

ASIAN DEVELOPMENT

Outlook 2004

Update

This *Asian Development Outlook 2004 Update* was prepared by the staff of the Asian Development Bank, and the analyses and assessments contained herein do not necessarily reflect the views of the Board of Directors or the governments that they represent. The Asian Development Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequence for their use. The term “country” does not imply any judgment by the Asian Development Bank as to the legal or other status of any territorial entity.

ISSN 1655-4809

Publication Stock No. 080404

Printed in Manila

© Asian Development Bank 2004

Foreword

The economies of developing Asia and the Pacific outperformed earlier forecasts during the first half of 2004. Buoyant exports and rebounding investment boosted growth. Although external demand is expected to abate somewhat and as the impact of high oil prices is felt more strongly during the second half of 2004, the region's gross domestic product (GDP) growth for 2004 is projected to reach 7.0%, slightly above the *Asian Development Outlook 2004 (ADO 2004)* forecast of 6.8%, made in April. In line with some leveling off of the expansion in major industrial countries and a slowdown in the People's Republic of China (PRC), the GDP growth forecast for 2005 has been scaled back to 6.2% from 6.7% in *ADO 2004*.

ADO 2004 Update features an overview of recent global economic trends and the region's recent macroeconomic performance and prospects. It also analyzes economic trends, policy developments, and the outlook for 21 selected developing member countries (DMCs) of the Asian Development Bank (ADB), which were included in *ADO 2004*. In addition, the *Update* assesses different scenarios relating to the short-term impacts of a PRC slowdown and sustained high global oil prices on the region's economies.

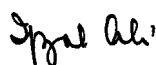
The *Update* was prepared by the staff of ADB from the East and Central Asia Department, Mekong Department, Pacific Department, South Asia Department, Southeast Asia Department, the Economics and Research Department (ERD), as well as the resident missions of ADB. The economists who contributed the country chapters are: Ramesh Adhikari and Dao Viet Dung (Viet Nam), William Bikales (Malaysia), Xiaoqin Fan (Taipei, China), Akiko Hagiwara (Hong Kong, China), Naved Hamid and Safiya Aftab (Pakistan), M. Zahid Hossain (Bangladesh), Mandar Jayawant (Uzbekistan), Thomas Crouch and Xuelin Liu (Philippines), Aliya Mukhamedyarova (Kazakhstan), Hiranya Mukhopadhyay (India), Cyn-Young Park (Republic of Korea), Michaela Prokop (Papua New Guinea), Kenji Takamiya (Lao PDR), Yumiko Tamura (Thailand), Sungsup Ra (Nepal), Purnima Rajapakse and Vanndy Hem (Cambodia), Ramesh Subramanian

and Amanah Abdulkadir (Indonesia), Fan Zhai (Singapore), Jian Zhuang (People's Republic of China), and J. Ernest Zveglic (Azerbaijan). Bruce Knapman drafted the chapter on the Fiji Islands.

Jean-Pierre A. Verbiest, Assistant Chief Economist, Macroeconomics and Finance Research Division, assisted by Charissa N. Castillo, coordinated the overall production of the publication. Jean-Pierre A. Verbiest, Cyn-Young Park, and Pilipinas Quising wrote the chapter in Part 1 on Developing Asia and the World. In Part 3, the chapter on Regional Impact of an Economic Slowdown in the PRC was contributed by Fan Zhai, and the chapter on Higher Global Oil Prices: Implications for Developing Asia in 2005 was prepared by Cyn-Young Park and Lea Sumulong.

Technical and research support was provided by Gmelina Guiang, Ludy Pardo, Grace Sipin, and Lea Sumulong, assisted by Bernadette Agustin, Roshan Ara, Laura Britt-Fermo, Mary Jane David, Leticia de Leon, Heidee Lozari, Nguyen Phuong Ngoc, Marife Principe, Sinha Roy Saikat, Bipulendu Singh, and Bing Villarante.

Richard Niebuhr and Anthony Patrick added substantive inputs in their capacity as economic editors. Jonathan Aspin did the copy editing and Elizabeth Leuterio was responsible for book design and typesetting. Patricia Baysa provided administrative and secretarial support. The cooperation of the Logistics Management Section under the supervision of Raveendranath Rajan contributed significantly to the timely publication of the *Update*. Robert Salamon, Ann Quon, Tsukasa Maekawa, and Ma. Mildred Villareal of the Office of External Relations planned and coordinated the dissemination of *ADO 2004 Update*.



IFZAL ALI
Chief Economist
Economics and Research Department
Manila
22 September 2004

Contents

Part 1 Developing Asia and the World 1

Developing Asia and the World 3

Part 2 Economic Trends and Prospects in Developing Asia 23

East Asia 24

People's Republic of China 25

Hong Kong, China 30

Republic of Korea 33

Taipei, China 37

Southeast Asia 40

Cambodia 41

Indonesia 43

Lao People's Democratic Republic 47

Malaysia 49

Philippines 53

Singapore 57

Thailand 60

Viet Nam 63

South Asia 66

Bangladesh 67

India 70

Nepal 75

Pakistan 77

Central Asia 82

Azerbaijan 83

Kazakhstan 85

Uzbekistan 88

The Pacific 92

Fiji Islands 93

Papua New Guinea 96

Part 3 Economic Scenarios for Asia 99

Economic Scenarios for Asia 101

Regional Impact of an Economic Slowdown in the People's Republic of China:
Three Alternative Scenarios 101

Higher Global Oil Prices: Implications for Developing Asia in 2005 109

Statistical Appendix 116

Statistical Notes and Tables 117

Figures

- Figure 1.1 Real GDP Growth Rate of the United States, Euro Zone, and Japan, Q1 2003–Q2 2004 5
- Figure 1.2 Growth of GDP and its Demand Components, United States, Q1 2003–Q2 2004 6
- Figure 1.3 Institute for Supply Management Index, United States, January 2003–August 2004 7
- Figure 1.4 Nonfarm Employment, January 2003–August 2004, million, seasonally adjusted 7
- Figure 1.5 Growth of GDP and its Demand Components, Japan, Q1 2003–Q2 2004 8
- Figure 1.6 Growth of GDP and its Demand Components, Euro Zone, Q1 2003–Q2 2004 9
- Figure 1.7 Non-Energy Commodity Prices, January 2003–August 2004 11
- Figure 1.8 Major Stock Market Price Indexes, 2004 12
- Figure 1.9 Volatility of US Treasury Securities, 2004 12
- Figure 1.10 Sovereign Risk Spreads of Emerging Asian Markets and High-Yield Corporate Spreads, January 2003–August 2004 13
- Figure 2.1 Contribution to GDP Growth, People’s Republic of China, 2002–2005 29
- Figure 2.2 Contribution to GDP Growth by Expenditure Account, Hong Kong, China, Q1 2002–Q2 2004 30
- Figure 2.3 Contribution to Growth by Expenditure Component, Republic of Korea, Q1 2002–Q2 2004 33
- Figure 2.4 GDP Growth by Expenditure Account, Taipei, China, Q1 2002–Q2 2004 37
- Figure 2.5 GDP and GDP Per Capita Growth, Cambodia, 1997–2005 41
- Figure 2.6 Poverty, Unemployment, and GDP Growth, Indonesia, 2001–2004 43
- Figure 2.7 GDP Growth by Sector, Lao People’s Democratic Republic, 1997–2005 47
- Figure 2.8 Contribution to GDP Growth by Expenditure Account, Malaysia, 2001–2004 49
- Figure 2.9 Fiscal Performance, Philippines, 1998–2003 55
- Figure 2.10 GDP Growth and Contribution by Expenditure Account, Singapore, 2003–Q2 2004 57
- Figure 2.11 GDP Growth and Inflation, Thailand, 1997–2005 62
- Figure 2.12 First-Half GDP and Sector Growth, Viet Nam, 2002–2004 65
- Figure 2.13 Total Merchandise Exports and Invisible Receipts by Category, Bangladesh, FY2004 68
- Figure 2.14 Sector Composition of Growth, India, FY2002 and FY2003 70
- Figure 2.15 Inflation, Pakistan, June 2003–June 2004 78
- Figure 2.16 GDP Growth, Azerbaijan, 1997–2005 83
- Figure 2.17 GDP Growth and Unemployment, Kazakhstan, 1996–2004 85
- Figure 2.18 Quarterly Visitor Arrivals, Fiji Islands, 2002–2004 93
- Figure 3.1 PRC Fixed Asset Investment and Retail Sales, Q1 2001–Q2 2004 102
- Figure 3.2 PRC Trade Balance, 1997–2003 103
- Figure 3.3 Spot and 3-Month Forward Oil Prices, Brent Crude, October 2002–August 2004 110
- Figure 3.4 Nominal and Real Prices, Brent Crude, Q1 1970–Q3 2004 111
- Figure 3.5 Foreign Exchange Reserves, 1979 and 2004 112
- Figure 3.6 Inflation Rates, 1979 and 2004 112
- Figure 3.7 Asian Exports, 1980–2003 113

Tables

Table 1.1	Selected Economic Indicators, Developing Asia, 2003–2005	4
Table 1.2	Baseline Assumptions on External Conditions, 2003–2005	6
Table 1.3	Percentage Change in Stock Market Prices (from end of previous period)	13
Table 2.1	Selected Economic Indicators, People’s Republic of China, 2004–2005, %	26
Table 2.2	Selected Economic Indicators, Hong Kong, China, 2004–2005, %	31
Table 2.3	Selected Economic Indicators, Republic of Korea, 2004–2005, %	34
Table 2.4	Selected Economic Indicators, Taipei, China, 2004–2005, %	38
Table 2.5	Selected Economic Indicators, Cambodia, 2004–2005, %	42
Table 2.6	Selected Economic Indicators, Indonesia, 2004–2005, %	44
Table 2.7	Selected Economic Indicators, Lao People’s Democratic Republic, 2004–2005, %	48
Table 2.8	Selected Economic Indicators, Malaysia, 2004–2005, %	50
Table 2.9	Selected Economic Indicators, Philippines, 2004–2005, %	54
Table 2.10	Selected Economic Indicators, Singapore, 2004–2005, %	58
Table 2.11	Selected Economic Indicators, Thailand, 2004–2005, %	61
Table 2.12	Selected Economic Indicators, Viet Nam, 2004–2005, %	64
Table 2.13	Selected Economic Indicators, Bangladesh, 2004–2005, %	69
Table 2.14	Selected Economic Indicators, India, 2004–2005, %	71
Table 2.15	Selected Economic Indicators, Nepal, 2004–2005, %	76
Table 2.16	Selected Economic Indicators, Pakistan, 2004–2005, %	79
Table 2.17	Selected Economic Indicators, Azerbaijan, 2004–2005, %	84
Table 2.18	Selected Economic Indicators, Kazakhstan, 2004–2005, %	86
Table 2.19	Selected Economic Indicators, Uzbekistan, 2004–2005, %	89
Table 2.20	Selected Economic Indicators, Fiji Islands, 2004–2005, %	94
Table 2.21	Selected Economic Indicators, Papua New Guinea, 2004–2005, %	97
Table 3.1	Regional Distribution of Merchandise Trade in Developing Asia, 2003, %	102
Table 3.2	PRC Share in Exports of Selected Asian Economies, 2001–2003, %	102
Table 3.3	Effects of the Investment-Induced PRC Slowdown on GDP and Trade, 2005	104
Table 3.4	Effects of Investment-Induced PRC Slowdown on Sector Output, 2005	105
Table 3.5	Price Effects of Investment-Induced PRC Slowdown, 2005	106
Table 3.6	Effects of Investment-Induced PRC Slowdown plus Changes in US and Japanese Growth	107
Table 3.7	OPEC Production and Quota vs Production Capacity (million barrels a day)	110
Table 3.8	The Impact of a Temporary Oil Price Increase: Scenario 1 vs Scenario 2, 2005	114
Table 3.9	The Impact of a Sustained Oil Price Increase: Scenario 1 vs Scenario 2, 2005	115

Statistical Appendix Tables

Table A1	Growth Rate of GDP (% per year)	120
Table A2	Inflation (% per year)	121
Table A3	Growth Rate of Merchandise Exports (% per year)	122
Table A4	Growth Rate of Merchandise Imports (% per year)	123
Table A5	Current Account Balance (% of GDP)	124
Table A6	Fiscal Balance of Central Government (% of GDP)	125

Acronyms and Abbreviations

ADB	Asian Development Bank
AIDS	acquired immunodeficiency syndrome
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
bbf	barrel
CEPA	Closer Economic Partnership Arrangement
CPI	consumer price index
DMC	developing member country
ECB	European Central Bank
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
GNP	gross national product
HIV	human immunodeficiency virus
ICT	information and communications technology
IMF	International Monetary Fund
IT	information technology
Lao PDR	Lao People's Democratic Republic
mb/d	million barrels a day
MDG	Millennium Development Goal
MFA	Multifibre Arrangement
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PBC	People's Bank of China
PRC	People's Republic of China
PRGF	Poverty Reduction and Growth Facility
q-o-q	quarter-on-quarter
saar	seasonally adjusted annualized rate
SARS	severe acute respiratory syndrome
SME	small and medium enterprise
SOE	state-owned enterprise
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 Update* are classified by major analytic or geographic groupings. For purposes of *ADO 2004 Update*, 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 the 42 developing member countries (DMCs) of the Asian Development Bank.
- **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, Palau, 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.

The *Statistical Notes* give a detailed explanation of how data are derived. *ADO 2004 Update* is based on data available up to 15 September 2004.

ASIAN DEVELOPMENT
Outlook
2004
Update

Part 1 Developing Asia and the World



ASIAN DEVELOPMENT
Outlook
2004
Update

Developing Asia and the World





Developing Asia and the World

Developing Asia: Economic Highlights of 2004 and Prospects for 2005

The economies of developing Asia outperformed earlier forecasts in the first half of 2004. While there are divergences among countries, economic growth has been strong in all subregions, but particularly so in East Asia and Southeast Asia. In most countries, growth has become more broad based, with a fast-expanding external sector complemented by robust domestic demand growth, which, significantly for the first time since the Asian financial crisis of 1997–98, also included business investment.

During the first half of the year, exports expanded at a surprisingly strong rate as the recovery strengthened in major industrial countries and intraregional trade remained buoyant. East Asian and Southeast Asian exporters also benefited from the strong revival in the electronics market in particular, as a result of increased United States (US) investment demand. The strong growth momentum also translated into fast-rising imports during the period. With some exceptions, business investment, which had been lagging since the Asian financial crisis in many East Asian and Southeast Asian economies, picked up in the first half, further supporting growth in domestic demand. Relatively robust economic growth over the past 2 years and higher capacity utilization, surging export demand, low interest rates, and recovering business confidence supported the pickup in investment spending.

In countries where agriculture remains a large source of employment, the sector has generally benefited from favorable conditions, leading to rising rural incomes and consumption, notably in the People's Republic of China (PRC).

A feature of the first half of 2004 was that, in spite of strong growth and high oil prices, inflation, though generally on a rising trend, remained relatively subdued across the region. As a result, accommodative macroeconomic policy stances remained mostly unchanged from 2003.

While external demand is expected to abate somewhat during the second half of 2004 and the impact of high oil prices could be felt more strongly in many economies, gross domestic product (GDP) growth for the region is nevertheless projected to reach 7.0% for 2004, slightly above the forecast of 6.8% made in *Asian Development Outlook 2004 (ADO 2004)*, which was published in April this year (Table 1.1). The region's growth will equal that of 2000, which was the fastest after the Asian financial crisis.

Compared with *ADO 2004*, projections have essentially been raised by about half a percentage point in both East Asia and Southeast Asia, mainly on account of faster growth in Hong Kong, China; Malaysia; Philippines; Singapore; and Taipei, China, while the expected slowdown in the PRC will be smaller than earlier thought. In contrast, growth in Cambodia, Indonesia, and Korea has continued to lag.

In South Asia, with the exception of Nepal, growth remains generally robust. However, GDP growth for India in 2004 has been cut by about 1 percentage point from the *ADO 2004* projection. In Central Asia, oil exporters are benefiting from high energy prices, while non-oil producers, such as the Kyrgyz Republic and Uzbekistan, continue to experience slow growth. In the Pacific, there is some improvement in the second-largest economy, the Fiji Islands, but overall growth remains fairly low in the subregion.

Merchandise export growth in developing

Table 1.1 Selected Economic Indicators, Developing Asia, 2003–2005

	2003	2004		2005	
		ADO 2004	Update 2004	ADO 2004	Update 2004
Gross Domestic Product (annual % change)					
Developing Asia	6.5	6.8	7.0	6.7	6.2
East Asia	6.5	6.9	7.3	6.8	6.4
Southeast Asia	4.8	5.7	6.2	5.4	5.7
South Asia	7.6	7.0	6.4	7.2	5.9
Central Asia	8.4	8.1	7.9	8.4	8.0
The Pacific	4.3	2.9	2.9	2.4	2.4
Consumer Price Index (annual % change)					
Developing Asia	2.3	3.3	3.7	3.1	4.4
East Asia	1.2	2.6	3.0	2.4	3.8
Southeast Asia	3.1	3.6	4.2	3.8	4.2
South Asia ^a	5.1	4.9	5.5	4.6	6.5
Central Asia	5.4	8.6	6.9	8.3	6.4
The Pacific	8.5	5.6	5.1	6.0	4.4
Current Account Balance (% of GDP)					
Developing Asia	4.6	3.2	2.8	2.9	2.1
East Asia	4.5	2.8	2.3	2.6	1.4
Southeast Asia	9.0	8.2	7.2	7.6	6.6
South Asia	1.6	0.4	1.3	0.2	0.6
Central Asia	-2.3	-3.6	-3.9	-4.3	-2.1
The Pacific	-0.6	0.9	0.8	-1.3	-1.7

^a India reports on a wholesale price index basis.

Sources: Asian Development Outlook database; staff estimates.

Asia has significantly surprised, on the upside, the *ADO 2004* forecast. In spite of some leveling off projected for the second half of 2004, exports are forecast to expand by 18.1% in 2004, compared with 12.4% in *ADO 2004*. This follows on from a growth rate of 19.4% in 2003. However, partly as a result of higher oil prices, merchandise imports will also increase, by 20.8% in 2004, well above the rate of 14.8% of *ADO 2004*. Imports will rise very rapidly in Kazakhstan (35%), PRC (30%), Azerbaijan (27%), Korea (27%), Thailand (27%), Pakistan (21%), and India (20%). The region's overall current account surplus will decline as a share of GDP to 2.8%, about half a percentage point below the *ADO 2004* projection. Notably, the PRC current account is projected to show a deficit for the first time since 1993.

Besides external trade, the strong economic performance of many Asian economies during the first half of 2004 was also underpinned by

a marked recovery in fixed investment, especially in Hong Kong, China; Malaysia; Singapore; Taipei, China; and Thailand. In Korea, Indonesia, and the Philippines, the improvement was more modest. In Pakistan, there has been a sharp pickup in investment by the private and public sectors, while in Azerbaijan and Kazakhstan the rapid pace of investment in oil and gas projects continued. With consumption expenditures continuing their rapid expansion, growth in many countries has become more broad based with both external demand and domestic demand contributing more evenly to GDP growth.

For 2004 as a whole, inflation in the region is projected at 3.7%, about half a percentage point higher than forecast in *ADO 2004*. The economies in East Asia and Southeast Asia will experience the fastest acceleration in inflation, due to a combination of robust growth and high oil prices. As shown in Part 3, some of these economies are more vulnerable than others to high oil prices. In South Asia, the largest economies, India and Pakistan, will also see faster inflation, partly as a result of high oil prices. In a number of countries in the region, inflationary pressures continue to be exacerbated by rigid exchange rate policies that have kept import prices high and, in some instances, have led to rapid domestic liquidity expansion.

The aggregate regional GDP growth forecast for 2005 has been reduced to 6.2%, half a percentage point lower than in *ADO 2004*. This downward revision is mainly the result of more subdued growth predictions for the larger economies, notably India; Korea; and Taipei, China, as well as somewhat slower growth in the PRC.

In line with some leveling off of the expansion in major industrial countries and a further deceleration in the PRC economy, regional exports are now projected to increase more slowly than expected in *ADO 2004*. In spite of oil prices significantly higher than in the *ADO 2004* baseline, imports will rise at about the same rate as earlier forecast, i.e., by 13.2%, but from a higher base. The aggregate regional current account surplus will continue to shrink to 2.1% of the regional GDP. The PRC's current account is expected to show a deficit of 1.4% of GDP in 2005.

While the contribution of the external sector to the region's GDP growth is expected to be reduced in 2005, macroeconomic policies are also likely to become neutral or moderately contractionary as domestic interest rates rise in line with world interest rates and the margins for further fiscal stimulus in most economies are significantly reduced. In spite of the tightening of macroeconomic policies, inflation is forecast to rise much faster than envisaged in *ADO 2004*, at an annual rate of 4.4%. The pass-through of higher oil prices will be one of the reasons. The acceleration of inflation will be particularly marked in East Asia and South Asia.

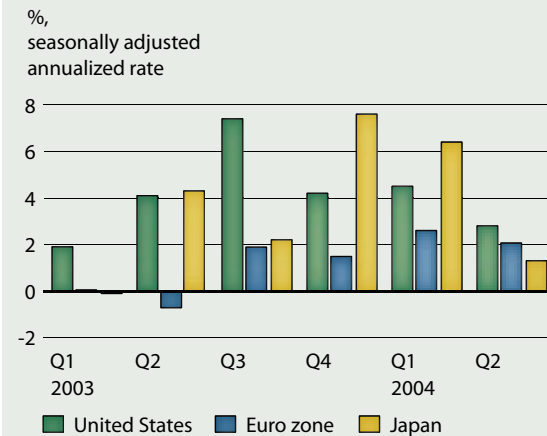
Overall, all main economic indicators for developing Asia, with the exception perhaps of inflation, remain bright for 2005. However, the pickup in inflation and the weaker external trade prospects, coming at the same time as macroeconomic policies need some tightening, call for measures to improve the investment climate in the various countries, enhance their competitiveness, and make them more resilient to withstand a (possibly) substantially weaker external environment in the second half of the decade. In addition, regional policy makers need to support the further expansion of domestic markets, in particular by raising the share of consumption in GDP.

Global Economic Update, 2004–2005

The impressive growth performance of major industrial countries since the second half of 2003 stretched into the first quarter of 2004, with growth projections well above trend rates for the US and Japan in particular. Although the performance of industrial countries has slowed somewhat since the second quarter, the baseline for 2004 is for robust GDP growth in industrial countries at 3.5–3.9%, about half a percentage point higher than in *ADO 2004* (Table 1.2).

Projections for 2004 have been raised substantially for Japan. For 2005 as a whole, the baseline now indicates slower growth compared with *ADO 2004*, with rates settling at around potential rates. Remarkably, for the first time since 2001, growth in major industrial countries has become much more synchronized, a sign of the strength of the current recovery (Figure 1.1).

Figure 1.1 Real GDP Growth Rate of the United States, Euro Zone, and Japan, Q1 2003–Q2 2004



Sources: US Department of Commerce, Bureau of Economic Analysis, available: <http://www.bea.gov/bea/dn/gdplev.xls>; Eurostat, available <http://www.europa.eu.int>; Economic and Social Research Institute of Japan, available, <http://www.esri.cao.go.jp>.

Despite this, significant imbalances remain embedded in the world economy, as growth in Japan and the euro zone has been driven largely by a stronger external sector, itself very much dependent on strong US expansion. But that expansion has been associated with a continued dramatic deterioration of both the fiscal and current accounts, as well as with historically low interest rates. These developments make the current strong performance of the world economy particularly prone to external shocks, whether they are prolonged, sustained, high oil prices—most likely leading to a sharp increase in inflation—or a loss of confidence in the US economy's ability to cope with the deficits—most likely accompanied by a collapse of the dollar. In industrial economies, there is little or no room left for fiscal expansion.

These imbalances and uncertainties necessitate a monetary policy return to a more neutral stance, in a continuation of the interest rate move that started in the US in the second quarter of 2004. The question is: Is the expansion in major industrial countries self-sustaining? The risk is that a synchronized strong recovery could turn into a synchronized slowdown. Growth prospects for industrial countries could well start weakening more significantly toward end-2005.

Table 1.2 Baseline Assumptions on External Conditions, 2003–2005

	2003	2004		2005	
		ADO 2004	Update	ADO 2004	Update
GDP Growth (%)					
Industrial countries	2.0	3.1–3.5	3.5–3.9	2.5–3.0	2.4–2.8
United States	3.0	4.2–4.7	4.1–4.5	3.2–3.7	3.1–3.5
Japan	2.4	2.5–2.8	3.8–4.2	1.5–2.0	1.6–2.0
Euro zone	0.5	1.7–1.9	1.8–2.0	2.1–2.4	1.8–2.2
Memorandum Items					
United States Federal Funds rate (average, %)	1.1	1.1–1.3	1.2–1.4	2.5–3.0	2.9–3.1
Brent crude oil spot prices (\$/barrel)	28.8	28.0–30.0	36.0–38.0	24.0–26.0	33.0–35.0
World trade volume (% change)	4.7	8.0–8.5	9.0–10.0	6.0–7.0	7.0–8.0

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

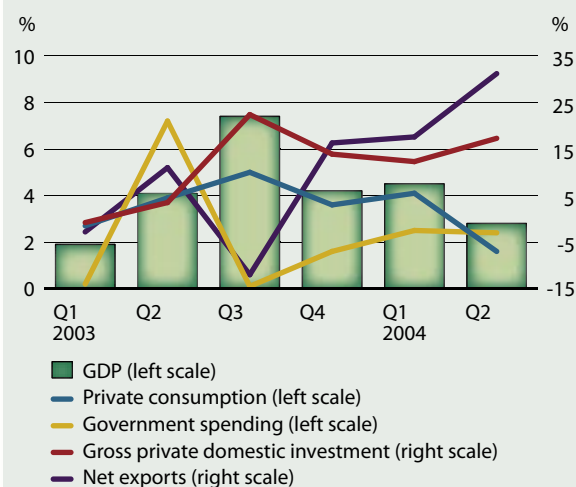
Sources: US Department of Commerce, Bureau of Economic Analysis, BEA News Releases, available: www.bea.doc.gov/bea/dn/nipaweb/index.asp; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp/index-e.html; Eurostat, available: www.europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat;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

United States

After a strong expansion starting in the second half of 2003, the US economy hit a soft patch in June–August this year amid rising concerns about high oil prices. GDP expanded at a quarter-on-quarter seasonally adjusted annualized rate (q-o-q, saar) of 2.8% in the second quarter of 2004, after registering solid 4.5% growth in the first. The main reason was a sharp slowdown in personal consumption expenditure, which grew by a mere 1.6% (q-o-q, saar) in the second quarter, falling from 4.1% in the first (Figure 1.2). However, relatively buoyant private domestic investment on the back of healthy corporate profits and strong business activities, as well as strengthening exports, continue to underpin the expansion in the US economy. Industrial production is still rising, though the earlier vigor has abated. The August Institute for Supply Management (ISM) composite index read 59, indicating generally vigorous economic activity, and was above 50 for the 15th consecutive month. The ISM manufacturing index has come down from a peak of 71.1 in January, but remains above 50 (Figure 1.3). Business activities also expanded in the nonmanufacturing sector, according to the ISM nonmanufacturing survey. New orders are growing, as are new export orders. Fairly upbeat business survey results suggest that economic fundamentals are intact, despite slowing consumption demand and rising oil prices.

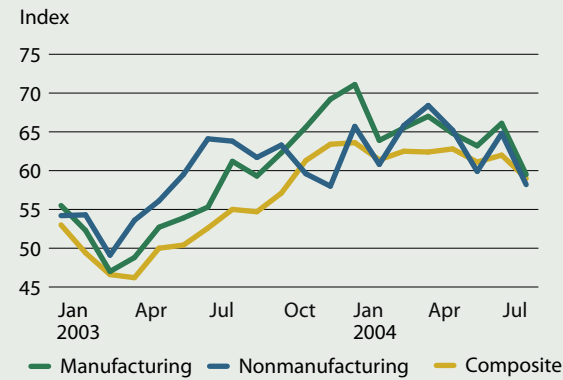
Business investment rose in the first half of 2004, taking advantage of improvements in export conditions and resilient residential construction numbers. Gross fixed investment surged in the second quarter, growing at 13.0% (q-o-q, saar). Corporate profits added modest gains in the same quarter, after a strong increase in the first. Capacity utilization is around 77%. Residential construction remained strong, but its long sustained vigor could wane next year.

Figure 1.2 Growth of GDP and its Demand Components, United States, Q1 2003–Q2 2004



Note: Rates are on a seasonally adjusted annualized basis.
Source: Bureau of Economic Analysis, available: <http://www.bea.gov/bea/dn/gdplev.xls>.

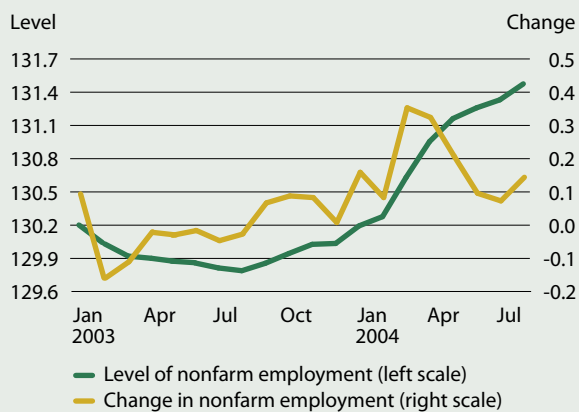
Figure 1.3 Institute for Supply Management Index, United States, January 2003–August 2004



Source: Datastream, downloaded 15 September 2004.

Developments in the labor market have been a major concern in the current US recovery. Nonfarm payroll numbers surged by 353,000 in March, and net increases averaged 295,000 a month during March to May. However, in July, nonfarm payroll gains were only 73,000, following a disappointing increase of 96,000 in June (Figure 1.4). Although August saw an additional 144,000 jobs, the job market situation in the US remains unsettled, and lack of job market growth could eventually exacerbate the slowdown in consumption. In addition, outstanding consumer credit, excluding mortgage debts, stood at more than \$2.0 trillion in July 2004, having risen by

Figure 1.4 Nonfarm Employment, January 2003–August 2004, million, seasonally adjusted



Source: US Bureau of Labor Statistics, available: <http://www.bls.gov>.

7.1% annually for the previous 5 years. Including mortgages, the figure shoots up to an estimated \$9.7 trillion or 83.7% of GDP.

The household debt-servicing burden is also creeping up. The estimated ratio of required debt payments to disposable income was 13.1 in the second quarter of 2004, but a broad measure of household financial obligations rises higher to 18.1. Hence, a household balance sheet correction is a possibility over the medium term.

The impact of sustained high oil prices on disposable incomes, the absence of further fiscal stimulus over the next 18 months, as well as rising interest rates, are all likely to damp consumer spending growth over the rest of 2004 and 2005. The Federal Reserve will continue to raise its policy rate at a “measured” pace over this period, with rates likely to be in the range of 3.5–4.0% by end-2005. Inflation has remained in check, despite the threat of sustained high oil prices. Headline inflation came in at 2.7% in August, while the Federal Reserve’s preferred core inflation measure—based on the price deflator of personal consumption expenditure, excluding food and energy components—was about 1.5%. Should inflation further increase, the Federal Reserve could accelerate its tightening of monetary policy.

Given these likely developments, the baseline GDP growth forecast for the US economy for the whole of 2004 is 4.1–4.5%—a solid performance. Private consumption growth will moderate over the forecast period, as households rebuild their savings. Business investment will likely be sustained, based on relatively sound corporate fundamentals. Exports will support growth through 2005. In that year, economic activity will moderate, with growth projected at 3.1–3.5%.

Japan

Growth in the first half of 2004 accelerated surprisingly in Japan, beating all projections. The external sector was the engine of growth, but growth has increasingly become more broad based as business investment and consumption expenditures also strengthened. Exports to Asia rose by 19.9% in the first half of 2004 from a year earlier, taking up the slack created by weaker demand from the US. An export-led increase in machinery and equipment investment contributed significantly to Japan’s unexpected growth. The

recovery in investment also responded to the substantial increase in industrial production, increased capacity utilization, and low levels of inventories.

Although GDP growth, on an annualized basis, slowed to 1.3% in the second quarter from 6.4% in the first (Figure 1.5), improved corporate sector fundamentals suggest that the expansion will likely continue for at least the rest of 2004. Public investment, though, dropped in the second quarter, reflecting ongoing fiscal consolidation. In contrast, private nonresidential investment continued to increase, as corporate profits remained healthy and machinery orders surged in the second quarter.

Corporate sector improvements slowly permeated through to the job market. New job openings have arisen, leading to a decrease in unemployment. However, firms remained cautious in hiring after such a long economic slump. Many of the gains were in temporary or part-time employment, thus limiting the recovery in wages. This picture should brighten over the coming quarters as labor market conditions further tighten on the back of changing demographics, although productivity growth and corporate efforts to cope with rising labor costs will mitigate the demographic impact. Moreover, the current

escalation in production and corporate profits will exert a positive influence on hiring decisions.

Private consumption recovered very modestly in the first half of 2004 and will likely continue its gradual recovery. Despite the poor performance of wage income, consumer spending maintained a slight gain, rising 2.6% (q-o-q, saar) in the second quarter after posting 4.2% growth in the first. The resilience of private consumption helps support GDP growth prospects. Consumer confidence has also been on an uptrend since the second half of 2003. With job market conditions improving and wages picking up over the coming quarters, the recovery in private consumption should gain firmer ground in 2005.

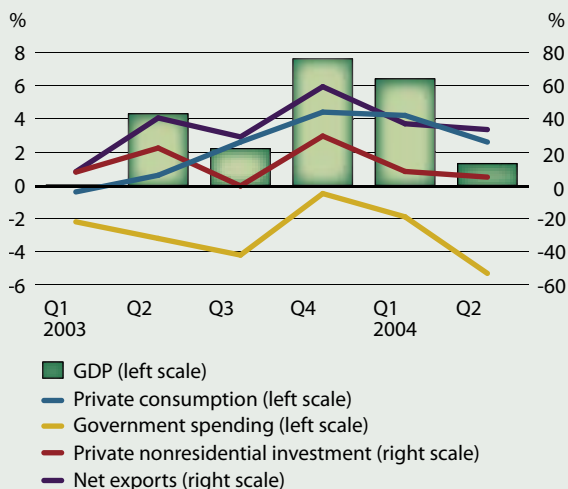
Deflation remains an issue. The consumer price index declined by an average of 0.2% in the first half of 2004 from a year earlier. The price level remained depressed despite rising oil prices and a mild depreciation of the yen, which fell by 1.6% from the start of the year through end-June, but the yen is still strong compared with its level of a year ago. Although the deflationary risk will gradually dissipate over time with a robust economic recovery, it remains an important factor to watch with regard to the strength and durability of the consumption recovery.

A strong export performance complemented by rising domestic demand—investment and increasingly consumption—has led to a revision of baseline GDP growth for Japan to 3.8–4.2%, significantly higher than in *ADO 2004*. As export growth moderates and business investment stabilizes in 2005 but the gradual recovery in consumption continues, Japan will settle to growth closer to its potential of 1.6–2.0%.

Euro Zone

A mild recovery is under way in the euro zone, driven mainly by a rebound in export demand. The euro zone economy grew at 2.1% (q-o-q, saar) in the second quarter of 2004, following growth of 2.6% in the first (Figure 1.6). Despite the sustained strength of the euro, exports surged by 15.7% (q-o-q, saar) in the second quarter following a 5.6% rise in the first. Robust external demand boosted industrial production across the euro zone, particularly in Germany, Italy, Netherlands, and Spain. Business sentiment has been improving, as has manufacturing production.

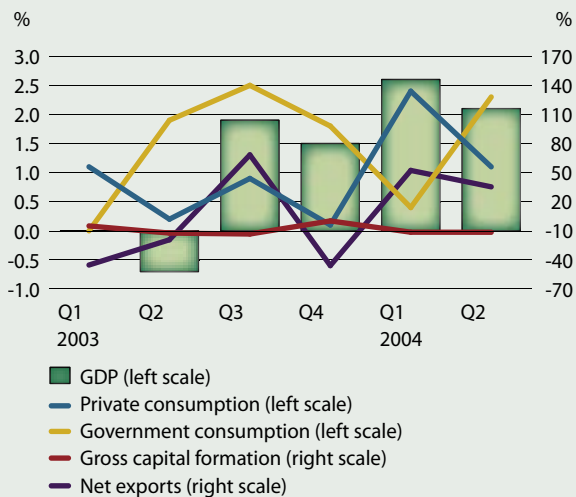
Figure 1.5 Growth of GDP and its Demand Components, Japan, Q1 2003–Q2 2004



Note: Rates are on a seasonally adjusted annualized basis.

Source: Economic and Social Research Institute of Japan, available: <http://www.esri.cao.go.jp>.

Figure 1.6 Growth of GDP and its Demand Components, Euro Zone, Q1 2003–Q2 2004



Note: Rates are on a seasonally adjusted annualized basis.
Sources: Eurostat, available: <http://www.europa.eu.int>;
Datastream, downloaded 7 September 2004.

The upward trend in economic activity has also exerted a positive influence on consumer spending. Private consumption grew by 2.4% and 1.1% (q-o-q, saar) in the euro zone in the first and second quarters, respectively. Reflecting the gradually broadening recovery, together with a turnaround in consumption, GDP is expected to grow in a range of 1.8–2.0% this year and 1.8–2.2% in 2005.

In Germany, the largest euro zone economy, GDP grew by 2.0% (q-o-q, saar) in the second quarter, accelerating slightly from 1.6% in the first. Net exports contributed about 2.1 percentage points to GDP growth in the second quarter, down from 5.0 percentage points in the previous quarter. Domestic demand, however, continued to stagnate in the second quarter, with consumer spending expanding at a meager 0.3% (q-o-q, saar). On an annualized basis, capital spending fell again by 3.4% during the second quarter, after plunging by 14.6% in the first.

While the weakness in domestic demand in Germany remains extensive, there are signs of improvement. Consumption, though still very weak, has recovered from a severe contraction in 2003. Industrial production is picking up speed, as new orders, both domestic and foreign, continue to increase. The Ifo business climate

index points to an improving business environment, reaching 95.7 in the second quarter, though this is a slight fall from 96.4 in the first. Based on a slow recovery in consumption and investment over the coming quarters, the German economy is expected to grow by 1.5–1.7% in 2004 and continue to expand at 1.7–1.9% in 2005.

Economic growth in France is more broad based and balanced. GDP expanded by 3.2% (q-o-q, saar) in the first and second quarters, fueled by strong consumption and exports. Private consumption slowed slightly to 2.9% growth (q-o-q, saar) in the second quarter, following 3.6% in the first. A rally in consumer spending boosted retail sales, providing a lift to industrial production and investment. Industrial production rose further in the second quarter, having contributed 0.8 percentage points to GDP growth in the first. However, the increase in consumer spending exceeded the growth in real income, making the rebound in consumption vulnerable to developments in the job market. At present, business sentiment is high, on the basis of increasing profits and buoyant economic activity, which will likely enhance job market prospects. Against this backdrop, the baseline for the French economy is to expand at a fairly respectable 2.2–2.4% in 2004 and 2.0–2.2% in 2005.

As some of the larger euro zone economies— notably Germany and Italy—still rely heavily on exports, the ongoing recovery remains vulnerable. Furthermore, domestic demand performance across the euro zone remains very uneven, limiting any scope for a harmonized policy approach to support the tentative recovery. For example, while gross fixed investment has improved in many euro zone countries since late 2003, Germany and the Netherlands saw a decline in investment. Consumer spending was particularly strong in France and Spain, but lagged in Germany.

The hesitant recovery in consumer spending remains key to a further strengthening of the euro zone. A major downside risk to the recovery in consumption is the situation in the job market, particularly at a time when unemployment benefits are being curtailed. The euro zone unemployment rate remained static, regis-

tering 9.0% for the fourth consecutive month in July. Policy makers' procrastination with regard to structural reforms is partly responsible for limited job creation in the current economic expansion. Indeed, the number of unemployed steadily increased from 12.6 million in January to 12.7 million in July. If job conditions do not improve as expected, consumer confidence, which has gradually picked up since the second half of 2003, could sharply deteriorate, clouding the growth prospects for 2004–2005.

The headline inflation rate jumped above the European Central Bank (ECB) target rate of 2% in the second quarter, mainly on account of rising oil prices. Although high oil prices are a significant risk in the short term, a slow recovery in domestic demand and a strong euro will likely pull back inflation toward the target over the forecast period. Nevertheless, with inflation above the target rate, ECB will be inclined to raise its policy rate, perhaps in late 2004 or in the first half of 2005. Fiscal policy is also constrained by the euro zone Stability and Growth Pact. Government consumption in the euro zone increased by 2.3% (q-o-q, saar) in the second quarter, following 0.4% in the first, but is expected to remain restrained over the forecast period.

Outside the euro zone, the United Kingdom (UK) grew at an above-trend rate of 3.6% (q-o-q, saar) in the second quarter, rising from 2.8% in the first. Domestic demand remained strong, though consumer spending has moderated somewhat along with what may be a less buoyant housing market. House prices, rising at a monthly average of 1.7% during the first quarter, have apparently started to slow in recent months. Investment recovery is gathering pace, growing by 1.7% in the first quarter and 1.4% in the second. Business confidence is staying high, pointing to continued economic expansion. However, due to high oil prices, inflation has picked up with the consumer price index rising in August by 1.3% year on year.

Robust economic expansion in the UK, coupled with tight labor market conditions, suggests that inflationary pressures will likely remain in place for some time. Reflecting largely buoyant global economic conditions, the UK is projected to grow by 3.2–3.4% in 2004 and 2.8–3.0% in 2005.

World Trade and Commodity Prices

World trade expanded rapidly in the first half of 2004, owing to a synchronized global economic recovery that was supported by strong industrial production growth in major industrial countries and in developing Asia. According to World Bank estimates, growth in world trade as measured by world export volume reached 9.0% in the first half of 2004. Drawing on the strong performance of the year to date, world trade is expected to expand at 9–10% over the full year, before moderating to 7–8% in 2005.

As the global recovery gained traction, imports of industrial countries expanded in nominal terms by 18.0% in the first quarter from the same period of a year earlier, according to the August 2004 International Monetary Fund *Direction of Trade Statistics*. The value of exports from developing Asia surged by 27.5% in the same period. In particular, exports from the PRC grew by 34.0% in the first quarter of 2004 from a year earlier while those from India expanded by 27.5%. More impressively, intraregional Asian trade increased by 26.8% to \$196.3 billion in the first quarter from \$154.7 billion in the year-earlier quarter.

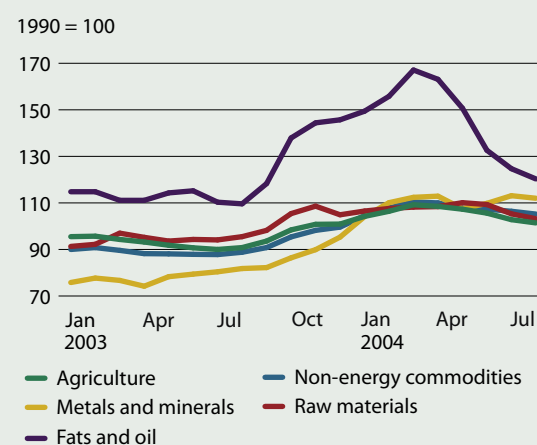
A cyclical upswing in high-technology industries has also boosted world trade in 2004. Demand for information and communications technology (ICT) products, such as wireless communications devices, digital cameras, and consumer electronics goods, has been increasing since late 2003. Worldwide sales of semiconductors rose to \$53.4 billion in the second quarter, increasing by 40.3% from a year earlier; Asia posted the strongest annual sales growth at 60.9% in June, followed by North America at 29.7%, the European Union (EU) at 28.9%, and Japan at 26.3%. DRAM chip prices were especially firm, reflecting strong demand and limited supply. Capacity utilization for related products, such as integrated circuits and processors, reached over 95% worldwide in the second quarter of 2004, while inventories remained low. According to the World Semiconductor Trade Statistics, the world semiconductor market is estimated to grow by 28.4% in 2004, amounting to \$213.6 billion in trade value. The growth momentum in the semiconductor and high-technology industries is expected to moderate over the next year.

Oil prices surged in 2004 on tight market conditions and geopolitical uncertainties (see Part 3). The latest data on oil production and consumption suggest that tight oil market conditions are likely to remain for some years to come. Strong demand, despite rising oil prices, coupled with speculative positions have pushed prices higher this year, with prices above \$40 a barrel in August. The International Energy Agency estimate for 2004 world demand, made in August, was 82.2 million barrels a day (mb/d), representing an increase of 2.5 mb/d in 2004. A further increase of 1.8 mb/d is projected in 2005. World supply rose by 0.6 mb/d to 83.5 mb/d in July. Spare capacity among members of the Organization of the Petroleum Exporting Countries (OPEC) fell to an estimated 1.2 mb/d in August compared with about 2.0 mb/d a year earlier. In these circumstances, oil prices for the *ADO Update* baseline have been substantially revised upward from the *ADO 2004* baseline (Table 1.2). The benchmark Brent crude price is put at an average of \$36–38 a barrel in 2004, easing somewhat to \$33–35 in 2005.

Prices of non-energy commodities stayed high during the first half of 2004 (Figure 1.7) as a result of the strong global recovery and sustained demand from the PRC, particularly for raw materials and metals. Prices of raw materials, including timber and rubber, further increased in the first half, with the notable exception of cotton, which sharply declined due to recent favorable output forecasts for 2005. Although still at relatively high levels, rubber prices started to stabilize in July. Overall, the World Bank price index of raw materials increased 15.2% year on year in the second quarter, following a 13.8% rise in the first. Prices of metals and minerals surged by 41.5% in the second quarter from a year earlier. Steel prices shot up by 68.3% over the same period, while prices of other metals such as copper, lead, and tin, all rose by more than 50%.

Agricultural and food commodity prices have generally eased recently, as forecasts for the next crop year have mainly been strong. Prices of grains, including maize, rice, and wheat, which had posted strong gains in the previous 12 months, started to retreat in July on the back of favorable crop prospects. The price rally in fats and oils seen in 2003 reversed during the first quarter and continued to stabilize, as supply

Figure 1.7 Non-Energy Commodity Prices, January 2003–August 2004



Source: www.worldbank.org/prospects/pinksheets.

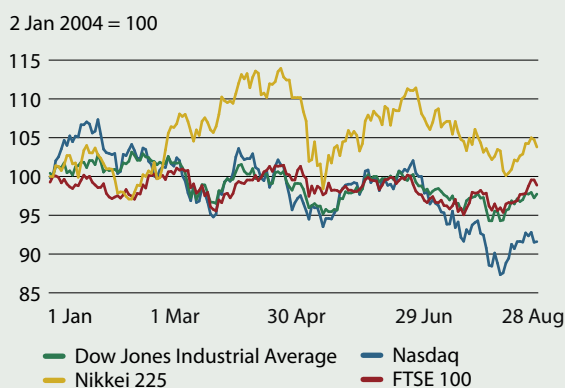
conditions improved. Coffee prices continued recovering in the first half, while cocoa prices fell sharply in the second quarter, due to a freer price regime in the Côte d'Ivoire, the world's top producer of cocoa. Fertilizer prices remained firm.

Looking forward, the prices of non-energy commodities, though stabilizing, are likely to remain relatively high in 2005 as demand from developing Asia, and the PRC in particular, appears to have shifted the demand/supply dynamics in commodities markets in a fundamental way. Despite a moderation of cyclical demand later this year, non-energy commodity prices are estimated to increase by about 5–6% in December 2004 from December 2003.

Financial Market Developments

Around midyear, global financial markets had generally cooled, as the strong expansion in the world economy softened in the second quarter of 2004. The bullish runs in equity prices since the latter half of 2003 paused in July and August to reassess the strength of the global recovery. Bond yields, which edged higher in April and May on anticipation of a phased monetary tightening, fell back in July and August.

