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Outlook 2004

Special Chapter:

Foreign Direct Investment in Developing Asia

ASIAN DEVELOPMENT Outlook 2004

Special Chapter:

Foreign Direct Investment in Developing Asia

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Foreword

The *Asian Development Outlook 2004* is the 16th edition of the annual comprehensive economic report on the developing member countries of the Asian Development Bank (ADB).

ADO 2004 provides a detailed analysis and assessment of macroeconomic conditions—including fiscal, monetary, and balance-of-payments developments—for 41 Asian and Pacific economies for 2003, as well as projections for 2004–2005. It also provides a broad diagnosis of macroeconomic challenges and future growth prospects for the region's economies.

The recovery in major industrial countries remained subdued in the first half of 2003, but strengthened considerably in the last 2 quarters of the year and in early 2004, mainly in the United States and Japan, as economic growth in the euro zone was insipid. Despite the upturn in growth, inflation remained generally low while in Japan deflation abated. Hence, monetary policies stayed highly accommodative in major industrial countries. Such a policy stance is likely to continue for most of 2004 with a tightening of monetary policy and higher interest rates likely later in the year and in 2005. Fiscal policies in major industrial countries, which have also been expansionary, are expected to become more neutral to moderately contractionary over 2004–2005.

The economies of developing Asia and the Pacific generally showed remarkable resilience in 2003. Despite the uncertainties caused by the Iraq conflict, high oil prices, and the outbreak of the severe acute respiratory syndrome (SARS) epidemic, gross domestic product growth reached 6.3% in 2003, much better than expected earlier in the year and making it the most dynamic region in the world. Average inflation remained low at 2.3%. The region also posted a sizable aggregate current account surplus of 4.2% of gross domestic product.

Two notable features characterized economic developments in the region over the past 2 years. The first is the emergence of the People's Republic of China as a major engine for intraregional trade, a trend that accelerated in 2003 as exports from the rest of the region to that country continued to surge. The second is the increasing importance of consumer demand as a domestic source of growth; with some exceptions, consumer spending in 2003 was a significant boost for many regional economies.

Given the strong economic fundamentals in the region, and with the outlook for major industrial countries brighter over the next 2 years, the economies of developing Asia and the Pacific are expected to expand by a robust 6.8% in 2004 and 6.7% in 2005. Such growth performance is expected to be increasingly broad based as domestic demand, particularly business investment, strengthens further, and as external demand, including intraregional trade, remains buoyant. There are, however, several significant risks to this outlook. First, geopolitical risks such as terrorist acts or an epidemic outbreak such as SARS or more recently the avian flu remain a reality. Second, imbalances in the recovery of industrial countries hold significant risks for developing Asia's economies, as their recovery might not be sustainable. Finally, the rapidly increasing regional economic interdependence and the surge in intraregional trade, while a very positive development for the region, also carries uncertainties.

ADO 2004 contains a theme chapter discussing foreign direct investment (FDI) in developing Asia and the Pacific. Such investment in the region has grown rapidly in recent years, both facilitating and being attracted by the region's economic dynamism. Governments throughout the region have been striving to find the best policy mix for FDI that will maximize the net benefits for their economies. The chapter discusses recent trends in FDI flows in the region, their impact on the domestic economy, and the importance of the policy context in which these flows occur. While incentives and regulations targeting FDI may have some effect, a conducive environment for domestic investment and competition is more important.

Tadao Chino

TADAO CHINO
President

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Contents

Part 1 Developing Asia and the World 1

Developing Asia and the World 3
Overview of Economic Highlights and Prospects 3
Resolving Developing Asia's Nonperforming Loans 31

Part 2 Economic Trends and Prospects in Developing Asia 39

East Asia 40
People's Republic of China 41
Hong Kong, China 50
Republic of Korea 55
Mongolia 60
Taipei,China 64

Southeast Asia 68
Cambodia 69
Indonesia 72
Lao People's Democratic Republic 79
Malaysia 82
Myanmar 86
Philippines 88
Singapore 94
Thailand 98
Viet Nam 102

South Asia 108
Afghanistan 109
Bangladesh 113
Bhutan 118
India 120
Maldives 126
Nepal 128
Pakistan 132
Sri Lanka 138

Central Asia 144
Azerbaijan 145
Kazakhstan 149
Kyrgyz Republic 153
Tajikistan 156
Turkmenistan 160
Uzbekistan 163

The Pacific 168
Cook Islands 169
Fiji Islands 172
Kiribati 177
Republic of the Marshall Islands 180
Federated States of Micronesia 184
Nauru 187
Papua New Guinea 189
Samoa 193
Solomon Islands 196
Democratic Republic of Timor-Leste 199
Tonga 202
Tuvalu 205
Vanuatu 208

Part 3 Foreign Direct Investment in Developing Asia 211

Foreign Direct Investment in Developing Asia 213
Trends 214
Impact of Foreign Direct Investment 217
Importance of the Policy Context 232
International Investment Agreements 235
Six Asian Case Studies 244
Conclusions and Policy Implications 259

Statistical Appendix 270

Statistical Notes and Tables 271

Boxes

Box 1.1 The People's Republic of China—A Growing Market for Regional Exports 5
Box 1.2 Developing Member Country Access to International Capital Markets 16
Box 1.3 Classification of Lending as Nonperforming Loans 33
Box 1.4 New Nonperforming Loans in Thailand 38
Box 2.1 Protecting Minimum Living Standards in Rural Areas 44
Box 2.2 Medium-Term Risks and Uncertainties 49
Box 2.3 Challenges in Meeting Infrastructure Needs 78
Box 2.4 Republic of Palau 176
Box 2.5 The Amended Compacts of Free Association of the United States with the Federated States of Micronesia and the Republic of the Marshall Islands 183
Box 3.1 Does FDI Contribute to Economic Growth … or Doesn't It? 220
Box 3.2 Special Economic Zones: The Case of India 222
Box 3.3 FDI in the Indian Automobile Industry 229
Box 3.4 Bilateral Investment Treaties 236
Box 3.5 The ASEAN Investment Area 238
Box 3.6 The TRIMS Agreement 240
Box 3.7 Possible Lessons for Viet Nam from Other ASEAN Countries' Experience 252

Figures

Figure 1.1 Growth of PRC Exports, 2001–2003, % 4
Figure 1.2 Growth of PRC Imports, 2001–2003, % 6
Figure 1.3 Quarterly GDP Growth, Q1 2002–Q4 2003 7
Figure 1.4 GDP Growth Components, United States, Q1 2002–Q4 2003 8
Figure 1.5 US Institute for Supply Management Index, January 2002–March 2004 9
Figure 1.6 US Consumer Confidence Index, January 2002–February 2004 9
Figure 1.7 Growth of Real Exports, Japan, Q1 2003–Q1 2004 10
Figure 1.8 Tankan Survey of Business Conditions, Q2 2001–Q1 2004 10
Figure 1.9 US Treasury Yield Curves 15
Figure 1.10 Euro Benchmark Yield Curve 15
Figure 1.11 Sovereign Risk Spreads, Emerging Markets, January 2002–March 2004 15
Figure 1.12 East Asia, GDP growth, % 17
Figure 1.13 Southeast Asia, GDP Growth, % 19
Figure 1.14 South Asia, GDP growth, % 22
Figure 1.15 Central Asia, GDP Growth, % 24
Figure 1.16 The Pacific, GDP Growth, % 26
Figure 1.17 Correlation Between 1-Year Lagged NPL Ratio and Annual Credit Growth 31
Figure 1.18 Nonperforming Loan Ratios of Banks in Selected Developing Member Countries, end-2002 32
Figure 2.1 GDP Growth and Inflation, People's Republic of China, Q1 2002–Q4 2003 42
Figure 2.2 Composite Consumer Price Index, Hong Kong, China, January 2000–February 2004 51
Figure 2.3 Contribution of Expenditure Components to Change in GDP, Republic of Korea, 1997–2003 56
Figure 2.4 GDP Growth and Inflation, Mongolia, 1998–2003 61

Figure 2.5 Growth Rates of GDP and Its Demand Components, Taipei,China, 1999–2003 **65**
Figure 2.6 GDP Growth, Cambodia, 1999–2005 **70**
Figure 2.7 Exchange, Inflation, and Interest Rates, Indonesia, December 2001–December 2003 **73**
Figure 2.8 Central Government Expenditures and Revenues and GDP Growth, Lao People's Democratic Republic, 1997–2003 **80**
Figure 2.9 Net FDI, and Total and Private GFCF, Malaysia, 1997–2003 **83**
Figure 2.10 Government Expenditures by Sector, Philippines, 2002–2004 **89**
Figure 2.11 GDP Growth and Contribution by Expenditure Account, Singapore, 2002–2003 **95**
Figure 2.12 GDP Growth by Expenditure Account, Thailand, 1999–2003 **99**
Figure 2.13 GDP and Sector Growth, Viet Nam, 1998–2005 **103**
Figure 2.14 Foreign Exchange Reserves and Worker Remittances, Bangladesh, FY1993–FY2003 **114**
Figure 2.15 Central Government Finance, Bhutan, FY1997–FY2004 **119**
Figure 2.16 GDP and Business Cycles, India, FY1950–FY2005 **121**
Figure 2.17 Tourist Arrivals by Month, Maldives, 2001–2003 **127**
Figure 2.18 Government Expenditures on Development and Security, Nepal, FY1997–FY2003 **129**
Figure 2.19 Interest Rates, Pakistan, July 2002–March 2004 **133**
Figure 2.20 Colombo Stock Exchange, Sri Lanka, 1993–2003 **139**
Figure 2.21 Estimated Sector Contributions to GDP Growth, Azerbaijan, 2000–2003 **146**
Figure 2.22 GDP Growth and Unemployment, Kazakhstan, 1996–2003 **150**
Figure 2.23 Real Wages and Poverty, Kyrgyz Republic, 1996–2003 **154**
Figure 2.24 GDP Growth and Fiscal Balance, Tajikistan, 1997–2003 **157**
Figure 2.25 GDP Growth and Consumer Price Inflation, Turkmenistan, 1998–2003 **161**
Figure 2.26 Visitor Arrivals by Quarter, Cook Islands, Q1 2000–Q3 2003 **170**
Figure 2.27 Current Account Components, Fiji Islands, 2000–2004 **173**
Figure 2.28 Government Revenues and Expenditures, Kiribati, 1997–2003 **178**
Figure 2.29 Government Wages, Republic of the Marshall Islands, FY1993–FY2003 **181**
Figure 2.30 GDP Growth, Federated States of Micronesia, FY1997–FY2004 **185**
Figure 2.31 GDP Growth, Papua New Guinea, 1997–2004 **190**
Figure 2.32 GDP Growth, Samoa, 1997–2004 **194**
Figure 2.33 GDP Growth, Solomon Islands, 1997–2004 **197**
Figure 2.34 Timor Sea Revenue Estimates, Timor-Leste, 2002–2024 **200**
Figure 2.35 GDP Growth and Inflation, Tonga, FY1997–FY2004 **203**
Figure 2.36 Government Revenues and Expenditures, Tuvalu, 1997–2003 **206**
Figure 2.37 GDP Growth, Vanuatu, 1997–2004 **209**
Figure 3.1 Exports, Selected Regions, 1970–2002 **214**
Figure 3.2 World Exports, FDI Outflows, and GDP, 1990–2002 **215**
Figure 3.3 Average Annual Growth of World Exports and FDI Outflows, 1981–2000 **215**
Figure 3.4 Cross-Border Mergers and Acquisitions, by Subregion, 1987–2001 **216**
Figure 3.5 FDI Inflows, by Subregion, 1970–2001 **216**
Figure 3.6 FDI Inward Stock, by Subregion, 1981–2002 **217**
Figure 3.7 FDI Inward Stock, Top 10 in Developing Asia, 2002 **217**
Figure 3.8 BITs in Developing Asia, by Subregion, 1959–2002 **235**
Figure 3.9 Number of BITs and DTTs in Developing Asia, 1959–2002 **237**
Figure 3.10 Number of BITs, Top 10 in Developing Asia, end-2002 **237**
Figure 3.11 FDI Outflows, Top 10 in Developing Asia, 2000–2002 **258**

Tables

Table 1.1 Selected Economic Indicators, Developing Asia, 2001–2005 **4**
Table 1.2 Baseline Assumptions on External Conditions, 2002–2005 **8**
Table 1.3 Direction of Trade: Intrasubregional, Intersubregional, and Total Exports, September 2002–September 2003, Annual % Change **12**
Table 1.4 Stock Market Prices and Capitalization in Selected Developing Member Countries **14**
Table 2.1 Major Economic Indicators, People's Republic of China, 2001–2005, % **43**
Table 2.2 Major Economic Indicators, Hong Kong, China, 2001–2005, % **52**
Table 2.3 Major Economic Indicators, Republic of Korea, 2001–2005, % **57**
Table 2.4 Major Economic Indicators, Mongolia, 2001–2005, % **62**
Table 2.5 Major Economic Indicators, Taipei,China, 2001–2005, % **66**
Table 2.6 Major Economic Indicators, Cambodia, 2001–2005, % **71**
Table 2.7 Major Economic Indicators, Indonesia, 2001–2005, % **74**
Table 2.8 Major Economic Indicators, Lao People's Democratic Republic, 2001–2005, % **81**
Table 2.9 Major Economic Indicators, Malaysia, 2001–2005, % **84**
Table 2.10 Major Economic Indicators, Philippines, 2001–2005, % **90**
Table 2.11 Major Economic Indicators, Singapore, 2001–2005, % **96**
Table 2.12 Major Economic Indicators, Thailand, 2001–2005, % **100**
Table 2.13 Major Economic Indicators, Viet Nam, 2001–2005, % **104**
Table 2.14 Major Economic Indicators, Bangladesh, 2001–2005, % **115**
Table 2.15 Major Economic Indicators, India, 2001–2005, % **122**
Table 2.16 Major Economic Indicators, Nepal, 2001–2005, % **130**
Table 2.17 Major Economic Indicators, Pakistan, 2001–2005, % **134**
Table 2.18 Major Economic Indicators, Sri Lanka, 2001–2005, % **140**
Table 2.19 Major Economic Indicators, Azerbaijan, 2001–2005, % **147**
Table 2.20 Major Economic Indicators, Kazakhstan, 2001–2005, % **151**
Table 2.21 Major Economic Indicators, Kyrgyz Republic, 2001–2005, % **155**
Table 2.22 Major Economic Indicators, Tajikistan, 2001–2005, % **158**
Table 2.23 Major Economic Indicators, Fiji Islands, 2001–2005, % **174**
Table 2.24 Major Economic Indicators, Papua New Guinea, 2001–2005, % **191**
Table 3.1 FDI Inflows in Selected Developing Asian Economies, 2002 **216**
Table 3.2 Top 10 Destinations for FDI in Developing Asia, 1991–1993 and 1998–2000 **218**
Table 3.3 Foreign Investment Regime in the Host Economy: Main Types of Regulatory and Incentive Measures **233**
Table 3.4 Comparative Statistics, Six Countries **245**
Table 3.5 Annual FDI, Portfolio, and Other Capital Inflows, 1990–2002, $ million **246**
Table 3.6 FDI Regimes: Some Stylized Facts **247**

Statistical Appendix Tables

Table A1 Growth Rate of GDP (% per year) **277**
Table A2 Growth Rate of Per Capita GDP (% per year) **278**
Table A3 Growth Rate of Value Added in Agriculture (% per year) **279**
Table A4 Growth Rate of Value Added in Industry (% per year) **280**
Table A5 Growth Rate of Value Added in Services (% per year) **281**
Table A6 Unemployment Rate (%) **282**
Table A7 Gross Domestic Investment (% of GDP) **283**
Table A8 Inflation (% per year) **284**
Table A9 Change in Money Supply (% per year) **285**
Table A10 Growth Rate of Merchandise Exports (% per year) **286**
Table A11 Direction of Exports (% of total) **287**
Table A12 Growth Rate of Merchandise Imports (% per year) **288**
Table A13 Trade Balance (US$ million) **289**
Table A14 Current Account Balance (US$ million) **290**
Table A15 Current Account Balance (% of GDP) **291**
Table A16 Foreign Direct Investment (US$ million) **292**
Table A17 External Debt Outstanding (US$ million) **293**
Table A18 Debt Service Ratio (% of exports of goods and services) **294**
Table A19 Exchange Rates to the US Dollar (annual average) **295**
Table A20 Gross International Reserves (US$ million) **296**
Table A21 Central Government Expenditures (% of GDP) **297**
Table A22 Central Government Revenues (% of GDP) **298**
Table A23 Fiscal Balance of Central Government (% of GDP) **299**

Acronyms and Abbreviations

AFTA	ASEAN Free Trade Area
AMC	asset management company
ASEAN	Association of Southeast Asian Nations
AusAID	Australian Agency for International Development
BIT	bilateral investment treaty
CEPA	Closer Economic Partnership Arrangement
CPI	consumer price index
DMC	developing member country
DTT	double taxation treaty
EU	European Union
FATF	Financial Action Task Force
FDI	foreign direct investment
FEZ	free economic zone
GDP	gross domestic product
GNP	gross national product
ICT	information and communications technology
IT	information technology
IMF	International Monetary Fund
kWh	kilowatt-hour
Lao PDR	Lao People's Democratic Republic
M&As	mergers and acquisitions
MAI	multilateral agreement on investment
MFA	Multifibre Arrangement
NPL	nonperforming loan
MNE	multinational enterprise
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PBC	People's Bank of China
PRC	People's Republic of China
PICTA	Pacific Island Countries Trade Agreement
PRGF	Poverty Reduction and Growth Facility
R&D	research and development
saar	seasonally adjusted annualized rate
SASAC	State-owned Assets Supervision and Administration Commission
SARS	severe acute respiratory syndrome
SME	small and medium enterprise
SOCB	state-owned commercial bank
SOE	state-owned enterprise
TRIMs	Trade-Related Investment Measures
UK	United Kingdom
UN	United Nations
US	United States
VAT	value-added tax
WTO	World Trade Organization

Definitions

The economies discussed in the *Asian Development Outlook 2004* are classified by major analytic or geographic groupings. For purposes of *ADO 2004*, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** refers to 41 developing member countries (DMCs) of the Asian Development Bank discussed in *ADO 2004*.
- **East Asia** comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China.
- **Industrial countries** refer to the high-income OECD countries defined in World Bank, available: www.worldbank.org/data/countryclass/classgroups.htm#High-income.
- **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.
- **The Pacific** comprises Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.
- **Transition economies** refer to the countries of Central Asia, People's Republic of China, Cambodia, Lao People's Democratic Republic, Mongolia, and Viet Nam.
- The **euro zone** 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 A19.

The *Statistical Notes* give a detailed explanation of how data are derived.
ADO 2004 is based on data available up to 31 March 2004.

ASIAN DEVELOPMENT
Outlook 2004

Part 1 Developing Asia and the World

Rollie del Rosario

ASIAN DEVELOPMENT

Outlook 2004

Developing Asia and the World

Developing Asia and the World

Overview of Economic Highlights and Prospects

The economic recovery in industrial countries, which was weak in 2002 and in the first half of 2003, strengthened considerably over the last 2 quarters of 2003 and in the first quarter of 2004. In such a context, and despite major external shocks in 2003, the economies of developing Asia and the Pacific expanded much faster than earlier anticipated, with their aggregate gross domestic product growing by 6.3%. Although substantial imbalances remain in the world economy, growth in major industrial countries is projected to be quite robust in 2004–2005, while in developing Asia and the Pacific, the improved external environment, combined with strong domestic demand and buoyant intraregional trade, will allow the region to grow at annual rates of around 6.8% over the forecast period.

Economic Highlights in 2003 and Prospects for Developing Asia and the Pacific in 2004–2005

The economies of developing Asia and the Pacific generally showed significant resilience in 2003. Despite the uncertainties caused by the Iraq conflict, high oil prices, the outbreak of the severe acute respiratory syndrome (SARS) epidemic, and a slow recovery in major industrial countries during the first half of the year, gross domestic product (GDP) growth for the region reached 6.3% in 2003, making it the most dynamic region in the world. Among the larger economies, People's Republic of China (PRC), India, Thailand, and Viet Nam turned in particularly strong performances. Average inflation remained low at 2.3%, compared with 1.5% in 2002. The aggregate current account of the region posted a sizable surplus of 4.2% of GDP. Finally, foreign exchange reserves of developing Asia rose to $1.3 trillion at the end of 2003.

However, the overall economic strength of the region hides significant differences in economic performance both among the subregions and among countries within subregions (Table 1.1). Among the subregions, economic growth in 2003 was particularly strong in East Asia, South Asia, and Central Asia, moderate in Southeast Asia, and still fragile in the Pacific (though much better there than in the past 3 years). Within subregions, developments also varied considerably. In East Asia, the impact of SARS, together with weak domestic demand conditions, resulted in low growth in Hong Kong, China; Republic of Korea (henceforth Korea); and Taipei,China. In Southeast Asia, the Singapore economy remained weak as economic restructuring continued and the uncertain employment situation kept domestic

Table 1.1 Selected Economic Indicators, Developing Asia, 2001–2005

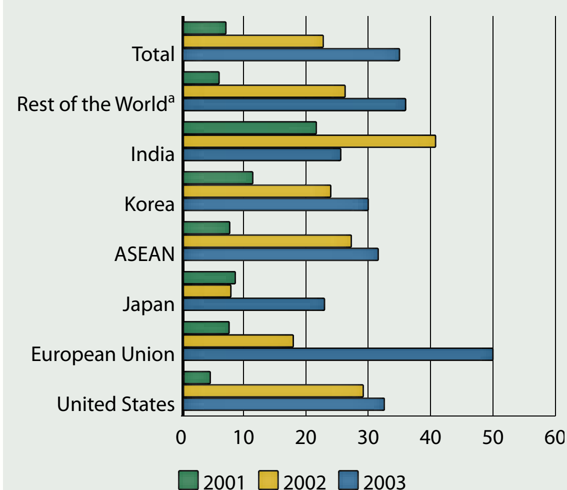
	2001	2002	2003	2004	2005
Gross Domestic Product (annual % change)					
Developing Asia	4.3	5.8	6.3	6.8	6.7
East Asia	4.6	6.7	6.5	6.9	6.8
Southeast Asia	1.9	4.2	4.6	5.7	5.4
South Asia	5.2	3.9	6.9	7.0	7.2
Central Asia	10.8	8.1	8.4	8.1	8.4
The Pacific	0.6	0.8	2.7	2.9	2.4
Consumer Price Index (annual % change)					
Developing Asia	2.4	1.5	2.3	3.3	3.1
East Asia	1.2	-0.1	1.2	2.6	2.4
Southeast Asia	4.6	4.2	3.1	3.6	3.8
South Asia[a]	3.7	3.5	4.9	4.9	4.6
Central Asia	14.3	10.9	6.9	8.6	8.3
The Pacific	6.4	7.0	7.4	5.6	6.0
Current Account Balance (% of GDP)					
Developing Asia	2.8	3.8	4.2	3.2	2.9
East Asia	2.6	3.7	4.0	2.8	2.6
Southeast Asia	6.9	7.4	9.1	8.2	7.6
South Asia	0.0	1.1	1.1	0.4	0.2
Central Asia	-3.0	-2.2	-3.3	-3.6	-4.3
The Pacific	3.9	-1.7	1.7	0.9	-1.3

[a] India reports on a wholesale price index basis.
Sources: Asian Development Outlook database; staff estimates.

demand subdued. Indonesia and the Philippines expanded moderately but at rates below potential. In South Asia, most economies showed strong performances in 2003, in part due to very favorable weather conditions. However, uncertain political conditions kept economic growth below par in Nepal. In Central Asia, the Uzbekistan economy continued to grow quite slowly. In the Pacific, several of the smaller economies experienced no growth in 2003, such as the Federated States of Micronesia and Nauru, or a decline, as in the case of Timor-Leste.

The region has witnessed two notable economic developments over the past 2 years. The first is the emergence of the PRC as a major engine for intraregional trade (Figures 1.1 and 1.2). This trend accelerated in 2003 for most of developing Asia. The economies in East Asia and Southeast Asia benefited most from the strong increase in the PRC's imports. The PRC has

Figure 1.1 Growth of PRC Exports, 2001–2003, %



[a] Excluding other groupings in the figure.
ASEAN = Association of Southeast Asian Nations.
Sources: CEIC Data Co. Ltd.; Datastream.

Box 1.1 The People's Republic of China—A Growing Market for Regional Exports

A notable feature of Asia's economic development is the emergence of the People's Republic of China (PRC) as an important export destination for regional economies. Exports to the PRC have been spurred by that country's strong economic growth, stable yuan exchange rate, and the international segmentation of production processes. Over 1995–2003, exports from all of Asia to the PRC, measured in dollars, grew at an average annual rate of 16.9%, or more than three times the 5.3% growth rate in world trade.

The product mix of exports to the PRC has changed, too. During 1995–2003, exports of precision instruments and electrical machinery to the PRC from its nine major Asian trade partners (Asia-9)[1] soared sixfold. Their exports of machinery, chemical products, and transportation equipment to the PRC surged threefold. However, shipments of agricultural goods and food, textiles and apparel, as well as leather and shoes to the PRC grew only slowly, or even declined (Box Figure 1).

Almost all major economies in East and Southeast Asia have experienced a shift in their exports to the PRC from low value-added sectors to high valued-added sectors in the past decade. Indonesia, Malaysia, Philippines, and Thailand exported mainly primary goods to the PRC in the early 1990s. By 2003, though, 56% of their aggregate exports comprised machinery and electrical machinery. In the more developed economies in the region—Japan and the newly industrialized economies of Hong Kong, China; Korea; Singapore; and Taipei,China—exports to the PRC have shifted from more traditional manufacturing sectors such as textiles and machinery to high-technology, high value-added sectors such as electrical machinery, transportation equipment, and precision instruments.

In 2003, the biggest category of exports to the PRC from its nine major regional trading partners was electrical machinery (34%), followed by machinery (17%), and chemical products (15%). Textiles and apparel accounted for only 6%. Sales of primary goods to the PRC were even less important for the nine economies, with just 1.3% of their exports comprising agricultural goods and food and 3.5% raw materials and oil.

An increase in production sharing, or vertical specialization, helped drive the significant changes. The PRC has established a strong comparative advantage in downstream stages of production, especially for electronics products, largely a result of its massive foreign direct investment inflows and large supply of low cost labor. The final stages of production of some items have been moved to the PRC from other Asian economies. As a result, the PRC's demand for intermediate components from its nine major regional trading partners has grown sharply, while its exports of final goods to non-Asian industrial economies also increased significantly. The structural trade balances between the PRC and its major trading partners clearly show its role as an assembly center for many exports from Asia to the United States and European Union (Box Figure 2).

Participants in the regional production chain benefit by specializing in particular steps in the production process. Production sharing has enabled the PRC to diversify into higher-technology products and so boost its total exports. Also, the PRC's structural deficit with other Asian countries has shrunk in some sectors such as machinery, partly reflecting the PRC's sharpening competitive edge in higher-technology products.

As PRC industries move up the value-added chain, they may win a greater slice of the global export market, so other economies need to adapt to this changing competitive landscape to maintain their export shares. However, no country could have a comparative advantage in all products or all stages of production. Indeed, production sharing is expected to become more important to regional trade, facilitated by improvements in transportation and communications and falling trade and investment barriers.

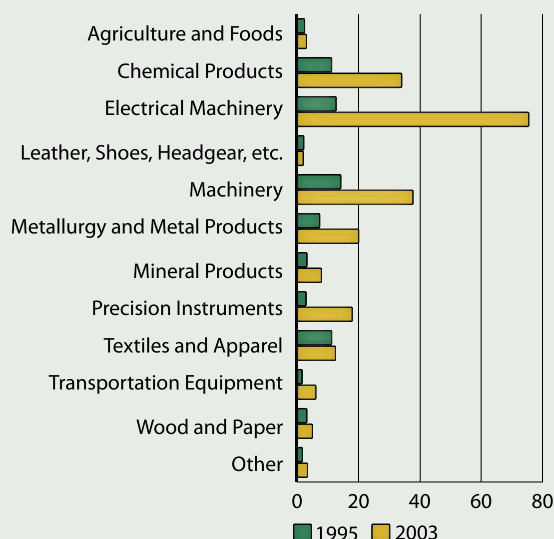
While the PRC's surging export industries provide a growing market for inputs from the region, its developing domestic market is starting to offer huge potential as well. In 2003, for example, PRC imports of automobile products and steel surged by 84% and 52%, respectively. Overall, the PRC's large size, rapid growth, and its deeper integration with other Asian economies will be a dynamic influence in the region. However, it will be crucial for those other economies to position themselves to take advantage of the changes in comparative advantage.

Source: ADB staff using data from CEIC Data Co. Ltd.

[1] Hong Kong, China; Indonesia; Japan; Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. A total of 54% of the PRC's total imports and 82% of its imports from Asia in 2003 were sourced from these nine economies.

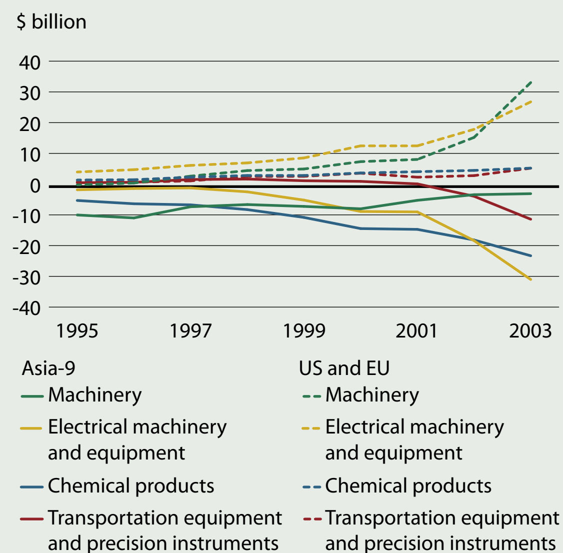
Box 1.1 *(continued)*

Box Figure 1 PRC Imports from Nine Asian Economies, 1995 and 2003, $ billion



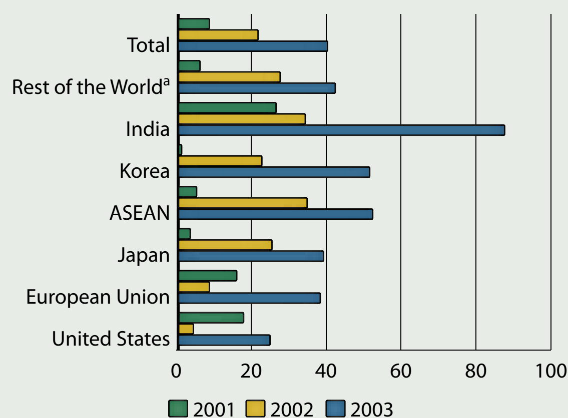
Source: CEIC Data Co. Ltd.

Box Figure 2 PRC Structural Trade Balances with the Nine Asian Economies, and the United States and European Union, 1995–2003



Source: CEIC Data Co. Ltd.

Figure 1.2 Growth of PRC Imports, 2001–2003, %



[a] Excluding other groupings in the figure.
ASEAN = Association of Southeast Asian Nations.
Sources: CEIC Data Co. Ltd.; Datastream.

become the single largest export market for East Asia while for Southeast Asian countries, its share in total exports has become sizable. In a major new development, exports from South Asia to the PRC also expanded rapidly in 2003, albeit from a low base (Box 1.1). Although economic growth in the PRC is projected to settle to more sustainable rates in 2004–2005, intraregional trade will remain a major driver of growth in developing Asia over the next 2 years. Progressively, the whole of the region will benefit from the dynamism in intraregional trade.

The second main feature of recent regional economic developments is the increasing importance of consumer demand in most countries. Although there are notable exceptions, consumer spending in 2003 was an important boost for many of the economies in East Asia and Southeast Asia, in particular PRC, Indonesia, Malaysia, Philippines, and Thailand. In a noteworthy development, similar changes are occurring in South Asia, particularly in India. The increasing importance of consumer demand in GDP growth has been supported in most countries by expansionary fiscal policies, and a low interest rate environment associated with accommodative monetary policies. An expanding urban middle class and the relatively young age structure of populations are fundamentally changing consumption behavior throughout developing Asia. Overall, confidence is high in the economic outlook for the region.

Intraregional trade and strong consumer

demand will continue to define the outlook in 2004–2005. Developments in 2003 and the first quarter of 2004 show that the economic fundamentals of the region are strong. Domestic demand has been picking up in some of the East Asian and Southeast Asian economies where it was weak in 2003, notably Hong Kong, China; Korea; Singapore; and Taipei,China. In addition, the strengthening of the recovery in major industrial countries is already showing up in the external sector performance of many regional economies. The stronger outlook in industrial countries for 2004–2005 will provide a cushion against some possible slowing of the surging export growth to the PRC. It will also mitigate the impact of fiscal consolidation measures that need to be taken in some of developing Asia's economies.

An important point is that the brighter economic outlook for 2004–2005 will present a timely opportunity to strengthen policies aimed at resolving macroeconomic imbalances, addressing the fragility of banking and financial systems, and implementing structural policy reforms to progressively improve the investment climate. The implementation of such reforms and the combination—for the first time since the Asian financial crisis of 1997–98—of buoyant domestic, regional, and international markets should significantly boost business investment in the region. Assuming robust growth in industrial countries over the next 2 years, and in the absence of major unforeseen shocks, aggregate GDP growth for developing Asia is projected at 6.8% in 2004 and 6.7% in 2005.

Prospects for the World Economy in 2004–2005

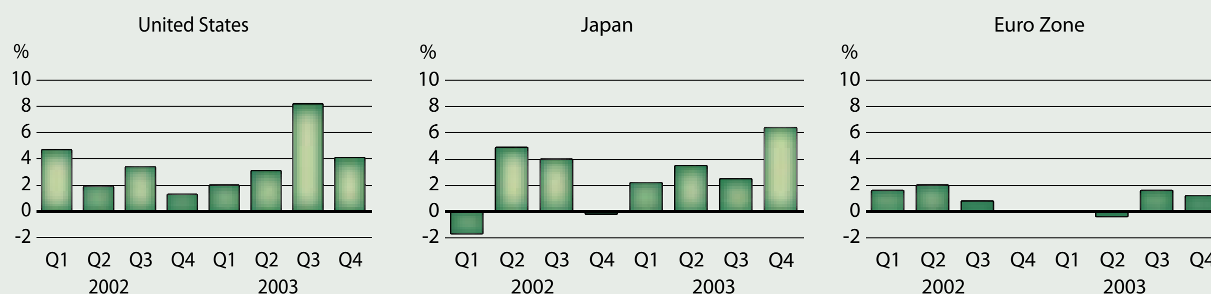
Prospects for Major Industrial Countries

The recovery in industrial countries, which started at the end of 2001 stayed relatively weak in 2002, and remained subdued during the first half of 2003, but strengthened considerably over the last 2 quarters of the year, mainly in the United States (US), Japan, and the United Kingdom (UK); economic growth in the euro zone has been lagging (Figure 1.3). In spite of a significant upturn in growth, inflation has remained low in the US while deflation abated somewhat in Japan. In the euro zone, weak domestic demand and the appreciation of the euro have put downward pressure on prices. As a result, monetary policies continued to be highly accommodative in major industrial countries. Such a policy stance should continue for most of 2004 with a tightening of monetary policy and higher interest rates in industrial countries likely to start later in the year.

Fiscal policies are expected to be neutral to moderately contractionary over the next 2 years. Although there are considerable imbalances and uncertainties in the world outlook, in particular with regard to employment creation in the US and the widening US fiscal and current account deficits, projections indicate robust growth in major industrial countries, largely due to a strong recovery in the US, for most of 2004, before some leveling off of growth in 2005 (Table 1.2).

United States. The US economy showed exceptional strength at the end of 2003 and in the first quarter of 2004, growing well above trend. A combination of factors resulted in exceptionally

Figure 1.3 Quarterly GDP Growth, Q1 2002–Q4 2003



Note: Growth rates are seasonally adjusted annualized rates.
Sources: US Department of Commerce, Bureau of Economic Analysis, BEA News Releases, available: www.bea.doc.gov/bea/dn/nipaweb/index.asp; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/index-e.html; Eurostat, available: www.europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat.

Table 1.2 Baseline Assumptions on External Conditions, 2002–2005

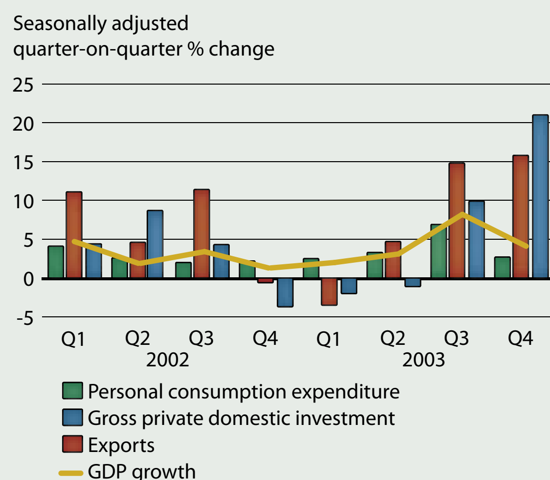
	2002 Actual	2003 Actual	2004	2005
GDP Growth (%)				
Industrial countries	1.6	2.0	3.1–3.5	2.5–3.0
United States	2.2	3.1	4.2–4.7	3.2–3.7
Euro zone	0.9	0.4	1.7–1.9	2.1–2.4
Japan	-0.3	2.7	2.5–2.8	1.5–2.0
Memorandum Items				
United States Federal Funds rate (average, %)	1.7	1.1	1.1–1.3	2.5–3.0
Brent crude oil spot prices ($/barrel)	25.0	28.8	28.0–30.0	24.0–26.0
World trade volume (% change)	3.7	4.7	8.0–8.5	6.0–7.0

Note: Staff projections are based on the Oxford Economic Forecasting World Macroeconomic model.

Sources: US Department of Commerce, Bureau of Economic Analysis, BEA News Releases, available: www.bea.doc.gov/bea/dn/nipaweb/index.asp; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/index-e.html; Eurostat, available: www.europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat; World Bank Development Economics Prospects Group; US Federal Reserve, available: www.federalreserve.gov/releases/; staff estimates.

high GDP growth of 8.2%, at a seasonally adjusted annualized rate (saar), in the third quarter of 2003. These factors included a surge in personal consumption expenditures resulting from the impact of tax refunds, a spike in residential and equipment (information processing hardware and software) fixed investment, and an improved export performance. Despite a slowdown of activity in the residential real estate market and a worsening trade balance, strong business investment spending maintained GDP growth of 4.1% in the fourth quarter of 2003, still above trend growth (Figure 1.4).

Figure 1.4 GDP Growth Components, United States, Q1 2002–Q4 2003

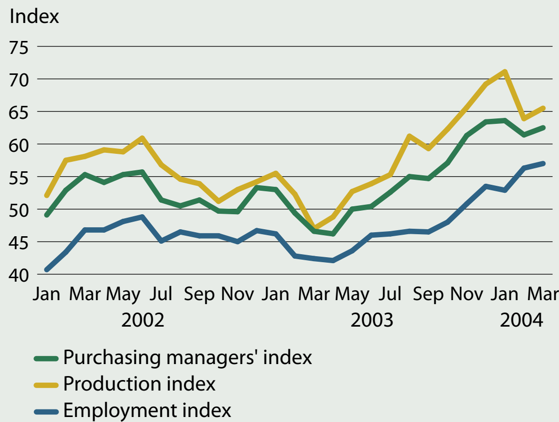


Source: www.bea.doc.gov/bea/dn/nipaweb/index.asp, downloaded 30 March 2004.

A worrisome feature of the strong US recovery in the second half of 2003 was that it did not generate significant increases in employment. From August to December, average monthly employment gains turned out to be less than 56,000, well below historical figures during recovery periods. A range of factors provides some explanation for the jobless growth, including large gains in productivity, and the continued impact of overhiring at the end of the 1990s. Employment will be a key variable in the US economy in 2004–2005.

Along with an improvement in the employment data in the first quarter of 2004, particularly in March, the fundamentals of the US economy appear to be strong, suggesting robust growth in 2004. The outlook for the business sector is very positive as new orders and order backlogs data show positive trends. The March Institute for Supply Manufacturing survey showed that the manufacturing sector continued to grow for the 10th consecutive month (Figure 1.5). Soaring profits due to declining unit labor costs and the fall in the dollar—bolstering profits from overseas operations—should translate into significant increases in capital expenditures in 2004. In spite of weak gains in average earnings and the

Figure 1.5 US Institute for Supply Management Index, January 2002–March 2004

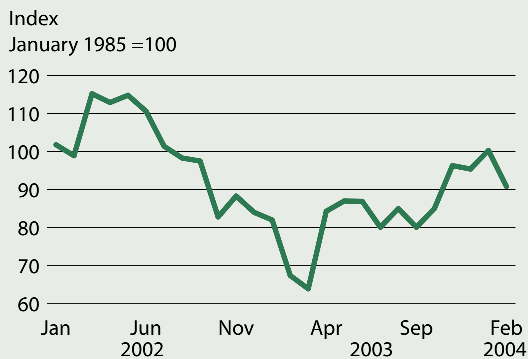


Source: Datastream.

uncertain employment outlook, tax refunds in the first quarter of 2004 as well as continued low interest rates, and strong consumer credit growth (up by 8.6% saar in January 2004) should keep consumer spending buoyant at least during the first half of 2004 (Figure 1.6). While activity in the residential real estate market is projected to slow somewhat, net exports should start to support growth positively as the economy moves to the upward segment of the J-curve.

With inflation projected to remain moderate and job creation still uncertain, the Federal Reserve is likely to keep its target Federal Funds rate of 1% unchanged until later in the year. Changes in core inflation will define the stance of monetary policy. Several factors are at play. First,

Figure 1.6 US Consumer Confidence Index, January 2002–February 2004



Source: Bloomberg, L.P. (US Conference Board).

sustained growth will not only start creating jobs, but also bring the economy closer to capacity, building up inflationary pressures. Second, the impact of the depreciation of the dollar should progressively be felt on domestic prices. Third, high projected oil and commodity prices will feed through and push up core inflation. Core inflation is therefore projected to accelerate during the second half of the year and into 2005, eventually leading to upward adjustments in interest rates. Projections of a further significant increase in the budget deficit for 2004 (to about $520 billion or 4.5% of GDP) will also put upward pressure on interest rates.

Against a background of a tightening of macroeconomic policy taking hold only later in the year and of significant downside risks, the US economy is projected to expand at a rate of 4.2–4.7% in 2004. In 2005, both monetary and fiscal policies are forecast to be less accommodative. In the budget for fiscal 2005 (starting on 1 October 2004), most discretionary spending growth is expected to be contained. Interest rate increases will moderate growth in private consumption expenditures and residential real estate investment. Business investment should, however, continue to expand moderately. Some improvement can be expected in the current account deficit, thus contributing to growth. Projections are for GDP growth in the range of 3.2–3.7% in 2005.

Japan. The economy of Japan turned out much stronger than anticipated in 2003, with GDP posting a 2.7% increase for the year as a whole. Growth in the last quarter of 2003 was a remarkable 7% on an annualized basis, the highest rate since the second quarter of 1990. The recovery was driven by a solid export performance (up 10% in real terms for the year as a whole) and a significant pickup in business investment. Private nonresidential investment contributed 1.5 percentage points to overall growth, and net exports a further 0.7 percentage point. Private consumption accounted for 0.6% of growth as consumer confidence remained weak through most of the year.

At the end of 2003, employment started to respond modestly to the revival of economic activity, particularly in some large businesses. Unemployment declined slightly to 5.0% in

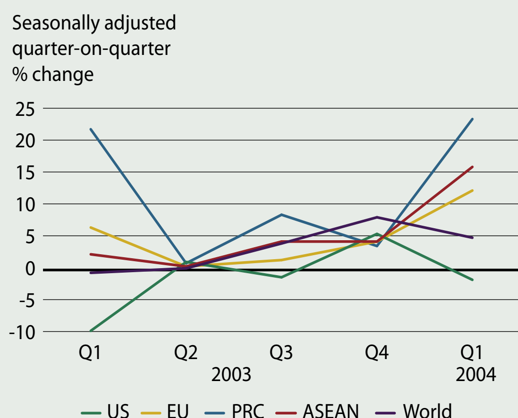
February 2004. An improved employment situation will contribute to a progressive strengthening of consumer spending in 2004–2005. Such spending already strengthened significantly in the last quarter of 2003 and the first quarter of 2004, indicating that the recovery is broadening. There are also indications that deflation is easing, and this would further stimulate consumption spending.

Despite some appreciation of the yen during the second half of 2003, exports have been buoyant, particularly to the PRC and the rest of Asia (Figure 1.7). In real terms, exports to the PRC grew at annual rates of 35.5% in 2002 and 41.2% in 2003. In contrast, exports to the US actually declined in 2003, while they expanded moderately to the European Union (EU). The PRC now accounts for 12.2% of Japan's exports, just below the EU market share. A wide range of industries has benefited from surging exports to the PRC, including machinery and electrical machinery, metals, and precision instruments. The manufacturing export industries are expected to continue to expand strongly in 2004, mainly on account of robust regional export demand and rising shipments to the US. For example, industrial output increased by a solid 3.4% in January 2004 compared with the previous month.

A key factor affecting export growth will be the value of the yen, which appreciated against the dollar by 8.5% over the period January 2003 to March 2004. Intervention by the Bank of Japan moderated the appreciation: in January 2004 alone, it spent $67 billion to support the yen. At the end of March 2004, Japan's total foreign exchange reserves (including gold) stood at $826.6 billion. Despite deflationary forces still at work in some sectors, business confidence, as measured by the Tankan survey of business conditions, was at a decade high in the first quarter of 2004 (Figure 1.8). In the financial sector, substantial progress has also been made in reducing nonperforming loans (NPLs), which had fallen below 7% of bank loan portfolios at the end of 2003. Assuming that export growth remains on track, business investment continues to strengthen, and real consumer spending revives, the Japanese economy could return to a period of robust growth not seen in over a decade. Projections indicate that GDP is likely to grow by about 2.5–2.8% in 2004, and between 1.5–2.0% in 2005. However, deflation remains severe in some sectors, such as capital goods, and could continue to dampen nominal GDP growth. Finally, in addition to accelerating structural reforms, addressing longer-term issues such as the huge budget deficit and public debt will be required to sustain robust growth.

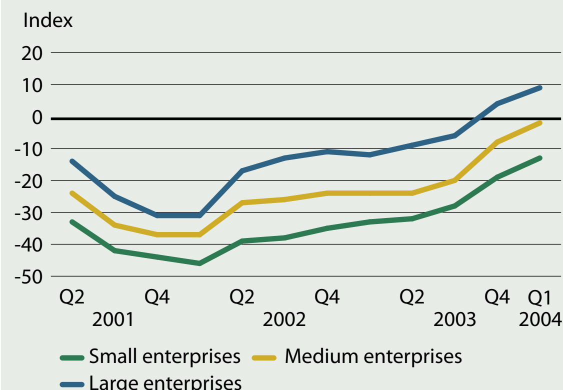
Euro Zone. Euro zone GDP growth was a meager 0.4% in 2003. In the second quarter of the year, the euro zone economy actually shrank by 0.4% as private consumption, investment, and net exports all declined. The second half of the year

Figure 1.7 Growth of Real Exports, Japan, Q1 2003–Q1 2004



Source: Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*, 18 March 2004.

Figure 1.8 Tankan Survey of Business Conditions, Q2 2001–Q1 2004



Sources: Bloomberg L.P.; Bank of Japan, Research and Statistics Department.

saw some recovery as, in spite of the euro's appreciation, exports and business investment improved somewhat, particularly in France, Germany, and notably Spain where domestic demand is more robust. With few exceptions, corporate confidence improved in the latter part of the year. However, consumer confidence and demand remained very weak. GDP expanded by 1.2% (saar) in the fourth quarter. Constrained by the Stability and Growth Pact limit on budget deficits, fiscal policy was only mildly expansionary, but the three biggest euro zone economies—Germany, France, and Italy—breached the 3.0% deficit limit as a result of tax cuts. Despite inflation falling just below 2%, the European Central Bank (ECB) left its target rate unchanged at 2.0% since July 2003. Domestic demand thus did not benefit from additional monetary policy support. Furthermore, structural reforms to improve the competitiveness of the euro zone economies appear to have slowed during the course of 2003.

By March 2004, the euro had appreciated against the US dollar by about 40% since February 2002, and the strength of the euro is increasingly a source of concern. In March 2004, the Ifo business climate index of manufacturing, construction, retailing, and wholesaling in Germany fell further to 95.4, after declining for the first time in 9 months to 96.4 in February. In contrast, the German purchasing managers' index (PMI), which measures future economic activity, improved somewhat to 54.1 points in March 2004 from 53.4 points in February. With limits to the squeeze on exports' profit margins, the strong euro could start dampening external demand, the main source of growth in the euro zone in 2003 and early 2004. This would affect employment prospects and further depress domestic demand.

Inflation is projected to fall to the 1.5–1.7% range in 2004–2005, opening a welcome opportunity to loosen monetary policy and reduce interest rates. On the fiscal side, not much stimulus can be expected over the next 2 years as the economies exceeding the Stability and Growth Pact limit try to bring back their budget deficits to below 3.0%. On the positive side, in spite of the euro's appreciation over the past year, business confidence in France and Spain has been improving, as shown by several early 2004 PMI surveys. After 3 months of stagnation, the PMI for the euro zone rose in March. In Germany, there has been a pickup in investment in machinery and equipment, as well as in construction, while consumer confidence also appears to have improved. Hence, some modest strengthening of growth to 1.7–1.9% is projected for the euro zone in 2004, assuming no further significant appreciation of the euro. In 2005, GDP growth is projected in the 2.1–2.4% range, as domestic demand and exports contribute more evenly to growth.

Within the EU, the UK economy offers a sharp contrast to that of the euro zone. It was on a rebound in 2003, expanding at an annual rate of 3.8% in the fourth quarter and 2.3% for the year as a whole. Domestic demand is providing a strong impetus to growth, particularly private and public consumption. For example, housing prices were up by 17% in February 2004 from a year earlier. In spite of a second rise in interest rates by 25 basis points to 4.0% in February 2004, domestic demand is seen as remaining robust in 2004–2005, even if some further interest rate rises can be expected later in the year and in 2005. Business confidence has also been rising as the world economy accelerates and stock markets remain fairly robust. Despite a substantial appreciation of the pound against the US dollar and lately against the euro, exports have been rising, with for instance exports to the PRC growing by more than 50% in 2003. Projections show the UK economy growing by 2.8–3.1% in 2004 and by 2.5–2.8% in 2005.

World Trade and Commodity Prices

Growth in world trade consistently strengthened throughout 2003, and remained strong in the beginning of 2004, growing at double-digit rates. According to World Bank estimates, world trade, as measured by world export volume, expanded by 4.7% in 2003, about 1 percentage point faster than in 2002. The trade performance resulted from a confluence of factors. First, trade between the rest of the world and Asia, as well as within Asia, boomed in 2003, led by the PRC and the other East Asian and Southeast Asian economies (Table 1.3). In the second half of 2003 and early 2004, shipments of electronics to and from nonregional economies as well as within the region increased rapidly. Exports from Japan, particularly

Table 1.3 Direction of Trade: Intrasubregional, Intersubregional, and Total Exports, September 2002–September 2003, Annual % Change

Exports From/To	East Asia	PRC	Southeast Asia	South Asia	Central Asia	Total Exports
East Asia	29.8	28.3	22.2	0.6	-56.5	18.5
PRC	35.5		39.6	10.2	-61.8	40.5
Southeast Asia	27.6	59.0	20.1	-20.3	-97.1	16.2
South Asia	23.8	41.5	15.5	28.7	-19.4	14.9
Central Asia	37.9	39.4	-30.8	31.1	7.0	20.0
The Pacific	27.7	41.2	49.7	-13.4	0.0	22.7

PRC = People's Republic of China.
Source: International Monetary Fund. 2004. *Direction of Trade Statistics*. February.

to the PRC and the rest of developing Asia, surged in the second half of 2003, and exports from the US also picked up by the end of the year. The EU (with the exception of the UK) is the only region where exports have been lackluster. With robust growth projected for the world economy in 2004–2005, and developing Asia in particular, the strong performance of world trade in the first quarter of 2004 should translate in world trade volume growth of around 8–8.5% in 2004, slowing somewhat to about 6–7% by 2005.

Oil prices in 2003 were volatile and remained high throughout the year. The average price of $28.80 a barrel (Brent crude) in 2003 is well above forecasts earlier in the year. Supply uncertainties related to the Iraq conflict and unrest in Venezuela, low stock levels, increasing demand from the PRC (30% oil import growth in 2003), which has now become the second-largest oil importer in the world, as well as weather-related demand, have all helped keep oil prices high. By the end of 2003, the significant fall in the dollar also put upward pressure on oil producers to maintain local currency revenues. Oil prices stayed at above $30 a barrel during the first quarter of 2004 as the Organization of Petroleum Exporting Countries (OPEC) played an active role in managing the oil markets, as stocks remained critically low in major Organisation for Economic Co-operation and Development (OECD) markets, and as seasonal factors pushed up demand. Furthermore, OPEC announced a quota cut of 1 million barrels a day from 1 April to 23.5 million barrels a day, which will support prices during the second quarter in spite of a seasonal decline in demand. Higher non-OPEC production could, however, start putting some downward pressure on prices as 2004 progresses. Overall, given OPEC's apparent determination to support higher prices in the face of a weak US dollar, and robust demand in a strongly growing world economy—particularly the PRC, India, and other Asian countries—Brent crude oil prices are projected to stay relatively high in 2004 in a range of $28–30 a barrel, before easing somewhat to the $24–26 range in 2005 as demand and supply are better matched. Following a substantial decline in 2002, natural gas prices rose by nearly 30% in 2003; moderate increases are projected over the forecast horizon.

The rally in prices of non-oil commodities, which started in 2002, strengthened considerably in 2003, with prices increasing by 13% over the year according to World Bank estimates. The combination of a weak dollar, a stronger world recovery, and soaring demand from the PRC for raw materials and base metals sent most commodity prices close to their mid-1990s peak. Speculative factors also contributed to the high prices in 2003 and early 2004. Demand from the PRC and falling world stocks led to a surge in metal and mineral prices by 28%. Raw materials, including cotton and rubber, rose by 16%, also largely due to strong demand from the PRC. Fertilizer prices rose by 15% over the year. Drought in producing countries led to a jump of 28% in prices for fats and oils while other agriculture prices rose moderately. Rice prices continued their rally, increasing by about 15% (Thai, 5% broken) between 2001 and 2003. After

3 years of decline, coffee prices rose slightly in 2003. Commodity prices are projected to remain generally strong in 2004 although the recent rates of price increases cannot be sustained for a number of items, particularly some agricultural commodities.

In the first quarter of 2004, metal and mineral prices continued to soar with a quarter-on-quarter price increase of about 20%. Projections indicate a continued strong rally of metal and mineral prices this year, led to a large extent by demand from the PRC and the rest of developing Asia. Price increases should level off in 2005 as world demand slows and stocks are reconstituted. Forecasts from the Oxford Economic Forecasting model show metal prices rising by about 20% in 2004. The projections point to continued strong price gains for copper, lead, nickel, steel, tin, and zinc. Strong demand from the PRC, increasing demand from industrial countries, and low stock levels will positively impact on the prices of these commodities in 2004.

Due to more rapid supply responses, agricultural prices are expected to continue their rally in 2004–2005 but at a much slower pace. However, agricultural raw materials prices—rubber and cotton in particular—are projected to show strong price gains in 2004 as world demand remains strong, but prices should level off in 2005, except perhaps for rubber. As supply improves, fats and oils prices (including palm and soybean oil) are projected to increase moderately in 2004, and decline somewhat in 2005. Among other main agricultural prices, forecasts for 2004 show stronger gains for rice prices and gains for coffee prices as markets for both commodities will be tight in 2004, before easing in 2005. Finally, the long-awaited revival of the electronics sector will lead to stronger dollar prices in 2004 for products such as DRAM chips, flash memory, and integrated circuits.

Financial Market Developments

Overall, inflation in the world economy, and in industrial countries in particular, remained historically low in 2003. OECD inflation (as measured by the GDP deflator) declined from 2.1% in 2002 to 1.8% in 2003, allowing monetary policies to remain accommodative throughout the year. Although relatively high oil prices have been creating upward pressures, overall consumer prices in the US rose by 1.7% (before seasonal adjustment) in the year to March 2004. Core inflation remains somewhat lower. In Japan, deflation is still apparent, although it has started moderating. In the euro zone, inflation recently abated to just under 2.0%.

Hence, in major industrial countries, interest rates also remain exceptionally low. The US Federal Funds rate has stayed at a 46-year historically low rate of 1.0% since June 2003, while in the euro zone, the ECB rate was 2.0% over the same period. In Japan, the discount rate has been maintained at 0.1% since 2002. A few countries have, however, started to raise interest rates in 2003, notably Australia and the UK, which have been concerned by a possible bubble in asset prices—mainly in real estate—and high household indebtedness. Forecasts indicate inflation in OECD countries slowing somewhat in 2004 before picking up mildly in 2005. Euro zone inflation is, though, projected to decelerate over the next 2 years, possibly leading to a downward adjustment in ECB rates. In the US, a pickup in core inflation is likely during the second half of 2004 as higher oil prices and the depreciation of the dollar pass through the system and as growth remains robust. The response of the Federal Reserve to an increase in inflation will critically depend on the performance of the labor market. If strong growth does not create a significant number of new jobs, the Federal Reserve is likely to keep rates on hold. A progressive return to somewhat higher rates is likely only later in 2004 as core inflation picks up. The baseline assumption is for the Federal Funds rate to average 1.1–1.3% in 2004, increasing to 2.5–3.0% in 2005. The 6-month London interbank offered rate is projected to increase to about 1.6% in 2004 (from 1.1% in 2003). In contrast, the 6-month euro interbank offered rate is forecast to edge down to 2.0% in 2004 (from 2.3% in 2003).

Corporate profits, which started to improve somewhat in 2002, mainly in the US, recovered sharply during the second half of the year, not only in the US but also in Japan, and to a lesser extent the EU. In the US, strong productivity growth continued to fuel corporate profitability. With corporate prospects improving and the uncertainties linked to the Iraq conflict abating, the US stock market recovered sharply from the second half of 2003; in Japan, the better outlook

for the economy led to a surge in the Nikkei 225; while in the EU, some improvements in the prospects for many economies also translated into significant stock market gains. Despite some setback in the first quarter of 2004, stock markets in major industrial countries should remain relatively robust through 2004–2005 as the cycle moves toward its peak. The improved corporate profitability outlook combined with a revival in stock markets augurs well for capital spending in major industrial countries in 2004–2005. In emerging markets, continued low world interest rates and a strengthening world recovery also led to surging equity markets, particularly across developing Asia (Table 1.4). Prospects for regional equity markets in 2004–2005 remain upbeat, which will have a positive impact on business investment.

After hitting a 45-year low in June 2003 and after the Federal Reserve indicated that deflation was no longer likely, US bond prices fell and the yield on 10-year US treasury bills jumped by more than 100 basis points to 4.85% on 31 July 2003. At that time, there was serious concern that long-term interest rates would start to rise as growth accelerated in the US and expectations of huge US treasury financing requirements would influence market expectations. As it turned out, the recovery indeed gained momentum in the US but it was "jobless." The lack of job creation appears to have

Table 1.4 Stock Market Prices and Capitalization in Selected Developing Member Countries

	% Change in Price Index[a]			2003 Market Capitalization		
	2002	2003	Q1 2004	$ billion[b]	Share of GDP (%)	Year Change (% of GDP)
PRC						
Shanghai A Shares	-17.1	10.6	16.4	355.2	25.2	3.8
Shenzhen A Shares	-17.9	-4.0	21.6	146.4	10.4	-0.4
Hong Kong, China						
Hang Seng	-18.2	34.9	0.8	705.6	443.6	155.4
H-Shares[c]	13.2	152.2	-4.8			
India						
BSE 30 Sensitive	3.5	72.9	-4.3	279.2	48.0	24.3
Indonesia						
Jakarta Composite	8.4	62.8	6.3	54.4	25.8	10.7
Korea						
KOSPI	-9.5	29.2	8.6	298.0	49.3	13.4
Malaysia						
KLSE Composite	-7.2	22.8	13.6	102.3	99.2	21.5
Pakistan						
KSE-100	112.2	65.5	14.2	16.7	23.8	8.9
Philippines						
PSE Composite	-12.8	41.6	-1.3	53.5	68.2	20.4
Singapore						
Straits Times	-17.4	31.6	5.4	225.4	240.9	59.8
Taipei,China						
Weighted	-19.8	32.3	10.7	376.9	130.7	38.3
Thailand						
SET	17.3	116.6	-16.2	121.0	80.6	47.2
Memorandum Items						
United States						
NYSE	-19.8	28.8	2.5			
Nasdaq Composite	-31.5	50.0	-0.5			
DJIA	-16.8	25.3	-0.9			

DJIA = Dow Jones Industrial Average, NYSE = New York Stock Exchange.

[a] From end of previous period. [b] Local currency data converted at end-year exchange rates. [c] Subindex of PRC state-owned enterprises with a secondary listing in the Hong Kong, China market.

Sources: Datastream; staff calculations.

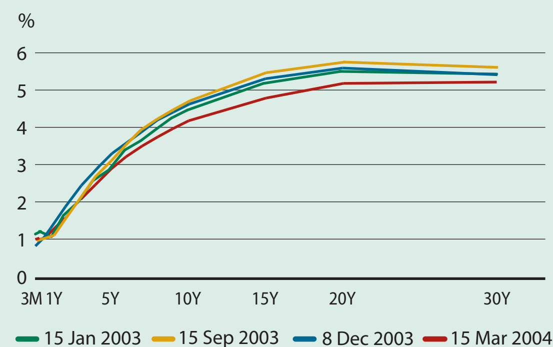
dominated market sentiment, moderating long-term (10-year) bond yields at around 4.5% since November 2003. At the short end of the market (up to 2 years), the US yield curve has steepened somewhat since the third quarter of 2003, as the market did not expect further rate cuts (Figure 1.9). At the long end (10 years), yields have remained virtually unchanged and even fallen somewhat since the end of the third quarter of 2003, reflecting market sentiment that interest rates will not be raised for some time. However, the reaction of the bond market to the Federal Reserve's January announcement that it will "be patient" on rate increases indicates that it could react fast (and furiously) to any hint of rate increases.

The euro benchmark yield curve continues to show an inverted shape, sloping down at the short end as further rate cuts by the ECB are expected, before sloping up for maturities beyond 1 year (Figure 1.10). At the long end, rates rose in July 2003 but by only 40 basis points to 4.2%, and they have stayed virtually unchanged since then. Since the beginning of 2004, euro bond yields for 10-year maturities have been falling somewhat, indicating that the markets expect no major interest rate hike.

Emerging markets have benefited from a long period of about 15 months of compression in sovereign risk spreads. Average spreads were 526 basis points in 2003, compared with 728 in 2002 (Figure 1.11). Developing member countries (DMCs) took advantage of these favorable conditions by issuing nearly $75 billion of bonds and notes in international capital markets in 2003, and by offering about $30 billion in stock issues (Box 1.2). As opportunities for higher returns in mature markets materialize in the period ahead with increases in interest rates, the decline in spreads is expected to reverse in later 2004 and the spread will continue to widen in 2005. This development will be very important for countries with lower credit ratings as external funding will become more onerous for them. This will call for careful planning of funding external requirements over the next 2 years.

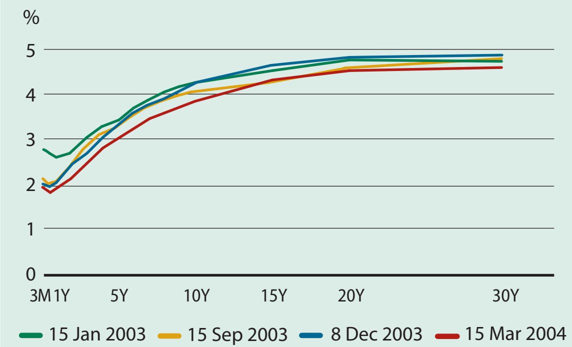
According to Institute of International Finance data, net private capital flows to emerging markets rose to a 3-year high of $194.1 billion in 2003,

Figure 1.9 US Treasury Yield Curve



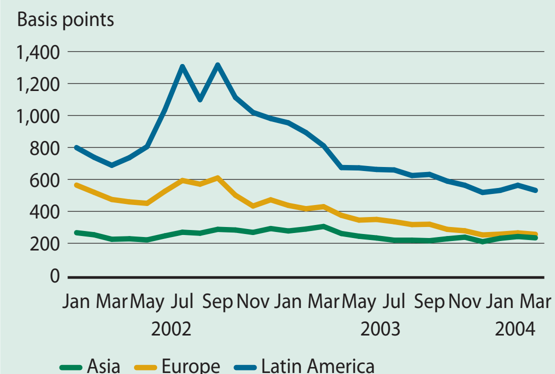
Source: Bloomberg L.P., downloaded 15 March 2004.

Figure 1.10 Euro Benchmark Yield Curve



Source: Bloomberg L.P., downloaded 15 March 2004.

Figure 1.11 Sovereign Risk Spreads, Emerging Markets, January 2002–March 2004



Notes: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. Asia consists of PRC, Malaysia, Pakistan, Philippines, Korea, and Thailand; Europe comprises Bulgaria, Croatia, Hungary, Poland, Russian Federation, Turkey, and Ukraine; Latin America is made up of Argentina, Brazil, Chile, Dominican Republic, Ecuador, El Salvador, Mexico, Panama, Peru, Uruguay, and Venezuela.
Source: Datastream, downloaded 16 April 2004.

Box 1.2 Developing Member Country Access to International Capital Markets

To take advantage of continued low interest rates and very narrow spreads, developing member countries (DMCs) of the Asian Development Bank (ADB), again in 2003, tapped international capital markets, according to Bank for International Settlements (BIS) data. Gross issuance of bonds and notes by market participants amounted to $52.0 billion by Asia and Pacific DMCs (defined in the Box Table to exclude the two offshore centers of Hong Kong, China and Singapore). While only modestly larger than in 2002, issuance in each of the past 2 years was over two-and-a-half times as large as average issuance during 1998–2001. Net issues of bonds and notes for the group amounted to $19.6 billion during the year. Including the two offshore centers, gross issuance by all DMCs was $74.4 billion.

Outstanding international debt securities (by nationality of the issuer) amounted to $177.1 billion at end-2003 for Asia and Pacific DMCs, amounting to about 28% of the developing-country and 1.5% of the all-country (total) outstanding securities debt in the BIS statistics. As indicated in the Box Table, financial institutions were the largest issuers of debt (about 47%) for this group, followed by corporations (about 33%) and governments (about 20%). In relation to GDP, the Philippines has made the largest use of the international debt markets followed by Malaysia and Korea. Including the two offshore centers, total DMC outstanding securities debt was $252.1 billion at end-2003.

International equity issues announced by the Asia and Pacific DMC group roughly doubled in 2003 to $23.7 billion, reflecting strong economic performance in the region and investor interest sparked by the large run-up in stock prices after March both in the region and worldwide. Nearly two thirds of the issuance took place in the fourth quarter, mainly reflecting $7.9 billion from People's Republic of China (PRC) issuers including the much oversubscribed $3.9 billion issue by China Life launched simultaneously in New York and Hong Kong, China. Asia and Pacific DMC issues amounted to about 83% of developing-country and 21% of all-country international equity issues in 2003 in the BIS data. Including the two offshore centers, total DMC international equity issues amounted to nearly $30 billion in 2003. Equity issuance appears to have continued to be brisk in the first quarter of 2004; however, market conditions became tougher as the quarter progressed. Barring some unanticipated event, market commentators expect another strong year, including about $12 billion by PRC issuers.

Source: ADB staff, calculated from BIS data.

Box Table Access by Market Participant to International Capital Markets ($ billion)

Developing Member Country	International Debt Securities by Nationality of Issuer: Gross Issuance of Bonds and Notes		Outstanding International Debt Securities		2003 Debt Breakdown				Announced International Equity Issues by Nationality	
Asia and Pacific	**2002**	**2003**	**2002**	**2003[a]**	**FI**	**Corp.**	**Govt.**	**% of GDP[b]**	**2002**	**2003**
PRC	2.2	5.0	17.2	19.9	11.2	2.2	6.5	1.4	5.4	9.3
India	0.3	0.5	3.5	3.5	1.3	2.2	0.0	0.6	0.3	1.3
Indonesia	1.3	2.2	9.7	9.7	8.6	0.2	0.9	4.7	0.3	1.2
Kazakhstan	0.6	0.8	1.4	2.3	1.5	0.2	0.7	7.8	0.0	0.0
Korea	22.0	21.0	54.6	63.5	37.2	21.3	5.1	10.5	1.5	1.3
Malaysia	7.1	2.4	23.4	23.4	10.6	8.3	4.6	22.7	1.3	0.6
Papua New Guinea	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2
Philippines	7.0	7.6	20.2	24.5	4.3	5.3	14.9	30.5	0.0	0.1
Sri Lanka	0.4	0.0	0.4	0.4	0.1	0.0	0.4	2.2	0.0	0.0
Taipei,China	6.5	12.0	12.4	19.4	4.0	15.4	0.1	6.8	3.1	8.3
Thailand	1.0	0.5	10.9	10.0	4.6	2.6	2.7	7.0	0.1	1.4
Viet Nam	0.5	0.0	0.5	0.5	0.0	0.0	0.5	1.4	0.0	0.0
Subtotal	**48.9**	**52.0**	**154.2**	**177.1**	**83.4**	**57.7**	**36.4**		**12.1**	**23.7**
Offshore Centers										
Hong Kong, China	7.6	17.1	41.7	51.5	36.5	15.0	0.0	32.4	1.4	4.5
Singapore	0.9	5.3	16.8	23.5	16.1	6.9	0.4	26.2	2.1	1.6
Subtotal	**8.5**	**22.4**	**58.5**	**75.0**	**52.6**	**21.9**	**0.4**		**3.5**	**6.1**
DMC Total	**57.4**	**74.4**	**212.7**	**252.1**	**136.0**	**79.6**	**36.8**		**15.6**	**29.8**

PRC = People's Republic of China, FI = financial institutions, Corp. = corporations, Govt. = governments.

[a] May not sum to subtotals due to rounding. [b] Staff estimates.

Source: *BIS Quarterly Review,* March 2004.

up from $128.3 billion in 2002. Net private flows to developing Asia accounted for $116.7 billion, nearly double the amount of $66.3 billion in 2002. Half of this total ($58.3 billion) was financed by direct investment, much of it flowing to the PRC. An improving economic environment and rising corporate profitability led to a surge in portfolio inflows to developing Asia from $2.8 billion in 2002 to $29.4 billion in 2003. Bank and nonbank lending accounted for a further $29.0 billion, up from $6.7 billion in 2002.

The prospects for private capital flows to developing Asia remain bright for 2004. The large foreign direct investment (FDI) commitments over the past few years, particularly in the PRC, should translate into continued strong growth in FDI inflows to the region. India and Thailand should also benefit from larger inflows of FDI in 2004. Estimates by the Institute of International Finance put total FDI inflows to the region at about $62 billion net, with about 85% going to the PRC. The region's stock markets will remain very attractive to investors, though inflows are likely to be somewhat lower than the high levels observed in 2003. In contrast, as yields move up and spreads widen for emerging markets, bond issues might be significantly lower than in 2003. The PRC might also take measures to discourage external borrowing.

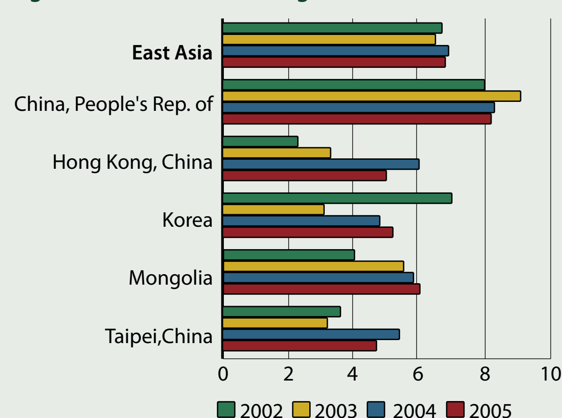
Developing Asia: Subregional Trends and Prospects

East Asia

East Asia's aggregate GDP expanded by 6.5% in 2003, a little slower than in 2002 but a much stronger result than was anticipated during most of 2003 (Figure 1.12). Expectations were relatively low because, in addition to the setbacks in the first half caused by SARS, the weak international economy, and conflict in Iraq, three of the five East Asian economies struggled with deep-seated problems of their own—widespread personal debt delinquencies in Korea; the slide in the Hong Kong, China property market, which did not bottom out until August; and the aftermath for Taipei,China of the ending of the global information technology (IT) boom.

Economic conditions varied between economies in the subregion. The PRC stood out

Figure 1.12 East Asia, GDP growth, %



Sources: Asian Development Outlook database; staff estimates.

with growth accelerating to 9.1%, bolstered by buoyant domestic demand, booming exports, and surging FDI. Hong Kong, China; Korea; and Taipei,China experienced brisk export growth, but their domestic demand was subdued for most of the year. In Mongolia, a recovery in agricultural output and expansion of services more than offset a slowdown in industrial growth. The generally firmer economic growth in the second half of 2003 reduced deflationary pressures in Hong Kong, China and in Taipei,China. In the PRC, concerns about overheating in some sectors prompted government measures to curb credit. Unemployment tended to rise in the subregion during the first half, then started to fall as economic growth picked up.

The prospects for 2004–2005 are bright. Global economic conditions have improved, Hong Kong, China's property market is recovering strongly, IT demand has picked up, and Korea is addressing its household debt problems. Average growth for East Asia in 2004 is expected to increase to 6.9%, the highest rate in 4 years, and to stay close to that level in 2005. One significant development is that rising domestic demand will play an important role in lifting overall growth. While exports will remain strong, the contribution to growth of net exports will probably moderate in most economies because imports will rise as domestic demand increases.

Again, the PRC will stand out with likely growth of 8.3% in 2004 and 8.2% in 2005, on the

back of buoyant domestic and external demand. Strong investment growth will contribute the majority of its overall growth. Consumption will accelerate, supported by rapid urbanization and changing consumption patterns, such as increased demand for higher-quality and a wider variety of goods and services. Growth in exports will slow from the torrid 34.6% pace in 2003, with the result that net exports will contribute little to overall GDP growth in the PRC.

The strong demand from consumers and industries in the PRC will continue to fuel growth in exports from many economies, especially the PRC's neighbors, though rising domestic demand will become the main factor propelling the economies of Hong Kong, China and Taipei,China as robust growth in their imports outpaces still-strong growth in exports.

The importance of exports, however, should not be underestimated because buoyant foreign sales will be a major factor leading to stronger domestic demand. In Taipei,China, for example, strong international demand for IT exports in recent months has raised capacity utilization at exporting firms, prompting them to expand their production capacity. This has laid a solid foundation for stronger investment growth. In turn, the labor market will receive a fillip from the greater production capacity and related construction activity. Increased employment will spur consumer spending. Consequently, GDP growth in Taipei,China is expected to jump by more than 2 percentage points in 2004. In Hong Kong, China, strong exports and a rebound in the property market will boost investment, employment, and consumption. GDP growth in that economy is likely to nearly double to around 6% in 2004, then slow a little to around 5% in 2005.

Korea presents a somewhat different scenario because net exports will continue to be the main driver of growth. Strong exports will increase investment demand, but it might be some time before private consumption growth revives as severe household debt problems have hit consumer confidence. When domestic demand strengthens later in 2004 and 2005, the relative contribution to growth of exports will fade. Korea's GDP growth is forecast at 4.8% in 2004, rising to 5.2% in 2005. In Mongolia, the least developed of the five East Asian economies, further expansion of agriculture and moderate gains in industry and services are projected to lift GDP growth to 5.8% in 2004 and to 6.0% in 2005.

Despite the positive outlook, all of the East Asian economies face policy challenges in 2004. One major challenge for the PRC is to prolong robust growth without causing serious imbalances, some of which emerged in 2003. A lending boom is fueling overinvestment in some sectors and pushing up prices of raw materials. There are concerns that the surge in lending may lead to more NPLs in the already weak banking system. Strong demand for electricity from industry and consumers has caused increasingly frequent power shortages. Economic policies need to maintain the growth momentum, facilitate expansion in sectors that need extra supply capacity, and also curb overheating, as the PRC monetary authorities have started to do by tightening credit.

The functioning of factor markets—labor and capital—requires attention in several economies. High unemployment is especially acute in the transition economies of the PRC and Mongolia. The PRC's rapid growth still is inadequate to absorb surplus agricultural labor, new labor market entrants, and workers laid off from state-owned enterprises (SOEs). Unofficial estimates put the jobless rate at 8%. Much of the unemployment comes from structural changes and cannot be quickly solved through rapid economic growth. Governments faced with such a situation need to ease the adjustment costs through retraining assistance, job creation, and by providing basic social safety nets if they are to maintain broad support for economic reforms. The key, though, is to improve the environment for the private sector to create jobs. Hong Kong, China; Korea; and Taipei,China have also experienced rising unemployment in recent years. Although employment has started to improve, strategies for the longer term require more flexible labor markets, mainly in Korea, and the related issue of training and support for people moving between jobs.

In the capital markets, financial reforms remain incomplete in the subregion. NPL ratios in Korea and Taipei,China have declined because of extensive financial reforms, though in Korea the need for further reforms was demonstrated by failures in risk control and regulation that allowed a consumer credit bubble to build. The

Government of the PRC has a long way to go to strengthen its banking sector. Much also needs to be done to strengthen capital markets and nonbank financial institutions in much of the rest of East Asia.

Fiscal policy issues represent another area for attention in 2004. As growth gathers momentum, the need to use fiscal policy for short-term demand management has lessened. Instead, fiscal policy needs to shift to address the longer-term market failures and structural problems. In the PRC, budgetary resources are needed to tackle issues of poverty, structural unemployment, inadequate education and health care in rural areas, a weak social security system, a deteriorating environment, and underdevelopment of the central and western regions. In Taipei,China, rising public deficits and debt have raised questions about the adequacy of tax revenues. The bursting of Hong Kong, China's property bubble exposed the vulnerability of its land-based revenue system and the authorities are considering changes to this system.

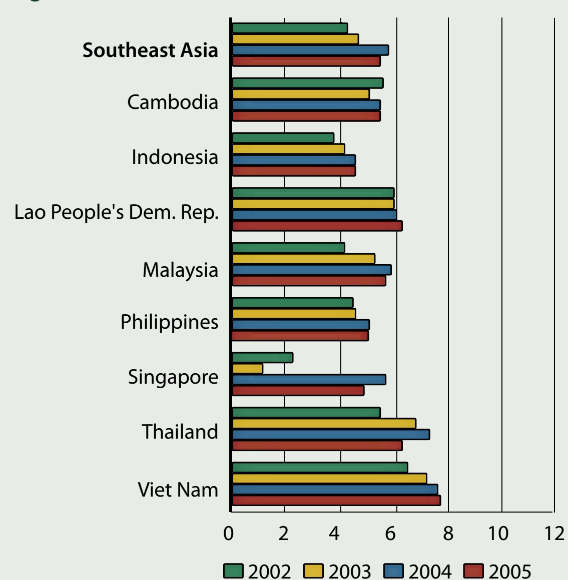
Subregional governments should also consider further measures to deal with poverty. Although the PRC's rapid growth has lifted millions out of poverty, eliminating absolute poverty remains a distant goal, and in Mongolia, poverty incidence is still high. They also need to tackle rising income inequalities, which have been widening in most of the subregion.

East Asia remains a dynamic region with a better record than most in terms of facing up to policy challenges. It is likely do so again, which will alleviate the risks emanating from the domestic factors as well as those from external events.

Southeast Asia

Despite a series of external shocks, aggregate GDP for Southeast Asia expanded by 4.6% in 2003, more than half a percentage point faster than anticipated (Figure 1.13). Thailand and Viet Nam posted particularly strong and broadly based growth. In Cambodia and the Lao People's Democratic Republic (Lao PDR), growth remained relatively robust. Malaysia's economy, the second highest in per capita income in Southeast Asia, pursued its recovery, growing well above the subregional average. GDP growth remained moderate in Indonesia and the Philippines, though improving somewhat relative to 2002. In contrast,

Figure 1.13 Southeast Asia, GDP Growth, %



Sources: Asian Development Outlook database; staff estimates.

Singapore's economy hardly grew as major structural changes dampened domestic demand. It was also the most affected by the SARS epidemic.

A key feature of the 2003 performance is that, in all countries (with the notable exception of Singapore), consumption expenditures, particularly private consumption, contributed the most to GDP growth. The continued strengthening of consumption in 2003 was fueled by generally accommodative monetary policies, combined with moderately expansionary fiscal policies. The fiscal stimulus was more aggressive in Malaysia where government consumption expanded rapidly. In Thailand, expenditures in rural areas were further boosted by off-budget programs. Strong growth in remittances supported consumer spending in the Philippines.

In a worrisome development, the 2003 outcome showed continued weakness in business investment in most Southeast Asian countries. The notable exceptions were Thailand and Viet Nam. Weak investment in the other countries stemmed from a variety of reasons, including remaining excess capacity, political uncertainties linked to elections in 2003 and 2004 in several countries, and uncompetitive investment climates checking FDI.

The acceleration of recovery in many

industrial countries as well as the huge increase in the PRC's demand for regional imports spurred strong export growth in many Southeast Asian countries in 2003. Despite the upward pressure of buoyant consumption demand on imports, net exports also contributed substantially to overall growth in most countries. (The only reason for Singapore's growth in 2003 was the contribution of exports.) Exceptions were the Philippines and Viet Nam: in the Philippines, some major exports such as electronics and garments turned in a lackluster performance, while in Viet Nam, despite a surge in exports, imports increased faster due to high demand for capital and intermediate goods by a fast-growing industry sector. Strong growth in the PRC and rapidly rising production-sharing in developing Asia has spurred the export growth of Southeast Asian countries to the PRC (Box 1.1). Exports of the subregion to the PRC accounted for 6.4% of exports and expanded by an average 59.1% in 2003.

GDP projections for Southeast Asia indicate an acceleration in growth to 5.7% in 2004, moderating somewhat to 5.4% in 2005. Prospects for all countries will improve, as in addition to domestic factors, the global outlook will be the most favorable in many years, benefiting the export-oriented economies of the subregion, though robust growth will largely emanate from the two best performers in 2003, namely Thailand and Viet Nam. The Lao PDR and Malaysia will also grow at just above the subregional average. A firm recovery should take hold in Singapore as measures to reduce the cost of business and to improve productivity and competitiveness start to show an impact. However, despite some improvement, growth will remain subdued in the Philippines and more so in Indonesia.

Consumption, particularly private consumption, will strengthen its position further as the main driver of growth in all countries. Supportive macroeconomic policies pursued in 2003 are expected to continue in 2004–2005, mainly in the guise of accommodative monetary policies. Consumption will also be supported by the sustained per capita income growth since 2002 in most subregional countries as well as by high commodity prices, while spending for 2004 elections in Indonesia, Malaysia, and Philippines will provide a further boost.

The wide diversity in growth performances among the countries of Southeast Asia over the forecast period can be traced to significant differences in investment expenditures. As in 2003, investment performance, though improving somewhat, will remain relatively weak in Indonesia, Philippines, and, to a lesser extent, Malaysia in 2004–2005. This trend can be observed both from the contribution of investment to growth and from low or falling investment ratios in these countries.

As restructuring of its economy proceeds and its cost structure is reduced, Singapore should see a recovery in investment, particularly in 2005. Projections indicate continued strong investment activity in Thailand and Viet Nam. A stable policy environment and strong domestic and external demand will lead to continued expansion in private investment in construction and equipment in Thailand. In Viet Nam, the private sector will develop rapidly as reforms to further improve the business environment continue. An estimated 19,000 private enterprises have been registered annually over the past 4 years alone. Investment-to-GDP ratios are also forecast to rise well above 20% in Cambodia and the Lao PDR, as the former benefits from increased investment in tourism activities and an improved political environment, and regional investment from Thailand in particular increases in the latter.

A very mixed picture for 2004–2005 emerges from the external sector performance in Southeast Asia. After the recovery in exports in 2003, export growth will settle to somewhat lower rates in 2004 and especially 2005, despite bullish global prospects. (The PRC's import growth rate should also moderate from its surge in 2003.) In contrast, buoyant domestic demand should lead to higher import growth in 2004. The overall current account surplus for the subregion might increase marginally to around $60 billion in 2004–2005 but mainly as a result of a widening surplus in Singapore. Overall, the external sector is forecast to contribute significantly to GDP growth in 2004 in Singapore and Thailand only. In all other countries, contributions will be negative (Philippines) or marginally positive.

Inflation in Southeast Asia will accelerate somewhat over the forecast horizon but remain relatively subdued at an average of 3.6% in 2004

and 3.8% in 2005. It is not a major concern except in Indonesia, Lao PDR, and Myanmar.

Fiscal deficits will remain high in the subregion with projections at 5.8% and 5.6% of GDP in 2004 and 2005, respectively. In most countries, fiscal deficits are a matter of concern and the scope for continued fiscal expansion will be limited over the next 2 years. Government debt levels are also high in Indonesia (55% of GDP), Malaysia (48% of GDP) and, particularly, the Philippines (77% of GDP). The window of opportunity given by a strong outlook should therefore be used by governments to ensure fiscal consolidation. This will better prepare these economies to withstand possible future economic shocks and slower economic growth, and to cope with higher interest rates.

The most worrisome feature of the outlook is the slow pace of business investment forecast for several countries of Southeast Asia at a time when these economies are expected to show more robust growth. These countries will need to substantially boost investment if they are to raise their potential growth rates and remain competitive in an increasingly integrated Asian region. They also need to position themselves to be able to compete with the PRC while being able to export to that country. In all of these countries, policies to improve the investment climate will be of paramount importance over the forecast period. Broadly, these include continued financial sector and fiscal reforms, public administration, trade and labor market reforms, and the establishment of a simple and transparent FDI regime (see Part 3).

Finally, another main concern is that while the growth environment over the next 2 years will be one of the best in a long time, GDP forecast growth in several Southeast Asian countries remains well below their potential, and will be insufficient to generate employment for new labor force entrants. As a corollary, these growth rates will be too low to bring about a significant reduction in the incidence of poverty. Economic growth projections for both Indonesia and the Philippines are of particular concern. The combined population of both countries is significant at 320 million, and unemployment is high and well above the levels in other countries in the subregion. It is estimated that economic growth in these two countries would need to accelerate by 1.5–2 percentage points above the average performance in 2002–2003 to ensure a decrease in unemployment and a significant reduction in poverty. Economic growth projections for Cambodia, too, are well below the pace required to generate sufficient employment in a country where the incidence of poverty is 35–40%. Unemployment is not a major issue in Malaysia, but the economy is forecast to expand below its potential, which is estimated at about 6.5–7%.

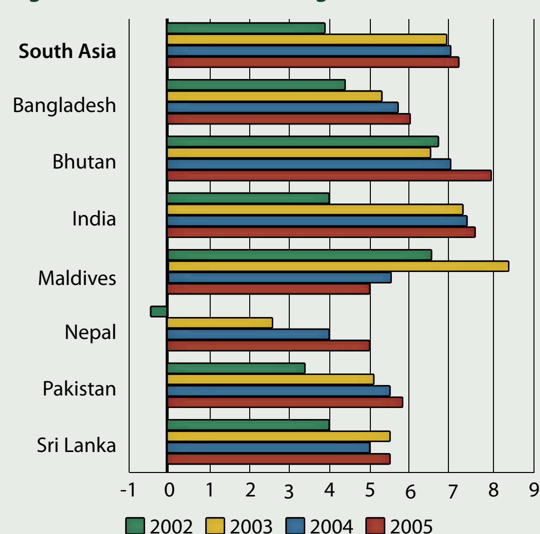
Hence, several subregional countries risk falling behind their competitors unless they aggressively pursue policies to improve productivity and competitiveness. The main challenge for them over the forecast period will be to raise investment substantially.

South Asia

The return of favorable weather conditions generally in South Asian countries in 2003 led to a marked recovery in agricultural output from the very depressed levels of a year earlier. With a relatively large share of agriculture in output and employment, GDP growth for the subregion rebounded to a record high of 6.9%, well above the 5.7% recovery projected in *ADO 2003*, with all countries achieving a more rapid expansion than had been projected (Figure 1.14).

In India (accounting for nearly 80% of the subregion's GDP output) the sharp turnaround in agricultural output (from a contraction of 5.2% to an estimated 7–8% growth in FY2003) combined with a continuing rapid expansion in industry and services pushed GDP growth to an estimated 7.3%. Growth in private consumption nearly doubled from a year earlier and contributed about two thirds of the increase in GDP; expansion of fixed investment continued to be relatively strong. Pakistan also saw a significant upturn in agriculture after 2 years of decline. GDP growth strengthened to 5.1%, the best outcome in 6 years, pushed by net exports that accounted for more than three fifths of the expansion. Faster growth in Bangladesh at 5.3% in FY2003 also reflected a significant pickup in agriculture and private consumption. Despite gains in export-oriented manufacturing, the net foreign balance, generally a positive source of growth, turned slightly negative because of buoyant import growth.

Figure 1.14 South Asia, GDP growth, %



Sources: Asian Development Outlook database; staff estimates.

The first rough estimates of GDP in Afghanistan indicate that the economy is likely to have grown by 20% in FY2003 after a 28.6% gain a year earlier. Following a 3-year drought, grain production increased by about 83% in 2002 and by 62% in 2003. This was a significant boost to welfare as agriculture accounts for about one half of GDP and four fifths of employment. The growth of the opium trade to about one half the size of the legal economy however, providing a large impact on domestic demand and incomes, is a major issue to be faced if Afghanistan is to become a truly secure and stable nation.

In the second year of the cease-fire agreement, Sri Lanka continued to recover from the 2001 recession with GDP in 2003 estimated to have grown by 5.5%. Tourist arrivals rose by over 27% to exceed 500,000, a record, supporting expansion in the services sector that accounted for about two thirds of the increase in GDP. Tourist arrivals also reached a record number of about 560,000 in the Maldives, where the economy grew by 8.4% after 2 tepid years stemming from the downturn in travel after the September 11 events. In Nepal, a cease-fire agreement with insurgents from January to August fostered a moderate economic recovery following the downturn of a year earlier. The trade and tourism sectors rebounded and manufacturing output strengthened, bringing GDP growth to 2.6% in FY2003. Bhutan's economy continued its steady development, growing at 6.5%, though this was a slight slowing from a year earlier mainly due to more moderate construction activity.

Growth in South Asia is projected to edge up from the record performance in 2003 to 7.0% in 2004 and to 6.9% in 2005 with virtually all countries boosting performance. This forecast assumes that the breakthrough cooperative efforts that India and Pakistan started in 2003 to assure peaceful relations are continued and that there is no deterioration in the security situations in Afghanistan, Nepal, and Sri Lanka.

India's GDP growth outlook is buoyant—7.4% in 2004 and 7.6% in 2005. Agriculture is expected to return to trend (3.0%). However, a peaking of industry sector growth in 2004 would be offsetting while expansion of the services sector would continue and provide the fillip in 2005. Despite this remarkable overall performance and the fact that India is becoming one of the fastest-growing economies in the world, it appears that it will not quite achieve the 8% target that the Government has set for rapid poverty reduction.

Pakistan's outlook is also for stronger growth of 5.5% and 5.8%, respectively, in 2004 and 2005. Solid improvement in macroeconomic fundamentals and structural reforms that are boosting investment activity (e.g., to modernize the textile industry) underpin this outlook. The Bangladesh economy has been strengthened by the policies adopted in completing its first-year of the Poverty Reduction and Growth Facility (PRGF) program with the International Monetary Fund. Deepening of reform efforts that would foster greater investment and the availability of additional concessional aid has improved the outlook for growth, which is projected to increase to 5.7% and 6.0%, respectively, in 2004 and 2005. However, the outlook for the garment and textile industry and employment generally in the post-Multifibre Arrangement (MFA) environment is worrisome.

Economic prospects in Afghanistan are promising and annual growth of 15% in the medium term is certainly feasible, though this will require the commitment of the international community to meet the country's investment and security needs.

Sri Lanka's GDP growth is tentatively projected to be 5.0% and 5.5% in 2004 and 2005,

respectively, rates somewhat below those set in the ongoing PRGF program. There are, however, major uncertainties, including the approach to economic policy by the new Government following recent elections, the evolution of the cease-fire and peace negotiations, and developments in the garment and textile industry post MFA. With a full recovery in tourism, growth in the Maldives is projected to moderate to 5.5% and 5.0% in the period ahead. The Government is seeking to expand its tourist marketing effort in new regions, find sources for economic diversification, and stimulate outer atoll development in an effort to reduce poverty.

Despite a breakdown in the cease-fire agreement in August 2003, the security situation in Nepal has remained relatively calm. On the assumption that this situation does not deteriorate, the outlook is for the economic recovery to continue with GDP growth increasing to 4.0% and then to 5.0% in 2005 based on further improvement in trade, tourism, and agriculture. Economic performance sufficient to substantially reduce poverty in the medium term, however, crucially depends on a lasting resolution of the insurgency as well as reconciliation between the Government and political parties over the dismissal of Parliament. In Bhutan strong growth is projected at 7.0% in 2004 and then 8.0% in 2005. A major hydropower project to be commissioned in September 2005 will provide a large step-up in export and budget revenues.

Balance-of-payments developments in South Asia continued to be strong in 2003 with all countries, except the Maldives and Sri Lanka, achieving a current account surplus that for the subregion amounted to 1.1% of GDP. Exchange rates against the dollar were generally stable or slightly appreciated over 2003; foreign exchange reserves substantially strengthened. Reflecting the pickup in the global economy, most subregional countries in 2003 posted double-digit growth in exports and imports while tourism and worker remittances also registered large gains. The outlook is for continued rapid growth in trade and the maintenance by countries of their current account surpluses, though these are expected to moderate; for the subregion as a whole they are projected at 0.4% and 0.2% of GDP, respectively, in 2004 and 2005.

Average subregional inflation increased to 4.9% in 2003 from 3.5% a year earlier, reflecting an edging up in prices in Bangladesh, India, and Nepal. Policies in Pakistan and Sri Lanka aimed at limiting inflation scored successes. While not at excessive levels, inflation in the subregion is appreciably higher than in East Asia or Southeast Asia. The projections for 2004 and 2005 indicate little change in the country pattern or level of inflation at just under 5%. This suggests that monetary policies will have to be tightened if global inflation picks up, particularly if oil prices exceed forecast assumptions, as South Asian countries are heavily dependent on imports.

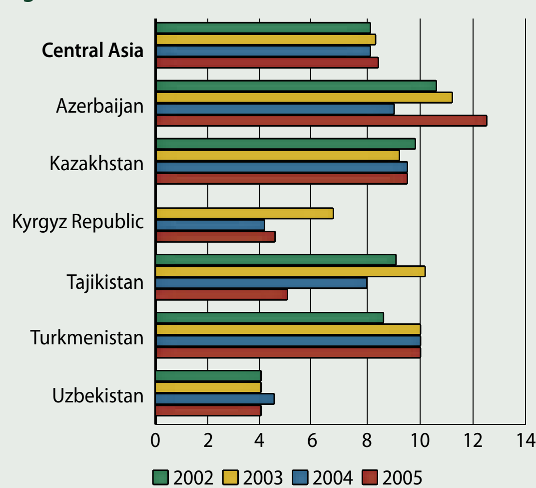
Orientation toward economic liberalization and great reliance on private sector development is now more strongly rooted in subregional country economic policies and this augurs well for strong growth in the medium term. However, the maintenance of outsized fiscal deficits and high levels of government debt in nearly all countries is a source of serious concern. The adoption of fiscal responsibility laws containing specific consolidation objectives in India, Pakistan, and Sri Lanka as well as medium-term fiscal objectives in PRGF programs in Bangladesh, Nepal, and Sri Lanka are important first steps. Firm implementation of fiscal consolidation will, though, be necessary to avoid risk of disruption to the present encouraging outlook for growth and poverty reduction.

Central Asia

GDP growth in 2003 in the six Central Asian republics (CARs) as a group is estimated to have been 8.4%, well above the 5.8% projection made in *ADO 2003* (Figure 1.15). In all countries GDP grew by more than had been forecast. Most of underestimation, however, was due to unanticipated strength in the oil- and gas-producing countries—Azerbaijan, Kazakhstan, and Turkmenistan—but especially in Kazakhstan, which accounts for about 45% of subregional GDP.

Higher than expected oil and gas prices boosted exports and economic activity in these three countries and the very rapid growth rates experienced in recent years were maintained. In Azerbaijan, investment in the oil sector was especially important, contributing just over one half of GDP growth of 11.2%. Kazakhstan saw some moderation in investment but exports were

Figure 1.15 Central Asia, GDP Growth, %



Sources: Asian Development Outlook database; staff estimates.

very strong and a sharp expansion in private consumption supported GDP growth (up by 9.2%) and the first signs of diversification in manufacturing production. Growth in Turkmenistan, where GDP rose by 10.0%, was largely due to continued expansion of energy production and exports.

Outside this group, the Kyrgyz Republic's economy rebounded to grow by 6.7% with a full recovery in gold production (following an accident at the large Kumtor mine in 2002 that stalled the economy that year). In Tajikistan, about two thirds of the economic expansion, where GDP posted 10.2% growth, came from outside the traditional economic pillars—cotton and aluminum—reflecting strong expansion in private consumption expenditure, spurred mainly by an upsurge in worker remittances. Uzbekistan maintained GDP growth at about only 4%, which was well below its potential.

The medium-term outlook—2004 and 2005—for the CARs is quite favorable though little change is expected in the subregion's high overall GDP growth rate—8.1% and 8.4%, respectively—from that in 2003, nor is great change foreseen in the country pattern of economic expansion. The oil and gas sector will continue to drive growth in the three hydrocarbon-producing countries. In Azerbaijan, growth is expected to moderate to 9.0% in 2004 before picking up to 12.5% in 2005 as output from ongoing oil and gas development investment comes on stream. In Kazakhstan and Turkmenistan, growth is expected to be maintained at about 9.5% and 10.0%, respectively. While some weakening in oil and gas prices is foreseen in 2005, an expansion in production volumes should offset this. Kazakhstan will benefit by the phasing-in of production from large projects at Karachagan and Kashagan, while Turkmenistan's outlook is underpinned by new long-term gas contracts with the Russian Federation and Ukraine.

Due to declining gold production (in view of depleting ore reserves) and the absence of any compensating source of economic expansion, GDP growth in the Kyrgyz Republic is expected to slow to 4.1%, but then lift a little to 4.5%, in 2004 and 2005. Tajikistan's GDP growth is expected to slow to 8.0% and then to 5.0% over these 2 years because of capacity limits to expansion in aluminum and cotton production. Growth in Uzbekistan is expected to continue to be relatively low at about 4.5% and 4.0% in 2004–2005, respectively; however, if policy reforms that have begun are accelerated, the outlook could brighten.

Inflation is no longer a central policy issue in the CARs, except for Tajikistan and Uzbekistan. It moderated in four of the six countries with the subregion's average rate declining to 6.9% in 2003 from 10.9% a year earlier, despite upward pressure in the year caused by weather-related poor subregional grain harvests. An unintended loosening of monetary policy was the main reason for a planned reduction in inflation in Tajikistan not being realized. Over 2004–2005, inflation is projected to be moderate in all CARs except Uzbekistan where inflation rates of 20% are forecast due the expected unwinding of the macroeconomic imbalances created in 2003 by the extensive ad hoc measures to stabilize the exchange rate.

In recent years, appropriate macroeconomic and structural policies in most CARs have maintained stability among balance-of-payments outcomes that were responsive to underlying economic forces, except in Turkmenistan and Uzbekistan that extensively relied on direct controls. In 2003, the subregional current account deficit averaged 2.5% of GDP, essentially unchanged from a year earlier. All countries recorded increases in foreign exchange

reserves. The subregional current account deficit is projected to increase to about 4% of GDP in 2004–2005, but is expected to be fully financed by capital flows.

The CARs, all of them countries in transition to market economies, have made varying degrees of progress in their reform efforts. Kazakhstan, with a per capita GDP of $1,510, has made the greatest progress in the transition by early adoption of structural reforms and sound macroeconomic policies. In 2003, it adopted an Industrial and Innovation Strategy to 2015 that targets 8% growth in manufacturing activity that will help deepen economic diversification and maintain growth momentum. Agriculture is one of the priority sectors in the strategy and large planned budget allocations for the sector (2–3% of GDP in 2004–2005), in combination with a recently passed Land Code, are expected to have a favorable impact on employment and poverty reduction.

Azerbaijan (per capita GDP $710), Kyrgyz Republic (per capita GDP $290), and Tajikistan (per capita GDP $180) have all now formulated medium-term poverty reduction and growth strategies that include broad structural and institutional reform agendas. The countries have PRGF economic programs with the International Monetary Fund and their development efforts are being supported by ADB, the International Bank for Reconstruction and Development, and bilateral donors.

Azerbaijan has enjoyed impressive oil-led economic growth in the past 5 years, though this resource is limited and it will be essential to translate oil-boom savings into sustainable economic growth and poverty reduction. Good progress has been made in fiscal and monetary reforms and macroeconomic performance has been strong. However, actions are still needed to implement the second phase of agricultural reform and to overcome obstacles to development of the non-oil private sector, including enhancing competition, enforcing property rights, and ending cumbersome licensing procedures.

The Kyrgyz Republic has also achieved macroeconomic stability and put in place a broad range of structural reforms to lay the basis for a market economy. A sustained farm sector-led expansion since 1996 has significantly reduced poverty, based on mutually reinforcing agriculture sector reform and a high level of public investment. Even though 2003 saw completion of bilateral negotiations under Paris Club understandings, external debt at about 100% of GDP poses a significant constraint on development. Growth that is sufficiently high to reduce poverty significantly will require new sources of growth, improved public resource management, easing of trade barriers, and enhanced subregional cooperation to diversify exports and, probably further external debt restructuring.

In the 6 years since the agreement that ended its civil war, Tajikistan has recorded strong growth based on recovery in cotton and aluminum production, though weak institutional capacity, deficiencies in the legal structure, and an underdeveloped financial sector are among the constraints that hamper investment and private sector development. Moreover, a large external debt has meant that public sector investment is limited and must be entirely financed by concessional assistance. Despite daunting reconstruction and development obstacles, policy efforts are focused on strengthening fiscal performance and reducing the quasi-budget deficit in the energy sector, containing inflation, and pursuing needed structural reforms.

Turkmenistan has relatively high income (per capita GDP $1,200) largely due to energy production and export. Poverty is limited as the Government guarantees employment and can subsidize or freely provide many basic consumer items. The Government also maintains highly centralized economic management, resulting in limited private sector activity. Although immediate growth prospects are good, investment resources are being put into projects of questionable economic and social value, and strains in the economic system are apparent—such as little diversification of production, deterioration in the education and health care systems, and a highly depreciated black market exchange rate.

Uzbekistan (per capita GDP $450) is largely dependent on its agriculture sector, especially cotton production. Economic reform has been limited and gradual while growth and investment have been sluggish. The Government achieved current account convertibility in 2003 as part of its medium-term effort to attract greater FDI and liberalize trade; however, significant economic imbalances were built up in stabilizing

the exchange rate. Reforms to date in agriculture are expected to underpin growth of about 4% in the period ahead, though implementation of announced policies, including withdrawal of government participation in the economy, could raise long-term growth rates to 7–8%.

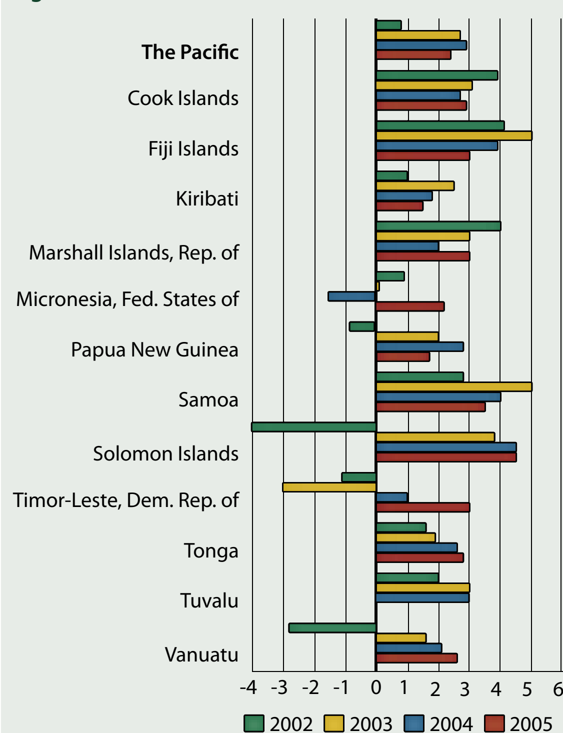
The Pacific

The economic performance of the Pacific subregion in 2003 was generally good, as the aggregate GDP growth of the Pacific DMCs (excluding the Republic of Palau, which joined ADB on 29 December 2003) was an estimated 2.7%, with increases ranging from 0.1% (Federated States of Micronesia) to 5.0% (Fiji Islands and Samoa). Only Timor-Leste registered a contraction (3.0%), which resulted mainly from drought and the scaling down of the postconflict international presence. Growth in the Pacific DMCs also benefited from high international prices for their primary commodity exports.

Papua New Guinea especially, benefited from higher oil, gold, and copper prices (Figure 1.16). Primary production grew rapidly in Solomon Islands, which emerged from 4 consecutive years of contraction, as the arrival of a multicountry regional assistance mission in July 2003 helped restore law and order. Tourism bounced back across the subregion, stimulating the services sector and investment in infrastructure, particularly in the Fiji Islands. The weak international financial markets resulted in fluctuating returns for the Kiribati and Tuvalu trust funds, although a certain strengthening was registered toward the end of the year. In line with faster economic growth and increase in domestic demand, labor market conditions generally improved and inflation accelerated to an average 7.4% in the subregion.

Fiscal outcomes varied considerably among countries. In Papua New Guinea, revenue collection was on target, but expenditure restraint was required to minimize the need for domestic borrowing and the consequent pressure on interest rates. The fiscal deficit exceeded the budget in the Fiji Islands, due to unanticipated expenditures and a failure to realize planned asset sales, despite strong revenue collection. Expenditures were uncontrolled and misallocated in Solomon Islands, but a considerable effort to regain control was made with the arrival of an Australian budget stabilization team in the latter part of the year.

Figure 1.16 The Pacific, GDP Growth, %



Sources: *Asian Development Outlook* database; staff estimates.

External accounts showed substantial variation in 2003. While export growth was generally positive, import growth was erratic; currency trends and earnings from tourism determined disparate outcomes in the accumulation of international reserves.

Political uncertainty and poor governance continued to hamper growth in several countries. The Pacific Islands Forum, the main regional cooperation body, is paying increasing attention to ways of pooling resources in the areas of governance, air transport, security, and international crime. A gradual move toward freer trade in the subregion occurred with the entry into force in April 2003 of the Pacific Islands Countries Trade Agreement, signed by 14 members and covering a 10-year implementation period.

At the national level, the main policy focus in the majority of countries was on maintaining macroeconomic stability through sound fiscal management as a key condition to encourage

private investment and economic growth. Efforts to consolidate gains from implementation of economic and public sector reforms varied in intensity and effectiveness.

Based on further improvements in the tourism sector and continued strong commodity prices, economic growth is forecast to continue at a relatively fast pace in 2004 and 2005, at least by historical standards. GDP in the subregion is expected to increase by 2.9% in 2004 and by 2.4% in 2005, while inflation is projected to slow to 5.6% but then increase to 6.0% over this period. These trends are essentially determined by projections for Papua New Guinea, by far the largest economy in the Pacific. While expected medium-term growth and inflation rates represent improvements from the trends of the last few years, creating jobs in the formal sector will remain a major concern, as almost all economies are unlikely to be able to absorb the net increase in labor market entrants, with high youth urban unemployment leading to potential social unrest. Aside from adverse external shocks, the main risk to the growth forecasts rests with the evolution of the internal political conditions and the capacity of local institutions to build up a climate of stability to boost business confidence.

With regard to policies, all Pacific DMCs are struggling with fiscal governance and public administration reform issues, the need to create an environment enhancing private sector development, and the necessity to improve local capacity and institution building. A prerequisite for attracting investment and boosting the private sector is bringing about an effective system for land-titling registration, which, given the general shortage of land and customary traditions in the Pacific, is not easy to achieve. External assistance, with an increased focus on participation and self-reliance, continues to play a crucial role for economic development and poverty eradication in the subregion.

Risks to the Outlook for Developing Asia

ADO 2003 and *ADO 2003 Update* identified three sets of risks for developing Asia: geopolitical, SARS related, and global economic. The geopolitical risks associated with the threat of terrorism remain, unfortunately, very much a reality for developing Asia, while the end-2003 and early-2004 outbreak of an avian flu epidemic has been a clear reminder that epidemics will continue to be a major risk for Asian economies. Enhanced regional cooperation is of paramount importance in containing the human and economic impact of such epidemics. Global economic risks have not abated, and they essentially pertain to the sustainability of the economic recovery in major industrial countries and to world economic imbalances. While developing Asia is increasingly playing a major role in the global economic context, developments in major industrial countries remain very important to the regional outlook. Imbalances in the recovery of industrial countries hold significant risks for Asian economies.

ADO 2004 adds a new set of economic risks that are more specifically regional. They are linked to rapidly increasing regional economic interdependence itself. The surge in intraregional trade has been a major positive development for the region, but it also carries with it these new risks.

Global Economic Risks

By the first quarter of 2004, and for the first time since 2000, a broad and robust economic recovery appears to be under way globally, led mainly by the US and developing Asia. In Japan, the economic pickup was deepening while in the euro zone some signs of improvements were also apparent. In spite of rising oil and commodity prices, inflationary pressures remained generally subdued. In major industrial countries, generally expansionary fiscal policies—and a huge fiscal stimulus in the US in particular—together with accommodative monetary policies have fueled the recovery. As a result, since mid-2003, interest rates have all been at historical lows across all maturity ranges while fiscal deficits have been widening particularly in the US. Room for further macroeconomic stimulus appears to have hit its limits.

Behind this upbeat picture of the world economy, there are however significant imbalances and risks, which could threaten economic performance over the forecast period. In the nearer term, the major concern is the uncertain employment situation in the US. While employment data released in March 2004 appear to indicate a revival in the labor market, uncertainties remain. If the improved job market

outlook is not confirmed over the next few months, consumer spending could be negatively impacted, and US growth would slow. The strengthening of labor markets in industrial countries, and with it the broadening of the expansion, is particularly crucial as the current stances of macroeconomic policies are not sustainable over the medium and longer term, especially in the US.

Monetary policy will have to be tightened within the next year, first in the US and later probably in the EU. The current extremely low interest rate environment cannot be maintained for several reasons. First, rising oil and commodity prices together with a prolonged period of production growth in the world economy will put upward pressure on inflation. Second, low interest rates have led to a ballooning of household debt—at over 100% of disposable income in the US—and the possible emergence of asset bubbles. Finally, the increasing burden of financing the US fiscal deficit will put upward pressure on interest rates, particularly if Asian central banks scale back their purchases of US debt (as is likely over the forecast horizon). While the timing remains very uncertain and looks still some time off, the rate increases will have a very significant impact on bond markets, financial markets, and asset prices.

The severity of the impact will crucially depend on the quality and depth of the recovery at the time, particularly in terms of employment and income generation. Investor and consumer perception of the depth of the recovery will determine the financial markets' responses to rate increases. Weak sentiment could create significant volatility in financial markets, and in fixed income markets in particular—as seen in June–July 2003—pushing long-term interest rates substantially higher. Costlier debt repayments would directly impact highly leveraged households and corporations. Real estate markets would be affected across industrial countries, and government borrowing costs would jump. The upshot is that the circumstances and imbalances characterizing the current economic recovery make the necessary adjustments to tighter macroeconomic policy particularly delicate and uncertain. A period of low growth in industrial countries with inflation and real interest rates both higher is a definite possibility.

Two major imbalances that do not appear to overly concern the markets so far could exacerbate the above outcome over the forecast horizon: the US fiscal and current account deficits. First, under present policies, projections indicate that the US will be running a very large fiscal deficit for a long time. Over the longer term, the burden of financing the needs of aging populations in industrial countries will also put pressure on national budgets. As interest rates rise, markets might start factoring in more strongly the prospect of financing widening fiscal deficits. This would tend to push up further long-term interest rates.

Second, while financial markets have not shown much concern about the US current account deficit so far, this situation may change. As monetary policies are tightened, greater volatility in financial markets amid rising interest rates could spill over into greater dollar exchange rate volatility. Markets could start evaluating more closely whether a visible correction of the US current account is under way. A number of outcomes are possible. A very large depreciation of the dollar itself will not suffice to narrow the US current account deficit. A compression of US demand will be needed to reduce imports, and hence the likelihood of a low growth period with higher interest rates. However, the negative impact of this outcome could be substantially mitigated if global growth is more broadly dispersed across countries. The implications are that growth needs to accelerate in industrial countries other than the US, and that more flexible exchange rate policies need to be followed, particularly in Asia. A worst-case scenario would be for governments to seek adjustments through a sharp rise in trade protectionism.

It is obvious from the above analysis that there is a large degree of uncertainty associated with the adjustment process that the global economy needs to go through over the next 2 years. For developing countries in Asia, it is important to evaluate what this negative outcome could be. It is also important to realize that, increasingly, developing Asia is an intrinsic part of the adjustment process. A smooth adjustment in the global economy will greatly benefit from continued strong growth and the pursuit of pragmatic economic policies in the region.

Regional Economic Risks

While, as mentioned, developing Asia is an increasingly important element in shaping global developments, there are a number of risks in the outlook that relate more specifically to the region. In most cases, risks can also be viewed as opportunities—opportunities to cooperate and reform. In fact, the current strong underlying economic growth trends in the region create a unique occasion to turn these risks into opportunities.

Two distinctive and very positive features of economic developments in the region over the past few years have been the emergence of intraregional trade as a major driver of growth and the increasing importance of domestic consumption demand in many countries. These features could become even more important if the recovery in major industrial countries were to falter. While these developments are positive elements in the medium-term outlook for developing Asia, they also inherently carry risks to regional growth as the interdependence among the economies of the region is becoming stronger (Table 1.3). Managing the concomitant risks is creating new challenges for policy makers as their national policy decisions are increasingly impacting on other countries in the region.

Among the regional risks that also have substantial global implications, an overheating of investment in the PRC is probably the most important. The phenomenal growth of investment in that country could increasingly become inflationary, as prices of raw materials, land, and factors of production other than labor could soar. Already, many commodity prices and transportation rates are being boosted by demand from the PRC. The Government has indeed announced measures to contain overinvestment. However, the situation will have to be closely monitored as the impact of overheating in the PRC could have repercussions on export trade in many other economies in developing Asia. Over the longer term, overinvestment would result in a capacity overhang which would also adversely affect the region. Other major policy challenges in the PRC are well known, and include the need for fiscal consolidation and for financial sector—particularly banking—reforms and SOE reforms. The successful handling of these challenges is extremely important to regional growth.

The shift toward progressively stronger domestic demand-led growth can be welcomed. Household debt levels must, though, be monitored and contained if financial systems, which have not fully recovered from the financial crisis, are not to face a new form of NPLs as well as a new crisis, if income growth slows. There is evidence that, in several Asian developing countries, continued accommodative monetary policies, and the proactive efforts of financial institutions to diversify their earnings base is fueling rapid growth in household debt. Improved regulation and supervision is called for, along with some tightening of monetary policies. The policy dilemma will be to mitigate the impact of higher interest rates on badly needed business investment, which has remained weak in a number of countries, particularly in Southeast Asia.

It is clear that the deepening of financial sector reforms, including the further development of nonbanking financial institutions, remains central to the reform process and sustained high growth in all economies of the region. There is concern that financial sector reforms have been slowing or have stalled over the past 2 years in several countries in developing Asia, partly because stronger growth masks possible problems (such as lack of resolution of NPLs—see following section). High growth thus offers a unique opportunity for accelerated economic reforms; it should not be used as an excuse for complacency.

The huge accumulation of foreign exchange reserves by many countries in Asia over the past 2 years is a striking phenomenon. Reserves are now estimated at $1.3 trillion. As pointed out in *ADO 2003*, reserves in most countries have significantly overtaken short-term debt. While originally the accumulation of reserves reflected the prudent behavior of policy makers, increasingly however, it appears to be fueled by speculative market behavior stemming from rigidities in many of the region's exchange rates. Such a development carries significant risks for the region. First, except for countries with closed capital accounts, capital flows could reverse briskly, sending negative signals about the economies affected, even though the economic fundamentals remained unchanged. Second, and more important, interventions to maintain stable exchange rates against the dollar could result in

significant further increases in domestic liquidity, which if not sterilized—an increasingly difficult task—might lead to unbridled domestic credit expansion and possibly create the conditions for a new Asian financial crisis. Third, the reserves, which are held mainly in the form of US dollar deposits and US treasury bills, are vulnerable to a loss in value as the dollar depreciates. Hence, it might be an opportune time to reassess the policies underlying the large accumulation of foreign exchange reserves in the region.

While countries in developing Asia all face major macroeconomic policy challenges and long reform agendas which, if not tackled, will become risks to their outlook, they all need also to maintain sustainable robust economic growth over the medium and long term in order to generate employment opportunities for large and fast-growing labor forces. In a sense, this is a key risk faced by the whole of developing Asia over the medium term. In this context, countries will need to implement structural reforms to improve their investment climate and competitiveness, and enhance productivity. These reforms will be particularly complex as they are needed at a time when the fiscal situation in many Asian countries needs consolidation. Ensuring greater efficiency of the public sector, competent public debt management, improved corporate governance, and enlightened public-private partnerships will be key policy challenges over the medium term. Again, greater regional integration has given a new dimension to the need for such policies. These issues will be particularly important in 2004 as many Asian economies are holding elections, including Hong Kong, China; India; Indonesia; Korea; Malaysia; Philippines; Sri Lanka; and Taipei,China.

