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ASIAN DEVELOPMENT

Outlook 2011

South–South Economic Links

Asian Development Bank

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Foreword

Developing Asia's economies proved their resilience in the face of a tremendous external shock. The *Asian Development Outlook 2011* shows that the region's recovery from the recent global economic downturn is firming with growth expected to reach nearly 8% in 2011 and 2012. This continued high growth follows the 9% expansion from the trough of the crisis.

The consolidation of the global recovery is, however, uneven. While developing Asia—and the economies of "the South" in general—have recouped the ground lost during the global downturn, the major industrial countries are progressing modestly. After the 2.6% rebound last year, the three economies of the United States, eurozone, and Japan are collectively expected to expand by 2.1% in 2011 and 2012.

Although the risk of these economies falling back into recession is receding, even this modest industrial-country recovery is fraught with risks. Tensions in the Middle East are pushing up oil prices. Japan is coping with the tragedy of the Tohoku earthquake and tsunami. Labor and housing market weaknesses are holding back recovery in the United States. The eurozone has not fully resolved the sovereign debt problems in its periphery.

The *Asian Development Outlook 2011* emphasizes two important challenges that developing Asia must resolve to sustain the inclusive growth that is needed to eliminate poverty in the region. The immediate problem is tackling rising consumer price pressures. Inflation's insidious effects call for preemptive action to contain it before it begins to accelerate. The poor are the most vulnerable, particularly from rising food prices.

Managing inflation is not easy. Because of the faster recovery, demand pressures are more intense in the region than among the major industrial economies. The recent surges in global oil and food prices are adding further pressures. Even though steps have been taken to reduce price pressures, inflation in the region is expected to pick up to 5.3% this year. Many countries may already be behind the curve in fighting inflation, and some countries are showing signs of overheating. The task is complicated because lifting interest rates may induce foreign capital inflows, which can add to price pressures.

Getting the policy response right depends on the problem. Where current account surpluses persist and exchange rates are misaligned with fundamentals, more flexible exchange rates may be the best option. For other economies, monetary tightening may be coupled with temporary capital controls, which should be coordinated internationally.

The second challenge is fostering new sources to sustain the region's growth into the future. In this regard, the trend of growing trade and investment with other developing countries—so-called South–South links—is encouraging. The share of world merchandise trade among countries in the South has more than doubled in less than two decades, from 7% in 1990 to 17% in 2009.

Much of the rise in trade and investment between economies in the South can be accounted for by the rise of “factory Asia”—where parts and components move across borders in the region but the assembled final goods are exported to major industrial-country markets. Thus while developing Asia is at the forefront of the South’s emerging economic influence, current production arrangements are still, ultimately, highly dependent on the North.

At a time of modest growth in industrial countries, improved South–South relations can be a potential new driver for global growth. Fortunately, there is considerable scope to deepen economic links within the South, but these will not come automatically. To fully tap the potential of these markets as new sources of growth, policy makers must remove impediments to South–South trade and investment, which are still higher than those with the North; and much work needs to be done to reduce barriers within the South to promote global integration.

As South–South ties evolve, developing Asia can draw on insights stemming from its success in its own regional cooperation and integration—both for itself and for other regions of the world. These ties are supported by the Asian Development Bank as an effective approach to eliminate poverty.

H. Kuroda

Haruhiko Kuroda
President
Asian Development Bank

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Definitions

The economies discussed in the *Asian Development Outlook 2011* (*ADO 2011*) are classified by major analytic or geographic groupings. For purposes of *ADO 2011*, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** refers to the 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member.
- **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **East Asia** comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China.
- **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka.
- **Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **The Pacific** comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.
- Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars.

ADO 2011 is generally based on data available up to **16 March 2011**.

Acronyms and abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
CPI	consumer price index
EU	European Union
FDI	foreign direct investment
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PRC	People's Republic of China
UNCTAD	United Nations Conference on Trade and Development
US	United States
USDA	United States Department of Agriculture
VAT	value-added tax
WTO	World Trade Organization

ADO 2011—Highlights

Developing Asia, having shown resilience throughout the global recession, is now consolidating its recovery. The region is forecast to grow by 7.8% in 2011 and 7.7% in 2012.

It faces two critical challenges to maintain inclusive growth in the years ahead. The most immediate is responding to swelling inflation pressures, which can be complicated by subsequent capital inflows. Policy makers will need to maintain a coherent policy mix to ensure success here.

Further ahead, the region must explore and then foster new sources of growth. The strengthening of ties with developing countries, both in the region and beyond, has much potential, but so far these links have been mainly used for final goods exports to major industrial countries.

To fully tap the potential of these developing-country markets as new sources of growth, policy makers must remove barriers to “South–South” trade and investment, which are still higher than those with the industrial world.

Key messages

- Developing Asia's recovery is firming. Its high growth is expected to continue despite the modest recovery in the major industrial economies. The region is forecast to grow by 7.8% in 2011 and 7.7% in 2012. In order to maintain sustainable and inclusive growth, however, Asia must confront two important challenges.

- First, on the immediate horizon, is coping with rising inflation pressures. Developing Asia's swift turnaround from the crisis provided the impetus for rising consumer prices. Tensions in the Middle East and the nuclear anxieties in Japan have further lifted market expectations of higher oil prices. Consumer price inflation in the region is forecast to rise to 5.3% in 2011, and some economies are showing signs of potential overheating.

- Although inflation is generally still low, regional policy makers need to make preemptive management of inflation a top priority. Developing Asia is home to two-thirds of the world's poor, and it is they who are the most vulnerable to its effects. Maintaining a coherent policy mix is key to success since monetary tightening to curb inflation pressures is likely to invite an increase in foreign capital inflows, which would compound the problems of managing inflation.

- More flexible exchange rates may be a better policy for countries with persistent current account imbalances and misalignment between their exchange rate and fundamentals. For countries without such symptoms, relying more on temporary policies, such as capital controls, may be an option if they are carried out in an internationally coordinated manner.

- The second challenge is to find and contribute to new sources of sustainable global growth. Industrial countries are unlikely to drive global growth any time soon and the economies of the South—developing Asia, Africa, Latin America, and the Middle East—should take up the slack.

- It is encouraging that South–South economic links are strengthening and contributing to the recovery of the world's economy. South–South trade has expanded fast in the past two decades, from about 7% of nonfuel world merchandise trade in 1990 to 17% in 2009. Foreign direct investment (FDI) links have also increased hugely as high-saving Southern economies have become new sources of outward FDI.

- This strengthening does not, however, guarantee sustainable growth for Asia. Much of it was the result of the rise of "factory Asia," where developing Asia sourced intermediate goods and parts from within Asia to assemble them into final goods to be exported to affluent markets in the North. Hence growing South–South links do not necessarily translate into greater economic independence from the North.

- Strengthening South–South links through recycling savings to finance investment (rather than holding them in safe assets) could enhance the growth potential of the South and contribute to the stability of the global economy by promoting global rebalancing. To do that, the South has to work hard to reduce internal trade and investment barriers—still higher than those with the North—and continue to promote global and regional integration.

Muted Industrial-country Upswing

- **Recovery is progressing modestly in the major industrial economies.** In 2010, the gross domestic product (GDP) of the United States, eurozone, and Japan together expanded by a respectable 2.6% (partly due to the effect of the lower base from the downturn). Yet it is still unclear whether private demand can sustain growth once authorities start to normalize fiscal and monetary policies. Consequently, their GDP is forecast to expand at a somewhat slower pace than the initial rebound: 2.1% in both 2011 and 2012. Despite rising global commodity prices and accommodative monetary policy, industrial-country inflation remains low due to their slower growth prospects.

- **Global uncertainties pose risks to maintaining their growth momentum, however.**

  - The recent surge in oil prices could undermine the global recovery, and geopolitical and other factors have heightened uncertainty about future prices. Political instability in the Middle East raises questions about oil supplies, while Japan's nuclear energy woes have heightened concerns about this alternative energy source. Food prices hit records in February 2011. While core inflation remains low in industrial countries, oil and food price pressures can fuel inflation in developing countries where recovery is well under way.

  - Despite the mild recovery that is forecast (2.8% in 2011 and 2.6% in 2012), the United States economy is beset by stubbornly high unemployment and weak housing markets. These undermine the strength of the economy, and thus the global outlook.

  - Sovereign debt problems in the eurozone periphery still await a fundamental resolution, which could jeopardize the 1.6% growth forecast for both 2011 and 2012. Further problems may precipitate financial instability within the eurozone—which could even spread globally. Inflation and global geopolitical uncertainty can increase borrowing costs, further aggravating the fiscal problems in the single-currency bloc.

  - Japan's economy is slowing after its rebound from the recession, and it must now face the challenges arising from one of the most destructive natural disasters in its history. The short-run economic impacts from the supply disruptions and power shortages could be substantial, but the long-run prognosis is less dire. Through reconstruction efforts and the return of productive activity, the economy is forecast to grow by 1.5% in 2011 and 1.8% in 2012.

Developing Asia's Outlook

- **Developing Asia's recovery is firming.** The region is projected to grow by 7.8% in 2011 and 7.7% in 2012. The moderation from 9.0% in 2010 stems from slower growth of the major industrial economies and world trade as well as normalization of fiscal and monetary policy. The exceptional performance of 2010 was partly due to the base effect, as the region bounced back from the impact of the global downturn. The moderation marks a welcome return to growth rates that can be sustained without stoking inflation.

- **Developing Asia's robust growth provided timely support during the crisis and recovery.** The region's resilience has contributed to the recovery of both industrial economies and non-Asian developing countries, primarily via the trade channel. Even as global trade collapsed, developing Asia's imports continued to grow. Rapid growth in the region's two giants—the People's Republic of China (PRC) and India—will continue to lift regional and global growth. The medium-term outlook for both is good, although finance sector risks in the PRC and the fiscal consolidation in India need to be addressed.

- **The current account surplus is falling and projected to decline further.** Rising commodity prices, especially for oil, and the region's strong GDP growth are raising its imports. The current account surplus fell from 4.7% of GDP in 2009 to 4.1% in 2010. Under the forecasts for even higher oil prices with continued strong growth, the region's current account balance is forecast to fall further to 3.3% of GDP in 2011 and 3.0% in 2012. Yet this should not be interpreted as an unwinding of the structural global imbalances.

- **Inflation pressures are building, and preemptive measures may well be needed to avoid overheating.** Inflation has risen more sharply in the region than in the major industrial countries. Consumer prices rose by 4.4% in 2010, accelerating from 1.2% in 2009, on a combination of external factors (global oil and food price shocks) and the robust domestic recovery. Although many central banks have already taken action, inflation is expected to accelerate further to 5.3% in 2011 before tapering off to 4.6% in 2012.

- **Rising oil and food prices could shake developing Asia's macroeconomic stability.** Model simulations show that a 30% increase in both oil and food prices over their 2010 levels could shave 0.7 percentage points from the region's forecast growth and add 1.7 percentage points to its inflation rate. An oil price shock has the bigger impact on macroeconomic stability, but rising food prices disproportionately affect the poor.

- **The need to take preemptive action on inflation is building in developing Asia.**

  » Demand pressure in some Asian economies is more intense than in the advanced countries. Growing demand pressures can put strains on the labor market, potentially inducing a wage–inflation spiral.

  » Inflation undermines the promotion of inclusive growth through its effects on poverty and inequality. Its impact, particularly if driven by food prices, increases the number of poor since the region's consumption baskets tend to have larger shares of food than those in the advanced economies. This widens income inequality and could potentially lead to social tensions.

  » Authorities have started responding to inflation, but some may be behind the curve. So far, Asian economies have either allowed their currencies to appreciate or have imposed tariff-relief measures to curb imported inflation (with varying results). They have also tightened monetary policy to manage the growing demand pressures, but some countries are still showing signs of overheating.

- **Managing inflation pressure is not easy.** The policy mix needs to be coherent.

  » Increasing benchmark policy rates would prompt wider interest differentials, and so attract more volatile capital inflows.

  » Letting currencies appreciate more flexibly is one option, but may not be appealing for those who favor maintaining international competitiveness. Intervening in the foreign exchange markets is not an alternative, however. The intervention may not be globally acceptable and could be self-defeating as it potentially worsens domestic inflation pressures.

  » Imposing selective and carefully designed temporary capital control measures on inflows might be another option. To be effective, however, such measures require high degrees of administrative capacity to implement and should only be exercised temporarily.

- **Appropriate policies to deal with inflation and capital inflows depend on the specific problem.** More flexible exchange rates may be a better policy for countries with persistent current account imbalances and misalignment between the exchange rate and fundamentals. For countries without such symptoms, relying more on temporary policies, such as capital controls, can be an option if executed in an internationally coordinated manner. G20's recent efforts to establish practical indicative guidelines for assessing countries' current account imbalances and principles for capital controls could provide useful tools.

Outlook by Subregion

- **East Asia will grow most rapidly in developing Asia.** Led by the PRC, aggregate subregional GDP growth will moderate somewhat from its 9.6% recovery pace in 2010 to 8.4% in 2011 and 8.1% in 2012. Slower investment (from the winding down of policy stimulus) and less-heated export growth will temper GDP expansion in the PRC—from the 10.3% recovery to 9.6% in 2011 and 9.2% in 2012. Hong Kong, China; the Republic of Korea; and Taipei,China will settle back to more sustainable growth of around 5% after their sharp 2010 rebound. Most East Asian economies are moving toward a tighter monetary stance as their production levels reach their potential and rising commodity prices add pressure. Inflation in the subregion is forecast to pick up in 2011 to 4.3% (from 3.1% in 2010) before easing back to 3.9% in 2012.

- **Southeast Asia's expansion will moderate after its exceptionally strong recovery.** Growth is expected to step down in light of the higher 2010 base (from 7.8% growth that year), a slowing in export growth, and policy tightening by governments. GDP will expand by 5.5% in 2011 and 5.7% in 2012. This moderation is most notable in Malaysia, the Philippines, Singapore, and Thailand, which grew rapidly during the recovery. The region is also playing its part in rebalancing growth toward private domestic demand, as seen in the increased investment rate in Indonesia. Inflation in Southeast Asia is accelerating from its moderate rate of 4.0% in 2010 to 5.1% in 2011. Inflation pressures have been more tenacious in some countries—Viet Nam, for example, is expected to hit double digits. With appropriate policy responses, Southeast Asia's average inflation is expected to come down to 4.2% in 2012.

