of the preferential treatment for member countries. Hence firms might set up in a member country with the lowest tariffs for the express purpose of including the minimum amount of local inputs with outside exports so that final products qualify as local goods.

The difference between the effects of PTA-enhanced trade and more general liberalization varies with the institutional design of the PTA. First, the size of the tariff differential for members relative to the rest of the world determines the extent of distortion, primarily trade diversion, which the PTA can create. The greater the advantage accorded to members, the more the agreement isolates members from competition by firms in countries outside of the PTA.

Second, incentives for inefficient specialization are created by the difference in member countries' external tariffs and the necessity for developing and implementing rules of origin to prevent nonmembers' goods from entering the group via the member country with the lowest level of trade protection. This can lead to distortions in production and location decisions as well as unproductive lobbying activity; it also offers wide scope for rent seeking.

Third, the extent of the market created by a PTA depends heavily on the trade facilitation and nontrade measures that are incorporated into the agreement. PTAs can potentially lower border costs more than general liberalization because the smaller number of member countries are more likely to reach agreement on regulatory policies, customs procedures, and infrastructure priorities to promote trade.

In regions where PTAs have been most successful in generating tangible changes in the internal structure of tariffs and other trade barriers, export growth may be more muted. Although other historical and institutional factors may also be important, this could be because distortions have been high and, as a result, members have become more isolated from competition outside of the PTA.

Still, from a broader perspective there are diverse opinions within the economics profession regarding the welfare effects of PTAs, particularly the effects of PTAs as institutional trading arrangements for broader regional economic corporation and integration, an area to which economic analysis has devoted less attention than the narrower effects of PTAs on international trade. Many of the positive effects of PTAs arise in this area. On nontrade grounds, PTAs have several potentially beneficial effects as instruments for structural change. The institutional design of the PTA can have an important impact on how much the gains from PTA trade approximate to the gains from more general liberalization as well as the degree to which nontrade benefits are realized. For example, the limited market size in a PTA can be mitigated by deep integration—such as harmonization of regulations and streamlining of customs procedures—that reduces border costs by more than the results of tariff changes.

Further, PTAs, as internationally negotiated pledges to leave unchanged the trade reforms that have been made in the past or to implement trade liberalization in the future, demonstrate greater commitment to reform than unilateral declarations of intent. This is particularly true when the PTA includes procedures for identifying and sanctioning countries that renege on their agreements. PTAs also provide forums for interaction between leaders as well as technical officials in member countries. This interaction can have positive spillovers for resolving other conflicts, enhancing regional cooperation in larger multinational negotiations, and generally ensuring a higher level of international communication between countries.

PTAs, Economic Growth, and Welfare

PTAs can be evaluated through examination of their effects on world trade patterns. These effects provide only a rough proxy for the PTAs' welfare effects and it is difficult to compare them with the alternative of widespread unilateral liberalization (the counterfactual). However, it is encouraging, at least, to know that PTAs do not appear to have limited trade. World trade has increased even as the number of PTAs has increased. Empirical conclusions from the gravity model estimates in this chapter do not indicate that PTAs have been trade diverting, and lend support to the contention that PTAs augment trade flows.

However, results differ widely across individual PTAs. This result highlights the importance of establishing the precise economic nature of the PTA in determining its effects. A number of institutional characteristics were identified as determining the PTAs' economic effects, e.g., rules of origin and dispute resolution mechanisms. The empirical results support the conclusion that PTAs' effects on trade vary significantly according to these characteristics.

On nontrade grounds, PTAs have several potentially beneficial effects as instruments for structural change.

Policies for Asia and the Pacific

The first point is that the PTAs in the Asia and Pacific region appear to be a suboptimal route to free trade, but offer potential benefits. The extent of trade facilitation and nontrade cooperation embedded in the PTAs has been increasing, but remains the first important area for reform. The second is that agreements in the region remain preferential trade agreements with only incremental progress toward becoming free trade areas. Furthermore, the exclusion of sectors from PTAs substantially reduces their potential welfare benefits, as it allows sectors in need of reform to continue inefficient production. Progress toward free trade is needed, particularly in agriculture—the second major area for reform. Third, all PTA agreements in the region have relatively complex rules of origin. This makes it profitable to alter production patterns simply to fulfill the rules for market access rather than to reduce costs and improve efficiency. Processes for certification of origin also create opportunities for rent seeking. Policies to reduce the differences between PTAs members' external policies and thus decrease the importance of rules of origin are the third major area for reform.

As institutions for international cooperation, PTAs in the region are relatively advanced. Two of the region's PTAs, AFTA and SAPTA, are embedded in larger regional cooperation organizations. Generally, PTAs' agendas could, however, be focused further on discussing regional priorities and on preparing for negotiations in larger forums such as WTO. The potential role of PTAs as enhancing commitment to policy reforms in member countries could also be strengthened. Many of the PTAs in the region resolve disputes via bilateral negotiations and have no real provisions for sanctioning members that violate the provisions of the PTA.

The future economic growth of the region is linked to the health of the multilateral trading system.

Prospects for Trade in Asia and the Pacific

There is great variation in the efforts undertaken by different PTAs throughout the world. In their broader sense, PTAs address concerns beyond narrow issues of trade liberalization between members and serve as vehicles for fostering regional cooperation in other economic and noneconomic issues. This makes it unproductive to discuss PTAs in general terms. Instead, greater nuance in the portrayal of PTAs can aid understanding of the types of PTAs that can serve as useful complements in a multitiered international trading system. At the same time, this analysis makes it possible to identify those aspects of PTAs that are most harmful either in terms of distorting actual trade flows or of making more difficult the eventual achievement of an all-inclusive global open trading system.

This chapter has identified areas in which PTAs have considerable merit in contributing to the improved welfare of members as well as nonmembers. These include improving communication between regional neighbors and reducing the chances of conflict, pursuing reform in areas not addressed or difficult to address in broader multilateral arrangements, providing commitment mechanisms to support or reinforce domestic policy reform, and areas for experimentation and learning in trade liberalization.

On the other hand, there are characteristics in existing PTAs that are not supportive of these goals and should be avoided in future PTAs and reformed in existing ones. These include rules of origin that distort comparative advantage, and overlapping jurisdictions and rules of the various PTAs.

The Asia and Pacific region should continue its historical efforts to further multilateral trading arrangements, while continuing to pursue limited PTAs focusing on broader aspects of regional cooperation. However, exceptions are warranted in particular sectors or on issues where the multilateral arrangements either have not addressed an important area where liberalization would be beneficial, or where the region's interests need to be better represented in the international arrangements.

Clearly, there is a need to reform the regulations governing the relations between PTAs and WTO, and to improve the institutional architecture guiding the interaction between PTAs and WTO. The future economic growth of the region is clearly linked to the health of the multilateral trading system.

The WTO rules-based multilateral trading system became further strengthened and even more globalized with the accession of the PRC to WTO in late 2001 and Taipei,China in early 2002. The trade growth that will emerge from the PRC over the next few years will present an adjustment challenge in the short term for other DMCs in the region. Nonetheless, the medium- to long-term prospect is for more efficient location of production in industry in general and thus for accelerated trade and economic growth.

Some DMCs are in the midst of negotiations to join WTO, including Bhutan, Cambodia, Lao PDR, and Nepal, several Central Asian countries, and some Pacific DMCs. The recent commitment by WTO members at Doha to accelerate the pace of accession negotiations for developing and, especially, least-developed countries provides an opportunity for these economies to speed up their reform process and thereby begin reaping the various benefits of WTO membership earlier.

The proliferation of PTAs outside of Asia and the Pacific is a source of concern for DMCs that fear that they may lose as a result of trade and investment diversion. In response, the region has seen numerous initiatives that aim to bolster trade growth. It is important that these initiatives are ultimately welfare enhancing both to the region and the world.

The proposed ASEAN-PRC Free Trade Area, and the moves toward economic partnership between ASEAN and Australia and New

Zealand have the potential to make similar contributions to boosting trade growth and increasing competition and economic efficiency. The ASEAN-PRC Free Trade Area, proposed by the PRC and endorsed by ASEAN's 10 leaders in Brunei in October 2001, represents a limited but concrete proposal. It envisages an FTA within 10 years, even though ASEAN's own FTA has yet to be fully implemented.

Bilateral agreements currently being negotiated or discussed are even more limited. Japan, for example, has signed and is currently implementing a Japan-Singapore Economic Partnership Agreement, and is exploring arrangements with Korea. Singapore has added bilateral trade agreements to its portfolio of trade policy measures. In addition to the agreement with Japan, it signed an FTA with New Zealand in 2001, is negotiating one with Australia, and is exploring arrangements with Chile and the countries of EFTA as well as the US (Rajan and Sen 2000).

In South Asia, bilateral PTAs have been signed (or are planned) between India and several other countries including Bhutan, Nepal, and Sri Lanka. Sri Lanka is currently seeking a bilateral arrangement with Pakistan. In the Pacific, 14 governments met in late February 2002 to consider an FTA. The meeting may contribute to a greater willingness among the governments to open up their economies more in the future.

The growth in bilateral trade deals is, however, likely to have only a small direct impact on goods trade within the region, but it must be remembered that goods trade is not the only focus of such agreements. Agreements that can lower barriers to services trade and to investment flows may well be able to deepen integration through regional forums and WTO.

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STATISTICAL NOTES

The Statistical Appendix presents selected economic indicators for 40 developing member countries (DMCs) of the Asian Development Bank (ADB), plus East Timor, in a total of 23 tables. These are presented by account, namely: (i) production and demand sectors of the national income accounts, (ii) inflation, (iii) money supply, (iv) components of the balance of payments, (v) external debt and debt service, (vi) exchange rate, and (vii) the budget of the central government. These tables contain time series information from 1996 to 2001. Except for fiscal and external variables, such as the budget of the central government, exchange rate, external debt, and debt service, the tables give projections for 2002 and 2003. The table on foreign direct investment shows data from 1995 to 2000 (the latest year for which data are available). The following sections describe the source, scope, and conceptual definition of the data in each table.

Historical data are derived primarily from ADB's Statistical Database System; official sources; statistical publications; secondary publications; and working papers and other internal documents of ADB, the International Monetary Fund (IMF), World Bank, and the United Nations. Some of the preliminary data for 2001 are official estimates or staff estimates calculated from quarterly or monthly data available for the year. Projections for 2002 and 2003 are staff estimates.

Despite limitations arising from differences in statistical methodology, definition, and coverage, efforts were made to standardize the data. The aim is to allow comparability of data over time and across DMCs, and to ensure consistency across accounts. Data-splicing and data-rebasing techniques were also used to merge data sets and to fill in data gaps.

Data in the tables refer to either calendar year or fiscal year. All data for Bangladesh, India, Federated States of Micronesia, Myanmar, Nauru, Nepal, Pakistan, and Tonga are on a fiscal year basis. For Bhutan, Marshall Islands, and Sri Lanka, except for national income accounts, data refer to the fiscal year. For the rest of the DMCs, data on national accounts, consumer or wholesale price index, monetary survey, and balance of payments are reported for the calendar year. Government finances for all DMCs are reported on a fiscal year basis though it coincides with the calendar year for some countries.

Regional averages or totals for the DMCs are incorporated in 10 of the 23 tables. These tables include growth rate of gross domestic product (GDP), growth rate of per capita GDP, changes in the consumer or wholesale price index, growth rate of merchandise exports and imports, trade balance, current account balance in absolute levels, current account balance as a percentage of GDP, and foreign direct investment.

The averages are computed as simple, weighted arithmetic means using the average of GDP values in 1995–1996, in current US dollars. This convention smooths out the rapid change in structure attributed to rapid movement of Asian currencies as a result of the financial crisis. The computation of averages for country groupings for Tables A1, A2, A9, and A16 is based on these weights.

Because of measurement problems, data for Afghanistan, East Timor, Myanmar, and Nauru are excluded from the computation of averages and totals. Where there are missing numbers, averages or totals are computed on the basis of a consistent set of sums.

Tables A1, A2, A3, A4, A5, and A6: Growth and Structure of Production. The definitions used in these tables relating to output growth and production are generally based on the United Nations System of National Accounts. Table A1 shows annual growth rates of GDP valued either at constant market prices or at constant factor costs. Most DMCs use constant market price valuations. The exceptions are Azerbaijan, Bhutan, Fiji Islands, India, Nepal, Pakistan, Solomon Islands, Sri Lanka, and Tuvalu, which use GDP at constant factor cost.

Table A2: Growth Rate of Real Per Capita GDP. Real per capita GDP is obtained by subtracting mid-year population growth from real GDP growth.

Tables A3, A4, and A5: Growth Rates of Real Gross Value Added in agriculture, industry, and services. The agriculture sector includes agricultural crops, livestock, poultry, fisheries, and forestry. Mining and quarrying, manufacturing, construction, and utilities fall under the industry sector. The services sector consists of transport and communications, trade, banking and finance, real estate, public administration, and other services. The sector growth rates are consistent with the reported GDP values in Table A1, except for the Republic of Korea (Korea); People's

Republic of China (PRC); and Taipei,China, where subsidies net of indirect taxes are included in the computation of sector growth. Growth of agriculture for Hong Kong, China is not included. Adding-up restrictions are imposed where numerical discrepancies are noted or where reclassifications of the sectors are implemented.

Table A6: Sector Shares of GDP. The sector shares of GDP are based on constant market prices. For Bhutan; Cambodia; PRC; Fiji Islands; India; Korea; Pakistan; Singapore; Solomon Islands; Sri Lanka; Taipei,China; and Tuvalu, the sector shares of GDP are based on constant factor costs. For the Marshall Islands, the shares are based on current market prices.