Finally, an issue to be looked at is how much fast-rising consumption demand in some countries reflects rapidly growing income inequalities. This could be a risk to the medium-term outlook, since not only income growth, but also employment generation for large and rapidly growing labor forces will be essential for economic growth to be sustainable. Labor market reforms and measures to lift the skills of the labor force will be critical to address these inequalities, as well as the inequalities between the countries of the region. Economic policies will thus need to emphasize how growth can be socially inclusive, benefiting progressively larger segments of the population. Increasingly, microreforms to foster the development of small and medium enterprises and the establishment of social safety nets will need to be a part of the core policy agenda. Also, in the context of greater participation of people in policy decision making in developing Asia in general, such inclusive growth will be important for people to feel any ownership of the continuing reform process.

In conclusion, the opportunity provided by the next 2 years of robust growth must be used to initiate and sustain a wide-ranging raft of reforms in developing Asia. These reforms should aim to support socially inclusive development, which is essential to rapidly expand the constituency for reform. The sustainability of the reform process and high growth rates hinges on building and broadening this constituency.

Resolving Developing Asia's Nonperforming Loans

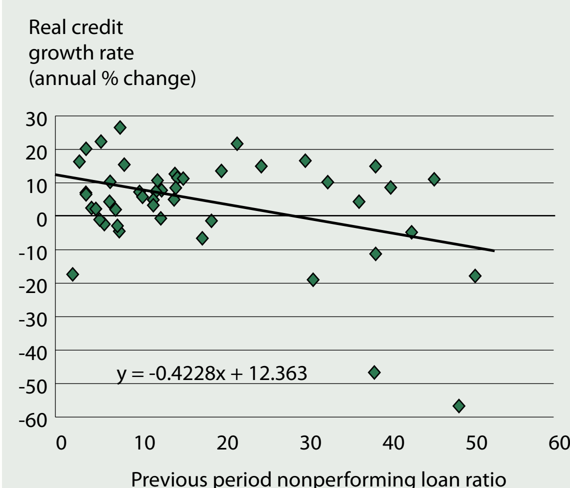
A high share of NPLs can cause systemic risk and possible fiscal liabilities, affecting financial intermediation, investment, and economic growth, as was exemplified during the Asian financial crisis. Public and private sectors in developing Asia have therefore been working to resolve their NPLs and to mitigate the effects of any that may arise in the future. In the face of continuing globalization, further financial sector reforms are vital while macroeconomic conditions are favorable, to minimize problems that future NPLs may cause.

High levels of NPLs were accumulated during the Asian financial turmoil of 1997–98 and led to a banking sector crisis in the economies of Indonesia, Korea, Malaysia, Philippines, and Thailand. That provided a wake-up call to the region to address both its NPLs and the underlying financial sector weaknesses so as to be able to meet the growing challenges of globalization and competitiveness. Seven years on, the health of the banking sectors in the crisis-affected economies is still fragile.

The measures taken to nurture them back to health have varied across countries and no consensus has been reached on the best procedures. Although these countries have been progressing with banking sector reform, in some other DMCs, reform efforts have been more limited and problems may be looming.

NPLs create problems for the banking sector's balance sheet on the asset side. They also create a negative impact on the income statement as a result of provisioning for loan losses. Ultimately, a riskier loan portfolio combined with lower net income makes new lending more difficult, often resulting in slower credit growth (Figure 1.17). In the worst scenario, a high level of NPLs in a banking system poses a systemic risk, inviting a panic run on deposits and sharply limiting financial intermediation, and subsequently investment and growth, in the economy.

Figure 1.17 Correlation Between 1-Year Lagged NPL Ratio and Annual Credit Growth



Note: Sample comprises Bangladesh; Hong Kong, China; India; Indonesia; Korea; Malaysia; Mongolia; Taipei,China; and Thailand for 1997–2002 when data are available.
Sources: National sources (details under Bibliography); Asia Recovery Information Center database, available: http://aric.adb.org; and International Monetary Fund, *International Financial Statistics*, available www.imf.org.

If not properly handled, resolution of NPL burdens can also create moral hazard incentives for banks and borrowers alike. Banks can be lulled by the idea that they can always rely on a centralized asset management company (AMC) to accept transfer of their bad loans, even if these resulted from their own recklessness. Borrowers,

on the other hand, can be made to believe that once their debts go to a government agency that has limited incentive and inadequate legal powers to run after defaulters, then they are essentially freed from their obligation to pay. These moral hazard incentives perpetuate a nonrepayment culture and nonaversion to risk. Consequently, the cycle of bank collapse and recapitalization, of crisis and restructuring, goes on.

Excessive NPLs may also create a contingent or actual fiscal liability resulting from the authorities' efforts to restore stability and solvency to the banking system by actions to reduce the level of NPLs. Public sector costs of these actions include three different components: the cost of government assistance to the banking sector, the quasi-fiscal cost assumed by the central bank, and the direct cost of depositors' compensation. Not all of these costs are immediately reflected in the fiscal accounts because government involvement, in a majority of cases, entails bond issues coupled with relatively small actual cash outlays. While the latter will appear in the current fiscal accounts, bond issues would only be taken into account as the government starts paying interest and principal.

On the other hand, fiscal cost accounting often fails to incorporate income from recoveries of bad loan assets, which can significantly offset the original fiscal expenses, particularly when the assets were transferred to a government-owned agency. Thus, it is difficult to estimate the true cost to the economy of attempting to remedy financial sector instability.

Because of the potential monetary, fiscal, and economic growth implications, governments are usually actively involved in the resolution process, often injecting capital into failing banks and setting up special AMCs. This chapter reviews recent developments in the resolution of developing Asia's NPLs. Recent trends are presented first, followed by a discussion of efforts to resolve the bad loans and the related costs involved in several groups of developing Asian economies. Finally, measures to prevent the recurrence of an NPL problem in the region are briefly elaborated.

Recent Trends

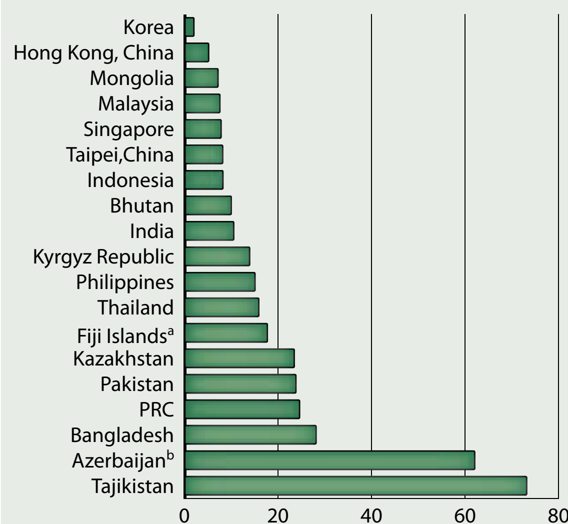
Since the financial crisis, the NPL ratio[1] has generally declined in DMCs, except in a few economies. NPL disposal has made progress—though this is partly because some NPLs have been transferred to AMCs. In Central Asia, the NPL ratio reached its maximum in 1999,[2] when the impact of the Russian crisis was felt in the region.

While no South Asian country has recently experienced anything like that in the crisis-affected countries, tight controls on credit allocation and policy lending during the 1980s and early 1990s resulted in NPL accumulation. As a result, the majority of bad loans in this subregion are explained by policy-directed lending and most are held by public sector banks. Nonetheless, South Asian economies, particularly India and Pakistan, have shown decreases in their NPL ratios to single-digit levels since 1999 due to progress in write-offs and loan recovery, and more stringent provisioning standards that have prompted greater efforts at risk management.

In the 19 DMCs for which adequate data are available, about 17% of the total loan value was classified as nonperforming at end-2002 (Figure 1.18 and Box 1.3). This rate was more than twice as high as in Latin America and Eastern Europe.

Even though the overall NPL situation in developing Asia appears to be improving, supported

Figure 1.18 Nonperforming Loan Ratios of Banks in Selected Developing Member Countries, end-2002



[a] 2001. [b] 1999.
Note: Nonperforming loan classification varies by economy.
Sources: National sources (details under Bibliography); International Monetary Fund.

Box 1.3 Classification of Lending as Nonperforming Loans

Official nonperforming loan (NPL) data often understate the magnitude of the problem because of lenient classification rules, concentration of NPLs in a specific type of bank (state-owned, for example), and exclusion of NPLs that have been transferred to asset management companies. Transferring NPLs may not affect systemic risk in the banking sector but can create actual or contingent fiscal liabilities.

The accepted international standard for classification of loans as nonperforming is 90 days or more overdue. At least until the impact of the Asian financial crisis, institutional weaknesses in banking supervision in developing Asia negatively influenced loan classification significantly (except the two economies of Hong Kong, China and Singapore). Loan classification was not implemented systematically, or only vague rules existed in most developing member countries. This situation has, though, changed somewhat:

- Indonesia, Korea, Malaysia, and Thailand revised their classification rules to accord with the international standard during or after the crisis.
- The PRC revised its classification rule from 180 days to 90 days in January 2002. However, implementation is not consistent across banks, and obscures the accuracy of statistics.
- In Mongolia, loan classification was brought to the international standard only in December 2000 despite a large amount of NPLs and a series of banking crises. Before 2000, classification was inconsistent and automatic loan rescheduling was prevalent.
- Some South Asian countries do not classify loans until 180 days overdue. Pakistan revised its rule to 90 days in 1992, and India in 2004.
- Central Asian countries tend to classify loans at just 30 days overdue, yet implementation is not consistent across banks.

Source: ADB staff.

by active resolution schemes including the establishment of AMCs, there are still high levels of NPLs in some countries (i.e., 20% or more) and adverse trends in others.[3] This situation reflects cases where resolution schemes and banking supervision may not be working properly. Another and more important cause is that banking sector reform has been limited and banks are creating more NPLs while disposing of the old ones. Countries where this may be a concern include Bangladesh, People's Republic of China (PRC), Pakistan, Philippines, and some Central Asian republics.

In countries with large NPL ratios (Bangladesh, PRC, Pakistan, and some Central Asian republics), NPLs tend to be concentrated in public sector banks, mainly resulting from substantial loans provided on other than commercial considerations. The PRC's NPLs, for example, are concentrated in the state-owned commercial banks as a result of the "transfer to loans" scheme, which was launched in the 1980s. This scheme aimed to route state budgetary allocations to SOEs through the banking system. As a consequence, the financial system's vulnerability in the PRC became increasingly evident in the late 1990s. The recent decline in NPL ratios in the countries where they are high has been mainly driven by the transfer of NPLs to AMCs, except in Bangladesh where there is no AMC so far. In the case of the PRC, the decline was also driven by the recent rapid increase in total loans. Slack loan-loss provisioning and strict rules for writing off bad debts, combined with quota controls and requirements for prior Ministry of Finance approval, have led to only modest debt write-offs so far in the PRC.

Meanwhile, the Philippines NPL ratio has trended upward. The country did not have an NPL problem of similar magnitude to the other crisis-affected countries at the onset of the crisis in 1997, and thus no centralized AMC was established. A legal framework for the establishment of private AMCs, the Special Purpose Vehicle Law, was signed in 2003, but no transactions have yet taken place under the law.[4] Major factors hindering the resolution process include the high cost of setting up an AMC and the limited investor base.

Nonperforming Loan Resolution in the Crisis-Affected Countries

Before the crisis, supervisory agencies in the crisis-affected countries had relatively lax regulations in terms of provisioning standards and loan classification, as well as accounting procedures.

While international best practice recommends 90 days overdue for substandard loans, these countries allowed up to 6 months nonpayment before loans were classified as substandard. Loan-loss provisioning was lenient, often allowing zero provision for substandard loans. Capital adequacy requirements were likewise below the international standard of 8%, raising the risk of insolvency. The result of these lax regulations was a weak loss-absorption capacity among banks, leaving them highly vulnerable to economic downturns and corporate debt defaults.

In terms of institutions, Indonesia, Philippines, and Thailand had outdated bankruptcy laws and low judicial efficacy compared with those of Korea and Malaysia. Generally across DMCs, the existing legal regime at the onset of the crisis was outmoded and had not been significantly adapted to more modern financial conditions. Such structural weaknesses, together with high corporate indebtedness and the mismatch between local currency deposits and foreign currency loans that resulted partly from weak financial surveillance, made financial systems in developing Asia highly vulnerable to a loss of confidence.

At the start of the banking crisis, governments gave blanket guarantees on bank deposits while central banks provided liquidity support and closed or merged nonviable financial institutions. Loan classification was tightened and provisioning standards increased to improve proper assessment of bank vulnerabilities. In mid-crisis, efforts at bank recapitalization, purchase of NPLs, more mergers, and temporary nationalizations were carried out. Even after all this, what still required the attention of financial and central bank officials was the problem of resolving the huge amount of NPLs that remained on the banks' books or that had been purchased through newly created AMCs.

The creation of AMCs was not the only important response to the banking crisis, but in time it proved to be central to most country strategies for the revitalization of the banking system. Indonesia, Korea, Malaysia, and Thailand each established a centralized AMC to purchase, restructure, and dispose of NPLs from banks and other financial institutions, and instituted informal mechanisms for corporate debt restructuring. Nearly 7 years since the onset of the crisis, some of these "crisis-created" institutions have already ceased operations, like the Jakarta Initiative Task Force and Malaysia's Corporate Debt Restructuring Committee. Likewise over the next 2 years, a couple of the AMCs will reach the end of their mandates.

Since 1997, the crisis-affected countries have spent billions of dollars in terms of liquidity support (ranging from $9 billion to $24 billion), recapitalization of financial institutions (ranging from $8 billion to $45 billion), closures, purchases of NPLs, and establishment of new government institutions to address financial sector problems.

A back-of-the-envelope computation of costs for banks and governments in connection with resolution of debts alone shows that further combined costs of cleaning up NPLs from the banks and AMCs can still range from 4% of GDP (Philippines) to 13% (Thailand) despite the fiscal costs already incurred of between 16% of GDP (Malaysia) and 55% (Indonesia) (Caprio and Klingebiel 2003).[5] These calculations assume that an NPL ratio of 5% remains in the banks, while the excess bad loans are completely written off. The magnitude of further costs for revitalizing the banking sector clearly depends on the effectiveness of asset recovery by banking institutions themselves and by the AMCs. The computation does not incorporate further costs associated with increasing bank capital for viable banks that remain below minimum capital requirements.

In the crisis-affected countries, deficiencies in national legal and judicial frameworks, particularly inadequacies in foreclosure and bankruptcy procedures and inexperienced judges, have been major obstacles in the bank restructuring process. A crucial element in these bankruptcy procedures is the protection of creditor rights. Modifying bankruptcy laws in these countries helped, but protection of creditor rights is not about bankruptcy laws per se, but about perfecting titles, registries, and court administration (Kawai 2001). These aspects cannot be dealt with overnight. Training expert court personnel and administrators, accountants, and other professionals who work on loan restructuring and disposal to be familiar with international best practice takes longer than redrafting laws. Still, the improved regulatory environment was an important step to prevent or limit potential future financial crises.

In addition, government resolve is highly

important and has a significant impact on the effectiveness of any loan disposition strategy. In Korea, the Government's acquisition of Daewoo and its forcing of several other *chaebol* into receivership served as an indication that it was serious about restructuring. This convinced other companies of the need to cooperate with creditors in out-of-court workouts, since creditors had the ability to overturn management through receivership. This was mirrored to a certain extent in Malaysia, with coherent and consistent policy and institutional support that facilitated financial and corporate restructuring. In sharp contrast, the inconsistent approach by the governments of Indonesia and Thailand caused negotiations to drag on, leading to ineffective restructuring of large corporations.

Nonperforming Loan Resolution in India; Pakistan; and Taipei,China

A second group of economies presents an interesting alternative. India, Pakistan, and Taipei,China share the same characteristic that, though none of them has yet experienced a full-blown banking crisis like those above, they may face one if the authorities are unable to forestall a crisis using preemptive financial reforms.

What is common in the banking systems in these three economies is that the pressure of globalization and ensuing liberalization brought latent inadequacies of the financial sector to the surface. Low capitalization ratios, limited expertise in risk management, an increased volume of loans turning sour, plus inadequate banking supervision and regulation were among the main problems uncovered when the authorities finally embarked on financial liberalization. Yet many of the problems can be traced to years of government intervention in the financial sector.

In both India and Pakistan, for many decades the banking system was tightly controlled—from credit allocation to pricing and other investment decisions—by the finance ministries and central banks. High government fiscal deficits crowded out private investment, and political interference in the banking system led to a broad-based lack of adequate risk management. That no private sector financial crisis has yet affected India or Pakistan on the same scale as that discussed above is largely due to their relatively closed capital accounts as well as to high domestic confidence in the ability of those governments to bail out banks. The situation in Taipei,China is more akin to that of the five crisis-affected economies—as well as Japan—where a very open capital market created pressures on the banking system. Further, volatilities in real estate and equity prices adversely affected banks' asset quality and led to the growth of NPLs.

NPL ratios are reaching all-time highs in these three economies, even as the reported figures are still thought to underestimate the actual levels. A study of Taipei,China found that, using the threshold indicators approach of the early warnings literature, close to 70% of the macroeconomic indicators already signal a banking crisis.[6] Major reform efforts are under way, however.

Reforms in the early 1990s essentially made India and Pakistan go through the process of transition from government control to a situation in which banks were left relatively on their own to contend with market forces. Though directed lending has not completely disappeared, it has somewhat abated due to the reductions in interest rate subsidies and sectors that are considered "priority" sectors. In India, 45% of bad loans stem from directed lending and are mostly held by public sector banks. In Pakistan, 90% of total bad loans are loans of government banks, which historically granted loans at government behest and which in general performed much more poorly than private sector banks. Stringent provisioning standards, however, have helped bring down the net NPL ratio steadily to the present single-digit levels in both India and Pakistan.

Supervision and regulation have been tightened in both countries. Loan classification and tighter accounting rules were introduced during the reforms in the early 1990s, but while India paced the adoption of tighter classification up to March 2004, Pakistan made the bad loan classification more stringent at 90 days overdue in 1992.[7] Thus, the higher NPL ratios of Pakistan mask great progress since it started financial reform. An increase in the minimum capital requirements has also forced consolidation of banks in Pakistan, and upgrading of capital adequacy requirements to international standards has led to strengthening bank capitalization. Only eight out of 40 banks are now undercapi-

talized in Pakistan, and five of those are considering mergers with other banks. Furthermore, mandatory rating from an independent and reputable credit rating agency has been adopted to introduce greater transparency in bank affairs.

Also in Pakistan, a centralized asset management company, the Corporate and Industrial Restructuring Corporation (CIRC) was established, while in India, private AMCs or asset recovery companies (ARCs) are appearing on the scene. Pakistan's government efforts at reforming the bankruptcy regime have somewhat stalled, while India's legal framework is now strongly pro-creditor.

Despite many years of financial reform, the banking system in both countries remains relatively inefficient. In Pakistan, for example, despite many improvements in regulation and the privatization program, cost ratios remain high and the bank spread has increased. One reason is the high level of NPLs that need to be provisioned against and that, therefore, increase the cost of bank operations. Another reason, also shared with India, is that labor unions have slowed cost reductions and rationalization of bank branches and employment.

Like India and Pakistan, Taipei,China's banking problem began when it embarked on financial liberalization, which resulted in overbanking and increased competition, eventually leading to a decline in overall credit quality. With financial liberalization, banks' traditional (and safer) clients reduced their reliance on bank borrowings and increasingly relied on direct funding through the equity and bond markets. The decline in banks' credit quality was reinforced by their overdependence on specific sectors, such as real estate, which left them extremely vulnerable to an economic slowdown.

Montgomery (2003) discusses how, during the housing bubble when prices quadrupled between 1987 and 1990 in Taipei,China, the share of loans to individuals also doubled, mostly for financing real estate transactions.[8] With the bursting of the bubble and consequent decline in real estate values, banks' excessive dependence on mortgages affected their asset quality.

As part of the moves toward financial reform and the adoption of international banking standards, Taipei,China's central bank urged banks to reduce their NPLs and provide larger provisions against bad loans, with the target to bring down their NPL ratios to below 5% in 2 years. Banks have also been urged to merge and consolidate to be able to meet capitalization requirements, but because most Taipei,China banks are family owned, there is resistance to do so for nonfinancial reasons. On the other hand, some of the mergers that were prompted by the authorities of troubled, smaller financial institutions with bigger, healthier banks have, in fact, caused the absorbing banks to weaken.

In contrast to the centralized AMCs that most of the crisis-affected economies instituted, the private and decentralized AMCs that are evolving in South Asia and Taipei,China provide interesting test cases of private sector-led bank resolution schemes in Asia. India and Taipei,China are already using decentralized, bank-owned AMCs, rather than a centralized government-funded AMC. In India, all of its AMCs are privately owned; in Pakistan, the AMC is currently government owned although it is scheduled to be wound down to give way to private sector AMCs; and in Taipei,China, a combination of private and public AMCs coexist, with the public AMC aiming to provide floor prices on purchases in the NPL market. Furthermore, by storing and managing the assets long enough, the public AMC aims to provide a softer impact on real estate prices.

Nonperforming Loans in Some Asian Transition Economies

Since embarking on creating a market economy, PRC, Kazakhstan, Kyrgyz Republic, Mongolia, and Tajikistan have had various banking crises, ranging from the less serious, e.g., banking stress involving a large share of NPLs, to dangerously grave, e.g., bank runs and systemic loss of confidence in the banking sector. Studies of banking crises in transition economies have focused on crisis resolution strategies, such as deposit guarantees, recapitalization, mergers and liquidation, as well as the heavy costs of bank restructuring (e.g., Enoch et al. 2002). These studies find that hyperinflation in the wake of transition in some countries actually reduced the real burden of the inherited debt. Consequently, governments were better able to distribute the burden of repayment among shareholders, depositors, and themselves. Moreover, the choice of resolution strategy

depended not only on prevailing macroeconomic conditions but also on the structure of the banking system. In particular, in countries where small banks proliferated as a market economy took hold, liquidation imposed relatively little cost on the broader economy.

The experience of these transition countries suggests that one key issue is the incentive structure for the rehabilitation agency to take over the bad loans. Another important factor is the quality of institutions—particularly the legal framework that governs property rights and commercial transactions between creditors and debtors and that relates to bankruptcy procedures, as well as the knowledge and expertise present in the country's court system.

These five transition economies have had broadly similar experiences in NPL disposal. In the first place, all of them made use of centralized agencies to take over bad loans and carry out their disposal. Likewise, they did not take over all bad loans but left some of them with banks. There are at least two advantages to this: one is to prevent moral hazard (creating a bailout expectation among banks); another is for the banks to develop in-house expertise in carrying out collection methods and individual loan workouts.

The success rates in the different countries are broadly similar. After around 3 years of operation, the PRC's AMCs had a cash-recovery rate equal to 21% of transferred value, Mongolia 17%, and the Kyrgyz Republic 12%. The share of AMC-recovered assets is larger in the PRC, at more than 50%, because of SOE restructuring via debt-equity swaps, which alone amounted to close to 29% of transferred loans. If these are taken out of the equation, the PRC's AMC disposal rate is around 25%, close to the Kyrgyz Republic's 26%. If measured in terms of enterprises that were restructured or sold, at least one of Kazakhstan's AMCs has had a 50% disposal rate.

Future Problems: Reentry and New Nonperforming Loans

The existing NPL situation appears to be improving in most of Asia. Nevertheless, there is a possibility of future NPL problems if underlying conditions in banking sectors do not improve (Box 1.4). For example, some banks and/or AMCs have utilized debt-equity swaps as a disposal method. These practices immediately improve the capital adequacy ratios of banks, but may not lead to sound banking operations, leaving the possibility of more NPLs in the future.

NPLs are a reflection of problems in the banking and corporate sectors. As far as loans are made with poor appraisal and inadequate follow-up and supervision, NPLs are likely to recur. In addition, the NPL situation could be exacerbated if it is combined with external shocks, such as a currency crisis, an unfavorable phase of the macroeconomic cycle, or inadequate political or legal support.

Therefore, it is imperative that policy makers continue their efforts to develop a competitive environment for the financial sector as a whole while the macroeconomic environment is relatively favorable in developing Asia. Major efforts should include:

- Development of capital markets—not only to serve as alternative financing sources, but also to enhance the competitive environment in the financial sector as a whole.
- Improvement of corporate governance of banks—strengthening institutional aspects of banking operations to achieve enhanced efficiency, transparency, and accountability.
- Implementation of appropriate legal frameworks—without efficient enforcement of the insolvency framework, the cost of the NPL problem will be amplified as resolution is delayed. Therefore, both further improvement of insolvency laws and enhanced efficiency of judiciary systems are needed.

Thus, one of the most important lessons from the financial restructuring experience in developing Asia is the need for strong legal and institutional support, accompanied by government resolve to improve the financial system. The role that globalization has played in exposing financial sector weaknesses suggests that financial sector problems could become more acute over the coming decade—unless, critically, governments take advantage of the current macroeconomic buoyancy to address them. The costs of preventing a crisis are, needless to say, far less than the costs of the crisis itself.

Box 1.4 New Nonperforming Loans in Thailand

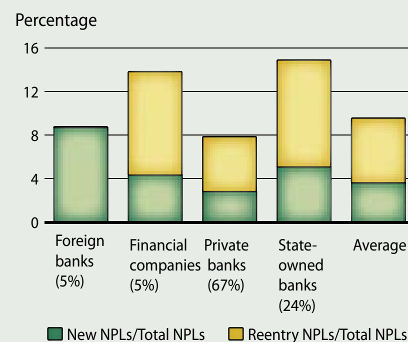
The nonperforming loan (NPL) ratio is net of increase and disposal of NPLs, where the increase of NPLs is the sum of new and reentry NPLs. New NPLs largely reflect banks' lending performance while reentry NPLs reflect inadequate corporate debt restructuring.

The Box Figure presents data for Thailand, and shows that net NPLs amounted to about 10% of the total stock at the end of Q3 2003, comprising 4% new and 6% reentry NPLs. Half of the increases in NPLs occur in private banks (67%).

A breakdown by type of financial institution suggests that reentry NPLs are more significant in financial companies and state-owned banks. New NPLs appear to be more problematic in foreign banks, which account for almost 9% of total NPLs.

Although the overall NPL ratio has been decreasing, the figures once again shed light on the slow NPL resolution in the state-owned banks where reentry of NPLs is prevalent. They also point out risks arising from weak supervision and regulation, which are more obvious in the nonbank financial sector.

Box Figure Thailand, Reentry and New Nonperforming Loans, Q3 2003



Source: Bank of Thailand.

Endnotes

1 This commonly used ratio represents banks' gross loans that are in default or not being fully serviced (i.e., typically past due for 90 days or more) as a share of total loans.

2 The rising trend in the NPL ratio since 2000 (after a spike in 1999) in the Central Asian republics is driven by Tajikistan's particularly high NPL ratio.

3 The limited data availability precludes any precise assessment of the new creation of NPLs.

4 Only one SPV had registered with the Securities and Exchange Commission as of January 2004.

5 Caprio and Klingebiel (2003) also estimate fiscal costs for Korea and Thailand at 28% and 35% of GDP, respectively.

6 See Montgomery (2003), who points out that this share is close to that of Korea a year before the Asian crisis, and higher than that of Japan just before its 1997 banking crisis.

7 India has started classifying loans as nonperforming after 3 months, from the previous 6 months overdue.

8 Nearly two thirds of loans to individuals are for this purpose. Real estate loans constitute more than one third of total banking loans, most of which are to individuals.

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ASIAN DEVELOPMENT

Outlook 2004

Part 2 Economic Trends and Prospects in Developing Asia

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ASIAN DEVELOPMENT

Outlook 2004

Economic Trends and Prospects in Developing Asia

East Asia

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People's Republic of China

The rapid economic growth seen in 2003 will slow in 2004, but still probably outpace the Government's target. Concerned at patches of economic overheating and unbalanced socioeconomic development, the Government has taken steps to control credit expansion and is emphasizing a more balanced approach, with help for rural areas. But the country faces many challenges, including a weak banking system, state enterprise reform, job creation, and poverty reduction.

Economic Assessment

Economic growth accelerated from 8.0% in 2002 to 9.1% in 2003, with quarterly figures showing a V-shaped pattern (Figure 2.1). Fueled by strong domestic demand and buoyant foreign trade, gross domestic product (GDP) grew rapidly in the first quarter of 2003. However, with the outbreak of severe acute respiratory syndrome (SARS), GDP expansion slowed in the second quarter, particularly in services and especially tourism. With SARS brought under control in June, GDP growth accelerated in the second half of the year. While the robust economy reflects substantial reforms associated with World Trade Organization (WTO) accession and the accumulated impact of the proactive fiscal policy of the past 6 years, some signs of economic overheating are causing concern.

On the demand side, investment was the main driver, contributing 6.3 percentage points to growth. (Consumption contributed 3.9 percentage points but net exports subtracted 1.1 percentage points from the total growth figure.) Fixed asset investment soared by 26.7% in 2003, 9.8 percentage points higher than the previous year. Public sector investment, which accounted for 72.1% of total investment, surged by 28.2%, driven largely by local government investment decisions. A rapid expansion of bank lending, continual foreign direct investment (FDI) inflows, and a property market boom were major factors contributing to the investment surge. Supported by a greater volume of housing mortgage loans from commercial banks, investment in real estate grew by 29.7%.

Signs of economic overheating included the extraordinary investment growth rate, rising prices of raw materials, and shortages in some sectors (e.g., oil, electricity, and coal). Power consumption increased rapidly, and 21 out of 31 provinces suffered blackouts in 2003. The State Grid Corporation predicted that power consumption in 2004 would rise to 2,091 billion kilowatt-hours (kWh)—an increase of 207 billion kWh over the 2003 level—and that more provinces would experience power blackouts.

Concerns focused on the possible overinvestment in industries such as steel, automobile manufacturing, aluminum, and cement as well as the rapid rise in bank lending, particularly in real estate. In the fourth quarter, some steps were taken to address these concerns. For instance, the People's Bank of China (PBC) increased the reserve requirement of commercial banks and prohibited them from providing mortgage loans for unfinished properties. The Government also sent several supervision teams to monitor the implementation of these measures at the provincial level.

Domestic consumption was hit by the SARS outbreak in the first half of 2003, but still

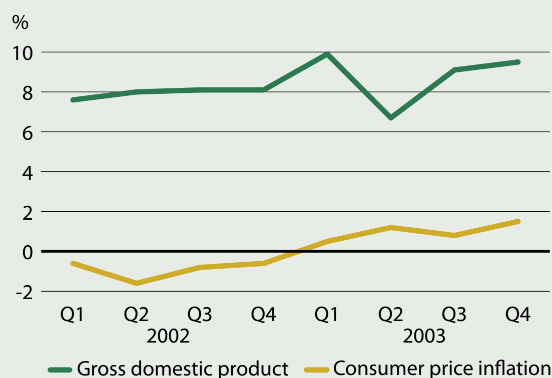


Figure 2.1 GDP Growth and Inflation, People's Republic of China, Q1 2002–Q4 2003

Source: National Bureau of Statistics.

expanded by 8.0% over the year. The growth rate of retail sales dropped in the second quarter but then rebounded in the second half of the year. Sales of private cars and home appliances rose sharply, fueled by higher urban incomes, a rising number of consumer loans, and lower import prices after WTO-related tariff reductions.

On the supply side, GDP growth came mainly from industry (including construction). Growth in value added in the sector accelerated to 12.5% in 2003, from 9.8% in 2002. Both production and sales of automobiles, electronic equipment, and construction materials increased rapidly.

The agriculture sector expanded by 2.5%. Because of a reduction in planted areas (partly due to lower profitability of grain compared with other crops), and natural disasters in some locations, total grain output at 430.6 million tons fell below the 2002 level.

While the SARS outbreak marginally affected industry and agriculture, it had a more serious impact on services, where growth slowed in the second quarter but recovered in the third and fourth. The services sector grew by 6.7% in 2003, 0.8 percentage point less than in 2002, with the value added of wholesale and retail sales, finance and insurance, and real estate rising by 6.6%, 6.9%, and 5.3%, respectively.

The living standards of both urban and rural households improved, but the rural-urban income gap continued to widen: real per capita income grew by 9.0% in urban areas, but only by 4.3% in rural areas.

According to official statistics, which significantly underestimate the problem, the registered urban unemployment rate rose from 4.0% in 2002 to 4.3% in 2003. If laid-off state-owned enterprise (SOE) workers who had not been reemployed were included, the adjusted unemployment rate would have been about 8%. Given that about 10 million young urban residents enter the labor market each year and that tens of millions of underemployed farmers have migrated to the cities in search of work, the actual employment situation is much worse than the official data indicate. (Since the "floating" population is not included in current statistics, the National Bureau of Statistics, together with other relevant government agencies, has decided to develop a more appropriate system for measuring employment.)

To ease unemployment pressures, the Government has prioritized job creation in the private sector, strengthened the social safety net, and accelerated employment reforms. Measures were implemented to promote small and medium enterprises to create jobs, and social security reforms have begun. In spite of the Government's efforts, the reduction in rural poverty has slowed in recent years. The characteristics of the remaining absolute poor suggest that a different approach is needed (Box 2.1).

Fiscal revenues increased by 14.7% in 2003, slightly lower than the 15.4% rise seen in 2002. Fiscal expenditures rose by 11.6%. While spending on capital construction declined, expenditures on health care, social security, and government administration grew rapidly, partly because of the efforts to contain SARS.

Given the better than expected revenue growth, the fiscal deficit was about 2.7% of GDP, below the budgeted target of 2.9%. However, if off-budget obligations such as the implicit pension debt and costs related to nonperforming loans (NPLs) in the banking sector are included, the fiscal deficit comes out as much higher than the official estimate. There are, indeed, many more fiscal challenges than is suggested by the official estimate of the deficit.

Money supply growth accelerated in 2003. M2 increased by 19.6%, or 2.7 percentage points faster than in 2002. Factors included strong domestic investment demand, which prompted banks to expand credit, and large inflows of foreign capital,

Table 2.1 Major Economic Indicators, People's Republic of China, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	7.3	8.0	9.1	8.3	8.2
Gross domestic investment/GDP	38.5	40.4	41.3	40.7	40.5
Inflation rate (consumer price index)	0.7	-0.8	1.2	3.0	2.7
Money supply (M2) growth	17.6	16.9	19.6	18.0	17.0
Fiscal balance[a]/GDP	-2.5	-3.0	-2.7	-2.5	-2.3
Merchandise export growth	6.8	22.4	34.6	15.0	15.0
Merchandise import growth	8.1	21.3	41.0	19.0	16.5
Current account balance/GDP	1.5	2.8	2.2	1.3	1.0

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

which the authorities attempted to sterilize. Total bank deposits grew by 21.7% to CNY20.8 trillion ($2.5 trillion) and total commercial bank loans amounted to CNY15.9 trillion ($1.9 trillion), a rise of 21.1% from 2002. There are concerns that the rapid expansion of M2 and bank credit might further fuel the overheating in some areas and cause a deterioration in loan quality, which could worsen the future NPL position.

The deflationary trend in consumer prices in 2002 was reversed. Driven mainly by rising prices of food and services, the consumer price index (CPI) rose by 1.2% in 2003. Grain price increases in the fourth quarter were in part caused by floods and drought, and by the continuing decrease in grain output of the past few years. Price rises in services reflected strong demand for education, health care, and housing.

Prices of other consumer goods (apart from food and services) continued to fall because of oversupply, tariff reductions, and greater market competition. As a consequence of the investment boom, producer prices rose significantly. While industrial producer prices increased by 2.5% on average, some raw material prices such as steel, iron, aluminum, and cement rose at double-digit rates. If this trend continues, the higher producer prices will be passed on, pushing up consumer prices.

Exports surged by 34.6% in 2003—after strong growth of 22.4% in 2002—pushed higher by increased production capacity and a favorable competitive position. Exports of foreign-funded enterprises rose by about 40% from the 2002 level, lifting their share in total exports to about 55% from 48%. Imports soared by 41.0%, nearly double the rate of 2002, due to strong domestic demand, higher oil prices, and lower tariffs. This caused a decline in the trade surplus to $41.4 billion from $44.2 billion in 2002. The country has a large trade surplus with the United States (US) but its trade deficit with East and Southeast Asia has widened in recent years. The PRC is the world's biggest consumer of copper, tin, zinc, platinum, steel, and iron ore; second biggest of aluminum and lead; third largest of nickel; and fourth largest of gold. It is now the world's second-largest oil consumer, and accounted for 35% of the global rise in oil demand in 2003.

The reduced trade surplus, together with a fall in receipts from services (in particular tourism), led to a decline in the current account surplus to an estimated $31.0 billion from $35.4 billion in 2002. The current account surplus is modest at 2.2% of GDP.

Actual FDI inflows rose by 1.4% to $53.5 billion, slowing from growth rates of 15.1% and 12.5% in 2001 and 2002, respectively. The SARS outbreak and the weak world economy during the first half of 2003 hurt FDI. The figures might overstate FDI because they include some "round tripping," i.e., PRC capital that is taken offshore and then returned to the country as FDI to take advantage of favorable policies designed to attract capital inflows.

About two thirds of foreign joint ventures in

Box 2.1 Protecting Minimum Living Standards in Rural Areas

The PRC has already achieved the Millennium Development Goal of reducing by half the number of people living on $1 a day from the 1990 level (from 280 million in 1990 to 138 million in 1996 and 97 million in 1999). In addition, the number of absolute rural poor, defined as those with annual incomes of below CNY625, fell from 125 million in 1985 to 28 million in 2002. Rural infrastructure and production conditions in poor areas have improved significantly.

However, the decline in the number of absolute rural poor has slowed since 2000. According to official statistics, most of the remaining 28 million absolute rural poor either live on degraded land unsuitable for human habitation or cannot participate in the market economy because of age or disability. The Government's poverty reduction program is based on improving their production conditions, but this may not be the most effective or efficient way of eliminating the remaining absolute poverty. A different approach should be considered, to set up a minimum living standard protection system for rural areas, similar to the program already used in urban areas.

Using such a system would be a major adjustment to the PRC's rural poverty reduction strategy. The current poverty reduction program could be structured to focus on people with per capita incomes below the $1-a-day international norm but over the PRC's official poverty line.

To establish this new rural minimum living standards system, the Government would need to:

- set up a special account in the budget for management and monitoring purposes;
- assign the Ministry of Civil Affairs as the agency to implement the system with assistance from the Leading Group of Poverty Reduction of the State Council and other ministries;
- use the poverty-mapping method developed by the World Bank to estimate the number of absolute poor at the township level; and
- use a participatory approach that involves villagers to improve transparency, efficiency, and accountability.

If the budget allowed for it, the Government should consider gradually increasing the rural minimum living standard such that it moves closer to the $1-a-day international norm.

Source: Observations and Suggestions. 2004. ADB Resident Mission in the PRC (in Chinese). February.

the PRC made a profit over the past 2 years and their profitability was frequently better than that of joint ventures elsewhere.

The FDI climate in the eastern part of the country is better than in the central and western regions. During the 1990s, over 90% of all FDI went to the east coast. Making the central and western regions more attractive for FDI would help reduce poverty but, according to the *2003 Private Sector Assessment Report (PRC)* of the Asian Development Bank (ADB), about 40% of foreign firms already operating in east coast provinces are not currently considering expanding their operations to the central and western regions, mainly because of poor infrastructure and lack of markets. Improving the environment for FDI in the poorer interior provinces therefore requires the Government to take action to (i) lower fees and charges for their operations, transport, and land costs; (ii) improve infrastructure; (iii) open more sectors to foreign investment beyond what is available in east coast provinces; and (iv) liberalize the general rules of business, increase transparency, reduce restrictions, and simplify approval procedures for foreign investors.

Making progress in these areas is important, as many studies have shown that tax breaks and financial incentives alone are not the most important factors influencing investors' decisions about whether or not to invest in a new location.

The FDI inflows, high domestic interest rates relative to international rates, and rising market expectations of a yuan appreciation led to a surge in foreign exchange reserves, which reached $403.3 billion by end-2003, 40.8% higher than at end-2002. Short-term foreign debt also increased sharply. Total external debt is estimated at $171.9 billion, equivalent to 12.3% of GDP, with short-term debt accounting for about 35% of this, which is 5 percentage points higher than in 2002. The exchange rate remained stable at CNY8.28/$1.

Policy Developments

While fiscal stimulus remains a key component of the Government's measures to bolster domestic demand and generate employment, the quick recovery from SARS and robust economic performance have lessened the need for such stimulus. In March 2003, the Government budgeted for both revenues and expenditures to rise by 8.0% in 2003. However, revenues actually grew by 14.7% as a result of the strong economy. At the annual National People's Congress (NPC) in March 2004, the Government targeted a 2004 deficit of CNY319.8 billion, the same as in 2003. This will lower the deficit-to-GDP ratio from 2.7% in 2003 to 2.5%. The 6-year expansionary fiscal policy is expected to be phased out. Related to this move, the Ministry of Finance announced that funds raised by treasury bond issues in 2004 will be used mainly for economic restructuring and social development rather than promoting economic growth.

The March 2004 NPC outlined the Government's priorities. Major themes included increasing rural incomes, creating jobs, developing the private sector, strengthening the rule of law, developing more mechanisms for citizen participation, financial sector reform, and SOE reform. Although rapid economic growth will continue to be a priority, there was a recognition that economic growth by itself is not enough to achieve sustained socioeconomic progress.

A more balanced development agenda is being adopted, which will provide more people with the opportunity to benefit from economic growth and reduce poverty. Balance is being sought in five areas: (i) rural-urban disparities (increasing rural incomes, reducing rural taxes, protecting the land use rights of farmers); (ii) humankind and nature (environmentally sustainable development); (iii) economic growth and social development (more emphasis on health, education, social security reform, and protecting urban migrants); (iv) regional disparities (fostering development in the west and northeast); and (v) domestic and international concerns (trade, investment, WTO, and competition). To support this agenda, the constitution was amended to protect lawful private property rights, pay compensation for expropriated land and private property according to the law, establish a sound social security system, and respect human rights.

As part of this agenda, the Government plans to allocate CNY95.5 billion from the 2004 budget, up by CNY10.0 billion from 2003, for spending on education, health, science and technology, and culture and sport, with priority given to rural areas.

Farmers are benefiting from several policy changes, including a tax reform called the "fees-for-tax" plan, initially introduced in 2000, to reduce their financial burden. In the past 4 years, the number of provinces adopting the policy has risen to 20. About 620 million farmers gain from this reform, which reduced their financial burden by at least 30%. A nationwide inspection of the progress of rural tax reforms was launched in 2003, in an effort to standardize rural taxes. The NPC in March lowered taxes on many agricultural products. Furthermore, the agricultural tax rate will be reduced by more than 1 percentage point a year on average from 2004, and agricultural taxes will be removed in 5 years. Since urban incomes are three times as high as rural incomes and the majority of the country's poor live in rural areas, these measures to reduce rural taxes should help reduce poverty.

Also on the tax front, the Government changed its export tax rebate system by (i) lowering the average export tax rebate rate from 15% to 12%, (ii) using all the increased revenues from imported products' VAT and consumption taxes to refund export tax rebates, (iii) allocating all delayed tax rebates accumulated until end-2003 to itself, and (iv) establishing a mechanism for central and local governments to share the tax rebates (75% for central and 25% for local governments).

Concerned that the rapid rise in bank lending and liquidity could lead to a deterioration in loan quality and an increase in inflation, PBC took several steps to control money supply growth. In April 2003, it began issuing short-term central bank bills to sterilize the influx of foreign capital. In June, it issued prudential regulations to control property loans, particularly in high-end housing projects. And in September, it raised banks' reserve requirement ratio from 6% to 7%. As a result of these measures, credit expansion slowed somewhat. Between August and end-2003, lending

growth decelerated from 23.9% to 21.1% and M2 growth slowed from 21.6% to 19.6%. PBC tightened monetary policy again effective 25 April 2004, when it raised the reserve requirement ratio to 7.5% for most banks and to 8.0% for banks considered to be inadequately capitalized. It had already raised the rediscount rate on commercial bills in March.

However, the incomplete nature of economic reforms has dampened the impact of monetary policy instruments. The authorities might have to consider complementing the monetary steps with fiscal measures, such as deferring treasury bond issues, delaying disbursements from bond issues and treasury payments for capital projects, taking administrative action to defer or postpone capital investment projects, and increasing the contract tax on buying and selling real estate. Taking administrative measures to slow the conversion of agricultural land to other uses and ensuring that people whose land and houses are expropriated are fully compensated according to law would also help reduce capital investment in the longer term. Clearly, though, there will be time lags before the economy responds to any monetary, fiscal, and administrative changes.

To accelerate bank restructuring and financial reform, the Government established the China Banking Regulatory Commission (CBRC) in April 2003 to take over the functions of regulating and supervising banks from PBC. A priority of CBRC is to improve management of the country's four major state-owned commercial banks (SOCBs). The new agency formulated supervisory rules and regulations to oversee bank operations; set up a branch in each province; and began spot checks of commercial banks and nonbank financial institutions to ensure that they were taking the appropriate measures to reduce their NPLs.

Subsequently, the Standing Committee of the NPC, in December 2003, approved the Law on the Supervision of the Banking Industry, which stipulates CBRC's powers and functions. It also amended the Law on the People's Bank of China, highlighting PBC's role in the economy, especially in currency policy. Other amendments made to the Law on Commercial Banks free SOCBs from granting policy-oriented loans and loosen the limits on investment by commercial banks.

Reforms in the banking sector accelerated as the PRC entered its third year in WTO. The Government adopted long-awaited reforms of the four SOCBs. It injected $45 billion of foreign reserves to recapitalize the Bank of China and the China Construction Bank (the third capital injection to SOCBs since 1998). A similar package was announced for the Industrial and Commercial Bank of China in January 2004, while the Agricultural Bank of China will receive additional funding later in the year.

PBC widened the lending interest rate bands for financial institutions from 1 January 2004. The upper limit on lending rates for commercial banks and city credit cooperatives is now 1.7 times the benchmark rate and 2 times for rural credit cooperatives.

The capitalization requirements for foreign banks were relaxed a little, although they remain high by international standards. The Government allowed foreign banks to provide yuan services to domestic businesses in 13 key cities beginning in mid-December 2003. In 2004, the PRC is expected to open three more cities to foreign banks. Eighty-four of the 191 foreign banks operating in the country now hold a local currency license. As required by the WTO accession agreement, regulations for automobile financing were issued and the first three foreign licenses were approved.

Although the exchange rate of the yuan remained within a narrow band around CNY8.28/$1, there were calls from some of the PRC's trading partners for a more flexible exchange rate policy and an effective appreciation of the yuan. The Government stated that it had no immediate plans to change its exchange rate policy, and that a flexible exchange rate regime would be a long-term goal, in conjunction with substantial financial reform and interest rate liberalization. It believes that one of the lessons of the Asian financial crisis is the importance of strengthening the domestic financial sector before adopting a convertible capital account and a flexible exchange rate.

The authorities did, though, take steps in 2003 to ease the pressure brought by high foreign exchange reserves: (i) the State Administration of Foreign Exchange allowed foreign trading companies to retain their foreign exchange incomes in full in their foreign exchange accounts from September 2003; (ii) the limit on individual

foreign exchange purchases for overseas travel was raised; and (iii) a group of 40 banking institutions in Hong Kong, China began accepting yuan deposits on 26 February 2004, marking the first "offshore" convertibility of the PRC's currency. The banks, including major players HSBC and Bank of East Asia, will change Hong Kong dollars into yuan up to CNY20,000 per day per account for funds on deposit, and up to CNY6,000 per day for cash transactions.

Accepting yuan deposits in Hong Kong, China is part of the Closer Economic Partnership Arrangement (CEPA) signed in 2003. As the deposits offer a medium for households to bet on yuan appreciation, their level will be watched as an indicator of such expectations. More important, the development signifies the Government's efforts to bestow greater economic benefits on a Hong Kong, China populace uneasy over closer economic integration with the mainland.

The State Administration of Foreign Exchange also granted qualified foreign institutional investor status to several international investment banks, and the Government encouraged more domestic companies to invest abroad, including allowing qualified domestic institutional investors to invest in foreign capital markets.

To accelerate SOE reform, the State-owned Assets Supervision and Administration Commission (SASAC) was established in April 2003. It acts to supervise the 196 central SOEs that had CNY6.9 trillion ($833.3 billion) in state assets at end-2002. SASAC appoints or removes senior SOE executives and has a say in the transfer of state holdings, corporate mergers, closures, or other major changes in SOEs. A major focus of SASAC will be to improve corporate governance such that it can exert its powers through well-functioning boards of directors. SASAC also intends that foreign companies will be able to participate in SOE reform through mergers and acquisitions.

In other policy developments, the Government took steps to promote private sector development, including introducing a mergers and acquisitions mechanism, allowing the private sector to invest in infrastructure and public utilities, and developing a modern property rights system. The Government intends to reform its investment regulatory system in 2004, which would mean that most nongovernment investment projects will no longer require government approval. Domestic investors will be allowed to make their own decisions and only notify the Government about the projects for record purposes.

Improvements are also planned for the PRC's statistics, which should provide a better basis for macroeconomic management and business decision making by the private sector. Some measures already taken include revising upward the GDP series to better reflect the contribution of services; participating in the General Data Dissemination System of the International Monetary Fund (IMF); producing quarterly national accounts by industry; revising and releasing estimates to reflect data that become available following initial publication; and conducting periodic economic censuses from 2004.

As the effect of these measures will be gradually felt over the long term, weaknesses are still evident in the country's statistics, including those related to data coverage and methodological issues. This has led some observers to question the accuracy and reliability of the figures. For instance, after examining indicators from the real sectors, they have concluded that the economy actually grew faster in 2003 than the official statistics indicated. The major reason is that, as a legacy of the centrally planned system, the statistical system does not fully capture data on the rapidly growing private sector, particularly services.

Looking to the longer term, a new generation of leaders was confirmed at the NPC held in March 2003. They pledged an overall continuity of policy and put a priority on balanced, sustainable socioeconomic development. In October, the Third Plenum of the 16th Communist Party of China Central Committee approved the Decision on Improving the Socialist Market Economic System, which outlines the main tasks for development and structural reforms and indicates that more emphasis will be placed on income equality, job creation, and private sector development.

Outlook for 2004–2005

Although the Government set an economic growth target of 7.0% for 2004, GDP looks more likely to grow by around 8.3%, and by 8.2% in 2005. In the first quarter of 2004, GDP expanded

by 9.7% on the back of 17.7% growth in industrial output. Investment in fixed assets rose by 43.0%, nearly double the rate in 2003. The PRC's growth in 2004 will account for 15% of the expected expansion in the world economy, even though the PRC has only about 4% of global GDP. The country's strong performance will stimulate growth in the rest of the region. However, over the medium term, the Government will need to tackle several issues to ensure sustainable socioeconomic development (Box 2.2).

Investment growth will likely fall by nearly half to around 16% annually in 2004–2005 because (i) high housing prices and a tightening of bank lending for real estate will cool property investment; (ii) the Government will limit investment in automobiles, iron and steel, aluminum, and cement; (iii) FDI inflows will grow only moderately; (iv) the rapid increase in bank credit will be brought under control; and (v) the gradual phaseout of the expansionary fiscal policy will slow government-dependent investment.

Economic growth will be unsustainable in the long run if one of its major drivers continues to be such government-dependent investment. Ways must be found to harness the rapidly increasing incomes of urban residents such that consumer expenditures play a greater role in stimulating growth. This will require the development of new financial products and new economic management tools. A beginning has, in fact, been made. Housing markets have been created and financial institutions have introduced new services, such as credit cards, consumer credit, and mortgages. However, other institutions need to be developed (e.g., consumer credit bureaus) and greater support must be given to financial institutions when they repossess assets on which consumers default.

Consumption growth will accelerate slightly to around 9% in 2004–2005, underpinned by several factors. First, rapid urbanization and changing consumption patterns support consumption growth. Second, income expectations and consumer confidence have been improving as urban wages rise and rural incomes increase following a rise in grain prices, rural taxation reforms, and fiscal support for agricultural development. Third, tourism and catering will grow significantly because of the lower base resulting from the impact of SARS in 2003.

Exports in 2004–2005 will continue to rise, but at a slower rate of around 15% a year. The lower export tax rebates will play a part in this. Also, after the revaluation demands of some of the PRC's major partners in 2003, trade friction, especially with the US and the European Union (EU), could intensify in 2004–2005, which would hamper export growth. On the other hand, some positive factors will contribute to exports. The global economic recovery will stimulate trade volumes worldwide, including trade with the PRC. Some components of the PRC-ASEAN Free Trade Area (AFTA) Agreement and the CEPA between the mainland and Hong Kong, China will become effective, and that will also stimulate trade.

Strong domestic demand, especially for oil, steel, grain, and raw materials, will be the major engine of import growth. Capital imports will continue to grow strongly due to rapid economic development. Import growth rates, while somewhat lower than in 2003, will be in the order of 16–20% and will exceed the increase in exports in 2004–2005, resulting in a lower trade surplus. As this surplus shrinks in the coming years, the current account-to-GDP ratio will narrow to 1.0–1.3% in 2004–2005. In the first quarter of 2004, exports rose by 34.1% and imports increased even faster, by 42.3%, resulting in a trade deficit of $8.4 billion.

The rise in the CPI will likely accelerate moderately to 2.7–3.0% in 2004–2005, on the assumption that (i) the current grain price increase will remain in place at least until the harvest in 2004; (ii) prices of electricity, coal, and construction materials will continue to move higher; and (iii) the price of services will rise somewhat based on the 2003 level of 2.2%. However, overcapacity in many industry subsectors will offset part of the inflationary pressure, as will the more open international trade regime, which will result in international markets responding to some of the shortages in bottleneck sectors.

Box 2.2 Medium-Term Risks and Uncertainties

In the medium term, the Government needs to address the following risks and uncertainties to ensure balanced and sustainable socioeconomic development.

Weak Banking System. Despite the measures already taken, the banking system, which is dominated by the four SOCBs, remains weak. A key indicator, the average NPL ratio in the financial sector, is still high. Indeed, some commentators believe that the actual level of NPLs is higher than the official figure.

Although the Government set an ambitious target to reduce the NPL ratio to below 15% by 2005 and major commercial banks reported higher operating earnings in 2003, addressing the financial risks in the banking system remains a daunting task. Profits generated by the four SOCBs are inadequate to quickly recapitalize the banking system, so a new round of government capital injections is under way.

In addition to injecting capital to deal with the stock of NPLs, approaches must be developed to improve governance and credit risk assessment in these banks to reduce future NPLs. New methods are also required to accelerate the disposal of NPLs. Necessary steps include strengthening asset management companies and encouraging foreign investors to participate in NPL disposal.

Dealing with NPLs and improving corporate governance and credit risk management are prerequisites for listing the banks on the stock exchange.

SOE Reform and Capital Market Development. Many provincial SOEs have been privatized through management buyouts or mergers with private and foreign firms. SASAC issued several directives on the subject of SOE restructuring to address issues such as conflict of interest, pricing, and moral hazard.

After a long debate that caused pressure on the market for class A shares, which are reserved for domestic investors, the Government realized that the issue of the disposal of nontradable state-owned stakes needed to be addressed for the healthy development of the stock market and to promote SOE reform. It is seeking an acceptable plan to distribute the SOE shares.

Fiscal Priorities. The amount of special long-term treasury bond issues will likely fall to CNY110 billion in 2004 from CNY140 billion in 2003 and CNY150 billion in 2002. This means that the pump-priming proactive fiscal policy is being phased out. The Government will pay more attention to problems that the market alone cannot solve. Examples include poverty, low agricultural productivity, unemployment, inadequate education and health care in poor rural areas, a weak social security system, a deteriorating environment, sluggish development in the central and western regions as well as old industrial bases in the northeast, and the income gaps between regions and between urban and rural areas.

To implement the strategic shift in fiscal policy, the Government needs to rationalize its tax system, improve tax collection, find a better balance in revenue sources and expenditure obligations at different levels of government, and develop a more efficient and targeted fiscal transfer system.

Unemployment and Poverty. According to official estimates, some 3 million SOE workers may lose their jobs every year until 2006, when SOE restructuring is expected to be completed. Although GDP growth in 2003 was 1.1 percentage points higher than in 2002, too few jobs were created to ease the growing unemployment pressures. Compared with the services sector, manufacturing is capital rather than labor intensive. Thus employment elasticity in manufacturing is much lower than in services. The unemployment issue cannot be solved through rapid economic growth unless the services sector grows and develops.

Because of the changes in the characteristics of rural poverty and development conditions in the PRC, a rural minimum living standard protection system (Box 2.1) is needed to address the needs of the remaining hard-core rural poor. This would be the first step in building a rural social security system.

Environment for Private Sector Development. The private sector plays a key role in economic growth and job creation. Although steps have been taken to improve the environment for the private sector, several issues are impeding its development.

The Government needs to focus more on improving transparency to reduce opportunities for corruption. It also should strengthen the rule of law, adopt an antimonopoly law to reduce local protectionism, pass a bankruptcy law, provide the private sector with better access to credit, and ensure the protection of private property rights and intellectual property rights.

Source: ADB staff.

Hong Kong, China

A rebound in the property market has laid the groundwork for a much broader-based recovery than any since the deep recession in 1998. Exports drove growth in 2003 and look set to remain strong. Investment will join the recovery in 2004. The authorities must now decide how they will strengthen the fiscal position—by raising taxes or by relying on the property market's rebound to produce higher revenues.

Economic Assessment

The economy continued to operate well below potential in 2003, but started to rebound strongly after the SARS outbreak faded. Weakness in the US dollar, to which the Hong Kong dollar is linked, helped. So did the decision by the PRC authorities to ease travel restrictions to Hong Kong, China. A recovery in the property market and a stock market rally spurred consumption spending. Most encouraging was a recovery in business investment, as empty office space began to be taken up, sparking a rebound in office purchase prices.

After grappling with various cyclical and structural problems for several years, the economy is showing clear signs of recovery. Growth rebounded from the third quarter of 2003, lifting overall GDP growth for the full year to 3.3%, the highest rate in 3 years. A key factor was the bottoming out of apartment prices in August 2003, after a plunge of about 60% from the 1997 peak. Between August 2003 and March 2004, prices of housing rebounded by about 40%.

The foundations of the recovery in housing were set late in 2002, when the authorities suspended sales of public apartments and land auctions and promised to minimize intervention in the housing market. (The application list system for the sale of land was resumed in January 2004.)

Rising property prices greatly reduced the number of homeowners with "negative equity" (i.e., when borrowing exceeds the market value of the mortgaged property). According to figures from the Hong Kong Monetary Authority (HKMA), in September 2003 the number of negative equity cases based on first mortgages was 99,800, with a total loan value of HK$155 billion. The upswing in the housing market inflated total housing stock wealth by about HK$500 billion by February 2004.

Retail sales hit their lows about the time that apartment prices hit theirs. By December 2003, retail sales in value terms had risen by 6.8% over 12 months, which was the first time in years that the increase in the value of retail sales was higher than the rise in real terms (of 5.8%). This suggested that price deflation was over. The January 2004 retail sales data were encouraging, too, with the volume index climbing to its highest level since January 1997.

Overall investment spending regained some strength in the second half of 2003. After declining by 5.7% in the second quarter, gross domestic fixed capital formation rebounded by 2.5% in the fourth quarter. Although for 2003 as a whole, real gross domestic fixed capital formation declined by 0.1%, this is a significant improvement from the 2002 drop of 4.3%.

The major element in GDP growth in 2003 was net exports, which contributed 2.7 percentage points. Exports of goods and services rose by

Figure 2.2 Composite Consumer Price Index, Hong Kong, China, January 2000–February 2004

Source: www.info.gov.hk/censtatd/eng/hkstat/fas/cpi/cpi_std_index.html.

12.7%. Services exports, in particular, rebounded in the third quarter after SARS had petered out. The strong export performance benefited from (i) the improved global economic environment later in 2003; (ii) increased price competitiveness of Hong Kong, China's exports, stemming from exchange rate movements and domestic cost reductions; and (iii) increasing exports from the PRC, the main source of the economy's reexports.

In line with strengthening domestic demand, inflation reappeared in September 2003 on a month-to-month basis, though deflation was still in evidence year on year. The composite CPI rose every month after hitting a trough of 91.0 in August. By January 2004, it had reached 92.4, before slipping to 91.7 in February (Figure 2.2).

Employment continued to shrink in the first 3 quarters of 2003. The unemployment rate peaked at 8.7% during May–July 2003, then declined, partly because some people dropped out of the labor market. New hiring started toward the end of the year, with 41,000 jobs created in the last quarter, and employment continued to grow in the new year. The authorities made a major effort to reduce unemployment by creating new, low-paid jobs and by helping with traineeships, which provided relief to the large number of unemployed young people. (Fiscal restraint, however, kept growth in government consumption to 1.9% in 2003.) Over the longer term, the work force of Hong Kong, China is becoming more integrated with the PRC's: more than 240,000 people from Hong Kong, China worked in the PRC in 2003, up sharply from 64,000 a decade earlier.

The economic revival will help restore living standards. The number of people registered for Comprehensive Social Security Assistance rose quickly from 267,609 in January 2003 to 283,823 by June, then at a slower rate to peak at 290,206 in December. January 2004 saw the figure dip to 289,538, the first decline in 3 years, promising further drops in the months ahead. In other measures of living standards, median household income fell to HK$15,500 a month in 2003 from HK$18,000 2 years earlier. However, the number of personal bankruptcies fell in 2003 as the housing market recovered, after a worrying rise in bankruptcies over the previous 5 years.

Hong Kong, China's fiscal position, too, benefited from the rebound in the property market, because higher property prices and sales boosted government revenues in FY2003 (ended 31 March 2004). Also, HKMA almost doubled its investment income in 2003 to HK$89.6 billion. Of this, the fiscal reserves' share amounted to HK$25.7 billion, more than double the amount budgeted in FY2003. On the other hand, the authorities spent an additional HK$9.1 billion as a result of SARS, as they reduced fees and charges, raised health spending, and refunded some income tax. The budget deficit for FY2003 was estimated at HK$49 billion, or 4.0% of GDP, well below an earlier estimate of more than HK$78 billion made in October 2003.

Sentiment toward the Hong Kong dollar swung sharply in 2003. After a period of weakness, the currency gathered strength on several factors: (i) speculation that the Hong Kong dollar would strengthen alongside the yuan if the PRC currency was revalued; (ii) optimism over the CEPA agreement between the PRC and Hong Kong, China; (iii) an upgrade by Moody's of Hong Kong, China's credit rating; (iv) signs of improvement in the domestic economy; and (v) the bottoming out of the slide in the housing market.

The Hong Kong dollar traded at around its linked rate of HK$7.8 to the US dollar for most of the year but in late September and early October it suddenly strengthened toward HK$7.7. To maintain monetary stability and avoid excessive currency deviation, HKMA purchased US dollars

Table 2.2 Major Economic Indicators, Hong Kong, China, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	0.5	2.3	3.3	6.0	5.0
Gross domestic investment/GDP	25.9	23.4	22.9	26.3	26.6
Inflation rate (consumer price index)	-1.6	-3.0	-2.5	1.1	1.1
Money supply (M2) growth	-2.7	-0.9	8.4	10.0	5.3
Fiscal balance/GDP	-5.0	-4.9	-4.0	-3.1	-2.5
Merchandise export growth	-5.8	4.9	12.1	6.8	7.3
Merchandise import growth	-5.5	3.1	12.2	9.0	6.4
Current account balance/GDP	6.1	8.5	11.0	6.8	8.5

Sources: Census and Statistics Department; Hong Kong Monetary Authority; staff estimates.

on the interbank market. As a result, the Hong Kong dollar eased to around HK$7.76–HK$7.77 by end-2003. The US dollar's weakness, capital inflows, and HKMA purchases of US dollars produced very expansionary monetary conditions in the last quarter of 2003. With the return of inflation on a month-to-month basis in September 2003, real interest rates turned negative, creating a great incentive for holders of Hong Kong dollars to buy real assets. As the property market rebounded, the "credit crunch" effect that had been associated with falling property values was reversed. This was reinforced by a continuous decline in interest rates. The Hong Kong dollar interbank offered rate started 2003 at 1.6% and fell to 0.76% by December, although the prime rate stood at 5.0% throughout the year. The stock market also benefited from the low interest rates and rising property prices. The Hang Seng Index rallied by 35% in 2003, similar to several other East Asian markets.

Overall bank deposits rose by 7.5%, compared with a decline of 2.6% in 2002, but the total value of loans fell by 2.0%, though this rate of decline slowed from 2002. The quality of bank assets has improved considerably, with the mortgage delinquency rate falling to 0.86% and the write-off rate for credit cards declining to 8.2% by end-2003. (Indeed, the jump in property prices and recovery in the labor market quickly improved the quality of assets on banks' balance sheets.) This development, together with the launch of yuan accounts in 2004, is expected to improve the profitability of banks in Hong Kong, China. The amount of yuan circulating in the economy is estimated at CNY50 billion–70 billion, a figure that is projected to rise to CNY150 billion–300 billion by 2005. The development of this "offshore" yuan business could help pave the way for the yuan to become a fully convertible currency in the future, and the Bank of China's role as the clearing bank for yuan business gives this bank a more prominent role in Hong Kong, China.

While merchandise exports rose by 14.2% in 2003 and imports grew by 13.1% in constant dollar terms (on account of weakness in consumption and investment), both grew by about 12% in current market prices. The trade deficit widened slightly to US$5.8 billion but the current account surplus rose to US$17.4 billion, or 11.0% of GDP. The economy's net international investment position improved rapidly over recent years, from HK$1.7 trillion at end-2000 to HK$2.7 trillion, or 210% of GDP, 2 years later. This reflects a growing net capital outflow because of a lack of confidence in the local economy, at least until the last quarter of 2003 when funds again poured into property and stocks.

Policy Developments

Recovery in the economy and asset markets has provided some relief to the fiscal position. Revenues from stamp duties leaped with surging property and stock transactions, and collection of profits tax saw a significant rise. Revenues from fees and charges have been progressively restored to the normal levels on expiry of the concessional

measures introduced in previous years. Pressures on expenditures eased, too, as for example, the number of cases registered for Comprehensive Social Security Assistance fell slightly in January 2004. However, the bursting of the property bubble in the late-1990s and the subsequent long economic slump exposed the authorities' vulnerability to the land-based revenue system, prompting debate on tax reform.

A key policy challenge for the authorities is balancing the budget by FY2008. In the March 2003 budget, they referred to a three-pronged strategy: increasing revenues through economic recovery; reducing expenditures; and raising revenues by other means. Certainly, the economic recovery and rebound in property prices in the second half of 2003 boosted revenues. The authorities have, as well, moved to reduce expenditures by lowering civil service pay by a total of 6% over 2 years and reducing the ranks of the civil service through natural attrition and early retirement.

The authorities are studying several possibilities to further raise revenues, including a goods and services tax. Broadening the tax base could hurt the working poor, though. A goods and services tax would provide a reliable, long-term source of revenues and would reduce the erosion of revenues lost to underground, or unreported, activities and to the PRC as more Hong Kong, China people live or work over the border. However, at times when the economy is weak and needs as much spending as possible, such a tax would reduce the amount that consumers actually have.

For the longer term, the authorities need to decide if they want to depend so much on land-based revenues, both directly through land premiums collected and indirectly through taxes paid by developers, banks, and property owners. The current system allows personal and corporate income taxes to stay low, but inevitably leads to high land prices. The alternative route would bring down land prices and raise these taxes. Given that Hong Kong, China recorded large budget surpluses as late as 1996 and 1997, that a deficit emerged only after a plunge in the housing market, and that the long-run elasticity of revenues with respect to housing prices is 0.8, the deficit problem might well be resolved, at least for the medium term, by a continued recovery in the housing market.

In FY2004, the authorities will issue Hong Kong dollar bonds for the first time in more than a decade. Issuance will be capped at HK$20 billion and the funds used only for capital expenditures. The bonds, issued in a period of low interest rates, will provide funds at a reasonable cost and add both breadth and depth to the local bond market.

HKMA and the authorities have repeatedly reasserted their commitment to maintaining the exchange rate link to the US dollar. Under a weak US dollar, inflation tends to rise, although as long as the yuan remains fixed to it, imported pressure on inflation should be mild.

Economic integration with the PRC took some important steps in 2003. CEPA, between Hong Kong, China and the PRC, was signed in June. Under CEPA, 273 types of goods made in Hong Kong, China gained tariff-free entry into the PRC from 1 January 2004 and more goods will be added to the list by 1 January 2006. This will help some of the economy's manufacturing industries, but overall benefits are likely to be modest given the small manufacturing base—its share of economic output had fallen to about 4% of GDP by 2003.

Benefits to the services sector from CEPA are likely to be more significant. The PRC services subsectors opened to Hong Kong, China firms include transportation, advertising, telecommunications, construction, tourism, banking, insurance, and legal and accounting services. Firms in these subsectors will gain access to the PRC market ahead of the deadlines stipulated in the PRC's WTO accession agreement. This may give the firms some first mover advantage.

The move to allow Hong Kong, China banks to offer bank accounts, credit cards, remittances, and foreign exchange services in yuan also strengthens the links between the two economies. In January 2004, HSBC, in cooperation with the Bank of Shanghai, became the first bank to provide credit card services for PRC residents traveling abroad. The credit cards enable PRC travelers to spend more money in Hong Kong, China. Prior to this change, each PRC visitor could only bring CNY6,000 into Hong Kong, China, and could not use credit cards issued by PRC banks.

Outlook for 2004–2005

The outlook is optimistic, with economic growth expected to strengthen to 6.0% in 2004 before settling to around 5.0% in the following 2 years. This is attributable partly to CEPA and to the approval for individuals to travel to Hong Kong, China from more PRC cities. This decision helped inbound tourism recover late in 2003, which boosted employment in hotels and brightened prospects for retailers. Retailers' rents have jumped, often by half.

The strong housing market is benefiting several other areas (e.g., builders, appliance retailers, decorators, lawyers, banks) and will give impetus to private consumption through the increased wealth effect. It will also boost investment, since owners of small and medium enterprises can increase borrowings using their homes as collateral. This will help drive business investment in 2004 and beyond. Fixed capital formation is expected to grow by double digits in 2004, but slow a bit to around 7% and 9%, respectively, in 2005 and 2006. With a continuing recovery in the economy, the fiscal deficit will gradually close, most probably by the target date of FY2008. Worries that the property market is becoming overheated appear unfounded at this stage because a recovery of 40% in apartment prices still puts them at more than 40% below the 1997 peak.

Several infrastructure projects are in the pipeline, the most noteworthy of which is the Zhuhai-Macau-Hong Kong Bridge, which has the approval of all governments concerned. Macau, China's gambling industry is being revamped with additional casinos and hotels and the participation of overseas casino companies. Construction of new facilities and a revival of tourism after SARS boosted that economy's growth rate to over 20% in the second half of 2003 and to 16% for the full year. International tourism to Macau, China will grow rapidly, and Hong Kong, China will benefit from the spillover. The Hong Kong, China Disneyland will provide further impetus to tourism when it opens in 2005 or 2006.

Exports are expected to remain strong, benefiting from fast economic growth in the PRC, steady growth in the US and Japan, and a recovery in the EU. Imports will rise as consumption and investment pick up. The current account surplus as a share of GDP is expected to fall slightly to 7–8%. Government consumption is the weakest component in GDP; it is forecast to rise moderately by 1.7% in 2004 and then decline slightly in 2005, amid government efforts to reduce the budget deficit. CPI inflation is projected in the 1–2% range.

This outlook assumes that economic growth in the US and PRC remains robust, that no significant protectionist measures are taken against either Hong Kong, China or the PRC, and that current exchange rate arrangements remain in place.

Republic of Korea

Economic growth slowed in 2003 due to declines in private consumption—as consumer credit dried up—and in business investment. Strong export growth kept the economy expanding. In 2004–2005, a recovery in the world economy will maintain growth in exports, which is likely to stimulate investment. However, the heavy household debt problem needs to be contained so that private consumption growth can resume.

Economic Assessment

Growth in GDP fell by more than half to 3.1% in 2003 from 7.0% in 2002. Year-on-year growth slowed through the first and second quarters before edging up in the third and picking up strongly in the fourth. Net exports posted robust growth of 90.6% and contributed 2.8 percentage points to GDP growth, but private consumption declined by 1.4%. After posting 4 years of steady growth, private consumption was hit by credit difficulties: household debt increased to exceed 70% of GDP and about 3.8 million people, or 8% of the population, were delinquent on credit card payments by January 2004. The defaults shook consumer confidence and prompted credit card companies to cut credit lines. Although consumption of nondurables showed resilience in the first half of the year and government consumption grew modestly, all categories of private consumption declined in the second half, restricting GDP growth for the year (Figure 2.3).

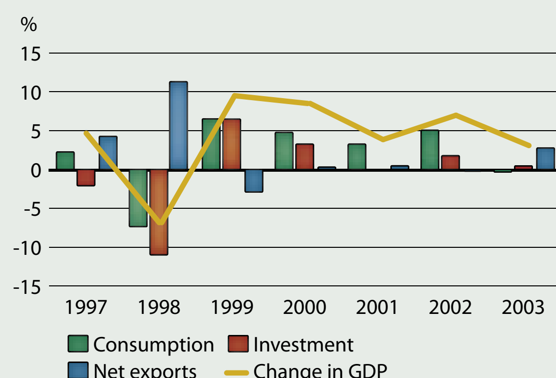
Gross fixed capital formation increased by 3.6% in 2003, as construction investment remained active throughout the year due to brisk housing construction. However, machinery and equipment investment fell by 1.5% in 2003, in contrast to growth of 6.8% in 2002.

On the supply side, despite the strong growth in construction, economic growth was held back by declining output in agricultural production and retail services, and slowing growth in manufacturing. Two consecutive years of agricultural contraction (3.5% in 2002 and 7.1% in 2003) were caused mainly by heavy rains and typhoons. Services sector growth in 2003 was limited to 1.8% as wholesale and retail trade fell, reflecting weak private consumption. Manufacturing increased by 4.8%, supporting the strong export performance.

Although poverty is not a major concern, the youth unemployment rate reached a historically high 8.6% at end-2003 because of the economic slowdown and rigidities in the labor market. The overall unemployment rate has also been increasing, reaching 3.9% in February 2004 from an average of 3.1% in 2002. Confrontation between management and labor unions has hindered the labor market, at an estimated cost to the economy of $2.1 billion in lost production in 2003.

The budget balance turned to a deficit equivalent to 1.7% of GDP in 2003 from a surplus of 0.4% in 2002. Two supplementary budgets were executed to promote economic recovery. The first was spent mainly on construction and social services while the second was used to repair typhoon damage of W4.2 trillion ($3.5 billion). Central government revenue collection improved slightly to 20.9% of GDP from 20.3% in 2002, mainly supported by growth in income and

Figure 2.3 Contribution of Expenditure Components to Change in GDP, Republic of Korea, 1997–2003



Source: Korea National Statistical Office, available: www.nso.go.kr.

profit taxes from the tradable sector, and made up for a loss in consumption tax. Expenditures increased faster, to 22.7% from 19.9% of GDP. Central government debt remains manageable at W165.2 trillion ($138.6 billion), or 22.9% of GDP at end-2003, significantly lower than the Organisation for Economic Co-operation and Development (OECD) average and allowing for further fiscal stimulus if necessary.

On the monetary front, core inflation (the CPI excluding agricultural products and oil) of 2.8% in 2003 remained within the targeted range of 2.5–3.5%. Meanwhile, the full CPI increased by 3.6%, up from the previous year's 2.7%, primarily due to higher oil and agricultural prices. The Bank of Korea maintained an expansionary monetary policy stance throughout 2003 in an attempt to lift private consumption. Long-term interest rates started to rise in October, driven by a surge in treasury bond issuance. Growth in the money supply (M3) slowed to below 5% in January 2004 from 12.4% in the first quarter of 2003 because of a sharp cutback in bank lending to households and a decline in corporate loans.

The won's exchange rate is increasingly market determined, with occasional intervention such as that seen in late 2003. After appreciating in the second and the third quarters of 2003, the won started to depreciate against the dollar in October, mainly driven by robust growth in the US. With this change, it ended 2003 with an appreciation of 4.7% against the dollar.

Strong demand in the PRC for raw materials put upward pressure on prices of commodities worldwide. As a result, the import price index rose at a faster rate (year-on-year average of 9.3% in 2003) than the export price index (year-on-year average of 2.5%), leading to a 5.8% worsening of the country's terms of trade.

Export growth accelerated to 20.9% in 2003, and this continued into February this year, marking its highest year-on-year growth at 45.9% since recording 52.6% in August 1988. Exports to the PRC and India surged by about 40% and 72%, respectively. Textile and clothing exports declined, but exports of semiconductors, ships, wireless communication devices, cars, and computers contributed to the strong export growth. Increased demand for inputs from the export sector, together with increased imports of crude oil, capital goods, and consumer goods pushed import growth up to 18.1% in 2003. The deficit in services trade widened, but with a sharp increase in the trade surplus the current account registered a surplus of $12.3 billion in 2003, more than double the previous year's $5.4 billion and reversing the downward trend seen since 1998.

Both approved and actual FDI inflows fell from 2001 through the first half of 2003. Actual FDI turned around in the second half, increasing by 30.6% in 2003 from the 2002 level, to $4.8 billion, but just five mergers or acquisitions accounted for most of this growth. While FDI to developing Asia as a whole is dominated by flows to the PRC, the Republic of Korea (henceforth Korea) attracted around half (about $13 billion) of the other types of capital flows (portfolio and bank lending), or as much as the PRC, India, Indonesia, Malaysia, Philippines, and Thailand combined. This contributed to the KOSPI stock index gain of 29.2% during 2003. Meanwhile, direct investment abroad fell by 12.4% to $5.4 billion in 2003, due to investor hesitation resulting from increased uncertainty from SARS and the Iraq conflict in the first half of the year, as well as a general sluggishness in Korean investment activity. The PRC continued to be the largest external destination for investment, followed by the US and Viet Nam. Overall, the capital account surplus rose from 1.1% to 2.2% of GDP.

By end-2003, total external liabilities amounted to $160.7 billion, or 26.6% of GDP,

Table 2.3 Major Economic Indicators, Republic of Korea, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	3.8	7.0	3.1	4.8	5.2
Gross domestic investment/GDP	27.0	26.1	29.4	30.0	31.0
Inflation rate (consumer price index)	4.1	2.7	3.6	3.1	2.8
Money supply (M2) growth	10.2	11.8	7.8	7.0	9.0
Fiscal balance/GDP	-1.7	0.4	-1.7	-0.5	0.0
Merchandise export growth	-14.0	7.9	20.9	21.0	19.0
Merchandise import growth	-13.4	7.7	18.1	22.0	20.5
Current account balance/GDP	1.7	1.0	2.0	2.7	2.6

Sources: Bank of Korea; Korea National Statistical Office; staff estimates.

about half of which are short term. However, the short-term external liabilities were more than adequately covered by $155.4 billion of foreign exchange reserves—the fourth-largest in the world after Japan; PRC; and Taipei,China—which increased by $34.0 billion, partly due to intervention in the foreign exchange market to maintain the won's competitiveness in the fourth quarter of 2003.

Policy Developments

Economic policies for 2004 focus on domestic issues, primarily the need to assist the recovery of machinery and equipment investment, private consumption, and employment. These issues are being addressed largely by the Ministry of Finance and Economy's new tax package, which came into effect at the beginning of the year. While the impact on tax revenues is expected to be minimal, a more business-friendly tax environment will be achieved through measures such as a reduction of the minimum tax rate from 12% to 10% for small and medium enterprises. Furthermore, to promote more equitable taxation, the Government will revise the tax code to cover all transactions resulting in property being inherited or gifted.

Other provisions include (i) an increase in the capital gains tax for short-term holdings (of less than 1 year) of land and buildings from 36% to 50% and from 9–36% to 40% on holdings of 1–2 years; (ii) greater support for low- and middle-income families through extension of the eligibility period for the Special Tax for Rural Development until June 2009; and (iii) an increase in the maximum tax credit for university tuition from W5 million to W7 million per student. Excise tax rates for cars, air conditioners, and other luxury goods have been reduced until end-2004 in an effort to increase domestic consumption.

The budget in 2004 will provide a mild fiscal stimulus and will focus on economic recovery through front-loading 54.8% of expenditures in the first half of the year. It will also provide support to investment that increases the country's competitiveness—in research and development (R&D), education, and information technology.

Several measures were initiated in 2003 to address the credit problems, including a system whereby personal debts could be rescheduled and partly written off. More substantial reforms are beginning in 2004. For example, the Government will establish a "bad bank" in May to help reschedule overdue consumer debt by providing consumer debtors with fresh loans of up to 8 years. The new bank will also acquire consumer NPLs from existing lenders, helping clean up their balance sheets. The Korea Housing Finance Corporation began operations in March 2004 to deal with the household debt issue in the medium to longer term. This government-led initiative aims to make mortgage money available to people in need and to help refinance short-term mortgage loans to reduce the risk of default.

To improve the labor situation, a tripartite commission representing workers, employers, and the Government reached agreement on the Social Pact for Job Creation in February 2004. Under

this pact, labor unions will cooperate to stabilize general wage levels. The pact aims to reduce confrontation between management and workers in an attempt to encourage firms to increase investment and create new jobs.

The Bank of Korea has kept its core inflation target range for 2004–2006 at the 2003 level. It intends to maintain the benchmark call interest rate at a historical low of 3.75% in the first half of 2004, until the economic recovery is firmly on track. However, the effectiveness of monetary policy hinges on reducing the high household debt because demand for liquidity is weak.

Although state ownership remains an important feature of the financial system, privatization has led to foreign ownership increasing in the banking sector, from below 10% of total issued share capital at the end of 1998 to 30% in 2003. Reforms of other financial institutions (e.g., specialized banks and nonbank financial institutions) are less advanced. An accounting fraud at SK Global in early 2003, which triggered a collapse in the market for bonds issued by credit card companies, showed that corporate reform is incomplete, entailing significant costs.

Free economic zones (FEZs) continue to be central to the Government's objective of turning the country into the business hub of northeast Asia. In addition to Incheon international airport area, two more areas (Busan/Jinhae and Gwangyang Bay) were designated as FEZs in 2003. Cash grants to refund part of the cost of investment and eased requirements for tax relief are the two main incentives to attract foreign investors to the FEZs. The success of this approach will depend on how the Government addresses various weaknesses—including a tightly controlled financial system, still difficult labor relations, and an underdeveloped regulatory system—to better compete as a business hub with other sites in northeast Asia.

These efforts, together with continually upgrading the skills of the labor force, will also determine whether the economy can, on a sustained basis, return to its long-run potential rate of growth (currently estimated at about 5% annually), and perhaps even raise that potential. One aim of the FEZ plan is to build on the fact that services created jobs in 2003 and manufacturing shed them, by attracting more services sector industries, such as financial services and R&D, which will create well-paid jobs.

Outlook for 2004–2005

Supported by strong growth in exports and accommodative monetary and fiscal policies to lift domestic demand, GDP growth is expected to recover to just below 5% in 2004 and to increase further in 2005.

Early containment of the credit card and household debt problems is the key for recovery in private consumption. While several measures have already been taken, there are few positive signs of recovery so far. The Consumer Sentiment Index improved for a fourth consecutive month in January 2004, but then declined in February and March. Growth in private consumption might resume only in the second half of 2004, after further progress has been made in reducing consumer NPLs. This would imply weak consumption growth for 2004 as a whole, before it strengthens in 2005.

Investment demand is expected to recover in 2004, bolstered by fiscal policy, although its timing and magnitude may be subject to rising uncertainty over developments in the north of the peninsula, the presidential impeachment, and National Assembly elections in April. Robust export growth is expected to raise demand for new investment, as has been observed in past export-led economic recoveries. However, the increasing trend in FDI flows to countries such as the PRC suggests possibly weaker spillover effects from export growth this time. Also, growth in construction will be slower because of government measures to cool a buoyant real estate market. Nonetheless, there are positive signs for investment, such as increasing capacity utilization and large retained earnings in the export sector, which might result in growth in machinery and equipment investment. Hence, investment growth will likely turn positive during the first half of 2004, but remain low, before firming up in 2005.

As the 2004 growth projection is slightly lower than assumed in the Government's budget, a wider than planned fiscal deficit may result. Nonetheless, relatively low central government debt (22.0% of GDP) allows room for fiscal policy to be more expansionary if necessary. The 2004

budget was designed to support the full turnaround of domestic demand, particularly by supporting investment. Running a planned deficit (0.5% of GDP) will continue the fiscal stimulus, with a more balanced budget likely to be targeted in 2005. As for monetary policy, the expansionary stance is projected to continue through the first half of 2004, before the stance tightens in the second half of the year and in 2005 when economic growth accelerates.

The trend of slower money supply growth may continue during the first half of 2004, until the demand for liquidity picks up in late 2004 and in 2005. Careful attention is required to ensure adequate liquidity, especially in the small and medium enterprise and household sectors. Recovery of these sectors, along with continued expansion by larger exporting firms, is the key to resuming balanced, strong growth. Core inflation appears under control and is expected to remain within the target range in 2004–2005.

Strong export growth will steer the economy along the recovery path. Although the country has a diversified export base in terms of products and markets, any weakness in demand from the PRC and US would set back its export performance, as would an appreciation of the won. However, merchandise export growth is expected to continue in 2004 at about 21%, before slowing to around 19% in 2005.

The increase in import prices needs to be monitored. The high demand for inputs to the export sector as well as higher oil prices are expected to lead to faster merchandise import growth in 2004 of an estimated 22%. Thus, the contribution to growth of net exports will decline slightly to 2.5 percentage points in 2004. Risks to the outlook could arise from domestic or external sources and would mostly affect investment or exports. Prolonged or violent disputes between labor and management, or heightened tensions across the northern border could deter investment. Weaker global expansion, and particularly any sharp deceleration of growth in the PRC, could also reduce the important contribution of net exports to growth.

Mongolia

The economy grew faster in 2003 as agriculture recovered (due to improved weather conditions) and services expanded. The fiscal deficit was contained, though it was largely financed externally. The resolution of the debt issue with the Russian Federation, solid progress in the privatization program, gold-related FDI inflows, and high commodity prices for the main exports augur well for sustained growth in 2004–2005—but favorable weather conditions will be important. Greater efforts are needed to translate growth into reduced poverty incidence.

Economic Assessment

On the back of brisk agricultural performance and a buoyant services sector, the economy grew by 5.5% in 2003, exceeding the Government's target of 5.0%. Agriculture, which employs one third of the work force, expanded by 4.5%, recording the first rise in output since 1999, as weather conditions improved after several extremely harsh winters (*dzud*). Growth in crops was particularly strong, while livestock registered a modest increase.

In contrast, industrial expansion was disappointing at 0.9% due to weakness in production of textiles and metal ores. Rapid development in Ulaanbaatar led to 8.0% growth in construction. Services increased by 8.6% as a result of sustained expansion in wholesale and retail trade, as well as transportation and communications. The regional outbreak of SARS reduced GDP by an estimated 0.2 percentage point, mainly in the areas of tourism, transportation, and trade.

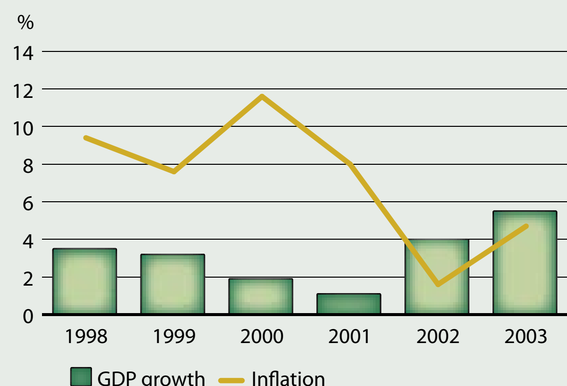
Continuing economic growth helped improve living standards and raise incomes by 12.0% in 2003. Average monthly wages reached MNT83,100 ($72), but salaries in the capital city are almost double those in the provinces.

Unemployment has been declining in recent years as the economy picked up, and, according to official figures, stood at 3.8% in 2003, although unemployment is significantly underreported because of a lack of incentives to register.

Available assessments indicate that the poverty incidence—36% of the population live below the poverty line—has not changed since 1998. Poverty in Mongolia is defined using the minimum living standards approach, and currently the poverty line is in the range of MNT19,500–25,000 ($17–21) per capita a month, depending on the region. Income inequality has widened as a result of the uneven distribution of the benefits of the economic transition and there is a widening gap in access to basic social services between urban and rural areas, exacerbated by poor infrastructure. The incidence of poverty is particularly high in large households and in those headed by a woman. Insufficient economic growth, unemployment, and underemployment are the primary causes of poverty.

The fiscal deficit remained within the IMF Poverty Reduction and Growth Facility (PRGF) target of 6.0% of GDP for the third year in a row. The deficit narrowed to 3.6% of GDP from 5.6% in 2002 as revenues exceeded the IMF target. Fiscal accountability improved after the implementation of the Public Sector Management and Financial Law, a medium-term fiscal framework, and a single treasury account that centralizes the Government's cash management. These benefits more than made up for problems caused by SARS, which eroded revenues and required additional

Figure 2.4 GDP Growth and Inflation, Mongolia, 1998–2003



Source: National Statistical Office of Mongolia.

government spending to contain it. Foreign funding, mainly through concessional finance, continues to cover about 70% of the fiscal deficit.

SARS also had an impact on consumer prices. Prices of oil and food increased sharply in the spring, pushing inflation to 5.7% in May. However, moderate price rises in the second and third quarters brought down the rate to 4.7% by year-end (Figure 2.4).

Money supply (M2) rose by 49.7% in response to faster economic growth and an easing of monetary policy. A continued surge in bank deposits reflected rising public confidence in the banking system. The banks, in turn, expanded credit to the corporate sector, but this generated concerns about the need to strengthen credit risk analysis and the banks' capital adequacy. Subsequently, the Bank of Mongolia (BOM), the central bank, raised the minimum capital requirement for banks to $4.0 million. Reported NPLs remained at a moderate 8.2% as both bank deposits and lending rose, but evidence from some banks suggests that the actual overall level of NPLs is higher.

Interest rates were broadly stable, although margins for banks narrowed because of competition from an increasing number of nonbank financial institutions following the liberalization of the sector. Rates remained at 12–18% for loans denominated in dollars, and 15–30% for local currency debt. The togrog depreciated by 4.3% in nominal terms against the dollar, the biggest depreciation since 2000, helping export businesses.

Total trade increased to $1.39 billion in 2003, with merchandise exports up by 14.5% as a result of higher exports of gold, copper, and cashmere. This represented a turnaround from a 3.9% decline in exports in 2002. Imports also rose significantly in 2003, by 14.0%, triggered by growing demand for capital goods and food. The trade deficit widened from 12.8% of GDP in 2002 to 15.7%.

The direction of trade continued to follow recent trends, with the PRC absorbing an increasing share of exports and the Russian Federation providing the largest share of imports. The current account deficit narrowed to 14.7% of GDP from 16.0% (excluding official transfers), while the overall balance of payments recorded another year of surplus as a result of remittances from overseas workers, the rising gold price, large inflows of external assistance, and growing FDI flows. Attracted by promising new gold prospects, FDI strengthened by 94% to $113 million.

After 10 years of negotiations, the pre-1991 debt to the former Soviet Union was resolved. Following Paris Club practice, the 11.4 billion transferable ruble debt was taken to be the equivalent of $11.4 billion. The Russian Federation agreed to write off 98% of the debt for an immediate cash payment of the balance of $250 million. The Government in December repaid this amount, which represents the equivalent of about 20% of GDP, partly by drawing $100 million from international reserves. This took reserves down to $180 million, equivalent to 9 weeks of imports. Total external debt was $1.1 billion, equal to 91% of GDP. Since most of the debt consists of concessional loans from multilateral or bilateral sources, the debt situation remains manageable, with a debt service ratio of 5.4% of exports.

Policy Developments

The Government aimed to reinforce macroeconomic stability, with overall policy guided by the PRGF. Mongolia was in full compliance with the first and second reviews under the PRGF. The strategy involves fiscal measures to restrain growth in public expenditures and a program of privatization. The IMF criteria for success are achieving 6.0% GDP growth by the end of its program in 2005, reducing consumer price inflation to 5.0%, containing the budget deficit to

Table 2.4 Major Economic Indicators, Mongolia, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	1.1	4.0	5.5	5.8	6.0
Gross domestic investment/GDP	28.3	26.7	-	-	-
Inflation rate (consumer price index)	8.0	1.6	4.7	4.5	4.0
Money supply (M2) growth	27.9	42.0	49.7	40.0	38.0
Fiscal balance/GDP	-5.4	-5.6	-3.6	-5.1	-5.0
Merchandise export growth	-2.4	-3.9	14.5	15.0	14.0
Merchandise import growth	2.5	3.3	14.0	12.0	12.0
Current account balance/GDP	-16.6	-16.0	-14.7	-14.0	-13.5
Debt service ratio	5.3	4.9	5.4	5.6	5.5

- = not available.
Sources: National Statistical Office of Mongolia; International Monetary Fund; staff estimates.

6.0% of GDP, and building gross official foreign exchange reserves to 4 months of import cover.

Mongolia completed drawing up an Economic Growth Support and Poverty Reduction Strategy in 2003. This plan, which reflects the Government's vision for growth, poverty reduction, and the achievement of the Millennium Development Goals, will be implemented from this year.

The country has made good progress in addressing non-income poverty, with increasing school enrollment rates, declining infant and under-5 mortality rates, and improved overall health care. Maternal mortality is declining, though it remains high compared with other countries at similar income levels.

The benefits of these improvements have not been shared equally, however. Rural areas and settlements of urban *ger* (traditional circular tents) on the outskirts of Ulaanbaatar lag well behind established urban areas in nearly all health and education indicators. In terms of gender equality, the country has higher tertiary enrollment rates for women than men, but women are underrepresented in private sector management and in the top echelons of government. The most challenging goal—in a context in which poverty has become more severe and income inequality has widened since 1998—is to halve the incidence of poverty by 2015.

Fiscal policies have focused on improving budget planning, execution, and control. In the first year of the implementation of the Public Sector Management and Financial Law, the sourcing of budget expenditures was transferred to a new system with the focus shifting from short- to medium-term planning.

The 2004 budget was approved by Parliament in the fourth quarter. Planned budget revenues are MNT553 billion, and planned expenditures MNT639 billion. This would keep the budget deficit to within the IMF target. However, the recent settlement of the Russian Federation debt and the possibility of a more lax fiscal policy ahead of parliamentary elections this year might put pressure on the budget. In addition, corporate and personal income tax rates were reduced in December, and the budget is providing for a 25% increase in salaries for public servants and for significant increases in pensions.

Monetary policy has focused on price and exchange rate stability, while ensuring an adequate supply of money. An easing of monetary policy in the fourth quarter of 2003, however, caused a greater than targeted increase in reserve money, and the growth in credit to the enterprise sector was high. As a result, BOM stepped up sales of BOM bills, aiming to bring reserve money growth into line with the IMF target. It also plans to raise banks' minimum capital requirements to $6.0 million later in 2004.

To strengthen BOM governance, Parliament approved a new supervisory board for the central bank, which will include outside representatives from the business world and academia, as well as former governors. The BOM exchange rate policy,

including the use of intervention, helped avoid sharp swings. A widening of the BOM buy-sell margin has improved exchange rate flexibility.

The privatization program has generally been successful, and the private sector now accounts for 85% of the economy. Agriculture Bank and the largest insurance company, Mongol Daatgal, were privatized in 2003. NIC, an oil company, was privatized early in 2004 and a tender for Gobi, the largest cashmere manufacturer, is expected to be completed in the second quarter of 2004. A 12-month contract was awarded in July 2003 to a foreign company to manage the state-owned airline, MIAT, in preparation for its privatization.

Outlook for 2004–2005

Mongolia has made substantial progress in achieving macroeconomic stability, but its narrow economic base makes it highly vulnerable to the weather and to volatility in world commodity markets. This limits its long-term development prospects, particularly as revenues from key commodities are the main source of the Government's income and the country's foreign exchange earnings.

Projections about the economy must depend on heavy assumptions about the weather and commodity prices. The underlying assumptions are (i) a strengthening global economy and growing external demand; (ii) increasing prices of gold, copper, and cashmere; (iii) favorable weather conditions; (iv) continued growth in the main trading partners (the PRC and Russian Federation); and (v) internal political stability after this year's elections.

Economic growth is expected to be close to 6% in 2004 and 2005. Milder winters, improved livestock-breeding techniques, and expanding crop areas will lift agricultural production. Manufacturing and mining are set to grow, helped by higher quality standards for cashmere production and meat processing, and by the initial operations of a new gold mine. Construction and services, the latter accounting for more that 50% of GDP, are projected to expand in line with rapid development in the capital city and growing demand for more sophisticated services. Tourism's recovery from a 21% drop in 2003, caused largely by SARS, will contribute to growth in the services sector.

The settlement of the pre-1991 debt to the former Soviet Union is regarded in Mongolia as a sign of independence from the Russian Federation and opens up the prospect for an improved trade and investment relationship. However, the substantial cash payment raises questions about fiscal stability and debt sustainability that could put at risk compliance with the IMF targets.

Although the donor community regards the settlement as a positive development, its terms might exert significant pressure on the 2004 budget. For example, some taxes payable in 2004 were collected in advance in 2003 and the Government borrowed from BOM to repay the debt. Other factors (i.e., more lax fiscal policy, lower income tax rates, and pension and salary increases) could also put pressure on the budget. Still, official estimates have the fiscal deficit staying within the IMF target as a result of improvements in revenue collection, restrained expenditures, and privatization receipts. Macroeconomic stability must remain a priority for the Government, and renewed efforts are needed to reduce poverty and to deliver public services to rural areas.

The BOM guidelines for 2004 and 2005 aim to maintain inflation at around 5% and contain the money supply within appropriate limits, while the exchange rate is expected to remain fairly stable. BOM also plans to strengthen regulation and surveillance of the financial sector. In 2004, a new system for interbank payments will be introduced and the Government intends to promulgate laws to fight money laundering.

A growing demand for consumer goods stemming from improved living standards, and for capital goods to supply the expanding construction and mining sectors, will keep the current account deficit at around 14% of GDP (excluding official transfers) in 2004–2005. Nevertheless, the deficit can be covered by the likely increases in overseas worker remittances, foreign aid inflows, and FDI in mining. Higher prices for gold and copper will help fill the gap in international reserves left by the debt settlement. International reserves could recover by $60 million a year. However, the Government should ensure that its borrowing is prudent and restricted to concessional loans to avoid putting pressure on debt servicing.

Taipei,China

The economy rebounded in the second half of 2003, largely due to surging exports. Prospects are promising, as a continued rise in exports will likely be joined by a pickup in domestic demand. A weak economy, relocation of firms offshore, and moves to higher-skilled industries have contributed to relatively high unemployment in recent years, but labor market conditions have started to improve. Areas for policy consideration include widening income inequalities and vulnerability to swings in global information technology demand.

Economic Assessment

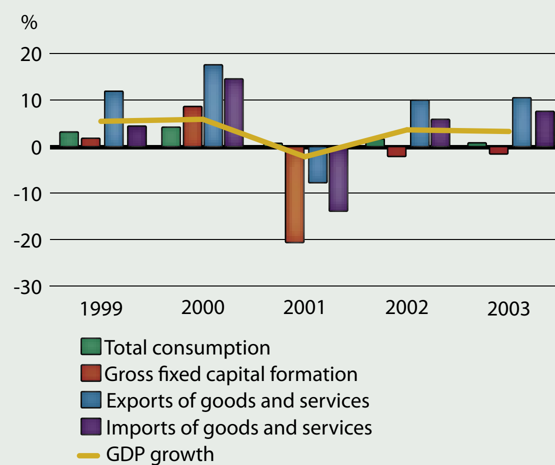
The economy's performance in recent years has been significantly affected by the bursting of the information technology (IT) bubble and the global economic downturn. The slump in demand for IT products worldwide was a particularly severe blow given IT's important role in the economy. However, nascent signs of recovery emerged in the first quarter of 2003, only to be disrupted by the outbreak of SARS in the second. Subsequently, though, the pickup in external demand for IT products and the declaration in July that Taipei,China was free of SARS sparked a sharp upturn in the economy, which was further underpinned by expansionary macroeconomic policies. GDP grew by 4.2% and 5.2% in the third and fourth quarters, respectively, and by 3.2% for the year as a whole.

The strong export momentum in the fourth quarter, reflected in the surge in shipments of electronics products, played an important role in lifting GDP growth (Figure 2.5). Domestic demand was subdued for most of 2003, so that imports continued to lag well behind exports. Consequently, net export expansion contributed 2.4 percentage points of GDP growth in 2003, and domestic demand just over 0.8 percentage point. However, signs were evident of improving domestic demand in the fourth quarter. Private consumption grew moderately, helped by rises in stock market prices and employment. Investment, which was hit hard by the reduced demand for IT products and had contracted since 2001, rose by 6.7% in the fourth quarter. Capacity utilization rates of firms rose as exports strengthened, spurring investment.

The labor market has changed substantially since the mid-1990s. The unemployment rate climbed from 1.8% in 1995 to a peak of 5.3% in October 2002, partly as a result of the Asian financial crisis, the end of the IT boom, and the global downturn. Structural factors also played a role because the economy moved into higher-technology industries, which require fewer low-skilled workers. Some labor-intensive industries relocated to economies with lower labor costs, especially the PRC, further reducing demand for blue-collar workers. The unemployment rate was 5.2% in August 2003, just after the SARS outbreak ended, then declined to 4.6% by year-end as the economy recovered and the authorities aggressively pushed forward their Expansion of Employment through Public Services Plan. Average monthly real earnings in the nonagriculture sector rose by 1.7% in 2003, after declining by 1.0% in 2002 and staying flat in 2001.

The authorities attempted to implement an expansionary fiscal policy in early 2003, but since the budget was not passed until June, most

Figure 2.5 Growth Rates of GDP and Its Demand Components, Taipei,China, 1999–2003



Source: Directorate-General of Budget, Accounting, and Statistics.

spending was made in the second half of the year. Also in the second half, public investment picked up, having declined for several years. The weak first-half economic performance and expansionary fiscal policies pushed the central government budget deficit to over 3.0% of GDP and public debt to more than 30% of GDP.

As a result of subdued domestic demand in recent years, plus lower import prices and intense competition in local markets, the economy has faced deflationary pressures. The CPI remained unchanged in 2001, declined by 0.2% in 2002, and fell by a further 0.3% in 2003. In the second half of that year, deflationary pressures abated as the economy strengthened and import prices of raw materials rose. Monetary policy, eased since 2000, remained accommodative: the official discount rate and money market rates fell to historical lows. The M2 monetary aggregate grew moderately in 2003, in line with the economy's performance. Stock market prices rallied in the second half, with the Taiwan Stock Exchange Weighted Price Index gaining 20.3%.

The trade surplus widened in 2003, reflecting a near 14% rise in exports in the second half. This and the expansion of net income receipts led to a marked improvement in the current account surplus. Direct investment recorded a net outflow, but the inflow of portfolio investment posted record figures in 2003, reflecting the large-scale portfolio allocation of international funds into Asia. Large current account surpluses, as well as the net inflow on the financial account, resulted in continued accumulation of substantial foreign exchange reserves, totaling US$206.6 billion by year-end, or the third largest in the world after Japan and the PRC.

Policy Developments

The authorities raised public spending moderately as a result of SARS. In April and May, they announced spending of NT$50 billion (US$1.4 billion) to help cover business losses and bonuses to doctors and nurses required to take care of SARS patients. In addition to the Expansion of Employment Plan, the authorities launched an Infrastructure Expansion and Economic Revitalization Program to boost domestic demand and employment; the combined budget was US$2 billion. By December 2003, 104,000 jobs had been created through the plan and 100 public projects had been selected for implementation under the program.

Various tax reductions and incentives have been introduced in recent years in an effort to stimulate output. However, these reductions and the slow economy have eroded tax revenues, which amount to less than 9% of gross national product (GNP), as against central government expenditures of about 16% of GNP. Furthermore, about 70% of the expenditures are stipulated by law, which leaves little room for reductions. As a result, the ratio of the central government deficit to GDP widened from 2.5% in 2002 to 3.1% in 2003; over a longer perspective, the ratio of public debt to GDP has risen from 14.8% in 1994 to 31.7% in 2003. Although the debt ratio is still moderate by international standards, the upward trend has caused some concern to policy makers.

The Central Bank of China (CBC) cut the discount rate on 15 occasions between December 2000 and June 2003 for a total of 337.5 basis points, to a historical low of 1.375% in an effort to boost domestic demand and alleviate deflationary pressures. Commercial bank lending rates, however, remained inflexible for some time as banks took advantage of higher interest rate spreads. To make the monetary transmission mechanism more responsive, CBC introduced

Table 2.5 Major Economic Indicators, Taipei,China, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	-2.2	3.6	3.2	5.4	4.7
Gross domestic investment/GDP	17.7	16.9	17.2	17.8	18.5
Inflation rate (consumer price index)	0.0	-0.2	-0.3	0.8	1.2
Money supply (M2) growth	4.4	2.6	5.9	5.5	5.0
Fiscal balance/GDP	-1.5	-2.5	-3.1	-3.0	-2.9
Merchandise export growth	-17.3	6.4	10.5	8.0	7.4
Merchandise import growth	-23.7	3.4	12.2	8.7	7.6
Current account balance/GDP	6.4	9.1	10.0	6.9	6.0

Sources: Central Bank of China; Directorate-General of Budget, Accounting, and Statistics; staff estimates.

adjustable rate mortgages and a base rate system, which move in line with market rates and have made the rates system more flexible. Interest rates are likely to remain low for some time, even though the economy has rebounded. In December, CBC left key interest rates unchanged, but the money supply target for 2004 has been increased in response to firmer economic conditions.

Economic weakness has prompted the intensification of reforms in several Asian economies, and in this context, the authorities in Taipei,China have identified financial reform as a major focus. This is partly to answer the calls for financial reform that were triggered by an increase in NPLs, which stemmed from a period of substantial property-backed lending by banks prior to 1997 and the subsequent downturn of the real estate market.

Various measures were adopted to resolve the NPLs. The Financial Restructuring Fund, established in July 2001 with a capitalization of US$4 billion, has liquidated 44 insolvent community financial institutions. Under the revised statute for this fund, which is being reviewed by the Legislative Yuan, the fund will be replenished so that it can be used to facilitate the acquisition of financially troubled banks and other lending institutions by healthy ones. Asset management companies are encouraged, through incentives such as tax breaks, to help dispose of the NPLs. The financial reforms are indeed yielding results: the average NPL ratio of domestic banks at end-2003 was 4.3%, down from a peak of 8.0% in March 2002.

Financial reforms have been extended to cover corporate governance and prudential regulation. The Financial Institution Merger Act and Financial Holding Company Law were passed in 2000 and 2001, respectively, to provide incentives for financial institutions to consolidate and so reduce the number of banks. A new agency, the Financial Supervisory and Management Committee, will be established on 1 July 2004 to bring the supervision of banks, securities and futures houses, and insurance companies under one roof, although CBC will retain the power to conduct examinations to monitor financial activities relevant to monetary policy. Other financial reform measures include the privatization of SOCBs and moves toward allowing universal banking. These reforms are expected to improve the efficiency and stability of the financial sector.

Reforms have also been spurred by increased competition with the PRC for labor-intensive industries. The relocation of some production to the PRC (and elsewhere) has prompted the authorities and the business community in Taipei,China to encourage the upgrading of technology and generally to make industries more efficient. The economy's early years of high growth were characterized by a rapid move to industrialize; the latest phase is to develop high-technology and services-oriented industries. A transition like this involves adjustment costs, such as unemployment, as older industries move away. These costs fall unevenly on different industries and members of society, and require official policies to mitigate the social and economic impact.

Outlook for 2004–2005

GDP growth is expected to strengthen to 5.4% in 2004 on the back of surging exports, a continued rise in domestic demand, and structural changes in the economy, though this rate is forecast to then slow to 4.7% in 2005. Buoyant external demand, especially for IT products, will be a boost to economic growth in 2004. Exports of goods and services are likely to strengthen by 8.0% in 2004 and by 7.4% in 2005. Higher levels of exports and capacity utilization have prompted major exporters to increase capital spending, and still further investment is likely. Some major companies, such as Taiwan Semiconductor Manufacturing Co., the world's largest semiconductor foundry, have indicated that they will raise their investment in 2004. Bank loans to the private sector are increasing to meet this demand. Technological upgrades in the IT industry will also require greater capital investment. Indeed, a surge in investment—by 8.5% in 2004 and 7.5% in 2005—is expected to be a major factor in the robust overall economic performance.

The gains in exports and capital investment, in turn, should revive the labor market. Higher employment and firmer asset prices will likely bolster private consumption, which is expected to expand by 4.0% in 2004 and by 3.8% in 2005. Inflation is projected to rise, but to remain low at 0.8% in 2004 and 1.2% in 2005, reflecting the competitive pressures in the domestic market. Strong economic and revenue expansion will narrow the budget deficit. Public debt, however, is forecast to rise because of the upturn in government borrowing to finance new projects. Interest rates may rise in 2004–2005, but will likely remain moderate, partly because of low domestic inflationary pressures. Strengthening domestic demand will see growth of imports at 8.7% and 7.6% over the forecast period, outpacing that of exports, leading to smaller trade and current account surpluses.

The economy depends heavily on the performance of its key trading partners, so this generally upbeat outlook assumes that the global economy will strengthen in 2004–2005.

While the economy is well on the road to recovery, longer-term policies need to address several challenges, three of which stand out. The first is rising income inequalities. Income per capita in Taipei,China is at a relatively high level of about US$12,000. However, according to official statistics, the ratio between the incomes of the highest and lowest quintiles widened from 5.4 in 1996 to 6.2 in 2002. Whereas the economy grew briskly in the 1970s and 1980s, with low unemployment and relatively even income distribution, since the early 1990s the development of electronics and other high-tech industries has seen incomes of skilled workers increase rapidly, while incomes for the unskilled have crept up more slowly or even declined, widening the income gap. Higher unemployment has also contributed to these income disparities.

The second challenge is how best to manage the relationship between deepening economic integration on the one hand and potential political uncertainties on the other, between Taipei,China and the PRC. The PRC is now Taipei,China's largest export market and largest investment destination, and economic integration between the two economies benefits both of them in the long run. However, any uncertainties could hamper investment and growth on both sides of the strait.

The significant impact of the bursting of the IT bubble on the economy highlights the increased effect of external shocks. The economy now is more open and the IT industry plays a more significant part, making Taipei,China more vulnerable to a weakening in global demand for IT products. The third challenge is therefore for economic policies to take into consideration such volatility. For example, more prudent fiscal policies are required, so that budgets in good economic years make allowance for periods when the economy turns down and requires policy stimulation.

ASIAN DEVELOPMENT

Outlook 2004

Economic Trends and Prospects in Developing Asia

Southeast Asia

T. Takahara

Cambodia

Growth slowed in 2003, but is set to pick up in 2004. The Government has made advances in rebuilding institutions and creating conditions for economic stability, though further progress is needed to reduce poverty. The private sector could play a much bigger role if infrastructure, financial, and governance weaknesses are overcome.

Economic Assessment

Growth in GDP eased to 5.0% in 2003 from 5.5% in 2002, the fourth consecutive year of slowdown (Figure 2.6). Domestic political uncertainties—including anti-Thai disturbances and the fact that Cambodian elections held in July 2003 have, as of early April 2004, yet to result in the formation of a new government—hurt investment and consumption, and delayed official transfers. Tourism was hit by the domestic political uncertainties and SARS.

Underpinning growth in 2003 was a recovery in agriculture following a drought-induced decline in 2002, and robust growth in the export-oriented garment sector. However, services sector activity weakened due to declines in the hotels, restaurants, and real estate subsectors as a result of lower tourist arrivals and the political deadlock after the elections.

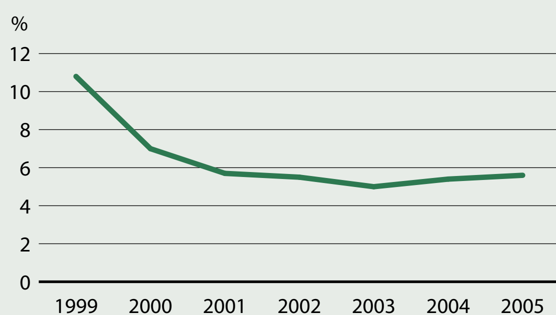
Preliminary data for 2003 indicate that the fiscal deficit narrowed to 6.1% of GDP from 6.6% in 2002. Although revenues came in below target, so did overall spending because current expenditures fell short of budgeted levels. Spending on economic and social transfers was higher than budgeted, while defense-related outlays were lower. The fiscal deficit was financed mainly by grants and concessional loans.

Inflation subsided from 3.3% in 2002 to 1.2% in 2003, reflecting the fiscal stance, relative exchange rate stability, and stable food prices following a rise in rice production after the drought of 2002. The riel depreciated by 1.6% against the dollar to KR3,973/$1, and the spread between the official and market exchange rates remained at 1%.

During 2003, merchandise exports are estimated to have increased by 14.4% to $2.0 billion, with strong growth in garments and natural rubber. The country's garment exports were granted special access privileges by the US and EU in the late 1990s, resulting in rapid growth that continued into 2003, especially to the US. The garment industry currently employs about 230,000 workers and generates more than 10% of GDP and over 80% of total exports.

Imports also increased, by a robust 12.5% to $2.6 billion, with a particularly large rise in transport equipment and, to a lesser extent, machinery and other equipment. Reflecting a higher base, the growth in imports offset the increase in exports, and led to a widening of the trade deficit to $599 million from $563 million in 2002. The current account deficit also widened, to 3.9% of GDP in 2003 from 1.6% in 2002, due to the wider trade deficit and a narrower services surplus as receipts from tourism moderated. The deficit was financed through official transfers and capital inflows, including about $130 million of FDI. Foreign exchange reserves at $737 million were sufficient to cover 3.4 months of imports.

Figure 2.6 GDP Growth, Cambodia, 1999–2005



Source: National Institute of Statistics; staff estimates.

Policy Developments

Given nearly three decades of conflict and a volatile political environment, most institutions were barely functioning when the Government began its first mandate in 1993. Since then, Cambodia has made important progress in rebuilding institutions, ensuring peace and security, and creating a stable macroeconomic environment. The country is now at a crossroads in its governance agenda and further progress in strengthening institutions is needed to guarantee sustainable economic growth and poverty reduction.

Central to strengthening governance is improving public administration at the central and local levels. A first phase that involved registration of civil servants and new career path and remuneration systems was completed in 2003; a second phase was started, under which the remuneration and classification systems are being overhauled and performance-based allowances are being introduced in priority sectors (i.e., education, health, agriculture, and rural development).

Public sector financial management is an important priority in governance, particularly given the need to increase revenues and improve the impact of government expenditures. The alignment of fiscal resources with development objectives in the past 2 years has resulted in an increase in budget allocations for the priority sectors and a reduction in defense spending. The revenue-to-GDP ratio, however, remains very low, and constrains spending on development. Increased revenue mobilization through tax and nontax collection and customs reforms is crucial.

Corruption has been a concern and is a serious impediment to private sector development. The Government adopted the Anticorruption Action Plan for Asia-Pacific—a program to combat corruption and bribery launched in 2001 by several countries and supported by international organizations—and submitted an Anticorruption Law to the National Assembly. In addition, both the National Audit Authority and the National Assembly's Finance and Banking Committee are being strengthened. These developments are expected to enhance accountability and thereby reduce the fiduciary risk of public funds. The challenge, however, is to implement the reform measures effectively.

In the agriculture sector, while donors are supporting privatization of SOEs as well as commercialization and diversification of the sector, there is a need to expedite the implementation of existing policy reforms, including the land titling system and social land concession policies, which will provide formal land rights to the poor. Natural resource management is another key area of governance. More equitable access and sustainable natural resource management are essential for sustainable economic growth and poverty reduction.

Notwithstanding efforts to improve governance, the outstanding reform agenda is still very long. Cambodia's incidence of poverty remains high, with 35–40% of the population living below the poverty line, and social indicators are among the lowest in the world. A reduction in the incidence of poverty requires a significant increase in economic growth, employment creation, and an increase in real wages. There is then a need for significantly higher rates of productivity and investment, and to nurture new sources of growth, particularly in the tradable goods and services sectors. The existing sources of growth remain narrowly based on garments and tourism, and prospects for the garment industry are uncertain with the phaseout of the Multifibre Arrangement (MFA) in 2005.

While there is a continued requirement for public investment, given increased fiscal pressures the private sector should be encouraged to play a considerably larger role in economic development. Private investment is, however, constrained by infrastructure bottlenecks, a weak financial system, shortage of skilled labor, and governance

Table 2.6 Major Economic Indicators, Cambodia, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	5.7	5.5	5.0	5.4	5.4
Gross domestic investment/GDP	21.2	22.2	20.3	21.1	21.3
Inflation rate (consumer price index)	0.3	3.3	1.2	2.9	3.3
Money supply (M2) growth	20.4	31.1	14.9	16.1	23.2
Fiscal balance[a]/GDP	-6.8	-6.6	-6.1	-5.8	-5.6
Merchandise export growth[b]	12.1	11.4	14.4	17.0	12.0
Merchandise import growth	8.0	10.5	12.5	16.0	14.5
Current account balance/GDP	-2.3	-1.6	-3.9	-4.3	-5.6

[a] Excluding grants. [b] Domestic exports.
Sources: National Institute of Statistics; National Bank of Cambodia; International Monetary Fund; staff estimates.

issues. These aspects need to be addressed if the country is to maximize benefits from its accession to WTO in September 2003.