Despite healthy earnings in major industrial countries in the second quarter, concerns about growth prospects over the medium term, together with high oil prices, depressed equity prices around the globe (Figure 1.8). A moderation

Figure 1.8 Major Stock Market Price Indexes, 2004

Source: Datastream, downloaded 16 September 2004.

in global ICT industry earnings further led to a weakening of markets in July and August. Finally, reflecting less certainty in a strong growth outlook, long-term government bond yields in the US and EU have come down. Yield curves have generally flattened.

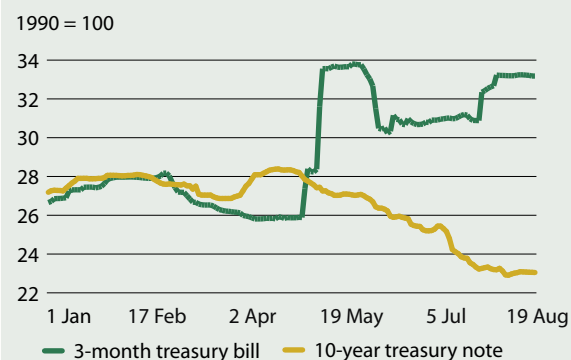
While policy rates around the world are still very low, central banks in major industrial countries have increasingly weighed the risk of inflated asset prices and high oil prices in deciding monetary policy. During the first half of 2004, surging oil prices put upward pressure on overall consumer price levels in major industrial countries except Japan, though core inflation has remained relatively subdued. At the same time, the strength of the world economy in general and the US economy in particular made the case for a tightening of monetary policy more compelling.

The Federal Reserve raised the target Federal Funds rate in June, August, and September, each time by 25 basis points, to 1.75%. (The central banks of Australia and the UK had raised rates earlier.) On the assumption of no sharp acceleration in inflation, the Federal Reserve is expected to continue raising its policy rate at a “measured” pace over the forecast period with the rate projected to reach 3.5–4.0% by end-2005. This is slightly higher than the baseline rate in *ADO 2004*. Based on the gradual increases at least until the first half of 2004, the 6-month London interbank offered rate is projected to reach 3.0% by June 2005, while, after more than 15 months of keeping the target rate at 2.0%, ECB is now also

likely to raise its policy rate in the near term as inflation in the euro zone reached 2.3% in July and as a stronger recovery takes hold there. The December futures for 3-month Euribor, priced at a discount rate of 2.3% as of 9 September, also point to a rate rise in early 2005. The Bank of Japan is struggling with deflation, which makes it unlikely that the zero-interest rate policy will change soon. As private consumption is yet to prove self-sustainable, the Bank of Japan will certainly wait until domestic demand pressures have a visible impact on inflation.

Although financial markets had expected a rein-in of very expansionary monetary policy for some time, uncertainties surrounding the turn of the monetary cycle nonetheless fueled financial volatility in April and May. Volatility for 3-month US treasury bills surged and remains high, reflecting unsettled issues on the outlook for the US economy and its impact on further interest rate increases (Figure 1.9). On the other hand, the volatility of 10-year US treasury notes has steadily decreased, indicating well-anchored inflationary expectations based on modest economic growth and the Federal Reserve’s clear intention to curb future inflationary pressures.

The impact of a US interest rate rise was felt more severely in emerging financial markets. Exceptionally low interest rates in support of the global recovery in 2003 heightened institutional investors’ risk appetite and led them to take on more leverage and venture into riskier assets. Emerging markets, particularly Asian equity and fixed-income markets, benefited from these speculative inflows throughout much of 2003

Figure 1.9 Volatility of US Treasury Securities, 2004

Source: Bloomberg L.P., downloaded 23 August 2004.

until mid-March 2004. As a result, equity prices bounced back from their lows and sovereign bond credit spreads narrowed sharply in the latter half of 2003 through March 2004. Against this backdrop, the prospect of rising short-term interest rates, together with the emergence of more attractive safe assets in mature markets, triggered a broad unwinding of speculative positions in emerging financial markets. A heavy sell-off of emerging market assets during April and May resulted, sharply lowering equity prices and widening credit spreads across Asia. Higher oil prices and the prospect of a slowdown in the PRC further weighed on investor confidence in Asia: equity market indexes across Asia fell in the second quarter (Table 1.3). Asian bond prices in general retreated from the rally seen in the second half of 2003, leading their credit spreads to widen more than those of high-yield corporate debt in mature markets (Figure 1.10).

New offerings from Asian issuers, which surged in the first quarter of 2004 to take advantage of favorable funding conditions prior to the rate increases, continued in the second quarter. Major issuers of emerging market sovereign bonds, including the PRC and Korea, also frontloaded their funding programs for the year. Overall the prospects for capital flows to

Figure 1.10 Sovereign Risk Spreads of Emerging Asian Markets and High-Yield Corporate Spreads, January 2003–August 2004



Notes: Sovereign risk spreads are yield spreads of sovereign bonds over US treasury bonds. High-yield corporate spreads are Merrill Lynch high-yield corporate bonds over US treasury bonds. Emerging Asia consists of PRC, Korea, Malaysia, Pakistan, Philippines, and Thailand.

Source: Datastream, downloaded 16 September 2004.

Table 1.3 Percentage Change in Stock Market Prices (from end of previous period)

	2003	March 2004	June 2004	July 2004	August 2004
PRC					
Shanghai A Shares	10.6	16.4	-19.6	-1.0	-3.2
Shenzhen A Shares	-4.0	21.6	-22.9	-0.7	-5.1
Hong Kong, China					
Hang Seng	34.9	0.8	-3.1	-0.4	5.0
Hang Seng China Enterprises	152.2	-4.8	-10.2	1.0	-1.0
India					
BSE 30 Sensitive	72.9	-4.3	-14.2	7.8	0.4
Indonesia					
Jakarta Composite	62.8	6.3	-0.4	3.4	-0.3
Korea					
KOSPI	29.2	8.6	-10.8	-6.4	9.3
Malaysia					
KLSE Composite	22.8	13.6	-9.1	1.7	-0.7
Pakistan					
KSE 100	65.5	14.2	3.4	0.2	1.1
Philippines					
PSE Composite	41.6	-1.3	10.9	0.3	-0.3
Singapore					
Straits Times	31.6	5.3	-1.1	2.9	1.4
Taipei, China					
TWSE	32.3	10.7	-10.5	-7.2	6.4
Thailand					
SET	116.6	-16.2	-0.1	-1.5	-1.9
Memorandum Items					
Dow Jones Industrial Average	25.3	-0.9	0.8	-2.8	0.3
Nasdaq Composite	50.0	-0.5	2.7	-7.8	-2.6
NYSE Composite	28.8	2.5	0.1	-3.0	0.8
Nikkei 300	23.0	11.5	0.4	-3.7	-1.0
Nikkei 225 Stock Average	24.5	9.7	1.2	-4.5	-2.2

Source: Datastream, downloaded 15 September 2004.

the Asia-Pacific region remain positive over the forecast period as economic growth in the region is expected to be robust.

Since midyear, emerging markets have been on the rebound. In contrast to weakening sentiment in mature markets, growth fundamentals in emerging Asian markets remain strong, providing support for higher equity and bond prices. Equity prices recovered some of the losses and emerging market spreads narrowed in July and August 2004. Capital flows resumed, in the form of syndicated loans and portfolio investment. Despite the large twin deficits in the US, the dollar's depreciation against other

major currencies and Asian currencies came to a halt in the first quarter of 2004 and started to reverse slowly in the second. The unwinding of speculative positions in riskier assets appeared to favor the US currency, as institutional investors and hedge funds reduced their emerging market positions, switching back into dollar assets. Historical evidence also shows that higher oil prices tend to accompany a stronger US dollar, mainly due to increased demand for dollar-denominated assets by oil-exporting countries.

The relative strength of the US dollar will likely be sustained, at least in the short term, as uncertainties surrounding oil price developments continue. However, downside risks to the dollar remain significant in the medium and longer term, mainly due to the large macroeconomic imbalances in the US. Large US current account deficits require substantial capital inflows to be sustained, and these inflows have increasingly been supplied by Asian central banks, appearing as large increases in their official reserves. A faltering of the US recovery could significantly change investor sentiment toward US assets. A reversal of capital flows away from the US, though more of a medium-term risk, could trigger a steep slide in the dollar, as well as a sharp rise in long-term bond yields.

Developing Asia: Subregional Trends and Prospects

East Asia

East Asian economies posted strong growth averaging 8.4% in the first half of 2004, helping lift the overall growth rate for developing Asia. The surge in exports in the second half of 2003 continued into 2004, and was joined by a strong pickup in domestic demand in most of the economies. Despite macroeconomic tightening in the PRC, its GDP expanded by 9.6% in the first half, slowing by just 0.2 percentage points between the first and second quarters. The economies of Hong Kong, China and Taipei, China also prospered, with GDP growth of 9.5% and 7.2%, respectively.

Higher levels of investment have been a major driver of growth in the PRC; Hong Kong, China; and Taipei, China. In the PRC, investment growth slowed in the second quarter, but was still high at 22.3%. Private investment surged

in Hong Kong, China and Taipei, China, fueled by strong exports, increased corporate profits, rising capacity utilization, and low interest rates. Consumption growth in the PRC strengthened as a result of rising urban and rural incomes. In Hong Kong, China and Taipei, China, too, private consumption rose after several sluggish years, spurred by the recoveries in labor and property markets.

Merchandise exports from the subregion, particularly of IT products, are forecast to rise by about 20% in nominal US dollar terms over all of 2004, or 7 percentage points faster than projected in *ADO 2004*. Merchandise imports also are much stronger than expected because of higher oil prices, stronger consumer demand, and East Asia's hunger for industrial inputs to its export sectors. Import growth for the full year will be around 23%, also 7 percentage points above the earlier projection. The contribution of net exports to GDP growth has declined in the PRC; Hong Kong, China; and Taipei, China, as growth in imports outpaces that in exports. At the same time, the contribution of domestic demand to GDP growth has increased in all three economies. The subregion's current account surplus will fall to 2.3% of GDP, half the level recorded in 2003. Korea's experience is less encouraging. Its exports are buoyant but domestic demand remains weak. Private consumption is constrained by a heavy household debt burden. Its gross fixed capital formation increased only moderately in the first half of 2004. As a result, Korea's GDP grew by 5.4% in the 6 months, well below the pace of the other three economies.

Strong domestic demand and high oil prices revived inflation in the PRC and Taipei, China. Price deflation concerns faded during the first half in Hong Kong, China, and year-on-year inflation was recorded in July for the first time since late 1998. Korea's inflation rate picked up because of higher oil prices and wage pressures, despite its weak domestic demand. The projection for average inflation for the subregion is raised to a still moderate 3.0% for 2004.

In view of improved economic performance, most East Asian governments cut back on fiscal and monetary stimuli. The PRC Government used monetary, fiscal, and administrative measures to slow investment in sectors that it considered

overheated. In order to achieve more balanced growth and to avoid a hard landing, the PRC Government also adopted measures to lift growth in lagging sectors as well as in poorer provinces. The authorities in Hong Kong, China pledged to rein in the deficit in the medium term and are considering a broad-based goods and services tax as a way to stabilize revenues. In Taipei, China, a Ministry of Finance tax reform committee proposed increasing the value-added tax, and a new pension reform package was passed to address fiscal and social security issues. In Korea, on the other hand, fiscal and monetary policies have remained expansionary in an effort to bolster domestic demand. The Bank of Korea lowered its policy interest rate, while the Government introduced a supplementary budget and is considering a further fiscal package.

For all of 2004, aggregate GDP growth in East Asia now is forecast at 7.3%, nearly half a percentage point higher than in *ADO 2004*. Going into 2005, growth is projected at 6.4%, with downward revisions for the PRC and Korea. That puts next year's expected subregional growth about 1 percentage point below this year's.

Export growth in 2005 will slow from 2004's rapid pace, but will remain robust at about 13%. Similarly, the burst in imports will decelerate. The subregion's current account surplus will shrink further to 1.4% of GDP. Domestic demand is expected to remain strong in most of the economies. In the PRC, investment growth is slowing, though the large amount of construction approved or ongoing means that growth in investment will remain high. Consumption growth will be robust thanks to increased household incomes. GDP is forecast to rise by 8.8% in 2004, up from the *ADO 2004* figure of 8.3%, while growth in 2005 has been revised down slightly to 8.0% from 8.2%.

Investment spending in Hong Kong, China and Taipei, China is expected to remain robust, while consumption will be strong on the back of the continuing recovery of the labor and property markets. GDP growth for Hong Kong, China is revised up to 7.5% in 2004 and 6.0% in 2005, from 6.0% and 5.0% in *ADO 2004*. For Taipei, China, forecast growth is raised to 6.0% in 2004 and 4.8% in 2005, from the 5.4% and 4.7% in *ADO 2004*. Exports from all three economies

are likely to expand briskly, although import growth will surpass that of exports.

In Korea, a sluggish recovery in domestic demand and moderation of export growth have led to a downward revision in growth forecasts to 4.4% in 2004 and 3.6% in 2005, compared with the *ADO 2004* forecasts of 4.8% and 5.2%. Thus, expansionary macroeconomic policies are likely to continue in Korea, as will the effort to reduce the household debt problem. Policy makers should also refocus on reforms to promote economic efficiency and productivity, through greater flexibility in the labor market, a healthier credit culture, and improved governance in the corporate sector.

Macroeconomic policies will remain broadly neutral in the PRC; Hong Kong, China; and Taipei, China in the short term, although central bankers will be watching the return of inflation. In the subregion, inflation is expected to rise, averaging 3.8% in 2005, with this figure heavily influenced by a 2 percentage point increase in the projection for the PRC's price levels. So far, the central bank in the PRC has avoided using higher interest rates as a way to stem investment, though interest rates may well be raised if inflation exceeds 5% for an extended period.

Southeast Asia

The rebound of economic growth in Southeast Asia was impressive in the first half of 2004. The subregion's GDP growth for 2004 is now estimated to reach 6.2%, half a percentage point higher than in *ADO 2004*, and up from about 4.5% growth over the past 2 years. The economies of Malaysia and Singapore performed well above expectations while those of Thailand and Viet Nam continued to show healthy growth. In Indonesia, the largest economy in Southeast Asia, and the Philippines, growth in 2004 has also been improving, though at a more moderate pace.

A combination of domestic and external factors contributed to the better than projected performance of most Southeast Asian economies during the first 3 quarters of 2004. The same combination is expected to continue to drive growth for the rest of 2004 and well into 2005. First, with robust growth in most industrial countries, continued strong demand from the PRC, and the brisk revival of the electronics industry, exports from Southeast Asian countries

expanded substantially faster than forecast in *ADO 2004*. In nominal US dollar terms, exports are expected to jump by nearly 14% for the subregion, about 4 percentage points above the *ADO 2004* forecast. With the notable exception of Indonesia, exports grew well into double digits in most countries in the first half of 2004. Indonesia's net oil and gas exports declined by 26% in the first half, mainly due to declining production. Both agricultural and manufactured exports from Southeast Asia grew rapidly.

While net exports were a significant contributor to overall GDP growth in Indonesia, Malaysia, Singapore, and Thailand in 2003, data for the first 2 quarters of 2004 mostly show that net exports have subtracted from GDP growth in all countries except the Philippines. Indeed, strong domestic and external demand as well as the impact of higher oil prices led also to a sharp double-digit increase in imports in Southeast Asia. In the Philippines however, imports will expand moderately in 2004.

For the subregion, total imports in US dollar terms are forecast to rise by 16.8% in 2004, about 5 percentage points higher than projected in *ADO 2004*. With imports rising much faster than expected, the subregion's current account surplus will shrink to 7.2% of GDP, about 1 percentage point below the *ADO 2004* projections. For Malaysia, Singapore, and Thailand, the surplus remains substantial, while Cambodia is forecast to run a current account deficit of about 10% of GDP, about the same as in 2003.

Second, compared with the analysis in *ADO 2004*, a major emerging new feature of the economic developments in Southeast Asia during the first half of 2004 was, for the first time since the Asian financial crisis, a marked revival of business investment in most countries. Investment growth is projected to remain strong over the rest of 2004. Higher capacity utilization, good progress in the resolution of nonperforming loans, low interest rates, and a revival in construction have led a significant pickup in business investment in many countries. In Indonesia, Malaysia, Philippines, and Singapore, total investment contributed positively and substantially to growth after several quarters of negative contributions. In Malaysia, investment contributed 3.9 and 5.1 percentage points to GDP growth in the first and second

quarters, respectively. In Singapore, the contribution was 8.4 and 5.1 percentage points, respectively, after a negative contribution throughout 2003. In Thailand, capacity utilization surpassed precrisis levels for automobiles, electrical appliances, electronics, and steel. In Indonesia and the Philippines, investment recovered also but to a lesser extent. In both countries, there was a pickup in construction investment, but in the Philippines, investment in durables also rose. Complementing the strong performance of private consumption expenditures over the past few years, the revival of private business investment growth in Southeast Asia was a long-awaited and welcome development. It augurs well for longer-term subregional growth.

Sustained demand, combined with higher oil prices, nudged up inflation throughout Southeast Asia, with average inflation now projected at 4.2% for 2004, about half a percentage point higher than projected in *ADO 2004*. Inflation thus remains quite moderate in the subregion, particularly in Malaysia, Singapore, and Thailand. Monetary policies are thus projected to remain accommodative over the year, although as was the case in Thailand, some interest rate increases to align with those in the US will occur.

While a more positive growth environment could have led to some fiscal consolidation, this has not occurred so far. Fiscal deficits as a share of GDP are low in Indonesia and Thailand. Although it has a small and shrinking fiscal operating deficit, the overall budget of Singapore has a surplus of about 3.6% of GDP. However in other Southeast Asian countries, the deficits have been sizable for many years, in particular in Cambodia, Lao People's Democratic Republic (Lao PDR), Malaysia, Philippines, and Viet Nam. Public debt has also been accumulating. Policies to improve fiscal balances will need to be put in place and will affect the short- and medium-term outlook for Southeast Asia.

Projections for the subregion in 2005 indicate another year of robust growth, albeit at a slightly lower rate than in 2004. GDP is forecast to expand by 5.7%, with the fastest growth in Lao PDR, Malaysia, Thailand, and Viet Nam. Following elections in 2004, a return of confidence in the economy will also lift Indonesia's GDP growth to the highest level for at least 5 years, while growth

is projected to be higher than forecast in *ADO 2004* for the Philippines. Singapore's economy should return to more sustainable trend growth.

In line with the baseline assumption of lower world economic growth and a further slowdown in the PRC, exports will rise at a more moderate rate of about 8.5%. With domestic demand projected to remain strong, imports will continue to rise somewhat faster and as a result the subregion's current account surplus will shrink further to a still comfortable 6.6% of GDP.

The major contribution to sustained growth in the subregion will come from domestic demand, both consumption and investment. Strong consumer sentiment will support further increases in private consumption spending. At the same time, the current improvements in investor sentiment are expected to continue underpinning robust growth in fixed investment over 2005.

A marked increase in capacity utilization in 2005, a more stable political environment in several Southeast Asian countries following peaceful elections in 2004 (notably Indonesia and the Philippines), as well as some improvement in the investment climate will spur business investment in 2005. In spite of relatively high oil prices, inflation is not forecast to accelerate significantly in 2005, and, as a result, monetary policies will remain generally neutral. Some fiscal consolidation will be effected notably in the Philippines and Malaysia, but this would have only a small impact on the outlook for 2005.

South Asia

A return of favorable weather in 2003 in South Asia led to a remarkable agricultural recovery and a surge in GDP growth to 7.6%. *ADO 2004* projected more moderate but still high growth for the subregion at 7.0% in 2004 and 7.2% in 2005. These forecasts are now revised downward to 6.4% in 2004 and 5.9% in 2005. Less favorable weather conditions in 2004, price pressures (mainly in oil and metals), and a less buoyant outlook for global growth in 2005 are the main factors underlying the downward adjustments. In addition, inflation in the subregion has been repegged at somewhat higher rates—at 5.5% in 2004 and 6.5% in 2005. Estimates for the balance-of-payments outlook continue to show strength with trade expanding at double-digit rates in most countries. South Asia

as a whole is expected to continue to record a current account surplus.

In India (accounting for about four fifths of the subregion's GDP), developments through August suggest that a weak and erratic monsoon will lower agriculture sector growth not only to below that of the sharp rebound expansion in FY2003 (ended 31 March 2004) but also below its trend rate of growth. This would markedly lower growth in personal income and consumption from the robust expansion in that year. Moreover, wholesale price index (WPI) inflation accelerated sharply to just over 8% by end-August, largely reflecting rising prices of oil, iron and steel, and coal. To temper price pressures, the Government responded in August by cutting excise and import duties on selected commodities and fuels. Subsequently, in September the Reserve Bank of India, which had intended to continue an accommodative monetary policy for FY2004, announced an increase in the reserve requirement ratio to 5%, effective 2 October, an action that will likely raise interest rates, limit bank lending, and restrain growth.

Taking these developments into account, FY2004 estimated agricultural growth in India has been downgraded to 2% while expansion in industry and services has been reduced to 7.8%, to yield revised GDP growth of 6.5%. For FY2005, GDP growth of 6.0% is now expected. This projection is based on a normal monsoon but a slowing expansion in industry and services, reflecting expected developments in the Indian business cycle. For FY2004, average WPI inflation is estimated at 5.7% and is projected to rise to 6.8% in FY2005 due to a full pass-through of the previous year's price increases.

The new United Progressive Alliance Government that took office in May has announced its National Common Minimum Program that emphasizes economic reform with a "human face." The main goals include generating employment and stimulating pro-poor growth, increasing rural credit and social spending, and stepping up investment in physical infrastructure. The (full-year) federal government budget for FY2004 released in July 2004 sought to implement some of these goals while reducing the revenue and overall budget deficits. Nevertheless, weaknesses in state government finances are expected

to keep the consolidated government budget deficit at about 10% of GDP. Comprehensive steps toward much-needed fiscal deficit reduction are expected to be taken in FY2005.

In Bangladesh, GDP growth is estimated at 5.5% for FY2004 (ended 30 June 2004), driven by steady growth in export-oriented industrial production and the services sector. Macroeconomic policies kept to a cautious tack; inflation that had been on the rise during the year was checked and held to 5.6%. Export growth rebounded sharply (15.9%) and, while imports also rose, growth in worker remittances and official transfers kept the current account in surplus. Policy reforms adopted with the FY2005 budget included the following: measures to expand income tax and value-added tax coverage; rationalization of customs duties to moderate tariff protection and promote efficiency of domestic industry; and adjustment of interest rates on National Savings Certificates to foster greater flexibility and market orientation.

The outlook for Bangladesh GDP growth in FY2005 has been revised downward to 4.8% (from 6.0% in *ADO 2004*) due to the devastating floods in July and August that severely damaged agricultural activities, infrastructure, and industry. Inflation is now projected to be 6.0% while the current account balance is likely to be pushed to a deficit of 1.5% of GDP as a result of the calamity. Macroeconomic management will be challenged, especially if recovery in food and other production takes an extended time. Since Bangladesh relies heavily on Multifibre Arrangement (MFA) quota-restrained markets, the abolition of quotas at year-end seriously threatens to undermine the country's textile and garment exports (75% of total exports) and consequently employment levels. This is because effective competition by the industry in the global market is hobbled by low productivity, inadequate infrastructure, and policy constraints.

Nepal's economy grew by only 3.6% in FY2004 (ended 15 July 2004), mainly due to the breakdown of the cease-fire with the insurgents in August 2003. Industry underperformed, expanding by only 1.8% with minimal growth in construction. Agricultural output strengthened, with paddy production up 7.8%, while some improvement in tourism lifted the services sector.

The continued insurgency hit government activity, causing a 16% shortfall in development expenditures. An ongoing deterioration in the investment climate was reflected in weak growth in credit to the private sector and a fall in interest rates for the second consecutive year.

A new prime minister, appointed in June, has formed a coalition Government that enjoys support from some political parties, despite the fact that Nepal's Parliament remains suspended. The FY2005 budget announced in July aims to implement the Government's poverty reduction strategy and to raise expenditure allocations to local-level, community-led projects as part of its effort to boost development expenditures and reform. Apart from this stimulus, monetary policy is to be accommodative so as to support a stronger economic expansion. Assuming no substantial deterioration in the security situation, GDP is forecast to grow by 3.7% in FY2005, underpinned by a favorable monsoon, and by some pickup in construction and manufacturing.

Pakistan's economic reforms of the past 4 years have made a major contribution to a stronger economy. GDP growth accelerated to 6.4% in FY2004 (ended 30 June 2004), with manufacturing accounting for half of the expansion. The current account of the balance of payments remained in surplus for the fourth straight year, though at a lower level. With macroeconomic reforms and policies on a sound footing, the FY2005 budget and the trade policy continued the structural adjustment process and moved on to "second generation reforms." Measures were taken to accelerate growth in agriculture, industry, housing and construction, and business activities—and to further improve tax administration. The measures largely involved tax and tariff rate cuts and new financial incentives, but also included steps to reduce the harassment of business by government regulators.

With private investment in Pakistan picking up and a sizable increase in the public sector development program, GDP is estimated to grow by 6.5% in FY2005, up from 5.8% projected in *ADO 2004*. Notwithstanding an expected gradual tightening of monetary policy that will raise interest rates, inflation is now estimated at 5.5% for the year, reflecting a buildup in domestic liquidity in recent years and the fact

that industries are approaching full capacity utilization. Rapid economic growth and continued high oil prices will widen the trade deficit, and the current account is now expected to switch to a deficit of about 1.3% of GDP in FY2005. Over the longer term, restructuring and modernization of the textile and garment industries have helped prepare the country to be competitive in the post-MFA quota era.

Central Asian Republics

In the six Central Asian republics (CARs), developments through midyear confirm that 2004 will be a year of continued rapid growth, as projected in *ADO 2004*. Economic performance remains driven by large investments in the oil and gas sector as well as by higher oil prices and gas sales in some countries. Additionally, higher prices for non-oil export commodities, especially for cotton and for gold and other metals, have, to varying degrees, boosted economic expansion in all countries in the subregion.

Economic growth for 2004 in the CARs as a whole is now estimated to be 7.9%, marginally lower than in *ADO 2004* with all countries but one expected to meet or exceed the original growth forecast. In summary: growth fueled by the oil and gas sector has supported rapid GDP expansion in Azerbaijan (10.0%), Kazakhstan (9.5%), and Turkmenistan (10.0%) while export commodity-led growth prevails in the Kyrgyz Republic (4.5%), Tajikistan (8.5%), and Uzbekistan (3.0%). The Kyrgyz Republic and Tajikistan are implementing poverty reduction growth strategies supported by international financial institutions and other aid partners. Despite achieving current account convertibility in 2003, economic growth in Uzbekistan remained low and well below potential as implementation of its policies for market-based structural reforms has been slow. Prospects may be enhanced following announcements that, over the next 5 years, the PRC and the Russian Federation aim to invest a combined total of about \$3 billion in Uzbekistan in various sectors, which could be the catalyst for a growth breakthrough.

Most countries have experienced a modest uptick in inflation from 2003 actual and *ADO 2004*-projected levels, mainly because of robust expansion in investment and consumer demand. Nevertheless, the revised estimate for subregional

average inflation in 2004 remains moderate at 6.4%, with individual country performance narrowly bunched around this average. This average is somewhat lower than the *ADO 2004* projection largely because inflation in Uzbekistan is now estimated at about 10%, well below the earlier projection, though inflationary imbalances there are still to be unwound. Growth in employment continues to be limited, in some countries by the capital-intensive nature of oil and gas sector-led development and in all countries by difficulties in achieving structural adjustments necessary to achieve broad-based rapid growth.

With higher than expected oil and commodity prices so far in 2004, export earnings in the CARs have expanded more rapidly than projected in *ADO 2004*. Increased earnings, however, have been offset by higher imports and larger net deficits on invisibles, especially larger oil sector payments for services, outflows of repatriated profits, and foreign labor remittances.

For the subregion, the current account deficit for 2004 is now estimated at 3.9% of GDP, slightly above the *ADO 2004* projection. Current account deficits are covered by foreign direct investment in Azerbaijan and Kazakhstan where large oil and gas development projects are under way, and by development aid and other capital flows in the other CARs. Azerbaijan's current account deficit in 2004, estimated at about 35% of GDP, is an extreme outlier among the CARs, reflecting heavy expenditure on four major oil and gas projects near completion in a relatively small economy.

The outlook projected for the CARs in 2005 is for a continuation of rapid GDP growth of about 8%. The pace of growth in individual countries is expected to be largely similar to that estimated for 2004, though in the Kyrgyz Republic and Tajikistan a modest improvement over the *ADO 2004* forecast is now expected as structural reform takes hold. Both these countries face intrinsically difficult economic circumstances and weak resource bases.

Governments are likely to maintain their generally cautious monetary and fiscal policies, and inflation is expected to moderate to an average of 6.4% for the subregion with essentially all countries improving on the 2004 projected outcome. Despite moderation in oil and commodity prices and slower growth in exports

and imports, the current account deficit for the subregion is forecast to be about 2% of GDP in 2005, about half the 2004 projected outcome. This mainly reflects some moderation in oil and gas sector investment activity.

A major issue facing the CARs is to diversify from their heavy dependence on oil and gas or a few non-oil sector commodities. Further structural reform and a broadened economic base will be necessary to maintain the sustainable, high growth necessary to generate the needed employment opportunities and reduce poverty.

Risks to the Outlook for Developing Asia

ADO 2004 identified various risks to the economic outlook, including global and regional economic risks, as well as terrorist outrages. In addition, the threat of various epidemics, most recently avian flu, appears to have become a recurrent concern. In short, the risks analyzed in *ADO 2004* are still relevant in September 2004, with perhaps, some adjustments required to the likelihood and dates of the economic risks occurring.

Global Economic Risks

At the time of writing *ADO 2004*, the quality and breadth of the recovery in industrial countries remained unclear, mainly due to weak employment generation, the prospects of rising inflation (associated with upward movements in oil and commodity prices), and the uncertainty of the timing and impact of the projected rise in interest rates from historically low levels. Over the medium to longer term, the ballooning US fiscal and current account deficits were seen as exacerbating the risks to the world recovery.

By the third quarter of 2004, growth in industrial countries—the US and Japan in particular, but also increasingly in the EU—has gained momentum and remains quite solid, while in developing Asia, growth is healthier than forecast earlier in the year.

In spite of higher oil prices for most of 2004, core inflation in major industrial countries remains little affected and, as a result, inflationary pressures are generally subdued. Although employment generation has been much softer than usual in this cyclical recovery in the US, the apparent strength of the growth momentum has

persuaded the Federal Reserve to start raising interest rates earlier than previously expected. Despite this, and contrary to the fears expressed in *ADO 2004*, no significant disruptions have occurred in financial markets. Although policy rates in all industrial countries are still extremely low, the cycle of progressive monetary tightening will continue and will likely accelerate at least in the US in 2005, especially if inflation picks up. Similarly, ECB could raise rates earlier than previously expected. With major industrial countries forecast to continue growing above trend over the rest of 2004 and the first half of 2005, an acceleration of monetary tightening will depend significantly on changes in inflation rates.

The impact of high oil prices, possibly sustained well into 2005, needs to be evaluated. Faster oil-induced inflation would require a sharper tightening of monetary policy in major industrial countries. The danger inherent in such tightening is partly that it could affect a recovery still rather uncertain in its self-sustainability. The outcome for the world economy, and industrial countries in particular, would then depend on a continued domestic consumption recovery and strengthening of business investment. The risks of a faster deceleration in growth in major industrial countries in the latter part of 2005 remain a distinct possibility.

The huge macroeconomic imbalances in the world economy—mainly the twin US deficits but also imbalances in Japan and the EU—have been left unresolved during the 2003–2004 recovery cycle. As 2005 advances and in 2006, these imbalances that are characterizing the current recovery cycle could start dragging down world growth, due both to sharply higher interest rates and to a substantial depreciation of the dollar. They could impact on growth as renewed inflationary pressures, stemming from sustained high oil prices, trigger policy tightening. Moreover, an extended period of slow growth in output and employment, especially if accompanied by inflationary pressures, would risk a rise in trade protectionism that would throttle what has been a main impetus to global expansion. Taken together, these elements hold significant risks for the world economy over the medium term.

As noted in *ADO 2004*, it will be important for developing Asia to evaluate the impact of

these possible negative outcomes, since they could well spell a return to a period of stagflation in the second half of the decade. Domestic policy adjustment and reforms need to be carried out now while growth is robust. One policy shift to consider is to increase domestic consumption demand in supporting growth in the context of making economies more open. As the experience in some countries of the region has shown in recent years, this requires a continuation of economic reforms, particularly in the financial sector.

Regional Risks

ADO 2004 identified a set of risks specific to the region. All are still in place. However, many of these risks also represent opportunities, such as the surge in intraregional trade, the increasing importance of domestic consumption demand as a driver of growth, and the accumulation of large amounts of foreign reserves by many Asian governments.

Intraregional trade dynamism continued as a major feature of the outlook in the first 3 quarters of 2004. It is likely to remain so over the forecast period under the current baseline projection that the PRC economy will achieve a soft landing. While the PRC is projected to expand robustly at least in 2004, a steeper slowdown in 2005 is possible. Investment is still growing fast in many sectors, and at the same time inflation has been rising substantially to about the central bank's intervention point of around 5%. A greater tightening of policy, including monetary policy, might be needed in late 2004 or 2005. However, an interest rate rise and a deterioration of the growth environment could lead again to a substantial surge in nonperforming loans, possibly affecting the medium-term economic outlook.

As discussed in Part 3, a slowdown in the PRC's growth rate by 2 percentage points would cut GDP growth in East and Southeast Asia by about 0.2–0.5 percentage points. Hong Kong, China would feel the impact more, at close to 1 percentage point. However, combined with a simultaneous slowdown in the US and Japan, the impact on East and Southeast Asia would be in the range of 0.5–1.0 percentage points (again, except Hong Kong, China where the impact could be about 1.4 percentage points). These possible scenarios highlight the need for many governments

in developing Asia to consider medium-term policies aimed at expanding the role of domestic consumption demand in sustaining growth.

However, the experience of Korea over the past 2 years shows that weaknesses in some areas of financial sector regulation and supervision can easily result in a sharp increase in household debt, and, possibly, in a consumer debt crisis. The Bank of Thailand, for instance, in 2004 tightened its credit card regulations in seeking to preclude a Korean-type crisis. As mentioned in *ADO 2004*, the importance of deepening financial sector reforms, including the development of nonbanking financial institutions in developing Asia, is highlighted. In an environment of rising international interest rates—even if rates remain low in a historical perspective—and mounting household debt in some countries, the urgency to accelerate such reforms is evident.

Looking at possible scenarios for the world economy over the medium term, many regional governments should use the current opportunity of robust economic growth projected in 2004–2005 to undertake reforms to consolidate their fiscal situation and reduce public sector indebtedness. Following the 2001 world recession, many Asian countries have indeed pursued expansionary fiscal policies to support economic growth. Outside these countries, mainly in South Asia, the Pacific, as well as the Philippines, large budget deficits have been common for many years. As a result, public debt-to-GDP ratios have been rising and have reached worrisome levels in several countries. As interest rates rise and economic growth slows over the medium term, the public sector's debt-servicing burdens will increase, leaving little room for possible fiscal support. Also, if robust growth is to be maintained in the region, business investment needs to expand substantially over the next few years. However, in a higher interest rate context, large fiscal deficits will crowd out private investment.

ADO 2004 also warned of the need to translate growth into employment generation and to address widening income inequalities. Developments in the first half of 2004 have confirmed the need to address these concerns, and, in many countries of the region, they are rapidly becoming a priority in public policy. In several countries, the robust growth rates observed during the first half

of 2004 did not generate sufficient employment for the expanding labor force. Significantly, in the many elections that have taken place so far in the region in 2004, employment and income inequality issues were major election themes that had a strong bearing on the election results.

Finally, in recent years, and increasingly so, outbreaks of various epidemics have become an integral part of regional risks. As the outbreak of the SARS epidemic in 2003 showed, if such epidemics are not detected early and dealt with promptly and openly at a regional level, they can cause considerable damage to regional economies. Had the SARS virus been more contagious, its economic impact would have been dire. Earlier in 2004, a widespread regional outbreak of avian flu also decimated the poultry industry in the region. The recent occurrence of new avian flu cases in several countries and subsequent reports that the H5N1 virus was found in pigs have further heightened concerns about diseases that may jump from one species to another, their possible impact on human health, and their potential economic consequences.

The impact of an avian flu outbreak obviously depends on the scale, duration, and spread of the disease. The macroeconomic impact will be limited if the outbreak is confined to poultry as this industry accounts for below 2% of GDP in most economies. Model simulations show that, among the countries concerned, Thailand will be the most hurt as poultry is an important export sector. But even with a half-year ban on poultry exports, the impact on Thailand's GDP would be in the order of 0.5 percentage points, and the impact on other Asian economies minimal, in this model. Despite the relatively low macroeconomic impact, some particular segments of society would be severely affected though. Until any effective vaccination or other control method becomes available, mass culling of poultry will remain the major means of controlling the disease, which will hit farming incomes and rural consumption hard in areas where poultry farming is concentrated. Government compensation packages will be necessary both to offset the income loss to farmers and to encourage early reporting.

Clearly, such measures will put pressure on government budget positions in the short term. One element cannot be calculated at the moment

and that is the effect of the virus mutating and becoming transmissible among humans. The health, economic, and social impacts would be extremely severe as flu viruses are much more contagious, and possibly more lethal, than the virus responsible for SARS. A pandemic could then occur. Enhanced regional cooperation and openness in dealing with possible large-scale epidemics, and significant improvements in regional and national early warning systems and preparedness plans, would then be of paramount importance to contain these multiple impacts.

In conclusion, the risks are not negligible. However, the underlying strong regional growth momentum could also create tremendous opportunities if it can be channeled into improving regional competitiveness. To this end, with regard to their long-term growth strategy, regional governments should focus on enhancing resilience to external shocks and on fostering domestic growth for greater sustainability. The following considerations are germane in this respect.

First, broadening intraregional trade has enabled the regional dynamics to allow more efficient resource allocation, thus helping developing Asia's economies achieve more balanced growth. Second, the emergence of strong regional domestic demand could provide extra resilience to adverse shocks from the rest of the world. Third, developing Asia's economies should continue structural reforms to foster the investment climate through improving competitiveness and productivity. These reforms include the successful implementation of ongoing financial sector transformations—strengthening bank balance sheets, broadening financial markets, establishing a sound credit culture, and enhancing governance—and they remain key to promoting domestic investment and attracting foreign investment. These structural reforms remain particularly important, as sustained progress in economic reforms would ensure resilient and balanced growth in developing Asia to counterbalance an adverse external environment. Fourth, the high oil prices that are likely to persist, largely as a result of rising global demand, make it imperative for developing Asia's economies to significantly improve their energy efficiency levels. Indeed, their continued competitiveness may ultimately hinge on this.

ASIAN DEVELOPMENT
Outlook
2004
Update

Part 2 Economic Trends and Prospects in Developing Asia



ASIAN DEVELOPMENT
Outlook
2004
Update

Economic Trends and Prospects in Developing Asia
East Asia





People's Republic of China

Economic Assessment

Growth in gross domestic product (GDP) slowed to 9.6% in the second quarter of 2004 from 9.8% in the first and 9.9% in the fourth quarter of 2003, largely as a result of government macroeconomic policy tightening. Growth for the first half of 2004 was 9.7%. On the supply side, the industry sector, including construction, grew by 11.9% in the first 6 months. Agricultural production expanded by 4.9%, better than expected in *Asian Development Outlook 2004 (ADO 2004)*, after a good summer grain harvest, and the services sector grew by 8.0%. Some caution is required in drawing conclusions from the data, though. For a start, the year-earlier production figures were depressed by the severe acute respiratory syndrome (SARS) epidemic. Also, the statistical system of the People's Republic of China (PRC) still has weaknesses. For example, the services sector and private sector are not well covered, although the National Bureau of Statistics is working to improve the accuracy, quality, and timely disclosure of data.

A surge in fixed asset investment and concerns about overheating in some subsectors prompted the Government to resort to a combination of monetary, fiscal, and administrative measures for damping the economy beginning in September 2003. Excessive investment was most evident in the aluminum, automobile, cement, real estate, and steel subsectors. Symptoms of overheating included steep price increases for raw materials and severe bottlenecks in power and transportation. For example, in the first half of 2004, 24 out of 31 provinces experienced power blackouts, while the railway system was unable to move all of the freight on time. The tightening measures had some impact, especially on those five subsectors, and the growth in fixed asset investment slowed from 43.0% in the first quarter of 2004 to 22.3% in the second. However,

investment growth in cement and steel remained very high in the first half of the year, at 54.7% and 56.5% year on year, respectively, though this was well below 2003's rates of 96% and 130%.

Retail sales in real terms grew by 10.2% in the first half—sales were particularly strong for telecommunications equipment (up 52.3%) and motor vehicles (up 43.7%)—with rising incomes fueling consumption. Urban disposable incomes rose by 11.9% and the average cash income of farmers by 16.1%, the latter representing the largest increase since 1997. The underlying reasons included reduced agricultural taxes, higher grain prices, and changes to the grain procurement system, as well as moves both to increase the incomes of rural migrants working in cities and to ensure they actually get paid for their work.

In contrast to the 2000–2003 period when deflation was a concern, inflation has become an issue in 2004. Overall, the consumer price index (CPI) rose by 3.6% in the first half of the year, at 3% in urban areas and 4.6% in rural areas. In July, the CPI rose at a year-on-year rate of 5.3%. Food prices rose in the first half from low year-earlier levels, despite the good harvest. Driven by the rapid growth of investment and industrial output, ex-factory prices for industrial products rose by 4.7%, and the cost of industrial inputs such as raw materials, fuels, and power jumped by 9.8%. Against these rises, prices fell for clothing, household appliances, communications, and transportation. The People's Bank of China (PBC) is closely monitoring inflation as it weighs the need for an increase in interest rates, which are expected to be raised if inflation exceeds 5% for an extended period.

External trade has soared. Exports in the first half of the year shot up by 35.7% to \$258.1 billion, but imports grew even faster, by 42.6% to \$264.9 billion. In contrast with previous years' healthy trade surpluses, the PRC posted a \$6.8 billion trade deficit in the first half. The PRC

Table 2.1 Selected Economic Indicators, People's Republic of China, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	8.3	8.8	8.2	8.0
Inflation (CPI)	3.0	3.4	2.7	4.9
Current account/GDP	1.3	-0.1	1.0	-1.4

Source: Staff estimates.

runs a large trade surplus with the US and EU, but a deficit with the rest of Asia, especially Japan, Republic of Korea, Singapore, and Thailand.

The policy tightening has had little effect so far on the inflow of foreign direct investment (FDI). Contracted FDI leaped 42.7% to \$72.7 billion in the first half of the year from a year earlier and actual FDI was 12.0% higher at \$33.9 billion. The PRC's accession to the World Trade Organization (WTO) allows foreign investors to become involved in more fields, such as telecommunications, banking, insurance, and securities markets. Foreign-funded enterprises accounted for 31% of the country's industrial production in 2003 and more than half of its exports.

Foreign exchange reserves continued to rise in the first 6 months of 2004, by \$67.3 billion to \$470.6 billion (and from \$346.5 billion in the year-earlier period), and required the central bank to undertake sterilization measures to help reduce inflationary pressures.

Fiscal revenues grew by 30.6% year on year in the first half, faster than expenditures that increased by 11.8%. As a result, the fiscal surplus in the period reached CNY350.4 billion. However, if off-budget obligations, such as the implicit pension debt and costs related to nonperforming loans (NPLs) are included, the Government's contingent liability remains substantial. The growth of money supply moderated, reflecting the macroeconomic tightening, with broad money supply (M2) up by 16.2% at end-June, down from 20.9% a year earlier. Total bank deposits grew by 18.2% and total loans by 16.3%. There are some concerns that rapid growth in loans in the last quarter of 2003 and the first quarter of 2004 may eventually result in an increase in NPLs.

Economic growth continues to create jobs

in the PRC, but not enough of them. Between 15 million and 20 million new jobs are needed each year to employ people entering the workforce and those being laid off by state-owned enterprises (SOEs), as well as to provide off-farm work for some of the 150 million surplus rural workers. Since most jobs will likely be created in the private sector, building an environment that allows private enterprises to flourish should be a government priority. For all of 2004, the Government has set a target of employing 9 million people in new jobs; by midyear, 5.9 million jobs had been created. Official statistics, which significantly underestimate the problem, put the number of registered unemployed at midyear at 8.3 million, or 4.3% of the urban workforce, similar to the figure 12 months earlier.

Policy Developments

The Government has used monetary and fiscal policies and administrative measures to slow the growth of overheated sectors. However, the incomplete nature of the economic reforms limits the impact of monetary policy instruments and inhibits the central bank's ability to conduct monetary policy through interest rate changes and open-market operations. Anticipated interest rate rises will also raise the cost of servicing SOE and government debt. As a result, changes in banks' reserve requirement ratio, rather than interest rate rises, have been used to slow activity.

The goal of the Government is not only to slow investment in the overheated subsectors, but also to spur growth in the lagging sectors, such as agriculture, services, and small and medium enterprises (SMEs), as well as in poorer provinces in the central, western, and northeastern parts of the country.

Among the tightening steps taken were the following:

- In April 2004, PBC raised the reserve requirement ratio from 7.0% to 7.5% for most banks and to 8.0% for banks considered inadequately capitalized.
- Also in April, ministries and local governments were ordered to curb credit expansion and investment in the aluminum, cement, real estate, and steel subsectors.

- In late April, the State Council raised the lending criteria for aluminum, cement, real estate, and steel projects by requiring more equity investment. The minimum equity ratio for steel was increased from 25% to 40% and for aluminum, cement, and real estate from 20% to 35%. The list of sectors for which investment was prohibited or restricted was expanded to include machinery, petrochemicals, pharmaceuticals, printing, and textiles.
- In May, to encourage energy conservation, electricity prices were raised by 2.8% and the electricity tariff restructured so that those industries using electricity heavily are charged higher prices.

Fiscal policy, too, has been tightened. Keeping in mind that the proceeds of government bond issues are often used to finance investment in fixed assets, the Ministry of Finance in March reduced the planned bond issuance for 2004 from CNY140 billion in 2003 to CNY110 billion. The focus of public investment switched from production-related investment to education, health, science, and technology, with priority given to rural areas.

The Government accelerated the progress of agricultural tax reform in 13 provinces where grain production accounts for a substantial part of their economy. Jilin and Heilongjiang provinces were exempted entirely from agricultural taxes and the tax rate was lowered from 8.4% to 5.4% in the other 11 provinces.

A pilot value-added tax (VAT) reform was announced for the provinces of Jilin, Heilongjiang, and Liaoning in the northeast. To reduce the tax burden on investors, the current production-based VAT regime is to be changed to a consumer VAT system for eight industries, including chemicals, oil, and automobile manufacturing. This reform may cut tax revenue in the short term, but in the long term it should expand the tax base, strengthen collection, and lift revenues. Other planned fiscal reforms include unifying the corporate tax of domestic and foreign-funded enterprises and reforming the personal income tax system.

In the area of banking reforms, the legal framework for banks has been improved with the adoption of the Central Bank Law, Commercial Bank Law, and Bank Supervision Law in

December 2003. In addition, the China Banking Regulatory Commission (CBRC) is strengthening its capacity for bank supervision. The Government is also planning to amend the Negotiable Instruments Law, the Securities Law, and the Companies Law. These amendments are expected to significantly improve the development of the financial sector. Improvements that still need to be made include the adoption of an antimoney laundering law, a law to provide a legal framework for audit bureaus, a bankruptcy law, and regulations to wind up insolvent financial institutions.

According to official statistics, NPLs at the PRC's major banks—the four state-owned commercial banks and 11 joint-stock banks—dropped by 4.4 percentage points from end-2003 to 13.3% of their total loan portfolio by mid-2004. Some observers estimate that NPLs are higher than these levels. The decline in the official figures was related largely to the disposal of bad loans at the Bank of China, China Construction Bank, and Bank of Communications, which are being restructured. Bank of China and China Construction Bank were selected for a pilot bank reform and received a combined \$45 billion for recapitalization in early 2004. These two banks also sold nearly CNY280 billion (\$33.7 billion) of NPLs to asset management companies in June 2004. Despite these huge NPL disposals, the task of reducing NPLs further remains challenging, given that they may rise this year both because of 2003's rapid growth in lending and as an unintended consequence of macroeconomic tightening.