Tables A7 and A8: Savings and Investment. Gross national savings (GNS) or gross domestic savings (GDS) are computed as the difference between gross national product (GNP) or GDP, respectively, and total consumption expenditure . They are expressed as a proportion of GNP or GDP. For some DMCs, gross savings data are obtained from official sources. Gross savings may differ from either GNS or GDS by being derived from the consolidated income and outlay account, and include private transfers recorded in the balance of payments. Gross domestic investment (GDI) is calculated as the sum of gross fixed capital formation and changes in stocks. For Cambodia, Lao People's Democratic Republic (Lao PDR), Thailand, and Viet Nam, GDS is computed as the sum of GDI and the current account balance. For India, adjusted GDS/GDI figures are obtained from official sources except for Azerbaijan which is based on the Statistical Database System, and the Kyrgyz Republic and Uzbekistan which are obtained from resident missions.

Table A7 gives the ratio of GDS to GDP, calculated from official sources. For Bangladesh, Bhutan, and Pakistan, the ratio of GNS to GDP is used and for the Philippines, the ratio of GNS to GNP is used. *Table A8* presents the ratio of GDI to GDP. Where GDS/GNS are taken as a ratio to GNP then GDI is computed as a proportion to GNP. All figures used in computing the ratios in Tables A7 and A8 are in current market prices. The data are obtained from official sources.

Table A9: Inflation. This table presents the annual inflation rate based on the consumer price index (except for India which reports the wholesale price index and Solomon Islands which uses the retail price index) as obtained from official local sources. For DMCs for which data are not available locally, data were obtained from IMF. For most DMCs, the reported inflation rates are period averages. For the Federated States of Micronesia, Tajikistan, and Uzbekistan, the end-of-period consumer price index is used. For Cambodia, inflation is based on the final quarter (October–December) of the year. For the Lao PDR, inflation is computed as the average of monthly year-on-year inflation. The consumer price index for Cambodia and Myanmar is for Phnom Penh and Yangon only.

Table A10: Growth of Money Supply. This table tracks the annual percentage change in broad money as represented by M2. M2 is defined as the sum of M1 and quasi-money, where M1 denotes currency in circulation plus demand deposits, and quasi-money consists of time and savings deposits, plus foreign currency deposits. For India, Kazakhstan, and the Philippines, M3 is used as the measure of liquidity. M3 is M2 plus quasi deposits for Kazakhstan and the Philippines, and M2 plus deposits with the Reserve Bank of India for India.

Tables A11 and A13: Growth Rates of Merchandise Exports and Imports. Historical data for 1996–2000 and some preliminary estimates for 2001 on merchandise exports and imports are taken from the balance-of-payments accounts, except for Hong Kong, China data, which are taken from the national income accounts. These figures are in US dollars and on a free on board basis. Export and import statistics are reported on a calendar year basis except for Bangladesh, Bhutan, India, Marshall Islands, Federated States of Micronesia, Myanmar, Nepal, Pakistan, and Tonga, which use fiscal year figures. For Cambodia, export data refer to domestic exports only, while import data refer to retained imports only. Retained imports are total imports net of reexports, and include project aid imports and an estimate of unrecorded imports. For the Maldives, export data includes reexports. Data for Cambodia, Lao PDR, Kiribati, Mongolia, Papua New Guinea, Tajikistan, Tonga, and Uzbekistan are derived from IMF documents. For Thailand and Viet Nam, the data come from the State Bank of Viet Nam and the Bank of

Thailand, respectively, and IMF.

Table A12: Direction of Exports. For each DMC, the table indicates the percentage share of that economy's exports going to each of its major trading partners (other DMCs, Japan, United States, European Union, and Australia and New Zealand). With the exception of Taipei,China, for which data are obtained directly from local sources, data are from IMF's *Direction of Trade Statistics*.

Tables A14, A15, and A16: Balance of Payments. The balance of trade is the difference between merchandise exports and merchandise imports. The current account balance is the sum of the balance of trade, net trade in services and factor income, and net transfers. In the case of Cambodia, Lao PDR, Mongolia, Nepal, Pakistan, Thailand, and Viet Nam, official transfers are excluded from the current account balance. The current account balance for Hong Kong, China is excluded as it is based on a different concept. The balance-of-payments data for the DMCs are obtained from local sources except for Cambodia, Kiribati, Lao PDR, Mongolia, Papua New Guinea, Tajikistan, Thailand, Tonga, Uzbekistan, and Viet Nam where data are obtained from IMF documents.

Table A17: Foreign Direct Investment. Data on gross inflows for 1995–2000 are obtained from the United Nations Conference on Trade and Development (UNCTAD) *World Investment Report 2001.* Direct investment capital refers to equity capital, reinvested earnings, and other capital associated with the transactions of enterprises.

Tables A18 and A19: External Debt. For most DMCs, external debt outstanding includes long-term debt, short-term debt, and IMF credit. Principal repayments and interest payments on long-term debt and IMF credit, and interest payments on short-term debt, are lumped together in the debt service payment. For most DMCs, data are collected from official country sources, except for Kiribati, Marshall Islands, Mongolia, Nepal, Samoa, Tajikistan, and Tonga where the data come from IMF documents, and for Bangladesh where the data are obtained from the World Bank. The debt service ratio is computed as a proportion of total exports of goods and services. For Kazakhstan, the ratio is expressed as a percentage of exports of goods, for India as a percentage of current receipts, and for the Lao PDR and Myanmar as a percentage of exports of goods and services and net factor services, with the latter being obtained from balance-of-payments data. For Cambodia, debt excludes debt to the Russian Federation. External debt and debt service for Hong Kong, China; Korea; Singapore; and Taipei,China are not presented as they are considered as capital surplus economies, and hence debt is not a binding financial constraint.

Table A20: Foreign Exchange Rates. The annual average exchange rates of the DMCs are quoted in local currencies per US dollar. IMF's *International Financial Statistics* is the source of basic data for Kiribati, Marshall Islands, Mongolia, Nepal, Samoa, Pakistan, Papua New Guinea, Tajikistan, and Tonga. For all other DMCs, the sources are official country publications.

Tables A21, A22, and A23: Government Finance. These tables account for only central government finance on a fiscal year basis, except for Azerbaijan data, which refers to the general Government, Myanmar data which refers to the union Government only, Tajikistan which present consolidated government figures, and the PRC which reports central and local government figures. Government expenditures include both current and capital expenditures. Likewise, total revenues include current revenues and capital receipts. For Hong Kong, China and Taipei,China expenditures exclude net lending. For Cambodia; Hong Kong, China; Indonesia; Korea; Lao PDR; Malaysia; Mongolia; Pakistan; Singapore; and Taipei,China, revenues exclude grants. In most DMCs, the overall budget surplus or deficit is the balance between government revenues and expenditures, including grants. For Korea, the balance includes social security contributions. For India, the overall balance excludes small savings to state, includes recovery of loans and disinvestments. For Vanuatu, and Kiribati it excludes in-kind grants. For Thailand it includes non-budgetary expenditures from loans. For Pakistan, and Viet Nam, the overall budget balance excludes grants. All ratios are reported as a percentage of GDP at current market prices. Data are from official country sources.

Consistency with ADB Annual Report 2001. In general, *ADO 2002* figures are consistent with the ADB *Annual Report 2001* figures. However, moderate discrepancies may be noted for some countries. The primary reason is that the *Annual Report* derives its numbers from official government sources. For instance, most of the *ADO 2002* figures for Central Asia were obtained through the respective ADB resident missions and from IMF documents as against the *Annual Report 2001* numbers which were reported by the official statistical agencies or from *Annual Report 2001* survey replies. In some cases, the concept and computational method used differ between the *ADO 2002* and the *Annual Report 2001*. For instance, the average of period inflation rates are derived from the average index for the year for the *Annual Report 2001*, as against taking the average based on a year-on-year computation of inflation rate using monthly data for the *ADO 2002*. Differences in base years for the various time series also account for minor discrepancies between the same series used in both publications. There are also some imputed adjustments in the definition for GDS and exports, imports and, balance of trade. Finally, there are cases, where our independent assessment falls short of converging with the official view of the Government. For these reasons, an artificial convergence between the *ADO 2002* and the *Annual Report 2001* numbers is not made.

GDP growth for the US, euro area, and Japan. These are deseasonalized figures and were obtained from the following websites, www.fedstats; www.ecb.int; and www.stat.go.jp.

Yield curve on US swap rates. The yield curve presents the yields of bonds of the same quality but different maturities. Swap rates represent the fixed rate that the broker is willing to pay in order to receive a floating rate (the pay side). For the receiver side, it is the rate the broker wants to receive in order to pay a floating rate.

Sovereign risk spreads. Yield spreads are the difference between the yields on sovereign bonds of developing countries and the US treasury bonds of comparable maturities. The Emerging Markets Bond Index stripped spreads are based on 150 sovereign US dollar bonds. In layperson's terms, the yield spreads on sovereign bonds reflect the market's perception of the risk of default, i.e., the higher the spread the greater the risk of default.

Multiyear average GDP growth rate for 12 selected DMCs. These are long run or decade growth figures estimated by fitting a trend line to the logarithmic values of GDP for the relevant period. The data begin in 1951 except for Korea which starts in 1953, Malaysia in 1955, and Bangladesh and Singapore in 1960.

TABLE A1 Growth Rate of GDP (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	7.7	7.0	1.8	7.6	8.3	3.9	5.2	6.2
China, People's Rep. of	9.6	8.8	7.8	7.1	8.0	7.3	7.0	7.4
Hong Kong, China	4.5	5.0	-5.3	3.0	10.5	0.1	2.1	4.8
Korea, Rep. of	6.8	5.0	-6.7	10.9	9.3	3.0	4.8	6.0
Mongolia	2.4	4.0	3.5	3.2	1.1	1.5	3.0	4.9
Taipei,China	6.1	6.7	4.6	5.4	5.9	-1.9	2.8	4.0
Southeast Asia	7.5	4.1	-7.9	3.8	5.9	1.9	3.4	4.3
Cambodia	3.5	3.7	1.5	6.9	5.4	5.3	4.5	6.1
Indonesia	8.0	4.5	-13.2	0.9	4.8	3.3	3.0	3.6
Lao People's Dem. Rep.	6.9	6.9	4.0	7.3	5.9	5.5	5.8	6.1
Malaysia	10.0	7.3	-7.4	6.1	8.3	0.4	4.2	5.8
Myanmar	6.4	5.7	5.8	10.9	6.2	—	—	—
Philippines	5.8	5.2	-0.6	3.4	4.0	3.4	4.0	4.5
Singapore	7.7	8.5	0.0	6.9	10.3	-2.0	3.7	6.5
Thailand	5.9	-1.4	-10.8	4.4	4.6	1.8	2.5	3.0
Viet Nam	9.3	8.2	4.4	4.7	6.1	5.8	6.2	6.8
South Asia	7.5	4.5	5.8	5.7	4.2	4.9	5.4	6.4
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	4.6	5.4	5.2	4.9	5.9	5.2	4.5	5.7
Bhutan	5.2	7.6	6.5	7.3	5.7	6.5	6.5	6.5
India	8.0	4.8	6.5	6.1	4.0	5.4	6.0	6.8
Maldives	9.1	10.2	8.2	7.4	4.6	2.1	2.0	0.0
Nepal	5.6	4.9	3.3	4.4	6.1	5.0	3.5	5.0
Pakistan	6.8	1.9	2.0	4.2	3.9	2.6	3.0	5.0
Sri Lanka	3.3	6.3	4.7	4.3	6.0	-1.3	3.5	5.5
Central Asia	0.3	2.1	2.0	4.9	8.7	10.7	5.7	6.4
Azerbaijan	1.3	5.8	10.0	7.4	11.1	9.9	10.0	11.0
Kazakhstan	0.5	1.8	-1.9	2.7	9.8	13.2	7.0	6.0
Kyrgyz Republic	7.1	9.9	2.1	3.7	5.4	5.3	4.5	4.5
Tajikistan	-4.4	1.7	5.3	3.7	8.3	10.0	6.0	5.0
Turkmenistan	-6.7	-11.3	7.0	16.0	17.6	20.5	11.0	11.0
Uzbekistan	1.6	5.2	4.4	4.4	4.0	4.5	4.0	5.0
Pacific Developing Member Countries	5.6	-3.4	-1.0	6.6	-1.0	-0.8	1.9	2.6
Cook Islands	-0.2	-2.8	-2.3	2.7	4.1	3.0	2.5	3.3
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	3.1	-0.9	1.4	9.7	-2.8	1.5	3.5	4.7
Kiribati	4.1	1.6	6.6	2.1	-1.7	1.5	2.8	2.5
Marshall Islands	-16.6	-10.1	0.8	-0.2	0.7	0.6	0.7	—
Micronesia, Federated States of	-2.4	-5.2	-2.3	1.1	2.5	0.9	3.3	0.7
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	7.7	-4.9	-2.8	7.6	-0.8	-3.3	1.2	1.8
Samoa	7.3	0.8	2.5	3.1	7.3	10.0	5.0	5.0
Solomon Islands	3.5	-2.3	1.1	-1.3	-14.0	-5.0	-5.0	0.0
Tonga	-0.4	0.2	1.6	3.1	6.2	3.0	2.9	2.6
Tuvalu	10.3	3.5	14.9	3.0	3.0	4.0	3.0	3.0
Vanuatu	2.5	1.5	2.2	-2.5	3.7	-0.5	0.7	1.9
Average	7.5	5.8	0.2	6.4	7.0	3.7	4.8	5.8

— Not available.