Outlook for 2004–2005

Assuming a speedy resolution of the political deadlock over forming a new government, economic growth is expected to improve to 5.4% in 2004, led by export-oriented manufacturing (primarily garments) and an upturn in tourism and construction. The garment industry and tourism will benefit from a stronger global economy.

A forecast increase in global rice prices is likely to lead to relatively robust agricultural growth, which will increase rural incomes and domestic consumption demand. Given the Government's commitment to improving the effectiveness of its expenditures, spending on the priority sectors is expected to rise, while spending for military purposes is projected to decline further.

Overall, the budget deficit should narrow because of a stronger revenue mobilization effort. Improved public financial management and renewed emphasis on structural reforms will help the investment climate, as will membership of WTO. Efforts to integrate more closely with other countries in the Mekong region are also likely to promote trade and tourism.

GDP growth is expected to remain at 5.4% in 2005. Although the phasing out of the MFA is likely to dampen growth, tourism is forecast to pick up further, as long as peace and order are maintained. Agriculture is also expected to grow faster with new irrigation projects coming into operation and as implementation of land ownership reforms gathers pace. Overall private economic activity will also be helped by progress in implementing structural reforms.

Inflation is likely to rise moderately over 2004–2005, due to a recovery in domestic demand, an expected upturn in global rice prices, and a likely modest depreciation of the riel as the current account deficit widens. This deficit is estimated at 4.3% of GDP in 2004, pushed by a wider trade gap. Exports are likely to rise on the back of stronger world trade growth and a US decision to increase its quota for Cambodian garments in 2004, but imports will likely rise even faster in absolute term because of the import-dependent nature of manufactured exports and a likely increase in capital goods as investment picks up.

In 2005, the current account deficit is expected to widen further when garment exports are affected by the phasing out of the MFA. Gross international reserves, however, are likely to remain at over 3 months of imports because of increased inflows of official transfers and FDI.

Indonesia

GDP growth improved modestly in 2003. Private and government consumption provided the impetus, but investment remained weak. The Government outlined a series of reforms to follow on from its IMF program exit. Although slightly faster GDP growth is expected in the next 2 years, to achieve higher growth rates and create employment over the longer term, the Government needs to improve the investment climate, strengthen its judicial and regulatory institutions, overcome infrastructure constraints, and resolve outstanding decentralization issues.

Economic Assessment

GDP growth picked up to 4.1% in 2003, a modest improvement over 3.7% the previous year, even though the country was hit by another terrorist attack (in Jakarta), and faced the regional problems caused by SARS and the conflict in Iraq. Inflation slowed to a year-end 5.1%, the reference interest rate fell, and the rupiah firmed against the dollar.

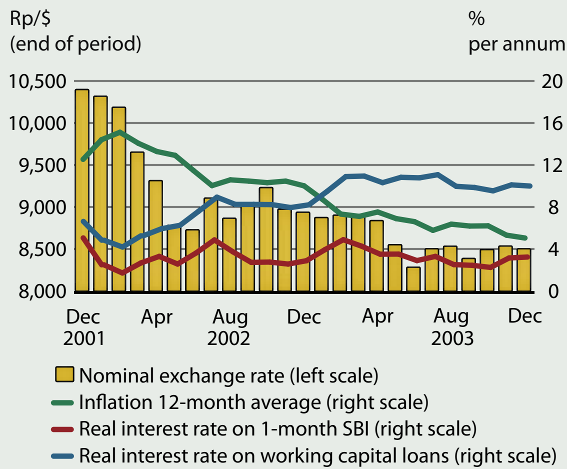
Private and government consumption remained the principal drivers of growth in 2003, as they have been since the 1997–98 Asian financial crisis. In particular, private consumption accounted for 2.8 percentage points of the GDP expansion in 2003, supported by declining interest rates and increasing bank credit for consumption spending. Such credit rose to one third of total lending from one quarter in 2002. The lending facilitated a 25% jump in purchases of cars and motorcycles during 2003. Government consumption accounted for 0.8 percentage point of the GDP expansion, while net exports added 0.7 percentage point, and net investments subtracted 0.2 percentage point.

Investment spending, measured by gross domestic fixed capital formation, has stayed at 20–25% of GDP over the past 5 years, down significantly from above 30% before the crisis. The National Development Planning Agency estimates that the efficiency of investments has declined, too, in that a given amount of investment produces a smaller increase in GDP now than before the crisis. The composition of investment has also been changing, with the share of investment in property rising over the past 3 years to over 80% of the total, while investment in capital goods declined to less than 18% in 2003. Although robust investment in construction may provide short-term gains in growth and employment, it is not likely to generate jobs in the longer term.

Net FDI continued to slide in 2003, by $2.1 billion, after falling by $7.1 billion in 2002. The Capital Investments Coordinating Board approved $13.2 billion of foreign investment projects in 2003, up from $9.8 billion in 2002, although only 38% of these investments were realized. In the first 2 months of 2004, FDI approvals fell by 66% from the year-earlier period, possibly a result of investors holding off ahead of Indonesian elections in 2004.

In terms of sector performance, the industry and services sectors together accelerated to 4.4% growth in 2003 from 4.0% the previous year. Manufacturing grew by 3.5%, continuing the slow trend seen since 2000. Growth in agriculture picked up to 2.5%, its best rate for several years. The overall modest expansion, especially in manufacturing, resulted in about 1 million new jobs, though this was not enough to stop the

Figure 2.7 Exchange, Inflation, and Interest Rates, Indonesia, December 2001–December 2003



SBI = Sertifikat Bank Indonesia.
Sources: Bank Indonesia; Central Bureau of Statistics; International Monetary Fund.

unemployment rate rising to 9.8% from 9.3% in 2002. Agriculture, which accounts for 15.8% of GDP, provides jobs for about 44% of the work force, and manufacturing 13.2%.

The incidence of poverty fell in 2002 to near precrisis levels of 18.2%, and declined further to 17.4% in 2003, with low inflation supporting this trend. These figures are based on a measure of income needed for a person to meet a daily minimum food requirement of 2,100 calories and on other locally accepted requirements for shelter and clothing. Poverty has pockets of concentration, and varies widely within and across regions, with 57% of the poor living in Java and Bali, and 66% in rural areas. Changes in real wages, as an indicator of improvements in welfare, have been modest. Manufacturing wages have picked up to precrisis levels, but agricultural wages stand at only three quarters of the 1996 levels.

Growth challenges notwithstanding, the Government has made advances in terms of fiscal consolidation, through revenue as well as expenditure reforms. It aims to balance the budget by 2006. The overall fiscal deficit widened to 2.1% of GDP in 2003 from 1.7% in 2002, slightly greater than the planned target of 2%, largely as a result of higher spending and lower than anticipated tax revenues. In terms of resources, domestic bank financing and privatization resulted in budgetary inflows equivalent to about 2% of GDP, with the partial divestment of stakes in four companies providing a record Rp7.5 trillion. The stock of total external debt at end-2003 leveled off at about 65% of GDP, at around $135 billion, with public external debt equivalent to 38.5% of GDP. The level of debt is well below that reached during the crisis and is scheduled to gradually decline to sustainable levels over 2005–2007.

On the monetary side, Bank Indonesia's policy stance has helped contain inflationary pressures (Figure 2.7). The appreciating rupiah and lower inflationary pressures enabled the central bank to reduce the interest rates on its 1-month certificates (SBI) by more than 4.5 percentage points over the course of 2003 to 8.4% at year-end. The rate reductions, in turn, helped the Jakarta share price index rise by 62% over the year.

The impact of the lower official interest rate on lending rates for investment and working capital, however, was limited. Banks give priority attention to consumer and small and medium enterprise financing, considering lending to the corporate sector too risky. Further, some of the bigger banks hold in their portfolios large amounts of tradable restructuring bonds issued in 1998 as part of the banking sector reform initiatives, which have provided a source of risk-free returns.

Progress was made in 2003 to restructure and privatize banks. Their overall capital structure has improved, with capital adequacy ratios exceeding 20% as against the minimum 8% requirement. Gross NPLs appear to have stabilized at around 8%, and average net NPLs were reported at 1.8% as of December 2003, although a relatively large share of restructured loans in the portfolios of some of the largest banks may mean that this figure will be revised upward as such loans mature. The Government sold 20% of its stake in Bank Mandiri in July 2003 and 40% in Bank Rakyat Indonesia in November 2003.

Weak governance in state-owned commercial banks continues, though, to be a source of concern. Fraudulent loan transactions at Bank Negara Indonesia and Bank Rakyat Indonesia in 2003 prompted Bank Indonesia to demand tighter internal controls in all banks, and the Government, as the major shareholder in Bank Negara

Table 2.7 Major Economic Indicators, Indonesia, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	3.5	3.7	4.1	4.5	4.5
Gross domestic investment/GDP	17.8	15.7	16.0	15.9	15.9
Inflation rate (consumer price index)	11.5	11.9	6.6	6.5	6.5
Money supply (M2) growth	13.0	4.7	8.1	5.0	5.0
Fiscal balance/GDP	-2.3	-1.7	-2.1	-1.3	-0.8
Merchandise export growth	-12.3	3.1	7.2	3.5	3.5
Merchandise import growth	-14.1	2.8	9.4	4.0	4.0
Current account balance/GDP	4.8	4.5	3.7	3.4	3.1

Sources: Bank Indonesia; Central Bureau of Statistics; Ministry of Finance; staff estimates.

Indonesia, reconstituted that bank's boards of directors and commissioners.

On the external front, the overall trade surplus rose by 3.9% to $24.4 billion in 2003. Relatively strong international oil prices contributed to 7.2% growth in merchandise exports. However, imports of oil and gas rose by 19.9%. Imports of capital goods increased by 7.6%, indicating a pickup in the machinery replacement rate. Indonesia, as with some other countries in the region, faces increasing competition in labor-intensive export products from countries such as the PRC and Viet Nam. On the other hand, the rapid development of the PRC and its role as a regional production hub in many sectors also provide Indonesia with a new export market—non-oil and gas exports to that country in 2003 rose by an estimated 25% from a year earlier.

Trade in services produced a deficit estimated at $16.7 billion, wider than the 2002 level of $15.9 billion. Earnings from tourism fell as a result of security-related concerns and of the impact of SARS on regional travel. International reserves grew by $4.2 billion to reach $36.2 billion at year-end.

Policy Developments

Indonesia was the last of the Asian crisis-affected countries to exit an IMF extended fund facility, in December 2003. In order to bridge the likely credibility gap that may emerge, in September 2003 the Government unveiled an economic policy package, better known as the White Paper, to consolidate and monitor ongoing and planned reforms under three planks: prudent macroeconomic management; financial sector restructuring; and real sector reforms aimed at increasing investment, exports, and employment. The White Paper's broad thrust has generally been well received by domestic and foreign investors, although its depth and breadth will require significant human and financial resources to ensure satisfactory implementation. While about three quarters of the measures have been completed, according to the Government, the content of the initiatives as well as their likely impacts are being debated.

With regard to macroeconomic management, measures are under way to achieve fiscal consolidation, particularly in expanding the revenue base. Delinquent taxpayers, especially those owing large amounts, are being pursued, customs operations are being strengthened, and a program to curb evasion of excise taxes is operational. Significant progress was made with the adoption of the State Finance Law in March 2003 and the State Treasury Law in December 2003. These two laws, together with proposed laws governing state audits, contain general principles aimed at strengthening budgetary processes, improving public expenditure and financial management, and enhancing public sector accountability. The new legal framework also paves the way for the separation of budget and treasury administration and consolidation of public debt management functions.

The Ministry of Finance also proposed amendments to the Tax Law, which have generated an intense debate in the business community

because some of the proposals are seen as coercive. Further public consultations are expected on these amendments. Fiscal decentralization is being strengthened through revisions to laws on regional autonomy, fiscal balances, and regional revenues. The revised laws will aim to clarify the role of the provinces and gradually achieve fiscal equalization. However, there have been concerns over inadequate consultation with local governments.

With regard to the financial sector restructuring plank of the White Paper, the Government closed the Indonesian Bank Restructuring Agency (IBRA) at end-February 2004. IBRA recovered about 28% of the $60 billion of assets it inherited, comparing favorably to similar agencies in the region. An asset management company will be established to manage and recover the corporate assets unsold by IBRA, which are valued at Rp43 trillion.

At the broader sector level, Bank Indonesia launched a study on the banking system in 2003, to formulate a new banking structure for the future. The study envisages consolidation of banks over the next 5 years, leading to two or three large financial institutions with a regional and international presence, three to five nationwide banks with a broad scope of business, and 30–50 specialized banks operating in different market segments and areas of Indonesia.

A draft law on a deposit insurance plan is under consideration by Parliament and a financial safety net framework is being formulated to support financial stability, particularly in times of systemic crisis. Amendments in December 2003 to the Central Bank Law will lead to the establishment of a new supervisory board to enhance the accountability of the central bank. The Government has also strengthened the regulatory framework for pension, insurance, and capital market institutions, which will enable the regulatory authorities to impose sanctions for noncompliance. In other significant financial sector developments, Indonesia adopted an amended Antimoney Laundering Law, established a Center for Financial Transaction Analysis and Reporting, and set up a National Committee on Antimoney Laundering to formulate policies in this area.

The third component of the White Paper—reforms aimed at increasing investment, exports, and employment—faces significant implementation challenges given its complexity. Progress in some areas is evident through the adoption of new labor laws, a State-Owned Enterprises Law, an amended Water Resources Law paving the way for the commercialization of the water sector, and a new regulatory framework for the telecommunications sector. A policy to issue land certificates through the conversion of informal titles has been stepped up to facilitate access to bank credits. The Supreme Court has finalized a blueprint on judicial reform, and the Government has established an Anticorruption Commission. The Government also completed the first stage of a Poverty Reduction Strategy Paper, which outlines measures to achieve the Millennium Development Goals. However, it is unlikely that the strategy paper will be finalized by May 2004, the date to which the White Paper committed.

Investment promotion is a key priority of the Government under the third plank of the White Paper. The Government labeled 2003 as the Year of Investments, but there was little tangible headway in facilitating direct investment. After considerable delay, a revised Law on Investments with provisions for equal treatment of foreign and domestic investment, simplified licensing, and clearer investment incentives is being finalized. The Government established a high-level National Team on Investment and Exports Promotion to resolve interministerial issues and address investor concerns. Proposals are being finalized for a one-stop facility for investment approvals and a revised, narrower list of sectors reserved for domestic investment. Despite these measures though, domestic and foreign investors alike remain concerned about regulatory uncertainties, lack of transparency in tax and customs procedures, and multiple layers of bureaucracy that have expanded the scope for corruption.

The decentralization program adopted by the Government in 1999 represents another concern for investors, because the regions are failing to coordinate with regard to investment incentives and regulations. Most important, investors view the Government as having adopted a culture of approvals and controls, rather than as having made a coordinated attempt to promote Indonesia as a regional investment destination. While extractive industries may retain their competitiveness because of the country's natural resources,

traditional industry sectors have seen productivity and efficiency eroded due to lack of investment.

Outlook for 2004–2005

With macroeconomic stability restored after the crisis, the key challenge facing policy makers is to achieve and sustain higher levels of economic growth, especially through greater domestic and foreign direct investment. That there is long-term investor interest in portfolio investments in Indonesia was evident when the country returned to the international debt markets early in 2004, for the first time in 8 years. On the back of strong global demand estimated at over $4 billion, the $1.0 billion 10-year bond was priced at a yield of 6.85%, or 227 basis points over the US Treasury rate. This compares favorably with a recent debt issue by the Philippines at a yield of 8.8%.

The 2004 budget approved by Parliament in November 2003 targets a deficit of 1.3% of GDP, narrower than the planned 2003 deficit of 2.0%. The budget assumes GDP growth of 4.8%, average inflation of 6.5%, and a steady exchange rate. The Government plans to reduce primary spending by 0.9% of GDP, partly by cutting nonfuel subsidies and transfers to the regions. This, together with lower interest payments, would reduce total expenditures by 1.6% of GDP. (However, it seems unlikely that subsidies and transfers can be reduced significantly in an election year.) Paris Club debt rescheduling provided annual relief equivalent to about $3 billion in debt service payments, but exit from the IMF loan program means that the country is no longer eligible for such rescheduling. Without this debt relief, the 2004 budget projects a gross financing need of 4.7% of GDP, the same level as in 2003, but with a greater amortization of debt, at 3.4% of GDP against 2.8% in 2003. Gross external financing is projected at 1.4% of GDP in 2004 (equivalent to $3.3 billion), compared with 0.9% of GDP in 2003.

Given the growth in private and government consumption, both of which are likely to rise further in 2004 (due to the availability of credit for consumption and government spending in an election year), GDP growth is forecast to rise to 4.5% in 2004 and in 2005. This higher rate will depend both on Bank Indonesia keeping a firm hand on monetary policy in the election period and on the oil industry's ability to ramp up oil production, which is currently below its OPEC quota. A key impediment to lifting oil production has been the delay in adopting satisfactory implementing regulations for the Oil and Gas Law enacted in 2001. The Government also needs to prudently manage its foreign reserves, as the external liquidity position is expected to deteriorate in 2004 due to the anticipated increase in the amortization of external debt to above $5 billion, in comparison with a net inflow of $1.9 billion in 2003. While the reserves position will still be adequate at about $33 billion, or equivalent to over 6 months of imports, it could become less comfortable if any unanticipated external events occur.

Looking at the risks to the outlook, in the short term growth may exceed the 2004 estimate. Political parties are expected to spend upward of Rp15 trillion ($1.8 billion) in campaigning during the year, which will have multiplier effects through greater consumption. The President signed a decree in March 2004 authorizing central and regional governments to access and disburse emergency funds to support immediate public needs. Thus, private and public spending may be stronger than projected. On the other hand, no significant new investments are expected in 2004 because of the election uncertainties, which may dampen growth. For public finance, a planned increase in domestic bond issuance by the Government may face investor resistance and may make it more difficult for companies to tap the bond market. In addition, the Government anticipates raising Rp10 trillion from privatization and asset recovery in 2004, but selling state assets might be difficult in an election year. Thus, prudent debt management will be critical as the Government has to redeem bonds worth Rp28 trillion.

In the medium term, there are continuing concerns that Indonesia may be trapped in a relatively low-level growth path, with the economy growing at less than 5%, unless certain key challenges are addressed.

The first key challenge is poor governance and inefficient and corrupt legal and regulatory environments. As the process of consensus building has become more complex in the new democratic period, the Government's approach has been to propose simple laws to expedite approval, leaving

critical issues to be addressed in implementing regulations. Lack of clarity and predictability in such regulations has hampered progress in many key areas, including decentralization, investment, and infrastructure, and has eroded overall investor and public confidence. Poor governance within tax and customs administrations is a major concern. Further, the public increasingly believes that corruption has become more pervasive and less predictable following decentralization. The Government has adopted only a few organizational measures toward improving the investment climate, without addressing the constraints in an integrated manner. The trends in 2002–2003 indicate that investment may recover only slowly over 2004–2005. In particular, the FDI environment is very weak, even in sectors where the country has a comparative advantage, including energy and mining.

The second key challenge relates to decentralization. Five years after the introduction of the ambitious decentralization agenda, significant issues and risks remain. Core concerns are the weak legal and regulatory framework governing decentralization; an inefficient intergovernmental fiscal system; and a lack of accountability at the local level. The Government's focus at present is on the political aspects of decentralization, while no major reforms to fiscal decentralization or equalization are yet envisaged. Given the revenue dependence of most local governments on the center, the Government needs to articulate a sound implementation framework that balances the fiscal and political aspects. Other issues that need resolution include a clear assignment of functions to the local governments; a strengthening of the finances of local governments and of accountability at the local levels; and increasing regional capacity to implement decentralization. A major issue is to ensure that development spending is increased from the current low level of 3.2% of GDP, in order to reduce the serious regional inequalities and address the state of disrepair and underprovision in infrastructure (Box 2.3).

Security presents the third key challenge. While the Government has been resolute in dealing with terrorist attacks, investors still see lack of security as a major concern, which in turn places a risk premium on investments. In addition, the Government needs to resolve the politically sensitive problems in the troubled provinces.

Box 2.3 Challenges in Meeting Infrastructure Needs

In the late 1990s, when the depreciating rupiah pushed up Indonesia's debt burden, the Government postponed several projects planned by independent power producers (IPPs) and directed the state-owned power utility, Perusahaan Listrik Negara, to reimburse only part of its obligations to the IPPs. The Government also postponed 37 proposed toll-road projects and launched a review of another 18. Several water utilities went bankrupt.

Since then, the Government has made progress in several areas of infrastructure development, including (i) adoption of laws that have strengthened the legal framework for telecommunications, oil and natural gas, electricity, and water resources (although the implementing regulations are still lacking for some of these laws); (ii) raising of tariffs for electricity from 2 cents/kilowatt-hour to 7 cents; (iii) renegotiation of 27 IPP contracts without disputes; and (iv) part privatization of the telecommunications sector.

However, the country may still face an infrastructure crisis if its infrastructure networks are not repaired and new investments are not undertaken. While infrastructure sectors received priority in the 1970s and 1980s, total infrastructure spending as a share of GDP fell from about 20% in 1992 to about 14% in 2002. Of this, central government spending on infrastructure declined steeply from about 4% in the early 1990s to just over 0.5% of GDP by 2002.

Also, although the central Government has devolved considerable functional responsibilities to district and provincial governments, infrastructure spending at these levels of government has not increased to compensate for the reduction in central government spending.

The following are key problems:

- **Road Transportation.** Interurban corridors are heavily congested and rural feeder networks are in poor condition. Progress on expanding toll-roads has been slow, although a new regulatory framework is being formulated. Investment needs are substantial, estimated at $12 billion over the next 5 years.
- **Water Supply and Sanitation.** Only 16% of the population has access to piped water, served by over 300 water utilities, most of which are in financial difficulties. Self-provision and other unregulated small-scale private providers cover the remaining needs. Unlike the power sector, water tariffs have not been raised to appropriate levels.
- **Electric Power.** The electrification rate of 53% is among the lowest in Southeast Asia. The sector is highly centralized with direction on investment coming from the Government, which causes problems for managers of IPPs.
- **Telecommunications.** Fixed-line telephone density of 36 lines per 1,000 people ranks among the lowest in Southeast Asia. Despite privatization, significant investments are needed to address disparities in service provision across the country.

Indonesia's large size and diverse geography present unique challenges in the provision of infrastructure. After the Asian financial crisis, the Government in 2001 established the National Committee on Infrastructure Policy and Development to coordinate infrastructure policy formulation and sector development. The committee's estimates show that $72 billion will be needed over 2005–2009 if the country is to achieve 6% average annual GDP growth, and more than $150 billion if the planning horizon is extended to 2014.

Considering that the central and local governments can allocate about $41 billion over the next 5 years, there is an urgent need to attract private sector investments of above $30 billion. The Government also wants to develop domestic (between East and West Java) and regional (Trans-ASEAN) oil and gas pipelines.

These investment plans need to be supported by reforms in two areas: first, expediting the adoption of a sound regulatory framework to accompany the recently adopted laws; second, strengthening the overall investment climate to provide for contract enforceability, legal and regulatory predictability and certainty, and flexibility in labor regulations.

Source: National Committee on Infrastructure Policy and Investment. 2003. *Policy Paper for the Consultative Group on Indonesia*. December.

Lao People’s Democratic Republic

Macroeconomic conditions were relatively stable in 2003, although inflation rose to nearly 18% at one stage and the fiscal position remained weak. The country’s major challenges include raising adequate government revenues to fund social and economic development and dampening inflation. Growth in 2004–2005 is expected to remain at around the 6% level.

Economic Assessment

The Government estimates that GDP growth in 2003 was 5.9%, or similar to rates of growth in the previous 2 years. Agriculture, which accounts for just over half of GDP, expanded by 8.3%, in part because rains in the upland areas after a dry period lifted rice output. While industry grew by 14.6%, the services sector contracted by 4.9%, stemming from regional weakness in tourism that followed the SARS outbreak as well as from security concerns. Slower private investment, due to more cautious bank lending, also hindered growth.

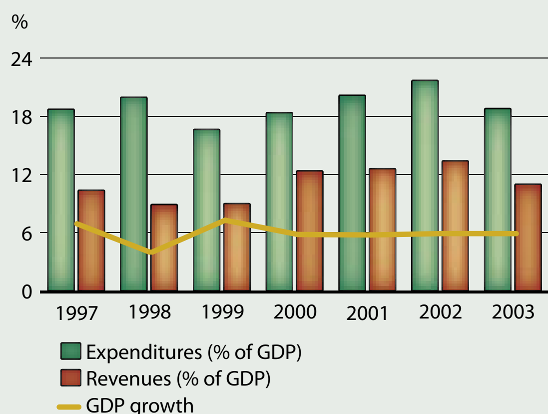
The overall budget deficit in FY2003 (ended 30 September 2003) was 7.8% of GDP (5.7% including grants). This represented an improvement from the deficit of 8.3% of GDP recorded in FY2002 (but a deterioration from 4.8% if grants are included). Either way, the deficit, mostly financed by grants and external concessional loans, was still above target. Revenue mobilization remains a major and worsening problem: as a share of GDP, revenues declined to 11.0% in 2003 (Figure 2.8). Fortunately, better expenditure controls prevented a repeat of the overrun in capital spending that was seen in 2002.

Inflation in the Lao People’s Democratic Republic (Lao PDR) has been running at one of the highest rates in the subregion and averaged 15.5% over 2003, up from 10.6% in 2002. Higher prices for food, water, electricity, and petroleum were contributory factors, as was the lingering impact of a depreciation of the kip against the Thai baht in 2002. The authorities took steps to restrain credit, reducing by nearly half the growth in broad money supply to about 20% in 2003. The kip depreciated by about 5% against the dollar over the year.

Merchandise imports and exports, after contracting in 2002, recovered. Exports rose by 23.0%, with the main contributors being hydropower, timber, and garments, which together account for about 80% of total exports. Imports grew by 7.2% in 2003. The merchandise trade deficit narrowed to an estimated $135.6 million from $170.1 million in 2002, continuing a narrowing trend evident for several years. The current account deficit is about $51 million, equivalent to 2.5% of GDP. Foreign exchange reserves increased to $215.5 million, sufficient to cover more than 4 months of imports. FDI rose from the weak 2002 level to a still low $19.5 million, and approvals went up sharply, indicating that FDI might head toward the much higher levels last seen 5 years ago.

With an estimated per capita income of just above $300, the country is one of the poorest in the region. The Expenditure and Consumption Survey conducted in FY1998 estimated that 39% of the population lived below the national poverty line of $1.50 a day. Preliminary results from a recent survey suggest that poverty incidence has fallen to around 30%, representing quite a sharp reduction over 5 years.

Figure 2.8 Central Government Expenditures and Revenues and GDP Growth, Lao People's Democratic Republic, 1997–2003



Source: National Statistical Center.

Policy Developments

The major challenge facing the Government is the fiscal weakness, because it seriously constrains resources available for social and economic development. The revenue effort has been chronically weak and it deteriorated again in 2003. The Government responded with increases in taxes on petroleum, beer, and tobacco, and committed to introduce a VAT, although the timing has not been finalized. However, it also introduced tax incentives for private investment that have the potential to erode revenues. Furthermore, the economy faces a reduction in customs revenues as it meets its commitments under the AFTA agreement to lower tariffs.

Concern over weak revenue collection and poor fiscal administration was a major impediment in 2003 to the IMF concluding a third review of its PRGF loan to the country. (These reviews are required by IMF before it disburses loan installments.) IMF finally concluded its review, which had been delayed since January 2003, in August, having found improvements in these areas, though it also indicated that further advances in revenue collection and tax administration are crucial.

The Government plans to tighten expenditure controls, improve its fiscal information system, and give stricter financial evaluations to proposed projects in an effort to make sure that spending does not again run out of control. In terms of the budget components, there has been a longstanding imbalance between capital and recurrent expenditures, with capital items receiving priority, though recent efforts have rectified this imbalance somewhat, as seen in a declining share of capital expenditures. Social sector spending as a share of expenditures has also risen, in particular on health and education, although in absolute terms these areas are still seriously short of funding.

Reforms of the state banking system are moving forward, but further progress is needed to put it on a commercially sound basis. The banks have strengthened their credit management and four international banking advisors were appointed to assist in various areas, including credit appraisal. Two small state-owned commercial banks were merged and the Government plans to seek strategic shareholders in another one. In contrast, few advances were made in reforming the debt-burdened SOEs, which need to be restructured to reduce their NPLs, a move that would complement the banking reforms.

Total external debt currently stands at around $3 billion, or just around 150% of GDP. At face value, this appears to be a significant debt burden. However, more than half of the total debt is owed to the Russian Federation and is currently not being serviced. After extended negotiations, the two governments in June 2003 agreed in principle to write off 70% of the bilateral debt and service the remaining debt, valued at $380 million, over 33 years at a preferential interest rate. This is consistent with the terms of the Russian Federation's memorandum of understanding as a creditor in the Paris Club.

A specific agreement relating to the interest rate, grace period, rescheduling, and payment modalities (cash, goods, investment) is still pending. Nevertheless, this is a major policy development that has the potential to significantly improve the overall debt position of the country. Of the remaining debt in convertible currency, less than 5% is commercial and the rest consists of long-term concessional loans with bilateral and multilateral institutions. The debt service ratio is about 7% of exports and will rise slightly when the Lao PDR starts servicing the renegotiated part of the debt to the Russian Federation.

Table 2.8 Major Economic Indicators, Lao People's Democratic Republic, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	5.8	5.9	5.9	6.0	6.2
Gross domestic investment/GDP	21.0	21.2	21.2	22.0	22.0
Inflation rate (consumer price index)	7.8	10.6	15.5	12.0	10.0
Money supply (M2) growth	13.7	37.6	20.1	28.0	25.0
Fiscal balance[a]/GDP	-7.6	-8.3	-7.8	-5.4	-5.3
Merchandise export growth	-3.3	-6.9	23.0	20.4	4.5
Merchandise import growth	-4.7	-8.4	7.2	11.7	1.8
Current account balance[b]/GDP	-4.6	-2.3	-2.5	-2.2	-1.9
Debt service ratio	7.2	8.3	6.8	-	-

- = not available. [a] Excluding grants. [b] Excluding official transfers.

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

Outlook for 2004–2005

GDP growth is expected to edge higher to around 6% in 2004–2005. Exports are likely to rise because of the improvement in global economic activity and the particularly rapid growth of the country's major trading partners—Thailand and Viet Nam—as well as the PRC. Furthermore, as part of Thailand's Economic Cooperation Strategy, the Lao PDR has been granted zero tariff rates on eight major agricultural products, while the Lao PDR and the US have signed a bilateral trade agreement that may pave the way to the US granting Normal Trade Relations status in 2004, which would not only help exports but also assist the country move toward membership of WTO. Receipts from tourism are also likely to increase in 2004 from the 2003 level, when they were affected by the regional SARS outbreak and security concerns. The lowering of tariffs in line with the AFTA agreement will lift imports.

The investment outlook is also improving. The Government is promoting FDI and is committed to support private sector development. Nevertheless, inflation needs to be curtailed and further progress made in developing infrastructure and the financial system in order to make the investment environment more attractive. The Government forecasts single-digit inflation in 2004, but inflation rates of 10–15% over the forecast period look more likely.

Among investment projects, the outlook for the construction of the Nam Theun 2 hydropower project has improved with the Electricity Generating Authority of Thailand agreeing to buy electricity from the plant over 25 years, while the Sepon mine plans to expand output, having produced 165,000 ounces of gold in 2003. The mine is also scheduled to start producing copper in early 2005.

Although it seems that the poverty incidence has fallen over the past 5 years, reducing poverty—generally worse and more concentrated in northern areas—remains a major challenge. The National Poverty Eradication Program and the Poverty Reduction Strategy Paper include specific policies, though the program requires prioritized action plans and effective follow-up to be successful. The expected growth in the economy will contribute to reducing the poverty incidence further, and, if the economic momentum is maintained over the medium term, the poverty reduction target of 25% or less by FY2006, as specified in ADB's poverty reduction partnership agreement with the Government, seems achievable.

These outcomes are contingent on the maintenance of macroeconomic stability, continued implementation of fiscal reforms, and relatively stable oil prices. The main risk to the outlook is the weak fiscal system: any further deterioration in revenue collection or sudden excessive expenditures would be particularly damaging.

Malaysia

GDP growth exceeded forecasts in 2003, supported by solid expansion in manufacturing and strong demand for exports. With still faster growth expected in 2004, the economy should be able to reduce its reliance on government spending. The major concern is low rates of capital formation, as both foreign and domestic investment are below levels needed to sustain strong economic expansion.

Economic Assessment

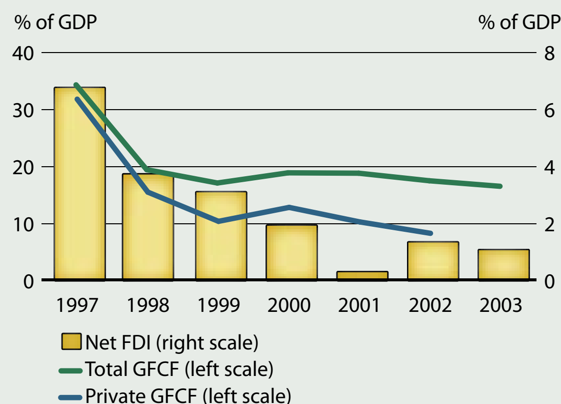
In 2003, the economy extended and deepened the recovery that took hold in 2002, with GDP growth picking up to 5.2%. Consumption continued to be the main driver of demand growth, contributing 3.5 percentage points to the overall GDP strengthening. Private consumption rose by 5.1% and public consumption by 7.9% as the Government raised its spending. Net exports contributed 2.0 percentage points to the expansion in GDP. Gross fixed capital formation grew by 2.7% in the year, accounting for 0.8 percentage point of growth. Total investment actually declined by 0.9%, due to a drop in inventories.

On the production side, industrial output rose by 7.0% and accounted for 2.9 percentage points of GDP growth. Manufacturing increased by 8.2% as the global economic recovery accelerated in the second half of the year to lift demand for electronics goods, the county's major export. Agriculture posted strong growth of 5.5%, of which 4.1 percentage points were generated by a 12.1% rise in crude palm oil production. Given higher world commodity prices in 2003, the nominal value of palm oil exports surged by 36.3% to RM20.2 billion, and agricultural products' share of exports rose from 6.5% in 2002 to 8.4% in 2003. Services grew by 4.4%, as the damage done by the regional SARS outbreak to the tourism and retail sectors faded in the second half.

The Government had aimed to reduce its budget deficit in 2003, but the SARS-induced problems and weak international demand in the first half caused it to change course and adopt a policy of aggressive fiscal stimulus. A fiscal package announced in May included tax incentives for investment and consumption, directed lending programs, and extra public spending. The package cost the Government $1.7 billion, or nearly 2.0% of GDP, but helped keep the recovery on track. The 2003 budget deficit came in at 5.3% of GDP, considerably wider than the original target of 4.0%.

Economic growth was also lifted by an accommodative monetary policy, as interest rates remained low despite the wide budget deficit. The monetary policy of Bank Negara Malaysia (BNM) remained anchored to the ringgit-dollar peg. During 2003, the market began to see an upside risk for the ringgit, leading to large purchases of dollars by the central bank and a buildup in foreign reserves. Though the resulting expansion in the ringgit money supply was partially sterilized by BNM, narrow money (M1) still increased by 14.6% and broad money (M2) by 11.1% over the year. The accumulation of foreign reserves was the main source of money supply growth because credit from banks and other lending institutions grew by only 4.8%. Interest rates fell modestly in 2003; in May, BNM cut its intervention rate by 50 basis points to 4.5%, and at year-end the rate on 1-year treasury bills was 2.8%, down slightly over 12 months. The banking sector continued to strengthen its financial position, with NPLs

Figure 2.9 Net FDI, and Total and Private GFCF, Malaysia, 1997–2003



FDI = foreign direct investment, GFCF = gross fixed capital formation.
Source: Bank Negara Malaysia.

at commercial banks declining to 6.4% from 7.4% (defining NPLs as loans that have been nonperforming for 6 months).

As a result of the ringgit's peg to the weakening dollar, the domestic currency declined by 6.0% against a trade-weighted basket of currencies, improving the country's export competitiveness after 2 years of ringgit appreciation. Inflation remained tame, despite the ringgit's depreciation and the money supply growth. Consumer price inflation slowed to 1.2%; the small rise was mainly due to a modest rise in food prices. The producer price index rose by 5.7% because of increases in petroleum products and other commodities.

On the external side, the improvement in the global economic environment in the second half of the year, coupled with the ringgit's depreciation, led to a doubling of growth in merchandise exports to 12.4%. Shipments to most traditional major markets grew in the 7–10% range, according to customs data, while exports to India jumped by 43.9% and to the PRC by 29.6%.

Imports rose modestly by 5.4%, with most of the growth attributable to a late surge in imports of capital and intermediate goods. Imports for consumption rose by only 1.1% for the year, and made up only 5.9% of the total. The trade surplus widened sharply to $25.7 billion from $18.1 billion in 2002. The current account surplus soared to $13.4 billion, or 13.0% of GDP, nearly double the 2002 level, and was reflected in a sharp increase in net official foreign reserves to a record $44.9 billion. The buildup in reserves was reinforced by a rise in portfolio investment resulting from renewed interest by international investors in Asian equities, and the apparent undervaluation of the ringgit. External debt was little changed at $49.3 billion at end-2003, equivalent to less than 48% of GDP.

FDI approvals in 2003 rose by $1.1 billion to $4.1 billion, though the increase was entirely due to two large planned investments by United Arab Emirates firms, including an aluminum smelting facility in Sarawak. Gross FDI inflows rose to $5.7 billion in 2003 from $5.4 billion in 2002. Net FDI declined slightly to $1.1 billion, primarily due to a buyout by a Malaysian company of foreign stakes in an energy sector joint venture (Figure 2.9).

Policy Developments

Economic performance in 2003 was built upon expansionary fiscal and monetary policies, as well as strong demand for exports. A revival of investment is required to provide a more sustainable foundation for stronger economic growth, though the Government did unveil some new measures in this area in 2003, including a liberalization of FDI regulations and a relaxation of previous ethnicity-based ownership restrictions (but full implementation of that sensitive decision has been slow).

If the economy is to reach its estimated potential growth rate of 6.5–7%, the Government needs to secure improvements in productivity and competitiveness, stimulate investment, and upgrade technology and work force skills. This is increasingly important as the PRC and India become greater competitors for FDI, and because they already offer much larger domestic markets and considerably lower unit labor costs, particularly in labor-intensive manufacturing sectors. (At the same time, the rise of these large regional neighbors presents significant opportunities for Malaysian businesses.) Public investment is expected to fall by 4.2% a year in 2004 and 2005 as the Government trims its fiscal deficit. Sharp increases in private investment are needed to make up for this decline, given the dependence of the economy on government capital spending in the past 5 years.

Table 2.9 Major Economic Indicators, Malaysia, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	0.3	4.1	5.2	5.8	5.6
Gross domestic investment/GDP	24.0	23.6	21.8	21.5	22.8
Inflation rate (consumer price index)	1.4	1.8	1.2	1.5	1.7
Money supply (M2) growth	2.2	5.8	11.1	9.8	11.0
Fiscal balance/GDP	-5.5	-5.6	-5.3	-3.6	-1.8
Merchandise export growth	-10.6	6.1	12.4	8.6	7.5
Merchandise import growth	-10.3	8.1	5.4	13.5	10.0
Current account balance/GDP	8.3	7.6	13.0	7.9	6.5

Sources: Bank Negara Malaysia; Department of Statistics, Malaysia; Ministry of Finance; staff estimates.

There are two main challenges to overcome if investment is to reach the levels needed to support sustained higher growth. First, considerable improvement is needed in the investment climate, including a reduction and eventual elimination of regulatory barriers to business operations. Examples include tariff and nontariff trade barriers, privileges that have been granted to *bumiputras,* and lingering restrictions on capital flows. A shift to higher value-added sectors would also require stricter enforcement of intellectual property rights. Although the legal foundation exists for these rights, court enforcement of laws has been inadequate. Improvement in the investment climate will also require further sustained action to combat corruption.

Second, further progress in implementing key structural reforms will be essential. A privatization program review recently initiated by the Government—under which sales of controlling stakes in state enterprises are being postponed while independent consultants review the procedures and plans for future sales—could be a positive step if it results in a more transparent, competitive, and efficient process. If Malaysian companies are to continue growing into global competitors, they need greater exposure to market forces and competition, both domestic and foreign, and a more open privatization process would contribute to achieving that goal. Opening more sectors to foreign investment would also help attract capital and technology.

Some long-anticipated privatizations were deferred in 2003. A decision to publicly list Felda, a large state-owned palm oil producer, was announced in September, but then indefinitely postponed when the Government said it needed more time to assess the impact of such a move on plantation settlers who own more than half of the land managed by Felda. Other anticipated privatizations are still pending, such as those of water utilities, most of which need additional capital.

An expected cut in the corporate income tax rate to stimulate investment was put on hold in 2003 because of the fiscal pressures, and the plan to reduce the budget deficit in 2004 and 2005 makes it unlikely that this measure will be implemented in the near future. In another policy change, the Government decided in November 2003 to impose high excise taxes on imported cars to maintain protection of domestic manufacturers, even though AFTA-mandated cuts in automobile tariffs were implemented. This sent a signal that protection of some manufacturing sectors is going to continue for some time. Proton, the major beneficiary of that decision, has performed poorly in recent years, and any incentive for it to improve itself was harmed by this decision. The excise tax rates are effective for 1 year, so the decision on whether to extend them beyond 2004 will provide the Government with another chance to consider its policy in this area.

In contrast to such protectionists efforts, BNM moved to open the financial system when it lifted restrictions that had forced foreign banks to raise at least 50% of their banking credit from domestic banks, so prompting some foreign banks to consider expanding their Malaysian operations.

Corporate restructurings are entering a new phase, as the work of the state agencies established to manage problem assets is nearing completion. Danaharta, the Malaysian asset management agency, achieved 75% of its key recovery target of RM30 billion, and expects to complete this task in 2005. The Corporate Debt Restructuring Committee ended its operations in late 2002. Danamodal Nasional Berhad was closed at the end of December 2003, having strengthened commercial bank balance sheets through the injection of RM7.6 billion during its 5 years of operations. Malaysia will now rely more on market-based restructurings, including mergers and acquisitions and bankruptcy, which require a strong legal and corporate governance framework. BNM issued new regulations to improve such governance in the banking sector, including guidelines governing the functioning and composition of banks' boards of directors. A new deposit insurance plan is being prepared and is expected to be implemented in 2004.

The changeover to a new prime minister on 31 October was smooth and the new leader took some decisive steps—including canceling a controversial RM14.5 billion railway proposal and cracking down on corruption—which were generally well received by the business community.

Outlook for 2004–2005

The improved economic performance of 2003, coupled with moves toward greater transparency in government decisions and a stronger anticorruption stance, has created favorable conditions for 2004. GDP growth is forecast to edge up to 5.8%, with strong export demand and private consumption projected to counteract the planned decline in government spending. In 2005, growth is forecast to slow slightly to 5.6%, due to further fiscal tightening.

The projections assume 12–15% growth in private investment, including increases in FDI of about $1 billion a year, offsetting the planned cuts in public investment but not generating a significant improvement in the ratio of gross capital formation to GDP. Better investment outcomes, which would be possible if policy is focused on investment-promoting initiatives, offer the opportunity for higher than projected economic growth.

The Government is targeting a reduction in the fiscal deficit to 3.3% of GDP in 2004, with revenues projected to increase by 7.2%. A planned 1.6% reduction in expenditures will be more difficult to achieve, although the Government's decision to hold elections early in the year, and avoid an extended period of politically driven budget decisions, is encouraging in this regard. Planned cuts in the development budget are already deep, but further modest cuts may be possible if necessary. The Government aims to further narrow the 2005 budget deficit to 1.8% of GDP, and balance the budget the following year. Under any plausible growth projections this will require significant further spending cuts.

In the past year, as the dollar fell against most currencies with floating exchange rates, pressure has gradually built on BNM to consider a more flexible exchange rate and allow the ringgit to appreciate against the dollar. The rise in portfolio investment inflows into Malaysia, fueled by the market view that the ringgit is undervalued, is likely to reinforce this. Upward pressure on the ringgit will be contained, though, by a likely accommodative monetary policy in the context of low inflation and a narrowing fiscal deficit.

Interest rates are expected to remain at their current low levels, although a further reduction in the BNM intervention rate cannot be ruled out if growth falters. Inflation will probably not rise above 2.0% in the coming 2 years, but moderate increases are possible.

With world economic growth expected to strengthen further in 2004, the outlook for exports is positive. They are likely to expand by 8–10% in 2004, which would be a solid result after the strong improvement in 2003. Imports are also expected to grow by 8–10%. As the US continues to be the major export market, prospects would be undermined if the US economy unexpectedly hit a flat patch because no other market is yet positioned to take up this slack. The Government seems determined to stimulate domestic demand to reduce the economy's exposure to external changes, though this will be a difficult goal in a period of fiscal consolidation. With indications that growth in the PRC may slow by 2005, and given the ripple effects that would be created in Malaysia's other markets if the US and the PRC both slowed, external risks pose the main threat to the economy in the coming 2 years.

Myanmar

GDP growth was officially reported at 10% for FY2002, but other indicators suggest that it was well below potential. Major problems, such as continuing budget deficits caused by subsidies to weak state enterprises and underinvestment in social areas, are yet to be addressed. Medium-term prospects are limited, but solid gains could be made over the longer term once the macroeconomic imbalances and structural issues are resolved.

Economic Assessment

According to the official estimate, GDP grew by 10.0% in FY2002 (ended 31 March 2003); growth was estimated at slightly over 10% in FY2003. The stronger areas of expansion in FY2002 were energy, mining, construction, and manufacturing. However, in FY2003 Myanmar faced several problems that constrained growth, including a hardening of international trade and investment sanctions that hurt exports of textiles and other goods and led to the closure of some garment factories. Troubles in the banking sector, shortages of certain imports and of power, and slower growth in fixed investment also hindered the economy.

Weaknesses in the data make an objective assessment of the economy difficult. Information is often incomplete, delayed, and difficult to reconcile. For example, GDP is officially estimated to have grown by 10% or more in each of the past 3 fiscal years, yet some essential factors of production, such as sown land area and the use of fertilizer, pesticides, crude oil, and natural gas, have been flat or declined for at least part of that period. Electricity generation in FY2002 was lower than in FY2000. A more modest growth scenario is also suggested by official figures on the growth of agricultural production, which slowed to 2.9% in FY2002 from 8.1% in FY2001.

The fiscal deficit, which is largely financed through central bank credit creation because of a low level of revenues, was targeted to narrow to 2.5% of GDP in FY2002 from 5.9% in FY2001, but provisional figures indicated that the target was not met, hitting 4.1% of GDP. More than 60% of the overall deficit was caused by the deficits of state economic enterprises. The current expenditures of such enterprises were higher than the Government's total spending. The capital expenditures of these enterprises in recent years have been less than 10% of their total expenditures, which helps explain a sharp slowdown in fixed investment. The continuing need for government subsidies stems from delays in the privatization of state enterprises, as well as repeated expenditure overruns and supplementary budgets.

Myanmar's inflation rate slowed to a still-high 24% in September 2003 from 57.0% at end-2002. Supply constraints contributed to price increases for items such as food, and some panic buying of essential goods was seen in early 2003 when the Government imposed limits on cash withdrawals during a period of turmoil in the financial system. The ability to use monetary policy to control inflation is constrained by the monetizing of the budget deficit and a policy of keeping nominal interest rates fairly stable. With high inflation, this meant that real interest rates were negative in 2003.

The financial sector troubles in early 2003 were apparently caused by the collapse of private finance companies, which took deposits from the public. The problem spread to some private banks and sparked runs by depositors. The crisis later subsided, but the cash withdrawal limits and a call by some banks for the early repayment of loans meant that confidence in the financial system has not been fully restored. A stronger regulatory framework for the banking system and a strategy to identify and resolve the problem banks seem necessary to restore such confidence.

Myanmar's balance of payments was in surplus by $94.3 million in FY2002, according to official data, but was in deficit by $38 million in the first 6 months of FY2003. Export growth in dollar terms had slowed in FY2002, and in FY2003 it would have been hurt by trade sanctions and a credit crunch caused by the banking crisis. However, stronger demand from the neighboring markets of PRC, India, and Thailand would have lessened the impact of sanctions somewhat. Private capital inflows remained low. Foreign exchange reserves at end-FY2002 covered 3.5 months of imports.

Policy Developments

The Government announced important changes to its rice trading policy in 2003 in an effort to encourage rice exports and help farmers: the rice trade was opened to all nationals; the Government will not buy rice from farmers and will not allow any private monopoly to develop in rice trading; and prices will be set by the market. However, rice exports will be allowed only when there is a surplus over domestic requirements.

Myanmar also introduced a law to combat money laundering and issued a notification in December to implement the law. These measures, while welcome, do not address the macroeconomic imbalances and impediments to structural adjustment that limit sustained economic growth and reductions in poverty. Large budget deficits stemming from subsidies to state enterprises and from the funding of the deficits by central bank monetization underpin high inflation and cause underinvestment in areas such as health, education, and social welfare. Public sector spending on health declined to just 0.3% of GDP in FY2002 from about 1% a decade earlier, while spending on education also declined as a share of GDP.

Major cuts in subsidies to state enterprises would enable Myanmar to spend more in these social development areas, which would reduce poverty and enhance productivity; ending the delays to the privatization of state enterprises would reduce the need for subsidies. Fiscal revenues could be increased by valuing imports for customs duty at the market exchange rate rather than at the official rate, phasing out tax exemptions, increasing user charges, and stepping up collection of excise taxes.

Other changes required include moves toward a unified exchange rate, since the dual exchange rate (in which the ratio of the parallel rate to the official rate is about 125:1) distorts both the economy and the official statistics, and restricts the country's gains from international trade. Strengthening the statistical system itself would allow a more accurate assessment of economic performance and assist in formulating appropriate economic policies.

The encouragement of more private sector activity could produce rapid results, especially on the supply side, and would stimulate investment, while the need to strengthen the banking system has become more pressing with the decline of confidence seen in 2003. Finally, basic infrastructure, such as roads, railways, and air transportation, must receive more investment if economic performance is to improve.

Outlook for 2004–2005

In view of the very limited reform agenda apparent at this time, growth prospects in the medium term are limited. International sanctions look likely to continue curbing exports and FDI. Insufficient investment in social areas and the slowdown in fixed investment suggest less than satisfactory reductions in poverty. The longer-term prospects for sustained growth are good, but only if the Government moves toward policies that reduce the macroeconomic imbalances and structural distortions.

Philippines

Stronger consumer spending lifted growth slightly in 2003 and is expected to do so again in 2004. For the economy to move to a more rapid growth path, however, the Government will have to address the heavy fiscal deficit and consequent debt burden, poor investment climate, lack of capacity of the economy to generate employment, and a high rate of population increase. Only then can per capita income growth rates of above 2.5% be achieved and poverty be reduced significantly.

Economic Assessment

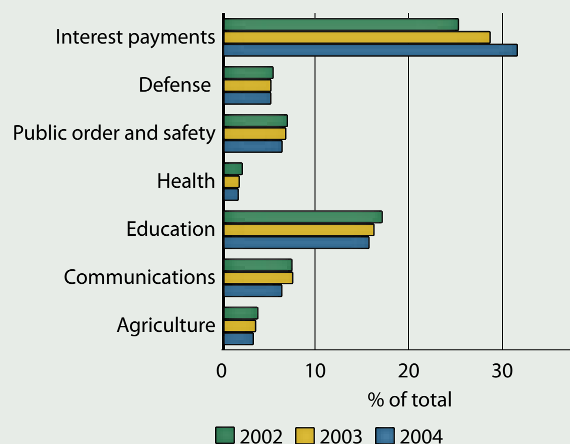
Little changed from the 2002 rate, GDP grew by 4.5% in 2003, while GNP growth strengthened to 5.5% on the back of continued rapid expansion in remittances from overseas workers (7 million citizens work abroad). On the demand side, these increased remittances and fairly stable price levels led to a 5.1% rise in private consumption expenditures, the fastest rate since 1990 and the main driver of the economy. In particular, spending rose on food and on transport and communications services. Private consumption spending contributed 4.0 percentage points to overall GDP growth. Government consumption fell by 2.8% following efforts to contain the budget deficit. Gross fixed capital formation rose by just 0.8%, which resulted in a meager contribution of 0.2 percentage point to GDP growth. Exports of goods and services increased by 3.3%, and imports by 10.3%.

By sector, agriculture, fisheries, and forestry grew by 3.9%. Industry expanded by 3.0%, propelled by manufacturing's 4.2% rise. Construction fell by 5.9%, mainly because of a 17.9% drop in public construction caused by government efforts to restrain its budget deficit. Private construction, in contrast, experienced a third year of recovery to register 7.4% growth after the monetary authorities widened the availability of housing loans. Services, the fastest-expanding sector in 2003 and the largest contributor to GDP growth from the supply side, grew by 5.9%, spurred by a recovery in the financial sector and by rising ownership of dwellings and real estate.

Unemployment remains high and is a major cause of poverty. In 2003, the economy generated 566,000 new jobs, of which 60% were in the services sector. Despite this, since new entrants numbered 624,000, unemployment rose. Unemployment stood at 11.4% of the labor force, a reflection of the country's lack of capacity to generate enough employment to keep up with labor force growth, itself a function of the rapidly rising population. This lack of employment also results in emigration. Likewise, underemployment, defined as the percentage of those employed who want to work additional hours, is also high at 17%. In 2002, one in three Filipinos lived below the annual per capita poverty threshold of P11,906.

As a share of GDP, the national Government's budget deficit for the year declined to 4.6% from 5.2% in 2002. Although tax revenues strengthened by 8.3% in 2003 and total revenues were P42.5 billion above target, poor revenue collection, rather than growth in domestic spending, remained the main cause of the deficit, thereby underscoring the need for more effective mechanisms to enhance tax collection. Ongoing reforms aimed at broadening the narrow tax base and efforts to collect unpaid taxes were apparently responsible

Figure 2.10 Government Expenditures by Sector, Philippines, 2002–2004



Source: Department of Budget and Management, *Budget of Expenditures & Sources of Financing FY 2004*, Table B.7.

for the upturn in revenues, even though Congress failed to pass several legislative bills aimed at raising more revenue. The net effect was that revenue raised (which includes taxes, fees charged by the Government, plus items such as interest earned by the Treasury) remained at about 14% of GDP. Likewise, the tax effort stood at a low 12.3% of GDP, unchanged from 2002. The inability of the Government to raise revenues further has led to an increasing reliance on borrowings. Debt service payments climbed to 27.4% of total outlays in 2003 from 23.9% in 2002, and to 42.1% of tax revenues from 37.4% in 2002. In fact, the outstanding national government debt has been rising since 1997, reaching about P3.4 trillion at end-2003 or 77% of GDP (50.8% was domestic). The debt service ratio stood at 11% of GDP.

Price stability, the primary mandate of Bangko Sentral ng Pilipinas (BSP), was maintained in 2003. The CPI rose by 3.1%, within BSP's target and the same as the previous year. This, together with low international interest rates, contained upward pressures on interest rates caused by the budget deficit. The 91-day treasury bill rate averaged 6.0% (5.4% in 2002), which was lower than expected. Private sector construction and personal consumption spending received a mild lift from this.

BSP was involved in the currency market to reduce volatility in the exchange rate. The peso weakened against the dollar in 2003 by about 5%, reaching an average of P54.2/$1, and, in a bid to curb this weakness, BSP raised commercial banks' liquidity reserve requirement early in 2004, thereby reducing the excess liquidity that could be used for speculation. The average nominal and real effective exchange rate indexes calculated by BSP depreciated against a basket of currencies of major trading partners.

Loan growth in 2003 was around 5%; domestic liquidity growth (the sum of cash, savings and time deposits, and marketable securities) rose by 3.3%, though this has slowed markedly in recent years from an annual average of 19.8% in 1990–1997. The main reason for this slowing is a combination of reduced credit to the private sector, as banks have become more cautious in lending due to the high levels of NPLs, together with lower private sector demand for loans as firms refrained from undertaking expansion plans or making new investments because of spare manufacturing capacity. The recent increase in the banks' liquidity reserve requirement had the effect of tightening the supply of credit, further exacerbating the problem of facilitating credit. As of December 2003, the commercial banks' NPL ratio was 14.1%, down slightly from 15.0% the previous December.

On the external front, lackluster results in 2003 from some of the main merchandise exports, such as electronics, produced a disappointing 3.3% rise in exports of goods and services. This calls attention to the need for broadening the country's export base. Exports of nonfactor services grew by 3.4%, mainly due to an 8.2% increase in income from private business services, which includes call centers and business outsourcing services. Exports to the PRC soared by 60% to $2.2 billion, while imports surged by 43.2% to $1.8 billion, nearly quadrupling the 2002 trade surplus with that country. Total imports rose at a double-digit rate because of higher imports of goods and nonfactor services.

Remittances from overseas workers increased by 6.3% to reach $7.6 billion in 2003, equivalent to 7.5% of GDP. Remittances are of paramount importance because they enable the economy to run a current account surplus, in 2003 at 4.2% of GDP, down from 5.6% a year earlier.

Inward FDI collapsed to $319 million, from $1.8 billion in 2002, largely due to political

Table 2.10 Major Economic Indicators, Philippines, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	3.0	4.4	4.5	5.0	5.0
Gross domestic investment/GDP	20.6	19.3	18.7	19.5	19.5
Inflation rate (consumer price index)	6.1	3.1	3.1	4.5	4.5
Money supply (M3) growth	6.8	9.5	3.3	5.0	5.5
Fiscal balance/GDP	-4.0	-5.2	-4.6	-4.2	-4.2
Merchandise export growth	-16.2	10.0	1.4	8.0	8.0
Merchandise import growth	-4.5	6.2	6.3	10.0	10.0
Current account balance/GDP	1.8	5.6	4.2	3.0	2.8
Debt service ratio	15.8	16.4	16.1	19.0	18.0

Sources: Bangko Sentral ng Pilipinas; Bureau of Treasury; National Statistical Coordination Board; National Statistics Office; staff estimates.

uncertainties that deterred investors. Moreover, investors do not regard the country as competitive, in part because of a lack of good infrastructure, so FDI would seem to have been lost to other locations such as the PRC. This is damaging because FDI contributes to technical progress as well as capital formation.

Foreign reserves in 2003 increased by $686 million to $16.8 billion, equivalent to about 5 months of imports.

Policy Developments

Although the economy has recorded growth of above 4% in 3 of the past 4 years, structural problems forestall any end to the boom-bust cycle that has afflicted it for the past two decades and that prevents it from moving to higher and sustained growth rates. Some initiatives taken by the Government, e.g., facilitating financial assistance to small and medium enterprises and making housing loans more widely available, will have a positive impact, as will the expected opening this year of a new terminal at Manila's international airport. However, other long-term issues still to be addressed include the backlog in physical infrastructure, the need to upgrade technological capabilities, and an appropriate population management program, of which better education is the pillar.

The most important constraints on growth are shortages of capital and technology. Therefore, the question is how to increase investment to accelerate the expansion of productive capacity, which is indispensable to achieving rapid national income growth. The key to achieving higher long-run growth rates of both GDP and labor productivity (which today is below the level of 1980) lies in (i) increasing the investment-to-GDP ratio, currently below 20%; and (ii) increasing the rate of capital accumulation, from its current low rate (even negative some years) to an annual rate of around 8–9% for a sustained period. This would improve the stagnant capital-labor ratio—the most important determinant of labor productivity, which in turn is the source of long-run growth—and help the country shift from consumption- to investment-led growth.

The lack of investment stems from a series of mutually reinforcing factors. For a start, the budget deficit results, directly, in low levels of public investment. The lack of public investment in infrastructure deters private investors. Then, the financing of the large deficit keeps interest rates relatively high for private investors and reduces funds available for private investment. The large deficit puts upward pressure on rates even when the central bank is trying to lower rates to keep inflation in check. The authorities have little room to maneuver given that nearly a third of the budget is dedicated to debt servicing, such that other government spending has to be restricted to control the deficit. In a year of election-related spending, fiscal policy seems to be pro-cyclical.

The budget deficit has become a chronic and structural feature of the macroeconomic landscape. Since 1970, the country has had only 6 years with budget surpluses and since 1998 the deficit has increased fourfold (in absolute terms) while the deficit-to-GDP ratio has risen from 1.9% to 4.6%. Moreover, government corporations, such as the National Power Corporation and the Philippine National Bank, often incur losses that need to be covered by off-budget borrowings that create a contingent liability for the national Government.

The chronic budget problem has several ramifications. First, the portion of the budget automatically appropriated for debt servicing is increasing, so that expenditure on much-needed social programs has declined (Figure 2.10). Interest payments in the proposed 2004 budget represented 31.4% of total projected budget outlays, and 76.6% of the proposed increase in outlays was needed to pay interest. Moreover, capital spending in 2004 is programmed to fall below the 2002 level and the proposed budget dedicates a smaller share of total national government spending than in 2002–2003 to social development and infrastructure. Second, the budget should have an important redistribution impact by raising taxes on the wealthy groups and focusing spending on the needy members of society. However, the tax collection step in this procedure is inadequate, so the redistribution impact is limited.

Third, the chronic budget deficit is the source of the country's high stock of debt. In the past, high inflation rates lowered real debt levels. Now, with greater emphasis on stabilization through monetary policy, real debt has become a more pressing problem. Maturing obligations and interest payments of the national Government in 2004 will amount to about P540 billion, or close to $10 billion. According to the 2004 budget figures, new gross borrowings for 2004 will amount to P411.9 billion. This will bring the total debt of the national Government at end-2004 to about P3.5 trillion (about 52% domestic), an increase of about P152 billion from 2003. This raises the question of the country's capacity to repay and refinance the debt in the future. Total public sector debt (national government plus government corporation debt) doubled after 1997 to about P5.4 trillion ($100 billion) by September 2003; about 72% is national government debt. This is about 120% of GDP, or twice IMF's "prudent" debt ceiling for developing countries.

Although the debt is prudently managed (only about 10%, or around $6 billion of the total external debt, is short term) and the current level of reserves is sufficient to cover short-term debt payments, the total level of debt must be reduced. The high debt-to-GDP ratio and a relatively small primary surplus (government income less expenditure, excluding debt payments) make the economy vulnerable to external shocks. If the peso continues depreciating, the large external debt would leave the economy in a weak position as the repayment burden in pesos would increase and interest rates could rise at the same time. An added element is that foreign reserves fell in February 2004, a decline likely exacerbated by external debt service payments. If the reserves continued to decline, BSP's ability to intervene in the market to reduce exchange rate volatility would be constrained. Also, financial markets would receive a strong negative signal. International credit rating agencies downgraded the country's sovereign debt rating in 2003 and early 2004, and the ratings will continue to be under threat if the deterioration in public finances persists through the next 2 years.

Furthermore, the fiscal problem and associated lack of funds for public investment damage the already poor climate for private investment. It will be difficult for the private sector to initiate investment unless the public sector takes the lead and provides, for example, adequate basic infrastructure. This is a necessary requirement to attract firms and thus to create employment.

To ensure that the fiscal problem does not deteriorate further, the Government needs to increase revenue collection by improving the reporting of income by taxpayers, broadening and deepening the tax base, and reducing corruption. One key reform measure yet to be passed by Congress is the National Revenue Authority Bill, which would transform the Bureau of Internal Revenue into a semi-independent body that would be better able to pursue revenue collection. The Government also needs to consider measures to reduce borrowing expenses.

Improving the investment climate requires greater attention to a wide range of areas,

including competition policy, antitrust legislation, impartial implementation of laws, anticompetitive practices (collusion and price fixing), bankruptcy procedures, labor markets, bank intermediation and capital markets, customs regulations, and security.

The low investment level has several implications. It has led to a low rate of capital accumulation and to a low capital-labor ratio, which directly affect output growth. It also makes it difficult to generate new employment. Unemployment and underemployment in the Philippines result from the shortage of capital, and the solution is to increase the productive capacity of the country.

The high rate of population growth is an underlying constraint: labor supply is outstripping labor demand (2.3% a year on average in 1998–2002 versus 1.7% a year for employment). It would be difficult to accommodate all the new entrants to the work force even if economic growth accelerated. Rapid population growth retards development in the country for two interrelated reasons: first, it does not permit a rise in per capita incomes sufficient to provide the savings necessary among the poorest for the required amount of capital formation for growth; second, as it outstrips the capacity of industry to absorb new labor, urban unemployment and rural underemployment are compounded, depressing productivity in the agriculture sector.

On current population and GDP growth trends, per capita income cannot rise by more than 2–2.5% a year, which is not enough to significantly reduce poverty. Hence, unless major economic and political reforms are accomplished, it will be extremely difficult for the country to lift its potential growth rate, which is about 5% now; or to escape the vicious cycle where capital scarcity implies low incomes, low incomes imply a limited capacity to save among the poor, and limited savings lead to limited investment and capital scarcity. In the end, low rates of growth have led to the budget deficit. The solution consists not only in implementing the necessary microeconomic measures to spur investment, but in simultaneously achieving a big push in investment, combined with a reduction in population growth. This requires an awareness that the main purpose of the development of genuine market-economy institutions is to facilitate the process of capital accumulation. It also requires a coherent plan in terms of a partnership between the public and private sectors. In this regard, an option worth considering would be to try to design policies so as to channel worker remittances, most of which are used for consumption, into development capital, i.e., investment, perhaps through microfinance or other financial institutions.

A significant reduction in unemployment and underemployment will require an expansion of jobs in both manufacturing and agriculture, together with an adequate population management program. The economy has relatively few linkages across sectors and its output grows faster than employment. As a result, a significant expansion in manufacturing production has only a limited effect on the rest of the economy and on the absorption of labor from rural areas (one third of the labor force is in agriculture).

For this reason, it is necessary to pursue a complementary policy of increasing physical productivity in agriculture with a view to raising wages in the sector. This may be achieved by labor-intensive investment in rural infrastructure and better supply of farm inputs, and by such methods as small-scale irrigation, proper use of manure, crop rotation, application of fertilizers, and improved seeds. For example, in 2004, land planted to genetically modified corn could expand to 50,000 hectares as more farmers adopt a newly developed technology, "Bt corn," whose yield is much higher than that of the traditional corn variety. However, one main obstacle to an increase in agricultural production is the prevailing institutional conditions (e.g., incomplete land reform).

The economy has run current account surpluses since 1998, together with budget deficits. Gross national savings have increased from 17.7% of GNP in 1997 to 25.6% in 2003. Yet gross national investment decreased from 23.8% of GNP to 17.4% in that period. These figures reinforce the view that although the savings rate is lower than that in other developing Asian countries, the country's critical problem is its lower and decreasing investment rate. Also, the savings-investment gap of the private sector is substantial (between 4.3% and 13.3% of GDP since 1998) and has more than compensated for the public sector's deficit. It is paradoxical that the country is, via a deficit on its capital account, financing others'

current account deficits. This indicates a failure of the financial sector to channel investment, combined with a lack of capacity to attract foreign investment.

Outlook for 2004–2005

Growth is likely to improve slightly in 2004–2005, with consumer spending the main factor. Expected better weather and higher election spending during the first half of 2004 will contribute to expansion, although some investors are holding back until the election is over in May. Brisk growth in the rest of Asia, particularly the PRC, and an improved global demand for electronics products, which represent about 70% of total exports, will help, too.

In both 2004 and 2005, growth is expected to be in the range of 4.5–5.5% for GDP and 5.2–5.8% for GNP. At the sector level, agriculture is projected to pick up by 3.7–4.7%. Industry is expected to improve by 3.6–4.8%, led by stronger manufacturing as a result of stronger global demand, and a rise in public construction from election-related spending. The services sector is expected to grow by 5.5–6.3%.

On the expenditure side, growth in private consumption is projected to remain strong at 5.5%, while government consumption will register slight growth of about 1.5%. Gross fixed capital formation is expected to recover and expand by 6%. Private investment will likely grow by about 6% and public investment will stage a recovery, rising by 7.5%.

Over 2004–2005, exports of goods and services are expected to grow faster than in 2003, by around 8%, pulled by the recovery of semiconductor exports and exports of nonfactor services arising from the income of IT-related services, call centers, and business outsourcing services. Imports are forecast to grow by around 10%, the same pace as 2003, because of higher prices for oil and other commodities, a need for more electronics components as inputs for the electronics-export industry, and a rise in equipment imports related to the expected increase in investment.

Inflation is projected to be in the range of 4.0–5.0%. This target considers the impact of the continuing high prices of oil and the lagged effect of the weaker peso in 2003. Unemployment is likely to remain at around 11%.

The growth forecasts are based on the assumption of a smooth transition to a new Government after the 2004 elections and no external shocks. An improved performance in 2004–2005 will be determined by progress in key economic legislation and policy reforms; improvement in security and law and order; and the country's capacity to take advantage of developments abroad, such as PRC growth and outsourcing by industrial countries. Uncertainties relate to the recovery of the US economy, the oil price outlook, the extent of peso depreciation, the budget deficit, and the outcome of the elections.

The key variable to monitor during 2004–2005 is the fiscal situation. For 2004, the Government's target is to achieve a public deficit equivalent to 4.2% of GDP. To monitor the evolution of the deficit, the authorities have set quarterly deficit targets, and the first quarter target was met. However, the task remains very difficult, given election spending and a low tax revenue target of 13.6% of GDP for 2004. The Bureau of Internal Revenue will probably not meet its initial revenue target because Congress did not pass the Indexation of Sin Taxes Bill to restructure the excise tax on distilled spirits, which will deprive the Bureau of about P7 billion in potential revenues. Without additional tax measures, the Government may miss its target. Moreover, the proposed 2004 budget was not approved for political reasons and, consequently, the Government had to reenact the 2003 budget. This has not sent any message of confidence to the market.

Singapore

Economic growth rebounded in the second half of 2003, on the back of external demand and the end of SARS, though a recovery in domestic demand was far from self-sustained. Macroeconomic policies remained accommodative to spur growth. The Government emphasized supply-side policies, such as cutting labor and business costs to maintain competitiveness, in line with its long-term strategy for a globalized, entrepreneurial, and diversified economy. Growth is forecast at a faster pace in 2004–2005, due to an improved external environment and increased domestic demand.

Economic Assessment

The economy recovered in the second half of 2003, after a weak first-half performance. A sluggish external environment resulted in slow growth early in the year, and the economy contracted by a sharp 3.9% in the second quarter because of the impact of SARS. Growth returned in the third quarter at a rate of 1.7%, accelerating to 4.9% in the fourth quarter to put full-year growth at 1.1%.

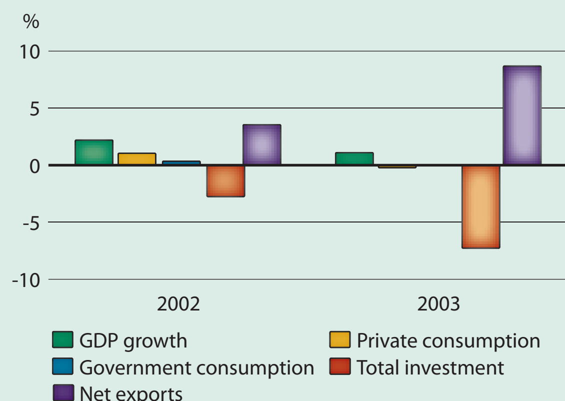
The recovery was driven by external demand. Measured in Singapore dollars, net exports surged by 36.5%, contributing 8.7 percentage points to the growth in GDP (Figure 2.11). Merchandise exports increased by 12.1%, thanks to a strong performance by the pharmaceuticals sector and the pickup in global IT demand since mid-2003. Demand was particularly strong from the PRC and EU. Merchandise imports rose at a slower pace of 7.0% (also in Singapore dollars) because of weak domestic demand and reduced import contents of exports, as Singapore's exports shifted toward higher value-added, capital-intensive goods, such as pharmaceuticals and semiconductor chips.

Declining domestic demand largely offset the strength of external demand. Private investment fell by 3.3% due to global economic uncertainties, increased international competition, and a substantial property overhang. Private consumption declined by 0.5%, weighed down by the SARS outbreak and a weak labor market. Public consumption and investment declined by 0.2% and 5.6%, respectively. Inventory reductions accelerated, reflecting the unexpected economic rebound and structural changes in manufacturing, as industries moved up the production chain.

Manufacturing value added grew by 2.8% in 2003, with export subsectors such as semiconductors, disk drives, and pharmaceuticals producing much of the growth. Output of electronics products increased by 5.5%, boosted by the cyclical recovery of the global electronics industry. The sector was not uniformly strong, however. Semiconductor output expanded, but production of communications and consumer electronics products remained weak. This reflects the relocation of low-end, labor-intensive assembly production to low-cost countries such as the PRC. The biomedical industry expanded by 8.1%, largely because of a switch of the product mix in pharmaceuticals to higher value-added products for patented drugs, which boosted exports. Output of chemicals rose by 6.2%. However, other major manufacturing subsectors, such as precision and transport engineering, continued to shrink, indicating that the recovery was far from broad based.

Construction declined for the fifth consecutive year in 2003, by 10.7%, against a backdrop of

Figure 2.11 GDP Growth and Contribution by Expenditure Account, Singapore, 2002–2003



Source: Ministry of Trade and Industry, *Economic Survey of Singapore 2003*.

significant oversupply in the property market. The services sector (including owner-occupied dwellings), hit hard by SARS, rebounded in the second half to post growth of 1.1% for the year. This was largely attributable to continued strength of Singapore's entrepôt trade, a rise in motor vehicle sales, and a recovery in financial services. The wholesale and retail trade sectors expanded by 6.7%. Financial services recorded growth of 3.7%, after a 6.3% decline in 2002. This subsector was helped by reduced risk aversion among investors and by the prospects of a pickup in regional economies, which boosted regional corporate financing activities and encouraged investment in Asian equities.

However, the labor market continued to weaken. The unemployment rate rose from 4.3% at end-2002 to 5.5% in September 2003, then fell to 4.5% by end-2003. Employment increased in the third and fourth quarters, after eight consecutive quarters of decline, but this weak job creation was unable to make up for first-half job losses, leaving total employment down by 0.8% for 2003. Job cuts in the first half resulted from the restructuring of the electronics sector and the sustained contraction of construction activity. The services sector added a moderate 4,000 jobs over the year.

Slower economic growth and tax reductions eroded fiscal revenues. Government operating revenues, which exclude investment income, interest income, and capital receipts, fell by 2.9% in 2003. Government expenditures (operating plus development expenditures) grew by 0.3%, mainly in the areas of education, housing, basic health care, and defense. As a result, the primary operating deficit widened to S$2.5 billion from S$1.7 billion in 2002.

The Monetary Authority of Singapore in July lowered the midpoint of the band governing the trade-weighted nominal effective exchange rate. The Singapore dollar remained stable against the generally weak US dollar, but depreciated against the yen, euro, and various other currencies. This easing of policy, combined with lower international interest rates, caused domestic rates to soften. The 3-month domestic interbank rate declined from 0.81% to 0.75% over the year.

The outstanding amount of lending by commercial banks to nonbank customers rose by 6.3%, propelled by strong growth in housing loans after buyers of apartments from the Housing Development Board were allowed to use their Central Provident Fund (CPF) retirement savings for the 20% downpayment on the apartments. As investor sentiment improved in the second half of the year, the stock market rebounded along with other regional markets, with the Straits Times Index gaining 31.6% in 2003.

Inflation was subdued. The CPI rose by 0.5% in 2003, after a 0.4% decline in 2002. Contributory factors included a 2003 increase in the goods and services tax (GST), higher taxes on liquor and tobacco, and rising prices of oil-related items.

The strong export performance pushed the current account surplus to US$28.2 billion, equivalent to 30.9% of GDP. Encouraged by the improved global economic environment in the second half and the Government's efforts to attract FDI, direct investment inflows doubled to US$11.4 billion in 2003, mainly in the electronics and chemical sectors. The net outflow on the capital and financial account rose to US$25.3 billion from US$13.6 billion, largely because of increased investments abroad by nonfinancial institutions and individuals. Gross foreign reserves rose to US$96.3 billion.

Policy Developments

The authorities kept fiscal and monetary policies accommodative in 2003 in an effort to increase domestic demand. The budget for FY2003 (begin-

Table 2.11 Major Economic Indicators, Singapore, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	-1.9	2.2	1.1	5.6	4.8
Gross domestic investment/GDP	24.9	21.2	13.4	17.4	21.8
Inflation rate (consumer price index)	1.0	-0.4	0.5	1.2	1.7
Money supply (M2) growth	5.9	-0.3	6.9	8.2	8.5
Fiscal balance[a]/GDP	-0.9	-1.6	6.4	3.5	3.6
Merchandise export growth	-10.5	2.7	15.0	12.2	7.5
Merchandise import growth	-13.7	-0.5	9.4	10.8	8.8
Current account balance/GDP	18.7	21.4	30.9	34.5	32.7

[a] Refers to the difference between total revenues (receipts credited to the Consolidated Revenue Account, Development Fund Account, and Sinking Fund Account, including investment income, capital receipts, and investment adjustments) and total expenditures (outlays made from these three accounts).

Sources: Ministry of Finance; Monetary Authority of Singapore; Singapore Department of Statistics; staff estimates.

ning 1 April) and adjustments in the CPF system reflected a need to stimulate the economy, preserve jobs, and improve competitiveness. Measures included extensions to a reduction in the levy on foreign workers and to rental and property tax rebates, a 3 percentage points cut in the employers' CPF contribution rate, and the lowering of the salary ceiling of the CPF contribution.

The Government also announced a S$230 million SARS relief package that included rebates and cuts in taxes and service charges for the most affected business sectors and a S$1 billion package to boost consumer sentiment, support small and medium enterprises, and accelerate public infrastructure projects. Increases in the GST and liquor and tobacco taxes partly offset the reduction in tax revenues.

The budget for FY2004 includes a reduction in corporate income tax rates to 20% from 22%, tax exemptions for newly incorporated companies, and tax exemptions for foreign-sourced income and Singapore-sourced investment income. Overall, FY2004 budget expenditures will increase by 5.6%, mainly in defense and transport infrastructure.

In response to the challenges of adjusting to a more competitive international landscape, the Government has set a long-term development strategy for the next 15 years, which aims to establish a globalized, entrepreneurial, and diversified economy. It also aims to enhance Singapore's integration with other economies through bilateral and multilateral trade arrangements that will link the economy closely to global economic networks, especially the regional production network centered around the PRC and India. Singapore has concluded free trade agreements with Australia, European Free Trade Association, Japan, New Zealand, and US, and is negotiating free trade agreements with Canada, Chile, PRC, India, Korea, Jordan, New Zealand, and Sri Lanka.

To cope with increased competition from lower-cost countries and reduce the economy's vulnerability to external shocks, the Government is also seeking to nurture new sources of growth by moving up the manufacturing value chain to knowledge-intensive activities and by developing the services sector. Some of these efforts are paying off, with the biomedical and chemical industries expanding more rapidly in recent years. However, Singapore is expected to experience more structural unemployment as a result of these changes. This underscores the importance of improving labor market flexibility and including education and training in the long-term development strategy. The Government is expected to help laid-off workers find new jobs through measures such as continuing education and training.

Some services sectors, especially telecommunications and financial services, have been reformed through a series of liberalization measures, to promote competition and spur innovation. Health

care, education, and creative industries will be encouraged through the removal of regulatory impediments, fostering of demand, and training. Services exports are expected to be a major engine of growth, and a more efficient services sector would also help sharpen the competitiveness of manufacturing.

Even with successful structural reform, however, growth potential in this new phase will be below the average 7.3% annual growth that the economy achieved over the past 15 years. Given its already advanced economic level and aging population, the sustainable growth rate might be 3–5% a year, underpinned by labor force growth of 1–2% and productivity growth of 2–3%.

Outlook for 2004–2005

As the most export-dependent economy in Asia, Singapore's prospects rely heavily on world market conditions. Assuming that the US recovery strengthens, the upturn in the global electronics market continues, and the PRC's growth remains robust, the GDP growth rate is forecast to increase to 5.6% in 2004, but then to fall slightly to 4.8% in 2005.

The recovery will likely be strengthened by increased domestic demand. The labor market will improve gradually as the recovery spreads across more industries. Recent government measures to reduce business costs, such as the CPF changes and cuts in taxes, are expected to facilitate the labor market rebound. As a result, unemployment is forecast to fall slightly and stabilize in the 4.0–4.5% range in 2004–2005. Wage increases will remain capped by high unemployment, but improved job security will likely boost consumption expenditure. Private consumption should also be helped by the low interest rate environment, although a recent further increase in the GST from 4.0% to 5.0% could hurt spending. Overall, private consumption is forecast to grow by 3.1% in 2004 and by 3.5% in 2005.

Investment in fixed assets is expected to rise modestly in 2004–2005. The upturn will be driven by investment in machinery and equipment, which showed a significant rebound in late 2003, coupled with some revival in construction. The easing of inventory adjustment will also contribute to the economic recovery in 2004–2005.

Merchandise exports measured in US dollars are forecast to grow by 12.2% this year and by 7.5% in 2005. This strong growth will be supported by economic recoveries in the US, EU, and Japan, as well as the pickup in global IT-related industries, significant growth in intraregional trade (stemming largely from the PRC's economic boom), and the free trade agreement with the US. Imports will likely rise at a slower pace than exports. The services trade surplus is expected to widen, due to an anticipated revival of trade and tourism in the region following the containment of SARS. The current account surplus is forecast to rise to 34.5% of GDP in 2004 but then decline to 32.7% in 2005.

Domestic prices are likely to edge higher as the economy picks up pace, but price rises will be restrained by a benign external inflationary environment and lack of domestic cost pressures. With stronger than expected GDP growth in the first quarter of 2004 (7.3% on a preliminary basis) and higher inflation in January and February, the Monetary Authority of Singapore tightened monetary policy in April by allowing a modest and gradual appreciation of the Singapore dollar. Given the moderate outlook for inflation, a neutral monetary policy is likely for much of the rest of the year, to support a sustainable recovery in domestic demand. Fiscal conditions are expected to improve, reflecting stronger economic growth. The operating fiscal deficit will shrink in 2004 and the operating budget is likely to be in balance in 2005.

From a sector perspective, the growth momentum of electronics, chemicals, and biomedicals will remain strong in 2004. An overall strengthening of manufacturing is likely from mid-2004 and the construction sector is forecast to gradually stop contracting. Services are expected to register strong growth in 2004–2005, reflecting the post-SARS recovery (for 2004), improving regional trade and investment, and increased consumer spending.

Risks to a sustained recovery include uncertainty in global demand conditions, and in particular uncertainty about the upturn in the global electronics cycle; possible interest rate hikes in the US; and possible terrorist attacks, which would damage Singapore's tourism, transport, and related services industries.

Rapid economic growth, budget and current account surpluses, and debt repayments continued to reduce the economy's external vulnerability in 2003. While private consumption has been a driver of growth, investment looks set to pick up in 2004, although it will remain well below precrisis levels. Risks to watch include a rise in household debt, a surge in asset prices, and violence in the south. The avian flu problem appears manageable.

Economic Assessment

The solid growth of 5.4% achieved in 2002 carried through into 2003 and picked up pace in the second half of the year, notably with a 7.8% burst in the fourth quarter. This final-quarter surge resulted in overall growth of 6.7% for the year, exceeding official projections (Figure 2.12). Thailand is now growing at rates not seen since before the Asian financial crisis, and has been able to recoup almost all of the crisis-induced losses in per capita income (measured in constant local currency prices).

As in 2002, private consumption was the major component that propelled growth in domestic demand, strengthening to 6.3% growth in 2003 from 4.9% in 2002, and contributing 3.5 percentage points to the GDP expansion. Private investment rose by 17.9% in 2003, albeit from a low base. Public investment declined in the first half of the year before recovering in the second, resulting in overall growth in total investment of 11.7%, approaching double the 6.5% recorded in 2002.

From a sector point of view, industry—sustained by strength in manufacturing—contributed 4.2 percentage points to GDP growth. The manufacturing production index gained 12.3% in 2003, up from 8.5% a year earlier. The upturn in the global electronics cycle boosted production of electronics and electrical appliances, while robust domestic and external demand increased production of motor vehicles.

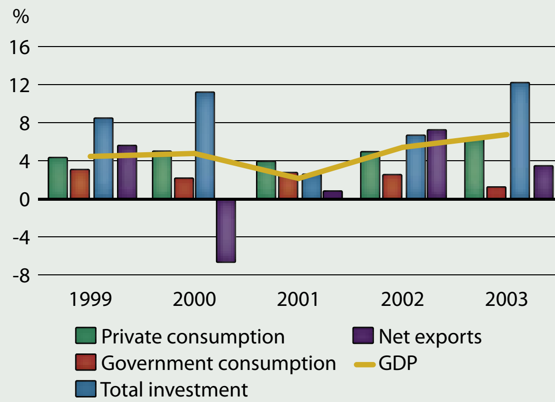
Stronger economic growth meant that the unemployment rate continued to trend down. After averaging 2.4% in 2002, it averaged 2.2% in 2003, the lowest rate since the crisis. However, the incidence of poverty remains a concern. The Government has been tackling it mainly through its fiscal spending program, and on 1 January 2004, introduced an unemployment security fund to provide a safety net for those laid off. It has launched a "war on poverty" in an attempt to eradicate poverty within 6 years.

Faster economic expansion also strengthened the fiscal position, mainly through mounting tax revenues. In FY2002 (ended 30 September 2002), the budget had been in deficit by the equivalent of 2.2% of GDP. FY2003 experienced a major turnaround: the budget recorded a surplus amounting to 0.6% of GDP.

Consumer price inflation rose to 1.8% in 2003 from 0.7% in 2002, but remains manageable. Much of the rise was a consequence of higher petroleum and food prices, with food up by 3.6% over the year. The core inflation rate, which excludes food and energy, edged up by just 0.2%.

The baht firmed up in 2003, with its reference rate averaging B41.5/$1, strengthening from B43.0 in 2002. Rising FDI and a recovering stock market contributed to this. In January 2004, the baht gained more ground, to around B39/$1. The

Figure 2.12 GDP Growth by Expenditure Account, Thailand, 1999–2003



Source: National Economic and Social Development Board, available: www.nesdb.go.th.

Stock Exchange of Thailand index soared by 117%. Most regional markets benefited from a surge of foreign funds in the second half of the year, and Thailand's equities also were helped by the strong economic growth and improved corporate profits.

Monetary policy of the Bank of Thailand (BOT) is aimed at maintaining core inflation within a 0–3.5% range. In June 2003, it cut the 14-day repurchase rate by 50 basis points to 1.25% and kept the key rate at this level, even though economic growth later in the year was stronger than expected and consumer prices rose a little. Surplus liquidity in the financial system helped keep rates down. However, domestic bond yields are rising in 2004 as a result of the pickup in inflation.

Especially in the fourth quarter, merchandise exports and imports both grew strongly, registering growth of 18.6% and 17.1%, respectively, for the year, and widening the merchandise trade surplus to $4.2 billion. Tourism recovered toward the end of 2003, after the SARS scare in the first half and, combined with the trade surplus, helped push the current account surplus to almost $8 billion in 2003 from about $7 billion a year earlier. As a share of GDP, the current account surplus was 5.6% in 2003, similar to the 2002 level. The overall balance of payments was in surplus only by about $143 million as a result of prepaying the IMF-led loan package. Foreign currency reserves rose to $42.1 billion, more than twice the level of short-term debt and equivalent to almost 7 months of imports.

Declining since 1997, the external debt stock continued its downward trend in 2003, to $52.3 billion at year-end from $59.5 billion 12 months earlier. The ratio of public sector external debt to total external debt also fell, from around 39% in 2002 to about 32% in 2003. This is in line with government efforts to repay loans from multilateral agencies such as IMF, World Bank, and ADB. Thailand paid off the last of the IMF-arranged loan package in July 2003, 2 years ahead of schedule. Soon after this, the Government announced that it would no longer borrow from multilateral sources. Net inflows of FDI rose to $954 million in 2003 from $841 million the previous year, with investment in manufacturing and trade-related activities accounting for the bulk of these inflows. Overall, Thailand further reduced its external vulnerability in 2003 by building international reserves, running budget and current account surpluses, and reducing its external debt.

Policy Developments

The economy grew faster than most others in the region in 2003, an unlikely forecast scenario even a couple of years ago. The fact that it has been able to achieve this performance while running both a budget and current account surplus, prepaying some loans, and containing inflation, is laudable. With its first fiscal surplus since the crisis, the economy is in a position to generate a cushion to address a future slowdown using injections of government spending. Factors that contributed to the surplus included strong economic growth, improvements in tax administration and collection, falling debt service costs, and the expiration of a 5-year period when companies were allowed to carry over losses incurred during the crisis. However, Thailand also has some significant off-budget items. For example, various government initiatives, such as the provision of credit to small and medium enterprises and housing projects for the poor, are paid for by state-owned banks. The cumulative cost of off-budget items since 2001 is estimated at 6% of GDP. Analysis of the strength of the overall fiscal position is marred by such items, and raises concerns about the size of the

Table 2.12 Major Economic Indicators, Thailand, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	2.1	5.4	6.7	7.2	6.2
Gross domestic investment/GDP	24.1	23.9	25.2	25.7	25.9
Inflation rate (consumer price index)	1.6	0.7	1.8	2.4	2.6
Money supply (M2) growth	4.2	2.6	4.9	1.9	4.5
Fiscal balance[a]/GDP	-2.1	-2.2	0.6	-0.1	-0.3
Merchandise export growth	-7.1	4.8	18.6	14.0	13.7
Merchandise import growth	-3.0	4.6	17.1	17.8	13.1
Current account balance/GDP	5.4	5.5	5.6	3.9	3.9
Debt service ratio	20.8	19.6	15.0	13.5	14.0

[a] Includes national Government's budgetary and nonbudgetary accounts.

Sources: Bank of Thailand; National Economic and Social Development Board; staff estimates.

Government's contingent fiscal liabilities. A move to include the costs of such items in the budget would reduce uncertainties about the fiscal position.

The war on poverty launched by the Government involves a registration process, which started pilot testing in late 2003, whereby poor people are required to explain their problems so that tailor-made solutions can then be applied. It is too early to gauge the ability of this program to reduce poverty over the long term.

While total investment on average accounted for more than 40% of GDP in the years before the crisis, the postcrisis period has seen investment fall to about half that rate. Private investment, which was sluggish for several years after 1997, started growing in 2002 and this carried through to 2003. Public investment, on the other hand, continued to fall in 2003, although it picked up toward the end of the year and is likely to strengthen further in the coming years. The budget surplus has encouraged the Government to pursue public infrastructure investment in 2004 and beyond. Although it will likely be some time before total investment levels approximate to those of the precrisis era, the figures for 2003 suggest that both private and public investment is trending up.

Completion of banking and corporate sector restructuring remains vital for the recovery of business investment. As of June 2003, the Thai Asset Management Corporation had acquired about $19 billion of NPLs, mainly from state-owned financial institutions, and had resolved about $14 billion of these, mainly by restructuring the loans. Improvements in the corporate bankruptcy law are required to complete the workout of NPLs, and if implemented effectively, will enhance the protection of creditors and the investment climate more generally.

Outlook for 2004–2005

The momentum associated with the high growth rate in the fourth quarter of 2003 is likely to continue through at least the first half of 2004. Growth for all of 2004 is estimated at 7.2%, moderating in 2005 to just above 6%. The 2004 projection takes into account the estimated impact of the avian flu outbreak.

Several factors underpin these growth projections. Exports are likely to accelerate in 2004, provided that global economic conditions keep improving and the baht appreciation is kept in check. The planned increase in government investment in 2004 will further contribute to growth. Moreover, in response to recent violence in the south, the Government has pledged to increase spending to accelerate development and improve livelihoods in that region. Election-related spending is also likely ahead of polls that must be held by early 2005. Private investment looks set to continue its revival. Most private sector forecasters expect that gross investment in 2004 will exceed 10%. Growth in private

consumption spending, which has been a major factor in spurring the economy over the past 2 years, is likely to continue at around 6% in 2004, before easing in 2005. A rise in interest rates to cap inflationary pressures and other measures to curb rising household debt may dampen growth toward the end of the year and into 2005.

Even with strong growth, consumer price inflation is likely to remain relatively subdued at around 2.4% in 2004 and 2.6% in 2005. This would be higher than in recent years, but would still be manageable.

Certainly, 2004 got off to a brisk start. The index of private consumption rose by 4.4% in February from a year earlier, according to preliminary data from BOT, and the index of private investment jumped by 23.1%. Farm incomes rose because of increases in prices of major crops. External demand—especially for electronics, vehicles, and plastics products—was robust, with the value of exports up by 21.0%. The value of imports in February shot up by 25.5%, boosted by increased purchases of imported intermediate goods and raw materials as well as capital goods for industrial use. Manufacturing production rose by a higher than expected 16.3% in February, accelerating from 10.9% in January. Prices also rose; the CPI increased by 2.2%, mainly due to higher food prices.

Continued strong economic growth suggests that the Government may be able to make significant inroads into the poverty that resulted from the crisis. The country's experience with poverty reduction from the mid-1980s to the onset of the crisis shows that rapid growth can reduce the incidence of poverty. GDP growth, coupled with government programs targeting the poor (particularly in the northeast and southern regions), should result in poverty being reduced appreciably over the next few years.

As a significant producer and exporter of poultry, Thailand faces a greater potential problem than most other subregional countries from the outbreak of avian flu, but the disease is not likely to have the impact that SARS had on business and tourist travel in 2003. Clearly, it will hurt the poultry industry and, to a lesser degree, tourism, and may well lower private consumption spending. The National Economic and Social Development Board recently estimated that avian flu would reduce GDP in 2004 by about 0.4 percentage point, which is built into the forecast.

The violence in the south is a risk factor, too. Martial law was declared in the three provinces bordering Malaysia, but a new attack in late March raised further concerns about security in the area. Continuing violence may harm the country's image as a safe destination for tourists.

Another potential problem is an increase in household debt resulting from low interest rates, easy access to credit, and rise in consumer confidence. According to the Thailand Development Research Institute, average debt levels are now equivalent to around 6 months salary. For those on a relatively low income of about B900 a month, the average debt is equivalent to 8.5 months salary, and for people earning B450 it is 15 months salary. Unless consumer credit is curbed, rising household debt could eventually lead to a significant level of defaults, particularly when interest rates start to move up. In turn, that would reduce consumer spending, erode economic growth, raise NPLs in the financial sector, and increase poverty. During the first quarter of 2004, BOT indicated its concern about household debt by, among other steps, setting new limits on the length of time that credit card issuers can roll over delinquent debts.

Related concerns are signs of a boom in asset markets. Since early 2002, property market transactions have been growing by about 40% a year. The stock market index more than doubled in 2003, although it retreated by 16% in the first quarter of 2004. The concern is that these sharp increases are fueled in large measure by short-term speculative flows that may be reversed at some stage, which would spark a plunge in business and consumer confidence.

In summary though, it is unlikely that these risks will threaten growth to any significant degree.

Viet Nam

Fast growth in 2003 was supported by strong investment and private consumption. This robust performance will continue in 2003–2004, though the country will likely perform below its potential. To reach this potential, it faces a long reform agenda that should be tackled while the economic climate is favorable.

Economic Assessment

Vigorous growth of 7.1% was recorded in 2003, with both consumption and investment making strong contributions on the demand side. Domestic demand grew by 9.4%, and total investment by 15.8%. Private consumption contributed 4.8 percentage points to GDP growth and gross fixed capital formation 4.7 percentage points. The strong domestic demand also pushed up imports, such that net exports subtracted 3.0 percentage points from growth.

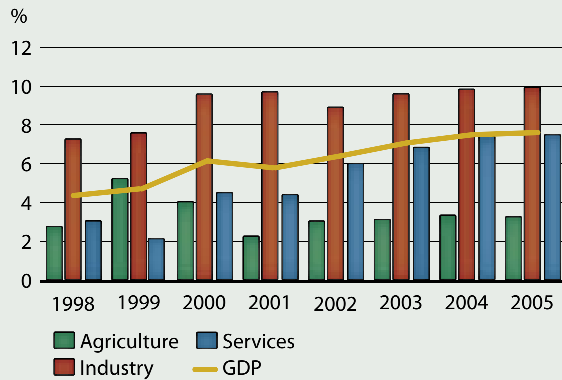
On the supply side, a robust 9.6% growth performance by the industry sector, which covers mining, manufacturing, utilities, and construction, provided impetus for economic expansion (Figure 2.13). The sector's share of GDP was 38.7% in 2003, but it contributed 3.6 percentage points to GDP growth. Within industry, the nonstate subsector grew by 18.7%. The continuing strong development of the private sector generally is a result of the improved business environment. Over the past 4 years, an average of 19,000 private enterprises have been registered every year, thus raising to 26.7% the share of private sector capital in total investment in 2003.

The performance of the agriculture and fisheries sector improved in 2003, to 3.1% growth, largely because of higher export prices for coffee and rubber, and an expansion of the fisheries subsector. The price of major export products, including coffee and rubber, rose by 8.9%. The outbreak of SARS in the country and in the region more widely hurt services, particularly in April and May, though they rebounded in the second half of the year. The net result was that the services sector grew by 6.8% in 2003, only slightly higher than in 2002, and contributed 2.8 percentage points to growth.

The country performed well on social issues. The Viet Nam Development Goals—the localized version of the Millennium Development Goals—showed a steady improvement in social indicators, such as education enrollment and infant mortality. Likewise, the unemployment rate in urban areas has been declining in recent years, from 6.9% of the labor force in 1998 to about 5.8% in 2003. However, underemployment in rural areas remains high. The minimum wage was raised by 38% (about $19 a month) in 2003.

Data from the 2002 household survey indicated that 28.9% of the population had expenditures below the General Statistics Office estimated poverty line, down from 58.0% in 1993. This implies that about 20 million people were lifted out of poverty in less than a decade. The broad improvement in living standards was largely the result of job creation by the private sector and further commercialization of agriculture. The rural poverty rate fell to about 36% in 2002 from about 45% in 1998, and the urban poverty rate to 6.6% from 9.0%. Poverty in the Mekong Delta area showed the sharpest drop,

Figure 2.13 GDP and Sector Growth, Viet Nam, 1998–2005



Sources: General Statistics Office; International Monetary Fund; staff estimates.

from about 37% in 1998 to about 23%, while poverty in the Central Highlands remained the highest, at about 52%. Demographically, a worrying situation has emerged whereby the food poverty incidence—the proportion of the population living below the Government's food poverty line of D1,372,774 (roughly $87) per person per year in 2002—of ethnic minorities, accounting for 41.5% of the population, has not improved, and their general poverty rate is high at 69.3%. In addition, Viet Nam has shown some weaknesses in its public health system, as seen in the outbreaks of SARS, avian flu, and a possible increase in HIV/AIDS.

Total government revenues in 2003, including grants, rose by 11.8% on the back of (i) stronger tax revenues, both from the corporate sector and from VAT, and (ii) the higher price of crude oil. VAT contributed about 29% of total tax revenues (which constituted 83.5% of total government revenues), followed by corporate income tax (28%), and trade taxes (21%). Government expenditures, including current, capital, and onlending expenditures, rose at the higher rate of 16.1%, in part because of increased wages and pensions and the cost of various government-financed reforms. Thus the budget deficit in 2003, including capital expenditures and onlending but excluding grants, widened to 4.8% of GDP from 3.8% in 2002.

Monetary aggregates expanded in response to the growth in GDP, strong demand for credit, and further monetization of the economy. Broad money supply (M2) rose by 21.0% in 2003, compared with 17.6% growth in 2002. Net domestic credit grew by 26.2% in 2003. Interest rates and the currency against the dollar were stable, though.

Viet Nam's CPI rose by 4.0% in 2003, within the Government's target of 4–5%, after an episode of mild deflation in 2000–2001. Higher prices were recorded mainly for pharmaceutical products, building materials, and education-related expenses.

In 2003, the top exports were crude oil (19.0% of total exports by value), textiles and garments (18.3%), footwear (11.2%), seafood (11.0%), rice (4.0%), and coffee (2.4%), which together accounted for two thirds of total exports. Exports of crude oil rose by 15.5%, with most of the increase attributable to higher prices, as oil production volume increased by just 1.7%. Exports of textiles and garments rose by 31.9%, mainly to the US, as firms tried to maximize shipments ahead of the imposition, in September 2003, of US quotas. The US has become one of the biggest markets for Viet Nam's exports, accounting for some 21% of all exports.

Total exports of $19.26 billion were exceeded by imports of $22.64 billion, widening the trade deficit to $3.38 billion in 2003 from $1.30 billion in 2002. The strong growth in imports was the result of higher demand from industry for capital goods and intermediate goods, including construction materials, and of preparations for the Southeast Asian Games that were hosted by Viet Nam in December 2003. A liberalization of import restrictions also spurred inward shipments.

The current account deficit in 2003 is estimated at $2.1 billion, equivalent to 5.8% of GDP, or double that in the previous year. The deficit is manageable because of foreign exchange inflows from official development assistance (ODA), FDI, and remittances from overseas Vietnamese. The net FDI inflow for 2003 was $622 million, and remittances rose to an estimated $2.6 billion from $2.0 billion in 2002. The ratio of external debt to GDP was around 38.7% and debt service in relation to the total value of exports was 8.3%, similar to the level in 2002. Gross international reserves, including gold, are estimated at $4.7 billion, equivalent to about 2.5 months of imports.

Table 2.13 Major Economic Indicators, Viet Nam, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	5.8	6.4	7.1	7.5	7.6
Gross domestic investment/GDP	25.9	31.3	33.7	35.3	35.0
Inflation rate (consumer price index)	-0.4	3.8	4.0	4.5	4.5
Money supply (M2) growth	25.5	17.6	21.0	16.4	14.7
Fiscal balance/GDP	-3.0	-3.8	-4.8	-4.6	-4.2
Merchandise export growth	6.5	7.4	16.5	12.0	12.0
Merchandise import growth	6.0	19.5	27.0	14.0	11.0
Current account balance/GDP	1.5	-2.8	-5.8	-5.7	-5.7
Debt service ratio	10.6	8.3	8.3	7.5	7.3

Sources: General Statistics Office; State Bank of Viet Nam; International Monetary Fund; staff estimates.

Policy Developments

The next 2 years are the last of the 5-year socio-economic development plan (2001–2005), in which the Government aims to achieve 7.5–8.0% GDP growth. In an attempt to ensure this, it has announced as its top priority regional as well as international economic integration. It is also focusing on quality of investment, governance and public administration, and competitiveness. The Government aims to keep the fiscal deficit at below 5.0% of GDP and inflation at a rate lower than 5.0%. It has said that it will maintain a more market-based flexible exchange rate system, remove the remaining quantitative import restrictions, and reduce tariffs.

To enhance revenues and to encourage the growth of the enterprise sector, some streamlining of tax rates has been introduced. The corporate tax rate for both domestic and foreign-invested enterprises has been unified at 28% with effect from January 2004. Previously, the tax rates were 32% and 25%, respectively. A supplementary tax on domestic enterprises and a profit remittance tax for foreign-invested enterprises have been abolished. Exemptions from VAT have been reduced and the number of VAT rates cut to two (5% and 10%). The Government introduced a special consumption tax on automobiles in December 2003.

Policy reforms have been initiated to develop the nascent equity market. In August 2003, the Government approved a plan envisaging market capitalization of 2–3% of GDP by 2005 and about 10% by 2010. A decree on securities and the stock markets will come into effect in the second quarter of 2004 to offer easier listing conditions, including provisions for securities investment funds. Efforts are being made to develop the bond market to address the problem of raising medium- to long-term finance for development. A measure of some success in this area was seen in the Government's issuance of bonds worth $160 million for education and $578 million for infrastructure projects, in 2003.

On the trade front, tariffs on 700 imported items from ASEAN members were reduced further from July 2003 as part of the implementation of AFTA commitments, with the ultimate target of achieving 0–5% tariffs on ASEAN imports by 2006. Viet Nam, moving to comply with its commitments under the Bilateral Trade Agreement with the US, is likely to introduce changes to its trade laws, regulations, and administrative procedures. This will help the nation align its trade procedures and practices with global standards, which also will pave the way for WTO accession in 2005. The sixth and seventh sessions of a working party on the country's accession to WTO were held in 2003 and three more sessions are scheduled for 2004. The Government also signed a trade and investment agreement with Japan, which includes a provision for most-favored-nation treatment for trade and investment.

In the SOE sector, the equitization program,

under which the state retains about 50% of its share holdings and sells the rest to employees and the private sector, has fallen behind schedule, and financial support to SOEs has not yet been reduced. A Prime Minister's directive in April 2003 called on SOEs to raise their efficiency and merge or close if they incur chronic losses. More rapid and effective reforms in the SOE sector are fundamental for ensuring fiscal sustainability, maintaining economic growth and reducing poverty, facilitating a smooth integration into the global markets and WTO, and for Viet Nam's transition to a market economy.

SOCBs are still weak in their operational and financial performance in such areas as credit decisions, resolution of NPLs (totaling about $1.5 billion as of 2000), and transparent financial reporting. The SOCBs have, in recent years, established asset management companies, but these are only serving as centers for the sale of mortgaged assets attached to NPLs. The target for the full resolution of NPLs of the SOCBs is 2006, which would also facilitate the process of SOCBs' international integration. Since the NPLs are a common and interrelated problem of both SOEs and SOCBs, a new state-owned debt trading and management company became operational in February 2004. Formerly, this task had been carried out by an administrative agency, but it was time consuming and progress was slow. The new company is expected to focus in 2004 on 20 SOEs that have bad debts and frozen assets worth from D5 billion (approximately $318,000) and will expand its operations in 2005.

The Government added a new chapter on large-scale infrastructure in its Comprehensive Poverty Reduction and Growth Strategy (CPRGS). To deepen the CPRGS implementation process, efforts are being made to integrate the CPRGS with local and provincial planning processes. The Government has also indicated that it will improve the quality of public investment through better screening of projects and through strengthening of project management capabilities.

Progress has been made in improving governance and public administration, particularly in the delivery of public services, by simplifying procedures. The Government published a decree on local associations, including business, social, and benevolent groups. This provides a legal basis for nongovernment organizations for the first time. In addition, Viet Nam signed the UN Convention against Corruption in December 2003 in Mexico, and a decree on the accountability of heads of government agencies has been drafted. The trial of a prominent gang leader and legal action against some senior government officials suggest that the Government is serious in curbing crime and corruption.

To improve the business environment further, the Government brought out new amendments to the Land Law. In force from April 2004, the amended law provides a uniform land administration regime, ensures clearer administrative procedures, levels the playing field between foreign and domestic land users, and breaks the current dual-pricing system involving government and market-determined prices. However, foreign investors still cannot use their land use rights for mortgages from offshore lenders.

In general, investors' perceptions of the country have become more favorable. The annual business sentiment survey carried out by Viet Nam Business Forum suggested a significant improvement in the operating environment. Furthermore, the World Economic Forum upgraded Viet Nam's position in terms of growth and business competitiveness indexes, to just above those of the Philippines.

Outlook for 2004–2005

While Viet Nam has made impressive progress in achieving both rapid economic expansion and poverty reduction in recent years, comparisons with other East Asian and Southeast Asian countries during their high-growth periods suggest that Viet Nam's GDP growth rates could be yet higher. The country is relatively well endowed in terms of natural resources, enterprising people, and a favorable geographic location. The chances of further growth stem from using these opportunities more efficiently and improving the efficiency of the existing capital stock.

Given the improvements in the business environment and the recovery of external demand, GDP growth is projected to improve somewhat to 7.5% in 2004 and to 7.6% in 2005. This will be underpinned by strong domestic demand, forecast to increase by 10.1% in 2004 and by 8.1% in

2005, and by annual export growth of 12.0%. The Government is expected to maintain an expansionary, but manageable, fiscal stance to cover the cost of increases in salaries and pensions of civil servants, as well as the cost of reforms. This fiscal position will also help keep domestic demand strong. In addition, business sentiment has improved, and the private sector, both domestic and foreign, is likely to respond positively, resulting in additional investment inflows. ODA inflows also have been rising; the total pledge by donor partners for 2004 is $2.8 billion.

The level of gross investment will likely be maintained at about 35% of GDP in both 2004 and 2005. Export growth will provide a further boost to manufacturing and buttress consumption, particularly through better prices for major primary agricultural products. However, strong domestic demand and further export growth will push up imports as well—particularly imports of plant and machinery, petroleum products, industrial intermediates, and construction materials. Trade deficits in excess of $4 billion are likely in both 2004 and 2005, in a sharp swing from trade surpluses recorded a few years ago.

On the supply side, the industry and services sectors will be the main sources of expansion, respectively accounting for about 3.8 and 3.0 percentage points of GDP growth in 2004. In terms of value added, the former sector is expected to grow by 9.8% in 2004 and by 9.9% in 2005, with manufacturing expected to strengthen slightly to 11.5% growth, driven by exports. Similarly, value added of power and utilities and of construction will grow by around 11% in 2004 and 2005, supported by a government emphasis on large-infrastructure development.

Value added in the services sector is expected to accelerate slightly to 7.4% in 2004, led by wholesale and retail trade (9.0%), hotels and restaurants (8.0%), and transport and tourism (8.0%).

Agriculture will maintain growth of around 3.3%, with strong contributions from fisheries and higher export prices of coffee and rubber.

Inflation is expected to be around 4.5% in both 2004 and 2005. The implementation of AFTA commitments and preparations for WTO accession are likely to reduce the cost of imports as tariffs are reduced. A further lowering of telecommunications charges and other administration costs (after the reductions in 2003) will help keep nonfood prices down. However, the continued rise in prices of building materials, including steel, as well as pharmaceuticals will have a partially offsetting impact.

The 2004–2005 outlook is not free from risks, namely the trade deficit, uncertainty over market access, the fiscal deficit, rapid credit expansion, and possible public health scares.

Export growth targets are $21.6 billion in 2004 and $24.2 billion in 2005. However, the price of crude oil may stabilize at a lower rate of around $24–26 a barrel. In addition, Viet Nam is likely to face difficulties in accessing the US market for its garments and seafood exports: the export of textiles and garments in 2004 will be capped at $1.7 billion by quota, while seafood products, including shrimp, are likely to face antidumping measures. In general, Viet Nam has strong potential to expand its exports because it has only small shares of major export markets. In 2002, the country's share of imports to the US was 0.21%, to Japan 0.75%, and to the EU 0.18%, suggesting scope for further expansion. In addition, the PRC is potentially a big market for Viet Nam's exports of natural resources such as crude oil, rice, and tropical agricultural products. Per capita manufactured export value is just $55, which is far below that of Thailand ($733), PRC ($178), and Indonesia ($142). The Government eliminated a 30% foreign exchange surrender requirement in April 2003 to encourage exports, and established a special export promotion program to help meet export targets and reduce the trade deficit.

The current account deficit is likely to stand at around 5.7% of GDP in both 2004 and 2005. FDI, ODA, and remittances from Vietnamese living abroad will finance the deficit.

To contain the widening fiscal deficit, the Government will have to broaden its tax base, strengthen its tax administration, and tighten lending to SOEs. At the aggregate level, revenue performance looks quite impressive compared with other East and Southeast Asian countries—for example, the revenue-to-GDP ratio is about 23%, higher than the average of 19.7% in Indonesia, Malaysia, Singapore, and Thailand, and 15.7% in the PRC. However, the revenue base is heavily dependent on the state sector, which

accounted for about 80% of corporate income tax, 60% of VAT, and 74% of excise duty in 2002. The personal income tax rate rises to 50%, compared with 28% for corporate taxes, resulting in low tax compliance. Personal income tax collections totaled just 0.4% of GDP in 2003.

While inflation risks are modest and manageable in 2004–2005, credit expansion—largely driven by growing investment requirements—is a concern. Over 1998–2002, the average annual domestic credit growth rate was 29.4%, higher than that of the PRC (about 16% in 1995–2002), Indonesia (18.6% in 1975–1995), and Thailand (15.9% in 1982–1996) when these countries had periods of high growth. Over 2000–2002, the share of SOCB and development assistance fund credit (in both local and foreign currencies) going to SOEs ranged between 46% and 50%, equivalent to about 22–25% of GDP. Such a high rate of credit expansion imposes a heavy burden on the state-owned financial intermediaries in their credit risk management. Given that most SOCBs have limited capability in credit risk assessment, the rapid credit growth could lead to misallocation of resources, resulting eventually in a high rate of NPLs. This also could impair national growth performance—particularly when capital productivity remains low—and worsen the fiscal deficit.

In recent years the frequency of public health problems including SARS, avian flu, and HIV/AIDS has increased, with social and economic implications. These incidences call for more serious government attention to public health (and animal health), which may require additional public spending over the medium term.

ASIAN DEVELOPMENT
Outlook 2004

Economic Trends and Prospects in Developing Asia

South Asia

Rollie del Rosario

Afghanistan

The Islamic Transitional Government of Afghanistan is working closely with development partners to rebuild the country's essential institutional and physical infrastructure. Good weather and sound economic policies, as well as partner aid, have generated a significant rebound in GDP. Economic prospects are promising, but whether rapid development will continue depends largely on the commitment of the international community to Afghanistan's investment needs and security.

Economic Assessment

An official but rough estimate by the Central Statistics Office puts the FY2002 GDP at $4.1 billion; per capita GDP, using a population estimate of 21.8 million, is about $186. (FY2002 ran from 21 March 2002 until 20 March 2003.) Agriculture (crop production, horticulture, and livestock) accounts for about 52% of GDP and employs an estimated 80% of the economically active population. Industry and services each make up about 24% of GDP. GDP growth during FY2002 is estimated at 28.6%, a significant but understandable rebound from a deteriorated economic base. By sector, it is estimated that agriculture grew by 27.7%, industry by 21.1%, and services by 39.5%. IMF has projected that with continued strong growth in agriculture, construction, and services, GDP is likely to have grown by about 20% in FY2003.

In agriculture, production recovered after 3 years of drought (1999–2001). Wheat production (irrigated and rain-fed) rose by 83% in 2002 and by another 62% in 2003, to 4.4 million tons, due to improvements in both area under cultivation and yield. Available evidence suggests that considerable potential exists for expanding irrigated areas; improving irrigation efficiency; increasing yields of both irrigated and rain-fed crops; shifting emphasis to low-volume, high-value crops for domestic consumption and exports; revitalizing production of industrial crops; and improving productivity of livestock and promoting dairy activities. However, continued progress in the agriculture sector is threatened by the recurrence of drought, further degradation of irrigation systems and natural resources, and a resumption of civil conflict.

Traditionally, livestock activities have been an integral part of most farm operations in Afghanistan. Since the early 1980s, the size of livestock herds has gone through cycles of decimation, reconstitution, and increase. Livestock enterprises are beset with serious problems, including diseases and decreased productivity due to overgrazing and reduced feed. The 3-year drought is estimated to have markedly reduced herd numbers, resulting in a decrease in fresh milk and indigenous beef production. Nomadic and semisedentary sheepherders are operating with high rates of animal mortality, and the reduction in veterinary services and vaccination programs has resulted in widespread animal diseases, particularly foot-and-mouth. The supply of livestock and livestock products has yet to recover to predrought levels and is reflected in higher animal prices and ongoing imports of animals.

The continuation of good harvests and lower prices, coupled with improved employment opportunities in both urban and rural areas arising from increased economic activity, is expected to improve food access for most households.

However, depressed cereal prices, especially if they continue to fall below the cost of production in marginal growing regions, would hurt farmers and push many further into poverty. In surplus-producing areas, the limited storage and financial capacity of private traders, together with poor roads, hinders storage of grain for long periods and the flow of produce from surplus to deficit areas.

Afghanistan was deindustrialized during the periods of Soviet occupation and civil conflict. Enterprises (textiles, cement, matches, processed foods, and cottage-based craft works) ceased to operate or operated at only a fraction of capacity, and the political and economic environment was not conducive to attracting private investment, either domestic or foreign. Public enterprises were run as an extended arm of the Government, with no consideration of efficient management or profitability. A new beginning of industrialization to allow the sector to play a major role in future growth of the economy would have to contend with many challenges, including needed strengthening in policy, institutions, finance, entrepreneurial and skilled labor availability, regional cooperation, marketing, and technology.

Nonetheless, in industry, a construction boom is under way in certain urban areas (especially Kabul), driven in large part by the international community's spending and emergency assistance efforts. In services, numerous hotels and guesthouses have been renovated or opened since the beginning of 2002. Retail trade, auto repair shops, and restaurant businesses have burgeoned, and taxis, trucks, and donor vehicles now clog Kabul's streets.

The country is rich in minerals, but the potential is seriously underexploited, except for natural gas and precious stones (lapis lazuli, amethysts, and rubies). Other minerals include coal, iron ore, copper, zinc, uranium, mercury, gold, and salt. In addition, an estimated 250 billion cubic meters of natural gas could be tapped for power generation, fertilizer production, and petrochemicals. The present gas supply—reduced to about one quarter of the level reached in the early 1980s because of loss of production facilities and a high rate of hazardous leakages—is inadequate to meet demand. Moreover, major users are reluctant to pay for gas because billing and collection have been largely ignored for years. Surveys will be needed to demonstrate the full potential of the mineral resources; however, mineral-based industrial development appears to offer considerable room for growth.

A significant feature of the economy is poppy production. The Taliban regime forcefully banned poppy cultivation in July 2000, but the practice has revived to become a major income source for rural farmers, and the country has once again become the world's largest producer of illicit opium. Ready profitability and easy transportability of poppies make poor farmers with few viable alternatives dependent on drug crop production. The United Nations Office on Drugs and Crime estimates the value of opium exports in 2002 at about $2.5 billion, making it the country's largest single export item. IMF estimates that including opium exports would bring FY2002 GDP to $6.5 billion; opium in this estimate would amount to about 40% of GDP. Expenditures stemming from drug-export income generate substantial demand, production, and income in other sectors of the economy. A reduction in poppy cultivation will therefore have a negative impact on economic growth unless matched by alternate livelihood schemes.