To improve capital adequacy, PBC and CBRC will allow commercial banks that meet the following criteria to issue subordinated bonds: (i) core capital adequacy ratios of not less than 5%, (ii) sufficient provisions for loan losses, (iii) sound corporate governance mechanisms, and (iv) no violations of laws and regulations within the past 3 years.

Under the current banking system, state-owned commercial banks, which account for 70–80% of total credit, make few loans to SMEs or to the private sector. Also, the PRC's capital market has been concentrated at the securities exchanges in Shanghai and Shenzhen, which were designed to meet the financing needs of large SOEs. To widen financial access for the private sector and SMEs, a new SME board was opened

at the Shenzhen Stock Exchange in May. Eight private companies were listed on the market on the opening day. Other measures that have been launched to help private sector and SME development include establishing SME development funds, improving SME service and support policies, and strengthening SME credit guarantee systems.

Although the Government has been attempting to cool some areas of fixed asset investment, it also has liberalized the approval system for those investments that have generally required government clearance. In July, it issued the Decision on the Reform of the Investment System, which aims to relax administrative control over investment by enterprises. Investments are classified into three categories: government-financed, large-scale and restricted, and other investment. Now, only government-financed investments need official administrative approval. Large-scale and restricted investments will be checked by the authorities, but other investments need to be registered only for statistical purposes.

The State Environmental Protection Administration called for the use of a “green” GDP methodology to reflect the relationship between environmental damage and economic growth. It said that average annual GDP growth from 1985 to 2000 would be 2 percentage points lower if environmental costs were reflected in the GDP estimates. The PRC still experiences considerable air and water pollution and land degradation. In addition to increasing investment in environmental protection, the Government needs to improve the regulatory system as well as strengthen compliance and enforcement, and make greater use of market-based instruments to put a financial cost on environmental damage.

The PRC has achieved the Millennium Development Goal (MDG) 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). However, official statistics revealed that in 2003 the country recorded its first increase, to 29 million, in the number of people living in absolute poverty in 25 years. Some 800,000 people, mostly farmers, fell below this line, which stands at an annual per capita income of CNY637 (or \$77, well below the international norm of

\$1 a day). This was partly because of floods and drought but also because of the SARS outbreak. This increase suggests decreasing effectiveness of the Government’s poverty reduction program. Despite the fact that, by end-2003, the program had delivered special subsidized poverty reduction loans totaling CNY147 billion, poor targeting, low repayments, and corruption have led to a fall in the share of loans reaching the poor, from 70% in the mid-1980s to about 20% in 2003.

The PRC has made progress in achieving most of the nonincome MDGs, including providing access to basic education and reducing maternal mortality. However, more progress is needed to achieve the MDGs related to gender issues, HIV/AIDS, safe drinking water in rural areas, child mortality, and environmental damage.

Outlook for 2004–2005

The Government will continue its macroeconomic tightening measures and, in an attempt to avoid a “hard landing,” encourage growth in lagging sectors. GDP is now forecast to rise by 8.8% in 2004, up from the *ADO 2004* figure of 8.3%, and growth in 2005 has been revised down slightly to 8.0% from 8.2%.

The rapid pace of investment growth is slowing, reflecting the gradual impact of the measures. However, the large amount of construction in progress means that growth in investment will remain high at 25% this year and 21% in 2005. In the longer term, such high levels of investment cannot sustainably be relied on to drive economic growth. Consumption is expected to expand by 13% a year in 2004–2005, supported by increased urban and rural incomes and a strengthened social security system.

The PRC’s exports are forecast to rise by 22.0% in 2004 and 16.0% in 2005, based on expectations that the world economy will achieve higher than expected growth in 2004 and more moderate growth in 2005, and that the PRC will remain the leading destination for global FDI. (Foreign investment will continue to stimulate exports because foreign-invested firms produce over half of all PRC exports.) Imports are likely to outpace exports, increasing by 30.0% in 2004 and 20.0% in 2005, due to the country’s growing appetite for a wide range of imports and its lower

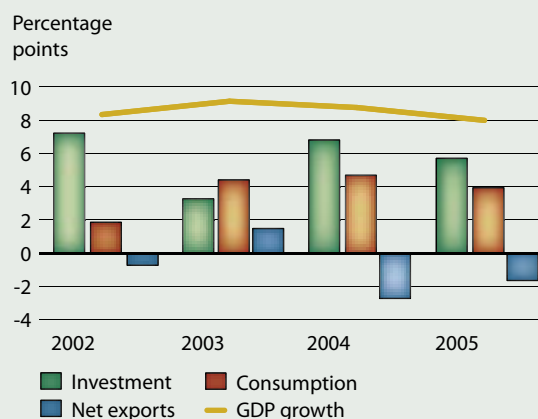
tariff and import barriers associated with WTO membership. The current account will turn from a surplus to a small deficit of about 0.1% of GDP in 2004 and 1.4% of GDP in 2005, for the first time since 1993.

In 2003, consumption, investment, and net exports all contributed to growth in GDP, at 4.4, 3.3, and 1.5 percentage points, respectively. The shares now are less balanced, with investment likely to account for 6.8 percentage points of GDP growth in 2004 and 5.7 percentage points in 2005. Consumption is forecast to contribute 4.7 and 3.9 percentage points, respectively, and net exports will subtract from growth (Figure 2.1).

Inflation will moderate in the second half from July's pace. The larger grain harvest in the first half will help lower inflation, which is now forecast at 3.4% in 2004 and 4.9% in 2005, both revised up from *ADO 2004*.

Higher global oil prices have introduced new uncertainties to the country's economic prospects for 2005. An extra \$10 a barrel for all of 2005 could translate into a decline in the GDP growth rate in 2005 of 0.8 percentage points and in the trade balance as a share of GDP of 0.1 percentage points, and a rise in the inflation of 0.5 percentage points. (Oil scenarios are discussed further in Part 3.) The PRC's demand for oil grew by 9% in 2003 to about 270 million tons, or double the 1992 level. Net oil imports in 2003, at 91 million tons, were more than twice the 1998 level. With continued economic growth and a rapidly growing number of motor vehicles, the demand for oil will continue its upward spiral. At the

Figure 2.1 Contribution to GDP Growth, People's Republic of China, 2002–2005



Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2003*; staff estimates.

same time, production from the nation's aging oil fields will decline. Some observers estimate that oil consumption could reach 600 million tons by 2020, with 400 million tons imported.

As it becomes more dependent on the international oil market, the Government is attempting to diversify both its sources of supply for its imported energy needs, as well as its types of supply, such as liquefied natural gas. A related issue for policy makers is the energy intensiveness of the economy, since its industries use over three quarters of a barrel of oil to produce \$1,000-worth of GDP, about double the average of other Asian countries. Increased efforts are needed in the areas of energy efficiency and energy conservation.

Hong Kong, China

Economic Assessment

The 9.5% rise in GDP in the first half of 2004—magnified by the low base of the year-earlier period when the economy was hit hard by the SARS outbreak and was still suffering from a prolonged property market slump—was stronger than expected. First-half growth was balanced between total consumption (contributing 5.2 percentage points) and total investment (4.2 percentage points) (Figure 2.2). Private consumption increased by 8.5% over the period. Fixed investment grew by 9.3%, helped by a pickup in machinery and equipment investment, and government spending rose by 2.8%.

Domestically, consumer spending has progressively recovered from the SARS setback. Partly reflecting a strong increase in tourism from the PRC, retail sales volume has remained strong since August 2003. In the first 7 months of 2004, it grew by 11.7%, with particularly buoyant growth in sales of durable goods. Exports of goods and services rose by 17.6% in the first half, helped by the Hong Kong dollar's link to the weakening US dollar as well as by robust inbound tourism and reexports. Faster import growth brought down net export growth to 1.6% in the first 6 months from 43.3% in the same period of 2003 and made no significant contribution to GDP's expansion. In contrast, in 2003 net exports were the main driver of growth.

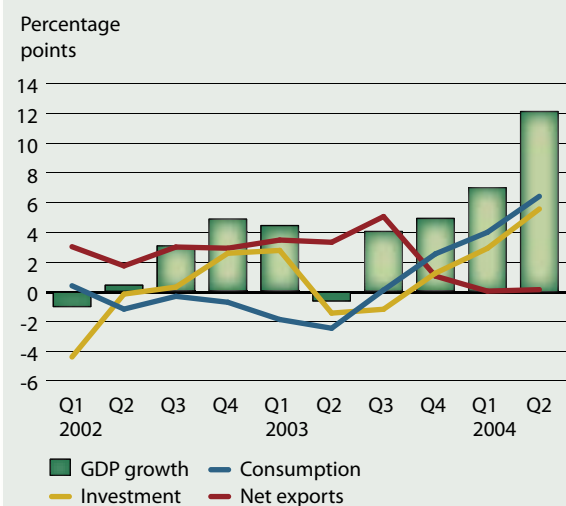
On the production side, services, by far the biggest sector, rebounded strongly from the previous year as tourism, wholesale and retail sales, and financial services all recovered. Labor market conditions also improved, with unemployment falling from 8.7% in May–July 2003 to 6.9% in the same period this year. In addition to the recovery creating new jobs, the unemployment rate was lowered by some people leaving the labor force. Employment expanded in the wholesale trade, hotels, transportation, and cleaning services

subsectors particularly. Nominal wages continued to decline during the first 3 months of 2004, leaving real wages almost unchanged at end-March from 12 months earlier.

The fiscal position has improved since the economy started to recover. The deficit in FY2003 (ended 31 March 2004) was HK\$40.1 billion, or 3.3% of GDP, well below an earlier official estimate of a HK\$49.0 billion budget gap. Expenditures for the first 4 months of FY2004 totaled HK\$78.7 billion and revenues HK\$73.4 billion, resulting in a deficit of HK\$5.3 billion, only 12% of the HK\$43 billion official deficit estimate for FY2004. (The official estimate of the deficit and the revenue for the 4 months includes HK\$20 billion in proceeds from a bond issue and HK\$6 billion from the sale of asset-backed securities.)

Major asset markets have taken different paths in 2004. The property market, mainly apartments, has maintained a rally that started in August 2003,

Figure 2.2 Contribution to GDP Growth by Expenditure Account, Hong Kong, China, Q1 2002–Q2 2004



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

Table 2.2 Selected Economic Indicators, Hong Kong, China, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	6.0	7.5	5.0	6.0
Inflation (CPI)	1.1	0.7	1.1	1.1
Current account/GDP	6.8	6.8	8.5	8.5

Source: Staff estimates.

underpinning the general level of consumer and investor confidence. But the benchmark Hang Seng Index of share prices, which rallied by 35% in 2003, turned down in mid-February on expectations of an increase in US interest rates and a tightening in PRC macroeconomic policies. Since May though, share prices have been edging back up.

Broad money (M2) grew by about 9% year on year in the first 6 months, picking up from 8.4% in 2003. Price deflation concerns faded, and the composite CPI was virtually flat over the first half in month-on-month terms. On a year-on-year basis, the index rose by 0.9% in July, the first year-on-year rise since November 1998, lifted by the recoveries in private consumption and property prices. The Hong Kong dollar moved back closer to the linked rate of HK\$7.8 to the US dollar after a sharp appreciation in October 2003, then strengthened again briefly in May along with the rebound in the stock market. The nominal trade-weighted effective exchange rate kept appreciating, though at a slower rate. With inflationary pressures and interbank offered rates low, current ample liquidity should not be a serious concern.

The rebound in inbound tourism picked up pace in the first half of 2004, due in part to a policy change in the PRC that allows residents in selected cities to visit Hong Kong, China individually, as well as in tour groups as previously. PRC visitors now account for more than half of total tourist arrivals, up from about 40% in 2002 and 30% in 2001. Also on the external front, a robust expansion of reexports (showing average annual growth of 16.9% for the first half of 2004) was fueled by outward processing activities in Guangdong province, where many of Hong Kong, China's companies have moved their manufacturing bases and ship the goods to Hong Kong, China for reexport. Due to the

strong growth in reexports, merchandise imports grew by 19.3% on average in the first half of 2004. Retained imports (imports excluding those for reexports), which account for around 28% of merchandise imports, rose by 26.2% as a result of a surge in fuel imports and stronger domestic consumption. Consequently, the merchandise trade deficit averaged HK\$11.5 billion in the first half of 2004, widening from HK\$5.7 billion in the year-earlier period, and the current account surplus fell to 5.0% of GDP, from 11.0%.

Policy Developments

Balancing the budget by FY2008 remains a major goal of the authorities. However, despite the better than expected economic growth, stronger property market, and bond sales this year, the budget has remained in deficit, reflecting the narrow tax base that relies on land-based revenues. The rumbling debate over the tax system continued in 2004, with the authorities still considering a goods and services tax (GST), which would be a broad-based and stable revenue source. The financial secretary has stated that the economic recovery provides a conducive environment to introduce a GST, but has also indicated that the authorities will not make a decision on the tax until 2005. The financial secretary had previously estimated that a GST would raise HK\$6 billion for every percentage point of the tax rate. Implementing the 5% GST under discussion would make a significant contribution toward eliminating deficits. A GST would take some time to introduce, so may not contribute to the balanced budget target of FY2008.

Sales of government assets and asset-backed securities are planned in an effort to improve the fiscal position. In May 2004, the authorities issued a HK\$6 billion bond that securitized future toll revenues from five government-owned tunnels and a bridge. The issuance of government bonds will help promote the domestic bond market, but the impact on the fiscal position may be limited, in part because the authorities pledged to make direct payments to support the asset-backed bonds if regular revenues from the tunnels and bridge fall short of projections.

The Closer Economic Partnership Arrangement (CEPA) between Hong Kong, China and the PRC, signed in the depths of the

SARS crisis in 2003, has been extended to cover more goods and services. The original agreement allowed for 374 products made in Hong Kong, China to have tariff-free access to the PRC market from January 2004, ahead of market-opening deadlines stipulated in the PRC's WTO accession pact. Under CEPA II, signed in August 2004, the PRC will apply zero import tariffs on an additional 713 products from Hong Kong, China, starting in January 2005. The PRC also agreed to grant preferential treatment to Hong Kong, China firms that provide eight types of services, including airport, information technology, and patent agency services.

Outlook for 2004–2005

GDP growth rates in 2004 and 2005 are now forecast at 7.5% and 6.0%, both higher than the 6.0% and 5.0% projections made in *ADO 2004*. The upward revisions stem from the stronger than expected retail sales and the surge in tourism. Overall investment is expected to grow by around 9% in 2004. Investment in machinery, equipment, and computer software has increased, but private construction investment remains weak. In 2005, investment growth will stay at around 9%, supported by planned government infrastructure projects and by private construction, since the authorities resumed land auctions this year after suspending them in late 2002.

For all of 2004, merchandise exports are expected to grow by 7.0%, moderating from 16.5% growth in the first half. The sustained global popularity of digital products will support exports of electronics products. Services exports will be underpinned by tourism, and are being buttressed by trading firms and manufacturers

in Hong Kong, China engaging in transaction services that involve goods made in the PRC and shipped directly from PRC ports to international markets, without passing through Hong Kong, China. This shift from reexporting to direct offshore trade is a result of the growth of PRC production and port capabilities.

Imports will also rise along with stronger consumption and investment. The current account surplus as a share of GDP is therefore expected to decline from 10.2% in 2003 to 6.8% in 2004 and 8.5% in 2005.

The recovery in the services sector will bolster the labor market. A survey of hiring intentions shows that job prospects in finance, insurance, and real estate continue to improve. Employment will grow in wholesale and retail trade, too. Deflation is expected to die out because of the firmer property prices, increases in the costs of some imported items, and the end of certain rebates on charges of utilities and public housing, but the lack of inflation in the first half of 2004 has resulted in a lowering of the full-year forecast to 0.7% (from 1.1%). For 2005, inflation is projected at 1.1%. The forecast for the fiscal deficit stays at 3.0% of GDP for 2004, with tax revenues rising due to higher corporate profits, stamp duties, and land premiums.

This outlook assumes continued economic growth in the PRC and the US and no serious public health scares, such as SARS or avian flu. Hong Kong, China's reliance on oil is fairly low, given the services orientation of the economy. Its retained imports of petroleum are equivalent to about 1% of GDP and fuel accounts for less than 5% of overall business operating costs (excluding labor). Hence, the direct effect of higher oil prices on aggregate demand is relatively limited.

Republic of Korea

Economic Assessment

The economy expanded by 5.4% in the first half of 2004 from a low base in the year-earlier period, but this masks a slowing from 3.0% in the first quarter to a mere 2.3% in the second, when measured in annualized quarter-on-quarter terms. Growth has been driven mainly by exports, which climbed by 27.1% in the first half from the previous year. Imports rose by 16.1%, picking up pace in the second quarter due to a surge in oil import costs. Net exports accounted for 5.5 percentage points of the first-half GDP growth, outweighing a contraction of 0.1 percentage points from domestic demand (Figure 2.3). Although the export performance remains robust, there are signs of a moderation in growth, led by information and communications technology (ICT) products. For example, semiconductor exports slowed sharply in August, with year-on-year growth decreasing to 29.3%, the lowest rate this year, from 57.3% on average in the first half of 2004.

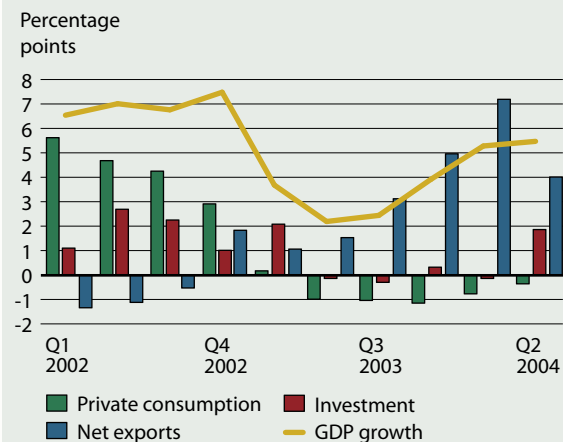
Strong exports, however, have been unable to accelerate a painfully slow recovery in domestic demand. Private consumer spending fell by 1.0% in the first half of the year and shaved 0.6 percentage points from GDP growth. A large overhang of consumer debt built up over the previous 2 years continues to cast a shadow over the economy. Household debt stood at the high level of 73.5% of GDP at the start of 2004. It rose by 7.8% in the first half of 2004, slightly below the increase of 9.1% for all of 2003. Consumers have been more inclined to bring down their debts and bump up their saving than to spend. Private consumption fell on a quarter-on-quarter basis for the third quarter in a row in the April–June period, though the pace of decline eased.

Gross fixed capital formation rose by 3.3% in the first half of 2004 as the surge in exports exerted increasing pressure on production

capacity. Investment in machinery and equipment rose by 6.2% in the second quarter, compared with a contraction of 0.3% in the first, ending 4 consecutive quarters of decline. However, the recent deceleration in export growth raises doubt on the need for further expansion in production capacity, and consequently on the strength and durability of the investment revival. Construction investment remained relatively resilient, despite policy measures to curb speculative activity in the housing market. Even then, growth in construction investment slowed to 3.9% in the first half from 2003's full-year rate of 7.6%. Overall, investment added 0.9 percentage points to first-half GDP growth.

As exports of products such as automobiles and ICT items climbed, manufacturing production rose by 12.8% in the first 6 months of the year. The overall industry sector—manufacturing, mining, utilities, and construction—grew by 10.6%. In contrast, the services sector expanded by just 1.6% because of declines in wholesale and retail trade and

Figure 2.3 Contribution to Growth by Expenditure Component, Republic of Korea, Q1 2002–Q2 2004



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

Table 2.3 Selected Economic Indicators, Republic of Korea, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	4.8	4.4	5.2	3.6
Inflation (CPI)	3.1	3.8	2.8	3.0
Current account/GDP	2.7	3.9	2.6	3.1

Source: Staff estimates.

in financial services, stemming from the weak private consumption and problems of credit card companies. Agricultural production increased by 3.6% in the first half from the same period a year earlier, after 2 consecutive years of contraction. Construction was held back by a cooling property market.

Business indicators point to a second-half slowdown in activity. The composite index of business leading indicators fell for 3 consecutive months in May–July. Industrial production appears to have peaked in the second quarter—month-on-month growth rates fell in June and July. Also, inventories of some ICT products are rising as their export growth scales down.

A recovery in the labor market faltered late in the first quarter, and 291,000 jobs were lost between February and July. The unemployment rate averaged 3.6% in the first half of 2004, rising from an average of 3.4% in 2003. This job-market weakening does not bode well for what may be the beginnings of a tentative firming in private consumption.

The Government provided support to domestic demand. Government consumption increased by 3.6% in the first half from the prior-year level, contributing 0.4 percentage points to GDP growth. Spending was front-loaded into the first quarter, resulting in a deficit of \$2.0 billion for that period. The Government estimates that the 2004 budget deficit, adjusted for social security contributions and repayment of government-guaranteed debt, will be 0.9% of GDP, well below the Organisation for Economic Co-operation and Development (OECD) average of 3.5% of GDP, providing ample room for further pump priming. Central government revenue collection continued to improve, rising by 14.6% in the first quarter from a year earlier, on account of rising tax revenues

from the export sector. Expenditures in the quarter jumped by 37.3% as the Government tried to stimulate the economy.

Inflation has accelerated, despite the weak domestic demand. The CPI rose by 4.8% and the producer price index by 7.0% in August from 12 months earlier. Although higher oil prices take much of the blame, rising input prices also partly reflect increasing wage pressures. Nominal wages, which had jumped by 9.5% in 2003, rose a further 4.5% in the first half, a period when working hours fell by 0.9%. These trends in wages and working hours are hurting Korea's competitiveness, thus hampering job creation.

The increase in inflation did not, however, deter the Bank of Korea from lowering its policy interest rate from 3.75% to 3.50% in August. The soft economic performance appeared to outweigh rising inflation risks for the markets, which pushed down long-term bond yields in the first half and flattened the yield curve. Notwithstanding easier funding conditions, corporate financing activity remained sluggish. The weakness in investment demand also partly explains a slow recovery in domestic credit. Growth in the M3 money supply was 5.1% in the first quarter and 5.8% in the second, below the 2003 average of 8.8%.

The won gradually strengthened against the US dollar. It fell in May, along with other regional currencies, ahead of the anticipated rise in US interest rates as international investment funds unwound speculative positions. Since then, the won has recouped much of its strength, supported by strong exports and inflows of portfolio investment attracted by export-oriented stocks. Also supporting the won was the robust position of the balance of payments, which remained in surplus and added \$12.7 billion to external reserves in the first half of 2004. The current account surplus rose to \$13.2 billion, helped by an expanded trade surplus, though the capital account switched to a deficit of \$600.0 million, partly reflecting a rebound in direct investment abroad. Korean investment in other Asian economies, mainly the PRC, rose by 53.0% to \$1.3 billion in the first half.

FDI inflows edged up to \$5.0 billion in the 6 months to June. US investors provided about half this amount, with Citicorp's acquisition of

KorAm Bank accounting for \$1.7 billion. Nevertheless, FDI is well below the peak of more than \$15 billion a year seen over 1999–2000. Labor market rigidities concern some foreign investors, and the strong attraction of the PRC for international investors is also diverting FDI away from Korea. However, portfolio investment inflows were buoyant. Equity and bond purchases generated net capital inflows of \$9.6 billion during the first half of the year, despite the sharp withdrawal of portfolio investment in May. With such investment flows resuming after August, the KOSPI stock market index regained some of the losses incurred in May and was little changed as of 1 September from the start of 2004.

Policy Developments

Economic policies have centered on encouraging investment, private consumption, and job creation; the outlook in these areas has generally deteriorated since *ADO 2004*. More specifically, the authorities have focused on strengthening social welfare, increasing investment in education, promoting research and development, and supporting SMEs.

Fiscal policy has become more expansionary. The central government 2004 budget originally was set at the equivalent of 22.9% of GDP, marginally higher than in 2003. It was aimed at providing a mild fiscal stimulus, mostly in the first half, before progressively returning to a balance. However, a much anticipated recovery in domestic demand did not materialize. As a result, the Government introduced a supplementary budget in May, mainly to allocate extra support for low-income earners. This lifted the central government budget to 23.5% of GDP. In addition, members of the majority political party have proposed a new fiscal package that involves tax cuts and further spending. The tax proposals include a 1.0 percentage point cut in income tax and capital gains tax, an increase in tax deductions for small enterprises, and the abolition of a special excise tax on luxury and high-tech goods. The additional spending will be allocated to research and development, education, and SMEs, if this proposal becomes government policy.

On the monetary front, further easing appears likely. Monetary settings have been accommo-

date since 2003, but private consumption is still struggling to pick up due to the overhang of household debt. The 25 basis point cut in the policy rate in August suggests that the priority is on resuscitating private consumption, even at the cost of higher inflation. However, with real interest rates already negative, monetary policy will have only limited effectiveness.

To address the credit problems, the Government has accelerated the restructuring of troubled credit card companies through capital injections, and mergers and acquisitions. Further reforms are planned in an attempt to build a sound credit culture in banking and financial institutions. However, sluggish spending and credit demand have delayed a recovery in the credit card business. Moreover, an effort in May to restructure overdue consumer loans was unsuccessful because the debtors considered the terms too tough. Against this backdrop, the Government introduced a new program that offers more generous grace periods and interest payments. The amended deal grants debtors a full-year grace period without any principal or interest payments, if they first pay 3% of the outstanding principal. After that year, the accrued interest and remaining 97% of the principal is amortized over 7 years.

Outlook for 2004–2005

Forecast GDP growth for all of 2004 is now revised down to 4.4%, from 4.8% in *ADO 2004*, and to 3.6% in 2005, from 5.2%. Growth in exports is expected to level off during the rest of 2004 and into 2005, with the ICT industry, a major source of Korea's exports, showing signs of cooling. Export growth will moderate for several reasons: softening demand in markets for high-tech equipment, rising prices of inputs, and the expected reduction in the PRC's growth rate.

While private consumption and investment may be strengthening, the recovery in domestic demand will remain gradual. Recent wholesale and retail sales data show a hesitant improvement in consumption. The wholesale sales index rose by 0.8% in July after a 1.6% gain in June, and the retail sales index posted more modest gains. Over the forecast period, the pickup in private consumption will be constrained by the household debt burden, unfavorable job market conditions,

and the higher cost of oil. The recent rebound in investment remains fragile because it has been confined mainly to the export sector. With exports slowing, the gains in machinery and equipment investment could dwindle. There are indications of slowing factory utilization rates and rising inventories. This suggests that investment growth may peak in the second half of this year, which would limit any substantial improvements in the labor market.

Expansionary macroeconomic policies will continue into 2005. The consolidated fiscal deficit could widen to 1.2% in 2005, from this year's forecast deficit of 0.9%, because the prolonged weakness in private consumption requires further fiscal support. At the same time, tax revenues will decline due to the moderation in the export sector and proposed tax cuts. Low investment demand is likely to contain the growth in the M3 money supply, despite further easing in monetary policy. Reflecting mounting inflationary pressure from the supply side, inflation is expected to remain high at least until the first half of 2005, before subsiding a little in the second half of 2005.

The current account surplus will fall in 2005, reflecting a decline in trade surpluses due to slowing exports and sustained high oil import costs. A reduction in the current account surplus implies a decrease in net national savings, and in fact both private and public sectors are expected to reduce savings in 2005. Households, as they gradually increase consumption, will save less. Firms are likely to save less because profits are expected to grow at a slower rate, or decline, while the Government's expenditures will exceed its revenues.

In the broader picture, concerns abound that deepening structural weaknesses are damaging the domestic investment environment and the economy's long-term growth potential. As Korea makes a structural shift from traditional manufacturing to ICT and services, the changing indus-

trial structure and higher labor productivity have led to a reduction in jobs. Adequate numbers of new jobs are not being created, in part because of rigidities in the labor market, which adds to downward pressures on household incomes. Labor unions at the large, unionized companies have pushed up wages, discouraging those firms from hiring or investing. Many consumers, faced with uncertain incomes and higher oil prices, have cut their spending, damping overall economic activity and thus discouraging firms from investing.

Indebted consumers and a cautious banking industry have contributed to a disjunction between a monetary policy (that is accommodative) and domestic demand (that is unresponsive). If monetary policy is less effective, a stronger fiscal stimulus remains the best option to bolster domestic demand. The proposed new fiscal package, if adopted, should provide a further fiscal stimulus, though it is unclear if it would have much impact in 2004.

However, short-term macroeconomic stimuli can play only a limited role in guiding the economy back onto a long-term sustainable growth path. The postfinancial crisis reforms—once praised by the international financial community for their speed and depth—are increasingly dominated by debates over the distribution of wealth versus economic growth. The focus of recent reforms has been more on socioeconomic concerns, such as increasing transparency in the *chaebol*, improving wealth distribution, upgrading labor conditions, and strengthening the social safety net.

Despite the long-term benefits of some of these policies, the change in focus has unsettled the business community. To reestablish its confidence and revive investment, the reforms should refocus on economic efficiency and productivity through greater flexibility in the labor market, a healthier credit culture in the financial sector, and improved governance and transparency in the corporate sector.

Taipei,China

Economic Assessment

Economic growth came in at 6.7% in the first quarter of 2004, accelerating to 7.7% in the second, for a 7.2% expansion in the first half of the year, the fastest since 1992. The pickup was export led, fueled particularly by the rebound in the global high-technology sector, since information technology (IT) products account for nearly 40% of the economy's total shipments. Exports surged by 24.8% year on year in the second quarter of 2004, and by 22.4% in the first half (Figure 2.4). However, the contribution of net exports to GDP fell because imports grew by 25.8% in the first half, so that net exports contributed only 1.1 percentage points of total GDP growth in the first half of 2004, compared with 3.0 percentage points of the 3.3% GDP growth for all of 2003.

Strengthening imports reflected rising domestic demand after years of lackluster performance. Total domestic demand expanded by 7.0% in the first quarter and 6.7% in the second. In particular, private investment surged by 20.1% in the second quarter, after 14.1% growth in the first, contributing 3.7 percentage points to GDP expansion in the half. Investment was bolstered by buoyant exports, higher prices for electronics products, rising corporate profits, improvements in capacity utilization rates, and low interest rates. Industries such as semiconductors augmented production capacity, boosting investment in other industries. Imports of capital equipment boomed by about 30% in the first quarter and 48.2% in the second, the largest rise in 6 years.

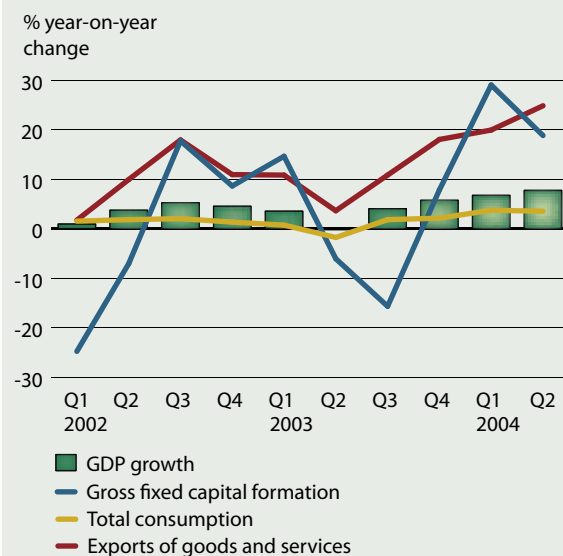
The pace of private consumption growth also picked up during the first half, from 3.2% in the first quarter to 4.1% in the second. As private consumption accounts for over 60% of GDP, this rise represented 2.4 percentage points of GDP growth in the first half. Taipei,China's consumption propensity has increased in line

with improving living standards and changing consumption patterns. Private consumption as a share of GDP rose from around 50% in 1980 to over 63% in 2003, while the savings ratio fell from 31% of GDP in 1989 to about 26% in 2003.

On the production side, growth was largely driven by manufacturing, which expanded by 11.8% in the first half of the year; overall industrial output rose by about 10%. The services sector grew by about 6%. Agricultural production declined by 7.2%, continuing a trend that has been reinforced by reduced domestic protection of farmers since Taipei,China joined WTO in 2001.

High growth rates in the second quarter were somewhat exaggerated by the low base of the previous year, when the economy was hit by the SARS outbreak, but strong momentum has continued since late 2003. The labor market has benefited from that momentum, with

Figure 2.4 GDP Growth by Expenditure Account, Taipei,China, Q1 2002–Q2 2004



Source: Directorate-General of Budget, Accounting, and Statistics, Executive Yuan, available: www.stat.gov.tw.

Table 2.4 Selected Economic Indicators, Taipei, China, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.4	6.0	4.7	4.8
Inflation (CPI)	0.8	1.5	1.2	2.0
Current account/GDP	6.9	6.8	6.0	6.0

Source: Staff estimates.

unemployment falling to 4.4% in April, before rising to 4.6% in July as job seekers graduating from school and university, and others, started looking for work as confidence in the recovery mounted. Real wages mirrored this development, with manufacturing earnings up by 5.8% in June from a year earlier (for all of 2003, they had risen by 2.9%).

Taipei, China's economic performance was hit hard by the bursting of the IT bubble and the global economic slowdown of recent years, and this flowed through to a decline in total government revenues from 22.7% of GDP in 1998 to just under 20% in 2003. The authorities responded by increasing spending to stimulate the economy, in the process widening the budget deficit to 4.0% of GDP. In recent months, the fiscal position appears to have been improving and the budget deficit narrowing.

Consumer price inflation, at just 0.9% in the first half, rose to 3.3% in July and 2.5% in August, due to strengthening domestic demand, higher global oil prices, and a weakening of the New Taiwan dollar against the US dollar. The property market revived, raising confidence among buyers and lenders, such that home mortgage and construction lending in May accelerated by 15.1% and 17.0%, respectively, from May 2003. Higher property prices increased household wealth and helped support private consumption expenditures. Share prices gained in the first quarter, then lost those gains in the following months, to show little change in September from the start of the year.

Exports of goods and services have grown at double-digit rates since mid-2003, boosted by particularly robust demand from Hong Kong, China and from the PRC. IT exports have been especially vigorous: electronics exports, for example, rose by around 40% in the first 7 months of 2004 from the same period a year earlier.

Imports of goods and services have also risen strongly, outpacing exports in recent months. The trade surplus contracted in the first 3 months of 2004, after widening for about 3 years. In June, the trade balance switched from surplus to deficit due to rising oil prices and the purchase of three civil aircraft, although the overall trade balance for the first half of 2004 is a US\$6.9 billion surplus. A continued trade surplus and inflows of foreign portfolio investment saw foreign reserves reach US\$230.1 billion at end-June 2004, the third largest in the world.

Policy Developments

The deterioration in the fiscal position during the years of weak economic performance—caused in part by a decline in tax revenues to 19.8% in 2003 from over 20% before 1999 and by demands for more social safety net payments—prompted calls from policy makers to raise tax revenues and simplify the tax system. In response, a Ministry of Finance tax reform committee has proposed increasing VAT from 5% to 7%, although a change is unlikely until after Legislative Yuan elections in December 2004. The authorities have also announced their intention to improve nonwage benefits for workers.

The period of weak performance also exposed the need for improvements to the social security system, and an aging of the population reinforces this. In June, the authorities passed a pension reform package that will require private sector companies to pay the equivalent of 6% of every employee's monthly salary into a centrally managed investment fund with individual accounts for retirement savings, effective 1 July 2005. Employees may voluntarily contribute up to an additional 6% of pretax salary into these interest-earning accounts. Employees' individual retirement funds are transferable if they change jobs. (Currently, companies are required to pay employees who retire between 2% and 15% of their monthly wage for each month worked, capped at a total of 45 months of benefits, but this benefit is not paid if an employee is not retiring but moving to another employer.) One result of the new pension plan will be to build up a large pool of investment funds that will deepen the local capital market.

However, business groups are concerned about the additional costs of the pension plan and they warn that they could accelerate the migration of manufacturing production to the PRC. Many of Taipei,China's traditional, labor-intensive manufacturing industries moved production to the PRC in the 1990s to reduce labor costs. Some high-technology firms have followed suit, so that manufacturing's share of GDP has fallen by half since the mid-1980s. The authorities are weighing options to keep their remaining traditional industries competitive and encourage the growth of high-technology and services-oriented industries while, at the same time, establishing a modern social safety net.

In the area of monetary policy, the Central Bank of China has not given any sign that it plans to raise interest rates in the near term. In June, it decided to keep the discount rate at 1.375%, after concluding that inflation risks are still low. There is, though, a longer-term risk that the Government's continued domestic bond issuance (public debt is now at about 30% of GDP) will increase the debt burden and put upward pressure on interest rates.

Outlook for 2004–2005

Growth is likely to moderate over the second half of 2004 from the first half's strong pace. The leading composite indicator, which gauges future economic conditions, supports this view: it fell in both May and June. Still, GDP is forecast to grow by 6.0% in 2004, well above the *ADO 2004* projection of 5.4%, and by 4.8% in 2005, revised up marginally from 4.7%.

Merchandise exports are forecast to rise by 16.2% in 2004 and 9.2% in 2005. Growth in imports will outpace that in exports, strengthening by 19.6% and 10.5% over these 2 years. The momentum in exports will continue to propel domestic demand as companies that are benefiting from exports raise their capital

expenditures. Imports are also projected to be strong, such that the contribution of net exports to GDP growth in the forecast period will be only about 0.4 percentage points. The trade surplus will decline, and the current account surplus will narrow to 6.8% of GDP in 2004 and 6.0% in 2005.

Private investment is expected to rise by 17.0% in 2004 and 9.8% in 2005 as exports and corporate profits improve and as interest rates stay low. Improved conditions in the labor and property markets will see private consumption rise by 3.9% over the whole of 2004 and by 3.7% in 2005. Private investment growth will account for 2.8 and 1.8 percentage points of GDP growth in 2004 and 2005, respectively, while private consumption growth will translate into 2.8 and 2.6 percentage points of the total.

Unemployment is projected to average 4.2% over 2004 and 4.0% in 2005, down from 5.0% in 2003. It will be difficult for the economy to return to the pre-1995 unemployment rates below 2%, despite the robust GDP upturn. Retraining programs and a stronger social safety net are required to help people move from declining into expanding industries.

Inflation looks likely to stay mild over the next 2 years. Upward price pressures come from the firm domestic demand and higher global oil prices, though the continued opening of the economy to greater competition, partly as a result of WTO membership, will offset some of these pressures. Consumer prices are forecast to rise by 1.5% in 2004 and 2.0% in 2005. The central bank may tighten its monetary stance a little from late 2004, but the favorable inflation outlook and the need to stimulate employment make significant rate rises unlikely.

A prolonged period of high oil prices poses a risk for Taipei,China because it is heavily dependent on energy imports. It is also vulnerable to any major slowdowns in its main export markets.

ASIAN DEVELOPMENT
Outlook
2004
Update

Economic Trends and Prospects in Developing Asia
Southeast Asia



T. Takahara

Cambodia

Economic Assessment

Estimated GDP growth in 2003 has been updated to 5.2% from 5.0% in *ADO 2004*, on the back of a recovery in agriculture from a drought-induced decline in 2002 (Figure 2.5). However, the dry season paddy crop in 2004 is estimated at 873,000 tons, a 3.7% decline from a year earlier, mainly due to drought conditions in the first half of the year. Bad weather also delayed cultivation of the larger wet season crop, and the 900,000 hectares that were reportedly cultivated by mid-August 2004 were 10% less than the area cultivated in 2003.

Although no official data on industrial output are yet available for the first half, robust export growth in garments, the main manufacturing industry, suggests a healthy expansion. So, too, does the increase in the number of tourist arrivals, up 21.8% in the first quarter, displaying a recovery from 2003 when the SARS outbreak and riots hurt visitor numbers. Investment approvals show a less optimistic picture though, with the total for the first quarter of 2004 falling by 42% from the previous year to \$63.3 million. The 12-month delay in forming a government after elections in July 2003 soured the business and private investment climate.

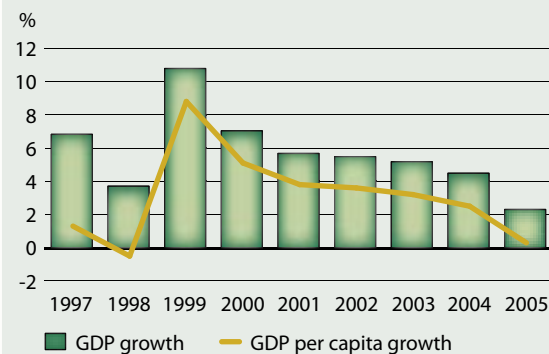
This political impasse also meant that the 2004 budget has yet to be passed. As an interim measure, revenue collections and expenditure allocations have been made in accordance with the 2003 budget provisions. Actual revenues and expenditures lagged the targets, though the revenue intake in the first half still exceeded the corresponding intake in 2003 by 25% because of increases in the collection of VAT and excise duties. Expenditures fell by 12%, with much of the decrease seen in nonwage operating costs and social transfers. The decline is attributed to a lack of absorption capacity and entrenched governance problems.

Broad money (M2) growth accelerated to 13.5% in the first 5 months of 2004, from 5.1% a year earlier. The main reason was a rise in net foreign assets of the banking system, reflecting an improved external account. However, domestic—largely private sector—credit expansion moderated, in response to a business environment somewhat subdued by the political uncertainties.

Inflation on a year-on-year basis accelerated from 0.5% in December 2003 to 3.0% in June 2004, on account of greater transportation costs (pushed up by higher fuel prices) and steeper food prices. The latter were driven by higher fresh fish prices, which in turn derived from the impact of a smaller catch in the Mekong River's lower water levels in the first half of the year.

Preliminary customs data for the first quarter of 2004 indicate that merchandise exports climbed by 24.2% year on year, with significant rises in shipments of garments and natural rubber. Import data for this period, however, indicate that merchandise imports contracted by 10.4% owing to a decline in tax-exempt imports (aid-financed imports and inputs for the export-oriented garment industry) and in petroleum products. The downturn in tax-exempt imports may be a

Figure 2.5 GDP and GDP Per Capita Growth, Cambodia, 1997–2005



Sources: National Institute of Statistics; staff estimates.

Table 2.5 Selected Economic Indicators, Cambodia, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.4	4.5	5.4	2.3
Inflation (CPI)	2.9	2.3	3.3	3.0
Current account/GDP	-4.3	-10.0 ^a	-5.6	-11.2 ^a

^a Current account excludes official transfers.

Source: Staff estimates.

reflection of slower aid disbursements during the period before the new Government was formed. The decline in petroleum imports, despite a sharp increase in price, has been attributed to greater smuggling across the country's porous borders. Based on these preliminary figures, the trade balance for the first quarter moved to a surplus of \$80.5 million from a deficit of \$36.6 million a year earlier. The pickup in tourist arrivals augurs well for a net services surplus.

Policy Developments

Cambodia's many development challenges were exacerbated by the delay in forming a government, which meant that the National Assembly could not meet and no legislative business could be carried out. Apart from the general climate of uncertainty, the implementation of reform measures slowed. With the formation of the new Government in July 2004, the prime minister launched an economic policy agenda, the Rectangular Strategy 2004–2008, so called as it can be represented schematically as a series of interlocking rectangles, with good governance at its core. According to the strategy, growth is to be promoted by development of agriculture, expansion of the private sector, rehabilitation and construction of physical infrastructure, and capacity building and human resource development.

The Government ratified the long-delayed WTO accession package. It also adopted measures aimed at reducing the cost and time associated with import and export procedures and with company registration, and is developing a plan to implement public financial management reforms. Still, progress has been slow on governance reforms, as for example in the legal and judicial areas, and in tackling corruption.

The garment industry, which has expanded rapidly in recent years to employ around 230,000 people, accounted for almost 80% of total exports in 2003. Its growth has been based on preferential access to major markets and, to a lesser extent, on low labor costs. Cambodia will probably hold on to some preferential market access in the post-Multifibre Arrangement (MFA) period, but its low productivity, high infrastructure costs, and corruption mean that the ending of MFA quotas will likely lead to a fall in exports, layoffs, and an economic downturn. Although agriculture has considerable potential, much needs to be done to improve the policy environment for small farmers and agro-based enterprises.

Outlook for 2004–2005

Growth in 2004 is now projected at 4.5%, revised down from 5.4% in *ADO 2004*. It is led by export-oriented manufacturing (mainly garments) and a recovery in tourism and construction. However, the uncertain prospects for paddy production, the impact of avian flu earlier this year, a smaller fish catch, and the base effect of a large crop in 2003 suggest weaker growth in agricultural output. This in turn, is likely to erode rural incomes and domestic consumption. GDP growth is forecast to slow further in 2005 to 2.3%, mainly because of the adverse impact of the ending of MFA quotas.

Inflation is forecast to edge up during the rest of 2004 to an annual average rate of 2.3%, and reach 3.0% in 2005, underpinned by high oil and food prices. In 2005, the probable continuation of high oil prices will be reinforced by any depreciation of the riel, caused by an expected widening of the current account deficit.

Exports are likely to pick up and imports, too, will rise due both to the import-dependent nature of garment exports, and to a likely increase in capital goods imports as public investment revives now that the new Government has been formed. As a result, the trade balance is projected to move into deficit in the second half of 2004. The services and income account will go the other way and post a modest surplus in 2004 as a consequence of higher tourist arrivals. These factors should marginally narrow the current account deficit to 10.0% in 2004, but in 2005 the deficit is forecast to widen to 11.2% as the trade balance deteriorates with the ending of MFA quotas.

Indonesia

Economic Assessment

The economy grew by 4.7% in the first half of 2004, with private consumption boosted by election-related spending accounting for 3.3 percentage points of the expansion. Government consumption contributed 0.6 percentage points, while investment added 1.6 percentage points. Weak growth in exports, at a time of surging imports, trimmed the GDP expansion. Communications, retail, and transportation activity picked up, and the sectors that matter most for jobs—agriculture and manufacturing—grew modestly. GDP growth in the second quarter was 4.3%, easing from 5.0% in the first.¹

The rupiah, which had been in a range around Rp8,600/\$1 since mid-2003, depreciated by about 12% over the first 6 months of the year to around Rp9,600. Government subsidies insulate consumers from the direct impact of rising oil prices, but higher prices for imported food and other items put upward pressure on consumer prices.

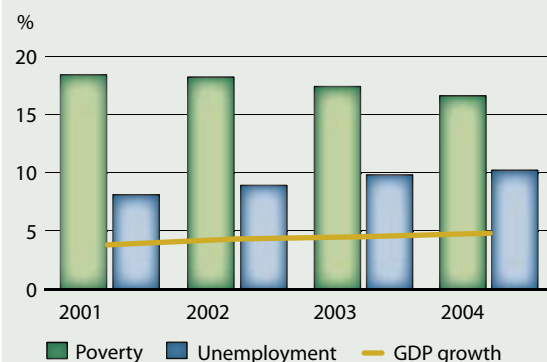
Consumer price inflation, which fell to a 3-year low in February 2004 of just below 5%, rose to 7.2% in July. Bank Indonesia intends to keep inflation at 6–7%, a target that might require higher interest rates in the near future. The central bank's reference interest rate has declined from above 11% in December 2003 to 7.4%. An increase in rates would damp private consumption at some stage, although election-related spending continued through September and holiday-related consumption spending will pick up in October and November.

Rising inflation raises concerns about further progress in poverty reduction. Indonesia reduced the poverty incidence from 27% in 1999 to 15% in 2003 but higher food prices, in particular, might slow or even reverse this process. Moreover, the nonincome aspects of poverty—poor health and

education delivery—remain. Regional disparities in the social indicators affect the country's efforts to achieve the Millennium Development Goals in a timely fashion. Steadily increasing unemployment also hurts poverty reduction. The unemployment rate rose to 10.2% in February 2004 from 9.8% in February 2003, partly because of the slow growth of manufacturing. Figure 2.6 reflects a gradually expanding economy that has been unable to contain unemployment.