TABLE A2 Growth Rate of Per Capita GDP (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003	Per Capita GNP, $ 2000
East Asia	6.4	6.0	0.8	6.7	7.5	3.3	4.6	5.6	
China, People's Rep. of	8.5	7.8	6.8	6.2	7.3	6.8	6.5	6.9	840
Hong Kong, China	-0.8	3.7	-6.5	1.9	9.5	1.0	2.9	5.6	25,950
Korea, Rep. of	5.7	4.0	-7.6	10.0	8.4	2.2	4.0	5.2	8,910
Mongolia	0.8	2.5	2.1	2.1	-0.2	0.3	1.8	3.7	390
Taipei,China	5.3	5.8	3.6	4.6	5.0	-2.9	1.8	3.0	13,880
Southeast Asia	5.4	2.3	-9.8	2.3	4.3	0.3	1.9	3.5	
Cambodia	-1.8	1.8	-3.4	4.3	2.3	1.8	1.4	3.0	260
Indonesia	6.2	3.0	-14.7	-0.5	3.3	1.9	1.6	3.6	570
Lao People's Dem. Rep.	4.5	4.4	1.5	4.9	2.9	4.0	3.9	4.2	290
Malaysia	7.7	5.0	-9.7	3.7	5.8	-1.9	1.7	3.3	3,380
Myanmar	4.6	3.9	3.9	9.1	4.4	—	—	—	—
Philippines	3.5	2.9	-2.8	1.2	1.8	1.3	2.1	2.6	1,040
Singapore	3.6	5.1	-3.4	6.2	8.6	-4.9	0.9	3.7	24,740
Thailand	4.9	-2.2	-12.0	3.4	3.8	1.0	1.7	3.0	2,010
Viet Nam	7.7	6.7	2.9	3.4	4.6	4.3	4.7	5.3	390
South Asia	5.5	2.4	4.0	3.2	2.3	3.1	3.6	4.7	
Afghanistan	—	—	—	—	—	—	—	—	—
Bangladesh	2.8	3.6	3.7	3.4	4.3	3.6	3.2	4.1	380
Bhutan	2.2	4.6	3.4	4.3	2.8	3.5	3.5	4.0	550
India	6.1	2.7	4.8	3.4	2.2	3.7	4.2	5.0	460
Maldives	7.2	8.3	6.3	5.5	2.7	0.2	0.1	-1.9	1,460
Nepal	3.6	2.4	0.9	2.1	3.6	2.0	1.2	5.0	220
Pakistan	4.3	-0.5	-0.4	1.9	1.6	0.3	0.8	2.8	470
Sri Lanka	2.2	5.2	3.5	2.9	4.3	-2.4	2.3	5.5	870
Central Asia	0.9	3.4	1.9	4.2	8.0	—	—	—	
Azerbaijan	0.3	6.8	9.0	4.6	10.3	—	—	—	610
Kazakhstan	1.9	3.4	-0.2	3.6	10.2	13.9	7.5	6.6	1,190
Kyrgyz Republic	5.6	8.4	0.7	2.2	4.0	—	—	—	270
Tajikistan	-6.0	0.1	3.7	2.3	6.8	—	—	—	170
Turkmenistan	-9.2	-14.1	4.0	12.4	13.9	16.9	8.3	7.3	840
Uzbekistan	-0.3	3.3	2.8	2.9	2.6	—	—	—	610
Pacific Developing Member Countries	3.1	-5.5	-3.4	4.1	-3.2	-3.0	-0.5	0.3	
Cook Islands	3.0	5.0	2.4	9.9	10.5	7.4	2.5	—	—
East Timor	—	—	—	—	—	—	—	—	—
Fiji Islands	2.1	-1.7	-0.7	7.8	-4.5	-0.3	1.6	2.8	1,830
Kiribati	1.7	-1.6	9.7	1.8	-2.3	2.0	—	—	950
Marshall Islands	-17.0	-10.6	-0.5	-1.5	-0.7	-0.8	-0.7	—	1,970
Micronesia, Federated States of	-2.6	-5.5	-2.5	-0.9	2.3	0.6	3.1	0.5	2,110
Nauru	—	—	—	—	—	—	—	—	—
Papua New Guinea	4.5	-7.7	-5.7	4.3	-3.7	-6.2	-1.9	-1.3	760
Samoa	6.7	0.3	2.0	2.6	6.8	9.5	4.5	4.5	1,460
Solomon Islands	0.5	-5.2	-1.9	-4.0	-16.3	-7.6	-7.6	-2.8	630
Tonga	-2.1	-0.6	0.9	2.5	5.6	2.4	2.3	2.0	1,660
Tuvalu	8.9	-2.6	12.2	1.0	1.0	2.0	1.0	1.0	—
Vanuatu	-0.2	-1.0	-0.4	-4.9	1.2	-3.1	-1.8	-0.6	1,140
Average	5.9	4.5	-1.1	5.0	5.8	2.5	3.7	4.9	

— Not available.

TABLE A3 Growth Rate of Value Added in Agriculture (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	5.1	3.5	3.5	2.8	2.4	2.8	2.4	2.5
Hong Kong, China	—	—	—	—	—	—	—	—
Korea, Rep. of	3.3	4.6	-6.6	5.4	2.0	1.4	3.0	3.0
Mongolia	4.4	4.3	6.4	4.2	-16.8	-16.0	—	—
Taipei,China	-0.3	-1.5	-6.6	2.7	1.2	-0.6	0.3	0.4
Southeast Asia								
Cambodia	-0.7	5.8	2.5	4.8	-2.7	5.0	3.0	5.4
Indonesia	3.1	1.0	-1.3	2.7	1.2	0.6	1.5	3.0
Lao People's Dem. Rep.	2.8	7.0	3.1	8.2	5.1	3.9	—	—
Malaysia	4.5	0.7	-2.8	0.4	0.6	2.3	-0.5	1.8
Myanmar	5.0	3.7	4.5	11.5	—	—	—	—
Philippines	3.8	3.1	-6.4	6.5	3.3	3.9	—	—
Singapore	3.4	0.0	-6.9	-1.1	-5.7	-4.9	-4.5	-4.0
Thailand	-8.1	-0.4	-3.2	2.7	4.8	1.5	1.4	2.0
Viet Nam	4.4	4.3	2.8	5.2	4.0	2.3	2.1	2.4
South Asia								
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	3.1	6.0	3.2	4.8	7.4	3.1	—	—
Bhutan	6.5	4.0	2.8	5.3	4.7	4.8	2.5	2.5
India	9.6	-2.4	6.2	1.3	-0.2	5.7	3.3	6.0
Maldives	2.2	1.3	6.4	3.3	-0.2	1.6	—	—
Nepal	4.4	4.1	1.0	2.7	5.0	4.0	3.0	2.5
Pakistan	11.7	0.1	4.5	1.9	6.1	-2.5	—	—
Sri Lanka	-4.6	3.0	2.5	4.5	1.8	-1.5	1.5	2.5
Central Asia								
Azerbaijan	3.0	-4.0	6.6	7.1	—	—	—	—
Kazakhstan	-5.0	-0.8	-18.9	28.0	-3.3	16.9	—	—
Kyrgyz Republic	15.2	12.3	2.9	8.2	2.7	6.8	—	—
Tajikistan	—	0.2	6.5	3.8	—	—	—	—
Turkmenistan	—	—	—	—	—	—	—	—
Uzbekistan	-7.3	5.8	4.1	5.9	—	4.5	—	—
Pacific Developing Member Countries								
Cook Islands	4.3	12.2	-17.2	-28.2	32.7	—	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	1.9	-13.0	-7.2	16.1	-1.2	-0.5	-0.1	4.1
Kiribati	12.1	-14.6	6.0	8.8	7.9	—	—	—
Marshall Islands	-21.9	-9.0	-13.9	1.7	3.7	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	11.0	-1.2	-11.3	4.3	9.1	0.9	5.1	3.6
Samoa	3.2	6.5	3.4	-3.5	1.5	—	—	—
Solomon Islands	-4.2	4.7	-7.5	-12.0	-26.4	—	—	—
Tonga	-8.2	3.8	-0.1	-3.1	10.8	1.3	3.0	—
Tuvalu	-16.2	5.8	0.7	—	—	—	—	—
Vanuatu	4.4	3.4	9.0	-9.3	2.5	-14.9	2.2	2.7

— Not available.

TABLE A4 Growth Rate of Value Added in Industry (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	12.1	10.5	8.9	8.1	9.6	8.7	8.0	8.3
Hong Kong, China	—	—	—	—	—	—	—	—
Korea, Rep. of	7.0	5.4	-7.5	12.8	11.9	2.6	6.0	8.0
Mongolia	-3.2	-3.3	3.8	1.1	7.4	11.8	—	—
Taipei,China	3.4	6.1	2.7	4.7	5.7	-6.0	2.0	2.9
Southeast Asia								
Cambodia	11.1	20.4	7.7	12.0	29.0	12.0	10.9	12.6
Indonesia	10.7	5.2	-29.0	2.1	6.1	3.0	3.6	3.5
Lao People's Dem. Rep.	17.3	8.1	9.2	7.9	7.5	8.5	—	—
Malaysia	14.4	7.5	-10.6	8.5	15.3	-3.6	4.4	7.0
Myanmar	10.7	8.9	6.1	13.7	—	—	—	—
Philippines	6.4	6.1	-2.1	0.9	3.9	1.9	—	—
Singapore	7.3	7.6	0.7	7.1	10.8	-8.9	2.5	7.5
Thailand	10.1	-1.9	-13.3	9.5	5.3	1.3	2.5	3.6
Viet Nam	14.5	12.6	7.3	7.6	9.6	9.7	10.0	10.2
South Asia								
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	7.0	5.8	8.3	4.9	6.2	7.2	—	—
Bhutan	5.8	3.5	8.6	11.6	4.0	8.0	10.5	11.0
India	7.8	4.3	3.7	4.9	6.3	3.3	4.8	5.7
Maldives	3.4	23.1	16.0	8.1	-0.9	4.7	—	—
Nepal	8.3	6.4	2.3	6.0	8.2	2.5	3.5	5.9
Pakistan	5.4	0.6	0.3	4.7	0.2	4.2	—	—
Sri Lanka	5.4	7.7	5.9	4.8	7.5	-1.9	4.0	7.5
Central Asia								
Azerbaijan	8.4	14.8	18.1	6.2	—	—	—	—
Kazakhstan	0.3	4.1	-2.4	2.8	15.5	13.5	—	—
Kyrgyz Republic	2.6	19.8	-1.8	-3.8	8.9	5.4	—	—
Tajikistan	—	-2.0	8.1	5.0	—	—	—	—
Turkmenistan	—	—	—	—	—	—	—	—
Uzbekistan	6.0	6.5	5.8	6.1	5.8	8.1	—	—
Pacific Developing Member Countries								
Cook Islands	-5.0	6.4	3.3	7.0	6.8	—	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	5.3	1.4	3.1	9.8	-7.4	-1.8	5.0	6.2
Kiribati	-4.6	17.4	32.9	38.0	-32.4	—	—	—
Marshall Islands	-36.6	-4.6	28.3	1.3	3.7	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	10.1	-17.0	9.7	5.7	-5.4	-6.1	-1.3	-0.4
Samoa	4.6	-2.1	-8.9	4.3	17.0	—	—	—
Solomon Islands	12.3	-10.9	-8.4	-3.9	-25.9	—	—	—
Tonga	11.3	-11.7	6.8	12.4	3.0	5.4	4.0	—
Tuvalu	85.6	4.0	21.5	—	—	—	—	—
Vanuatu	-5.7	-3.2	6.7	5.2	8.4	-1.1	-2.5	1.1

— Not available.

TABLE A5 Growth Rate of Value Added in Services (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	7.9	9.2	8.3	7.5	9.5	7.4	8.5	7.0
Hong Kong, China	—	—	—	—	—	—	—	—
Korea, Rep. of	6.7	5.7	-4.0	8.4	7.3	4.6	5.0	5.2
Mongolia	4.6	9.0	0.3	3.5	17.0	9.2	—	—
Taipei,China	7.7	8.1	6.0	5.7	5.4	0.9	2.9	4.5
Southeast Asia								
Cambodia	3.1	-3.7	-0.6	5.8	3.1	1.9	1.8	2.5
Indonesia	6.8	5.6	-1.0	-0.7	5.2	4.5	3.1	3.8
Lao People's Dem. Rep.	8.5	7.5	5.5	6.9	6.2	6.0	—	—
Malaysia	8.9	11.1	-1.1	4.5	4.6	3.9	4.1	5.4
Myanmar	6.5	6.7	7.0	9.2	—	—	—	—
Philippines	6.4	5.4	3.5	4.0	4.4	4.3	—	—
Singapore	8.1	9.4	-0.2	6.1	8.8	1.7	5.0	7.9
Thailand	5.3	-1.2	-10.0	-0.1	4.0	2.3	1.7	2.5
Viet Nam	8.8	7.1	3.0	2.1	4.5	4.4	5.0	6.0
South Asia								
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	4.0	4.5	5.0	5.2	5.5	5.4	—	—
Bhutan	4.7	13.4	6.7	5.1	9.1	6.3	7.0	7.6
India	7.2	9.8	8.3	9.5	4.8	6.5	8.0	7.8
Maldives	11.2	9.2	6.9	7.8	6.3	1.6	—	—
Nepal	5.8	4.6	6.4	5.6	6.3	7.3	3.5	5.5
Pakistan	5.0	3.6	1.6	5.0	4.8	4.4	—	—
Sri Lanka	6.0	7.1	5.1	4.0	7.0	-1.0	4.0	5.5
Central Asia								
Azerbaijan	-5.9	11.2	5.2	8.8	—	—	—	—
Kazakhstan	0.0	0.0	-0.1	-0.7	9.3	13.6	—	—
Kyrgyz Republic	-0.2	1.2	3.6	1.2	7.7	2.4	—	—
Tajikistan	—	—	—	—	—	—	—	—
Turkmenistan	—	—	—	—	—	—	—	—
Uzbekistan	9.9	21.3	9.5	12.6	13.0	14.2	—	—
Pacific Developing Member Countries								
Cook Islands	-0.6	-6.9	-2.0	13.5	6.5	—	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	2.5	2.4	3.3	7.9	-1.1	3.5	12.7	4.0
Kiribati	2.6	8.1	6.5	3.4	2.1	—	—	—
Marshall Islands	-10.2	-10.1	0.2	-0.5	-0.8	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	3.4	6.1	-8.6	12.4	-5.8	-2.6	-0.1	1.3
Samoa	10.9	5.7	7.8	5.2	5.5	—	—	—
Solomon Islands	5.6	-2.0	-2.9	-2.0	0.8	—	—	—
Tonga	1.8	0.9	3.2	4.1	5.6	3.8	2.5	—
Tuvalu	2.6	2.7	16.0	—	—	—	—	—
Vanuatu	3.3	1.8	-0.1	-1.7	3.3	3.3	0.8	1.8

— Not available.