The Islamic Transitional Government of Afghanistan has endeavored to foster development of the real sector through responsible fiscal and monetary management. In its first budget, the Government met 90% of the FY2002 expenditure target in domestic currency (afghani) terms. The revenue target of $83 million was exceeded by 59% (60% of total revenues were from customs). However, provincial authorities, which collect the bulk of customs duties, remitted to the national Government only a relatively small amount of revenues collected. The financing gap of $232 million for FY2002 was fully met by donors.

The national development budget for FY2003 announced in March 2003 set ordinary (recurrent) budget expenditures at $550 million; $350 million was to be financed by external assistance with the balance from domestic revenue generation. The revenue target, almost double that in the previous year, is ambitious and its full realization depends on customs and tax reforms. Data for the first quarter suggest that revenue realization has improved over the previous year and that the bulk of provincial collections were remitted, though expenditures made a slow start.

The Kabul-based CPI compiled by the Central

Statistics Office showed relative stability early in 2002; however, September through November witnessed a surge in inflation. This was due to depreciation of the exchange rate caused by speculation associated with the new currency notes (introduction of which started in October), because exchange rate movements heavily influence changes in consumer prices. When the exchange rate strengthened in December and early 2003, the CPI declined month to month and from May was broadly stable, as was the exchange rate, for the remainder of 2003. In 2003, inflation was near zero.

Despite many difficulties associated with the widespread use of foreign currencies in Afghanistan and the conversion of large amounts of foreign aid into the afghani, Da Afghanistan Bank (DAB), the central bank, has effectively calibrated monetary policy to maintain price stability and confidence in the new currency. The conversion of the currency was completed by the end of January 2003, and after an introductory bout of speculative depreciation, the exchange rate strengthened and has stabilized to around AF48/$1 since May 2003. The inflow of foreign aid funds and the Government's no DAB deficit financing policy, along with periodic foreign exchange auctions to reduce excess liquidity, have fostered currency stability, which in turn has strengthened the investment climate. Monetary expansion has been programmed and implemented to keep pace with the increase in the transactions demand for money, which has been met by accumulation of foreign exchange reserves. These reserves stood at $568 million in late September 2003, well above the AF22.4 billion currency in circulation.

According to IMF estimates, the formal balance of payments in FY2002 showed a small surplus after grants and external assistance. The trade deficit was about $1.3 billion, since official exports, at $100 million, were very low (though if trade in opium was included, both current and capital accounts would show a large surplus).

Policy Developments

The Government's performance in pursuing difficult reforms, in particular the recent passage of the landmark central bank and banking laws, indicates a strong commitment to pushing ahead with the structural reform agenda. A payments decree has been drafted and work on a national payments system is progressing. Three new foreign banks have been licensed and several dormant national banks have been allowed to resume operations. DAB has established a Banking Supervision Department and has prepared plans for developing bank supervision functions. The Government has established a track record of overseeing difficult budgetary and financial sector reforms, including introducing the new currency; establishing the budget as a central instrument of policy making; centralizing revenue collection; and engaging international experts in financial management, procurement, and audit to ensure transparency and accountability of external assistance funds.

The budget decree for FY2003 reiterated the authorities' strong commitment to fiscal discipline and explicitly reaffirmed the policy of no DAB deficit financing. It also included ceilings for total staff numbers by ministry, but unlike the previous year, the authorities have the technical capacity to effectively monitor and enforce these ceilings. The budget policy specifically called for the passage of a customs reform package and ranked the centralization of revenues as a priority for the year. Only limited progress has been made so far in civil service reform, although the President has issued three decrees paving the way for implementation of the Public Administration Reform and Economic Management Program, and efforts are under way within the framework of these decrees.

A Civil Service Reform Fund of $20 million was established to implement recommendations for reform that are designed to (i) enable civil servants to function more efficiently and effectively, and (ii) strengthen the capacity of the Independent Administrative Reforms and Civil Service Commission to carry out its functions, improve the performance of departments delivering essential services, and help institute sound policies for human resources management.

Ministry of Finance (MOF) capacity to manage a coherent budgetary process has been strengthened considerably over the past 2 years. A computerized system for expenditure recording, payment processing, and financial reporting has been developed. Moreover, advisors have been provided to all provincial MOF offices to strengthen financial reporting.

The Government has undertaken to collect

substantially higher domestic revenues in FY2003. Collection of the Government's target of $200 million hinges on the strong and early implementation of customs reform measures. Significant measures already put in motion include (i) reviewing and simplifying customs procedures and rationalizing the tariff structure, (ii) introducing a computerized system for processing customs documents, (iii) moving key staff at Kabul Airport and Kabul Customs Authority and filling key posts with professional and experienced personnel, and (iv) computerizing public financial accounting procedures. The Cabinet approved a customs policy decree specifying the market exchange rate for customs valuation (to replace artificially low historical rates) and reduced the number of tariff bands from 25 to five, with rates in the range of 0–20% (from the previous range of 0–150%).

A debt policy statement has been adopted by the Government and a Debt Management Unit has been reestablished in the Treasury Department. An initial inventory of debt has been completed and procedures to maintain loans from international financial institutions in a current status have been established, though other debts have not been serviced. Afghanistan has obtained cancellation of loans from some bilateral creditors (e.g., PRC, Denmark, and Germany). The bulk of external claims are from the former Soviet Union (amounting to almost $10 billion) and these are in dispute as they were mostly incurred during its intervention in Afghanistan. Discussions have been held with the Russian Federation; however, no conclusion has been reached.

Outlook for 2004–2005

With the adoption of the Constitution by the *Loya Jirga* on 4 January 2004, the country is one step further along the road to political reunification, with its associated implications for security and economic development. This year will see presidential and parliamentary elections, thus establishing national institutions intended to further stabilize and develop the country. A key to stability is the disarmament and demobilization of the remaining warring groups—maintaining order will require considerable foreign assistance until the Afghan army and security forces themselves can enforce the rule of law.

The economy's robust GDP growth in FY2002 gives a positive base to scenarios for the future. IMF projects 20% growth in FY2003, driven by continued strong growth in agriculture and donor finance-induced growth in services and construction. According to ADB staff estimates, annual GDP growth rates of 15% through 2008 followed by 10% annual growth over the following 5 years are achievable. The long-term projections are based on assumed growth elasticities by sector and exogenously derived agricultural growth, along with an assumed sequencing of external resource flows in a macroeconomic framework. Available data suggest that, with development of intensive and intermittent irrigation—traditional, small, medium, large, and multipurpose—including rehabilitation and new construction of water conservation projects, the command area could be substantially increased from the present estimate of 1.1 million hectares to about 2.5 million hectares.

These improvements in irrigation, as well as other practices, could also reduce the substantial yield gap in cereal production. Extrapolating the potential growth of cereal production over the next decade, agricultural value added could grow by 5–7.5% annually. Such growth rates would need to be supported by shifting emphasis to low-volume, high-value crops for domestic consumption and export; revitalizing production of industrial crops like cotton, sugar beet, and sugarcane; and improving productivity of livestock and promoting dairy activities. While GDP growth will be driven mainly by agricultural growth in the short and medium term, growth elasticities in industry and services are much higher than in agriculture, and the economy will develop away from the current high share of agriculture in total value added.

All scenarios, of course, depend on the realization of the hopes for peace, security, and further stability raised by the adoption of the Constitution and on the success of the national elections planned for 2004.

GDP growth in FY2003 strengthened due to a recovery in agriculture and a pickup in industry. Growth is likely to improve further in FY2004–FY2005 on the back of a recovery in global demand and structural adjustment measures undertaken by the Government in support of its poverty reduction strategy. To mitigate the risks stemming from the phaseout of the MFA, competitiveness in the garment industry should be improved.

Economic Assessment

GDP growth for FY2003 (ended June 2003) is provisionally estimated to have strengthened to 5.3% from 4.4% in FY2002. Faster growth was initiated by a recovery in agriculture and a pickup in industry. The increase in agricultural output—3.3% in FY2003 from near stagnation a year earlier—was due mainly to a rebound in food grain production, which rose by 3.0% following a 3.2% decline the previous year. The rebound reflected favorable weather, an expansion in area of high-yield variety rice cultivated, and higher domestic rice prices.

Growth in industrial output rose to 7.3% from 6.5% in FY2002 on account of more robust manufacturing activity. The rise in growth from 4.6% to 6.0% in medium- and large-scale manufacturing output was underpinned by a recovery in the export-oriented chemicals, processed foods, and knitwear and garment subsectors. The output of domestic market-oriented small-scale manufacturing also saw strong growth while the power, gas, and water supply subsectors (which support manufacturing activity) rose significantly. Growth in construction, however, slowed marginally to 8.3% from 8.6% due to an ongoing oversupply of commercial buildings and apartments. Higher export-oriented manufacturing and food grain production led to increases in wholesale and retail trade, and transport, storage, and communications activities, boosting growth in overall services sector activity (about half of GDP) to 5.8% from 5.4% in FY2002.

On an expenditure basis, GDP growth in FY2003 was underpinned by a rise in private consumption and public investment. Higher agricultural output and a recovery in the export-oriented garment industry boosted rural and urban disposable incomes and markedly raised growth of private consumption expenditures to 5.9% from 4.9% in FY2002. Even though expenditures on the Government's Annual Development Programme (ADP) fell short of target, public investment increased to 6.7% of GDP in FY2003 from 6.4% the previous year, as utilization of the ADP was stepped up. Private investment, however, moderated to 16.5% of GDP from 16.8% in FY2002, reflecting constraints on activity posed by infrastructure bottlenecks (particularly in power, roads, and ports), rigidities in factor markets, and weak governance. As a result, growth in gross fixed capital formation slowed to 6.4% in FY2003 from 8.2% the previous year.

Although below target, government revenue collection in FY2003 increased by 12.4%. The gain reflected budgetary measures adopted during the year as well as improved tax administration; however, as a share of GDP, revenues remained low at only 10.4%. Overall expenditures in FY2003 were also slightly below target, with current expenditures overshooting the budgeted

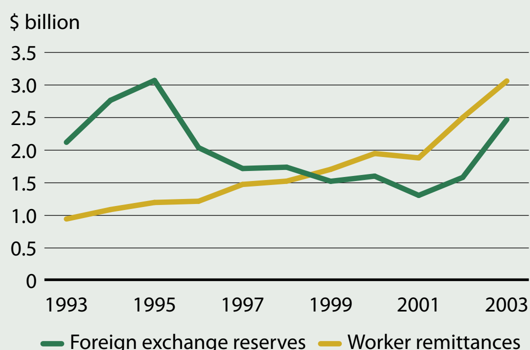


Figure 2.14 Foreign Exchange Reserves and Worker Remittances, Bangladesh, FY1993–FY2003

Source: Bangladesh Bank.

amount by 5.6% and ADP expenditures undershooting by 10.9%. Higher than targeted current expenditures were mainly due to higher than budgeted interest payments, which now account for 14.8% of total revenues. ADP expenditures were lower than targeted because projects of low priority, those showing little implementation progress, and those with unsustainable costs were dropped. As a result, the overall fiscal deficit for FY2003 narrowed to 4.2% of GDP from 4.6% of GDP a year earlier, but still slightly exceeded the 4.0% target. Domestic resources financed 45.3% of the deficit while foreign financing (almost entirely concessional loans) covered the remainder.

In FY2003, broad money (M2) supply growth rose to 15.6% from 13.1% in FY2002, with a sharp rise in net foreign assets of the banking system accounting for nearly one third of the growth. The increase in domestic credit during this period fell to 9.5% due to a contraction in credit to the public sector on account of reduced budgetary financing requirements. Private sector credit growth, however, edged up slightly from the previous year to nearly 15%, reflecting steady growth in domestic economic activity.

Inflation rose steadily to 4.4% in June 2003 from 2.8% in June 2002. On a year-on-year basis, it picked up to 5.0% in June 2003 from 3.6% 12 months earlier. Unlike recent years, food prices were the main factor. Despite higher food grain production, the food price rise can partly be attributed to a reduction in food procurement and distribution by the Government, due to the monetization of some of its food distribution schemes under the safety net programs. Another element in the food price rise was the increase in fuel prices in January 2003 (energy amounts to over 30% of the input costs of food grain production). Nonfood prices, which remained at a relatively high level during the first half of FY2003, came down in the latter half of the year on account of greater exchange rate stability and a tighter fiscal stance. Although both rural and urban inflation accelerated in FY2003 relative to FY2002, the former (4.7%) remained higher than the latter (3.5%). This stems from greater availability of cheaper imports in urban areas and an increase in transport costs to rural areas.

Although higher inflation offset, to some extent, nominal wage increases in manufacturing (15.4%), agriculture (8.0%), construction (7.4%), and fisheries (6.4%), except for fisheries the rate of increase in real wages for these production sectors exceeded that of the preceding year. The higher real wage increase for manufacturing, relative to agriculture and fisheries, reinforces the observed trend of poverty incidence falling at a faster rate in urban areas than in rural areas.

During FY2003, merchandise exports and imports grew by 9.5% and 13.0%, respectively, from the FY2002 level, to $6.5 billion and $8.7 billion. This marked a strong rebound from FY2002 when both sides of the account fell. Export growth was broad based, with frozen foods, tea, chemical products, raw jute, and knitwear posting double-digit growth. After months of decline, readymade garments, which account for about 50% of exports, recorded a steady upturn in value from April 2003, as strong volume growth offset low unit values. The higher volume of garment exports can, to some extent, be attributed to the ongoing consolidation process in the industry.

Import growth was also broad based, with particularly large increases evident for rice, edible oils, sugar, and oil products. The surge in rice imports, in turn, is grounded in rising rice prices in the domestic market, lower rice prices in international markets, and declining inflows of food aid. Reflecting a higher base, the growth in imports offset the increase in exports, and led to a widening of the trade deficit to $2.2 billion in FY2003 from $1.8 billion the previous year.

Table 2.14 Major Economic Indicators, Bangladesh, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth[a]	5.3	4.4	5.3	5.7	6.0
Gross domestic investment/GDP	23.1	23.1	23.2	24.3	25.1
Inflation rate (consumer price index)	1.9	2.8	4.4	4.7	4.2
Money supply (M2) growth	16.6	13.1	15.6	15.9	15.2
Fiscal balance/GDP	-5.0	-4.6	-4.2	-4.8	-4.5
Merchandise export growth	12.6	-7.6	9.5	13.5	11.0
Merchandise import growth	11.4	-8.7	13.0	17.5	15.0
Current account balance/GDP	-2.3	0.4	0.5	0.0	-1.5
Debt service ratio[b]	6.6	6.3	5.6	5.3	5.6

[a] Based on constant 1995/96 market prices. [b] Represents the ratio of debt service on medium- and long-term loans to total foreign exchange earnings from exports of goods and nonfactor services plus worker remittances.

Sources: Bangladesh Bureau of Statistics; Bangladesh Bank; Export Promotion Bureau; Ministry of Finance; staff estimates.

The higher trade deficit was, however, more than covered by a 22.4% improvement, to $3.1 billion, in worker remittances in FY2003 (Figure 2.14). As a consequence, the surplus on the current account (excluding official grants) rose to $268 million from $171 million in FY2002.

This improvement was reinforced by a significantly larger financial account—due to higher inflows of medium- and long-term loans and FDI—and widened the overall balance-of-payments surplus to $899 million in FY2003, from $365 million in the preceding year. The large overall balance, which was buoyed by disbursements from the World Bank's Development Support Credit and IMF's PRGF, raised foreign exchange reserves to $2.5 billion at end-FY2003 from $1.6 billion at end-FY2002. Outstanding external debt at end-FY2003 amounted to $16.9 billion, a slight increase over the end-FY2002 level of $16.2 billion, though as a share of GDP it decreased to 32.6% from 34.0% over the same period. Also over this period, due to the improvement in exports, debt service as a proportion of exports declined to 5.6% from 6.3%.

Policy Developments

The Government formulated its interim poverty reduction strategy paper, called the National Strategy for Economic Growth, Poverty Reduction and Social Development (NSEGPRSD), which seeks to reduce by half the incidence of income poverty by 2015. The NSEGPRSD and the Government's commitment to prepare a full poverty reduction strategy by end-2004 provided the basis for obtaining concessional assistance from IMF's PRGF and the World Bank's Development Support Credit.

Underpinning the NSEGPRSD is a medium-term (FY2004–FY2006) macroeconomic framework that seeks to raise economic growth to 6.5% and bring down inflation to 4.0% by FY2006, as well as contain the fiscal deficit to under 5% of GDP during the period. To help achieve these goals, the Government has embarked on a program of reform measures aimed at maintaining macroeconomic stability while addressing structural constraints on faster economic growth. These include (i) further fiscal reforms involving a sustained revenue effort and a shift in spending toward infrastructure and human capital formation, (ii) reform of the banking sector to reduce the fiscal risk of NPLs and to bring down the high cost of funding investment, (iii) reform of SOEs to reduce their burden on the budget and enhance the role of private sector-led growth, and (iv) trade reforms to improve competitiveness.

The FY2004 budget seeks implementation of the fiscal priorities identified in the medium-term macroeconomic framework. While the fiscal deficit target for FY2004 has been increased to 4.8% of GDP in view of the greater availability

of concessional aid, several measures were taken to strengthen public resource management. For instance, the economic composition of recurrent expenditures is set to improve with higher allocations for the social sector and for operation and maintenance, and reduced allocations for subsidies. There is also an emphasis on making development expenditures more effective, by improving public service delivery and by expanding private sector participation in the provision of infrastructure services. Achieving the deficit target for FY2004 will largely depend on achieving the revenue target that is budgeted to increase by 16.2%, well above the 12.4% performance in FY2003, but data for the first 6 months of FY2004 indicate that revenue collection fell marginally short of its target for the period. Accordingly, there can be no letup in ongoing revenue mobilization efforts to plug leakages, improve compliance, reduce exemptions, and enhance cost recovery.

On the structural front, utility tariffs and energy prices have been revised upward, while Bangladesh Bank has been granted greater autonomy and expanded authority to conduct monetary and exchange rate policy and to supervise all banks. In the context of the four nationalized commercial banks (NCBs), steps have been taken to introduce professional management contracts to three NCBs and to privatize the other. With regard to private commercial banks, their minimum paid-up capital has been increased, and their boards have been strengthened by new rules on the composition and tenure of bank directors.

Having improved the institutional capacity of Bangladesh Bank and developed a more market-based monetary framework to control inflation, the authorities floated the taka at the end of May 2003 by withdrawing the official band for buying and selling rates against the dollar (fixed in January 2002 at Tk57.4 and Tk58.4, respectively). Monetary policy, which remained tight in the runup to the float, has recently been eased as the taka continued to show great stability. In November 2003, Bangladesh Bank reduced the statutory liquidity requirement from 20% to 16%, and lowered its bank rate from 6% to 5%. M2 growth during the first 5 months of FY2004 has, however, moderated to 3.9% due to a further reduction in credit growth to the public sector. The latter is a result of ongoing downsizing of SOEs, upward revision of utility tariffs, and a slower pace of ADP implementation.

Notwithstanding recent progress in structural adjustment, the outstanding reform agenda for the NCBs and SOEs remains long and much more needs to be done in the area of economic governance reforms, especially in public resource management. Significant effort will be required to halve income poverty by 2015, since it is estimated that it would require an acceleration of GDP growth to at least 7% in the medium term. Such a rate will require substantially higher investment and new sources of growth.

Although much more public investment in infrastructure and social services is urgently needed, prospects for this are limited due to the very low government revenue base, weak project implementation capacity, and significant fiscal obligations, including the recapitalization of NCBs and retrenchment costs of employees at loss-incurring SOEs. Private investment, moreover, is hampered by infrastructure bottlenecks, a weak and shallow financial system, a shortage of skilled labor, and a host of governance issues ranging from an ineffectual policy and regulatory environment and poor public service delivery, to bureaucratic inefficiency and endemic corruption. The scope for future expansion of rice production, the main driving force in agriculture, is limited while prospects for the garment industry, the main engine of growth in manufacturing, appear uncertain with the phaseout of the MFA at end-2004.

Outlook for 2004–2005

GDP growth in FY2004 is expected to increase to 5.7%, lifted by expansion in both domestic and external demand. Although year-on-year data for the first quarter of FY2004 indicate that growth in medium- and large-scale manufacturing output moderated to 3.0% from 5.2% in FY2003, more recent data on manufactured exports, and on imports of industrial raw material and industrial credit suggest a strong recovery that would bring manufacturing growth up to its expectation for FY2004.

Agricultural growth is expected to increase, with preliminary indications of a bumper *aman* (winter-harvest) crop. A higher budgeted fiscal

deficit for FY2004 and a more relaxed monetary stance are expected to spur domestic demand. Services sector activities, particularly trade, transport, and finance are likely to show notable improvement with the anticipated further recovery in export-oriented manufacturing and continued strong food crop production. Assuming normal weather, GDP growth is likely to strengthen further to 6.0% in FY2005. Although growth in manufactured exports is projected to moderate with the phaseout of the MFA at end-2004, domestic-oriented private economic activity is expected to strengthen as the Government makes progress on structural and economic reforms.

Annual average inflation, which picked up to 5.1% in November 2003, is likely to moderate due to an anticipated increase in domestic food grain production and lower global commodity prices. Inflation is expected to end FY2004 at around 4.7%. In FY2005, it is forecast at 4.2%; although the taka is likely to depreciate somewhat on account of a deteriorating current account balance, this pressure on prices will likely be offset by further moderation in global commodity prices (both oil and non-oil).

During the first 5 months of FY2004, year-on-year exports strengthened by 13.2%, with strong growth evident for knitwear, woven garments, frozen foods, and chemical products. Imports also experienced robust growth, and year on year in the first 4 months of FY2004 were up by 18.4%. A breakdown of import data indicates continuing large increases for food grains, both rice and wheat. Large increases in imports were also evident for inputs into the garment industry, suggesting that further recovery is under way. Imports of capital goods rose strongly during this period, which augurs well for expanded domestic industrial activity.

As in the recent past, the growth in imports offset the rise in exports, and led to a widening of the trade deficit to $486 million in the first 4 months of FY2004 from $263 million in the same period of FY2003. The higher trade deficit was accompanied by a significant fall in the growth rate of worker remittances to 7.3%, compared with 32.9% in the year-earlier period, because the number of people leaving to work abroad barely increased between the two periods. This has been attributed to instability in the Middle East and a fallout from the ongoing "war on terror." As a result of these developments, in the first 4 months of FY2004 the surplus on the current account (excluding grants) narrowed to $321 million from $558 million in the same period of the previous year.

If these developments in imports, exports, and worker remittances continue, the current account surplus is likely to fall considerably during the remainder of FY2004, but remain marginally positive. The current account is likely to move to a deficit of 1.5% of GDP in FY2005 as import growth continues to outpace the growth in exports that will be adversely affected by the MFA phaseout. However, due to the likely availability of greater concessional assistance associated with the Government's poverty reduction program, such a deficit is sustainable.

The macroeconomic prospects for FY2004–FY2005 appear favorable with upside potential from a more buoyant global economy. However, there are risks in the outlook that threaten to undo the recent gains in socioeconomic progress. Unless further improvements in competitiveness are attained in the garment industry, the end of the MFA era may result in a substantial shift in sourcing to strong, large competitors such as the PRC and India. A sudden, very large switch would have a highly adverse impact on the balance of payments, currency, price stability, and employment generation in Bangladesh. Instability in the Middle East remains a source of concern for the country, as its large earnings from labor exports hinge on stability in the region. Moreover, the Government faces significant fiscal obligations in the period ahead, which, if not dealt with appropriately, could threaten budgetary targets and economic stability.

Bhutan

Prudent policies, strong support from development partners, and rising export earnings from exploitation of the country's vast hydropower resources have steadily raised incomes and social indicators. The outlook for continued development is bright, though reducing heavy dependence on grants and concessional loans at the same time as creating employment opportunities for new school graduates by promotion of greater private sector activity remain important challenges.

Economic Assessment

In 2003, Bhutan registered estimated GDP growth of 6.5%, slightly lower than the 6.7% achieved in 2002. All sectors of the economy recorded faster expansion than in the previous year except electricity production and construction, which together account for about one quarter of the economy. No new electricity production capacity was added during the year, and construction growth slowed to 9.8% from 25.0% in 2002. Nevertheless, projects under way indicate that these two sectors will continue, as in previous years, to be the main drivers of the economy. Major ongoing investments include the country's main hydropower project in Tala, a low-income housing project in Thimphu, and the Thimphu expressway.

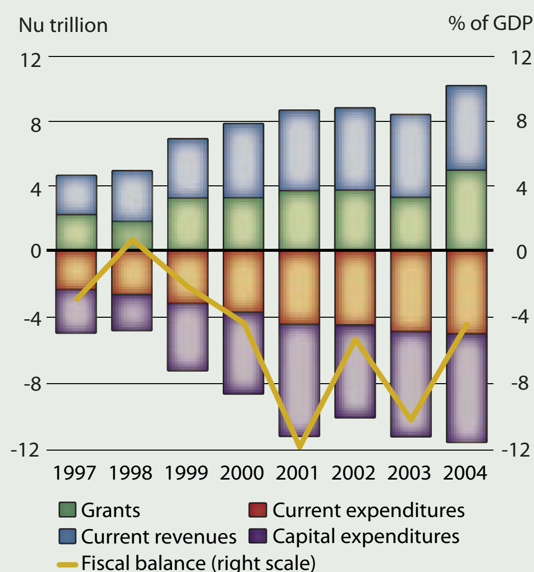
The 2001 National Labor Force Survey estimated labor force participation at 56.5% and open unemployment at only 1.9%. The unemployment rate is estimated at 4.1% in urban areas (5.3% for females and 3.0% for males) and 0.6% in rural areas. About 50,000 school graduates and 19,000 migrants from rural to urban areas are expected to enter the labor market in the Ninth Five-Year Plan (NFYP) period (1 July 2002 to 30 June 2007). To absorb this relatively large inflow, the Government is pursuing measures to expand private sector employment opportunities.

In FY2003 (ended 30 June 2003), the Government continued to exercise prudent fiscal management by maintaining the policy of covering all current expenditures by domestic revenues. However, larger than budgeted expenditures and lower than planned grant receipts led to a doubling of the fiscal deficit to 10.0% of GDP (Figure 2.15). The larger deficit was financed by external borrowings from development partners, advances from commercial banks, and issuance of securities.

Inflation fell to 1.8% in the year to June 2003, from 2.7% the previous year, due to continued price declines in nonfood items. However, the CPI, which is under revision, may not be fully representative of price changes as it is based on an outdated basket and excludes services. Broad money supply (M2) grew by 29.7% in FY2003, mainly reflecting a rise in net foreign assets. Despite an increase in credit to the private sector, excess liquidity persisted with banks still holding some 48% of their deposits as reserves with the Royal Monetary Authority.

Provisional balance-of-payments estimates for FY2003 show a marked improvement in the current account balance to a $61.3 million surplus (10.6% of GDP) from a $6.2 million deficit (1.2%) a year earlier. While the traditionally large trade deficit posted a small reduction, the current account turnaround resulted mainly from an increase in net transfers, in turn generated by large inflows of nonbudgetary grants from India for major power projects and greater official

Figure 2.15 Central Government Finance, Bhutan, FY1997–FY2004



Notes: Data for 2004 are budget. Fiscal balance-GDP ratio is derived by dividing fiscal year balance by the previous calendar year GDP.
Sources: Department of Budget and Accounts, Ministry of Finance; National Statistical Bureau, *National Accounts Statistics Report 2002*; staff estimates.

convertible currency grants. The financial account surplus widened as FDI in the tourism and hotel industry picked up, though larger concessional aid was the main factor. As of end-June 2003, total foreign reserves amounted to $374 million (nearly 80% in convertible currency and the balance in Indian rupees), providing import cover of almost 24 months. Also at that time, total external debt stood at $405.5 million, equivalent to 71.0% of GDP (44% in convertible currency loans and the balance in Indian rupee loans). Since all outstanding debt is on concessional terms, the debt service ratio in FY2003 was only 4.9%.

Policy Developments

Bilateral negotiations with India, which were concluded in 2003, confirmed that substantial grant resources would continue in the first 3 years of the NFYP. The FY2004 budget targets a reduced deficit of 4.2% of GDP to be financed primarily by grants. Domestic revenues are expected to strengthen marginally by about 2%. No new tax measures were taken so as not to stifle private sector development. Moreover, revenues from personal income tax (introduced in 2002 to enhance the domestic revenue base) are expected to decline because of likely tax rate cuts. On the expenditure side, a modest increase of around 3% is projected for both current and capital expenditures.

Managing excess liquidity to promote growth remains a key financial challenge because of conservative bank lending practices and a dearth of investment opportunities. Implementation of planned financial sector reforms will likely result in increased competition and enhanced corporate governance. In July 2003, the National Pension and Provident Fund reduced housing loan rates from 13% to 10% in order to foster construction of new housing, which is in short supply in urban areas. In view of the strong external position, the one-to-one peg of the ngultrum to the Indian rupee has worked well and has not constrained private credit expansion.

NFYP anticipates average annual GDP growth of 8.2%. NFYP emphasizes infrastructure expansion, sound macroeconomic policy, good governance, devolution of authority to localities, and improvement of access to social services.

Outlook for 2004–2005

The outlook for the economy over the medium term is favorable. The scheduled delivery to Druk Air of two Airbus A319 aircraft in late 2004 and ventures by foreign investors to build luxury resorts will buoy tourism, though the electricity and construction sectors are expected to maintain their lead role as the primary engines of high growth. GDP is forecast to strengthen to 7.0% in 2004 and to 8.0% in 2005. The major Tala hydropower project, with 1,020 megawatts capacity, is expected to be commissioned by the end of September 2005. Larger power exports to India will eventually narrow the trade deficit and lift government revenues, facilitating a progressive reduction in the present total reliance on external resources to finance capital expenditures. Expansion of existing and planned subregional economic cooperation activities is expected to lead to export diversification and an expansion of Bhutan's economic base.

India

The economic outlook for India is mixed. GDP is growing strongly, the markets are buoyant, and the balance-of-payments position is comfortable. However the large fiscal deficit, short-term and reversible nature of foreign exchange inflows, poor quality of infrastructure, and slow growth of employment are concerns, as are the poor performance in human development and growing interregional disparities.

Economic Assessment

The consensus growth forecast for India in FY2003 (ended 31 March 2004) is in the range of 7.2% to 7.3%, a sharp increase from average growth of 4.7% in the preceding 3 years. This improvement in aggregate growth reflected an acceleration in services, combined with a strong recovery in agriculture and stronger growth in industry. The key question is whether such high growth is sustainable.

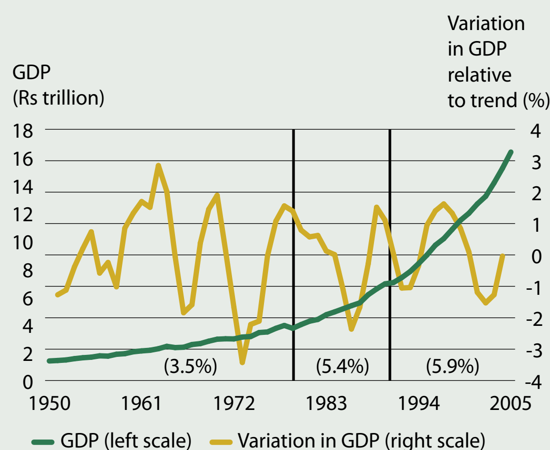
An analysis of growth patterns over the past 50 years since FY1950 indicates that the economy is now on the upswing of a new business cycle (Figure 2.16). This in turn is riding on an underlying long-term trend of accelerating growth, which has increased from 3.5% during the 1950s–1970s to 5.4% in the 1980s and further to 5.9% in the 1990s. Growth acceleration, particularly in the 1990s, stems from a significant step-up in services sector growth.

The variations in trend growth across sectors have led to a major change in the structure of the economy. The share of services in GDP increased from 27.9% to 50.8% between FY1950 and FY2002. The increase in the share of industry during the period was more modest, from 14.7% to 27.2%, and the share of agriculture saw a corresponding decline, from 57.4% to 22.0%. As growth in services is much more stable than in agriculture or industry, the rising share of services in GDP implies that growth volatility is also declining over time.

The growth acceleration in services to become the largest sector in the economy relates to several factors. A growth decomposition exercise shows that it is not just a statistical artifact arising from pay raises and the expansion of the wage bill in public administration. Nor is it attributable to the highly visible growth of software services, since their weight and contribution to total services sector growth is still limited. The two subsectors of trade, hotels, and restaurants, and transport and communications account for just more than half of total services sector growth in recent years, and financial services account for just over one fifth of it. A recent IMF study suggests that growth acceleration in the services sector is explained by high-income elasticity of demand, user industry demand, and rising exports, in addition to reforms and technological advances.

The high trend of growth in services was maintained in FY2003. Industry also recorded robust growth, of about 6.1%, which was broad based among capital, consumer, and intermediate goods. Growth in the country's core industries, such as petroleum, coal, electricity, cement, and steel, started picking up toward the end of the year. It is expected that, as a consequence of large public investments being undertaken under various national infrastructure programs, the

Figure 2.16 GDP and Business Cycles, India, FY1950–FY2005



Note: Figures in parentheses are trend growth rates for respective periods.
Source: Mundle, S. et al. 2003. India's Long-run Macroeconomic Performance. Paper presented at the ADB-RIS seminar on Monetary and Financial Cooperation in Asia, New Delhi, 11 December.

demand for construction intermediates, such as cement and steel, will rise further.

Agriculture also recorded a strong recovery, with estimated growth of 7–8% in FY2003. Excellent monsoon rains, moderate temperatures, and good winter precipitation account for this recovery. However, there is no guarantee that the recovery will be sustained. Agriculture remains a highly unstable sector, dependent on the weather. Average growth is fluctuating around 3% at present compared with 5.3% in the 1980s. Declining growth and continuing instability of agricultural production due to dependence on rain-fed cropping both point to the urgency of raising public investment in irrigation and reducing dependence on rainfall.

It seems therefore that sustaining a high rate of growth will depend primarily on high investment, not only to stimulate aggregate demand in the short term but also to enhance the long-term growth potential of the economy. The investment rate has been stuck at 23–24% in recent years, lower than the peak rate of 26.9% in the mid-1990s. A high rate of growth of over 7%, despite the lower investment rate, implies an improvement in capacity utilization and efficiency of capital use. The incremental capital-output ratio has come down from about 4 to 3.6 as targeted by the 10th Five-Year Plan (FY2002–FY2006). However, as the opportunities for improving capital use efficiency and capacity utilization are exhausted, sustaining high growth will depend on raising the rate of investment, which in turn will critically depend on fiscal consolidation.

A large fiscal deficit in the order of 9–10% over many years has built up a public debt stock amounting to 75.5% of GDP. Interest payments alone eat up 21.3% of consolidated public expenditures of the central Government plus the states. This, together with other current expenditures, especially subsidies and wages of public employees, amounts to 25.8% of GDP, exceeding total revenues that amount to 19.1% of GDP. Thus the Government has to borrow not only to finance the entire public investment program but also a component of current expenditures. However, the large fiscal deficit is a double-edged sword. Although in the short run it stimulates demand and steps up the rate of growth, by directly crowding out public investment, as well as private investment via the financial market, the deficit constrains capacity expansion and the long-term growth potential of the economy on the supply side. It is this long-term risk and nonsustainability of a deficit-financed, public expenditure-led pattern of growth that underlines the urgency of fiscal consolidation.

The Government has so far avoided monetizing the fiscal deficit in order to contain inflationary pressures, especially since large foreign capital inflows are causing a rapid expansion of the monetary base. The deficit has been financed largely through borrowing from the financial sector. As a consequence, lending to the Government has accounted for as much as 41.2% of total commercial bank lending. Such large-scale sovereign borrowing at relatively high interest rates has tended to crowd out private borrowers, especially small and medium enterprises. The Reserve Bank of India (RBI) has been pursuing an accommodative monetary policy and progressively reduced the cash-reserve ratio and the bank rate to contain this tendency. Prime lending rates have accordingly softened marginally and the flow of bank credit to the commercial sector has been rising, growing by 17.1% in FY2003. Total money supply (M3) grew by 13.7% over this period, which is in

Table 2.15 Major Economic Indicators, India, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth[a]	5.8	4.0	7.3	7.4	7.6
Gross domestic investment/GDP[a]	23.1	23.3	24.0	24.5	25.0
Inflation rate[b] (wholesale price index)	3.6	3.4	5.3	5.0	4.7
Money supply (M3) growth[c]	14.1	15.1	13.7	13.6	13.5
Fiscal balance[a, d]/GDP	-9.9	-10.1	-11.0	-10.0	-9.5
Merchandise export growth[a]	0.0	16.9	15.1	16.1	17.6
Merchandise import growth[a]	-2.8	13.5	19.7	18.7	19.5
Current account balance/GDP[a]	0.2	0.8	0.7	0.3	0.3
External debt/GDP[a]	20.6	20.5	18.0	16.0	15.0

[a] Data for 2003 are estimates. [b] Data for 2003 are for April–December. [c] Data for 2003 are as of 6 February 2004. [d] Includes combined fiscal deficit of the central Government and all state governments.

Sources: Ministry of Finance and Company Affairs; Ministry of Statistics and Programme Implementation; Reserve Bank of India; staff estimates.

line with the target rate of 14.0%. Accordingly, inflation, as measured by the wholesale price index, remained moderate in FY2003, fluctuating at around the average rate of 5.3%.

Apart from domestic demand stimulation through expansionary fiscal policy and accommodative monetary policy, aggregate demand has also been stimulated by a positive turnaround in the external sector in recent years. A chronic current account deficit of around 1.6% in the 1980s and 1990s turned into a surplus for the first time in over 20 years in FY2001. This improvement is primarily attributable to the strong growth in the invisibles account, especially the surge in export earnings from IT-associated services. In FY2003, merchandise exports are estimated to have grown by 15.1%. Imports are estimated to have risen by 19.7%, and from a larger base, reflecting the revival of economic activity and larger domestic absorption of certain consumer durables and nondurables. Consequently a trade deficit of $17.9 billion is expected, but after adjusting for receipts from invisibles, a net current account surplus of $4.2 billion is likely.

Along with improvements in the current account position, foreign exchange reserves increased to $107.4 billion as of end-March 2004. However, these gains on the capital account are not without risk, given the rising share of reversible portfolio investments, banking flows, and short-term loans. These components accounted for about half the annual capital inflow of around $21 billion in FY2002. In contrast, of the $33.9 billion foreign exchange accrual in FY2003, as much as $19.5 billion is in the form of net portfolio investments, net short-term loans, and net banking capital inflows. On the other hand, FDI inflows remained low at only $3.6 billion during this period. There is a risk, therefore, that a shift in investor preferences abroad could reverse these flows, and sharply reduce foreign exchange reserves (as observed in many countries during the 1997–98 Asian financial crisis). Moreover, the nominal exchange rate of the rupee vis-à-vis the dollar has appreciated by 7.8% over the past 2 years, though the real effective exchange rate has appreciated by only 1.2%. However, since the US is India's major trading partner, a further appreciation of the rupee against the dollar could undermine expansion of exports.

Apart from the above macroeconomic risks, the economy faces various social challenges relating to employment, poverty reduction, and human development. Agriculture is critically important for the first two elements. Though the sector now accounts for only 22% of GDP, it still provides about 57% of total employment (as well as supporting the bulk of poor people), despite having seen almost no growth in employment over recent years. The only sector where

employment has risen is the industry sector, where annual average employment growth increased from 0.6% during FY1987–FY1992 to 2.4% during FY1993–FY1998. However, the sector accounts for only 17.6% of the work force. The services sector accounts for about 26% of total employment. Average annual employment growth in this sector declined from 3.1% during FY1987–FY1992 to 2.1% during FY1993–FY1998. As a consequence, while GDP grew by 6.6% in FY1993–FY1998 overall employment expanded by less than 1% a year—virtually jobless growth. Set against annual labor force growth of 1.3%, this implies increasing open unemployment or underemployment and a weakening of the poverty-reducing impact of growth. This is clearly a major social challenge. The incidence of income poverty fell from 54.9% in FY1973 to 26.1% in FY1999. However, there is some doubt as to whether this pace of poverty reduction will be sustained over the next decade, despite high growth.

Another major social challenge relates to human poverty. Despite some recent improvements, performance in terms of education, health, and social exclusion indicators remain disappointing. India is still ranked as low as 127 out of 175 countries on the Human Development Index, lower than its per capita income rank of 115. The 10th Five-Year Plan has accordingly identified the strengthening of social service delivery as one of its most urgent tasks. It has proposed a sharp 80% increase in public social spending in this period, along with improved governance to ensure more decentralized and improved delivery of pro-poor public services.

An emerging social challenge relates to accentuation of economic and social disparities between leading states, such as Gujarat, Haryana, Kerala, Maharashtra, Punjab, and Tamil Nadu, and lagging states, such as Assam, Bihar, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh. Such growing interregional disparities can lead to serious sociopolitical tensions in the future if they are not urgently addressed.

Policy Developments

Several policy developments in the past year are significant in the context of the economic assessment presented above. These can be broadly grouped into developments in fiscal policy and monetary policy; policy measures to promote FDI; and policy reforms for infrastructure development, especially power.

As part of its steps to tackle the large fiscal deficit, the Government enacted the Fiscal Responsibility and Budget Management Act, 2003. The main purpose of this act is to ensure effective fiscal management and reduce the deficit of the federal Government, which accounts for about half of the total fiscal deficit. The federal Government has also started introducing IT-enabled services to improve tax administration, which should enhance tax buoyancy and help reduce the deficit. However, in early 2004 it introduced a number of tax exemptions and customs and excise duty reductions that have partly reversed these gains. Had these duty reductions been introduced as part of a planned shift from excessive dependence on indirect taxes to greater reliance on direct taxes, this would have served as a sound tax rationalization measure. Given the ad hoc manner of introducing the rate reductions without a corresponding enhancement of the direct tax base through elimination of exemptions, the tariff adjustments have made it more difficult to accomplish the act's targets. A fiscal consolidation program for the state governments has also been under implementation since FY2000, though the results of this program have also been mixed.

The main thrust of monetary policy during the year was to contain the inflationary potential of a rapidly expanding monetary base due to large foreign capital inflows, while attempting to contain the crowding-out effect of government borrowing from the financial market. Accordingly, along with sterilization through open market operations to offset the monetary impact of foreign capital inflows, the monetary and credit policy for FY2003 reduced the cash-reserve ratio and the bank rate, respectively, from 4.75% to 4.5% and 6.25% to 6.0%. The central bank also initiated several measures to enhance transparency and disclosure of financial information on capital adequacy and risk exposure of commercial banks. It has also taken steps to strengthen the microcredit system. However, these policy initiatives notwithstanding, lending rates remain high with prime rates of 10.25–11% as against 5–5.5% on deposits of 1-year maturity.

Against a background of remarkably low and declining levels of FDI, and the need for a more attractive policy environment to attract it, the Government has progressively abolished or substantially liberalized the FDI ownership limitations that earlier applied in most sectors. These measures were extended to the hydrocarbon sector and banks during the year.

Other structural weaknesses that have been major disincentives for FDI include nontransparent and cumbersome regulatory procedures; archaic labor, land, and rent control laws; and poor infrastructure. Reforms to correct these structural distortions on a countrywide basis will take years. As an interim measure though, the Government has started establishing a large number of special economic zones through public-private partnerships. Aiming to attract more FDI, these zones provide high-quality infrastructure, simplified implementation of regulatory procedures, exemption from certain legal provisions relating to land and labor, and several tax incentives.

Finally, unreliable and inadequate power supply has been a major impediment to industrial recovery and growth. Continuing and severe shortages of power are as much due to inadequate generation capacity as to huge transmission and distribution losses from theft as well as technical inefficiencies. As these losses amount to nearly one third of power generated, a significant reduction in them would considerably ease power shortages even before new generation capacity comes on stream. Moreover, a reduction in the large subsidies in power distribution would also allow for better demand management and help reduce the demand-supply imbalance.

These issues require improved corporate governance in the power sector, especially the restructuring of public sector state electricity boards. Enactment of the 2003 Electricity Act, based on the principles of promoting competition, efficiency, and commercial viability, is a significant landmark in this direction. The act provides for delicensing thermal power generation, a liberalized captive power policy, open access to transmission and distribution networks, transparency in subsidy management, and the formation of an appellate tribunal for speedy resolution of disputes.

Outlook for 2004–2005

The medium-term economic growth outlook is buoyant. The economy is on the upswing of a business cycle, which is in turn riding on an accelerating long-term growth path. The high growth momentum is likely to be sustained through FY2004–FY2005. This forecast is based on the assumption that sound macroeconomic fundamentals will be maintained, including the expected initiation of a serious fiscal consolidation effort following elections in May 2004; that business sentiment will continue to strengthen inside and outside the country; and that there will be normal monsoons during the period. Based on these positive assumptions, GDP is forecast to grow at 7.4% in 2004, with trend growth of 3.0% and 8.0% in agriculture and services, respectively, and 10.2% in industry, which reflects a peaking of the industrial business cycle that started in FY2002, prior to the upturn of the GDP business cycle. Despite the downturn of the industrial cycle in FY2005, higher services growth of 9.0% is expected to lead to aggregate growth of 7.6%. In terms of the contribution to growth of different components of aggregate demand, consumption growth has the largest estimated share of 52.2% during FY2004–FY2005, followed by 36.3% for investment, 9.5% for government consumption, and 2.0% for net exports. However, over 80% of the change in consumption demand is itself endogenously derived from income growth. Thus, analytically it is the contribution of investment growth that must be regarded as the leading determinant of the rate of GDP growth.

The positive assumptions underlying the projections above have associated risks. If the new Government that takes over in May 2004 fails to come to grips with the fiscal deficit and other urgent reform issues, this will erode business confidence and undermine investment, resulting in reduced growth. A shift in international investor preferences could curb or even reverse the inflow of foreign capital since much of the current capital inflows are easily reversible. This calls for a cautious policy with regard to capital account liberalization. Finally, a setback in agriculture due to poor monsoons could be damaging for growth, and especially for employment and poverty reduction.

Of all these risks, the link between fiscal consolidation, investment, and growth is particularly important. The private sector savings rate is about 26% of GDP, while the private sector investment rate is only around 16%. Thus, over 10% of GDP or 38.5% of private savings is appropriated for the public sector. However, since there is a dissaving of about 2.0% of GDP in the public sector, and a small current account surplus, the investment rate has remained at around 23–24%. The 10th Plan growth target of 8.0% assumes an increase in the investment rate to 28.4% of GDP and a public investment rate of 8.4% of GDP, including financing by public savings of about 0.44% of GDP. These targets and assumptions are unrealistic, since even this modest public sector surplus implies a sharp fiscal turnaround from the dissaving at present. However, assuming that the new Government will launch a serious fiscal consolidation effort and achieve some reduction in public dissaving, the overall savings rate is expected to rise to 24.8% and 25.3% of GDP in FY2004 and FY2005, respectively. The investment rate is projected at 24.5% and 25.0% of GDP during these 2 years, allowing for a small current account surplus of 0.3% of GDP.

Taking advantage of declining interest rates abroad and the large inflow of foreign capital, India has been prepaying some of its high-cost external debt. This process is likely to continue over the medium term, reducing the external debt ratio from about 18.0% in FY2003 to around 16.0% in FY2004 and further to 15.0% in FY2005. Debt prepayment has also moderated the appreciation of the exchange rate and the impact of capital inflows on the monetary base. The central bank is expected to continue the policy of sterilization within an accommodative monetary policy stance. Accordingly, money supply growth is likely to remain in the range of 13.5–13.6% over the forecast period, and inflation will remain moderate at 4.7–5.0%.

Per capita income will be rising through FY2004 and FY2005 because of GDP growth well in excess of low and stable population growth, leading to a decline in the poverty ratio, though its pace will depend on employment growth, especially in the agriculture sector. Even then, the poverty-reducing impact of agricultural growth is expected to be weak because of low employment growth in the sector.

An alternative route to employment growth is through progressive transfer of the work force from agriculture to industry and services. Unfortunately, expansion of the modern services sector has created mainly high-skill, high-productivity jobs rather than mass employment. The observed higher growth of employment in the industry sector is more promising. The employment share of industry, only around 17% at present, will rise if the recent strong growth of industry can be sustained through high investment. More important, with continuing high public investment in transport and communications infrastructure, as the rural and the urban economies become better integrated, this will give an impetus to the growth of industry and services in rural areas. This should in turn lead to rapid growth of rural off-farm employment, rising rural incomes, and further generation of rural employment.

However, the development of this virtuous cycle is a long-term process. Hence it would be unrealistic to expect a major improvement in employment growth or poverty reduction in the medium term. The same applies to the Millennium Development Goals (MDGs), where India's performance has been mixed. While some targets, such as enrollment for primary education and access to improved water sources, are on track, others, such as female secondary enrollment and reduction in infant mortality, are lagging. The 10th Plan set up its own monitoring targets, which are more demanding than the MDGs, and also called for an 80% increase in social sector spending to speed up social development.

The accomplishment of these goals will depend both on successful fiscal consolidation and on improvements in governance to ensure better delivery of education and health services. Thus, dramatic improvements within the next couple of years are unlikely. However, social indicators are improving, albeit gradually, and the MDGs for 2015 are certainly achievable if the required reforms are pursued with determination.

Maldives

The economy returned to the rapid growth seen in the 1990s, after tepid gains in the 2 previous years. Future economic performance and poverty reduction will depend not only on further development of the tourism sector, but also on diversification of production and on outer atoll development.

Economic Assessment

The economy grew by 8.4% in 2003, marking a nearly full recovery from the adverse effects of the September 11 events on tourism. The sector accounts for about one third of GDP and contributed more than half of GDP growth during the year. Tourist arrivals reached a record number of nearly 564,000 in 2003, up by about 16% from the 2002 level (Figure 2.17). Neither the Iraq conflict nor the SARS threat appeared to have great negative impact; indeed, hotels were over 90% occupied in the first quarter of 2003. The fisheries sector, the traditional economic mainstay, experienced a 5% decline in catch from the high 2002 level. Despite this, marine exports increased by over 35%, reflecting stronger export prices and larger volume, and were responsible for most of the overall increase in total exports in 2003.

Fiscal performance improved in 2003 and the overall deficit was reduced to 4.1% of GDP from 4.9% a year earlier. Domestic revenues increased by 12.8%, while expansion in expenditures and net lending was held to 10.0%. The Government continued development of the large infrastructure Hulhumalé project, which is reclaiming land and developing a new town on an island close to Malé, the capital city. A reduced overall deficit and somewhat larger foreign financing of capital expenditures allowed a net repayment to the Maldives Monetary Authority.

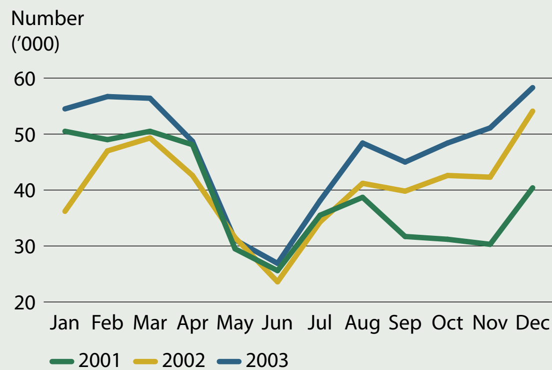
Monetary conditions in 2003 were characterized by an expansion of 14.6% in broad money (M2) reflecting a large increase in net foreign assets. Growth in credit to the private sector slowed from the 2002 rate because of the reduced needs of the tourism sector as its cash flow improved; credit to other sectors showed a marked improvement, however. Average consumer prices fell by 4.0%, reflecting lower prices for fish—an important staple—and imported goods.

Exports and imports grew rapidly by 12.8% and 18.1%, respectively, pushing up the historically large trade deficit by about $45 million to $258 million. With the improvement in tourism, the current account deficit rose only by about $12 million to $48.1 million (6.9% of GDP). Expansion of private sector capital inflows and larger official assistance led to a higher capital account surplus of $103.6 million. Accordingly, the overall balance posted a surplus of $55.5 million, about $15 million higher than in 2002. Official reserves reached $161.0 million at end-2003, providing comfortable import cover of 4.1 months. External debt rose to $264.2 million at end-2003, equivalent to about 38% of GDP. With most debt contracted on concessional terms, the debt service ratio in the year was low at 3.9%.

Policy Developments

Larger fiscal deficits in recent years financed by the Maldives Monetary Authority posed a potential threat to the fixed exchange rate system, and so the Government took steps to achieve fiscal consolidation during 2003, in part by expen-

Figure 2.17 Tourist Arrivals by Month, Maldives, 2001–2003



Source: Maldives Monetary Authority.

diture control. Moreover, the Government intends that domestic financing of future deficits be carried out only by market sale of securities.

To enable more comprehensive and up-to-date control over public expenditures, initial actions have been taken to introduce a new public accounting system. Draft bills have been processed and are awaiting the endorsement of the President's Office before submission to the People's Majlis, including a public finance bill, a public enterprise accountability bill, as well as amendments to the Audit Bill. The Government has also taken steps to expand the tax base, and is planning to enact a business profit tax and a property rental value tax.

With the involvement of the World Bank and IMF, a public expenditure management and budgeting workshop was held in June 2003, and the preparation of a medium-term expenditure framework began in March 2004. From 2005, government budgets will be formulated on this basis and all line ministries and agencies will prepare multiyear estimates showing not only capital spending but also estimates of required recurrent expenditures.

To improve conditions on the outer islands, atoll development plans are being formulated with the participation of island communities in selected atolls to guide atoll- or region-based economic and social development. In tandem with these moves, the Government will plan cost-effective infrastructure spending to spur regional economic growth by investing in the areas of regional airport upgrading, resort development, and harbor and marina construction.

Outlook for 2004–2005

Economic performance will remain reliant on tourism, and the uptrend in tourist arrivals is expected to continue. In this regard, efforts are under way to attract more tourists from markets outside Europe (currently accounting for about 70% of arrivals). The Government's Hulhumalé project and regional development programs are expected to continue to spur domestic demand for local construction and transport. With tourism now recovered from its slump, GDP is projected to grow more moderately, by 5.5% in 2004, and is likely to come close to that rate the following year.

The overall budget deficit for 2004 is projected to widen to 4.5% of GDP, with domestic financing of only 0.3% of GDP. Tax revenues are budgeted to rise by 10.7% from the 2003 level, reflecting rate increases in the tourist bed tax and stamp duty. Total expenditures and net lending are planned to rise by 7.6%, with current expenditures up by 13.5% (mainly due to higher salaries and allowances), and capital expenditures down by 5.5%.

More rapid growth in the world economy and favorable developments in tourism are expected to keep the current account deficit at manageable levels. A major factor in favorable balance-of-payments developments to date has been the availability of concessional aid and consequent avoidance of a heavy debt service burden. The eligibility of the country for maintaining its least developed country status is currently being reviewed by the Economic and Social Council of the UN, and a decision is expected by mid-2004. Graduation from this status would have a direct impact on growth in debt servicing.

It is important that the Government keep gradually moving from substantial direct participation in the economy by privatization, enhancing private sector participation, and broadening the production base. As part of the process of economic diversification, the Government has formed several working committees to develop plans on how to diversify the industrial base as well as export products and markets.

Nepal

A cease-fire between the Government and insurgents from January to August 2003 fostered a moderate economic recovery in FY2003, following the downturn a year earlier. The outlook is for continued recovery based on a strong agricultural performance and a further rebound in trade and tourism. However, the tense security situation continues to weigh heavily on the economy.

Economic Assessment

The cease-fire between the Government and the insurgents in effect during the second half of FY2003 (ended 15 July 2003) induced economic recovery. GDP grew moderately by 2.6% over the full year, representing a marked improvement from the 0.4% decline in FY2002. The cease-fire particularly helped hard-hit manufacturing and the trade and tourism subsectors, which rebounded from a contraction in FY2002. The rebound boosted growth in transport and communications services output. Agriculture sector growth was limited to 2.4% due to an inadequate monsoon. Gross fixed capital formation at 19.2% of GDP showed no significant improvement from FY2002. While private investment strengthened marginally by 0.6% of GDP from the FY2002 level, public investment declined by 0.7% of GDP, reflecting the difficult peace and order environment in parts of the country.

The budget deficit narrowed in FY2003 to a record low of 1.8% of GDP, from 3.9% in FY2002, due to improved revenue collection and low development spending (Figure 2.18). The former, climbing to 11.9% of GDP, was only marginally short of the budget target and 11.1% higher than in FY2002. The latter was caused by the security situation and weak local government administration (the term of elected local bodies expired in July 2002 and, as an interim measure, the Government itself appointed committees of civil servants to act on their behalf). Key sectors with significant underspending were health, water supply, and power, where only about half of the respective budget allocations were disbursed.

Reflecting improved economic activity in the second half of FY2003, growth of broad money (M2) nearly doubled to 8.1% from a year earlier. Interest rates fell in FY2003 due to high liquidity in the banking sector caused by the lowering of the cash reserve requirement by 1 percentage point in August 2002 and due to moderate loan demand stemming from investment uncertainties. Given the exchange rate peg of the Nepalese rupee to the Indian rupee and Nepal's large trade with that country, inflation in Nepal generally follows price developments there. CPI inflation picked up to 4.8% in FY2003, from 2.9% a year earlier, reflecting price developments in India, short-term supply constraints of some agricultural products, and upward adjustment of certain administered prices, such as oil products.

The trade deficit widened significantly in FY2003 to $925.9 million. Greater economic activity in the second half of the year boosted growth in total imports to 8.1%. Total exports declined by 14.9% during FY2003, mainly because there were no reexports of oil products to India during the year. (Excluding such reexports, exports increased by 3.3% in FY2003, having declined by about 19% in FY2002.)

This sluggish export performance stemmed largely from four diverse developments: (i) exports

Figure 2.18 Government Expenditures on Development and Security, Nepal, FY1997–FY2003

Source: Ministry of Finance.

to India, which had been growing robustly until FY2000, declined by 5.2% in FY2003, reflecting the more restrictive provisions of the revised 2002 Nepal-India Trade Treaty; (ii) exports to other countries rebounded and rose by 15.9% after their sharp drop of nearly 40% in FY2002; (iii) readymade garment exports, on a downward trend since FY2000, rose markedly by about 58%, mainly due to the upturn in external demand; and (iv) exports of woolen carpets and pashmina continued to decline due to quality problems, lack of market diversification, and increased competition from neighboring countries.

Worker remittances, including unrecorded flows, reached about $820 million (14.1% of GDP) in FY2003, from about $750 million in FY2002, and exceeded exports of $642.8 million. With growing migration, remittances are forecast to steadily strengthen and remain a key resource fostering macroeconomic stability. Tourism receipts rose from about $110 million (2.1% of GDP) in FY2002 to $150 million (2.6%) in FY2003, as tourist arrivals went up by about 9% during the second half of the year thanks to the improved security environment. However, the current account surplus dropped to $107.5 million (1.8% of GDP) in FY2003 from $233.8 million (4.2%) in FY2002 due to the burgeoning trade deficit. Foreign exchange reserves remained adequate at $1.1 billion, equivalent to 7 months of imports. Convertible currency reserves grew by about 33%, on the back of higher remittances, while nonconvertible (Indian currency) reserves collapsed, by about 58%, reflecting the widening trade deficit with India.

At end-FY2003, external public debt stood at around $2.9 billion (50% of GDP). Historically, the external debt service ratio has been low—about 6% of current receipts—primarily because of the highly concessional terms of external loans. However, the ratio has increased in the last 2 years, to exceed 9%, as a result of both the decline in exports and tourism receipts and of higher amortization payments due on past loans. External debt is still manageable though.

Policy Developments

The Government announced its poverty reduction strategy (PRS) in June 2003 based on the Tenth Plan (FY2003–FY2007) approved by the Government earlier in February 2003. The Tenth Plan aims to reduce the current poverty level of about 40% to 30% by FY2007 and sets out a reform and investment program to achieve higher and broad-based economic growth, improve delivery of basic services, promote social inclusion, implement targeted programs for poor and disadvantaged groups, and strengthen governance. The Tenth Plan macroeconomic framework envisages annual average GDP growth of 6.2% under its normal scenario assumption of rapid restoration of political stability and an alternative lower-case scenario of 4.3% if there is prolonged political instability.

The PRS/Tenth Plan has been linked with the Medium-Term Expenditure Framework (now extended to the development budget of all line ministries), which prioritizes public investments based on poverty reduction criteria and realistic resource estimates. Based on the results of the initial Immediate Action Plan (IAP) 2002, the Government prepared and carried out the 2003 IAP to effectively implement the core elements of the PRS/Tenth Plan, particularly measures to strengthen the fiscal position, improve delivery of basic services through devolution, and promote social inclusion in the development process.

The FY2004 budget aims to strengthen domestic revenue mobilization, improve efficiency of public expenditures, and reduce domestic borrowing. The budget targets revenue collection of 12.5% of GDP through improved tax

Table 2.16 Major Economic Indicators, Nepal, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth[a]	4.6	-0.4	2.6	4.0	5.0
Gross domestic investment/GDP	24.1	25.6	26.9	25.5	25.0
Inflation rate (consumer price index)[b]	2.4	2.9	4.8	4.5	5.0
Money supply (M2) growth	15.2	4.4	8.1	9.3	11.0
Fiscal balance/GDP	-4.5	-3.9	-1.8	-2.7	-4.5
Merchandise export growth	-	-20.3	-14.9	10.0	12.0
Merchandise import growth	-	-15.3	8.1	10.0	12.0
Current account balance/GDP	4.5	4.2	1.8	1.0	0.5
Debt service ratio	6.8	9.3	11.4	9.0	9.0

- = not available. [a] Based on constant 1994/95 factor cost. [b] Urban consumers only.

Sources: Ministry of Finance; Nepal Rastra Bank; staff estimates.

administration and revision of key tax rates and fees based on the recommendations of the Fiscal Reform Task Force constituted in January 2003. The budget deficit (including grants) is forecast at 3.1% of GDP, based on an expenditure target of 18.7% of GDP. The projection for current expenditures is an increase of 12.0% from the FY2003 level, and for development expenditures an ambitious rise of nearly half.

After being stalled for many years, the privatization program has gained momentum with the privatization of the Butwal Power Company and the initiation of privatization or liquidation of nine public enterprises. The budget announced divestment plans for other key public enterprises, such as Nepal Telecom, Royal Nepal Airlines Corporation, and the National Life Insurance Corporation. An unbundling of the Nepal Electricity Authority is slated for FY2004. It is also planned to open up oil product imports to the private sector, to generate competition and improve the efficiency of the Nepal Oil Corporation.

The autonomous Nepal Accounting Standard and the Nepal Auditing Standard boards have been established to upgrade corporate accounting and auditing to international standards. The three new Secured Transactions, Insolvency, and Company laws are being promulgated to advance corporate and financial governance reforms. Efforts are under way to increase trade and competitiveness. The Government has ratified the WTO accession agreement, as a result of which Nepal now faces two difficult challenges: to cope with the elimination of the MFA quotas in 2005 and to comply with WTO accession commitments.

Following the enactment of the Nepal Rastra Bank (NRB) Act in 2002, which enhances NRB's autonomy and strengthens its supervisory and regulatory functions, a new Banking and Financial Institutions Ordinance has been adopted to further strengthen NRB's oversight on all institutions in the financial system. A debt recovery tribunal has been established, providing a time-bound process for recovering debts. NRB also issued a new blacklisting directive naming major loan defaulters.

NRB issued directives to end limits on commercial banks' interest rate and foreign exchange rate spreads. The ceiling of a 1% spread between the buying and selling rates of foreign currencies was revoked, effective 17 December 2003, and the regulation setting a maximum spread of 0.5% from a bank's declared lending interest rate was withdrawn, with the aim of better accounting for risk and enhancing competition among commercial banks.

To strengthen governance, the Government continues to implement anticorruption measures. A Judicial Investigation and Probe Commission was constituted to investigate properties of public officeholders, providing a basis to initiate anticorruption actions. With regard to civil service reforms, the current personnel information system has been enhanced with an integrated

payroll management system. Steps are also being taken to identify vacant civil servant positions for elimination.

Outlook for 2004–2005

Despite the breakdown of the cease-fire in August 2003, the economic recovery is likely to continue in FY2004, mainly due to the strong performance of the agriculture sector and continued improvement in the trade and tourism sectors. However, economic performance in the medium term will fundamentally depend on a lasting resolution of the insurgency and the political impasse between the Government and political parties. The underlying assumptions of the projections are that (i) there will be no significant deterioration in security conditions in FY2004 and some improvement in them in FY2005, facilitating both private and public sector investment; (ii) the global economic recovery will continue; (iii) the Indian economy will expand by about 7%; and (iv) weather conditions will be normal. On this basis, the economy is projected to grow by about 4.0% in FY2004 and by about 5.0% in FY2005.

Agricultural output growth is likely to improve to about 3.4% in FY2004 and then moderate to 2.9% the following year. In FY2004, agriculture will be buoyed by a nearly 8% rise in paddy production due to the strong monsoon, while output of standing crops, such as maize and millet, is also expected to exceed the FY2003 growth rate.

The industry sector is likely to grow by 3.5% in FY2004 and by 6.9% in FY2005. Growth in 2004 will be supported by the commissioning of three new hydropower plants, a continued increase in construction activities, and improved manufacturing performance. The services sector can be expected to expand by 4.9%, bolstered by further recovery of trade and tourism and continued strengthening of transport, communications, finance, and real estate services. Despite the breakdown of the cease-fire in August 2003, the number of tourist arrivals has grown by 39% during the first 8 months of FY2004—underpinning the likely considerable boost in the services sector.

The fiscal deficit is projected to be about 2.7% of GDP and below the FY2004 budget target of 3.1% due to a likely shortfall in development spending. The security tensions, coupled with the disruption in local government administration, will continue to constrain development spending. The fiscal deficit could widen to about 4–5% in FY2005 if these tensions are relaxed sufficiently, allowing major reconstruction work to be carried out.

Inflation is expected to be contained at below 5.0% in FY2004–FY2005, reflecting the price situation in India and the expected strong agricultural production in both countries. Given the likely impact of the security situation on business activity, the Government's 11.2% target for money supply (M2) growth in FY2004 appears high and a 9.3% expansion is projected. However, money growth could reach 11.0% in FY2005 if the situation improves and business activity picks up.

The trade deficit is forecast to widen in FY2004 without a significant improvement in export performance. The inflow of remittances is expected to continue at the present rate and underpin the country's balance of payments. Tourism receipts are likely to increase moderately. The current account surplus is likely to further shrink to 1.0% of GDP in FY2004 and 0.5% of GDP in FY2005 but higher aid and other capital inflows should offset the usual negative errors and omissions item and expand Nepal's international reserves to maintain a cover of about 7 months of imports.

The economy is projected to continue its recovery in FY2004–FY2005. The security situation however continues to present a substantial risk to the economy, and urgent efforts are required to resolve the present crisis. In this context, the Government needs to find ways to accelerate development activities, especially at the local level, and build political consensus.

Pakistan

Improvements in macroeconomic fundamentals, as well as recovery in the economy, were further consolidated in FY2003. Given continued buoyancy in both domestic and external sectors in the first half of FY2004, GDP growth is likely to exceed the government target of 5.3% for the year. It seems that the foundations have been laid for significantly higher growth and it should be possible to exceed the target of 5.8% in FY2005 and move to a path of over 6% in subsequent years.

Economic Assessment

The recovery of the economy, which started in the second half of FY2002 (ended 30 June 2002), gained momentum in FY2003, when the economy expanded at a pace not seen in the preceding 6 years. The substantial improvement in key macroeconomic fundamentals achieved in FY2002 was further consolidated in FY2003, with the current account surplus increasing sharply, foreign exchange reserves touching new highs, the overall fiscal deficit declining further, and inflation remaining low. Export growth was also the highest in over a decade.

GDP growth in FY2003 strengthened to 5.1% from 3.4% in FY2002. GNP rose by 8.4%, on the back of a sharp rise in net factor income from abroad (largely due to almost doubled worker remittances). Against a background of the population growing by 2.2%, per capita GNP increased by 6.1%. GDP growth was export led, with net exports accounting for more than three fifths of it. Government consumption picked up by 10.4%, largely because of the sharply higher government salary bill, and mainly reflected the full-year impact of the salary raise that came into effect on 1 January 2002. However, the effect of rising government consumption on the demand side was offset by a fall in private consumption, and total consumption remained unchanged at the previous year's level.

Total investment edged up to 15.5% of GDP in FY2003 from 14.7% the previous year, largely because of stronger private sector investment induced by privatization and deregulation in the oil and gas, communications, and financial sectors, as well as by accumulation of stocks. National savings rose from 17.0% of GDP to 19.4% over the same period.

On the supply side, agriculture, after declining in the preceding 2 years, marked a significant upturn of 4.1% in FY2003. This stemmed from a recovery in major crops, largely attributable to the greater availability of irrigation water. The industry sector (comprising mining, manufacturing, construction, and the electricity and gas distribution subsectors) maintained robust expansion of 5.4% in FY2003 for the second consecutive year, mainly due to acceleration in the growth of the large-scale manufacturing (LSM) subsector, which constitutes about half of the industry sector. Faster LSM growth was a feature of all subsector groups (except leather products), and was most pronounced in automobiles, electronics, cement, textiles, and sugar production. Automobiles and electronics benefited from rising sales, fueled by growing availability of consumer finance at low interest rates. Higher remittances pushed up real estate prices and construction activity, leading to greater demand for cement and other construction-related products. Large investments in modernization of the textile industry—the

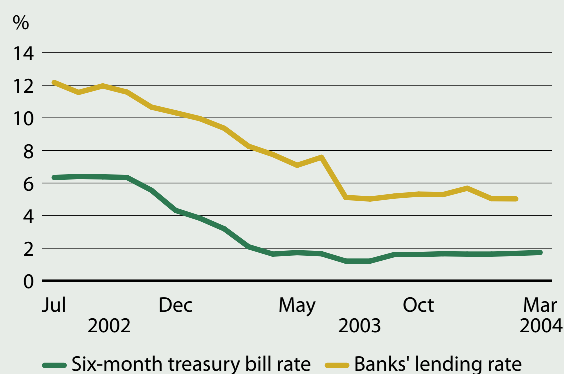


Figure 2.19 Interest Rates, Pakistan, July 2002–March 2004

Source: State Bank of Pakistan.

country's largest industry—over the past 3–4 years have boosted textile production; increased sugar production was the result of a recovery in the sugarcane crop.

Growth in the services sector picked up to 5.3% in FY2003 from 4.1% in FY2002, mainly due to a sharp rise in external trade and the recovery in domestic economic activity. Expansion of wholesale and retail trade as well as transport, storage, and communications accelerated, reflecting an increased volume of external trade and rapid expansion in the telecommunications sector. Public administration and defense also registered high growth due to the full-year impact of the government salary increase and higher expenditures on defense.

Although FY2003 data for unemployment are not yet available, statistics show that it had been on a rising trend in the preceding 3 years. It rose from 5.9% in FY1998 to 7.8% in FY2000 and further to 8.3% in FY2002. The female rate, at 16.5%, was more than twice the male rate in FY2002. With low employment elasticity and a burgeoning labor force, economic expansion of over 6% is required to reduce unemployment.

Inflation declined to 3.1% from 3.5% in FY2002, due to a comfortable supply position of essential food commodities, lower credit costs, excess capacity in most industries, and appreciation of the Pakistan rupee. In an environment of stable prices, the State Bank of Pakistan (SBP) continued to pursue an easy monetary stance to stimulate investment and growth. The 6-month treasury bill rate and the bank lending rate maintained a steep downward trend throughout FY2003 (Figure 2.19). SBP only partially sterilized the additional foreign exchange reserves, and money supply (M2) growth accelerated to 18.0% from 15.4% in FY2002. Private sector demand for credit picked up by PRs167.7 billion, or more than three times as fast as in FY2002, reflecting the further strengthening of the economic recovery.

Share prices continued climbing through most of FY2003, with the Karachi Stock Exchange-100 index surging by 92.2% to 3,402 in the year to end-June 2003. Persistent high levels of worker remittances, appreciation of the rupee, low deposit interest rates, improved corporate profitability, and better relations with India were the key factors in this. The corporate bond market showed moderately greater levels of activity in FY2003, raising PRs10.4 billion, up from PRs9.5 billion in FY2002. However, new corporate bond issues slowed discernibly in the fourth quarter of FY2003, reflecting the impact of low interest rates and the commercial banks' aggressive lending policies.

The process of improving fiscal sustainability continued, and the overall fiscal deficit declined to 4.4% of GDP in FY2003 from 6.6% the previous year. (Excluding one-time expenditures, the fiscal deficit in FY2002 was 5.2% of GDP.) The budget deficit was below the revised target for FY2003 as agreed with IMF under its PRGF. The increase in expenditures was larger than the target, but was more than offset by a much stronger rise in revenues. The process of improving debt sustainability also continued, with public debt as a share of GDP declining to 94.7% in FY2003 from 105.4% in FY2002.

Exports shot up by 19.6% to $11.0 billion and imports by 20.1% to $11.3 billion in FY2003. Better access to EU markets, improved competitiveness of the domestic textile industry, and greater availability of export finance at lower interest rates helped boost exports, while the surge in imports reflected the upturn in the domestic economy. A sharp rise in worker remittances as well as a decline in interest payments on foreign debt pushed up the current account surplus by 49.5% to $4.1 billion. The capital account also showed a significant improvement because of substantial increases in FDI, suppliers' credit, and disbursement of foreign assistance.

Table 2.17 Major Economic Indicators, Pakistan, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth[a]	2.2	3.4	5.1	5.5	5.8
Gross domestic investment/GDP	15.5	14.7	15.5	16.5	17.0
Inflation rate (consumer price index)	4.4	3.5	3.1	4.0	4.0
Money supply (M2) growth	9.0	15.4	18.0	14.0	12.0
Fiscal balance[b]/GDP	-5.2	-5.2	-4.4	-4.0	-3.9
Merchandise export growth	9.1	2.7	19.6	12.0	10.0
Merchandise import growth	6.2	-7.5	20.1	16.4	12.0
Current account balance/GDP	0.6	4.6	5.9	3.0	2.1
Debt service ratio[c]	38.0	44.7	28.7	25.0	23.0

[a] Based on constant 1980/81 factor cost. [b] Data for 2002 exclude one-off expenditures. [c] As share of exports of goods only.
Sources: Ministry of Finance; State Bank of Pakistan; staff estimates.

Consequently, foreign exchange reserves at SBP more than doubled to $9.5 billion on 30 June 2003 compared with $4.3 billion held 12 months previously. The country's external debt and liabilities also declined, by $1.0 billion to $35.5 billion in FY2003, as SBP continued to retire expensive and short-term liabilities.

Policy Developments

The past 4 years have witnessed several positive policy developments. The important areas of policy focus have been developing a poverty reduction strategy, addressing the issue of unsustainable public indebtedness, and controlling the fiscal imbalance through improved resource mobilization, privatization of loss-incurring public sector enterprises (PSEs), and strengthened public resource management at the national and provincial levels.

The Government finalized the full Poverty Reduction Strategy Paper (PRSP) in December 2003. The areas that have been strengthened compared with the interim paper published in 2001 are employment, environment, and gender. For purposes of monitoring public expenditures on poverty reduction, the PRSP identified 17 poverty-focused sectors. The target is to raise public expenditures in these sectors from 5.2% of GDP in FY2003 to 6.0% in FY2006. In addition, nonbudget poverty-related expenditures will be doubled from 0.2% of GDP to 0.4% over this period. The Government has set a goal of reducing the incidence of poverty from 32.1% in FY2001 to 28.0% in FY2006. A Core Welfare Indicators Questionnaire Survey is being instituted to monitor and assess the short-term impact of poverty-related expenditures. The Government's commitment to the implementation of the PRSP can be seen in its increase in the share of pro-poor expenditures from 4.5% of GDP in FY2002 to 5.2% in FY2003.

Since FY2001, the Government has implemented a comprehensive debt reduction strategy by undertaking fiscal adjustment and paying off expensive outstanding liabilities. It has achieved much in implementing this strategy: the ratio of total public debt to GDP fell from 106.9% in FY2000 to 94.7% in FY2003, while the ratio of interest payments to government revenues declined from 52.5% to 33.5% over the period. This has created fiscal space for the Government to increase expenditures on poverty reduction and the development program. The Government has set up a Debt Policy Coordination Office, which is to prepare a 10-year debt reduction path for it to follow. A Fiscal Responsibility and Debt Limitation Bill was submitted in October 2003 to the National Assembly for approval. The law will bind the Government, among other things, to eliminate the revenue deficit (i.e., there will be no borrowing to finance current expenditures) by 30 June 2007 and to reduce the outstanding public debt to 60% of GDP by 30 June 2012. It will

also require the Government to submit annual and midyear reports to the National Assembly on progress toward lowering public debt, so as to ensure transparency in debt management.

The FY2004 budget announced various measures supporting the implementation of the ongoing tax reforms for increased revenue mobilization. In the area of tax administration, a number of medium taxpayers' units are being set up in different cities, where taxpayers will be able to pay all their taxes (corporate income tax, sales tax, excise duty) at one place. This follows the establishment of the Large Taxpayers' Unit in Karachi last year, which has been very effective in realizing greater tax receipts in the area that it covers. As part of the income tax reforms, with effect from FY2004, all returns are filed under the self-assessment system, which places the responsibility for determining tax liability on the taxpayer (and not on the tax officer, as was the case in the past), with a certain percentage of tax returns selected randomly for audit.

In line with the plan to have one corporate tax rate by FY2007, tax rates for banks and private limited companies were further reduced. To broaden the tax base, the Government announced the withdrawal of 20 more exemptions from income tax in the FY2004 budget. As part of the policy to phase out excise duty, duties on paper and paper board as well as on cables and wires were withdrawn and those on cement were lowered by 25%. Tax reforms implemented over the last 4 years have started paying off, with the tax-to-GDP ratio up by 0.8 percentage point to 13.7% over the past 2 years.

Also over the last 2 years, the rate of privatization of PSEs has accelerated. The Privatization Commission has increased the use of the stock market for divesting government shares in PSEs, which has the added advantage of deepening and strengthening the stock market. The value of divestments of government equity through the stock market rose from PRs7.5 billion in 2002 to PRs9.3 billion in 2003. The sale of 5% of the shares of the Oil and Gas Development Corporation for PRs6.9 billion in 2003 was the largest sale of PSE shares through the stock market to date. In December 2003, the Privatization Commission finalized the sale of 51% of equity in Habib Bank Limited for PRs22.4 billion, and with this, almost 80% of banking assets are now with the private sector. In addition to increasing efficiency, privatization also reduces the burden on the federal budget. For example, the cumulative equity injection from the national government budget into public sector banks until FY2002 amounted to PRs46.6 billion.

Following significant macroeconomic reforms at the federal level, the provincial governments have started implementing fiscal and financial management reforms. Sindh and North-West Frontier Province started these programs in 2002, and Punjab in 2003. Under its program, the Punjab government has implemented measures to enhance revenue mobilization; rationalize and restructure public expenditures; and improve effectiveness, predictability, and accountability in financial management. To enhance revenues, it introduced a new system of property tax assessment, raised user charges for water supply in all major cities, and rationalized irrigation water charges. The Punjab government has introduced facility-specific contractual employment in the education and health departments, which is expected to help contain pension liabilities, enhance accountability of teachers and health personnel, and upgrade service delivery in these sectors.

Outlook for 2004–2005

In a context of brisk growth in the real sectors of the economy in the first half of the year and of several factors conducive for growth, it is expected that GDP will rise more strongly than the government target of 5.3% in FY2004. The agriculture sector is expected to expand by 4.2%. Major summer crops other than cotton have shown higher output, and the winter crop prospects have improved due to greater availability of water in reservoirs, timely winter rains, and an increase in the support price of wheat. A sharp upswing in agricultural credit in the first half of FY2004 and a larger offtake of fertilizers in October 2003–January 2004 also point to better prospects for winter crops. The industry sector is likely to post higher growth in FY2004, propelled by continuing double-digit rises in textile exports and by domestic demand for consumer durables that has been fueled by a threefold increase in

consumer credit in the first half of FY2004. LSM production rose by 14.7% during that period, compared with 5.3% in the same period in FY2003. Industrial growth should also benefit from higher hydropower generation resulting from greater availability of water. The services sector looks set to record continued strong performance with an upturn in output in the financial sector, as indicated by financial results for major banks and other financial institutions in the first quarter of FY2004. Telecommunications, particularly cell phone services, and electronic media (TV and radio stations) are also expanding rapidly, and the recent deregulation of the sector and issuance of licenses to new operators should sustain this trend.

Inflation started rising in the second quarter of FY2004 in the wake of reports of a wheat shortage. However, despite this, SBP continued its easy monetary policy during the first half of FY2004, when money supply (M2) growth accelerated slightly to 9.1%, from 8.6% in the same period in FY2003. Private sector credit picked up further, and as a result, interest rates have started inching up.

SBP is expected to continue its easy monetary policy in the second half of FY2004, to sustain the economic recovery. M2 growth is likely to surpass the full-year target of 11.0% in the wake of ongoing rapid expansion in private credit and a substantial increase (16.4%) in reserve money in the first half of the fiscal year. Although interest rates are expected to continue rising in the second half of FY2004, they are still likely to remain at historically low levels because of excess liquidity in the banking sector and continuing subdued demand for credit by the Government. Due to the tight fiscal stance, continuing excess capacity in the LSM sector, appreciation of the Pakistan rupee, and global price stability, annual inflation, while higher than the previous year, is unlikely to exceed 4.2%.

The fiscal balance improved significantly in the first half of FY2004, when the budget deficit declined to 0.8% of GDP from 1.6% in the same period in the previous year, reflecting a sharp increase in revenues and containment of expenditures. Revenues strengthened by 13.9%, but expenditures went up by only 3.6%. Tax receipts, which exceeded the target in the first 8 months of the year, are expected to be on target for the whole year in view of the broad-based recovery in the domestic economy and the robust increase in imports. Public expenditures are also expected to remain under control, particularly following the easing of tensions with India. After a sharp decline in the fiscal deficit in the first half of FY2004, the prospects for meeting the 4.0% budget target for the year look promising.

Exports grew by 18.3% to $7.2 billion and imports by 14.3% to $7.5 billion in the first 7 months of FY2004, compared with the same period in FY2003. The current account maintained a comfortable surplus of $1.9 billion in the first 7 months of FY2004, though slightly down on the $2.5 billion in the same period in FY2003. Robust growth in exports as well as a continued high level of remittances (despite some decline) in the first 7 months of FY2004 point to a comfortable balance-of-payments position for the whole year. With the global recovery gaining momentum and the domestic economic upturn continuing, both exports and imports are expected to maintain double-digit growth in the rest of FY2004. However, as domestic economic recovery strengthens in the second half of the fiscal year, imports are expected to outpace exports, resulting in a wider trade deficit. The current account is forecast to remain in surplus for the year, although substantially lower than in FY2003.

Several developments on the domestic and external fronts have improved the medium-term prospects for the economy. The political atmosphere has cleared somewhat with the passage of the 17th Constitutional Amendment, which provides cover to reforms and policies implemented in the last 4 years, and a vote of confidence received by the President from members of the national and provincial assemblies and the Senate in December 2003. This, along with sound macroeconomic fundamentals, is providing a favorable environment for investment. Better relations with India will further enhance the investment climate and give a boost to economic activity. Medium-term economic prospects have also strengthened with the acceleration in the global economy and the signing of the South Asia Free Trade Area (SAFTA) agreement by the members of the South Asian Association for Regional Cooperation (SAARC).

The performance of the two most important

commodity-producing sectors, namely agriculture and manufacturing, is expected to improve in the medium term. Agriculture will be bolstered both by investments made in irrigation infrastructure in the past few years to combat drought, as well as by the adoption of water-saving techniques by farmers during the drought years. A surge in public expenditures in rural development in the past 3 years, as part of the Government's poverty reduction strategy, will also help the sector, as will the apparent end to the drought of the past 4–5 years. The agriculture sector, always highly weather dependent, is therefore expected to expand, by 4.3% in FY2005 and by 4.4% in FY2006.

The significant investments in the textile industry, as indicated by a more than doubling of imports of textile machinery in the past 3 years, have substantially improved the industry's prospects. The Government's policy of assigning a greater role to the private sector, as reflected in its deregulation and privatization programs, has also encouraged investment in the overall private sector, particularly in LSM. Fixed capital formation in the private sector expanded by 16.0% in FY2003, the highest rate in the last decade. Investment in LSM rose by 25.9%, following a 35.6% increase in FY2002. The ongoing upsurge in imports of machinery, as well as credit to the private sector, in the first 7 months of FY2004 indicates that growth in investment is continuing. This sustained rise in private sector investment, particularly in textiles, augurs well for manufacturing's medium-term prospects. The LSM sector is expected to expand by 8–9% annually over the next 2 years.

The Government's active debt management policy and tax reforms are expected to lead, respectively, to further reduction in debt servicing and to increases in revenues. The resulting fiscal leeway will allow it to spend more on development and operation and maintenance in the public sector. This will in turn improve physical infrastructure, which along with continuing low interest rates, is likely to further encourage investment, as various industries approach their capacity limits. Investment and industrial production will also be facilitated by the expected reduction in electricity tariffs, resulting from the approximately 28% increase in hydropower generation capacity upon the upcoming completion of the Ghazi Barotha Hydropower Project, with a total installed capacity of 1,425 megawatts.

A significantly strengthened economic base now exists, and if the Government continues to pursue sound macroeconomic policies and to implement its planned economic and governance reforms, the economy should be able to grow by 5.8% in FY2005 and by 6.0% in FY2006. This higher rate should help reverse the rising poverty trend of the 1990s and achieve the PRSP poverty reduction target of 4 percentage points by FY2006.

Sri Lanka

With the peace dividends from the second year of the cease-fire, economic growth and policy reforms strengthened in 2003. But the promising year ended with unexpected political developments that might slow growth and weaken the economic reform agenda.

Economic Assessment

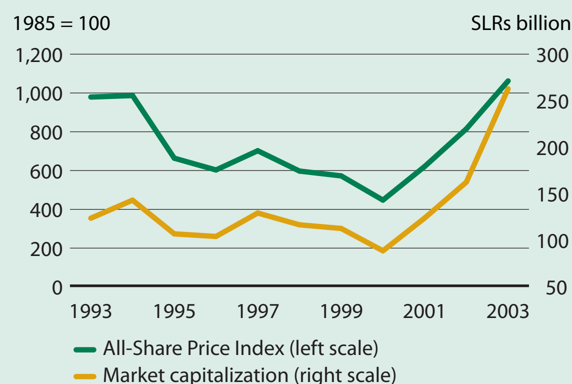
A Norwegian-brokered truce, in effect since 23 February 2002, has provided the most promising prospect to date for ending the 20-year civil conflict with the Liberation Tigers of Tamil Eelam (LTTE). Uncertainties over the outcome of peace negotiations and the outlook for the future direction of the economy heightened in November 2003 when the President assumed control of several important ministries, citing policy differences over the peace negotiations. The President dissolved Parliament in early February 2004 and called for new elections on 2 April, 4 years ahead of schedule. In March, an additional area of uncertainty emerged when the eastern region commander broke with the LTTE leadership, although by mid-April the latter appeared to have restored its control over the east. The President's party secured victory in the recent election and has formed a new Government. However, this Government's approach to economic policies and to the peace process suggests that peace negotiations and reform implementation will face a period of considerable uncertainty.

In 2003, the economy continued its comeback from the 2001 recession—a year when the economy was battered by the global slowdown, a severe drought, and an attack on Colombo airport. Aided by the Government's strong financial and structural reform policies, GDP is estimated to have grown by 5.5%, while inflation fell substantially and the budget deficit narrowed further. Tourist arrivals registered record numbers of over 500,000, for a 27.3% increase from 2002. The services sector was the most significant source of growth, accounting for about two thirds of the GDP increase; it was the most rapidly growing sector, at 6.8%, driven mainly by expansion in banking and insurance services.

The industry sector, which before the recession had contributed substantially to economic growth, registered a slower comeback than services, growing by 5.8%. An increase in hydropower generation, which forestalled continued load shedding, and further recovery in the garment industry contributed to the expansion. The slowing rate of export orders for garments in the third quarter is partly attributable to ongoing reorganization in the sector to prepare for the phaseout of the MFA in 2005. The sector suffers from falling productivity and high factor costs in comparison with competing countries and faces challenges in the post-MFA environment. Agricultural growth was slow at 1.7%, despite a record rice harvest and a return to more normal weather conditions. Tea production was hampered in the first half of the year by floods, but despite production setbacks, exports were up by 3.6%.

The ongoing cease-fire has yet to lead to a significant improvement in private sector investment, which expanded only marginally during 2003. The key sectors attracting what investment there was included power generation, telecommunications, transportation, and retail trade. Uncertainty over the peace process caused investors

Figure 2.20 Colombo Stock Exchange, Sri Lanka, 1993–2003



Sources: Central Bank of Sri Lanka, *Annual Report 2002* and *Selected Economic Indicators*, December 2003.

to continue to wait and see what transpired. On the demand side, the main driving force behind economic growth was private consumption, which accounts for over three quarters of GDP. Consumption spending was partially fueled by rising remittances from overseas workers, which increased by 9.8% in 2003 from $1.3 billion a year earlier. Unemployment in the third quarter fell to 8.4% from 9.1% with jobs being created predominantly in the private sector, since the public sector maintained its hiring freeze. Unemployment among the young however, did not improve and remains structural and entrenched: over two thirds of all unemployed people have never had a job and most are long-term unemployed. Many frustrated job seekers simply left the labor force.

Fiscal action during the year was characterized by expenditure streamlining. Attempts to increase tax revenues were disappointing and collection fell about 18% short of the 2003 budget revenue target of SLRs303 billion. The reduction of the fiscal deficit to 8.1% of GDP (from 8.9%) stemmed largely from lower debt-servicing costs and military spending, as well as from underspending on planned capital investments, which were held 22% below the budget target. The cost of debt servicing was reduced because of lower than anticipated prevailing interest rates and restructuring of the public debt through the replacement of expensive commercial debt with concessional loans and long-term government bonds. Military spending fell as a result of the cease-fire agreement. About half of the deficit was financed with domestic debt, the remainder with foreign concessional borrowing, grants, and privatization proceeds. The Government met its target for privatization (SLRs13.5 billion) for the year; receipts included those from the delayed privatization of Sri Lanka Insurance, originally due in 2002, and the partial sale of a government petroleum company to the Indian Oil Corporation.

Inflation, as measured by the Colombo CPI, fell to 6.3% from 9.6% in 2002, reflecting increased production and availability of consumer goods, bumper main (*maha*) and secondary (*yala*) rice harvests, lower imported inflation, and tight financial policies. As inflation subsided, the central bank reduced its main lending rates three times during the year, and the yield on 91-day treasury bills fell by 257 basis points to 7.35% at end-2003. The decline in rates was followed, albeit sluggishly, by the banking sector lowering deposit and lending rates; the average weighted prime lending rate of 9.26% at end-2003 was down by nearly 300 basis points over the year as was the average weighted fixed deposit rate. The exchange rate vis-à-vis the dollar at end-2003 (SLRs96.6/$1) remained slightly changed (0.5% depreciation) from December 2002. In nominal terms, the rupee depreciated by approximately 10.2% against the Japanese yen and 17.1% against the euro in 2003.

Broad money supply (M2b) increased by 15.3%, with about three fifths of the expansion reflecting an increase in net foreign assets. Lower interest rates and better business conditions lifted growth in credit to the private sector to 16.9% from 12.0% in 2002. Buoyed by the peace process and general prevailing optimism, the stock market was among the best performing in Asia. The events in November disrupted the seemingly unstoppable rise, but the All-Share Price Index at year-end was nevertheless 30.3% higher than 12 months earlier (Figure 2.20).

Export growth of 10.5% and import growth of 13.0% in 2003 showed marked improvement from the performance of the previous 2 years. The beginning of global recovery led to increased demand for the country's exports: garments and textiles (about half of total exports) were up by 6.3% and other industrial products (about 27% of total exports) increased more rapidly by 16.1%. Buoyant domestic demand expanded imports of

Table 2.18 Major Economic Indicators, Sri Lanka, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth[a]	-1.5	4.0	5.5	5.0	5.5
Gross domestic investment/GDP	22.0	21.3	22.2	22.5	22.5
Inflation rate (Colombo CPI)	14.2	9.6	6.3	7.0	6.0
Money supply (M2b)[b] growth	13.6	13.4	15.3	13.0	12.5
Fiscal balance[c]/GDP	-10.8	-8.9	-8.1	-7.3	-6.5
Merchandise export growth	-12.8	-2.4	10.5	10.0	9.0
Merchandise import growth	-18.4	2.2	13.0	12.0	12.5
Current account balance/GDP	-1.5	-1.6	-2.2	-3.0	-3.5

[a] Based on constant 1996 factor cost. [b] Includes time and savings deposits held by commercial banks' foreign currency banking units. [c] Excludes foreign grants and privatization proceeds.

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

capital, intermediate, and consumer goods. The traditionally substantial trade deficit widened to $1.7 billion. The US and EU remained the most important export markets. With the ironing out of problems in the free trade agreement with India, that country has become the second largest source of imports after the EU, displacing the US.

Increased services receipts, mainly from tourism, and larger transfers in the form of worker remittances held the current account deficit to $416 million (2.2% of GDP), an outcome broadly in line with expectations. Overseas workers, predominantly based in the Middle East, stepped up their remittances during the year, apparently in response to their unsettled employment situation. The surplus on the financial account was bolstered by improved aid utilization and new program loans, though net inflows fell marginally to $226 million in 2003, in contrast to 2002 when the cease-fire and privatization of government assets spurred FDI inflows. The overall balance-of-payments surplus increased to $390 million for the year. Official foreign reserves increased to $2.3 billion, providing 4.2 months of import cover.

Policy Developments

The Government's progress toward a peace settlement and commitment to economic reforms caught international attention as never before. A donor group, meeting in June 2003 and co-chaired by the US, EU, Norway, and Japan, pledged $4.5 billion for reconstruction and development. The disbursement of funds was to be closely linked to progress in the peace process. New lending from the International Bank for Reconstruction and Development and ADB approved during the year supports the Government's goal of reducing the national poverty rate from 25% to 20% and the rural rate, where 90% of the poor reside, from 27% to 22% by 2006. Aid efforts would also focus on reconstructing conflict-affected areas. Moreover, a PRGF lending arrangement with IMF, which outlines a macroeconomic framework for a 3-year period, was agreed in April 2003, although it may be reviewed in light of recent developments.

The budget for FY2003 had revenue reforms and control of public expenditures high on the agenda. The Fiscal Responsibility Act passed in December 2002 committed the Government to reducing the budget deficit to 5% of GDP and the public debt from 100% to 85% of GDP by 2006. Since interest payments alone now account for over 7% of GDP, or over 30% of budget revenues, these are crucial objectives.

Implementation of reform plans for the year was mixed. The politically controversial introduction of VAT on wholesale and retail trade and the plan to remove the tax division of the Board of Investment (BOI), which can grant companies exemptions outside internal revenue laws and regulations, was passed by Parliament but has not

yet been implemented. In contrast, the Government succeeded in restructuring public debt by converting SLRs33.5 billion of high interest rate rupee loans into long-term treasury bonds and by retiring expensive unauthorized off-budget overdrafts. Debt restructuring efforts will continue in 2004, although the new Government has yet to announce its intentions in this respect. The Government also introduced a tax amnesty in the 2003 budget, and as a result 10,000 new tax files were opened during 2003. However, a rigorous follow-up on the new files will be required if the tax amnesty is to have a positive effect on revenues.

In November, the Government passed a reform-oriented budget for 2004. The budget outlined in greater detail reforms to achieve ambitious revenue targets and plans to establish a new revenue authority, restructure the civil service, and broaden the tax base. With the passage of this budget, IMF was about to conclude its PRGF review and release an $80 million loan installment in December. This was postponed though because implementation of one of the major program components—the new revenue authority—became doubtful.

The central bank began to introduce inflation targeting in March, and contained liquidity and broad money growth in line with the targets of about 13%. The monetary stance was broadly accommodative to boost the economy, and key interest rates were lowered in line with falling inflation. The central bank also conducted open-market operations to contain excess liquidity, which remained high throughout the year due to the substantial foreign exchange inflows. Banking reform progressed, albeit slowly, and toward the end of the year the cabinet approved the Asset Management Law. This provides the basis for the largest state-owned bank shifting its NPLs to an asset management company.

The domestic environment for FDI remains difficult because of the mixture of political uncertainty, regulation, inflexible labor laws, and infrastructure problems, which deters investors. To help overcome some of these hurdles, the Government set up the BOI. It is, perhaps, telling that the largest and most active department of the BOI is the one dealing with government bureaucracy, customs clearance, and license applications. Other problems facing FDI are less easy to solve, and require determined political will. Some changes to labor laws that impede the hiring and firing of new staff and were due to be passed in 2003 are still with Parliament. For example, laying off staff except for well-documented disciplinary reasons is illegal, unless a substantial compensation package is provided to the employee; neither is there any transparency in the size of the compensation package, which is set on a case-by-case basis by the labor commissioner, and a company has no recourse to appeal against the decision.

The garment industry is undergoing restructuring to be able to face the phaseout of the MFA at the end of this year. A recent study shows that high labor and energy costs, the lack of functioning trade services, and weaknesses in infrastructure seriously impede competitiveness. Unbundling the power sector is moving ahead, but the process of approval for a new power plant, in the planning stage since 1988, has not moved forward as the site location remains hotly contested. This means that the essential large-scale load generation plant required to reduce prohibitively high power tariffs and to ensure reliable supply cannot enter into service before 2009 at the earliest. If demand increases as currently projected, and no new capacity is added to the system by 2005, it is likely that the power outages that so adversely affected the economy in 2001 will return by 2006.

The economy has important advantages that should help it meet the targets of the Government's ambitious long-term strategy, outlined in "Regaining Sri Lanka," of 8–10% annual growth, although it is not yet clear if the new Government will retain that strategy. These are high literacy rates, a relatively high human development index, location next to a fast expanding and large economy, and the goodwill of the international community that pledged record assistance to the country's reconstruction and development. To achieve its growth targets, the new Government will need to continue moving from an economy with large-scale government involvement in production to one where the private sector becomes the key source of economic growth. It needs to continue targeting four critical reform areas: a mismanaged power sector and consequent high electricity prices, restrictive land and labor laws, protective tariffs stifling growth and

efficiency, and a weak regulatory framework that has led to low tax revenues and distortions in investment. The long-term strategy must also continue an ambitious privatization program, a streamlining and gradual reduction of the huge civil service, and a gradual and sustained lowering of public debt.

Outlook for 2004–2005

Assuming broadly supportive political mandate for continued economic reform, the economy is expected to record solid growth over the next 2 years, but projections have been recently revised downward because of the persistent drought in early 2004, an anticipated power shortage, and the need to generate expensive emergency power, as well as a slowdown in legislating economic reforms due to the delay caused by the elections. Domestic investment activities might not be as strong as had been expected earlier, though stronger growth in the key export markets of the US and EU should help counterbalance this. Tourism has proved to be quite resilient, growing steadily through end-January and is expected to continue to expand rapidly.

Even though the pressure of high global oil prices is expected to abate somewhat, a major uncertainty is the availability of sufficient hydropower. Water levels in reservoirs at end-2003 were already low and power cuts are likely unless supplemented by expensive emergency power from thermal power plants. Electricity demand is projected to increase by about 9% in 2004 and a very heavy reliance on thermal sources would be costly and disruptive to industrial growth. Given all these factors and the still uncertain global environment, projections for GDP growth are 5.0% for 2004, and 5.5% in 2005.

Several factors will put upward pressure on prices in 2004. These include the possibility of the drought being prolonged (pushing up agricultural prices), power shortages (raising electricity tariffs and manufacturing costs), increases in VAT rates (on some goods), wage pressures (stemming from electioneering), and a likely greater depreciation of the rupee against the dollar (raising the cost of imports). The Government's inflation targets are ambitious, with a minimal increase to 7.0% in 2004 and then a 1 percentage point decline to 6.0% in 2005, but they could indeed be achieved with continuing strong fiscal and monetary discipline.

The original target for 2004 was to narrow the budget deficit to 6.8%, reducing recurrent expenditures while increasing capital expenditures as a share of GDP. The Finance Secretary's Pre-Election Budgetary Position Report (mandated under the Fiscal Management Act and issued on 27 February) indicated likely revisions to the 2004 budget; revenues would likely be 3.6% lower than initial estimates, mainly due to legislative delays, and would now amount to 15.6% of GDP, while expenditures would increase to 22.9% of GDP. This would bring the estimated deficit to 7.3% of GDP.

Although this revision in the deficit would continue to indicate some further fiscal consolidation during the year, the Report noted risks that included the effects of political uncertainty and the possibility of a prolonged impasse in the peace process affecting investment. While the revised budget deficit estimate for 2004 is used in the *ADO 2004* projection, given the current political environment the Government might have to resort to making more substantial cuts than anticipated in the Report in capital expenditures to achieve the targeted deficit. Reflecting the established policy direction, the fiscal deficit for 2005 is tentatively projected at 6.5% of GDP.

The current account deficit is projected to widen steadily to 3.0% in 2004 and to 3.5% in 2005. Growth of merchandise exports depends crucially on developments in the textile sector, and demand for textiles should pick up with higher growth in the global economy.

Export growth in 2004 is projected at about 10% and then about 9% in 2005, the first year that the country's textile exports have to compete fully on a price basis and are not governed by MFA import quotas. But imports of capital goods, intermediate goods—including crude oil for power generation—and consumer goods will increase faster than exports; import growth during the next 2 years is expected to be about 12% each year. The widening trade gap will be somewhat offset by expected continued strong growth in tourism receipts and worker remittances. Anticipated foreign assistance and other capital inflows, including larger FDI inflows, are expected to more than fully cover the current account deficit.

ASIAN DEVELOPMENT
Outlook 2004

Economic Trends and Prospects in Developing Asia

Central Asia

Ian Gill

Azerbaijan

Macroeconomic performance remained strong in 2003, with double-digit GDP growth, low inflation, and rising international reserves. The medium-term prospects are good, as the ongoing investment boom in the oil sector is expected to continue through 2004, leading to rapid expansion of oil production and exports until about 2010. A challenge for the Government will be to translate this oil boom into sustainable economic growth and enduring poverty reduction.

Economic Assessment

GDP growth accelerated to 11.2% in 2003 from 10.6% in 2002, boosted by substantial FDI inflows into the oil and gas sector (the "oil sector"), which reached $2.8 billion (39.4% of GDP). The full development of the Azeri-Chirag-Gunashli oil fields and the construction of the associated Baku-Tbilisi-Ceyhan (BTC) oil pipeline proceeded apace, despite delayed approval of loans by international creditors. In addition, two new large-scale gas projects—namely, the development of the Shah-Deniz gas field in the Caspian Sea and the construction of the South Caucasus Pipeline, which will deliver gas from Shah-Deniz to Turkey—were launched in early 2003.

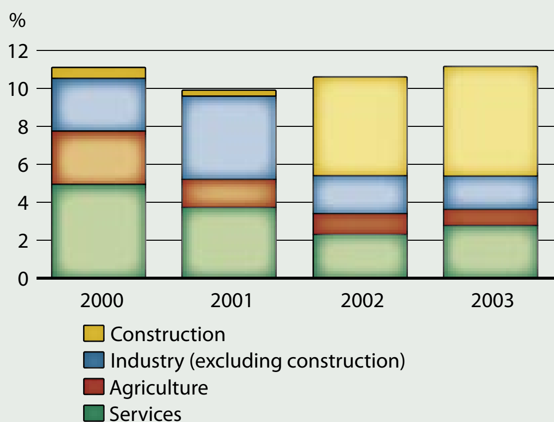
On the production side, construction, which benefited most from the growing investment demand, surged by 61.0%, contributing an estimated 5.8 percentage points to GDP growth (Figure 2.21). Other industrial subsectors relating to hydrocarbon development, such as metallurgy and the production of construction materials, also performed well, while oil production itself remained flat at about 310,000 barrels a day. Agriculture, the economy's largest sector in terms of employment, recorded robust growth of 5.6%, notwithstanding relatively unfavorable weather conditions. The services sector expanded by an impressive 8.0%, led by communications and domestic trade.

Rapid output growth does not appear to have been accompanied by a commensurate increase in employment. According to official labor statistics (based on reports by enterprises and labor exchanges), total employment increased by 0.5% and the unemployment rate rose from 1.3% to 1.4% between end-2002 and end-2003. These statistics, however, underestimate the true unemployment level because only a fraction of the unemployed register with labor exchanges. Results of a recent labor market survey, conducted by the State Statistical Committee, suggest that the actual unemployment rate was 10.7% in mid-2003.

The consolidated budget, including the State Oil Fund of Azerbaijan Republic (SOFAZ), recorded a small surplus of 0.2% of GDP, compared with a surplus of 1.3% of GDP in 2002. Although the non-oil deficit—defined as the deficit of the consolidated budget excluding hydrocarbon-related receipts and outlays—widened to 8.2% of GDP in 2003 from 7.7% the previous year, it remained well below the estimated long-term sustainable level. Assets of SOFAZ, which accumulates and manages most of the Government's revenues from production-sharing agreements in the oil sector, reached $817 million at end-2003.

Inflation remained subdued, with the average annual CPI rising by 2.2%, compared with 2.8% in 2002. While the nominal exchange rate of the national currency (the manat) against the dollar

Figure 2.21 Estimated Sector Contributions to GDP Growth, Azerbaijan, 2000–2003



Sources: State Statistical Committee of Azerbaijan Republic; staff estimates.

remained virtually unchanged, the real effective exchange rate depreciated by an estimated 13.1%, giving domestic producers a competitive edge. Remonetization of the economy continued, albeit from a low base, with broad money supply increasing by 29.8%, and the monetization ratio—as measured by the ratio of broad money to GDP—rising to 14.5% in 2003 from 13.0% in 2002. At the same time, a high degree of dollarization persisted, with foreign exchange deposits accounting for about half of broad money. Real interest rates as well as the spread between deposit and lending rates stayed high (more than 4% and 6%, respectively). This primarily reflected underlying weaknesses of the financial sector, such as the lack of public confidence in banks and weak competition, although tight monetary policy is seen as a contributing factor.

Preliminary data suggest that the current account deficit more than doubled to 28.3% of GDP in 2003 from 12.3% in 2002. Strong performance of both oil and non-oil exports was more than offset by a sharp rise in imports of capital goods and services for the oil sector. The current account deficit was fully financed by inflows of FDI and other capital inflows such that the overall balance of payments recorded a surplus of $236 million. Consequently, gross official international reserves, including SOFAZ assets, increased from $1.4 billion at end-2002 to $1.6 billion at end-2003. The external debt burden remained moderate, with the end-of-year stock of public and publicly guaranteed debt standing at $1.6 billion (22.0% of GDP) and the ratio of debt servicing to exports of goods and nonfactor services amounting to 5.0%.

Policy Developments

Fiscal policy was moderately expansionary. Several taxes, including the enterprise profit tax and the payroll tax, were lowered to reduce the tax burden on the non-oil sector. Moreover, sector and regional variations in the enterprise profit tax rate were introduced in an attempt to stimulate non-oil sector growth and more balanced regional development. At the same time, salaries of public sector employees were raised considerably to reduce the gap between wages in the public and private sectors, and SOFAZ expenditure was increased to finance high-priority social and infrastructure projects.

Nonetheless, the consolidated budget was kept in surplus, in part due to an increase in oil-related revenues. Moreover, part of the revenue windfall arising from higher than anticipated world oil prices was saved as a cushion against possible future declines in oil prices and, consequently, oil-related budgetary revenues. In this way, the Government effectively established a stabilization oil fund separate from SOFAZ. (Unlike, for example, Kazakhstan's oil fund, SOFAZ does not perform the stabilization function in that its receipts and outlays are not directly linked to world oil prices and the domestic budgetary situation.)

Monetary policy remained tight, with the primary goal of maintaining domestic price stability. The National Bank of Azerbaijan Republic (NBAR) kept its refinancing rate unchanged at 7% per annum. NBAR also continued with its policy of informal exchange rate targeting, frequently intervening in the foreign exchange market to smooth out fluctuations of the nominal exchange rate and to ensure continued depreciation of the real exchange rate of the manat vis-à-vis the dollar. Reserve money grew by 23.5%, mostly resulting from a buildup of NBAR's net foreign assets.

Considerable headway was made in structural reform, though it was uneven across various

Table 2.19 Major Economic Indicators, Azerbaijan, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	9.9	10.6	11.2	9.0	12.5
Gross domestic investment/GDP	20.7	32.0	-	-	-
Inflation rate (consumer price index)	1.5	2.8	2.2	4.0	3.0
Money supply (M2) growth	31.7	14.4	29.8	27.9	28.5
Fiscal balance/GDP	1.8	1.3	0.2	1.1	1.5
Merchandise export growth	13.7	12.7	13.9	-0.8	29.3
Merchandise import growth	-4.8	24.5	49.3	26.5	-6.1
Current account balance/GDP	-0.9	-12.3	-28.3	-32.5	-18.1
Debt service ratio	4.9	4.4	5.0	-	-

- = not available.

Sources: Ministry of Finance, National Bank, and State Statistical Committee of Azerbaijan Republic; International Monetary Fund; staff estimates.

reform dimensions. A wide range of fiscal reforms was introduced to enhance efficiency, transparency, and accountability of public financial management. Most notably, the Budget System Law was amended in May to integrate SOFAZ more closely into the consolidated budget and to strengthen parliamentary oversight of the fund. A timetable for privatization of the two remaining state-owned banks—the International Bank of Azerbaijan (IBA) and the United Universal Joint Stock Bank—by end-2004 was announced, and the 50% ceiling on foreign participation in the domestic banking system was lifted, with effect from 1 January 2004. However, the planned sale of 20% of IBA shares from the Government's holding to the European Bank for Reconstruction and Development was delayed. While the domestic prices of natural gas and most oil products were raised to estimated long-term import or export parity levels to reduce implicit energy subsidies, the amount of explicit energy subsidies to the electricity and gas sectors included in the 2003 budget exceeded the target level because of increased oil consumption by these sectors.

Progress in some other key areas of structural reform was limited. Agricultural reform had lost momentum following the distribution of 1.3 million hectares of land to rural households in the second half of the 1990s. The implementation of the Second Privatization Program adopted in 2001 was slow, with only about one tenth of some 350 SOEs included in the program having been privatized by end-2003. Despite the Government's recent efforts to improve the business environment in the non-oil sector, formidable obstacles to the development of the non-oil private sector remain. These include weak protection and enforcement of property and contractual rights; cumbersome licensing procedures; corruption; and limited access to, and high cost of, bank credits. Many sectors of the economy continue to be characterized by a high degree of market concentration and weak competition, with incumbent companies using their dominant position to prevent potential competitors from entering the market.

The Government recognizes that structural reform is essential to fostering the development of the non-oil sector, creating productive job opportunities, and enhancing the economy's long-term growth potential. Thus, following his election victory in October 2003, President Ilham Aliyev issued decrees that called for initiating the second phase of agricultural reform, tightening financial discipline in the energy sector, accelerating privatization of SOEs, enhancing competition, and stimulating the development of the non-oil private sector.

Outlook for 2004–2005

The macroeconomic outlook for 2004–2005 is positive. GDP is projected to grow by 9.0% in

2004 and by 12.5% in 2005, on the baseline assumptions that the key oil sector projects will be implemented on schedule and that the benchmark price of Brent crude oil will average $28 per barrel in 2004 and $26 per barrel in 2005. Growth will be driven by a continuing investment boom in the oil sector in 2004 and by rapid expansion of oil production and exports in 2005. Pushed by the considerable rise in public sector wages in 2003, average annual consumer price inflation is forecast to accelerate to 4.0% in 2004, before moderating to 3.0% in 2005. While the nominal exchange rate of the manat will remain fairly stable against the dollar, its real effective exchange rate will continue to depreciate. The current account deficit is expected to widen further to 32.5% of GDP in 2004 due to anticipated modest declines in world oil prices and the volume of oil exports, and a further rise in imports related to hydrocarbon development. The deficit will shrink to 18.1% of GDP in 2005, as a rebound in the volume of oil exports will more than offset continued weakening of world oil prices, and oil sector imports will start to decrease. The deficit will continue to be financed by FDI inflows.

No significant shift in macroeconomic policies is expected in 2004–2005. The consolidated budget is likely to remain in surplus in both years. The reduction in the number of VAT exemptions and the unification of the enterprise profit tax at 24%, effective 1 January 2004, will broaden the tax base and mitigate the negative impact on budget revenues of the anticipated decline in oil production and exports in 2004. Likewise, the planned further increase in capital expenditure in 2005 will be offset by a recovery in oil-related revenues. A challenge for monetary policy will be to accommodate growing demand for money while preserving price stability. It will also become increasingly difficult for NBAR to counter upward pressure on the exchange rate stemming from large oil-related foreign exchange inflows.

These projections are, however, very sensitive to changes in the underlying assumption about world oil prices. A 1 dollar rise (decline) in the assumed average annual price of Brent crude oil in 2004 raises (lowers) the projected GDP growth rate by about 1 percentage point and reduces (increases) the forecast current account deficit by more than 1% of GDP, with the opposite impact on the consolidated budget surplus. The projections for 2005 are also dependent on the timely implementation of the key investment projects in the oil sector. For example, a considerable delay in the completion of the BTC oil pipeline, which is scheduled to become fully operational in early 2005, would have a major adverse impact on GDP growth and the budgetary situation in 2005. This simple sensitivity analysis highlights Azerbaijan's vulnerability to a sustained decline in world oil prices and possible delays in the implementation of a few oil sector projects, and underscores the need to diversify the economy to reduce its dependence on the oil sector.

Kazakhstan

The economy continued to grow rapidly in 2003 with greater pace in manufacturing showing the first fruits of economic diversification. An Industrial-Innovation Development Strategy will help deepen economic diversification and maintain growth momentum in the medium term. Policy measures will need to avoid overreliance on capital-intensive sectors and continue their emphasis on employment creation by expanding an enabling environment for private sector development.

Economic Assessment

Early structural reforms and sound macroeconomic management laid the basis for the economic progress that the country has made in recent years. GDP growth, led by the oil sector, averaged 11.0% during 2000–2002, and continued in 2003 at 9.2%. On the demand side, most of the 2003 expansion was driven by a 15% increase in real private consumption, supported by public sector wage raises and an expansion of bank credit.

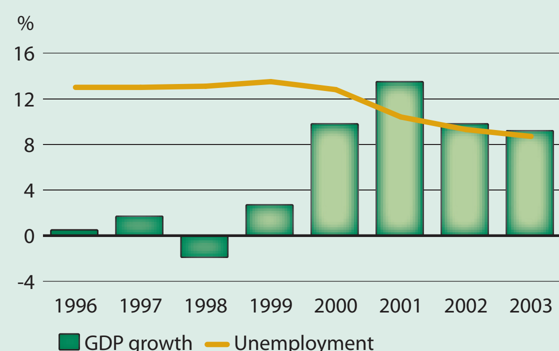
On the production side, industry and, especially, services played major roles. Industry sector output grew by 8.8%—with manufacturing at 8.9% and mining at 8.1%—revealing the first signs of economic diversification, as food processing, machinery building, oil refining, and chemicals all showed marked production increases. Construction climbed by 9.3%, remaining a dynamic sector fueled by vigorous investment in housing and infrastructure development in the new capital, Astana. The services sector continued its very strong growth, of 11.1%, mainly due to a large rise in transport and communications. A slight decline in the grain harvest in 2003, offset by the good performance in the livestock subsector, led to agricultural growth of just 1.4%.

Continued economic growth helped foster employment and improve living standards. In 2003, real incomes rose by 8.3% with average monthly wages totaling T23,250 ($156). For the first time, real wages increased in all sectors, unlike previous years when wages rose significantly only in the manufacturing and financial subsectors. Unemployment declined to 8.7% from 9.3% in 2002, mainly due to greater employment in construction, services, and agriculture (Figure 2.22). Sustained economic growth and targeted poverty interventions helped reduce the number of people living below the subsistence minimum (T5,200 or $35 a month) to 21.0% from 24.2% in 2002. However, unemployment remains sizable in rural areas, where poverty remains three times as high as in urban areas.

The fiscal position remained robust in 2003. Buoyant tax collections led the Government in May to revise upward both revenue and expenditure targets. For the year, the budget deficit amounted to 0.9% of GDP, well below the planned 2.0% target. The revenue-to-GDP ratio edged up to 22.6% from 21.4% in 2002, largely due to strengthened tax administration. General budget expenditures rose to 23.5% of GDP, 2 percentage points higher than in 2002, as the supplemental budget lifted wages and pensions and raised expenditures for social sectors and national security. Social assistance and education remained the major items of recurrent expenditures, together accounting for 45% of such expenditures.

The monetary policy of the National Bank of Kazakhstan (NBK) continued to be accommoda-

Figure 2.22 GDP Growth and Unemployment, Kazakhstan, 1996–2003



Source: National Statistical Agency.

tive in 2003. Broad money supply (M3) rose by 26.8% in response to continued economic growth and financial deepening. Credit to the economy jumped by about 46% as banks became more responsive in meeting the credit needs of small and medium enterprises and households. End-of-period inflation rose to 6.8% (the annual average figure was 6.6%), 1 percentage point higher than the planned target, mainly due to higher prices for gasoline and bread products in the last months of the year. This was caused by a jump in the prices for gasoline in the Russian Federation, which led to an increase in exports of local gasoline to that country (Kazakhstan's main trading partner), thus reducing domestic supply; and by government intervention to raise the price of grain.