Indonesia, traditionally an exporter of oil and gas, did not benefit from the rise in global oil prices over the first half of the year. The Government's subsidies on domestic fuel are projected to cost \$2.4 billion this year, constituting a major drain on the budget. Adding to this, net exports of oil and gas declined by 26% in January–June because the industry could not maintain production levels due to a weak regulatory environment and lack of investment. Crude oil production has declined from 1.4 million barrels a day (b/d) in 2000 to 900,000 b/d in 2004, even though its Organization of the Petroleum Exporting Countries (OPEC) quota has stayed at 1.4 million b/d, and the country became a net oil

Figure 2.6 Poverty, Unemployment, and GDP Growth, Indonesia, 2001–2004



Source: www.bps.go.id.

Table 2.6 Selected Economic Indicators, Indonesia, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	4.5	4.8	4.5	5.2
Inflation (CPI)	6.5	6.5	6.5	7.0
Current account/GDP	3.4	3.4	3.1	3.1

Source: Staff estimates.

importer for a brief period in the first half. The 2004 budget assumes crude oil exports of just over 23,000 b/d, a substantial reduction from levels close to 700,000 b/d in 1998.

Overall exports grew only by 3.2% in the first half, but imports jumped by over 27%, pushed up by consumer spending. Non-oil and gas imports rose by over 24% while non-oil exports increased by just 2.2%, suggesting that Indonesia's export competitiveness is falling behind other countries'.

FDI has played a major role in boosting exports in the past, but foreign investment approvals fell by 34% to \$3.0 billion in the first half of 2004 from a year earlier. Domestic investment approvals picked up by 52% to \$1.8 billion from the year-earlier period, but actual investments lag approvals and many approved projects never proceed. In 2003, for instance, actual foreign and domestic investments were 30–40% of the level of approvals. Further, the quality of investments has become a concern, with more funds headed into property, which does not create as many long-term jobs as investments in manufacturing.

On the fiscal front, the deficit is likely to increase to 1.3% of GDP, against a target of 1.2%, due to the higher cost of fuel subsidies. In terms of financing, the Government has generated Rp3.3 trillion through privatization and anticipates raising most of the remaining funding through domestic bonds. It might ask SOEs to prepay debt, which would be a temporary cushion. The Government's external financing requirement still stands at \$2.8 billion for 2004, while the public debt-to-GDP ratio at end-2004 is projected at 60%, down from 66% a year earlier. External reserves, at \$35 billion as of July, are forecast to be around this level by year-end.

Policy Developments

The Government's policy reform agenda has been guided by its policy package, or White Paper, adopted in September 2003, to prioritize reforms in the post-International Monetary Fund (IMF) program era. As of July 2004, the Government had completed about 76% of the 160 measures intended for the September 2003–July 2004 period. Many of these actions were interim steps or relatively minor developments, though some major accomplishments were made, particularly in the first two planks (out of three) of the White Paper, namely Maintaining Macroeconomic Stability and Restructuring of the Financial Sector. The third plank, Increasing Investments, Exports and Employment, has fallen behind in implementation.

In the area of macroeconomic stability, most significant policy developments in 2004 have been on fiscal matters. Parliament enacted the State Treasury Law in January and the State Audit Law in June. These laws focus on enhancing the fiscal responsibility of the national and local governments. A new functional budget classification system unifies the development and recurrent budgets. To support the implementation of these measures, the President approved a reorganization of the Ministry of Finance that will include the establishment of a modern treasury management system. The Government has drafted amendments to the Tax Law, aimed at simplifying individual and company income tax rates and raising the income level at which income tax starts for individuals. The Tax Code is being amended to improve the governance of tax administration, and the authorities hope to increase tax revenues through improved administration, clearer procedures, and a broadening of the taxpayer base.

Uncertainty over the roles and responsibilities of different levels of government has affected the delivery of public services, such as education and health, and has been one reason for the deterioration of the investment climate. The Government has proposed amendments to the Law on Regional Autonomy and the Law on Fiscal Balances to provide for direct elections of regional representatives, enhance the role of provincial governors, and streamline local revenues. However, it is unclear when the amendments will be enacted.

Moreover, they do not appear to resolve issues of roles and responsibilities among the various tiers of government.

In the financial sector, good progress has been made on the sale of commercial banks that were put in the hands of the Indonesian Bank Restructuring Agency after the 1997–98 financial crisis, with the sale now under way of Bank Permata, the last of these banks. However, governance in state-owned banks remains a concern, especially as some of them plan to merge with other large state-owned or private banks. Given the potential scope for systemic risks stemming from one or two large banks that could account for a substantial part of total banking assets, it will be important that the Government and Parliament evaluate mergers between large institutions. Thus far, the authorities have not issued a clear policy statement on the issue.

The third plank of the White Paper—Increasing Investment, Exports and Employment—is more problematic. While the Government has established a National Investment and Export Promotion Team, Anticorruption Commission, Electricity Market Supervision Agency, and a one-stop investment licensing system, these institutions are yet to have an impact. The national team, chaired by the President, has taken some initial steps to reduce customs and inspection-related impediments to investments. However, a lack of implementing regulations is a problem in many areas. In other cases, a lack of progress in amending laws has been a major constraint. For instance, the Government and Parliament were expected to work together to amend the Bankruptcy Law in the second quarter, in order to allay investors' concerns following a damaging episode where the Jakarta Commercial Court declared the profitable and solvent Indonesian subsidiary of Prudential PLC to be bankrupt, before that bankruptcy verdict was overturned by the Supreme Court. But the amendments to the law have still not been adopted.

As part of efforts to improve the business environment, the Government has proposed a comprehensive national social security system. The draft law aims at integrating health, workplace, and other social safety-net provisions with basic pensions, and to expand social security coverage to workers in the informal

sector. However, the draft law is vague and its fiscal implications are unclear. It has also added to the prevailing uncertainties as to labor costs. Sound implementing regulations will be required to guide a gradual implementation of the law, if Parliament enacts it.

Outlook for 2004–2005

Growth in 2004 is forecast at 4.8%, with the revision from *ADO 2004* caused entirely by the official change in base year prices from 1993 to 2000. Growth could be up to 0.2 percentage points higher if the oil price is sustained at over \$40 a barrel for at least 3 months. However, if growth continues to slow in the third quarter as it did in the second, the full-year outturn could be slightly below the forecast. The proposed 2005 budget, which might be amended after a new Government takes office in October, projects GDP growth of 5.5% in 2005, and forecasts an overall budget deficit of 0.8% of GDP (against a 1.2% target in 2004). It also assumes a 5.5% inflation rate and a 6.5% reference interest rate (compared with 8.5% in 2004). Growth in the forecast period will depend to a large extent on investment and the export performance. The forecast for 2005 is revised up to 5.2%, partly because of the pickup in domestic investment. Inflation is projected to average 6.5% in 2004, similar to 2003, and to edge higher to 7.0% in 2005. Growth may exceed the forecasts if Indonesia's new President, elected directly by the people for the first time, shows early signs of policy clarity on key issues and forms a balanced and focused cabinet.

Downside risks are also apparent. On the political side, the President's party will almost certainly not have a clear majority in Parliament. The weather is a potential problem, too. Parts of Indonesia could suffer from drought caused by a predicted El Niño weather pattern, which would reduce agricultural production.

Several major issues face the new Government in October. One is promoting job creation. More than 10 million people are classified as unemployed and around 40 million are reported to be working fewer than 40 hours a week. About 2.5 million people enter the labor force annually and, based on past performance, the economy needs to grow consistently at 5–6% a year to absorb these new

entrants into the formal sector. However, only 1 million new jobs have been created in each of the past 2 years.

Another dimension is that unemployment among young people has been rising rapidly: almost two thirds of the unemployed are now in the 15–24 age group. New jobs are mainly in the informal sector, where labor productivity is significantly lower. Employment in the formal sector has been discouraged by a rise of more than 60% in labor costs in the past decade. Labor markets in the formal sector have also become more rigid, influenced by increases in minimum wage rates and by uncertainty over labor regulations. Some new jobs were being created in labor-intensive industries such as footwear, but there is evidence that jobs in these industries are shifting to the PRC and Viet Nam.

With regard to export competitiveness, Indonesia's export growth rates have lagged those of other countries in the region, due partly to declining FDI and partly to greater competition from those countries. For instance, over 2000–2003, Indonesian exports to the PRC increased by 30% to \$5.8 billion, while over that period Malaysia almost tripled its exports to the PRC (to \$14 billion), and Singapore and Thailand doubled their exports (to \$10.5 billion and \$8.8 billion, respectively). Besides the rising wage costs and weak growth in labor productivity, problems such as corruption and weak coordination within the Government have reduced the country's industrial and trade competitiveness. Indonesia needs to revive its competitiveness by, among other steps, attracting investment and revamping its import licensing system.

Another challenge for the new administration is reducing nonincome poverty. The Government has issued its first Progress Report on the Millennium Development Goals, which highlights the difficulties in attaining them, including resource constraints and the complexity in coordinating development policies in a decentralized environment. The United Nations Development Programme's *Human Development Report 2004* places Indonesia at 111 out of 177 countries surveyed, with the country's human development index below that of the Philippines and Thailand.

Strengthening the Indonesian civil service should receive priority attention as well. The public widely believes that the civil service is neither professional nor performance-oriented. Recruitment is based on merit, but mobility within the system is not. The pay system is complex and incentives are not geared to promote productivity, but are linked to seniority and other factors. It is critical that the new Government undertake a functional and organizational review at the central and local levels, and formulate a system for determining skill requirements and relative compensation levels for skill categories. The adoption of a State Finances Law has paved the way for integrating planning and budgeting processes. It also provides for performance-based budgeting. However, the challenge lies not only in formulating regulations, but also in implementing them effectively.

1 The National Statistics Agency has recalibrated GDP data using a base of 2000 prices, which has changed reported growth rates.

Lao People's Democratic Republic

Economic Assessment

The first half of 2004 saw GDP growth at an estimated annual rate of 6.5%, driven by mining (gold and zinc), manufacturing, construction, tourism, and electricity production. Agriculture's performance was moderate, with growth of 3.5%, due to a reduction in dry-season rice production caused by irrigation problems (Figure 2.7). Higher production was recorded for most other crops, especially export-oriented cash crops such as maize, sugarcane, and tea. Within the services sector, tourist arrivals rose by 30% in the first 5 months of 2004, more than offsetting the downturn in 2003 caused by the regional SARS outbreak and local security concerns.

Reflecting effective restraints on credit expansion by the monetary authorities, inflation has been contained to some degree since October 2003, and declined to an average of 12% for the first 8 months of 2004, from an average of 15.5% in 2003. Credit expanded by just 3.6% in June 2004 from a year earlier, while the M2 money supply grew by 21.7%. The higher price of imported oil has resulted in price increases for some consumer items and for construction materials, and could exert further upward pressure on inflation over the rest of this year.

Preliminary estimates indicate that revenue collection through August 2004 reached 89% of the target for the fiscal year (October–September), an improvement from a year earlier. Gains in revenue collection reflect a series of measures undertaken by the Government, including enhanced onsite tax inspection of firms, provincial customs reform, and improvement in tax administration.

The trade deficit narrowed to 1.0% of GDP in the first quarter from 4.3% in the same period in 2003, reflecting increases in exports of gold, cash crops, and garments. Building on recent successes

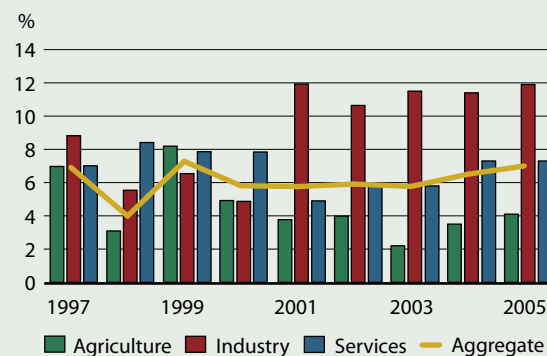
and interest in industry (particularly mining), FDI inflows have been trending up in recent years.

Policy Developments

Steady progress has been made on the restructuring of state-owned commercial banks, addressing challenges associated with their low capital base, and a high burden of NPLs. The Government has issued instructions on the capital requirements of these banks for supervisory purposes, and a forthcoming decree for commercial banks generally is expected to help establish an improved environment for foreign private commercial banks operating in the country.

Momentum has also picked up on restructuring the four largest SOEs—Lao Airlines, Bolisat Phattana Khet Phoudoi (a rural developer), Pharmaceutical Factory No. 3, and Nam Papa Lao (a water utility). The Government outlined the key principles of SOE reforms early in 2004 and followed up with four implementation guidelines to put the SOE restructuring plans into effect and

Figure 2.7 GDP Growth by Sector, Lao People's Democratic Republic, 1997–2005



Sources: Government of the Lao PDR; staff estimates.

**Table 2.7 Selected Economic Indicators,
Lao People's Democratic Republic, 2004–2005, %**

Item	2004		2005	
	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>
GDP growth	6.0	6.5	6.2	7.0
Inflation (CPI)	12.0	12.4	10.0	10.0
Current account/GDP	-2.2	-2.0	-1.9	-1.6

Source: Staff estimates.

to monitor progress in 2004–2005. Restructuring is also proceeding at Electricité du Laos.

In moves to encourage the private sector, in April the Government issued a decree on the promotion and development of SMEs. The decree defined overall policies on private sector development and authorized the establishment of an SME promotion and development fund. The policy aims to create an enabling regulatory environment, enhance competitiveness, expand access to domestic and international markets, improve access to finance, and encourage entrepreneurship. A separate decree was issued to implement an earlier decision to provide tax incentives for priority private investment, and the Government is in the process of reviewing the 1994 Investment Law. In addition, a commercial court division is being established in provincial courts.

Trade issues also have received attention from the Government. Under the Common Effective Preferential Tariff (CEPT) scheme of the ASEAN Free Trade Area (AFTA), all import items currently listed in the Temporary Exclusion List will be moved to the Inclusion List by 2005, and the CEPT rates on the items in the Inclusion List will be phased down to 5% or less by 2008. In accordance with AFTA commitments, tariff rates were reduced and a number of items shifted from the Temporary Exclusion List to the Inclusion List in January 2004. The Government issued instructions in April to integrate seven major customs checkpoints under central administration, paving the way for a streamlined customs administration. On the multilateral front, the first working party session for the country's accession to WTO is planned for end-October, in Geneva.

Reducing poverty remains a major challenge—the latest estimate is that the incidence of poverty declined from 38.6% in 1997 to a still-high level of around 32% in 2003. A National Growth and Poverty Eradication Strategy approved by the National Assembly in October 2003 was subsequently finalized by the Government in April as the Poverty Reduction Strategy Paper. The aim is to reduce poverty through economic growth and an increased focus on the poorest districts, with agriculture, education, health, and transportation proposed as priority sectors for action. The Government selected 47 of the poorest districts for priority investment.

A related challenge is to develop the capacity of the labor force to improve the country's competitive position in attracting investment and trade and to reduce underemployment. The population growth rate increased to 2.8% in 2003, implying a broad-based population pyramid and rapid growth of the labor force. Most of the population is engaged in rural subsistence farming, where seasonal underemployment is pervasive.

Outlook for 2004–2005

GDP growth of 6.5% is forecast for all of 2004, revised up from 6.0% in *ADO 2004*. There are signs that stronger growth has continued, supported by the same drivers as in the first half of the year. The Government's continued efforts to simplify administrative procedures for investment will help improve the environment for private sector-led growth. It also is possible that the US may grant Normal Trade Relations status, in which case exports to the US could increase significantly.

If global oil prices stabilize later in the year, then continued monetary discipline, combined with new revenue-raising measures, should keep inflation in check. On these grounds, stronger GDP growth of 7.0% is projected for 2005, up from 6.2% in *ADO 2004*. Given the mostly concessional nature of the country's external debt and with strong export growth forecast, future debt service flows should remain at a manageable level.

Malaysia

Economic Assessment

At 7.8% in the first half of 2004, the economy expanded faster than forecast in *ADO 2004*. Private consumption rose by 9.9% from a year earlier to contribute 4.7 percentage points to growth, though government consumption added only 1.0 percentage point, the lowest figure since 2000. After years of anemic performance, investment surged as businesses expanded capacity to meet strengthening domestic and foreign demand for their products. Total investment rose by 16.8% from 2003, and gross fixed capital formation increased by 3.5%, as against a 2.0% rise in the first half of 2003. Private investment drove this trend, as, according to preliminary data, government development spending in the first half fell by 28.2% from a year earlier. Imports of capital goods surged by 27.6% in the second quarter, underpinning a concurrent rapid 18.2% expansion in investment, which contributed 4.5 percentage points to GDP growth.

Exports rose by 19.8% in the first half of the year, with the improvement spread evenly across major manufacturing, agricultural, and commodity exports. Exports to the PRC continued to soar, by 32.4% to \$4.0 billion, while those to the US climbed by 13.8% to \$11.1 billion. Imports surged by 27.9%, reducing the trade surplus to \$9.9 billion, for a drop of 9.4%. Net exports fell by 19.6%, taking 2.4 percentage points off GDP growth.

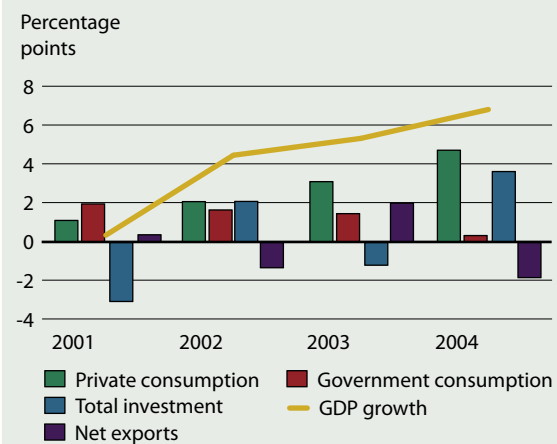
While 2003's 5.2% GDP expansion was primarily due to strong external demand, along with continued pump priming by the Government, this year a healthier and more sustainable balance between external and domestic—primarily private—demand is taking root. This marks a significant structural shift in the growth dynamics of the economy (Figure 2.8).

Growth was bolstered by continued strength in manufacturing output (up 16.2%) and in services (up 7.4%). Tourism rebounded strongly from the 2003 SARS-related slump, with total arrivals in the first half 71.4% higher than in the year-earlier period, and markedly higher than in 2002 and 2001. Agriculture put on a moderate 3.2%, as the improvement in palm oil production slowed.

A rising stock of official external debt, which reached 48.2% of GDP at end-2003, has made fiscal balance one of the Government's priorities. This year's strong economic performance is providing an additional fiscal cushion, as revenues are expected to rise by 4.7%. This will allow for a reduction in the deficit, even though the Government announced in June an RM10 billion boost to development expenditures, targeting small projects. The 2004 fiscal deficit is expected to narrow to 4.5% of GDP from 5.3% in 2003.

Inflation in the first half was subdued, with the CPI up 1.1% in the year to 30 June. The Government continues to subsidize energy prices, insulating consumers from the main impact of

Figure 2.8 Contribution to GDP Growth by Expenditure Account, Malaysia, 2001–2004



Sources: Department of Statistics; staff estimates.

Table 2.8 Selected Economic Indicators, Malaysia, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.8	6.8	5.6	6.0
Inflation (CPI)	1.5	1.5	1.7	2.2
Current account/GDP	7.9	7.8	6.5	7.0

Source: Staff estimates.

increases in world oil prices. Higher US interest rates have not led Bank Negara Malaysia (BNM) to change its accommodative stance, despite the ringgit peg to the US dollar. Most analysts consider the local currency to be either undervalued or fairly valued against the US dollar, suggesting limited exchange rate risk in holding ringgit assets. The peg of the PRC yuan against the US dollar has created a de facto ringgit-yuan peg as well, a source of stability in Malaysia's booming trade with that country.

A relatively slow rate of growth in bank lending, of only 6.0% in the year to 30 June, and a reduction in new government borrowing will help maintain current interest rate settings. BNM seems to be under little pressure to remove or adjust the currency peg at this time, and is focusing on strengthening the banking industry to establish conditions for further financial liberalization, including the exchange rate regime, in the future.

Policy Developments

Nearly 1 year after the leadership succession, a clearer picture of the new Government's economic policies is emerging. It has indicated that it intends to review and overhaul some elements of the economic system, so as to reinvigorate the nation's drive to achieve developed country status. The economy starts from a strong position. The 2004 IMD *World Competitiveness Yearbook* shows that Malaysia is now ranked 16th out of the 60 countries surveyed on competitiveness. Within Asia, Malaysia comes behind only Singapore; Hong Kong, China; and Taipei, China and well ahead of Japan, Thailand, and Korea. In the past 3 years, Malaysia has risen from 28 to 16 in these rankings.

However, several policies that were closely identified with the previous administration require reexamination if competitiveness is to be improved further. Three key examples of such policies are: (i) the dominant role of opaquely managed state enterprises in major sectors of the economy; (ii) policies that exclude non-*bumiputra* Malaysians as well as foreigners from key economic positions; and (iii) government reliance on tight controls over interest rates, exchange rates, and capital flows to maintain financial sector stability. Even though any challenge to the interest groups that have coalesced around those policies will be difficult, the early months of 2004 have seen encouraging developments in all three of those areas.

Government-linked companies (GLCs) dominate several sectors of the economy and account for 34% of the market capitalization of the Bursa Malaysia, formerly the Kuala Lumpur Stock Exchange. This has led to politicization and inefficiency in policy making and management, and has virtually frozen out private investment from some infrastructure and related sectors. Recent steps toward reform of these companies by the Government, while gradualist, are encouraging. In May, key performance indicators and performance-based management compensation for GLCs were announced, to be implemented first in Tenaga Nasional Berhad, the national power utility, and Telekom Malaysia, and then rolled out to others by year-end. Chief executives of these and five other GLCs have been replaced. A Corporate Governance Committee has been established, headed by the chairman of the Securities Commission and reporting to the prime minister, and is tasked explicitly with monitoring the enforcement of corporate governance laws in all enterprises.

Similarly, the Government has moved to strengthen and reorient Khazanah Nasional Berhad, its investment holding company. More than 30 GLCs that had previously been supervised directly by the Ministry of Finance were shifted to Khazanah's oversight. A new chief executive with a private sector background was appointed, with a mandate to accelerate the transformation of GLCs into world-class competitors. The new chief executive said Khazanah is looking into making its first-ever investments abroad.

The Government has reiterated its intention to gradually relax policies that are designed to maintain *bumiputra* ownership of assets and control over strategic sectors, and has taken some action. Most notably, non-*bumiputras* are now allowed, for the first time, to serve as chief executives of GLCs. This is an important step to creating a more dynamic corporate culture in the state sector, by emphasizing ability and performance over other criteria for promotion.

The financial sector continued to make efficiency improvements, in keeping with the 10-year Financial Sector Master Plan launched in 2001. The Kuala Lumpur Stock Exchange was demutualized, effective 1 January, and renamed Bursa Malaysia. It has announced plans to establish a cross-trading arrangement with the Singapore Stock Exchange by end-2005. BNM introduced a new interest rate framework in April, establishing its overnight policy rate as the benchmark. BNM also eliminated its base lending rate formula for commercial banks, allowing each bank to determine its own rate, in another small but significant move toward banking liberalization.

However, the small size of the banking industry and the underdeveloped local bond market reflect the limited nature of liberalization to date, particularly in interest rates, which continue to be heavily controlled. Major steps are still to be taken to create a competitive financial sector, including further opening to foreign institutions and relaxation of remaining controls over interest rates and capital flows, in tandem with continued strengthening of the regulatory system.

Outlook for 2004–2005

The vigorous economic recovery has gained enough momentum to continue through 2005, although some deceleration is becoming apparent. For example, the rise in the industrial production index slowed to 9.9% year on year in July. Nevertheless, GDP growth forecasts have been revised up to 6.8% for 2004, from 5.8% in *ADO 2004*, and to 6.0% for 2005, from 5.6%. Inflation is likely to nudge up to 1.5% in 2004 and 2.2% in 2005, as budgetary consolidation may lead the Government to reduce its subsidies on consumer energy. A slowdown in the export expansion, alongside continued strong import growth, is

projected to cut the current account surplus to \$9.4 billion in 2004, with a rise to \$11.0 billion in 2005. Investment growth is put at 15.0% in 2004, easing to 9.5% in 2005 because of further planned cuts in government development spending. Private consumption will remain the main source of strengthening GDP.

The 2005 budget targets a modest reduction in the deficit to 3.8% of GDP. Further out, the Government's plan for a new broad-based goods and services tax in 2007 adds credibility to its commitment to fiscal balance, and may pave the way for a long-anticipated cut in business income taxes.

The unemployment rate is expected to rise to 4.0% by end-2004 from 3.6% at the start of the year, and to remain around 4% in 2005. The announced increase in government development spending, along with positive trends in the labor-intensive tourism sector, should help mitigate the negative impact on employment of the anticipated slowdown in merchandise exports.

As a small net oil exporter—crude oil has a 5% share of exports—Malaysia benefits to a degree from the higher world oil prices. However, an extra \$10 a barrel over all of 2005 could push up inflation by 1.4 percentage points, hurting domestic demand, and leading to a decline in the GDP growth rate of 0.9 percentage points. (Oil scenarios are discussed further in Part 3.)

In the medium term though, burgeoning regional demand for energy offers many economic opportunities. Deepwater exploration is accelerating, driven by the expectation that higher prices are likely to be sustained for some time. Various new exploration agreements have been made public over the last few months. Petronas, the national oil company, plans to raise oil production by 20% over the next 10 years, which will require exploitation of many new oil and gas fields. Consequently, energy production is predicted to be a pillar of the Malaysian economy and a focus of new FDI.

A slowdown in the US economy would have both heavy direct and indirect negative effects on exports, since the US is by far Malaysia's biggest export market. Direct exports to the US made up 18.6% of all exports in the first half of 2004, and recent estimates suggest that half of Malaysia's exports to the PRC are then reexported, and many

of them go to the US. Slower US growth could affect other export markets as well. The signing of a Malaysia-US Trade and Investment Framework Agreement in May 2004 may further strengthen the two countries' economic ties.

To a lesser extent, Malaysia's economic performance will be affected by the PRC's ability to engineer a soft landing, though that country's demand for most Malaysian products—particularly those that are reexported—does not seem to be declining so far.

Looking further ahead, long-term sustainability of growth requires building on this year's promising start in restructuring GLCs.

The Government has said that it intends to seek foreign investment in these companies, and to divest significant blocks of shares in some of them. Strong and commercially oriented Khazanah oversight of these state holdings and greater private, including foreign, share ownership in the GLCs will help accomplish the key purposes of their restructuring. Achieving such an agenda will likely also entail further progress in the two other structural reform areas highlighted above: relaxation of ethnically determined rules on ownership and the holding of management positions, and further liberalization of the financial sector.



Philippines

Economic Assessment

Exceeding the expectations of *ADO 2004*, GDP growth came in at 6.3% in the first half of 2004. Unusually for the Philippines, the rise in gross national product (GNP) at 6.1% was less than in GDP, mainly reflecting a drop in the growth rate of remittances from overseas workers. Personal consumption (two thirds of aggregate demand) rose by 5.9% and remained the main driver of domestic demand in the first half, contributing 4.6 percentage points to the rise in GDP. Tight public expenditure controls to reduce the budget deficit resulted in government consumption expenditure growing by just 0.5%, making virtually no contribution to the GDP expansion. Gross capital formation, which accounted for 2.1 percentage points of GDP growth, increased by 9.4%, with a pickup in both construction and durable equipment. Exports grew by 13.0% and imports by 5.7%, resulting in a net export contribution to GDP growth of 2.3 percentage points.¹ On the production side, good weather helped agriculture, fisheries, and forestry (together accounting for 20% of GDP) to grow by 6.3%. The industry sector (33% of GDP) climbed by 5.6%, with manufacturing and construction the leading sources of sector strengthening. Services (47% of GDP) grew by 6.9%. All subsectors in services posted gains; election-related activities peaked in the second quarter.

However, the economy did not generate enough jobs for the growing workforce, as seen in high rates of unemployment (13.7% in April) and underemployment (18.5%). The deployment of workers overseas, after a slowdown in 2003, grew by 7.2% in January–June.

Congress has not passed the proposed 2004 budget, and the Government will operate on the reenacted 2003 budget for the rest of the year. The budget retains the full-year deficit target of

P197.8 billion (4.2% of projected GDP), while revised quarterly cumulative deficit targets were set to track the 2003 actual levels, except for the last quarter, given this year's projected 0.4 percentage point reduction in the deficit-to-GDP ratio from 2003. The tight targets and the reenacted budget limit opportunities for financing new initiatives.

In the first half of the year, the actual fiscal deficit of P80.1 billion was 0.7% higher than the target. A 3.0% overrun against the expenditure target was matched by a proportionate increase of revenues over target. However, the low revenue-to-GDP ratio continues to force the Government to borrow to meet its operational needs, and the national Government's debt stock was P3.5 trillion at end-June (74.6% of GDP), up from P3.3 trillion (78.0% of GDP) at end-2003. During the period January–June 2004, foreign public borrowings (equal to 41.2% of total public borrowings of P233.3 billion) breached the programmed borrowing mix of 84% domestic and 16% foreign.

Domestic liquidity (M3) decelerated somewhat to 5.7% in the first half of 2004 from 5.9% in the same period in 2003. Corporate demand for credit remained subdued. On the credit supply side, although there was a slight improvement in the NPL ratio from 14.1% at end-2003 to 13.8% in June 2004, weak asset quality continued to limit the ability of commercial banks to expand lending. With the monetary policy of the Bangko Sentral ng Pilipinas anchored in inflation targeting, key overnight policy rates have been unchanged since July 2003, at 6.75% for borrowing and 9.0% for lending. High demand for deficit financing saw 91-day treasury bill rates increase to an average 7.0% in the first half, from an average 6.1% in 2003.

Inflationary pressures have been more pronounced than expected in *ADO 2004*, with the CPI rising by 5.1% in June and 6.0% in July,

Table 2.9 Selected Economic Indicators, Philippines, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.0	5.5	5.0	5.5
Inflation (CPI)	4.5	5.2	4.5	5.5
Current account/GDP	3.0	3.0	2.8	2.8

Source: Staff estimates.

the fastest pace since October–November 2001. The acceleration was caused by higher prices for food, fuel products, and rises in transport fares, all linked to world oil prices. The peso slid slightly against the dollar in the first half of the year, adding to domestic price pressure, though the slide in the real effective exchange rate index as measured against a regional currency basket was less marked. In the external sector, reflecting a healthier current account, the balance of payments recorded a \$68 million surplus in the first half, marking a turnaround from the \$609 million deficit a year earlier. Merchandise exports rose by 8.5% to \$18.7 billion, led by increases in electronics. Imports grew by 7.2% to \$19.9 billion, on the back of higher demand for equipment and intermediate goods primarily for the export-oriented electronics industry, which augurs well for future exports. Higher oil imports were also a factor. The merchandise trade balance was in deficit by \$1.2 billion, down slightly from a year-earlier deficit of \$1.3 billion. Remittances from overseas workers rose by 2.6% to \$4.0 billion over January–June. On the capital and financial accounts, capital outflows continued to exceed inflows, by \$30.4 million in the first quarter.

As of 30 June, gross international reserves amounted to \$16.2 billion, down from \$16.9 billion 6 months earlier, and were equivalent to about 4.4 months of imports of goods and services. The decline was caused by the debt service requirements of the Government and the central bank. The three major global credit rating agencies retained their sovereign ratings for the Philippines at two notches below investment grade with a negative outlook, implying substantial credit risk but with expected access to financing. Although the country has access to international capital, the cost of foreign sovereign debt has been high

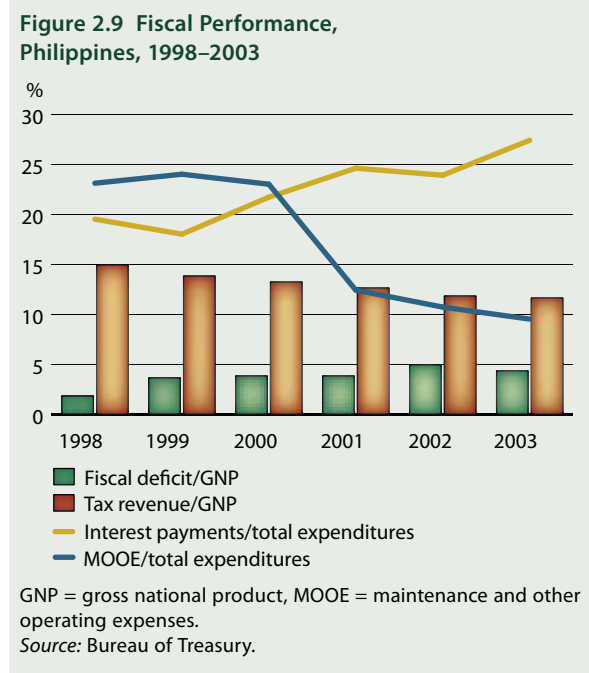
(for 10-year sovereign bonds, currently about 450 basis points over US treasury bill rates), partly reflecting the low credit ratings.

Policy Developments

President Arroyo’s “five-point reform package” and “10-point agenda” highlight broad goals such as job creation, economic growth, and good governance. Greater detail and coherence are expected from the new Medium Term Philippine Development Plan (2005–2010) being prepared for cabinet consideration in mid-October. An important omission is any serious message about tackling high population growth; subsequent statements have indicated that the national administration intends to leave this issue to the initiative of local governments.

Economic targets outlined so far are ambitious. A goal of creating 6 million jobs over the next 6 years compares with the record of an average 800,000 net jobs created each year during 1999–2003. Even if this target is achieved, unemployment is expected to remain high. Given an average of 1.4 million additions to the labor force each year, it is estimated that unemployment could reach 6 million by 2010, up from its present 5 million. A major hurdle to achieving these targets is that they require higher spending during a period when strict fiscal consolidation will be needed. To balance the budget by 2009, while allowing expenditures to increase by 10% per year, the Government needs to increase revenues by at least 15% per year (from 1999 to 2003 revenues grew by an average 6% annually). Overall, strict fiscal discipline, in revenue collection and in managing the level and effectiveness of public expenditures, will be required to implement the economic and social agenda.

The new Government has made the precarious fiscal position a high priority for action. Declaring the country to be in a “fiscal crisis” and identifying the budget deficit as the “most urgent problem,” in August the President noted that “sometimes stamping out deficits can slow growth. But ignoring them can kill the economy.” The problem is mirrored in rising public debt and interest costs, with a consequent lack of discretionary expenditure for infrastructure, health, and education. Interest payments as a share of total expenditures have steadily increased (Figure 2.9) as have other



nondiscretionary expenditures including those on personnel services and allocations to local governments, and the indications are that there will be no respite under the 2005 budget being formulated.

Acknowledging that chronically low revenues are a fundamental cause of the budget deficit, the Government announced a package of measures to increase annual tax revenues by more than 10% (P80 billion). Bills filed with Congress include a two-step increase in VAT; reimposition of a 3% franchise tax on telecommunications companies; adoption of gross income taxation for corporations and self-employed individuals to simplify the tax procedure; rationalization of fiscal incentives for investors; and adjustment in the excise tax and tariff on petroleum products. Aside from these legislative measures, the Government is also pushing for improved tax administration. If approved, these measures are expected to yield an additional P130 billion in revenues yearly. The efficacy of some proposals, such as returning to gross income tax and sales tax, needs careful scrutiny. Also, the Government faces a difficult challenge in convincing the public of the urgency of the measures and so securing its support, and in encouraging Congress to approve the legislation. The challenge is made even harder by recently publicized failures of tax agencies to

collect existing taxes effectively, and consequent large losses in revenues.

On the budget expenditure side, initiatives under government consideration include a reduction in the annual P20 billion Priority Development Assistance Fund that provides nonaudited allocations to each member of the Senate and Congress; a reduction in the Internal Revenue Allotment to local governments; and a change to the cost-sharing formula between the national Government and local governments to eliminate the grant-financed element now provided to poorer local governments. As part of the reforms of local government financing, the Municipal Development Fund Office (the agency through which aid funds are channeled to local governments, and through which grant financing is provided) is being corporatized, with the aim of making it a commercially oriented financing vehicle for local governments. Local governments also are being encouraged to enhance their own revenue bases and seek commercial financing for projects.

The Government is vulnerable to high levels of contingent liabilities, primarily for underwriting the finances of government-owned and controlled corporations, government financial institutions, and the public pension system. The Department of Finance has submitted proposals to reduce the limits on borrowings by such corporations and to lower the Government's contingent exposure to the public pension system (which faces insolvency and the prospect of negative cash flows as early as 2008) through an increase in members' contributions and review of benefits.

The fiscal imbalance cannot be corrected without addressing the financial losses of the public power sector. Currently, the liabilities of the National Power Corporation (NPC) represent about 65% of the Government's total contingent liabilities. A recently approved NPC rate hike of P0.98 per kilowatt-hour, while less than the amount requested, will reduce future losses by about 30%. The President has reconfirmed the Government's intention to privatize state-owned power generation and transmission assets. After two failed biddings for the sale of the assets of the national transmission agency in 2003, the Government is assessing expressions of interest from bidders for a 25-year concession for the operation and maintenance of the transmission

grid. In addition, 35 of the NPC's generation plants are scheduled for sale later in 2004.

A "fighting target" has been set by the Government of increasing investment as a proportion of GDP from 16.6% in 2003 to 25–28% in 2005–2010. Given the public sector's fiscal constraints, most of the increase will need to come from private investors. Steps to improve the investment climate include amending the build-operate-transfer law and its implementing regulations to promote wider private participation; generating more transparency in public sector purchasing through wider use of electronic procurement; and resolving infrastructure bottlenecks. A judicial reform agenda is also ready for implementation. Politically, the timetable for finalizing a peace agreement with the Moro Islamic Liberation Front in Mindanao remains uncertain, though this is a government priority and the outcome will have an important influence on investor perceptions for the country as a whole.

Outlook for 2004–2005

The need for fiscal consolidation and the adverse impact of continued high international oil prices and increases in interest rates are likely to slow the economy in the second half of 2004. GDP in 2004–2005 is expected to strengthen to a range of 4.7–5.7%, higher than forecast in *ADO 2004*, while GNP growth is projected to rise to 5.4–6.0%. Agriculture will show stronger growth than forecast in *ADO 2004*, at 4.7–5.7%, as a result of rapid expansion in the first quarter of 2004 and continuing good weather. Industry is forecast to grow by 4.0–4.5%, led by exports. The services sector is expected to maintain its growth of 5.5–6.3%.

Exports look likely to grow by 10.0% in 2004, faster than envisaged in *ADO 2004*, and will be supported by the first-half recovery of semiconductor shipments and exports of nonfactor services arising from the income of ICT-related services, call centers, and business outsourcing services. Imports are projected to rise by 7.0%.

Following the steeper than anticipated price rises in June and July, inflation in 2004 is expected to be in the range of 5.2–5.9%, exceeding the Government's target of 4–5% and higher than forecast in *ADO 2004*. The increase accommodates

the impact of the continuing high oil prices and expected pass-through rises in the costs of transportation and some wages. Monetary policy is unlikely to be tightened in the near future as the price pressures stem mainly from the supply side.

International oil prices and interest rates will have an important bearing on whether targets will be met, given the country's high dependency on energy imports and large stock of foreign debt. For example, an extra \$10 a barrel in the oil price for all of 2005 could translate into a decline in that year's GDP growth rate of 1.9 percentage points and a rise in inflation of 1.4 percentage points. (Oil scenarios are discussed further in Part 3.) Rising interest rates, both domestic and foreign, would have a direct impact on public debt service payments, which totaled P270.0 billion in the first half, or 64% of government expenditures and 79% of government revenues for that period. Higher debt service requirements compress the resources available for much-needed public investments, and this, in turn, compromises the attainment of long-term economic growth targets. Consumer spending is expected to fuel growth; however, this is vulnerable to any disruption in remittances from overseas workers, likely to be more than \$8 billion in 2004.

Achieving the forecasts for 2004–2005 requires adjustments to be carried out promptly. While some analysts have disputed the President's "fiscal crisis" assertion (on the basis of a technical definition related to the country's current capacity to service debt and access international capital markets), the central point is the Government's clear recognition of the need for action to prevent an already precarious fiscal position from worsening. However, key elements of the Government's recovery plan will be unpopular with the electorate. The ability of the administration to convince stakeholders of the need for necessary action will be as important as in the actual implementation. The longer the consensus building takes, the less likely the macroeconomic targets will be met.

1 The contributions to GDP growth are indicative only because a large statistical discrepancy of 2.6 percentage points is subtracted on the demand side to match the 6.3% GDP growth. The contribution of personal consumption expenditure, in particular, may be overstated.

Singapore

Economic Assessment

Singapore continued its strong growth momentum in the first half of 2004, reflecting the overall pickup in global economic activity and recovery from the impact of SARS a year earlier. GDP expanded by 7.5% in the first quarter and 12.5% in the second, supported by stronger external and domestic demand (Figure 2.10).

The nascent recovery in domestic demand seen in late 2003 has become stronger and broader in 2004. Higher spending on machinery and equipment pushed up fixed investment, which increased in real terms by 12.7% in the first half, compared with a 3.8% decline over the whole of 2003. After several quarters of significant inventory reductions, stocks began to build and contributed to growth in manufacturing output in the first half. Private consumption accelerated to 11.6% in the second quarter, from 7.9% in the first, as consumer confidence improved.

A turnaround in labor market conditions helped boost consumption expenditures. Total employment strengthened by 24,100 in the first half of 2004 to the highest level in nearly 2 years. Most of the new jobs were created in services, with some also in manufacturing, but construction continued to shed numbers. The seasonally adjusted unemployment rate has been steady at around 4.5% since December 2003.

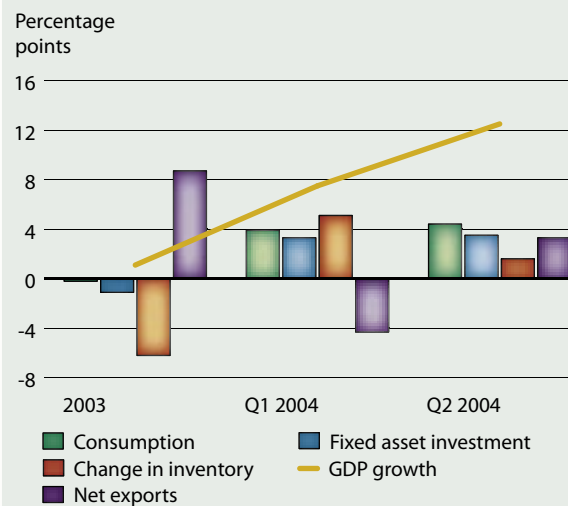
All major manufacturing industries posted growth, lifting manufacturing value added to 11.0% in the first quarter and 20.6% in the second. Output of electronics rose by 12.9% and 25.4% in the first and second quarters, respectively, driven by an impressive rise in semiconductor and consumer electronics production. The biomedical industry grew by 20.5% in the first quarter and by a vigorous 51.2% in the second, with much of the impetus coming from pharmaceuticals, due in part to a higher-value product mix than a year

earlier and to strong exports to the EU and US. Transportation engineering also performed well in the first half, largely on the back of increased demand for ship repairs, ship building, and oil rigs. Construction, which has been depressed in the past 5 years, revived a little, by 1% in the first quarter, but then resumed its decline in the second when value added fell by 5.1%, dragged down by weaker construction activity in both the public and private sectors. Continued oversupply in the property market remains a major reason for the sector's poor performance.

Services posted strong growth of 9.0% in the first half, spurred by continued strength in entrepôt trade, a rise in motor-vehicle sales, and a rebound in global travel. The low base of 2003 contributed to the upswing in tourism-related industries such as hotels, restaurants, and transportation.

Financial services expanded by 8.6% in the first half of the year. The Straits Times Index gained 4.2% from end-2003, and the value of

Figure 2.10 GDP Growth and Contribution by Expenditure Account, Singapore, 2003–Q2 2004



Source: Ministry of Trade and Industry.

Table 2.10 Selected Economic Indicators, Singapore, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.6	8.1	4.8	4.2
Inflation (CPI)	1.2	1.8	1.7	1.6
Current account/GDP	34.5	27.0	32.7	25.0

Source: Staff estimates.

stock trading increased by 21.3% in the period. Total commercial bank lending to nonbank customers rose by 5.8%, while housing loan growth remained strong. However, after a tentative recovery in the first quarter, credit to the corporate sector contracted for most segments in the second.

On a year-on-year basis, the CPI rose by 1.4% in the first quarter and 1.9% in the second, compared with an increase of just 0.5% for all of 2003. Structural factors, such as a 1 percentage point rise in the goods and services tax from January 2004, the low SARS-induced base of 2003, and the impact of higher global commodity prices contributed to the uptrend in prices.

Bolstered by the upturn in the global electronics industry and booming demand from regional economies such as the PRC, merchandise exports measured in nominal US dollars jumped by 28.3% in the second quarter after a gain of 15.3% in the first. The key products contributing to this included electronics, petrochemicals, pharmaceuticals, and specialized machinery. Merchandise imports surged by 23.5% in the first 6 months to meet the need for rising inputs for the export industries and as a consequence of the recovery in domestic demand. The current account surplus as a share of GDP fell to 26.8% in the first half of 2004, from 30.9% a year earlier, mainly due to the rapid growth in imports.

The strong economic pickup was reflected in a rapid improvement in fiscal revenues. Government operating revenues, which exclude investment income, interest income, and capital receipts, improved by 12.4% in the first half, while government expenditures (operating plus development expenditures) grew by 3.4%. As a result, the primary operating deficit shrunk to 2.6% of GDP in the first half of 2004 from 4.1% in the year-earlier period.

Policy Developments

Against the backdrop of a more favorable external environment and a sustained recovery in domestic demand, the authorities switched from an accommodative macroeconomic policy stance to a moderate tightening. The budget for FY2004 (beginning 1 April) aims at maintaining a prudent fiscal position and at continuing to use tax policy in an effort to improve competitiveness and so attract FDI. It includes a reduction in corporate income tax from 22% to 20% and tax exemption for newly incorporated companies, foreign-sourced income, and Singapore-sourced investment income. Overall, budget expenditures will increase by 5.6% in FY2004, mainly in defense, education, and transportation infrastructure. The budget deficit is estimated to narrow to S\$1.4 billion in FY2004 (0.8% of GDP), and the Government intends to balance the budget by FY2005.

A well-functioning social safety net is key to the country's structural adjustment to capital- and skill-intensive industries. Some principles on this issue were set out in the FY2004 budget, which calls for careful targeting of assistance, as well as a balance between assisting those in need and avoiding the erosion of the work ethic.

To contain inflationary pressure, the Monetary Authority of Singapore in April shifted its monetary policy from zero appreciation of the trade-weighted nominal effective exchange rate to a modest and gradual appreciation. In line with the global low interest rate environment and easy domestic liquidity conditions, interest rates remained low. The 3-month domestic interbank rate stayed at 0.75% in the first half, then rose to 1.13% in August in response to US rate increases.

Related to the change in exchange rate policy, the Government emphasized that Singapore companies should secure their competitiveness through improvements in productivity and innovation, rather than attempting to rely on currency depreciation. The strength of the Singapore dollar is helping expand Singapore's overseas investments, which include foreign assets owned by government-linked companies and the private sector, enabled by the country's significant current account surpluses. Recent official statistics put the cumulative value of overseas invest-

ments at US\$159 billion in 2002. Investments by government-linked companies have risen sharply since then, so their present level is much higher. Government-linked companies increased strategic investments at home and abroad during the first half of the year. Given its substantial domestic savings, and diminishing returns on those savings, the Government is likely to continue investing overseas, especially in other Asian economies.

However, to tackle the problems of an aging population and in response to a prolonged decline in the birth rate, the Government announced a number of pro-fertility measures, including an extension of paid maternity leave and higher child care subsidies, in an effort to raise the birth rate to the level needed to keep the population stable.

Outlook for 2004–2005

Robust expansion in the first half of the year has brightened the cyclical outlook. Given the improved global demand and domestic momentum, GDP growth in 2004 is now forecast at 8.1%, significantly higher than the 5.6% projected in *ADO 2004*. The forecast for 2005 has been revised down by 0.6 percentage points to 4.2% to reflect the impact of the anticipated slowdown in the PRC and global monetary tightening.