- **South Asia's GDP is expanding steadily.** After growing by 7.9% in 2010 in line with the global recovery, growth will continue steadily, at 7.5% in 2011 and 8.1% in 2012. Leading the subregion, India's 2010 expansion was robust and broad-based (8.6%)—even in the face of fiscal consolidation and substantial monetary tightening—and is set to remain strong at 8.2% in 2011 and 8.8% in 2012. Pakistan's floods weighed on its growth in 2011, but Sri Lanka's peace dividend continues to support its expansion. Food price pressures in India pushed inflation in South Asia to 9.3% in 2010, although that country's sharp monetary tightening should help bring the subregional average inflation rate down to 8.7% in 2011 and 7.3% in 2012.

- **Central Asia is benefiting from higher international commodity prices.** Much higher prices for the region's key exports (oil and gas, metals, cotton, and gold) supported the recovery (6.6% in 2010) and will stay important drivers. Growth is set to rise slightly to 6.7% in 2011 and 6.9% in 2012. Following its V-shaped recovery, Kazakhstan will slow somewhat from the higher base as it winds down its anticrisis measures. The non-oil economies strengthened with the economic revival in the Russian Federation (their main source of remittances, trade, and finance). Inflation across the subregion is expected to average 8.2% in 2011, up from 7.1% in 2010, driven by higher food prices in all countries and higher energy prices in the oil importers. Moderation in food prices in 2012 will provide some relief, and inflation should ease to 6.6%.

- **Resource-rich economies will drive growth in the Pacific.** Most of the 6.3% growth forecast in 2011 is attributable to the resource-rich economies of Papua New Guinea, Timor-Leste, and Solomon Islands, which are benefiting from higher global commodity prices, new investment, and higher government revenue from resources. While income from tourism and remittances generally picked up in step with the global recovery, most small Pacific economies are projected to grow only slowly (2% or less). Growth for the subregion should settle back to 5.4% in 2012. Inflation is also picking up alongside global commodity prices as these import-dependent countries cope with rising world food and oil prices. Inflation is forecast to rise from its 2010 rate of 5.9% to hit 6.5% in 2011, before falling to 5.6% in 2012.

Special Theme: South–South Economic Links

Growing importance of South–South links

- **The share of the South in world GDP rose from about 25% in 1980 to 45% in 2010, of which developing Asia alone contributed two-thirds.** The South has burnished its economic credentials on the world stage by leading the way out of the global economic crisis, developing Asia in front. Concomitantly, it has raised its profile in international governance. The emergence of the G20 summit reflects a belated response to this reality.

- **Concurrent with high growth, South–South links have proliferated.** Trade and financial integration in the South have intensified in tandem with its rising global economic role. Greater integration allows the economies of the South to share experiences and to learn from each other. As there is no single model for development, it is imperative for countries to diversify sources of knowledge and share development experiences. As well as North–South knowledge exchanges, South–South knowledge sharing is becoming a reality.

- **South–South links are creating new potential drivers of aggregate demand.** Given their reversals in the recent crisis, industrial economies are unlikely to drive demand in the world economy any time soon. With their strong prospects for growth, the economies of the South should take up the slack. Potentially, the rising consumption of emerging economies and the new investment flows within the South can be new sources of growth for the world economy—but only if the economies of the South become more open to trade and capital flows.

Expanding South–South economic links through trade

- **South–South trade has shot up in the past two decades.** Trade among Southern countries rose from about 7% of world nonfuel merchandise trade in 1990 to 17% in 2009. Developing Asia now accounts for about three-quarters of South–South trade, and the PRC alone for roughly 40%.

- **The rise of factory Asia explains most of the rise of South–South trade.** Intermediate goods are sourced mainly within the region, including Japan, for assembly in the PRC, the regional hub. Final goods are then exported, predominantly to affluent markets in the North.

- **South–South trade has grown rapidly for Latin America, Africa, and the Middle East.** Although these regions' trade with the South is relatively small, at roughly one-quarter of South–South trade, it has been quickly expanding, particularly with Asia.

- **Tariff levels and other barriers to trade in the South have tumbled in the past two decades, but are still higher than with the North.** As a 2005–2008 average, applied tariffs in the South were 9.3%, compared with 3.2% in the North. Trade-related infrastructure and logistics performance, as measured by World Bank surveys, shows that the South lags far behind the North, although it has been closing the gap.

- **A gradual removal of these remaining bottlenecks would especially spur South–South trade, where they tend to hold back trade on both sides.** Simulation analysis suggests that lowering tariff barriers to South–South trade even to the levels prevailing in South–North trade could bring three-quarters of the gains to Southern countries of freeing all countries' goods trade. South–South trade would expand by 6 percentage points as a result. However, trade reforms supporting South–South trade must not undermine continuing global integration. In view of the proliferation of regional trade agreements in Asia and elsewhere, it is increasingly important that future agreements be made as inclusive as possible and ensure compatibility with provisions of the World Trade Organization.

Expanding South–South economic links through investment

- **In developing Asia, FDI is by far the most important source of capital from abroad.** Developing Asia received an average of $187 billion in FDI each year during the last two decades, which far exceeded the average annual combined flows of $126 billion in portfolio and bank investments. The importance of FDI is even clearer given its resilience to external shocks, hence serving as a stable source of financial resources to Southern economies.

- **Southern countries became sources of outward FDI in the 2000s.** Most FDI is among Northern countries, but the share of the South has grown fast. By 2009, about a quarter of global inward FDI stocks and about 13% for outward FDI stocks were in the South. Developing Asia accounts for more than 70% of developing countries' outward FDI stocks.

- **As part of the deepening of factory Asia production networks, Asian FDI has become more intraregional.** Over half the inflows to developing Asia are estimated to be regional. The concentration is especially high in East Asia and Southeast Asia, stimulated by regional integration efforts, expansion of production networks, and relocation of production to lower-cost areas within the region.

Upgrading South–South links is key to Asian and global growth

- **South–South links can be a new source of global growth, but to maximize potential, structural weaknesses must be overcome.** Growing South–South relations at a time of modest growth in industrial economies could be a potential new driver of global growth. However, this trend does not guarantee sustainable growth for Asia and the global economy, since it stems from the rise of factory Asia. Growing South–South links do not therefore necessarily mean greater economic independence from the North.

- **The potential for tighter South–South integration is strong.** The industrial migration associated with South–South FDI helps to enhance the growth potential and productive capacity of host Southern economies by filling investment gaps. Developing Asia could contribute to this if it were to recycle its saving to finance investment in the South (rather than hold it in safe assets). Such a move could contribute to the stability of the global economy by promoting rebalancing. It would also encourage regional financial-market deepening. But the South has to reduce its trade and investment barriers, which are still high relative to those with the North, to promote global and regional integration.

- **Signs of progress are positive in international cooperation for South–South links.** Cooperation at the bilateral, regional, and multilateral levels is broadening. It includes sharing knowledge on development experiences, labor migration, and macroeconomic policy coordination. Here, the role of multilateral development banks is crucial as a source of technical and financial assistance.

Table 1 Growth rate of GDP (% per year)

Subregion/Economy	2008	2009	2010	2011	2012
Central Asia	**6.1**	**3.2**	**6.6**	**6.7**	**6.9**
Azerbaijan	10.8	9.3	5.0	5.8	5.8
Kazakhstan	3.3	1.2	7.0	6.5	6.8
East Asia	**7.3**	**6.8**	**9.6**	**8.4**	**8.1**
China, People's Rep. of	9.6	9.2	10.3	9.6	9.2
Hong Kong, China	2.3	-2.7	6.8	5.0	4.7
Korea, Rep. of	2.3	0.2	6.1	4.6	4.6
Taipei,China	0.7	-1.9	10.8	4.8	5.0
South Asia	**6.3**	**7.1**	**7.9**	**7.5**	**8.1**
Bangladesh	6.2	5.7	5.8	6.3	6.7
India	6.7	8.0	8.6	8.2	8.8
Pakistan	3.7	1.2	4.1	2.5	3.7
Sri Lanka	6.0	3.5	7.6	8.0	8.0
Southeast Asia	**4.2**	**1.2**	**7.8**	**5.5**	**5.7**
Indonesia	6.0	4.6	6.1	6.4	6.7
Malaysia	4.7	-1.7	7.2	5.3	5.3
Philippines	3.7	1.1	7.3	5.0	5.3
Singapore	1.5	-0.8	14.5	5.5	4.8
Thailand	2.5	-2.3	7.8	4.5	4.8
Viet Nam	6.3	5.3	6.8	6.1	6.7
The Pacific	**5.3**	**4.2**	**5.2**	**6.3**	**5.4**
Fiji	0.2	-3.0	0.1	0.5	0.8
Papua New Guinea	6.6	5.5	7.1	8.5	6.5
Developing Asia	**6.7**	**5.9**	**9.0**	**7.8**	**7.7**

Notes: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; East Asia comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China; Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam; South Asia comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and The Pacific comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India, and Pakistan are recorded on a fiscal-year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.

Table 2 Inflation (% per year)

Subregion/Economy	2008	2009	2010	2011	2012
Central Asia	**16.5**	**5.9**	**7.1**	**8.2**	**6.6**
Azerbaijan	20.8	1.5	5.7	7.5	7.0
Kazakhstan	17.3	7.3	7.1	8.5	6.0
East Asia	**5.5**	**-0.1**	**3.1**	**4.3**	**3.9**
China, People's Rep. of	5.9	-0.7	3.3	4.6	4.2
Hong Kong, China	4.3	0.5	2.4	4.5	3.3
Korea, Rep. of	4.7	2.8	2.9	3.5	3.0
Taipei,China	3.5	-0.9	1.0	2.8	2.9
South Asia	**9.5**	**4.3**	**9.3**	**8.7**	**7.3**
Bangladesh	9.9	6.7	7.3	8.0	8.5
India	8.7	2.1	9.2	7.8	6.5
Pakistan	12.0	20.8	11.7	16.0	13.0
Sri Lanka	22.6	3.4	5.9	8.0	7.5
Southeast Asia	**8.6**	**2.5**	**4.0**	**5.1**	**4.2**
Indonesia	9.8	4.8	5.1	6.3	5.8
Malaysia	5.4	0.6	1.7	3.0	3.0
Philippines	9.3	3.2	3.8	4.9	4.3
Singapore	6.6	0.6	2.8	3.2	2.0
Thailand	5.4	-0.9	3.2	3.5	3.0
Viet Nam	23.0	6.9	9.2	13.3	6.8
The Pacific	**9.8**	**5.0**	**5.9**	**6.5**	**5.6**
Fiji	7.8	3.7	7.8	4.0	3.0
Papua New Guinea	10.8	6.9	6.0	8.0	7.5
Developing Asia	**6.9**	**1.2**	**4.4**	**5.3**	**4.6**

Notes: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; East Asia comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China; Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam; South Asia comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and The Pacific comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India, and Pakistan are recorded on a fiscal-year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.

1

ASIA IN THE UNEVEN GLOBAL RECOVERY

Asia in the uneven global recovery

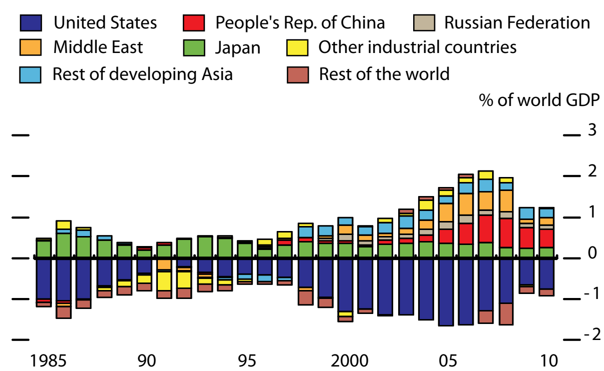
The world has come out of its deepest downturn since the Great Depression, in a recovery marked by an interesting bifurcation: the developing world has made a rapid return to its precrisis growth path while major industrial countries continue to struggle. The asymmetric nature of the crisis—a financial crisis in the United States (US) and Europe and a trade shock elsewhere—helps to explain this dual outcome, as the output effects of a financial crisis tend to persist.

Developing Asia will continue to spearhead the global recovery. Private demand is sustaining growth even as monetary and fiscal policies are normalized. The region's growth in 2011 will remain vigorous, albeit somewhat slower than in 2010. Inflation pressures are building, however, and overheating is an emerging threat in some economies. The resurgence in global oil and food prices complicates the challenge of managing inflation.

In the medium term, sustaining growth requires the global imbalances that built before the crisis to be unwound. These imbalances narrowed significantly during the crisis and remain well below their peaks (Figure 1.1.1). This positive trend will be temporary, though, unless surplus and deficit countries make the necessary structural adjustments to ensure more balanced growth.

For developing Asia, that means exploring and fostering new sources of growth. Intensifying efforts toward greater regional integration will be an important part of that story. Yet there is huge potential beyond the region's boundaries. Developing countries in Africa, Latin America, and the Middle East—together with developing Asia, the so-called South—also rebounded rapidly from the worst effects of the global slump. At a time of modest growth in industrial countries, improved South–South relations may well become an important new driver for global growth.

1.1.1 World current account balance



Note: 2010 data are estimates.

Source: International Monetary Fund. 2010. World Economic Outlook database. October. http://www.imf.org (accessed 1 March 2011).

Click here for figure data

This chapter was written by Donghyun Park, Arief Ramayandi, Cindy Castillejos-Petalcorin, Gemma Estrada, Benno Ferrarini, Nedelyn Magtibay-Ramos, Aleli Rosario, and Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila. Background materials from Jeff Brown, Arpitha Bykere, Peter Morgan, Elisa Parisi-Capone, and Paul Vandenberg are gratefully acknowledged.

Twin-track global growth

The major industrial countries have stepped back from the brink of further global turmoil. Gross domestic product (GDP) in the US, eurozone, and Japan together grew by a respectable 2.6% in 2010. While the risk of another recession is receding, it is unclear whether private demand can sustain itself without continued policy stimulus. As a result, the combined GDP in 2011–2012 will expand at a somewhat slower pace than it did during the initial rebound (Table 1.1.1). Global trade will continue to expand at a healthy pace during this period, although somewhat less strongly than in the postcrisis rebound of 2010.

While forecasts indicate that the major industrial economies will continue to recover from the recent downturn, authorities must carefully maneuver around their own particular obstacles: soft labor and housing markets in the US, vulnerable sovereign debt positions in the eurozone, and the aftermath of natural disaster in Japan pose critical risks to growth. Upward-trending commodity prices add to the uncertainty.