During 2003, the tenge strengthened against the dollar by 12.6% in real terms, driven by large export earnings and foreign exchange inflows from increased private external borrowing and FDI. Under the managed float arrangement, NBK continued its policy of intervening in the market to prevent undue appreciation of the currency, though with limited tools for sterilization this led to a 52.2% expansion in reserve money. In contrast to its performance against the dollar, the tenge recorded real devaluations against the Russian ruble by 5.3% and the euro by 6.9%, which helped sustain the competitiveness of domestic producers.

The balance-of-payments position strengthened because of high world oil prices. The current account deficit was reduced from 2.8% of GDP in 2002 to 0.2% ($69 million) in 2003, reflecting a much improved trade balance. Merchandise exports soared by 32.0%, driven mainly by buoyant world oil prices; the increase in oil volume was only 7.9%. Imports surged by 18.4%, led by greater imports of capital goods and construction materials. Gross international reserves (including the assets of the National Fund of the Republic of Kazakhstan, which accumulates part of the Government's oil and mineral revenues for stabilization purposes and savings for future generations) leaped by 69.3% over the year to $8,565 million at end-2003. The National Fund's assets jumped by 89.0% to $3,606 million due to the strong hydrocarbon exports while NBK's net international reserves shot up by $1,820 million or 58.1% to $4,959 million (4.8 months of imports).

While public external debt continued to fall in 2003, by 3.5% to $3.4 billion (equivalent to 12.4% of GDP), private external debt rose by 5.5%, pushing total external debt to $19.9 billion at end-2003, including intracompany debt (mainly among oil companies) that accounts for about 70% of private external debt. However, excluding intracompany debt, the debt-to-GDP ratio is 29.3%, representing a low external debt burden.

Policy Developments

The new Government, formed in June 2003, endorsed the existing policy of maintaining rapid economic growth, increasingly fostered through economic diversification. It adopted an Industrial-Innovation Development Strategy to 2015 that targets 8% average annual growth in manufacturing and a threefold gain in manufacturing productivity by 2015. The strategy also sets up priority sectors, namely oil refining, agriculture, and space and information technology. The Government created five institutions to help implement the strategy, i.e., the Innovation Fund, the Investment Fund, the State Insurance Corporation for Export Credits and Investment, the Engineering and Technology Transfer Center, and the Marketing-Analytical Research Center.

The Government continued to implement an adaptive, sound fiscal stance while advancing structural fiscal reforms. The 2003 budget revision in May reflected policy by raising wages and pensions and providing initial capital to the four

Table 2.20 Major Economic Indicators, Kazakhstan, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	13.5	9.8	9.2	9.5	9.5
Gross domestic investment/GDP	26.9	27.3	26.3	25.1	25.3
Inflation rate (consumer price index)	8.4	5.9	6.6	5.4	5.0
Money supply (M3) growth	45.1	32.8	26.8	23.4	18.4
Fiscal balance/GDP	-0.4	-0.3	-0.9	-1.9	-1.0
Merchandise export growth	-3.9	12.3	32.0	6.0	6.0
Merchandise import growth	11.1	1.6	18.4	12.4	6.8
Current account balance/GDP	-5.0	-2.8	-0.2	-1.1	-0.6
Debt service ratio	37.5	35.2	34.2	33.6	32.3

Sources: Ministry of Economy and Budget Planning; Ministry of Finance; National Bank of Kazakhstan; National Statistical Agency; staff estimates.

newly created institutions. The 2004 budget has expanded government efforts to stimulate growth through tax rate reductions. The VAT rate is to be reduced from 16% to 15%, personal income tax from 30% to 20%, and the social (payroll) tax from 21% to a range of 7–20%. The tax cuts, effective 1 January this year, are estimated to reduce revenues for 2004 by about 1.2% of GDP, though the simultaneous introduction of a new tax on oil exports, which doubles the tax burden for new oil contracts, is expected to be fully offsetting. In terms of institutional change, the Government began preparing its first medium-term fiscal policy plan for the period 2005–2007, and started revising the budget code to promote better planning and transparency in budgeting, greater fiscal independence of local governments, and a clearer delineation of responsibilities between the various levels of government.

NBK announced that it would adopt EU monetary policy standards by 2007 and focus on the single objective of price stability in the medium term. However, in 2003 it continued to pursue a difficult twofold task—moderating inflation and preventing a real appreciation of the tenge against the dollar. The accumulation of a large part of oil revenues in the National Fund and NBK's intervention in the market to make large foreign exchange purchases helped limit appreciation of the tenge against the dollar. NBK recognizes that it will be increasingly difficult to carry out sterilized intervention in view of expected rising oil export earnings, and some real appreciation of the tenge can no longer be avoided. Moreover, NBK's move to an inflation targeting framework would preclude intervention (except to calm a disorderly market). While this change will reinforce the tenge's strengthening, the National Fund remains available to limit undue movements. With the establishment of an independent financial market supervisory and regulatory agency in January 2004, NBK has been freed to concentrate solely on its macroeconomic policy functions.

The banking sector continued to strengthen, with the ratio of total assets to GDP increasing to 37% at end-2003 from 25% a year earlier. Growing public confidence in the banking system was reflected in a 30% rise in household deposits. Public response to the first ever appreciation of the tenge against the dollar made foreign currency deposits less attractive and helped raise the share of local currency deposits in total deposits to 52.6% from 40.0% in 2002. A slight reduction of the refinance rate (from 7.5% to 7.0%) led to a 1 percentage point decline in the commercial interest rate, from 15.2% to 14.2%. Despite declining in recent years, lending rates are now high in real terms as inflation has fallen. This appears to be due to high deposit rates demanded by customers, stemming from their experience of previous bank defaults, untested creditor rights, and weak competition both among banks and from other financial institutions.

The Government made progress in implementing structural reforms in 2003 when a Land Code and a Law on Joint-Stock Companies were enacted. The Land Code provides for private ownership of agricultural land, which lays the foundation for strengthening productivity and competitiveness of the agriculture sector by enhancing incentives and opportunities for both investment and financing. The Law on Joint-Stock Companies tightened the requirements for enterprises' capital base and promoted better corporate governance practices. During 2003, the Government succeeded in selling its share in the two largest mining sector companies and in one of the largest banks, the Halyk Saving Bank.

Outlook for 2004–2005

The medium-term outlook is positive, as likely strong FDI inflows continue to rapidly expand development in the oil sector and as the Government steps up its efforts to diversify the economy. Although the Government remains cautious in its projections for GDP growth at 7–7.5% in the medium term, it will likely be higher due to the phased start of production at Kazakhstan's largest gas and oil projects at Karachaganak and Kashagan in 2004–2005. Also, regional demand is expected to remain strong. Accordingly, *ADO 2004* forecasts that average annual GDP growth will remain at about 9.5% in 2004–2005. While the oil sector will continue to be a driving force, growth in the non-oil sector is also expected to pick up due to the projected increases in capital investment in manufacturing. Services are likely to remain dynamic, with annual average growth of 7–8% over the medium term. Agricultural output is forecast to expand by 3–4% due to ongoing reforms as well as increased budget allocations for rural revival during the next 2 years (total government investment is expected to be 2–3% of GDP).

The fiscal stance is likely to remain cautious with the Government's projections for the general budget deficit at 1.9% of GDP in 2004 and 1.0% in 2005. Budget revenues are expected to be around 23% of GDP over the forecast period, based on conservative budget assumptions for world oil prices. The expenditure-to-GDP ratio is projected to decline from 25.2% in 2004 to 23.1% in 2005 as expenditure growth is to be held to less than nominal GDP growth. Social sectors and rural development will be the major expenditure items in 2004–2005.

In view of large projected foreign exchange inflows, the tenge is likely to continue appreciating and NBK expects a real appreciation of about 4–5% against the dollar over the next 3 years. The Government will seek to foster greater productivity in the non-oil sector to help prevent loss of competitiveness. NBK projects inflation in the range of 3–6% over 2004–2005 and will adopt monetary policies tailored to this objective. The expected substantial increases in public sector wages and pensions will likely keep inflation at the higher end of this range.

Exports of goods and services are forecast to grow moderately (about 6% each year), reflecting cautious assumptions on the world oil price. Imports are projected to rise faster than exports due to the increase in capital goods imports, led by implementation of the large oil and gas investment projects and expected technological modernization of enterprises. The current account balance is projected to remain in deficit, at 1.1% of GDP in 2004 and 0.6% of GDP in 2005.

Enhancing living standards remains a key government objective. Through its programs on medium-term poverty reduction (2003–2005) and rural development, it plans to reduce the number of people living below the subsistence minimum to 18% from the current 21%. To this end, it is expected that the minimum wage will increase by 32% and the pension level by 30% over the period 2004–2005. The unemployment rate is projected to fall but at a moderate pace and expected to be around 8.0% by 2005, as overall growth will continue to be driven by capital-intensive sectors.

Kyrgyz Republic

Aided by a recovery in gold production, the economy rebounded in 2003 and inflation was kept in check. Negotiations with bilateral creditors, on the basis of the 2002 Paris Club understandings, were successfully concluded. The Government has again formulated strong macroeconomic and structural policies for its third year of the IMF's PRGF in 2004 that should maintain growth and poverty reduction while keeping external debt on a sustainable track.

Economic Assessment

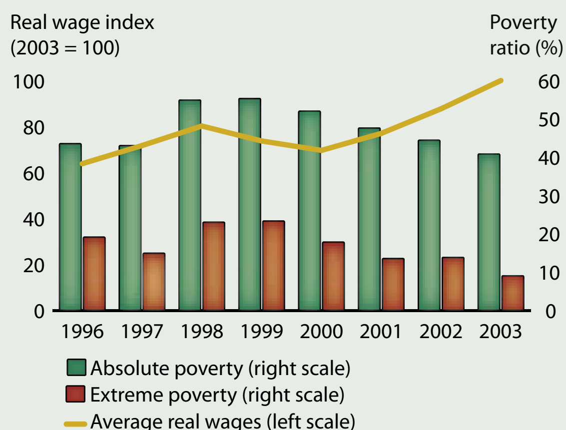
The economy rebounded in 2003, having been virtually stagnant in 2002, as output from the Kumtor gold mine recovered to the levels prevailing before the July 2002 accident. GDP climbed by 6.7%, but excluding the gold sector (accounting for about one tenth of GDP and two fifths of industrial output), a 4.9% expansion was seen, indicating broad-based strengthening. Industrial output, excluding gold, was up by 8.5% with strong gains in electricity generation, food processing, chemicals, and nonmetallic products. Agriculture grew by 3.8% despite unfavorable weather affecting the summer crops, mainly grain and cotton. Falling public investment was reflected in a 6.8% decline in construction output. Increased tourism and sales to foreign military bases helped the services sector grow by 5.8%.

Gross domestic investment and savings are low, and amounted to 17.6% and 13.8% of GDP, respectively, in 2002. These levels are inadequate to foster economic diversification and rapid growth. Since the Government will continue to cut public investment as part of its debt reduction strategy, maintaining even the existing level of aggregate investment will depend on securing higher levels of private investment—both domestic and foreign. Preliminary data for 2003 indicate a fall in public investment from 4.8% to 3.6% of GDP; however, larger FDI and high growth in bank credit to the commercial sector indicate a possible rise in private investment.

Preliminary labor market data indicate a fall in unemployment in 2003, and a gain in real wages of 14%. The previous year, absolute poverty—based on the cost of a basket of basic goods containing two thirds food—fell to 44.4% from 47.6% in 2001 (Figure 2.23). Rural areas showed a slightly steeper decline. Initial estimates indicate a fall in absolute poverty to 40.8% in 2003. Regional differences in poverty, too, have generally narrowed, except with regard to the poorest *oblast*, Naryn, which is in an inaccessible mountainous region. Sustained farm sector-led expansion since 1996 has fostered poverty reduction that resulted from mutually reinforcing reforms in the agriculture sector and a high level of public investment. These conditions will be difficult to replicate in the future and broadening the sources of growth is essential to reduce poverty in the medium term.

The 2003 fiscal deficit was reduced to 5.0% of GDP from 5.4% in 2002, as against a target of 4.7%. Total domestic revenues rose by 0.8 percentage point to 18.7% of GDP as a result of new tax measures, though a delayed foreign grant kept the overall revenue-to-GDP ratio below the projected level. The fiscal gap widened prior to the fourth quarter, mainly due to unanticipated spending on disaster relief and emergency rehabilitation in the south following large-scale floods

Figure 2.23 Real Wages and Poverty, Kyrgyz Republic, 1996–2003



Sources: National Statistical Committee, *Social Development of the Kyrgyz Republic of 1998–2002*; staff estimates.

and mud slides. Partly to offset this, various spending items were cut or postponed in the fourth quarter to minimize slippage from the deficit target. The Government negotiated agreements with all bilateral creditors (except Kuwait where discussions are ongoing) following the Paris Club understandings reached in March 2002. External public debt is estimated to amount to about $2.0 billion, or about 103% of GDP at end-2003, down from about 124% at end-2000.

At a similar rate to 2002, broad money supply (M2) grew by 33.5% in 2003, mainly reflecting a large increase in foreign exchange reserves. Rising demand for the som due to remonetization of the economy accommodated the growth, without causing inflation. Commercial bank credit to the private sector surged by over 40%. Interest rates eased somewhat during the year, yet remain high. Consumer price inflation was 3.0% (below the 4.0% target), though a poor regional grain harvest and delayed petroleum shipments in the last quarter pushed up the CPI to 5.5% on an end-year basis.

The trade gap widened in 2003 to $82.7 million from $54.0 million the previous year. Exports posted an 18.5% gain mainly due to a recovery in gold exports, but non-gold exports fell as electricity and agricultural exports shrank. Imports grew by 21.9% reflecting (i) the economic rebound, (ii) the fact that a stronger som made consumer goods imports cheaper (the average exchange rate against the US dollar appreciated by 7.3% in 2003), and (iii) the rise in recorded imports (attributable to excise tax reforms that reduced the smuggling of oil products). Preliminary data for the year indicate a fall in the current account deficit to $30.7 million, equivalent to 1.6% of GDP.

Policy Developments

A large external public debt; declining levels of public investment; a difficult policy, regulatory, and legal environment for the private sector; a weak financial sector; and transit difficulties in accessing export markets are the key constraints to sustainable development. In 2003, the Government implemented structural reforms to strengthen public resource management, the financial sector, the energy sector, and governance in order to promote private sector-led economic development. Reflecting these endeavors, the Government successfully completed the second year of IMF's ongoing 3-year PRGF.

In 2003, VAT was introduced on large farms (those with turnover exceeding Som500,000). Property tax legislation was approved by Parliament and is likely to be introduced in 2004 once valuation and exemption limits are decided. Annual yields from these two taxes are expected to reach 0.4% of GDP in 2004. Excise duties on oil products were cut by 40–50% resulting in a sharp fall in smuggling and a rise in revenues. A new draft customs code based on international standards was submitted to Parliament and measures were adopted to streamline tax administration, including the setting up of a large taxpayers unit. A new consolidated tax code is in preparation to simplify and rationalize taxation.

The enactment by Parliament in 2003 of the Law on Banks and Banking Activity strengthened the regulatory powers of the central bank to ensure good management and corporate governance in banks, improve financial disclosure, and control insider dealing. Other important financial sector laws pending in Parliament include a draft law on pledges to protect creditor rights and a draft law on bankruptcy of commercial banks to facilitate speedy closure, restructuring, or reorganization of problem banks. Passage of these laws will substantially improve the legal framework for

Table 2.21 Major Economic Indicators, Kyrgyz Republic, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	5.3	0.0	6.7	4.1	4.5
Gross domestic investment/GDP	18.0	17.6	18.0	-	-
Inflation rate (consumer price index)	6.9	2.0	3.0	3.8	3.8
Money supply (M2) growth	11.3	34.1	33.5	20.0	-
Fiscal balance/GDP	-5.0	-5.4	-5.0	-4.4	-3.5
Merchandise export growth	-6.0	3.7	18.5	2.3	6.3
Merchandise import growth	-13.1	25.4	21.9	5.4	6.1
Current account balance/GDP	-1.3	-2.2	-1.6	-4.2	-5.3
Debt service ratio	30.8	20.7	-	-	-

- = not available.
Sources: Ministry of Finance; National Bank of the Kyrgyz Republic; National Statistical Committee; staff estimates.

the financial sector. The largest public sector bank, Kairat, is to be privatized in 2004.

Progress was made on various structural reforms. The Government launched a broad program of judicial reforms by (i) completing a comprehensive review of adjudication processes to develop a reform road map; (ii) accomplishing legal and administrative steps to allow third-party arbitration for swift out-of-court resolution of commercial disputes; and (iii) amending laws to bring finality to the judgments of higher courts. The National Council for Good Governance was established to supervise the implementation of anticorruption and governance reforms. Concerned by the lack of progress to bring down the high quasi-fiscal deficit (over 12% of GDP) in the electricity sector, the Government established an energy sector crisis group under a special representative of the President. It is expected that a combination of better management, higher tariffs, improved collection, reduced arrears, and action to limit theft of electricity will reduce the quasi-fiscal deficit by 2.0% of GDP in 2004.

Outlook for 2004–2005

GDP growth is expected to slow to 4.1% in 2004 and pick up somewhat to 4.5% in 2005. Reflecting recently adopted revenue measures, the fiscal deficit is targeted to narrow to 4.4% of GDP and to 3.5% over these 2 years. Continued monetization is expected to allow a 20.0% expansion in broad money in 2004 and to be consistent with keeping inflation at less than 4.0%. The external current account deficit is forecast to widen to 4.2% of GDP, as gold exports fall because of depleting ore reserves at the Kumtor mine, so limiting overall export growth to 2.3%. Import expansion at 5.4% is estimated to be in line with the GDP growth rate (given the one-time factor of larger oil product imports moving into official channels in 2003). The current GDP projection is lower than the 5.0% target set for 2003–2005 under the National Poverty Reduction Strategy because (i) gold production is expected to decline as ore is worked out and (ii) the current investment climate does not provide the confidence to assume that private investment will be sufficiently offsetting to sustain the higher growth rate. Two small gold mines, planned for development with foreign investment, are not expected to be working before 2006.

Achieving GDP growth of 5% or more, which is necessary for poverty reduction, will require (i) further external debt restructuring; (ii) improvement in public resource management; (iii) expeditious implementation of structural reforms; (iv) easing of trade barriers by neighboring countries and enhanced regional cooperation to diversify exports; and (v) a favorable external environment. The Government's medium-term challenge is therefore to achieve sustainable growth while pursuing further fiscal consolidation but without burdening vulnerable groups.

Tajikistan

Economic growth continued its brisk pace and welcome signs of diversification were seen, but a reduction in inflation was not realized. Progress was made in implementing the poverty reduction strategy program despite the legacy of weak institutional capacity and severe financial strain. The outlook is for further progress, but structural constraints present important challenges.

Economic Assessment

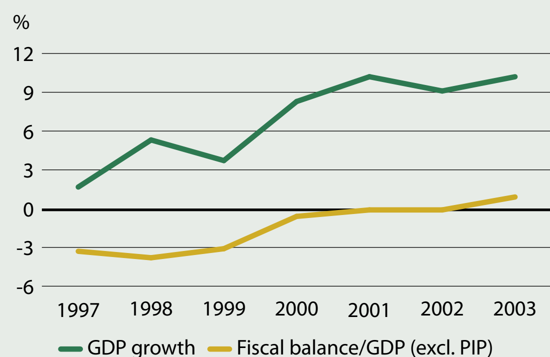
The year 2003 was another year of strong economic expansion, the sixth consecutive year following the agreement that ended the civil war. GDP growth accelerated to 10.2% from 9.1% in 2002. While cotton and aluminum, the two traditional pillars of the economy, remained important driving forces, economic growth become more broad based with about two thirds of it coming from outside cotton and aluminum activities. The industry sector expanded by 10.2%, including production of consumer goods that rose by about 12%. The services sector grew by 14.7%, with retail trade surging by about 24% and transportation by roughly 20%. The agriculture sector posted a strong gain of 9.6% as output was boosted by a good cotton harvest but dampened by a poor grain harvest. The main elements in growth were increased private consumption buoyed by an approximate tripling in worker remittances (to about 13% of GDP) and a leap in global cotton prices that also helped finance a surge in imports.

About 80% of the population were estimated to be living below the poverty line in 1999 and, while the economic recovery has likely helped lower this rate, Tajikistan remains one of the poorest countries in the world. The average monthly wage in mid-2003 was TJS44.3 or about $15. The lack of employment opportunities remains the prime social concern and a substantial number of the working population have become migrant laborers seeking employment opportunities abroad, mainly in the Russian Federation. A recent study by the International Organization for Migration for Tajikistan estimated that about 1 million people, or 15% of the population, are living in households in which the main source of income is derived from a family member working abroad.

The fiscal performance for 2003 was impressive. The overall budget balance (excluding the foreign-financed Public Investment Program, or PIP) moved to a surplus of 0.9% of GDP from a 0.1% deficit in 2002 (Figure 2.24). This reflected the combined effects of higher tax revenues associated with the stronger than anticipated growth and strengthened fiscal discipline on expenditures. Consistent with the budgetary objectives, essential social spending—including education, health, social security and welfare, and other social services—increased by about 35%.

Average inflation in 2003 was unexpectedly high at 16.4% (up from 12.2% in 2002), exceeding the 9.0% target set by the National Bank of Tajikistan (NBT). The year-on-year increase to December, however, was held to 13.8% due to better price performance in the last 2 months of the year. While price pressures from higher tariffs for electricity and gas introduced under the energy sector reforms had been expected, the uptick in inflation stemmed from two unanticipated factors: the sharp increase in prices of

Figure 2.24 GDP Growth and Fiscal Balance, Tajikistan, 1997–2003



Source: International Monetary Fund, *Country Report,* Nos. 03/10 (January 2003) and 04/17 (January 2004).

imported grains and wheat flour caused by severe droughts in neighboring countries producing these commodities, and an unintended loosening of monetary policy that resulted in a steep 44.4% increase in the money supply (M2). The nominal exchange rate against the dollar was kept at about TJS3.09/$1 for most of the year.

Merchandise exports increased by 14.2%, mainly due to higher exports of cotton boosted by sharply rising global prices. The trade deficit widened, due to higher imports (up by 23.2%) associated with strong economic growth and imports of capital goods under the external financed projects. Notably, the current account deficit narrowed in 2003 to about $21 million or 1.3% of GDP from 2.7% the previous year; this was on account of an upsurge in remittances from migrant workers, from about $65 million to about $202 million. International reserves strengthened from $96.2 million at end-2002 to $135.4 million, providing largely unchanged import cover of about 1.8 months. Preliminary data indicate that total external debt outstanding rose by about $25 million to about $1 billion at end-2003; it declined to about 65% of GDP from 82% a year earlier, mainly because of a large increase in nominal GDP in the context of exchange rate stability.

Policy Developments

In line with the macroeconomic framework supported by IMF's PRGF, the Government has adopted a prudent fiscal policy that aims at a balanced budget (excluding the PIP) over the medium term. Several reform measures have been undertaken to enhance tax collection, including broadening the application of the destination principle for VAT, revising the tax and customs codes, and strengthening tax administration, including the establishment of a modernization office to oversee the reform effort.

The low level of civil service wages, equal to about half those earned in the nonagriculture private sector, has been a concern of the Government, both in terms of maintaining qualified staff to ensure proper provision of public services and of curbing corruption in the public sector. The strong revenue collection enabled the Government to raise civil service wages by 20% in 2003, although this was substantially eroded in real terms because of exogenous shocks that pushed up inflation. The Government has implemented a further 25% increase effective 1 January 2004. It recognizes that wage increases need to be carried out in line with the civil service reforms that are streamlining the bureaucracy, and made a cut in staff of about 5% in 2003. Further staff reductions are planned for 2004.

In response to the recommendations during the World Bank-led Consultative Group Meeting in May 2003, the Government has increased substantially the allocation for the social sector in its budget for 2004. To keep external debt at a manageable level, it further agreed that the annual disbursement for the PIP, which is financed by external borrowing, will not exceed 3.0% of GDP. Moreover, no debt will be contracted on commercial terms. The restructuring agreement with the Russian Federation reached at the end of 2002 on debts of about $300 million allows a 3-year grace period of principal repayment up to 2005, an extension of maturity from 15 to 17 years, a reduction in interest payment for 2002–2005, and a reduction in principal repayment falling due in 2005–2006. External borrowing to finance the PIP and larger debt payments to the Russian Federation after 2005 make the sustainability of the debt a matter of continuing concern though.

Through structural reforms, measures have been undertaken to address the quasi-budget deficit and the buildup of arrears in receipts at the government-owned public utility industries. In this

Table 2.22 Major Economic Indicators, Tajikistan, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	10.2	9.1	10.2	8.0	5.0
Inflation rate (consumer price index)	38.6	12.2	16.4	8.5	5.0
Money supply (M2) growth	33.4	37.4	44.4	20.0	-
Fiscal balance[a]/GDP	-0.1	-0.1	0.9	-0.5	0.0
Merchandise export growth	-17.3	7.3	14.2	10.8	6.4
Merchandise import growth	-7.3	6.5	23.2	11.0	6.6
Current account balance/GDP	-6.7	-2.7	-1.3	-2.2	-4.7
Debt[b] service ratio	25.6	22.9	18.1	12.6	14.9

- = not available. [a] Excludes foreign-financed Public Investment Program. [b] Nonfinancial public sector debt.
Sources: Ministry of Economy and Trade; International Monetary Fund; staff estimates.

effort, two major gas tariff increases were introduced in 2003 to bring revenues to approximately the cost recovery level as of July 2003. While continued efforts are needed to further improve collection rates, the reforms managed to bring down the quasi-fiscal deficit of the gas sector to 1.2% of GDP in mid-2003 from 3.0% at end-2002.

Progress in other areas of structural reform, however, has been uneven. Arrears in receipts in the electric power sector remain large, amounting to about 20% of GDP as estimated by the World Bank. To cushion the impact of the energy price increases on vulnerable groups, the Government set up a compensation mechanism in 2003 and has further raised the allocation for the compensation fund in its budget for 2004. This approach is expected to facilitate reforms to eliminate the remaining subsidies in the tariff structure.

In 2003, the focus of monetary policy was directed at maintaining a stable exchange rate against the dollar at the time of strong foreign exchange inflows resulting from good export performance, higher worker remittances, and inflows stimulated by an amnesty for funds held abroad. Large foreign exchange purchases meant a much faster increase in reserve money than had been planned since tools for sterilization are limited and this led to intensified inflationary pressures. Accordingly, the focus of monetary policy has been reoriented to reducing inflation and improving liquidity management.

With respect to banking sector reforms, the internal restructuring of NBT has been completed and the Government has also strengthened the function of the Monetary Policy Committee to guide monetary policy formulation and implementation. The Law on Amnesty of Cash Holdings was implemented from 1 April through 10 June 2003. The amnesty was intended to channel individuals' cash holdings and deposits abroad into the formal economy through investment, property acquisition, or bank deposits. During this period, any cash holdings and deposits from abroad could be deposited in one of the eight commercial banks without source documentation. It is estimated that $190 million (about 12% of GDP) entered the banking system, of which about $40 million remained as demand deposits.

With the support of international development agencies, reforms in the banking sector have made progress. The restructuring of Agroinvestbank, the largest commercial bank, to put it on a sound financial footing was delayed in 2003 and was completed in March 2004. The minimum capital requirement for banks will be raised from the current $1.5 million to about $2.0 million by end-2004. Moreover, NBT is expected to enhance the quality of its supervision of commercial banks to further strengthen the banking sector.

To achieve the long-term development and poverty reduction goals, the Government aims to achieve economic growth at an average annual rate of 6.0% over the medium term. This requires continued policy reforms and economic restructuring to foster sustained growth through private sector development and economic diversifica-

tion. It also calls for greater efforts to integrate the economy with the world market through enhanced international cooperation, particularly with countries within the subregion where progress has been slow. The strategy of the Government to address these challenges is summarized in its Poverty Reduction Strategy Paper and many measures have been initiated in line with the paper. While it recognizes the need to restore and maintain economic stability through strengthened macroeconomic management, the Government is constrained by substantial institutional weakness and very limited financial resources, and has to prioritize and coordinate its development initiatives and restructuring undertakings. In this regard, progress in economic reform is likely to remain patchy.

Outlook for 2004–2005

Persistent growth over the past 6 years reflects the steady recovery of the economy from the civil war. Assuming continued improvement in the general security situation in the country as well as in the Central Asian republics generally, this growth is expected to continue, but most likely at a more moderate rate of about 8% in 2004 and about 5% in 2005 as the recovery phase is completed. The momentum of rapid expansion in the services sector, and in the non-cotton agriculture and non-aluminum manufacturing sectors is anticipated to continue, thus further strengthening the driving forces for growth in the economy. While production of cotton and aluminum is expected to stabilize gradually as it reaches capacity limits, anticipated volumes and prices for these commodities (which represent about 75% of total exports) over 2004–2005 are likely to support continued export growth of 10.8% in 2004 and 6.4% in 2005.

Import growth is projected to slow to 11.0% in 2004 and to 6.6% in 2005 given the pattern of economic growth envisaged. The current account deficit is forecast to widen to 2.2% of GDP in 2004 and then further in 2005, though concessional assistance from development partners as well as IMF financing are expected to be sufficient to cover the deficit and to provide for some increase in international reserves.

With its commitment to a balanced budget, the Government is expected to continue its prudent fiscal policy in accordance with the macroeconomic framework supported by the PRGF. Following the 2003 surplus, the budget for 2004 is targeted to have a small deficit of 0.5% of GDP and then return to balance in 2005. Social sector expenditures in 2004 are planned to rise markedly, one half of which will be devoted to nonwage health and education spending. Revenue performance in 2004–2005 is forecast to steadily improve as a result of the ongoing tax reforms.

High inflation will remain the major concern of macroeconomic stability. The economic program calls for a 20% increase in the money supply (M2) in 2004. The shift of the monetary policy focus from the exchange rate to liquidity management may lead to some nominal appreciation in the TJS/$ exchange rate. Further tariff adjustments in 2004 are planned for the power sector as part of the restructuring program and this, coupled with the country's vulnerability to price fluctuations on grain imports, indicate that NBT will have to strictly implement its monetary program to achieve the targeted inflation rate of 8.5% this year.

Over the medium to long term, economic progress will need to be increasingly supported by real headway in efforts aimed at resolving certain core structural problems. The large debt (about $216 million or 18% of GDP) accumulated by the cotton farms and the quasi-fiscal deficit of the power sector require resolution. The increase in external debt service in the years after 2005 could become a major constraint on continued growth. The economy needs to diversify, so as to foster and develop new sources of economic expansion. Moreover, sustaining such growth in a small, landlocked economy will be contingent, to a large extent, on the progress made in promoting mutually beneficial economic cooperation with its neighbors.

Output growth was strong in 2003 and is expected to remain buoyant in 2004–2005, largely due to continued expansion of energy production and exports. However, it will have only a limited impact on living standards and is likely to be short lived unless the Government rationalizes public spending, reverses the negative trends in human capital formation, and implements structural reforms.

Economic Assessment

According to preliminary official statistics, the economy maintained strong momentum in 2003, with GDP growing by 18.1%, slightly down from the rate of 19.8% in 2002. Industrial output grew by 16.2%, with rapid expansion reported in almost all industrial subsectors. Agricultural output rose by 9.9% on account of a record grain harvest and a partial recovery in cotton production from the previous year's extremely poor harvest. The services sector expanded by an impressive 24.9%, led by domestic trade and hotels, restaurants, and catering.

However, official output statistics should be treated with caution, as they tend to overestimate true growth for at least two reasons. First, they continue to be based on reports by enterprises. While private companies generally underreport output growth to evade taxes, SOEs—which account for the bulk of the economy's total output—have a strong incentive to exaggerate output figures because the performance of their managers is evaluated primarily on their meeting government-set production targets. Second, some industries that appear to be expanding at distorted domestic prices may in fact be producing negative value added at international prices. Alternative staff estimates adopted by *ADO 2004* suggest that the actual growth rate of the economy in 2003 was around 10% (Figure 2.25).

Growth was driven largely by domestic investment, which reached TMM16.0 trillion (27.0% of GDP) in 2003. Most of this consisted of state-led investments in so-called priority sectors, such as oil and gas extraction, petrochemicals, electricity generation and transmission, textiles, and luxury housing. About $173 million (1.5% of GDP) was invested by foreign companies developing Turkmen oil fields under five production-sharing agreements.

Since Turkmenistan officially guarantees employment to every citizen, there is no official unemployment in the country, and people registered as job seekers at labor exchanges are not formally considered unemployed. The number of such people remained unchanged at about 57,000 (2.6% of the labor force) in 2003. True unemployment is believed to be much higher, due to substantial hidden unemployment and underreporting.

The official average wage rose by 84.2% to TMM1.75 million in 2003, in part reflecting a 100% upward adjustment in public sector salaries in February 2003. While the official exchange rate of the national currency, pegged at TMM5,200/$1, remained unchanged, the illegal parallel market rate appreciated by 7.4% to about TMM20,000/$1. This helped reduce open inflation—as measured by the official CPI—to 5.5% in 2003 from 8.8% in 2002.

The state budget moved to a small deficit of 1.0% of GDP in 2003, after a surplus of 0.2% in 2002. However, the overall fiscal position of the Government is difficult to assess because much of

Figure 2.25 GDP Growth and Consumer Price Inflation, Turkmenistan, 1998–2003

Source: National Institute of State Statistics and Information of Turkmenistan; staff estimates.

its revenue and expenditure is channeled through extrabudgetary funds and off-budget accounts of budgetary organizations. Since most export earnings accrue to extrabudgetary funds, it can be inferred that the total revenues of these funds were most likely greater than the revenues of the state budget in 2003.

The merchandise trade surplus nearly doubled to $1.27 billion in 2003 from $736 million in 2002. Exports surged by 30.3% to $3.72 billion, largely on account of high world prices for energy products and cotton fiber. This was partly offset by a 15.6% rise in imports, which reached $2.45 billion. Reflecting the Government's policy to increase exports with high value added, the share of petrochemicals in total exports rose to 18.3% in 2003 from 14.2% in 2002, while the share of natural gas and crude oil fell to 58.6% from 69.4%. At the same time, the commodity composition of imports did not change significantly, with machinery and equipment accounting for about half of total imports. Ukraine, which imports some 36 billion cubic meters of Turkmen natural gas annually, remained by far the country's largest trading partner, accounting for 27.0% of its total foreign trade turnover in 2003.

Policy Developments

Turkmenistan maintains a policy management system akin to central planning. In managing the economy, the Government relies on such attributes of central planning as production targets, mandatory state procurement, directed bank credits, foreign exchange restrictions, and intergovernment trade arrangements. Key sectors, including oil and gas, remain in state hands. As the enterprise sector continues to operate under "soft budget" constraints, price controls and restrictions on withdrawing cash from banks are used to contain open inflation in the consumer goods market. A central element of the social protection system is the provision of basic consumer goods and utilities free of charge or at heavily subsidized prices to the entire population.

In line with this approach, in August 2003 the Government adopted the Strategy for Turkmenistan's Economic, Political, and Cultural Development for the Period up to 2020; the strategy sets ambitious production targets for all sectors of the economy, to be supported by state-led investments. Specifically, using 2000 as the base year, the strategy envisages gross output increases of 28-fold for the total, 26-fold for industry, and 18-fold for agriculture, by 2020. The strategy also calls for a 12-fold rise in public sector salaries between 2003 and 2020 and maintenance of price and exchange rate stability.

In November 2003, Parliament approved a balanced state budget for 2004, with both revenues and expenditures at TMM64.3 trillion ($12.4 billion at the official exchange rate). A total of TMM1.4 trillion was allocated to supplying gas, electricity, water, and salt free of charge to the population. At the same time, allocation to health care was apparently cut (details of the 2004 budget are lacking) so that, shortly after the budget was approved, the Government announced its decision to reduce the number of public medical workers by some 13,000 and introduce charges for a range of previously free medical services. The decision is symptomatic of the worsening state of the health care system, which—combined with a deteriorating quality of education and a continuing brain drain—is undermining the human capital base and prospects for sustainable development.

Expanding the production and exports of energy products remains the Government's top priority. In April 2003, Turkmenistan and the Russian Federation concluded a long-term intergovernment agreement on cooperation in

the gas sector, according to which the country's natural gas exports to the Russian Federation are to increase from 5–6 billion cubic meters in 2004 to 70–80 billion cubic meters for the years 2009–2028. A similar agreement with Ukraine is expected to be signed in the near future. Further, Turkmenistan started exporting electricity to Turkey via Iran in late 2003 and intends to substantially raise electricity exports to that country as well as to Afghanistan and Iran over the medium term. Turkmenistan is also looking for new export markets for its energy products. Under consideration are oil pipelines via Iran to Armenia and the Gulf as well as a gas pipeline that would carry up to 30 billion cubic meters of natural gas per year from Turkmenistan via Afghanistan to South Asian markets. The Government has recently appointed internationally reputed companies to certify the availability of gas reserves to meet these ambitious production and export targets.

Outlook for 2004–2005

GDP growth is expected to remain buoyant, at around 10% per year in 2004–2005, driven largely by continuing expansion of production and export of energy products. In 2004, the Government is planning to boost the production of natural gas by 24% to 73 billion cubic meters, of which 58 billion cubic meters are to be exported. The production of crude oil is planned to increase by 50% to 15 million tons. More than half of this is to be processed in Turkmenistan, leading to a considerable rise in the production of petrochemical products. Cotton output is targeted to reach 2.2 million tons in 2004, up from 0.7 million tons in 2003. While these Government targets appear too ambitious, the production and exports of natural gas, crude oil, and petrochemical products are indeed likely to strengthen significantly in 2004–2005, as are the production and export of electricity. By contrast, agricultural production is likely to stagnate unless the Government initiates much-needed sector reforms, including the dismantling of the existing mandatory state procurement system.

Open consumer price inflation is expected to be kept to about 5% by a combination of tight monetary policy, subsidies, price controls, and cash restrictions. The official exchange rate is likely to remain fixed at TMM5,200/$1, while the parallel market rate is projected to stay broadly stable at around TMM20,000/$1.

The merchandise trade surplus is forecast to widen further to $1.5 billion in 2004. Exports will rise, to $4.2 billion, mainly due to an increase in the volume of energy exports. Imports are also projected to strengthen, to $2.7 billion, in part because most of the country's natural gas is exported under intergovernment arrangements, whereby half of the payment for gas deliveries is made in kind via a reciprocal supply of goods. The trade surplus in 2005 is expected to remain unchanged, with a continued increase in the volume of energy exports counterbalancing some weakening of world energy prices.

However, the anticipated rapid output growth, macroeconomic stability, and trade surpluses will have only a limited positive impact on the living standards of the majority of the population. The reason is that few new jobs will be created, while much of the additional national income will be invested in state-led projects of questionable economic and social value. Furthermore, the economy would remain vulnerable to possible swings in world energy prices, bottlenecks in export routes, and possible delays in payments for deliveries of natural gas by its major trading partners. A sharp fall in world oil prices or constraints on increased exports of natural gas due to the limited throughput capacity of existing pipelines would have a major adverse impact on exports, output growth, and the Government's fiscal position. Finally, growth based on exploitation of natural resources is likely to be short lived, as seen in the experience of many other resource-rich countries. Therefore, the Government needs to rationalize public expenditures, halt and then reverse the negative developments in the country's human capital base, and embark on structural reforms to diversify the economy, promote the private sector, and achieve sustainable and equitable growth.

Uzbekistan

Even though currency convertibility was announced and fiscal and monetary targets were met, the economy continued to perform below potential in 2003—growth was sluggish and investment modest. The key for immediate improvement lies in expansion in agriculture and the small enterprise sector, while implementation of already announced policies and a concerted withdrawal of government participation in the economy could lift the country toward its long-term potential.

Economic Assessment

In 2003, officially reported GDP growth remained at its 2002 rate of about 4%, as slower growth in private consumption expenditures mirrored noticeable weakness in retail trade and a slowdown in industry. IMF's growth projections were lower. Government-directed investment in hydrocarbons and construction continued, but overall government investment spending fell sharply as part of austerity measures aimed at reducing inflation and stabilizing the exchange rate. Exports gained ground but private domestic and foreign direct investment stayed modest.

In the agriculture sector, growth in 2003 was again about 6%, with a good grain harvest offset by lower cotton production, and though productivity of large farms has risen since privatization, small household plots were the major contributors to the expansion. A 20% depreciation of the exchange rate bolstered export competitiveness, and some machinery enterprises boosted production and exports. Most industries, especially those favored by the Government in its import-substituting industrialization drive, continued to underperform. The Government reported that industrial growth was 6.2% in 2003. Services sector growth was only 2.5% as retail trade in particular continued its struggle to adjust to government regulations intended to suppress demand for foreign exchange.

As sluggish economic growth negatively affected social welfare, the Government made efforts to provide social support. State procurement prices remained below world market levels and, combined with state production targets hindering optimal crop choices, kept incomes below potential, though agricultural families supplemented incomes through production on household plots. The slow entry of private operators into the cotton-ginning sector maintained high processing margins and contributed to keeping farm incomes relatively depressed. Enterprise restructuring, farm privatization, and the muted economic growth hit employment even as the Government declared jobs a top priority. Incomes of small businesses and retailers fell, as they were unable to adjust to trade restrictions and regulations. The Government increased salaries of employees at budgetary institutions, pensions, social allowances, and scholarships, but payments were delayed and arrears accumulated.

The Government managed to restrict the state budget deficit in the first 9 months of 2003 to 0.1% of GDP, largely through its austere fiscal stance and partly by delaying spending and payments. More detailed budget figures released for the first half of 2003 indicate a marked decline in budgetary investment and reduced spending on social services compared with budget targets. Collection of indirect taxes improved but direct tax collection deteriorated because of rate

reductions in profit and individual income taxes intended to spur economic activity.

The tight credit policy of the Central Bank of Uzbekistan (CBU) over 2003 as well as the fiscal squeeze lowered inflation from about 27% in 2002 to about 10% in 2003. The Government reported inflation nearly eliminated for the year, but *ADO 2004* has made some adjustment as the official index excludes many items bought in private markets where shortages put upward pressure on prices. Broad money (M2), which was sharply reduced in 2002, appears to have been relatively stable over the year but cash restrictions and difficulties experienced by commercial banks in accessing their reserve accounts at CBU restricted money availability, even though the traditional cash budget mechanism was formally abolished in February. As a result, the premium on cash over noncash payments for transactions more than doubled to 30–40% from the rate at end-2002 as businesses tried to keep their sales receipts out of the officially controlled banking channels. Interenterprise arrears probably rose. With inflation apparently waning, CBU cut its monthly refinancing rate twice, from 2.5% to 2.0% in August 2003 and to 1.7% (22.4% annualized) in September.

The balance-of-payments situation improved in 2003 although available data, as with other macroeconomic statistics, are sparse and lack detail. Imports and exports both increased according to official sources. Capital goods imports for the hydrocarbons sector were largely responsible for import growth, since private sector and consumer goods imports were compressed by restrictions. Higher international prices for cotton and gold, the main exports, aided by somewhat stronger energy and machinery exports, underpinned higher earnings for the year. These gains, plus a step-up in antiterrorism assistance transfers from the US, appear to be the main elements in the current account surplus reported at 6% of GDP. External debt repayments continued to exceed loan disbursements in 2003, and outstanding debt was about $3.8 billion, or 38% of GDP. FDI, at about $40 million, is now the lowest on a per capita basis among the Central Asian republics. Gross international reserves in excess of $1.5 billion at year-end provided about 6 months of import cover.

Policy Developments

In 2003, policy measures, including tight monetary and fiscal policies, were directed mainly toward formally establishing current account convertibility. This has been a long-standing goal of the authorities as part of their efforts to attract greater FDI. The Government made its announcement in October 2003, followed by an IMF statement, that Uzbekistan had accepted its Article VIII obligations for current account convertibility. Uzbekistan has maintained a managed floating exchange rate. However, in addition to the official main reference rate, prior to October 2003 and exchange rate unification, the exchange rate system had included an official depreciated secondary market rate for certain transactions as well as various restrictions on making current payments and transfers. Black-market transactions had been made at spreads generally well above both official rates.

The Government's financial policies, combined with intensified trade restrictions and procedural barriers to accessing cash and foreign currency, exerted downward pressure on the demand for foreign exchange. These actions, begun the previous year, induced a convergence of the two official rates and the black-market rate to around Som975/$1 by September 2003. This was maintained for the rest of the year.

Attaining Article VIII status was an important milestone, but the Government nevertheless faces major challenges in making current account convertibility work in practice to achieve the economic efficiencies underlying the concept. Significant imbalances have been built up in the economy, including fiscal arrears, while trade restrictions have been raised to the point where they are stunting economic activity. Unwinding these imbalances will be difficult and requires careful management, but will likely entail the release of pent-up price pressures involving some adjustment in the exchange rate as the economy moves to greater market orientation, which is an aim of government policy.

The Government has stated that its medium-term objective is to liberalize trade, attract foreign investment, and realize the benefits of currency convertibility. It views the intensified trade and procedural restrictions as temporary actions.

Moreover, it has stated its intention to concentrate future public spending on social welfare and to reduce its participation in the economy. The Government has also said that it will maintain a tight monetary policy to facilitate a smooth transition to its convertibility obligations and has indicated that the cash restrictions were an administrative problem. Since 2002, the Government has maintained a conservative external borrowing stance and has set stringent requirements for government guarantees of external borrowing by enterprises.

Progress was made in some areas of structural reform. For example, farm privatization targets were met. The Government has stressed the centrality of agriculture to its development vision and announced wide-ranging agricultural reforms. State procurement prices for grain and cotton were raised closer to world market prices, and regulations according greater control to farmers over their production of cotton and grain were passed.

Marketing reform in the grain sector saw some success with increased private participation in grain trade and processing, though the transition in the cotton sector has been slower. While the Government declared an end to its monopoly on cotton exports, adequate private marketing channels have yet to emerge and procedural bottlenecks remain. Moreover, some local authorities continue to control farmers' production decisions in contravention of government resolutions.

The Government has begun the process of formulating a new strategy for improving living standards. The strategy foresees more broad-based links between poverty reduction goals, economic growth, and sector-specific interventions. This is the first time that steps toward a comprehensive strategy aimed at poverty reduction have been made, and more important, if the strategy is completed as planned, the first time that poverty reduction will be looked upon as an allocative rather than purely redistributive function, i.e., to be addressed within larger growth initiatives and not merely through social assistance.

If resource allocations in agriculture and industry follow market signals and trade is freed from restrictions, the economy has the potential to attain long-term growth rates of 7–8%. Agriculture could be the primary driver of any initial expansion, with small industry development playing a complementary role as direct controls over economic decision making are replaced by indirect macroeconomic management. In addition to headway made in farm privatization, complementary progress on reforming the state procurement system, trade liberalization, and private sector development in agricultural support services and processing could quickly induce agricultural growth of 2–3 percentage points over its current level.

Trade liberalization has the potential to raise services sector growth by 5–6 percentage points over its presently depressed level. Rising incomes in these sectors in turn could well feed into higher industrial expansion over time as policy changes lead to enterprise restructuring and new investment. The Government's announcement of current account convertibility is the first step in transmitting appropriate price signals to the economy. Trade liberalization, removal of price controls, rationalization of the tax regime, sustained progress on the enterprise privatization program, discontinuation of preferential treatment for favored enterprises, and a phaseout of state planning and resource allocation would work to raise industrial growth by 2.5–3.5 percentage points above the present level.

While initial improvement can come about through relatively less capital-intensive supply responses in the agriculture sector and growth in the small enterprise sector, higher long-term growth will require increased domestic savings and investment as well as larger inflows of FDI. For this, the creation of a healthy business climate and banking sector reforms should be made a government priority.

Legal reforms, including the protection of property rights and improvements in the enforcement of contracts, are essential to foster and sustain the needed strengthening in investment activity by both domestic and foreign investors. In addition to encouraging savings, banking sector reforms to allow banks to function as genuine financial intermediaries will be essential. The abolition of the extrafinancial roles of banks (such as tax enforcement and cash planning) and interest rate controls; banks' freedom to manage liquidity and lend, subject only to the usual prudential regulations; and sustained progress in bank privatization will be key elements in banking reform.

Outlook for 2004–2005

The economic outlook depends on progress in agricultural reforms, changes to the trade regime, follow-through with currency convertibility, and installation of a conducive environment for business development. GDP growth over the forecast period is not projected to improve significantly from the 2003 rate of about 4%, although the outturn in 2004 could be slightly higher at about 4.5% if the global recovery and buoyant import demand in Uzbekistan's main markets are sufficiently strong. In 2004–2005, growth will be conditioned by whether farm privatization and other reforms stimulate agricultural supply responses and greater industrial capacity utilization, and by whether enterprise privatization increases productivity. The outlook for 2005 would brighten if policy reforms could be accelerated.

It will be difficult for the Government to maintain high fiscal arrears without risking social unrest, and the budget deficit is projected to widen to roughly its 2002 level of about 2% of GDP as these are unwound. Despite government intentions to maintain tight monetary and fiscal policies, inflation is projected to increase to perhaps 20% in 2004 and then likely remain at around this level in 2005. The sustainability of a tight monetary policy is doubtful in the face of CBU's reduction in the refinancing rate, budgetary financing requirements, and the need to ease the present procedural barriers to accessing cash and foreign exchange (to strengthen enterprise activity). In these circumstances the exchange rate is likely to depreciate, especially if trade restrictions are eased.

Export growth and a continued strict import regime are expected to maintain the current account surplus at roughly its present level of 6% of GDP over 2004–2005. Although it is expected that the cotton harvest and exports will decline in this period, the fall will be offset by stronger global prices. If enterprises are able to respond to the likely depreciation of the currency through greater capacity utilization, machinery exports are in a favorable position to increase, with relatively little additional investment. Strong demand for energy in the Russian Federation is expected to result in moderately higher energy exports.

Imports will remain concentrated in capital goods for the hydrocarbons sector, and will be partly funded by foreign investment. The compression of private sector and consumer goods imports will continue, though it will be important that restrictions ease and that the exchange rate and tariff policy come to play a greater role in controlling demand.

Agricultural growth will be a primary determinant of living standards over the forecast period. It can be expected to translate into widespread income increases if land reforms and changes in the state procurement system proceed as planned and if the business environment for small enterprise development in the agriculture sector improves. Industrial growth is not expected to lead to substantial employment generation because of redundancies, while small enterprises and domestic trade are unlikely to grow rapidly without substantial policy changes. Moreover, the number of government budget-financed jobs in health, education, social protection, and administration is expected to fall as the Government streamlines budgetary expenditures. Thus the pace of longer-term improvement in living standards and poverty reduction depends on strong action to pursue wide administrative, structural, and macroeconomic reforms.

ASIAN DEVELOPMENT

Outlook 2004

Economic Trends and Prospects in Developing Asia

The Pacific

Cook Islands

Tourism was the driving force in the continuing modest economic expansion, though economic development and the fiscal position, while improving, are still affected by political instability. Growth is forecast to remain at current levels over the medium term.

Economic Assessment

Overall GDP estimates have been revised due to an improvement in data collection and a rebase from 1990 to 2000 prices. According to these revised estimates, economic growth declined from 3.9% in 2002 to 3.1% in 2003.

The tourism sector remains the main element in growth. The industry recovered from a drop in visitor arrivals triggered by the September 11 events, with visitor arrivals rising by 8.7% for the first 3 quarters of 2003 compared with the same period in 2002 (Figure 2.26). Tourism-related subsectors, such as hotels, restaurants, transport services, and wholesale and retail trade witnessed moderate strengthening. The increased number of tourist arrivals also resulted in higher demand for locally produced fruits and vegetables.

Preliminary results of the 2001 census suggest continuing migration to New Zealand, particularly from the outer islands. The decline in the resident population, combined with the economic recovery after the 1996 Economic Reform Program (ERP), has led to a significant increase in GDP per capita from NZ$8,349 in 1996 to NZ$14,377 in 2003. However, the continuous out-migration of skilled personnel creates particular challenges for the Government in maintaining basic health and education services on the outer islands. Overall, the incidence of poverty is probably rather low. The country has already achieved several of the Millennium Development Goals, such as universal primary education, low and decreasing child and maternal mortality rates, and almost universal access to safe drinking water.

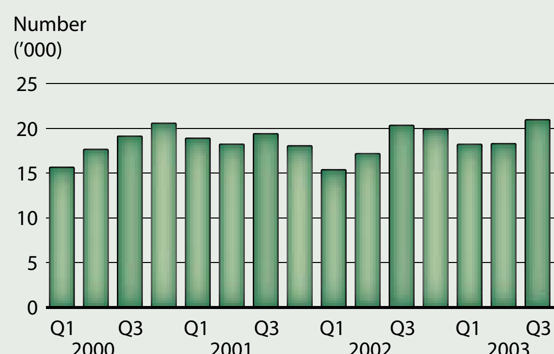
The fiscal position is continuing to improve. Significant operating surpluses have been achieved, mainly due to better revenue management. Tax revenues have increased from NZ$37.4 million in FY1997 to NZ$61.9 million in FY2003 (ended 30 June 2003). The operating surplus is expected to turn out higher than the budgeted NZ$4.8 million, equivalent to 2.1% of GDP, due to an upward revision in taxation forecasts.

Capital expenditures remain low, representing only 6.7% of total expenditures in FY2003. Consistent with previous years, the FY2004 budget policy statement outlines several priority areas: economic sustainability, good governance, infrastructure support, outer island development, and environmental management.

Inflation follows the levels in New Zealand since the country uses the New Zealand dollar as its domestic currency. Year-end inflation decreased to 2.4% in FY2003, with the food index group showing the highest rise, and low inflation or deflation in most of the other categories.

Net foreign assets in the banking system at end-June were NZ$19.5 million compared with NZ$26.2 million a year earlier. Maintaining the previous year's strong growth trend, net domestic credit rose from NZ$75.5 million at the end of 2002 to NZ$107.3 million in September 2003 due to a continuing increase in claims on the private sector. The greatest share of lending went

Figure 2.26 Visitor Arrivals by Quarter, Cook Islands, Q1 2000–Q3 2003



Source: Cook Islands Statistics Office, *Quarterly Statistical Bulletin*, Table 4.1, September 2003.

to tourist accommodation projects followed by lending to the wholesale and retail sector.

Money supply growth accelerated to 9.9% in FY2003 from 3.2% in FY2002 due to an increase in demand deposits. Nominal interest rates changed marginally during the year, ranging from zero to 3.0% for deposits and from 8.9% to 16.5% for loans.

In the mid-1990s, government debt reached unsustainable levels, culminating in a fiscal and economic crisis. The Manila Agreement, signed in 1998, led to the restructuring of debt and reduced the face value of government debt by more than 30% and provided for concessions on interest rates. As of end-FY2003, total foreign debt stood at NZ$109.7 million, representing 48.6% of GDP, most of it held on concessional terms. The Government is gradually building up its loan repayment reserves, which are budgeted to climb from NZ$11.8 million in FY2003 to NZ$15.1 million in FY2004.

Total merchandise exports in FY2003 recorded a year-on-year 12.9% fall (in US$ terms), attributable mainly to a continuing drop in sales of pearls. Pearl exports, constituting approximately 90% of commodity exports, continued to be affected by a disease outbreak in 2000 and a general slump in market prices. In contrast, exports of other marine resources, in particular fish, soared from a modest NZ$288,000 to NZ$2.9 million. Total imports rose by 9.2% in FY2003 (in US$ terms) resulting from the New Zealand dollar's appreciation. As in previous years, there is a large trade deficit. However, the significant surplus on the services account, with tourism receipts representing the bulk of service income, has helped the country achieve a positive current account balance over the last few years.

Policy Developments

Political instability continued in 2003 with a new Government formed in February and a major cabinet reshuffle in November. Despite an overall improvement of fiscal management since the ERP, the frequent changes in government coalitions impact adversely on the consistency and strategic directions of economic and fiscal policies. Economic planning is frequently improvised, with little coordination among ministries, and focuses on the annual budget, with little regard for long-term prioritization for public investment. Now that the economy is shifting out of a recovery mode, the lack of a coherent development strategy has been recognized as an important priority issue that needs to be addressed.

The Government held a National Economic Planning Forum in November 2003 and has set up a National Planning Task Force to develop a national economic development framework for the medium and long term in consultation with a wide range of stakeholders. The forum provided a first platform for discussions of the main challenges confronting the country, particularly the impact of the continuous out-migration of skilled people.

The relatively lax fiscal discipline in the FY2003 budget, several continuing tax and customs exemptions introduced as "transitional" measures, and the granting of new exemptions with inadequate consideration of their longer-term impact on government revenues are signs that the continuing political instability affects economic reform measures. Additionally, political intervention in operational public service management, poor performance by public service managers, and ineffective enforcement all highlight the need for improved governance. A marked increase in the public sector wage bill has reversed some of the savings and efficiency gains made during the ERP.

Nevertheless, overall revenue management has improved with the introduction of VAT, which represents 43% of tax revenues, and increased efficiencies in tax enforcement and audits. The 2003/2004 Budget Statement recommended the

establishment of a reserve trust fund representing 2% of tax revenues to enable greater fiscal flexibility in the long term and to set aside NZ$319,000 for the first year. Income from fees of offshore company registrations are now used to administer the newly established Financial Supervisory Commission; surplus funds are to be returned to the Government. The commission is charged with licensing and regulating all trustee companies and banks that provide domestic and international trustee and banking services in, or from, the Cook Islands. As a party to the Cotonou Agreement with the EU, the Cook Islands will receive NZ$1 million a year over the next 5 years. The assistance has been earmarked for education and health sector improvements on the outer islands.

The heavy emphasis on operating, rather than development, expenditures affects the country's ability to implement the capital projects required for the development of the private sector, especially tourism. The Cook Islands Investment Corporation is currently reviewing the deferred maintenance of all government assets and there are plans to increase the provision of maintenance and investment over the next few years particularly with regard to power generation, water supply, wastewater treatment, and waste disposal.

The Cook Islands remains on the list of Non-Cooperative Countries and Territories of the OECD Financial Action Task Force (FATF) and has been placed under sanction. Although the Government has made efforts to comply with the FATF recommendations, including new offshore banking regulations and the establishment of the Financial Supervisory Commission, there is further need for early and effective implementation.

Outlook for 2004–2005

GDP is forecast to grow by 2.7% in FY2004 and by 2.9% FY2005, on the assumption of modest expansion in the tourism industry and in pearl and fishing exports. The economy remains heavily reliant on tourism, and thus is extremely vulnerable to global developments. However, the tourism industry in the Cook Islands is likely to continue to benefit from the view of the Pacific region as a relatively safe destination. Visitor arrivals are expected to continue to edge up over the next few years. The main constraints confronting the tourism industry are a shortage of skilled and unskilled workers exacerbated by the continuous out-migration, and inadequate flight connections. While there are several projects to increase accommodation facilities, further expansion of tourism capacity will depend on investment to maintain and expand infrastructure, especially power, sewage, and water facilities.

In an effort to develop the domestic fishing industry, the Government has introduced an exemption of levies for the fishing sector for fuel, bait, and equipment. Even with these exemptions, and despite the significant increase in fish exports, high import costs for inputs are likely to significantly limit the potential of the industry. Labor shortages also remain a constraint on the expansion of the commercial fishing industry. The recovery of the pearl industry is likely to take a few more years, with export earnings staying at less than half of those in FY2002 in the forecast period.

Inflation is projected to stabilize at an average of 2.0% over the next 2 years.

Parliamentary elections are due in September 2004. Efforts to follow up the proposals suggested at the National Economic Planning Forum have been postponed because of recent staff turnover and are likely to be affected by the preparations for the elections.

For long-term economic growth to continue, it is important that a consensus is reached among all stakeholders and political parties through a renewed commitment to the national economic development framework, especially the medium- and long-term public investment program.

Fiji Islands

The economy grew quite fast in 2003, led by the tourism and construction sectors. Against this positive background, the Government remained committed to implementation of economic and public sector reforms, including restructuring of the sugar industry, while seeking to rein in the budget deficit. The medium-term outlook is for growth at modest rates.

Economic Assessment

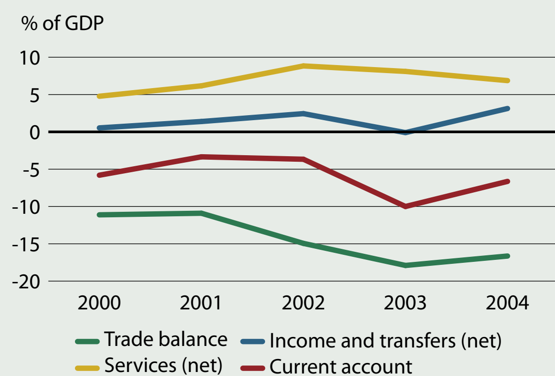
The economy expanded for the third year in succession in 2003, with GDP strengthening by an estimated 5.0%. Tourism, which accounted for about 10% of GDP, was the leading growth sector, with visitor numbers reaching a new record of 426,000 in 2003, up from about 398,000 in 2002. The hosting of the South Pacific Games and the perception of a safe and affordable destination were major reasons for rising tourist arrivals. Stimulated in part by the latter, and by increased remittances from overseas, the wholesale and retail trade, restaurant and hotels, and transport and communications subsectors registered strong expansion of over 8.0%. Other services subsectors grew more slowly. The construction sector grew by a rapid 17.0% because of government spending on physical infrastructure and the implementation of several large private sector projects in hotels and trade activities.

Manufacturing recovered from a downturn in 2002 as a result of strong rises in all subsectors except sugar manufacturing, which continued to suffer from inefficiencies in milling and transporting of sugarcane. The garment subsector, in particular, rebounded strongly from its 2002 decline. In the primary sector, sugarcane production dropped because of the effects of prolonged drought and the ongoing nonrenewal of land leases, while copra production was weakened by the effects of cyclone Ami, which hit early in the year. The fisheries subsector grew slowly, with poor weather and overfishing possible reasons for low catches. The forestry and mining subsectors each grew by about 1.0%.

Private consumption remained strong in 2003, as evidenced by an 11% rise in VAT revenues (adjusted for the 2003 rise in the tax rate). Imports of investment goods were about 20% higher than in 2002, and a rise in investor confidence was evident in the start of several large private sector tourism projects in the last quarter. Under the Hotel Aid Act, duty exemptions and tax breaks of 10 years for investments of over F$10 million and 20 years for investments of over F$40 million are granted. Confidence among the resident business community was also growing in 2003.

Labor market conditions remained strong. In the period from January to end-December, 9,524 new taxpayers were registered, representing a 14.3% increase on the 2002 figure. Employment surveys showed a rise in job advertisements, and jobs were created in the ICT sector with the establishment of back-office operations in the country. However, in the first 10 months of 2003, 4,800 people emigrated, representing an increase of almost 6% on the corresponding period in 2002. The health and education sectors, in particular, were hit by the continuing brain drain, which began after the two coups in 1987 and accelerated after the mid-2000 coup.

Figure 2.27 Current Account Components, Fiji Islands, 2000–2004



Sources: Republic of Fiji, Ministry of Finance and National Planning, *Economic and Fiscal Update: Supplement to the 2004 Budget Address*, 7 November 2003, Tables 4 and 7; Reserve Bank of Fiji, *Quarterly Review*, February 2004, Table 4.1; staff estimates.

The 2003 fiscal target of reducing the budget deficit to 4.0% of GDP was not met. Current revenues were up by 6.2% on the 2002 level because of strong economic growth and the January 2003 increase in the VAT rate from 10.0% to 12.5%. However, a substantial extrabudgetary appropriation was made in order to deal with the impact of cyclone Ami, and planned asset sales were not made. The budget deficit consequently came in at 6.1% of GDP. At end-2003, the Government's domestic debt stood at 44.7% of GDP, with the Fiji National Provident Fund, which accounts for almost half of financial sector assets, holding 62.0% of it.

Inflation rose from 0.8% in 2002 to 4.1% in 2003, reflecting primarily a rise in food prices attributable to the supply-side impact of cyclone Ami, as well as the drought. Other contributory factors were the one-off impact of the higher VAT rate and a general strengthening of domestic demand. The nominal effective exchange rate index of the Fiji dollar rose by 0.8% in 2003, indicating a slight appreciation against a basket of trading partner currencies. With inflation running at about double the rate of that in the country's major trading partners, the real effective exchange rate index rose by 3.0%, indicating some deterioration in international competitiveness of an economy characterized by relatively high wage costs.

Broad money grew by 15.6% in the year to end-November 2003, largely because of a rise in domestic credit. Net credit to government increased rapidly in order to finance the budget deficit, and there was a significant rise in credit to the private sector, which was concentrated in personal loans and loans to the trade, construction, and food and beverages sectors. The commercial banks' weighted average lending rate fell from 7.89% in January to 7.36% in November. Real interest rates on deposits became heavily negative.

The current account deficit widened significantly to 10.0% of GDP in the first 3 quarters of 2003 as the trade balance worsened substantially (Figure 2.27). Exports were down by about 1% in domestic currency terms on the corresponding period in 2002 because of major falls in gold, fish, and timber exports. Imports picked up substantially in domestic currency terms, especially in the categories of machinery and transport equipment and in manufactured goods. The growth in tourist arrivals contributed to inflows on the services account though higher transport costs linked to imports reduced the surplus on this account. Net inward transfers increased. The capital account moved into surplus because of higher FDI and loan drawdowns by the Government. The overall balance-of-payments deficit rose slightly to 2.3% of GDP. A pickup in exports in the quarter to December 2003 contributed to a current account improvement, but there was nonetheless some deterioration in the balance of payments over the whole year. By the end of the year, foreign reserves had declined to the equivalent of 3.0 months of imports of goods and nonfactor services, compared with 3.6 months at end-2002. The Government's external debt, as of September 2003, was 4.2% of GDP, with debt servicing equivalent to 2.5% of total exports.

Policy Developments

Soon after its election in 2002, the Government announced a target of increasing the sustainable economic growth rate to 5% a year. The key to achieving the target is the reversal of a long-term decline in the investment rate, which had fallen from around 20% of GDP in the 1970s to around 12% in the 1990s, and had been associated with a drop in average annual GDP growth rates from

Table 2.23 Major Economic Indicators, Fiji Islands, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	3.0	4.1	5.0	3.9	3.0
Gross domestic investment/GDP	14.8	13.8	14.2	13.5	-
Inflation rate (consumer price index)	4.3	0.8	4.1	3.0	3.0
Money supply (M2) growth	-3.1	7.9	15.6	7.3	-
Fiscal balance[a]/GDP	-6.6	-5.6	-6.1	-3.5	-0.8
Merchandise export growth	-8.4	2.6	-17.6	12.7	14.5
Merchandise import growth	-4.2	13.5	-11.6	7.6	18.6
Current account balance/GDP	-3.3	-3.7	-10.0	-6.6	-9.6
Debt service ratio	1.9	1.9	2.5	-	-

- = not available. [a] Including asset sales.

Sources: Ministry of Finance and National Planning, *Economic and Fiscal Update: Supplement to the 2004 Budget Address*, 7 November 2003; Reserve Bank of Fiji, *Quarterly Review*, various issues; staff estimates.

over 8% in the 1970s to under 3% in the 1990s. Declining private sector investment was of particular concern, having dropped from about 14% of GDP in the 1970s to about 4% in the 1990s. Major reasons for the decline were political instability following the coups of 1987, uncertainty over land leases, administrative delays and impediments in the investment approval process, and shortages of skilled workers. These factors remain relevant today. The investment ratio in 2003 was estimated to be 13–14% of GDP, compared with 21.3% in 1977.

Achieving 5% annual growth by raising the investment rate to 25% of GDP is a priority area of the current medium-term strategic development plan. IMF, however, estimates that an investment rate of 30% of GDP would be needed to sustain 5% growth. The Government aims to increase the share of capital expenditures in total public expenditures to 30%, from the budgeted level of 14% in 2004, and to encourage private sector investment by ensuring macroeconomic stability, implementing structural reforms, improving infrastructure, and maintaining existing incentives (e.g., accelerated depreciation for buildings and duty-free importation of raw materials for companies planning to expand their operations). The Government also plans to amend the Foreign Investment Act. Despite the rising investment in tourism in 2003, a general improvement in private sector investment was not evident, with foreign investors, in particular, remaining hesitant because of ongoing concerns over political stability. In addition, increasing public capital expenditures toward the 30% target requires a reallocation of expenditures away from personnel. This will be difficult to achieve in the medium term.

Other priority areas that receive explicit resource allocations in the 2004 budget include rural development, social justice and poverty alleviation, infrastructure, tourism, social and community development, natural resources and environment, and law and order. The Government is committed to reducing poverty by 5% annually. The proportion of households living below the national poverty line rose from about 15% in 1983 to about 26% at the start of the 1990s, and is likely to have increased since then. However, the budget provides for only a 1.3% rise in nominal expenditures on poverty reduction projects, a significant drop in real terms. In addition, nominal expenditures on rural sector and outer island assistance are to fall by 16.5%. The only component of the poverty reduction program to attract significant additional funding is tuition-free education. Social welfare payments, housing assistance, and microfinance also suffer a drop in funding.

The 2004 budget estimates an overall deficit, excluding asset sales, of 3.9% of GDP, which is to be financed by domestic borrowing. Current revenues are forecast to rise by 8.3% from the

2003 level, with collection expected to improve as a result of greater coordination between the processing of income and VAT returns through the introduction of the Fiji Integrated Tax System. The top marginal personal and corporate tax rate is to be reduced from 32% to 31%, the export tax on sugar goes back to 3% from the 10% rate introduced in the 2003 budget, and the number of tariff bands is to be reduced from six to four. Operating expenditures are forecast to rise by 3.5%, with personnel costs increasing by 2.2% and accounting for 48.7% of total operating expenditures. The Government intends to replace wage indexation in the civil service with productivity-based wage increases. A staff freeze is also to be imposed on all ministries except education, health, and the police, and expenditure control is to be improved through the introduction of a new financial management information system. Expenditures on military personnel may prove difficult to limit. Capital expenditures are budgeted to drop substantially.

In 2003, the functions of the Reserve Bank of Fiji were extended to include formal supervision of the Fiji National Provident Fund and an interim Financial Intelligence Unit was established to counter money laundering and terrorist financing, pending passage of enabling legislation. Means of improving rural financial services delivery were under investigation, including restructuring the Fiji Development Bank. Exchange controls are to be relaxed in 2004 by increasing delegation of capital transactions to the commercial banks.

Implementation of structural reforms has generally been a slow process. In late 2003, the Government restated its commitment to the difficult task of restructuring the sugar industry, and will guarantee loans raised by the Fiji Sugar Corporation for a 5-year F$170 million program of upgrading transport and milling infrastructure. The Government will also seek to resolve long-standing land tenure issues within the framework of the Native Land Trust Act, which potentially allows agricultural leases of 50 years. Labor legislation is to be consolidated into a new, comprehensive Industrial Relations Bill aimed, among other things, at supporting collective bargaining procedures and establishing tribunals and courts for dispute settlement.

Outlook for 2004–2005

The forecast is for the growth rate to drop to 3.9% in 2004. With sugarcane production continuing to fall, growth in the agriculture, forestry, and fisheries sector will be slow at an estimated 0.9%. Mining production will grow rapidly as a strong gold price stimulates exploitation of new ore deposits at the existing mine. Continued rapid growth in the construction sector will be driven by completion of private investment projects in tourism, and by some aid-funded infrastructure projects. Manufacturing is forecast to expand by just over 4% as food and beverages production increases and textile, clothing, and footwear producers take advantage of the final year of full preferential access to the Australian market under the South Pacific Regional Trade and Economic Cooperation Agreement. The services sector, which accounts for 58.7% of GDP, is forecast to grow at 3.0%. Tourist numbers are expected to increase by 3.5% on the record 2003 level, assuming that stronger Australian and New Zealand currencies will encourage tourism from the region.

In 2005, growth is forecast to slow further to 3.0%. The agriculture, forestry, and fisheries sector is expected to continue its limited overall expansion, while the growth rates in the mining, manufacturing, and construction sectors are expected to drop. The garment subsector faces removal of quota protection in the US market, and is likely to register little growth. The services sector is forecast to grow at 3.5% on the assumption that tourist numbers will grow by around 6%. Given the growth in supply of tourist accommodation and the possible expansion of aircraft seat capacity with the entry of an additional airline into the regional market, the realization of this projected increase in tourist numbers will depend largely on marketing efforts and cost competitiveness.

Economic growth at rates in the 3–4% range will generate annual increases in formal sector employment of about 2%, which is well below the rate required to absorb the annual net increase in those seeking paid employment. Simultaneously, efforts to increase the capacity of the poor to take advantage of income-earning opportunities will be limited by the real decline in funding for poverty reduction programs, as the traditional family-network support system continues to weaken.

The Government's past projections of declining budget deficits have proven to be over-optimistic, and this may again be the case for 2004 and beyond. Official projections suggest a reduced budget deficit (after inclusion of asset sales) of 0.8% of GDP in 2005. Revenue projections are conservative, but projections of a fall in nominal operating expenditures are unconvincing, and projected cuts in nominal capital expenditures will have major implications for infrastructure development if they are actually implemented. It is unlikely that government debt will track down toward the targeted level of less than 40.0% of GDP by 2006.

Export growth (in domestic currency terms) in 2004 is forecast to be negligible as a decline in reexports offsets a surge in gold exports and strong growth in mineral water exports. At the same time, imports are expected to drop, largely as a result of a fall in imports of machinery and equipment, so that the trade balance could improve. However, the above trends change if trade is calculated in US$ terms due to an expected appreciation of the local currency relative to the US$ (from F$1.9/US$1 in 2003 to F$1.7/US$1 in 2004). In particular, exports and imports in US$ terms are forecast to increase in 2004 by 12.7% and 7.6%, respectively. The current account deficit is likely to increase to about 10% of GDP in 2005 as import growth resumes. The overall balance of payments is expected to record a small surplus in 2004 and 2005.

Box 2.4 Republic of Palau

Palau, a sovereign nation since 1994 and with a population of 19,129 in 2000, joined ADB on 29 December 2003 as its 63rd member. Historically, the country has received substantial financial transfers under its Compact of Free Association with the US, which helped the economy grow in the mid-1990s.

In recent years, however, the country has been experiencing an economic downturn and a sizable contraction in per capita GDP, from $8,806 in 1997 to $5,753 in 2003. Compact financial transfers, which will come to an end in 2009, include grant money for budget support and the creation of a Trust Fund, income from which will replace direct assistance after 2009. While total grants under the Compact amount to approximately $600 million, almost half of this value was front-loaded in the first few years of the agreement. Foreign assistance, including financial resources from Japan and Taipei,China, has been mainly used to build physical infrastructure and to maintain a large public sector.

Today, one third of the Palauan work force is employed in that sector, which offers high salaries (almost double those in the private sector), and which accounts for about one quarter of total GDP. (Unemployment is low, at about 2%.) Total government expenditures are also high, at about 60% of GDP, and amounted to $79.7 million in 2002, as against revenues of $70.1 million. A drastic reform of the public sector and fiscal consolidation are urgently required in view of the country's rapidly deteriorating financial position.

One of the main challenges for the Government is the need to pare back public expenditures, while facilitating the development of a vibrant private sector. Tourism is the main source of national income, with 63,337 visitor arrivals in 2003, and has potential to further develop, due to favorable location and a pristine environment. However, tourism heavily depends on imported inputs, and, due to lack of adequate facilities, it is still highly concentrated in terms of activities and visitors' source countries. A significant share of investment in this sector is foreign owned.

Source: Office of Planning and Statistics.

Kiribati

Economic growth in 2003 picked up slightly after a period of political uncertainty, but tight fiscal control as well as economic and structural reforms to promote broader-based domestic private sector activity are needed to maintain the growth momentum.

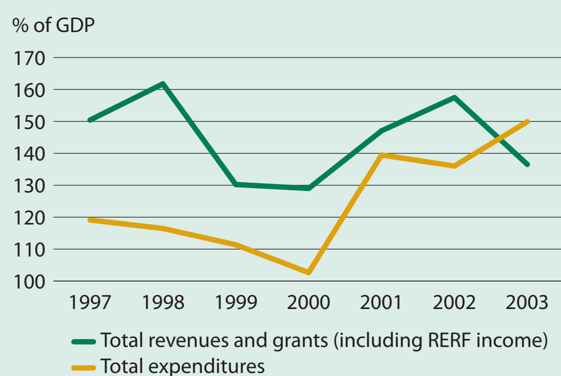
Economic Assessment

GDP is estimated to have grown by 2.5% in 2003, improving somewhat from the previous 2 years. Higher consumer spending—triggered by a rise in government expenditures in the run-up to two national elections (in late 2002 and mid-2003) and employment in large construction projects—contributed to this improvement. Significant development projects included the construction of secondary schools, a new power generating plant, and improved water and sanitation infrastructure, all on South Tarawa. Although higher than in previous years, GDP growth in 2003 was held back in part by poor performance in agriculture, especially a decline in copra and seaweed production.

Despite the narrow production base, Kiribati's financial situation is underpinned by large external earnings. GNP is approximately 70% higher than GDP due to high external factor income from fishing license revenues, investment income, and seafarer remittances. In 2003, GNP is estimated to have fallen by 4.8% from A$168 million in 2002 mainly due to a further drop in fishing license revenues of about 22% (they were down 10.5% from 2001 to 2002) and a decline in passport sales to foreigners. As a result, the fiscal position tightened markedly in 2003 with central government current revenues, including Revenue Equalization Reserve Fund (RERF) income, decreasing from A$101.9 million in 2002 to A$82.3 million in 2003. Growth in remittances from overseas workers kept pace with inflation while income from overseas investments of the RERF began to recover some of the value lost during the weak global financial markets in 2001–2002. There was also a fall in tax and other nontax revenues, suggesting either a reduction in domestic economic activity, weaker compliance, or a combination of the two.

Expansionary expenditure decisions in the lead-up to the 2003 elections with an increase in both public sector wages and workforce numbers, higher subsidies to government-owned businesses and the copra industry, and large contributions to development projects affected the fiscal position in 2003. The Government also leased an ATR-72, a medium-range aircraft for the national airline, but this arrived in mid-2003 and only started commercial operations in December, causing a net drain on resources for lease payments and operating costs. However, central government current expenditures are estimated to have subsided from A$71 million in 2002 to A$65 million in 2003. This reduction is attributable partly to election date delays and to expenditure cuts made in anticipation of lower revenues. Combined with a 19.2% reduction in current revenues in 2003 and a 48% rise in development expenditures, the overall impact was a budget deficit of A$14 million or about 13% of GDP (Figure 2.28). The deficit was financed by drawing down RERF surplus funds accumulated in previous years, other government funds, and external loans. The tightening fiscal position did not directly affect disposable

Figure 2.28 Government Revenues and Expenditures, Kiribati, 1997–2003



RERF = Revenue Equalization Reserve Fund.
Sources: Staff calculations based on data from the Kiribati National Statistics Office, Ministry of Finance, *Government Finance Statistics, 1985–2000*, November 2001, Tarawa; *Budget Papers*, various years; International Monetary Fund, *Kiribati Staff Report for the 2003 Article IV Consultation*, July 2003; staff estimates.

incomes on South Tarawa, which were supported by aid-financed capital projects in education and infrastructure. Incoming foreign investment was minimal.

Inflation in 2003 was modest at about 2%, partly reflecting Kiribati's use of the Australian dollar as its domestic currency. Price indexes in the food, beverage, and transport subsectors were unchanged in 2003, reflecting both the low rates of inflation in countries where most of the imports originate (primarily Australia and New Zealand) and the degree of price control exercised over petroleum products and other "basic" commodities.

The balance of payments remains vulnerable and is expected to have been in deficit by an estimated A$3.2 million, or about 3% of GDP, in 2003. The strong appreciation of the Australian dollar against the US currency in 2002–2003 and the consequent fall in the domestic currency value of most of Kiribati's foreign income over this period were areas of major concern. Despite a trade deficit of some US$58.7 million, official external assets remained substantial at the equivalent of 4 years' imports of goods and services. The RERF was valued at A$576 million as of end-2002 and A$593 million 12 months later. Public external debt was relatively low at about 23% of GDP in 2003 and had been provided on highly concessional terms. Domestic public debt is virtually nonexistent.

Policy Developments

On taking office, the new Government expressed its priority as "enhancing and ensuring the equitable distribution of development benefits to the people of Kiribati." It promised to pursue these aims in accordance with the principles of good governance. The key policy areas were stated as (i) economic growth through a partnership of public and private investment in infrastructure and production; (ii) equitable distribution of services and economic opportunity, particularly on the outer islands; (iii) public sector performance through improved efficiency in resource use by ministries and public enterprises; (iv) equipping people to manage social and economic change through policies in education, health, culture, and governance; (v) sustainable use of physical resources, including adaptation to climate change; and (vi) protecting and using financial reserves while making use of them to finance development, particularly through the village banks and strengthening the governance of the RERF.

The Government also developed the third statement of the National Development Strategy (NDS) covering the years 2004–2007. The NDS introduces new measures for performance reporting, not only in terms of statutory reporting, but also of ensuring effective monitoring and review of planning efforts. Penalties for failing to comply with reporting requirements include holding back some of the funds allocated to ministries and withholding subsidies to public enterprises. The NDS is closely aligned with the budget through the financial management information system and will be reviewed annually at midyear to shape the following year's budget. The annual budget is to be set in a 7-year multiyear budget framework. Increased confidence in fiscal sustainability is to be achieved by effectively implemented budgets, maximizing the sustainable collection of revenues from existing sources, and preparing for the introduction of a VAT-style consumption tax.

Consultations with representatives of civil

society, as well as public acceptance of a population policy and climate change adaptation policy, will help address sustainability issues. Land use planning is to be fostered through public consultation in heavily populated areas. Infrastructure, small enterprise development, and rural production (which has been declining) are to be reemphasized. Private partners for government-owned hotels are to be sought. Public sector performance is to be encouraged by a new award system and the revision of the national conditions of service. Service agreements are to be introduced for all public enterprises on the understanding that some may be unsustainable. Public tenders are to be introduced for subsidized services.

In 2003, the Government introduced several financial sector reforms. A draft law on licensing supervision and regulation of financial institutions and on combating money laundering was introduced, as was a reduced guaranteed rate of return for Kiribati Provident Fund assets. Contributions to this fund were also increased. However, concerns remain over poor standards of project evaluation, increased levels of government guarantees for Bank of Kiribati loans to public enterprises, the setting up of a proposed Guarantee Corporation, and the rise in the NPL ratio at the Development Bank of Kiribati.

Outlook for 2004–2005

GDP is projected to grow by 1.8% in 2004 and by 1.5% in 2005, roughly equivalent to the rate of population growth. This will mean continuing low levels of job creation, and an increase in the number of unemployed young people, particularly on South Tarawa. Growth in GNP is expected to track that of GDP, thereby keeping real income per head at about 2003 levels.

Short-term prospects for economic activity and employment are determined by current and planned externally funded public sector projects. The 2004–2005 budgets will also be influenced by the better outlook for RERF earnings, which are expected to continue improving alongside a general recovery in global financial markets. Fishing license revenues are expected to remain at around 2003 levels in 2004–2005 with the help of a new licensing agreement with the EU, then return to 2001–2002 levels by 2007. In 2004, official external assets are projected to remain at the equivalent of about 5 years of imports, and public external debt at about 30% of GDP (with no domestic debt).

Although the fiscal situation remains a source of concern, the 2004 budget deficit is projected to decline to A$6 million, largely due to expenditure compression. Total expenditures are projected to decline by 11.6%. In particular, the recent decision to cancel the lease of the ATR-72 removes one of the greatest threats to uncontrolled expenditure.

Critical challenges include the increasing levels of unemployment, especially among the young; the deteriorating urban environment on South Tarawa; and the apparent declining educational standards, particularly among young men.

The NDS recognizes the importance both of these issues and of a comprehensive population policy, which includes family planning and emigration, for reducing poverty and sustaining living standards in the country. The challenge is for the Government to deliver a consistent and strong national message, implement modernization measures, and bring about real structural change in the economy.

Kiribati's potential for long-term growth is constrained by the physical limitations of its many small islands; widespread geographic distribution; and fragile, low-lying, and poor land resources. These factors, as well as the small size of the domestic market, make it difficult to exploit locally the marine resources of the country's extensive exclusive economic zone. Notwithstanding these constraints, it is essential that Kiribati both broaden and deepen the private sector component of the domestic economy. New employment and new investment opportunities are clearly needed.

Republic of the Marshall Islands

As a result of limited expansion in the public sector and in primary production, the economy grew slowly in 2003. The late-2003 approval of the amended Compact of Free Association, which reaffirms the importance of private sector development, laid a foundation for achieving long-term fiscal sustainability, though this will require an adjustment to lower levels of public spending.

Economic Assessment

After strengthening by an estimated 4.0% in FY2002 (ended 30 September 2002), GDP is likely to have risen by close to 3.0% in FY2003, following recently revised public expenditure figures and analysis of the main local firms' annual reports. Statistical weakness, however, makes it difficult to assess economic performance.

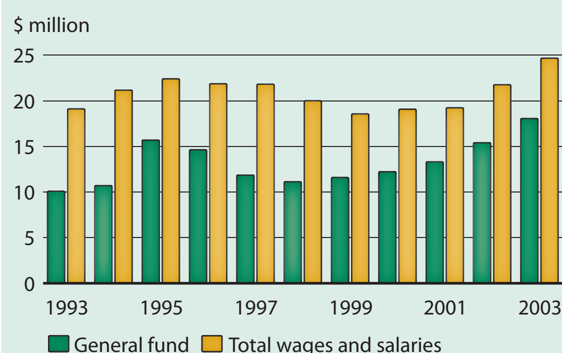
Copra production expanded on account of higher copra prices, continued government subsidies, and intensified frequency of outer island shipping services. Also, the tuna loining plant turned in higher production figures than in 2002. Government spending expanded, though at a much slower rate than in FY2002, which was the first year of a 2-year boost in Compact funding pending finalization of the amended Compact of Free Association between the US and the Marshall Islands. The upturn in government demand, albeit modest, provided some stimulus to activity in other services sectors, particularly transport and communications. In the retail trade sector, increased competition led to faster growth.

Employment edged up in FY2003, primarily due to the filling of some civil service vacancies, and government wages rose from the previous year's level (Figure 2.29). However, growth in labor demand fell short of the annual increase in the labor supply (averaging about 2.4%).

The FY2003 budget forecast an overall surplus equivalent to 14.1% of GDP, compared with an actual surplus of 14.8% in FY2002. Tax revenues were expected to rise by 3.1% from the FY2002 level, largely because of a rise in gross revenues and import taxes. External grants, mostly supplied under Compact provisions, were forecast to remain unchanged, accounting for 50.4% of total revenues (exclusive of loan funds). Total expenditures in FY2003 were forecast to rise by 3.8% from the FY2002 level. The FY2003 budget provided for a 5% limit to the growth of general fund expenditures and continued the public service wage freeze (with the exception of some increases in the Ministry of Education that brought teachers' salaries in line with Public Service Commission pay scales). The actual budget outcomes for general fund activities in FY2003 showed that expenditures were well controlled, coming in just under the budget estimate, and that revenues were slightly above the budget estimate, mainly the result of improved tax collection.

The surplus was allocated as a contribution to the Marshall Islands Intergenerational Trust Fund (MIITF), which at end-FY2003 had a total capital of $31 million that was to be the seed money for the Compact Trust Fund to be established in FY2004. However, prior to the general elections of November 2003, $7 million of this allocation to the MIITF was provided as a deposit to the Marshall Islands Development Bank (MIDB) for onlending at concessional rates to two major retailers, and effectively became unavailable for augmenting Compact Trust Fund capital. External

Figure 2.29 Government Wages, Republic of the Marshall Islands, FY1993–FY2003



Source: Republic of the Marshall Islands, *Government Audit Reports,* Ministry of Finance.

public debt in FY2003 was just over 50% of GDP and was dominated by ADB concessional loans. Debt service was at a manageable level following the 2001 repayment of high-cost commercial debt.

Inflation tends to track that in the US, which supplies 50–60% of imports. The estimated inflation rate in FY2003 was 2.5%, up from 2.0% in FY2002. Commercial banking services are provided by the Bank of Guam and the Bank of the Marshall Islands. Due to persistent defaults on consumer loan repayments, these banks slightly raised their lending rates on consumer loans to 18.5% in FY2003. In contrast, MIDB offered consumer loans at about 14%. The interest rate spread remained in the 7–12% range—with commercial loans at the lower end of the scale, and consumer loans at the upper.

The reexport of diesel fuel associated with the fishing transshipment base in Majuro remained the largest export in FY2003, while domestically generated exports were limited mainly to copra cake and coconut oil. After declining in FY2002, it is estimated that merchandise exports picked up by 12.3% in FY2003, but imports, at about five times the value of exports, rose moderately, and as a result the trade deficit remained substantial. Net income receipts and external transfers ensured another substantial current account surplus. The country's location, small size, and high cost structure continued to be the main obstacles to FDI, despite the possibility of receiving considerable tax and regulatory exemptions of the sort granted to the tuna loining operation.

Policy Developments

The critical policy development in 2003 was the passage into US law in late November of the Compact of Free Association Amendments Act 2003, which sets out the nature and terms of US financial assistance for the period FY2004–FY2023 (Box 2.5). The overall annual financial support potentially receivable in this period, prior to inflation and other adjustments, is in the order of $66 million, or about 60% of the current nominal GDP level. Under the amended Compact, there will be a shift from general budgetary grants to sector grants, characterized by enhanced measures for accountability.

The FY2004 budget was the second formulated within a medium-term and investment framework context, and the phased introduction of performance-based budgeting. It estimates that total revenues and grants will rise by 5.2% from the level estimated in the FY2003 budget. The amended Compact contribution is $57.7 million, including a $7 million US contribution to the Compact Trust Fund. External grants will fund 51.4% of the budget, with tax revenues projected to rise by 3.0% in FY2004. Total expenditures are estimated to rise by 16.4% from the FY2003 figure, so that the budget surplus falls to $7.0 million from $16.0 million in FY2003. The education, health, and environment sectors are to receive substantial increments in their budget allocations.

The Government was returned to office in the November 2003 election and remained committed to the implementation of structural reforms, including the creation of a leaner, results-oriented civil service, tax and tariff reform, SOE reform, and enhancement of the environment for private sector activities. In 2003, a review of management systems and pay scales in the civil service was under way and several initiatives to facilitate private sector development were introduced. These included the amendment of the Development Land Registry Act, increased provision of business development services, streamlining of company registration processes, and the start of a process of strengthening land management and administration. However, transaction costs for foreign investment licensing remained high and no discernible progress was made in reforming the

regressive taxation system. The financial performance of most SOEs remained poor in 2003, and the Government had still to follow through on its stated intention to divest itself of unprofitable businesses.

Outlook for 2004–2005

It is highly unlikely that there will be a significant medium-term expansion in the private sector, independently of public sector developments. It is accepted that the key to generating such an expansion is foreign investment in export-oriented ventures, but pilot projects in outer island tourism as well as farming seaweed, black pearls, and fish have not resulted in commercially viable outcomes, and there has been no notable foreign investment since the 1997 establishment of the tuna loining plant. Consequently, the public sector will continue driving the economy over the medium term.

The FY2004 budget provides for a boost to public expenditures, particularly in the health and education sectors, in line with the amended Compact. This is expected to create a demand-side stimulus to the economy, which is forecast to grow by 2–3% in FY2004. Major capital projects will probably only start in late 2004, and this will provide a stimulus in the years to come. In addition, there will be a one-off increase in Compact sector grant assistance in FY2005 of $5.6 million, prior to the phased $0.5 million annual reduction planned for subsequent years. Growth in FY2005 is expected to be around 3%. Cyclones and drought, which have had major impacts on subsistence agriculture and fishing in the past, as well as on physical infrastructure, could cause output volatility in the medium term. Inflation is forecast to remain in the 2–3% range in FY2004 and FY2005, in line with trends in the US economy.

The balance-of-payments profile is forecast to remain fundamentally unchanged in the medium to long term. The performance on the trade account will depend crucially on diesel reexports, which in turn will be a function of the transshipment business and thus the tuna catch and price. Copra production may be stimulated by a possible liberalization of the buying arrangements, but the copra processing plant is heavily subsidized and makes a negative contribution to GDP. The large trade deficit is expected to continue to be more than covered by net income from remittances and official transfers.

Over the long term, the Government faces the major fiscal challenge of managing the adjustment to a decline in Compact funds and placing government revenues on a sustainable basis. A promising start was made with the initial allocation of the bulk of "bump up" Compact funding in FY2002 and FY2003 to the MIITF, but the diversion of $7 million to MIDB in late 2003 is a fiscal governance concern, and sizable budget surpluses will need to be run into the future, in order to build up the Fund to the required level. The medium-term budget and investment framework for FY2004 and FY2005 projects surpluses in the $7 million–10 million range, which at under 6% of GDP may prove to be insufficient to build up the Fund. A comprehensive reform of taxation and tax collection is needed but faces strong opposition from groups with vested interests in maintaining the current tax arrangements. In addition, budget pressures could arise in the long term if sea-level rise causes accelerated coastal erosion, greater risk of storm surges, and excessive saltwater intrusion into fragile freshwater resources.

The Government is committed to poverty reduction and is planning to implement projects aimed at improving transport and basic social services to the outer islands, where hardship is somewhat higher. However, the prospects are that the numbers of unemployed and disadvantaged in Majuro and Ebeye, where two thirds of the population live, will rise. The rate of increase in the labor force is expected to outpace the rate of job creation by a wide margin, making emigration an even more important means of relieving population pressures and placing private sector development as a main item on the government agenda for future economic growth.

Box 2.5 The Amended Compacts of Free Association of the United States with the Federated States of Micronesia and the Republic of the Marshall Islands

On 20 November 2003 the US Congress passed the Compact of Free Association Amendments Act of 2003. The legislation revises the two Compacts of Free Association signed in 1986 with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI). The 2003 Compact sets forth the terms of financial assistance, estimated at more than $3.5 billion, from the US to the two countries for a 20-year period starting from fiscal year (FY) 2004, i.e., from October 2003.

Over the 17 years (FY1987–FY2003) from the start of the two original Compacts, the US provided a total of approximately $2.1 billion ($1,350 million to the FSM and $750 million to the RMI).

The main objective of the amended Compact is to enable the two countries to achieve economic self-reliance by the end of FY2023. Although there are provisions specific to each of the two countries (see the relevant country chapters), it includes several features common to both (as follows).

Coordination through Joint Committees. Compact funds are to be managed and monitored through a mechanism of joint committees. These are, respectively, the Joint Economic Management Committee (JEMCO) in the FSM and the Joint Economic Management and Financial Accountability Committee (JEMFAC) in the RMI. Among other things, the joint committee in each country will review planning and budget documents of the government, monitor the progress of the country toward sustainable economic development and budgetary self-reliance, review and approve annual grant allocations and performance objectives, and review quarterly trust fund investment reports.

Grants for Key Sectors. Grant assistance under the amended Compact is targeted for specific purposes, with priority accorded to six key sectors. Annual sector grant assistance gradually declines over the 20-year term. The grant reduction amount is matched by a corresponding increase in annual contributions to trust funds established for the two countries. Priority sectors are education, health, environment, private sector development, public sector capacity building, and public sector infrastructure development and maintenance. The allocation of funds among these sectors will be decided through a medium-term planning process to be prepared by the FSM and the RMI governments. Priority funding sectors are education, health, and infrastructure. Public sector infrastructure development and maintenance are identified as one of the grant sectors in the FSM agreement, while in the case of the RMI, not less than 30% and not more than 50% of total grant assistance must be channeled to infrastructure development and maintenance. In addition, in both countries, 5% of the grant amount allocated to infrastructure, combined with a matching amount from the respective government, is placed in an Infrastructure Maintenance Fund.

Establishment of a Trust Fund. Central to the amended Compact is the establishment of a trust fund, in each country. These trust funds are meant to ensure sustainable sources of revenue and foster economic self-reliance, in anticipation of the fact that the financial support under the amended Compact is scheduled to end in September 2023. The amended Compact provides for US government control over the administration of the two trust funds until FY2023. Each country is required to provide $30 million to set up its respective trust fund. Initial contributions by both countries will be augmented annually by the gradually increasing contributions from the US. All earnings from the trust funds will remain untouched until 2023 and will be reinvested. At an assumed annual rate of return of 6%, each trust fund is expected to generate earnings from 2023 onward that would be enough to replace the annual US contributions to their budgets.

Continuing Access to Selected US Federal Programs. The amended Compact ensures continued access to several US federal programs for FSM and RMI citizens, while an agreement was reached to "cash out" other previously available programs. In particular, supplemental education funds were provided in lieu of continued eligibility for certain education grants. For programs that will be terminated, the cash equivalent of the assistance previously provided has been reflected in the financial package. Continued access to essential programs from the Department of Homeland Security and the Federal Emergency Management Agency was agreed until FY2008, while negotiations for new disaster assistance arrangements are expected to start soon.

Accountability and Reporting Mechanisms. New procedures have been introduced to enhance financial accountability and economic management, such as targeted priority areas for grant assistance, expanded reporting requirements, coordination, and overall supervision by the respective JEMCO, and the possibility for the US Government to withhold funds in case of noncompliance with grant terms and conditions. The governments of the FSM and the RMI are required to submit annual budgets with sector expenditures and performance measures, annual reports on the use of assistance, quarterly and annual financial reports, and quarterly grant performance reports. Annual audit grants (in the amount of "up to the lesser" of $500,000 or one half the annual audit cost) are also provided to both countries in order to conduct effective financial control and monitoring.

The amended Compact also deals with defense arrangements, immigration provisions, and special provisions for judicial training.

Sources: United States Congress; Compact Negotiations Office, Republic of the Marshall Islands; Joint Committee for Compact Economic Negotiations, Federated States of Micronesia.

Federated States of Micronesia

The economy is estimated to have recorded only slight growth in FY2003, with considerable variation in the economic performance of the four states. Another economic downturn is expected in FY2004 as the economy adjusts to the new assistance provisions under the amended Compact of Free Association. A return to moderate expansion is forecast for FY2005.

Economic Assessment

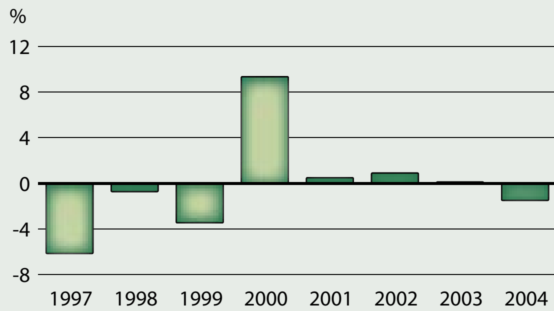
GDP growth fell to an estimated 0.1% in FY2003 (ended 30 September 2003) following a rise of 0.9% in FY2002. This national average reflected the impact of contraction in the public and financial sectors, but the four state economies displayed considerable economic variation. The Pohnpei economy, which includes the national Government and accounts for 45% of national GDP, contracted by an estimated 2.8% because of declining private sector and public enterprise activity, while the government sector expanded. The smallest state economy, Kosrae (9% of GDP), experienced a broad-based contraction of 4.5%. In contrast, the Chuuk (30% of GDP) and Yap (17% of GDP) economies grew by 2.2% and 7.5%, respectively. In Chuuk, private sector strengthening more than offset the effects of contraction in the public and financial sectors, while in Yap a strong private sector was reinforced by growth in public enterprise activities.

Aggregate employment was down by almost 1% in FY2003, as falling employment in public administration, manufacturing, and finance outweighed increases in the trade, hotels and restaurants, and education sectors. The drop in employment was concentrated in Chuuk state, due to a substantial drop in government employment. Two factors that distort the labor market are the high level of public sector wages relative to those in the private sector (about double); and the ease of migration to high-wage locations such as Guam, Commonwealth of the Northern Marianas, Hawaii, and mainland US.

In FY2003, the overall budget recorded a surplus of 1.9% of GDP, as consolidated revenues and grants for the national and four state governments went up by 2.1% to $163.7 million, while total expenditures rose by 3.1% to $159.6 million. Most of the improvement in revenues and grants came from higher levels of fishing license fees, dividend and interest income, and external grants, with the last element constituting 70% of total revenues and grants. Two thirds of the rise in total expenditures was attributable to higher capital spending, while the increase in current expenditures stemmed from a higher wage bill. All of the state governments ran budget surpluses in FY2003, but the national Government recorded a deficit for the seventh successive year. Total official external debt outstanding at the end of FY2003 was $54.3 million, or about 24.5% of GDP, with debt servicing equivalent to 6.1% of exports. The debt position was further enhanced by the fact that the five governments held portfolio investments in an External Debt Management Fund. Adjusting for these assets, the unsecured component of external debt was equivalent to about 9% of GDP.

Following the November 2002 closure of the Bank of Hawaii, Federated States of Micronesia (FSM) branch, only two commercial banks were operating in 2003. Total deposits in the

Figure 2.30 GDP Growth, Federated States of Micronesia, FY1997–FY2004



Source: National Accounts worksheet as of December 2003, Economic Management Policy Advisory Team Web site, available: www.empat.fm/statistics/stats.htm.

commercial banks at end-FY2003 were 6.9% higher than at end-FY2002. Commercial loans fell by 52% as the banks restricted lending in response to accumulating arrears on commercial loan repayments, which in turn reflected a deterioration in the timeliness of state and national government payments to private service providers. Consumer lending fell by 23.3% because of a similar arrears problem and declining government employment levels. Prices tend to track those in the US, and in FY2003 estimated deflation was unchanged from the prior-year rate of 0.2%, and was largely attributable to falling food prices.

Exports edged up by 2.4% in FY2003, reaching $20.1 million. Imports increased by 8.3% to $108.9 million and the merchandise trade deficit consequently widened. The deficit on the services account remained virtually unchanged at $28.4 million, with tourism arrivals declining by 3.0%, while the surplus on the income account widened on the growth in fishing access fees. Unrequited transfers, primarily Compact and other official transfers, increased significantly to $119.0 million. As a result, the current account surplus rose to $16.3 million, or 7.3% of GDP, while the surplus on the capital account dropped to 31% of its FY2002 level because of a large short-term outflow. The overall balance-of-payments surplus was 12.5% of GDP.

Policy Developments

The crucial policy development in 2003 was the passage into US law in late November of the Compact of Free Association Amendments Act 2003, which sets out the nature and terms of US financial assistance for the period FY2004–FY2023 (Box 2.5). In order to meet their obligation of contributing $30 million to the start-up capital of the Compact Trust Fund, the national and state governments committed to save $30 million of the $34 million in "bump-up" Compact funding received in FY2002 and FY2003. By the end of FY2003, $27 million had been provided. The deadline for completion of contributions is 30 September 2004, and an initial $16 million US pledge to the Trust Fund is conditional on this deadline being met. Further contributions of $16 million are expected by the US in FY2005 and FY2006.

Under the amended Compact, there will be a shift from general budgetary grants to sector grants linked to performance conditions. The sector grant assistance receivable during FY2004–FY2023 is $76.2 million in the first year, rising to $88.4 million in FY2005 and FY2006, and declining thereafter by $800,000 annually. As noted, this annual decrement will be matched by contributions to the Trust Fund, so that US financial contributions will be $104.9 million annually from FY2005 (prior to adjustment for inflation and inclusive of annual audit grants of $500,000). Given the more rigorous accountability provisions under the amended Compact, the FSM Economic Policy Implementation Council endorsed an Accountability Improvement Project aimed at ensuring that future grant assistance is not jeopardized by inadequate public expenditure management and reporting.

The planned reduction in Compact grant assistance from $99 million in FY2003 to $76.2 million in FY2004 (exclusive of Trust Fund contributions) was reflected in the formulation of the FY2004 budget, which primarily involved expenditure cuts to produce an overall budget surplus estimated at 1.9% of GDP. It was also recognized that an increased revenue effort was required at national and state levels. Following a national revenue symposium in early FY2003, key reform elements included a move to a broad-based consumption tax, the establishment of an Autonomous Unified Customs and Tax Administration to replace current national and state

authorities, and a rationalization of current revenue-sharing arrangements. However, little progress in implementation was made subsequently. A constitutional amendment to enable simultaneous national and state jurisdiction of a VAT failed to gain the required level of voter support, and no progress was made in establishing an autonomous tax administration. Changes to revenue-sharing arrangements in late 2003 effectively reduced, rather than raised, the revenue share of the state governments, which bear most of the responsibility for service delivery.

Following the election of the 13th FSM Congress in 2003, the new President called for a third FSM Economic Summit to be held in April 2004 as part of the formulation by consensus of a strategic development plan. An amended Compact requirement, the plan is expected to incorporate a private sector development strategy initiated in 2003. At the same time, a long-term infrastructure development plan will be formulated to guide public investment in a manner that is consistent with the sector priorities identified in the amended Compact. Remittances are not an important macroeconomic variable at present, but there is potential for them to grow and sustain FSM income levels as external grants decline over time.

Outlook for 2004–2005

A decline of 1.5% in GDP is projected for FY2004 because of an anticipated fiscal shock of approximately 10% of GDP (Figure 2.30). This fiscal shock is the combined result of a 7.3% reduction in Compact transfers to national and state government budgets, and the delayed availability of infrastructure sector grant funding. The reduction in transfers will be partially offset by spending of reserves and, in Yap and Chuuk, spending under US Federal Emergency Management Agency typhoon-relief programs. The delay in infrastructure project spending means that $18 million, or 24%, of the planned $76 million Compact transfers are effectively frozen in FY2004. The latter funds will become available in FY2005 and, with a rise in sector grant assistance under the amended Compact, are expected to contribute to an economic recovery. Growth in GDP is forecast at 2.2% in FY2005.

The major risk to the above scenario is that the national or state governments may fail to meet the accountability requirements of the amended Compact, in which case cash transfers to one or more of the governments could be suspended. Growth could exceed expectations if improvements in the private sector enabling environment pull in greater volumes of domestic and foreign investment in agriculture, fishing, and tourism. Such improvements would result from land tenure reform, streamlined investment approval and licensing procedures, and improved management of public utilities and of physical infrastructure. Inflation is forecast to remain low, rising to 0.5% in FY2004 and 1.2% in FY2005, in line with the US inflation rate.

The balance-of-payments profile is forecast to stay fundamentally unchanged in the medium term. The limited base of primary product exports is not projected to expand significantly, while import expansion will remain in line with aggregate economic growth rates. Accordingly, the merchandise trade deficit is projected to narrow in FY2004 before returning to about the FY2003 level the following year. The current account surplus, inclusive of official transfers, is forecast to decline as amended Compact funding drops in FY2004, offsetting any increases in tourist arrivals and fishing access fees. The external debt is primarily concessional and will remain manageable.

Over the long term, the five FSM governments face the major fiscal challenges of managing the adjustment to the decline in sector grants and of placing government revenues on a sustainable basis. In FY2007, the reduction in real official transfers is estimated to be equivalent to 0.6% of GDP, and the national Government's economic modeling suggests that during the amended Compact period a compensatory rise in taxation revenues from the present level of about 12% of GDP to over 16% is needed. A comprehensive reform of taxation and tax collection is required but faces strong opposition. Sizable budget surpluses will be needed into the future to build up the Compact Trust Fund to the required level, with the completion of contributions to the Fund scheduled for 2004 representing a major initial test of the national and state governments' commitment.

Nauru

With phosphate reserves nearly exhausted, and the situation exacerbated by prolonged economic and financial mismanagement, a complete collapse of the economy has only been averted by financial assistance from Australia. Urgent measures to improve governance and restructure government finances are now critical.

Economic Assessment

Any economic analysis for Nauru relies heavily on qualitative information and has to be interpreted cautiously as recent data are not available. In 2003, the financial and economic situation continued to deteriorate, as the main natural resources, phosphate reserves, have become nearly exhausted. At the current level, revenues from phosphate production do not cover operating costs, and royalty and dividend payments have been delayed. Phosphate exports were at a virtual standstill in most of 2003 following strikes, sabotage, and other disruptions in production and shipping.

With the decline in phosphate revenues, borrowings against trust fund assets administered by the Nauru Phosphate Royalties Trust (NPRT) have represented the Government's main revenue source. The total value of NPRT assets has declined from an estimated A$1.3 billion in 1990/91 to an estimated A$300 million today, and stems from poor investment decisions and other bad management. The remaining NPRT assets are now almost fully, and relatively expensively, mortgaged.

The size of the budget deficit for the last 3 fiscal years is unknown. FY2003 (ended 30 June 2003) provided for a deficit of A$15.2 million, though the actual budget deficit is expected to have been much higher. In FY2004, expenditures are estimated at A$40 million and revenues at A$18 million.

The Nauru Phosphate Company (NPC) and other SOEs are under pressure to retain high staffing levels despite declining output, but are unable to meet salary expenses. With the Government and NPC no longer able to absorb the increasing number of young job market entrants, youth unemployment has risen to an estimated 35%, impacting severely on standards of living.

Nauru uses the Australian dollar as its currency, thus inflation tends to follow Australia's (2.8% in 2003).

There are no reliable commercial banking services in Nauru. The Bank of Nauru, the country's main bank, is illiquid and insolvent by international standards and is operating only on a very limited basis. Public entities continue to use the bank and the Government issues the bank's checks to fund its budget deficits and royalty payments to landowners.

The country is plagued by frequent fuel, power, and water shortages while the cost of living has increased. Air Nauru, the only airline servicing the country, faced repeated interruptions in 2003, due both to a shortage of funds for lease and maintenance payments and to fuel supply disruptions. Education and health services have deteriorated and suffer from a chronic shortage of skilled staff. Greater numbers of Nauruans have therefore resorted to subsistence farming and fishing.

A complete collapse of the economy has been averted by the continuing support of external

sources, particularly Australia's humanitarian and development assistance linked to Nauru's agreement to host asylum-seekers. Australia's assistance has been essential in maintaining water and power supplies as well as education services. Health is receiving substantial support from both Australia and the International Organization for Migration in return for services in refugee camps. In February 2004, the governments of Australia and Nauru signed a new memorandum of understanding providing for A$22.5 million in assistance for the period July 2003–June 2005.

Policy Developments

A new Government was elected in May 2003. It committed to return to the fiscal and financial reform program initiated in 1998. Recommended priorities for reform include (i) addressing the structural budget deficit through expenditure reduction, improvements in revenue collection, and new revenue measures; (ii) restructuring the trust funds; (iii) overhauling arrangements for the management of public finance and public enterprises; (iv) reassessing arrangements for the provision of air services by Air Nauru; and (v) reestablishing commercial banking services.

The Government was overturned in August 2003 and the momentum for reform reversed. Nevertheless, a National Economic Forum was held in October 2003. The consultations that preceded the forum demonstrated general support among the population for increasing government transparency and accountability, widespread acceptance of reductions in government spending, and increases in revenue-raising efforts, provided that the Government adopted improved governance standards. The new Government expressed commitment to consider the recommendations of the forum.

Nauru remains on the OECD's list of Non-Cooperative Countries and Territories of the Financial Action Task Force (FATF) on Money Laundering. Sanctions have been imposed since December 2001 and have hurt the economy. To comply with the FATF recommendations, the Government revoked all banking licenses issued by the Bank of Nauru, enacted legislation eliminating its offshore shell banks, and passed an antimoney-laundering act and new banking legislation. However, additional steps will be necessary before countermeasures are removed. In late 2003, Nauru was, though, removed from the OECD List of Uncooperative Tax Havens following a commitment to improve transparency and establish effective exchange of information on tax matters with OECD countries.

Outlook for 2004–2005

The medium-term outlook is very bleak, particularly in light of the Government's lack of commitment to confront the drastic structural changes essential for reversing the economic decline and bringing back political stability.

The promised assistance package from Australia relieves some of the most immediate pressures. The package also includes provisions for Australian personnel serving in line positions, including an Australian Secretary of Finance, with a clear mandate to address key economic and financial reforms. Agreed tasks also include auditing and assessing the remaining assets of the trust funds and beginning a restructuring of these assets.

Measures to reduce the structural budget deficit are needed. With the steep decline in the value of the NPRT, few options remain for the Government to fund future budget deficits. The failure to reduce expenditures—particularly the public sector wage bill—and to address revenue shortages through taxation and cost recovery remains a particular concern.

Currently the revenue base is very narrow. Some phosphate reserves are left and production could increase to break-even level for several more years, but significant dividends are unlikely. There is an urgent need to restructure the investment portfolio away from its current reliance on property investment, and to maximize income from the remaining trust funds. Few opportunities exist to develop agriculture and service industries targeting the local market, or to expand revenues from licensing of foreign fishing vessels. Improvements in the efficiency of provision of public utilities, including telecommunications, power, and water, as well as stronger mechanisms for cost recovery, are crucial for reducing the dependency on emergency Australian aid.

Papua New Guinea

The economy emerged from recession to record modest, broad-based growth in 2003 and improved public finances. Moderate expansion in the medium term is achievable, but will require strengthened performance from the nonmining sectors and implementation of difficult fiscal adjustments.

Economic Assessment

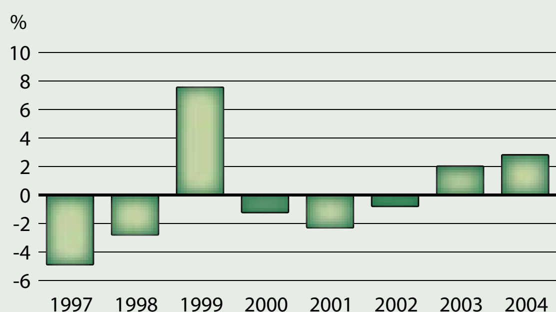
After 3 successive years of contraction, GDP rose by 2.0% in 2003 (Figure 2.31), and was relatively broad based. Output of the oil and gas and of the mining sector, which together account for one quarter of GDP, picked up by 3.4% in response to rising minerals and metals prices. The nonmining sectors edged up by 1.7%. The agriculture, forestry, and fishing sector expanded by 1.6%, aided by favorable weather, an early coffee harvest, and generally strong commodity prices. Manufacturing and construction both climbed by close to 5%, the latter sector stimulated by investments in a new oil refinery and a tuna processing plant, and improvements to the Highlands Highway. Services grew by 2.3%.

The pickup in economic activity was reflected in employment growth in both the mining and nonmining sectors, with the private sector employment index rising by 8.9% between June 2002 and June 2003. Employment rose strongly in construction, but less so in cocoa, palm oil, vanilla, and tuna production. Nonetheless, with private sector investment remaining subdued and annual new entrants to the labor market totaling an estimated 80,000, the greater labor demand fell well short of the expansion in supply.

The 2003 budget deficit was officially estimated at 1.7% of GDP, compared with an original budget target of 2.0%. Total revenues and grants amounted to 31.7% of GDP and exceeded budget expectations, largely because of unexpectedly high receipts from mining and petroleum tax and dividends. These receipts more than compensated for a shortfall in indirect tax revenues, which was attributable to stagnant domestic consumption. Higher revenues permitted the Government to retire some domestic debt. Total expenditures and net lending exceeded the original budget estimate, reaching 33.4% of GDP. Development spending fell by even more than the budgeted amount, but recurrent expenditures exceeded the budget estimate by 6.7%. This stemmed largely from increased expenditures on domestic debt servicing. The wage bill of national departments was relatively well controlled, but still constituted 49.3% of their total recurrent expenditures. With asset sales falling short of the budget figure, and negative external financing generated by amortization of loans from bilateral and multilateral creditors, the budget deficit was financed by short-term government domestic borrowing. In consequence, total public domestic debt rose to 27.3% of GDP, from 23.5% in 2002. However, the stock of external debt fell from 48.0% of GDP at end-2002 to 47.0% at end-2003.

Inflation in the year to September 2003 edged down to 11.8% from 12.3% in the same period in 2002. The rate accelerated in the first quarter of 2003, primarily as a result of the lagged effects of currency depreciation in late 2002 (particularly against the Australian dollar), as well as higher domestic food prices, an increased tobacco excise rate, and higher school fees consequent upon the Government's removal of education subsidies. In

Figure 2.31 GDP Growth, Papua New Guinea, 1997–2004



Source: Papua New Guinea 2004 National Budget, Volume 1: Economic and Development Policies, November 2003, Table A3.1.

response, the central bank tightened monetary policy. A reduction in inflationary pressures after midyear led the bank to reduce the official Kina Facility Rate to 14.0% in October, when the bank also reduced the cash requirement rate from 5.0% to 3.0%. Treasury bill rates dropped to 16.95% in December and commercial banks reduced their weighted average lending rate to 13.4% in November.

A cautious monetary policy stance was maintained for the purposes of exchange rate stability as well. Money supply fell by 8.4%, largely because of a drop in credit to the private sector. Tighter macroeconomic policies and stronger export revenues underpinned a relative stabilization of the kina in 2003, which appreciated against the US dollar, yen, and pound sterling, but depreciated by 9.0% against the Australian dollar by year-end (for a 20% depreciation since January 2002). Given that about half of the country's imports are denominated in the Australian currency, this depreciation was a major reason for recorded price level rises.

The trade surplus in 2003 is estimated to have surged from the 2002 level as a result of strong growth in oil and gold exports and a fall in merchandise imports. In 2003, the US dollar prices for oil and gold were up by 15.9% and 17.3%, respectively, from the average prices recorded in 2002. The current account moved from a deficit of 4.6% of GDP in 2002 to an estimated surplus of 9.1% in 2003. However, the capital account went in the opposite direction, as net outflows of both direct and portfolio investment were recorded, with a withdrawal of foreign investments in the minerals sector and a rise in foreign asset holdings by resident companies. The overall balance of payments moved from an officially estimated deficit of 2.2% of GDP in 2002 to a surplus of 2.8% in 2003. Foreign reserves at end-2003 provided 5.0 months of total import cover, compared with 4.2 months a year earlier.

Policy Developments

Consistent implementation of sound macroeconomic policies has been undermined in the past by political instability, and several political measures were undertaken in 2003 to remedy this, though many unresolved issues remain.