Private consumption is forecast to rise by 6.0% in 2004 and 5.0% in 2005, underpinned by continuing improvement in consumer sentiment. Employment will continue to improve gradually as the recovery spreads across more industries. However, the unemployment rate is unlikely to fall sharply because of the ongoing structural transition, and is forecast at 4.0–4.5% in 2004–2005. A slight increase in real wages is expected as the economy continues to recover. However, the rise in wages is likely to lag productivity gains, exerting little cost pressure on domestic inflation.

Export growth will remain strong over the

rest of 2004, supported by the global corporate personal computer replacement cycle, but will moderate in 2005 due to the anticipated slowdown in the PRC and US. Merchandise exports measured in US dollars are forecast to rise by 15.0% in 2004 and 7.5% in 2005. In line with the strength of domestic demand, the rise in imports will outpace that in exports in 2004–2005. Overall, the current account surplus is projected to fall to 27.0% of GDP in 2004 and 25.0% in 2005.

Investment growth is expected to be strong, bolstered by greater confidence in manufacturing as a result of expanding exports. Fixed asset investment is forecast to strengthen by 6.7% and 4.5% in 2004 and 2005, respectively. Investment in machinery and equipment will continue to be the major driver. The rebuilding of inventories will also help lift output in this period.

Domestic prices are projected to rise slightly, though they will be restrained by the anticipated strengthening of the Singapore dollar and weak domestic cost pressures in terms of unit labor costs and profit margins. The CPI is forecast to edge up by 1.8% in 2004 and 1.6% in 2005. Given the benign domestic inflation and interest rate environment, the monetary authority is likely to continue its current policy stance for much of 2004. Fiscal conditions will improve as the economic rebound continues. The operating fiscal deficit is expected to shrink in 2004 and the operating budget is likely to be in balance in 2005.

The main downside risk to these forecasts comes from the uncertainty in global demand conditions, and in particular the extent of the upturn in the global electronics cycle, given Singapore's high exposure to swings in global demand. A possible further slowdown in the PRC's demand for imports would also hurt export-oriented manufacturing. In addition, the potential for reduced liquidity in global financial markets following US rate increases as well as continued high oil prices could pose threats to the recovery of domestic demand.



Thailand

Economic Assessment

GDP growth slowed to 6.6% in the first quarter of 2004, from the 7.8% burst in the fourth quarter of 2003, and decelerated further to 6.3% in the second quarter. The deceleration was largely attributable to a long drought, avian flu, rising oil costs, and tensions in the southern provinces.

For the first half of 2004, GDP grew by 6.4%, with private consumption again the main driver, making a contribution of 3.2 percentage points. Nevertheless, growth in private consumption, which accounts for more than 50% of GDP, slowed from 7.1% in the last quarter of 2003 to 6.1% and to 5.5% in the following 2 quarters, as consumer confidence was affected by the factors listed above.

Investment growth, which accounts for about 20% of GDP, decelerated from almost 20% in the last quarter of 2003 to 16.2% and to 12.1% in the next 2 quarters. Private investment recorded more stable expansion of around 17% during the first half year. Gross fixed capital formation contributed 2.9% to total GDP growth in the half.

Both the business sentiment index and the consumer confidence index have generally been positive, though slightly affected at times by the negative factors. Export demand remained buoyant in the first half but was outpaced by imports, such that net exports subtracted 2.0 percentage points from GDP growth.

On the supply side, slower GDP growth was almost entirely due to the performance of agriculture. Agricultural production fell by 2.6% in the first quarter and dropped a further 7.5% in the second, after a strong performance in the last 2 quarters of 2003. This significant slowdown was the result of a prolonged drought and the impact of avian flu on the poultry industry. Against this, prices of major crops stayed high, which supported farm incomes. The nonagri-

culture sectors grew steadily, by 7.7% in the first and second quarters of 2004. Manufacturing expansion slipped from 10.3% in the first quarter to 7.5% in the second. The services sector picked up, partly due to the low base in 2003 when the SARS outbreak hit tourism. Wholesale and retail trade grew at around 3–4%.

In the labor market, tightness was reported in several sectors, which helped push up real wages by 0.3% and 0.7% in the first and second quarters, respectively.

The Government's fiscal situation is on track. In the first 8 months of FY2004 (ending 30 September 2004), government revenues amounted to B659 billion while expenditures totaled B752 billion, putting the budget in deficit by B94 billion. After taking into account expenditures from external financing of B5 billion and a nonbudgetary surplus of B77 billion, the overall government balance was a deficit of B22 billion. Overall public debt stood at B2,850 billion as of 31 March, equivalent to 44.0% of GDP. This was down from B2,918 billion (49.7% of GDP) at end-FY2003. The ratio of central government debt to GDP also declined, from 27.4% in September 2003 to 24.8% in May 2004.

Inflation accelerated to 1.9% in the first quarter of 2004 and to 2.6% in the second. Inflationary pressures picked up due to rising oil and nonfuel commodity prices, together with the tightening of the labor market and higher capacity utilization in the industry sector. In the first 7 months of 2004, prices of agricultural products increased by 15.8%, while the rise in manufacturing product prices was contained at 2.9%. Core inflation (CPI excluding food and energy) was 0.3% in the first 7 months, still within the 2004 Bank of Thailand (BOT) inflation target. Liquidity growth measured by M2 also accelerated, to 6.4% in the first quarter of 2004, but in the second it slowed a little to 5.8%. Similarly, the pace of expansion in commercial bank credit picked up to

Table 2.11 Selected Economic Indicators, Thailand, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	7.2	6.4	6.2	6.6
Inflation (CPI)	2.4	2.8	2.6	2.6
Current account/GDP	3.9	4.0	3.9	4.0

Source: Staff estimates.

6.7% in April and 9.0% in June, due to increased lending to the corporate sector.

The Stock Exchange of Thailand Index has given back some of the large gains it made in 2003, when it more than doubled, declining by about 14% to mid-September from the start of the year. In the foreign exchange market, the baht averaged B40.3/\$1 in the second quarter, depreciating slightly from B39.2 in the first, and by mid-September it was quoted at around B41.3. Reasons for the softening included investors' concerns over rising oil prices and the unrest in southern provinces, foreign investors' net sales of Thai stocks, local oil companies' demand for dollars, and market concerns over higher US Federal Funds rates.

External performance remained strong through the first half of 2004. Exports grew by 20.9% in the first quarter and 24% in the second, as a result of higher exports of agricultural items and of manufactured products, such as electrical appliances, automobiles, and plastics. Export prices also climbed rapidly, by about 17% in the 6 months to 30 June. Concurrently, imports increased even faster, by 27.3% in the first quarter and 35.3% in the second. At midyear, the trade surplus was down to about \$100 million, compared with \$2.5 billion a year earlier, and contributed to a current account surplus of \$2.8 billion, from \$3.7 billion. International reserves stood at a comfortable level of \$43.5 billion at end-July, higher than the level before the Asian financial crisis in 1997–98.

External debt continued its steady decline of recent years, from \$51.8 billion at end-2003 to \$50.0 billion 6 months later, and the debt service ratio fell from 16.0% to 9.3%. Short-term debt accounted for about 23% of total external debt at midyear.

Policy Developments

BOT raised the 14-day repurchase rate from 1.25% to 1.50% in August, concerned over the inflationary pressures caused by increasing capacity utilization, rising oil prices, and a tightening labor market. BOT had previously flagged that it might well move toward a gradual tightening of monetary policy.

With the economy reaching sustained growth supported by private investment, fiscal policy also tightened a little. In FY2004, the consolidated general government balance is expected to record a surplus of about 0.8% of GDP, larger than earlier projections, as a result of higher tax collection arising from the economic expansion. For FY2005, the Government is expected to propose a balanced budget, the first since the financial crisis.

Thailand continues to make advances on restructuring the financial and corporate sectors. The share of NPLs in total commercial bank lending was 13.1% in June 2004, slightly lower than 13.5% in January and down significantly from 16.8% in June 2003. However, Krung Thai Bank, a major financial institution, reported in July a sharp increase in its NPLs. Prudent financial sector management needs to be maintained to prevent higher levels of lending by the banks to the corporate, property, and household sectors from becoming NPLs. Further strengthening of capital markets would enable the corporate sector to secure higher levels of longer-term funding.

Outlook for 2004–2005

GDP growth for 2004 is revised down to 6.4% from 7.2% in *ADO 2004*, on the basis of the deceleration in the first and second quarters. For 2005, it is forecast to pick up slightly to 6.6% (Figure 2.11), on the assumption that the factors that caused the deceleration in the first half of 2004 will have subsided. Domestic demand, particularly private investment, is expected to continue to underpin growth. According to BOT, industries with capacity utilization rates higher than average precrisis levels, including automobiles, electrical appliances, electronics, and steel, will step up their investments.

Inflation is now forecast at 2.8% in 2004

rather than 2.4% to reflect the recent inflationary pressures, before it declines to 2.6% in 2005. The monetary authorities expect that core inflation will rise at a slower rate, to average 0–1% and 1–2%, respectively.

With imports growing faster than exports, the trade balance may turn into deficit in 2004 or 2005. However, investment inflows, particularly FDI, may well outweigh the deficit, and the current account balance will likely remain in surplus in 2004–2005. Indeed, a recent survey by the United Nations Conference on Trade and Development (UNCTAD) indicated that Thailand was viewed as the third most attractive destination for FDI in Asia.

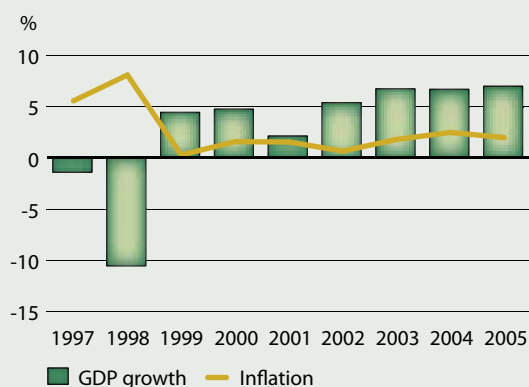
Domestic risk factors that may affect these forecasts include unrest in the south and avian

flu. A widespread recurrence of avian flu would hurt the poultry industry, which is an important segment in both agriculture and food processing, and services if the disease starts to affect larger numbers of people. Externally, the most obvious risk is that crude oil and nonfuel commodity prices could be higher than expected, lowering growth and raising inflation in the process. Other external risks include larger than expected global interest rate rises and slower economic growth among the country's major trading partners.

Other than these risks, the Government, particularly BOT, needs to monitor several vulnerable parts of the economy. Rising levels of household debt remain a concern: the average household debt went up from B68,279 in 2001 to B110,133 in the first quarter of 2004. If domestic interest rates increase, sustainability of household debt may become a serious issue that could affect the banks and consumer spending. The property sector, too, could cause problems for banks if the recent surge in activity and prices turns down and interest rates rise.

External stability could become an issue in the medium term, despite the fact that the economy has become less vulnerable to shocks over recent years, with, for example, external debt at 40% of GDP and the ratio of international reserves to short-term debt at 3.8:1 in January. Large increases in imports and investments to support high economic growth may result in a decline in the current account surplus in the short term, which could turn into a deficit further out.

Figure 2.11 GDP Growth and Inflation, Thailand, 1997–2005



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

Viet Nam

Economic Assessment

Similar to the year-earlier period, GDP strengthened by 7.0% in the first half of 2004. The industry sector, which covers mining, manufacturing, and construction, led the expansion with 10.0% growth, and contributed 3.8 percentage points. The services sector grew by 7.0%, contributing 2.8 percentage points. However, agriculture, which includes forestry and fisheries, was up by just 2.0%, accounting for only 0.4 percentage points of the total.

Improvements in the investment climate led to an increase in realized investment by 14.0% to D116.9 trillion in the first half of 2004 from a year earlier. Foreign investment climbed by 22.9% and investment in the state sector, which accounts for just over half of the total, rose by 12.8%. In the increasingly important private sector, investment rose by 10.5%. A total of 280 foreign-invested projects were licensed in the first half, the same as in the year-earlier period, although the total registered capital for the FDI projects was \$807 million, up from \$710 million a year earlier. One third of the FDI projects were in heavy industry and one quarter in light industry. About one third of the FDI originated from Taipei, China. A 17.3% rise in the value of retail sales suggested that household consumption was robust in the first half.

On the external trade front, the value of exports grew by about 20% in the first half of 2004, well above the full-year target of 12%. Imports were 14.7% higher, responding to growing demand for industrial inputs. The trade deficit, at around \$2.4 billion, was similar to the year-earlier level. Viet Nam is a net exporter of oil and its exports of crude oil exceeded its imports of petroleum products by nearly \$1 billion in the first 6 months of the year.

Remittances from Vietnamese living abroad have become a major source of foreign exchange, exceeding either FDI flows or official aid flows.

During the first half of 2004, private remittances recorded by Ho Chi Minh City banks rose by 11.0% from a year earlier to \$900 million.

Consumer price inflation picked up to 7.2% in the first 6 months, the highest rate since 1998 and exceeding expectations for the period. Food prices rose because of prolonged drought in central and northern areas and the spread of avian flu, which prompted the culling of millions of chickens and a temporary ban on the selling and processing of poultry products. This ban pushed up prices of alternative meats and seafood. Prices for imported steel, refined petroleum products, fertilizer, and other commodities were also bumped up by the global price pressures on these items.

Revenue collection in the first half was on track at D73.2 trillion, or 49% of the full-year target. Government expenditures for the period were slightly higher than revenues at D73.4 trillion, or 44.5% of the total estimated spending for the year, and the budget deficit (excluding onlending) narrowed.

Policy Developments

Concerned about the rise in inflation and rapid expansion in net domestic credit (up 10.9% in April from December 2003), the Government sharply raised the reserve requirement ratio for commercial banks in July 2004 to damp their lending. For dong deposits, this was lifted from 2% to 5% (less than 12 months) and from 1% to 2% (12–24 months). For US dollar deposits, this was doubled from 4% to 8% (less than 12 months) and from 1% to 2% (12–24 months). However, the prime interest rate was left at 7.5%.

Measures to improve the business climate included a cut, effective 6 August, in the corporate tax rate levied on newly established enterprises in industrial zones to 10–20%, from the usual corporate tax rate of 28%. The Government also started work on preparing one unified law

Table 2.12 Selected Economic Indicators, Viet Nam, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	7.5	7.5	7.6	7.6
Inflation (CPI)	4.5	9.0	4.5	6.0
Current account/GDP	-5.7	-4.1	-5.7	-4.1

Source: Staff estimates.

for all types of enterprises and one investment law for investments, aiming to simplify procedures, enhance transparency, and promote good corporate governance. Such policy developments have helped raise the status of Viet Nam among international investors. What also may help foreign investment is, for example, the fact that the semiannual meeting of the Viet Nam Business Forum reported that the Government had made reasonable progress in reducing telecommunications costs, though costs of infrastructure and of housing and office rents are still high in comparison with other countries in the region, and access to markets for the private sector remains limited.

In an effort to spur development of the nascent capital market (Viet Nam has just 24 listed companies with a market capitalization equivalent to 3.4% of GDP), the State Securities Commission is expected to soon issue implementing guidelines for Decree 144, which deals with the securities market. A more comprehensive securities law is expected to be approved by 2006. In a related move, the Government mandated the equitization and listing of five SOEs to build up the supply of securities. Furthermore, the State Bank of Vietnam has issued a regulation to allow joint-stock commercial banks to be listed, and a proposal to list the Viet Nam Securities Investment Fund, the country's first such fund, is under review. Against this, efforts to promote the bond market are constrained by a lack of secondary markets, a benchmark yield curve, domestic credit rating agencies, and weak disclosure practices.

Viet Nam took some steps to improve the quality of governance in the early months of 2004 by strengthening the State Inspectorate (the anticorruption watchdog) and the Public

Administration Reform Steering Committee, and by allowing the State Audit (which audits state spending) to operate outside the executive branch and report its results to the National Assembly. A draft competition law also was prepared.

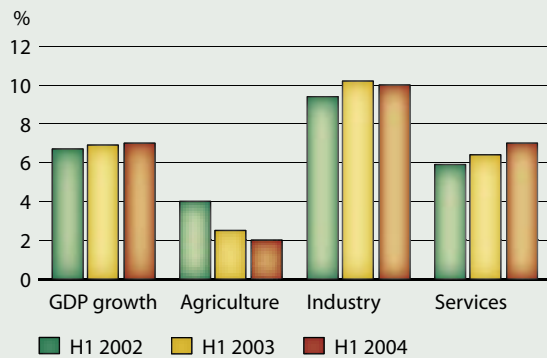
Preparations have also begun for the 5-year plan 2006–2010, with planning guidelines circulated to all provinces and government agencies. The guidelines indicate that the annual average GDP growth target rate during the period will be 7.5–8.0%. The sector growth targets will be 3.0–3.5% for agriculture; 10.0–15.0% for the industry sector; and 7.2–7.5% for services. The aim will be to create about 8 million additional jobs over the 5 years.

The Poverty Reduction and Growth Facility (PRGF) arrangement with IMF expired in April because the Government did not agree to an IMF request that the central bank's foreign exchange reserves be verified by an external auditor proposed by IMF. IMF has continued its presence in Viet Nam and provides advice on macroeconomic management and tax issues. The loss of IMF assistance, which was used to support foreign reserves, is not expected to cause any immediate difficulty because it constituted a small part of the country's donor funding, which is valued at more than \$2.8 billion in 2004. Also, the country's foreign reserves, estimated at about \$5.5 billion or the equivalent of 10 weeks of imports, have been bolstered by strong private capital inflows, especially remittances from overseas Vietnamese (estimated at \$3 billion in 2004) and FDI (probably \$600 million net). However, the Government's decision against external auditing may undercut its attempt to join WTO next year since WTO rules require transparency and compliance with international standards.

Outlook for 2004–2005

The first-half performance, combined with improvements in the business environment and robust external demand, suggests that GDP growth will be 7.5% in 2004 and 7.6% in 2005, unchanged from the *ADO 2004* forecasts (Figure 2.12). Domestic demand is forecast to increase by 8.7% and 8.1%, and exports by 16.3% (revised up from 12.0% in *ADO 2004*) and 12.0% (unchanged from *ADO 2004*), over the 2 years.

Figure 2.12 First-Half GDP and Sector Growth, Viet Nam, 2002–2004



Source: General Statistics Office.

The Government is expected to continue an expansionary fiscal stance, partly a result of raising civil servants' salaries and pensions, scheduled for October 2004. This will support domestic demand. The level of gross investment will likely be maintained at about 35% of GDP in both years. Budgetary deficits will be 4.6% of GDP in 2004 and 4.2% in 2005, unchanged from the *ADO 2004* forecasts.

On the supply side, the industry and services sectors will be the main sources of GDP expansion. Growth in industry is revised up to 10.3% in 2004, from 9.8% in *ADO 2004*, and to about 10% in 2005, from 9.9% in *ADO 2004*, partly because of the rise in international oil prices. Growth in services is estimated at 7.5% in both years, unchanged from *ADO 2004*. Agriculture's forecast growth is revised down to 2.5% in 2004 from a previous forecast of 3.3%, because of lower than expected strengthening in the first half and slower growth in fisheries, but it is expected to pick up to 2.7% in 2005.

With the ending of the MFA quotas at the end of this year, WTO members will no longer be subject to quotas for market access for their garment exports, with the result that Viet Nam's competitors, such as the PRC, will secure greater export opportunities. Viet Nam, yet to enter

WTO, will still face constraints on its garment exports. In an effort to reduce the impact of the end of quotas, the Ministry of Trade plans to concentrate the disbursement of its quotas in larger, more competitive enterprises. Along with a new quota worth \$1.8 billion with the US, an expanded quota with the EU, and diversified markets to Canada and Japan, this will make the prospects reasonable for garment and textile exports in 2005.

The trade deficit is now forecast at \$3.6 billion in 2004 (from \$4.2 billion in *ADO 2004*) and \$3.8 billion in 2005 (from \$4.5 billion) because of a better than expected first-half export performance and higher prices for export commodities such as oil, rice, pepper, tea, and coffee. The current account deficit for 2004 is estimated at around \$1.6 billion, excluding official transfers, or equivalent to 4.1% of GDP (slightly lower than the *ADO 2004* forecast). Such a deficit is manageable because of foreign exchange inflows in the form of remittances from Vietnamese living abroad, official aid, and FDI.

Inflation is likely to reach 9.0% by end-2004 because of the higher food prices and the impact of rising international commodity prices, and is then expected to ease to 6.0% in 2005. Against a background of estimated unemployment of 2.5 million, the Government aims to create 1.5 million jobs in 2004. Whether this is achieved or not, the economy needs to create jobs faster than it has in recent years to absorb the greater numbers of new entrants to the labor market.

Risks to the outlook include rising inflation and possible public health scares. Inflation could exert upward pressure on the prime interest rate (to avoid a negative real rate), on real wage rates, and on the foreign exchange rate, if more people revert to holding their savings in foreign currency. On the subject of public health, avian flu has been reported as recurring in 11 provinces over recent months. So far there has been no serious spread of the disease to humans, but this will require the careful and continuing attention of the public health authorities.

ASIAN DEVELOPMENT
Outlook
2004
Update

Economic Trends and Prospects in Developing Asia
South Asia



Rollie del Rosario



Bangladesh

Economic Assessment

In FY2004, which ended in June 2004, GDP is estimated to have risen by 5.5%, a rate virtually unchanged from 5.3% in the previous year. It was driven by steady growth in industrial production and services, which accounted for 2.1 and 2.8 percentage points, respectively, of growth. Agriculture accounted for the balance, with a slight expansion of 2.7% in FY2004, down from 3.1% in the previous year, largely due to weaker growth in food grain production.

Industrial output is estimated at 7.7% stronger, up from 7.3% in FY2003, due to further gains in export-led manufacturing and domestic construction activity. Manufacturing expanded by 7.4%, from 6.8%. Construction growth also edged up, to 8.3% from 8.1% in FY2003, while services showed an improvement of 5.7%, again, just a tad higher than the previous year's 5.4%.

On an expenditure basis, the GDP expansion in FY2004 was fueled by stronger private consumption, rising to 6.0% from 4.1% a year earlier. In contrast, private investment decelerated moderately to 7.4% growth from 8.8% in the previous year, while public investment climbed to 8.4% growth, against 5.4%.

In spite of a shortfall in targeted revenues, the fiscal deficit in FY2004 narrowed to 4.2% of GDP from the 4.8% projected in *ADO 2004*. This stemmed from the restraint imposed on current expenditures to keep inflation under control and from underperformance in development spending. As a share of GDP, revenues remained at 10.6%, a low rate even by South Asian standards. Domestic resources funded 43% of the deficit, and foreign financing the rest.

Supported by the PRGF arrangement with IMF, the Government, in line with its ongoing economic reform program, pursued a prudent monetary policy to keep inflation low while promoting growth through assuring conditions

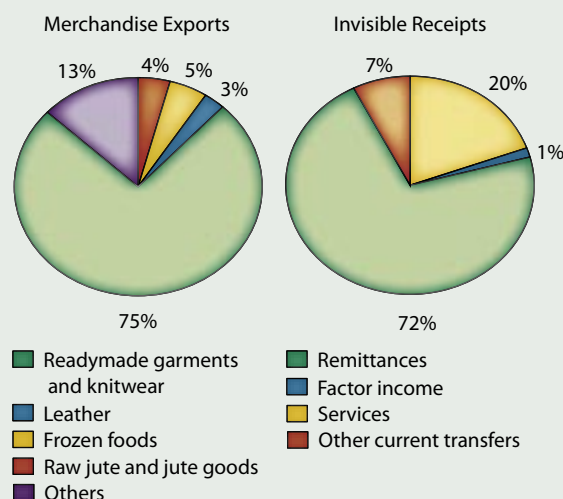
for a steady flow of credit to the private sector. Broad money (M2) growth, which declined from 15.6% in FY2003 to 13.8%, remained broadly in line with the Government's program target of 14.1%. Reserve money growth (7.6%) was also lower than the target of 10.0%. Credit to the private sector increased by 16.2% from 14.9% in FY2003, reflecting the continued strengthening in manufacturing and services.

Year-on-year inflation stepped up from 5.0% in June 2003 to a peak of 6.7% in November that year, but declined subsequently, with some fluctuations. It fell to 5.6% in June 2004, due mainly to the tightening of the money supply, controls on current expenditures, and reductions in import taxes. On an annual average basis, inflation rose to 5.8% in FY2004 from 4.4% a year earlier. Higher import prices of food and nonfood products were the main factors. The exchange rate remained largely stable against the US dollar, requiring minimal intervention from the central bank.

Propelled by a rise in external demand for the country's major products, exports gathered further pace in FY2004, strengthening by 15.9% compared with 9.5% in the previous year. This performance was underpinned by garments, knitwear, textiles, and frozen food (Figure 2.13). Import growth slowed slightly to 12.6% from 13.1% a year earlier. As the rise in imports offset that in exports, the trade deficit widened slightly to \$2.3 billion in FY2004 from \$2.2 billion. The surplus on the current account also widened, to \$184 million from \$176 million in the preceding year, mainly due to an increase in current transfers, including worker remittances.

The overall balance-of-payments surplus fell sharply to \$184 million from \$815 million in FY2003, reflecting reductions in the capital and financial account surpluses, in turn rooted in the steep fall in aid disbursements caused by low development spending. Foreign exchange reserves

Figure 2.13 Total Merchandise Exports and Invisible Receipts by Category, Bangladesh, FY2004



Sources: Bangladesh Bank; Export Promotion Bureau.

stood at \$2.7 billion, equivalent to about 3 months of imports, at end-FY2004.

Policy Developments

The budget for FY2005 (effective July 2004) sets an ambitious revenue target of a 16.7% increase in revenue collection from the FY2004 level, with measures to expand income tax and VAT coverage, and to rationalize customs duty, supplementary duty, and income tax rates. Attaining the revenue target will require an effective revenue mobilization drive and enforcement of greater discipline in tax management, including increased monitoring and supervision of tax officials. The budget gives priority to projects with growth and poverty reduction potential, and seeks to raise public investment in infrastructure and the social sector with a 15.6% increase in total spending from FY2004's figure. Achieving this will require improved public expenditure management and stronger institutional capacity for the selection, preparation, and implementation of development projects.

In the area of monetary policy, the authorities made greater use of market-based instruments to manage liquidity. As a part of the PRGF-supported program, the interest rates on National Savings Certificates (NSCs) are expected to be

adjusted semiannually to stimulate greater flexibility in the interest rate structure and to bring down the costs of financing the fiscal deficit. The NSC rates were reduced in January 2004, and, largely due to this move, average bank and nonbank lending rates subsequently declined. The NSC rates were lowered again in July 2004.

The FY2005 budget moderates tariff protection by reducing the top tariff rate to 25% and compressing tariff rates, and should promote the efficiency of domestic industries by generating greater competition. Gas prices were adjusted upward by 3.5% effective July 2004 and the price of kerosene was raised to the level of diesel to discourage adulteration, although prices of other oil products were left unchanged in spite of the sharp rise in the international oil price.

Outlook for FY2005

In FY2005, GDP is now expected to rise by 4.8% against the *ADO 2004* projection of 6.0%, a downgrade resulting from the devastating flooding of July and August. Its damage to infrastructure and other assets will slow economic growth and present a serious challenge to macroeconomic management. Industrial growth is expected to be lower than in FY2004 due to the severe flood damage to SMEs, including the export-oriented knitwear industry. Similarly, the destruction of standing crops and the severe impact on output of poultry, livestock, fisheries, and forestry will lower agricultural growth from the year-earlier level. Expansion in services is also likely to suffer, reflecting deceleration in industry and agriculture.

Annual average inflation is likely to edge up to 6.0% in FY2005, mainly due to higher domestic food prices and, in part, to the pass-through of high international oil prices. Given the unsustainability of leaving administered prices of oil products unadjusted for long, the Government will likely allow a partial pass-through of the increased oil prices to consumers.

The combined effects of the termination of the MFA quotas at end-2004, affecting the second half of FY2005, and the flood-related damage will cut by nearly half, to 8.5%, growth in exports of textiles and clothing to \$6.2 billion in FY2005. Since textile and clothing exports normally

Table 2.13 Selected Economic Indicators, Bangladesh, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.7	5.5	6.0	4.8
Inflation (CPI)	4.7	5.8	4.2	6.0
Current account/GDP	0.0	0.3	-1.5	-1.5

Source: Staff estimates.

account for about 75% of total exports, overall export growth will also likely fall steeply, probably by more than half, to 7.0% from 15.9% in FY2004.

Import growth will remain high at 14.0%. Reduced imports of raw materials for the textile and clothing industry will be more than offset by the rise in postflood imports of food grains, medicines, and machinery, and by a higher import bill for oil. Although an expected increase in remittances from overseas workers to their flood-devastated families and in flood-related grants will cushion the trade deficit, the current account will switch to a deficit of 1.5% of GDP from an estimated surplus of 0.3% in FY2004. IMF's augmentation of the PRGF by SDR53 million under the first tranche of its Trade Integration Mechanism will help the country cope with balance-of-payments pressures. Due to the restraint imposed on current spending, particularly in the wake of the floods and the planned financing of postflood reconstruction through diversion of resources from low-priority projects, the fiscal deficit is expected to remain around the FY2005 budget projected level of 4.3% of GDP, unless there is a major shortfall in revenue collection.

Bangladesh relies on MFA quota-restrained markets (primarily the EU and US) for around 94% of its textile and clothing exports. Although wages are low, poor labor productivity along with inadequate infrastructure and policy constraints could cause the country to lose much of its market share after MFA quota abolition. A recent WTO study¹ using the Global Trade Analysis Project (GTAP) model indicates that Bangladesh's market share for textiles in the EU will fall from 5% in 2002 to 3%, once quotas are eliminated in 2005, although its market share for clothing there will increase from 3% to 4% over the same

period. The study also shows that the country's market share for clothing in the US will decline from 4% to 2% between 2002 and 2005. An IMF study² notes that a simple extrapolation of Bangladesh's performance under stage 3 integration, effective 1 January 2002, of the WTO Agreement on Textiles and Clothing suggests a net loss of \$750 million on the merchandise trade account after the end of the quota system.

In addition to putting pressure on the balance of payments, the abolition of MFA quotas is likely to pose serious problems in terms of reduced output and employment. According to the same IMF study, GTAP simulations (assuming standard GTAP elasticities and fixed nominal wages) indicate contractions in GDP of 2.3% and in employment of 4.5% from baseline levels that assumed the maintenance of quotas through 2007. Apart from affecting jobs in the textile and clothing industry, which employs around 1.8 million people (mostly poor women), representing 40% of manufacturing employment, the MFA phaseout will also likely displace workers in activities linked to the sector. Although some temporary employment will be generated by the postflood reconstruction activities and under the Government's food for works program, enlarged because of the flooding, this may not benefit the displaced workers. However, greater availability of donor-supported financing and business development assistance to SMEs may create jobs in this sector in the coming years.

In FY2005, macroeconomic management will be a challenge, given the likely deterioration in the current account and the increase in public expenditures for flood rehabilitation. Sound operation of monetary and fiscal policies will be constrained if domestic food and nonfood production takes time to pick up. In addition, sustaining competitiveness of the textile and clothing industry in the post-MFA era, and so protecting jobs in the industry, will require that governance issues and key infrastructure constraints be urgently addressed.

1 WTO. 2004. *The Global Textile and Clothing Industry post the Agreement on Textiles and Clothing*. Geneva.

2 IMF. 2004. *The End of Textiles Quotas: A Case Study of the Impact on Bangladesh*. Working Paper. June.

India

Economic Assessment

GDP growth more than doubled to 8.2% in FY2003 (ended 31 March 2004) from 4.0% in the previous year (Figure 2.14). The upturn was also broad based. In FY2004, economic growth is forecast to moderate, but remained high, due to the impact of delayed monsoon rains in large parts of the country and devastating floods in other parts in the first 4 months. These natural calamities will contain agriculture sector output and private disposable income. Higher world oil prices will also act as a drag on the economy.

The exceptionally high agricultural expansion of 9.1% in FY2003 represented a significant jump in output, exaggerated by the drought-driven decline a year earlier. In FY2004, delays in the monsoons and a highly skewed rainfall distribution pattern across the country are likely to have an adverse impact on agriculture and keep the expansion below trend. In the industry sector, the previous year's high momentum was sustained: following 7.2% growth in FY2003, manufacturing production picked up further to 7.9% in the first quarter of the current fiscal year (April–June), spurred by high growth of capital goods, intermediates, and consumer durables. The broad-based manufacturing growth was supported by solid growth in key infrastructure industries, such as energy.

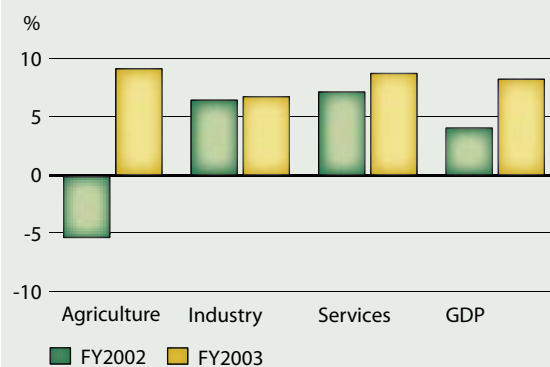
Services sector growth at 8.7% in FY2003 was significantly higher than in the previous year and ongoing developments suggest continuing healthy performance in FY2004. The dynamism in this sector in recent years has stemmed from high income elasticity of demand and domestic reforms, coupled with high productivity in certain subsectors and improved access to the global market. Unfortunately, employment growth has remained limited despite the acceleration of overall output growth. This issue of

“jobless” growth is a major challenge, and was discussed in *ADO 2004*.

In FY2003, the consolidated deficit of the federal and the state governments showed a marginal improvement, declining to 9.4% of GDP from 9.5% a year earlier. Nevertheless, the deficit is still very large compared with those in other major developing countries. In fact, the improvement masks a worrying disparity: it came entirely from the federal government side, since the finances of state governments deteriorated further. Total public debt amounted to 76.7% of GDP at end-FY2003, with interest payments in the year equal to 34% of revenue receipts (or 6.5% of GDP) and so crowding out public development expenditures. Accordingly, fiscal consolidation remains a major macroeconomic and developmental challenge.

Money supply (M3) grew rapidly at 15.5% year on year as of 20 August 2004, significantly higher than 11.9% growth registered in the same period of FY2003. This largely reflected the continuing rise in foreign exchange reserves at the Reserve Bank of India (RBI) and the consequent expansion of the monetary base. Credit conditions

Figure 2.14 Sector Composition of Growth, India, FY2002 and FY2003



Source: Compiled from www.mospi.nic.in/stat_pr.htm.

Table 2.14 Selected Economic Indicators, India, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	7.4	6.5	7.6	6.0
Inflation	5.0	5.7	4.7	6.8
Current account/GDP	0.3	1.4	0.3	1.1

Source: Staff estimates.

have been relaxed, though banks' prime lending rates have seen only a small decline. Wholesale price inflation is picking up, mainly on the back of rising prices of petroleum, iron and steel, and coal. From an average of around 5.0% year on year in the first quarter (April–June) of FY2004, wholesale price inflation accelerated to 6.6% in July 2004, and further to around 8.0% in August 2004. As measured by the CPI for industrial workers, however, inflation remained moderate at 3.2% in the year to July 2004.

Full-year data now available for FY2003 indicate that the economy did well on the external front. Imports grew by 21.8%, reflecting strong domestic absorption, while exports expanded by 19.9% led by the growth of world demand, especially demand from the PRC and other Asian countries. Faster merchandise import than export growth swelled the trade deficit in FY2003, but despite this, the current account posted a higher surplus of 1.4% of GDP, up from 0.8% in FY2002. This was due to net invisible earnings of \$25.4 billion in the year, mostly from business processes sourced to India, including software and IT-enabled services. Services exports now account for over 30% of total exports and their share is rising rapidly. Exports of software and IT-enabled services alone had risen to \$12.2 billion in FY2003.

The capital account registered a significantly higher surplus in FY2003, of \$22.1 billion, split into net portfolio investments plus short-term loans of \$12.9 billion, net banking capital inflows of \$6.2 billion, and net other capital flows of \$3.0 billion. FDI was a very modest \$3.1 billion. With large surpluses on both the current and capital accounts, foreign exchange reserves increased by \$36.9 billion (including valuation gains) over the year to about \$113 billion by

31 March 2004, offering import cover of around 17 months. At that date, gross reserves were about equal to outstanding external debt.

External sector developments in the first quarter of FY2004 continued buoyant. Export growth surged to 28.0% from the year-earlier period, reflecting stronger global demand and manufacturers' responsiveness, while continuing firm domestic demand lifted imports by 31% in the period, including a 26% rise in non-oil imports. An overall surplus of \$7.5 billion was recorded in the quarter to bring foreign exchange reserves to about \$120 billion at end-June. Subsequently though, in July and August, momentum in the overall balance weakened as foreign exchange reserves declined by about \$2 billion (to \$117.5 billion at end-August 2004) in contrast to about a \$4 billion increase in these 2 months in the previous year.

The strong balance-of-payments position led to very easy conditions in the foreign exchange market in FY2003, and RBI intervened to release upward pressure on the local currency. Despite this intervention, the rupee appreciated by 9.3% against the dollar over the year to 31 March, or by about 5.9% using monthly average exchange rate data. In the following 5 months to end-August, despite net sales in the market by RBI since April, the rupee has tended to depreciate against the dollar with the August average rate about 3% weaker than in March. To accommodate foreign exchange market operations in FY2004, a Market Stabilization Scheme was established in April whereby the Government issues securities specifically for use by RBI to sterilize foreign exchange market intervention.

Policy Developments

The National Common Minimum Program (NCMP), announced by the new United Progressive Alliance Government that took office in May 2004, emphasizes economic reforms "with a human face." The main goals include generating employment and stimulating pro-poor growth, doubling rural credit in 2004–2007, increasing social spending, stepping up investment in the development and expansion of physical infrastructure, and eliminating the revenue deficit of the federal Government by 2009 to release more

resources for development spending (i.e., ending the crowding out). In order to tackle the problem of “jobless” growth, the NCMP also focuses on promoting employment-intensive growth.

The FY2004 federal budget released in July has attempted to translate some of these goals of the NCMP into concrete proposals. However, it has done so without much increase in total expenditures, which are projected to rise by only 0.73% in FY2004. This is partly because the federal Government did not pass on a large volume of funds raised from the states under the debt swap scheme, which has significantly compressed projected capital expenditures. On the other hand, total revenues are expected to grow by 17.6% from FY2003. Based on these estimates, the federal budget has projected a reduction of the revenue deficit from 3.6% of GDP in FY2003 to 2.5% of GDP in FY2004, and a reduction of the fiscal deficit from 4.8% to 4.4% in the same period.

Revenue proposals in the FY2004 budget included a surtax of 2% on all federal taxes and duties, to be earmarked for education. The service tax rate was raised from 8% to 10% and coverage was broadened from 58 to 70 activities. It also has a proposal to replace the long-term capital gains tax by a new transaction tax on market-traded securities (with a 0.15% rate), which will be shared equally by the buyer and the seller. To help prepare the textile sector for the removal of MFA quotas from the end of this year, various excise duty revisions have been introduced.

Apart from these tax measures and some other ad hoc revisions of rates of excise and customs duties, the budget has no major tax proposals. The finance minister has indicated that his tax reform proposals will be presented in the FY2005 budget (in February 2005) as part of his comprehensive medium-term fiscal consolidation program.

On the expenditure side of the FY2004 budget, the thrust is on education, especially primary education, and a proposed health insurance scheme for families below the poverty line. The budget also accords high priority to agriculture, rural infrastructure, and irrigation. It announced, in addition, an innovative program to restore about 500,000 out of 1 million traditional irrigation facilities that are cost effective to operate, while the coverage of the “last mile” irrigation

projects under the Accelerated Irrigation Benefit Program is also important. The emphasis on some specific antipoverty programs implies a new and sharpened focus on poverty reduction. The significant push to social and rural development programs notwithstanding, it is important to note there is no increase in such priority spending relative to GDP. Thus, total federal expenditures on education programs in the FY2004 budget at 0.4% of the GDP are exactly the same as in FY2003, as are federal expenditures on health programs at 0.25% of GDP. Similarly, federal spending on agriculture, rural development, irrigation, and flood control amounts to 2.18% of the GDP in FY2004 as compared with 2.19% in FY2003. This does not mean that increased spending on these programs is a myth: it simply points to the fiscal space expected from high growth.

However, a comprehensive fiscal consolidation program will be necessary, at least in the full-year budget for FY2005, to comply with the Fiscal Responsibility and Budget Management (FRBM) Act 2003, which requires a progressive reduction in both the revenue deficit and the fiscal deficit. The finance minister has announced that he will amend the Act to set FY2008 as the target date for eliminating the revenue deficit. He has also committed to prepare a medium-term fiscal consolidation program that will aim to reduce the fiscal deficit by 0.4 percentage points of GDP each year; to continuously monitor deficit performance; and to present quarterly performance reports to Parliament. A major initiative has already been taken in the direction of reform: the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act has submitted its report on consolidated fiscal reform, which is now being considered.

Apart from introducing tax and expenditure proposals, the federal budget is also a vehicle for announcing many policy proposals to indicate the broad direction of the Government’s overall economic management. Important among these are further liberalization of FDI ceilings, especially in telecommunications (from 49% to 74% of equity), civil aviation (from 40% to 49% of equity), and insurance (from 26% to 49% of equity). The Government is still deliberating its policy on disinvestments in public enterprises.

Meanwhile, it has proposed establishing a Board for Reconstruction of Public Sector Enterprises to recommend the sale or closure of unprofitable companies.

In the field of monetary policy, RBI has made no change to its key monetary targets in its Annual Policy Statement for FY2004, presented in May. In essence, the policy was to continue an accommodative stance on the assumption that underlying inflation did not worsen. More recently, in response to the unexpected acceleration in inflation, RBI tightened policy by raising the reserve requirement ratio to 4.75% from 18 September and to 5.0% from 2 October. These moves will likely result in higher interest rates and reduced bank lending. The Annual Policy Statement also dealt extensively with issues relating to the credit delivery mechanism, especially with regard to priority sector lending, micro-finance, SMEs, infrastructure, and the “gold card scheme” for exporters. In its recently submitted report, the Rakesh Mohan Committee on Administered Interest Rates proposed linking the administered rates on government securities with market interest rate movements, to ensure alignment of the two sets of rates.

The Government has also announced its new foreign trade policy for the next 5 years, which is aimed at doubling India’s share in world trade by FY2008. Currently, India accounts for only about 0.8% of global merchandise exports in contrast to its nearly 6% share in global GDP at purchasing power parity exchange rates or 1.6% share at market rates. Some of the highlights of the new trade policy include special initiatives for development of agribusiness and exports of traditional exports, such as handlooms, handicrafts, gems and jewelry, and leather and leather manufactures, through numerous tax incentives; further expansion of Agri Export Zones; and the establishment of “new towns of export excellence” as dynamic industrial clusters in selected sectors.

The policy has also laid down measures further simplifying the Government’s trade-processing procedures to reduce transaction costs and neutralize the incidence of duties on inputs used in export production through tax incentives. Moreover, the Government has announced various tax incentives for promoting infrastructure to facilitate exports. It is unclear whether the

proposed incentives are WTO compliant; they will also entail a significant revenue loss.

Outlook for FY2004–FY2005

The *ADO 2004* growth forecasts for FY2004–FY2005 have been revised down. This is partly on account of a weak monsoon, and especially because of the sharp increase in oil prices, which is both reactivating inflation and damping growth. A range of forecasts for FY2004 was prepared, and the best estimate of 6.5%, adopted for the *Update*, reflects 2.0% growth in agriculture and a weak monsoon, and 7.8% growth in both services and industry. In FY2005, GDP growth is expected to decline to 6.0%, despite the assumption of 3.1% growth in agriculture and a normal monsoon. This is mainly on account of lower projected growth in both industry and services as a consequence of the expected downturn in the country’s business cycle.

The risks associated with these growth projections include another weak monsoon in FY2005, higher than assumed global interest rates and crude oil prices, and inadequate progress in fiscal consolidation. Of all of these, the price of crude oil is the most critical for India, as it imports most of its oil. Past experience shows that a steep rise in oil prices triggers inflation, adversely impacts on the balance of trade, and lowers growth.

Rising inflation is likely to prevail through FY2004 and FY2005. Inflation is forecast at 5.7% and 6.8%, largely because of rising prices of oil and agricultural commodities in FY2004 and an expected escalation in the price of manufactured goods in FY2005. Manufacturers who are currently absorbing the increase in costs through reduced profit margins will eventually pass this on to consumers, leading to a lagged increase in industrial prices in FY2005 as a consequence of the oil price escalation in FY2004. The Government has taken some short-term measures to contain the impact on consumer prices, including a reduction in excise and customs duties on petroleum products, announced in August. For the long term, the Government is considering a strategic oil reserve in an attempt to moderate oil price volatility through buffer stock operations.

Though the fiscal deficit showed a slight

improvement in FY2003, it is likely to rise to 10.0% in FY2004. The federal budget has targeted a reduction in the FY2004 fiscal deficit to 4.4% in line with the FRBM Act. However, the target is likely to be overshoot because of ad hoc fiscal concessions being introduced after the budget to contain the inflationary impact of rising oil prices and because of the incentives introduced in the new trade policy. Moreover, the fiscal position of state governments further deteriorated through FY2003, and the reduction in federal revenues in FY2004 will also reduce their receipts from their share of federal revenues.

The fiscal situation of the federal Government, in contrast, is likely to recover in FY2005 because of the strong fiscal reform measures expected in that year's budget, and this will also have a positive impact through shared taxes on the revenue receipts of the states. This is likely to be reinforced by the states' fiscal consolidation proposals of the Twelfth Finance Commission, which will submit its recommendations in December 2004. Consequently, the consolidated fiscal deficit for FY2005 is projected to decline to 9.5% of GDP. Introduction of a VAT, which has been repeatedly postponed, has been tentatively rescheduled for 1 April 2005. However, even if it is introduced, its immediate impact on the fiscal deficit should be negligible as it has been designed to be revenue neutral.

Turning to the external sector, the outlook is buoyant. Based on expected strong global expansion, merchandise exports are projected to

grow by 20.9% in FY2004 and 17.9% in FY2005. India's export basket is quite diversified, ranging from traditional products, such as textiles and garments, to chemicals and pharmaceuticals, transport equipment, and other engineering products. The rise in exports is likely to be concentrated in textiles (following the elimination of MFA quotas at end-2004), and pharmaceuticals and automotive ancillaries (products for which exports have been rising rapidly). Imports are projected to grow at 19.9% and 19.3% in FY2004 and FY2005, respectively, based on the above domestic growth projection. The major components of India's merchandise imports are petroleum products, gems and semiprecious stones, chemicals including fertilizers, and machinery and electronic goods. The projected increases in imports will be dominated by the increase in the oil import bill.

With both merchandise exports and imports growing at similar high rates, the current account surplus is projected at 1.4% of GDP in FY2004, declining to 1.1% in FY2005 when merchandise imports are forecast to grow at a significantly higher rate than exports. Net invisibles income will continue to register robust growth. The overall annual net capital inflow of around \$22 billion is likely to increase further on account of the liberalization of FDI ceilings. Given that foreign exchange reserves will likely rise to over \$150 billion in FY2005, and the current account will remain in surplus, India's external position looks very comfortable over the medium term.



Nepal

Economic Assessment

In FY2004 (ended 15 July 2004), the economy grew by 3.6%, somewhat lower than the 4.0% projection in *ADO 2004*, mainly due to the breakdown of the cease-fire with the insurgents in August 2003. Industry underperformed, expanding by only 1.8%, down from 2.3% a year earlier, due to the security situation. Growth in construction (0.3%) was particularly sluggish; however, performance of agriculture and services strengthened. Agricultural output increased by 3.7%, from the previous year's 2.5%, boosted by favorable weather that lifted paddy production by 7.8%. Services showed a slightly better growth rate of 4.2% against 3.3% in FY2003, on account of some strengthening in tourism and strong performance of the transport, communications, and storage subsector.

On the expenditure side, gross fixed capital formation as a share of GDP continued its slide of recent years to 18.7% in FY2004—well below the average of 20.8% of GDP for the last decade. Both public and private investment shares declined, ascribable to the deterioration in the investment climate in the country. Total consumption grew by 3.0%, underpinning the expansion in GDP, based on the rise in government recurrent expenditures and private consumption that was boosted by higher worker remittances. Trends in aggregate expenditures and output indicate a recovery from the FY2002 recession, albeit anemic and fragile.