Developing Asia's robust growth has provided the major industrial economies—and developing economies outside Asia—some much-needed support during the downturn and recovery. But it is unclear how far the region can extend this role without a firmer industrial-country recovery.

1.1.1 Baseline assumptions for external conditions

	2009 Actual	2010 Actual	2011 *ADO 2011* projection	2012 *ADO 2011* projection
GDP growth (%)				
Major industrial economies[a]	-3.8	2.6	2.1	2.1
United States	-2.6	2.9	2.8	2.6
Eurozone	-4.1	1.7	1.6	1.6
Japan	-6.3	3.9	1.5	1.8
World trade (% change)				
Merchandise exports	-12.2	13.5	7.5	8.5
Prices and inflation				
Brent crude spot prices (average, US$ per barrel)	61.7	79.6	104.0	112.0
Energy price index (% change)	-36.8	25.9	17.8	5.2
Food and beverage price index (% change)	-13.1	11.8	15.0	1.0
Inflation (major industrial-economy average, %)	-0.2	1.2	1.3	1.8
Interest rates				
United States Federal funds rate (average, %)	0.2	0.2	0.3	0.6
European Union refinancing rate (average, %)	1.3	1.0	1.0	1.0
Japan interest rate (average, %)	0.1	0.1	0.2	0.4
US$ Libor[b] (%)	0.3	0.3	0.5	1.0

[a] Average growth rates are weighted by gross national income, Atlas method (current US dollars).
[b] Average interbank quotations on 1-month loans.

Sources: US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp; World Trade Organization, http://www.wto.org; Consensus Forecasts; Bloomberg; International Monetary Fund, Primary Commodity Prices, http://www.imf.org; World Bank, Global Commodity Markets, http://www.worldbank.org; ADB estimates.

Even with welcome signs of strength in the global environment, several risks underline the need for the region's policy makers to stay vigilant.

One major global development has been a surge of commodity prices. High and volatile oil and food prices will in particular reverberate through the world economy, and they are likely to stay that way in 2011–2012. They will thus be a significant source of global inflation, especially in developing countries where recovery is firmly under way.

Outlook for industrial countries

United States: Soft labor and housing markets

The rise in economic activity continued apace in the US. Industrial production has picked up gradually (Figure 1.1.2) from the trough in early 2009, but remains below its precrisis level. Consumer confidence and retail sales have been on the rise, although the occasional wobble reflects household uncertainty in the strength of the recovery.

Reflecting this increased activity, US GDP expanded in all 4 quarters of 2010, the bulk of this coming from a recovery of private consumption and investment (including changes in inventories) (Figure 1.1.3). The revival of private demand is promising, but it is unclear that private demand can sustain itself beyond the recently extended fiscal and monetary expansion.

Private consumption in particular will stay weighed down by the sluggish housing market and persistently high unemployment rate. Households increasing their saving to bolster their net worth (which was hammered by the crisis) will damp consumption in the medium term. Self-sustaining growth based on robust private consumption will require concrete progress in both labor and housing markets, and a rebound in households' net worth.

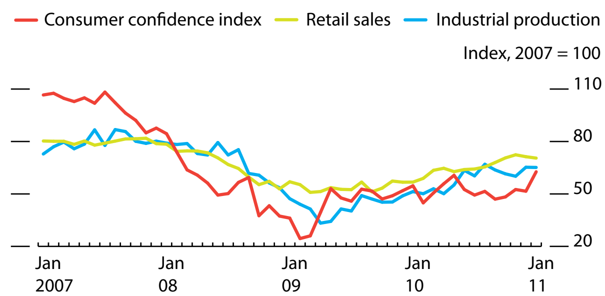
The recent outcomes for private investment suggest that business owners are still tentative about the future. Inventory restocking (to replenish recession-depleted stocks) made up a large part of investment growth, rather than increased corporate spending on new plant and equipment. But even here, a rundown in inventories in the fourth quarter became a drag on growth.

External demand for US goods picked up in 2010. Exports grew by 11.7%, after declining by 9.5% in 2009. But the export rise was more than offset by imports, which grew by 12.6% after declining the previous 2 years.

Growth moderated from a high of 5.0% (quarter on quarter) in the fourth quarter of 2009 to 3.1% in the same quarter of 2010. This was natural since growth in the fourth quarter of 2009 stemmed from the very low base around the trough of the recession. Growth for all 2010 reached 2.9%, recovering much of the ground lost in 2009 when GDP contracted by 2.6%.

Overall consumer price inflation remains low, even with the energy price spike in 2010. Increases in international commodity prices

1.1.2 Business activities and consumer confidence indicators, United States



Source: CEIC Data Company (accessed 11 March 2011).

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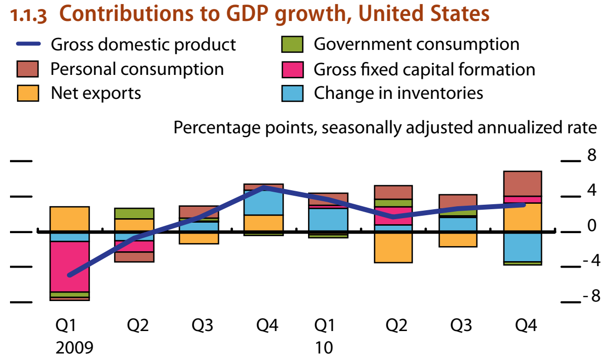
1.1.3 Contributions to GDP growth, United States



Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov (accessed 11 March 2011).

Click here for figure data

accounted for most of 2010's rise in inflation, with core inflation staying below 1% (Figure 1.1.4) and supporting the Federal Reserve's decision to maintain its expansionary monetary policy.

Despite the recovery in GDP, two important segments of the economy are still weak—labor and housing. Although the pickup in business activity supported some job creation, the labor market remains soft. Unemployment has only crept down from its peak of 9.8% in April 2010 to 8.9% in February 2011 (Figure 1.1.5), and long-term unemployment remains high.

In the 5 years before the crisis (2003–2007), the long-term unemployed made up about 20% of the total and the median duration of unemployment was less than 10 weeks. As of February 2011, the share of the long-term unemployed was 44% while the median duration was just under 21 weeks. The economy needs to grow much faster to bring these indicators back to their precrisis levels.

So, too, with housing. Prices have continued to slip, and residential construction has followed suit (Figure 1.1.6). This weakness persists, even with low mortgage rates. The low and still falling median price for housing is heavily affected by the overhang of vacant and foreclosed properties. Concerns over possible further declines in home values may have kept potential homebuyers from looking for mortgages, despite the recent low borrowing rates.

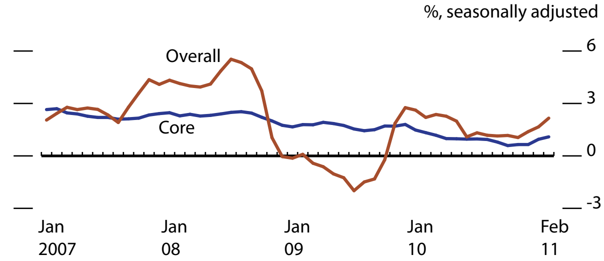
With continued low inflation and lingering high unemployment, monetary policy is expected to remain expansionary in 2011. The Federal Reserve will likely maintain the policy interest rate—the Federal funds rate—at near-zero levels to midyear as it completes its second round of purchases of longer-term Treasury securities (so-called quantitative easing). Some move toward less expansionary monetary policy may begin toward the end of the year, depending on the strength of the recovery and consumer price movements.

Fiscal policy will also remain expansionary in 2011. The temporary tax cuts enacted in 2001 have been extended through 2012, and the extended period of eligibility for unemployment benefits will continue through end-2011, which should help to support demand. Some tightening of other expenditure, though, is expected. As incomes recover and the labor market improves, revenue will increase and unemployment spending will decline. The fiscal position is expected to become less expansionary in 2012.

Growth in 2011 will be close to its 2010 level, and may well offer a positive surprise. If the policy stimulus contributes to faster than expected recovery of the labor and housing markets, improved business and consumer confidence may lift 2011's growth above the current projection of 2.8%. On the downside, households rebuilding their balance sheets will continue to handicap consumption, particularly if housing and labor markets stay soft.

While the fiscal stimulus is a recovery driver, the lack of a credible medium-term plan to bring the fast-rising public debt is a growing risk.

1.1.4 Inflation, United States



Source: CEIC Data Company (accessed 17 March 2011).

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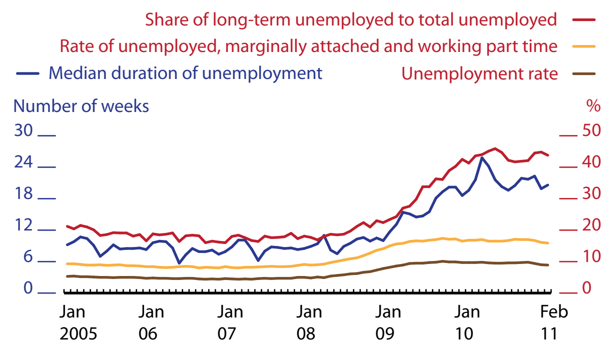
1.1.5 Unemployment, United States



Source: CEIC Data Company (accessed 22 March 2011).

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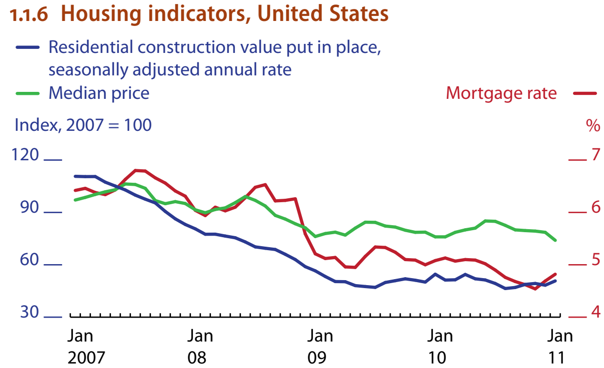
1.1.6 Housing indicators, United States



Source: CEIC Data Company (accessed 11 March 2011).

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As the effects of the stimulus fade and concerns over fiscal sustainability mount, the outlook for 2012 becomes more uncertain. Growth is forecast to slow somewhat to 2.6%.

Eurozone: Sovereign debt vulnerabilities

The eurozone economy picked up from the third quarter of 2009, but after a strong performance in the first half of 2010 it slowed to 0.3% quarter on quarter in both the third and fourth quarters. For the whole of 2010, growth came in at 1.7%.

Uncertainty remains high, however, with many downside risks clouding the outlook. Externally they relate to shocks that could dent the current global recovery, while internally most are associated with a possible disruption from disorderly debt workouts in one or more of the eurozone's peripheral economies. Some internal risks reflect the damping effect on growth of fiscal austerity packages (and restrictive monetary policies to stem inflation).

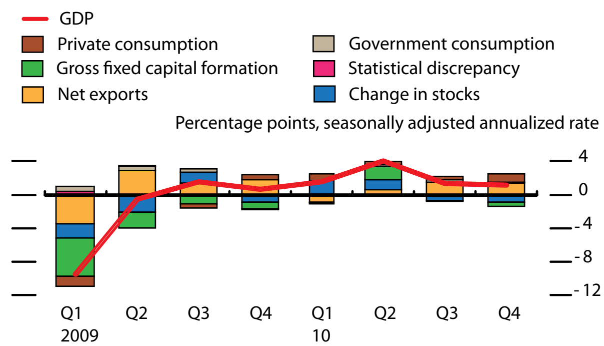
Net exports and, to a lesser extent, private consumption were the main contributors to eurozone growth in the third and fourth quarters of 2010 (Figure 1.1.7). They had this role against the backdrop of dwindling government spending (as postcrisis support measures petered out), a drag on GDP from fixed capital investment and inventories, and an exceptionally harsh winter. Pulled by the global recovery and by growing external demand from, especially, the US, the People's Republic of China (PRC), and Brazil, eurozone exports to the rest of the world rose by 2.2% in the third quarter and by 1.8% in the fourth (quarter on quarter). In terms of net exports, the trade surplus rose, primarily with the US, benefiting from the recovery there.

Germany continued to drive export performance—and overall eurozone economic expansion. The country further consolidated its trade surplus and powered ahead with 4.0% growth (year on year) in the last quarter of 2010. Far less impressive fourth-quarter growth rates were recorded by France (1.5%) and Italy (1.3%), and particularly the troubled peripheral states, where Spain did best with 0.6% growth, against Greece's huge 6.6% contraction.

Private consumption remained subdued during the whole of 2010, although edging up somewhat in the last quarter, spurred by the holiday season and firming consumer confidence. Retail trade trended upward by 5% (year on year) on average in the 6 months from July 2010. Consumer confidence was supported by a slight improvement in unemployment, which in January 2011 fell back to 9.9%, after hovering around 10% throughout 2010. As with growth, eurozone data mask considerable disparity among its members: Spain's unemployment is above 20%, almost five times that in the Netherlands or Austria, and more than three times Germany's.

Industrial output (except construction) continued its slow, upward postcrisis crawl. It was pulled up by accelerating new industrial orders in the fourth quarter of 2010, largely reflecting external export demand for capital goods (Figure 1.1.8). Continuing impetus from strong industrial new orders, reflected also in the upward-trending

1.1.7 Contributions to GDP growth, eurozone



Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 4 March 2011).

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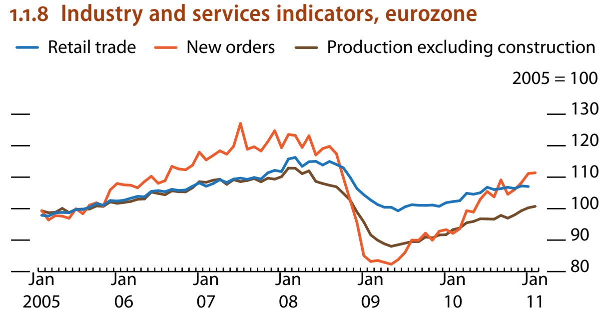
1.1.8 Industry and services indicators, eurozone



Note: Since May 2010 data are classified in accordance with an updated version of the Nomenclature of Economic Activities (NACE rev2) causing a potential break in series at this date.

Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 23 March 2011).

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industrial confidence indicator (Figure 1.1.9), is expected to drive up gross fixed capital investment and domestic demand in the first half of 2011, from their subdued levels in the fourth quarter of 2010.