While the 2004 budget strategy continues the "stabilization with growth" approach introduced in 2003, a lower budget deficit of 1.5% of GDP is targeted for 2004, and is to be funded by domestic borrowing. External financing is again negative; the Government plans to meet the amortization due on previous commercial and concessional loans by undertaking relatively costly new external commercial borrowing (equivalent to 1.6% of GDP), in addition to anticipated external concessional borrowing (1.3% of GDP).

The main 2004 budget initiatives on the revenue side include the imposition of a temporary 2% import levy (for 2004 only) and a reduction in income tax rebates for dependents. These initiatives, alongside improved tax compliance, are expected to offset a drop in revenues from the mining and oil and gas sectors, which is mainly attributable to a budget forecast that the oil price will fall by 7% in 2004. However, if the oil price stays close to 2003 levels, the revenue outcome will be stronger than anticipated. Expenditure control measures include continuing the public service recruitment freeze, with the exception of more recruitment of teachers; cleansing the payroll of ghost workers; terminating the contracts of nonessential casual employees; and granting what in theory are "minimal" wage increases. However, these increases actually involve a budget provision for a 6.7% rise in the wage bill of national departments, so that keeping recurrent expenditures close to the 2003 level is to be achieved by cutting national departments' goods and services expenditures,

Table 2.24 Major Economic Indicators, Papua New Guinea, 2001–2005, %

Item	2001	2002	2003	2004	2005
GDP growth	-2.3	-0.8	2.0	2.8	1.7
Gross domestic investment/GDP	-	-	-	-	-
Inflation rate (consumer price index)	9.3	11.8	11.8	8.7	9.6
Money supply (M2) growth	4.2	9.4	-8.4	-	-
Fiscal balance/GDP	-3.6	-4.1	-1.7	-1.5	-1.1
Merchandise export growth	-13.7	-9.5	27.5	-4.0	-5.5
Merchandise import growth	-6.4	14.6	-4.6	2.1	-1.4
Current account balance/GDP	9.5	-4.6	9.1	5.0	3.2
Debt service ratio	7.1	7.4	8.3	9.3	9.8

- = not available.

Sources: Bank of Papua New Guinea, *Quarterly Bulletin*, various issues; *Papua New Guinea 2004 National Budget, Volume 1: Economic and Development Policies*, November 2003; staff estimates.

reducing grants to provincial governments, and paying less in domestic debt servicing as a result of lower interest rates on treasury bills. Development spending is forecast to rise, with the bulk of it going on infrastructure and social development. However, the forecast appears unrealistic in view of the country's limited absorptive capacity. Overall, the 2004 budget maintains aggregate fiscal discipline but does little to improve the strategic allocation of public resources. A public expenditure rationalization review has been completed and work on the medium-term fiscal framework is continuing. Additionally, a public sector reform program has been drafted, and the 2004 budget states the Government's intention to downsize the public service head count by at least 10% over a 3-year period.

In 2003, the central bank demonstrated its capacity to conduct an independent monetary policy aimed at protecting foreign reserves and stabilizing the kina, and thereby built confidence among the business community. However, the scope for monetary easing and interest rate reductions is limited both by the risk of capital flight and consequent currency depreciation, and by the domestic financing requirements of the 2004 budget deficit.

The medium-term development strategy for 2003–2007 and the long-term national poverty reduction strategy were still being formulated at the end of 2003. A key issue for the medium to long term is how to accelerate income growth, improve equity, and reduce poverty in a context of a probable secular decline in oil and gas production and slow growth in mineral production. This contrasts with the fact that exploration has increased as a result of the phaseout of the Government's mining levy, and that the Highlands gas project has moved further toward commercial viability. An expansion of private sector activity in the nonmining sectors is needed, and the Government has introduced a tax incentive package aimed at encouraging investment in agriculture. However, private business remains concerned at the lack of law and order and the uncertainty of the political environment. The absence of personal security is a major obstacle, affecting in particular the development of tourism.

Outlook for 2004–2005

GDP is forecast to grow by 2.8% in 2004 and 1.7% in 2005. Agriculture, forestry, and fishing is forecast to expand by 3.0% and 3.4% in these years, as production of major crops and logs picks up in response to generally higher US dollar commodity prices and as tuna production rises in response to demand from the new processing facility. Achieving these rates requires favorable weather conditions, realization of planned expansion in palm oil production, and continued efforts to encourage smallholder coffee production. The

provision of better transport infrastructure and an improvement in market access are also needed. With the effective ending of a moratorium on issuing new timber licenses, the growth forecast also assumes a return to logging at rates recorded in the mid-1990s, thus raising renewed concerns about the sustainability of the harvest.

The oil and gas sector is expected to grow strongly in 2004 as the Moran oil field reaches full production. In contrast, mining output is expected to contract in 2004, with the cessation of operations at the Porgera and Misima gold mines outweighing the stimulus of a forecast 7.5% rise in the gold price. Output is then expected to grow slowly in 2005 as the Kainantu gold mine begins operations and the Ok Tedi copper mine steps up production. The net result for the oil and gas and mining sectors together is that real output in 2005 is projected to be just 0.1% above the 2003 level. However, this official forecast is based on the assumption of declining US dollar prices for oil in 2004–2005, a drop in the gold price in 2005 after the 2004 rise, and a 7% rise in the copper price in the next 2 years. In fact, oil and metals (especially copper) prices in 2004–2005 are most likely to be significantly higher than the budget forecasts, such that the official growth projections for these two sectors are conservative. Stronger expansion in mining GDP could push the aggregate growth rates toward 3.0% in 2004 and 2.0% in 2005.

Manufacturing is forecast to grow by 2.2% in 2004 and 2.8% in 2005 on the basis that tighter government budgets will be counterbalanced by some strengthening in private sector domestic demand as inflation drops into the 8–10% range, interest rates fall (to about 12% for treasury bills), and the exchange rate remains stable. Stronger domestic demand is also expected to stimulate modest growth in the services sector. The official forecasts for the manufacturing and services sectors seem plausible, but the private sector response to improved economic management has historically been sluggish. Growth in the construction sector is forecast to slow to 3.0–3.5% in 2004–2005.

Aside from adverse external shocks, the main risk to the official growth forecasts is that the present administration will fail to convince the private sector and potential overseas investors that it is capable of addressing the country's economic and social problems over the medium to long term and that, in consequence, there will be no substantial or sustained revival of business confidence and investment. On the other hand, there has been some investor response to opportunities in the traded goods sector created by the trend depreciation of the kina, as evidenced by expansion of palm oil production and a start of palm oil and tuna processing operations. Moreover, the 2003 budget outcome and control of wage expenditures suggest that economic management has improved.

The official projections of a medium-term decline in inflation and interest rates, and of exchange rate stability, depend on fiscal tightening, disciplined monetary policy, and wage restraint. The budget deficit is projected to fall to 1.1% of GDP in 2005, on the assumption that total expenditure and net lending can be reduced from 33.4% of GDP in 2003 to 29.5% in 2005. This reduction would more than offset an anticipated drop in total revenues and grants from 31.7% of GDP in 2003 to 28.4% in 2005, which is attributable to declines in mining and petroleum taxes and in dividend payments. A shortfall in expenditure savings would jeopardize the targeted reduction in total public debt to 68.3% of GDP in 2005 and place a heavier burden on monetary policy. Additionally, increased pressure for cost of living adjustments for public service workers would make it difficult to achieve the expenditure targets.

A failure to secure the anticipated fiscal improvements would increase pressure on the price level, balance of payments, and exchange rate. The external current account surplus is forecast to decline to 3.2% of GDP in 2005 as oil exports fall, and the overall balance of payments is expected to move into deficit, with import cover in 2005 reduced to 4.6 months.

Even with economic growth at the officially projected rates, job creation will continue to fall well short of providing paid employment to all new entrants to the labor market. This, in turn, will mean higher urban unemployment rates and increased pressure on the semisubsistence agriculture sector on which the vast majority of the poor depend for their livelihood.

Samoa

The services and manufacturing sectors spurred growth in 2003, and inflation fell. Reform efforts focused on civil service restructuring and improving efficiency of the public enterprise sector, while maintaining fiscal discipline. The medium-term outlook is for economic growth in the 3–4% range.

Economic Assessment

GDP growth accelerated to an estimated 5.0% in 2003 from 2.8% in 2002, led by the services sector, particularly commerce, public administration, and transport and communications. Some manufacturing activities also grew strongly as the strengthening of the world economy stimulated manufacturing of automotive wiring harnesses. Tourist arrivals picked up from the 2002 levels. Remittances were up substantially, constituting close to 20% of GDP and providing a major demand-side stimulus to the economy. In the second quarter of 2003, agriculture started to grow for the first time since the last quarter of 2000. The fishing industry experienced a significant weakening due to unfavorable climatic conditions, while construction activity slowed as a result of both the completion, and deferral, of several major public sector projects.

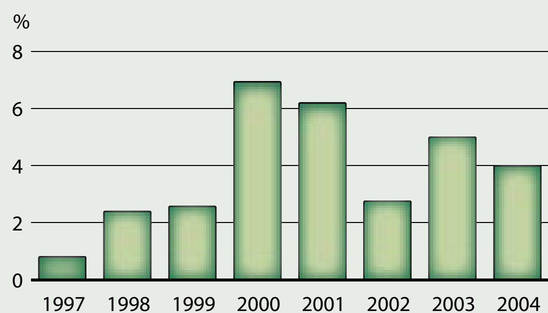
In 2003, formal sector employment growth in the commerce, hotels and restaurants, and personal services subsectors was probably sufficient to absorb a large share of new entrants into the labor force, though out-migration continued. The resident population age 15 years and above grew annually at 0.9% in 1991–2001, and those unable to find wage employment were usually absorbed into the agriculture sector. However, a relatively large number of Samoan individuals and families experience hardship in the form of inadequate access to cash income-earning opportunities and to basic services.

In FY2003 (ended June 2003), Samoa posted a budget deficit of 0.6% of GDP, in contrast to the target surplus of 1.9%. Total revenues and external grants were equivalent to 32.9% of GDP, just below the budget estimate, due to a shortfall in nontax revenue. Tax revenue estimates of 22.4% of GDP were realized primarily because of the October 2002 increase in the value-added and goods and services tax (VAGST) rate from 10.0% to 12.5%, supplemented by rises in excise taxes and an extension of income tax to the commercial fishing sector from 1 January 2003. Current expenditures, at 21.9% of GDP, came in slightly below budget estimates, while development expenditures were 9.4% of GDP compared with an original budget estimate of 11.2%, since development projects were delayed.

Net lending substantially exceeded the original estimate because of a shortfall in repayments of advances and interest by government-owned corporations. Official external debt was equivalent to about half of GDP at end-September 2003, and debt servicing costs were equivalent to 6.1% of exports of goods and services.

Inflation declined over the course of 2003 to 0.1%, compared with 8.1% in 2002. The fall reflected the ending of the one-off impact from the late-2002 VAGST rate rise and a drop in domestic food prices, while there was little change in the import component of the CPI. In 2003, broad money supply rose by 14.0%, and credit from commercial banks to the private sector and public institutions grew by 6.5%. The central bank

Figure 2.32 GDP Growth, Samoa, 1997–2004



Sources: Ministry of Finance, Economic Planning and Policy Division, *Quarterly Economic Review, July–September 2003*, January 2004 issue, Table 2.1; *2002 National Accounts*; staff estimates.

tightened the monetary policy stance during the second quarter of 2003, continuing its reliance on open market operations as the primary monetary policy instrument. Interest rates on all maturities of central bank securities rose. The monetary policy stance was eased later in the year to stimulate private sector growth. In October, the average commercial bank lending rate stood at 11.3%.

After registering a small overall surplus in 2002, the overall balance-of-payments deficit for 2003 was about 1% of GDP. In 2003, export revenue was down by 4.3% in domestic currency terms, while imports were 10.4% lower, leading to a narrowing of the merchandise trade deficit. The export outcome reflected a substantial fall in fish exports, which was partly offset by growth in garment exports. Tourism receipts and private remittances grew significantly. Early in 2003, official loan disbursements fell, and a large one-off payment was made, associated with the early return by the state-owned Polynesian Airlines of a leased aircraft.

Net foreign reserves in October were marginally above the level in October 2002, and provided increased import cover of 5.2 months partly due to the import decline. In 2003, the domestic currency, the tala, appreciated by 15.1% against the US dollar and 3.6% against the Japanese yen, but depreciated against the euro (3.9%), Australian dollar (13.9%), New Zealand dollar (8.0%), and Fiji dollar (2.4%). Overall, the nominal and real effective exchange rates of the tala remained relatively stable.

Policy Developments

During the FY2004 budget preparation process, some pressure to relax fiscal policy became evident. In order to sustain tourism development, the Government committed to providing further budgetary support to keep the financially troubled Polynesian Airlines operational, equivalent to about 2% of GDP. Construction of a major hotel has begun.

The overall budget deficit for FY2004 is projected to be 1.5% of GDP. Total revenues and grants are expected to rise by 4.9% from the actual level in FY2003, with no major new revenue-raising measures introduced. Total expenditures and net lending are projected to increase by 7.5% from the previous year's level. Current expenditures are up by just 2.9% as ministries' budgets are held to their FY2003 levels under the new public administration structure effective in FY2004. The new structure was introduced as part of the government Institutional Strengthening Program and replaces 28 departments with 14 ministries.

Development expenditures are projected to rise by 7.6% as previously delayed infrastructure projects come on stream. Under the budget, net lending to government corporations and public enterprises increases by 54.6%, underlining the importance of reducing this drain on the public purse. In this regard, attaining commercial viability of the national airline is a specific need, but a broad public enterprise reform agenda that was officially endorsed in late 2003 will also need to be implemented. The budget deficit is to be financed mostly by concessional external borrowing (92%). However, external debt, high by regional standards, will need to be contained over the medium term.

In line with the current medium-term development strategy, resource allocation in the FY2004 budget aims at supporting development of human resources, agriculture, infrastructure, small businesses, and community services. In an attempt to redress widening rural-urban income disparities, the focus is on rural areas. Initiatives in agriculture include construction of a national abattoir, a sheep project, and continuation of the copra subsidization program. Additionally, the Government announced its intention to facilitate commercial agriculture and tourism development

by reforming management of communal land, which accounts for 98% of the coastal areas. This policy could involve government leasing of communal land for subleasing to investors.

The monetary policy statement for FY2004 reaffirms the central bank's objectives of maintaining a 3% inflation rate, and maintaining net international reserves at a minimum of 4.0 months of merchandise import cover. In 2003, the central bank was in the process of developing prudential guidelines to govern its supervision of the National Provident Fund and the Development Bank of Samoa, and of building a commensurate supervisory capacity. The regulatory framework for the offshore banking sector was strengthened with the passage of a new International Banking Bill. In 2003, a fourth and locally owned commercial bank began operations.

Outlook for 2004–2005

On 5 January 2004, Samoa's two main islands were hit by tropical cyclone Heta, which generated winds of up to 170 kilometers per hour. Damage was inflicted upon the agriculture, power, and transport and communications sectors, but it was not so severe as to constitute a full-fledged disaster. Rehabilitation work in the aftermath of the cyclone will tend to stimulate economic activity in 2004, but this will be offset by the adverse impact of the cyclone on agricultural production.

The outlook is for 2004–2005 growth in the 3–4% range (Figure 2.32). This will be driven by ongoing and new construction projects in the public sector, which will peak in 2005–2006 as construction for the 2007 South Pacific Games is carried out. Private sector hotel development will provide added stimulus. Fisheries production is expected to recover from its 2003 falloff, if climatic conditions remain favorable, while agriculture is forecast to decline in 2004 as a result of the cyclone damage, before recovering in 2005. Automotive harness manufacture will benefit from expected continued strong growth in the Australian economy.

In contrast, garment manufacture is likely to be hurt by the ending of the MFA in 2005 unless new markets can be found and greater productivity can be achieved in the face of low-cost international competition. A slowdown in the growth of public administration is expected as fiscal restraint continues, but some acceleration in tourism-related sectors is anticipated in response to the reopening of a major resort.

Inflation is forecast to rise to about 3.0% in 2004. While import prices will increase moderately in line with low world inflation, higher food prices due to cyclone damage as well as stronger prices for construction goods and imported fuel will contribute to its rise.

Macroeconomic stability is expected to be maintained, with overall budget deficits remaining at around 2% of GDP over the next 2 years. Monetary policy will continue to be generally accommodative. The major threats to this scenario include a failure to resolve Polynesian Airlines' problems, a return to interventionist policies out of impatience with seemingly sluggish private investment, and a temptation to spend in the lead-up to national elections (scheduled before March 2006).

The balance of payments is forecast to remain in moderate deficit and foreign reserves to drop toward 4 months of import cover. Exports are expected to grow as the fishing industry recovers, beer and *nonu* (Indian mulberry) product exports to American Samoa and Japan increase, and automotive harness exports remain strong. Desiccated coconut exports are also expected to recover after the recent installation of new quality control machinery. The continued strength of the Australian and New Zealand economies will underpin growth in private remittance flows. Imports will grow substantially from a low 2003 base, largely because of construction-related imports. On the capital account, increased official loan disbursements are likely to be partly offset by an expected reduction in external grants.

Economic growth is expected to generate an increase in per capita average income of around 2% annually, and create jobs for those entering the labor market. However, in order to have a significant impact on increasing the access of the poorer households to basic needs, direct government interventions announced in the 2004 budget will have to be continued over the medium term. Such interventions include building and upgrading schools in rural areas, increased funding of microcredit schemes, and support to the small business enterprise center.

Solomon Islands

After the restoration of law and order and fiscal discipline, and following 4 years of contraction, the economy expanded. The medium-term outlook is for faster economic growth, led by exports and externally funded government spending.

Economic Assessment

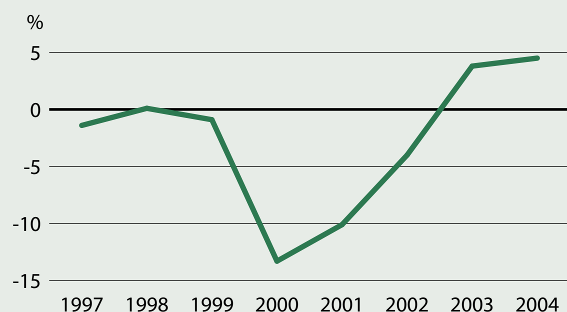
After 4 straight years of contraction, GDP rose by an estimated 3.8% in 2003 (Figure 2.33). Forestry production was on track to reach near-record levels, providing crucial foreign exchange earnings and tax revenues, but involving logging at rates that, if continued, will eliminate the remaining virgin forest before 2015. Fisheries, cocoa, and copra production all grew rapidly. Rehabilitation and resumption of palm oil production, previously a major export activity, is required, and recently some investor interest was seen. Gold mining operations remain suspended, and manufacturing suffered a setback in October with the closure of a food-processing operation. Construction activity in the capital visibly picked up, and the trade and hotels and restaurants subsectors grew. This patchwork of expansion and contraction, alongside a labor force increase of about 3.6%, meant that aggregate growth had limited impact on unemployment.

The law and order situation substantially improved after the arrival, in July 2003, of a multicountry regional assistance mission. This involved the deployment of nearly 3,000 military personnel from five countries, 250 Australian Federal police under New Zealand leadership, and over 70 civilian technical advisors, including a 16-person budget stabilization team occupying line and advisory positions in the Ministry of Finance and National Planning. This team, particularly, was to help restore sound public financial management in a situation where budget execution and planning had broken down and debt management was absent.

In the first 3 quarters of 2003, actual public expenditures were 25% higher than budgeted, largely because of a huge expenditure overrun by the Ministry of Police. There were delays in payment of public service wages, and severe shortfalls in nonpayroll expenditures and debt servicing. Despite poor tax compliance, actual revenues were 31% higher than budgeted, so that the budget was in cash surplus for the first 3 quarters. However, it was in substantial overall deficit because of continued growth in arrears. Preliminary estimates indicated that, by 31 August 2003, arrears on official debt had reached SI$479 million (80% of it on domestic debt), and arrears on informal debt—such as debts to trade creditors and to public enterprises—was even higher at SI$593 million. Total official and informal debt, inclusive of arrears, was estimated to be at least SI$2,200 million (US$296.9 million), or almost 140% of GDP.

Key actions implemented after the arrival of the budget stabilization team included imposing tight expenditure control, extending a 10% sales tax to bar-trade activities as intended by the existing law, initiating a payroll audit, and preparing a budget plan for the fourth quarter of 2003 that incorporated SI$15.7 million in Australian government budget support. The formulation of a medium-term debt management strategy was initiated, and the reengagement of multilateral financial institutions

Figure 2.33 GDP Growth, Solomon Islands, 1997–2004



Sources: International Monetary Fund, *Solomon Islands Staff Report for the 2002 Article IV Consultations*, 10 January 2003 and *Selected Issues and Statistical Appendix*, 13 January 2003; staff estimates based on Solomon Islands Government, Department of National Reform and Planning, *National Economic Recovery, Reform, and Development Plan, 2003–2006*, Honiara, October 2003.

in the country was facilitated by the Australian Government's settlement of arrears with regard to ADB and World Bank loans and its commitment to servicing those loans until mid-2004.

From 9.0% in 2002, inflation dipped to 8.3%, reflecting primarily a drop in domestic food prices, as the restoration of law and order allowed greater supplies of fresh fruit and vegetables through to the Honiara markets. Currency depreciation continued to exert a major influence on prices. With foreign exchange controls still in place, the local currency remained stable against the US dollar but depreciated against major trading partner currencies, most importantly 18.4% against the Australian dollar (the country that supplies about 56% of imports).

The financial sector remained under serious strain. Commercial banks and the National Provident Fund continued to be encumbered by government debt, and are awaiting a comprehensive government financial restructuring package. Following several years of poor performance, the Development Bank of Solomon Islands became insolvent in 2003 and it was expected that the central bank would write off its 10% share holding. Broad money rose by 19.4% in the first 3 quarters of 2003, largely reflecting an increase in net foreign assets. A lack of commercially viable projects was reflected in greater excess liquidity in the banking system. The weighted average interest rate on deposits rose from 0.64% in January 2003 to 0.99% in September, while the rate on loans fell from 15.58% to 15.39%.

Export growth in 2003 was strong, led by logs and supported by cocoa and fisheries exports. Imports increased in line with the economic recovery, particularly oil, building and construction materials, and plant, vehicles, and machinery. Both the trade and current accounts recorded a surplus and, with the capital account also recording one due to higher official inflows, foreign reserves (exclusive of the Government's external debt arrears) rose to cover almost 3 months of imports. There was no evidence of a revival in FDI, with most long-term foreign investors still regarding Solomon Islands as an unstable environment for investment.

Policy Developments

The 2004 budget provides for a balanced cash position. Domestic revenues are estimated to be 7.4% higher than the expected outcome for the whole of 2003, as a result of greater compliance with tax and customs laws, closure of unofficial revenue accounts operated by line ministries, and redeployment of staff to revenue-gathering positions. Budget support from Australia and New Zealand amounts to almost one quarter of total revenues (with the latter's support targeted at the education sector). This budget support permits total recurrent expenditures to rise by 41.5% (from the expected outcome for all of 2003) in 2004. Spending is reallocated toward the key service areas of health and education, financial administration, provincial affairs, and law and justice. However, spending 21% of domestic revenues on debt servicing is insufficient to fully service all debts and the current budget makes no explicit allocation for the payment of past arrears. Arrears are addressed as part of the comprehensive debt management plan formulated in the first quarter, for consideration in future budgets. The Government intends to use revenues in excess of budget estimates to deal with its arrears and debt obligations, while acknowledging that medium-term fiscal tightening will be required to meet them fully. To improve accountability throughout government, the Auditor General's Office is to be strengthened.

Increased public expenditures in 2004 should improve service delivery, but care will be needed to ensure that budgetary supplementation is used to support a transition to fiscal self-reliance and sustainability, and that higher spending does not create dependence on donor funding for recurrent as well as development spending. Australian budget support is provided for 2004 only, while New Zealand's support is scheduled to end sometime in 2006. The 2004 development budget is huge in the context of recent fiscal history, almost matching the planned level of recurrent expenditures (SI$480 million), and focusing mostly on general government and security, and human resources and community development. The recurrent and development budgets together constitute a heavy demand on the country's limited administrative and technical capacity.

The Ministry of Finance has developed a medium-term fiscal framework to assist in a durable rebuilding of public finances. A key issue is the public service payroll, which accounts for 52% of estimated domestic revenues in 2004, and which the Government accepts as too high. The payroll audit begun in late 2003 and a planned downsizing of the police force will likely generate savings, but funding for implementation of a redundancy and retirement program needs to be secured.

In November 2003, the Government finalized its National Economic Recovery, Reform and Development Plan, 2003–2006, which sets out an ambitious program of action in several strategic areas, including public sector reform. The sector has not delivered adequate services because of a failure by central and provincial administrations to perform core government functions, and because of poor SOE performance in the electricity, water, transport, and telecommunications sectors. A prerequisite for successful reform is genuine government ownership at the highest political level. Given the need to restore and improve administrative capacity, reform of public services will need to be planned carefully, and not carried out simply as downsizing. Similarly, reform of SOEs will need to consider various options for improving performance, including better management, corporatization, and privatization within an appropriate regulatory framework. Improving the performance of the public sector generally will be central to generating higher living standards, especially in rural areas.

A plan to create a federal system of government under a new constitution is expected to be introduced by July 2004. However, while moves toward decentralization are an understandable response to the widely held view that the national Government has failed and that resources have been shared very inequitably between the capital and the rest of the country, the benefits and costs of decentralization need to be assessed carefully prior to legislative change, in full recognition that the Government is already facing the major challenge of restoring public financial management and central public administration, with limited managerial capacity.

Outlook for 2004–2005

Economic growth of 4–5% is forecast for 2004–2005, on the premise that the vastly improved law and order situation will be maintained, further progress in public financial management will be made, and investor confidence will gradually return. Log, fisheries, and cocoa exports to a stronger international economy will be the main drivers of growth, with an additional stimulus coming from external grant-funded development expenditures and from the substantial budget supplementation provided by Australia and New Zealand. It is unclear whether palm oil and minerals exports will show a significant recovery in the medium term, given investors' uncertainty over the medium- to long-term policy environment. The absence of such a recovery will make it difficult to achieve the target of creating 1,000 new jobs in the private sector in 2005.

Inflation is projected to moderate slightly to 6–7% in a context of rising domestic food supplies and a cautious monetary policy stance. Imports will rise as economic growth accelerates, but export expansion and increased official transfers are expected to more than offset this, allowing for some easing of foreign exchange rationing. On the assumption that the projections made in the 2004 budget are realized, the public debt will fall relative to GDP. The extent to which domestic investor confidence, in particular, returns will depend crucially on the provisions to be made for payment of trade creditor arrears under the Government's forthcoming comprehensive debt management plan.

Democratic Republic of Timor-Leste

The economy continued to contract in 2003 as most activities were affected by the phaseout of the large international presence, though some signs of private sector activity are emerging. A major issue is the substantial reduction in Timor Sea oil and gas revenue projections due to development delays, and the resulting significant financing gap that will constrain potential growth.

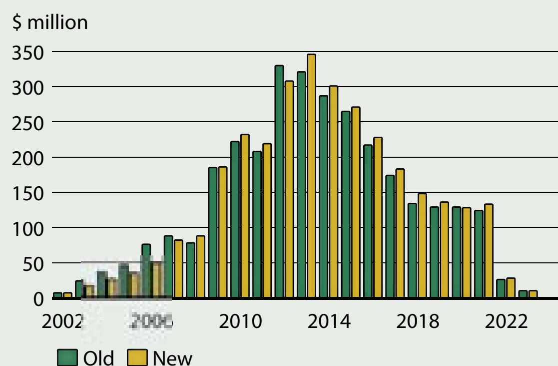
Economic Assessment

The economy contracted by about 3% in 2003—according to IMF estimates—as the international presence was further reduced, reconstruction projects were executed at a slower pace than expected, and substantial flood damage to the crops (following a delayed 2002 rainy season) lowered agricultural production. The downturn was prominent in the construction and services sectors, especially in urban areas, as projects funded by multilateral and bilateral donors were gradually scaled down. However, the private sector showed some timid signs of improvement. The Timor-Leste Revenue Service reported significant growth in the number of Timorese taxpayers in 2003, and several new shops and restaurants catering to the needs of nationals were opened in Dili. Unemployment increased. According to World Bank estimates, at the end of 2003, unemployment among urban males was at least 20%, surpassing 40% among those aged between 15 and 24. Employment creation in the formal sector was mainly in the public administration, which by June 2003 employed about 18,000 people, including military and police. The capacity of the private sector to create new jobs remains weak because of limited opportunities for investment. Due to the tight local market, since 2001, many young Timorese in search of jobs have gone abroad, especially to Ireland and the United Kingdom, passing through Portugal. While this trend seems to have declined in 2003, due to stricter visa requirements by Portugal, an opportunity to ease the unemployment pressure through increased labor migration was offered by Malaysia, which declared its willingness to accept Timorese migrant workers.

Data on the implementation of the FY2003 government budget under the Consolidated Fund for East Timor show that revenue collection exceeded estimates by 12%, as a result of higher Timor Sea oil and gas revenues. At the same time, actual expenditures fell short of budgeted figures as reconstruction projects were implemented more slowly than projected. In particular, while the public sector capacity to carry out projects increased from FY2002, the actual execution of capital development expenditures was only 81% of the budgeted figure. In the first quarter of FY2004, Timor Sea oil and gas revenues were, however, below estimates, as a result of modified tax provisions, while non-oil revenues were substantially higher, due to increased import duties. In contrast, expenditures grew faster than budget estimates.

The financial sector underwent significant developments in 2003. In August, a new commercial bank started operations, inducing more local competition and a revision of lending policies by the two existing banks to provide better services to the public. The average interest rate on lending was lowered to around 15%. Operations of the Microfinance Institution have also expanded, both

Figure 2.34 Timor Sea Revenue Estimates, Timor-Leste, 2002–2024



Source: Democratic Republic of Timor-Leste Ministry of Planning and Finance, *2003-04 Mid-Year Budget Update*, November 2003, Figure 4.1, Page 18.

in terms of deposits—which reached the ceiling of $1 million—and loans. Major beneficiaries of lending schemes were small and microbusiness operators and public servants who could take advantage of programs that linked loan collection to employee payroll numbers. Several microfinancing schemes provided by nongovernment organizations were also available outside the formal sector. Though affected by poor collections, these schemes have a positive impact, especially in rural areas. The Banking and Payment Authority (BPA) of Timor-Leste reported that deposits increased by 30% during the year, reaching $72.9 million in December 2003. Credit provided by commercial banks to the private sector also expanded substantially from $6.0 million to $27.8 million during the year. As a consequence, the credit-to-deposit ratio increased from 10.7% in January to 38.2% in December 2003.

The BPA introduced new local coins in small denominations, known as centavos, in November 2003, and these were put in simultaneous circulation with the US dollar coins. The main purpose of the new coins is to facilitate small transactions. During 2003, inflation was on a decelerating trend, with the price slowdown mainly attributable to an improvement in food supply following the harvesting of the 2002 crops. Inflation was 4.2% in December 2003, compared with 9.5% in December 2002. The external current account balance remained substantially negative, although fully financed through official transfers. According to IMF estimates, the current account deficit (excluding official transfers) was more than $206 million in 2003, or approximately 61% of GDP. This included a trade deficit of more than $160 million, while receipts originating from the Timor Sea oil and gas operations were estimated at $27 million. The value of imports continued a declining trend. Total imports were estimated at $168 million in 2003, compared with exports for a total value of only $7 million. The structural trade deficit for goods not directly related to external assistance increased in 2003, as the growth in the value of taxable merchandise imports exceeded that of exports, which, excluding oil and gas, were dominated by coffee (accounting for more than 85% of total exports).

Policy Developments

In December 2003, the Government informed its development partners of considerable delays in the development of the Bayu-Undan oil and gas fields in the Timor Sea, resulting in significant reductions in the projected revenues from this source. As a consequence, the total budget financing gap for the period FY2005–FY2007 is projected to increase dramatically to $126.3 million, almost double that initially expected. As the perspective to increase non-oil revenues seems quite remote, cuts in expenditures will be required. In addition, the Government is considering selling assets, and requesting its development partners to increase budget support beyond the completion of the Transitional Support Program II, expected in FY2005. The Government may decide to revise its financing policy by making Timor Sea royalty receipts and interest income available, at least in part, for budgetary financing, or it may start to borrow from multilateral institutions.

No financing gap is expected to emerge in FY2004, despite a downward correction of projected oil and gas revenues by $18 million. During the midyear budget revision, the Government introduced significant expenditure cuts through which the overall fiscal deficit was kept to a level at which increased external assistance and a drawdown of cash balances, combined with the effect of the US dollar, are projected to fully cover the higher financial requirements. A matter of concern rests, however, in the poor performance

of the power authority in terms of revenue collections. Without a rigorous implementation of a reform program aimed at structural improvements in the power management and billing systems, the government financial position may be further jeopardized.

While the issue of international maritime boundaries with Australia and permanent demarcation of the borders between the two countries is still under intense negotiation, an interim Timor Sea Treaty entered into force in April 2003. The treaty, which defines a 90–10 split of tax and royalty revenues between Timor-Leste and Australia, allowed the production of natural gas from the Bayu-Undan field to start in mid-February 2004, with expectations to generate about $3 billion in revenues from gas and oil over the next 20 years (Figure 2.34). With the start of the Bayu-Undan project, the need to establish a petroleum fund has become a priority. Structural reforms were introduced in 2003 to strengthen the expansion of business activity and capacity for economic and financial management.

Draft laws on commercial companies and private investment are at present under parliamentary scrutiny, and concrete measures have been taken to establish public agencies for administering state property and leasing of public and private property. A land and property registry and a cadastre registry have been introduced. The Government is also undertaking measures to create an industrial park to attract foreign investors and to start a pilot tourism venture. Early steps have been taken to develop a banking payment law to address the risk associated with the payments system, an insurance law to foster insurance service activities, and a related framework for insurance supervision.

The security situation was under control in 2003. The Timor-Leste Defense Force was increased to about 1,400, and policing functions were completely transferred from the UN Police to the National Police of Timor-Leste, with an increased staff of 200. A major concern, though, is the expected pullout in May 2004 of the UN assistance, including peacekeeping forces. Given the limited local resources, the vacuum in technical and administrative capacities is expected to have a significant negative impact on government functions and services as well as on internal security, in addition to the related economic contraction. In view of the possible destabilizing effect of a premature pullout, the UN Secretary General has requested the UN Security Council to authorize an extension until May 2005 of the UN presence in Timor-Leste.

Outlook for 2004–2005

After the substantial downward revision of the Timor Sea oil and gas revenue outlook, the GDP growth projections have been accordingly reduced. The figures in the midyear budget update indicate, respectively, a 2.0% and 3.0% decline for FY2004 and FY2005, followed by 2.0% growth in FY2006. However, more recent estimates indicate that, on a calendar year basis, GDP growth could be positive in 2004 (1.0%) and 2005 (3.0%). Given the limited role played by the private sector, the medium-term growth potential of the economy is largely dependent on the stimulus created by public expenditures. A major challenge is, therefore, to identify the right mix of policy measures to close the fiscal financing gap expected through FY2007 without excessive restraint on economic growth and, in turn, poverty reduction.

Apart from appropriate expenditure cuts and additional requests for grant assistance from bilateral and multilateral donors, this mix encompasses the possible choice of a development path allowing for borrowing from international financial institutions. The medium-term outlook still largely depends on the level of external assistance to which development partners will be able to commit, and on the fiscal policy of the Government. The environment for private sector development and the results of efforts to build local capacity and institutions are also major factors affecting future growth. The tentative signs of economic activity shown by the domestic private sector in 2003 may be early indicators of a gradual increase in entrepreneurship that could help reduce the traditional heavy dependence on public expenditures.

Tonga

Economic growth in 2003 picked up slightly, though inflation remained high and foreign reserves were under pressure. The outlook is for faster expansion and improving public finances, provided that the economic and public sector reform program is implemented effectively.

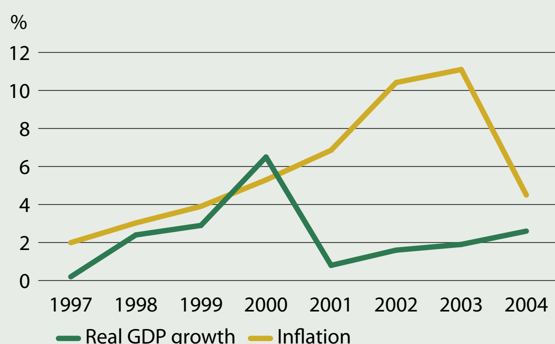
Economic Assessment

Economic growth in FY2003 (ended 30 June 2003) climbed a little to 1.9% from 1.6% in FY2002. Agriculture, forestry, and fisheries grew slowly at 1.4%, with expansion of squash, vanilla, and root crop production offsetting a decline in fishing caused by poor regional weather conditions. Construction expanded by 4.0%, as reconstruction work following the late 2001 cyclone was completed. The services sector grew by 2.4%, with growth reportedly strong in finance; modest in commerce, hotels, and restaurants; and stagnant in government services. Tourist arrivals in FY2003 were up by 7.0% from the FY2002 level. In the transport and communications subsector, Royal Tongan Airlines expanded its international services by leasing an aircraft. Continued slow economic growth exacerbated the problem of inadequate employment opportunities, especially for young school leavers, and prevented a reduction in the 23% of households living below the basic needs poverty line.

The overall budget deficit for FY2003 was T$10.5 million (3.1% of GDP), slightly above the original target deficit of T$8.7 million. There were shortfalls in external grants and nontax revenues that were partly offset by tax revenues coming in above budget estimates. Total revenues and grants amounted to 28.9% of GDP. Total expenditures and net lending were below budget at 32.1% of GDP, primarily because of lower capital expenditures. Wages and salaries rose by 10% on the FY2002 level but fell slightly to 48.8% of total current expenditures. In contrast, net lending to nonfinancial public enterprises (NFPEs) was almost 10 times the budget estimate because the Privy Council (King and Cabinet) authorized assistance to Royal Tongan Airlines outside the budget appropriation process. The overall budget deficit was financed 28% externally and 72% domestically through borrowing and drawdowns of government cash balances. The public domestic debt outstanding at end-FY2003 was T$37.4 million (about 11% of GDP), and included government debt and government-guaranteed debt of public corporations. Public external debt was T$164.4 million, equivalent to just under half of GDP.

Inflation continued at double-digit rates, reaching an average of 11.1% in FY2003 as a result of higher oil prices and further weakening of the local currency (Figure 2.35). In January–December 2003, the Tongan dollar appreciated by almost 9% against the US dollar, but depreciated slightly against the yen and substantially against the currencies of Australia (23%) and New Zealand (15%), which together supply about two thirds of the country's imports. Broad money increased by 13.4% in FY2003, with domestic credit rising by 18.2%. Net foreign assets declined in FY2003, but rose by 18.8% by end-September 2003 from a relatively small base in September 2002. Domestic credit growth in FY2003 involved a 28% increase in lending to NFPEs and an almost 11% expansion in lending to the private sector for business and personal purposes. Given

Figure 2.35 GDP Growth and Inflation, Tonga, FY1997–FY2004



Sources: Government of Tonga, Ministry of Finance, *Budget Statement for the Year ending 30th June 2004*, Appendix Table 2; International Monetary Fund, *Public Information Notice on the Staff Report for the 2002 Article IV Consultations with Tonga*, January 2003; National Reserve Bank of Tonga, *Quarterly Bulletin,* September 2003; staff estimates.

the high inflation rate, real deposit rates were substantially negative and some real lending rates were marginally negative. The ability of the central bank to conduct open market operations remained constrained by its limited capital base and low income from foreign reserves. Reliance was placed on quarterly credit ceilings on each of the commercial banks.

According to central bank data, the US dollar value of merchandise exports fell slightly in FY2003 while imports rose by 21%, largely because of higher imports of consumer goods, construction materials, fuel, and capital equipment. The consequent widening of the trade deficit, together with increased deficits on the services and investment income accounts, more than offset the increased surplus on the transfers account. The current account deficit reached 3.1% of GDP. The capital account surplus rose as increased net official inflows outweighed a decline in net private capital flows, but the overall balance of payments moved from surplus into deficit. Foreign reserves reached 3.5 months of import cover by December 2003.

Policy Developments

In 2003, the Government focused on implementing the Economic Public Sector Reform Program (EPSRP), which has the primary aims of maintaining a stable macroeconomic environment and achieving sustainable economic growth led by private sector development. In pursuit of these aims, the legislative framework for public sector management underwent substantial change, with four acts coming into force during 2003. The Public Finance Management Act strengthens the power of the Minister of Finance to ensure fiscal discipline. The Revenue Administration Act provides a legal foundation for improving tax and customs administration. The Public Enterprise Act gives the Minister of Finance the power to appoint public enterprise directors, requires public enterprises to submit timely annual reports, and provides a framework for corporatization and privatization. Finally, the Public Service Act provides for a modernization of the civil service.

The budget for FY2004 projects a reduction in the overall deficit to T$6.6 million or about 1.8% of GDP. Revenues and grants are forecast to rise by 29% on the FY2003 level and total expenditures and net lending by 22.5%. Half of the rise in revenues and grants comes from an expected increase in external grants to an historically high level. The other half of the rise is expected to come from economic growth and improved tax compliance, especially in collection of import duties, and administrative fees and charges. Taxes on income and profits are budgeted to fall. The revenue estimates assume speedy and effective implementation of tax administration reform. Current expenditures are projected to increase by 14.6% from the FY2003 level, largely because of greater purchases of goods and services. Capital expenditures are projected to rise eightfold because of the construction of a new hospital in the capital city through external funds. Net lending is projected to be negative in the expectation that assistance to NFPEs will be confined to direct subsidies of T$3.2 million. The actual budget outcome in FY2004 will depend heavily on the extent to which the Government can control demands from public enterprises.

About 89% of the budget deficit projected for FY2004 is to be funded by external loans at concessional rates. The concessional nature of external debt means that the net present value of public external debt is considerably below the book value, standing at 25.8% of GDP in June 2003. Debt service costs are manageable at less than

10% of exports of goods and services. Tightening of monetary policy is hampered by the weakness of the central bank's balance sheet. The Public Finance Management Act permits the Government to allow the central bank to use government-issued bonds for liquidity management purposes. Ultimately, recapitalization of the central bank and higher income from foreign reserves are needed. In the meantime, reliance will be placed on credit ceilings, which need to be made binding, and on minimum reserve requirements.

With regard to private sector development, the budget strategy for FY2004 and beyond is to contain the tax burden on the private sector. A new tax policy under discussion, and scheduled for implementation in FY2005, intends to change the corporate tax rate from over 37% for nonresident companies and 15–30% for resident companies to a flat rate of 20%; raise the income tax threshold; introduce a single 10% duty on most imports; and shift the tax mix from import duties to a broad-based consumption tax. Simultaneously, the Government will repeal the Industrial Development Incentives Act of 1978. The Government has already passed a new Foreign Investment Act and a Business Licenses Act, which, respectively, simplify conditions for foreign investment and streamline business registration procedures. The length of land leases and relatively frequent revisions of land rents are fundamental issues subject to ongoing government review.

The Government is also seeking to attract investment through implementation of its public enterprise reform program including privatization. However, some mixed signals have been sent to foreign investors. In July 2003, the Government passed legislation restricting foreign ownership of media organizations in the country, and followed this up with selective issuing of newspaper licenses.

Outlook for 2004–2005

Assuming that the effective implementation of the EPSRP, no adverse external shocks, and private remittance flows of about T$80 million–90 million a year, the outlook is for growth to accelerate into the 2.0–3.0% range during 2004–2005. Agriculture and fisheries are forecast to register a modest strengthening as fishing expands and the supplies of squash, vanilla, root crops, and kava respond to better opportunities in regional and global markets. Construction is expected to expand relatively strongly as a result of externally funded projects and a greater government capacity to fund capital expenditure. Minimal growth in the dominant government services subsector will constrain overall tertiary sector growth, but commerce, restaurants and hotels, entertainment, and private services are projected to edge up as remittance flows continue and tourism expands. The Government plans to market the country as a unique and safe tourist destination but it will need to secure adequate air services.

The strengthening of public financial management, tax policy reform, and civil service and public enterprise reform should result in better budgetary outcomes, an improved strategic allocation of public resources, and more effective public service delivery. On the expenditure side, wages and salaries are budgeted to increase by 9.2% from the FY2003 level, to allow for some pay increases in the context of a continued recruitment freeze. Priority in spending is to be given to law and order, education, health, and basic infrastructure. The major risks in this scenario are a push for civil service wage increases and greater demands on the budget from an unreformed public enterprise sector. The inflation rate is projected to moderate to around 4–5% on the assumption of continued exchange rate stability. The estimate current account is expected to improve as export growth accelerates and remittances maintain their current level, but no major improvement in the overall balance of payments is likely, unless foreign investment grows significantly. Foreign reserves are projected to stay in the vicinity of 3 months of import cover.

Economic growth in the forecast range would create some employment opportunities for young entrants to the labor force, but the high level of youth unemployment and an associated rise in crime will probably continue to be major social issues. Rationalization of the civil service is also likely to directly contribute to unemployment.

Tuvalu

The Government needs to reestablish a broadly balanced budget and develop a coherent statement of its medium-term strategies, generally because it determines the volume of economic activity and particularly, in 2003, because its income fell sharply. Improved stability and some recovery are likely in 2004–2005, but the economy remains highly vulnerable to financial and climatic risks.

Economic Assessment

The level of economic activity is overwhelmingly determined by the amount and direction of government expenditures. In 2003, financial resources available to the Government were sharply reduced from the levels of the previous 3 years. The main causes were (i) climatic variations reducing exclusive economic zone fishing license revenues; (ii) contractual factors lowering receipts from the ".tv" Internet domain address; (iii) the need for the Tuvalu Trust Fund (TTF) to rebuild the maintained capital value of its investments in slowly recovering financial markets before it can resume distributions; (iv) and the continuing appreciation of the Australian dollar (Tuvalu's national currency and the TTF numeraire) against the US dollar, which reduced the domestic currency value of most of the country's foreign income.

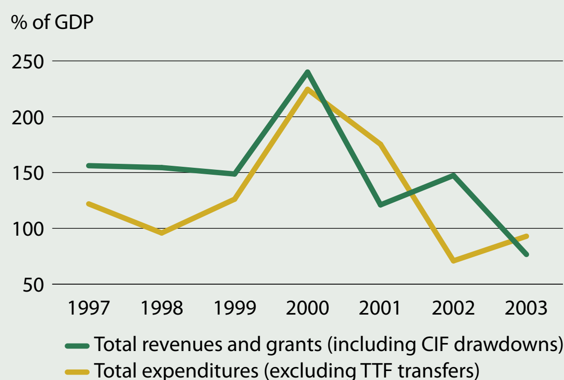
Economic growth is anticipated to have revived to about 3% in 2003 after a dip to 2% in 2002. The increase stemmed from two relatively large aid-funded projects on the capital island of Funafuti, improvements to a marine training facility, and other construction works on the outer islands. These projects stimulated the private sector. The impact flowed through to the retail sector and domestic consumption. The outer islands also benefited from growing remittances from Tuvalu seafarers, now estimated at well over A$5 million a year, or equivalent to about 20% of GDP.

Total estimated government expenditures in 2003, excluding transfers to the TTF, amounted to A$25.1 million, or 38% higher than actual expenditures in 2002. The increase was primarily due to a rise in the number of civil servants and higher special and capital expenditures. Maintenance, while low by international standards at 2.9% of expenditures, was almost double that in 2002. Special development expenditures, i.e., noncore expenditures of a one-off nature, at A$1.8 million were less than half the 2002 level, reflecting the need to cut expenditures to balance the budget.

The market value of the TTF at 30 September 2003, of A$75.8 million, was 6.6% less than the so-called Maintained Value. As a result, for the third year in a row the TTF did not make a distribution to the Government, and while world capital markets have improved, it is by no means certain that the TTF will make a distribution before 2006. The TTF had suffered a serious decline in capital value from 2001 to 2003. Consequently, in November 2003, as world financial markets were rallying, the TTF Board approved a restructuring to a stronger growth orientation. Also at end-September, the balance on the Government's buffer account, the Consolidated Investment Fund (CIF), which was designed to provide funds when the TTF makes no distribution, was 30% less than the minimum value required.

The labor market is dominated by the public service, whose wage and salary rates impact on the private sector. In 2003, overall employment

Figure 2.36 Government Revenues and Expenditures, Tuvalu, 1997–2003



Sources: 2004 Budget Address by the Minister of Finance, Economic Planning, and Industries, November 2003; *17th Annual Report of the Tuvalu Trust Fund Advisory Committee*, 13–21 November 2003.

changed little and there were no general salary increases. Starting 1 January 2004, the Government has provided a 5.0% cost-of-living increase for the public service.

Total estimated government revenues and grants fell by 45.4% to about A$20.7 million in 2003 from a 3-year annual average of A$41.6 million. The main contributors to the fall were decreases in .tv revenues, down by A$15.9 million, and fisheries license revenues, A$4.1 million lower.

The resulting budget deficit was A$4.4 million, or 16.3% of GDP (Figure 2.36). Taking into account the TTF transfers reported for 2003, the budget deficit is higher at A$5.3 million, equivalent to 20% of GDP. Despite the fact that the transfers made to the TTF for 2003 were A$6.9 million lower than the level in 2002, the reduction was not enough to stave off the deficit. The CIF drawdown for 2003 is unknown, but it is likely that the drawdowns actually made may have brought the actual outcome for 2003 into an almost balanced budget. The Government borrowed heavily from the National Bank of Tuvalu in 2003 and at one point this borrowing reached a record level of A$3.5 million, equivalent to 13% of estimated government expenditures in 2003.

The weak US dollar has adversely impacted on Tuvalu. Fisheries license and .tv revenues both fell in Australian dollar terms. Inflation in 2003 was 2.6%, close to Australia's rate.

Foreign trade statistics for Tuvalu are unavailable. Debt servicing requirements are low, amounting to less than 1% of GDP. Foreign debt is very low and is all concessional; ADB and the European Investment Bank are the two principal credit sources. Net foreign assets inclusive of the TTF, despite suffering from financial market weaknesses, still underpin a sound external position of around 5 years of import cover.

Policy Developments

The enforced expenditure constraint coincided with a political crisis that lasted most of the year. This was caused by the apparent loss of the Government's parliamentary majority and its refusal to hold a meeting of Parliament until its numerical supremacy was assured. The Government's ability to make policy decisions was much reduced during this period, and most issues were put on hold. The situation was resolved with a restored majority for the elected government in early November 2003.

The 2004 budget stresses securing sustained growth through a sound and stable pro-investment macroeconomic climate. Historically, when revenues fall the Government cuts back on maintenance and other discretionary expenditure categories, including development that is not donor funded. Basic social services in the face of reduced revenues can be maintained at the cost of a larger budget deficit. The fiscal deficit would, however, more than double without the drawdowns from the CIF. The amount approved by the Government to be drawn down from the CIF for the 2004 budget is A$1.75 million, or some A$0.5 million more than the likely amount sustainable over the medium term.

The Government is taking a multifaceted approach to financing the deficit. First, it intends exploring options for raising additional revenues through taxation, user charges, and privatization of certain government entities. Second, it may use reserves that amounted to A$8 million at end-2003 as a fall-back position. Third, it intends deferring certain programs or reducing current levels of services, including freezing vacant posts and salary increments, and reviewing personnel numbers.

To stimulate the private sector, the Government has negotiated a soft loan for

onlending by the Development Bank of Tuvalu for domestic investment. It has also boosted its equity investment in the bank. Additionally, a proposed amendment to the Tuvalu National Provident Act will allow for capital resources to be onlent for small business development. Public sector investment will also be aided through a Public Sector Investment Program for 2004–2006, which will include special development expenditures and projects to be financed by donors. Ministries will be required to submit detailed profiles on all projects to be funded by such expenditures and donors for proper appraisal.

On the external side, the Government will continue negotiations to obtain a share of revenues for the use of the country's outer air space and satellite orbital slots, and is considering a fisheries licensing deal with the EU.

The last National Development Strategy (1995–1998) was published 9 years ago and the Government has been planning to develop a new strategy for some time. In 2004, it intends holding a National Summit on Sustainable Development that will lead to the formulation of a Statement of Economic Strategy. This will form the foundation for developing a longer-term national development plan and associated multiyear sector plans.

Outlook for 2004–2005

Short-term prospects for economic activity and employment are dominated by existing externally funded public sector projects and the speed with which others in the pipeline can be implemented. Economic growth is projected at around 3% a year in 2004–2005, provided that the end to building of the two relatively large aid-funded projects (in 2003 and mid-2004) is succeeded by further large infrastructure projects.

In the short term, government expenditures will be constrained by the downturn in external revenues, in part due to the weak US dollar affecting receipts from the .tv and fisheries licenses. After 3 years of zero distribution from the TTF there is a possibility of some revenue for 2005, but it will be modest at best. Developments on the outer islands, which have been constrained by the lack of a distribution from the Falekaupule Trust Fund—a fund initiated in July 1999 with the purpose of providing a source of funds for island development—will be subject to the same factors that have affected the performance of the TTF. Remittances from Tuvalu's seafarers will continue to provide a major source of income.

Major development challenges include inadequate enabling legislation for private sector development, insufficient suitably skilled and experienced personnel, lack of effective strategic planning, lack of adequate financial management information, lack of proper reporting and full accountability, insufficient working capital, and restrictive financing arrangements imposed by the Government on SOEs, except the National Bank of Tuvalu. On the positive side, benefits could emanate from government initiatives to capture some of the fees from the country's outer airspace, a possible new fisheries license agreement with the EU, and a positive outcome from legal action over .tv revenue.

The outcome of the strategic planning exercise to be undertaken in 2004 should result in a better focus on the medium term. A specific focus will be on poverty reduction to ensure that the whole population has adequate provision for basic needs. In the longer term, greater emphasis on the primary and secondary education systems, which are in serious decline, could have a profound impact on the prospects for the economy.

Vanuatu

The economy emerged from recession to record moderate, agriculture-led growth in 2003. The budget deficit was reduced through expenditure cuts. The Government anticipates a slight acceleration over the medium term, but this will require increased smallholder production in agriculture and more tourist arrivals.

Economic Assessment

After 2 successive years of contraction, GDP posted growth of an estimated 1.6% in 2003, below the annual population increase rate of 2.6% (Figure 2.37). The growth was led by an 8.7% rise in the agriculture, fishing, and forestry sector. Boosted by strong world commodity prices, cocoa, copra, and cattle production surged. The industry sector contracted by 1.1% as manufacturing, electricity, and commercial construction all fell.

The services sector was virtually stagnant, with the trade subsector recording just 1.0% growth, government services stationary, and the transport and communications, and hotels and restaurants subsectors both contracting.

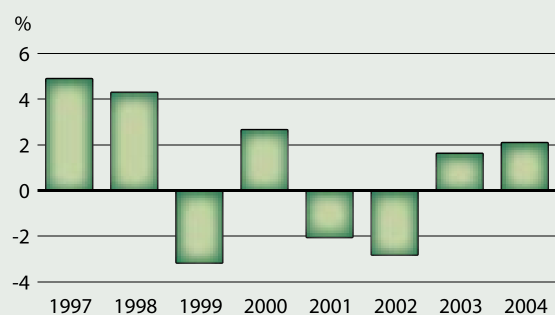
Total tourist arrivals in the first 3 quarters of 2003 were 1.2% down on the same period in 2002, largely because of relatively low numbers in the first half of the year. Tourism picked up in the third quarter as a result of supplementary flights from Australia, and the hotel occupancy rate rose to 53.8% from 38.8% in the previous quarter.

The economic recovery contributed to a limited reversal in the downward trend in formal sector employment that was seen in 2001 and 2002. However, employment growth fell well short of the 10% rate required to absorb the 3,500 school leavers entering the workforce in 2003. With limited emigration possibilities, the majority of these new entrants to the labor market had to seek work in the subsistence or urban informal sectors.

The 2003 fiscal target of a budget surplus of 0.4% of GDP was based on a 7.7% rise in revenues and grants and a 7.8% drop in total expenditures and net lending, relative to the actual levels in 2002. On the basis of actual outcomes in the first three quarters of 2003, the deficit target will not be met. Revenues and grants were 4.0% lower than the corresponding figure for 2002, largely because of a shortfall in grants and import duties. Total expenditure and net lending was 12.2% down on the corresponding figure for 2002 as a result of tighter expenditure control on both wages and nonsalary outlays. The overall budget deficit for 2003 is estimated to be about 1.0% of GDP, with domestic financing in the form of central bank advances. Nonetheless, this outcome represents an improvement from a deficit of 3.2% of GDP in 2002. In 2003, the Government's external debt was estimated at 28.2% of GDP, and its domestic debt at 11.0% of GDP. Debt servicing costs were equivalent to approximately 7% of domestic revenues and 4% of recurrent expenditures.

The inflation rate accelerated from 2.0% in 2002 to 3.0% in 2003, because of the one-off impact of increased duties on imported food; increased alcohol and tobacco excise duties; higher education and health fees; and because the domestic currency, the vatu, depreciated significantly against the Australian and New Zealand dollars, in which approximately 60% of

Figure 2.37 GDP Growth, Vanuatu, 1997–2004



Sources: Government of the Republic of Vanuatu, Budget 2004, Volume 1: *Fiscal Strategy Report 2004*; Vanuatu Statistics Office, *1997–2002 National Accounts*, December 2003.

Vanuatu's imports are denominated. The vatu in 2003 appreciated slightly against the yen, and substantially against the US dollar (13.2%). Broad money supply dropped by 0.8% in 2003 as net domestic and foreign assets registered a decline. Domestic credit, however, grew by 5.3% because of strong growth in credit to the private sector, consisting mainly of personal and household loans. Interest rates on housing and commercial loans were reduced in early 2003, with a consequent narrowing of the interest rate spread from 9.5% in January to 9.1% in June. The Reserve Bank of Vanuatu's repurchase facility rate remained at 6.5% throughout the year, indicating an unchanged monetary policy stance.

Official balance-of-payments projections presented in the 2004 budget suggested that the current account deficit would decline to 0.3% of GDP in 2003. These projections are likely to prove overoptimistic. In the first 3 quarters of 2003, merchandise export growth was strong enough to lead to a slight narrowing of the trade deficit, but the foreign reserves level in October had fallen to $37 million, some Vt200 million short of the projected figure, and sufficient to cover just over 4 months of imports. The overall balance-of-payments was on track to record a small deficit in 2003.

Policy Developments

An amendment to the Debits Tax Act of December 2002 effectively increased the tax levied on bank accounts without addressing community concerns that it was an antipoor tax. The Vanuatu National Provident Fund Amendment Act reduced the rate of contributions from 12% to 8% of salaries, reduced the percentage of funds potentially invested overseas from 50% to 15%, and increased the power of the Minister of Finance over the fund, including approval of the appointment of the general manager. This last development constituted a significant reversal of policy initiatives introduced under the 5-year-old, long-term Comprehensive Reform Program, aimed at improving corporate governance in the public enterprise sector. Political interference in the operations of public enterprises continued. The public enterprise sector remained a drain on the public purse, and privatization of several larger enterprises was delayed.

At the same time, trade reform was pursued with the passage of the Pacific Islands Countries Free Trade Agreement Act and the Pacific Agreement on Closer Economic Relations Act, which paved the way for a resurrection of efforts to join WTO, but also raised the issue of future loss of government revenues from import duties. Legislation was finalized to align the regulatory and supervisory framework for offshore banks with that for domestic banks, and to bring that framework under the control of the Reserve Bank. As a result, Vanuatu was removed from the OECD List of Uncooperative Tax Havens.

In September 2003, the Government outlined a Prioritized Action Agenda intended to more effectively link the Comprehensive Reform Program with the Government's medium-term investment program and annual budget. The agenda identifies three key objectives: (i) macroeconomic stability; (ii) achieving faster, sustainable economic growth; and (iii) improving public service delivery, especially in rural areas. Successful implementation of the last two strategies has proven difficult. Economic growth is constrained by low private investment, with foreign investors continuing to be concerned about political instability, an uncertain policy environment, and the economy's high cost structure (including transaction costs of obtaining investment approvals and business licenses).

The 2004 budget aims at further fiscal consolidation. On the assumption that growth will pick up to about 2% and inflation will moderate slightly, an overall budget surplus of 0.4% of GDP

is targeted for 2004. Other than the removal of the debit tax on bank account withdrawals below Vt5,000, no revenue initiatives are envisaged, and reaching the estimated revenue level will require a considerable improvement in revenue collection. Recurrent expenditures are to be reduced from the 2003 budget level through cuts in expenditure on wages, nonsalary goods and services, and transfers to government bodies, with education and health receiving reduced budget allocations. The share of wages in total recurrent expenditures is still high at 58.3%. No change is envisaged in capital expenditures, funded mostly by external grants. Given a substantial negative external financing, a small domestic financing requirement is to be met from government cash balances.

Outlook for 2004–2005

The 2004 budget forecasts GDP growth to accelerate to 2.1% in 2004 and to 2.6% in 2005. The agriculture sector is expected to be the driving force behind this, with the industry and services sectors playing increasingly supportive roles. For agriculture to perform as expected, weather conditions and world commodity prices will need to remain favorable, and smallholder cattle and cocoa production will need to be further encouraged. World commodity prices are likely to be strong, but tropical cyclone Ivy hit Vanuatu in late February 2004 and damaged property and crops to an extent yet to be assessed. At present, there is no comprehensive agricultural development strategy in place. Growth in the services sector requires tourism expansion in a context of strong and increasing competition from other Pacific destinations. Given the country's relatively high costs of international and domestic air travel and accommodation, this expansion will be difficult to achieve, unless a tourism marketing strategy successfully differentiates what Vanuatu has to offer. The Government's decision to opt for an open skies policy could lead to an increased and more competitive international air service, however.

Given the population growth rate, the projected growth would imply a decline in per capita income in the medium term, increased unemployment and underemployment, and little alleviation of hardship in rural areas, where 51% of the population live below the poverty line of $1 per day. The private investment necessary for faster growth in income and employment is unlikely to be forthcoming, unless the factors deterring foreign investors can be addressed effectively.

The Government forecasts budget surpluses of 0.4% in 2004 and 2005, on the assumption that the recurrent and capital expenditure cuts planned for 2004 can be locked in. Assuming a slight deceleration of inflation to the 2.0–2.5% range, there would be a decline in real spending and little growth in real revenue. The wage bill is forecast to rise at 2.0% annually in nominal terms but to decline only marginally as a share of total recurrent spending. This will leave limited room for improving the strategic allocation of public resources.

The current account of the balance of payments is expected to continue to be characterized by trade deficits, a surplus on the services account, and inflows of foreign aid, with the net result being small current account deficits. The Government forecasts a rising surplus on the capital account in 2004 and 2005 and an increase in foreign reserves to over 5 months of import cover. However, these forecasts rest on expectations of a rise in foreign investment, which is unlikely to be forthcoming. Official external debt is forecast to drop to 24.9% of GDP in 2005.

ASIAN DEVELOPMENT
Outlook 2004

Part 3 Foreign Direct Investment in Developing Asia

T. Takahara

ASIAN DEVELOPMENT

Outlook 2004

Foreign Direct Investment in Developing Asia

Foreign Direct Investment in Developing Asia

The rapid growth of developing Asia has attracted, and been facilitated by, foreign direct investment (FDI), flows of which have increased substantially in recent decades. Part of the reason for this is that developing countries, particularly in Asia, have removed restrictions and implemented policies to attract FDI inflows to benefit from the investments and potential spillover effects. The potential benefits of FDI inflows extend far beyond financial resources—but costs may be entailed as well. Governments throughout the region have been striving to find an appropriate policy mix for FDI that will maximize the net benefits for their economies. Consequently, there is considerable variation in policies and experiences with FDI across countries, reflecting differing economic, social, and political conditions.

Until the mid-1980s, most developing countries worldwide viewed FDI with great wariness. The sheer magnitude of FDI from multinational enterprises (MNEs) was regarded as a threat to host countries, raising concerns about MNEs' capacity to influence economic and political affairs. These fears were driven by the colonial experience of many developing countries and by the view that FDI was a modern form of economic colonialism and exploitation. In addition, the local affiliates of MNEs were frequently suspected of engaging in unfair business practices, such as rigged transfer pricing and price fixing through their links with their parent companies.

Consequently, most countries regulate and restrict the economic activities of foreign firms operating within their borders. Such regulations often include limitations on foreign equity ownership, local content requirements, local employment requirements, and minimum export requirements. These measures are designed to transfer benefits arising from the presence of foreign firms to the local economy. At the same time, most countries also offer incentives to attract FDI. These often include tax concessions, tax holidays, tax credits, accelerated depreciation on plant and machinery, and export subsidies and import entitlements. Such incentives aim to attract FDI and channel foreign firms to desired locations, sectors, and activities. This "carrot and stick" approach has long been a feature of the regulatory framework governing FDI in host countries (McCulloch 1991).

In recent years, however, FDI restrictions have been substantially reduced as a result of a host of factors—accelerating technological change, emergence of globally integrated production and marketing networks, existence of bilateral investment treaties (BITs), prescriptions from multilateral development banks, and positive evidence from developing countries that have opened their doors to FDI.

In addition, the drying-up of commercial bank lending in the 1980s due to debt crises brought many developing countries to reform their investment policies to attract more stable forms of foreign capital, and FDI appeared to be an attractive alternative to bank loans as a source of capital inflows. In the process, incentives and subsidies were aggressively offered, particularly to MNEs that supported developing countries' industrial policies.

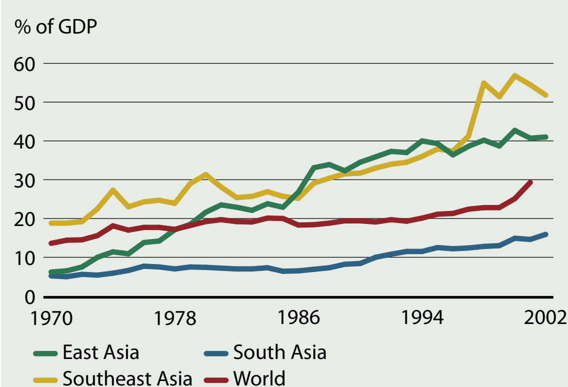
This part of the *Asian Development Outlook 2004* reviews recent developments in FDI flows and their impacts in developing Asia, and the importance of the policy context in which those flows occur. It summarizes findings of an Asian Development Bank-supported study of FDI in general and particularly in six diverse, developing Asian countries.[1]

Flows of FDI have seen a dramatic rise in the last 20 years due to increasing openness of host economies. The growing internationalization of trade and investment has prompted a proliferation of BITs. From diverging perspectives, host and source countries have a common interest in establishing some—perhaps minimal—accepted international architecture, the "rules of the game," regarding MNE obligations and host country responsibilities. This has led some countries to call for increased cooperation through the establishment of international investment rules and commitments. The failed multilateral agreement on investment (MAI) initiative led by the Organisation for Economic Co-operation and Development was one attempt in this direction. FDI is now on the World Trade Organization (WTO) Doha agenda, which has explicitly included "development issues." Whether this will progress any further than the MAI appears doubtful at present. Collective action toward a common business regulatory framework is even more complex than coordinated trade liberalization.

Trends

Cross-border trade in developing Asia has grown rapidly since 1970. Global exports of goods and services rose by an annual average of 5.6% in real terms and 9.5% in nominal terms from 1970 to 2001. As a share of output, exports increased from less than 14% in 1970 to more than 29% in 2001 (Figure 3.1). While South Asia has more or less followed the world trend, East Asia has seen increasing exports relative to output, surpassing the world average since 1979. Southeast Asia has consistently achieved a higher ratio of exports to gross domestic product (GDP) since 1970 than the world average.

Figure 3.1 Exports, Selected Regions, 1970–2002

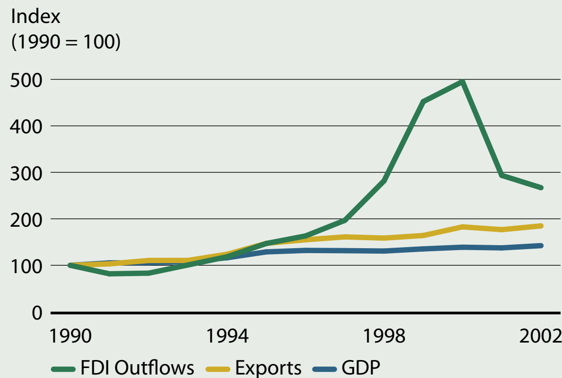


Source: World Bank, World Development Indicators database, downloaded 25 November 2003.

Relative to world output and exports, FDI outflows have risen tremendously since the early 1990s (Figure 3.2). World FDI outflows increased about five times from 1993 to 2000 before falling beginning in 2001, while world trade and output grew at a more modest pace, not even doubling in value between 1990 and 2002.

From only $53.7 billion in 1980, annual FDI outflows reached $1.2 trillion in 2000. (Since then, however, the weaker global economy has considerably reduced outflows, which dropped by 44% in 2001, a further 9% in 2002, and remained flat in 2003.) The upsurge in FDI substantially changed the international economic landscape. From 1980 to 2000, the growth rate of world FDI outflows surpassed that of world exports (Figure 3.3). This

Figure 3.2 World Exports, FDI Outflows, and GDP, 1990–2002



Sources: Exports and GDP: IMF, World Economic Outlook database, September 2003; FDI outflows: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

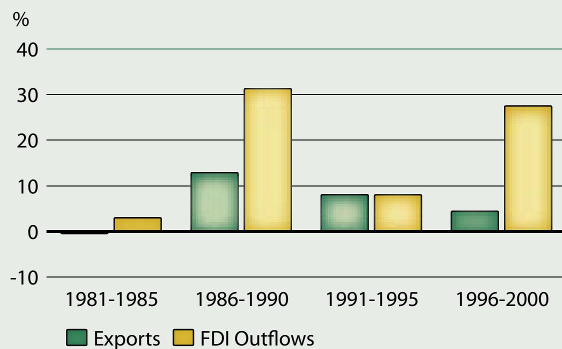
swift expansion in FDI was more pronounced during 1986–1990, when many host countries began to relax regulations to attract FDI, and 1996–2000, when companies undertook scores of mergers and acquisitions (M&As) in the wake of privatization programs in Latin America and the 1997–98 Asian economic crisis.

As trade has been liberalized, the old "tariff factory" model of FDI has given way to a new FDI-led, export-oriented paradigm. This is sometimes characterized as a switch from "rent-seeking" to "efficiency-seeking" FDI. This transformation has profound implications for host countries' management of FDI. The regulatory apparatus that was constructed to manage (and frequently siphon off) rents under the old regime is generally still present in most countries. Yet it has become largely irrelevant, and has usually been bypassed in the reform process, which has typically been driven by other parts of the bureaucracy. The contemporary challenge for developing countries is to develop a new approach to managing FDI. In a globalizing world, competition for FDI is no longer about rents but instead *focuses on the establishment of an enabling, business-friendly commercial environment, consistent with national development objectives.* In this context, a useful paradigm is the so-called "three Is": incentives, institutions, and infrastructure. That is, as economies open up, these three factors (examined in greater detail in the section *The Commercial Environment* below) are key determinants not only of the overall rate of economic growth but also of the magnitudes and productivity of capital flows.

The geographic pattern of FDI outflows has changed only slightly in recent years. Europe and North America continue to be the largest sources of FDI flows in the world, supplying at least 75% of the total since 1991. In contrast, the share of developing Asia in total FDI outflows fell significantly beginning in 1998 due to the declining importance of Japan as an FDI supplier.

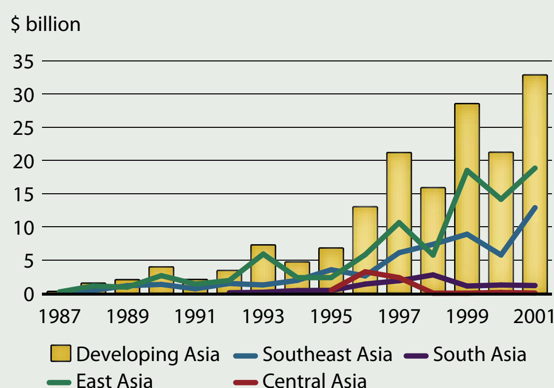
While Europe and North America continue to be major recipients of FDI, the People's Republic of China (PRC) has emerged as another favored destination. Economies in developing Asia received increasingly larger shares of world FDI inflows beginning in the 1990s, but the Asian economic crisis temporarily reversed this trend. FDI flows soon recovered, particularly in the wake of M&As after the crisis. M&As in developing Asia rose more than 128 times by value between 1987 and 2001, from only $256.1 million to $32.9 billion. In descending order of size, Hong Kong, China; Republic of Korea (Korea); Philippines; Singapore; and PRC were the top five recipients of M&A flows between 1997 and 2001. This has made East Asia the top subregional recipient in developing Asia, followed by Southeast Asia (Figure 3.4).[2]

Figure 3.3 Average Annual Growth of World Exports and FDI Outflows, 1981–2000



Sources: Exports: IMF, World Economic Outlook database, September 2003; FDI outflows: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Figure 3.4 Cross-Border Mergers and Acquisitions, by Subregion, 1987–2001



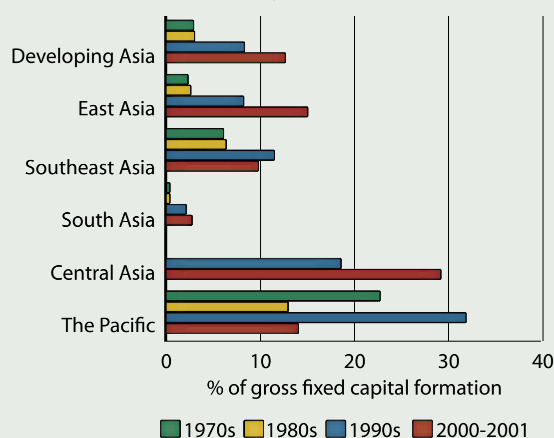
Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

All subregions in Asia experienced a sharp increase in the average ratio of FDI inflows to gross fixed capital formation during the 1990s, with South Asia seeing a fivefold increase, although from a low base (Figure 3.5). FDI inflows to developing Asia grew from only $694 million in 1970 to a huge $138.6 billion in 2000, before declining to $90.1 billion in 2002, representing an average growth rate of 15.2% per year.

There have been shifts in the preferences of foreign investors for individual country destinations over the last decade. Malaysia, Singapore, and Thailand, which were among the 20 largest FDI recipients during 1991–1993, were replaced by Brazil, Finland, and Ireland during 1998–2000. In addition, Japan and Korea became preferred locations for FDI in the post-Asian crisis era (JBICI 2002).

Among the favored Asian destinations for FDI, there has not been as much change. Indonesia and Kazakhstan, two of the top 10 FDI destinations in the early 1990s, dropped from the list primarily due to uncertainties in their domestic economies and were replaced by India and Viet Nam in the late 1990s. Meanwhile, Hong Kong, China; Singapore; Korea; and Thailand overtook Malaysia as preferred FDI destinations. Among the countries in developing Asia, the top 10 recipients of FDI inflows in 2002 accounted for over 97% of total FDI in the region, with the top three recipients alone accounting for 81% (Table 3.1). Azerbaijan, however, which is not even in the top 10 developing Asian FDI recipients, had the highest ratio of FDI to GDP, reflecting the importance of FDI in its hydrocarbons development. On the other hand, four out of the top 10 FDI recipients in developing Asia have FDI-to-GDP ratios lower than the average of 2.6% of GDP. This means that FDI to developing Asia is somewhat concentrated—only 10 out of 36 economies for which data are available have FDI shares equal to or exceeding their GDP shares in developing Asia.

Figure 3.5 FDI Inflows, by Subregion, 1970–2001



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Table 3.1 FDI Inflows in Selected Developing Asian Economies, 2002

Economy	% of Total FDI	Ratio to GDP
PRC	57.7	4.3
Hong Kong, China	15.0	8.4
Singapore	8.4	8.8
India	3.8	0.7
Malaysia	3.5	3.4
Kazakhstan	2.8	10.5
Korea	2.2	0.4
Taipei,China	1.6	0.5
Viet Nam	1.3	3.5
Philippines	1.2	1.4

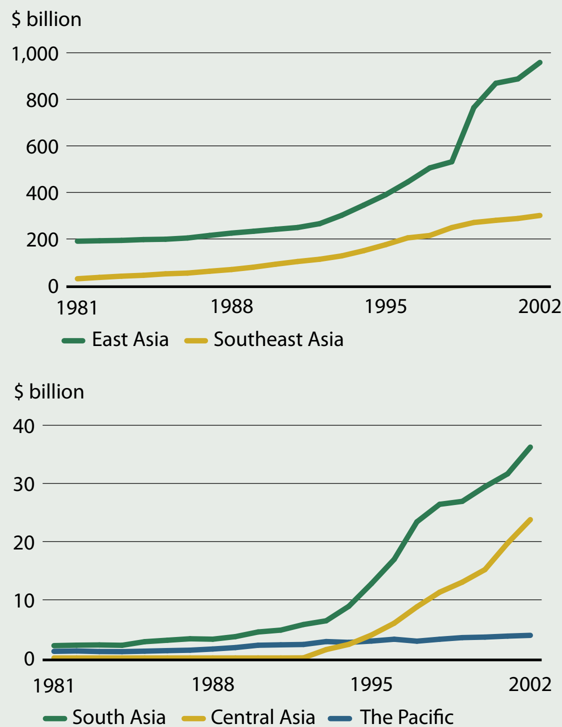
FDI = foreign direct investment, GDP = gross domestic product, PRC = People's Republic of China.

Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

While the total value of FDI inflows to the top 10 Asian destinations surged during the last decade, developing Asia's share in the world total dropped significantly. Average FDI inflows per capita showed remarkable increases in some Asian economies. In Hong Kong, China, for instance, per capita inflows increased 7.5 times to $5,006 between the early and late 1990s. The total annual inflow there was greater than three quarters of gross fixed capital formation by the end of the decade. In other Asian economies, FDI amounts to over 30% of gross fixed capital formation (Table 3.2).

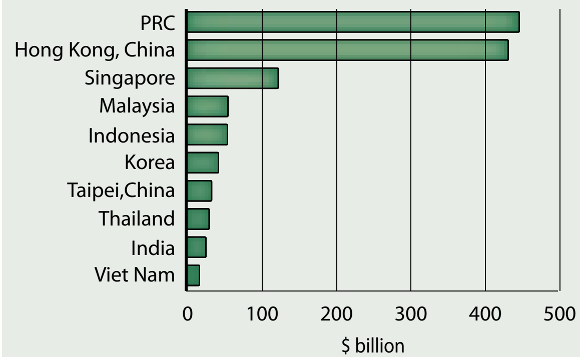
Among the subregions in developing Asia, East Asia and Southeast Asia have the highest levels of accumulated FDI inward stock (Figure 3.6), with Hong Kong, China traditionally the largest. In 2002, however, it was overtaken by the PRC as the largest holder of FDI inward stock (Figure 3.7).

Figure 3.6 FDI Inward Stock, by Subregion, 1981–2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Figure 3.7 FDI Inward Stock, Top 10 in Developing Asia, 2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Impact of Foreign Direct Investment

Overview

Supporters of FDI contend that foreign investors introduce a package of highly productive resources into the host economy, including production and process technology, managerial expertise, accounting and auditing standards, and knowledge of international markets. The challenge for the host economy is to benefit from the MNE presence, and to appropriate some of the increased income accruing from the resultant productivity growth. The large literature on FDI impacts[3] concludes that the host economy benefits are quite uneven, both across and within countries. This suggests that host country policies are an important factor in the distribution of these benefits. Of particular relevance here, as postulated in this literature, are the commercial environment, institutional quality, and supply-side capacities.

It should be emphasized that many FDI impacts are inherently difficult to measure. The academic literature typically approaches the issue in one of three ways. The first is in the context of the determinants of growth (Box 3.1). In

Table 3.2 Top 10 Destinations for FDI in Developing Asia, 1991–1993 and 1998–2000

Rank	Host Economy	1991–1993	Rank	Host Economy	1998–2000
Average Annual Total Inflows (US$ billion)					
1	PRC	14.3	1	PRC	41.6
2	Malaysia	5.0	2	Hong Kong, China	33.8
3	Hong Kong, China	3.9	3	Singapore	11.1
4	Singapore	3.9	4	Korea	8.0
5	Thailand	2.0	5	Thailand	5.6
6	Indonesia	1.8	6	Malaysia	3.5
7	Taipei,China	1.0	7	Taipei,China	2.7
8	Philippines	0.9	8	India	2.4
9	Korea	0.8	9	Philippines	1.6
10	Kazakhstan	0.7	10	Viet Nam	1.5
	Total Developing Asia	35.4			111.6
	(% of world total)	(19.3)			(10.6)
Average Inflows per Capita (US$)					
1	Singapore	1,234	1	Hong Kong, China	5,006
2	Hong Kong, China	667	2	Singapore	2,826
3	Malaysia	264	3	Korea	172
4	Vanuatu	164	4	Malaysia	154
5	Fiji Islands	104	5	Taipei,China	121
6	Solomon Islands	51	6	Vanuatu	94
7	Taipei,China	49	7	Thailand	94
8	Kazakhstan	42	8	Kazakhstan	87
9	Thailand	36	9	Azerbaijan	71
10	Maldives	29	10	Fiji Islands	63
FDI as % of Gross Fixed Capital Formation					
1	Vanuatu	53.1	1	Hong Kong, China	75.7
2	Fiji Islands	38.7	2	Cambodia	45.3
3	Viet Nam	32.0	3	Kazakhstan	42.7
4	Solomon Islands	26.5	4	Singapore	39.3
5	Singapore	23.1	5	Azerbaijan	38.9
6	Malaysia	22.8	6	Papua New Guinea	36.5
7	Cambodia	17.9	7	Vanuatu	28.2
8	Kyrgyz Republic	15.2	8	Kyrgyz Republic	24.4
9	Hong Kong, China	13.2	9	Thailand	22.1
10	Papua New Guinea	12.1	10	Viet Nam	19.7

FDI = foreign direct investment, PRC = People's Republic of China.

Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

international comparisons of economic growth, FDI, or some other measure of foreign presence, is introduced as an explanatory variable, together with a range of interactive or "conditional" variables (e.g., trade orientation, human capital, institutional quality). The hypothesis is that, other things being equal, a larger presence is associated with faster economic growth. The other two methodologies focus on technology spillovers within countries, from foreign to domestic firms, as measured either through firm-level case studies or an analysis of cross-section industry data. Both provide only a proximate and partial picture: the former is limited by the sample size and the flows are generally not quantified; the latter is presumptive and inferential rather than demonstrated. The relative importance of the various channels through which spillovers occur—emulation, interfirm worker mobility, subcontracting networks—is generally not demonstrated conclusively. A range

of non-equity channels (international labor migration, international buying groups, licensing arrangements) could be just as important as FDI in some circumstances.

A related set of literature attempts to draw a distinction between positive, "crowding-in" effects of FDI, and negative, "crowding-out" effects. Among the former are the positive technology and trade effects alluded to above, together with various dynamic externalities such as clustering and country reputation. The latter draws attention to a range of possible outcomes: anticompetitive impacts (e.g., displacement of domestic firms or investment), bidding scarce resources (e.g., skilled labor, credit) away from domestic firms, or squeezing out domestic supply networks as new foreign entrants bring with them integrated upstream and downstream supply chains.

It is now generally accepted that the distinguishing characteristics of FDI are its stability and ease of service relative to commercial debt or portfolio investment, as well as its inclusion of nonfinancial assets in production and sales processes. Aside from increasing output and income, potential benefits to host countries from FDI inflows include the following:

(i) **Foreign firms bring superior technology.** The extent of benefits to host countries depends on whether the technology spills over to domestic and other foreign-invested firms.

(ii) **Foreign investment increases competition in the host economy.** The entry of a new firm in a nontradable sector increases industry output and may thereby reduce the domestic price, leading to a net improvement in welfare.

(iii) **Foreign investment typically results in increased domestic investment.** In an analysis of panel data for 58 developing countries, Bosworth and Collins (1999) found that about half of each dollar of capital inflow translates into an increase in domestic investment. Their findings suggest a foreign resource transfer equal to 53–69% of the inflow of financial capital. However, when the capital inflows take the form of FDI, there is a near one-for-one relationship between the FDI and domestic investment.

(iv) **Foreign investment gives advantages in terms of export market access arising either from foreign firms' economies of scale in marketing or from their ability to gain market access abroad.** Besides their contributions through joint ventures, foreign firms can serve as catalysts for other domestic exporters. In an empirical analysis, the probability that a domestic plant will export was found to be positively correlated with proximity to multinational firms (Aitken et al. 1997). One implication is that governments may encourage potential exporters to locate near each other by (i) creating special economic zones (SEZs—see Box 3.2) or export processing zones, or promoting clusters, or by (ii) conferring special benefits, such as duty-free imports of inputs, subsidized infrastructure, or tax holidays, to help reduce costs for domestic firms in breaking into foreign markets.

(v) **Foreign investment can aid in bridging a host country's foreign exchange gap.** Two gaps may exist in the economy: insufficient savings to support capital accumulation to achieve a given growth target, and insufficient foreign exchange to purchase imports. Often investment requires imported inputs. If domestic savings are insufficient, or face barriers in being converted to foreign exchange to acquire imports, they may be insufficient to guarantee growth. Capital inflows help ensure that foreign exchange will be available to purchase imports for investment.

For countries with relatively easy access to international capital markets (such as Korea) or with substantial holdings of foreign reserves (such as the PRC or India), the nonmonetary benefits of FDI, such as (i)–(iv) above, still make it an attractive source of investment.

Foreign Direct Investment and Trade

A capital inflow can lead to increased demand in the host country, in turn leading to a rise in the prices of nontradable goods and services relative to those of imported goods and services facing world market prices. If world demand for the country's exports is perfectly price elastic, the price of nontradables will rise relative to the price of exports as well. Consequently, the change will affect the returns to factors that are

Box 3.1 Does FDI Contribute to Economic Growth … or Doesn't It?

A number of studies have been undertaken to determine whether FDI impacts positively on economic growth. Two types of studies—macro and micro—have generally been conducted to study the relationship between FDI and growth. Micro studies usually find no positive evidence that FDI makes a positive contribution to growth. Macro studies, on the other hand, often find FDI to positively affect economic growth under certain conditions.

Balasubramanyam et al. (1996) test the hypothesis that export-promoting (EP) countries enjoy greater efficiency from FDI using a production function in which FDI is considered an additional input to domestic capital and labor. They argue that, since it is a prime source of human capital and new technology for developing countries, the FDI variable captures the externalities, learning by watching, and spillover effects. Exports are also used as an additional factor input into the production function, following the large number of empirical studies that investigate the export-led growth hypothesis. The model they use has real GDP dependent on labor, domestic capital stock, foreign capital stock, exports, and a time trend capturing technical progress.

Following Bhagwati's (1973) hypothesis, in which an EP strategy is likely to attract higher levels of FDI and promote its efficient utilization more than an import-substituting (IS) strategy, the FDI coefficient in the econometric model is expected to be positive and greater for EP countries than for IS countries. Also, for EP countries, it is expected that FDI is a more potent growth contributor than domestic investment because of the spillover effects and externalities associated with human capital, and the higher rate of technical innovation associated with FDI.

Their results for the entire sample of countries indicate that the impact of foreign capital on growth exceeds that of labor, which in turn exceeds that of exports. The parameter estimate for the impact of domestic capital is not significantly different from zero. Meanwhile, their results from the subsample of EP and IS countries provide further support for the Bhagwati hypothesis. Their findings indicate that FDI is a positive and a significant contributor to growth for EP countries, while having no influence on growth for IS countries. In addition, as far as EP countries are concerned, it is FDI and not domestic investment that acts as a driving force in the growth process.

A later study by Balasubramanyam et al. (1999) tested four hypotheses of FDI's contribution to growth: (i) FDI can promote growth in the presence of a liberal trade regime; (ii) a threshold level of human endowment is necessary for the promotion of growth through FDI; (iii) effective utilization of human capital in conjunction with FDI requires an adequate domestic market for the goods produced; and (iv) technology and skill spillovers from FDI do not materialize from the mere presence of FDI, but from a competitive environment.

Their first hypothesis is the same as the one they tested in 1996. While the authors used the ratio of imports to GDP to determine whether a country is EP or IS in their 1996 study, they used the residual approach, calculating the deviation between actual and predicted export volumes, to measure trade policy orientation in their 1999 study. Classifying countries according to this method yielded the same results as their 1996 study. To test their second hypothesis, the authors included an FDI-human capital interaction term in their model, but found the coefficient to be statistically insignificant. In testing their third hypothesis, the authors used per capita GDP as a proxy for the role of the domestic market. While the coefficient of this variable turned out to be statistically significant, its sign was negative. The authors explained that the variable may be picking up the dominance of convergence effects observed in endogenous growth literature. In addition, the coefficient of the FDI-human capital interaction term became statistically significant with the inclusion of the domestic market proxy. Finally, the authors tested their fourth hypothesis by including

used intensively in either tradable or nontradable sectors. Thus, a capital inflow-induced terms-of-trade effect may affect real income for any given level of real output, while the output level may or may not be affected.

When the price of nontradables rises relative to the prices of imports and exports, "Dutch disease" may result, in which resources are drawn from production of tradables to nontradables, and exports fall as the macroeconomy adjusts to a new equilibrium with corresponding changes in factor demand and prices. Distributional effects will result (Cooper 2002).

When there are "lumpy" adjustment costs for new investment and economies of scale exist in the investment technology, trade openness can trigger discrete changes in the terms of trade and thereby lead to discrete jumps in the level of investment. However, it can also lead to boom-bust cycles of investment where multiple equilibria

Box 3.1 *(continued)*

the share of manufacturing to total value added as a proxy for local competition, but the coefficient of this variable turned out to be insignificant.

Another study, by Borensztein et al. (1998) tested the effect of FDI on economic growth in a cross-country regression framework. They used data on FDI received by developing countries from industrial countries only. The results suggest that FDI is an important vehicle for the transfer of technology, contributing more to growth than domestic investment. There were also indications that FDI has a positive effect on economic growth, but this impact was dependent on the human capital stock in the host economy. The higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies that it brings is available in the host economy.

The authors also found some evidence of a crowding-in effect, i.e., that FDI is complementary to domestic investment. A one-dollar increase in FDI inflows is associated with an increase in total investment in the host economy of more than one dollar. This implies that FDI exerts a positive effect on domestic investment, ranging from 1.5 to 2.3, probably due to the attraction of complementary activities that dominate the displacement of domestic competitors. Most of the effect of FDI on growth likely derives from efficiency gains rather than an overall higher induced level of investment.

More recent studies, however, assert that the results of such macro studies are flawed. Nair-Reichert and Weinhold (2001) argue that traditional panel and time series estimators often impose homogeneity assumptions across countries in studies of the relationship between FDI and growth. Their findings, meanwhile, show strong evidence of considerable heterogeneity across countries. This indicates that incorrectly imposing the homogeneity assumption on the data can lead to biased estimates and faulty policy implications. To circumvent the problem, the authors use mixed, fixed, and random (MFR) panel data estimation to test for causality between FDI and economic growth in developing countries. Results from the MFR estimation differ substantially from traditional panel data causality results. While traditional tests suggest a significant and uniform impact on growth from FDI, this study finds the causal relationship between investment (foreign and domestic) and economic growth in developing countries to be highly heterogeneous. And while domestic investment seems to be strongly correlated contemporaneously with growth, it is not generally a strong causal determinant of future growth. In addition, the study finds a causal relationship from FDI to growth and there is some evidence that the efficacy of FDI is greater in more open economies, although this relationship is highly heterogeneous across countries. The study also finds no statistically significant role for human capital in economic growth, but this does not mean that human capital is unimportant, since the relationship between human capital and growth is quite complex and may not be adequately captured in linear models.

Carkovic and Levine (2002) also dispute the generally positive findings on the FDI-growth relationship. They argue that the many macroeconomic studies that find a positive link between FDI and growth do not fully control for endogeneity, country-specific effects, and inclusion of lagged dependent variables in growth regressions. After controlling for these statistical problems, the authors find that FDI inflows do not exert an independent influence on economic growth.

The studies mentioned above illustrate the ongoing controversy regarding the importance of FDI on economic growth. While an exhaustive literature has already emerged to support each side of the debate, closure remains elusive.

Sources: Balasubramanyam et al. (1996, 1999); Borensztein et al. (1998); Nair-Reichert and Weinhold (2001); Carkovic and Levine (2002).

are supported by self-fulfilling expectations (Razin et al. 2002).

As foreign investors search for the location that will provide the highest returns on their investment, they may be drawn to countries with abundant natural resources but low-quality institutions. Weak and inefficient institutions allow the extraction of natural resources at a pace faster than that required for sustainable development. As a result, ethnic communities are sometimes harmed as the environment, their main source of livelihood, is damaged or destroyed. Foreign investment-led growth also promotes Western-style consumerism, which could have serious potential consequences for the health and food security of the host population (French 1998).

Nevertheless, MNEs are playing an ever more prominent role in the global economy, with crucial implications for countries pursuing an export-oriented development strategy. Compared

Box 3.2 Special Economic Zones: The Case of India

Establishing special economic zones (SEZs) is one of many ways used to encourage FDI and promote exports. Generally throughout the world, an SEZ is a geographic area that has different economic laws from the rest of the country. SEZs are often developed as independent communities with limited government intervention, but receive tax incentives and special privileges from the government. Foreign equity of up to 100% is often permissible for firms locating in SEZs. The most common incentives and privileges include:

- reduced red tape in securing licenses and permits by establishing one-stop shops;
- duty free imports of raw materials, intermediate inputs, and capital goods;
- tax concessions;
- subsidized utility and rental rates; and
- reliable infrastructure.

The Government of India introduced an SEZ scheme in 2000 to provide an internationally competitive and conducive environment for export production. The main objectives of these zones were to enhance foreign exchange earnings, develop export-oriented industries, and generate employment. These zones were separated from the rest of the country by physical barriers. The scheme allows units to set up in SEZs for activities related to manufacturing, trading, reconditioning, repair, or services. All trading operations of SEZ units are on a self-certification basis. While they are not subject to predetermined value addition or minimum export requirements, SEZ units must be net foreign exchange earners within 3 years of starting operations. SEZ units' sales to outside the SEZ are subject to full customs duties and the prevailing government import policy.

SEZs can be set up by either the public or private sector—or jointly—or by the state governments. The scheme envisages the conversion of some existing export processing zones into full-blown SEZs. Thus, the Government has converted export processing zones located at Kandla and Surat (Gujarat), Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra), Falta (West Bengal), Madras (Tamil Nadu), Visakhapatnam (Andhra Pradesh), and Noida (Uttar Pradesh) into SEZs (Box Table). In addition, the Government has approved the setting up of 21 SEZs in various parts of the country.

Basic infrastructure is often provided in each SEZ. This includes developed land for construction of factory sheds, standard-design factory buildings providing ready-built industrial sheds, roads, power, water supply, and drainage. The Government provides the facilities for customs clearance within the zone (at no cost to the SEZ units).

As of end-FY2002/03, 659 units were in operation in the eight functional SEZs. Total investments had reached Rs100.6 billion, and employment had risen to over 85,000. Exports had also grown to Rs100.5 billion, representing about 4% of the country's total exports.

However, a large percentage of approved projects remains in the planning stage. In addition, SEZ exports in other countries account for a substantially larger share of total exports. In the Philippines for instance, exports from SEZ firms grew rapidly from 31.6% of total exports in 1996 to 66.1% in 2002, and as of September 2003, employment had expanded to almost 900,000. In the People's Republic of China, SEZ exports as a share of total exports have likewise grown steadily, particularly for high-tech exports.

India's experience can be taken as evidence that providing special privileges to foreign investors does not always produce the intended results. Governments need therefore to be more careful in granting incentives to foreign firms.

In general, maintaining an economic environment that is conducive to both domestic and foreign investment is the ideal path for governments to take. A favorable policy framework for investment is one that generally provides economic and political stability, transparent rules on entry and operations, and equitable standards of treatment between foreign and domestic firms, and secures the proper functioning and structure of markets (UNCTAD 2003a). This involves efforts to improve the quality of immobile assets, i.e., institutions as well as social, legal, and physical infrastructure. To enhance investment prospects, governments must strive to reduce uncertainty, asymmetric information, and related search and other transaction costs (especially time and number of steps involved in acquiring approval) faced by investors.

Removing the special treatment provided to SEZs would also pave the way for export-oriented firms to connect with the domestic economy through forward and backward linkages. Local suppliers would have the chance to serve export-oriented firms on a more even footing with importers.

Box 3.2 *(continued)*

Meanwhile, local consumers would have an expanded choice of consumption goods.

Overall, the sole benefit that is unquestionably provided by firms in SEZs is job creation. But the contribution of SEZ firms is often not enough to make a dent in a host economy's unemployment rates due to the larger rate of increase in the economy's labor force. The rest of the purported benefits that host economies are expected to reap from the establishment of SEZs entail corresponding costs, which make it difficult to determine whether the overall effect is a net benefit.

Sources: http://www.ciionline.org/services/, downloaded 8 January 2004; http://www.sezindia.nic.in/, downloaded 8 January 2004; http://www.projectstoday.com/sitemap/sezs_database.asp, downloaded 9 January 2004; http://www.peza.gov.ph/indi_frmset.htm, downloaded 9 January 2004; UNCTAD 2003a.

Box Table Exports of Functional Special Economic Zones: FY2000/01–FY2002/03, Rs million

Special Economic Zone	2000/01	2001/02	2002/03
Kandla	5,278.9	4,759.8	7,292.9
Santa Cruz	51,937.0	52,256.0	60,830.2
Cochin	3,043.0	2,585.0	2,704.2
Surat	622.8	3,118.6	2,807.1
Noida	10,342.0	9,804.1	10,011.7
Madras	6,908.4	7,625.9	8,191.0
Visakhapatnam	2,190.8	2,530.2	3,572.7
Falta	5,199.7	9,236.3	5,123.9
Total Special Economic Zone Exports	85,523.0	91,895.5	100,533.7
Total Country Exports	2,035,710.0	2,090,180.0	2,551,370.0
(% of total exports)	(4.2)	(4.4)	(3.9)

Source: http://www.sezindia.nic.in/, downloaded 8 January 2004.

with a decade or more ago, FDI will now typically (i) be more export oriented, (ii) be less likely to be attracted by the old tariff factory model of production for a protected domestic market, and (iii) account for an increasing share of host economy exports.[4]

Two factors have been driving these trends. The first has been the more or less simultaneous liberalization of both trade and FDI regimes. The second has been technological advances in transport costs and production technologies. The rise of the "global factory" has been made possible by much reduced international transport costs and by disaggregated, transborder production processes, particularly in MNE-intensive industries such as electronics and automobiles. In the most successful cases of these industrial clusters, notably southern coastal PRC and to a lesser extent the Singapore-centered SIJORI—Singapore-Johore (Malaysia)-Riau (Indonesia)—triangle, production operations constitute a seamless web in which national boundaries virtually disappear.

It is now much more difficult for late-comer industrializers to achieve high rates of export growth without MNE participation (Urata 2001), the more so for transitional economies with a history of international commercial isolation. The earlier literature on this subject, in which Nayyar (1978) was a major study, argued that MNE involvement in export expansion from the newly industrializing economies was mostly low by international standards. (As a corollary, therefore, developing countries could achieve rapid economic development while maintaining relatively restrictive FDI policies, especially with purchases of technology.) While this generally remains the case for Korea and Taipei,China, it is important to note that in both economies the MNE share in exports did increase significantly from about the mid-1970s to the mid-1980s, relative to the figures reported by Nayyar for the late 1960s.

In any case, however, and contrary to Nayyar's arguments, there is clear evidence that the strong export performance of developing countries since the 1970s has been closely associated with MNE involvement. By linking individual country data

on MNEs' shares in exports with general export data, Nayyar estimated the share of MNEs in total manufactured exports from developing countries to be not more than 15% around 1974. Moreover, he found that the share had not registered any significant increase since 1966. By contrast, a similar calculation, based on unpublished estimates prepared by Chandra Athukorala of the Australian National University, suggests that MNEs accounted for 24% of total manufactured exports from developing countries around 1980. This figure had increased to 36% around 1990. When Hong Kong, China; Korea; and Taipei,China are excluded from the calculations, the latter estimate increases to 45%. Given the huge increase in manufactured exports from the PRC, and the increased share of MNEs in this export expansion (from 17% to 48% over this decade), this figure would have surpassed 50% by 2000.

Two additional observations on MNE trade impacts are relevant. One is that the earlier concerns about "immiserizing growth"—as expressed by, e.g., Bhagwati (1973)—are less relevant. This analytical paradigm, motivated by the experience of India and other highly distorted economies, postulated that FDI that entered highly distorted industries would generate negative value added at international prices, in addition to any fiscal incentives offered to attract MNEs (Brecher and Diaz-Alejandro 1977). More open trade regimes alleviate these concerns.

Second, in any case, what matters is the efficiency of MNE investments rather than their trade orientation. As in the case of the PRC, some government officials still worry about whether MNEs generate a trade surplus or deficit. However, "deficits" and "surpluses" carry no normative implications; they can be either "good" or "bad" depending on the efficiency of firms' operations. As it happens, the trade of MNEs in the PRC is shifting from deficits to surpluses as reform progresses and the "dual regime" becomes less important. That is, the initial concentration of MNEs in joint ventures with uneconomic state-owned enterprises (SOEs) was a major explanation for the observed "deficits." The trade orientation of MNEs has changed rapidly as export-oriented firms have begun to predominate.

Thus, the trade orientation of MNEs is largely influenced by the domestic policy environment. Here the East Asian and South Asian comparison is striking. MNEs account for a trivial share (about 3%) of Indian exports, compared with the 50% or more found in many East Asian economies. Skeptics might argue that the East Asian figures are overwhelmed by lower domestic value added in intensively traded goods such as electronics, or that East Asian governments have been more successful in imposing export performance requirements as a condition of entry. While the former does inflate both export-to-GDP ratios and MNE export shares, the differences fundamentally reflect the fact that the East Asian economies offer more congenial commercial environments: entry is simpler and less restrictive, and export/import procedures are less complex. The more protected South Asian markets offer more incentive for rent seeking.

In countries where MNEs dominate host country exports, there is some concern over the potential loss of economic policy sovereignty. Malaysia, where MNEs account for about 75% of exports, exemplifies this issue. Decisions that are made in far-off corporate headquarters, it is alleged, might not reflect host economy interests and priorities. Threatening large-scale exit, highly mobile MNEs might exact very generous tax concessions. Intra-MNE export restrictions and franchises may inhibit export growth. The international evidence supporting these allegations is not persuasive, however. MNEs tend to put down roots in congenial environments, and FDI is not as mobile as other forms of foreign capital. MNE interaffiliate export decisions are fundamentally driven by the same considerations as market-based ones. Of course, regime instability and nationalist sentiment will discourage FDI, as they do domestic investment. As a country loses comparative advantage in labor-intensive activities, MNEs will shift their low-end activities to other locations. But domestic firms will do likewise, and the challenge for policy makers is to play a creative role in managing the upgrading process.

Employment, Distribution, and Poverty

The social and distributional impacts of FDI depend principally on host country policies and institutions. For example, employment outcomes depend on the flexibility of the labor market. The growth-poverty relationship depends on the

extent to which governments have pursued policies that enable low-income groups to take advantage of growth opportunities. Similarly, regional (subnational) impacts will be shaped by the spatial distribution of complementary production inputs, such as physical and social infrastructure.

The employment impacts of FDI illustrate this proposition. The more open and less distorted Malaysian and Thai economies have experienced chronic labor shortages since the late 1980s, necessitating very large imports of mainly unskilled labor.[5] This phenomenon was only briefly interrupted by the Asian economic crisis. The predominant location of MNEs in labor-intensive, export-oriented industries, combined with rapid economic growth in general, hastened the emergence of labor scarcity and, consequently, rising real wages.

By contrast, in less open and in transitional economies, labor market outcomes, complicated by history and institutions, have been less satisfactory. In the PRC, there is some evidence suggesting negative employment effects of FDI. The problems appear to be concentrated in MNE joint ventures with state enterprises. Thus, the root cause lies in the overstaffed SOEs, and the solution is reform of this sector rather than restricting FDI. Indeed, the entry of export-oriented, labor-intensive FDI is facilitating the necessary process of structural adjustment. Moreover, the freeing up of the domestic labor market is enabling workers from poor hinterland regions to seek employment in the booming FDI-connected coastal regions. While this migration has considerable and sometimes disruptive social implications, and may create unemployment of the Harris-Todaro variety,[6] it is also an important mechanism for equalizing the benefits of spatially uneven growth.

Similarly, the employment effects of FDI in India have been mixed. With its earlier emphasis on heavy industry and the modest export performance of labor-intensive industries, until recently India largely missed out on East Asian-style export-oriented industrialization. This was the central conclusion of the one major (albeit dated) comparative study of this issue (Little et al. 1987). Moreover, as a corollary, India has not enjoyed the equity dividend that flows from such a broad-based participation in the industrial workforce.

If both labor and capital are fully employed before and after the capital movement, the total and average returns to capital increase, and total and average returns to labor decrease in the source country, changing the distribution of income among factors of production. While the source country gains as a whole, income is redistributed from labor to capital. Meanwhile, in the recipient country, income is redistributed from capital to labor, as total and average returns to capital decrease and total and average returns to labor increase. The result is potentially a win-win situation for both countries.

However, capital inflows do not always increase welfare in the host country. For example, when capital flows to an industry in which an existing firm has monopoly power in the world market, an increase in output from the new competition lowers the price of the exportable, thus reducing the terms of trade and lowering welfare in the host country. Also, the benefits from foreign investment are usually evaluated under the assumption that host countries can absorb a large inflow of capital without large declines in its rate of return. But if capital grows much faster than the productivity of labor, its productivity will fall, which might reduce its rate of return.

Under full employment, a capital inflow that reduces the relative scarcity of capital and raises the productivity of labor in the host country can raise real wages across the board and reduce income disparity within the host country. However, the question of distribution also arises with respect to the sharing of gains between foreign capital and host country factors. Traditionally, foreign investment was geared toward primary commodity exports. During the colonial period in Indonesia, for instance, foreign investment in Java was concentrated in tea and sugar export sectors and in Sumatra in rubber and oil exports. In some cases, this led to capacity expansion, productivity growth, declining prices of exportable commodities, and deterioration in the host country's terms of trade, possibly leading to welfare losses. In addition, there were (and are) generally few spillovers to the rest of the host economy from primary commodity production. The resulting view was that the gains from capital inflows favor the source economy more than the host economy.

Many new foreign investments in developing countries are in process manufacturing because of lower labor costs, such as Nike's shoe factories across developing Asia. The host countries often import unfinished components and export finished goods or refined components for further processing elsewhere. While wages may rise throughout the work force in host countries and reduce income disparity, in practice wages are likely to rise only for a small fraction of the labor force employed by the foreign investor. By creating a favored local group, this can lead to greater income disparity within the host country. Generally, this favored group belongs neither to the lowest nor highest income group. The result can be to improve the absolute and relative condition of workers within this favored group, in the process aggravating income inequality in society. Over time, however, and given a conducive policy environment, linkages and leakages emerge, creating a country reputation that influences other potential investors. The Singapore story (discussed in the subsection *Enabling Policy Framework*, below) is a case in point.

With regard to spatial impacts, foreign investors are attracted to regions with good social and physical infrastructure, and business-friendly environments. In these respects, they behave no differently from domestic firms. However, MNEs are likely to exhibit greater spatial concentration than their domestic counterparts for at least three reasons. First, MNEs are generally more trade intensive, and therefore more likely to locate in regions that are better connected to the global economy. Second, to the extent that MNEs operate in more skill- and capital-intensive activities, they are more likely to locate in regions with stronger endowments of these attributes. Thirdly, MNEs will not generally have the operating history of local firms in the host economy, and therefore will be less "historically attached" to particular regions.

Technology and Productivity Spillovers

Technology and productivity spillovers are central to the study of FDI impacts. They constitute the core of MNE competitive advantages, and they feature prominently in host government expectations of FDI. The major general conclusion from Asian country studies is that these spillovers are positive, both economy-wide and for specific industries. However, there are questions about the (i) magnitude of these impacts, (ii) speed of technology transfer, and (iii) government development of an enabling policy framework. Each of these is now considered in turn.

Magnitude of Impacts

Both the aggregate and case study approaches usually, though not always, point in the same direction. In the case of Thailand, Archanun (2003) found that spillovers from foreign- to domestically owned firms in manufacturing industries were significant. He also concluded that they were more likely to occur in less protected sectors, both because these sectors are more attractive to MNEs and because of the presumed competitive spur of lower protection.

As in most other countries, MNEs have played a key role in the automotive industry in Thailand. The country is now the Southeast Asian leader in the industry, with major clustering effects evident among both assemblers and suppliers. Two factors appear to explain its success. It possesses a relatively large domestic market, which initially attracted MNEs during the earlier import-substitution phase. In addition, it reaped an early mover advantage in being the first country in the region to enact major trade reform in the industry, thus quickly building up a strong export-oriented supplier base. By contrast, although Thailand has attracted much export-oriented FDI in electronics, it has not emerged as a major player in this industry. The explanation is that Thailand was slower to provide the major prerequisites required in this MNE-dominated, internationally integrated industry: export zones with high-quality infrastructure, linked in a seamless manner to international markets, and allowing 100% foreign ownership. It is important to note that MNEs have not been central to all of Thailand's export successes. The country's agro-based exports, including seafood, have performed very well, and foreign-based MNEs have not been major players in most cases, compared with several large domestic firms, most notably the Charoen Pokphand group (now an MNE itself). This illustrates a more general proposition, that MNEs are particularly important in industries that are characterized by high levels of cross-border vertical

integration, and where knowledge of international market chains may be firm specific.

The literature on FDI in the PRC generally concludes that it has been beneficial for growth.[7] This has occurred through the usual channels: augmenting investment, connecting firms in the PRC to global markets (very important for a country which hitherto had experienced several decades of international commercial isolation), and facilitating a rapid transition from uneconomic SOE-dominated heavy industry investments.

While its reforms are much more recent, Viet Nam's FDI impacts appear to be broadly similar to those in the PRC. Much of the early FDI went into uneconomic joint ventures with SOEs and nontradables such as hotels and construction.[8] More recently, following policy reform and disappointment with some early investments, MNEs have shifted to labor-intensive, export-oriented investments.

Speed of Technology Transfer

A common feature of FDI experiences is impatience with the apparently slow pace of local linkage formation. Malaysia was one of the earlier countries to attract the MNE-dominated export-oriented electronics industry. The literature on FDI in that country generally concludes that the impacts have been positive. However, it is alleged that MNEs have been slow to develop a local supplier base, have undertaken little research and development (R&D), have remained largely confined to the export zone enclaves, and much of the local content is in reality intra-MNE.[9]

The Malaysian experience well illustrates the challenges associated with maximizing technology transfers in the context of an MNE and export-led development strategy that is initially based on export zone enclaves. Linkage development and spillovers proceeded slowly, as would be expected. Malaysia's industrial history is recent; its human capital base was quite limited, especially so for technical skills; firms had great difficulty complying with government requirements to hire *bumiputra* employees, or source from their companies; and the incentives regime anyway discouraged firms in the zones from sourcing outside the enclave. But the evidence suggests that, over time, MNEs began to put down local roots, particularly as supply-side capacities improved. By the 1990s, the country was quickly losing its comparative advantage in labor-intensive activities, although the Government sought to prolong this advantage by opening up the labor market. From a low base, expenditure on R&D has been increasing rapidly, and is now approximately 0.5% of GDP (compared with 3.0% in Korea). MNEs are shedding low-skill activities, and shifting to higher-value segments. Although the Government will arguably have to be more activist in developing supply-side capacities,[10] Malaysia's experience with FDI and electronics has clearly been more successful than with the auto industry, where a highly protected monopoly has achieved few of the original technology and export objectives.

This pattern of enclave-based FDI will inevitably remain important as long as dual policy regimes (discussed in the subsection *Dual Policy Regimes* below) persist. For example, the Vietnamese Government may be disappointed at the absence of strong linkages from MNEs beyond the export zones. In fact, firms within the zones have powerful incentives *not* to cultivate commercial linkages beyond them. Customs and other administrative procedures are complex and often corrupt. Infrastructure is poor. The choice of local partners may simply be either a bureaucratic and inefficient SOE, or a legally insecure and occasionally harassed private firm.

Not all investments by MNEs lead to technology transfer and positive spillovers. In their desire to protect the technology of the parent company, MNEs may limit the production of affiliates in host countries to low value-added activities, thereby reducing the scope for technical change and technological learning. MNEs may also restrict vertical integration by relying completely on foreign suppliers for their inputs.

As would be expected, MNEs' local linkages are quite selective, and are much more developed in conducive environments. In the PRC, for example, the spillovers seem to be more pronounced in the case of the township and village enterprise sector than with the SOEs (see Fan [2003] for a case study). Typically, there is also considerable regional diversity in these linkages. In Malaysia, the state of Penang, for example, has been an outstanding performer, as the home of the earliest export-oriented investments, and where the strongest small and medium

enterprise (SME) subcontracting base in the country has developed. Penang's commercial and business history, together with effective political leadership and public institutions, are generally regarded as the keys to its success.[11]

It also needs to be emphasized that local linkages in themselves are not inherently desirable. For example, there is concern in India about the apparently limited linkages between MNEs and local firms, and the fact that these linkages may even be declining in a statistical sense. Such a trend could, rather, be interpreted positively, as indicative of Indian firms connecting on their own to the global economy as the national economy opens up. Indeed, it would be surprising if this did not occur as liberalization progresses. In other words, the interpretation of linkages is no simple matter: the former Soviet Union had the most "developed" domestic linkages in the world; Singapore has perhaps the least. But Singapore has the most important linkage, i.e., international trade and, in consequence, international standards of efficiency.

There is also debate about the most effective policy options to promote efficient linkages. Case studies in the Indian context generally endorse past interventionist strategies, including restrictive MNE entry, conditionality, and export obligations (Box 3.3). There can be no doubt that some technological advances have resulted from these policies. But they have come at a cost of deterring potential MNE entrants. The most striking Indian success has been in information technology software rather than manufacturing hardware. Here it appears that the keys to success have been a base of domestic competence and strong human capital connections to international centers of excellence, but limited FDI. A major puzzle in the Indian story is why this success has not been replicated in more manufacturing sectors. Presumably the explanation is that the East Asian exporters enjoy the agglomeration and international reputation benefits of reforming earlier, together with the fact that the facilitating Indian reforms are still at an early stage.

It is clear that, in assessing FDI impacts, the stages of development and commercial histories matter. For countries with prolonged commercial isolation, attracting MNEs is a key indicator that they are being recognized as entering the global economy. This especially applies to centrally planned states such as the PRC and Viet Nam, but it is also a broader phenomenon.[12] It also explains why these late reformers frequently "overdo" their FDI liberalizations, and offer excessively generous fiscal incentives, at the expense of domestic firms.

The expectations of host countries toward FDI differ over the course of economic development. For low-income countries, the principal attraction is employment generation. As noted above, when governments adopt export-oriented strategies, MNEs may play a very important role in exploiting a country's (hitherto latent) comparative advantage in labor-intensive activities. For countries shifting out of this phase of development, or with a stronger domestic R&D base, interest focuses on the potential contribution of FDI to enhance the process of structural adjustment toward higher value-added activities. These shifts are amply illustrated among the sample of countries. In Malaysia, for example, the focus on MNE impacts is principally to do with technological upgrading issues. For Viet Nam, it is employment and exports, together with managing the foreign presence in the context of limited bureaucratic expertise. India seeks to build on, and modernize, its domestic R&D strengths.

In this context, policy makers are concerned that MNEs may be reluctant to undertake local R&D. In Thailand, for example, foreign firms appear to undertake less R&D than local firms.[13] Similar concerns are voiced in India. The explanation presumably is that much of the R&D carried out by MNEs is embodied in their investments and staffing, and thus is not formally recorded in local (host country) R&D statistics. Moreover, the international evidence is that the R&D activities of MNEs are being internationalized, but quite slowly, and that they remain typically heavily concentrated in their headquarters (Dunning 1998). Where these activities do go abroad, they are likely to go to countries whose R&D human capital is internationally cost-competitive (e.g., India or the Russian Federation), or whose governments offer generous fiscal incentives for such activities (e.g., Singapore).

An additional concern in India is whether MNE entrants may be motivated by a desire to appropriate domestic R&D strengths. India's research base is (like the PRC's) unusually strong due to its scale and concerted public policy

Box 3.3 FDI in the Indian Automobile Industry

Until about a decade ago, India's auto sector had been highly protected, restricting the entry of foreign companies and imposing steep tariffs against imports. In 1983, the Government permitted Suzuki Motor Corporation of Japan to enter the market in a joint venture with Maruti, a state-owned enterprise. The auto sector was subsequently opened significantly in 1993, though still heavily regulated. Multinational enterprises (MNEs) were required to make specified capital investments, balance foreign exchange flows, and meet export obligations. Nevertheless, a high volume of FDI was encouraged with the sector's liberalization. Additionally, government policies such as import barriers and local content requirements contributed to the influx of FDI. High tariffs forced original equipment manufacturers (OEMs) to set up plants in India because they could not access the market through exports. Local content requirements of up to 70% forced OEMs and their suppliers to make significant capital investments.

Overall, the impact of FDI on the auto industry was highly positive. Sector performance has improved steadily since 1993. Labor productivity has grown at an annual rate of 20%; FDI firms are 38% as productive as US plants on average. Auto industry output has grown at over 15% per year, up from 13% in 1983–1993 and from less than 1% in the decade prior to 1983. Significantly, the components industry benefited from spillover effects, more than tripling its size during the period as new car sales boomed and OEMs outsourced more of their cost base. Competition was also provided by international components firms, which entered the sector to serve international assemblers, resulting in increased quality and reliability.