TABLE A6 Sector Share of GDP (%)

	Agriculture			Industry			Services		
	1970	1980	2001	1970	1980	2001	1970	1980	2001
East Asia									
China, People's Rep. of	42.2	25.6	11.3	44.6	51.7	64.6	13.2	22.7	24.0
Hong Kong, China	—	—	—	—	—	—	—	—	—
Korea, Rep. of	29.8	14.2	5.1	23.8	37.8	44.0	46.4	48.1	50.9
Mongolia	33.1	17.4	27.5	26.3	33.3	27.8	40.6	49.3	44.7
Taipei,China	17.3	8.4	2.4	32.3	42.8	32.1	50.4	48.8	65.5
Southeast Asia									
Cambodia	—	—	32.0	—	—	24.0	—	—	44.0
Indonesia	35.0	24.4	16.2	28.0	41.3	36.0	37.0	34.3	47.8
Lao People's Dem. Rep.	—	—	51.3	—	—	23.1	—	—	25.6
Malaysia	—	22.9	8.2	—	35.8	43.1	—	41.3	48.7
Myanmar	49.5	47.9	—	12.0	12.3	—	38.5	39.8	—
Philippines	28.2	23.5	20.1	33.7	40.5	34.0	38.1	36.0	46.0
Singapore	2.2	1.1	0.1	36.4	38.8	30.7	61.4	60.0	69.2
Thailand	30.2	20.2	8.0	25.7	30.1	44.0	44.1	49.7	48.0
Viet Nam	—	42.7	22.7	—	26.3	36.9	—	31.0	40.4
South Asia									
Afghanistan	—	—	—	—	—	—	—	—	—
Bangladesh	—	49.4	25.1	—	14.8	26.2	—	35.8	48.7
Bhutan	—	56.7	49.4	—	12.2	5.0	—	31.1	45.6
India	44.5	38.1	24.3	23.9	25.9	26.8	31.6	36.0	49.0
Maldives	—	—	8.8	—	—	15.4	—	—	75.7
Nepal	—	61.8	38.5	—	11.9	20.1	—	26.3	41.3
Pakistan	40.1	30.6	24.7	19.6	25.6	25.1	40.3	43.8	50.3
Sri Lanka	30.7	26.6	20.4	27.1	27.2	27.4	42.2	46.2	52.1
Central Asia									
Azerbaijan	—	—	—	—	—	—	—	—	—
Kazakhstan	—	—	—	—	—	—	—	—	—
Kyrgyz Republic	—	—	50.2	—	—	18.9	—	—	30.9
Tajikistan	—	—	—	—	—	—	—	—	—
Turkmenistan	—	—	—	—	—	—	—	—	—
Uzbekistan	—	—	30.1	—	—	19.9	—	—	50.0
Pacific Developing Member Countries									
Cook Islands	—	—	—	—	—	—	—	—	—
East Timor	—	—	—	—	—	—	—	—	—
Fiji Islands	30.2	22.5	16.5	23.1	21.7	24.9	46.7	55.8	58.6
Kiribati	—	—	—	—	—	—	—	—	—
Marshall Islands	—	—	—	—	—	—	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—	—
Papua New Guinea	—	—	33.1	—	—	36.0	—	—	30.9
Samoa	—	—	—	—	—	—	—	—	—
Solomon Islands	—	52.5	—	—	10.0	—	—	37.4	—
Tonga	—	47.6	29.4	—	11.0	14.9	—	41.4	55.6
Tuvalu	—	—	—	—	—	—	—	—	—
Vanuatu	—	—	15.5	—	—	11.6	—	—	72.9

— Not available.

TABLE A7 Gross Domestic Savings (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	41.1	41.5	39.8	39.4	38.9	38.1	37.9	37.6
Hong Kong, China	30.7	31.1	30.1	30.4	32.3	31.1	34.9	34.7
Korea, Rep. of	34.0	33.7	34.4	33.5	32.6	30.1	30.5	31.0
Mongolia	—	—	—	20.0	18.0	18.0	19.0	21.0
Taipei,China	26.6	26.4	26.0	26.1	25.2	23.5	24.1	25.5
Southeast Asia								
Cambodia	10.8	9.0	9.5	11.8	6.9	9.6	11.1	12.3
Indonesia	30.1	31.5	26.5	20.2	25.7	25.5	23.0	21.0
Lao People's Dem. Rep.	12.4	9.4	14.8	16.4	14.7	13.8	14.0	14.0
Malaysia	42.9	43.9	48.7	47.3	46.8	42.3	41.8	41.0
Myanmar	11.5	11.8	11.8	13.0	11.1	—	—	—
Philippines	18.0	17.7	16.7	18.7	21.0	22.1	20.2	19.5
Singapore	49.3	50.5	50.8	48.8	49.3	45.8	44.5	45.7
Thailand	37.4	37.4	36.5	29.9	30.2	27.5	26.3	25.5
Viet Nam	17.6	21.8	17.8	26.3	25.5	27.4	27.1	27.8
South Asia								
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	20.2	21.6	21.8	20.8	22.0	21.0	20.7	21.9
Bhutan	27.6	21.6	12.7	13.5	17.2	27.5	27.5	27.7
India	23.2	23.1	21.7	23.2	23.4	23.0	23.6	23.8
Maldives	—	—	—	—	—	—	—	—
Nepal	13.8	14.0	13.8	13.8	15.0	16.0	13.0	13.0
Pakistan	11.6	11.6	14.3	11.4	13.5	12.8	14.6	14.7
Sri Lanka	15.3	17.3	19.1	19.5	17.3	17.3	17.5	18.0
Central Asia								
Azerbaijan	-4.0	12.9	4.8	4.9	23.1	—	—	—
Kazakhstan	19.8	17.1	15.9	16.0	22.9	22.3	23.5	24.7
Kyrgyz Republic	-0.6	13.8	8.1	3.2	9.8	—	—	—
Tajikistan	32.0	—	23.3	19.4	—	—	—	—
Turkmenistan	—	—	—	—	—	—	—	—
Uzbekistan	7.9	14.9	9.9	10.5	16.5	—	—	—
Pacific Developing Member Countries								
Cook Islands	—	—	—	—	—	—	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	—	—	—	—	—	—	—	—
Kiribati	—	—	—	—	—	—	—	—
Marshall Islands	—	—	—	—	—	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	31.0	21.5	22.6	13.3	—	—	—	—
Samoa	—	—	—	—	—	—	—	—
Solomon Islands	—	—	—	—	—	—	—	—
Tonga	—	—	—	—	—	—	—	—
Tuvalu	—	—	—	—	—	—	—	—
Vanuatu	—	—	—	—	—	—	—	—

— Not available.

TABLE A8 Gross Domestic Investment (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	39.6	38.2	37.7	37.4	36.1	36.3	36.1	36.4
Hong Kong, China	32.1	34.5	29.0	25.0	27.6	25.8	28.0	27.7
Korea, Rep. of	37.9	34.2	21.2	26.7	28.2	26.7	29.0	30.7
Mongolia	—	—	—	27.0	29.0	28.0	29.0	31.0
Taipei,China	23.2	24.2	24.9	23.4	22.9	18.2	18.7	23.0
Southeast Asia								
Cambodia	15.2	14.4	12.0	17.0	14.1	16.2	17.0	17.4
Indonesia	30.7	31.8	16.8	12.2	17.9	17.0	17.0	17.0
Lao People's Dem. Rep.	29.0	26.2	24.9	22.7	20.5	21.0	22.0	22.0
Malaysia	41.5	43.0	26.7	22.3	26.8	24.8	25.9	26.4
Myanmar	12.3	12.5	12.4	13.4	11.2	—	—	—
Philippines	23.1	23.8	19.3	17.8	16.9	16.6	18.0	18.5
Singapore	37.1	38.6	33.3	31.9	31.6	24.3	23.6	24.1
Thailand	41.6	33.3	20.5	19.9	22.7	22.0	22.2	22.5
Viet Nam	28.1	28.3	22.5	22.2	23.9	25.9	26.8	28.0
South Asia								
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	20.0	20.7	21.6	22.2	23.0	23.1	23.2	24.0
Bhutan	44.7	34.1	38.2	43.1	43.8	44.0	43.5	43.7
India	24.5	24.6	22.7	24.3	24.0	24.0	24.5	24.9
Maldives	—	—	—	—	—	—	—	—
Nepal	27.3	25.3	24.8	20.5	23.3	24.4	22.0	22.0
Pakistan	18.8	17.7	17.7	15.6	15.6	14.7	15.2	16.2
Sri Lanka	24.2	24.4	25.1	27.3	28.0	25.1	27.5	29.0
Central Asia								
Azerbaijan	29.0	34.2	33.4	23.0	18.8	—	—	—
Kazakhstan	16.1	15.6	14.3	17.8	17.9	23.0	16.9	16.8
Kyrgyz Republic	25.2	21.7	15.4	18.0	16.0	—	16.1	15.8
Tajikistan	22.3	0.0	15.4	17.3	—	—	—	—
Turkmenistan	—	—	—	—	—	—	—	—
Uzbekistan	15.1	18.9	10.2	11.8	15.9	20.2	—	—
Pacific Developing Member Countries								
Cook Islands	—	—	—	—	—	—	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	—	—	—	—	—	—	—	—
Kiribati	—	—	—	—	—	—	—	—
Marshall Islands	—	—	—	—	—	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	22.7	21.3	17.9	16.4	—	—	—	—
Samoa	—	—	—	—	—	—	—	—
Solomon Islands	—	—	—	—	—	—	—	—
Tonga	—	—	—	—	—	—	—	—
Tuvalu	69.0	58.2	24.9	—	—	—	—	—
Vanuatu	—	—	—	—	—	—	—	—

— Not available.

TABLE A9 Inflation (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	6.3	3.3	2.4	-0.7	0.7	1.4	1.5	2.3
China, People's Rep. of	8.3	2.8	-0.8	-1.4	0.4	0.7	1.0	1.5
Hong Kong, China	6.4	5.8	2.8	-4.0	-3.8	-1.6	-0.8	0.6
Korea, Rep. of	4.9	4.5	7.5	0.8	2.3	4.1	3.5	4.0
Mongolia	23.6	36.6	9.4	10.0	8.1	11.2	6.0	5.0
Taipei,China	3.1	0.9	1.7	0.2	1.3	0.0	0.7	2.1
Southeast Asia	-9.1	14.3	19.2	1.0	2.5	5.2	5.7	4.4
Cambodia	9.0	9.1	12.6	0.0	0.5	0.0	2.0	3.0
Indonesia	-39.6	35.6	46.5	-1.9	3.7	11.5	13.1	7.7
Lao People's Dem. Rep.	13.0	19.3	87.4	134.0	27.0	7.8	6.5	6.0
Malaysia	3.5	2.7	5.3	2.8	1.6	1.4	2.3	2.8
Myanmar	20.0	33.9	49.1	11.4	—	—	—	—
Philippines	9.1	5.9	9.7	6.7	4.4	6.1	5.0	6.0
Singapore	1.3	2.0	-0.3	0.1	1.3	1.0	0.4	1.4
Thailand	5.9	5.5	8.1	0.3	1.6	1.7	2.0	2.2
Viet Nam	4.4	3.6	9.2	0.1	-0.6	0.8	3.0	4.0
South Asia	5.8	5.2	6.3	4.2	6.2	4.6	4.1	4.8
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	6.6	2.5	7.0	8.9	3.4	1.6	2.4	2.6
Bhutan	9.3	7.4	9.0	9.2	3.6	3.6	4.5	5.2
India	4.6	4.4	5.9	3.3	7.2	4.7	4.0	5.0
Maldives	6.2	7.6	-1.4	3.0	-1.2	0.7	—	—
Nepal	8.1	8.1	8.4	11.3	3.5	2.4	5.0	5.0
Pakistan	10.4	11.3	7.8	5.7	3.6	4.4	5.0	5.0
Sri Lanka	14.6	7.1	6.9	5.9	1.2	11.0	8.5	6.0
Central Asia	139.1	20.6	13.3	15.5	16.9	13.7	10.0	5.6
Azerbaijan	19.8	3.6	-0.8	-8.5	1.8	1.5	1.8	2.0
Kazakhstan	39.3	-0.8	7.1	8.3	13.2	8.4	6.6	5.6
Kyrgyz Republic	32.0	23.4	10.5	35.9	18.7	6.9	7.5	5.5
Tajikistan	40.6	163.6	2.7	30.1	32.9	38.5	8.9	7.6
Turkmenistan	992.4	83.7	16.7	23.5	7.4	6.0	8.5	7.5
Uzbekistan	64.3	27.6	26.1	26.0	28.0	26.6	18.0	—
Pacific Developing Member Countries	8.7	4.0	10.1	9.2	9.5	7.2	6.0	3.1
Cook Islands	-0.6	-0.4	0.7	1.4	3.2	8.0	2.5	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	3.1	3.4	5.7	2.0	1.1	4.3	3.0	—
Kiribati	-1.5	2.1	3.7	1.8	0.9	7.1	2.7	2.7
Marshall Islands	9.6	4.8	2.2	1.7	-1.9	2.0	2.3	—
Micronesia, Federated States of	3.0	2.2	1.5	2.6	3.2	2.6	2.6	2.6
Nauru	4.0	6.1	4.0	6.7	7.5	4.0	—	—
Papua New Guinea	11.6	4.0	13.6	14.9	15.6	9.8	8.3	5.0
Samoa	5.4	6.8	2.2	0.3	0.9	4.0	3.0	—
Solomon Islands	11.8	8.1	12.4	8.0	8.8	8.0	8.0	6.0
Tonga	2.8	1.8	2.9	3.9	4.9	6.3	10.0	5.0
Tuvalu	0.0	1.4	0.8	1.0	5.3	1.8	1.5	2.1
Vanuatu	0.9	2.7	3.3	2.1	2.5	3.6	4.5	4.0
Average	4.4	6.4	7.2	0.8	2.3	3.0	3.1	3.3

— Not available.