Consumer price inflation is on the rise. It reached 2.4% in February 2011 (Figure 1.1.10), up from 2.3% a month earlier and from an average of 1.6% in 2010. The most recent upward pressures reflect the global rise in energy and commodity prices, which some parts of the eurozone saw reinforced by their higher exposure to the fallout from the unrest in North Africa and the Middle East. Pushed by external factors, inflation is projected at 2.3% in 2011, but is expected to fall back to 1.9% in 2012. This deceleration assumes the return of a more favorable external environment, and reflects still moderate upward pressures on wages, as the output gap narrows and a more restrictive monetary policy takes effect.

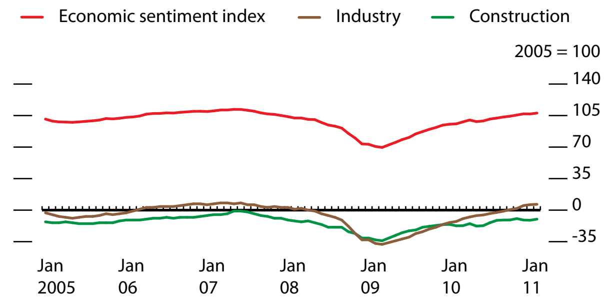
Policy interest rates are poised to rise. In early March, the European Central Bank hinted for the first time at an imminent increase in its reference rates, up from the 1% mark it has maintained during the entire postcrisis recovery. Worries remain that rate hikes in the months ahead could add to the difficulties not only of the eurozone's most troubled countries, primarily Greece, Ireland, and Portugal, but also of its larger economies, such as Italy and Spain, both of which have embarked on stringent fiscal austerity packages. To avoid weakening the eurozone's already fragile growth prospects, the central bank is likely to favor a gradual and soft approach rather than aggressive tightening.

The bloc is expected to continue expanding at about 1.6% in both 2011 and 2012, supported by the global recovery—particularly in the US and emerging markets—and by vigorous domestic demand on the back of growing consumer and manufacturing confidence.

Continued finance sector recovery and banks' expanded access to money markets will be key to sustaining the momentum. Weaknesses remain, however, as banks' balance sheets are still constrained, and lending to households has been very slow to pick up. In sovereign bonds, market confidence improved temporarily in November last year, coinciding with the €67.5 billion bailout of Ireland. Such emergency funding by the European Union (EU) and the International Monetary Fund (IMF) to Ireland, and to Greece earlier in 2010, will keep these countries from having to access the markets for 2 or more years.

Against the backdrop of soaring 10-year government bond credit default swaps for Greece, Ireland, and Portugal (Figure 1.1.11), EU leaders agreed to increase the lending capacity of the eurozone's bailout fund at EU summits held on 11 and 24–25 March. The commitments were to increase the fund to €440 billion (up from its current €250 billion), by increasing guarantees or paid-up capital. EU leaders did not, however, agree on how to raise those funds, and left open details on how

1.1.9 Economic sentiment index and subindexes, eurozone



Note: From February 2011, business surveys are presented exclusively in accordance with the NACE rev. 2 classification. In previous months, a combination of NACE rev. 1 and rev. 2 are used.

Source: Directorate General for Economic and Financial Affairs. http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm (accessed 23 March 2011).

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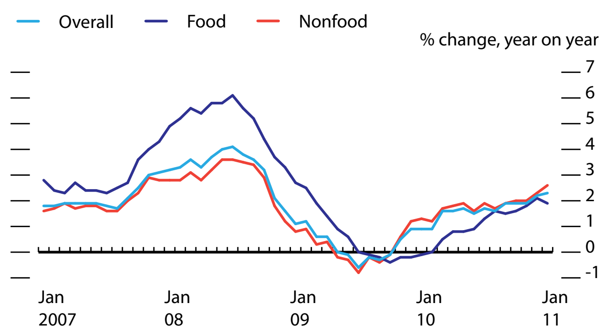
1.1.10 Harmonized indexes of consumer price inflation, eurozone



Note: Starting January 2011, a new methodology defines how seasonal products are to be treated, affecting the all-items index in the euro area by a reduction of 0.1 percentage points for January 2011.

Source: Eurostat. http://www.ec.europa.eu/eurostat (accessed 4 March 2011).

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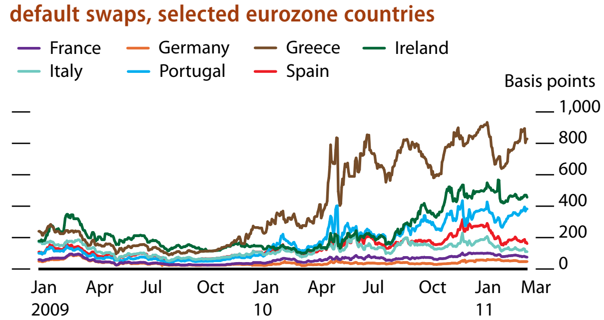
1.1.11 10-year euro-denominated government bond credit default swaps, selected eurozone countries



Source: Datastream (accessed 16 March 2011).

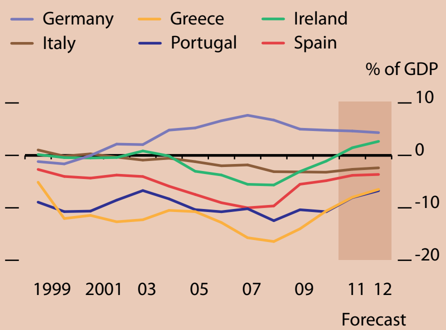
to replace the European Financial Stability Facility, which runs out in mid-2013, with a permanent European Stability Mechanism. This would be allowed to lend up to €500 billion to aid debt-distressed eurozone members.

At a more fundamental level, resolving the eurozone debt crisis will require winding down the large internal and external imbalances that lie at its heart (Box 1.1.1). The political willingness of the region's surplus countries to pay for a debt-restructuring program will depend on a credible medium-term initiative for the region's deficit countries to reduce their imbalances.

1.1.1 Eurozone sovereign debt crisis: Causes and possible solutions

The question of cohesion of a monetary union rests on whether there is convergence or divergence of living standards and macro fundamentals among member countries. In the eurozone, the main manifestations of growing divergence were the emergence of sizable and persistent current account deficits in Greece, Portugal, and Spain (and to a lesser extent France and Italy), mirrored by high current account surpluses in northern eurozone countries, especially Germany and the Netherlands. Ireland shows a persistent trade surplus, but high factor income payments abroad had increasingly contributed to a current account deficit (Box figure 1).

1 Current account



Source: European Commission, Directorate General for Economic and Financial Affairs, Annual Macro-economic Database. http://ec.europa.eu/economy_finance/db_indicators/ameco (accessed 1 March 2011).

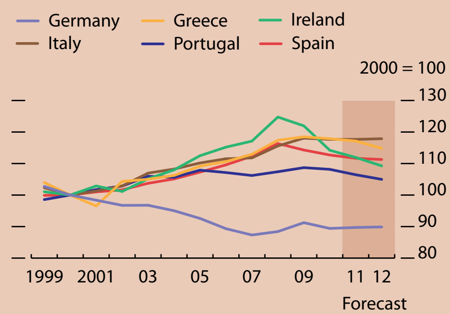
Click here for figure data

Further, the buildup of large current account deficits in peripheral countries was accompanied by a steady decline in competitiveness, as shown by relative unit labor costs (Box figure 2). These were driven by persistent price and wage differentials relative to underlying productivity trends.

Market data—wide sovereign bond spreads for example—suggest dim prospects for a quick resolution of the crisis. Revealingly, yields have not come down for the two countries receiving large bail-outs, namely Greece and Ireland. The markets are clearly awaiting more fundamental solutions.

So what might these be? Contagion to other eurozone countries can be prevented if governments in high-risk countries successfully deleverage in spite of the social and short-term economic pains of fiscal adjustment. Accommodative macro policies from surplus countries, resorting to bank recapitalization or insolvency regimes, and better risk sharing through a common eurobond, for example, could help to put the eurozone onto a path of rebalancing and fiscal sustainability.

2 Real effective exchange rate based on unit labor costs



Source: European Commission, Directorate General for Economic and Financial Affairs, Annual Macro-economic Database. http://ec.europa.eu/economy_finance/db_indicators/ameco (accessed 1 March 2011).

Click here for figure data

A promising new development here is the pact for the euro, to which eurozone leaders agreed on the general principles in the March summits. The pact aims to increase competitiveness and tighten convergence among the countries of the eurozone. Under the pact, measurable yearly targets for key objectives would be enshrined in national legislation, to increase peer pressure and accountability. The pact also includes an agreement on a numerical debt-reduction benchmark.

With reform and fiscal discipline commitments by its debt-stressed members anchored in this way and the European Stability Mechanism coming into place as a permanent financial backstop facility, eurozone leaders hope to have found a response strong enough to assuage financial market sentiment now and to avert similar crises down the road. So far, market reactions have been muted.

Japan: Uncertainty compounded by disaster

GDP grew by 3.9% in 2010, after contracting by 6.3% in 2009. Rebounding exports, the low 2009 base, and a series of fiscal stimulus packages boosted growth. External demand contributed 1.8 percentage points of GDP growth, with domestic demand accounting for the rest.

Private consumption rose by 1.8% in 2010, largely due to fiscal stimulus packages on household appliances and passenger cars, making a 1.1 percentage point contribution to total growth. After that surge, however, consumption was flat in the fourth quarter (Figure 1.1.12). Growth in real exports, after a strong rebound in the first half, fell by 0.8% in the fourth quarter from the third.

A sluggish labor market continues to weigh on private consumption. Unemployment is high and job offers remain well below precrisis levels. Nominal wages grew strongly in the first half of 2010, mainly in manufacturing, before decelerating in the second, and with the labor market expected to improve only gradually, labor income is unlikely to make much headway in 2011.

Business fixed investment was generally weak in 2010, but has started to recover in recent months (Figure 1.1.13). Healthy corporate profits will add further momentum but lingering excess capacity will remain a drag. Housing investment has also started to recover. Inventory adjustment, along with lower mortgage rates and housing prices, boosted housing sales, mainly of owner-occupied houses and condominiums.

Prior to the earthquake and tsunami (Box 1.1.2), the overall outlook was mixed. The slower growth of global trade, fading effects of the fiscal stimulus, and labor market weakness all pointed to deceleration in the years ahead. The recent tragedy further clouds the immediate prospects for Japan as well as the global outlook.

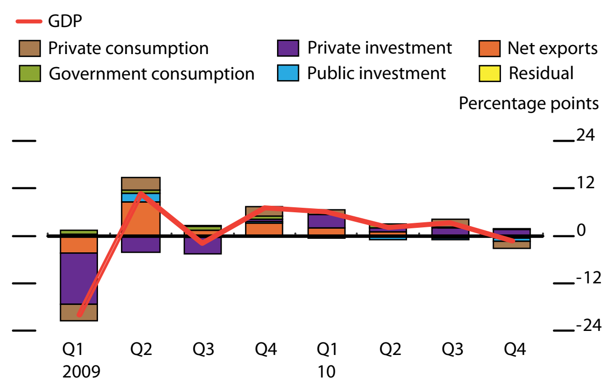
The one area where the earthquake may have a lasting and sizable impact is the global energy market. More precisely, to the extent that Japan's unfolding nuclear crisis raises long-term worldwide concerns about the safety of nuclear energy, it may precipitate a structural shift in the global energy mix.

Overall then, aside from energy, the regional and global impact of the Japanese earthquake is hard to quantify but likely to be temporary and limited.

Including the impact of the earthquake and tsunami, Japan's real GDP is projected to grow at 1.5% in 2011 and 1.8% in 2012 (2011 a shade lower than predisaster projections but 2012 a touch higher). This benign baseline scenario assumes no major aftershocks, extended power shortages, or massive radiation leaks from the Fukushima plant.

In looking over the performance of the major industrial economies, it is clear that—despite the severity of the recent crisis and the lingering uncertainties—they have returned to growth. Also that developing Asia's support arrived at a critical time.

1.1.12 Contributions to GDP growth, Japan



Source: Economic and Social Research Institute. Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (accessed 17 March 2011).

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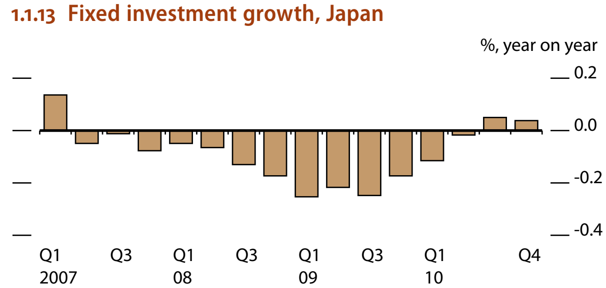
1.1.13 Fixed investment growth, Japan



Sources: Ministry of Finance, Japan. Policy Research Institute. http://www.mof.go.jp/english/pri/index.htm (accessed 23 March 2011).

Click here for figure data

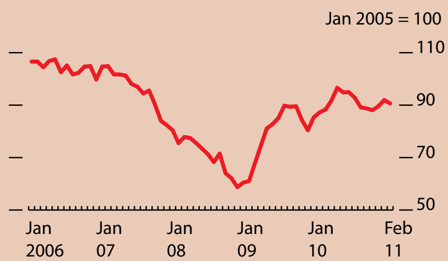
1.1.2 Economic effects of the Tohoku disaster on Japan

A Richter-scale 9.0 earthquake and a tsunami devastated the Tohoku region of Japan on 11 March (the January 1995 Kobe earthquake was 7.3). This region accounts for around 6% of Japan's GDP, 7% of its population, and 7% of the private sector capital stock.

How the disaster will affect 2011 GDP growth is hard to quantify since it is still unfolding. Economic activity in the Tohoku region will be severely hit in the short run due to extensive damage to production facilities, transport, and other infrastructure. The earthquake has also caused substantial power shortages related to the shutdown of three nuclear facilities in the area. Nuclear power supplies a third of Japan's electricity and power companies have already put into place a program of rolling blackouts.

Possible erosion of consumer and business confidence is an intangible factor. An improvement of consumer confidence after December 2008 had stalled from May 2010, reflecting the mixed outlook and overall uncertainty (Box figure). One huge short-term influence on confidence is how well the authorities contain the radiation leakage from Fukushima nuclear plant.

Consumer confidence, Japan



Source: Economic and Social Research Institute. Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (accessed 17 March 2011).