The impact of FDI on increased productivity and competitiveness has ensured that benefits accrue to consumers and labor. Firms, on the other hand, have been forced to reduce their margins with increased competition. As the only FDI-OEM in the 1980s, Maruti-Suzuki used to enjoy profit margins of 10–12%, significantly higher than the global average of 5%. However, with the influx of new FDI firms, Maruti-Suzuki's profit margin declined to 3–4%, while European and US OEMs selling larger cars have been losing money. Some local assemblers went out of business because of the competition; others entered into joint ventures with foreign firms to keep afloat. A few local assemblers that developed products customized to local needs have managed to remain in business.

Meanwhile, overall employment in the auto sector declined marginally due to the forced exit of low productivity firms, even as employment grew for most OEMs. There is also strong evidence suggesting that wages have risen due to the FDI inflows.

Prices have declined in the sector by as much as 8–10% annually in the last 5 years even as the consumer price index has increased by 4–7% a year. Cheaper products increased demand and led to a rapid expansion of the sector, with new (and improved) products introduced in the market. The Government also benefited from increased tax revenues generated by expanding sales.

The liberalization that started in 1993 was responsible for making India's auto industry competitive. While Maruti-Suzuki successfully tapped into latent demand for high-quality, low-cost cars, production of local OEMs continued to expand as excess domestic demand remained unmet. With the entry of foreign OEMs after 1993, competitive pressure began to increase as manufacturers expanded their product lines and competed on price. Productivity significantly increased, not only because of the arrival of more productive international firms, but also because existing firms were forced to either exit or improve.

FDI jumpstarted innovation in the auto industry. Before Suzuki arrived, India's auto sector had for decades been offering two models, a figure that climbed to eight after Suzuki's entry. Currently, there are more than 30 international-quality models in the market, some of which are now being exported to MNEs' home markets.

FDI also contributed to improving auto sector productivity in upstream activities. Supplier productivity increased as foreign OEMs colocated suppliers (i.e., put them in a common area) and required home-country suppliers to invest in India. This led to the creation of a reliable OEM supplier industry, which encouraged more FDI-OEMs.

In summary, FDI in India's auto industry produced positive results—increased productivity, higher output, better and cheaper products, and (most probably) higher wages. However, MNEs' full productivity potential has not been realized because of other factors external to the industry, such as local content requirements (which forced OEMs to set up subscale component manufacturing plants), high import tariffs (which compelled OEMs to establish subscale operations in larger car segments even as high domestic taxation suppressed demand), and poor infrastructure (which led to production inefficiencies and larger inventories).

Source: McKinsey Global Institute (2003).

interventions. Yet international experience suggests that interactions between domestic and foreign R&D can potentially be mutually beneficial, as the Singaporean experience (next subsection) demonstrates. Much depends on how R&D is managed.

It also needs to be noted that spillovers are not just about production technology or commercial expertise. There may also be broader implications for institutional development and the quality of corporate governance. MNEs are presumed to employ higher standards of accounting, auditing, and reporting than most existing host country firms. In a liberalized FDI regime, international providers of these business services may also establish local operations. The entry of foreign banks in various economies, for example, appears to have raised standards in the industry locally, in addition to increasing competitive pressures and providing access to a broader range of risk-sharing portfolio instruments. Of course, certain caveats need to be attached to this argument. The causality between MNE entry and institutional quality is arguably bidirectional, that is, better quality institutions are both a cause and a consequence of an increased MNE presence. Moreover, considerable evidence suggests that MNEs adapt, often quite quickly, to local corporate cultures: if the prevailing rules of the game are characterized by extensive corruption and poor corporate transparency, MNEs tend to adjust their behavior accordingly.

Enabling Policy Framework

There is finally the question of the extent to which host economies may "leverage" the MNE presence. In an open economy context, two main factors appear to be significant here. One is the propensity of MNEs to establish deep local roots, which in turn is determined by the nature of the host economy's commercial and policy environment.[14] The second is whether, and how, an activist approach to tapping the MNE presence may achieve success through emulation, local R&D programs, and advanced training facilities.

Singapore is a leader in developing Asia in both these respects, and its strategy is therefore worthy of brief mention.[15] The Government has displayed an ability to adjust the policy settings as the economy has shifted quickly from its labor-intensive industrialization phase to one that is increasingly knowledge and technology intensive. The Government anticipated the shift out of low-wage activities, and developed several programs to upgrade local capacities.

In addition to its excellent infrastructure, critical for highly trade-intensive industries, the Government introduced a Local Industry Upgrading Program, as a means of tapping into MNEs' expertise. Technical skills were upgraded continuously through high-quality technical, vocational, and tertiary education. As the country began to lose comparative advantage in labor-intensive sectors, the Government worked with MNEs to induce them to stay and upgrade, while shedding uncompetitive segments. On-the-job training was facilitated by the Skills Development Fund, funded in part by a levy on foreign workers. The Economic Development Board introduced schemes to fund MNEs' local R&D activities. The Board was highly attentive to these firms' requirements, and was also willing to target specific MNEs that it considered would be useful for future industrial growth.

Some commentators feel that, as a tiny, heavily managed city state, Singapore's experience is not internationally replicable. However, while the country's geography, history, and political economy are unique, there is no reason why other countries cannot learn from its success, in which at least five features would appear to deserve emphasis:

- Its economy is open, and so firms are immediately subjected to some sort of market discipline and test.
- As part of the package to induce MNEs, it offers some of the world's best physical infrastructure, and a predictable and business-friendly investment climate.
- The Government has demonstrated a clear capacity to recover and learn from mistakes. A highly open economy reveals these mistakes quickly, and Singapore's largely meritocratic Government is not hostage to the usual set of vested interests that constrain governments from adopting first-best solutions.
- The Government has revealed a willingness to open its labor market to an extent that is rare among modern nation states. At least 25% of its work force are foreign, and a higher percentage were born overseas. With its high

salary structure, it is able to recruit in the most cost-efficient labor markets regionally and internationally.
- Singapore has a high-quality, professional civil service. Its public sector remuneration is one of the highest in the world, and the civil service is insulated from political pressures. Thus, a selective industrial policy is more likely to be successful there than in practically any other country in the world.

Competition and Concentration

The evidence concerning FDI impacts on competition, concentration, and profitability in the six economies focused on is mixed, as it is in the general literature (see the section *Six Asian Case Studies*, below). A priori, FDI entry might be expected to lower concentration simply because a new entrant means more producers. Of course, in the longer term, concentration could rise if the foreign firms were able to drive out local competitors, or if they located in oligopolistic industries (as they often do, to exploit firm-specific advantages). In addition, here too the host country's trade policy matters: MNEs are more likely to be attracted to countries with outward-oriented regimes to be able to fully exploit their vertically integrated international production activities. Thus, if their primary motivation is export orientation, as it normally is, competition issues are largely irrelevant.

Moreover, in open economies, high concentration levels per se are not necessarily a problem, certainly for tradables activities, as the industry is exposed to foreign competition. Of course, even in the most open of economies, there are public policy concerns in activities that may be characterized as natural monopolies, or that are essentially nontraded. However, it remains the case that there is much less discussion or concern about monopolies in, for example, the open Malaysian economy, compared with countries with more interventionist regimes.

In reality, much of the analysis of concentration, including FDI impacts, focuses on a commercial environment featuring state-sanctioned monopolies combined with restrictive trade barriers. In other words, the "competition problem" has more to do with the removal of government privileges, barriers to new entrants, and import protection. In the PRC and Viet Nam, SOEs continue to receive much special assistance, some in the form of restrictions on competition. Where these SOEs form joint ventures with foreign firms, MNE entry may thus appear to cause increased concentration, whereas in fact the fundamental problem lies with the regulatory regime.

Although their SOE sectors have been historically smaller, similar general comments apply to Korea and India. The promotion of *chaebol* (conglomerates) in Korea has resulted in high levels of concentration and an underdeveloped SME sector. India's highly interventionist industrial planning regime has stifled competition. For this reason also, studies of FDI impacts in the prereform period provide little indication of likely contemporary effects.

It also needs to be emphasized that the extent of competition is best measured by some notion of "contestability," rather than the more standard indicators of concentration (such as 4-firm ratios or the Herfindahl index). This proposition is illustrated in Thailand. After its recent FDI liberalization, concentration fell significantly in the banking industry, but it may have risen in the retail sector as large international companies pushed out local petty traders. In the latter case, however, although there may have been some adverse social consequences, competitive pressures through the possibility of further new entrants appear to have lowered retail margins.

In some cases, MNEs, by their sheer size, can even eliminate competition by crowding out domestic producers. As integral parts of global value chains, MNEs have a built-in advantage (e.g., economies of scale and scope) over their local competitors.

No absolute consensus on the positive effects of FDI have been reached by all governments or the general public, reflecting differences in economic conditions, specific histories of utilizing FDI, cultural variation, and ideological differences. However, greater flows of FDI across borders have increased the impact of FDI on national economies and the international economy as a whole, with the view widely held in Asia that the net effect was positive. It is notable that the policy framework everywhere plays an important role in determining the effects of FDI on a host country.

Importance of the Policy Context

Whether—and the ways in which—FDI is beneficial or harmful to the host country depends on the context in which the investment takes place and in which the resulting economic activity operates. This is particularly true of the policy environment in the host country and especially in that local area of the host country where the investment is located. It is also true of policies that may be internal to the investing firm, such as transfer pricing.

The growing evidence that investment can make significant contributions to domestic development has increased the proliferation of incentives to attract such FDI. Government action at the national level can enhance FDI prospects by significantly reducing the uncertainty, asymmetric information (and related search costs), and other transaction costs (especially the amount of time and number of steps involved in acquiring approval) that are faced by foreign investors.

Tax breaks and subsidies are also common, but generally influence investment location decisions only at the margin. More important to most potential investors are the size and expected growth rate of the market that could be served, long-term macroeconomic and political stability, supply of skilled or trainable workers, and modern transportation and communications infrastructure. Once these criteria are satisfied, then financial incentives may influence the investor's choice of suitable sites. More important, such incentives often create distortions and inefficiencies. Table 3.3 indicates the wide variety of both incentive- and rule-based measures commonly used to attract FDI. By distorting the relative costs for other sectors and investment projects that are not targeted for incentives, such schemes typically discriminate against smaller and domestic investors, as well as areas of actual or potential comparative advantage that are not recognized as such by policy makers. Over time, these actions can contribute to the development of a governance system that lacks transparency and accountability (JBICI 2002).

Incentives and regulations are often closely linked, such as when the former are granted subject to conditions. For example, many countries allow foreign firms majority ownership on condition that they export all or a significant proportion of their input. The length of tax holidays and the amount of tax credit granted often depend on, among other things, the market orientation of the venture and the local content of the output.

Arrangements that commit host country entities to purchase fixed quantities of output on a take-or-pay basis, and especially to pay in foreign currency, are common means of shifting risk from investors to the host government but can be detrimental to that government. This was evident in Southeast Asia during the Asian economic crisis when regional currencies depreciated sharply and swiftly but foreign investments in infrastructure, such as power plant investments in Indonesia and the Philippines, were based on continuing repayments in United States (US) dollars at rates that did not take the depreciation into account.

Too often, policies ostensibly designed to maximize net benefits of FDI for recipient economies have resulted in subscale manufacturing plants, frequently through mandated joint ventures, which are not allowed to source inputs freely and contribute little to the technological, social, or economic development of the country. Arrangements between foreign investors and host country authorities that block other new entrants to the industry or that inhibit alternative cheap sources of supply are also common but are generally not in the best interests of the host country. However, the host country can capture part of the rents from the scale economies through a licensing fee or an increase in factor prices in the export sector as foreign firms bid up factor costs above the level sustained by the small domestic export industry.

Incentives for foreign investors and benefits for the host economy will be less when the investments are directed toward serving small and protected domestic markets.[16] The potential benefits to the host economy are greatest when international companies can exploit economies of scale both locally and globally, and are continually driven to update their technologies and managerial practices in order to remain competitive. Moreover, competition policy can strengthen the benefits associated with FDI for the host economy. As noted by the WTO working group on the interaction between trade and competition policy:

Table 3.3 Foreign Investment Regime in the Host Economy: Main Types of Regulatory and Incentive Measures

Type of Measure	Examples
Screening, admission, and establishment	Closure of certain sectors, industries, or activities to FDI Minimum capital requirements Restrictions on modes of entry Admission to privatization bidding procedures Establishment of special zones (e.g., export processing zones) for FDI with legislation distinct from that governing the rest of the country
Fiscal incentives	Reduction in standard corporate income tax rate Tax holidays Reduction in social security contributions Accelerated depreciation allowances Duty exemptions and drawbacks Export tax exemptions Reduced taxes for expatriates
Financial incentives	Investment grants Subsidized credits Credit guarantees
Other incentives	Subsidized service fees (electricity, water, telecommunications, transportation, etc.) Subsidized designated infrastructure (e.g., commercial buildings) Preferential access to government contracts Closure of the market to further entry or granting of monopoly rights
Performance requirements	Protection from import competition Local content (value added) Minimum export shares Trade balancing Technology transfer Local equity participation Employment targets Research and development requirements

FDI = foreign direct investment.
Source: JBICI (2002, p. 84).

The point has been made in various oral and written contributions to the Group that the implementation of a transparent and effective competition policy can be an important factor both in enhancing the attractiveness of an economy to foreign investment, and in maximizing the benefits of such investment. More specifically, these contributions have suggested that competition policy can enhance the attractiveness of an economy for foreign investment by providing a transparent and principles-based mechanism for the resolution of disputes involving such investment that is consistent with international norms that are widely-accepted internationally. This increases investor confidence and therefore the propensity to invest. Vigorous competition in markets, reinforced by competition policy, also helps to maximize the benefits of such investment to host countries, by encouraging participating firms to construct state-of-the-art production facilities, to transfer up-to-date technology into host countries and to undertake appropriate training programmes, and by preventing the exploitation of consumers (WTO 1998, p. 8).

Investors will invest more of the latest proprietary technology and procedures when they feel that they have the greatest control over protection

of the proprietary content transferred through the investment and greatest freedom in its use. Restrictions, such as forced sharing of technology through mandatory joint ventures, local content, or performance criteria, reduce the investor incentives to apply the most modern techniques and technologies, hindering integration into the global sourcing network of the parent company.[17] Subsidiaries have been found to receive greater resources than partially licensed or partially owned or independent firms with lower transaction costs involved in technology transfer. Thus, multinational investment is found to be superior to direct licensing of technology to independent firms. Technology transfer and interchange of managers and technicians between parent and subsidiary firms have been found to be significantly higher for wholly owned subsidiaries than for joint-venture partnerships or licensees (Ramachandran 1993).

Hopes have faded that import-substituting industries benefiting from infant industry protection would grow to become globally competitive. So have hopes that domestic content and joint-venture requirements for foreign investors would stimulate domestic supply chains. In fact, empirical evidence has accumulated in the 1990s that the reverse is actually more likely. FDI facilitates integration into international supply chains, allowing host economies both to increase efficiency of existing activities and to enter into new economic activities. Allowing wholly owned affiliates of foreign firms the freedom to source from wherever they consider most advantageous is *more* likely to lead to domestic suppliers achieving economies of scale and becoming integrated into global supply chains, often under the direct supervision of the foreign buyers. Foreign buyers have increasingly helped local suppliers export first to sister plants and later to independent purchasers in order to lower the suppliers' costs of production through economies of scale, thereby promoting contract manufacturing as an implicit new infant industry development strategy. Externalities in adoption of production, quality control, and managerial processes (including export coaching) frequently spread vertically within the invested sector and eventually to other sectors in the host economy (Moran 2002).[18]

National-level programs to promote the development of linkages between foreign-invested firms and domestic firms commonly include: (i) provision of market and business information; (ii) matchmaking by such means as trade fairs or databases; and (iii) support to local enterprises through provision of managerial and technical assistance, training, audits and, occasionally, by financial assistance or incentives (UNCTAD 2001, p. 183).

The Economic Development Board of Singapore has successfully encouraged foreign investors to voluntarily serve as scouts to identify promising local suppliers and then contribute to vendor development. This sort of *buildup* strategy is most effective in a conducive economic environment, i.e., one that provides low inflation and a realistic exchange rate, that rewards saving and investment, and that encourages legal and regulatory consistency (Moran 2002). Not only does the high return to capacity building pay off in terms of income, it attracts additional FDI in higher-skill areas, encouraging progression from lower to higher skilled activities with consequent social improvements in worker treatment.

With strengthened interest in human resources development and skill formation in the context of FDI policy, many countries regulate the hiring of foreign workers and impose training requirements on foreign investors. Malaysia is one example that has provided incentive schemes to promote technical and vocational training (JBICI 2002). In general, attracting internationally mobile factors of production will increasingly require host countries to improve the quality of their immobile assets.

Protection of intellectual property rights also plays an important role in attracting advanced technology production processes. Weak intellectual property protection deters foreign investors in technology-intensive sectors that rely heavily on intellectual property rights, and encourages investors to undertake projects focusing on distribution rather than local production (Smarzynska 2002). Primarily to protect property rights of foreign investors, but also the interests of host countries, there has been a surge of interest in international investment agreements, discussed in greater detail in the following section.

International Investment Agreements

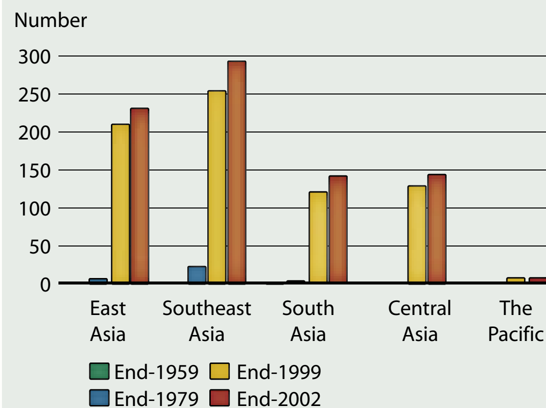
In addition to national policies, bilateral agreements also shape FDI policy frameworks. Over 2,100 BITs and 2,200 double taxation treaties (DTTs) were in effect by end-2002 (UNCTAD 2003a). These BITs vary across countries but generally contain binding commitments on expropriation, transfer of funds, and compensation due to armed conflict or political instability. In the context of bilateral and multilateral trade and investment negotiations, most-favored-nation treatment obliges the host country to offer equally advantageous investment conditions to potential investors from all treaty signatories. National treatment (nondiscrimination) requires the same treatment of both foreign and domestic investors. Some BITs include provisions for extension of national and most-favored-nation treatment to FDI. Disagreements between foreign investors and the host government are usually referred to private arbitration centers of the International Chamber of Commerce or the International Centre for Settlement of Investment Disputes.

BITs are intended to protect foreign investors against unpredictable host country actions that would negatively affect the profitability of their investments. In this sense, they guard against problems of dynamic inconsistency (Box 3.4). However, their implementation may not always be effective in developing countries. Furthermore, their benefits for the host countries are not clear. Empirical evidence has not found a strong link between the existence of a BIT and an increase in FDI flows to BIT signatories. Furthermore, BITs complement, rather than substitute for, institutional quality, including strength of property rights (Hallward-Dreimeier 2003). DTTs may even reduce FDI where potential FDI includes an element of tax evasion. At the same time, BITs may reduce policy options for host country governments and leave them open to being sued for substantial amounts. While using private sector arbitration mechanisms has generally worked satisfactorily so far, it raises the potential for political disagreements in that a sovereign judicial system can be overruled by a foreign arbitration panel that is unelected and usually operates with little transparency. Decisions handed down behind closed doors by the arbitration panels, which have no public accountability, cannot be amended by the domestic legal system.

Despite the asymmetry of BIT benefits for foreign investors and host economies, these agreements have proliferated. Since 1959, the number of BITs concluded with countries in developing Asia has grown, reaching 815 by end-2002, with the surge occurring mostly in the 1990s (Figure 3.8). While a larger number of DTTs was also concluded in the 1990s, the increase in DTTs was relatively more gradual than for BITs (Figure 3.9). The PRC has signed bilateral agreements with 107 countries on protection of investment, and with 75 countries on taxes (Figure 3.10). By December 2002, India had signed 46 bilateral investment promotion and protection agreements.

As some developing economies mature and their outward FDI flows increase, as in the case of Korea, they become more interested in protecting the rights of their own investors. They may also reach regional agreements to avoid race-to-the-bottom offerings of competitive incentives to attract FDI (Box 3.5). In the broadest international context, this has led to calls for a multilateral framework on investment. Currently, the prime example of a multilateral framework is the Agreement on Trade-Related Investment Measures (the TRIMs Agreement), discussed in the next section.

Figure 3.8 BITs in Developing Asia, by Subregion, 1959–2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Box 3.4 Bilateral Investment Treaties

With the collapse of the Cancun trade talks due to seemingly unbridgeable differences on the so-called Singapore issues and agriculture, bilateral investment treaties (BITs) have now become a more important instrument in the protection of foreign investment. BITs normally deal with the following: scope and definition of foreign investment, access to specific sectors and industries, nondiscrimination, most-favored-nation treatment, guarantees and compensation in respect of expropriation, compensation for war and civil disturbance, guarantees of free transfer of funds and repatriation of capital and profits, and dispute-settlement provisions. BIT provisions vary considerably, even in BITs signed by the same country, implying different bargaining positions and approaches (UNCTAD 2000).

The first BIT was concluded between Germany and Pakistan in 1959. Since then, the number has grown, reaching 2,181 by the end of 2002 (Box Figure 1). In their early years, BITs were often concluded between industrial (usually capital-exporting) and developing (usually capital-importing) countries, at the initiative of the former to ensure legal protection for its firms in the latter. The developing country usually agreed to the BIT to encourage foreign investors.

Things changed from the late 1980s, when developing countries started to sign BITs among themselves. The distinction between capital-exporting industrial countries and capital-importing developing countries began to blur. Countries entered into BITs to protect their outward investment to, as well as inward investment from, the other BIT partner.

Through the years, it is not only the number of BITs that has increased. The number of countries that are party to BITs likewise increased significantly. From only two at the end of the 1950s, the number has increased to 172—24 industrial countries, 53 countries from Africa, 31 from Latin America and the Caribbean, 15 from the Middle East, 31 from developing Asia, and 18 from central and eastern Europe—by the end of 2002.

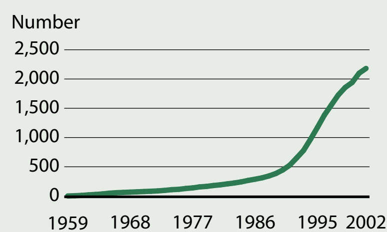
Since the 1960s, countries in Africa have been actively involved in BITs. Starting from only three BITs in 1960, African countries are currently party to 533 BITs, most of which were concluded with members of the European Union. Countries in developing Asia have also concluded a large number of BITs, the majority of which were signed after the dissolution of the former Soviet Union in 1991. In recent years, the Central Asian republics have been the most prolific BIT parties, signing 144 BITs between 1992 and 2002.

Up until the late 1970s, only a handful of countries in Latin America and the Caribbean were involved in BITs. It was not until the late 1980s that the rest of the countries in that region began concluding their first BITs. The number of BITs involving Latin American and Caribbean countries soon increased rapidly, reaching 413 at the end of 2002, mostly with Western European countries.

Meanwhile, Central and Eastern European countries had concluded 716 BITs by end-2002, mainly among themselves and with other developing countries. Western European countries have concluded the most number of BITs, reaching 1,038 in 2002. More than half of these BITs were signed with developing countries.

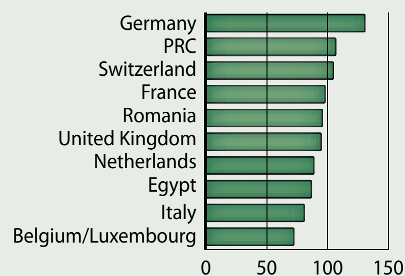
Non-European developed countries became involved with BITs relatively late in the 1970s and early 1980s. But they started to catch up in the 1990s, such that by the end of 2002, the US had 45 BITs, Canada 24, Australia 21, Japan 10, and New Zealand 2. Box Figure 2 shows the top 10 countries in terms of number of BITs signed as of end-2002. These trends indicate the increasing importance that countries have placed on the role of FDI in their development strategies.

Box Figure 1 Number of BITs, 1959–2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

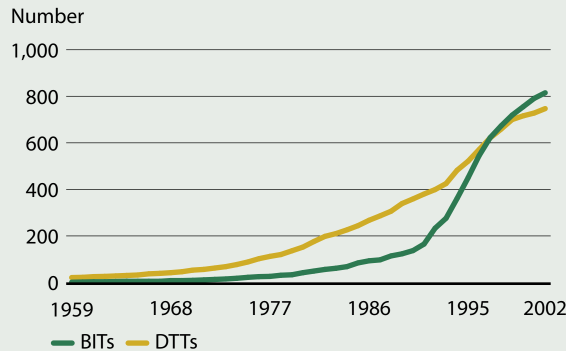
Box Figure 2 Top 10 Countries in Terms of BITs Concluded, end-2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Sources: UNCTAD (2000, 2003b).

Figure 3.9 Number of BITs and DTTs in Developing Asia, 1959–2002

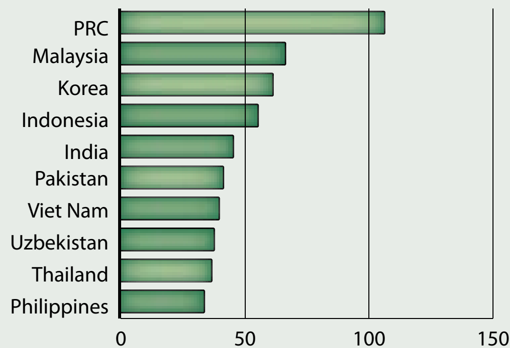


Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

Agreement on Trade-Related Investment Measures

After a failed attempt to formulate an MAI among mostly industrial countries in the Organisation for Economic Co-operation and Development (OECD), the TRIMs Agreement was formulated in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) (1986–1994), the forerunner of WTO (Box 3.6). TRIMs are a subset of the incentives and regulations designed to influence FDI. Broadly speaking, they consist of incentives and regulations deemed to have a direct impact on international trade. A combination of factors led to the inclusion of foreign investment in the work program of the Uruguay Round negotiations. First, there had been the changing perception of the role of FDI in development. Foreign investment had become increasingly important and the flows far more sizable. Perceptions had also moved from initial anxiety about FDI to a more welcoming stance. A dispute between the US and Canada over the latter's application of performance measures on foreign firms around this time also facilitated debate on the linkages between GATT rules and foreign investment policy (Bora 2001).

Figure 3.10 Number of BITs, Top 10 in Developing Asia, end-2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

The TRIMs Agreement recognizes that certain investment measures distort trade and that these distortions are inconsistent with GATT principles. Export subsidies, import entitlements, minimum export requirements, and local content requirements directly affect volumes and prices of imports and exports, and in some cases the composition of trade. Local content requirements mean that imports are treated less favorably than domestic inputs, violating the national treatment principle of GATT. A trade-balancing requirement that limits the quantity of imported products that can be used if an MNE does not meet its export target also violates national treatment obligations. Some foreign exchange balancing requirements impose a similar scheme whereby a corporation's permitted imports are tied to the value of its exports to ensure a net foreign exchange earning.

Despite this recognition, only a brief TRIMs Agreement was put into effect on 1 January 1995 after a lengthy debate.

All WTO developing member countries were to have implemented the TRIMs Agreement and eliminated their relevant regulations by 1 January 2000. Twenty-six developing country members with widely varying economic characteristics gave notice that at that time they still had a variety of policies in existence, however. Most of the policies related to the auto industry or the agro-food industry. The policies overwhelmingly adopted by these countries were local content schemes. The second most frequently notified type of TRIM was foreign exchange balancing requirements (Bora 2001).

In Malaysia, TRIMs Agreement compliance was completed with the phaseout at end-December 2003 of the local content policy on motor vehicles for both new and existing firms.

Box 3.5 The ASEAN Investment Area

In line with the Association of Southeast Asian Nations (ASEAN) objectives of promoting collaboration and accelerating economic growth, the Framework Agreement on the ASEAN Investment Area (AIA) was signed in October 1998. The AIA aims to provide a more liberal and transparent investment environment by 1 January 2010 in order to attract higher and sustainable levels of direct investment flows into ASEAN, and to contribute to the realization of ASEAN Vision 2020, i.e., the free flow of investments by 2020.

Main Provisions

The Agreement covers all direct investment except portfolio investment and those investments covered by other ASEAN agreements. Important features of the AIA include extending national treatment (nondiscrimination) and opening all industries (market access) to ASEAN investors by 2010 and to all other investors by 2020. An ASEAN investor refers to a national or juridical person of an ASEAN member state investing in another member state, whose equity meets the national equity requirement of domestic laws in the host country. In other words, an ASEAN investor is equal to a national investor in terms of the equity requirements of the host country. However, each member state is allowed to identify a Temporary Exclusion List (TEL) and a Sensitive List (SL) of industries or measures affecting investments, in which it is unable to open up or accord national treatment to ASEAN investors. The TEL is subject to review every 2 years and will be progressively phased out by 2010 by all member states except Viet Nam, which will phase it out by 2013, and Cambodia, Lao People's Democratic Republic (Lao PDR), and Myanmar by 2015. The SL was last reviewed on 1 January 2003. It will continue to be reviewed periodically but is not subject to phasing out.

Under the AIA, member states agreed to undertake the development and implementation of three programs:

- investment cooperation and facilitation, through increased transparency of rules, regulations, policies, and procedures, simplification of procedures, and expansion of the number of double taxation treaties among ASEAN member states. Member states also agreed to collectively establish investment databases, promote public-private linkages, and identify target areas for technical cooperation;
- investment promotion and awareness, by organizing joint promotion activities and officials' training programs; and
- investment liberalization, through reduction and elimination of restrictive investment measures, and promotion of freer flow of capital, skilled labor, professionals, and technology among ASEAN member states.

Recent Changes

In September 2001, the scope of the AIA was expanded to include sectors and services incidental to manufacturing, agriculture, fisheries, forestry, and mining and quarrying. Additional sectors and services may be included upon agreement of all member states. At the same time, the TEL phaseout for manufacturing was advanced from 2010 to 2003 for all member states except Cambodia, Lao PDR, and Viet Nam, which are to comply

Box Table FDI Inflows to ASEAN Members, 1998–2002, $ million

ASEAN Members	1998	1999	2000	2001	2002
Brunei Darussalam	573.3	747.6	549.2	526.4	1,035.3
Cambodia	242.9	230.3	148.5	148.1	53.8
Indonesia	-356.0	-2,745.1	-4,550.0	-3,278.5	-1,523.0
Lao PDR	45.3	51.6	34.0	23.9	25.4
Malaysia	2,714.0	3,895.1	3,787.6	554.0	3,203.4
Myanmar	683.6	304.2	208.0	192.0	128.7
Philippines	1,718.0	1,725.0	1,345.0	982.0	1,111.0
Singapore	7,594.3	13,245.4	12,463.8	10,949.4	7,654.6
Thailand	7,491.2	6,090.8	3,350.3	3,813.5	1,067.8
Viet Nam	1,700.0	1,483.9	1,289.0	1,300.3	1,200.1
Total ASEAN	22,406.5	25,028.8	18,625.4	15,211.0	13,957.1
% of World Total	3.3	2.3	1.3	1.8	2.1

Source: UNCTAD (2003b).

Box 3.5 *(continued)*

by 2010. This means that since 1 January 2003, ASEAN investors have enjoyed national treatment in the manufacturing sector of the first seven member states. The removal of exceptions to free entry and national treatment for non-ASEAN investors was also advanced to 2010 from 2020 for Brunei Darussalam, Indonesia, Malaysia, Philippines, Thailand, and Singapore, and to 2015 for the rest of the ASEAN member states. Significant achievements have also been made in transferring sectors and measures from the SL to the TEL.

Deliberations are under way among senior ASEAN officials to make recommendations for expanding the scope of the AIA to include services sectors, such as education, health care, telecommunications, tourism, banking and finance, insurance, trading, e-commerce, distribution and logistics, transportation and warehousing, and professional services.

What Lies Ahead

Data starting from the inception of the AIA indicate that gross FDI inflows to ASEAN have been declining (Box Table). However, improvements have been noted in the share of ASEAN in the world total since 2000. ASEAN officials remain optimistic about FDI flows to the region. Preliminary figures indicate that the outbreak of SARS in the early part of 2003 had limited impact on regional investment. Additionally, officials are upbeat that FDI flows to the services sectors will continue to increase in the coming years, particularly in light of the expected improved access to these sectors. Additional positive factors for the ASEAN region's promising outlook include (i) the decision made in November 2001 to establish an ASEAN-PRC Free Trade Area, which includes investment matters within 10 years; (ii) the ASEAN-Japan Plan of Action, which places emphasis on cooperation for enhancing economic competitiveness of ASEAN members, including through investment promotion; and (iii) the Framework Agreement on Comprehensive Economic Cooperation, signed in October 2003 by ASEAN and India, which calls for strengthening and enhancing economic, trade, and investment cooperation.

Sources: ASEAN Secretariat Web site, available: http://www/aseansec.org; UNCTAD (2003b).

Local content requirements are also being phased out in Viet Nam as part of its moves toward WTO accession. Compliance with the TRIMs Agreement was also instrumental in overcoming resistance to investment policy reform in Thailand, as TRIMs were gradually abolished.

A couple of dozen countries requested extensions of the transition period. Among them, Argentina, Malaysia, Philippines, and Thailand cited financial crises that added to their structural adjustment problems as a major factor behind their extension requests. Colombia and Pakistan cited specific development reasons for their extension requests. Colombia detailed difficulties in transforming its economic model, especially in terms of developing substitutes for illegal crops, which may also be relevant in a number of Asian economies. They argued this would require domestic absorption, or local content policy, to ensure that farmers are able to sell their produce. Pakistan argued that opening its economy to import competition rapidly would not allow it to exploit domestic resources optimally, to promote the transfer of technology, or to promote employment and domestic linkages. Another reason cited for an extension request was inconsistency between preferential trade agreements and multilateral obligations (Bora 2001).[19]

The current TRIMs Agreement resulted from a compromise. During the Uruguay Round discussions, developed economies, including the European Union (EU), Japan, and US initially proposed to establish a comprehensive agreement on investment. Their proposed framework covered a wide range of areas such as technology transfer requirements, restrictions on the transfer of profits overseas, controls on foreign exchange flows, government reviews of foreign investment performance, and nationalization. This plan faced strong resistance from governments of developing countries. Brazil and India maintained that investment was outside GATT's competence, while other developing countries tended to take a defensive position with regard to any agreement on TRIMs (Ariff 1989). In particular, many developing countries resisted the extent to which market access for foreign firms would be included. The result was that negotiations focused on policies that applied

Box 3.6 The TRIMS Agreement

The Agreement on Trade-Related Investment Measures (TRIMs Agreement) includes the following terms:

- It only covers regulations and requirements imposed on foreign investors that directly impinged on international trade flows.
- Its coverage "applies to investment measures related to trade in goods only." This means that it excludes investment incentives and many forms of performance requirements. Furthermore, services are covered by the World Trade Organization (WTO) General Agreement on Trade in Services, and export subsidies are covered in the Subsidies Agreement. As such, requirements for technology transfer, licensing, and joint ventures are not included in the TRIMs Agreement. Export performance requirements are not actually part of the annexed list of the TRIMs Agreement. There has been ongoing debate about whether the list should be extended to prohibit these policies.
- The central provision of the TRIMs Agreement prohibits trade-distorting investment measures subject to GATT Article III (national treatment) or Article XI (elimination of quantitative restrictions). Measures specifically identified as inconsistent with Articles III and XI include provisions for local content, trade balancing, import substitution, foreign exchange, and export limitation requirements.
- The Agreement sets deadlines for removing TRIMs. Member states were given 90 days from 1 January 1995 to notify the Council for Trade in Goods of all measures that did not conform with the Agreement. They were then given a "transition period" to eliminate their notified TRIMs. A member's level of development determined the length of time it was given to eliminate TRIMs. Developed members were allowed 2 years; developing countries were given 5 years and least-developed countries were given 7 years.
- There is provision for developing and least-developed countries to apply for an extension of the transition period. Ten WTO members have so far submitted transitional period extension requests. The requests range from less than a year for Chile to 7 years for Pakistan.
- An allowance is made for developing country members to deviate temporarily from the provisions of the obligations as, for example, under the Balance-of-Payments Provisions of GATT 1994. The waiver of an obligation will be granted providing that three quarters of the members agree.
- The Agreement is overseen by the WTO Council for Trade in Goods, with the WTO dispute settlement mechanism applying to the TRIMs Agreement. A review of the operation of the Agreement took place in 2000, 5 years after its entry into force.
- The Agreement does not provide an explicit definition of TRIMs, nor does it define investment. Instead, it provides an Illustrative List in the Annex with examples of laws, policies, or regulations that are considered as TRIMs and that are deemed to violate GATT Articles III and XI.

Source: GATT (1994).

to the operations of foreign firms. Even then, negotiations still proved difficult.

Since the enactment of the Agreement, the main focus has been on the trade effect of local content and export performance requirements. Since 1995, TRIMs Agreement obligations of new members on accession to WTO have depended on the terms of their accession. So far, all acceding countries have agreed to implement the TRIMs Agreement upon accession regardless of whether they are developing countries or not.

The TRIMs Agreement, in relation to the complicated issues it covers, is very short. Its brevity is a manifestation of the divisions that emerged between developed and developing countries. This lack of consensus also explains the vague nature of elements of the agreement. The current TRIMs Agreement does not contain a basic definition of investment, even though the definition of investment has profound implications for the scope and coverage of the Agreement. The definition of investment in the draft OECD MAI, for example, went far beyond the traditional notion of FDI to include portfolio investment, debt capital, intellectual property rights, and various forms of tangible or intangible

assets (Ganesan 1998). Korea has suggested using an enterprise-based definition of investment for investment liberalization, and an asset-based definition for investment protection. This approach could help developing countries avoid negative effects of volatile short-term portfolio investment.

There is also no well-defined phase-in period in place to bring laws into conformity for members that notify WTO of relevant policies under the TRIMs Agreement. Members are under no obligation to respond to notification requirements in detail. This has caused some implementation difficulties. None of the notifying countries has either developed an implementation plan or identified alternative policies that could be used to achieve conformity.

TRIMs are typically used in conjunction with a number of other policies. One aspect, which was not taken into account during the Uruguay Round negotiations, was how the removal of certain TRIMs without addressing companion policies would affect trade. For example, local content schemes are usually combined with a subsidy. The TRIMs Agreement disciplines trade policy, but not incentives. Views are still divided on how to deal with both incentives and regulations.

Ambiguity in the wording of the TRIMs Agreement has made the interpretation of obligations difficult. Some developing countries' lack of capacity to fully understand the scope and implications of these obligations has exacerbated this problem. These problems have also created a tension between the generally accepted notion of efficiency and the broader definition of development. Some work to clarify these issues has been done recently by the WTO Council for Trade in Goods, but solving these problems will require much time and effort (Bora 2001).

The current TRIMs Agreement relies on the state-to-state mechanisms of WTO for dispute settlement and arbitration under which, for example, a dispute settlement panel is established and makes its judgment. Some argue that it is necessary to establish investor-to-state mechanisms to ensure that investors receive a hearing (Moran 2002). Others believe that inclusion of an investor-to-state dispute settlement mechanism would add an excessive burden on developing countries' legal machinery and impose a threat to their national sovereignty (Tangkitvanich et al. 2003). Korea's preliminary position was that the dispute settlement mechanism of a multilateral framework on investment should not cover investor-to-state disputes.

Believing the existing TRIMs Agreement to be inadequate, industrial country parties such as the EU, Japan, and US largely view it as a mechanism for removing performance requirements on foreign investment (Greenfield 2001). Still, the Agreement represents a step forward in ensuring that countries are all subject to the same rules respecting the use of certain investment-related performance requirements. Although most FDI has occurred between industrial countries, the Agreement allowed investment issues to be discussed in the context of multilateral negotiations. These discussions continued through the WTO Working Group on Trade and Investment where members have further assessed the linkages between trade, FDI, and development. It has also allowed disputes between member states to be settled in the WTO context, and has enforced GATT provisions.

The Ongoing Divide Regarding a Multilateral Framework on Investment

Investment was again put on the agenda for the Doha round of WTO negotiations. Investment, competition policy, transparency in government procurement, and trade facilitation were labeled the "Singapore issues," following the WTO work program in the 1996 Singapore Ministerial Declaration. The Doha Declaration continued to attach the usual operational qualifications of "trade-related aspects only" for investment and competition policy. However, as evidenced at the Fifth WTO Ministerial Conference in Cancun, Mexico, in 2003, members are still far from an agreement on investment issues.

In the WTO discussions, negotiations take place in what is known as a "single undertaking" in which concessions in one sector can be traded off against concessions in other sectors. In Cancun, resistance by more developed economies to make further concessions on agriculture prompted some developing countries to refuse to negotiate on the Singapore issues, and vice versa. In the end, the discussions broke down on the issue of investment, although disagreement

on investment alone could probably have been overcome.

In a joint submission with Brazil to the WTO's Committee on TRIMs in October 2002, India argued that the TRIMs Agreement should be amended to incorporate stipulations that provide developing countries with the flexibility to implement development policies. In particular, it proposed that developing countries should be allowed to use investment measures or performance requirements to promote domestic manufacturing capabilities in high value-added sectors, to stimulate transfer and indigenous development of technology, to promote domestic competition, and to correct restrictive business practices (Kumar 2003). Despite its increasing trend of investment abroad, Malaysia also views multilateral rules on investment as impinging on development policy options and has called for clarification of the issues before negotiations begin (Tham 2003).

Some developing countries take the view that TRIMs and other investment measures are domestic investment issues that should therefore not involve WTO. This point was emphasized during the WTO Ministerial meeting in Cancun. India and others have also asserted that the mandate of WTO is confined to trade and does not extend to investment. They fear they would be deprived of a major means of exercising control over foreign firms operating locally if their right to impose TRIMs or other investment measures were removed. Some developing countries, including India and Malaysia, also consider that policies such as domestic content requirements are essential policy tools for industrialization. At the WTO Doha Ministerial Conference in November 2001, a number of countries stated that joint-venture requirements encourage indigenization. They believed developing countries should be allowed to use TRIMs and other investment measures flexibly in pursuit of developmental objectives because each country's unique needs and circumstances require sufficient freedom and flexibility to pursue one's own policies. They propounded the view that, although the TRIMs Agreement established uniform obligations for all members, it does not take account of structural inequalities and disparities in levels of development; technological capabilities; or social, regional, and environmental conditions; and does not incorporate a meaningful development dimension. A legally binding treaty on foreign investment would further reduce the degree of flexibility available (Ganesan 1998).

In a broader context, Panagariya (2001) has pointed out that trade is generally easier to liberalize than investment, which is easier to liberalize than labor flows. Within trade, goods trade is easier to liberalize than services trade. Within investment, FDI is easier to liberalize than portfolio investment. And within labor, opening up to immigration of skilled labor is easier than opening up to immigration of unskilled labor.

To date, it is still unclear whether WTO will negotiate investment-related issues further, and what form and scope the negotiations will take if they do proceed. Furthermore, it is not clear whether any new talks would center around extension of the current TRIMs Agreement or a new comprehensive multilateral framework on investment. In large part, this reflects the continuing difference of opinions between developing and industrial countries. The next subsection explores some issues that might arise in future negotiations.

Is a Multilateral Framework on Investment Necessary?

Investment measures would largely become a nonissue if trade liberalization succeeded in dismantling tariff and nontariff barriers to trade. For example, local content requirements tend to raise production costs and render final products uncompetitive. A local content program can only be sustained behind protectionist walls, as in India. Similarly, elimination of protection will diminish the need for export incentives, as in Thailand. Without tariffs, quotas, and other import barriers, there is less rent to extract and thus less scope for performance requirements. Thus, trade liberalization can also induce more liberal investment regimes. The more successful is trade liberalization, the less will there be need to worry about investment agreements. This raises two questions: should liberalization focus on trade, and is an agreement on investment needed?

The reality is that trade and FDI coexist. Impediments to trade are a factor in the growth of FDI, but other market imperfections also have

important influences on the decisions of firms to invest abroad. Real market conditions seldom approximate the free trade model. Oligopoly rather than perfect competition is a characteristic of many market structures in which foreign firms operate, and these firms have considerable discretion over the choice of market in which they operate (Balasubramanyam 1991). It is unrealistic to assume that all trade barriers will disappear soon. In these circumstances, restrictions on foreign investment, as well as incentives to promote it, may exist for a long time.

An agreement on investment might strengthen the investment climate of host countries and contribute to trade liberalization. Foreign investment and trade are not necessarily substitutes for each other. Often they have a complementary relationship. Effects of restrictions on trade or investment are empirically indistinguishable from one another. This argues for reducing barriers to investment under multilateral disciplines, just as barriers to trade have been reduced under GATT/WTO rules.

Is an Investment Agreement a North-South Divide?

Industrial countries represent both major sources of, and hosts for, FDI. The increased extent of intra-industry FDI among the industrial nations blurs the distinction, at least among those nations, between host and source countries. The investment issue is thus of interest to industrial countries as both suppliers and recipients of FDI. Developing countries are mainly recipients of FDI, but a number of them—most prominently Hong Kong, China; Korea; Singapore; and Taipei,China—have undertaken significant investment abroad. Thus for some developing countries, their stake or interest in the TRIMs Agreement and other investment issues may be more similar to that of their industrial counterparts than to other developing countries.

There are different views between, and within, industrial and developing nations. For example, given their generally open capital markets, relatively higher income levels, and preoccupation with agricultural liberalization, countries in Latin America were not particularly opposed to negotiation of the TRIMs Agreement. Much of the opposition derived from countries in Africa and Asia (Panagariya 2001). Still, in its submission to the Working Group on the Relationship between Trade and Investment at WTO, the Government of Korea supported the EU position on banning technology transfer requirements for foreign investment (Greenfield 2001).

Conventional wisdom holds that developing countries engage in trade-distorting investment measures while industrial countries do not. However, trade and investment figures clearly show that developed countries also use investment measures. Most industrial countries make available location-based incentive packages for both domestic and international investors. Ireland reports that its special incentive packages have attracted more than 1,200 foreign firms to its economy, and these account for 70% of the country's industrial output and three quarters of its manufactured exports (O'Donovan 2000). OECD (and others) found that almost 90% of all domestic support programs in the EU were available to foreign investors (OECD 1996, Moran 2002). Any multilateral effort to create a level playing field for national and international companies among source and host countries around the world would be seriously deficient if it ignored the proliferation and escalation of location-based incentives by industrial countries.

Overall, it appears that, with or without a multilateral framework for investment, many countries have carried out liberalization of investment regimes. This has two possible implications: (i) a multilateral framework is redundant; or (ii) it is more necessary as policies converge, and a more comprehensive international agreement on investment becomes increasingly possible and necessary for facilitating the liberalization process and governing investment measures. Which outcome emerges will depend on the bargaining positions adopted by different countries and the attitudes they hold toward the process. Even a small group of Asian economies hold widely diverging views on negotiating a multilateral framework for investment, from strongly in favor (Korea) to strongly opposed (India), from viewing it as a helpful spur to domestic liberalization (Thailand) to a constraint on development policy options (Malaysia), and from acceptance if implementation is gradual (PRC) to concern over capability to address the challenges of achieving compliance (Viet Nam).

Six Asian Case Studies

To draw some general principles, at least for developing Asia, this section assesses FDI inflows (and outflows), patterns, and policy regimes in six developing Asian countries, in the context of general economic trends, ownership structures, and policy reforms.[20] One of the major arguments of this part of the *Asian Development Outlook 2004* is that trade reform alters the incentive of production for the domestic market relative to exports, resulting in a fundamental shift in the behavior of MNEs and in the FDI cost-benefit calculation.

Tables 3.4 and 3.5 present a set of comparative statistics for these six diverse Asian countries. These include some general economic indicators, as well as those relating to the trade regime and FDI. The tables also include some indicators of countries' attractiveness to FDI. Table 3.6 offers some summary stylized facts of FDI regimes in the six.

The sample includes the world's two most populous nations, together with a range of intermediate-sized countries with populations in the range of 20 million–100 million. In terms of GDP, the largest economy (PRC) is more than double that of the next largest (India) and about 35 times that of the smallest (Viet Nam). Korea is a rich OECD member. Malaysia is an upper middle-income developing country. The PRC and Thailand are in the lower middle-income group, while India and Viet Nam are low income. The range of per capita GDP from the richest (Korea) to poorest (Viet Nam) is about 30:1, or 7:1 in purchasing power parity terms.

All six have performed creditably for most of the past two decades. Their real per capita incomes in 2002 were at least double those of 1980, and more than five times higher in the case of the PRC. Since 1990, the PRC has consistently recorded impressive economic growth, to the point where it is now the East Asian growth locomotive, and a major global economy. If its current growth rates are maintained, it will become the world's largest economy (in purchasing power parity terms) in a very few decades. Korea, Malaysia, and Thailand all grew at more than 6% until the Asian economic crisis; Thailand was the world's fastest growing economy in the decade from the mid-1980s. All three experienced a sharp contraction in 1998, but recovery has been fairly rapid. Viet Nam grew strongly for most of the 1990s, with slower (but consistently positive) growth during the crisis. Until very recently, India never achieved the very high growth rates of the others. However, reforms from the late 1980s lifted its performance significantly, and it was largely unaffected by the crisis.

All six have reasonably good macroeconomic management. Since 1990, all have averaged single-digit inflation. None is a heavily indebted economy. Malaysia and Thailand have the highest debt-to-GDP ratios. Both were running very large current account deficits before the crisis, albeit in the context of very high investment rates, low fiscal deficits, and (due to their outward orientation) moderate debt service ratios.

The Commercial Environment

The large variations in the foreign presence among the six countries are explained fundamentally by the countries' attractiveness to FDI. This in turn reflects the rate of economic growth in each, and the policy environment, including ease of entry for foreign investors. In addition to macroeconomic management and openness, a number of factors codetermine both economic growth and attractiveness to FDI. Several proxies for these factors appear in Table 3.4. Informed analytically by the "three Is" (incentives, institutions, and infrastructure), these variables include proxies for human capital, quality of physical infrastructure, institutional quality and country risk, and financial conditions. The argument here is that, as economies open up, governments have to make the transition from protectionist/regulatory regimes to a new emphasis on investment promotion and efficiency. This may require emphasis on microeconomic, or second generation, reforms. Thus, there needs to be more effective R&D and other support schemes, better physical infrastructure, legal reform, improved education, and administrative reform. Broader still are issues of country risk and policy predictability. Hence, countries' performance according to a range of "competitiveness" variables listed in Table 3.4 is central to economic progress.

Table 3.4 Comparative Statistics, Six Countries

Indicator	PRC	India	Korea	Malaysia	Thailand	Viet Nam
1. General Economic Indicators						
GDP, 2002 ($ billion)	1,237	515	477	95	126	35
GDP per capita PPP, 2002 ($)	4,475	2,571	16,465	8,922	6,788	2,240
GDP per capita growth, 1990–1996 (%)	9.2	3.7	6.5	6.7	7.4	5.8
GDP per capita growth, 1997–2002 (%)	6.9	3.5	3.9	0.8	0.0	5.1
Annual average inflation, 1990–2002 (%)[a]	6.5	8.3	5.1	3.2	4.1	3.1
Total external debt/GDP, 2001 (%)	14.7	20.2	25.8	49.2	58.4	38.2
GDP per capita 2002/GDP per capita 1980[b]	5.6	2.2	3.7	2.1	2.7	2.2
2. Openness						
2.1 Trade						
(Exports+Imports)/GDP, 1990 (%)	31.9	15.7	59.4	147.0	75.8	81.3
(Exports+Imports)/GDP, 2002 (%)[c]	52.2	31.3	78.6	210.1	122.3	111.5
Export growth, 1990–2002 (%)[d]	16.6	12.5	13.6	10.7	9.9	25.6
Average tariff rate, 1999 (%)	18.7	30.2	7.9	8.1	5.9	20.0
Index of Economic Freedom (2003)[e]	3.6	3.5	2.7	3.2	2.9	3.9
2.2 Investment						
FDI as % of total capital inflows, 1990–1996[f]	90	15	7	147	16	81
FDI as % of total capital inflows, 1997–2001[g]	92	22	34	32	-57	82
Total cumulative FDI inflow, 1990–2001 ($ billion)	372.2	20.9	38.3	52.5	33.1	15.8
Total FDI stock, 1990 ($ billion)	24.8	1.7	5.9	10.3	8.2	0.3
Total FDI stock, 2001 ($ billion)	395.2	22.3	47.2	53.3	28.2	15.9
Outflow/inflow FDI Stock, 1990 (%)	10.1	16.8	39.2	25.9	4.9	-
Outflow/inflow FDI Stock, 2001 (%)	7.0	9.3	86.4	35.6	9.2	-
Total FDI stock as % of GDP, 1990	7.0	0.5	2.3	23.4	9.6	4.0
Total FDI stock as % of GDP, 2000	32.3	4.1	13.7	58.8	20.0	46.7
FDI as % of GDP, 1990–2000 (annual average)	4.1	0.4	0.8	6.4	2.2	6.6
3. Human Capital						
Years of education, 2000[h]	5.7	4.8	10.5	7.9	6.1	3.8
Tertiary enrollment as % of age group, 2000[i]	7.5	10.5	77.6	28.2	35.3	9.7
R&D expenditure as % of GDP, 2000[j]	1.0	1.2	2.7	0.4	0.1	-
Number of Internet users as % of total population, 2001	2.6	0.7	51.5	27.3	5.8	1.3
Public spending on education as % of GDP, 2000[k]	2.9	4.1	3.8	6.2	5.4	2.8
4. Physical Infrastructure[l]	44	56	18	29	32	60
5. Institutional Quality and Risk						
Corruption (Corruption Perceptions Index, 2003)[m]	3.4 (66)	2.8 (83)	4.3 (52)	5.2 (37)	3.3 (75)	2.4 (105)
Country risk (composite risk rating, 2001)	74.3	65.3	79.3	76.0	73.8	69.5
Property rights index, 2003[n]	4	3	2	3	3	5
Bureaucratic quality (Public Institutions Index, 2003)[o]	4.33 (52)	4.26 (55)	5.03 (36)	5.12 (34)	4.97 (37)	4.11 (61)
6. Fiscal/Finance						
Stock market capitalization as % of GDP, 2002[p]	13	23	43	129	37	-
Average corporate tax rate, 1999 (%)	33	35	28	28	30	25

- = not available, FDI = foreign direct investment, GDP = gross domestic product, PPP = purchasing power parity, PRC = People's Republic of China, R&D = research and development.

Notes: [a] Data for the PRC are for the period 1990–2001 and for Viet Nam, 1996–2002. [b] Data for Viet Nam are for 1984 and 2002. [c] Data for Viet Nam are for the year 2001. [d] Data for Viet Nam are for the period 1990–1997. [e] Index of Economic Freedom ranges from 0 (mostly free) to 5 (highly restricted). [f] Data for India refer to the period 1991–1996; for Viet Nam 1996. [g] Data for India refer to the period 1997–2000; for Korea and Thailand 1997–2002; for Malaysia 1999 and 2000 are missing. [h] Average years of schooling of population aged 25 and over; data for Viet Nam refer to 1990. [i] Tertiary enrollments (regardless of age) as percentage of 20–22 age group; data for the PRC and India refer to 1999. [j] Data for India, Malaysia, and Thailand refer to 1996, 1998, and 1997, respectively. [k] Data for India and Viet Nam refer to 1999 and 1997, respectively. [l] Growth Competitive Index, 2003, 1–102 ranking, 1 = best. [m] The index ranges from 10 (highly clean) to 0 (highly corrupt) for 133 countries; the maximum is 9.7 and the minimum 1.3; numbers in parentheses are the country rankings. [n] The property rights index is a composite from the Index of Economic Freedom; this index ranges from 0 (very good) to 5 (very poor). [o] The Public Institutions Index is based on survey data and ranges from 2.28 to 6.56 across 102 countries; the higher the index the higher the quality; numbers in parentheses are the country rankings. [p] The figure for India is for 2001.

Sources: Barro and Lee (2000); World Bank (2003); Transparency International (2003); UNCTAD (2002, 2003a); Miles et al. (2004); World Economic Forum (2003); International Monetary Fund (2003b).

Table 3.5 Annual FDI, Portfolio, and Other Capital Inflows, 1990–2002, $ million

Country/Indicator	1990	1996	2002
PRC			
Total capital inflows	4,557	43,834	50,031
FDI	3,487	40,180	49,308
Portfolio	0	2,372	1,752
Other	1,070	1,282	-1,029
India			
Total capital inflows	-	16,798	-
FDI	-	2,426	-
Portfolio	-	3,958	-
Other	-	10,413	-
Korea			
Total capital inflows	6,506	48,080	11,014
FDI	788	2,326	1,972
Portfolio	662	21,514	4,940
Other	5,056	24,240	4,102
Malaysia			
Total capital inflows	1,989	5,343	-
FDI	2,332	5,078	-
Portfolio	-255	-268	-
Other	-89	533	-
Thailand			
Total capital inflows	9,402	17,797	-6,500
FDI	2,444	2,336	1,075
Portfolio	-38	3,585	-1,347
Other	6,996	11,876	-6,228
Viet Nam			
Total capital inflows	-	2,942	-
FDI	-	2,395	-
Other	-	547	-

- = not available, FDI = foreign direct investment, PRC = People's Republic of China.
Source: International Monetary Fund (2003b).

It needs to be emphasized that domestic investors are invariably the key players in any economy and that domestic investor sentiment weighs heavily in MNEs' international location decisions. Therefore *what matters is the host economy's commercial environment in general*, and not especially as it relates to foreign investors. Indeed, FDI regimes that are significantly "pro-foreign" in their incentives or other provisions are unlikely to be fiscally or politically durable, and are therefore heavily discounted by MNEs. It is important that any study of competitiveness and the business environment recognize this fact.[21]

The proxies and data in Table 3.4 are highly selective and subject to qualifications.[22] But they are illustrative, and generally accord with a priori notions. Moreover, they effectively draw attention to the diversity of the six countries.

The PRC's human capital base is comparatively strong, with near universal literacy and segments of technical excellence. It is also increasingly able to tap into a very large international diaspora. It has R&D strengths, some military related, or resulting from the past emphasis on heavy industry. It is rapidly opening up to foreign trade and investment. Its commercial institutions have historically been weak, and the country continues to score poorly in international comparisons of corruption and protection of property rights. But institutional quality is improving quickly, especially in regions most connected to the international economy. Physical infrastructure is being upgraded rapidly, although its quality is spatially very uneven.

India's human capital and R&D base has pockets of international excellence, most notably in information technology and in some defense-related heavy industry. Until recently, and in contrast to much of East Asia, its educational priorities resulted in centers of international quality alongside quite high levels of illiteracy. It also differed in that its inward-looking strategy meant that it was unable to exploit its human capital strengths in the global economy. Thus, in contrast to the PRC, its major intrusion into the international information technology industry has been via services rather than manufacturing. Its commercial environment is broadly predictable, and the legal system cumbersome but independent. It also has the highest level of decentralized economic policy making among the six countries. A large diaspora facilitates its connections to the international economy. The 1991 reforms and their aftermath have begun to transform the commercial environment, but the unfinished agenda is large and complex, and the forward momentum appears to have slowed significantly in recent years.[23]

Korea's development strategy has been underpinned by exceptional strength in certain areas. It reached OECD levels of educational achievement and R&D expenditure at comparatively low levels of per capita income.[24] Its Internet access and usage are among the highest in the world. Its infrastructure and institutional quality are good,

Table 3.6 FDI Regimes: Some Stylized Facts

Feature	PRC	India	Korea	Malaysia	Thailand	Viet Nam
Ownership Structures	Dominant but declining SOEs, rapidly rising private and foreign firms	Large SOE sector; reservations schemes for small firms	Predominantly private; *chaebol* important; high concentration; small SME presence	Always large foreign presence; active *bumiputra* promotion	Predominantly private; Sino-Thai dominance	Dominant SOEs, actually rising post reform
FDI History	Closed to 1978; rapid increase from 1980s, especially in south	Very restrictive pre-1991, then gradual opening	Restrictive until 1990s; then gradual opening; major 1998 reforms	Consistently open	Consistently fairly open	Closed to late 1980s; rapid rise from early 1990s
FDI Presence	Modest but rising	Modest, no clear trend	Low, rising gradually	Very high	Substantial, and rising	Low, but rising quickly
Trade Regime	Closed to 1978; then progressive opening, especially for exports; 2002 WTO accession	Very restrictive pre-1991, then gradual opening	From 1960s, open for exports, otherwise restrictive; major 1990s reforms	Consistently open	Consistently fairly open	Closed to late 1980s; then major opening, especially for exports
International Connections	Hong Kong, China important; large diaspora	Large and active diaspora	Large US diaspora; reverse brain drain in 1990s	Singapore ties historically strong	No special features	Large diaspora, still regarded with suspicion
FDI Regime in Practice	Continuing though declining SOE preference; rapid decentralization; much corruption	Reforming, in context of dirigiste history; states are powerful; much corruption	Business climate becoming more predictable and open; powerful nationalist sentiment	Predictable commercial environment	Reasonably predictable commercial environment	Continuing SOE preference; north-south differences; private firms insecure
Institutional Quality	Uneven, though improving	Well developed, though cumbersome	Generally high, though legal system still evolving	Generally high	Generally quite high	Weak; very limited investor protection
Human Capital	Pockets of excellence; uneven, rapid catch-up	Pockets of excellence; continuing high illiteracy	Extremely strong education; R&D base, though not very international	Generally quite good; major affirmative action program; continuing non-*bumiputra* brain drain	Historical underinvestment in postprimary education	High literacy, though limited international commercial know-how and entrepreneurship

FDI = foreign direct investment, PRC = People's Republic of China, R&D = research and development, SME = small and medium enterprise, SOE = state-owned enterprise, WTO = World Trade Organization.

Source: Hill (2003).

if not outstanding. External factors—aspiring to membership of international organizations and the Asian economic crisis—have been important factors in Korea's policy reforms. As with its trade and FDI regimes, the internationalization of its human capital strengths has proceeded more slowly (Dahlman and Andersson 2000).

Malaysia emerges as a country with comparatively high institutional quality, excellent physical infrastructure, and large public investments in

education, much of it designed to redress past ethnic imbalances. It has had the most consistent commercial policy environment of the six. Nevertheless, there are concerns that the independence of its legal system may have been weakened over the past two decades, and there has been a persistent loss of high-level non-*bumiputra* human capital. Its very open international labor market has delayed the process of upgrading its technological capabilities, and in particular it faces competitiveness challenges from below (especially the PRC) and from above (the Asian newly industrializing economies).

Thailand scores well on most indicators, with the principal exception of human capital. Until recently, while achieving almost universal primary enrollment, its retention of students through secondary school was low. In consequence, during the 1990s, as real wages began to rise quickly in the wake of rapid economic growth, it experienced difficulty managing the transition out of labor-intensive activities. It has become progressively more open in its trade and FDI policies. Historically, its legal and commercial institutions were not strong, though its informal commercial "rules of the game" were widely understood and observed (by foreigners as well). Physical infrastructure is generally good.

Having successfully completed the first round of macroeconomic and commercial policy reforms, the principal challenges in Viet Nam relate to establishing the infrastructure that underpins a market-based economy, since property rights, the legal system, financial intermediation, and physical infrastructure all remain poorly developed. Illiteracy levels are low, but so too is the stock of internationally experienced entrepreneurs. Many small and household enterprises operate in an insecure commercial environment. SOE reform lags. The quality of the physical and commercial infrastructure shows pronounced regional differences.

Foreign Direct Investment Regimes

An Overview

In their FDI regimes, it is useful to divide the six countries into three groups. The first comprises those with historically very restrictive regimes, including outright prohibition, which have opened up during the past quarter century, namely PRC, India, and Viet Nam. The second covers those which have traditionally been reasonably open, and become progressively more so. Malaysia and Thailand belong to this group. Finally is the special case of Korea, which was initially highly selective in its opening up to FDI, and which has become progressively more open over time. None of the sample countries has become less open toward FDI.

The comparative FDI data reported in Table 3.4 illustrate these general characterizations. In 1990, Malaysia, the least populous of the six, had the largest stock of FDI after the PRC. Thailand was well ahead of the other three. The amount in Viet Nam was negligible. By 2001, the PRC had emerged as the dominant recipient, with more than seven times the stock of the next two, Malaysia and Korea. In 2002, it was the world's largest FDI recipient, overtaking the US. India and Viet Nam still had the smallest stocks, though they had both increased quickly, especially Viet Nam. Relative to GDP, Malaysia was the largest recipient of FDI in both years, and India the smallest. The greatest absolute increase in these ratios occurred in Viet Nam, followed by Malaysia.

In some cases, it is possible to date the opening up to FDI as part of a package of major general reforms. In Korea, there was gradual liberalization from the late 1980s, with major reforms in 1997-98 in the wake of the economic crisis. In the PRC, the reform process began in 1978. It was further consolidated in the late 1980s, and again in 2002 upon accession to WTO. In India, 1991 is regarded as the key reform year. In Viet Nam, it was the late 1980s *Doi Moi* reforms, with further liberalizations around the turn of the century.

By contrast, Thailand, and particularly Malaysia, have always been quite open to FDI, and over time have become progressively more so. In neither case have there been major swings in the policy pendulum. In the decade up to the Asian economic crisis, Thailand was a huge capital importer, in some years running a current account deficit of more than 8% of GDP. While FDI increased to record levels, an increasing proportion of the total capital flow was portfolio and other short-term capital. The Government's objective to promote Bangkok as a regional capital

market center in competition with Hong Kong, China and Singapore was a factor here, as virtually all restrictions on capital flows were removed. Following the 1997–98 capital flight and consequent collapse of the Thai baht, the Government maintained its open posture toward FDI, despite a growing nationalist backlash, and FDI flows actually increased for a period.

In Malaysia, the principal ownership issue has arguably been the political imperative to redistribute toward the *bumiputra* community (Gomez and Jomo 1997), rather than the foreign presence per se. Under the New Economic Policy, announced in 1970, the *bumiputra* share of the corporate sector was to rise from 2% to 30%. With the share reaching about 20% in 1990, the scheme has been somewhat de-emphasized. In fact, the very high foreign presence at the outset of the New Economic Policy facilitated this transformation, as the major redistribution occurred not from non-*bumiputra* to *bumiputra* but rather from foreign to domestic groups. The non-*bumiputra* share actually rose throughout the period, while the foreign share fell continuously until recently (see *Speed of Technology Transfer*, above).

It is worth pointing out that a range of internal and external factors was operational, in most if not all the six countries. At an intellectual level, these factors include a recognition that outward-oriented economies grow more quickly, and that it is possible to achieve national objectives in an open economy context. Competitive liberalizations—keeping up with one's neighbors—have been a factor. Foreign pressures, including a desire to join international agencies (GATT/WTO and, for Korea, OECD) have often coaxed countries along. Conversely, the demise of an international benefactor (the former Soviet Union) was a major trigger in Viet Nam's reforms. Coalitions of key bureaucrats and political figures have often accelerated progress once they judged the environment for reform to be favorable.

Obviously, policy reform has very different connotations across the six countries. In traditionally open Malaysia and Thailand, it has implied a gradual shift of focus. In other cases, reform has constituted a major change in policy emphasis, even a U-turn, in which FDI liberalization has been important. The PRC and Viet Nam are both significant cases of a transition from a prohibitive to a quite open FDI regime.

Dual Policy Regimes

At the most, only a handful of countries globally have completely open FDI regimes. Thus, while FDI regimes have become more open among the six, considerable selectivity remains across sectors and firms. Governments have typically been slower to open up the services sectors to FDI. All countries have national projects where a range of noneconomic considerations intrude. Among the sample, for instance, even the most open economy, Malaysia, has consistently protected its uneconomic automotive industry, and restricted foreign equity participation in it.

More generally, countries usually have a mix of both rent-seeking and efficiency-seeking FDI, reflecting both partial reform of their trade regimes, and the political economy of dispensing patronage. Consequently, all the countries studied draw attention to what may be termed "dual policy" regimes. For example:

- FDI policy may differ between regions. Three of the six countries (PRC, India, Malaysia) feature quite high levels of decentralized economic policy making. Thailand has been pursuing a policy of industrial decentralization for some time. In all but Malaysia, economic authority is being progressively devolved away from the center at varying degrees and speeds.
- There are large interindustry differences in protection, and thus incentives, in all six.
- SOEs frequently receive preferential treatment, especially in PRC, India, and Viet Nam, and so therefore do their MNE joint venture partners.
- Most countries offer some sort of fiscal or financial incentives to foreign investors. These vary by sales orientation, technology introduced by the foreign investor, location of investment, and other factors.
- The regulatory regime frequently offers more than one entry option for potential foreign investors, especially in the late reformers, i.e., the PRC and Viet Nam.

Not surprisingly, this phenomenon of dual

policy regimes is particularly pronounced in the late reformers. Governments there reveal the greatest ambivalence toward foreign investors. There is often an awareness, at least among the reform lobby, that after a period of commercial isolation, special promotional measures may be required as the country attempts to enter the international commercial mainstream. Sometimes this results in more generous treatment of foreign firms at the expense of domestic firms. Such preferential treatment can often be easily circumvented (e.g., the PRC "round-tripping" discussed in the section *Foreign Direct Investment Inflows and Patterns*, below), and runs the risk of a domestic backlash.

In such cases, there is at one extreme FDI flowing into joint ventures with SOEs, often in protected, uneconomic sectors, producing negative value added at international prices. FDI also frequently flows into nontradables such as real estate and hotels where, in thin markets for international-quality assets, asset-price bubbles may occur. Meanwhile, another group of foreign investors enters sectors with comparative advantage—SMEs and labor-intensive, export-oriented activities. Often the latter locate in special zones that are free of the regulatory and bureaucratic complexities found elsewhere in the economy. Such a pattern has been clearly evident in the case of the PRC. The country's initial export orientation was confined to four southern coastal zones. Most of the labor-intensive FDI originated in Hong Kong, China, and later in Taipei,China. This FDI coexisted with FDI going into joint ventures with SOEs, much of it in uneconomic and protected heavy industry. Firms from OECD countries were the dominant investors in these activities. The domestic welfare implications of different types of FDI are of fundamental importance. There is no such thing as a single FDI model in these economies. A major feature of the reform process is, therefore, the diminished importance of rent-seeking FDI, and its progressive replacement with efficiency-seeking FDI.

Even among the relatively successful late reformers, policy progress is invariably uneven and unpredictable, as is the response of investors. Viet Nam in the 1990s illustrates both these propositions. Following *Doi Moi*, growth accelerated and there was an initial period of euphoria among foreign investors. By the mid-1990s, however, they became more wary as the reality of doing business in a transitional, partially reformed, centrally planned economy sank in (Freeman 2003). The prolonged commercial isolation and prevailing ideology permeating much of the bureaucracy and the Communist Party meant that policy makers frequently had little understanding of how to manage a foreign commercial presence. For example, they often had unrealistic expectations of FDI.[25] Moreover, many of the broader problems associated with the business environment were not addressed in the first round of reforms: red tape, corruption, insecure property rights, an ill-defined legal environment, poor physical infrastructure, limited financial development, and the huge, inefficient, and privileged SOE sector. Finding private sector business partners was difficult, especially as much of the non-SOE business sector was either neglected or had its operations hindered. The transition from rent-seeking to efficiency-seeking FDI has thus been gradual, though, as part of the Association of Southeast Asian Nations (ASEAN), which it joined in 1995, Viet Nam is learning from the experiences of its neighbors in attracting and managing FDI (Box 3.7).

The PRC is an excellent illustration of the political economy proposition that, *in some circumstances, partial reform is desirable if it can be a precursor to successful economy-wide liberalization*. Evidently, the latter was not politically feasible during the early years of reform in the PRC. As the coastal zones began to grow at a spectacular rate, they became the model for the rest of the economy to emulate, and reform progressively extended to other regions and sectors.[26]

Reform: Rhetoric versus Reality

Frequently, the investment boards charged with regulating FDI have little general authority. "One-stop shops" may simply refer to their own operations and not the regulatory complexities of many other, more powerful agencies. Moreover, the rationale for the existence of these boards continues to be obscure. Over a decade ago, there was concern in the literature over how Asian investment boards married their (potentially conflicting) promotion and regulatory functions.[27] Such a concern appears to be even more valid

today, in the wake of the transition to outward orientation and of the region's 1997–98 economic crisis (Buckley 2003).

In any evaluation of policy regimes, it is crucial to distinguish between formal FDI and trade regimes, and their operation in practice. Nominally open regimes may in fact be highly complex and corrupt. Widespread physical and technical smuggling, and unrecorded capital flows, are present in all six countries, especially the less reformed ones. For example, smuggling renders irrelevant much of Viet Nam's formal trade regime. The value of investment incentives is significantly eroded by administrative complexities and corruption.

Moreover, reform at the center does not necessarily ensure that liberalization proceeds smoothly everywhere. This is illustrated in the case of India, where power is diffused and the vested interests and philosophical predisposition toward planning and intervention built up during decades of dirigisme cannot be quickly overturned. The reforms have been a "positive-sum game," since growth has accelerated. But there have been losers too, notably among the bureaucrats who dispensed power and patronage, the SOEs sheltered from competition, and the unions in cosseted (especially state-owned) industries. In addition, under India's federal structure, the states wield considerable power.[28]

In Korea, too, there seems to have been ambivalence about recent reforms in sections of the bureaucracy that are reluctant to relinquish control. Considerable sector restrictions on FDI remain, while business surveys (e.g., that conducted by AMCHAM Korea in December 2001) report that foreign investors find the business environment fairly unaccommodating. To overcome these difficulties, reformers have proposed the establishment of "free economic zones," where liberalization (particularly of labor markets) can proceed more quickly than elsewhere. It is unlikely that Korea could achieve its current objective of becoming an economic hub for Northeast Asia unless these reforms are introduced and implemented successfully.

One general lesson from the reform experience is that one-party states like the PRC and Viet Nam can reform very quickly, once key leadership figures are convinced of the case for change. Democratic states such as India invariably move more slowly. Conversely, it may be that the reforms are likely to be more durable in democratic states, since greater persuasion is required to get the reforms through and potential losers are more likely to be compensated—with the result that opposition is more likely to be lessened.

Korea undertook its major liberalizations after it had become democratic, but in any case it appears that external factors were a major trigger for reform. Two factors in particular stand out. One was the Government's desire to join international organizations (GATT then OECD), membership of which required reform. The second was the Asian economic crisis when, in spite of intense nationalist sentiment, the Government felt it had no choice but to open up the economy.

Across developing Asia, especially in larger states, subnational policy regimes matter increasingly. In well-established federal structures like those of India and Malaysia, states compete for investment and the rules of the game are quite well established, but can be quite unequal. Decentralization is, though, taking place rapidly in most of East Asia's nominally unitary states (Hill 2002). Regional authorities are now offering a range of incentives, some only quasi-legal. The general presumption is that this intranational competition for FDI (and investment in general) is desirable, since it will be a spur to improve the quality of governance at the local level. However, there are dangers, especially moral hazard concerns of local governments offering excessively generous incentives, secure in the knowledge of central government bailouts. Moreover, as international barriers to commerce are declining, paradoxically, subnational barriers are occasionally rising.

Ownership Structures and the Foreign Presence

Rising FDI flows into the six economies have generally been associated with an increased foreign presence, as measured by MNE shares of output, employment, and exports. However, it needs to be emphasized that rising FDI inflows do not necessarily result in increasing foreign ownership for a number of reasons.[29] First, especially in high-growth economies, increased FDI flows have been accompanied by rising domestic investment rates, and thus the share of foreign-owned firms

Box 3.7 Possible Lessons for Viet Nam from Other ASEAN Countries' Experience

Jalilian and Weiss (2001) assessed the degree to which FDI induces growth and reduces poverty using a sample of developing and some industrial countries. They found evidence that FDI in the Association of Southeast Asian Nations (ASEAN) is poverty reducing and that this effect is, among the countries in their sample, strongest there. In addition, it is only in the ASEAN-5 countries (the founding members, i.e., Indonesia, Malaysia, Philippines, Thailand, and Singapore) that a direct relation between FDI and poverty reduction exists.

This implies that the ASEAN-5 members have potential lessons to teach other developing countries. The uniqueness of ASEAN can also be seen in other ways. Between 1985 and 2000, six of 10 ASEAN members (the 10 by now including Brunei Darussalam, Cambodia, Lao PDR, Myanmar, and Viet Nam) were included in the "top 20" countries that increased their export market share (relative to other countries) across a range of technology categories (UNCTAD 2002, p. 150). In addition, Malaysia, Thailand, Singapore, and Viet Nam were export winners across all sectors taken together.

There is no doubt that Viet Nam has been learning from the original ASEAN members. Well before formally joining ASEAN, it was an observer at many ASEAN investment forums. It is thus no accident that the three key planks of the country's *Doi Moi* policy were trade liberalization, FDI promotion, and recognition of private ownership (Gates 2000).

However, general policies toward FDI liberalization have to be carefully designed—not all affect poverty the same way. For instance, some analyses suggest that openness of economies to trade reduces poverty, whereas financial "openness" can have the opposite effect (Santarelli and Figini 2003, Heshmati 2003).

Thus, Viet Nam's policy makers should learn lessons about what to avoid when it comes to multinational enterprises (MNEs) and FDI. In a study conducted by Mirza et al. (2003), econometric analysis showed that the direct effects of FDI (such as employment and training) accounted for 60% of the poverty reduction

Box Table Possible Lessons for Viet Nam

Type of FDI Effect	Malaysia	Thailand	Viet Nam	Implications for Viet Nam
Direct Effects (at sample subsidiaries)				
Employment				Difference arises from age (most are new), origin (East and Southeast Asian investments can be small), and orientation (a few are aimed at the small local market). Need to encourage wider range of industries and investors. The Government might consider issues related to location (i.e., how poorer provinces can benefit) and gender. Careful linking with East and Southeast Asia and global economies can maximize net benefits of FDI.
Average number of employees	2,699	3,750	86	
Average annual output ($ million)	1,504	327	20	
Women workers (%)	48	71		
Training and Human Capital				A similar policy to Malaysia, where companies are taxed 1% of payroll, but which can be recouped when workers are trained, might be useful. Viet Nam can build strongly on its high employee skills.
Educational level[a]	90	90	78	
Spending on human resources development (% of payroll)	1.9	2.7	1.5	
Training days (per year)	6	6	9	
Employee skills	3.7[b] 4.0[c]	3.4[b] 3.8[c]	3.1[b] 3.4[c]	
Consumption Multipliers				
Consumption	Inferred as high by econometric study			Viet Nam should encourage local companies to take advantage of rising purchasing power in terms of manufactured products, and not just in retailing them.
Taxes	Income taxes collected through companies (i.e., high collection rate even if low tax rate)			Careful infrastructural development and urban planning would be wise. Care should be taken regarding export privileges extended to foreign MNEs.
Net Exports[d]				Not yet an issue for Viet Nam and in the short run there is much to be gained from trade links with the rest of East and Southeast Asia.
Exports	70% of output			
Imported inputs	Over 70% of total inputs			
Export orientation	Most firms, with few oriented toward local markets			

FDI = foreign direct investment, MNE = multinational enterprise.

[a] % of work force reaching secondary school or higher. [b] On a scale of 1–5 (unweighted). [c] For pure production-related skills (excluding innovation, soft skills, etc.). [d] Exports less imported inputs.

Box 3.7 *(continued)*

occurring in the ASEAN countries examined (Cambodia, Malaysia, Singapore, Thailand, and Viet Nam) and indirect growth effects—such as consumption multipliers, value chain multipliers, and spillover effects—for the balance. In other words, development and poverty reduction were largely a scale effect and the much-discussed spillover effects were scarcely experienced.

The Box Table summarizes the main findings of Mirza et al. (2003) in terms of the key types of FDI impact, and outlines possible lessons for Viet Nam using Malaysia and Thailand as examples. In general, the findings support those of Jalilian and Weiss.

For Viet Nam to follow the development path chosen by Malaysia and Thailand, which have relied heavily on MNEs, the country should encourage further FDI to benefit from the type of scale effects enjoyed by these two economies. It is also essential to support the development of local supplier, competitor, and champion companies, which can learn from foreign investors. Viet Nam could also be more involved in regional value chains in ASEAN and East Asia, because much of the new investment in the country may come from MNEs already established in nearby countries. Viet Nam's highly educated work force gives it a distinct advantage, but much needs to be done to assure the transfer of knowledge and skills to the work force, and to indigenous suppliers and other companies. Local firms have to develop absorptive capacities for knowledge and skills to enable them to reap the benefits of spillovers.

Box Table *(continued)*

Type of FDI Effect	Malaysia	Thailand	Viet Nam	Implications for Viet Nam
Value Chain Multipliers				
Suppliers				Viet Nam has to pursue the establishment of capable local suppliers. Import of inputs not yet an issue because (i) local suppliers do not exist and (ii) inputs from ASEAN allow entry into regional/global value chains.
Inputs from non-affiliated suppliers	73%, but only 41% of these are bought in the domestic market	68%, 48%	50%, 32%	
Distributors and sales organizations	Most firms are export oriented so no forward linkages in the domestic economy. The few firms with linkages aim to ensure high-quality distribution, sales, and service.			Viet Nam is currently producing quite a few consumer products in local-foreign joint ventures. Greater attempts should be made to learn sales and marketing skills. A large population with rising incomes gives Viet Nam some leverage in this respect.
International Links				Can develop a regional value chain with ASEAN and ASEAN+3, since over half of inputs come from them.
Important trading partners	Europe	East Asia		
Spillover Effects (training, competitive effects, demonstration effects, and human mobility)				
Suppliers				Vietnamese companies have to get to the first few rungs of (i) having sufficient foreign plants to supply and (ii) developing a wider supplier base. Viet Nam clearly has to give priority to its supplier base, the quality of suppliers, and the relationships between suppliers and foreign subsidiaries.
Likelihood of product specification transfer[e]	4.6	4.4	3.1	
Transfer of other types of knowledge[e]	2–3	2	1–2	
Supplier partnership schemes (%)	52	32	0	
Skill improvement[f]	3.6	3.1	2.4	
Distributors and Sales Organizations	Few forward links with local distributors, etc. because of the export orientation of foreign firms.			As under Distributors and sales organizations, above.
Competitors	Few had significant direct competition from local firms.			Viet Nam has to encourage the development of local companies that can take advantage of demonstration effects, spin-offs, and learning by doing.
Human Capital	Considerable human capital of high caliber has been generated, but only a minimal level finds its way to local firms.			As under Training and Human Capital.

ASEAN = Association of Southeast Asian Nations, FDI = foreign direct investment. [e] On a scale of 1–5. [f] On a scale of 1–4.

Note: Data are drawn from 27 Malaysian, 25 Thai, and 22 Vietnamese subsidiary companies in the sample.

Source: Mirza et al. (2003).

has not necessarily risen. Second, much FDI takes the form of reinvested earnings rather than capital inflow. This is especially the case in countries with long-established foreign investors, such as Malaysia. In recent years, retained earnings have accounted for as much as half of all new FDI in that country.

Even in the rare instances where ownership statistics are comprehensive, the foreign presence is always recorded imperfectly. There are substantial non-equity forms of foreign commercial involvement, such as licensing and franchising. In some cases, foreign firms have no choice but to enter through non-equity forms, principally licensing arrangements. It is generally—though not necessarily—the case that these commercial arrangements are less important in countries with more open FDI regimes. Thus, for example, the foreign presence is probably more accurately captured in the ownership statistics in Malaysia than in India or Korea. Also, international labor flows are increasing, thus bringing in an additional element to the foreign presence.

Moreover, ownership is often an empirically slippery concept, and the distinction between foreign and domestic is likely to become blurred in the future. The existence of large diasporas will hasten this trend. These originated in all six countries, particularly PRC, India, and Viet Nam. But, perhaps inevitably, their commercial activities are not consistently recorded. Official attitudes to this community also vary, from embrace to suspicion.

To place these rising FDI flows in context, and bearing in mind the serious data deficiencies, it is useful to briefly examine patterns of ownership in the six countries.

Accurate economy-wide ownership data are unavailable for the PRC. The best documented sector is manufacturing, where the major ownership feature has been the rapidly diminishing importance of the once dominant SOE sector. Its share of industrial output declined from 49% in 1994 to just 18% in 2001. Over this period, shares of the non-SOE domestic sector and foreign firms rose by approximately similar amounts: 38% to 53% for the former, and 13% to 28% for the latter. Among the latter, firms from Hong Kong, China; Macau, China; and Taipei,China account for 40–45% of the total. There has been some, but limited, privatization of SOEs. The major change has been the unshackling of the nonstate sector, which has been the source of the country's economic dynamism since the late 1980s.

In India, too, economy-wide ownership data are patchy, but all estimates point to minor ownership changes over time and a modest foreign presence. As would be expected, foreign shares declined prior to liberalization, from around 30% of industrial output in the early 1970s to about 25% in 1990, according to unpublished Reserve Bank of India data cited by Athreye and Kapur (2001). These figures likely overstate the foreign presence since they refer only to medium and large public companies surveyed by the Reserve Bank of India. As the authors note (p. 409), the decline is explained by "… the restrictions placed on foreign firms by the overall regulatory framework. Greater selectivity in industrial licensing restrained the growth of many multinationals [which] were unable to compete against well-organized domestic industrial lobbies." Post liberalization, this trend appears to be slowly reversing. For listed companies on the Indian stock exchange—a data series that cannot be directly compared with the source above—the share of foreign firms in manufacturing output gradually rose toward the end of the century: from 9.5% in 1990 to 12.8% in 2000. It could be that the foreign presence has risen more sharply in other sectors, especially the newly opened service industries. The foreign presence in India's manufactured exports is minuscule as noted, especially compared with East Asian norms.

The foreign presence has always been modest in Korea, given its historically restrictive ownership regime. Within manufacturing, at the onset of the Asian economic crisis, foreign firms produced about 10% of manufacturing output and employed 5.5% of the industrial work force. Liberalization and M&A activity raised these shares to 13.3% and 8% respectively by 1999. Over the period 1997–1999, foreign firms accounted for about 15% of the country's manufactured exports.

The Malaysian data confirm the historically large foreign presence in the economy. Foreign firms owned approximately one third of the nation's share capital in 1999, although down from over one half in 1970. Within manufacturing, foreign firms generated about 44% of value added and 38% of employment in 2000. They also

accounted for 73% of manufactured exports and 65% of total exports in 1995.

Ownership statistics for Thailand are the weakest of the six countries. No economy-wide estimates are available, while even for manufacturing the first reasonably comprehensive data were prepared only in 1996. They report that firms with a foreign presence (i.e., a foreign share greater than zero) produced about 50% of the country's industrial output and employed 41% of its work force. Estimates for 1999 suggest little change in the immediate aftermath of the economic crisis.

Ownership structures in Viet Nam are unusual. As FDI flowed in from the late 1980s, the share of the SOE sector actually increased. The explanation is that the SOEs retained their privileged access to secure land titles and the domestic banking sector for much of the reform period, and thus foreign investors interested in entering the economy were forced into joint ventures with them. Meanwhile, the policy regime suppressed the emergence of a domestic SME sector. This trend began to reverse, but very slowly, as the monopoly privileges of SOEs were eroded. One important milestone in this respect was the granting of 100% foreign ownership in certain circumstances (principally for firms in export zones), and the formal recognition that foreign firms are no longer part of the "state capitalist sector." Another was the passing of the Law on Enterprises in 2000, which provided a more secure environment for the domestic private sector. Over the period 1995–2001, there were no major changes in economy-wide output shares by ownership, apart from a doubling of the foreign firms' share (6% to 13%). The state sector remained virtually constant (39–40%), while collectives and the private/household sector declined slightly (10% to 8%) and (39% to 36%), respectively. The small mixed sector remained unchanged (4%). In these respects, Viet Nam is yet to experience the far-reaching ownership changes evident in the PRC. The foreign share of Viet Nam's manufactured exports has been rising sharply, from 17–19% in 1993–1995 to 57% in 2000. This share is likely to rise still further in the medium term as the country entrenches itself as an attractive destination for labor-intensive manufactured exports.

Foreign Direct Investment Inflows and Patterns

At least five features of the FDI flows and patterns discussed above are worthy of comment. The first concerns inflows to the PRC and PRC-India comparisons. Although the PRC is now considered the world's largest FDI recipient, the size of its inflows is a subject of debate. The principal uncertainty relates to round-tripping, that is, PRC investments being channeled through Hong Kong, China and returning as "foreign" investment to secure the greater privileges and security that foreign investors typically receive. As the PRC reforms progress, however, and the gap between the commercial environment in Hong Kong, China and adjoining southern regions narrows, this round-tripping FDI appears to be a diminishing proportion of total inflows.

These magnitudes have also triggered a recent debate about the comparative attractiveness of the PRC and India to foreign investors. Superficially, the PRC appears to be a far more attractive destination, owing to its earlier reforms, faster economic growth, and recorded FDI inflows some 20 times greater in recent years. However, recent literature has argued that the reported differences are greatly exaggerated. At least 20% of the PRC's FDI is still thought to be round-tripping, while Indian statistics until recently have significantly understated its FDI receipts, partly due to the way it measures outflows. In addition, the PRC's economy is more than double that of India. Making these adjustments, the reported 20:1 differential in flows becomes perhaps 3:1 in terms of FDI-to-GDP ratios. Since the PRC's investment rate (relative to GDP) is at least one third higher than India's, the FDI to gross domestic investment ratio is about 2:1. Thus, in the PRC-India comparison, the PRC is less exceptional (and more generally, is less of an outlier). Its magnitudes are extremely large, owing as much to its size as to its openness to FDI.

A second feature of FDI flows is their changing sector composition. Prior to the 1980s, most FDI in developing countries was in extractive industries and import-substituting manufacturing. The first major compositional shift was within manufacturing, from import-substituting to export-oriented manufacturing. This transition began in the late 1960s, but really

accelerated from the 1980s. A more recent shift has been toward services. By 2000, about half the total stock of FDI in developing countries was in services, more than double the figure in 1990 (UNCTAD 2002). Three factors principally account for this trend: the rising share of services in practically all countries, the increasingly tradable nature of many service outputs, and liberalized entry into many service industries previously closed to foreign businesses. However, substantial barriers to FDI in services are still in place.

These global changes are evident in all six economies, and have been driven in particular by the opening up of service industries to FDI. The changes are particularly pronounced in the more recent reforming economies. In the PRC, FDI began entering the banking and the foreign and domestic trade sectors in the 1990s. With the PRC's WTO accession, insurance, telecommunications, and other sectors are being progressively opened. In India, liberalization has resulted in a sharp decline in the earlier dominance of manufacturing, from 85% to 48% of the total. Most of the increase has gone into services. There is also a more even distribution of FDI across subsectors. In Korea, most service industries were closed to MNEs prior to the 1990s. Here too reform has led to a major reallocation of FDI flows.

Third, there are the changing modalities of capital flows. For a period in the 1990s, portfolio investment flows to Southeast Asia exceeded FDI. During and after the 1997–98 crisis, this trend was dramatically reversed. Moreover, the nature of FDI is also changing. The old pattern of greenfield FDI, and durable, long-term joint ventures is increasingly being replaced by M&As. The extent of M&A FDI is poorly documented, but appears to be increasing in most countries. These activities certainly increased in the late 1990s in the five crisis-affected countries (i.e., Indonesia, Korea, Malaysia, Philippines, and Thailand), as exchange rates and stock markets collapsed, inducing so-called "fire-sale FDI," that is, foreigners purchasing distressed and much cheapened assets. In India, too, there was a sharp rise in M&A FDI. During the restrictive era, virtually all FDI was greenfield by government diktat; now about 40% is M&A. However, there continues to be much official ambivalence about the domestic welfare effects of this form of MNE entry.

The modalities of foreign capital entry have varied significantly among the six economies (Table 3.5). FDI has been the major source of capital flowing into the PRC, dwarfing portfolio investment owing to the semiclosed capital account, including restrictions on foreigners trading shares on the domestic stock market. Total capital flows to India have risen significantly since the 1991 reforms, with a sharp increase from 1996. FDI still remains a relatively unimportant part of these flows, though it is rising over time as MNEs adjust to the country's more open policies. Capital flows to Korea also increased sharply in the first half of the 1990s, until the Asian economic crisis precipitated major capital flight. The major declines occurred in portfolio and other capital flows; as noted earlier, FDI inflows increased strongly in 1997–1999.

In contrast to the other countries, and reflecting its consistently open regime, Malaysia has traditionally received most of its capital in the form of FDI. FDI declined during the onset of the crisis, though it was still large. In the wake of the September 1998 imposition of capital controls, portfolio flows turned negative, but FDI strengthened. Thailand experienced the greatest volatility in capital flows, reflecting the large swing in its capital account balance during the crisis, equivalent to about 15% of GDP. Capital flows were negative in 1997–2002, but FDI remained positive, increasing strongly in the immediate aftermath of the crisis. Comprehensive capital flow data to Viet Nam are poorly recorded. It has the least internationally integrated capital market of the six. Most of the capital inflows have taken the form of FDI, remittances, and transfers. Inflows declined in the wake of the economic crisis, but remained positive.

Fourth, the major sources of FDI vary across countries, although some common patterns may be discerned. The EU, Japan, and US are typically the major investors. In addition, in some cases much smaller, but very open, proximate, and historically connected economies are major players in much larger economies. Thus, Hong Kong, China is the largest investor in the PRC, given its traditionally important (though declining) role in connecting that country to the global economy. Round-tripping is also a factor. Singapore remains a significant actor in Malaysia, reflecting their historically close commercial

ties. A major foreign investor in India is Mauritius where, in addition to historical connections, special taxation privileges have played a key role.

The 1970s FDI debates about whether particular source countries matter, and whether some are more desirable than others, no longer resonate.[30] This is so for several reasons: the evidence demonstrates that FDI, when well managed, contributes to growth; there is a greater diversity of sources compared with earlier periods of US and European domination; and even middle-income countries are now investing abroad. Much of the literature on "FDI differences" simply reflected the particular stages of development of the source countries. These alleged "unique" MNE characteristics generally faded as the source countries' industries were transformed.

Finally, there is the issue of FDI behavior during crises, including the magnitude and composition of flows. Three of the six economies in the sample (Korea, Malaysia, and Thailand) were severely affected by the Asian economic crisis, and another (Viet Nam) saw markedly slower growth. It is therefore useful to examine briefly the behavior of FDI, and related policy responses, during this episode. Sudden capital flight is indeed a central feature of modern economic crises. Crisis economies typically switch quickly from current account deficits to surpluses. On the current account, expenditure switching and absorption effects reduce imports and promote exports. In addition, slower economic growth and increased economic and political uncertainty result in the rest of the world being unwilling to finance a current account deficit.

Moreover, the behavior of different forms of capital diverge during crises. Portfolio and other forms of highly mobile capital are more likely to exit a country. By contrast, FDI flows are usually much less volatile. In fact, postcrisis FDI may well increase, along the lines postulated in Krugman's fire-sale FDI thesis (Lipsey 2001). Asset prices become cheaper owing to depreciated exchange rates, demand contractions, and financial collapse. Policy regimes are typically liberalized as part of the government's recovery package. Athukorala (2003) demonstrates that this is precisely what happened in most of the five crisis-affected countries in 1997–98. In aggregate, there were immense net capital outflows, principally portfolio investment and nonrenewal of short-term debt. Yet FDI actually rose modestly.[31]

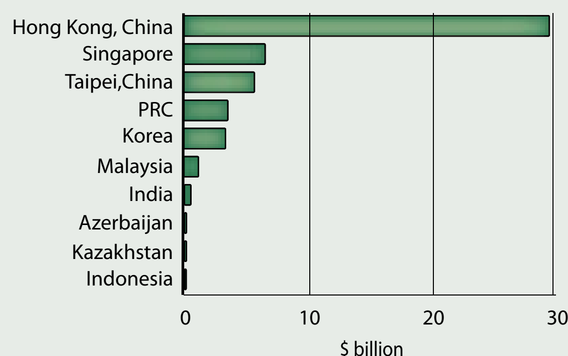
FDI may also play an important role during the recovery of crisis-hit economies. The analytical connection between the two starts with the collapse in aggregate demand during a crisis: consumer confidence and therefore expenditure wanes; the capacity for governments to run fiscal deficits is often constrained; and domestic investment falls owing to financial fragility, weak domestic demand, and uncertainty. Exports are therefore the critical component in the immediate recovery period. Crucial to the latter are MNEs. Given their global market networks and know-how, deeper pockets, and stronger connections to global capital markets, they have the capacity to translate large increases in potential competitiveness (arising from the depreciated currency) into export growth, in turn facilitating economic recovery.

The 1997–98 crisis also served as a reminder that restrictions on short-term capital flows may be compatible with an open FDI regime, at least in the short to medium term. This is the major conclusion of the controversial Malaysian policy experiment introduced in September 1998.[32] Nevertheless, it is important to note Malaysia's special circumstances: its very open economy, its high-quality bureaucracy, and the fact that it has never had a balance-of-payments crisis.

Foreign Direct Investment Outflows

Capital outflows are central to the process of globalization. Although occasionally the subject of mercantilist objections, to the effect that national savings are being employed for the benefit of others, theory and the vast majority of empirical evidence point clearly in the opposite direction. Outward FDI benefits the source economy, since domestic factors of production are able to maximize their returns. It is also presumed to constitute a spur to better economic policy, to the extent that the option of "exit" for investors exerts a policy discipline on governments. Outward FDI has become significant for a number of developing Asian economies (Figure 3.11). Outflows present a mixed and imperfectly recorded picture, but it is clear that patterns vary across the six economies focused on here. In all but Viet Nam, these investments abroad are sizable. In all cases, there has

Figure 3.11 FDI Outflows, Top 10 in Developing Asia, 2000–2002



Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm, downloaded 15 September 2003.

been a general relaxation of controls on outflows, although in some cases quite onerous restrictions remain in place. However, with the exception of Korea, all six are generally net FDI recipients.

The Korean case, at a relatively low per capita income becoming a large investor abroad with outflows often exceeding inflows, is very unusual. This appears to reflect a number of factors. One was its traditionally restrictive approach to inflows. The second was the country's rapid loss of comparative advantage in labor-intensive activities during the 1980s and the consequent relocation on a huge scale of much of this industry to high-growth, receptive, nearby economies. A third was the aggressive internationalization of the major *chaebol* from the late 1980s, with support from the Government. A considerable proportion of its FDI was high-end investment in sectors where protection in the targeted markets necessitated investment rather than export from the home base (e.g., the automotive and consumer electronics industries). Reverse engineering-type FDI, to obtain access to host country technology, has sometimes been a factor. (In India too, this motive is increasingly important.)

The PRC is also emerging as a major investor abroad. This phenomenon may appear surprising in view of its rapid growth, on the presumption that returns on capital would be higher at home than abroad. Three factors appear to be relevant in this story (Garnaut and Song, eds., 2003). One relates to macroeconomic policy. The PRC is running large current account surpluses and is accumulating substantial international reserves, currently estimated to exceed $400 billion. Most of these reserves are held abroad, albeit largely in the form of government securities rather than FDI. The second factor is the outward leg of the round-tripping phenomenon. This is not of course genuine FDI, and should be discounted from the outflows figure. The third relates to investments abroad by state-related entities in sectors deemed to be of commercial and strategic importance, such as natural resource projects or M&A activity to acquire technology.

For some countries, it is useful to distinguish between what may be termed state-sponsored and market-driven investments. This is evident in Malaysia, for example. The Government has sponsored several major investment projects abroad, including directly through its state-related entities. Some of these have been high profile, quasi-political investments in other developing countries, with mixed commercial results. Alongside these have been straightforward efficiency-motivated investments, principally in neighboring countries and reflecting firms' competitive advantages.

Three additional features of these outflows are worthy of mention. First, as noted above, many of the outward investment projects draw on the country's overseas communities, which is to be expected given that this diaspora lowers the transaction costs of going abroad. Second, in countries with complex regulatory systems, outward FDI may be a means of exploiting firm-specific advantages in a less restrictive environment. This has been hypothesized in some of the Indian literature, though presumably it is now a less important motive. Third, it appears to be the case that increasing outward FDI has contributed to the liberalization of policies toward FDI inflows. The argument is that investing abroad increases appreciation, in the source country, of the case for a more predictable and open regime. This has evidently been the case in Korea, particularly in the context of its accession to OECD.

Trade Regimes

Openness to the international economy varies significantly among the six countries. All have become more open to trade since 1990, as

indicated by both trade reforms and rising export-to-GDP ratios. This ratio has increased by more than 50% in three of the countries (PRC, India, and Thailand) and substantially in the others (Table 3.4).[33] Malaysia and Thailand were among a very small group of developing economies classified by Sachs and Warner (1995) as "always open." Both exhibit very high trade orientation, quite low average tariffs, modest interindustry tariff dispersion, and limited incidence of nontariff barriers. Qualitative indicators support this conclusion. Korea now has fairly low average tariff rates. Notwithstanding recent reforms, PRC, India, and Viet Nam still have relatively high tariffs, and a higher incidence of nontariff barriers than the other three countries. The more protected an economy is, the more that smuggling is likely to be a problem.

Among the six, Korea's trade and investment regime has arguably been the most unusual. From the early 1960s, it achieved very rapid export-led growth, albeit in the context of (until recently) very restrictive policies toward imports (except those required by export-oriented firms) and FDI. Its unique industrial policy resulted in tremendous achievements but also high costs.[34] In addition to tariff reform and a reduced incidence of nontariff barriers, Korea's reforms in the 1990s also included a reduction in the number of subsidy programs as well as customs simplification. As with its FDI regime, a desire to join both GATT/WTO and OECD, and the imperative to reform in the wake of the 1997–98 crisis, drove much of the liberalization.

Viet Nam's reengagement with the international economy is of very recent origin. For much of the period following the start of its 1986 *Doi Moi* reforms, it was effectively shut out of the world's largest market: the US Embargo was lifted in 1993, while the two countries signed a bilateral trade agreement only in 2001. As is the case with late reformers, its official trade regime remains opaque and poorly documented. Only quite recently was a formal tariff schedule released. It still retains very high levels of protection (several hundred percent) for its automotive, sugar, and garments industries. Much protection is firm-specific in nature, tailored to the needs of inefficient SOEs. Viet Nam aspires to WTO membership by 2005, which constitutes a powerful incentive to continue and broaden the reform process. ASEAN membership and the gradual introduction of ASEAN Free Trade Area commitments have constituted a useful "training exercise" for its WTO application.

A central feature of trade reform in all six economies is its unilateral nature. While four of the countries have for fairly long been members of preferential trading arrangements—ASEAN in the case of the three Southeast Asian economies and South Asian Association for Regional Cooperation for India—in practice these arrangements have meant practically no deviation from nondiscriminatory reform.[35] Unfortunately, this may be changing. All six are exploring additional preferential trading arrangement options, especially Korea, Singapore, and Thailand. If Asian preferential trading arrangements ever become significant, MNEs will certainly respond by including preferential access to selected export markets as a factor in their investment decisions.

Conclusions and Policy Implications

Several key points emerge from this survey of approaches to, and experiences with, FDI. Notwithstanding their diversity, almost all developing Asian economies have adopted progressively more open policies toward FDI during the past decade or two, and this trend appears likely to continue. This more open posture has been accompanied by the adoption of more liberal trade regimes, a process that has had profound implications for the motives for, and impact of, foreign investment. These changes have been so rapid in some cases that the policy framework has been unable to keep pace.

Apart from these key points, it is increasingly difficult to characterize and typify foreign investment. In most economies, it enters practically all sectors. It originates from industrial and developing economies. It may take the form of long-term greenfield investment or short-term, opportunistic M&As. It ranges from the global investments of the world's largest corporations

to smaller cross-border investments. The distinction between foreign and domestic investment is increasingly blurred, especially when a country's diaspora is actively involved. A world of increasingly seamless national boundaries also connotes highly fluid capital whose national characteristics are often difficult to discern.

The general conclusion in the empirical literature is that FDI confers net benefits on the host economy. The capital stock is augmented, productivity rises, and some (often much) of the increase is appropriated by domestic factors of production. These benefits appear to be especially important in connecting the host country to the global economy, and in the area of technology transfer. Nevertheless, analysts still keenly debate the magnitudes, channels, and lags associated with these transfers.

In assessing the impact of FDI, a key issue is one of attribution, in the sense of discerning causality. Some opponents argue that the entry of FDI may be associated with negative effects, such as rising interpersonal or within-country inequality, the demise of petty traders, increased concentration of ownership, higher levels of pollution, and more corruption. The challenge in each case is to determine whether there is any causality in the relationship. In most cases, the causality appears to be either weak or nonexistent. For example, pollution normally rises as countries pass through a transitional phase of industrialization characterized by greater pollution intensity. Petty traders and cottage industry experience difficulty competing with large retail outlets and factory-scale production regardless of who owns the latter. Regional inequality (both within individual countries and among groups of countries) often rises during the process of globalization, as those regions in the domestic economy better connected to the global economy have the capacity to grow faster. One cannot help but note in passing that some of the strongest criticisms of MNEs emanate from countries with the smallest FDI presence.

It is also important to emphasize that MNEs generally adapt to the local commercial environment. Any assessment of their impact needs to make due allowance for this factor. For example, if corruption is deeply embedded in the host country environment, MNEs are presumably likely to adjust to this characteristic (subject of course to source country restrictions). If tax evasion via transfer pricing occurs, it could be because tax rates are significantly above comparable benchmarks and such evasion is a general feature of local corporate behavior. If the incentives regime is strongly biased against exports, employment, or balanced regional development, MNEs cannot reasonably be expected to behave any differently from local firms. Limited technology spillovers are likely to be present when the domestic human capital base is weak. It is unlikely that MNEs will maintain high environmental standards if the general policy environment is lax in this respect. In other words, it is important to diagnose the root cause of a particular problem, rather than engage in an exercise of "guilt by association."

Investment measures have long been a feature of the regulatory framework governing FDI in most host countries. Most measures were designed to transfer benefits from the operations of foreign firms to the local economy and to promote development objectives. In essence, the primary objective of these measures is for host countries to obtain the maximum possible share of the gains from FDI. However, such regulations distort trade and investment and impose welfare losses (Moran 2002). The various regulations used may in fact have weakened, rather than enhanced, the contribution of FDI to national development objectives. In terms of incentives, there is some evidence that incentives play a relatively minor role in MNEs' decisions about where to locate relative to other location-based considerations (Ganesan 1998; Balasubramanyam 1991). Moran (2002) has provided much evidence to show how counterproductive and damaging domestic content requirements and joint-venture requirements can be for host country development. He also demonstrates just how beneficial a policy—of allowing subsidiaries that are wholly owned and unfettered by local content mandates—can be for host country growth and development.

Investment measures have frequently turned out to be costly and inefficient. Many countries, both industrial and developing, have abandoned or scaled back their use. Perhaps the most telling empirical evidence on this issue is not the number of governments that have such policies, but the

number of governments that have reduced them. Indeed, one key feature of the use of policies, such as local content schemes and export performance requirements, is that they are becoming less popular. Therefore, the appropriate question to ask is whether there are reasonable grounds for adopting or maintaining such policies. The most frequent answer to this question is that these policies are required to "develop" specific industries in order to compete in an open trading environment. Another reason sometimes cited is that structural adjustments involved in removing these types of policies will result in unemployment and loss of technology transfer and opportunities to move into high-technology industries (Bora 2001).

The core of the debate on the use of these policies is typically referred to as the "development dimension." In this context, the term development includes elements of self-sufficiency, national pride, and, perhaps most importantly, employment. It also has a technology transfer dimension, where FDI is supposed to induce technology transfer into developing countries. Protection may induce expansion of output and employment in certain sectors, although this expansion often carries a substantial cost for the society implementing such a policy.

The upsurge in FDI to developing countries in the 1990s was largely caused by unilateral liberalization of their FDI policies and regulatory regimes. Theoretical and empirical evidence provide strong support for the proposition that neutral policies designed to enhance the efficiency of investment are better suited to attracting foreign investment and enhancing its contribution to development than interventionist methods (Bora 2001). The challenge in multilateral negotiations on trade and investment is to identify the best ways to foster economic development while taking into account the specific conditions and policies prevailing in a developing country. Ariff (1989) points out that some investment measures appear to be redundant. For example, export performance requirements that set minimum export-output ratios to qualify for incentives or perks are scarcely binding in the sense that firms are required to do what they would have done anyway, even in the absence of explicit performance requirements.

A central issue is whether investment measures actually alter the allocation of resources in production and trade or merely affect the distribution of rents between firms and host countries. Both suppliers and recipients of FDI gain from the liberalization of investment measures. Foreign investors may benefit from new investment opportunities resulting from liberalized investment regulations, while host countries may benefit from increased FDI inflows and greater market discipline resulting from this. Since many developing countries compete with one another to offer foreign investors generous fiscal, infrastructure, and financial incentives, the scaling down of investment incentives could yield additional revenue for the host country governments.

The international benefits of FDI appear to be highly uneven. For some countries the benefits of an MNE presence are clear, while for others the impacts are ambiguous or possibly negative. Since all countries face the same international commercial environment, the presumption is that host country policy regimes and institutional capacities are the deciding factors of these differences. This section therefore concludes with a discussion of seven salient policy issues.

(1) **Flexible and Adaptable Regulatory Environment.** A major challenge for policy makers is keeping up with a rapidly changing international commercial environment. The calculation for mobile, export-oriented, foreign investors differs from that for investors in the import substitution era. *The quality of incentives, institutions, and infrastructure matters more than before.* In transitional economies, the first round of reforms typically focuses on macroeconomic stabilization and partial trade liberalization, while other, microeconomic, components of the "three Is" typically lag.

The question arises as to whether the FDI regulatory framework adapts adequately to this fast-changing environment. Inert and bureaucratic investment agencies, accustomed to distributing and exacting rents, may not be able to change quickly enough. Over a decade ago, Wells and Wint (1991) observed that, with the exception of Singapore, these agencies struggled with their dual, and potentially conflicting, identities as both promoter and regulator of FDI. These agencies have rarely been in the forefront of major economic policy reform. A mind-set remains that views FDI primarily as for "greenfield"

investment rather than for M&As. The rise of the new economy in various guises is transforming international business patterns. Even in relatively successful and long-lived cases of regional economic cooperation, such as ASEAN, the notion of a seamless market and business environment is still far from realization.

(2) **Unfinished Reform Agenda**. Significant obstacles to FDI are still in place, and these are typically more substantial than trade barriers. Many of them are concentrated in services industries, notwithstanding the significant liberalizations of the past decade.[36] In fact, countries with a tradition of openness toward merchandise trade have often been quite restrictive on services trade and FDI in services sectors. Malaysia, Thailand, and even Singapore may be included in this characterization. Of course, there may be good grounds for rejecting certain FDI applicants, when their presence would harm national interests.[37] Moreover, governments everywhere have to bend to nationalist sentiment, particularly in the wake of economic crises when there is a perception that deep-pocketed foreigners are picking up distressed assets at fire-sale prices. Nevertheless, it needs to be recognized that, for all the rhetoric of "open borders," major commercial barriers still exist.

(3) **Different Countries, Different FDI Issues**. The diversity of the country sample discussed above draws attention to the fact that host countries have diverse expectations for FDI. For late reformers, a major objective is simply entering the international commercial mainstream. Thus "bagging the first contract" is a prime objective. For resource-rich economies, taxation and environmental arrangements, and the rate of resource depletion, feature prominently. For low-wage, densely populated economies, export-oriented labor-intensive FDI can be crucial. By contrast, as host economies lose their comparative advantage in the latter, attention shifts to how FDI may play a role in the process of upgrading to more technology-intensive activities. Where there already exists a strong domestic R&D base, policy makers can seek to build on these strengths through joint ventures with MNEs.

The key point, therefore, is that, while the notion of one size fits all may apply at the general level to the adoption of open trade and investment regimes, there is in addition much scope for specific micro interventions to maximize the benefits of the foreign presence.

(4) **Toward a Unified Investment Environment**. A major challenge for policy makers is the introduction of a unified investment regime that confers national treatment on foreign investors, except when they deem domestic ownership to be essential (on the basis of carefully articulated national interest arguments).[38] Foreign and domestic investors are generally concerned with the same set of policy issues—including the tax regime, labor relations, the quality of human capital and infrastructure, and adequate legal protection. *There is therefore little point in attempting to devise different policy regimes for foreign firms.* Invariably, MNEs are attracted to a commercial environment that domestic firms find conducive.

The question of national treatment for FDI is particularly important in transitional economies. As part of the opening-up process, their policy makers recognize the importance of attracting MNEs into a hitherto hostile commercial environment. It is therefore not uncommon for them to "overdo" the FDI incentives regime by offering excessively generous arrangements for foreign investors. This results in the familiar dual policy regime, and often in round-tripping. Moreover, since these transitional economies also typically have a large, unreformed, and subsidized SOE sector, a lopsided ownership structure frequently emerges in which domestic private firms are underrepresented. In such circumstances, if domestic opposition to these privileged arrangements intensifies, the reform process itself could be jeopardized.

(5) **FDI and Trade Issues, Again**. Foreign investors have changed orientation from rent seeking to efficiency seeking. Underpinning this transformation in Asia has been trade liberalization, which has been primarily unilateral in nature and supported by a conducive multilateral environment. These twin pillars are under challenge as never before. The momentum for multilateral trade reform appears to have slowed down, especially with the disappointing results at the Cancun WTO meeting in 2003. Bilateral and regional preferential arrangements, discriminatory in nature, are proliferating. There is a danger that a world of "hubs and spokes" may emerge,

under which trade barriers between the spokes could increase. Such a trend would constitute a reversal from the postwar trend toward a more liberal global environment. It would also frustrate the emergence of the global factory phenomenon, and the capacity of MNEs to source globally at the lowest cost. *It is therefore possible that, if the current predilection for preferential trading arrangements intensifies, MNEs will be forced to incorporate discriminatory trade barriers in their location decisions.* For host economies, being a predictable and efficient production site would thus be a necessary but not sufficient condition for attracting FDI.

(6) **FDI in Decentralized Policy Environments**. Over time, the power of central governments in many countries is likely to diminish, as authority devolves to the regional level. In transitional economies such as the PRC and Viet Nam, this process is an inevitable outcome of the shift from the planned to the market economy. In Thailand, the process is a deliberate one, as a major decentralization program was introduced in 1993. India and Malaysia are already federal entities. As this process takes root, it is possible that energetic local governments within a country will begin to compete among themselves to seize business opportunities, in the process bypassing cumbersome national agencies. *The challenge for national governments will be to encourage this competitive potential, while ensuring that it operates in a manner consistent with national development objectives.*[39] The structure of center-regional fiscal relations is also a key to the success of these reforms: severe vertical fiscal imbalances may starve subnational governments of the resources needed to facilitate growth, and typically result in chronic "buck-passing" between tiers of government.

(7) **Fiscal Incentives**. Fiscal incentives are a risky and generally costly means of attracting MNEs. They are invariably second best in nature, when a first-best approach would be to address at source the unattractive features of the host economy environment. If granted on a large scale, there is a risk that they will undermine the government's fiscal base. *Foreign firms are attracted to commercially profitable and politically stable environments. Surveys of MNEs invariably record these features as the major determinant of their location decisions when investing abroad.* The empirical evidence also supports such a finding. Hong Kong, China, for example, has traditionally eschewed fiscal incentives in favor of a uniformly low tax regime. A report by the Foreign Investment Advisory Service on Thailand suggests that the payoff from incentives is very low. Moreover, in the absence of regime credibility, foreign investors implicitly discount the value of these incentives because they doubt their fiscal sustainability.[40]

Fiscal incentives are also corruption prone. Government officials can treat these "rents" as bargaining tools for corruption. It is quite common for up to half of their nominal value to be dissipated in this manner. In addition, they may be employed as a de facto instrument of industrial policy by agencies without the analytical capacity to devise and implement such programs. Performance criteria often lack any clear rationale; and are often not enforced anyway. Even in the well-managed Malaysian economy, for example, the rationale for the granting of incentives is ambiguous,[41] and their opportunity cost has not been thoroughly assessed for a decade or more.

There may be a case for distortions of these kinds in special circumstances. For example, investment incentives may be a useful signaling device in cases where governments are seeking to press their reform credentials in international business circles. In such cases, the key is to ensure that these are time bound, transparently costed, and transitional. To prevent vested interests from proliferating around these initiatives, they should desirably contain clearly defined and nonnegotiable sunset clauses. However, *the political economy of reforming these incentives is complex. None of the six countries discussed above has been able to introduce major reforms in their incentives regime, despite the clear case for doing so.*

Regardless of the outcome of the Doha round of WTO negotiations, individual countries can adopt a policy framework that is beneficial to both foreign and domestic investors, as well as to recipient economies as a whole. Basic components of such policies would include transparency about investment rules and regulations, with clear identification of agencies responsible for issuing relevant licenses, permits, and approvals. With efficiency-seeking FDI, a liberal trade regime, and a competitive commercial environment, FDI can remain a win-win proposition for developing Asia.

Endnotes

1 For more detailed information, see Brooks and Hill (2004). The countries studied in detail are People's Republic of China (PRC), India, Republic of Korea (Korea), Malaysia, Thailand, and Viet Nam.