TABLE A10 Change in Money Supply (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	25.3	19.6	14.8	14.7	12.3	14.4	13.0	14.0
Hong Kong, China	10.9	8.3	11.8	8.1	8.8	-2.9	4.0	5.3
Korea, Rep. of	15.8	14.1	27.0	27.4	25.4	13.2	20.0	25.0
Mongolia	25.8	32.5	-1.7	31.7	17.5	27.9	17.0	15.0
Taipei,China	9.1	8.0	8.6	8.3	6.5	4.4	5.8	6.4
Southeast Asia								
Cambodia	40.4	46.6	15.7	17.3	26.9	18.0	16.0	14.0
Indonesia	29.6	23.2	62.3	11.9	15.6	17.5	18.0	18.0
Lao People's Dem. Rep.	26.7	65.8	113.3	78.3	45.8	20.0	18.0	16.0
Malaysia	19.8	22.7	1.5	13.7	5.2	5.3	6.9	8.5
Myanmar	38.9	30.2	27.6	32.3	—	—	—	—
Philippines	15.8	20.9	7.4	19.3	4.6	6.8	10.0	11.0
Singapore	9.8	10.3	30.2	8.5	-2.0	5.9	5.9	6.5
Thailand	12.6	16.4	9.5	2.1	3.7	4.2	6.5	5.0
Viet Nam	22.5	26.1	25.6	39.3	39.0	23.2	25.0	26.0
South Asia								
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	10.7	9.9	11.4	12.8	18.6	16.6	16.0	17.0
Bhutan	30.4	30.9	41.7	21.4	21.4	5.5	17.0	15.0
India	15.2	18.0	19.4	14.6	16.7	11.2	14.0	15.0
Maldives	26.0	23.1	22.8	3.6	4.1	9.0	—	—
Nepal	14.4	11.9	21.9	20.8	21.8	14.9	12.0	12.0
Pakistan	13.8	12.2	14.5	6.2	9.4	9.0	9.1	—
Sri Lanka	10.8	13.8	9.7	13.3	13.0	11.4	12.0	11.5
Central Asia								
Azerbaijan	25.8	29.2	-21.7	15.2	18.3	9.7	—	—
Kazakhstan	16.6	28.2	-14.2	84.4	44.9	40.2	27.0	22.4
Kyrgyz Republic	21.3	25.4	17.2	33.9	12.4	11.3	13.5	—
Tajikistan	93.2	110.7	53.9	19.7	49.3	—	—	—
Turkmenistan	247.8	107.2	67.7	23.6	68.3	—	—	—
Uzbekistan	113.7	36.0	28.0	31.5	17.1	16.4	—	—
Pacific Developing Member Countries								
Cook Islands	6.9	15.7	23.6	-0.8	16.2	9.1	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	0.9	-8.7	-0.3	14.2	-2.1	-1.5	7.0	—
Kiribati	11.7	-3.1	11.1	0.3	5.0	—	—	—
Marshall Islands	—	—	—	—	—	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	32.0	6.9	1.8	8.9	5.4	10.0	9.3	—
Samoa	5.1	13.2	5.0	12.5	11.5	13.8	—	—
Solomon Islands	15.7	6.3	4.8	4.5	0.4	-12.5	—	—
Tonga	2.8	14.1	2.4	15.0	8.4	26.5	15.0	—
Tuvalu	—	—	—	—	—	—	—	—
Vanuatu	10.1	-0.3	12.6	-9.2	5.5	5.5	—	—

— Not available.

TABLE A11 Growth Rate of Merchandise Exports (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	7.3	9.3	-5.0	5.8	22.0	-5.8	5.0	8.7
China, People's Rep. of	17.9	20.9	0.5	6.1	27.9	6.8	6.0	10.0
Hong Kong, China	4.0	4.0	-7.5	-0.1	16.1	-5.9	1.6	6.2
Korea, Rep. of	4.3	6.7	-4.7	9.9	21.2	-14.0	7.0	10.0
Mongolia	-13.0	34.5	-18.8	-1.7	18.2	-17.4	9.4	7.7
Taipei,China	3.8	5.4	-9.5	9.9	21.8	-17.3	5.5	8.0
Southeast Asia	5.9	4.7	-7.4	8.9	19.6	-9.8	6.1	9.7
Cambodia	10.0	81.0	13.1	17.9	53.2	7.7	7.6	7.8
Indonesia	5.8	12.2	-10.5	1.7	27.6	-9.8	10.5	8.0
Lao People’s Dem. Rep.	2.6	-1.4	6.4	7.7	8.3	8.1	8.5	8.5
Malaysia	6.9	1.0	-7.3	16.8	17.0	-8.8	7.0	11.9
Myanmar	-0.5	8.7	4.3	42.7	7.6	—	—	—
Philippines	17.7	22.8	16.9	19.1	9.0	-16.2	3.0	6.0
Singapore	6.4	-0.2	-12.1	4.5	20.4	-11.9	5.0	10.0
Thailand	-1.9	4.3	-6.8	7.4	19.6	-7.0	4.0	9.0
Viet Nam	41.2	24.6	2.0	23.2	25.2	6.5	8.5	12.0
South Asia	6.5	4.8	-0.1	4.4	17.3	0.5	7.2	12.9
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	11.8	14.0	16.8	2.9	8.2	12.4	-8.0	10.0
Bhutan	39.6	1.7	12.0	-5.9	9.2	-1.8	—	—
India	5.6	4.5	-3.9	9.5	19.6	-1.0	11.0	14.0
Maldives	-6.0	15.8	3.4	-4.3	18.8	-1.7	—	—
Nepal	1.9	10.2	11.9	18.2	42.4	3.7	5.0	10.0
Pakistan	7.1	-2.6	4.2	-10.7	8.8	9.0	-0.3	7.6
Sri Lanka	7.6	13.3	3.4	-3.9	19.8	-12.8	7.0	15.0
Central Asia	9.9	14.4	-16.4	6.4	49.1	-0.6	10.1	5.5
Azerbaijan	5.1	25.6	-16.1	51.5	83.6	7.9	—	—
Kazakhstan	15.7	9.7	-14.9	2.0	60.6	-3.5	11.6	5.2
Kyrgyz Republic	29.9	18.8	-15.2	-13.5	10.4	-6.0	2.8	3.4
Tajikistan	-1.2	-3.1	-21.4	13.7	18.9	1.8	8.8	8.7
Turkmenistan	-18.8	-54.2	-20.6	93.3	111.7	5.0	6.0	6.0
Uzbekistan	1.7	4.5	-17.5	-8.9	1.4	—	—	—
Pacific Developing Member Countries	2.9	-12.2	-14.2	8.6	5.9	-9.1	8.5	6.5
Cook Islands	-31.0	-10.1	13.8	10.7	155.5	-16.6	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	21.1	-21.1	-13.4	19.2	-0.7	-17.2	7.7	12.8
Kiribati	-27.9	16.2	-6.0	49.8	-33.6	-33.2	2.7	20.8
Marshall Islands	-12.2	-29.0	-47.2	-4.0	9.7	5.1	—	—
Micronesia, Federated States of	22.1	-7.0	-46.8	-16.4	106.3	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	-2.4	-14.8	-16.1	9.1	7.3	-6.3	10.9	1.9
Samoa	15.9	42.3	30.0	-3.6	-25.4	20.2	—	—
Solomon Islands	-3.4	-4.0	-9.1	1.1	-51.7	-31.1	13.7	40.4
Tonga	-26.4	3.9	-9.8	1.7	-9.9	3.7	6.2	—
Tuvalu	9.8	-2.0	-84.8	—	—	—	—	—
Vanuatu	7.5	16.9	-3.9	-26.3	2.7	-16.2	6.6	10.0
Average	6.8	7.5	-5.7	6.8	21.2	-6.8	5.5	9.2

— Not available.

TABLE A12 Direction of Exports (% of total)

To / From	DMCs		Japan		United States		European Union		Australia/ New Zealand		Others	
	1985	2000	1985	2000	1985	2000	1985	2000	1985	2000	1985	2000
East Asia												
China, People's Rep. of	38.2	32.1	22.3	14.6	8.5	26.9	7.8	14.8	0.8	1.7	22.5	9.9
Hong Kong, China	35.6	48.4	4.2	5.3	30.8	21.4	11.8	14.4	2.3	1.3	15.3	9.2
Korea, Rep. of	12.9	34.4	15.0	11.4	35.6	22.5	10.4	13.3	1.3	1.7	24.7	40.9
Mongolia	3.1	49.5	1.1	1.7	5.5	27.1	20.5	9.5	—	—	69.8	—
Taipei,China	13.4	52.0	11.3	11.2	48.1	23.5	5.5	10.8	2.7	1.2	19.0	—
Southeast Asia												
Cambodia	67.9	34.9	7.0	2.6	—	46.4	13.2	14.6	0.0	0.1	11.9	—
Indonesia	17.2	37.2	46.2	22.3	21.7	15.5	6.0	14.1	1.2	2.7	7.6	8.1
Lao People's Dem. Rep.	71.9	23.9	6.6	3.2	2.7	2.5	0.5	30.4	5.5	0.1	12.7	39.9
Malaysia	38.1	42.5	24.6	12.6	12.8	21.8	13.6	13.8	1.9	2.7	9.1	6.6
Myanmar	47.1	36.4	8.4	6.0	0.8	24.3	8.4	16.5	0.0	0.5	35.4	16.3
Philippines	19.5	30.8	19.0	14.7	35.9	30.2	13.8	16.6	2.1	0.8	9.7	6.9
Singapore	36.8	52.2	9.4	7.4	21.2	17.2	10.1	13.4	4.4	2.6	18.0	28.8
Thailand	27.1	33.2	13.4	15.7	19.7	22.6	17.8	16.7	1.9	2.8	20.1	9.2
Viet Nam	15.9	27.0	4.7	18.5	—	6.2	6.2	26.6	0.3	10.1	72.9	11.6
South Asia												
Afghanistan	—	—	—	—	—	—	—	—	—	—	—	—
Bangladesh	14.5	5.3	7.2	1.3	18.1	33.5	13.0	38.9	1.8	0.4	45.5	20.6
Bhutan	—	—	—	—	—	—	—	—	—	—	—	—
India	8.9	22.2	11.1	5.4	18.9	22.8	16.7	24.0	1.4	1.1	43.0	24.5
Maldives	50.8	11.9	10.1	1.4	24.3	33.2	4.0	33.0	—	0.0	10.9	20.6
Nepal	41.4	30.1	0.7	3.1	35.3	32.8	20.3	23.3	0.1	0.4	2.3	10.3
Pakistan	16.0	20.1	11.3	2.6	10.0	24.8	20.9	27.0	1.1	1.6	40.6	23.9
Sri Lanka	11.2	7.9	5.1	3.8	22.3	36.7	17.9	30.6	1.7	5.0	41.9	16.0
Central Asia												
Azerbaijan	—	3.2	—	0.1	—	1.3	—	60.4	—	—	—	—
Kazakhstan	—	16.0	—	1.2	—	4.9	—	33.8	—	—	—	75.7
Kyrgyz Republic	—	37.5	—	0.1	—	0.5	—	30.1	—	—	—	69.4
Tajikistan	—	28.9	—	0.1	—	1.2	—	27.5	—	—	—	70.6
Turkmenistan	—	5.6	—	0.0	—	1.4	—	10.0	—	—	—	—
Uzbekistan	—	40.2	—	2.7	—	1.2	—	17.3	—	—	—	65.1
Pacific Developing Member Countries												
Cook Islands	—	—	—	—	—	—	—	—	—	—	—	—
East Timor	—	—	—	—	—	—	—	—	—	—	—	—
Fiji Islands	22.5	18.9	3.0	5.1	4.9	20.8	31.0	17.7	18.2	28.6	20.4	8.9
Kiribati	7.1	11.6	4.3	58.2	—	6.2	—	2.1	0.4	1.2	88.2	20.7
Marshall Islands	—	—	—	—	—	—	—	—	—	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—	—	—	—	—	—	—
Nauru	—	50.4	—	1.9	—	3.6	—	1.2	—	38.4	—	—
Papua New Guinea	9.9	16.8	22.1	11.4	4.0	1.2	46.5	9.8	12.0	30.2	5.6	30.6
Samoa	0.3	2.0	0.9	0.3	59.4	13.0	5.8	5.4	29.7	72.7	3.9	6.7
Solomon Islands	11.1	53.8	52.1	22.3	2.4	0.6	26.3	14.9	3.2	2.7	5.0	5.8
Tonga	5.9	1.9	0.2	50.4	3.2	31.7	0.5	2.3	83.1	6.1	7.1	7.6
Tuvalu	63.7	12.0	—	0.0	—	0.0	—	40.4	8.1	1.4	28.2	46.3
Vanuatu	1.4	13.7	6.7	31.3	0.0	17.1	25.4	29.2	1.6	1.7	65.0	7.1
Total	25.3	39.5	16.4	11.5	26.3	22.7	10.7	14.7	2.1	2.0	19.2	9.7

— Not available.