The continued insurgency adversely affected FY2004 government expenditures. Only 88% of the targeted level of NRs91 billion was achieved, primarily due to a 16% shortfall in capital spending. While disbursements in the education sector were on target, health, drinking water, roads, and agriculture all recorded significant underspending, reflecting the constraints caused by the insurgency on undertaking development activities in rural areas. Recurrent expenditures

related to development activities also fell short, but security expenditures rose by 8.0% from the FY2003 level. Revenue collection increased by 11.0% from FY2003, aided by some improvement in income tax and excise duty collection. Nevertheless, the revenue effort at 12.3% of GDP remains weak. Given these developments, the budget deficit after grants amounted to 1.5% of GDP for the second year running.

Broad money (M2) grew by 13.5% during 2004, above the 11.2% target. Weak investor confidence resulted in lower private sector credit growth than in FY2003 and in interest rates falling for the second consecutive year. Inflation was contained at 4.0%, benefiting from declining food prices.

On the external side, the improvement in the global economy helped push up exports by 13.1% to \$737 million while the economic recovery, limited as it was, pushed up imports by 15.4% to \$1.8 billion. The trade deficit widened slightly to 15.8% of GDP from 15.5%. Export growth was supported by a rebound in exports of woolen carpets, leather goods, and polyester yarn, which offset the decline in exports of readymade garments, vegetable ghee, and agricultural products. Import growth stemmed from 23% and 16% increases in raw material and machinery imports, respectively. The trade deficit was outweighed by stronger tourism receipts (58%), worker remittances (17%), and grants (70%). The sharply higher net surplus on the services and transfer accounts raised the current account surplus to 3.5% of GDP in FY2004 from 2.6% in FY2003. Official foreign exchange reserves climbed by 24.8% during FY2004 to \$1.4 billion, providing import cover of about 10 months.

Policy Developments

A new prime minister, appointed in June 2004, has formed a coalition Government that enjoys support from some of the political parties, despite

Table 2.15 Selected Economic Indicators, Nepal, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	4.0	3.6	5.0	3.7
Inflation (CPI)	4.5	4.0	5.0	5.5
Current account/GDP	1.0	3.5	0.5	4.0

Source: Staff estimates.

the fact that Parliament remains suspended. The FY2005 budget announced in July aims to implement the priorities identified in the Government's poverty reduction strategy. In view of the slowdown of development activities, against a backdrop of security concerns, the budget proposes various measures to accelerate development spending. To this end, it has expanded allocations for local-level, community-led development projects, and has announced incentives for more effective utilization of block grants to local governments. It has also proposed the devolution to local communities of management of public schools and health posts, of agriculture extension services, and of electricity distribution. Reflecting these initiatives, total expenditures are slated to rise by 22% with recurrent expenditures up by 19% and capital expenditures by 29%. Revenues are targeted to rise by 12.4% and the overall deficit is to increase to 2.5% of GDP.

Tax reforms are under way, focusing on improving administration of VAT, simplifying the Income Tax Act, implementing a 3-year customs reforms and modernization program, and establishing a large taxpayers' office within the Inland Revenue Department. Nevertheless, stronger policy efforts are needed to broaden the tax base, especially of VAT; eliminate the wide range of tax exemptions; and address the burgeoning tax arrears, as recommended by the 2003 Fiscal Reforms Taskforce.

The Nepal Rastra Bank's monetary policy announced in August 2004 aims to maintain low inflation and the domestic currency's parity peg with the Indian rupee. It also targets broad money growth of 12.5% in FY2005. More widely, the

policy seeks to be accommodative so as to support a fuller economic recovery and, with this in mind, reduced the mandatory cash reserve ratio from 6.0% to 5.0%.

Outlook for FY2005

Assuming no substantial deterioration in the security situation and normal weather conditions, GDP is now forecast to grow by 3.7% in FY2005. The projection has been downgraded from 5.0% in *ADO 2004* due to the worsening insurgency, including the negative impact of intensified disruptions in the first quarter of the fiscal year on manufacturing output and tourism. With anticipated robust growth in summer crops following a favorable monsoon, the agriculture sector is expected to expand by 3.7% in FY2005. Services are likely to falter, rising by 3.8% in FY2005, as gains in tourism slow from a year earlier, while industry is forecast to strengthen to 3.3% in FY2005 on the back of a remittance-driven recovery in construction and some improvement in manufacturing. Nevertheless, the ending of MFA quotas will further hit garment production and exports, which have already declined over the past year.

Inflation is forecast to increase to 5.5% in FY2005, slightly higher than the *ADO 2004* figure of 5.0%, reflecting price developments in India and continued high international oil prices. Money supply (M2) growth in FY2005 is likely to be limited to 12.5%, as targeted by the central bank. The fiscal deficit is now projected at 2.5% of GDP in FY2005, in line with the government target. *ADO 2004* had forecast a higher deficit of 4.5% of GDP on the basis of greater internal security that would have allowed larger development expenditures and aid utilization.

The trade deficit is expected to widen in FY2005, mainly due to an expected decline in garment exports. Growth in tourism receipts is likely to slow. A continued expansion in worker remittances and development grants is expected to underpin the balance of payments, keeping the current account in surplus in FY2005 at the equivalent of 4.0% of GDP.



Pakistan

Economic Assessment

Economic reforms of the past 4 years have made a major contribution to the strong economic recovery, which gained further momentum in FY2004 (ended 30 June 2004) and exceeded the growth forecast in *ADO 2004*. The current account of the balance of payments remained in surplus for the fourth consecutive year, though the size of the surplus fell significantly. Inflation emerged as an area of concern, as it took a sharp upturn and the annual rate exceeded the Government's target.

GDP growth accelerated to 6.4% from 5.1% in FY2003, with the industry sector contributing almost half of the expansion. Manufacturing, the major subsector, expanded due to the availability of excess capacity in most industries at the start of the year. Subsector growth was underpinned by a domestic demand surge originating in an increase in consumer credit, higher cash incomes of farmers, continuing strong levels of worker remittances, and faster economic growth. The Quantum Index of Large-Scale Manufacturing registered a gain of 18.1% compared with 8.0% in FY2003. Value added in generation and distribution of electricity and gas, the other key subsector in industry, rose by 22.5%, mainly because of steep rises in hydropower generation and production of gas. Value added in construction strengthened to 7.9%, also significantly stronger than in FY2003, because of a larger public sector development program, greater private sector investment, and more readily available housing finance from banks.

The 2.6% growth of agriculture in FY2004 was much lower than expected in *ADO 2004*, and had its basis in reduced cotton output (resulting from a widespread pest attack) and lower growth in wheat (due to adverse weather). However, higher prices of most major crops, particularly for cotton, rice, and wheat, led to a significant improvement in farmers' cash incomes.

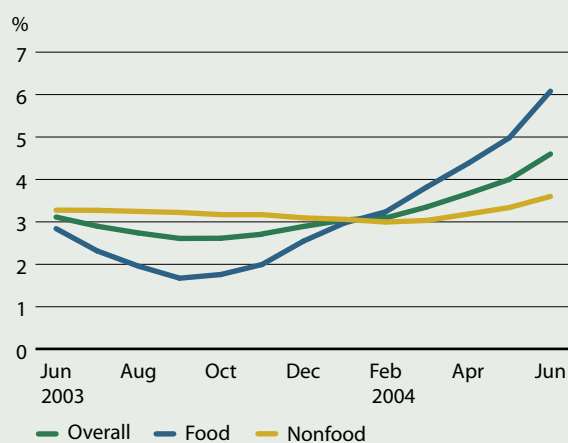
The services sector essentially maintained the FY2003 growth rate. Value added in wholesale and retail trade went up by 8.0%, reflecting recovery in domestic economic activity, acceleration in imports, and maintenance of the double-digit expansion in exports. Telecommunications services continued to power forward, and the number of cell phone subscribers more than doubled to 5.0 million. Growth in public administration and defense, however, was significantly less than in the previous year.

On the demand side, the impetus for growth came from investment and government consumption. Gross fixed capital formation in constant prices accelerated strongly to 14.7% from 1.0% in FY2003. Both the public and private sectors saw a recovery in investment. As a share of GDP, investment, inclusive of accumulation of stocks, climbed from 16.7% to 18.1%.

The Government kept its tight fiscal stance in FY2004 as a result of which the overall budget deficit declined further to 3.3% from 3.7% of GDP in FY2003. Government revenues strengthened by 8.3%, while the rise in spending was kept at 6.6%, despite sharp increases on development and defense of 17.6% and 12.7%, respectively. As a share of GDP, development expenditures moved up marginally from 2.7% to 2.8%, while defense expenditures remained unchanged at 3.3%. There was a welcome shift in sources of financing the fiscal deficit from high-cost nonbank borrowing to low-cost bank borrowing. This was the result of the ongoing rationalization of interest rates on National Saving Scheme instruments and the tightening of State Bank of Pakistan (SBP) controls on lending by banks against these instruments. Most debt indicators showed significant improvements, with the public debt-to-GDP ratio declining from 73.9% to 67.9%.

Inflation picked up in the second quarter of FY2004, to give 4.6% for the whole year compared with 3.1% in FY2003 (Figure 2.15). This stemmed

Figure 2.15 Inflation, Pakistan, June 2003–June 2004



Note: Data refer to 12-month moving average inflation rates.
Source: Federal Bureau of Statistics.

from shortages in wheat (due to bad weather) and chicken (resulting from the avian flu crisis in January–February 2004), and from sharply higher house rents. However, SBP continued to pursue easy monetary policy through most of the year. Money supply growth accelerated slightly, and credit to the private sector increased to PRs301.2 billion, or nearly double the previous year's level.

Growth in exports decelerated while that in imports accelerated in the second half of FY2004. For the full year, exports rose by 13.5%, mainly due to higher world prices, and imports by 21.2%. The current account surplus fell by more than half to \$1.8 billion in FY2004. This was the result of a more than threefold widening of the trade deficit, a sharp rise in the services deficit, a reduction in official transfers due to discontinuation of the Saudi Oil Facility in January 2004, and a decline in worker remittances.

In the previous 2 years, SBP had been intervening in the foreign exchange market, as a net buyer of foreign exchange to prevent undue appreciation of the Pakistan rupee. In contrast, in the latter part of FY2004, SBP emerged as a net seller to prevent a sharp fall of the currency. For the year as a whole, the domestic currency depreciated slightly against the dollar by 0.3% after a 4.4% appreciation in FY2003. Foreign exchange reserves grew unspectacularly by 10.8% to \$10.6 billion, in comparison with FY2003 when they more than

doubled. External debt outstanding remained virtually the same at \$33.4 billion; debt indicators improved further with the debt-to-GDP ratio declining to 35.2% from 40.5% in FY2003.

Policy Developments

The FY2005 federal budget and trade policy contain various policy measures that reflect the Government's commitment to continue the structural reforms initiated in the last 4 years, and to move on to "second generation" reforms. The budget changes the focus from fiscal consolidation to promoting economic growth, taking full advantage of the fiscal space created by improvements in revenue generation and reductions in interest payments, in order to expand development expenditures and trim business costs for the private sector.

The budget announced several measures to accelerate growth—particularly in agriculture, industry, housing and construction, and business activities—and to further improve tax administration.

To promote investment in agriculture, the import duty on tractor models not manufactured locally was reduced and no general sales tax (GST) or withholding tax is to be levied. Neither will duty or GST be applied to imports of specified agricultural machinery and implements not manufactured locally. The budget also exempted from GST agricultural machinery manufactured locally.

So that industry can meet the challenges of increased international competition resulting from further liberalization of trade under the WTO regime—particularly the impact of the ending of MFA textile and clothing quotas by year-end—the cost of investment has been eased by lowering the customs duty on imports of machinery, not manufactured locally, and exempting it from GST. Tariff protection for locally manufactured capital goods has been lessened to induce efficiency in the engineering industry and to lower the cost of locally manufactured machinery for investors. Customs duty on a large number of industrial raw materials has been brought down significantly, which will benefit such key industries as iron and steel, plastics, locally manufactured plant and machinery, and chemicals and dyes. Multiple GST

Table 2.16 Selected Economic Indicators, Pakistan, 2004–2005, %

Item	2004		2005	
	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>
GDP growth	5.5	6.4	5.8	6.5
Inflation (CPI)	4.0	4.6	4.0	5.5
Current account/GDP	3.0	1.9	2.1	-1.3

Source: Staff estimates.

rates ranging from 15% to 23% have been replaced with a 15% standard rate. Ginned cotton, raw hides, and leather have been exempted from GST, which will ease cash-flow problems for processors.

The housing and construction industry has been identified as one of four priority areas for growth and poverty reduction. To encourage investment in the industry, the government budget abolished excise duty on paints and lowered import duties on a range of building materials, including steel and steel products, as well as construction machinery. It has also exempted construction machinery from GST and withholding tax.

To tackle the long-standing problems of harassment of business activities, the central Government in the budget announced steps to ensure that provincial governments limit interventions by various departments, such as the shop inspectorate or the labor and electricity departments. In contrast to past practice, their visits to industrial units will be preannounced with appropriate notice.

As part of steps to improve tax administration and move to a “business friendly” tax collection system, the Government already set up one large taxpayers’ unit in Karachi in July 2002 and one medium taxpayers’ unit in Lahore in September that year, providing one place where taxpayers can pay all their taxes (corporate income tax, GST, and excise duty). They have been very effective in realizing greater tax receipts in their areas, as well as increasing taxpayers’ satisfaction. Building on this positive experience, the FY2005 budget provides for the establishment of one more large taxpayers’ unit and five more medium taxpayers’ units. In addition, the GST refund system is being reformed to cut back on delays and the need for interaction with tax officials.

For its part, the trade policy aims to enhance competitiveness, diversify exports, and promote investment in the country. In order to take advantage of global industrial restructuring, particularly relocation of the textile industry from industrial to developing countries, the trade policy has allowed relocation of projects to Pakistan without any import duty. This should accelerate the ongoing modernization of the domestic textile industry, aiding its preparation for the end of the MFA quota regime. The trade policy has also provided fiscal incentives for developing testing facilities, obtaining international certification, and establishing facilities to meet environmental requirements.

Because Pakistan’s exports have an extremely narrow base, the trade policy aims at export product diversification by promoting nontraditional exports, such as exports of horticultural products, furniture, and finished products of granite and marble. The trade policy has various incentives, including payment out of the Export Development Fund of the first 6% of the interest rate on investment loans taken for setting up greenhouses and cool-chain infrastructure. Another incentive is a freight subsidy from Pakistan Horticulture Development and Export Board on horticultural products for exporters complying with standards developed by the board. A 25% freight subsidy is also to be provided to exporters of furniture, and finished products of granite and marble.

Outlook for FY2005

With sound macroeconomic fundamentals, private investment picking up, and the sharp increase in the public sector development program, the economy is now projected to grow by 6.5% in FY2005, compared with the 5.8% forecast in *ADO 2004*. However, as money supply has been growing much faster than nominal GDP over the past 3 years, the resulting large liquidity overhang will put pressure on prices. Also, with the surge in oil prices and with most domestic industries approaching full capacity, the inflation forecast for FY2005 has been raised from 4.0% to 5.5%. Monetary policy will tighten in FY2005; however, the SBP has indicated that it will ensure gradual increases in interest rates that do not adversely

affect the growth momentum. From the surplus forecast in *ADO 2004*, the current account is now projected to move into deficit, as imports grow faster than exports and as official transfers decline.

Agricultural growth is likely to be stronger than in FY2004, but because of emerging water shortages, it is difficult to make any accurate predictions. Rice and sugarcane are likely to suffer, as availability of water for the summer crops is 20–30% lower than in FY2004 and the area sown under sugarcane has declined by 11.3%. An anticipated shortage of water in the country's two main reservoirs poses a major risk for the winter crops, which depend heavily on canal irrigation. However, cotton production is likely to strengthen by 7–9% in FY2005 because of a higher sown area of about 7% and a lower incidence of pest attacks due to dry weather. Performance of the livestock subsector is forecast to pick up, primarily because of a recovery in the poultry subsector, which was hurt by avian flu in FY2004. On the basis of these factors, agriculture is expected to grow by about 3.5% in FY2005.

Growth in manufacturing in FY2005 will be lower than a year earlier, but is still likely to be in the double-digit range, given the strong recovery in sector investment seen in FY2004. A raft of incentives, such as reduction in import duties on industrial raw materials and machinery, together with liberalization of imports of second-hand machinery and incentives for exports, is expected to further boost investment and production in manufacturing. An anticipated larger cotton crop and lower cotton prices will help the textile subsector. The envisaged increase in interest rates is unlikely to hurt manufacturing, because interest rates will still be low.

In the services sector, telecommunications growth is likely to accelerate further with new licenses issued for mobile telephone, long distance international, fixed local loop, and wireless local loop services, as well as for new television and radio channels. Introduction of wireless local loop services will open up rural areas to telecommunications services. The banking industry is also expected to register robust expansion, induced by reforms and privatization.

With GDP growth expected to remain well

above 6.0% and imports maintaining a double-digit increase, tax revenues should grow by about 12% in FY2005. As public debt indicators are projected to improve further, debt servicing, the largest budget expenditure item, is likely to remain under control. Similarly, defense expenditures are expected to stay on target, given a significant improvement in relations with India. The fiscal deficit target of 3.5% of GDP for FY2005 is therefore likely to be achieved.

Rapid economic growth, continuing high oil prices, and the planned import of 1 million tons of wheat in FY2005 point to imports maintaining their 20% rise. With the termination of textile and clothing quotas at year-end, exports are expected to sustain their strong performance of the last 2 years, supported by the industry's substantial restructuring and modernization, and grow by 12.0%. With imports outpacing exports, the trade deficit will widen further. The deficit on the services account is also expected to increase due to anticipated higher expenditures on shipping and lower receipts from the US for logistics support for the conflict in Afghanistan. These, along with the lower official transfers because of the full-year impact of the discontinuation of the Saudi Oil Facility, will push the current account to a deficit of \$1.3 billion or 1.3% of GDP. This is likely to put pressure on exchange rate.

The medium-term prospects for the economy are positive because of the substantial improvements in macroeconomic fundamentals over the last 3–4 years and the sharp pickup in investment in FY2004. In addition, improving relations with India may well lead to an upturn in trade between the two countries and greater foreign investment, and so boost growth. However, several downside risks are apparent. International oil prices have been very volatile in recent months and, if they remain high, projections for imports, the fiscal deficit, and inflation will have to be revised upward. High oil prices could also damp the global economic recovery, so lowering Pakistan's export growth. On the domestic front, water availability for the winter crops is now projected to be significantly lower than in FY2004. Finally, the possibility of an increase in terrorist incidents cannot be ruled out.

ASIAN DEVELOPMENT
Outlook
2004
Update

Economic Trends and Prospects in Developing Asia
Central Asia



Azerbaijan

Economic Assessment

S spurred by continued large FDI inflows into the oil and gas sector, the economy largely maintained its rapid expansion in 2004 (Figure 2.16). GDP grew by 9.4% in the first 7 months of the year compared with the same period in 2003. These large inflows were reflected in the rapid expansion of investment, which grew by 54%. The agriculture sector, which accounts for about 40% of the labor force but only about 14% of GDP, posted growth of 4.4% in production volume. Average real wages were up by about 19% in the period, though wage rates and gains are uneven across sectors, with employees in the oil and investment-associated sectors the main beneficiaries.

After 3 years of consistently low inflation, price increases have begun to accelerate in 2004. Average monthly prices are more than 5% higher than in the same months of 2003, pushing up the 12-month moving average rate to 4.5% in July. This acceleration occurred despite a slight appreciation of the manat and delays in reducing the effective subsidies on the prices of oil products and electricity. Reductions in prices of locally produced food products in July and August will temper inflation for the remainder of the year, but it will remain above the targeted level of 2.5% set in the economic program with IMF. Even though broad money grew more rapidly in the first 7 months of 2004 than 2003, greater monetization of the economy helped relieve the pressure of money growth on prices. The budget in this period was on track to achieve the planned moderate surplus for the year.

Merchandise exports grew by 8.5% during the first quarter of 2004 from a year earlier, while imports surged by 46.3%. The current account deficit widened sharply to \$737.8 million (about 37% of GDP), mainly owing to large payments for goods and services related to development

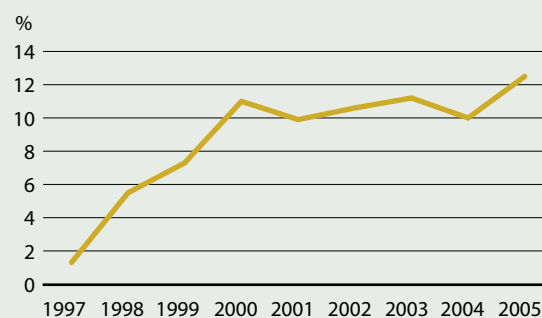
of the oil sector. Inflows of FDI, however, more than covered the current account deficit. Official reserves rose by \$42.0 million (to \$862.9 million) by end-June.

Policy Developments

The uptick in inflation and real exchange rate appreciation indicate that foreign exchange inflows pose challenges for the authorities, especially as oil revenues are expected to rise markedly. In this regard, the adoption of an appropriate oil revenue management strategy and use of the oil fund, SOFAZ, are fundamental. Due to the thin treasury bill market, the National Bank of Azerbaijan is exploring a possible pilot issue of its own short-term bonds to aid sterilization of foreign exchange receipts and so allow better control of monetary and exchange rate developments.

While macroeconomic management has generally been sound, progress on the structural reforms needed to move the country to a sustainable growth path has slowed. In particular, the Government's implementation of the structural reforms agreed with IMF under the PRGF program has been delayed. The outstanding unresolved reforms include adopting a long-term oil

Figure 2.16 GDP Growth, Azerbaijan, 1997–2005



Source: State Statistical Committee of Azerbaijan Republic.

Table 2.17 Selected Economic Indicators, Azerbaijan, 2004–2005, %

Item	2004		2005	
	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>
GDP growth	9.0	10.0	12.5	12.5
Inflation (CPI)	4.0	5.0	3.0	3.0
Current account/GDP	-32.5	-35.0	-18.1	-23.0

Source: Staff estimates.

revenue management strategy, implementing an automatic adjustment mechanism for domestic energy prices, adopting revenue and expenditure plans for SOEs, and further strengthening the finance sector. Slow movement on these reforms has delayed completion of the fourth and fifth reviews of the PRGF, holding up release of approximately \$38 million from IMF.

Planned reforms in the financial sector are key to establishing a favorable environment for private sector development. As commercial banks dominate the sector, the playing field needs to be leveled for the sector to operate efficiently. In this regard, the Government's postponement to 2005 of the sale of a 20% equity stake in the International Bank of Azerbaijan, the largest commercial bank, to the European Bank for Reconstruction and Development is a retrograde step. While the new Banking Law, which is consistent with the Basle Core Principles, was enacted in December 2003, it is essential that procedures be adopted so that its provisions are made fully operational. Moreover, the Government needs to finalize the new National Bank Law and present it to Parliament.

Outlook for 2004–2005

Clearly, macroeconomic projections for Azerbaijan are very sensitive to world oil price developments, as indicated in *ADO 2004*. Subject to this caveat, performance is forecast to be strong through 2004–2005. GDP growth in 2004 is now projected to be 10.0% (as against 9.0% projected in *ADO 2004*), based on the favorable developments through midyear. Although construction delays on the Baku-Tbilisi-Ceyhan oil pipeline

will affect exports, which could damp GDP growth prospects for 2005, the 12.5% projection is maintained in this *Update*. However, the strong economic expansion has only a limited effect on employment creation, given the capital-intensive nature of oil sector-led growth. Consequently, the Government's plans to promote development in the regions, with a particular focus on the non-oil sectors, especially agriculture, are well directed. Nevertheless, it remains to be seen how the plans will be implemented, and what their actual impact on the extensive underemployment and poverty there will be.

The monetary authorities will likely act to keep inflation in check, and inflation is now expected to be held to 5.0% in 2004 and then reduced to 3.0% in 2005. As projected in *ADO 2004*, the general government budget is forecast to show a surplus of 1.1% and 1.5% of GDP, in 2004 and 2005 respectively, despite tax relief granted in 2004 to foster the non-oil sector and mooted for 2005. Increased oil and gas production from new facilities is expected to keep oil revenues buoyant.

Higher than expected world oil prices have boosted export growth (volume is up marginally as envisaged in *ADO 2004*), though the current account deficit is likely to be wider than earlier projected because of quickened oil sector investment activity. Merchandise exports are projected to increase by 12.0% in 2004 (revised from a slight contraction in *ADO 2004*, based on first quarter performance and continued high oil prices) and by 20.0% in 2005 (revised from the 29.3% projection in *ADO 2004* due to the higher growth expected in 2004 and delays in completing the Baku-Tbilisi-Ceyhan pipeline). Imports will grow rapidly in 2004 but will contract moderately in 2005 as four major investment projects near completion. Overall, the current account deficit is expected to be nearly 35.0% of GDP in 2004, before narrowing in 2005 to 23.0%. FDI and other capital flows are likely to ensure an overall balance-of-payments surplus. While growth and fiscal outcomes are healthy, the Government's response to rising inflation is an area that will require continued monitoring through 2005.

Kazakhstan

Economic Assessment

Still fueled by the oil and gas sector, the rapid economic advance of recent years continued through the first half of 2004 with GDP up by 9.1% year on year. On the demand side, the expansion was driven by strong domestic consumption supported by public sector wage raises and investment, including buoyant housing activity. On the production side, a rapid expansion of oil and gas output (up 11.1% and 47.7%, respectively) boosted the industry sector, which benefited from high world prices of oil and metals, while strong gains in transportation and communications output led the services sector. Moreover, the agriculture sector grew by 5.2%, well above its historical average.

Economic growth was accompanied by rising demand for labor and higher incomes. According to official statistics, unemployment declined from an average of 8.7% in 2003 to 7.8% at end-June 2004. Employment gains were notable in construction and services. Notwithstanding sustained strong growth, the capital-intensive nature of the industry sector has produced only moderate employment gains (Figure 2.17). The average real wage rose by 13.1% during the first half of 2004 from a year earlier, reflecting both the Government's policy to carry through substantial increases in wages in the public sector to raise incomes and living standards as well as strong demand for qualified workers in certain activities.

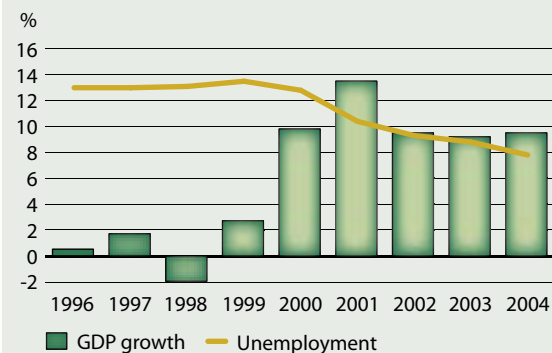
Fiscal policy remained expansionary in the first half of the year. Despite the tax cuts estimated at 1.2% of GDP (VAT was reduced by 1 percentage point to 15%, personal income tax was cut from 30% to 20%, and social payroll taxes were adjusted to a range of 7–20% from 21%), general budget revenues rose by 20.0% year on year. Both oil and non-oil revenues recorded strong gains. Total expenditures grew by 24.0%, mainly driven by higher expenditures for social

sectors, infrastructure, and development of the new capital, Astana. The general budget recorded a surplus of T35.3 billion, or 1.5% of GDP.

Inflation (annual average CPI) at 6.9% for the year ended June 2004 came in somewhat above the National Bank of Kazakhstan target of 5%, largely due to higher prices for food products. Rapid monetary expansion (M2 was up 22.6% in June from a year earlier), public sector wage increases, and imperfect competition in some products are among the factors creating price pressures. Strong export receipts and FDI cash inflows have generated pressures on the exchange rate, although the central bank continued its intervention policy to limit an undue appreciation of the currency. Accordingly, the tenge continued to strengthen against the dollar by 6.6% in real terms during the first half of 2004. In contrast to 2003, the local currency also appreciated against the Russian ruble by 1% and the euro by 8.7%, contributing to domestic producers' loss of price competitiveness.

Exports increased by 29.0% in the first quarter of 2004 from the year-earlier period, mainly as a result of high world prices of oil and metal exports. Although imports rose more rapidly

Figure 2.17 GDP Growth and Unemployment, Kazakhstan, 1996–2004



Source: National Statistical Agency.

Table 2.18 Selected Economic Indicators, Kazakhstan, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	9.5	9.5	9.5	9.0
Inflation (CPI)	5.4	6.5	5.0	6.0
Current account/GDP	-1.1	-1.0	-0.6	-0.6

Source: Staff estimates.

in this period (up 44.0%), in response to high domestic demand, the trade surplus at \$1.5 billion was 15.0% higher than in the first quarter of 2003. However, the usual large net deficits on the services, income, and transfer accounts worsened due to a surge in payments for services for major investments in oil and gas sector projects and greater repatriation of FDI earnings and remittances of foreigners working in the country. As a result, the current account posted a deficit of \$349.0 million for the quarter, compared with a current account surplus (\$525.2 million) in the same period of 2003. As FDI and other capital flows remained significant, gross international reserves (including the assets of the National Fund) increased by \$1.9 billion in the first half of 2004 to \$10.5 billion at end-June.

Policy Developments

The Government continued with the implementation of its 12-year Innovative Industrial Development Strategy for 2003–2015 to foster economic diversification. It undertook several important steps toward structural reforms. In particular, it passed several new laws to restructure railways and energy and to liberalize telecommunications. The policy effort to “de-bureaucratize” the economy included overhauling the permits and licensing system. A total of 55 licenses were abolished with 24 more licenses to be cut by end-2004. In addition, the Government continued its policy effort to promote non-oil investment, with several new incentives: (i) 10-year corporate income tax holidays for new businesses, starting from 2005; (ii) a new amortization policy to reduce the amortization period from 30 years to 4–15 years, thus stimulating renewal of fixed

assets of enterprises; and (iii) a 30–50% reduction in profits subject to the corporate income tax for enterprises that undertake higher value-added production and adopt international quality standards.

Reflecting higher than expected world oil prices, the Government upgraded its estimate for central budget revenues by 7% in June 2004, though the budget deficit target of 1.9% of GDP for 2004 remains unchanged. The majority of the additional oil-related revenues will be used for financing social programs. A smaller part will be budgeted to start the Government’s new housing program for 2005–2007; the program will receive full funding in 2005.

The Government is undertaking comprehensive reforms in education and health. A switch from an 11- to 12-year compulsory education system, modernization of education management, and rationalization of the vocational and technical training systems are the priorities for education reform. Health services improvement and expansion of the number of primary health units are the main tasks in the health sector. The 2005 budget envisages an increase of expenditures for education and health of 49% and 83%, respectively, from 2004 levels.

A well-developed financial sector would significantly aid economic diversification and private sector development. Currently dominated by private commercial banks, the sector needs strengthening to efficiently channel the growing financial savings originating from extractive industries into funding for development of other parts of the real sector. Bank lending has grown rapidly; however, high lending rates hinder borrowing by some potentially fast-growing enterprises. Moreover, nonbank financial institutions (pension funds and insurance companies) are not yet active investors because the domestic securities market has yet to become a significant source of financial intermediation. To address these issues, the Government has taken steps toward financial sector deepening. In January 2004, it set up an independent Financial Supervision Agency to oversee financial institutions, and in June it established an Inter-Ministerial Commission to formulate a medium-term strategy for financial sector development.

Outlook for 2004–2005

The medium-term outlook is positive. The *ADO 2004* forecast for GDP growth of 9.5% in 2004 seems to be on track. Revised forecasts suggest that world oil prices may ease somewhat over the closing months of 2004 and moderate further in 2005. Given this outlook and a possible need to tighten financial policies to counter inflationary pressures, the projection for GDP growth in 2005 has been repegged at 9.0% from 9.5% in *ADO 2004*. Employment growth will continue, though it will stay below the output growth rate because of the capital intensity of ongoing industrial development.

The fiscal position is expected to remain strong, as growing oil revenues and strengthening tax administration will offset tax cuts. The revenue performance and the surplus recorded in the first half of 2004 suggest that the general budget deficit for 2004 will be less than the Government's forecast of 1.9% of GDP (as adopted

for *ADO 2004*) and it is now projected at 0.5% of GDP. The projected budget deficit of 1.0% of GDP in 2005 is maintained in view of the current medium-term fiscal plan.

The inflation forecast is now revised higher to 6.5% in 2004 and 6.0% in 2005 due to increases in public sector wages and expansion in the money supply. In view of projected high foreign exchange earnings, the tenge is likely to strengthen further.

Exports and imports are now expected to grow more rapidly than projected in *ADO 2004* due to higher than expected world prices for key export commodities in 2004–2005 and implementation of the large oil and gas investment projects. With this revised outlook, the trade surplus is expected to improve further, though net deficits on the services, income, and transfer accounts are likely to be largely offsetting. Accordingly, there has been no essential change made to the projection of the current account deficit, which remains at 1.0% of GDP in 2004 and 0.6% in the following year.



Uzbekistan

Economic Assessment

For the first quarter of 2004, the Government announced that GDP grew at 4.8% year on year. Although its official plan investment reportedly shot up during this period, and may, with export increases, have boosted growth, official data are difficult to fully reconcile with the tight monetary and fiscal policies and widespread downbeat reports from the private sector. Moreover, official data show that overall capital investment contracted in the first quarter of 2004 by 0.4% from a year earlier. The IMF estimate of 1.5% GDP growth in 2003 stands in contrast to the 4.4% government estimate for 2003 and exemplifies the difficulties in using available statistics for assessing economic developments.

Agricultural output expanded by 6.7% in the first quarter of 2004 from the previous year, according to official figures. For the whole of 2004, the Government revised down its target for raw cotton production to 3.60 million tons from its original target of 3.75 million tons, reflecting a reduced crop area. Industrial growth was officially put at 8.8% in the first quarter, but again, as these data rely on self-reported figures by SOEs and high, undocumented output growth in small enterprises, they should be viewed with circumspection. The production of cars, machinery, and certain chemicals is reported to have increased, but these have high import content and contribute relatively little to real GDP growth. The Government lowered its 2003 industrial growth estimate to 2.8%; according to IMF estimates, the sector contracted. Various indications point to an expansion of the shadow economy, particularly in the services sector, largely because businesses struggle to keep earnings out of strictly controlled official channels.

The budget deficit in 2003 was 0.4% of GDP, down from 0.8% in 2002. State revenues were 24.2% of GDP and expenditures 24.7%, down

from 25.0% and 25.9%, respectively, in 2002. A combination of rate reductions in profit and individual income taxes, special tax and customs exemptions associated with government efforts to encourage local production, and sluggish economic growth were responsible for the lower revenue share. Modest wage increases, lower energy subsidies, and weaker budgetary investment expenditures were the main reasons for the lower expenditure ratio.

The Government reported a fall in inflation from 21.6% in 2002 to 3.8% in 2003, against an IMF estimate of 7.7%. Over the first quarter of 2004, inflation was officially put at 1.1%, down from 5.2% in the first quarter of 2003. The annualized growth in broad money in the first quarter decelerated to about 23% from around 27% a year earlier. Public access to cash stayed restricted and cash payments on transactions continued to benefit, as in 2003, from a 30–40% discount against noncash payments. The Central Bank of Uzbekistan (CBU) further lowered the monthly refinancing rate from 1.7% to 1.5% (19.6% annualized) from July 2004. At end-July, the exchange rate stood at Som1,020/\$1, representing a depreciation of approximately 5% since the establishment of currency convertibility (by government acceptance of IMF Article VIII obligations) in October 2003.

The balance-of-payments situation reportedly improved in the first half of 2004. Imports and exports both rose, according to official sources. However, details are scarce and the real extent of the prominence of state-owned or state-supported trade activity is unclear. IMF data show that the current account surplus jumped in 2003 to about 9% of GDP, mostly due to a surge in exports on account of stronger export volumes of gold and natural gas and higher world prices for cotton and gold. Gross international reserves at end-2003 were officially put at \$1.6 billion, or equivalent to about 6.5 months of imports.

Table 2.19 Selected Economic Indicators, Uzbekistan, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	4.5	3.0	4.0	3.0
Inflation (CPI)	20.0	10.0	20.0	10.0
Current account/GDP	6.0	6.0	6.0	6.0

Source: Staff estimates.

Policy Developments

As discussed in *ADO 2004*, in order to stabilize and unify exchange rates in the run-up to convertibility, the authorities tightened monetary and fiscal policies but also adopted intensified trade restrictions, erected procedural barriers to accessing cash at commercial banks, and delayed budgetary payments, which resulted in substantial arrears. Subsequently, the authorities have allowed a gradual depreciation of the som but have yet to unwind the large economic imbalances created in 2003. Government payment arrears have persisted.

The trade regime has continued its bias against imports by small traders—mainly of consumer goods—granting preferential treatment to goods and enterprises considered a state priority. In addition, there have been reports of unofficial restrictions on currency convertibility, particularly for imports of consumer goods and items not considered a priority. Moreover, since March 2004, national currency imports and exports have been restricted in an attempt to clamp down on foreign exchange transactions across the border with Kazakhstan.

In the monetary area, broad money growth maintained its declining trend in the first quarter of 2004 with CBU's increased use, since 2002, of indirect monetary policy instruments (mainly CBU certificates of deposit and special deposits held by commercial banks) to control reserve money growth. The authorities do not appear to have sterilized their buildup of foreign exchange reserves but have continued to use cash controls instead of conventional monetary measures. Cash shortages persisted in the first half of 2004 as commercial banks failed to fully meet customers' demands for withdrawals despite the CBU declaration that, as of February 2004, banks would

have unrestricted access to their correspondent accounts with CBU. State efforts to control commercial activity via the banking system, together with the cash shortages, have prompted businesses to curtail their use of banking channels: the ratio of bank deposits to GDP has fallen from the already relatively low level of 8% in 2001 to only 6% in 2003.

The Government raised salaries for public sector workers, pensions and social benefits, and stipends for students at higher, specialized, and vocational educational establishments by 30% from 1 August 2004. It plans to partly offset these added expenditures by a 20% reduction in the public sector workforce. The same month, it added 20% to the negotiated price of cotton, which applies to purchases over the 25% of production that farmers are required to sell to the state at the procurement price (though almost all cotton is still channeled through the state procurement system as no private traders have been licensed).

Some market-oriented structural changes were put into effect. For example, privatization revenues of close to \$40 million were reported in the first half of 2004 from the sale of over 1,000 enterprises, an 80% increase over the same period in 2003, though information on transactions has not been made public. However, stringent investment requirements attached to privatization offers and strict conditions on postprivatization operations continued to deter private investors, especially for any large enterprises on offer. In addition, the authorities undertook measures to partially replace the centralized distribution of some commodities with transactions on commodity exchanges, which serve as clearinghouses for spot transactions, and combined this with price liberalization for selected commodities.

The Government has also continued its efforts to directly steer the economy. For example, the "localization" program—originally announced in 2000 as a means of supporting domestic industry to encourage local production of priority products—has been revamped. This included a new list of projects for products, inputs, and raw materials eligible for state support; new tax exemptions and preferential access to bank credits for eligible enterprises; and a special committee to oversee project implementation.

To date, FDI in Uzbekistan has been relatively

small with the Russian Federation the major source. However, much larger capital flows are in prospect. Russian companies have recently stated their aim of investing close to \$2 billion in Uzbekistan's oil and gas sector and one company in 2004 acquired a 75% stake in the nation's largest mobile phone operator. In addition, the Government has announced that it expected to secure credits of \$955 million from the PRC in the period 2004–2007 for investment projects.

With backing from the authorities, the governments of the PRC and the Russian Federation separately made public their intention to invest a total of about \$3 billion in the country over the next 5 years. It is envisaged that this will be directed mainly to the oil and gas, fertilizer, energy, telecommunications, irrigation, and financial subsectors. In contrast, the US indicated in July 2004 that it would cut \$18 million of annual aid to Uzbekistan, citing disappointing progress toward democracy and a poor human rights record.

Outlook for 2004–2005

The proposed investments from the PRC and the Russian Federation are expected to bolster economic growth, though after the forecast period. Policy reforms and agricultural restructuring are unlikely to provide any substantial growth effect over the forecast period and the main stimulus to growth remains tied to world prices of cotton and gold, which are expected to stay robust over this period. The Government's targets for low broad money growth could lead to a limited expansion in credit to the economy and pose a further constraint on economic growth. Official projections point to an average annual growth rate of about 6% over 2004–2005, against the *ADO 2004* forecast of 4.0–4.5%. The *Update*

forecast is now put at 3% in light of greater than expected difficulty in adjusting to the economic imbalances.

The increase in public sector salaries will lift the revenues of the pension and employment fund (business units' dues to these funds are assessed on salaries). The cost of increased pensions and social benefits as well as larger student grants will be partly offset by the planned reduction in public sector employment. Tax benefits and preferential import duties associated with the Government's efforts to encourage local production will have a negative impact on its revenues. The net effect is that the budget deficit in 2004 is expected to exceed the official target of 1% of GDP but not differ substantially from the *ADO 2004* forecast of about 2%. The absence of detailed data on the composition of government investment spending makes it difficult to assess the implications of lower public investment for future growth.

The authorities will likely continue their efforts to control inflation. Nevertheless, reflecting the higher social support payments and public sector salaries as well as proposed increases in electricity and gas tariffs, inflation over 2004–2005 is now expected to rise to about 10%, but be substantially below the 20% inflation rate forecast in *ADO 2004*. The trade restrictions make it difficult to assess the appropriateness of the exchange rate.

However, a gradual further depreciation of the som over the rest of 2004 is expected as imports linked to the revamped localization program strengthen, though a sharper depreciation would be likely if trade distortions are substantially corrected. The state is expected to maintain its tight control over the external trade regime, and the balance of payments is unlikely to move much from the current account surplus of 6% of GDP projected in *ADO 2004* for 2004–2005.

ASIAN DEVELOPMENT
Outlook
2004
Update

*Economic Trends and Prospects in Developing Asia
The Pacific*



Fiji Islands

Economic Assessment

The economy is projected to grow at 4.1% in 2004, compared with an original *ADO 2004* forecast of 3.9%. This upward revision reflects an unexpectedly strong stimulus from tourism in the first two quarters of the year (Figure 2.18). The midyear introduction of new air services from Australia and New Zealand is expected to underpin continued expansion in tourism in the latter half of 2004 and thereby further stimulate the trade, restaurants and hotels, and transport and communications subsectors. A relatively strong performance is also anticipated in the community, social, and personal services subsector, with the services sector as a whole projected to contribute 2.4 percentage points to the aggregate growth rate for 2004.

In contrast, figures for the primary sector have been revised downward. Sugarcane production is likely to fall, while noncane agricultural production was damaged by flash flooding in major growing areas in April. Fisheries production is expected to stay subdued, with a new Fisheries Management Bill intended to monitor and control catches. The small forestry subsector is forecast to grow at a historically high rate, though from a small base. Mining production in 2004 is being ramped up as a result of the expansion program at the Emperor Gold Mine, with maximum production to be achieved in 2005. The primary sector is projected to contribute 0.4 percentage points to aggregate growth in 2004.

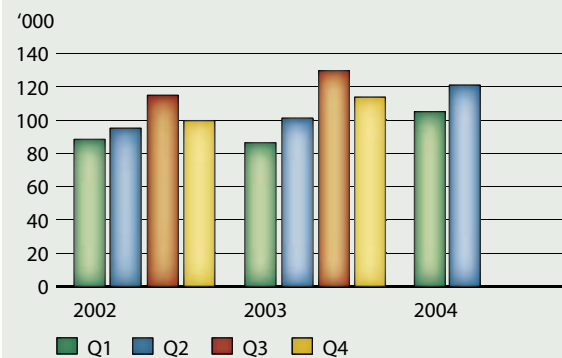
Growth in the secondary sector, i.e., manufacturing, construction, electricity, and water, has also been revised downward, and is expected to contribute 1.3 percentage points to the aggregate GDP figure. This revision primarily reflects midyear sugar mill breakdowns that have hampered crushing. Production in the clothing and footwear subsector was virtually stagnant in the first 5 months of 2004, but is likely to increase

and register some positive year-on-year growth. As envisaged, construction has expanded significantly, with a range of private and public sector investment projects completed or initiated. Private business will drive much of the activity in this subsector during the second half of 2004. The electricity and water subsector is growing modestly.

Labor market conditions have improved somewhat. In the year to end-June 2004, the number of new registered taxpayers rose by 6% from the year-earlier period, with the vast majority of new jobs generated in the services sector. Employment surveys have also shown a higher volume of job advertisements, and employers are expected to create more jobs while wage increases remain moderate and are limited to a few sectors, including pay increases of 1% for civil servants in February and 5% for transport workers in March. However, the demand for skilled labor is unlikely to be met in full by domestic supply, as emigration continued in the first 5 months of 2004, albeit at a slower rate than previously.

On the demand side, stronger employment has benefited private consumption as evidenced by a substantial rise in VAT revenue and bank

Figure 2.18 Quarterly Visitor Arrivals, Fiji Islands, 2002–2004



Source: Reserve Bank of Fiji, *Quarterly Review*, June 2004.

Table 2.20 Selected Economic Indicators, Fiji Islands, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	3.9	4.1	3.0	3.2
Inflation (CPI)	3.0	3.0	3.0	3.0
Current account/GDP	-6.6	-6.0	-9.6	-8.8

Source: Staff estimates.

lending to individuals during the January–May period. Investment spending has also been relatively buoyant, mainly due to revived construction activity. Overall business confidence seems to have improved, but it remains to be seen if the long-term decline in the investment-to-GDP ratio has bottomed out.

The 2004 budget targeted an overall deficit of 3.9% of GDP (before asset sales), to be financed by domestic borrowing. Preliminary data show a budget surplus equivalent to 0.2% of GDP in the first 4 months of 2004, suggesting that the Government is on track to achieve or possibly exceed its target. Capital expenditure has been well below the budgeted level, but is forecast to pick up. Operating expenditure has been broadly in line with budget forecasts, largely because the public sector wage bill has remained under control. At the same time, revenue collection has exceeded expectations, partly because of improved coordination between the tax and customs authorities. At end-June, the Government's domestic debt stood at 42.6% of GDP, down from 44.7% at end-2003.

Annual inflation in the year to June 2004 was 2.7%, in line with the *ADO 2004* forecast of 3.0% for the calendar year. Some upward pressure on prices has been exerted by food shortages following the April floods, and there may be further pressure if oil prices stay high. The nominal and real effective exchange rate indexes of the Fiji dollar have both risen marginally in 2004, leading to a slight deterioration in the country's international competitiveness. In the first 7 months of the year, the local currency appreciated by about 2% against the US dollar.

Broad money declined during the first 5 months of 2004 because of a drop in net foreign assets. Domestic credit growth was dominated by

increased private sector credit, with commercial banks lending quite heavily to individuals seeking housing finance. The trade, construction, business services, and public sectors have also borrowed more, whereas lending to agriculture and utilities has fallen. The commercial banks' weighted average lending rate fell to 7.17% by May 2004, while rates on savings fell to 0.36% and rates on time deposits rose to 1.72% at that time. Consequently, the interest rate spread narrowed slightly, while real interest rates on deposits remained substantially negative.

The export performance of the first 5 months of 2004 was disappointing vis-à-vis the year-earlier period. Reexports and exports of sugar, garments, mineral water, and fish all declined. Imports slid even further as a result of reduced imports of intermediate and investment goods. The resultant narrowing of the trade deficit, though somewhat offset by higher inflows on the services account due to tourism, helped reduce the current account deficit. By end-June 2004, foreign reserves covered the equivalent of 3.2 months of imports of goods and nonfactor services.