2 Any analysis of foreign investment has to be heavily qualified by data constraints. Common weaknesses include the following:
First, FDI flows are poorly recorded. Investment agencies typically report approved investments, which often differ significantly from actual flows: realization rates fluctuate and may lag by several years; some agencies include domestic borrowings and even equity in their "foreign" totals.
Second, realized FDI estimates produced by central banks from balance-of-payments data are generally very approximate. Moreover, they do not include FDI in the form of reinvested earnings.
Third, disaggregated FDI flow data, by sector and source, are mostly incomplete. Often, the administrative responsibility of investment agencies does not extend to key sectors of the economy. Attempts to match source and host country FDI estimates typically reveal large discrepancies.
Fourth, accurate stock estimates of the foreign presence are rarely available. As noted, the flow data are inadequate. In addition, census estimates of foreign ownership are irregular and mostly patchy.
Fifth, data on other dimensions of the foreign presence, which may also include foreign equity, are even weaker. In some countries, there is substantial foreign ownership via the stock market, which (except during periods of crisis) may resemble FDI in its behavior. Notably, there has been a large diaspora from all six countries, but no consistent treatment of their investment activities. Associated flows of human capital and technology, which often also entail some implicit or explicit FDI, are also poorly recorded.

3 See Fan (2003), Lim (2001), and Moran (2002) for recent literature surveys.

4 See Yusuf (2003, chapter 7) for a recent analysis of this phenomenon in an East Asian context.

5 Migrant labor flows into Malaysia have been particularly large, and at the time of the Asian economic crisis these workers, many of them illegal, totaled 20–25% of the work force (Athukorala and Manning 1999).

6 The migration model of Harris and Todaro (1970) explains the persistence of rural-urban migration in developing countries with high urban unemployment as a reaction to the expected (rather than actual) high urban wage.

7 See Fan (2003) for a summary of this large literature.

8 An extreme example is the auto industry, which had high levels of protection. In 2002, 11 foreign manufacturers competed for a local annual market of less than 27,000 cars and commercial vehicles.

9 For comprehensive analyses of these issues, see the papers in Jomo and Felker (eds., 1999), and Jomo et al. (eds., 1999).

10 It is worth remembering that Malaysia was a world leader among tropical countries in pioneering high-quality agricultural research and extension programs, partly to address problems of rural Malay poverty. However, for reasons that are not entirely clear, industrial extension programs have never been developed to the same extent, with the Government preferring to adopt a more passive, MNE-led approach.

11 See Rasiah (2001) and Toh (2002) for interesting accounts of Penang's export-oriented industrialization success and challenges.

12 The key architect of Indonesia's dramatic FDI regime liberalization in 1967, Moh Sadli, later expressed the context as follows:
"When we started out attracting foreign investment in 1967 everything and everybody was welcome. We did not dare to refuse; we did not even dare to ask for bonafidity of credentials. We needed a list of names and dollar figures of intended investments, to give credence to our drive. The first mining company virtually wrote its own ticket. Since we had no conception about a mining contract we accepted the draft written by the company as a basis for negotiation and only common sense and a desire to bag the first contract were our guidelines" (quoted in Hill 1988, p. 28).

13 Although this may be changing. For example, Toyota has recently transferred some of its R&D activities to Thailand.

14 An important consideration here is whether fully owned foreign operations are permitted. The empirical evidence suggests that MNEs are more likely to develop strong local supply and content networks in a secure environment that permits 100%, or at least majority, foreign ownership (Moran 2002).

15 See McKendrick et al. (2000) and Wong (2003) for detailed analyses of Singapore's upgrading strategies.

16 Efforts to protect domestic markets offer an incentive to foreign investors to reap a secondary round of oligopoly rents from older technology.

17 *Voluntary* joint ventures, on the other hand, to spread risk and increase market access offer fewer disincentives for technology transfer, at least for more established technologies.

18 However, the affiliates of foreign investors generally try to avoid horizontal technology transfers that may create greater competition for themselves.

19 Argentina's request stated specifically that negotiations within the context of the MERCOSUR Common Automotive Policy were important. Mexico did not specifically mention it in its request, but it has been noted that there is an inconsistency in

the phaseout periods for TRIMs between the North American Free Trade Agreement and WTO.

20 The countries were selected for the variety of their conditions and experiences with FDI. They were studied in greater detail as part of an ADB regional technical assistance study (see Brooks and Hill 2004).

21 Some special provisions will always be required in any investment law tailored specifically for foreign investors, e.g., concerning guarantees against expropriation and provision for profit remittance.

22 Numerous data sources could have been selected. One recent and very useful series, with heavy emphasis on technological capacity and learning, is presented in UNIDO (2002). Its major drawback for this section is that it does not include Viet Nam. Part III ("Competitiveness in Developing Asia") of ADB (2003) provides a comprehensive review of various competitiveness estimates.

23 For a detailed review of these issues, see the contributors to Krueger (2000). On the reform list, major areas include fiscal imbalances, public sector enterprises, trade policy (especially in consumer goods industries), labor market rigidities, SMEs and reservation schemes, the regulatory and licensing system, and center-state relations. Many of these, of course, overlap.

24 For example, R&D expenditure rose from 0.3% of GDP in 1971 to 2.8% in the mid-1990s.

25 For example, official documents state that FDI should go to "mountainous and remote regions with difficult economic and social conditions." MNEs are criticized for not developing greater local sourcing, and yet the policy regime inhibits the development of a vibrant SME sector.

26 See Lardy (1996) for a detailed analysis of the PRC's trade and FDI liberalization.

27 See Wells and Wint (1991). In their sample of countries, only Singapore appeared to have an effective separation of responsibilities.

28 To quote Joshi (2003): "In practice, however, the system [i.e., the FDI regime] is more restrictive than it sounds, because there still remain numerous hurdles to jump, erected by State governments if not the Centre." Athreye and Kapur (2001, p. 422) note that the irony that "… even in sectors where foreign investment is readily allowed, firms must secure 'automatic approval'!" On the Indian reforms, see also Joshi and Little (1997) and Krueger (2002).

29 See Ramstetter (1999) for a detailed empirical study of the issue.

30 This debate included the assertions that Japanese and third world FDI were superior to that from the US and other developed countries respectively. Kiyoshi Kojima (e.g., 1996) was commonly associated with the former argument, while Wells wrote a major early study of the latter (1983).

31 Indonesia has of course been the principal outlier among the crisis-affected economies, in that FDI did not rise, due to its regime change and prolonged period of political uncertainty.

32 See Athukorala (2001) for a detailed examination.

33 Some caveats have to be attached to the data in Table 3.4. Trade-to-GDP ratios need to allow for country size. Average tariffs need to take account of tariff dispersion and the presence of nontariff barriers. To varying degrees, all six countries maintain dual trade regimes as between export sectors and the domestic economy. Nonetheless, the picture presented here is a reasonably plausible characterization of the country differences.

34 For contending perspectives on the impact of these interventions, see for example Amsden (1989, 2001) and Smith (2000).

35 That is, the ASEAN Free Trade Area liberalizations have almost always been multilateralized, while the South Asian Association for Regional Cooperation concessions have so far been relatively small. To the extent that these preferential trading arrangements are now being broadened (and overlapping), their benefits may increase.

36 See Hardin and Holmes (2002) for the development of a methodology to estimate FDI barriers, and some empirical estimates.

37 For example, as Stiglitz (2001, p. 521) notes, Singapore earned high marks "… when it excluded the Bank of Credit and Commerce International, which [later] succeeded in duping the US' regulatory authorities."

38 Much revolves around the definition of "essential," which usually includes defense-related industries, and sometimes the media and major natural resources. Divestment requirements may also be stipulated, although these are contrary to the spirit of national treatment.

39 For example, in some cases of rapid decentralization, regional governments, in their desire to quickly expand the local revenue base, resort to the imposition of local trade taxes or sanction environmentally unsound practices (e.g., excessive deforestation).

40 A recent study of Caribbean nations' proliferating fiscal incentives to attract FDI, especially in information technology sectors, underlined this point: "If anything, the plethora of incentives for different categories of investors in industrial parks may raise uncertainty regarding the stability of concessions and the government's long-term plans" (Berezin et al. 2002, p. 32).

41 For example, like most countries, proposed investment per employee is one of the criteria. However, Malaysia is also actively courting advanced information technology projects, which typically have relatively low (physical) capital-to-labor ratios.

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ASIAN DEVELOPMENT Outlook 2004

Statistical Appendix

Statistical Notes and Tables

The Statistical Appendix presents selected economic indicators for 41 developing member countries (DMCs) of the Asian Development Bank (ADB) in a total of 23 tables. These tables can generally be classified into the following accounts, namely: (i) national accounts, both production and expenditure; (ii) labor (unemployment); (iii) prices; (iv) money supply; (v) components of the balance of payments; (vi) external debt and debt service; (vii) exchange rates; (viii) international liquidity (gross international reserves); and (ix) government finance. The DMCs are grouped into five subregions: East Asia, Southeast Asia, South Asia, Central Asia, and the Pacific.

These tables contain historical data from 1998 to 2003. Forecasts for 2004 and 2005 are also provided in the following tables: Growth Rate of GDP (A1), Growth Rate of Per Capita GDP (A2), Growth Rate of Value Added in Agriculture (A3), Growth Rate of Value Added in Industry (A4), Growth Rate of Value Added in Services (A5), Gross Domestic Investment (A7), Inflation (A8), Changes in Money Supply (A9), Growth Rate of Merchandise Exports (A10), Growth Rate of Merchandise Imports (A12), Trade Balance (A13), Current Account Balance (A14), Current Account Balance as Percent of GDP (A15), Debt Service Ratio (A18), Central Government Expenditures (A21), Central Government Revenues (A22), and Fiscal Balance of Central Government (A23).

As much as possible, efforts were undertaken to standardize the data to allow comparability over time and across DMCs. However, limitations exist because of differences in statistical methodology, definitions, coverage, and practices. A discussion of the sources, definitions, scope and nature of data in the 23 tables, as well as methodology for regional averages, follows.

Historical data are obtained from the ADB Statistical Database System; official sources, statistical publications, secondary publications, other working papers, and internal documents of ADB, the International Monetary Fund (IMF), and the World Bank. Projections for 2004 and 2005 are staff estimates except for the 2004 projections for Tonga, Micronesia, Papua New Guinea and Vanuatu, and the 2005 projections for Micronesia, Papua New Guinea and Vanuatu, which are official government projections. Data in the tables refer to either calendar year or fiscal year. For some countries, the majority of their accounts are reported on a fiscal year basis (see figure), but some of their accounts are recorded on a calendar year basis, as follows: GDP data for Bhutan; and GDP and current account data for the Cook Islands. Other DMCs record their data in calendar year format except for government finance data, which are reported on a fiscal-year basis: Hong Kong, China; Indonesia (1997–1999 only); Democratic Republic of Timor-Leste; Samoa; and Taipei,China (fiscal year ending 30 June); and the Lao People's Democratic Republic (Lao PDR), and Thailand (fiscal year ending 30 September).

Calendar Year 2003 | Calendar Year 2004

J F M A M J J A S O N D | J F M A M J J A S O N D

Country	Fiscal year
Afghanistan	FY2003 (2003/04)
Bhutan	FY2004 (2003/04)
Bangladesh	FY2004 (2003/04)
Cook Islands	FY2004 (2003/04)
India	FY2003 (2003/04)
Marshall Islands, Rep. of	FY2004 (2003/04)
Micronesia, Fed. States	FY2004 (2003/04)
Myanmar	FY2003 (2003/04)
Nepal	FY2004 (2003/04)
Pakistan	FY2004 (2003/04)
Tonga	FY2004 (2003/04)

External debt as well as debt service ratio data for Samoa are reported on a fiscal year basis.

Regional averages or totals for DMCs are provided for nine economic indicator tables. Data for Afghanistan, Myanmar, and Nauru are excluded in the computation of subregional averages due to measurement problems. For 1998 and 1999, data on inflation for Timor-Leste are excluded from the regional average due to measurement problems.

Out of the nine economic indicator tables, six have regional averages (A1, A2, A8, A10, A12, and A15). Where there are missing data for a given year, subregional averages are computed on the basis of the available information only. Totals are incorporated in three tables (A11, A13, and A14) except that in Table A11, subregional totals are represented in terms of percentage shares to developing Asia.

For four tables, (A1, A2, A8, and A15), levels of gross national income (GNI) in current US$ using the World Bank Atlas method are used as subregional weights to calculate the subregional and regional averages. Tables on growth rates of merchandise exports and imports (A10 and A12) do not incorporate weights in the computation of averages.

The GNI data, in current US$, for DMCs from 1998 to 2002 were obtained from the World Bank Group WDI Data Query (http://devdata.worldbank.org/data-query/). The most recent data, 2002, are also used to derive the weights for the computation of regional averages for 2003 to 2005. The GNI data, in current US$, for three of the DMCs are unavailable, namely Cook Islands; Taipei,China; and Tuvalu. For these economies, GNI data are estimated.

Six tables (A1, A2, A3, A4, A5, and A7) refer to the national income accounts. They show output and sector growth rates, as well as gross domestic investment (GDI) as a percentage of GDP. Definitions relating to output growth, production, and demand, are generally based on the United Nations System of National Accounts.

Sector shares of agriculture, industry, and services for 2002 are, respectively, presented in Tables A3 to A5. For Hong Kong, China; Republic of Korea (Korea); and Samoa, import duties and taxes net of imputed bank service charges are added to the services sector only for the computation of the sector shares to obtain a 100% sum for all sectors. For Bhutan, Maldives, and Nepal, the sector levels include imputed bank service charges while total GDP does not include these charges. To compute the sector shares, imputed bank service charges are added to total GDP to obtain a 100% sum for all sectors. In the case of Azerbaijan and Kazakhstan, sums of sector shares do not add up to 100% because of some statistical discrepancies and differences in definitions (see below). However, for Azerbaijan and Kazakhstan, where the sum is not equal to 100%, import duties and taxes less imputed bank service charges are excluded in the sector data but are not netted out in the total value of output or GDP. In the case of the Republic of the Marshall Islands (RMI) and Solomon Islands, the sum of sector levels do not add up to the total GDP level due to differences in definition or revisions on the GDP levels with no available sector breakdown. For these Pacific countries, the calculation of sector shares is based on the share of each sector to the sum of gross value added. Data on total value of output or GDP in constant prices are not available for Timor-Leste; only GDP growth rate estimates are available. For Fiji Islands, Kiribati, Papua New Guinea (PNG), Tonga, and Vanuatu, imputed bank service charges are added to the services sector. For Bangladesh, Kiribati, PNG, and Tonga, import duties and taxes are excluded in the sector data but are also netted out in the total GDP level so that the sector shares still add up to 100%.

Sector shares are computed based on constant prices except for Timor-Leste where shares are based on current prices.

GDI from the expenditure side of the national income accounts is also presented in Table A7. This represents final expenditures on investment at purchasers' prices. It is presented as a percentage of GDP; valued at current prices.

The following paragraphs examine the tables in closer detail.

Table A1: Growth Rate of GDP (% per year). This shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value-added or similar taxes. Other valuations for GDP use gross

payments to factors of production and amounts receivable by the producer from the purchaser for a unit of a good or service exclusive of taxes payable and inclusive of subsidies receivable on products, excluding transport charges invoiced separately by the producer. These valuations respectively refer to factor costs and basic prices. Most DMCs use constant market price valuation. South Asian countries predominantly use constant factor costs, including Bhutan, India, Nepal, Pakistan, and Sri Lanka, while Maldives' GDP valuation is at basic prices. Among the Pacific countries, Fiji Islands, Solomon Islands, Tuvalu, and Vanuatu employ constant factor cost valuation. For Hong Kong, China, the computations of real GDP and sector growth rates are based on volume indexes, while GDP sector growth rates for Solomon Islands were based on GDP production indexes.

Table A2: Growth Rate of Per Capita GDP (% per year). The table provides the growth rates of real per capita GDP, which is defined as GDP at constant prices divided by the population. Data on per capita gross national product in US$ terms for 2002, sourced from the World Bank, are also shown.

Table A3: Growth Rate of Value Added in Agriculture (% per year). The table shows the growth rates of value added in agriculture and its corresponding share in 2002. The agriculture sector includes agricultural crops, livestock, poultry, fisheries, and forestry.

Table A4: Growth Rate of Value Added in Industry (% per year). The table provides the growth rates of value added in industry and its corresponding share in 2002. This sector includes the manufacturing and nonmanufacturing subsectors. Mining and quarrying, construction, and utilities fall under the latter subsector. For Kazakhstan, the industry sector does not include construction.

Table A5: Growth Rate of Value Added in Services (% per year). The table gives the growth rates of value added in services and its corresponding share in 2002. Subsectors include trade, banking, finance, real estate, public administration, and other services.

Table A6: Unemployment Rate (%). The unemployment rate is the percentage of the labor force that actively seeks work but is unable to find work at a given time. The age of the working population falls within the range of 15 to 65, except for Bangladesh where the labor force includes those aged 10 and above. The unemployment rates of the PRC and Viet Nam refer to unemployment in the urban areas only. For Sri Lanka, data for 2003 refer to the third quarter only. For the Pacific countries, data are primarily obtained from various national censuses, various national poverty assessment reports undertaken by the ADB for the period 2002–2003, and the Secretariat of the Pacific Community's Pacific Regional Information System database. For 1997, the unemployment figures for the Cook Islands and Tonga are from the 1996 Census; the data for Kiribati are from the 1995 Census; the figure for Nauru is from the 1992 Census; and the figure for PNG is from the 1990 Census. For 2002, the unemployment figure for the Fiji Islands is from the 2002 Urban Household and Income Expenditure Survey.

Table A7: Gross Domestic Investment (% of GDP). This table provides the ratio of GDI to GDP. GDI is the sum of gross fixed capital formation plus changes in inventories. Gross fixed capital formation is measured by the total value of a producer's acquisitions, less disposals, of fixed assets in a given accounting period. Additions to the value of nonproduced assets, e.g., land, form part of gross fixed capital formation. Inventories are stocks of goods held by institutional units to meet temporary or unexpected fluctuations in production and sales. For the Lao PDR, investment approvals based on staff estimates are used as the GDI figure.

Table A8: Inflation (% per year). Except for India, which reports the wholesale price index; Kiribati and Solomon Islands, which use the retail price index; and the Federated States of Micronesia (FSM), which uses the Implicit GDP Deflator, annual inflation rates presented are based on consumer price indexes. For most DMCs, the reported inflation rates represent period averages except for Bhutan, Cook Islands, and Timor-Leste, which use end-of-period data. The data for Singapore is on a calendar year basis, yet the base year used for the computation of inflation rates is November 1997–October 1998. The inflation rate for India in 2003 is for April–December only. For Sri Lanka, inflation is calculated using the new Sri Lanka consumer

price index, which measures all-island price movements and uses an updated basket of goods with 1995–1997 as the base period. The consumer price indexes of the following countries are for a given city or group of consumers only: Cambodia is for Phnom Penh, Kiribati is for Tarawa, RMI is for Majuro, Solomon Islands is for Honiara, and Nepal is for urban consumers.

Table A9: Growth in Money Supply (% per year). This table tracks the annual percentage change in the end-of-period supply of broad money as represented by M2 (for most DMCs). 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 including foreign currency deposits. For Korea, M2 includes transferable savings deposits. For Sri Lanka, M2 includes time and savings deposits held by commercial banks' foreign currency banking units. For RMI and FSM, broad money consists only of deposits, while for India, Kazakhstan, and Philippines, broad money is represented by M3, defined as M2 plus other assets that are less liquid than what would be classified under M2 and M1. For India, M3 includes deposits with the Reserve Bank of India, and its FY2003 data are only until 6 February 2004. For Solomon Islands and the Fiji Islands, the money supply growth reported for 2003 is as of end-September 2003 and end-November 2003, respectively. For Timor-Leste, money supply levels are derived from IMF estimates on M2 as a % of GDP. The money supply level for 2003 is as of end-September 2003 only, and the growth rate for 2003 is calculated vis-à-vis the money supply level as of end-2002. Figures after 1999 exclude currency holdings by the public, for which data are not available.

Tables A10, A12, A13, A14, A15, A16: Balance of Payments. This set of tables primarily contains items from the balance of payments (BOP). These items cover the annual flows recorded in the BOP account. Data for Nepal have been revised based on the new BOP format. The revisions are consistent with the IMF's Fifth Edition BOP manual. Substantial changes and additions in almost all BOP items have been implemented in the new format. The new format was implemented for FY2003 data, with the data for FY2001 and FY2002 also converted to the new format.

Tables A10 and A12: Growth Rates of Merchandise Exports and Imports (% per year). The annual growth rates of exports and imports, in terms of merchandise goods only, are shown in these tables. Data are in million US$, primarily obtained from the BOP account of each DMC. Exports in general are reported on a free-on-board (f.o.b.) basis. In this case, exports are valued at the customs frontier of the exporting country plus export duties and the costs of loading the goods onto the carrier unless the latter is borne by the carrier. It excludes the cost of freight and insurance beyond the customs frontier. For Cambodia, exports refer to domestic exports. Import data are reported either on an f.o.b. or c.i.f. (cost, insurance, freight) basis. On a c.i.f. basis, the value of imports includes the cost of international freight and insurance up to the customs frontier of the importing country. It excludes the cost of unloading the goods from the carrier unless it is borne by the carrier.

For East Asia, all economies report imports on an f.o.b. basis except for Mongolia which records them on a c.i.f. basis. Imports are valued on an f.o.b. basis for Indonesia, Malaysia, and Viet Nam while the rest of the Southeast Asian countries' imports are valued on a c.i.f. basis. Bhutan and India record imports on c.i.f. basis while Bangladesh, Maldives, Nepal, Pakistan, and Sri Lanka value them on an f.o.b. basis. For most of the Central Asian republics, all imports are costs on an f.o.b. basis. Most of the Pacific countries report imports on an f.o.b. basis while imports of Cook Islands, Fiji Islands, PNG, and Samoa are recorded on a c.i.f. basis. For the Fiji Islands, exports and imports growth for 2003 are computed based on the levels for the first 3 quarters of 2003 only vis-à-vis the levels for the whole of 2002.

Table A11: Direction of Exports (% of total). Data from this table are sourced from IMF, *Direction of Trade and Statistics*, CD-ROM (February 2004), with the exception of Taipei,China, for which data are obtained from domestic sources. It shows the percentage share of exports of each DMC to developing Asia excluding the PRC; PRC only; US; Japan; European Union (EU); and others (or rest of the world). The rest of the world is derived as total exports of DMCs to the world minus their exports among themselves and to US, Japan, and EU.

Table A13: Trade Balance (US$ million). The trade balance is the difference between merchandise exports and merchandise imports. Figures on this table are based on the exports and imports levels used to generate Tables A10 and A12.

Table A14: Current Account Balance (US$ million). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. The amounts shown in this table are in million US$. In the case of Bangladesh, Lao PDR, Mongolia, and Viet Nam, official transfers are excluded from the current account balance. Data for Bhutan are not comparable with previous years' ADO figures since current transfers used to be excluded. For the Fiji Islands, 2003 data on current account balance includes the first 3 quarters only.

Table A15: Current Account Balance (% of GDP). The values reported in Table 14 are divided by GDP at current prices in US$. In the case of Bhutan, GDP for the previous calendar year is used as the denominator.

Table A16: Foreign Direct Investment (US$ million). Foreign direct investment refers to equity capital, reinvested earnings, and other capital associated with the transactions of the enterprises. These data are net of capital flows in the home reporting country. For the PRC, foreign direct investment refers to (i) investments of foreign enterprises, economic organizations, and individuals through joint ventures and cooperation; (ii) reinvested earnings; and (iii) enterprises' borrowings from abroad under approved investment projects. Data on foreign direct investment for Korea comprise equity purchased and long-term, intracompany loans. In the case of Cambodia and the Lao PDR, gross capital flows, instead of net capital flows, are presented. For Bangladesh, only those capital investments passing through banking channels are reported. For India, data for 2003 are estimated on flows from April to September 2003. Data for the Maldives are derived from the United Nations Conference on Trade and Development (UNCTAD) *World Investment Report 2003* and refer to gross inflows. Data for Cook Islands, RMI, FSM, and Tuvalu are from the Organisation for Economic Co-operation and Development (OECD), *Geographical Distribution of Financial Flows to Aid Recipients 1997/2001*, 2003. For the rest of the Pacific countries, data on net foreign direct investment inflows are taken from UNCTAD's *World Investment Report 2003*, July 2003, Annex Table B.1.

Table A17: External Debt Outstanding (US$ million). For most DMCs, external debt outstanding includes long-term debt, short-term debt, and IMF credit. The external debt reported by Cambodia and Lao PDR also excludes that owed to the Russian Federation and the U.S. For 2003, India's external debt figure is as of September. Total external debt outstanding for the Fiji Islands includes external debt of the Government, statutory bodies, and the private sector. The figure for 2003 is as of end-September 2003 only.

Table A18: Debt Service Ratio (% of exports of goods and services). This table presents the total debt service payments of each DMC as a percentage of exports of goods and services. Total debt service payments comprise principal repayments and interest payments on outstanding external debt. For Taipei, China, the debt service refers to external public debt only. Exports of goods is used as the denominator in the calculation of the ratio for PRC, Kiribati, Mongolia, Pakistan, PNG, and Viet Nam. For the Philippines, exports of goods, services, and income is used as the denominator in the calculation of the ratio. For Bangladesh, the ratio represents debt service payments on medium- and long-term loans as a percentage of exports of goods, nonfactor services, and worker remittances. In the case of India, the ratio for 2003 is as of September. For Azerbaijan, the ratio represents public and publicly guaranteed external debt service payments as a percentage of exports of goods and nonfactor services.

Table A19: Exchange Rates to the US Dollar (annual average). The annual average exchange rates of the DMCs are quoted in local currencies per US dollar. The 2003 average exchange rate reported by the Cook Islands reflects the period January–November 2003 only; for Solomon Islands, the average exchange rate is based on the period January–September 2003 only; for India, the average is based on data from April to January only.

Table A20: Gross International Reserves (US$ million). Gross international reserves (GIR) are defined as the US$ value of holdings of special drawing rights (SDR), reserve position

in the IMF, foreign exchange, and gold at the end of a given period. Most DMCs report GIR without gold. For a few countries, GIR data are reported as of the end of the fiscal year as indicated in the figure at the start of these notes. However, for Southeast Asian countries, gold is included in the computation of gross international reserves. For Maldives, GIR comprises foreign assets of the Maldives Monetary Authority. For Taipei,China, GIR refers to foreign exchange reserves only. For Pakistan, GIR consists of net foreign reserves with the State Bank of Pakistan. The Fiji Islands' GIR data refer to gross foreign exchange reserves; the figure for 2003 covers the period until November 2003 only. Cook Islands data refer to net foreign assets while Samoa's GIR refers to gross foreign assets. For Kiribati, GIR refers to total official external assets. For Solomon Islands, data reported for 2003 covers the period until September 2003 only. In the case of PNG, GIR includes the Bank of Papua New Guinea's holdings of gold.

Tables 21, 22, and 23: Government Finance. This set of tables refers to the revenue and expenditure transactions as well as the fiscal balance of the central government. For Azerbaijan, PRC, India, Kazakhstan, Mongolia, and Tajikistan, transactions are those reported by the general government. The shares of these major fiscal items as against GDP are calculated for this group of tables. For Bhutan, ratios are calculated relative to the previous calendar year's GDP.

Table 21: Central Government Expenditures (% of GDP). Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a percentage of GDP at current prices. For Singapore, expenditures refer to outlays made from the Consolidated Revenue Account, Development Fund Account, and Sinking Fund Account) plus net lending minus repayments. For Thailand, expenditures refer to budgetary expenditures excluding externally-financed expenditure and corresponding borrowing. For Bangladesh, expenditures include a residual. One-off expenditures are excluded but a statistical discrepancy is included for Pakistan. For Tuvalu, Tuvalu Trust Fund (TTF) transfers are excluded. Meanwhile, expenditures in Solomon Islands for 2003 include recurrent expenditures only, and refer to the actual figures until the end of September 2003.

Table 22: Central Government Revenues (% of GDP). Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a percentage of GDP at current prices. For Singapore, revenue refers to receipts credited to Consolidated Revenue Account, Development Fund Account, and Sinking Fund Account, including investment income, capital receipts, and investment adjustments. In some countries, other revenue items are included or excluded in the reported revenue figures: social security contributions are excluded for Korea; grants are excluded for Cambodia, Lao PDR, Malaysia, Singapore, Thailand, and Viet Nam; capital receipts are excluded but revenues from disinvestment are included for India; only current revenues are included for Bangladesh and Pakistan; privatization proceeds are excluded for Sri Lanka; the Oil Fund is included for Azerbaijan; sales from assets are excluded for the Fiji Islands; the Revenue Equalization Reserve Fund income is included for Kiribati; and Consolidated Investment Fund drawdowns are included for Tuvalu. For Solomon Islands, total revenues and grants in 2003 refer to the actual figures to end of September 2003 only.

Table 23: Fiscal Balance of the Central Government (% of GDP). This is the residual between central government revenues and expenditures. The difference is also computed as a share of GDP. Data variations may arise due to statistical discrepancies, e.g., balancing items for both central and local governments, and differences in the concept used in the individual computations of revenue and expenditure as compared with the calculation of the fiscal balance. For Thailand, the fiscal balance is a cash balance composed of the budgetary balance and nonbudgetary balance. For the Fiji Islands, the computation of the fiscal balance includes the proceeds from the sale of assets. For Kazakhstan, privatization proceeds are treated as financing items rather than revenues in 2002. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan.

Table A1 Growth Rate of GDP (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	2.8	7.0	8.0	4.6	6.7	6.5	6.9	6.8
China, People's Rep. of	7.8	7.1	8.0	7.3	8.0	9.1	8.3	8.2
Hong Kong, China	-5.0	3.4	10.2	0.5	2.3	3.3	6.0	5.0
Korea, Rep. of	-6.9	9.5	8.5	3.8	7.0	3.1	4.8	5.2
Mongolia	3.5	3.2	1.9	1.1	4.0	5.5	5.8	6.0
Taipei,China	4.6	5.4	5.9	-2.2	3.6	3.2	5.4	4.7
Southeast Asia	-6.8	4.1	6.3	1.9	4.2	4.6	5.7	5.4
Cambodia	3.7	10.8	7.0	5.7	5.5	5.0	5.4	5.4
Indonesia	-13.1	0.8	4.9	3.5	3.7	4.1	4.5	4.5
Lao People's Dem. Rep.	4.0	7.3	5.8	5.8	5.9	5.9	6.0	6.2
Malaysia	-7.4	6.1	8.5	0.3	4.1	5.2	5.8	5.6
Myanmar	5.8	10.9	13.7	11.3	10.0	10.6	-	-
Philippines	-0.6	3.4	4.4	3.0	4.4	4.5	5.0	5.0
Singapore	-0.9	6.5	10.1	-1.9	2.2	1.1	5.6	4.8
Thailand	-10.5	4.4	4.8	2.1	5.4	6.7	7.2	6.2
Viet Nam	4.4	4.7	6.1	5.8	6.4	7.1	7.5	7.6
South Asia	6.0	5.7	4.5	5.2	3.9	6.9	7.0	7.2
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	5.2	4.9	5.9	5.3	4.4	5.3	5.7	6.0
Bhutan	6.4	7.8	5.5	7.1	6.7	6.5	7.0	8.0
India	6.5	6.1	4.4	5.8	4.0	7.3	7.4	7.6
Maldives	9.8	7.2	4.8	3.4	6.5	8.4	5.5	5.0
Nepal	3.2	4.5	6.0	4.6	-0.4	2.6	4.0	5.0
Pakistan	3.5	4.2	3.9	2.2	3.4	5.1	5.5	5.8
Sri Lanka	4.7	4.3	6.0	-1.5	4.0	5.5	5.0	5.5
Central Asia	1.7	4.8	8.2	10.8	8.1	8.4	8.1	8.4
Azerbaijan	5.5	7.3	11.0	9.9	10.6	11.2	9.0	12.5
Kazakhstan	-1.9	2.7	9.8	13.5	9.8	9.2	9.5	9.5
Kyrgyz Republic	2.1	3.7	5.4	5.3	0.0	6.7	4.1	4.5
Tajikistan	5.3	3.7	8.3	10.2	9.1	10.2	8.0	5.0
Turkmenistan	7.0	16.0	17.6	20.5	8.6	10.0	10.0	10.0
Uzbekistan	4.4	4.4	3.3	4.1	4.0	4.4	4.5	4.0
The Pacific	-0.6	4.5	-0.1	0.6	0.8	2.7	2.9	2.4
Cook Islands	-0.8	2.7	13.9	4.9	3.9	3.1	2.7	2.9
Fiji Islands	1.5	9.6	-3.2	3.0	4.1	5.0	3.9	3.0
Kiribati	12.6	9.5	1.6	1.8	1.0	2.5	1.8	1.5
Marshall Islands, Rep. of	3.0	0.8	-2.0	-1.5	4.0	3.0	2.0	3.0
Micronesia, Fed. States of	-0.7	-3.5	9.3	0.5	0.9	0.1	-1.5	2.2
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	-2.8	7.6	-1.2	-2.3	-0.8	2.0	2.8	1.7
Samoa	2.4	2.6	6.9	6.2	2.8	5.0	4.0	3.5
Solomon Islands	0.1	-0.9	-13.3	-10.1	-4.0	3.8	4.5	4.5
Timor-Leste, Dem. Rep. of	1.3	-35.0	15.0	17.0	-1.1	-3.0	1.0	3.0
Tonga	2.4	2.9	6.5	0.8	1.6	1.9	2.6	2.8
Tuvalu	14.9	3.0	3.0	4.0	2.0	3.0	3.0	-
Vanuatu	4.3	-3.2	2.7	-2.1	-2.8	1.6	2.1	2.6
Average	1.6	6.2	7.0	4.3	5.8	6.3	6.8	6.7

- = not available.

Table A2 Growth Rate of Per Capita GDP (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005	Per Capita GNP, $, 2002
East Asia	2.0	6.2	7.2	3.9	6.0	6.2	6.3	6.2	
China, People's Rep. of	6.9	6.3	7.2	6.6	7.4	8.9	7.7	7.6	940
Hong Kong, China	-5.8	2.5	9.3	-0.4	1.3	3.1	5.6	4.0	24,750
Korea, Rep. of	-7.6	8.8	7.6	3.1	6.3	2.5	4.2	4.8	9,930
Mongolia	3.9	1.9	0.6	-0.1	3.2	4.7	5.0	6.4	440
Taipei,China	3.6	4.6	5.0	-2.9	3.0	2.9	4.5	3.8	13,409
Southeast Asia	-8.6	2.6	4.8	0.3	2.7	3.1	4.3	4.0	
Cambodia	-0.9	8.0	4.3	3.1	2.8	2.5	2.2	2.8	280
Indonesia	-14.3	-0.6	2.1	2.1	2.2	2.6	3.1	3.0	710
Lao People's Dem. Rep.	0.9	2.6	3.9	3.8	3.8	3.8	3.8	3.8	310
Malaysia	-9.5	3.6	4.9	-1.8	1.9	1.9	2.5	2.3	3,540
Myanmar	1.9	8.7	11.5	-	-	-	-	-	-
Philippines	-2.7	1.2	4.8	2.6	2.4	2.5	3.0	3.0	1,020
Singapore	-4.2	5.7	8.3	-4.6	1.2	0.8	5.6	4.8	20,690
Thailand	-11.5	3.4	4.6	0.5	4.5	5.8	6.4	5.2	1,980
Viet Nam	2.6	3.0	4.7	4.1	5.4	5.6	6.4	8.1	430
South Asia	4.0	3.8	2.7	3.3	2.1	5.1	5.3	5.5	
Afghanistan	-	-	-	-	-	-	-	-	-
Bangladesh	5.1	3.4	4.5	3.8	3.1	3.9	4.3	4.6	360
Bhutan	3.4	4.5	2.5	3.5	4.1	3.5	-	-	590
India	4.4	4.2	2.5	3.9	2.2	5.5	5.7	5.9	480
Maldives	7.6	5.1	2.7	1.7	4.8	6.7	3.9	-	2,090
Nepal	0.9	2.2	3.6	2.3	-2.7	0.3	-	-	230
Pakistan	1.0	1.8	1.6	0.0	1.2	2.9	3.5	3.8	410
Sri Lanka	3.4	2.4	5.0	-2.9	2.5	4.2	2.9	3.4	840
Central Asia	1.5	4.3	7.7	12.9	9.0	8.1	9.0	8.9	
Azerbaijan	4.0	6.4	10.1	9.0	9.8	-	-	-	710
Kazakhstan	-0.2	3.7	10.2	13.8	9.6	8.5	9.4	8.9	1,510
Kyrgyz Republic	0.4	3.2	3.7	4.5	-0.8	5.3	-	-	290
Tajikistan	3.6	1.9	9.5	6.0	7.1	4.0	2.1	-	180
Turkmenistan	4.0	12.4	13.9	16.9	-	-	-	-	1,200
Uzbekistan	2.8	2.9	2.6	-	-	-	-	-	450
The Pacific	-2.7	3.1	-2.1	-1.9	-1.1	0.7	0.7	-	
Cook Islands	4.0	10.0	20.9	9.4	-1.7	9.7	-	-	-
Fiji Islands	0.3	8.2	-3.7	2.5	2.7	5.7	3.5	-	2,160
Kiribati	10.6	7.6	0.3	0.2	-0.6	0.9	-	-	810
Marshall Islands, Rep. of	1.5	-1.8	-5.4	-5.0	0.2	-0.9	-1.9	-	2,350
Micronesia, Fed. States of	-1.0	-3.7	9.1	0.3	0.7	-0.1	-1.7	2.0	1,980
Nauru	-	-	-	-	-	-	-	-	-
Papua New Guinea	-5.8	4.2	-4.5	-5.3	-3.9	-1.1	-0.4	-1.5	530
Samoa	1.9	2.1	5.0	4.1	0.7	2.9	2.0	-	1,420
Solomon Islands	-2.7	-3.8	-15.6	-12.6	-6.7	0.9	1.6	1.6	570
Timor-Leste, Dem. Rep. of	0.1	-18.4	14.3	5.6	5.0	-10.8	-3.6	-	-
Tonga	1.7	2.3	6.0	0.4	1.3	1.5	2.1	2.3	1,410
Tuvalu	13.5	1.7	1.7	2.7	0.7	1.7	-	-	-
Vanuatu	1.7	-5.6	0.0	-4.6	-5.4	-0.9	-	-	1,080
Average	0.4	5.1	5.9	3.3	4.8	5.5	5.8	5.7	

- = not available.

Table A3 Growth Rate of Value Added in Agriculture (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005	Sector Share 2002, %
East Asia									
China, People's Rep. of	3.5	2.8	2.4	2.8	2.9	2.5	3.0	3.0	10.9
Hong Kong, China	-	-	-	4.1	-0.7	2.0	-1.7	-12.3	0.1
Korea, Rep. of	-6.4	5.9	1.2	1.1	-3.5	-7.1	0.5	1.2	3.8
Mongolia	6.4	4.2	-14.9	-18.5	-10.5	4.5	-	-	23.4
Taipei,China	-6.6	2.7	1.2	-2.1	4.7	-0.2	0.2	0.2	2.5
Southeast Asia									
Cambodia	5.8	3.4	-1.5	2.2	-2.7	3.0	2.7	2.8	35.6
Indonesia	-1.3	2.2	1.9	1.7	2.0	2.5	2.0	2.3	16.1
Lao People's Dem. Rep.	3.1	8.2	4.9	3.8	4.0	8.3	8.1	7.4	50.2
Malaysia	-2.8	0.5	2.6	-0.9	3.0	5.5	5.7	6.2	7.9
Myanmar	4.5	11.5	11.0	8.1	2.9	-	-	-	-
Philippines	-6.4	6.5	3.4	3.7	3.3	3.9	4.2	4.0	19.7
Singapore	-7.0	-1.8	-4.9	-5.9	-5.8	-0.4	-2.0	-2.0	0.1
Thailand	-1.5	2.3	7.2	3.5	3.0	6.8	5.0	4.8	10.2
Viet Nam	2.8	5.2	4.0	2.3	3.0	3.1	3.3	3.3	21.9
South Asia									
Afghanistan	-	-	-	-	-	-	-	-	-
Bangladesh	3.2	4.7	7.4	3.1	0.0	3.3	4.8	4.6	24.0
Bhutan	2.8	5.2	4.5	3.2	2.6	4.0	-	-	31.7
India	6.2	0.3	-0.1	6.5	-5.2	6.0	3.0	3.0	22.0
Maldives	6.9	3.5	-0.7	5.1	15.9	2.6	2.9	-	10.0
Nepal	0.9	2.8	4.9	5.5	2.2	2.4	3.4	2.9	39.0
Pakistan	4.5	1.9	6.1	-2.7	-0.1	4.1	4.2	4.3	23.9
Sri Lanka	2.5	4.5	1.8	-3.4	2.5	1.7	0.5	2.5	19.8
Central Asia									
Azerbaijan	6.2	11.4	12.1	11.1	6.4	5.6	-	-	14.3
Kazakhstan	-18.9	21.7	-3.2	17.1	3.4	1.4	-	-	9.6
Kyrgyz Republic	2.9	8.2	2.6	7.3	3.1	3.8	-	-	50.9
Tajikistan	-	-	-	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-	-	-	-
Uzbekistan	4.1	5.9	-	4.1	6.0	6.0	-	-	30.6
The Pacific									
Cook Islands	33.5	9.2	0.1	-2.9	9.5	-	-	-	13.1
Fiji Islands	-7.2	16.2	-0.9	-4.9	2.2	0.4	0.9	1.0	15.4
Kiribati	3.1	21.2	-7.5	0.0	-4.1	-	-	-	12.9
Marshall Islands, Rep. of	-13.9	-28.6	15.5	4.2	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-
Papua New Guinea	-11.3	4.3	9.1	-5.3	7.3	1.6	3.0	3.4	33.6
Samoa	3.4	-3.5	0.3	-4.6	-7.2	-4.0	1.1	0.0	15.7
Solomon Islands	-8.3	-4.0	-43.0	-12.6	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-27.4	-28.6	18.7	3.7	-	-	-	27.1
Tonga	-0.1	-3.2	10.6	-1.1	2.1	1.4	-	-	29.2
Tuvalu	0.7	-	-	-	-	-	-	-	-
Vanuatu	8.6	-12.2	7.4	0.5	1.7	8.7	3.3	3.5	19.4

- = not available.

Table A4 Growth Rate of Value Added in Industry (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005	Sector Share 2002, %
East Asia									
China, People's Rep. of	8.9	8.1	9.4	8.4	9.8	12.5	10.0	9.5	65.2
Hong Kong, China	-	-	-	-3.7	-3.4	-4.6	3.8	3.1	12.3
Korea, Rep. of	-8.2	12.2	11.7	3.1	6.4	5.5	8.0	6.0	35.8
Mongolia	3.8	1.1	7.4	11.9	4.7	0.9	-	-	27.9
Taipei,China	2.7	4.7	5.7	-6.0	5.0	4.7	5.5	5.2	33.7
Southeast Asia									
Cambodia	-2.5	19.3	30.7	12.9	17.7	12.5	16.0	10.0	27.9
Indonesia	-14.0	2.0	5.9	3.1	3.5	3.4	3.8	4.4	43.4
Lao People's Dem. Rep.	5.5	6.5	4.9	11.9	10.6	14.6	8.3	7.1	21.7
Malaysia	-10.6	8.8	13.6	-3.8	3.9	7.0	6.3	6.5	42.1
Myanmar	6.1	13.8	21.3	-	-	-	-	-	-
Philippines	-2.1	0.9	4.9	0.9	3.7	3.0	4.2	4.0	34.5
Singapore	0.4	6.6	11.1	-9.1	3.5	0.2	7.1	5.6	31.6
Thailand	-13.0	9.6	5.3	1.7	6.9	9.3	10.0	7.8	44.7
Viet Nam	7.3	7.6	9.6	9.7	8.9	9.6	9.8	9.9	37.8
South Asia									
Afghanistan	-	-	-	-	-	-	-	-	-
Bangladesh	8.3	4.9	6.2	7.4	6.5	7.3	6.1	6.8	26.7
Bhutan	8.5	12.2	3.9	13.7	17.9	7.3	-	-	34.9
India	3.7	4.8	6.5	3.4	6.4	6.1	10.2	8.9	27.2
Maldives	17.2	12.4	1.6	8.1	10.4	6.9	7.2	-	15.0
Nepal	2.3	6.0	8.7	2.7	-2.9	2.2	3.5	6.9	22.8
Pakistan	6.1	4.9	1.3	2.5	5.4	5.4	7.5	7.6	25.6
Sri Lanka	5.9	4.8	7.5	-2.1	1.0	5.8	5.2	6.5	26.6
Central Asia									
Azerbaijan	7.1	3.8	6.3	7.3	17.7	-	-	-	46.2
Kazakhstan	-2.4	2.7	15.5	13.5	10.4	8.8	-	-	34.0
Kyrgyz Republic	-2.2	-3.9	10.1	5.1	-8.3	8.5	-	-	17.2
Tajikistan	-	-	-	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-	-	-	-
Uzbekistan	5.8	6.1	5.8	8.1	8.0	6.2	-	-	14.1
The Pacific									
Cook Islands	16.3	6.6	18.2	13.3	5.0	-	-	-	9.1
Fiji Islands	3.1	9.8	-7.4	7.7	0.0	6.8	7.6	2.8	25.9
Kiribati	108.3	8.0	1.9	25.5	-10.1	-	-	-	11.3
Marshall Islands, Rep. of	28.4	12.0	11.7	2.9	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-
Papua New Guinea	9.7	5.7	-4.8	-0.3	-10.8	3.8	1.9	0.5	32.2
Samoa	-9.2	1.4	11.4	10.2	-1.8	2.8	5.8	4.0	23.7
Solomon Islands	5.6	22.2	-49.2	-33.2	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-21.2	33.1	20.4	2.9	-	-	-	19.8
Tonga	6.6	12.3	3.7	2.3	5.5	4.0	-	-	15.3
Tuvalu	21.5	-	-	-	-	-	-	-	-
Vanuatu	4.2	4.6	2.1	-4.6	-5.9	-1.1	0.3	1.3	9.1

- = not available.

Table A5 Growth Rate of Value Added in Services (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005	Sector Share 2002, %
East Asia									
China, People's Rep. of	8.3	7.7	8.1	8.4	7.5	6.7	7.0	6.5	24.6
Hong Kong, China	-	-	-	1.6	3.5	4.4	11.3	5.2	87.7
Korea, Rep. of	-3.9	6.6	6.1	4.8	7.8	1.8	2.4	4.8	60.4
Mongolia	0.3	3.5	17.0	10.0	12.0	8.6	-	-	48.3
Taipei,China	6.2	6.0	6.1	-0.1	2.8	2.6	5.4	4.9	63.8
Southeast Asia									
Cambodia	4.8	10.9	5.7	4.2	4.5	1.5	4.3	3.2	36.5
Indonesia	-16.5	-1.0	5.2	4.6	4.5	5.5	6.2	5.4	40.5
Lao People's Dem. Rep.	8.4	7.9	7.8	4.9	5.9	-4.9	-0.4	2.6	28.0
Malaysia	-1.1	4.4	6.0	6.1	4.2	4.4	5.3	4.9	50.0
Myanmar	7.0	9.2	13.4	-	-	-	-	-	-
Philippines	3.5	4.0	4.4	4.3	5.4	5.9	5.9	6.1	45.8
Singapore	-0.6	5.8	8.5	2.5	1.4	1.1	4.9	4.4	68.3
Thailand	-10.0	0.4	3.7	2.3	4.5	4.2	4.8	4.8	45.1
Viet Nam	3.0	2.1	4.5	4.4	6.0	6.8	7.4	7.5	40.3
South Asia									
Afghanistan	-	-	-	-	-	-	-	-	-
Bangladesh	5.0	5.2	5.5	5.5	5.4	5.8	5.7	6.2	49.3
Bhutan	6.5	5.9	8.7	7.6	-2.3	7.8	-	-	33.4
India	8.4	10.1	5.5	6.8	7.1	8.4	8.0	9.0	50.8
Maldives	8.9	6.8	6.0	2.4	4.7	9.6	5.5	-	75.0
Nepal	6.7	5.4	5.7	5.3	-1.3	3.1	4.9	5.9	38.2
Pakistan	1.6	5.0	4.2	4.7	4.1	5.3	5.1	5.6	50.6
Sri Lanka	5.1	4.0	7.0	-0.5	6.0	6.8	6.5	6.0	53.6
Central Asia									
Azerbaijan	3.4	10.2	9.6	8.4	5.9	8.0	-	-	32.4
Kazakhstan	1.8	-0.5	8.7	13.0	10.9	11.1	-	-	51.6
Kyrgyz Republic	3.9	3.4	5.8	3.3	4.2	5.8	-	-	31.9
Tajikistan	-	-	-	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-	-	-	-
Uzbekistan	9.5	12.6	13.0	14.2	1.5	2.5	-	-	55.4
The Pacific									
Cook Islands	-6.5	1.1	16.2	5.3	2.9	-	-	-	77.8
Fiji Islands	3.3	7.7	-1.8	3.3	6.5	5.4	3.0	3.5	58.7
Kiribati	11.4	4.3	5.4	-0.7	3.0	-	-	-	75.8
Marshall Islands, Rep. of	0.2	-0.5	-2.9	-2.3	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-
Papua New Guinea	-7.6	11.6	-7.0	1.9	1.2	2.3	1.5	1.5	34.2
Samoa	7.8	5.5	7.6	8.5	7.4	8.2	4.0	4.1	60.6
Solomon Islands	3.7	-8.0	-26.0	-4.6	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-37.1	64.0	20.4	-6.1	-	-	-	53.1
Tonga	2.8	4.0	5.2	3.4	0.6	2.4	-	-	55.5
Tuvalu	16.0	-	-	-	-	-	-	-	-
Vanuatu	3.2	-1.8	1.6	-2.3	-3.6	0.1	2.0	2.5	71.5

- = not available.

Table A6 Unemployment Rate (%)

	1998	1999	2000	2001	2002	2003
East Asia						
China, People's Rep. of	3.3	3.1	3.1	3.6	4.0	4.3
Hong Kong, China	4.7	6.3	4.9	5.1	7.3	8.0
Korea, Rep. of	7.0	6.3	4.1	3.8	3.1	3.4
Mongolia	5.9	4.7	4.7	4.6	3.6	3.8
Taipei,China	2.7	2.9	3.0	4.6	5.2	5.0
Southeast Asia						
Cambodia	5.3	0.6	2.5	2.8	3.0	3.5
Indonesia	5.5	6.4	6.1	8.1	9.3	9.8
Lao People's Dem. Rep.	-	-	-	-	-	-
Malaysia	3.2	3.4	3.1	3.6	3.5	3.3
Myanmar	-	-	-	-	-	-
Philippines	10.1	9.7	11.1	11.1	11.4	11.4
Singapore	3.2	3.5	3.1	3.3	4.4	4.7
Thailand	4.4	4.2	3.6	3.3	2.4	2.2
Viet Nam	6.9	7.0	6.4	6.3	6.0	5.8
South Asia						
Afghanistan	-	-	-	-	-	-
Bangladesh	-	-	3.6	-	-	-
Bhutan	1.4	1.4	-	1.9	-	-
India	-	7.3	-	-	-	-
Maldives	-	-	-	2.0	-	-
Nepal	-	1.9	-	-	-	-
Pakistan	5.9	5.9	7.8	7.8	8.3	-
Sri Lanka	9.2	8.9	7.6	7.9	9.2	8.4
Central Asia						
Azerbaijan	1.1	1.1	1.1	1.3	1.3	1.4
Kazakhstan	13.1	13.5	12.8	10.4	9.3	8.7
Kyrgyz Republic	5.9	7.2	7.6	7.8	8.6	11.0
Tajikistan	3.2	3.0	2.7	2.5	2.7	2.5
Turkmenistan	2.0	2.1	2.4	2.6	2.5	2.6
Uzbekistan	0.3	0.3	0.3	0.3	0.3	0.2
The Pacific						
Cook Islands	-	-	-	9.0	-	-
Fiji Islands	7.4	7.6	12.1	-	14.1	-
Kiribati	-	-	1.6	-	-	-
Marshall Islands, Rep. of	-	30.9	-	-	-	-
Micronesia, Fed. States of	21.3	-	22.0	-	-	-
Nauru	-	-	-	-	-	-
Papua New Guinea	-	-	2.8	-	-	-
Samoa	-	-	-	4.9	-	-
Solomon Islands	-	11.0	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-	-	5.3	-	-
Tonga	-	-	-	-	-	-
Tuvalu	-	-	-	-	-	-
Vanuatu	-	1.7	-	-	-	-

- = not available.

Table A7 Gross Domestic Investment (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia								
China, People's Rep. of	37.7	37.4	36.3	38.5	40.4	41.3	40.7	40.5
Hong Kong, China	29.2	25.3	28.1	25.9	23.4	22.9	26.3	26.6
Korea, Rep. of	25.0	26.9	28.3	27.0	26.1	29.4	30.0	31.0
Mongolia	-	27.0	26.1	28.3	26.7	-	-	-
Taipei,China	24.9	23.4	22.9	17.7	16.9	17.2	17.8	18.5
Southeast Asia								
Cambodia	11.9	17.0	17.3	21.2	22.2	20.3	21.1	21.3
Indonesia	16.8	11.4	16.1	17.8	15.7	16.0	15.9	15.9
Lao People's Dem. Rep.	24.9	22.7	20.5	21.0	21.2	21.2	22.0	22.0
Malaysia	26.7	22.4	27.2	24.0	23.6	21.8	21.5	22.8
Myanmar	12.4	13.4	12.4	11.3	-	-	-	-
Philippines	20.3	18.8	29.1	20.6	19.3	18.7	19.5	19.5
Singapore	32.3	32.0	32.0	24.9	21.2	13.4	17.4	21.8
Thailand	20.4	20.5	22.8	24.1	23.9	25.2	25.7	25.9
Viet Nam	22.2	22.2	23.9	25.9	31.3	33.7	35.3	35.0
South Asia								
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	21.6	22.2	23.0	23.1	23.1	23.2	24.3	25.1
Bhutan	37.6	43.0	48.4	52.0	53.3	-	-	-
India	22.6	25.3	24.4	23.1	23.3	24.0	24.5	25.0
Maldives	30.1	33.6	26.3	28.1	25.5	29.8	29.5	-
Nepal	24.8	20.5	24.3	24.1	25.6	26.9	25.5	25.0
Pakistan	17.7	15.6	16.0	15.5	14.7	15.5	16.5	17.0
Sri Lanka	25.2	27.2	28.1	22.0	21.3	22.2	22.5	22.5
Central Asia								
Azerbaijan	33.4	26.5	20.7	20.7	32.0	-	-	-
Kazakhstan	15.8	17.8	18.1	26.9	27.3	26.3	25.1	25.3
Kyrgyz Republic	15.4	18.0	20.0	18.0	17.6	18.0	-	-
Tajikistan	15.4	17.3	11.6	16.6	-	-	-	-
Turkmenistan	54.9	44.8	39.2	37.6	-	-	-	-
Uzbekistan	20.9	17.1	19.6	21.1	21.8	20.8	-	-
The Pacific								
Cook Islands	-	-	-	-	-	-	-	-
Fiji Islands	15.9	14.9	12.6	14.8	13.8	14.2	13.5	-
Kiribati	-	-	-	-	-	-	-	-
Marshall Islands, Rep. of	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	17.9	16.4	13.0	-	-	-	-	-
Samoa	-	-	-	-	-	-	-	-
Solomon Islands	-	-	-	-	-	-	-	-
Timor-Leste, Dem. Rep. of	35.0	21.0	29.0	39.0	36.0	32.0	29.0	27.0
Tonga	19.9	22.0	22.6	21.7	-	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	17.7	20.3	22.1	20.0	20.9	-	-	-

- = not available.

Table A8 Inflation (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	1.8	-0.9	0.5	1.2	-0.1	1.2	2.6	2.4
China, People's Rep. of	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.0	2.7
Hong Kong, China	2.9	-4.0	-3.7	-1.6	-3.0	-2.5	1.1	1.1
Korea, Rep. of	7.5	0.8	2.3	4.1	2.7	3.6	3.1	2.8
Mongolia	9.4	7.6	11.6	8.0	1.6	4.7	4.5	4.0
Taipei,China	1.7	0.2	1.3	0.0	-0.2	-0.3	0.8	1.2
Southeast Asia	19.2	6.8	2.3	4.6	4.2	3.1	3.6	3.8
Cambodia	12.6	-0.5	-0.9	0.3	3.3	1.2	2.9	3.3
Indonesia	58.5	20.5	3.7	11.5	11.9	6.6	6.5	6.5
Lao People's Dem. Rep.	91.0	128.4	25.1	7.8	10.6	15.5	12.0	10.0
Malaysia	5.1	2.8	1.6	1.4	1.8	1.2	1.5	1.7
Myanmar	25.3	21.3	-0.2	21.2	57.0	-	-	-
Philippines	9.7	6.6	4.4	6.1	3.1	3.1	4.5	4.5
Singapore	-0.3	0.1	1.3	1.0	-0.4	0.5	1.2	1.7
Thailand	8.1	0.3	1.6	1.6	0.7	1.8	2.4	2.6
Viet Nam	7.3	4.1	-1.7	-0.4	3.8	4.0	4.5	4.5
South Asia	6.4	3.9	6.2	3.7	3.5	4.9	4.9	4.6
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	8.7	7.0	2.8	1.9	2.8	4.4	4.7	4.2
Bhutan	9.0	9.2	3.6	3.6	2.7	1.8	-	-
India	5.9	3.3	7.2	3.6	3.4	5.3	5.0	4.7
Maldives	-1.4	3.0	-1.2	0.7	0.9	-4.0	0.3	2.3
Nepal	8.3	11.4	3.5	2.4	2.9	4.8	4.5	5.0
Pakistan	7.8	5.7	3.6	4.4	3.5	3.1	4.0	4.0
Sri Lanka	6.9	4.0	1.5	12.1	10.2	2.6	-	-
Central Asia	14.2	15.2	17.2	14.3	10.9	6.9	8.6	8.3
Azerbaijan	-0.8	-8.5	1.8	1.5	2.8	2.2	4.0	3.0
Kazakhstan	7.1	8.3	13.2	8.4	5.9	6.6	5.4	5.0
Kyrgyz Republic	10.5	35.9	18.7	6.9	2.0	3.0	3.8	3.8
Tajikistan	43.2	27.5	32.9	38.6	12.2	16.4	8.5	5.0
Turkmenistan	16.7	23.5	8.0	11.6	8.8	5.5	5.0	5.0
Uzbekistan	26.1	26.0	28.0	27.4	27.0	10.0	20.0	20.0
The Pacific	9.8	9.1	8.8	6.4	7.0	7.4	5.6	6.0
Cook Islands	1.1	1.3	1.7	9.5	3.9	2.4	1.9	2.4
Fiji Islands	5.7	2.0	1.1	4.3	0.8	4.1	3.0	3.0
Kiribati	3.7	1.8	0.4	6.0	3.2	2.0	-	-
Marshall Islands, Rep. of	2.2	1.7	1.6	1.7	2.0	2.5	2.5	2.5
Micronesia, Fed. States of	1.6	1.9	2.1	1.3	-0.2	-0.2	0.5	1.2
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	13.6	14.9	15.6	9.3	11.8	11.8	8.7	9.6
Samoa	2.2	0.2	1.0	3.8	8.1	0.1	3.0	3.0
Solomon Islands	12.4	8.0	7.3	6.8	7.3	8.3	6.0	6.5
Timor-Leste, Dem. Rep. of	80.0	140.0	3.0	0.0	9.5	4.2	3.0	3.0
Tonga	3.0	3.9	5.3	6.9	10.4	11.1	4.5	4.5
Tuvalu	0.9	3.8	5.3	1.8	2.6	2.6	2.5	-
Vanuatu	3.3	2.1	2.5	3.7	2.0	3.0	2.6	2.5
Average	6.1	1.6	2.2	2.4	1.5	2.3	3.3	3.1

- = not available.

Table A9 Change in Money Supply (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia								
China, People's Rep. of	14.8	14.7	12.3	17.6	16.9	19.6	18.0	17.0
Hong Kong, China	11.6	8.8	7.8	-2.7	-0.9	8.4	10.0	5.3
Korea, Rep. of	43.8	20.4	21.7	10.2	11.8	7.8	7.0	9.0
Mongolia	-1.7	31.6	17.6	27.9	42.0	49.7	40.0	38.0
Taipei,China	8.6	8.3	6.5	4.4	2.6	5.9	5.5	5.0
Southeast Asia								
Cambodia	15.7	17.3	26.9	20.4	31.1	14.9	16.1	23.2
Indonesia	62.3	11.9	15.6	13.0	4.7	8.1	5.0	5.0
Lao People's Dem. Rep.	113.3	78.4	46.0	13.7	37.6	20.1	28.0	25.0
Malaysia	1.5	13.7	5.2	2.2	5.8	11.1	9.8	11.0
Myanmar	36.5	29.6	42.2	44.8	34.2	-	-	-
Philippines	7.4	19.3	4.6	6.8	9.5	3.3	5.0	5.5
Singapore	30.2	8.5	-2.0	5.9	-0.3	6.9	8.2	8.5
Thailand	9.5	2.1	3.7	4.2	2.6	4.9	1.9	4.5
Viet Nam	25.6	56.6	39.0	25.5	17.6	21.0	16.4	14.7
South Asia								
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	10.2	12.8	18.6	16.6	13.1	15.6	15.9	15.2
Bhutan	41.7	21.4	21.4	5.5	17.6	29.7	-	-
India	19.4	14.6	16.8	14.1	15.1	13.7	13.6	13.5
Maldives	22.8	3.6	4.1	9.0	19.3	14.6	-	-
Nepal	21.9	20.8	21.8	15.2	4.4	8.1	9.3	11.0
Pakistan	14.5	6.2	9.4	9.0	15.4	18.0	14.0	12.0
Sri Lanka	13.2	13.4	12.9	13.6	13.4	15.3	13.0	12.5
Central Asia								
Azerbaijan	-8.6	8.7	27.1	31.7	14.4	29.8	27.9	28.5
Kazakhstan	-14.1	84.4	45.0	45.1	32.8	26.8	23.4	18.4
Kyrgyz Republic	17.2	33.9	12.1	11.3	34.1	33.5	20.0	-
Tajikistan	53.9	9.1	64.5	33.4	37.4	44.4	20.0	-
Turkmenistan	70.0	22.0	68.3	18.7	-0.5	-	-	-
Uzbekistan	-	-	-	-	-	-	-	-
The Pacific								
Cook Islands	12.1	16.7	4.8	14.4	3.2	9.9	-	-
Fiji Islands	-0.3	14.2	-2.1	-3.1	7.9	15.6	7.3	-
Kiribati	-3.4	4.0	20.0	-3.9	29.0	-	-	-
Marshall Islands, Rep. of	29.1	14.7	-1.9	25.0	-0.5	1.3	-	-
Micronesia, Fed. States of	9.8	-0.8	1.4	0.7	-8.0	6.9	-1.5	2.0
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	3.6	9.0	7.1	4.2	9.4	-8.4	-	-
Samoa	5.2	15.7	16.3	6.1	10.2	14.0	7.5	-
Solomon Islands	4.8	4.5	0.4	-13.3	4.0	19.4	-	-
Timor-Leste, Dem. Rep. of	-3.5	-14.8	-84.6	155.5	8.6	-	-	-
Tonga	2.4	15.0	8.4	26.5	7.9	13.4	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	12.6	-9.2	5.5	5.6	-1.7	-0.8	-	-

- = not available.

Table A10 Growth Rate of Merchandise Exports (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	-5.3	5.7	22.0	-5.8	12.1	22.6	13.4	13.2
China, People's Rep. of	0.5	6.1	27.9	6.8	22.4	34.6	15.0	15.0
Hong Kong, China	-8.5	-0.6	16.0	-5.8	4.9	12.1	6.8	7.3
Korea, Rep. of	-4.7	9.9	21.2	-14.0	7.9	20.9	21.0	19.0
Mongolia	-23.5	3.8	30.1	-2.4	-3.9	14.5	15.0	14.0
Taipei,China	-9.5	9.9	21.8	-17.3	6.4	10.5	8.0	7.4
Southeast Asia	-6.4	9.3	19.5	-10.1	4.7	12.8	10.2	8.3
Cambodia	8.8	41.1	24.1	12.1	11.4	14.4	17.0	12.0
Indonesia	-10.5	1.7	27.6	-12.3	3.1	7.2	3.5	3.5
Lao People's Dem. Rep.	6.4	-10.5	9.6	-3.3	-6.9	23.0	20.4	4.5
Malaysia	-7.2	17.1	17.0	-10.6	6.1	12.4	8.6	7.5
Myanmar	10.1	21.6	34.0	3.5	4.8	-	-	-
Philippines	16.9	16.0	9.0	-16.2	10.0	1.4	8.0	8.0
Singapore	-15.2	5.7	20.1	-10.5	2.7	15.0	12.2	7.5
Thailand	-6.8	7.4	19.5	-7.1	4.8	18.6	14.0	13.7
Viet Nam	2.4	23.2	25.2	6.5	7.4	16.5	12.0	12.0
South Asia	-1.1	4.4	17.0	1.2	10.7	14.6	14.9	15.6
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	15.3	3.5	7.9	12.6	-7.6	9.5	13.5	11.0
Bhutan	12.1	-5.9	9.1	-12.9	4.1	8.9	-	-
India	-3.9	9.5	19.6	0.0	16.9	15.1	16.1	17.6
Maldives	6.6	-4.3	18.8	1.4	20.1	12.8	7.3	-
Nepal	-	-	-	-	-20.3	-14.9	10.0	12.0
Pakistan	4.2	-10.7	8.8	9.1	2.7	19.6	12.0	10.0
Sri Lanka	3.4	-3.9	19.8	-12.8	-2.4	10.5	10.0	9.0
Central Asia	-21.8	8.8	47.1	-2.6	8.8	27.8	6.1	9.4
Azerbaijan	-16.2	51.3	75.5	13.7	12.7	13.9	-0.8	29.3
Kazakhstan	-14.9	2.0	55.1	-3.9	12.3	32.0	6.0	6.0
Kyrgyz Republic	-15.2	-13.5	10.4	-6.0	3.7	18.5	2.3	6.3
Tajikistan	-21.4	13.7	18.5	-17.3	7.3	14.2	10.8	6.4
Turkmenistan	-20.9	99.9	111.1	4.6	9.0	30.3	12.9	-
Uzbekistan	-22.1	-3.1	5.2	-9.9	-5.1	26.9	3.6	-
The Pacific	-15.1	9.8	-0.6	-12.6	-5.9	15.9	-0.2	-0.7
Cook Islands	-5.0	27.2	38.7	100.9	-39.0	-12.9	-	-
Fiji Islands	-17.6	19.2	-4.2	-8.4	2.6	-17.6	12.7	14.5
Kiribati	-6.3	54.2	-60.4	25.0	15.6	11.5	8.6	3.2
Marshall Islands, Rep. of	-63.4	32.7	19.1	11.8	-	-	-	-
Micronesia, Fed. States of	14.5	-12.1	8.3	2.1	17.9	2.4	4.2	5.7
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	-16.1	9.1	7.3	-13.7	-9.5	27.5	-4.0	-5.5
Samoa	28.7	-3.5	-27.7	13.1	-3.9	4.0	10.0	-
Solomon Islands	-9.7	6.5	-53.8	-32.6	13.5	20.2	22.6	17.9
Timor-Leste, Dem. Rep. of	27.1	-14.8	-90.4	-20.0	50.0	16.7	14.3	25.0
Tonga	-9.8	1.5	-9.6	9.5	49.0	-0.3	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	-3.9	-24.3	5.7	-26.7	1.1	20.1	5.0	-
Average	-5.7	6.9	21.1	-6.8	9.5	19.2	12.4	11.4

- = not available.

Table A11 Direction of Exports (% of total)

From \ To	DMCs		People's Rep. of China		Japan		United States		European Union		Others	
	1990	2002	1990	2002	1990	2002	1990	2002	1990	2002	1990	2002
East Asia	24.7	25.4	7.3	13.8	12.5	10.6	23.7	21.2	15.4	13.9	16.4	15.2
China, People's Rep. of	52.2	32.0			14.7	14.9	8.5	21.5	10.0	14.8	14.7	16.8
Hong Kong, China	10.7	9.4	24.8	39.3	5.7	5.4	24.1	21.4	18.5	13.3	16.2	11.2
Korea, Rep. of	14.8	19.7	0.0	14.7	18.6	9.4	28.6	20.4	14.8	13.5	23.1	22.4
Mongolia	2.6	1.6	11.4	44.7	17.6	1.5	2.0	34.4	20.5	4.7	45.9	13.1
Taipei,China	26.1	40.6	0.0	7.7	12.6	9.3	32.8	20.8	17.4	13.2	11.1	8.3
Southeast Asia	29.1	35.3	1.9	5.3	18.3	12.3	19.6	17.9	15.8	14.1	15.3	15.2
Cambodia	82.9	8.5	0.4	1.3	7.6	3.9	0.0	59.9	5.0	23.9	4.1	2.6
Indonesia	18.4	30.3	3.2	5.1	42.5	21.1	13.1	13.2	12.0	13.9	10.6	16.4
Lao People's Dem. Rep.	69.0	38.6	9.1	2.2	7.1	1.5	0.1	0.7	9.4	28.5	5.3	28.5
Malaysia	40.0	37.8	2.1	5.6	15.3	11.3	16.9	20.2	15.4	12.4	10.3	12.8
Myanmar	49.0	50.5	8.1	4.8	6.9	3.8	2.3	13.2	6.9	13.8	26.8	13.9
Philippines	14.2	26.5	0.8	3.9	19.8	15.0	37.9	24.7	18.5	18.1	8.9	11.8
Singapore	34.7	43.9	1.5	5.5	8.8	7.1	21.3	15.3	15.0	12.5	18.7	15.6
Thailand	19.3	28.7	1.2	5.2	17.2	14.5	22.7	19.6	22.7	14.8	17.0	17.2
Viet Nam	25.3	18.0	0.3	6.4	13.5	14.6	0.0	14.9	6.8	24.2	54.1	21.9
South Asia	12.3	15.2	0.4	3.3	8.4	3.2	16.3	24.7	29.9	25.3	32.8	28.2
Afghanistan	14.3	57.6	0.4	0.1	1.5	1.6	3.4	4.3	61.7	19.0	18.7	17.3
Bangladesh	8.6	4.7	1.5	0.2	3.9	1.0	30.5	27.6	31.5	42.9	24.0	23.5
Bhutan	-	-	-	-	-	-	-	-	-	-	-	-
India	11.3	16.4	0.1	4.2	9.3	3.8	15.1	22.9	27.7	22.9	36.5	29.8
Maldives	38.5	28.9	0.0	0.0	8.5	7.5	24.2	50.7	26.2	9.1	2.6	3.7
Nepal	11.6	49.7	2.3	0.9	0.8	1.1	23.4	28.0	53.3	15.4	8.6	5.0
Pakistan	17.2	15.6	1.2	2.4	8.2	1.4	12.4	24.5	36.0	27.2	25.0	28.9
Sri Lanka	9.1	7.5	0.2	0.2	5.4	3.5	25.9	40.8	26.3	29.7	33.2	18.3
Central Asia	-	7.9	-	6.5	-	0.5	-	1.8	-	21.5	-	61.8
Azerbaijan	-	5.2	-	0.1	-	0.0	-	2.0	-	61.6	-	31.1
Kazakhstan	-	5.6	-	10.6	-	0.2	-	1.2	-	15.9	-	66.5
Kyrgyz Republic	-	19.8	-	8.5	-	0.0	-	7.4	-	3.9	-	60.4
Tajikistan	-	14.0	-	0.3	-	0.0	-	0.1	-	32.5	-	53.1
Turkmenistan	-	3.2	-	0.1	-	0.0	-	1.8	-	19.2	-	75.7
Uzbekistan	-	24.4	-	1.4	-	3.9	-	4.3	-	18.8	-	47.1
The Pacific	13.3	11.2	0.3	4.5	21.6	9.6	4.2	7.4	23.4	8.9	37.3	58.3
Cook Islands	-	-	-	-	-	-	-	-	-	-	-	-
Fiji Islands	4.1	15.6	0.5	0.2	5.9	6.4	8.4	25.5	23.3	13.1	57.7	39.2
Kiribati	1.0	33.1	0.0	0.0	12.2	56.4	8.9	3.4	72.3	3.8	5.7	3.3
Marshall Islands, Rep of	-	-	-	-	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-	-	-	-
Nauru	11.5	66.1	0.0	0.0	0.0	0.8	2.0	3.1	0.5	6.6	86.1	23.5
Papua New Guinea	17.0	6.3	0.2	5.4	27.8	9.5	2.4	3.3	24.1	8.5	28.6	67.0
Samoa	6.8	12.2	0.0	0.0	0.9	3.3	6.9	9.2	20.5	3.5	64.9	71.7
Solomon Islands	19.4	52.0	0.0	18.4	43.1	20.9	3.9	0.8	22.6	1.9	10.9	6.0
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-	-	-	-	-	-	-
Tonga	1.7	2.3	0.0	0.0	30.0	41.4	26.0	39.3	1.6	5.6	40.7	11.4
Tuvalu	0.0	8.9	0.1	0.0	0.0	0.0	0.0	0.0	12.6	86.3	87.3	4.8
Vanuatu	3.3	78.3	0.0	0.3	20.6	4.9	3.7	3.2	54.3	4.7	18.1	8.6
DMCs	25.3	27.6	5.1	10.5	14.1	10.6	21.9	20.1	16.5	14.7	17.1	16.6

- = not available.

Table A12 Growth Rate of Merchandise Imports (% per year)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	-14.2	9.6	28.4	-6.6	10.4	24.3	15.7	13.8
China, People's Rep. of	0.3	15.9	35.2	8.1	21.3	41.0	19.0	16.5
Hong Kong, China	-12.3	-3.1	18.6	-5.5	3.1	12.2	9.0	6.4
Korea, Rep. of	-36.2	29.1	36.2	-13.4	7.7	18.1	22.0	20.5
Mongolia	7.5	1.9	19.8	2.5	3.3	14.0	12.0	12.0
Taipei,China	-7.4	6.6	25.9	-23.7	3.4	12.2	8.7	7.6
Southeast Asia	-23.1	7.6	25.1	-9.5	4.2	10.6	12.2	9.7
Cambodia	9.6	36.5	21.9	8.0	10.5	12.5	16.0	14.5
Indonesia	-30.9	-4.2	31.9	-14.1	2.8	9.4	4.0	4.0
Lao People's Dem. Rep.	-14.7	0.3	-3.4	-4.7	-8.4	7.2	11.7	1.8
Malaysia	-26.6	13.5	26.3	-10.3	8.1	5.4	13.5	10.0
Myanmar	6.1	-2.7	-11.7	17.8	-	-	-	-
Philippines	-18.8	-0.9	14.5	-4.5	6.2	6.3	10.0	10.0
Singapore	-21.1	7.3	22.0	-13.7	-0.5	9.4	10.8	8.8
Thailand	-33.8	16.9	31.3	-3.0	4.6	17.1	17.8	13.1
Viet Nam	-1.1	1.1	34.5	6.0	19.5	27.0	14.0	11.0
South Asia	-8.5	10.9	7.1	-1.8	7.3	18.5	17.8	17.8
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	-5.4	6.6	4.8	11.4	-8.7	13.0	17.5	15.0
Bhutan	3.7	19.2	14.0	6.1	-5.0	1.2	-	-
India	-7.1	16.5	7.0	-2.8	13.5	19.7	18.7	19.5
Maldives	1.5	13.6	-3.4	1.3	-0.5	18.1	6.9	-
Nepal	-	-	-	-	-15.3	8.1	10.0	12.0
Pakistan	-8.4	-6.7	-0.1	6.2	-7.5	20.1	16.4	12.0
Sri Lanka	0.4	1.5	22.4	-18.4	2.2	13.0	12.0	12.5
Central Asia	-11.0	-10.4	12.6	8.7	0.4	21.4	12.3	3.9
Azerbaijan	25.4	-16.9	7.4	-4.8	24.5	49.3	26.5	-6.1
Kazakhstan	-7.0	-15.3	21.2	11.1	1.6	18.4	12.4	6.8
Kyrgyz Republic	17.0	-27.1	-8.0	-13.1	25.4	21.9	5.4	6.1
Tajikistan	-10.0	-4.4	20.6	-7.3	6.5	23.2	11.0	6.6
Turkmenistan	-14.9	46.7	20.7	31.6	-9.8	15.6	10.2	-
Uzbekistan	-20.2	-12.0	-5.6	4.0	-13.9	13.4	0.8	-
The Pacific	-19.4	4.4	-2.5	-2.3	7.7	-5.4	3.7	6.7
Cook Islands	-5.3	-13.2	18.1	13.0	-8.7	9.2	-	-
Fiji Islands	-25.2	25.1	-8.7	-4.2	13.5	-11.6	7.6	18.6
Kiribati	-16.4	24.2	-2.7	12.1	18.3	23.1	-11.0	2.6
Marshall Islands, Rep. of	10.4	2.4	-20.6	-10.6	-	-	-	-
Micronesia, Fed. States of	0.4	-3.0	10.1	8.6	-9.0	8.3	-8.8	9.8
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	-27.0	-0.1	-7.0	-6.4	14.6	-4.6	2.1	-1.4
Samoa	-3.2	19.3	-11.7	24.1	10.4	-2.6	15.0	-
Solomon Islands	-0.1	-25.1	-16.0	-12.4	-11.0	-2.8	20.7	20.8
Timor-Leste, Dem. Rep. of	7.0	-21.7	97.5	5.5	-19.0	-16.4	-7.7	-11.0
Tonga	29.7	-28.9	12.7	-1.6	-0.3	21.1	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	-5.5	9.3	-7.6	0.9	-0.4	10.2	5.0	-
Average	-16.8	8.7	25.3	-6.8	8.1	19.8	14.8	12.6

- = not available.

Table A13 Trade Balance (US$ million)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	90,604	75,837	56,710	58,922	77,917	82,552	71,526	73,698
China, People's Rep. of	46,614	35,982	34,474	34,017	44,166	41,432	31,772	29,453
Hong Kong, China	-7,833	-3,158	-8,193	-8,331	-5,053	-5,775	-11,210	-9,791
Korea, Rep. of	41,665	28,463	16,954	13,488	14,777	22,161	25,060	26,611
Mongolia	-158	-155	-148	-116	-167	-187	-181	-331
Taipei,China	10,316	14,705	13,624	19,864	24,193	24,921	26,085	27,757
Southeast Asia	60,128	70,313	67,513	58,311	62,616	78,302	78,783	79,223
Cambodia	-365	-462	-538	-523	-563	-599	-677	-833
Indonesia	18,429	20,642	25,041	22,695	23,513	24,439	25,100	25,775
Lao People's Dem. Rep.	-216	-253	-205	-191	-170	-136	-120	-110
Malaysia	17,644	22,644	20,827	18,383	18,135	25,711	24,000	23,500
Myanmar	-1,318	-1,012	-275	-584	-	-	-	-
Philippines	-28	4,959	3,814	-743	407	-1,253	-2,076	-3,035
Singapore	13,410	12,430	12,732	15,722	19,850	29,319	34,833	35,595
Thailand	12,235	9,272	5,466	2,494	2,739	4,202	1,962	2,821
Viet Nam	-981	1,080	377	473	-1,295	-3,380	-4,239	-4,489
South Asia	-18,114	-23,549	-19,749	-18,239	-17,336	-23,401	-29,844	-36,995
Afghanistan	-	-	-	-	-1,315	-	-	-
Bangladesh	-1,669	-1,934	-1,865	-2,011	-1,768	-2,207	-2,853	-3,576
Bhutan	-25	-58	-71	-97	-83	-76	-	-
India	-13,246	-17,841	-14,370	-12,703	-12,910	-17,869	-22,782	-28,557
Maldives	-216	-262	-233	-236	-212	-258	-275	-
Nepal	-	-	-	-766	-695	-926	-1,018	-1,141
Pakistan	-1,867	-2,085	-1,412	-1,269	-261	-359	-901	-1,255
Sri Lanka	-1,091	-1,369	-1,798	-1,157	-1,406	-1,706	-2,015	-2,466
Central Asia	-2,681	-273	3,873	2,198	3,664	5,668	4,837	3,654
Azerbaijan	-1,046	-408	260	581	482	-98	-842	133
Kazakhstan	-801	340	2,440	1,321	2,301	4,088	3,750	3,890
Kyrgyz Republic	-221	-89	4	40	-54	-83	-105	-111
Tajikistan	-139	-27	-46	-121	-124	-215	-240	-258
Turkmenistan	-414	-291	721	272	736	1,270	1,500	-
Uzbekistan	-61	202	494	106	323	706	775	-
The Pacific	15	157	208	-91	-394	125	129	159
Cook Islands	-41	-35	-40	-41	-40	-45	-	-
Fiji Islands	-210	-294	-241	-255	-348	-340	-343	-428
Kiribati	-27	-32	-36	-40	-47	-59	-51	-52
Marshall Islands, Rep. of	-62	-61	-46	-39	-	-	-	-
Micronesia, Fed. States of	-78	-77	-85	-94	-81	-89	-78	-87
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	717	881	1,099	875	563	1,065	960	864
Samoa	-78	-97	-89	-112	-126	-122	-141	-
Solomon Islands	-6	40	-23	-34	-19	-6	-6	-10
Timor-Leste, Dem. Rep. of	-91	-67	-230	-244	-195	-161	-147	-128
Tonga	-66	-43	-52	-50	-44	-57	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	-43	-58	-50	-58	-57	-61	-64	-
Total	129,953	122,485	108,555	101,100	126,468	143,248	125,432	119,740

- = not available.

Table A14 Current Account Balance (US$ million)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	77,680	63,799	48,536	53,101	79,992	89,135	80,171	84,018
China, People's Rep. of	31,472	21,115	20,518	17,405	35,422	31,000	20,000	17,000
Hong Kong, China	2,529	10,289	7,084	9,942	13,725	17,407	12,096	15,947
Korea, Rep. of	40,371	24,522	12,251	8,033	5,394	12,321	17,694	18,876
Mongolia	-129	-119	-169	-169	-178	-160	-157	-175
Taipei,China	3,437	7,992	8,851	17,891	25,629	28,567	30,538	32,370
Southeast Asia	46,505	54,177	45,555	38,128	44,222	58,283	60,508	59,054
Cambodia	-175	-188	-135	-86	-64	-163	-185	-245
Indonesia	4,097	5,783	7,991	6,900	7,822	7,709	7,535	7,331
Lao People's Dem. Rep.	-130	-145	-124	-79	-40	-51	-52	-50
Malaysia	9,532	12,604	8,487	7,286	7,190	13,381	12,500	10,500
Myanmar	-578	-468	-115	-102	-	-	-	-
Philippines	1,546	7,219	6,258	1,323	4,383	3,347	2,500	2,500
Singapore	18,583	15,284	13,246	16,104	18,873	28,186	33,861	34,181
Thailand	14,291	12,466	9,328	6,205	7,008	7,975	6,565	7,230
Viet Nam	-1,239	1,154	505	475	-950	-2,101	-2,216	-2,393
South Asia	-6,537	-7,867	-5,397	-42	6,955	8,288	4,344	2,935
Afghanistan	-	-	-	-	-132	-	-	-
Bangladesh	-589	-697	-502	-1,090	171	268	0	-911
Bhutan	39	23	29	-8	-6	61	-	-
India	-4,038	-4,698	-3,590	782	4,137	4,245	2,045	2,008
Maldives	-22	-79	-52	-59	-36	-48	-68	-
Nepal	-	-	-	250	234	108	67	37
Pakistan	-1,701	-1,856	-217	326	2,723	4,070	2,300	1,800
Sri Lanka	-226	-560	-1,066	-243	-268	-416	-	-
Central Asia	-3,440	-1,056	760	-1,494	-1,246	-1,545	-2,216	-990
Azerbaijan	-1,364	-600	-187	-50	-769	-2,021	-2,592	-1,667
Kazakhstan	-1,236	-236	675	-1,109	-696	-69	-350	-210
Kyrgyz Republic	-364	-184	-80	-19	-35	-31	-	-
Tajikistan	-120	-36	-62	-74	-32	-21	-	-
Turkmenistan	-102	164	184	-50	47	-	-	-
Uzbekistan	-254	-164	230	-192	238	597	726	887
The Pacific	61	146	358	245	-118	143	20	-156
Cook Islands	2	1	7	10	12	-	-	-
Fiji Islands	-9	-71	-96	-55	-67	-171	-182	-280
Kiribati	17	7	6	2	4	-13	-8	-9
Marshall Islands, Rep. of	-3	-8	21	39	32	-	-	-
Micronesia, Fed. States of	-7	3	-2	-19	10	16	11	4
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	60	144	353	281	-129	293	177	120
Samoa	15	5	11	-6	5	3	-4	-
Solomon Islands	16	79	0	-14	-12	1	5	5
Timor-Leste, Dem. Rep. of	-21	6	54	20	23	20	21	5
Tonga	-18	-1	-10	-13	7	-5	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	8	-19	13	2	-4	-1	0	-2
Total	114,270	109,200	89,812	89,939	129,804	154,304	142,827	144,861

- = not available.

Table A15 Current Account Balance (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia	4.6	3.3	2.4	2.6	3.7	4.0	2.8	2.6
China, People's Rep. of	3.3	2.1	1.9	1.5	2.8	2.2	1.3	1.0
Hong Kong, China	1.5	6.4	4.3	6.1	8.5	11.0	6.8	8.5
Korea, Rep. of	11.6	5.5	2.4	1.7	1.0	2.0	2.7	2.6
Mongolia	-13.2	-14.1	-17.8	-16.6	-16.0	-14.7	-14.0	-13.5
Taipei,China	1.3	2.8	2.9	6.4	9.1	10.0	6.9	6.0
Southeast Asia	9.9	10.5	8.9	6.9	7.4	9.1	8.2	7.6
Cambodia	-5.7	-5.4	-3.8	-2.3	-1.6	-3.9	-4.3	-5.6
Indonesia	4.3	4.1	5.3	4.8	4.5	3.7	3.4	3.1
Lao People's Dem. Rep.	-10.1	-10.0	-7.1	-4.6	-2.3	-2.5	-2.2	-1.9
Malaysia	13.2	15.9	9.4	8.3	7.6	13.0	7.9	6.5
Myanmar	-0.2	-0.1	0.0	0.0	-	-	-	-
Philippines	2.4	9.5	13.2	1.8	5.6	4.2	3.0	2.8
Singapore	22.7	18.6	14.3	18.7	21.4	30.9	34.5	32.7
Thailand	12.8	10.2	7.6	5.4	5.5	5.6	3.9	3.9
Viet Nam	-4.6	4.1	1.6	1.5	-2.8	-5.8	-5.7	-5.7
South Asia	-1.2	-1.4	-0.9	0.0	1.1	1.1	0.4	0.2
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	-1.3	-1.5	-1.1	-2.3	0.4	0.5	0.0	-1.5
Bhutan	10.1	5.9	6.8	-1.7	-1.2	10.6	-	-
India	-1.0	-1.1	-0.8	0.2	0.8	0.7	0.3	0.3
Maldives	-4.1	-13.4	-8.2	-9.4	-5.6	-6.9	-9.1	-
Nepal	-	-	-	4.5	4.2	1.8	1.0	0.5
Pakistan	-2.7	-3.0	-0.4	0.6	4.6	5.9	3.0	2.1
Sri Lanka	-1.4	-3.6	-6.4	-1.5	-1.6	-2.2	-3.0	-3.5
Central Asia	-7.1	-2.5	1.7	-3.0	-2.2	-3.3	-3.6	-4.3
Azerbaijan	-30.7	-13.1	-3.5	-0.9	-12.3	-28.3	-32.5	-18.1
Kazakhstan	-5.6	-1.4	3.7	-5.0	-2.8	-0.2	-1.1	-0.6
Kyrgyz Republic	-22.2	-14.7	-5.8	-1.3	-2.2	-1.6	-4.2	-5.3
Tajikistan	-8.3	-3.4	-6.5	-6.7	-2.7	-1.3	-2.2	-4.7
Turkmenistan	-3.6	4.3	3.7	-0.7	0.5	-	-	-
Uzbekistan	-1.7	-1.0	1.7	-1.7	2.5	6.0	6.0	6.0
The Pacific	1.0	2.3	5.3	3.9	-1.7	1.7	0.9	-1.3
Cook Islands	2.8	1.5	8.4	12.0	11.3	-	-	-
Fiji Islands	-0.5	-3.8	-5.8	-3.3	-3.7	-10.0	-6.6	-9.6
Kiribati	35.1	12.4	13.2	3.2	7.9	-18.7	-12.5	-13.7
Marshall Islands, Rep. of	-2.6	-7.9	21.4	38.2	29.7	-	-	-
Micronesia, Fed. States of	-3.6	1.6	-0.9	-8.6	4.6	7.3	5.1	1.9
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	1.6	4.2	10.2	9.5	-4.6	9.1	5.0	3.2
Samoa	6.6	2.2	5.0	-2.7	1.8	0.9	-1.1	-
Solomon Islands	4.9	25.5	0.0	-5.2	-5.2	0.4	2.0	2.0
Timor-Leste, Dem. Rep. of	-5.4	2.2	16.8	5.2	6.1	5.9	6.4	1.5
Tonga	-11.2	-0.6	-6.4	-9.8	5.3	-3.1	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	3.2	-7.5	5.3	0.8	-1.6	-0.3	0.0	-0.6
Average	4.3	3.6	2.8	2.8	3.8	4.2	3.2	2.9

- = not available.

Table A16 Foreign Direct Investment (US$ million)

	1998	1999	2000	2001	2002	2003
East Asia						
China, People's Rep. of	45,463	40,319	40,715	46,878	52,743	53,510
Hong Kong, China	-2,204	5,194	2,562	12,431	-7,782	9,792
Korea, Rep. of	5,221	10,598	10,186	4,863	3,679	4,806
Mongolia	19	30	54	63	58	113
Taipei,China	-3,614	-1,494	-1,773	-1,371	-3,441	-5,226
Southeast Asia						
Cambodia	223	221	142	141	139	130
Indonesia	-356	-2,745	-4,551	-5,877	-7,066	-2,100
Lao People's Dem. Rep.	45	52	34	24	5	20
Malaysia	2,708	2,473	1,762	287	1,299	1,104
Myanmar	592	304	208	186	-	-
Philippines	1,592	608	1,348	1,953	1,733	161
Singapore	4,695	8,551	11,919	-2,025	2,030	5,873
Thailand	7,360	5,742	3,372	3,540	841	954
Viet Nam	669	358	459	273	397	622
South Asia						
Afghanistan	-	-	-	-	-	-
Bangladesh	249	198	194	174	65	92
Bhutan	0	1	0	0	2	2
India	2,480	2,167	3,272	4,741	3,611	3,585
Maldives	12	12	13	12	12	-
Nepal	-	-	-	0	-4	12
Pakistan	572	428	473	286	483	771
Sri Lanka	193	177	173	82	230	226
Central Asia						
Azerbaijan	1,023	510	148	298	1,048	2,353
Kazakhstan	1,143	1,472	1,278	2,861	2,157	2,138
Kyrgyz Republic	87	38	-7	-1	5	20
Tajikistan	25	21	24	9	36	24
Turkmenistan	-	-	-	-	-	-
Uzbekistan	131	109	66	76	58	40
The Pacific						
Cook Islands	11	-12	-28	-	-	-
Fiji Islands	196	-20	-25	90	77	-
Kiribati	1	1	1	1	1	-
Marshall Islands, Rep. of	-3	-	-	-	-	-
Micronesia, Fed. States of	0	-1	-	-	-	-
Nauru	-	-	-	-	-	-
Papua New Guinea	110	296	96	63	50	-
Samoa	3	2	-2	1	1	-
Solomon Islands	2	-19	1	-12	-7	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-
Tonga	2	2	5	1	2	-
Tuvalu	0	-	-	-	-	-
Vanuatu	20	13	20	18	15	-

- = not available.

Table A17 External Debt Outstanding (US$ million)

	1998	1999	2000	2001	2002	2003
East Asia						
China, People's Rep. of	144,007	152,085	145,706	170,110	168,538	171,900
Hong Kong, China	43,703	49,713	366,998	340,024	350,732	361,120
Korea, Rep. of	163,807	152,945	148,454	130,834	144,602	160,666
Mongolia	701	810	754	899	974	1,090
Taipei,China	-	38,628	34,757	34,336	45,033	58,092
Southeast Asia						
Cambodia	2,146	2,223	2,195	2,218	2,218	2,218
Indonesia	150,886	148,097	141,693	133,073	131,343	134,851
Lao People's Dem. Rep.	1,374	1,067	1,122	1,205	1,283	1,328
Malaysia	43,324	42,667	42,392	45,636	48,853	49,276
Myanmar	5,647	6,004	5,928	5,670	-	-
Philippines	47,817	52,210	52,060	52,355	53,874	57,395
Singapore	134,202	146,321	159,812	162,416	161,789	174,017
Thailand	105,062	95,051	79,715	67,509	59,459	52,258
Viet Nam	9,848	9,756	11,915	13,242	13,100	14,100
South Asia						
Afghanistan	5,326	5,322	5,319	-	-	-
Bangladesh	14,813	15,338	15,791	14,902	16,167	16,939
Bhutan	135	150	174	237	292	406
India	96,886	98,263	101,132	98,761	104,699	112,537
Maldives	185	186	178	182	223	264
Nepal	2,382	2,658	2,739	2,661	2,807	2,914
Pakistan	32,080	31,285	32,254	32,124	33,400	33,352
Sri Lanka	8,749	9,088	9,031	8,544	9,291	8,933
Central Asia						
Azerbaijan	661	964	1,162	1,270	1,356	1,568
Kazakhstan	9,921	12,093	12,685	15,158	18,190	19,877
Kyrgyz Republic	1,481	1,648	1,704	1,677	1,784	1,966
Tajikistan	1,179	1,233	1,226	1,017	982	1,007
Turkmenistan	2,259	2,015	-	-	-	-
Uzbekistan	3,467	4,237	4,449	4,600	4,360	3,800
The Pacific						
Cook Islands	65	64	58	55	55	57
Fiji Islands	225	261	249	227	231	258
Kiribati	7	8	8	10	10	16
Marshall Islands, Rep. of	123	99	87	67	58	-
Micronesia, Fed. States of	94	84	67	58	53	54
Nauru	-	-	-	-	-	-
Papua New Guinea	1,298	1,348	1,394	1,390	1,357	1,517
Samoa	157	147	148	144	143	153
Solomon Islands	133	133	128	136	152	159
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-
Tonga	60	64	64	59	68	75
Tuvalu	-	-	-	-	-	-
Vanuatu	53	64	77	70	71	75

- = not available.

Table A18 Debt Service Ratio (% of exports of goods and services)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia								
China, People's Rep. of	8.6	9.0	7.4	8.0	7.3	7.5	7.6	7.6
Hong Kong, China	-	-	-	-	-	-	-	-
Korea, Rep. of	13.1	25.0	11.2	14.4	11.8	10.9	-	-
Mongolia	7.3	9.3	4.5	5.3	4.9	5.4	5.6	5.5
Taipei,China	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Southeast Asia								
Cambodia	2.1	1.6	3.8	3.8	3.3	3.0	3.1	3.7
Indonesia	46.8	65.8	41.3	36.0	32.1	26.5	-	-
Lao People's Dem. Rep.	9.6	6.3	5.7	7.2	8.3	6.8	-	-
Malaysia	7.0	6.3	5.6	6.8	6.7	6.1	6.2	6.0
Myanmar	5.2	5.0	3.7	3.1	-	-	-	-
Philippines	11.7	14.1	13.5	15.8	16.4	16.1	19.0	18.0
Singapore	-	-	-	-	-	-	-	-
Thailand	21.4	19.4	15.4	20.8	19.6	15.0	13.5	14.0
Viet Nam	13.9	12.8	10.5	10.6	8.3	8.3	7.5	7.3
South Asia								
Afghanistan	-	-	-	-	-	-	-	-
Bangladesh	6.1	7.0	7.3	6.6	6.3	5.6	5.3	5.6
Bhutan	8.0	12.1	4.8	4.6	4.8	4.9	-	-
India	17.8	16.2	17.2	13.9	14.7	-	-	-
Maldives	3.5	3.9	4.2	4.3	4.3	3.9	-	-
Nepal	6.1	6.1	6.0	6.8	9.3	11.4	9.0	9.0
Pakistan	55.4	35.3	37.2	38.0	44.7	28.7	25.0	23.0
Sri Lanka	13.3	15.2	14.7	13.2	13.2	-	-	-
Central Asia								
Azerbaijan	1.2	4.2	4.6	4.9	4.4	5.0	-	-
Kazakhstan	22.4	27.3	31.5	37.5	35.2	34.2	33.6	32.3
Kyrgyz Republic	21.8	26.0	28.1	30.8	20.7	-	-	-
Tajikistan	-	11.9	17.5	25.6	22.9	18.1	12.6	14.9
Turkmenistan	50.5	39.1	13.9	-	-	-	-	-
Uzbekistan	12.4	16.5	27.3	28.0	29.0	32.0	-	-
The Pacific								
Cook Islands	3.7	4.8	3.5	3.5	-	-	-	-
Fiji Islands	4.1	3.2	2.9	1.9	1.9	2.5	-	-
Kiribati	1.3	1.5	6.6	3.9	2.0	1.9	2.3	2.5
Marshall Islands, Rep. of	87.2	115.8	53.5	60.4	6.6	-	-	-
Micronesia, Fed. States of	66.0	63.6	65.7	32.8	6.2	6.1	6.0	5.8
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	7.3	7.5	6.7	7.1	7.4	8.3	9.3	9.8
Samoa	12.9	11.8	12.7	11.7	-	-	-	-
Solomon Islands	3.7	4.5	8.2	0.8	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-	-	-
Tonga	8.1	3.9	12.0	21.8	8.2	-	-	-
Tuvalu	-	-	-	-	-	-	-	-
Vanuatu	0.4	4.8	0.9	1.0	1.3	1.7	1.6	1.6

- = not available.

Table A19 Exchange Rates to the US Dollar (annual average)

	Currency	Symbol	1998	1999	2000	2001	2002	2003
East Asia								
China, People's Rep. of	Yuan	CNY	8.3	8.3	8.3	8.3	8.3	8.3
Hong Kong, China	Hong Kong dollar	HK$	7.7	7.8	7.8	7.8	7.8	7.8
Korea, Rep. of	Won	W	1,395.0	1,188.7	1,131.1	1,291.0	1,250.7	1,191.9
Mongolia	Togrog	MNT	840.8	1,021.9	1,076.7	1,097.7	1,125.0	1,173.4
Taipei,China	New Taiwan dollar	NT$	33.4	32.3	31.2	33.8	34.6	34.4
Southeast Asia								
Cambodia	Riel	KR	3,744.4	3,807.8	3,840.8	3,916.3	3,912.1	3,973.3
Indonesia	Rupiah	Rp	10,013.6	7,855.1	8,421.8	10,260.8	9,311.2	8,577.1
Lao People's Dem. Rep.	Kip	KN	3,298.3	7,106.0	7,846.2	8,871.1	10,056.3	10,619.0
Malaysia	Ringgit	RM	3.9	3.8	3.8	3.8	3.8	3.8
Myanmar	Kyat	MK	6.3	6.2	6.4	6.7	6.6	-
Philippines	Peso	P	40.9	39.1	44.2	51.0	51.6	54.2
Singapore	Singapore dollar	S$	1.7	1.7	1.7	1.8	1.8	1.7
Thailand	Baht	B	41.4	37.8	40.2	44.5	43.0	41.5
Viet Nam	Dong	D	13,268.0	13,943.2	14,167.7	14,725.2	15,279.5	15,732.0
South Asia								
Afghanistan	Afghani	AF	37.5	48.9	67.3	55.7	44.8	-
Bangladesh	Taka	Tk	45.5	48.1	50.3	54.0	57.4	57.9
Bhutan	Ngultrum	Nu	38.4	42.6	43.6	46.4	48.2	47.9
India	Indian rupee	Re/Rs	42.1	43.3	45.7	47.7	48.4	46.1
Maldives	Rufiyaa	Rf	11.8	11.8	11.8	12.2	12.8	12.8
Nepal	Nepalese rupee/s	NRe/NRs	61.9	67.9	69.0	73.7	76.7	77.9
Pakistan	Pakistan rupee/s	PRe/PRs	43.2	46.8	51.8	58.4	61.4	58.5
Sri Lanka	Sri Lanka rupee/s	SLRe/SLRs	64.6	70.4	75.8	89.4	95.7	96.5
Central Asia								
Azerbaijan	Azerbaijan manat	AZM	3,868.7	4,120.2	4,474.2	4,656.0	4,860.8	4,910.7
Kazakhstan	Tenge	T	78.6	120.1	142.3	146.9	153.5	149.5
Kyrgyz Republic	Som	Som	20.8	39.0	47.7	48.4	46.9	43.7
Tajikistan	Somoni	TJS	0.8	1.2	1.8	2.4	2.8	3.1
Turkmenistan	Turkmen manat	TMM	4,890.2	5,200.0	5,200.0	5,200.0	5,200.0	5,200.0
Uzbekistan	Sum	SUM	94.5	124.6	236.6	423.0	769.0	971.3
The Pacific								
Cook Islands	New Zealand dollar	NZ$	1.7	1.9	2.0	2.4	2.3	1.9
Fiji Islands	Fiji dollar	F$	2.0	2.0	2.1	2.3	2.2	1.9
Kiribati	Australian dollar	A$	1.6	1.5	1.7	1.9	1.8	1.5
Marshall Islands, Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0	1.0
Micronesia, Fed. States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	-	-	-	-	-	-
Papua New Guinea	Kina	K	2.1	2.5	2.8	3.4	3.9	3.6
Samoa	Tala	ST	2.9	3.0	3.4	3.5	3.2	3.0
Solomon Islands	Sol. Islands dollar	SI$	4.8	4.9	5.1	5.3	6.8	7.4
Timor-Leste, Dem. Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0	1.0
Tonga	Pa'anga	T$	1.3	1.6	1.6	1.9	2.2	2.2
Tuvalu	Australian dollar	A$	1.6	1.5	1.7	1.9	1.8	1.5
Vanuatu	Vatu	Vt	127.5	129.1	138.3	145.7	139.1	129.7

- = not available.

Table A20 Gross International Reserves (US$ million)

	1998	1999	2000	2001	2002	2003
East Asia						
China, People's Rep. of	144,960	154,675	165,574	212,165	286,400	403,250
Hong Kong, China	89,625	96,256	107,583	111,159	111,919	118,387
Korea, Rep. of	51,974	73,987	96,130	102,753	121,343	155,281
Mongolia	125	157	188	207	226	180
Taipei,China	90,341	106,200	106,742	122,211	161,656	206,632
Southeast Asia						
Cambodia	390	422	484	548	663	737
Indonesia	23,762	27,054	29,394	28,016	32,037	36,246
Lao People's Dem. Rep.	112	106	141	133	196	216
Malaysia	25,348	30,859	29,886	30,848	34,583	44,862
Myanmar	329	280	201	454	542	-
Philippines	10,806	15,107	15,024	15,658	16,180	16,866
Singapore	75,028	77,176	80,362	75,800	82,276	96,324
Thailand	29,536	34,781	32,661	33,048	38,924	42,148
Viet Nam	1,995	2,947	2,831	3,540	3,815	4,661
South Asia						
Afghanistan	-	-	-	-	-	-
Bangladesh	1,739	1,523	1,602	1,307	1,583	2,470
Bhutan	217	259	293	294	317	374
India	29,522	35,058	39,554	51,049	71,890	107,448
Maldives	120	128	124	94	135	161
Nepal	712	791	942	1,020	1,052	1,116
Pakistan	932	1,663	991	1,677	4,333	9,525
Sri Lanka	1,981	1,636	1,044	1,338	1,700	2,329
Central Asia						
Azerbaijan	449	697	951	1,218	1,414	1,620
Kazakhstan	1,964	2,003	2,096	2,508	3,141	4,959
Kyrgyz Republic	189	249	261	285	317	389
Tajikistan	65	58	87	96	96	135
Turkmenistan	1,379	1,607	1,854	1,935	-	-
Uzbekistan	-	-	-	-	-	-
The Pacific						
Cook Islands	10	14	13	16	12	11
Fiji Islands	385	420	422	370	340	357
Kiribati	379	406	400	341	345	351
Marshall Islands, Rep. of	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-
Nauru	-	-	-	-	-	-
Papua New Guinea	190	216	330	481	355	484
Samoa	64	68	62	57	65	78
Solomon Islands	48	51	31	21	13	30
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-
Tonga	16	22	16	13	18	17
Tuvalu	-	-	-	-	-	-
Vanuatu	45	43	40	38	35	37

- = not available.

Table A21 Central Government Expenditures (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia								
China, People's Rep. of	15.1	17.2	18.1	19.7	21.3	21.6	21.7	21.4
Hong Kong, China	18.7	17.9	18.1	18.8	19.0	20.5	19.4	18.0
Korea, Rep. of	23.8	22.8	22.3	22.0	19.9	22.7	-	-
Mongolia	41.9	39.4	40.5	42.1	43.2	43.9	44.3	-
Taipei,China	12.5	12.7	15.5	16.4	15.9	16.8	17.0	17.5
Southeast Asia								
Cambodia	13.5	13.9	15.1	17.3	17.7	16.6	16.8	17.1
Indonesia	18.1	21.1	17.5	22.8	20.3	21.2	19.2	-
Lao People's Dem. Rep.	20.0	16.6	18.4	20.2	21.7	18.8	19.0	19.3
Malaysia	21.8	22.7	23.8	29.3	28.8	28.1	27.1	25.7
Myanmar	6.5	5.1	3.5	-	-	-	-	-
Philippines	19.2	19.8	31.0	19.3	19.3	19.0	18.3	18.3
Singapore	26.7	25.3	21.4	23.5	19.2	14.2	17.4	17.2
Thailand	17.9	17.8	17.5	17.2	18.2	16.2	17.0	16.9
Viet Nam	20.6	20.7	22.8	24.4	26.4	27.4	27.5	24.5
South Asia								
Afghanistan	-	-	-	-	8.6	-	-	-
Bangladesh	13.3	13.8	14.7	14.0	14.8	14.5	15.6	15.9
Bhutan	34.3	44.9	46.5	52.4	41.3	40.3	36.2	-
India	25.9	27.4	27.8	27.6	29.3	31.9	29.0	28.7
Maldives	32.3	36.1	36.7	37.7	38.0	38.5	38.7	-
Nepal	16.9	15.4	15.5	17.6	17.0	16.0	16.8	19.2
Pakistan	23.7	22.0	22.8	21.4	22.4	22.4	21.0	21.0
Sri Lanka	26.5	25.2	26.7	27.5	25.4	23.6	22.9	22.5
Central Asia								
Azerbaijan	22.9	23.6	20.8	20.1	20.8	27.2	-	-
Kazakhstan	25.8	23.1	22.8	23.0	21.7	23.5	25.2	23.1
Kyrgyz Republic	29.3	30.8	24.9	22.8	23.3	23.7	-	-
Tajikistan	15.8	16.6	14.2	15.3	16.8	16.3	18.7	19.1
Turkmenistan	24.6	19.4	23.9	21.7	17.5	19.4	-	-
Uzbekistan	33.0	31.0	29.0	26.7	25.8	24.7	-	-
The Pacific								
Cook Islands	40.2	35.5	38.2	42.5	37.5	39.1	-	-
Fiji Islands	26.2	25.2	27.1	28.7	28.1	27.7	25.5	22.3
Kiribati	116.5	111.4	102.6	139.5	136.0	149.9	-	-
Marshall Islands, Rep. of	59.4	56.8	65.8	93.9	78.2	76.9	89.6	-
Micronesia, Fed. States of	83.8	85.2	75.3	68.6	69.7	72.0	63.1	65.2
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	27.3	31.9	33.6	35.6	33.4	33.4	31.9	29.5
Samoa	34.1	39.6	35.1	34.3	35.7	33.5	34.3	-
Solomon Islands	40.5	51.1	39.7	34.0	36.1	15.3	54.5	-
Timor-Leste, Dem. Rep. of	-	-	-	14.5	13.8	19.8	22.9	24.3
Tonga	32.9	26.9	27.9	30.9	33.7	32.1	36.7	-
Tuvalu	95.9	126.2	224.5	175.3	70.9	93.0	87.5	-
Vanuatu	31.2	23.6	27.8	25.2	25.0	21.4	20.5	20.1

- = not available.

Table A22 Central Government Revenues (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia								
China, People's Rep. of	13.0	14.3	15.3	17.1	18.3	18.8	19.2	19.1
Hong Kong, China	16.9	18.7	17.5	13.8	14.1	16.5	16.3	15.5
Korea, Rep. of	17.8	18.1	20.9	20.3	20.3	20.9	-	-
Mongolia	28.3	28.1	33.4	37.2	37.1	40.2	39.3	-
Taipei,China	14.4	13.4	14.1	14.9	13.4	13.7	14.0	14.6
Southeast Asia								
Cambodia	8.1	10.0	10.2	10.5	11.1	10.4	11.0	11.5
Indonesia	16.5	18.6	16.2	20.4	18.6	19.1	17.9	-
Lao People's Dem. Rep.	8.9	9.0	12.4	12.6	13.4	11.0	13.6	14.0
Malaysia	20.0	19.5	18.1	23.8	23.2	22.7	23.5	23.9
Myanmar	7.3	4.9	4.2	-	-	-	-	-
Philippines	17.4	16.1	24.6	15.3	14.1	14.4	14.1	14.1
Singapore	43.6	35.8	32.7	22.6	17.5	20.6	20.9	20.7
Thailand	15.6	15.4	15.4	15.0	15.8	16.6	16.9	16.6
Viet Nam	19.9	19.3	20.4	21.4	22.6	22.7	22.9	20.3
South Asia								
Afghanistan	-	-	-	-	3.3	-	-	-
Bangladesh	9.3	9.0	8.5	9.0	10.1	10.4	10.9	11.4
Bhutan	35.4	43.0	42.4	40.7	36.3	30.3	32.0	-
India	16.9	17.8	18.2	17.7	19.2	20.9	19.0	19.2
Maldives	30.4	32.1	32.3	33.0	33.1	34.4	34.2	-
Nepal	12.3	11.5	12.2	13.0	13.1	14.2	14.1	14.7
Pakistan	16.0	15.9	16.3	16.2	17.2	17.9	17.1	17.1
Sri Lanka	17.3	17.7	16.8	16.7	16.5	15.4	15.6	16.0
Central Asia								
Azerbaijan	20.2	18.8	18.1	17.9	18.5	24.1	-	-
Kazakhstan	21.7	19.6	22.7	22.6	21.4	22.6	22.6	22.1
Kyrgyz Republic	18.0	17.7	15.1	17.0	17.9	18.7	-	-
Tajikistan	12.0	13.5	13.6	15.2	16.7	17.2	19.2	19.1
Turkmenistan	22.0	19.4	23.5	22.3	17.7	18.6	-	-
Uzbekistan	31.1	29.3	28.0	25.7	25.0	24.2	-	-
The Pacific								
Cook Islands	37.7	33.1	36.3	44.0	37.7	35.9	-	-
Fiji Islands	25.4	24.6	23.7	22.1	22.5	21.6	22.0	21.5
Kiribati	161.7	130.2	129.0	147.1	157.4	136.5	-	-
Marshall Islands, Rep. of	75.1	67.3	74.7	96.1	93.0	91.1	95.8	-
Micronesia, Fed. States of	76.6	77.0	68.4	62.4	72.2	73.8	65.0	64.2
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	25.6	29.3	31.6	32.0	29.4	31.7	30.4	28.4
Samoa	36.1	40.0	34.4	31.9	33.6	32.9	32.8	-
Solomon Islands	40.9	46.8	35.5	22.5	25.0	16.1	54.5	-
Timor-Leste, Dem. Rep. of	-	-	-	7.7	8.2	13.6	13.8	14.2
Tonga	30.4	26.7	28.7	30.0	32.1	28.9	34.9	-
Tuvalu	154.4	148.7	240.0	121.0	147.4	76.6	86.2	-
Vanuatu	21.7	22.5	21.0	21.6	21.9	20.3	20.9	20.5

- = not available.

Table A23 Fiscal Balance of Central Government (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia								
China, People's Rep. of	-2.1	-2.9	-2.8	-2.5	-3.0	-2.7	-2.5	-2.3
Hong Kong, China	-1.8	0.8	-0.6	-5.0	-4.9	-4.0	-3.1	-2.5
Korea, Rep. of	-6.0	-4.7	-1.4	-1.7	0.4	-1.7	-0.5	0.0
Mongolia	-12.5	-10.6	-6.8	-5.4	-5.6	-3.6	-5.1	-5.0
Taipei,China	1.9	0.7	-1.4	-1.5	-2.5	-3.1	-3.0	-2.9
Southeast Asia								
Cambodia	-5.4	-3.9	-4.9	-6.8	-6.6	-6.1	-5.8	-5.6
Indonesia	-1.5	-2.5	-1.3	-2.3	-1.7	-2.1	-1.3	-0.8
Lao People's Dem. Rep.	-11.1	-7.6	-6.0	-7.6	-8.3	-7.8	-5.4	-5.3
Malaysia	-1.8	-3.2	-5.8	-5.5	-5.6	-5.3	-3.6	-1.8
Myanmar	0.8	-0.2	0.7	5.9	4.1	-	-	-
Philippines	-1.9	-3.8	-6.4	-4.0	-5.2	-4.6	-4.2	-4.2
Singapore	16.9	10.4	11.3	-0.9	-1.6	6.4	3.5	3.6
Thailand	-2.5	-2.9	-2.4	-2.1	-2.2	0.6	-0.1	-0.3
Viet Nam	-0.7	-1.4	-2.4	-3.0	-3.8	-4.8	-4.6	-4.2
South Asia								
Afghanistan	-	-	-	-	-5.4	-	-	-
Bangladesh	-4.1	-4.8	-6.2	-5.0	-4.6	-4.2	-4.8	-4.5
Bhutan	1.0	-1.9	-4.1	-11.7	-5.0	-10.0	-4.2	-
India	-9.0	-9.5	-9.6	-9.9	-10.1	-11.0	-10.0	-9.5
Maldives	-1.9	-4.1	-4.4	-4.7	-4.9	-4.1	-4.5	-
Nepal	-4.6	-3.9	-3.3	-4.5	-3.9	-1.8	-2.7	-4.5
Pakistan	-7.6	-6.1	-6.6	-5.2	-5.2	-4.4	-4.0	-3.9
Sri Lanka	-9.2	-7.5	-9.9	-10.8	-8.9	-8.1	-7.3	-6.5
Central Asia								
Azerbaijan	-2.6	-4.8	-2.7	1.8	1.3	0.2	1.1	1.5
Kazakhstan	-4.2	-3.5	-0.1	-0.4	-0.3	-0.9	-1.9	-1.0
Kyrgyz Republic	-9.5	-11.9	-9.9	-5.0	-5.4	-5.0	-4.4	-3.5
Tajikistan	-3.8	-3.1	-0.6	-0.1	-0.1	0.9	-0.5	0.0
Turkmenistan	-2.6	0.0	-0.3	0.6	0.2	-1.0	-	-
Uzbekistan	-1.9	-1.7	-1.0	-1.0	-0.8	-0.1	-2.0	-
The Pacific								
Cook Islands	-2.5	-2.4	-1.9	1.5	0.2	-3.2	-	-
Fiji Islands	-0.8	-0.6	-3.4	-6.6	-5.6	-6.1	-3.5	-0.8
Kiribati	45.3	18.9	26.4	7.6	21.4	-13.4	-	-
Marshall Islands, Rep. of	15.6	10.5	8.9	2.2	14.8	14.1	6.2	-
Micronesia, Fed. States of	-7.1	-8.2	-6.9	-6.2	2.5	1.9	1.9	-1.1
Nauru	-	-	-	-	-	-	-	-
Papua New Guinea	-1.8	-2.6	-2.0	-3.6	-4.1	-1.7	-1.5	-1.1
Samoa	2.0	0.3	-0.7	-2.3	-2.1	-0.6	-1.5	-
Solomon Islands	0.4	-4.3	-4.2	-11.5	-11.1	0.9	0.0	-
Timor-Leste, Dem. Rep. of	-	-	-	-6.8	-5.6	-6.2	-9.0	-10.1
Tonga	-2.5	-0.3	0.8	-0.9	-1.6	-3.1	-1.8	-
Tuvalu	58.6	22.5	15.4	-54.3	76.5	-16.3	-1.3	-
Vanuatu	-9.4	-1.2	-6.8	-3.7	-3.2	-1.1	0.4	0.4

- = not available.

The annual *Asian Development Outlook* provides a comprehensive economic analysis of 41 economies in developing Asia and the Pacific. On the basis of the Asian Development Bank's unique knowledge of the region, this 16th edition overviews aggregate trends and medium-term prospects by subregion—East Asia, Southeast Asia, South Asia, Central Asia, and the Pacific—in the context of global economic movements.

The region's developing economies generally showed remarkable resilience in 2003. Despite the uncertainties generated by the Iraq conflict, high oil prices, the outbreak of the severe acute respiratory syndrome (SARS) epidemic, and a slow recovery in major industrial countries during the first half of the year, economic growth reached 6.3% in 2003, making it the most dynamic region in the world.

Intraregional trade and strong consumer demand will define the outlook for developing Asia in 2004–2005. The stronger outlook for industrial countries over that period will provide a cushion against a possible slowing of surging exports to the People's Republic of China. It will also soften the impact of fiscal consolidation measures that need to be taken in some regional economies.

This issue of the *Asian Development Outlook* also includes a chapter on foreign direct investment (FDI) in developing Asia. It argues that, based on a study of a diverse group of developing Asian countries with large or rapidly rising inflows of FDI, the international benefits of FDI are, in fact, highly variable but not necessarily cost free. The magnitude and productivity of capital flows are dependent on the establishment of an enabling, business-friendly commercial environment, consistent with national development objectives. In this context, a useful paradigm is the "three Is"—incentives, institutions, and infrastructure.

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