TABLE A13 Growth Rate of Merchandise Imports (% per year)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	8.1	3.8	-13.9	9.6	28.4	-6.5	7.7	11.6
China, People's Rep. of	19.5	3.7	0.3	15.8	35.4	8.2	10.0	14.0
Hong Kong, China	3.0	5.1	-11.6	-2.7	18.5	-5.5	1.9	7.8
Korea, Rep. of	12.3	-2.2	-36.2	29.1	36.2	-13.3	12.0	14.0
Mongolia	4.5	5.3	8.2	-2.6	21.2	-9.7	4.9	6.2
Taipei,China	-0.1	10.1	-7.4	6.2	25.9	-23.8	8.0	10.0
Southeast Asia	5.3	-0.1	-24.2	8.0	24.2	-8.9	7.0	11.2
Cambodia	20.4	5.8	1.6	27.0	37.1	3.4	6.0	6.5
Indonesia	8.1	4.5	-30.9	-4.2	31.9	-12.2	10.0	10.0
Lao People’s Dem. Rep.	17.1	-6.0	-14.7	0.3	6.6	10.5	11.0	11.0
Malaysia	1.4	1.5	-26.6	12.8	26.2	-7.6	10.0	16.1
Myanmar	3.1	14.4	16.5	-2.9	-12.6	—	—	—
Philippines	20.8	14.0	-18.8	4.2	3.8	-6.2	2.5	4.0
Singapore	5.4	0.7	-23.2	9.0	22.2	-14.0	6.0	11.1
Thailand	0.8	-13.8	-26.2	16.9	31.3	-2.8	5.0	9.2
Viet Nam	25.5	-0.2	-1.1	1.1	34.5	6.0	10.0	13.0
South Asia	12.5	3.3	-5.7	10.5	7.3	-0.4	9.3	12.6
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	19.1	3.1	5.1	6.6	4.8	11.4	-5.0	6.0
Bhutan	36.2	58.1	8.9	74.7	14.0	16.3	—	—
India	12.1	4.6	-7.1	16.5	7.0	-0.9	13.0	14.5
Maldives	12.6	15.6	1.5	13.6	-3.4	2.0	—	—
Nepal	5.8	21.7	-12.4	-10.3	20.2	-0.9	5.0	5.0
Pakistan	16.7	-6.4	-8.4	-6.7	-0.1	5.9	0.2	6.2
Sri Lanka	2.4	7.8	0.4	1.5	22.4	-18.4	15.0	14.0
Central Asia	26.2	6.7	-5.7	-11.5	12.1	17.9	10.9	14.3
Azerbaijan	35.7	2.8	24.8	-16.6	7.5	-5.4	—	—
Kazakhstan	24.4	8.3	-7.0	-15.3	21.3	23.5	11.7	15.3
Kyrgyz Republic	47.5	-17.5	17.0	-27.6	-8.2	-14.4	4.8	5.9
Tajikistan	-6.2	2.9	-9.6	-5.2	21.1	8.0	4.5	6.8
Turkmenistan	-15.5	-27.6	13.1	30.0	16.6	32.0	12.0	15.0
Uzbekistan	31.0	-11.2	-22.0	-11.9	-5.7	—	—	—
Pacific Developing Member Countries	16.3	-0.4	-22.3	5.8	-5.0	-3.4	14.3	-1.1
Cook Islands	-10.8	10.8	-20.9	9.8	22.5	14.0	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	10.6	-2.2	-25.2	25.1	-5.4	-12.8	2.7	6.1
Kiribati	8.4	1.6	-15.8	24.0	-13.6	-9.0	7.3	2.0
Marshall Islands	-0.9	-10.0	2.9	4.2	-1.3	2.9	—	—
Micronesia, Federated States of	-1.5	6.7	1.7	5.6	12.6	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	23.3	-1.6	-27.0	-0.1	-7.0	-2.2	26.0	-6.1
Samoa	8.1	-0.9	-2.2	19.2	-9.5	31.1	—	—
Solomon Islands	-2.0	21.6	-30.5	-17.7	-12.3	-7.1	4.4	6.4
Tonga	-10.8	-9.5	29.7	-28.9	12.8	-4.3	8.0	—
Tuvalu	9.8	28.8	18.6	—	—	—	—	—
Vanuatu	2.5	-3.6	-5.5	-0.1	2.3	2.6	0.8	0.9
Average	7.7	2.4	-16.7	8.8	25.0	-6.6	7.6	11.6

— Not available.

TABLE A14 Balance of Trade (US$ million)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	3,674	35,835	87,492	73,510	53,825	55,794	40,365	22,623
China, People's Rep. of	19,535	46,222	46,614	36,207	34,474	33,813	26,551	18,987
Hong Kong, China	-18,351	-21,121	-10,945	-5,997	-11,386	-11,510	-12,297	-16,343
Korea, Rep. of	-14,965	-3,179	41,627	28,371	16,872	13,392	7,430	1,992
Mongolia	-88	31	-120	-113	-151	-177	-166	-169
Taipei,China	17,543	13,882	10,316	15,042	14,017	20,277	18,847	18,156
Southeast Asia	-12,593	3,496	61,830	69,502	70,014	59,982	60,643	49,844
Cambodia	-428	-231	-173	-275	-263	-225	-220	-210
Indonesia	5,948	10,074	18,429	20,642	25,041	23,560	26,210	27,528
Lao People’s Dem. Rep.	-368	-331	-216	-191	-198	-228	-264	-304
Malaysia	4,003	3,656	17,657	22,772	21,017	18,241	17,378	4,459
Myanmar	-958	-1,150	-1,463	-938	-516	—	—	—
Philippines	-11,342	-11,127	-28	4,959	6,918	2,747	2,792	3,734
Singapore	2,225	1,118	14,907	11,227	11,572	12,872	12,420	12,384
Thailand	-9,489	1,652	12,235	9,288	5,550	2,542	2,037	2,093
Viet Nam	-3,142	-1,315	-981	1,080	377	473	289	160
South Asia	-24,115	-24,104	-19,792	-25,074	-21,328	-20,679	-23,722	-26,537
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	-3,063	-2,735	-2,352	-2,694	-2,641	-2,887	-2,937	-2,875
Bhutan	-13	-32	-25	-58	-71	-103	—	—
India	-14,815	-15,507	-13,246	-17,841	-14,370	-14,286	-17,032	-19,748
Maldives	-186	-214	-216	-262	-233	-242	—	—
Nepal	-990	-1,245	-995	-765	-803	-762	-748	-764
Pakistan	-3,704	-3,145	-1,867	-2,085	-1,412	-1,243	-1,290	-1,245
Sri Lanka	-1,344	-1,225	-1,091	-1,369	-1,798	-1,157	-1,716	-1,905
Central Asia	-2,003	-1,229	-2,592	-284	4,084	1,742	1,037	-72
Azerbaijan	-694	-567	-1,038	-404	319	580	—	—
Kazakhstan	-335	-276	-801	341	2,766	819	909	0
Kyrgyz Republic	-252	-15	-221	-84	9	50	43	33
Tajikistan	-16	-63	-145	-27	-47	-100	-70	-58
Turkmenistan	—	-234	-498	-300	661	265	155	-47
Uzbekistan	-706	-73	111	191	376	128	—	—
Pacific Developing Member Countries	379	-137	107	193	388	400	502	712
Cook Islands	-40	-45	-35	-38	-42	-40	-42	-42
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	-237	-374	-210	-294	-250	-244	-228	-205
Kiribati	-33	-33	-27	-32	-29	-28	-30	-30
Marshall Islands	-42	-41	-50	-52	-51	-52	—	—
Micronesia, Federated States of	-86	-95	-109	-118	-122	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	1,011	662	717	881	1,099	989	948	1,064
Samoa	-90	-84	-78	-97	-91	-80	—	—
Solomon Islands	11	-28	14	38	-23	-38	-35	-19
Tonga	-54	-47	-66	-43	-52	-49	-53	—
Tuvalu	-8	-6	-7	—	—	—	—	—
Vanuatu	-54	-46	-43	-51	-52	-59	-58	-56
Total	-34,658	13,862	127,045	117,848	106,983	97,238	78,825	46,571

— Not available.

TABLE A15 Balance of Payments on Current Account (US$ million)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	-4,940	35,861	75,145	48,404	41,496	47,049	32,608	18,600
China, People's Rep. of	7,243	36,963	31,472	15,667	20,519	19,574	12,550	5,000
Hong Kong, China	—	—	—	—	—	—	—	—
Korea, Rep. of	-23,005	-8,167	40,365	24,477	12,241	8,617	8,818	3,581
Mongolia	-101	14	-129	-124	-167	-170	-159	-155
Taipei,China	10,923	7,051	3,437	8,384	8,903	19,028	11,399	10,173
Southeast Asia	-21,513	-2,885	47,573	55,280	50,071	40,680	31,949	27,184
Cambodia	-547	-268	-209	-259	-257	-211	-200	-186
Indonesia	-7,801	-5,001	4,097	5,783	7,991	5,145	2,866	1,513
Lao People's Dem. Rep.	-307	-283	-130	-92	-100	-125	-144	-148
Malaysia	-4,455	-5,942	9,539	12,606	8,401	6,859	4,934	2,690
Myanmar	-414	-660	-670	-605	-243	—	—	—
Philippines	-3,953	-4,351	1,546	7,363	8,459	4,504	2,000	1,500
Singapore	12,822	17,927	19,706	16,527	15,921	17,885	17,654	18,279
Thailand	-14,692	-3,128	14,262	12,197	9,151	6,149	4,742	3,611
Viet Nam	-2,580	-1,839	-1,239	1,154	505	475	97	-74
South Asia	-11,734	-10,825	-6,929	-8,431	-5,799	-4,972	-9,796	-12,712
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	-1,291	-534	-253	-394	-584	-817	-1,258	-1,754
Bhutan	-37	-56	-47	-98	-130	-125	—	—
India	-4,619	-5,500	-4,038	-4,698	-2,579	-2,698	-5,430	-7,890
Maldives	-7	-34	-23	-82	-53	-62	—	—
Nepal	-527	-460	-422	-168	-245	-242	—	—
Pakistan	-4,575	-3,846	-1,921	-2,429	-1,143	-508	-2,084	-1,877
Sri Lanka	-677	-394	-226	-563	-1,065	-519	-1,024	-1,191
Central Asia	-3,156	-3,075	-4,118	-1,901	60	-1,251	-1,363	-1,641
Azerbaijan	-931	-916	-1,365	-591	-167	-134	-195	-363
Kazakhstan	-751	-799	-1,236	-236	753	-938	-992	-1,097
Kyrgyz Republic	-425	-138	-364	-180	-77	-11	-78	-88
Tajikistan	-70	-56	-108	-36	-61	-110	-98	-93
Turkmenistan	—	-580	-952	-694	-572	—	—	—
Uzbekistan	-979	-585	-94	-164	184	-58	—	—
Pacific Developing Member Countries	421	-194	60	111	272	124	39	222
Cook Islands	0	-4	-3	2	-2	-2	5	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	61	35	-6	-75	-61	-73	-42	1
Kiribati	-14	4	18	8	5	2	-3	1
Marshall Islands	20	20	-1	-5	7	14	—	—
Micronesia, Federated States of	56	18	13	10	7	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	289	-263	23	144	353	221	94	211
Samoa	11	19	15	17	8	8	—	—
Solomon Islands	11	-15	11	24	-44	-31	-16	8
Tonga	-11	-2	-18	-1	-10	-12	—	—
Tuvalu	—	—	—	—	—	—	—	—
Vanuatu	-3	-7	8	-12	11	-5	1	2
Total	-40,922	18,883	111,729	93,462	86,101	81,631	53,437	31,652

— Not available.