Policy Developments

The key macroeconomic policy development in 2004 has been a tightening of monetary policy, introduced at end-May. The official interest rate (the rate on 91-day Reserve Bank notes) was raised from 1.25% to 1.75% to restrain burgeoning consumer spending which, in the monetary authority's assessment, was threatening to create unsustainable pressure on the balance of payments. The Reserve Bank has emphasized the need for an improved export performance if recent economic growth is to be sustained, but has not indicated any intention to review the exchange rate policy. (As anticipated, measures to relax exchange controls were introduced from January.) In a midyear economic symposium, the Government, too, underlined the need for faster private sector-led export expansion, and reiterated its commitment to the development objectives and policies enunciated in the current strategic development plan, and to the 2001–2020 plan aimed at enhancing the participation of Fijians in the economy.

With regard to the key issue of investment promotion and achievement of an investment-to-

GDP ratio of 1:4, the Government has amended foreign investment legislation and formulated accompanying regulations intended to streamline the approval process for foreign investment. The business community is awaiting the outcome of an associated review of the list of potential investment areas restricted or reserved for nationals.

In general, rather than exchange rate adjustments, factors such as infrastructure quality, reliability and price of utilities, availability of skilled labor, and efficiency of public administration are the major determinants of the country's competitiveness.

The early months of 2004 have seen progress on another key issue—restructuring the sugar industry. A new board has been appointed to reform the Fiji Sugar Corporation. The Indian Government is providing technical assistance and a concessionary loan to expand sugarcane cultivation and to improve the transport and milling systems. The aim is to make the industry internationally competitive after the renegotiation of the European Union Sugar Protocol in 2007, which will lead to a significant reduction in prices for sugar from the Fiji Islands. In the matter of fundamental land issues, a bipartisan committee of politicians is due to report in September 2004, while the Government is reviewing the legislation governing landowner-tenant relations in the hope of resolving long-standing tensions in this area.

Outlook for 2004–2005

The services sector is expected to drive the economy in its fourth year of brisk economic expansion since the 2000 coup, with the construction sector playing a crucial auxiliary role. In 2005 and broadly in line with the *ADO 2004* projections, growth is forecast to slow to 3.2%, with the services sector contributing 2.2 percentage points to this outcome. The secondary sector is projected to contribute a lower 0.6 percentage points as construction activity decelerates with the completion of several large projects. Garment producers will struggle to adjust to greater international competition when the MFA quota in the crucial US market expires at end-2004, though a more severe adjustment scenario has been avoided with the recent 7-year extension of duty-free access to the Australian

market. Sugar production is expected to pick up slowly as transport and milling problems are gradually solved, while mineral water production is likely to show the benefits of the 2004 investment program. The growth projection for the secondary sector may turn out to be conservative if garment producers secure new markets and sugar restructuring is accelerated.

The primary sector is projected to contribute 0.4 percentage points to growth in 2005. Little improvement is foreseen in the agriculture and fisheries subsectors, though the forestry subsector could expand significantly if the country's mature mahogany forestry resources are commercially exploited. Output from gold mining is expected to grow relatively fast.

Economic expansion in the 3–4% range will generate essential growth in formal sector employment of about 2% a year, but this is insufficient to fully absorb the annual net increase in the labor force. Many job seekers will be forced to enter the informal sector or become openly unemployed. Additionally, former tenants of sugarcane land are likely to join the labor market, and the garment industry may resort to redundancies. Clearly, such events would strain the Government's capacity to address poverty. Already, about 10% of the population live in squatter settlements in the Suva-Nausori corridor, and fiscal constraints have limited the scope of poverty reduction programs.

Macroeconomic stability is expected to be maintained through 2005 as the Government continues to rein in the budget deficit and adheres to a cautious monetary policy stance. However, the official projection of a budget deficit of 0.8% of GDP in 2005 appears overoptimistic, since it relies on a fall in nominal operating expenditure that will be difficult to achieve. Inflation is projected to remain at around 3%, while the nominal effective exchange rate is likely to appreciate marginally. There is considerable uncertainty surrounding balance-of-payments projections, given the lack of timely and reliable data, and the difficulties facing the sugar and garment industries.

Growth in gold, mineral water, and timber exports, combined with tourism expansion, will boost foreign exchange earnings, though the current account deficit is likely to widen as imports pick up from their 2004 level.



Papua New Guinea

Economic Assessment

Preliminary estimates suggest that GDP growth for 2004 will reach the *ADO 2004* forecast of 2.8%, thus continuing the modest upward trend of 2003. Growth, while broad based, remains heavily dependent on exports of primary commodities: gold accounts for approximately 37% of total exports, copper for 20%, agriculture for 19%, and crude oil for 18%. Supported by high global commodity prices, the total value of exports of most mineral and nonmineral commodities has risen. However, the volume of gold exports declined by 12.2% from 18.8 tons in the last quarter of 2003 to 16.5 tons in the first quarter of 2004, while copper production fell by 33% from 69,100 to 46,300 tons in the same period.

The agriculture, forestry, and fishery sector benefited from favorable weather conditions, resulting in higher export volumes for most commodities compared with the first quarter of 2003. The volume of crude oil exports in the first quarter of 2004 increased to 3.3 million barrels, from 2.9 million barrels in the last quarter of 2003, though this was still 12.8% lower than in the equivalent period in 2003 due to natural decline in the older fields. New capacity in the Moran field is expected to come on stream toward the end of 2004.

Further consolidation of the budgetary situation was achieved through the Government's efforts at expenditure control and improved revenue collection. As of May 2004, higher than expected revenues resulting from increased collections from personal, corporate, and mineral taxes, together with lower expenditures, had led to an overall budget surplus of K258.5 million, equivalent to 2.0% of GDP, compared with K16.2 million a year earlier. The decrease in expenditures was primarily due to lower interest payments and slow disbursement of the devel-

opment budget. In the first 5 months of 2004, the Government retired K61.6 million of its domestic and K161.8 million of its external debt.

Prudent monetary policy and better fiscal management helped further reduce inflation in the first quarter of 2004. In the quarter to March 2004, year-on-year inflation fell to 2.9%, the lowest rate since 1997. The kina strengthened against the US dollar and to a lesser extent against the Australian currency. The stronger kina offset somewhat the effects of higher international fuel prices and the 2% import levy introduced in the 2004 budget. The easing of inflationary pressures led to further cuts in the official Kina Facility Rate from 14.0% in December 2003 to 9.0% in September 2004. Interest rates on 28-day treasury bills declined from 16.1% in December 2003 to 6.5% at end-July 2004.

Broad money supply increased by 5.4% in the first 6 months of 2004 after an overall drop of 1.0% in 2003. Liquidity levels in the banking system increased but did not translate into an expansion of commercial bank credit to the private sector. With private sector demand for credit remaining weak, commercial lending rates continued their downward trend to 13.3% in June 2004. Lower interest rates are expected to boost private consumption and investment levels.

Official government forecasts show a balance-of-payments deficit of K44.8 million in 2004 as the deficit on the capital and financial accounts more than offsets the gains in trade. The latter deficit is expected to reach K678.3 million in 2004, resulting from higher external loan repayments by the Government, lower loan drawdowns, and higher balances held in offshore accounts by mineral companies. However, preliminary estimates for the first 5 months point to a slightly better outturn. Gross foreign reserves are expected to build up to \$491.9 million by year-end, equivalent to approximately 6.5 months of nonmineral import cover.

Table 2.21 Selected Economic Indicators, Papua New Guinea, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	2.8	2.8	1.7	1.7
Inflation (CPI)	8.7	7.4	9.6	6.0
Current account/GDP	5.0	5.0	3.2	3.2

Source: Staff estimates.

Policy Developments

While higher commodity prices and improvements in fiscal management led to a reversal of the 3-year contraction from 2003, political instability and frequent government reshuffles are still hampering the Government's ability to implement structural reforms, such as reducing government payroll numbers. Fearing a motion of "no confidence," the Government has several times tried to adjourn Parliament since the beginning of the year. The prime minister has also resorted to frequent reshuffles in his coalition, which has harmed continuity.

The governments of Australia and Papua New Guinea agreed, at end-June 2004, on an Enhanced Cooperation Program. This provides for additional assistance to the Government of K2 billion as well as senior in-line advisors in the public sector to strengthen law and order, customs, transport and border security, governance, and economic and public sector administration. Additionally, Australian police officers will assist with the improvement of the law and order situation, which is likely to lift business confidence in the medium term.

The Government has made progress toward implementing the recommendations of the Public Expenditure Review and Rationalization (PERR), finalized in mid-2003. The PERR outlined recommendations for four core areas: a road map to fiscal sustainability, reduction in civil service size, restoration of the integrity of budget institutions and systems, and expenditure adjustment and prioritization. It also provides recommendations for improving health and education spending.

While progress to date has been particularly noticeable in terms of restoring the integrity of the budget process, the focus is still on

improving processes and technical solutions. The Government is also aiming for a 10% reduction in public sector staffing by end-2007. Current plans are to achieve this through a 1% reduction in the workforce in 2004 and 3% in each of the remaining 3 years. Progress has already been made in implementing the integrated payroll and human resource records management system as well as in identifying ghost workers and eliminating overpayment of allowances.

Financial controllers have been positioned in key spending departments, leading to improvements in reducing arrears and budget overruns. The first phase of data cleansing of trust accounts has been completed and efforts to close irregular trust accounts are currently under way. Despite these efforts, the Government is aware that further attention is needed to directly improve fiscal sustainability and strengthen accountability mechanisms and oversight institutions. Another formidable challenge is to strengthen the effectiveness of provincial expenditures and to improve monitoring and reporting systems of subnational accounts.

Since end-2003, the Medium Term Development Strategy (MTDS) covering 2003-2007 has undergone substantial changes and is yet to be finalized and endorsed by the National Executive Council. Based on the Government's agenda for Recovery and Development, the MTDS emphasizes good governance, export-driven growth, rural development, human resource development, and poverty reduction as the main priorities. However, the resources required to implement the MTDS have not been clearly mapped out and its link to the annual budgets is unclear. The PERR provides a framework for identifying sources of saving, for revenue-raising initiatives that would permit a reprioritization of government spending while maintaining aggregate fiscal discipline, and for improving accountability. However, much remains to be done to integrate and move forward the implementation of the various initiatives.

Privatization of the state-owned telecommunications company, Telikom PNG, is currently awaiting cabinet approval. Efforts are also under way to improve performance standards and corporate governance of other SOEs with a view to privatization or corporatization in the medium term.

Outlook for 2004–2005

Economic growth projections are expected to remain at the forecast level of 2.8% for 2004 and at slightly lower levels for the following 2 years. However, the economic growth seen since mid-2003, while relatively broad based, remains fragile and highly dependent on favorable commodity prices and weather conditions.

Most commodity prices are likely to remain high in 2005, particularly for crude oil and gold, while the start of operations of the Wewak tuna loining facility and the Napa Napa oil refinery in June 2004 is expected to boost manufacturing output. As a result, the merchandise trade account is projected to maintain its surplus in 2005.

The Government is committed to limiting

the budget deficit to 1.0% of GDP in 2005 and to lowering it thereafter. Provided that these fiscal targets are met, the IMF estimates that central government debt could be reduced from 63% of GDP at end-2003 to 46% at end-2009. However, 2005 budget savings, initially targeted at K240 million, have been scaled down to K80 million on account of anticipated lower interest payments and improved revenues from commodity exports. To reach its targets, the Government will have to vigorously pursue the steps initiated for generating savings, particularly in continuing to reduce the public sector wage bill.

Annual inflation is forecast to reach 7.4% in 2004, somewhat lower than earlier projected, and to continue to fall to 6.0% in 2005.

ASIAN DEVELOPMENT
Outlook
2004
Update

Part 3 Economic Scenarios for Asia



T. Takahara

ASIAN DEVELOPMENT
Outlook
2004
Update

Economic Scenarios for Asia





Economic Scenarios for Asia

Regional Impact of an Economic Slowdown in the People's Republic of China: Three Alternative Scenarios

Introduction

Developing Asia's trade and economic growth have benefited greatly from the emergence of the People's Republic of China (PRC) as a major economic power.¹ Over the past 2 years, for example, exports from developing Asia to the PRC have soared by an average annual rate of 30%. But if a buoyant PRC has helped lift regional growth rates, what will be the impact on Asia of a slowdown in that country?

This question is timely because the PRC Government is making serious efforts to slow several key sectors of its economy, including automobiles, property, and steel, where excessive investment has caused sharp price rises in raw materials and bottlenecks in the supply of power and transportation. The authorities have used monetary, fiscal, and administrative measures over the past year to damp fixed asset investment in those sectors, with some success (see the PRC chapter in Part 2). The macroeconomic tightening reined in gross domestic product (GDP) growth rates from 9.9% in the fourth quarter of 2003 to 9.8% in the first quarter of 2004 and 9.6% in the second. It seems likely that the PRC economy will slow to a soft landing and achieve a more sustainable growth path of 7–8% from 2005, though the risk of a hard landing remains.

So far, the PRC's investment slowdown has not had a perceptible effect on the exports or economic growth of its trading partners. Moreover, an economic modeling exercise, detailed below, to gauge the effect on the region of a significantly sharper cut in PRC industrial investment suggests that the impact on regional economies

of this scenario would be moderate. Hong Kong, China is the most vulnerable to such a development. The Republic of Korea (Korea); Singapore; and Taipei, China are next. Southeast Asian nations generally would avoid any significant losses in output, and South Asia is the most insulated from developments in the PRC. The results of the exercise also suggest that if the United States (US) and Japan achieve stronger than expected growth, this could more than offset the reductions in growth caused by the PRC slowdown for most of developing Asia's economies.

How a Slowdown in the PRC Affects Other Economies in Developing Asia

Given that trade links dominate the economic relationship between the PRC and its developing Asian neighbors, it is through the trade channel that most impact is likely to be felt when the PRC's economy slows significantly, in the process lowering demand for manufactured exports from the region. The prices of those exports may also fall. The boom in the PRC has contributed to recent strength in world commodity markets, so a slowdown in the PRC could also reduce exports from regional economies of rubber, metals, and other primary products.

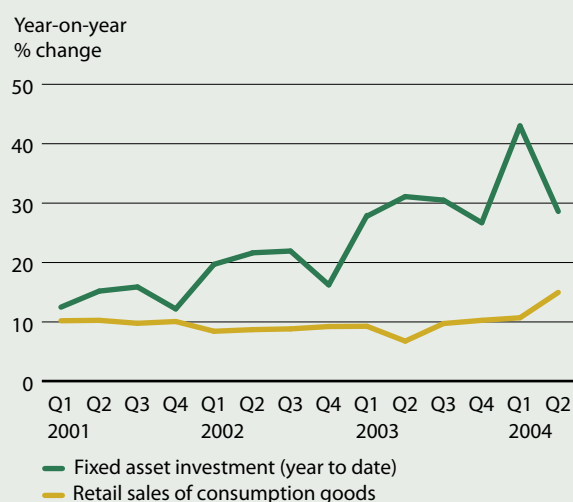
The extent of these effects depends on the characteristics of each PRC trading partner and its trade relationship with the PRC, as well as the nature of the slowdown in the PRC.

In the current situation, the PRC's tightening measures are aimed at slowing fixed asset investment in selected industries, meaning that investment (capital) goods sectors might be

severely affected, but the export sector could avoid the slowdown (Figure 3.1). Consumption is likely to be spared because of rising urban and rural incomes, and low interest rates. So the impact on the PRC of these tightening measures could be contained within a few sectors.

With regard to the PRC's trade relationship

Figure 3.1 PRC Fixed Asset Investment and Retail Sales, Q1 2001–Q2 2004



Source: CEIC Data Co. Ltd.

with the rest of the region, links have become much more extensive in recent years, but the country is still a relatively small trading partner for most developing Asian economies compared with the US, Japan, and European Union (EU). The PRC accounted for 16.9% of developing Asia's trade in 2003, while the US, Japan, and EU together accounted for 39.0% (Table 3.1). The newly industrialized economies (NIEs) of Hong Kong, China; Korea; Singapore; and Taipei, China have closer trade relationships with the PRC, with 42.7% of Hong Kong, China's exports and 14.9% of Taipei, China's exports going to the PRC in 2003—though this probably underestimates shipments from Taipei, China because some that are destined for the PRC go through Hong Kong, China. Korea, too, is vulnerable because the PRC became its biggest export destination in 2003, taking 20.0% of its exports.

Southeast Asia is less dependent on the PRC. The share of total exports from the Association

Table 3.1 Regional Distribution of Merchandise Trade in Developing Asia, 2003, %

Economy or Region	PRC	US	EU	Japan
Developing Asia	16.9	14.1	12.9	12.0
NIEs (excl. Hong Kong, China)	17.8	22.1	18.0	19.2
Hong Kong, China	30.4	8.4	7.6	6.1
ASEAN (excl. Singapore)	8.7	14.5	12.2	15.4
South Asia	1.8	4.0	6.9	1.1

ASEAN = Association of Southeast Asian Nations, EU = European Union, NIEs = newly industrialized economies, PRC = People's Republic of China, US = United States.

Source: CEIC Data Co. Ltd.

of Southeast Asian Nations (ASEAN) economies, excluding Singapore, to the PRC has doubled from 4.3% in 2001, but to just 8.8% of total exports from the group, excluding Singapore, in 2003 (Table 3.2). Similarly, India boosted its share of exports to the PRC, from 1.8% in 2000 but only to 6.3% in 2003. The PRC is Japan's second-biggest market (after the US), buying 12.2% of Japan's exports.

In addition to extent, the composition of trade between the PRC and its regional partners is also relevant to assessing the impact of an economic slowdown in the PRC. A large part of developing Asia's exports to the PRC involves intermediate goods that are processed and reexported, so

Table 3.2 PRC Share in Exports of Selected Asian Economies, 2001–2003, %

Economy or Region	2001	2002	2003
Japan	7.7	9.6	12.2
Developing Asia			
NIEs	16.8	19.3	23.5
Hong Kong, China	36.9	39.3	42.7
Korea	12.1	14.7	20.0
Singapore	4.4	5.5	7.0
Taipei, China	3.9	7.6	14.9
ASEAN (excl. Singapore)	4.3	5.2	8.8
Indonesia	3.9	5.1	7.2
Malaysia	4.3	5.6	10.5
Philippines	2.5	3.9	11.9
Thailand	4.4	5.2	7.1
South Asia	2.8	3.3	5.0
India	3.4	4.1	6.3

ASEAN = Association of Southeast Asian Nations, NIEs = newly industrialized economies.

Sources: International Monetary Fund, *Direction of Trade Statistics*, July 2004; Datastream, downloaded 15 August 2004.

much of the PRC's import growth is related to demand levels outside the region. A strong trend has been apparent in recent years toward vertical specialization, where steps in the manufacturing production process are divided between several Asian countries and where the components are shipped to another country for final processing and assembly and then reexport. Improvements in transportation and communications, as well as falling trade and investment barriers, have bolstered this trend. The PRC has developed many of the centers for final processing and assembly because it has the biggest low-cost labor force and has attracted substantial inflows of foreign direct investment to build the facilities. As a result, the PRC's demand for intermediate goods from developing Asia has grown sharply while its exports of final goods to industrial countries have also increased significantly. During 2001–2003, the PRC's trade surplus with the US and EU burgeoned from \$33 billion to \$77 billion, but over the same period the PRC ran a deficit of about the same size with Korea; Taipei, China; and the ASEAN economies (Figure 3.2).

Consistent with the rising vertical specialization of production within Asia, there has been an increase in the proportion of intra-industry trade, especially for electronics, within intraregional trade. The International Monetary Fund has estimated that intra-industry trade accounted for 75% of total trade growth in East and Southeast

Asia on average in 1996–2000, much higher than in other developing regions. There is evidence from other studies (e.g., Frankel and Rose 1998) that countries with closer trade linkages have highly correlated business cycles, and that intra-industry trade is the major channel through which the business cycles of East Asian economies become synchronized (Shin and Wang 2003).

It is clear that increasing vertical specialization and intra-industry trade have created a new channel to transmit economic shocks through Asia. A slowdown in one country's demand will not only lead to reduced exports, but also to lower demand for imported intermediate inputs and capital goods by its trading partners. Therefore, besides the direct and indirect demand effects associated with the income decline, there are production-related demand effects that can quickly travel along the production chain.

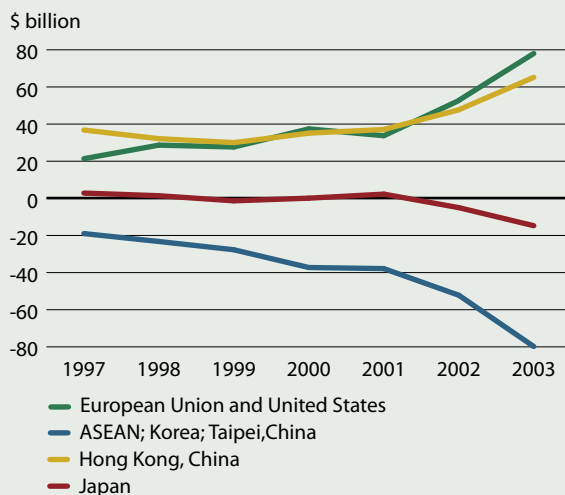
However, the current slowdown in the PRC is less likely to exert strong demand reduction effects through the region because developing Asia's production chain depends on final demand from industrial countries, and the linkage between the PRC's export processing sector and its internal economy is relatively weak.

Assessing the Impact of a Sharper PRC Slowdown

To quantify the potential impact of a sharper slowdown in the PRC, a global trade simulation model—Linkage—is used, to assess the effects on trade flows, terms of trade, income and output of different regions under various scenarios. The Linkage model is a multiregion, multisector, dynamic computable general equilibrium model that captures the geographic and sector structure of global trade flows (see van der Mensbrugge 2003). A baseline is established, in which economic growth and other macroeconomic indicators are broadly assumed to be consistent with the benchmark projections of the *ADO 2004 Update*. Under the baseline scenario, the PRC is set to achieve a soft landing, with its GDP growth rate slowing from 8.8% in 2004 to 8.0% in 2005. This is expected to have only a slight impact on the PRC's trading partners.

Three alternative scenarios for 2005 are then considered:

Figure 3.2 PRC Trade Balance, 1997–2003



Source: CEIC Data Co. Ltd.

- a cut in real investment growth in the PRC from 10.2% to 5.0% in 2005;²
- an identical investment cut in the PRC and an acceleration of growth in the US and Japan by 1 percentage point from the baseline; and
- an identical investment cut in the PRC and growth slowdowns in the US (to 2.0%) and Japan (to 1.0%)—simultaneous slowdowns in all three countries.

Effects on Output and Trade

The first alternative scenario (investment growth cut in the PRC) looks at the potential results of a further slowdown in the PRC economy. As a result of the simulated reduction in investment, private consumption growth in the PRC would decline by 0.5 percentage points to 6.6%, export growth from 7.6% to 7.2%, import growth from 8.9% to 7.0%, and the PRC's GDP growth rate from 8.0% to 6.0%.

The simulation results suggest that such a slowdown would have a moderate impact on the region in 2005. Hong Kong, China would

be most affected, with a loss of 0.95 percentage points of GDP (Table 3.3). The other three NIEs would also experience relatively large losses in output, with their GDP growth rates falling by 0.39–0.43 percentage points from the baseline position. The adverse growth effects on ASEAN countries (excluding Singapore) would be generally smaller, from 0.15 to 0.32 percentage points. South Asia is the most insulated from a PRC slowdown—its subregional GDP growth would be clipped by 0.09 percentage points in 2005.

Industrial economies would also be affected under this scenario, although the negative effect would be small. Japan appears to be more exposed than the US or EU because of its stronger export dependence on the PRC. Through trade linkage and multiplier effects, such a slowdown in the PRC could lower world GDP growth by 0.24 percentage points in 2005.

Changes in net exports, or the trade balance, driven by the PRC slowdown are key factors that determine the above growth effects. The simulation results show that the investment cut

Table 3.3 Effects of the Investment-Induced PRC Slowdown on GDP and Trade, 2005
(first alternative scenario; % change relative to the baseline)

Economy or Region	GDP Growth (percentage points)	Exports (%)	Imports (%)	Trade Balance	
				(percentage points of GDP)	(\$ billion)
PRC	-2.00	-0.39	-1.71	0.58	10.24
United States	-0.11	-0.18	-0.14	-0.01	-1.49
Japan	-0.24	-0.40	-0.20	-0.04	-2.16
European Union	-0.12	-0.14	-0.11	-0.02	-2.55
Rest of OECD	-0.13	-0.15	-0.11	-0.02	-0.56
NIEs	-0.50	-0.57	-0.40	-0.11	-1.49
Korea	-0.39	-0.55	-0.31	-0.10	-0.70
Hong Kong, China	-0.95	-1.01	-0.70	-0.18	-0.32
Taipei, China	-0.43	-0.49	-0.32	-0.10	-0.35
Singapore	-0.43	-0.38	-0.37	-0.11	-0.12
ASEAN (excluding Singapore)	-0.24	-0.33	-0.25	-0.08	-0.65
Indonesia	-0.23	-0.32	-0.22	-0.07	-0.17
Malaysia	-0.32	-0.38	-0.30	-0.22	-0.26
Philippines	-0.28	-0.29	-0.26	-0.03	-0.02
Thailand	-0.25	-0.31	-0.23	-0.08	-0.14
Others	-0.15	-0.23	-0.21	-0.03	-0.04
South Asia	-0.09	-0.16	-0.13	-0.02	-0.16
Latin America	-0.22	-0.23	-0.19	-0.02	-0.31
Rest of the World	-0.19	-0.22	-0.17	-0.03	-0.88
The World	-0.24	-0.24	-0.24	0.0	0.0

NIEs = newly industrialized economies, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

Source: Linkage model simulations.

and subsequent growth slowdown would reduce the PRC's imports by 1.71% from the baseline, and increase its net exports by \$10.24 billion, or 0.58 percentage points of GDP. This would be accompanied by a global trade adjustment. As shown in Table 3.3, world trade would decline by 0.24% from the baseline. Economies with closer trade links to the PRC would suffer sharper declines in exports. Hong Kong, China's total exports would fall by 1.01% from the baseline in 2005. Its imports would decline by 0.70% given that a larger proportion of its trade is entrepôt trade where imports are reexported. Korea and Taipei, China would be the second- and third-biggest losers in terms of exports, with declines of 0.55% and 0.49%, respectively. The PRC slowdown would damp export growth in Japan, Malaysia, and Singapore by around 0.40%. Exports from the other economies generally would fall by 0.20–0.30% relative to the baseline.

The increased trade surplus of the PRC would cause a reduction in the trade balances of many industrial economies. In the US, Japan, and EU the reductions in the trade balances would be \$1.49 billion, \$2.16 billion, and \$2.55 billion, respectively. Trade balance reductions in developing Asia's economies would be proportionately larger because their economies are smaller. For example, Hong Kong, China's trade balance would decline by 0.18 percentage points of GDP. Also, given these economies' often heavy dependence on

external trade, the reduction in external demand contributes significantly to a decline in GDP in developing Asia.

The extent of the impact on economic growth also depends on the magnitude of the Keynesian demand multiplier in individual economies. The Keynesian multiplier is the rate at which changes in exogenous demand are magnified into changes in the overall level of income. Countries with higher propensities to consume tend to have larger multipliers. This explains why the Philippines would suffer a similar loss of GDP as Indonesia and Thailand, even though the reduction in its trade balance as a ratio to GDP would be smaller.

The output reduction in 2005 would vary across sectors (Table 3.4). In the PRC, services, including construction, and capital goods sectors such as motor vehicles and ferrous metals would be the major losers. Output in these industries in the PRC would shrink by 2.21–3.32% relative to the baseline. Clothing, electronics, and food would be the least affected, but they too would suffer output contractions of 0.49–0.87% because of the general economic slowdown. In Japan, textile output would contract by 0.55% due to reduced exports to the PRC. The NIEs would likely experience some production losses in their chemicals, energy and mining, metals, services, and textile sectors. Declines in industrial output in Southeast Asia would be relatively evenly

Table 3.4 Effects of Investment-Induced PRC Slowdown on Sector Output, 2005
(first alternative scenario; % change relative to baseline)

Sector	PRC	US	Japan	EU	NIEs	ASEAN (excluding Singapore)	South Asia	Rest of the World
Agriculture	-1.05	-0.08	-0.09	-0.06	-0.23	-0.22	-0.08	-0.17
Energy and mining	-1.79	-0.10	-0.25	-0.12	-0.61	-0.27	-0.13	-0.22
Foods	-0.87	-0.05	-0.09	-0.07	-0.25	-0.21	-0.08	-0.17
Textiles	-1.03	-0.05	-0.55	-0.09	-0.66	-0.21	-0.13	-0.17
Clothing	-0.49	-0.05	-0.21	-0.09	-0.47	-0.19	-0.10	-0.17
Chemical	-1.55	-0.09	-0.29	-0.11	-0.62	-0.36	-0.10	-0.20
Ferrous metals	-2.21	-0.07	-0.32	-0.10	-0.54	-0.23	-0.07	-0.21
Other metals	-1.94	-0.07	-0.36	-0.08	-0.61	-0.35	-0.08	-0.25
Motor vehicles	-3.32	-0.04	-0.15	-0.09	-0.21	-0.19	-0.01	-0.11
Electronics	-0.49	-0.15	-0.30	-0.10	-0.44	-0.42	-0.08	-0.14
Other manufacturing	-2.05	-0.06	-0.24	-0.09	-0.47	-0.23	-0.07	-0.15
Services	-2.48	-0.12	-0.24	-0.13	-0.54	-0.20	-0.09	-0.17

EU = European Union, NIEs = newly industrialized economies, PRC = People's Republic of China, US = United States.

Source: Linkage model simulations.

distributed across sectors, ranging from 0.19% in clothing to 0.42% in electronics.

Price Effects

The increasing importance of the PRC in global commodity markets has raised concerns that a slowdown in its economy might hit commodity prices and so erode the terms of trade for its trading partners. To capture the price effects of a PRC slowdown, a separate simulation is run, based on different adjustment mechanisms for factor markets and external accounts.³ This simulation also assumes the further cut in PRC investment, resulting in the GDP growth rate slowing from 8.0% to 6.0%. The simulation results reported in Table 3.5 suggest that in the face of falling global demand due to such a PRC slowdown, the other economies would depreciate their real effective exchange rates against the yuan by around 0.70–1.20% to maintain their trade balances at the baseline level. As a result of the global price adjustment, the PRC would receive

a modest terms-of-trade gain of 0.88% and the terms of trade of its trading partners would deteriorate slightly.⁴

What Happens if Japan and the US Speed Up or Slow Down?

As developing Asia's economies generally have large exposures to swings in the business cycles of industrial countries, the second and third alternative scenarios are used to examine the consequences of the interaction between a PRC slowdown and changes in growth conditions in Japan and the US. The second alternative scenario assumes an identical investment cut in the PRC, with growth acceleration in the US and Japan of 1.0 percentage point from the baseline due to increases in investment spending. The third alternative scenario—simultaneous slowdowns in all three countries—assumes an investment-induced PRC GDP growth slowdown, with growth slowdowns in the US (to 2.0%) and Japan (to 1.0%) from the baseline. The major simulation results are reported in Table 3.6.

In the case where growth accelerates in Japan and the US while growth slows in the PRC, the simulation indicates that the adverse effects of the PRC slowdown on the GDP of most countries would be more than offset by the stronger growth in Japan and the US. Global economic growth would be raised by 0.43 percentage points. Only Hong Kong, China; Korea; and Taipei, China would still suffer declines in their GDP growth rates. The Philippines, Latin America, and other OECD countries would gain most in terms of GDP growth.

The differences between Table 3.6 and Table 3.3 show that most economies would benefit from an additional 0.30–0.50 percentage point gain in GDP growth from such pickups in Japan and the US. Singapore and the Philippines would benefit most—their GDP growth rates would increase by about 0.55 percentage points compared with the earlier scenario of just a PRC slowdown. But GDP gains in South Asia and the PRC from the accelerated growth in the US and Japan are less than 0.20 percentage points.

In the scenario of simultaneous slowdowns in the PRC, US, and Japan, global economic growth would be reduced by 1.0 percentage point from

Table 3.5 Price Effects of Investment-Induced PRC Slowdown, 2005
(first alternative scenario; % change relative to baseline)

Economy or Region	Terms of Trade	REER Relative to PRC
PRC	0.88	0.00
United States	-0.07	0.65
Japan	-0.14	0.77
European Union	-0.04	0.68
Rest of OECD	-0.05	0.69
NIEs	-0.19	0.89
Korea	-0.12	0.85
Hong Kong, China	-0.59	1.16
Taipei, China	-0.07	0.78
Singapore	-0.10	1.02
ASEAN (excluding Singapore)	-0.04	0.76
Indonesia	-0.06	0.80
Malaysia	-0.04	0.81
Philippines	-0.02	0.74
Thailand	-0.04	0.75
Others	-0.08	0.68
South Asia	-0.06	0.69
Latin America	-0.04	0.72
Rest of the World	-0.05	0.71

PRC = People's Republic of China, NIEs = newly industrialized economies, OECD = Organisation for Economic Co-operation and Development, REER = real effective exchange rate.

Source: Linkage model simulations.

Table 3.6 Effects of Investment-Induced PRC Slowdown plus Changes in US and Japanese Growth
(% change relative to baseline)

Economy or Region	PRC Slowdown but US and Japan Acceleration ^a		Simultaneous PRC, US, and Japan Slowdown ^b	
	GDP Growth (percentage points)	Trade Balance (\$ billion)	GDP Growth (percentage points)	Trade Balance (\$ billion)
PRC	-1.81	11.99	-2.20	8.40
United States	1.00	-10.04	-1.67	12.27
Japan	1.00	-6.11	-0.87	-2.00
European Union	0.09	1.98	-0.36	-7.45
Rest of OECD	0.35	1.48	-0.75	-3.21
NIEs	-0.15	-0.33	-0.89	-2.76
Korea	-0.12	-0.17	-0.69	-1.28
Hong Kong, China	-0.54	-0.17	-1.39	-0.49
Taipei, China	-0.04	-0.01	-0.86	-0.71
Singapore	0.11	0.02	-1.01	-0.28
ASEAN (excluding Singapore)	0.12	0.25	-0.59	-1.54
Indonesia	0.07	0.06	-0.49	-0.38
Malaysia	0.07	0.06	-0.74	-0.61
Philippines	0.27	0.02	-0.87	-0.08
Thailand	0.12	0.08	-0.62	-0.37
Others	0.10	0.03	-0.40	-0.12
South Asia	0.05	0.09	-0.27	-0.45
Latin America	0.19	0.26	-0.70	-0.99
Rest of the World	0.08	0.43	-0.47	-2.27
The World	0.43	0.00	-1.00	0.00

NIEs = newly industrialized economies, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China. ^a Second alternative scenario. ^b Third alternative scenario.

Source: Linkage model simulations.

the baseline in 2005. The PRC's growth rate would fall by an additional 0.20 percentage points, to 5.80%, as a result of slower growth in the US and Japan. Hong Kong, China would still be the largest loser in terms of economic growth, with a loss of 1.39 percentage points of GDP. The other NIEs, as well as the Philippines and Malaysia, are more exposed than other Asian economies. Their GDP growth would slow by around 0.7–1.0 percentage point. The rest of the OECD and Latin America would also experience relatively large output losses due to their strong dependence on the US economy. Again, the adverse effect on South Asia is smallest given its relatively weak linkages to the rest of the world.

Conclusion and Policy Implications

The model-based analysis suggests that a further cut in PRC fixed investment and reduction in its GDP growth rate from 8.0% to 6.0% would have a moderate impact on Asian economies,

reducing GDP by less than 0.45 percentage points in most Asian economies. Hong Kong, China is the most vulnerable, while South Asia is the most isolated from changes in the PRC. Furthermore, the simulations suggest that the adverse effects of such a PRC slowdown would be more than offset for most developing Asian economies if GDP growth rates in Japan and the US were to rise by 1.0 percentage point.

Two alternative estimates of the PRC's output multiplier effects using a macroeconomic model from Oxford Economic Forecasting (Huang and Hanna 2004) and a structural vector autoregression (Abeyasinghe and Lu 2003) generally lead to conclusions that are consistent with the Linkage simulation analysis.

However, there are several important limitations in the Linkage simulation exercise. First, it captures the trade channel of international business cycle linkage only. It does not include some other transmission channels, such as private capital flows and contagion in regional financial

markets. Second, it lacks financial variables and nominal prices changes. This limits its ability to incorporate macroeconomic adjustments and policies that are important to determine the transmission of macroeconomic fluctuations. Third, the model has only 12 sectors so it may underestimate the impact of a collapse of the PRC's investment growth in some special commodity markets. Therefore, the results should be viewed as indications rather than predictions.

Two major policy implications emerge from the simulation exercise. The export orientation of most developing Asian economies makes them vulnerable to the business cycles in the industrial countries and to global current account imbalances. Although the rise of the PRC economy and increasing intraregional trade have helped buffer the demand shocks from the industrial countries, developing Asian economies remain

dependent on the levels of final demand in the US, Japan, and EU. Reducing the vulnerability to external events so as to achieve sustained prosperity requires governments to put more emphasis on domestic demand-led growth, and indeed, signs have emerged in recent years of strengthening domestic consumption. A further structural shift toward domestic demand requires improvements in income distribution and in domestic financial markets to mobilize savings for domestic investment.

In the longer term, continued growth in the PRC economy and in the regional production chain will make developing Asia's economies more exposed to economic events in the PRC and lead to greater synchronization of business cycles in regional economies. This calls for Asian countries, including Japan, to strengthen coordination of macroeconomic policies.

Endnotes

- 1 "Developing Asia" in this section excludes Central Asia and the Pacific.
- 2 This policy simulation assumes that total investment is exogenous and the unemployment rate is endogenous for adjusting income and savings. The real exchange rate is fixed and foreign savings are endogenous. This specification corresponds to the Keynesian macro model adjustment mechanism in the computable general equilibrium literature (e.g., Taylor 1990, Robinson 1991) and makes the model behave like a Keynesian trade multiplier model.
- 3 In factor markets, the supply of factors is assumed to be fixed and factor prices are assumed to be endogenous to clear the market. The trade balances are fixed at the baseline level and changes in relative domestic prices (i.e., the real exchange rate) bring about equilibrium in the foreign exchange market. Total investment in each region is endogenous and determined by aggregate savings (domestic and foreign).
- 4 The results should be viewed as an extreme case because the model assumes that the adjustment would be made fully through exchange rate changes. The actual result would likely be a mix of exchange rate and trade balance adjustments.

References

- Abeyasinghe, Tilak, and Ding Lu. 2003. "China as an Economic Powerhouse: Implications on its Neighbors." *China Economic Review*, 14, 164-185.
- Frankel, Jeffrey, and Andrew Rose. 1998. "The Endogeneity of the Optimum Currency Area Criteria." *The Economic Journal*, 108, 1009-1025.
- Huang, Yiping and Don Hanna. 2004. "What if There Is a Hard Landing in China." *Citigroup Economic and Market Analysis: Greater China Insights*, 12 May.
- International Monetary Fund. 2002. *World Economic Outlook*, September, Washington, DC.
- Robinson, Sherman. 1991. "Macroeconomics, Financial Variables, and Computable General Equilibrium Models." *World Development*, 19(11), 1509-1525.
- Shin, Kwanho, and Yunjong Wang. 2003. "Trade Integration and Business Cycle Synchronization in East Asia." *Asia Economic Papers*, 2(3), 1-20.
- Taylor, Lance. 1990. "Structuralist CGE Models." In L. Taylor, ed., *Socially Relevant Policy Analysis*. Cambridge, MA: MIT Press.
- van der Mensbrugghe, Dominique. 2003. LINKAGE Technical Reference Document: Version 5.3. Washington, DC: World Bank, March (<http://www.worldbank.org/prospects/pubs/TechRef.pdf>).

Higher Global Oil Prices: Implications for Developing Asia in 2005

Introduction

The *Asian Development Outlook 2004* released in May this year projected global oil prices to stay within the \$28–30 a barrel (/bbl) range in 2004, or higher than the historic average, and easing to \$24–26/bbl in 2005. However, oil prices in 2004 have already breached these levels and prices are likely to stay relatively high for some time. Brent crude oil prices have risen to a record high, approaching the \$45/bbl mark in August 2004, while West Texas Intermediate crude oil prices have surged close to the \$50/bbl mark. Oil prices at these levels could threaten the present global economic recovery. Developing Asia's economies (also "the region" or "Asia") are particularly vulnerable to an oil shock as most of them are highly dependent on oil imports, and are more energy intensive and less energy efficient than most industrial countries. In addition, Asia is growing much faster than other regions, and although it now produces 11% of world crude oil supply it consumes about 21% of it. As a result, Asia now imports more than 44% of the oil it consumes, up from 7% during the 1970s and 1980s and 32% in the 1990s. Overall, the region's oil dependency ratios leave much to be desired. Oil consumption in Asia is equivalent to 4.5% of its GDP. This is much higher than in industrial countries, which averaged 1.6% of GDP in 2003.

Why are Global Oil Prices High?

The recent run-up in oil prices is the result of the interplay among demand, supply, and speculative factors, which can be analyzed under four main headings. First, over the past 2 years, global demand grew more than expected, due to

a strengthening economic recovery in the US, as well as fast-growing demand in developing Asia, especially the PRC. The global recovery led to a rise in oil demand in 2003 of 1.48 million barrels a day (mb/d), from 76.6 mb/d in 2002, and more than double the average increase in annual demand between 2000 and 2002. In 2003, the PRC and the US were responsible for demand increases of 0.60 mb/d and 0.31 mb/d, respectively. That year, the PRC's net oil imports surged to an average of 2.6 mb/d, compared with 12.6 mb/d in the US. In 2004, the PRC Government expects crude oil imports to climb by about another 40%.

Another factor that contributed to stronger demand is the low level of stocks in industrial countries and their rebuilding in a period of greater supply uncertainty. Also, some developing countries, notably the PRC and India, have indicated that they intend to start building their own strategic reserves over the next 3 years. Some countries in Southeast Asia will likely do the same—indeed, it seems that the process has already started. All of these factors have contributed to upward demand pressure.

Second, a long period of stable and low prices has led oil producers to maintain current supply conditions, with low inventory levels and stagnating production and refining capacity. While additional supply from new oil fields is expected to come on stream by end-2004, this extra capacity was meant to replace reduced supply from planned shutdowns of aging oil fields. Additional supply amounting to 0.65 mb/d from two new oil fields in Saudi Arabia, for instance, was planned before the recent surge in prices and was intended to offset declines in field output. World oil supply in the first half of 2004 reached 82.2 mb/d, 3.5 mb/d higher than during the same

Table 3.7 OPEC Production and Quota vs Production Capacity (million barrels a day)

	July 2004 Production	August 2004 Quota	Sustainable Production Capacity ^a
Algeria	1.25	0.83	1.25
Indonesia	0.96	1.35	1.00
Iran	3.95	3.82	4.00
Kuwait	2.38	2.09	2.35
Libya	1.56	1.39	1.58
Nigeria	2.40	2.14	2.50
Qatar	0.80	0.67	0.80
Saudi Arabia	9.32	8.45	9.50
United Arab Emirates	2.42	2.27	2.55
Venezuela	2.56	2.99	2.25
OPEC (excluding Iraq)	27.60	26.00	27.78
Iraq	1.96	^b	2.50
OPEC	29.56	26.00	30.28

^a Capacity levels can be reached in 30 days and sustained for 90 days.

^b Due to political instability, Iraq is not included in the OPEC quota allocations.

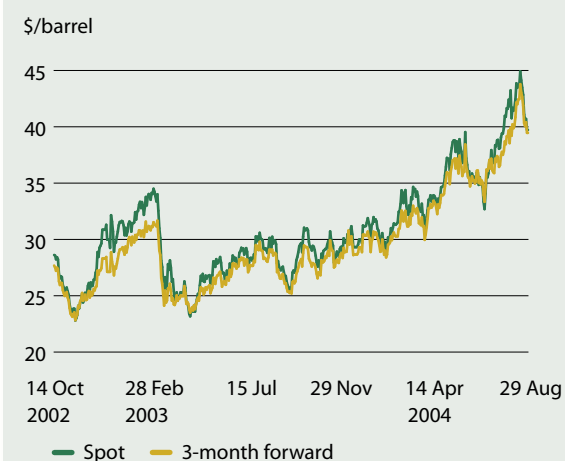
Sources: OPEC Market Indicators, July 2004, available: <http://www.opec.org/NewsInfo/mi/pdf/MI072004.pdf>; International Energy Agency Monthly Oil Market Report, August 2004, available: <http://omrpublic.iea.org/omrarchive/11Aug04full.pdf>.

period in 2003. In July, production was 83.5 mb/d, up 0.6 mb/d from the previous month's level. Most of this increase came from the 11 members of the Organization of the Petroleum Exporting Countries (OPEC), including Iraq. OPEC production reached 29.6 mb/d, which is just about 0.7 mb/d below estimated total OPEC crude oil production capacity (Table 3.7). The increase in July followed OPEC's decision to raise production by 0.5 mb/d. OPEC committed to further increases of 0.5 mb/d and 1.0 mb/d in August and November 2004, respectively. But beyond this, most OPEC oil producers (except probably for Saudi Arabia, Kuwait, and United Arab Emirates), have limited ability for further production growth as they are close to full capacity. By the fourth quarter of 2004, OPEC spare capacity is expected to rise by 370,000 barrels a day as new capacity is brought on stream and the scheduled shutdown of some oil fields is delayed in an effort to meet demand and pull prices lower. Non-OPEC supply, at about 50 mb/d, accounts for 60% of total world supply. While there is some potential for higher non-OPEC production, it is limited over the short term. Possible increases in non-OPEC production

are projected mostly from the countries of the former Soviet Union, with likely small output gains from Latin America and Africa. Hence, present world oil surplus production capacity is at a low point, providing little cushion in the event of unexpected oil market disruptions. New exploration and refining investments have only recently been initiated in response to higher oil "floor" prices, i.e., the base prices considered by oil producers to be the minimum.

Third, the present risk premium on oil is high and persisting, as supply by some main producers is regarded as potentially unstable. Iraq has some spare production capacity, but its current exports are small and volatile due to the uncertain political situation. Similarly, uncertainty surrounding the future of Yukos Oil Corporation in the Russian Federation, recent political turmoil in Venezuela, as well as the potential for a worsening of the political situation in the Middle East have contributed to the high risk premium. The threat of supply problems in the Russian Federation and Venezuela had receded by end-August, while exports from Iraq continued, though they remained very erratic.

Fourth, geopolitical uncertainties and tight market conditions have encouraged speculative funds to enter the market and further push up prices in the short term. Hedge funds have driven up forward and futures prices, such that spot and forward prices now move very closely together (Figure 3.3).

Figure 3.3 Spot and 3-Month Forward Oil Prices, Brent Crude, October 2002–August 2004

Source: Datastream, 15 September 2004.

Rising Oil Prices in the Current Global and Regional Economic Context

The impact of an oil shock generally depends on the size and duration of the shock, as well as on an economy's dependence on oil (and on energy more generally). In analyzing the size of the shock, it is necessary to consider oil prices in real terms and the extent of the price increases. With Brent averaging about \$40/bbl in the third quarter, the oil price now is high. While it has not gone past the average real levels reached during the previous oil shocks (of 1973, 1979, and 1990), it is dangerously close to the level reached during the third oil shock of 1990 (Figure 3.4). On the other hand, the price of oil now is still well below the peak seen in the fourth quarter of 1979, when in real terms it breached the \$100/bbl mark. Oil prices are therefore now about 40% of 1979's all-time high in real terms. In nominal terms, oil prices have risen by more than 108% since the fourth quarter of 2001, slightly more than the rate of increase seen during the 1990 oil shock, which was brief and had a substantially slower rate of increase than the first and second oil shocks.

Against this backdrop, the risk of higher oil prices arises mainly from a possible aggravation of existing imbalances in the global economy. Since the 2001 economic slowdown, most industrial countries, but notably the US, have pursued highly expansionary macroeconomic policies. As a result, world interest rates are close to historical lows and

many countries have high public sector deficits. Low interest rates have fueled housing and asset price rises, at the same time as supporting consumption and leading to a sharp deterioration in the current account in the US. As world GDP accelerated over the past year, inflationary pressure started to mount, albeit remaining very mild. However, higher oil prices, if sustained over a long period of time, will feed inflationary pressures, possibly forcing interest rates to rise faster than expected. This could trigger a sudden reversal in consumption and savings behavior, leading to a substantial slowdown in world economic growth and affecting, in particular, non-oil exports from Asian economies. Thus higher oil prices, if sustained for long enough, would slow economic activity in Asia.