Click here for figure data

The earthquake will affect other key variables. For example, right after the disaster, the stock market plummeted while the yen rose to a post–Second World War high on expectations that Japanese firms would repatriate profits to bolster domestic balance sheets. G7 coordination has, though, stemmed the currency's rise, which would have dented confidence and prospects.

A rough parallel is the Kobe earthquake, whose impact on growth turned out to be modest. Many local macroeconomic indicators initially fell but quickly reverted to their predisaster levels. The recovery was spearheaded by government reconstruction spending, which paved the way for a robust rebound in private investment.

The magnitude of both damage and the funding for recovery are likely to be much larger than for Kobe. At that time, the damage to buildings, roads, and other infrastructure amounted to about 2% of GDP, and the fiscal outlays for reconstruction totaled little more than ¥3 trillion. Market estimates of the damage from the Tohoku earthquake are in the range of $150 billion–$200 billion, or 3%–4% of GDP.

Beyond the very short term, Japan's economic prospects are less dire, assuming that the nuclear crisis at Fukushima is brought under control. Private consumption and production are now falling but capital-stock rebuilding, largely financed by the government, will exert a positive effect in the longer run.

The one caveat to this optimistic longer-term view is that the fiscal demands of post-earthquake reconstruction will impose new burdens at a time when net public debt is over 120% of GDP. The lack of fiscal space may constrain the positive effect of the recovery-related government stimulus by requiring higher taxes. In addition, the funding demands of reconstruction may exacerbate financial market jitters about debt sustainability. Monetary policy, however, can afford to remain expansionary given near-zero inflation before the disaster, which should help to contain government borrowing costs.

Developing Asia's role in the global recovery

Developing Asia's prospects have long depended on the economic health of the major industrial countries, the main markets for the region's exports. When Indonesia, the Republic of Korea, Thailand, and other economies were hit by the late 1990s' Asian financial crisis, demand for their goods from the US and the rest of the world constituted the primary driver of recovery. Even now, the drop in industrial-country demand during the recent global downturn showed that developing Asia is not immune to a deep recession originating from outside.

But a notable shift is under way, one that accelerated during the crisis. The region itself is now exerting greater impact on the global economy. Increasingly, the region's own outlook will affect the prospects of the rest of the world, including the major industrial countries. The rising economic influence of developing Asia is a result of its change into a major player in the global landscape. In fact, when developing Asia and Japan are considered together, they are one of three main hubs of the global economy, along with the US and EU. And the region is now the world's largest net exporter of capital.

The crisis in fact marks a significant milestone, proving that the region has evolved and can now withstand even a colossal external shock. When the financial crisis that originated in the US intensified and led to a collapse in output and trade, the region's surprising resilience had global benefits. When export demand elsewhere was drying up, developing Asia's unexpectedly strong demand provided some much-needed relief—but to what extent?

Quantifying developing Asia's role in the recovery

The relative importance of developing Asia and the PRC in trade has grown, pointing to their growing role as importers. For a group of eight countries, Figure 1.1.14 shows the share of the region (proxied by 10 developing Asian economies accounting for the bulk of the region's output and trade) in their exports, and Figure 1.1.15 the PRC's share. The eight economies are the four largest industrial economies and four of the largest developing economies. (South Africa is the biggest economy in Africa; Brazil and Mexico the two largest economies of Latin America; and Saudi Arabia the biggest in the Middle East.)

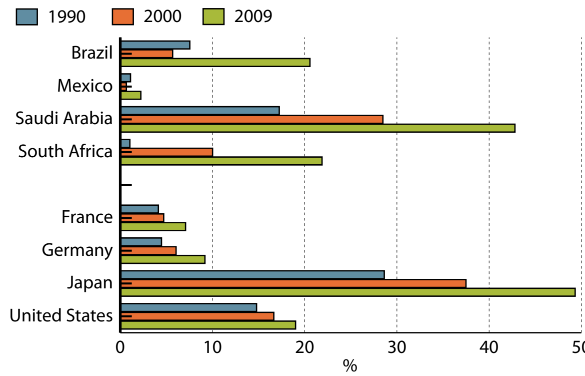
As a large and growing market for the world's goods, developing Asia contributed to the global recovery through trade (Figure 1.1.16). Germany, for example, exported $52 billion to the PRC and $103 billion to Asia-10 in 2009, when Brazil exported $19 billion to the PRC and $32 billion to Asia-10. Further, exports are growing rapidly, even for countries whose trade with the region is relatively limited. For example, South Africa's exports to Asia-10 shot up from $250 million in 1990 to $3.1 billion in 2000 and further to $12 billion in 2009.

In the depth of the crisis and the early recovery, continued strong export growth to developing Asia shows that the region was indeed providing much-needed demand, even while markets in the rest of the world contracted (Figure 1.1.17).

For both the industrial economies and the non-Asian developing countries, there is a marked difference between the growth of exports to Asia-10 and the rest of the world. In fact, for all eight economies, during the crisis the average growth rate of exports to Asia-10 exceeded export growth to the rest of the world. For the US, for instance, the average growth rate was 5.5% for the Asia-10 but a contraction of 0.4% for the rest of the world. Even more strikingly, for Brazil, the figures are 25.4% and a contraction of 0.9%.

Of particular interest is the role of the PRC. Its robust demand for imports held up well in the downturn because of

1.1.14 Share of exports to Asia-10 in total exports, eight economies

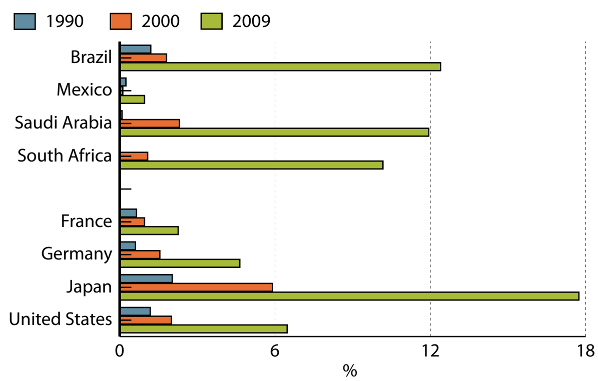


Note: Asia-10 are China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand.

Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

Click here for figure data

1.1.15 Share of exports to the PRC in total exports, eight economies



Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

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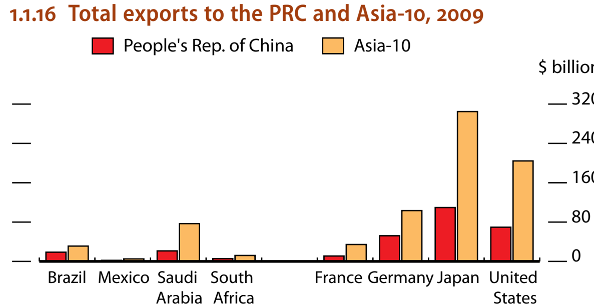
1.1.16 Total exports to the PRC and Asia-10, 2009



Sources: International Monetary Fund. 2011. Direction of Trade Statistics. February; CEIC Data Company (accessed 15 March 2011).

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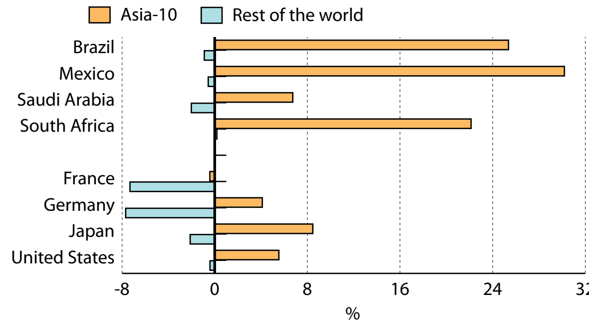
its slightly slower (but still very high) growth throughout the crisis. As with exports to Asia-10, exports to the PRC from the eight economies outpaced exports to the rest of the world (Figure 1.1.18). For example, for the US, the average growth rate was 10.9% for the PRC but flat for the rest of the world. For Brazil, the corresponding figures are a staggering 34.0% and 0.2%.

To sum up, developing Asia—the PRC in particular—provided much-needed support to the global recovery as a major market for the world's products around the crisis. Demand in the region had itself been supported by the unprecedented fiscal stimulus that authorities rolled out in the face of collapsing external demand and weak private demand. The PRC's 11% of GDP, 2009–2010 stimulus program attracted much attention but across the region governments aggressively boosted public spending and cut taxes. Although fiscal expansions were motivated by domestic needs, the demand support in developing Asia had positive global spillovers.

Although trade was the most important, there were other channels. Purchases of US, EU, and Japanese sovereign bonds by regional governments provided support during the recovery. Those purchases kept down the cost of borrowing for the industrial-country governments, thus facilitating their countercyclical fiscal expansion, and helping to stave off a deeper recession. This approach will, however, need to be unwound as recovery progresses to avoid the reemergence of the unsustainable global imbalances that were a contributing factor to the recent financial turmoil.

Developing Asia's strength has been a rare shaft of light in an otherwise gloomy environment. And as the major industrial countries face their own internal challenges to recovery, the return of higher global oil and food prices presents further complications for the region.

1.1.17 Average quarterly growth rate of exports to Asia-10, eight economies, Q3 2008–Q3 2010 (year on year)



Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

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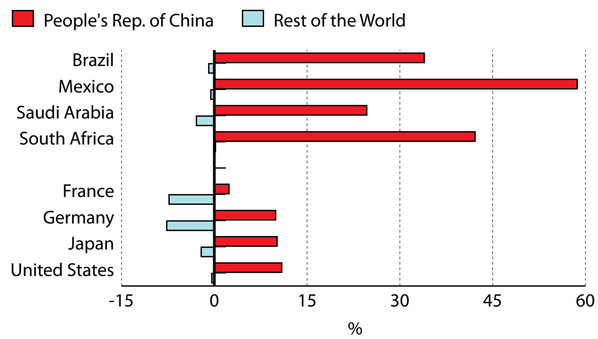
1.1.18 Average quarterly growth rate of exports to the PRC, eight economies, Q3 2008–Q3 2010 (year-on-year)



Note: Rest of the world excludes the other Asia-10.

Source: ADB calculations based on data from International Monetary Fund. Direction of Trade Statistics. February 2011; and CEIC Data Company (accessed 15 March 2011).

Click here for figure data

Resurgence of global oil and food prices

The sharp rises in global commodity prices—before and after the crisis—have substantial repercussions on developing Asia's economy. Immediately before the global crisis, oil prices leaped to around $150 in July 2008 and the price of food and other commodities also jumped. As the world economy went into a deep recession and global trade collapsed, global commodity prices also tumbled.

They subsequently rebounded on the back of the global recovery, accelerating in the second half of 2010, so much so that nonenergy commodity prices—agricultural products, metals and minerals, and raw materials—have reached record highs. Two commodities—oil and food—are especially important for developing Asia.

Global oil price trends and prospects

During the first 8 months of 2010, oil prices remained relatively stable, oscillating within a limited range of $75–$85 a barrel. Despite robust global demand growth, particularly in Asia, persistently high inventory levels capped price escalation, as did lingering uncertainty over the recovery of industrial countries.

Since September, however, prices have shown a sustained increase (Figure 1.1.19). Brent crude climbed from $77 a barrel on 1 September to $96 at end-year and was nearly $120 by mid-March.

Both demand- and supply-side factors explain the rise. Growing market perceptions of firmer industrial-country recovery lifted demand, as did the exceptionally cold winter in Asia and Europe. Disruption of supply from Libya, which normally exports around 1.3 million barrels per day (mbd) pushed up prices. The indirect effect from Libya has been much bigger, triggering broader geopolitical concerns about Middle East supply.

Global oil demand strengthened steadily during 2010, from 86.5 mbd in the first quarter to 88.9 mbd in the fourth. For the year as a whole, global demand averaged 87.7 mbd. Year on year, global oil demand rose by 3.2% relative to 2009, the strong growth partly reflecting a rebound from weak demand. Demand from countries in the Organisation for Economic Co-operation and Development (OECD) grew by 1.4% and demand from non-OECD economies by 5.2%, reflecting the two-speed global recovery. Within the non-OECD group, Asian demand climbed by 5.7%, fueled by the PRC's oil-demand growth of 12.6%.

Global oil demand will remain robust in the short run as the world recovery continues. Demand growth is projected at a shade under 2% in 2011, mirroring projected global growth and its twin-track pattern—OECD demand flat in 2011 but non-OECD demand to rise by around 4%.

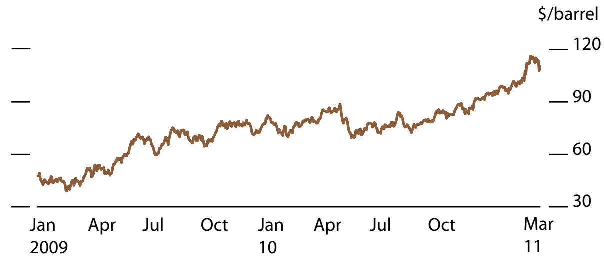
Healthy inventory levels and adequate spare capacity will, though, contain price pressures. Global oil supply is set to rise by around 2 mbd in 2011, with members of the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries each contributing about half the projected growth.

A supply-side development with major longer-term ramifications is the recovery of Iraqi output, which may rise by as much as 700,000 barrels in 2011. The restoration of political stability and security in Iraq, which has vast reserves, has led to a substantial increase in investment and production. Outside OPEC, Brazilian output is likely to be ramped up substantially in 2011, due to recently developed offshore fields.

The relatively benign global supply outlook has contributed to substantial spare OPEC capacity (Figure 1.1.20). This cushion is unlikely to shrink noticeably in the short term and will guard against sharp price surges.

The high inventories maintained by OECD countries are another limiter of price spikes (Figure 1.1.21). The inventory levels declined somewhat in the fourth quarter of 2010 and the decline is set to fall further in the first quarter of 2011 but overall supply and demand factors make a sharp fall in inventories unlikely.

1.1.19 Price of Brent crude



Source: Bloomberg (accessed 16 March 2011).

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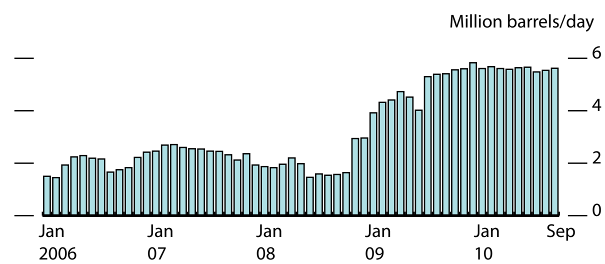
1.1.20 OPEC effective spare capacity



Source: JP Morgan Energy Strategy.