TABLE A16 Balance of Payments on Current Account (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	-0.3	1.9	6.0	3.2	2.3	2.7	1.8	1.0
China, People's Rep. of	0.9	4.1	3.3	1.6	1.9	1.7	1.0	0.4
Hong Kong, China	—	—	—	—	—	—	—	—
Korea, Rep. of	-4.4	-1.7	12.7	5.8	2.7	2.0	1.9	0.7
Mongolia	-8.5	1.3	-13.2	-13.7	-17.2	-16.7	-14.7	-13.4
Taipei,China	3.9	2.4	1.3	2.9	2.9	6.7	3.9	3.4
Southeast Asia	-3.0	-0.6	9.7	9.9	8.5	6.9	5.0	4.0
Cambodia	-17.3	-8.6	-7.4	-8.4	-8.3	-6.6	-5.9	-5.1
Indonesia	-3.4	-2.3	4.3	4.1	5.2	3.1	1.5	0.7
Lao People’s Dem. Rep.	-16.5	-16.2	-10.1	-6.3	-5.8	-7.2	-8.0	-8.0
Malaysia	-4.4	-5.9	13.2	15.9	9.4	7.8	5.3	2.6
Myanmar	-0.3	-0.4	-0.3	-0.2	-0.1	—	—	—
Philippines	-4.6	-5.1	2.3	9.2	10.7	6.0	2.0	1.5
Singapore	14.1	19.0	24.0	20.0	17.2	20.9	19.8	19.0
Thailand	-8.1	-2.1	12.7	10.0	7.5	5.5	4.1	3.0
Viet Nam	-10.5	-6.5	-4.6	4.1	1.6	1.5	0.3	-0.2
South Asia	-2.4	-2.1	-1.4	-1.6	-1.0	-0.8	-1.7	-1.9
Afghanistan	—	—	—	—	—	—	—	—
Bangladesh	-4.0	-2.1	-1.1	-1.4	-1.0	-2.1	-2.5	-2.1
Bhutan	-13.2	-17.6	-12.8	-25.9	-30.6	-27.5	—	—
India	-1.2	-1.3	-1.0	-1.1	-0.6	-0.5	-1.0	-1.5
Maldives	-1.6	-6.8	-4.5	-14.6	-9.5	-10.9	—	—
Nepal	-12.0	-9.4	-8.7	-3.3	-4.5	-4.4	-5.0	-5.0
Pakistan	-7.7	-6.4	-3.2	-4.1	-1.9	-0.9	-3.6	-3.1
Sri Lanka	-4.9	-2.6	-1.4	-3.6	-6.5	-3.4	-6.5	-7.5
Central Asia	-7.7	-7.1	-9.3	-4.4	0.3	-2.9	-4.5	-4.9
Azerbaijan	-29.3	-23.1	-30.7	-13.1	-3.4	-2.3	-3.0	-5.0
Kazakhstan	-3.6	-3.6	-5.6	-1.4	4.1	-4.6	-4.5	-4.7
Kyrgyz Republic	-23.2	-7.8	-22.2	-14.4	-5.6	-0.7	-6.3	-6.5
Tajikistan	-6.7	-5.0	-8.3	-3.2	-5.9	-7.7	-6.2	-5.5
Turkmenistan	—	-21.7	-32.7	-18.0	-13.0	—	—	—
Uzbekistan	-7.2	-4.0	-0.6	-1.3	0.8	-0.5	—	—
Pacific Developing Member Countries	4.9	-2.4	0.9	1.8	4.3	2.2	0.2	3.0
Cook Islands	-0.1	-3.7	-3.3	-2.6	-3.2	6.3	—	—
East Timor	—	—	—	—	—	—	—	—
Fiji Islands	3.4	1.9	-0.4	-4.1	-3.6	-4.4	-2.4	0.0
Kiribati	-27.2	7.4	39.0	17.4	11.2	4.4	-6.5	1.1
Marshall Islands	20.6	21.7	-1.5	-5.5	7.4	14.3	—	—
Micronesia, Federated States of	25.6	8.7	6.1	4.4	2.8	—	—	—
Nauru	—	—	—	—	—	—	—	—
Papua New Guinea	5.5	-5.3	0.6	4.2	10.1	7.5	2.7	5.7
Samoa	5.0	7.7	6.6	7.1	3.4	3.2	—	—
Solomon Islands	2.7	-3.4	3.1	6.9	-15.8	-14.3	-7.3	3.3
Tonga	-6.3	-0.9	-11.2	-0.6	-6.3	-8.2	-8.1	—
Tuvalu	2.7	—	—	—	—	—	—	—
Vanuatu	-1.2	-2.8	3.6	-5.5	4.8	-2.1	0.3	1.0
Average	-1.4	0.5	5.4	3.9	3.2	3.0	1.9	1.1

— Not available.

TABLE A17 Foreign Direct Investment (US$ million)

	1995	1996	1997	1998	1999	2000
East Asia	44,978	54,812	60,600	64,200	78,400	120,300
China, People's Rep. of	35,849	40,180	44,200	43,800	40,300	40,800
Hong Kong, China	6,213	10,460	11,400	14,800	24,600	64,400
Korea, Rep. of	1,357	2,326	2,800	5,400	10,600	10,200
Mongolia	10	16	25	19	30	25
Taipei,China	1,559	1,864	2,200	200	2,900	4,900
Southeast Asia	23,692	29,586	32,482	18,281	14,767	13,765
Cambodia	151	294	204	121	135	153
Indonesia	4,346	6,194	4,700	-400	-2,700	-4,600
Lao People’s Dem. Rep.	88	128	91	46	79	72
Malaysia	5,816	7,296	6,500	2,700	3,500	5,500
Myanmar	277	310	387	314	253	240
Philippines	1,459	1,020	1,200	1,800	700	1,500
Singapore	7,206	8,984	13,000	6,300	7,200	6,400
Thailand	2,000	2,405	3,600	5,100	3,600	2,400
Viet Nam	2,349	2,455	2,800	2,300	2,000	2,100
South Asia	2,945	3,519	4,923	3,527	3,103	3,020
Afghanistan	—	—	—	—	—	—
Bangladesh	2	14	141	190	179	170
Bhutan	—	—	—	—	—	—
India	2,144	2,426	3,600	2,600	2,200	2,300
Maldives	7	9	11	12	12	12
Nepal	8	19	23	12	4	13
Pakistan	19	18	713	507	531	308
Sri Lanka	65	133	435	206	177	217
Central Asia	1,625	1,690	2,916	2,584	2,362	2,251
Azerbaijan	33.0	62.7	1,115	1,023	510	883
Kazakhstan	964	1,137	1,321	1,152	1,587	1,249
Kyrgyz Republic	96	47	83	109	35	19
Tajikistan	15	16	4	30	29	—
Turkmenistan	100	108	108	130	80	—
Uzbekistan	120	55	285	140	121	100
Pacific Developing Member Countries	562	158	133	251	297	278
Cook Islands	—	—	—	—	—	—
East Timor	—	—	—	—	—	—
Fiji	70	2	16	107	-33	30
Kiribati	—	—	1	—	—	—
Marshall Islands	—	—	—	—	—	—
Micronesia, Federated States of	—	—	—	—	—	—
Nauru	—	—	—	—	—	—
Papua New Guinea	455	111	29	110	296	200
Samoa	3	4	20	3	2	8
Solomon Islands	2	6	34	9	10	18
Tonga	2	2	3	2	2	2
Tuvalu	—	—	—	—	—	—
Vanuatu	—	—	30	20	20	20
Total	73,803	89,766	101,054	88,843	98,929	139,614

— Not available.

TABLE A18 External Debt Outstanding (US$ million)

	1996	1997	1998	1999	2000	2001
East Asia						
China, People's Rep. of	116,300	131,000	146,000	151,800	145,700	—
Hong Kong, China	—	—	—	—	—	—
Korea, Rep. of	—	—	—	—	—	—
Mongolia	542	605	753	850	854	912
Taipei,China	—	—	—	—	—	—
Southeast Asia						
Cambodia	0	1,985	2,039	2,083	2,100	1,158
Indonesia	128,940	136,173	150,884	150,096	146,600	135,000
Lao People's Dem. Rep.	2,178	2,322	2,561	2,617	2,558	2,662
Malaysia	39,673	47,228	44,769	45,939	41,777	42,500
Myanmar	5,184	5,063	5,609	5,999	5,600	—
Philippines	40,145	45,682	47,817	52,210	52,060	52,360
Singapore	—	—	—	—	—	—
Thailand	107,777	109,731	105,084	95,648	80,248	68,748
Viet Nam	—	—	20,500	20,400	11,900	13,000
South Asia						
Afghanistan	—	—	—	—	—	—
Bangladesh	16,007	15,125	16,375	17,534	15,800	16,200
Bhutan	117	119	132	148	172	235
India	93,470	93,531	96,886	98,263	100,356	106,559
Maldives	164	156	172	213	328	340
Nepal	2,215	2,633	2,382	2,658	2,764	2,661
Pakistan	29,825	30,069	32,319	34,269	32,750	34,000
Sri Lanka	8,486	8,197	8,748	9,049	9,496	9,685
Central Asia						
Azerbaijan	438	507	708	1,036	—	—
Kazakhstan	5,807	7,750	9,932	12,051	12,526	—
Kyrgyz Republic	1,151	1,356	1,480	1,647	1,704	1,701
Tajikistan	867	1,106	1,179	1,214	1,205	1,608
Turkmenistan	751	1,771	2,269	2,015	—	—
Uzbekistan	4,163	4,665	3,467	4,237	4,449	4,600
Pacific Developing Member Countries						
Cook Islands	34	31	63	61	57	54
East Timor	—	—	—	—	—	—
Fiji Islands	252	244	225	261	258	231
Kiribati	10	9	8	9	8	8
Marshall Islands	133	108	97	70	59	46
Micronesia, Federated States of	102	98	94	84	67	58
Nauru	—	—	—	—	—	—
Papua New Guinea	1,354	1,258	1,298	1,348	1,394	1,472
Samoa	169	155	157	155	151	144
Solomon Islands	104	106	118	128	126	146
Tonga	62	61	60	67	62	58
Tuvalu	—	—	—	—	—	—
Vanuatu	42	42	53	64	77	68

— Not available.

TABLE A19 Debt Service Ratio (% of exports of goods and services)

	1996	1997	1998	1999	2000	2001
East Asia						
China, People's Rep. of	6.0	7.3	10.9	11.5	10.0	10.0
Hong Kong, China	—	—	—	—	—	—
Korea, Rep. of	—	—	—	—	—	—
Mongolia	11.8	6.3	7.3	9.3	6.0	7.0
Taipei,China	—	—	—	—	—	—
Southeast Asia						
Cambodia	—	1.2	2.1	1.7	4.2	4.0
Indonesia	37.9	31.2	33.0	31.3	44.8	—
Lao People's Dem. Rep.	4.5	8.7	11.1	11.4	10.1	10.5
Malaysia	11.0	9.2	8.7	5.6	5.4	6.0
Myanmar	11.2	7.4	5.4	4.8	—	—
Philippines	12.7	11.6	11.7	13.4	12.7	16.4
Singapore	—	—	—	—	—	—
Thailand	13.9	16.7	21.4	19.4	15.4	17.4
Viet Nam	9.8	11.1	13.9	12.8	11.2	10.2
South Asia						
Afghanistan	—	—	—	—	—	—
Bangladesh	7.9	7.0	5.9	7.0	7.2	7.5
Bhutan	25.7	10.4	9.0	13.6	5.7	5.6
India	21.2	19.0	18.0	16.2	17.1	—
Maldives	3.2	6.9	3.5	3.9	4.2	4.4
Nepal	6.0	4.5	6.1	6.1	5.9	3.9
Pakistan	33.9	39.3	35.5	41.2	38.4	32.1
Sri Lanka	15.3	13.3	13.3	15.2	14.7	—
Central Asia						
Azerbaijan	9.7	7.3	4.6	4.8	4.4	—
Kazakhstan	17.6	24.5	22.4	27.3	49.9	—
Kyrgyz Republic	15.5	12.0	21.8	26.0	25.7	29.4
Tajikistan	38.3	10.7	6.8	5.1	10.0	18.0
Turkmenistan	11.4	34.0	50.5	39.1	13.9	—
Uzbekistan	8.3	9.0	9.0	11.0	—	—
Pacific Developing Member Countries						
Cook Islands	16.9	11.0	3.7	4.8	3.5	3.5
East Timor	—	—	—	—	—	—
Fiji Islands	4.1	2.9	4.1	3.2	2.9	2.2
Kiribati	9.1	7.1	9.5	7.6	9.3	7.9
Marshall Islands	58.8	66.0	78.2	151.3	50.1	—
Micronesia, Federated States of	50.0	49.0	61.0	58.0	49.0	22.0
Nauru	—	—	—	—	—	—
Papua New Guinea	5.3	8.6	7.3	7.5	6.7	6.8
Samoa	13.3	13.1	12.9	12.4	12.6	18.5
Solomon Islands	11.3	1.6	3.7	4.5	8.2	—
Tonga	12.8	10.7	8.2	4.0	12.1	19.5
Tuvalu	—	—	—	—	—	—
Vanuatu	1.5	1.7	1.1	1.0	1.1	1.4

— Not available.