Expansionary macroeconomic policies, in particular monetary policies, have provided much support to consumption growth in most Asian economies over the past few years. Consequently, consumer credit expansion has been strong, leading to higher household indebtedness. Lower real incomes due to higher oil prices and higher interest rates would significantly raise the debt-servicing burden of households, possibly leading to a substantial rise in default rates in some countries. At the same time, business investment in some Asian economies, which is only starting to firm up after the Asian financial crisis of 1997–98, could also suffer a new setback. Falling profitability could lead firms to curtail business investment and employment plans, affecting growth potential. Finally, higher world interest rates could also affect the emerging financial markets of Asia, reducing their attractiveness to investors.

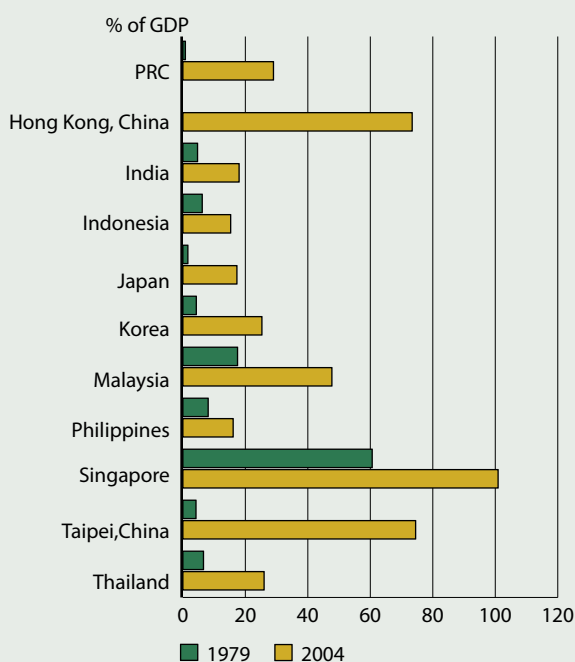
Developing Asia is vulnerable to high oil prices, but its current economic fundamentals significantly mitigate the risks associated with high oil prices, for four main reasons. First, the region now has a high level of international reserves, which could provide a cushion against an anticipated short-term deterioration in balance-of-payments positions (Figure 3.5). In 1979, Asia's foreign exchange reserves ranged from less than 1% of GDP in the PRC to over 61% in Singapore. Recent data suggest, however, that many regional economies now hold foreign exchange reserves equivalent to well over 25%

Figure 3.4 Nominal and Real Prices, Brent Crude, Q1 1970–Q3 2004



Source: IMF, IFS Online, August 2004, available: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>.

Figure 3.5 Foreign Exchange Reserves, 1979 and 2004



Sources: IMF, IFS Online, August 2004, available: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>; *World Economic Outlook*, April 2004.

of their GDP—indeed, for Singapore the figure is more than 100% of GDP, and close to 75% for Hong Kong, China and for Taipei, China. For many economies, these reserves could help reduce the impact of an external shock resulting from sustained high oil prices.

Second, in spite of strong growth in 2003 and the first half of 2004, inflation has stayed quiescent in many Asian economies (Figure 3.6). This provides ample room for necessary policy support, if growth were to falter in a significant way. During the second oil shock of 1979, several Asian economies experienced high inflation rates, with some economies, notably Indonesia, Korea, and Philippines, in double digits. In the current period, inflation has moderated in many Asian economies.

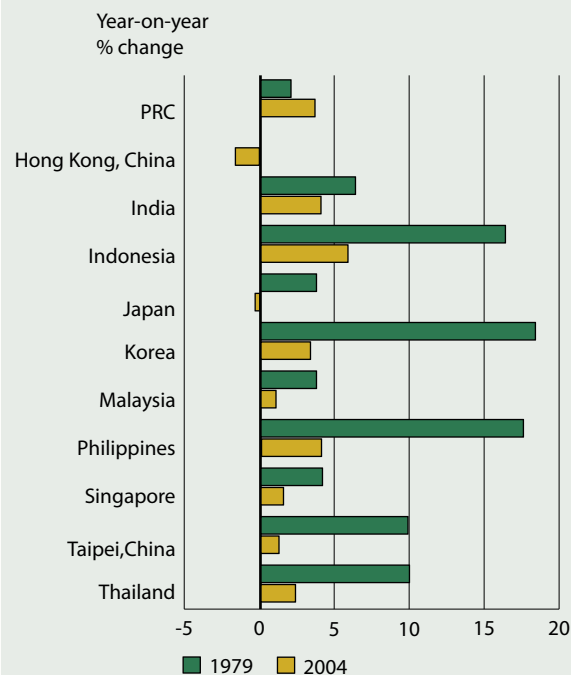
Third, though still high, Asia's dependence on oil has fallen over time. The region's oil consumption as a share of GDP has dropped by about half in the last 20 years. When the second oil shock hit Asia, it was more dependent on oil than it is today in terms of consumption. In

1979, the region spent \$0.073 on oil per dollar of output; by 2003, it was spending only \$0.045. The economies of Hong Kong, China; Korea; Philippines; Singapore; and Taipei, China all successfully made significant improvements in this regard in the last two decades, reducing their oil dependency ratios by at least half. PRC, Malaysia, and Thailand also achieved some improvement, though more gradually than the first group. Despite such progress though, energy efficiency can still be further improved.

Fourth, the increasing importance of intra-regional trade has to some extent reduced the region's susceptibility to slowdowns in the global, particularly the US, economy. While the current share of Asian exports to the US has remained at the same rate as in 1980, intraregional Asian trade has risen substantially (Figure 3.7). Intraregional trade in Asia in 2003 was almost 75% higher than in 1980. In addition, while intraregional trade accounted for just a quarter of total Asian exports in 1980, it was close to 45% in 2003.

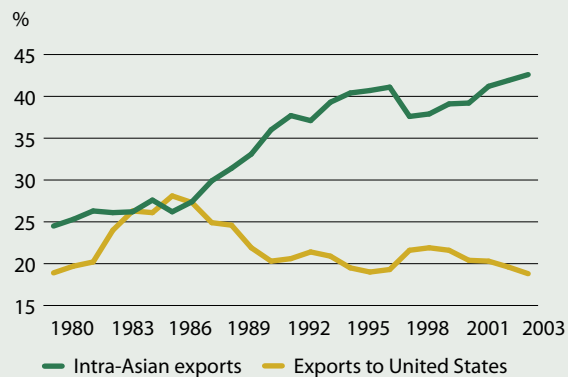
Thus, despite much concern, the current oil

Figure 3.6 Inflation Rates, 1979 and 2004



Sources: IMF, IFS Online, August 2004, available: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>; Institute of International Finance database, available: <http://www.iif.com>.

Figure 3.7 Asian Exports, 1980–2003



Source: IMF, *Direction of Trade Statistics*, July 2004.

price rally is unlikely to impact on developing Asia as severely as earlier shocks, and the region is in a better position to weather the recent run-up in crude oil prices than it was during those shocks. However, in spite of its strengths, the region would still be hurt by a sustained high oil price.

Oil Price Scenarios and their Impact on Asian Economies

To assess the potential impact of higher oil price scenarios, a set of simulations was made with the Oxford Economic Forecasting World Macroeconomic Model. Two oil price scenarios are presented to shed light on the impact and policy implications of oil price rises on developing Asia's economies. No policy responses—such as tightening macroeconomic policies or changes in exchange rate policies—have been assumed. Only oil price shocks were introduced in the model.

As mentioned earlier, an oil price rise may affect Asia's macroeconomic performance through various channels. First, higher oil prices transfer income from oil-importing to oil-exporting countries through a shift in the terms of trade. In this process, net oil-importing countries suffer a loss of real national income. Second, a rise in oil prices reduces industry output through higher costs of production. This supply-side impact exerts inflationary pressure on the economy. Third, the impact of an oil price rise can be amplified by a secondary price effect. Although higher oil prices directly raise consumer prices via higher prices of imported goods and petroleum products, higher

input costs on the supply side also translate into inflation. The higher price levels, together with lower real incomes, further depress domestic demand, leading to rising unemployment. Moreover, consumers who sustain a loss in real income may consider seeking wage increases, which further feeds into higher production costs, which are then passed on to consumers. In the first two oil shocks, this upward spiral of inflation and wages proved devastating in the absence of appropriate policy responses.

Two alternative price scenarios for Brent crude are examined: Scenario 1—an increase in prices of \$10/bbl; and Scenario 2—an increase in prices of \$20/bbl. In both scenarios, temporary and sustained increases are considered. In the temporary increase analysis, high oil prices are assumed beginning in the second quarter of 2004, and remain only until the first quarter of 2005; for the sustained increase analysis, oil prices are assumed to remain high for the whole of 2005.

As the impact on Asian economies is somewhat muted in 2004, the focus of Tables 3.8 and 3.9 is on the impact of the rise in oil prices in 2005. Obviously, the impact on growth is proportionately larger in Scenario 2. In the temporary increase analysis, trade balances are barely affected as oil exporters expand imports of non-oil products from Asia and the impact of higher prices dissipates in 2005. Inflation picks up significantly in Scenario 2. This has a stronger impact on domestic demand and economic growth. Essentially, the secondary impact effects are much more pronounced than in Scenario 1. Sustained high oil prices significantly affect growth in industrial countries, damping export growth from Asian countries. This would amplify the direct inflationary and balance-of-payment effects of the high oil prices on Asian economies. The situation in the third quarter of 2004 makes the scenario of a sustained price rise of about \$10/bbl quite possible. A crucial point is that a \$10/bbl price rise sustained over 7 quarters is much more damaging to Asian trade balances than a \$20/bbl oil price increase lasting 4 quarters. Thus, the duration of the shock is more an issue for Asian trade balances than the extent of the price increase.

The worst-hit Asian economies are Philippines, Singapore, and Thailand. The impact differs substantially across the countries in the table,

Table 3.8 The Impact of a Temporary Oil Price Increase: Scenario 1 vs Scenario 2, 2005

	Scenario 1 (\$10/bbl increase)			Scenario 2 (\$20/bbl increase)		
	GDP (percentage points)	Trade Balance (% of GDP)	Consumer Prices	GDP (percentage points)	Trade Balance (% of GDP)	Consumer Prices
Asia excluding Japan	-0.6	0.1	0.5	-1.2	0.1	1.1
Asia including Japan	-0.5	0.0	0.5	-0.9	0.0	1.0
PRC	-0.6	0.2	0.3	-1.2	0.3	0.6
Hong Kong, China	-0.5	-0.5	0.2	-0.9	-0.9	0.3
India	-0.6	-0.1	0.9	-1.1	-0.1	1.8
Indonesia	0.0	0.1	0.6	0.0	0.1	1.2
Japan	-0.4	-0.1	0.3	-0.7	-0.1	0.5
Korea	-0.5	0.0	0.4	-0.8	-0.2	0.8
Malaysia	-0.7	0.8	0.7	-1.8	1.7	1.4
Philippines	-1.5	-0.4	0.7	-3.0	0.1	1.4
Singapore	-1.2	-0.2	0.6	-2.4	-0.3	1.2
Taipei,China	-0.3	0.0	0.2	-0.5	0.0	0.3
Thailand	-1.7	-0.1	0.8	-3.3	-0.2	1.5

PRC = People's Republic of China.

Source: Staff estimates based on Oxford Economic Forecasting World Macroeconomic Model.

and can be direct or indirect. The direct effect of higher oil prices on the domestic economy depends on oil import dependency, efficiency in use, and the structure of GDP in each economy. For instance, although oil consumption to GDP as a ratio in both the PRC and India is about 2.5 times higher than the Organisation for Economic Co-operation and Development average, India's oil imports account for about 25% of its total import bill but less than 5% in the PRC. Thus, the direct effect on India is larger than in the PRC. The indirect effect of an oil price shock is seen in the impact on exports to the rest of the world and, again, depends on the composition of exports and export demand elasticities. In this instance, the PRC would be more affected than India. All of these factors explain the different orders of magnitude of the impact of oil price rises in Tables 3.8 and 3.9.

Policy Responses

Policy responses to higher oil prices obviously will not be identical across countries. The type and depth of the responses will have to depend on the initial conditions prevailing in the economy. Responses also have to be tailored to the duration and extent of the oil price increase, and the scenarios above are revealing in this respect.

Inflation will obviously be the first economic

indicator affected by higher oil prices. If the high oil prices transmit rapidly to domestic prices and wages, stabilizing policy responses will be needed, possibly through some tightening of monetary policy. Also, as mentioned earlier, many Asian economies are running current account surpluses and have accumulated substantial foreign exchange reserves. This would permit some of them to adopt a more flexible exchange rate policy, allowing the currency to appreciate moderately, and help cushion the impact of higher oil prices.

Other selective measures to bring down oil consumption in the short run will also be required. The dilemma facing governments will therefore be to attempt to avoid an excessive negative impact on growth. Again, this will depend on particular circumstances and the strength and structure of each economy. Another indicator to monitor would be the government budgetary situation. Slower growth will reduce revenues. In addition, in countries where fuel subsidies are high, the budgetary impact of higher oil prices could be sizable, requiring some policy adjustments in the short term.

The above possible policy responses would definitely help in the short run, but a higher oil price environment calls for an in-depth review of some policies. An implication of the current

Table 3.9 The Impact of a Sustained Oil Price Increase: Scenario 1 vs Scenario 2, 2005

	Scenario 1 (\$10/bbl increase)			Scenario 2 (\$20/bbl increase)		
	GDP (percentage points)	Trade Balance (% of GDP)	Consumer Prices	GDP (percentage points)	Trade Balance (% of GDP)	Consumer Prices
Asia excluding Japan	-0.8	-0.4	1.1	-1.5	-0.8	2.0
Asia including Japan	-0.6	-0.3	1.0	-1.2	-0.7	1.9
PRC	-0.8	-0.1	0.5	-1.5	-0.3	0.9
Hong Kong, China	-0.6	-0.8	0.3	-1.1	-1.6	0.5
India	-0.8	-0.7	1.7	-1.5	-1.4	3.3
Indonesia	0.1	0.9	1.3	0.1	1.9	2.1
Japan	-0.5	-0.3	0.7	-1.0	-0.6	1.3
Korea	-0.6	-0.8	0.8	-1.2	-1.7	1.4
Malaysia	-0.9	0.3	1.4	-2.4	1.1	2.7
Philippines	-1.9	-0.9	1.4	-3.6	-1.9	2.8
Singapore	-1.7	-1.3	1.3	-3.4	-2.5	2.5
Taipei,China	-0.4	-0.6	0.3	-0.7	-1.2	0.6
Thailand	-2.2	-1.2	1.5	-4.1	-2.5	2.9

PRC = People's Republic of China.

Source: Staff estimates based on Oxford Economic Forecasting World Macroeconomic Model.

experience is that the floor price of oil is likely to rise from \$22–28/bbl to \$31–36/bbl. Medium- to long-term structural adjustments need to be made in the face of this. For example, developing Asia's economies have much scope for improving energy efficiency use, and governments need to focus on this. Among other things, they should consider phasing out fuel subsidies and adopting measures to encourage the efficient use of oil and discourage wasteful consumption as well as other schemes—including tax incentives—to develop and use alternative renewable energy resources.

In many of these policy areas, it would seem that developing Asia is in a position to make rapid progress over the next few years.

Bibliography

- British Petroleum. 2004. *Statistical Review of World Energy*. Available: <http://www.bp.com/statisticalreview2004>.
- Institute of International Finance. 2004. China database. Available: http://www.iif.com/verify/data/country_docs/924db_0704.xls.
- International Energy Agency. 2004. *Oil Market Report*, 11 August. Available: <http://www.oilmarketreport.org>.
- International Monetary Fund. 2004. International Financial Statistics Online, August. Available: <http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT>.
- . 2004. World Economic Outlook database, April. Available: <http://www.imf.org/external/pubs/ft/weo/2004/01/data/index.htm>.
- . 2004. Direction of Trade Statistics CD-ROM, July.
- Organization of the Petroleum Exporting Countries. 2004. OPEC Market Indicators, July 2004. Available: <http://www.opec.org/NewsInfo/mi/pdf/MI072004.pdf>.
- Park, C.-Y. 2004. *Higher Oil Prices: Asian Perspective and Implications for 2004–2005*. ERD Policy Brief No. 28. Manila: Asian Development Bank.

ASIAN DEVELOPMENT
Outlook
2004
Update

Statistical Appendix



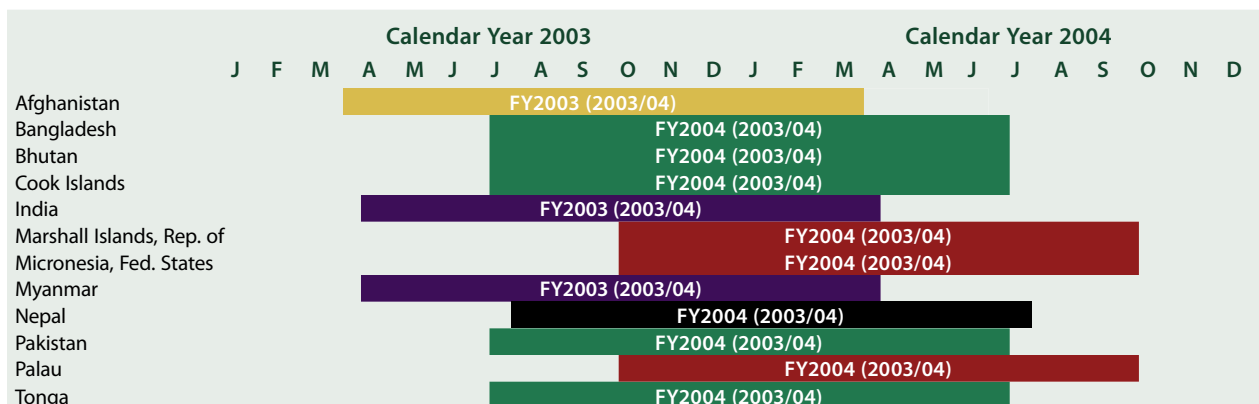
Statistical Notes and Tables

The Statistical Appendix presents six selected economic indicators: gross domestic product (GDP) growth (A1), inflation rate (A2), merchandise exports and imports growth (A3 and A4), and current account and fiscal balance as shares of GDP (A5 and A6), for the 42 developing member countries (DMCs) of the Asian Development Bank. The DMCs are grouped into five subregions: East Asia, Southeast Asia, South Asia, Central Asia, and the Pacific. These six tables are a subset of the accounts included in the Statistical Appendix of *Asian Development Outlook 2004 (ADO 2004)*.

These tables contain historical data from 2001 to 2003 and forecasts for 2004 and 2005. *Update* forecasts are compared with forecasts provided in *ADO 2004*. For economies where *Update* forecasts are unavailable, projections from *ADO 2004* are used. Historical data are obtained from official sources, statistical publications, secondary publications, other working papers, and internal documents of the Asian Development Bank (ADB), International Monetary Fund (IMF), and World Bank. Projections for 2004 and 2005 are staff estimates. Data in the tables are reported on either a calendar year or fiscal year basis. The DMCs that record most of their accounts on a calendar year basis (except for government finance data, which are reported on

a fiscal year basis), are: Hong Kong, China; Lao People's Democratic Republic (Lao PDR), Samoa; Taipei, China; Thailand; and Democratic Republic of Timor-Leste (Timor-Leste). Palau reports government finance and balance of payments data on a fiscal year basis. Some countries record the majority of their accounts on a fiscal year basis (see figure), with some of their accounts recorded on a calendar year basis, i.e., GDP data for Bhutan, and GDP and balance-of-payments data for Cook Islands and Kiribati. Regional and subregional averages for DMCs are provided in all tables, except for fiscal balance as a share of GDP. Data for Afghanistan, Myanmar, and Nauru are excluded in the computation of subregional averages due to measurement problems.

For growth rate of GDP (A1), inflation (A2), and current account balance as a share of GDP (A5), levels of gross national income (GNI) in current US\$ using the World Bank Atlas method are used as weights to calculate the subregional and regional averages. These are the same weights as used in the computation of subregional and regional averages in *ADO 2004*. Tables on growth rates of merchandise exports and imports (A3 and A4) do not incorporate weights in the computation of averages; regional and subregional averages in these two tables are computed on the basis of a consistent sum, which means that if



there are missing country data for a given year, the sum of the prior year used for computing the growth rate excludes the corresponding country data.

The GNI data, in current US\$, for DMCs from 2001 to 2002 were obtained from the World Bank Group WDI Data Query (<http://devdata.worldbank.org/data-query/>). The same weights used in *ADO 2004* are applied in the computation of regional and subregional averages. Data for 2002, as the most recent data available, are used as weights for 2003, 2004, and 2005. The GNI data, in current US\$, for three of the DMCs are unavailable, namely Cook Islands; Taipei, China; and Tuvalu. For these economies, weights were estimated using GDP at current prices.

The following paragraphs look at the tables in greater 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. Factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. 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, and Tuvalu 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 are based on GDP production indexes.

Table A2: 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, Timor-Leste, and Viet Nam, which use end-of-period data. The data for Singapore are on a calendar year basis, yet the base year used for the computation of inflation rates is November 1997–October 1998. 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, Palau is for Koror State, Republic of Marshall Islands is for Majuro, Solomon Islands is for Honiara, and Nepal is for urban consumers.

Tables A3 and A4: 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 balance of payments account of each DMC. Exports in general are reported on a free-on-board (f.o.b.) basis, when they 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, imports are valued 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 for the rest of the Southeast Asian countries, imports are valued on a c.i.f. basis. Bhutan and India record imports on a 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 costed on an f.o.b. basis. For the Pacific, Micronesia, Kiribati, Palau, Tonga, and Vanuatu report imports on an f.o.b.

basis while imports of Cook Islands, Fiji Islands, Papua New Guinea, Samoa, Solomon Islands, and Timor-Leste are recorded on a c.i.f. basis.

Table A5: Balance of Payments on Current Account (% of GDP). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. In the case of Bhutan, GDP for the previous calendar year is used as the denominator. In this table, the reported current account levels are divided by GDP valued at current US\$ prices.

Table A6: Fiscal Balance of the Central Government (% of GDP). Fiscal balance is the difference between central government revenues and expenditures presented in nominal local currency. 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 revenues and expenditures 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. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan.

Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a share of GDP at current prices. For the Republic of Korea (Korea), revenues incorporate the repayment on government-guaranteed debts. The revenue data series for Taipei, China was revised in view of the inclusion of the items "Retention of Previous Fiscal Years" and "Special Budget" in the revenue items. For Singapore, revenues refer 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; current revenues only are included for Bangladesh and Pakistan; grants and privatization proceeds are excluded for Sri Lanka; the Oil Fund is included for Azerbaijan; sales from assets are excluded for the Fiji Islands; Revenue Equalization Reserve Fund income is excluded for Kiribati; and Consolidated Investment Fund drawdowns are included for Tuvalu. For Kazakhstan, privatization proceeds are treated as financing items rather than revenues in 2002.

Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a share of GDP at current prices. The expenditure data series for Taipei, China was revised in view of the inclusion of the items "Retention of Previous Fiscal Years" and "Special Budget" in the expenditure items. For Singapore, expenditures refer to outlays made from the Consolidated Revenue Account, Development Fund Account, and Sinking Fund Account plus lending minus repayments. For Thailand, expenditures refer to budgetary expenditures excluding externally financed expenditures and corresponding borrowing. For Bangladesh, expenditures include a residual. One-time expenditures are excluded but a statistical discrepancy is included for Pakistan. For Tuvalu, Tuvalu Trust Fund transfers are excluded.

Table A1 Growth Rate of GDP (% per year)

Item	2001	2002	2003	2004		2005	
				ADO 2004	Update	ADO 2004	Update
East Asia	4.6	6.7	6.5	6.9	7.3	6.8	6.4
China, People's Rep. of	7.3	8.0	9.1	8.3	8.8	8.2	8.0
Hong Kong, China	0.5	1.9	3.2	6.0	7.5	5.0	6.0
Korea, Rep. of	3.8	7.0	3.1	4.8	4.4	5.2	3.6
Mongolia	1.1	4.0	5.5	5.8	6.0	6.0	6.0
Taipei,China	-2.2	3.6	3.3	5.4	6.0	4.7	4.8
Southeast Asia	1.9	4.4	4.8	5.7	6.2	5.4	5.7
Cambodia	5.7	5.5	5.2	5.4	4.5	5.4	2.3
Indonesia	3.8	4.3	4.5	4.5	4.8	4.5	5.2
Lao People's Dem. Rep.	5.8	5.9	5.8	6.0	6.5	6.2	7.0
Malaysia	0.3	4.4	5.3	5.8	6.8	5.6	6.0
Myanmar	11.3	10.0	10.6	-	-	-	-
Philippines	1.8	4.3	4.7	5.0	5.5	5.0	5.5
Singapore	-1.9	2.2	1.1	5.6	8.1	4.8	4.2
Thailand	2.1	5.4	6.8	7.2	6.4	6.2	6.6
Viet Nam	5.8	6.4	7.1	7.5	7.5	7.6	7.6
South Asia	5.1	3.9	7.6	7.0	6.4	7.2	5.9
Afghanistan	-	29.0	23.0	-	-	-	-
Bangladesh	5.3	4.4	5.3	5.7	5.5	6.0	4.8
Bhutan	7.1	6.7	6.5	7.0	7.0	8.0	8.0
India	5.8	4.0	8.2	7.4	6.5	7.6	6.0
Maldives	3.5	6.5	8.5	5.5	5.4	5.0	5.0
Nepal	4.6	-0.4	2.7	4.0	3.6	5.0	3.7
Pakistan	1.8	3.1	5.1	5.5	6.4	5.8	6.5
Sri Lanka	-1.5	4.0	5.9	5.0	5.0	5.5	5.5
Central Asia	10.8	8.1	8.4	8.1	7.9	8.4	8.0
Azerbaijan	9.9	10.6	11.2	9.0	10.0	12.5	12.5
Kazakhstan	13.5	9.8	9.2	9.5	9.5	9.5	9.0
Kyrgyz Republic	5.3	0.0	6.7	4.1	4.5	4.5	4.6
Tajikistan	10.2	9.1	10.2	8.0	8.5	5.0	7.5
Turkmenistan	20.5	8.6	10.0	10.0	10.0	10.0	10.0
Uzbekistan	4.2	4.0	4.4	4.5	3.0	4.0	3.0
The Pacific	1.0	1.2	4.3	2.9	2.9	2.4	2.4
Cook Islands	4.9	3.9	3.1	2.7	2.7	2.9	2.9
Fiji Islands	3.0	4.1	10.1	3.9	4.1	3.0	3.2
Kiribati	1.8	0.9	3.3	1.8	1.8	1.5	1.5
Marshall Islands, Rep. of	-1.5	4.0	3.0	2.0	2.0	3.0	3.0
Micronesia, Fed. States of	0.5	0.9	0.1	-1.5	-1.5	2.2	2.2
Nauru	-	-	-	-	-	-	-
Palau	3.8	-4.7	-0.1	-	-	-	-
Papua New Guinea	-2.3	-0.8	2.0	2.8	2.8	1.7	1.7
Samoa	7.1	1.5	3.5	4.0	4.0	3.5	3.5
Solomon Islands	0.0	6.6	11.8	4.5	4.2	4.5	4.4
Timor-Leste, Dem. Rep. of	15.0	2.0	-2.0	1.0	1.0	3.0	2.0
Tonga	1.8	2.1	2.9	2.6	1.6	2.8	2.8
Tuvalu	5.9	1.3	7.0	3.0	3.0	-	-
Vanuatu	-2.1	-2.8	1.6	2.1	2.1	2.6	2.6
Average	4.3	5.8	6.5	6.8	7.0	6.7	6.2

- = data not available.

Table A2 Inflation (% per year)

Item	2001	2002	2003	2004		2005	
				ADO 2004	Update	ADO 2004	Update
East Asia	1.2	-0.1	1.2	2.6	3.0	2.4	3.8
China, People's Rep. of	0.7	-0.8	1.2	3.0	3.4	2.7	4.9
Hong Kong, China	-1.6	-3.0	-2.5	1.1	0.7	1.1	1.1
Korea, Rep. of	4.1	2.7	3.6	3.1	3.8	2.8	3.0
Mongolia	8.0	1.6	4.7	4.5	4.5	4.0	4.7
Taipei, China	0.0	-0.2	-0.3	0.8	1.5	1.2	2.0
Southeast Asia	4.6	4.2	3.1	3.6	4.2	3.8	4.2
Cambodia	0.3	3.3	1.1	2.9	2.3	3.3	3.0
Indonesia	11.5	11.9	6.6	6.5	6.5	6.5	7.0
Lao People's Dem. Rep.	7.8	10.7	15.5	12.0	12.4	10.0	10.0
Malaysia	1.4	1.8	1.1	1.5	1.5	1.7	2.2
Myanmar	21.2	57.0	-	-	-	-	-
Philippines	6.1	3.1	3.1	4.5	5.2	4.5	5.5
Singapore	1.0	-0.4	0.5	1.2	1.8	1.7	1.6
Thailand	1.6	0.7	1.8	2.4	2.8	2.6	2.6
Viet Nam	-0.4	3.8	4.0	4.5	9.0	4.5	6.0
South Asia	3.7	3.5	5.1	4.9	5.5	4.6	6.5
Afghanistan	-	52.3	10.5	-	-	-	-
Bangladesh	1.9	2.8	4.4	4.7	5.8	4.2	6.0
Bhutan	3.6	2.7	1.8	-	1.2	-	-
India	3.6	3.4	5.5	5.0	5.7	4.7	6.8
Maldives	0.7	0.9	-2.9	0.3	0.3	2.3	2.3
Nepal	2.4	2.9	4.8	4.5	4.0	5.0	5.5
Pakistan	4.4	3.5	3.1	4.0	4.6	4.0	5.5
Sri Lanka	12.1	10.2	2.6	-	4.0	-	4.0
Central Asia	14.3	9.7	5.4	8.6	6.9	8.3	6.4
Azerbaijan	1.5	2.8	2.2	4.0	5.0	3.0	3.0
Kazakhstan	8.4	5.9	6.6	5.4	6.5	5.0	6.0
Kyrgyz Republic	6.9	2.0	3.0	3.8	4.9	3.8	4.6
Tajikistan	38.6	12.2	16.4	8.5	7.3	5.0	5.6
Turkmenistan	11.6	8.8	5.5	5.0	5.0	5.0	5.0
Uzbekistan	27.4	21.6	3.8	20.0	10.0	20.0	10.0
The Pacific	6.2	7.0	8.5	5.6	5.1	6.0	4.4
Cook Islands	9.5	3.9	2.4	1.9	1.9	2.4	2.4
Fiji Islands	4.3	0.8	4.1	3.0	3.0	3.0	3.0
Kiribati	6.0	3.2	1.8	-	-	-	-
Marshall Islands, Rep. of	-1.8	0.4	1.2	2.5	1.5	2.5	1.5
Micronesia, Fed. States of	1.3	-0.2	-0.2	0.5	0.5	1.2	1.2
Nauru	-	-	-	-	-	-	-
Palau	-0.6	0.1	1.3	-	-	-	-
Papua New Guinea	9.3	11.8	14.7	8.7	7.4	9.6	6.0
Samoa	3.8	8.1	0.1	3.0	3.0	3.0	3.0
Solomon Islands	7.7	9.4	10.0	6.0	5.6	6.5	2.5
Timor-Leste, Dem. Rep. of	0.0	9.5	4.2	3.0	3.0	3.0	3.0
Tonga	8.4	10.3	11.7	4.5	11.0	4.5	11.0
Tuvalu	1.5	5.0	2.9	2.5	2.5	-	-
Vanuatu	3.7	2.0	3.0	2.6	2.6	2.5	2.5
Average	2.4	1.4	2.3	3.3	3.7	3.1	4.4

- = data not available.

Table A3 Growth Rate of Merchandise Exports (% per year)

Item	2001	2002	2003	2004		2005	
				ADO 2004	Update	ADO 2004	Update
East Asia	-5.8	12.1	22.6	13.4	20.0	13.2	12.6
China, People's Rep. of	6.8	22.4	34.6	15.0	22.0	15.0	16.0
Hong Kong, China	-5.8	4.9	12.5	6.8	7.0	7.3	7.0
Korea, Rep. of	-14.0	7.9	20.9	21.0	33.0	19.0	13.0
Mongolia	-2.3	0.2	11.1	15.0	15.0	14.0	14.0
Taipei, China	-17.3	6.4	10.5	8.0	16.2	7.4	9.2
Southeast Asia	-10.5	4.7	12.7	10.2	13.9	8.3	7.8
Cambodia	12.1	11.4	16.9	17.0	20.3	12.0	-7.6
Indonesia	-12.3	3.1	6.9	3.5	3.5	3.5	3.5
Lao People's Dem. Rep.	-3.3	-5.9	19.5	20.4	22.5	4.5	4.5
Malaysia	-10.6	6.1	12.4	8.6	14.6	7.5	9.4
Myanmar	56.4	-5.2	-	-	-	-	-
Philippines	-16.2	10.0	1.4	8.0	10.0	8.0	10.0
Singapore	-10.5	2.7	15.0	12.2	15.0	7.5	7.5
Thailand	-7.1	4.8	18.6	14.0	20.0	13.7	8.0
Viet Nam	6.5	7.4	16.5	12.0	16.3	12.0	12.0
South Asia	1.2	10.7	18.0	14.9	19.1	15.6	15.8
Afghanistan	-	-	-	-	-	-	-
Bangladesh	12.6	-7.6	9.5	13.5	15.9	11.0	7.0
Bhutan	-12.9	4.1	8.9	-	-	-	-
India	0.0	16.9	19.9	16.1	20.9	17.6	17.9
Maldives	1.4	20.1	14.9	7.3	7.3	-	-
Nepal	11.7	-20.3	-13.8	10.0	13.1	12.0	10.0
Pakistan	9.1	2.7	19.6	12.0	13.5	10.0	12.0
Sri Lanka	-12.8	-2.4	9.2	10.0	10.0	9.0	9.0
Central Asia	-2.4	8.6	27.8	6.1	17.9	9.4	12.3
Azerbaijan	11.9	10.9	13.9	-0.8	12.0	29.3	20.0
Kazakhstan	-3.9	12.3	32.0	6.0	25.0	6.0	11.4
Kyrgyz Republic	-6.0	3.7	18.5	2.3	7.5	6.3	5.8
Tajikistan	-17.3	7.3	14.2	10.8	8.8	6.4	8.5
Turkmenistan	4.6	9.0	30.3	12.9	12.9	-	-
Uzbekistan	-9.9	-5.1	26.9	3.6	3.6	-	-
The Pacific	-15.4	-5.5	22.7	-0.2	2.7	-0.7	-0.9
Cook Islands	-25.7	-25.3	67.3	-	-	-	-
Fiji Islands	-8.8	0.7	-17.6	12.7	10.6	14.5	12.0
Kiribati	25.0	15.6	11.5	8.6	8.6	3.2	3.2
Marshall Islands, Rep. of	-	-	-	-	-	-	-
Micronesia, Fed. States of	2.1	17.9	2.4	4.2	4.2	5.7	5.7
Nauru	-	-	-	-	-	-	-
Palau	62.6	8.6	-41.4	-	3.4	-	-
Papua New Guinea	-14.2	-8.9	35.6	-4.0	0.8	-5.5	-3.9
Samoa	13.1	-3.9	4.0	10.0	10.0	-	-
Solomon Islands	-27.9	24.1	27.4	22.6	11.9	17.9	6.1
Timor-Leste, Dem. Rep. of	-20.0	50.0	16.7	14.3	14.3	25.0	25.0
Tonga	7.0	61.0	2.1	-	-	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-26.7	1.2	48.3	5.0	5.0	-	-
Average	-6.9	9.5	19.4	12.4	18.1	11.4	10.9

- = data not available.

Table A4 Growth Rate of Merchandise Imports (% per year)

Item	2001	2002	2003	2004		2005	
				ADO 2004	Update	ADO 2004	Update
East Asia	-6.6	10.4	23.9	15.7	22.7	13.8	15.0
China, People's Rep. of	8.1	21.3	39.8	19.0	30.0	16.5	20.0
Hong Kong, China	-5.5	3.1	12.5	9.0	8.7	6.4	6.4
Korea, Rep. of	-13.4	7.7	18.1	22.0	27.0	20.5	16.0
Mongolia	2.5	8.6	7.1	12.0	12.0	12.0	12.0
Taipei,China	-23.7	3.4	12.2	8.7	19.6	7.6	10.5
Southeast Asia	-9.5	4.2	10.7	12.2	16.8	9.7	8.9
Cambodia	8.0	10.5	12.2	16.0	18.5	14.5	2.9
Indonesia	-14.1	2.8	10.9	4.0	4.0	4.0	4.0
Lao People's Dem. Rep.	-4.7	-12.4	7.9	11.7	16.2	1.8	1.8
Malaysia	-10.3	8.1	5.4	13.5	17.5	10.0	10.6
Myanmar	14.9	-18.3	-	-	-	-	-
Philippines	-4.5	6.2	6.3	10.0	7.0	10.0	7.0
Singapore	-13.7	-0.5	9.4	10.8	17.5	8.8	10.0
Thailand	-3.0	4.6	17.1	17.8	27.0	13.1	8.0
Viet Nam	6.0	19.5	27.0	14.0	15.0	11.0	11.0
South Asia	0.2	7.3	19.7	17.8	18.8	17.8	18.5
Afghanistan	-	-	-	-	-	-	-
Bangladesh	11.4	-8.7	13.1	17.5	12.6	15.0	14.0
Bhutan	6.1	-5.0	1.2	-	-	-	-
India	-2.8	13.5	21.8	18.7	19.9	19.5	19.3
Maldives	1.3	-0.5	20.2	6.9	6.9	-	-
Nepal	6.7	-15.3	7.1	10.0	15.4	12.0	12.0
Pakistan	6.2	-7.5	20.1	16.4	21.2	12.0	20.0
Sri Lanka	-18.4	2.2	9.2	12.0	12.0	12.5	12.5
Central Asia	8.7	0.4	21.4	12.3	23.4	3.9	6.3
Azerbaijan	-4.8	24.5	49.3	26.5	26.5	-6.1	-6.1
Kazakhstan	11.1	1.6	18.4	12.4	35.0	6.8	9.4
Kyrgyz Republic	-13.1	25.4	21.9	5.4	10.5	6.1	8.9
Tajikistan	-7.3	6.5	22.0	11.0	9.1	6.6	8.9
Turkmenistan	31.6	-9.8	15.6	10.2	10.2	-	-
Uzbekistan	4.0	-13.9	13.4	0.8	0.8	-	-
The Pacific	-9.5	7.4	4.6	3.7	1.7	6.7	6.0
Cook Islands	-8.1	0.5	49.2	-	-	-	-
Fiji Islands	-6.9	14.2	-6.0	7.6	6.2	18.6	15.0
Kiribati	12.1	18.3	23.1	-11.0	-11.0	2.6	2.6
Marshall Islands, Rep. of	-	-	-	-	-	-	-
Micronesia, Fed. States of	8.6	-9.0	8.3	-8.8	-8.8	9.8	9.8
Nauru	-	-	-	-	-	-	-
Palau	-21.5	0.9	-7.0	-	16.1	-	-
Papua New Guinea	-7.0	15.5	11.4	2.1	-2.2	-1.4	0.3
Samoa	24.1	10.4	-2.6	15.0	15.0	-	-
Solomon Islands	-8.0	-31.0	36.8	20.7	19.8	20.8	17.3
Timor-Leste, Dem. Rep. of	-4.4	-15.3	-21.3	-7.7	-8.0	-11.0	-2.5
Tonga	-3.9	7.8	25.1	-	-	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	0.9	-0.6	31.0	5.0	5.0	-	-
Average	-6.8	8.1	19.7	14.8	20.8	12.6	13.2

- = data not available.

Table A5 Current Account Balance (% of GDP)

Item	2001	2002	2003	2004		2005	
				ADO 2004	Update	ADO 2004	Update
East Asia	2.6	3.7	4.5	2.8	2.3	2.6	1.4
China, People's Rep. of	1.5	2.8	3.2	1.3	-0.1	1.0	-1.4
Hong Kong, China	6.1	7.8	10.2	6.8	6.8	8.5	8.5
Korea, Rep. of	1.7	1.0	2.0	2.7	3.9	2.6	3.1
Mongolia	-16.6	-15.9	-14.9	-14.0	-14.0	-13.5	-13.5
Taipei,China	6.4	9.1	10.2	6.9	6.8	6.0	6.0
Southeast Asia	6.9	7.5	9.0	8.2	7.2	7.6	6.6
Cambodia	-9.2	-8.9	-10.2	-4.3	-10.0	-5.6	-11.2
Indonesia	4.8	4.5	3.6	3.4	3.4	3.1	3.1
Lao People's Dem. Rep.	-4.6	-2.3	-0.3	-2.2	-2.0	-1.9	-1.6
Malaysia	8.3	8.4	12.9	7.9	7.8	6.5	7.0
Myanmar	0.0	-	-	-	-	-	-
Philippines	1.9	5.7	4.2	3.0	3.0	2.8	2.8
Singapore	18.7	21.4	30.9	34.5	27.0	32.7	25.0
Thailand	5.4	5.5	5.6	3.9	4.0	3.9	4.0
Viet Nam	1.5	-2.8	-5.8	-5.7	-4.1	-5.7	-4.1
South Asia	0.0	1.0	1.6	0.4	1.3	0.2	0.6
Afghanistan	-	-4.7	-3.4	-	-	-	-
Bangladesh	-2.3	0.4	0.3	0.0	0.3	-1.5	-1.5
Bhutan	-1.7	-1.2	10.6	-	-	-	-
India	0.2	0.8	1.4	0.3	1.4	0.3	1.1
Maldives	-9.4	-5.6	-4.3	-9.1	-9.1	-	-
Nepal	4.9	4.3	2.6	1.0	3.5	0.5	4.0
Pakistan	0.5	3.8	4.9	3.0	1.9	2.1	-1.3
Sri Lanka	-1.4	-1.4	-0.6	-3.0	-3.0	-3.5	-3.5
Central Asia	-3.2	-2.5	-2.3	-3.6	-3.9	-4.3	-2.1
Azerbaijan	-0.9	-12.3	-28.3	-32.5	-35.0	-18.1	-23.0
Kazakhstan	-5.4	-3.5	-0.2	-1.1	-1.0	-0.6	-0.6
Kyrgyz Republic	-1.3	-2.2	-1.6	-4.2	-3.9	-5.3	-5.4
Tajikistan	-6.7	-2.7	-1.3	-2.2	-2.0	-4.7	-2.2
Turkmenistan	-0.7	0.5	-	-	-	-	-
Uzbekistan	-1.7	2.5	6.5	6.0	6.0	6.0	6.0
The Pacific	2.8	-3.0	-0.6	0.9	0.8	-1.3	-1.7
Cook Islands	12.0	11.3	-	-	-	-	-
Fiji Islands	-3.3	-3.7	-10.1	-6.6	-6.0	-9.6	-8.8
Kiribati	3.2	7.6	-16.3	-12.5	-12.5	-13.7	-13.7
Marshall Islands, Rep. of	29.7	19.9	21.1	-	13.2	-	-
Micronesia, Fed. States of	-8.6	4.6	7.3	5.1	5.1	1.9	1.9
Nauru	-	-	-	-	-	-	-
Palau	-6.1	-13.9	-4.3	-	-17.8	-	-
Papua New Guinea	9.4	-4.5	4.1	5.0	5.0	3.2	3.2
Samoa	-11.9	-7.6	-0.6	-1.1	-1.1	-	-
Solomon Islands	-12.8	-6.8	1.4	2.0	-0.6	2.0	-10.1
Timor-Leste, Dem. Rep. of	4.1	2.7	8.5	6.4	5.8	1.5	-0.3
Tonga	-8.8	4.8	-3.7	-	-	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	0.8	-7.8	-14.1	0.0	0.0	-0.6	-0.6
Average	2.8	3.7	4.6	3.2	2.8	2.9	2.1

- = data not available.

Table A6 Fiscal Balance of Central Government (% of GDP)

Item	2001	2002	2003	2004		2005	
				ADO 2004	Update	ADO 2004	Update
East Asia							
China, People's Rep. of	-2.6	-3.0	-2.5	-2.5	-0.7	-2.3	1.1
Hong Kong, China	-5.0	-4.9	-3.3	-3.1	-3.0	-2.5	-2.5
Korea, Rep. of	-1.7	0.4	-1.7	-0.5	-0.9	0.0	-1.2
Mongolia	-4.5	-5.9	-4.5	-5.1	-5.1	-5.0	-5.0
Taipei,China	-6.7	-4.3	-4.0	-3.0	-2.9	-2.9	-2.6
Southeast Asia							
Cambodia	-5.6	-6.6	-7.0	-5.8	-6.1	-5.6	-6.0
Indonesia	-2.3	-1.7	-2.1	-1.3	-1.3	-0.8	-0.8
Lao People's Dem. Rep.	-7.6	-8.3	-7.8	-5.4	-9.2	-5.3	-5.3
Malaysia	-5.5	-5.6	-5.3	-3.6	-4.5	-1.8	-3.8
Myanmar	5.9	4.1	-	-	-	-	-
Philippines	-4.0	-5.3	-4.6	-4.2	-4.2	-4.2	-3.6
Singapore	-0.9	-1.6	6.4	3.5	3.6	3.6	3.8
Thailand	-2.4	-1.4	0.4	-0.1	-0.1	-0.3	-0.3
Viet Nam	-3.0	-3.8	-4.8	-4.6	-4.6	-4.2	-4.2
South Asia							
Afghanistan	-	-5.4	-	-	-	-	-
Bangladesh	-5.0	-4.6	-4.2	-4.8	-4.2	-4.5	-4.3
Bhutan	-11.7	-5.0	-10.0	-4.2	-6.0	-	-
India	-9.9	-9.5	-9.4	-10.0	-10.0	-9.5	-9.5
Maldives	-4.7	-4.9	-4.1	-4.5	-4.5	-	-
Nepal	-4.5	-3.9	-1.5	-2.7	-1.5	-4.5	-2.5
Pakistan	-4.3	-4.3	-3.7	-4.0	-3.3	-3.9	-3.5
Sri Lanka	-10.8	-8.9	-8.0	-7.3	-7.3	-6.5	-6.5
Central Asia							
Azerbaijan	1.8	1.3	0.2	1.1	1.1	1.5	1.5
Kazakhstan	-0.4	-0.3	-0.9	-1.9	-0.5	-1.0	-1.0
Kyrgyz Republic	-5.0	-5.4	-5.0	-4.4	-4.3	-3.5	-4.0
Tajikistan	-0.1	-0.1	0.9	-0.5	-0.4	0.0	-0.5
Turkmenistan	0.6	0.2	-1.0	-	-	-	-
Uzbekistan	-1.0	-0.8	-0.4	-2.0	-2.0	-	-
The Pacific							
Cook Islands	1.5	0.2	-3.2	-	-	-	-
Fiji Islands	-6.6	-5.6	-6.1	-3.5	-3.5	-0.8	-0.8
Kiribati	-42.1	21.4	-30.1	-	-	-	-
Marshall Islands, Rep. of	2.2	9.4	19.4	6.2	6.5	-	-
Micronesia, Fed. States of	-6.2	2.5	1.9	1.9	1.9	-1.1	-1.1
Nauru	-	-	-	-	-	-	-
Palau	-20.9	-28.1	-2.3	-	-12.4	-	-
Papua New Guinea	-3.6	-4.1	-1.0	-1.5	-1.5	-1.1	-1.0
Samoa	-2.2	-2.1	-0.6	-1.5	-1.5	-	-
Solomon Islands	-12.3	-10.5	0.2	0.0	0.0	-	-0.5
Timor-Leste, Dem. Rep. of	-6.9	-5.8	-7.3	-9.0	-9.0	-10.1	-2.4
Tonga	-0.2	1.2	-3.8	-1.8	-0.7	-	-2.8
Tuvalu	-51.0	71.5	-16.3	-1.3	-1.3	-	-
Vanuatu	-3.0	-2.1	-1.8	0.4	0.4	0.4	0.4

- = data not available.