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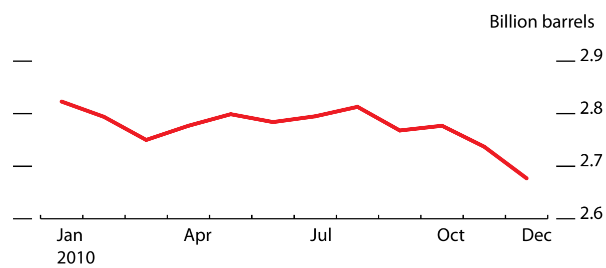
1.1.21 OECD oil inventories



Source: JP Morgan Energy Strategy.

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The civil conflict in Libya, which erupted in February 2011, has the potential to be very disruptive to oil supplies. Libya is an OPEC member and ranks among the top 15 exporters. It usually pumps around 1.6 mbd but output may have fallen by more than half.

Prices will be higher in both 2011 and 2012 due to the Libya factor, and there has been a significant increase in market expectations for oil prices since the outbreak of the fighting there (Figure 1.1.22). Those same expectations suggest, however, that the Libya effect will be limited, as evident in the decline in medium-term forward prices between 21 February and 16 March. The broader implication is that market perceptions of supply and demand fundamentals remain unchanged. Libya is likely to be a temporary shock unless instability threatens the entire Middle East.

The baseline medium-term outlook is still grounded on adequate spare capacity, bolstered by expansion of global output until the middle of this decade. The risk in that period of a sharp escalation is modest. Japan's disaster may, however, have medium-term ramifications if it leads to a significant shift of global energy demand from nuclear power to oil.

Global food price trends and prospects

Global food prices are set to remain high in 2011.[1] They have climbed sharply since bottoming in early 2009 and accelerated fast in the second half of 2010, as part of a broader surge in commodity prices enveloping oil and energy, metals, nonenergy, and agriculture (Figure 1.1.23).

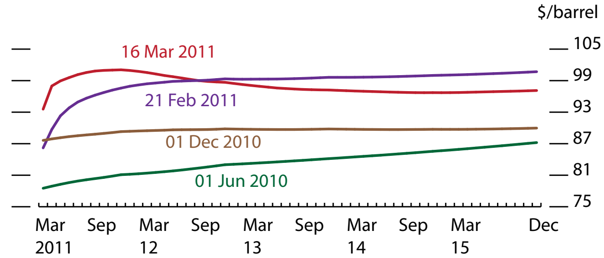
The world witnessed a similar commodity boom immediately before the global crisis. After commodity prices reverted to their historic trend levels in late 2008 as a result of the global slump, it was widely believed that they would rise at a moderate speed in the medium term. The events of the last few months have realigned expectations. In fact, while oil remains well below its peak of July 2008, many food and other nonenergy commodities have reached new highs.

In February 2011, for example, the benchmark index for food prices of the Food and Agriculture Organization of the United Nations reached the highest level (nominal and real) since its inception in January 1990. The index went up by 34.2% relative to a year earlier, driven by cereals, edible oils, and dairy products (Figure 1.1.24).

Fortunately, though, the price of rice—along with wheat one of the two staple cereals produced and consumed in Asia—moved up less rapidly in June 2010–February 2011, by 17% (Figure 1.1.25). A key difference with the food-price crisis of 2007–2008, this rise was moderate partly because Thailand and Viet Nam released ample supplies from their rice stocks to mitigate rising price pressures. The price of wheat, however, almost doubled in the same period.

Domestic rice and wheat prices in many developing Asian

1.1.22 NYMEX futures price, West Texas Intermediate



Source: Bloomberg (accessed 16 March 2011).

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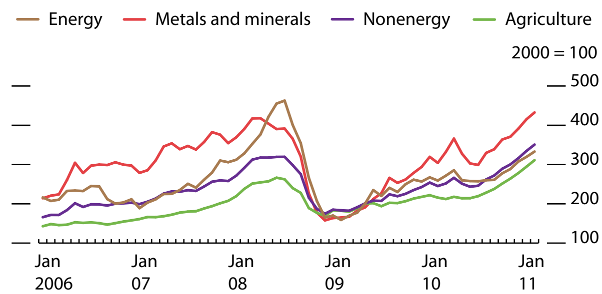
1.1.23 Commodity price indexes



Source: World Bank. Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 4 March 2011).

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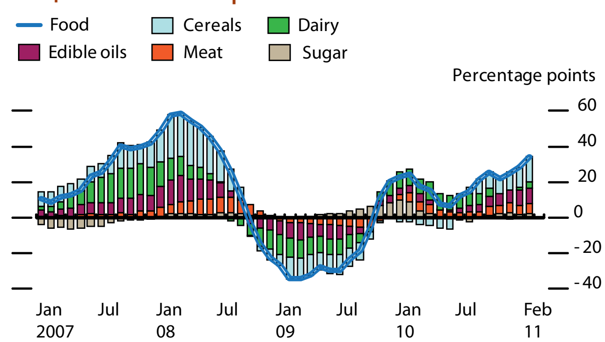
1.1.24 Sources of food price increases



Source: ADB calculations based on data from Food and Agriculture Organization of the United Nations. Food Price Index. http://www.fao.org/worldfoodsituation/en (accessed 4 March 2011).

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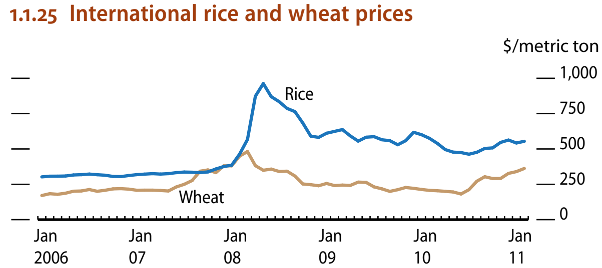
1.1.25 International rice and wheat prices



Source: Food and Agriculture Organization of the United Nations. Global Food Price Monitor. http://www.fao.org/giews/english/index.htm (accessed 1 March 2011).

Click here for figure data

economies are following the rise in international grain prices. Domestic rice prices went up, for example, by 21.4% in Bangladesh, 21.6% in Indonesia, and 36.7% in Viet Nam from June 2010 to February 2011. But while international wheat prices rose by 99.6% in the 8 months to February 2011, domestic wheat price increases in the region in local currency terms generally did not exceed 70%.

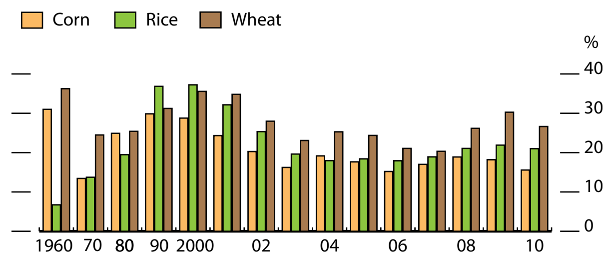
The food price surge was triggered by weather-related production shortfalls and reinforced by cyclical factors. In the second half of 2010, crops failed in Australia, Europe, North America, and Argentina. In addition, the worst La Niña weather pattern in three decades led to widespread flooding in many food-producing countries. Corn, coffee, rice, wheat, and sugar output have all been hit. The strong economic recovery (boosting demand for food) and rising oil prices (raising input costs) also played a role.

Structural factors that are driving long-term demand trends also come into play in the current price surge. Such factors include a growing world population, strong income growth in emerging economies, and changing diets from staple foods toward increased consumption of meats. The supply–demand balance in global food markets has tightened, as reflected in a decline in stock-to-use ratios for corn, rice, and wheat since around 2000 (Figure 1.1.26).

Global food prices are likely to remain elevated and volatile in the short term. Grain stocks have been falling as production has been unable to meet demand. Production in 2011 will therefore be crucial in determining stability in global markets. Supply uncertainties are also rising on weather disturbances.

The international price of wheat is expected to remain high, exacerbated by the ongoing drought in the major wheat-producing belt in the PRC and extremely low global inventory stocks. The outlook for rice is more uncertain but upward pressures will persist if La Niña weather conditions continue to affect production.

1.1.26 Stock-to-use ratios of selected grains



Source: United States Department of Agriculture. Foreign Agricultural Service. http://www.usda.gov (accessed 4 February 2011).

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Risks to the global outlook

Although the global recovery is showing signs of firming, it is still uneven and laden with risks. The risks to the outlook for the major industrial countries differ, but weakness in one could undermine recovery in the others—and have spillover effects globally. Developing countries are more susceptible to instability originating from rising commodity prices, and for those developing countries that have bounced back fastest from the recent downturn, overheating is a growing concern.

Persistent weakness of labor and housing markets in the United States

The health of the US economy has a strong impact on the global economy. The immediate prospects for the country have brightened somewhat with the support of monetary and fiscal stimulus, but it is still unclear whether private demand is strong enough to stand on its own. Persistent weakness of the labor and housing markets in particular are a drag on private consumption and investment.

Despite unemployment falling to 8.9% in February, without more sustained progress, uncertainty over jobs will continue to damp consumer confidence and hold back consumption. A weak housing market inhibits households from repairing their balance sheets, and may also prevent workers from moving to more promising locations for jobs.

Sovereign debt risk in the eurozone

The sovereign debt problems pose a serious downside risk for international financial markets. The wide spreads between 10-year government-bond yields for Germany and for peripheral countries—Greece and Ireland in particular—show that the markets have real doubts about these two countries' fiscal sustainability. Although the EU and IMF averted a crisis in 2010, the risk of disorderly debt crisis remains.

These two economies are small, but crisis in either of them could jeopardize the financial stability of the eurozone, the EU, and beyond, given the substantial financial links between them and the eurozone's core economies. Such disruptions have the potential to spill over into global financial markets as well.

Uncertain aftermath of the disaster in Japan

It is premature to gauge the full economic impact of the huge earthquake and tsunami that hit Japan on 11 March 2011, either for Japan or the rest of the world. The effects of such natural disasters are typically large in the short run, when production is disrupted and private consumption suffers. Given the role of Japanese firms in global production networks, supply-chain disruptions could impede growth elsewhere, particularly where suitable replacements are not readily available. In the longer run, government reconstruction programs will help to revive private investment.

The benign baseline scenario of quick normalization assumes that there will be no major aftershocks, extended power shortages, or widespread radiation contamination (discussed further in Box 1.2.2 below).

Fiscal risks in industrial economies

Fiscal risks manifest themselves differently in the eurozone, US, and Japan. Those eurozone peripheral countries facing mounting concerns over their sovereign debt are pursuing austerity programs to improve their public finances. While such programs are necessary to avert default and bolster market confidence, they act as a drag on economic activity (as seen in Greece's shocking contraction). The slowdown of growth may then hit tax revenue and worsen the fiscal position in the short run.

In the US and Japan, fiscal risks stem from failure to develop medium-term consolidation plans. Both countries face a dilemma, because the fragility of their recoveries calls for a continued accommodative fiscal stance. In Japan, the dilemma is further heightened by the expected fiscal burden of disaster relief and recovery efforts stemming from the earthquake and tsunami. Given the escalation of public debt in both countries, such a failure could erode financial market confidence, which would push up borrowing costs, further exacerbating the problem.

High and volatile global commodity prices

The return of global growth, combined with lack of readily available spare production capacity, is driving demand for both oil and food. The narrowing of the gap between demand and potential global supply, along with the erratic recovery of the major industrial countries, will cause greater price volatility. The probability of a sustained surge of food prices in 2011 remains limited, however, because temporary supply factors were largely in play. Still, the short-term outlook for high and volatile commodity prices will add to inflation pressures, especially in high-growth developing countries.

Risk of overheating in fast-growing developing countries

Robust recovery and growth are giving rise to incipient overheating and inflation pressures in some developing countries. Risks here are notably evident in fast-growing developing Asia and are becoming apparent in other areas, such as parts of Latin America. Capital inflows and rising commodity prices may exacerbate asset and consumer price inflation. Any failure by policy makers to damp overheating pressures will jeopardize macroeconomic stability and growth. Given the current dependence of global growth on developing-country dynamism, this would cloud the global outlook.

The global recession may have ended, but its aftereffects linger. While advanced economies are struggling, the prospects for developing Asia are much more positive. Yet even there the risks are tilted toward the downside.

Firming recovery in developing Asia

Developing Asia is on a firm path of recovery. The policies that were put in place at the onset of the recent global turmoil set the stage for strong performance last year. Low inflation from the weak global demand allowed policy makers to respond aggressively with fiscal and monetary stimulus. Consequently, 2010 growth for most countries in the region surprised on the high side relative to the forecasts in the *Asian Development Outlook 2010*.

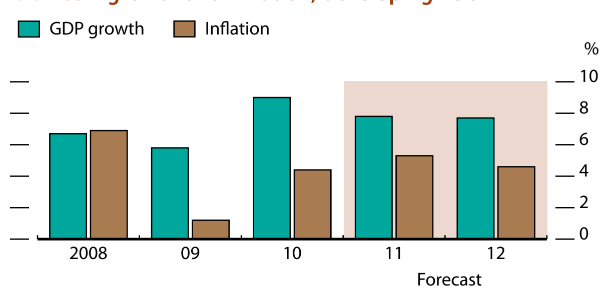
A year ago, the question facing policy makers was how to time the normalization of fiscal and monetary policies to avoid undermining the nascent rebound. At that time, the risk of overheating was much lower because of the soft global demand, hence erring on the side of continued stimulus made sense. Now that the region's growth is on a more solid footing, it is time to reevaluate that approach. Many of the stimulus measures are being wound down, but the fiscal and monetary stances are not yet back to their precrisis positions.

The region's continued rapid growth is far from guaranteed, and as discussed in the previous section, the global recovery faces many risks. The region's outlook, however, is for continued strong growth in 2011–2012, but with the threat of inflation looming closer. When weighing their macroeconomic policy choices, many of developing Asia's policy makers see that the balance has tipped toward avoiding overheating.

Recent trends and outlook

Developing Asia bounced back rapidly from the effects of the global recession and will consolidate these gains in the coming years. The region is projected to grow by 7.8% in 2011 and 7.7% in 2012 (Figure 1.2.1). Growth in 2011, as in 2010, will be broad-based, and rest on both domestic and external demand. Private consumption and investment are expected to take over as the mainstay of domestic demand.