TABLE A20 Exchange Rates to the US Dollar (annual average)

	Currency	Symbol	1996	1997	1998	1999	2000	2001
East Asia								
China, People's Rep. of	Yuan	Y	8.3	8.3	8.3	8.3	8.3	8.3
Hong Kong, China	Hong Kong dollar	HK$	7.7	7.7	7.7	7.8	7.8	7.8
Korea, Rep. of	Won	W	804.8	951.1	1,398.9	1,138.4	1,130.6	1,290.8
Mongolia	Togrog	MNT	548.4	790.0	840.8	1,021.9	1,076.7	1,096.8
Taipei,China	New Taiwan dollar	NT$	27.5	28.7	33.5	32.3	31.2	33.8
Southeast Asia								
Cambodia	Riel	KR	2,635.0	2,952.0	3,756.0	3,803.0	3,854.0	3,900.0
Indonesia	Rupiah	Rp	2,342.3	2,909.4	10,013.6	7,855.2	8,421.8	9,748.0
Lao People’s Dem. Rep.	Kip	KN	926.1	1,259.5	3,296.2	7,108.2	7,845.8	8,871.0
Malaysia	Ringgit	RM	2.5	2.8	3.9	3.8	3.8	3.8
Myanmar	Kyat	MK	5.9	6.2	6.3	6.3	6.5	—
Philippines	Peso	P	26.2	29.5	40.9	39.1	44.2	51.0
Singapore	Singapore dollar	S$	1.4	1.5	1.7	1.7	1.7	1.8
Thailand	Baht	B	25.3	31.4	41.4	37.8	40.2	44.5
Viet Nam	Dong	D	11,033.0	11,076.0	13,297.0	13,944.0	14,168.0	15,050.0
South Asia								
Afghanistan	Afghani	AF	—	—	—	—	—	—
Bangladesh	Taka	TK	40.9	42.7	45.4	48.1	50.3	53.9
Bhutan	Ngultrum	Nu	34.3	35.8	38.4	42.6	43.6	46.4
India	Indian rupee	Re/Rs	35.5	37.2	42.1	43.3	45.7	47.8
Maldives	Rufiyaa	Rf	11.8	11.8	11.8	11.8	11.8	12.3
Nepal	Nepalese rupee	NRe/NRs	55.2	57.0	61.9	67.9	69.1	73.8
Pakistan	Pakistan rupee	PRe/PRs	35.9	40.9	44.9	49.1	52.8	62.0
Sri Lanka	Sri Lanka rupee	SLRe/SLRs	55.3	59.0	64.5	70.6	77.0	89.4
Central Asia								
Azerbaijan	Azerbaijan manat	AZM	4,301.3	3,985.4	3,869.0	4,120.2	4,473.8	4,259.8
Kazakhstan	Tenge	T	67.3	75.4	78.3	119.5	142.3	147.2
Kyrgyz Republic	Som	Som	12.8	17.3	20.8	39.0	47.7	48.4
Tajikistan	Somoni	TJS	296.0	559.0	786.0	1,197.0	1,740.0	—
Turkmenistan	Turkmen manat	TMM	3,869.0	4,156.0	4,808.0	5,200.0	5,200.0	—
Uzbekistan	Sum	SUM	40.2	67.7	94.7	124.9	236.9	421.0
Pacific Developing Member Countries								
Cook Islands	New Zealand dollar	NZ$	1.5	1.5	1.9	1.9	2.2	2.4
East Timor	US dollar	US$	—	—	—	—	—	—
Fiji Islands	Fiji dollar	F$	1.4	1.4	2.0	2.0	2.1	2.3
Kiribati	Australian dollar	A$	1.3	1.4	1.6	1.6	1.7	1.9
Marshall Islands	US dollar	US$	1.0	1.0	1.0	1.0	1.0	1.0
Micronesia, Federated States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	1.3	1.4	1.6	1.6	1.7	1.9
Papua New Guinea	Kina	K	1.3	1.4	2.1	2.6	2.8	3.4
Samoa	Tala	ST	2.4	2.6	3.0	3.0	3.3	3.5
Solomon Islands	Solomon Islands dollar	SI$	3.6	3.7	4.8	5.1	5.1	5.3
Tonga	Pa’anga	T$	1.2	1.2	1.4	1.6	1.6	2.0
Tuvalu	Australian dollar	A$	1.3	1.4	1.6	1.6	1.7	1.9
Vanuatu	Vatu	Vt	111.6	115.9	127.5	129.1	137.8	145.6

— Not available.

TABLE A21 Central Government Expenditures (% of GDP)

	1996	1997	1998	1999	2000	2001
East Asia						
China, People's Rep. of	12.8	13.6	15.1	17.2	17.8	20.0
Hong Kong, China	14.6	14.7	19.0	18.2	18.4	19.0
Korea, Rep. of	20.2	22.1	26.0	25.1	24.5	25.1
Mongolia	32.7	34.5	41.9	39.4	40.5	38.7
Taipei,China	13.9	14.1	13.2	13.1	23.8	24.3
Southeast Asia						
Cambodia	16.2	13.9	14.8	15.7	17.7	17.1
Indonesia	14.2	16.6	16.8	20.9	17.0	22.6
Lao People’s Dem. Rep.	22.1	19.8	13.0	19.3	21.9	22.6
Malaysia	22.3	21.0	21.8	22.7	23.9	27.4
Myanmar	9.3	8.0	6.9	5.8	4.2	—
Philippines	17.9	18.6	18.3	18.8	18.6	18.4
Singapore	15.0	18.4	18.0	17.8	17.5	18.1
Thailand	17.7	19.7	23.8	27.4	19.6	17.9
Viet Nam	23.7	24.8	22.5	21.2	23.8	25.6
South Asia						
Afghanistan	—	—	—	—	—	—
Bangladesh	13.5	13.5	13.3	14.2	14.7	15.8
Bhutan	44.3	43.5	34.3	44.9	46.6	44.9
India	14.7	15.2	16.0	15.4	17.9	16.2
Maldives	31.4	32.3	33.8	38.1	40.8	41.3
Nepal	17.1	16.5	17.0	15.4	15.5	18.1
Pakistan	24.2	22.0	23.7	22.0	23.0	21.0
Sri Lanka	27.9	23.9	25.9	25.2	26.7	27.2
Central Asia						
Azerbaijan	26.1	20.8	23.7	23.7	20.8	20.1
Kazakhstan	18.6	28.1	21.9	23.2	23.1	24.7
Kyrgyz Republic	25.2	25.3	28.8	30.4	26.1	21.0
Tajikistan	17.9	15.5	13.9	14.9	12.5	—
Turkmenistan	16.3	25.0	24.6	19.4	—	—
Uzbekistan	34.3	29.7	32.4	31.5	29.5	—
Pacific Developing Member Countries						
Cook Islands	44.8	31.1	39.0	31.4	31.5	34.6
East Timor	—	—	—	—	—	—
Fiji Islands	37.2	41.4	43.9	38.4	27.5	28.0
Kiribati	108.9	118.2	122.1	122.2	114.8	159.8
Marshall Islands	61.9	65.5	59.2	56.8	65.8	66.1
Micronesia, Federated States of	74.8	65.6	79.2	76.1	66.5	—
Nauru	215.2	101.2	67.5	103.2	104.6	89.9
Papua New Guinea	27.0	31.4	31.9	31.9	33.2	32.8
Samoa	49.0	39.8	34.1	39.5	35.2	34.0
Solomon Islands	38.6	33.2	37.1	41.2	44.3	42.5
Tonga	30.8	36.7	32.9	26.9	27.6	30.6
Tuvalu	—	121.9	95.9	126.2	129.5	103.6
Vanuatu	27.3	25.5	31.4	26.2	30.1	25.4

— Not available.

TABLE A22 Central Government Revenues (% of GDP)

	1996	1997	1998	1999	2000	2001
East Asia						
China, People's Rep. of	11.4	12.1	13.0	14.3	15.3	17.4
Hong Kong, China	17.5	21.2	17.2	19.0	17.8	13.8
Korea, Rep. of	20.4	20.6	21.8	22.4	25.6	26.4
Mongolia	24.8	25.5	27.6	27.2	33.6	33.6
Taipei,China	12.6	12.4	13.4	11.8	19.0	20.0
Southeast Asia						
Cambodia	9.0	9.6	8.9	11.4	11.9	11.5
Indonesia	16.5	17.9	16.4	18.1	20.7	203
Lao People's Dem. Rep.	13.2	11.0	9.8	10.6	14.0	14.5
Malaysia	23.0	23.3	20.0	19.5	18.2	20.7
Myanmar	6.9	7.8	7.3	4.9	4.5	—
Philippines	18.2	18.7	16.5	15.3	14.7	14.6
Singapore	21.9	21.8	20.5	20.4	21.0	20.1
Thailand	18.5	17.9	16.2	16.2	16.5	15.8
Viet Nam	22.9	20.9	20.5	18.8	19.6	21.2
South Asia						
Afghanistan	—	—	—	—	—	—
Bangladesh	9.0	9.2	9.3	9.0	8.5	9.6
Bhutan	46.7	40.8	34.7	42.4	41.3	36.9
India	13.7	15.3	16.1	15.4	15.6	16.2
Maldives	28.9	31.0	31.8	33.8	36.0	36.0
Nepal	12.7	12.7	12.3	11.5	12.2	13.9
Pakistan	17.8	15.6	16.0	15.9	16.5	15.7
Sri Lanka	20.1	19.4	17.9	18.3	17.2	17.1
Central Asia						
Azerbaijan	23.3	19.1	19.5	18.2	18.6	18.0
Kazakhstan	16.2	24.3	22.0	19.8	22.6	24.2
Kyrgyz Republic	16.4	16.2	17.5	17.3	15.3	15.8
Tajikistan	12.1	12.1	11.2	12.5	12.1	—
Turkmenistan	16.6	24.9	22.0	19.4	—	—
Uzbekistan	39.9	32.0	34.8	32.6	28.5	—
Pacific Developing Member Countries						
Cook Islands	37.7	31.7	31.4	30.5	32.9	38.8
East Timor	—	—	—	—	—	—
Fiji Islands	29.1	30.7	40.6	32.0	24.1	23.1
Kiribati	72.0	117.0	134.6	105.2	113.9	122.3
Marshall Islands	80.5	74.6	74.7	67.3	74.7	83.7
Micronesia, Federated States of	75.1	66.0	72.5	68.4	66.7	—
Nauru	96.1	48.2	26.1	115.5	98.5	79.3
Papua New Guinea	26.7	31.5	29.5	29.3	30.8	31.0
Samoa	50.5	40.0	36.1	39.8	34.4	31.6
Solomon Islands	34.7	29.0	35.5	37.5	37.8	34.5
Tonga	31.7	31.8	30.4	26.6	27.3	27.9
Tuvalu	—	156.1	154.4	148.7	227.5	123.1
Vanuatu	25.6	24.9	24.1	24.9	22.5	21.6

— Not available.

TABLE A23 Overall Budget Surplus/Deficit of Central Government (% of GDP)

	1996	1997	1998	1999	2000	2001
East Asia						
China, People's Rep. of	-1.4	-1.5	-2.1	-2.9	-2.8	-2.6
Hong Kong, China	2.9	6.6	-1.8	0.8	-0.6	-5.2
Korea, Rep. of	0.3	-1.5	-4.2	-2.7	1.1	1.3
Mongolia	-7.9	-9.1	-14.3	-12.2	-6.8	-5.1
Taipei,China	-1.3	-1.6	0.1	-1.3	-4.8	-4.3
Southeast Asia						
Cambodia	-7.2	-4.2	-5.9	-4.2	-5.8	-5.6
Indonesia	1.0	0.5	-1.7	-2.8	-1.6	-2.3
Lao People's Dem. Rep.	-8.9	-8.8	-3.2	-8.8	-7.9	-8.0
Malaysia	0.7	2.4	-1.8	-3.2	-5.8	-6.7
Myanmar	-2.4	-0.2	0.3	-0.9	0.3	—
Philippines	0.3	0.1	-1.8	-3.6	-3.8	-3.8
Singapore	6.9	3.4	2.5	2.6	3.5	1.9
Thailand	0.7	-1.8	-7.6	-11.2	-3.2	-2.1
Viet Nam	-1.3	-4.8	-2.6	-2.8	-3.0	-4.9
South Asia						
Afghanistan	—	—	—	—	—	—
Bangladesh	-4.6	-4.3	-4.1	-4.8	-6.2	-6.1
Bhutan	2.5	-2.6	1.0	-1.9	-4.1	-5.1
India	-4.1	-4.8	-5.1	-5.4	-5.7	-5.7
Maldives	-2.5	-1.4	-2.0	-4.3	-4.9	-5.3
Nepal	-4.4	-3.9	-4.6	-3.9	-3.3	-4.2
Pakistan	-6.4	-6.4	-7.6	-6.1	-6.5	-5.3
Sri Lanka	-7.8	-4.5	-8.0	-6.9	-9.5	-10.0
Central Asia						
Azerbaijan	-2.8	-1.7	-4.2	-4.5	-2.2	-2.1
Kazakhstan	-2.4	-3.8	0.1	-3.5	-0.1	-0.6
Kyrgyz Republic	-9.3	-9.1	-10.8	-12.7	-10.0	-4.0
Tajikistan	-5.8	-3.3	-2.7	-2.3	-0.4	-0.2
Turkmenistan	0.3	-0.2	-2.7	0.9	0.3	—
Uzbekistan	-7.4	-2.2	-3.4	-2.2	-1.0	-1.0
Pacific Developing Member Countries						
Cook Islands	-7.2	0.6	-7.6	-0.9	1.4	4.2
East Timor	—	—	—	—	—	—
Fiji Islands	-8.0	-10.6	-3.2	-6.4	-3.4	-4.9
Kiribati	-36.9	-1.2	12.5	-16.9	-0.8	-37.5
Marshall Islands	18.5	9.1	15.5	10.5	8.9	17.5
Micronesia, Federated States of	0.3	0.4	-6.8	-7.7	0.2	—
Nauru	-119.1	-53.1	-41.4	12.3	-6.1	-10.6
Papua New Guinea	-0.3	0.1	-2.4	-2.5	-2.4	-1.8
Samoa	1.5	0.3	2.0	0.3	-0.7	-2.3
Solomon Islands	-3.9	-4.2	-1.6	-3.7	-6.5	-8.0
Tonga	0.9	-4.9	-2.5	-0.2	-0.4	-2.6
Tuvalu	—	34.2	58.6	22.5	97.9	19.6
Vanuatu	-1.7	-0.6	-7.3	-1.3	-7.6	-3.9

— Not available.