1.2.1 GDP growth and inflation, developing Asia



Source: Asian Development Outlook database.
Click here for figure data

The region's moderation from the rapid 9.0% growth in 2010 stems from slower growth of the major industrial economies, more measured expansion of world trade, and the unwinding of fiscal and monetary stimulus. The exceptional performance of 2010 was partly due to the base effect, following the relatively slow growth in 2009. The moderation marks a welcome return to growth rates that can be sustained without aggravating price pressures.

Although macroeconomic policies are heading back to their precrisis positions, most are still accommodative relative to 2008. Price pressures are building, and some countries may need to act preemptively to corral inflation before it accelerates further. Consumer prices rose by 4.4% in 2010, accelerating from 1.2% in 2009—a steeper rise than in the major industrial countries. The uptick is being driven by a combination of external factors (global oil and food price shocks) and the robust domestic recovery. Although many central banks have already taken action, inflation is expected to accelerate further to 5.3% in 2011 before tapering off to 4.6% in 2012.

All subregions of developing Asia performed well in 2010. They are expected to continue to do so in the next 2 years, if the major risks are not realized.

East Asia rebounded strongly in 2010 (Figure 1.2.2), led by the return of the PRC to double-digit growth. Aggregate GDP for the five economies in this subregion expanded by 9.6%, faster than the rest of developing Asia. Growth in the PRC of 10.3% was powered by a continuing surge in investment and robust private consumption, and its external trade flows fully recovered from the slowdown in 2009. The recovery in world demand for manufactured goods benefited the subregion's newly industrialized economies (Hong Kong, China; the Republic of Korea; and Taipei,China), and rising demand for raw materials boosted Mongolia. East Asia is expected to moderate somewhat, to 8.4% in 2011 and 8.1% in 2012, as policy stimulus measures are withdrawn.

The PRC's resilience helped speed the recovery in East and Southeast Asia (Box 1.2.1). Even in 2009—the trough of the global recession—the PRC grew by 9.2% while world output was flat and global trade contracted.

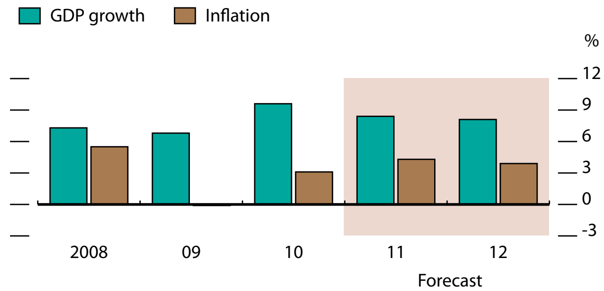
Inflation in the East Asian economies is forecast to pick up in 2011, owing to higher global prices of commodities and oil, reinforced by robust domestic demand. The subregional inflation rate is put at 4.3% in 2011, easing to 3.9% in 2012.

Southeast Asia's exceptionally strong recovery in 2010 (Figure 1.2.3) reflected the steep rebounds of the more open economies. Aggregate growth propelled to 7.8% from just 1.2% in 2009, largely driven by Malaysia, Singapore, and Thailand, whose economies had contracted during the global slump of 2009. Other major economies in this subregion—Indonesia, the Philippines, and Viet Nam—also registered solid growth, after slowdowns in the previous year. Recoveries in exports and investment underpinned expansion. Growth is expected to step down in light of the higher 2010 base, a moderation in export growth, and policy tightening by governments. GDP will expand by 5.5% in 2011 and 5.7% 2012.

Inflation in Southeast Asia is accelerating. Consumer prices in the subregion rose by a moderate 4.0% on average in 2010, picking up to 5.1% in 2011. However, inflation pressures have been more tenacious in some countries—Viet Nam, for example, is expected to hit double digits. Subregional inflation is expected to come down to 4.2% in 2012, with appropriate policy responses and slower growth in global commodity prices.

South Asia was less affected by the crisis and growth remained fairly strong throughout, dipping only slightly when the global recession hit its nadir (Figure 1.2.4). India is setting the pace for South Asia's overall performance. The subregional

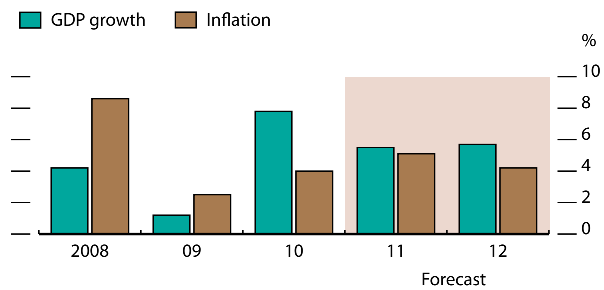
1.2.2 GDP growth and inflation, East Asia



Source: Asian Development Outlook database.

Click here for figure data

1.2.3 GDP growth and inflation, Southeast Asia



Source: Asian Development Outlook database.

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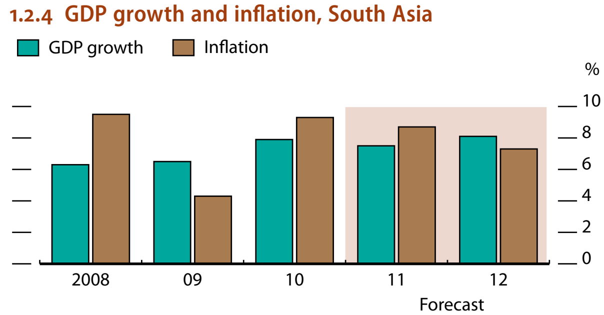
1.2.4 GDP growth and inflation, South Asia



Source: Asian Development Outlook database.

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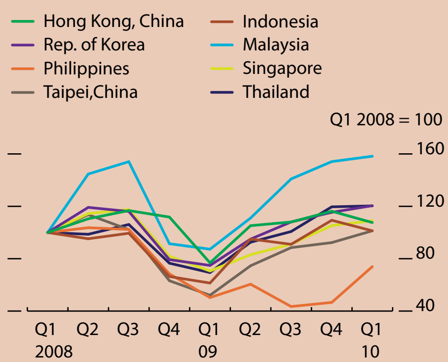
1.2.1 Impact of the People's Republic of China on East and Southeast Asia's recovery

Developing Asia has traditionally relied on exports to the US and other industrial countries for growth. The PRC's emergence as a global heavyweight is fueling hopes that it can supplement the US as an additional source of demand and growth. Those hopes are especially pronounced in East and Southeast Asia, which have close trade links with the PRC.

The box figure shows quarterly export volumes from the two subregions to the PRC. Their export volumes to the PRC decreased by 10%–50% during the global downturn but in most cases more than fully recovered to starting levels. This suggests a possible link between the robust recovery of the two subregions and their exports to the PRC.

Quarterly export volumes to the People's Republic of China



Source: Park and Shin (forthcoming).

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The PRC's support for GDP growth in the rest of the region involves the trade channel. If the PRC is indeed an engine of growth, there should be a positive relationship between the PRC's imports from, for example, Malaysia and that country's output level.

Of particular interest are the relative size of the impact of the PRC's imports on Malaysia's GDP and the evolution of this size over time. An impact that is comparable to the impact of US imports would support the view of the emergence of a second engine of growth. Further, an impact that grows over time relative to the US impact would also support a twin-engine paradigm.

When this hypothesis is tested econometrically, two key findings emerge. In the short run, the PRC's imports seem to exert an independent, positive impact on its neighbors' growth. This impact is especially evident if we include the global crisis period. For many countries, exports to the PRC had a quantitatively similar impact as exports to the US on their output

However, in the long run, the positive impact of the PRC's imports on its neighbors' output largely reflects US demand. That is, US demand for final goods is driving the PRC's demand for components from, say, the Republic of Korea.

The evidence has two interesting implications. One is that exports to the US still have a big effect on the performance of East and Southeast Asian economies, despite Asia's growing weight in the world economy. The other is that exports to the PRC contributed to its neighbors' recovery from the global crisis. This provides some grounds for optimism about the PRC's role as a second engine of growth.

Source

Park and Shin (forthcoming).

giant's recovery to 8.6% growth was both robust and broad-based even in the face of fiscal consolidation and a substantial tightening of monetary policy during the year. This helped to boost subregional growth to 7.9% in 2010.

India's strong growth will moderate somewhat—8.2% in 2011—before picking up again in 2012 to 8.8%. Consequently, growth in South Asia is expected to dip to 7.5% in 2011 and come up again to 8.1% in 2012. Sri Lanka's peace dividend continues to support its expansion.

Inflation in South Asia averaged 9.3% in 2010, much above the 4.3% of a year earlier when decelerating inflation generally prevailed. The high subregional average is almost entirely due to high food inflation in India and continued double-digit inflation in Pakistan. South Asia's inflation is expected to stay high at 8.7% in 2011 and ease to 7.3% in 2012, with global food and oil prices the main culprits.

Central Asia's economies benefited from the higher international commodity prices. Much higher prices for the subregion's key exports (oil, metals, cotton, and gold) supported the recovery (6.6% growth in 2010) and will stay important drivers during the forecast period (Figure 1.2.5).

In Kazakhstan, the largest subregional economy, the recovery was V-shaped, as growth came in at 7.0% on a resurgence in external demand (particularly oil) and domestic anticrisis measures. The non-oil economies strengthened with economic revival in the Russian Federation, their main source of remittances, trade, and finance. Growth in all Central Asia is expected to rise slightly to 6.7% in 2011 and 6.9% in 2012.

Across the subregion, inflation tended to accelerate throughout the year, largely due to higher food prices. It averaged 7.1% in 2010, up from 5.9% in 2009. Subregional inflation is expected to accelerate further to 8.2% in 2011. Higher food prices in all countries and higher energy prices in the oil importers are the main instigators. Moderation in food prices in 2012 will provide some relief, and inflation should ease to 6.6%.

Growth in the Pacific strengthened in 2010 (Figure 1.2.6). Most of the 5.2% growth is attributable to the resource-rich economies of Papua New Guinea, Timor-Leste, and Solomon Islands. These economies benefited from higher global prices for mineral and agricultural resources, new investment, and higher government revenue from resources.

Income from tourism and remittances generally increased as the global economic performance improved. However, the solid aggregate growth masked a marginal GDP gain in Fiji (0.1%) and zero to slight growth in most of the small Pacific islands. Growth should reach 6.3% in 2011, due in part to the start of a large natural gas project in Papua New Guinea, before settling back to 5.4% in 2012.

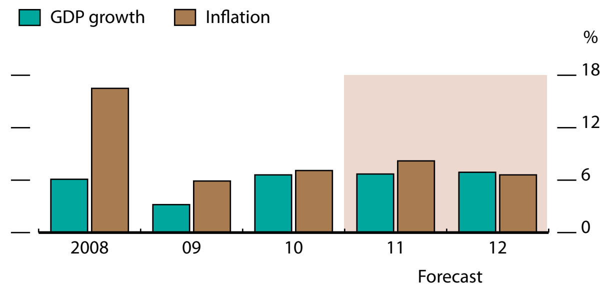
Pacific inflation is also picking up alongside global commodity prices as these import-dependent countries cope with rising world food and oil prices. Inflation reached 5.9% in 2010 and is forecast to hit 6.5% in 2011, before falling back to 5.6% in 2012.

Developing Asia's overall current account surplus is falling—from 4.7% of GDP in 2009 to 4.1% in 2010—and is projected to decline further (Figure 1.2.7). Rising commodity prices, especially for oil, and the region's strong GDP growth are raising its imports. Under the forecasts for even higher oil prices with continued strong growth, the balance is projected to fall further to 3.3% of GDP in 2011 and 3.0% in 2012.

It would, however, be premature to interpret this movement as an unwinding of the global current account imbalances that persisted before the crisis. Lasting rebalancing will require key structural changes in both the current account surplus countries in the region and the US.

The region is forecast to continue its strong growth in the coming years, with the rate moderating to a more sustainable pace. There are, however, risks.

1.2.5 GDP growth and inflation, Central Asia



Source: Asian Development Outlook database.

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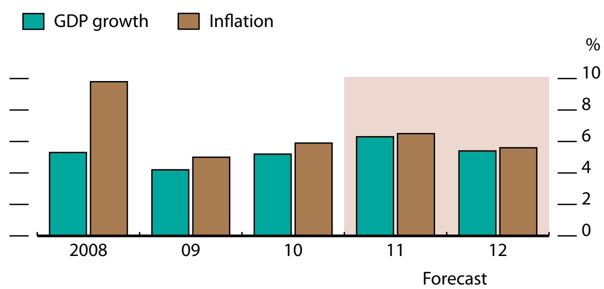
1.2.6 GDP growth and inflation, the Pacific



Source: Asian Development Outlook database.

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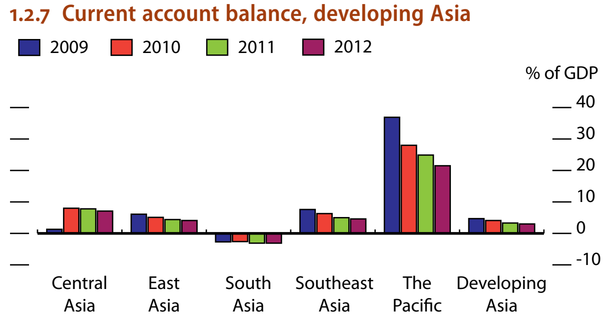
1.2.7 Current account balance, developing Asia



Source: Asian Development Outlook database.

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Risks to the regional outlook

For developing Asia, the main risks to the outlook are possible prolonged sluggish growth in the major industrial countries and the challenge of managing price pressures early. The unfolding effects of the Japanese earthquake and tsunami will also need to be monitored carefully (Box 1.2.2).

Continued slow industrial-country expansion

The downside risks to the global outlook apply as well to developing Asia. While the region has supported industrial-country recovery, it is not clear how well its own growth would hold up if faced with prolonged sluggish growth in advanced economies. As will be discussed in Part 2, *South–South Economic Links,* expanding economic ties outside the region's traditional markets will be important to sustain future growth and global stability, but this shift will not come easily. In the short run, developing Asia's fortunes are still linked with those of the US, eurozone, and Japan.

Uncertain regional impacts from the Japanese disaster

The massive earthquake and tsunami that hit Japan on 11 March 2011 pose a risk, too, especially if production disruptions persist for some time. In addition to the effect on exports in the short term, extended disruptions would affect the regional production networks. The region is also closely tied to Japan through foreign direct investment and other financial flows.

Building inflation pressures

Higher international oil and food prices are posing a risk for global growth generally. Developing Asia, as a net importer of commodities, could see the recent price surges undermine its performance, too.

Fuel enters the household consumption basket directly, but oil is also a critical factor of production. Rising oil prices push up production costs and hence overall price levels. In contrast, food price effects are limited to the direct effects, but they also account for a large share of household spending in the region (Table 1.2.1). For example, the share of food is around 30% in the PRC and over 45% in India.

Model simulations show that a 30% increase in both oil and food prices over their 2010 levels can depress the region's growth by 0.7 percentage points and can add 1.7 percentage points to its inflation rate (Box 1.2.3). The macroeconomic effects of oil price shocks tend to be bigger because of their indirect effects through higher input costs.

As production levels return to their potential, internal price pressures could add to the effects of the external price shocks. Although still manageable, inflation is trending upward, and some economies are showing signs of overheating. Capital inflows from industrial countries, where the monetary stance remains loose, may add further price pressures. As the recovery firms, policy makers may need to put a higher priority on containing inflation.

Table 1.2.1 Food weights in consumer price index baskets

Economy	Share (%)
Developing Asia	
Bangladesh	58.84
Philippines	46.58
India	46.19
Sri Lanka	45.50
Cambodia[a]	44.78
Pakistan[b]	40.34
Viet Nam	39.93
Indonesia[c]	36.20
Thailand[a]	33.01
Malaysia[a]	31.40
China, People's Rep. of[b]	30.20
Hong Kong, China	26.67
Taipei,China	26.08
Singapore[a]	22.05
Korea, Rep. of[a]	14.04
Major industrial economies	
Japan[b]	25.90
United States[b]	14.80
Eurozone	14.00

[a] Includes nonalcoholic beverages. [b] Includes beverages. [c] Includes beverages and tobacco.

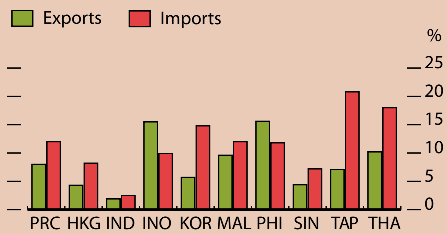
Sources: CEIC Data Company (accessed 1 March 2011); National statistics websites.

1.2.2 Tohoku disaster: Effect on developing Asia's economies

Japan is the world's third-largest national economy, and the recent earthquake and tsunami are bound to reverberate on the global and Asian economies through various channels.

The main mechanism will be trade. The earthquake will trigger a short-term decline in the exports of Japan's major trading partners. Japan accounts for a significant share of developing Asia's trade (Box figure 1), especially East and Southeast Asia.

1 Share of Japan in exports and imports, 2009



PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PHI = Philippines; SIN = Singapore; TAP = Taipei,China; THA = Thailand.

Sources: International Monetary Fund. 2011. Direction of Trade Statistics. February; CEIC Data Company (both accessed 21 March 2011).

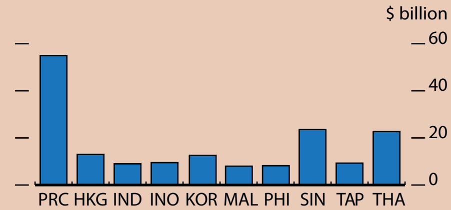
Click here for figure data

In trade, since Japan plays an important role in global supply chains and regional production networks, short-run regional and global production may be disrupted. As production of semiconductors, auto parts, and optical lens is suspended in the quake-hit Tohoku region, concern about a shortage of supply is growing within and outside Asia. Such disruptions are especially significant for East and Southeast Asia, which are tightly integrated with Japan in regional production networks. This production network linkage is why, for example, the PRC runs a large and persistent trade deficit with Japan.

Beyond the short run, the impact on trade will be mixed and differ for different products and different countries. For example, imports of reconstruction materials and energy products will rise.

Finance is another important channel, as Japan is a major exporter of capital and a significant source of foreign direct investment (FDI) for countries in the region (and beyond). Again, because of the production network links, Japanese investment is particularly notable in East and Southeast Asia (Box figure 2). As Japanese firms focus on reconstruction at home and bolster their balance sheets, they will curtail their FDI and other outward investment.

2 Japan's outward FDI stock, end-2009



Note: For country acronyms, see Box figure 1.

Source: Japan External Trade Organization.

Click here for figure data

Another channel of impact is commodity market prices. Japan is a globally significant net importer of commodities. It imports, for example, around 4.3 million barrels of oil a day. Unsurprisingly, some commodity indexes initially fell heavily after news of the earthquake, though the impact on most commodity prices will wear off quickly.

Where there may be some lingering effects is in energy markets. The unfolding nuclear crisis may raise worldwide concerns about the safety of nuclear energy, and may benefit energy exporters such as Kazakhstan and Timor-Leste if those concerns lead to a medium-term shift in the global energy mix.

Other transmission channels include tourism from Japan and remittances of those foreign workers likely to be affected in the very short term. But the overall negative impact on developing Asia is likely to be limited in both magnitude and duration, and concentrated in East and Southeast Asia.

The disaster shows that even well-prepared advanced economies find it difficult to cope with natural shocks, and thus the need to be well prepared. This is even more urgent for developing Asia, which accounted for 61% of global fatalities and 90% of all people affected by natural disasters in 1970–2008. Developing countries are of course more vulnerable to natural disasters because of weaker infrastructure and lack of anticipatory measures.

In developing Asia, earthquakes are the single most destructive disaster, accounting for just over 420,000 deaths and $156 billion in damage in 2000–2010 (Box table).

A wide range of policies are available for developing Asia to reduce its vulnerability. Above all are anticipatory measures, including the built and natural environments; early-warning systems; and emergency-response plans.

Natural disasters in developing Asia, 2000–2010

	Earthquake		Flood		Storm		Drought		Epidemic
	Deaths	Damage ($ bn)	Deaths	Damage ($ bn)	Deaths	Damage ($ bn)	Deaths	Damage ($ bn)	Deaths
Central Asia	74,965	5.6	5,910	10.5	727	1.6	180	0.8	3,708
East Asia	91,003	130.9	9,302	66.6	5,582	73.4	134	10.8	769
Pacific	59	0.0	56	0.1	270	0.1	0	0.0	381
South Asia	73,221	6.9	18,668	19.7	6,856	2.9	20	1.5	2,964
Southeast Asia	183,979	12.8	7,701	5.8	147,457	9.4	0	0.7	2,034
Total	423,227	156.3	41,637	102.7	160,892	87.4	334	13.8	9,856

Source: EM-DAT, The International Disaster Databases, Centre for Research on the Epidemiology of Disasters. http://www.emdat.be/database (accessed 16 March 2011).

1.2.3 Macroeconomic impacts of oil and food price shocks: Simulation results

The impact of higher global oil and food prices on developing Asia were simulated using the Oxford Global Economic model.[1] The model was used to generate projections of two key economic variables—GDP growth and consumer price inflation—in 10 regional economies listed in Box figure 1. The simulations help to quantify the short-run effects of changes in macroeconomic variables.

The model assumes that the region's monetary authorities will gradually tighten monetary policy over the next 2 years in response to the inflation impact of higher oil and food prices. Monetary adjustment is motivated by inflation concerns, but it will have a negative effect on private demand, especially investment, and hence growth.

To trace the potential impact of the rise in global oil and food prices on developing Asia in 2011 and 2012, the following scenarios were run. To simulate effects of international price spikes, global oil prices were increased temporarily by 30% in 2011 (from the 2010 level) and then allowed to fall back by 3% in 2012. This would correspond to a scenario where market fears about Middle Eastern supply subside as the Libyan civil conflict moves toward some sort of resolution.

Similarly, global food prices were increased temporarily by 30% in 2011 (from the 2010 level) and then reduced by 5% in 2012. This corresponds to a scenario where temporary weather-related production shortfalls are the immediate catalyst of the price surge.

The two shocks are examined separately, and as a joint shock. There is some relationship between oil and food prices: higher oil prices raise production costs, such as fertilizers, irrigation, and transport. The effects of the shocks are compared with the baseline of oil and food prices remaining at their 2010 levels.

The model simulations show that oil and food price shocks could dent developing Asia's growth but do not derail the robust momentum of its recovery. An oil price shock has a visibly bigger effect. This is plausible since the region's dependence on imported oil is substantially higher than its dependence on imported food. An oil price shock cuts the region's growth by 0.5 percentage points in 2011 and 0.7 percentage points in 2012.

The impact of the food price shock retards the region's growth by 0.1 percentage points in 2011 and 0.2 percentage points in 2012.

Predictably, combining the oil and food price shocks magnifies their impacts. Together they knock off 0.7 percentage points and 0.8 percentage points from growth (Box figure 1). Singapore and the Philippines will be most adversely affected in 2011, India and Malaysia in 2012.

Oil and food price shocks add substantially to the region's inflation in the short run. An oil price shock has the bigger impact, lifting it by 1.0 percentage points in 2011 and 0.6 percentage points in 2012. A food price shock lifts regional inflation by 0.7 percentage points and 0.6 percentage points. Although food prices have a more direct effect on consumer price inflation than oil prices, pass-through from global prices to local prices may be higher for oil due to higher import dependence.

Higher oil and food prices together add 1.7 percentage points to inflation in 2011 and 0.9 percentage points in 2012 (Box figure 2). The projected impact will be highest in India and Singapore in 2011, where inflation will rise by more than 2 percentage points each. The impact for 2012 will be less than 1 percentage point in most of the 10 economies.

Overall, the results indicate that an oil price shock would have a bigger impact on developing Asia's short-run macroeconomic performance than a food price shock. This is true for both inflation and, particularly, growth. Such results stem from the region's greater dependence on imports for oil than for food. Also, the two shocks would have a bigger effect on inflation than on GDP growth. In light of the region's robust recovery in 2012 and incipient inflation pressures, the results further strengthen the case for stepping up vigilance on inflation.

1 Changes in GDP growth rates due to joint oil and food shocks

Source: ADB estimates.

Click here for figure data

2 Changes in CPI inflation due to joint oil and food shocks

Source: ADB estimates.

Click here for figure data

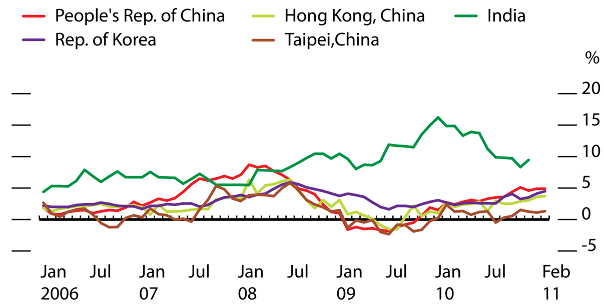
1. The model uses a macroeconometric approach that provides both forecasting and policy analysis tools. It allows significant cross-country differences in model structures but applies the same functional form of equations across countries, where possible. As a general equilibrium model, it traces the economywide effects of exogenous shocks and allows for endogenous monetary policy responses to shocks. See http://www.oef.com/OE_FA_Display_Frm.asp?Pg=GlobMod&Txt=Economic%20Models.

Inflation as a growing concern

Economic growth in Asia has been robust but it has been paced by rising inflation, sparking worries about its sustainability as this combination signals overheating. Figures 1.3.1 and 1.3.2 display year-on-year aggregate consumer price inflation in 11 developing Asian economies in the last 5 years. In virtually all cases, inflation since the global crisis is back on a rising trend, and is comparable to its precrisis rate.

At this stage, inflation in Asia may not yet be a serious problem, though it may become one. Growing uncertainties from tensions in the Middle East as well as the recent natural disaster in Japan and its consequent nuclear disruption raise the risks for higher prices of oil and commodities. This tendency intensifies pressures for further inflation hikes in Asia, requiring policy makers to pay greater attention to it. If inflation is allowed to accelerate further, it could threaten to derail growth in the region.

1.3.1 Inflation trends, East Asia and India



Source: CEIC Data Company (accessed 10 March 2011).
Click here for figure data

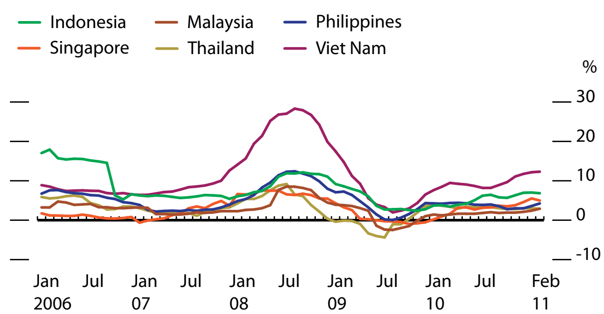
Why inflation matters for developing Asia

One reason why the region should now focus on inflation is the impact of rising global commodity prices on domestic prices. The oil price surge is a global external shock, largely beyond Asia's control. Soaring global oil prices often lead to higher domestic retail fuel prices, and broadly to higher production costs and overall prices.

The impact of higher global food prices on overall domestic prices can be substantial since food accounts for a large share of Asia's consumption basket (Table 1.2.1 above). In some countries, food accounts for at least 30% of the consumer price index. Food price inflation in these countries has reached double-digit levels in recent months, driving up general inflation.

A key factor why inflation should be a main priority for the region's policy makers is its impact on poverty and inequality. In the case of high food prices, the poor are especially vulnerable since they spend a large portion of their income on food. Inflation, especially food price inflation, can push those who subsist within the margins or just above the poverty line into poverty. Recent estimates indicate that a 10% increase in domestic food prices would raise the number of poor in developing Asia by about 65 million, a 7.2% increase in the number of poor (Box 1.3.1). Heightened inflation can thus dilute the region's hard-won gains in poverty reduction.

1.3.2 Inflation trends, Southeast Asia



Source: CEIC Data Company (accessed 10 March 2011).
Click here for figure data

By disproportionately harming the poor, inflation not only worsens poverty but can exacerbate inequality (Easterly and Fischer, 2001; Romer and Romer, 1998). Unlike the rich or the nonpoor, those living in poverty typically lack the financial assets and human capital that can protect them against the effects of inflation. In addition, since a large portion of

1.3.1 The likely poverty impact of global food inflation

A shock in the global food prices would have a direct adverse impact on poverty as the poor tend to spend more of their income on food. According to ADB (2011), about one-third of an increase in global food prices is transmitted to local food prices in the region. This means that the recent 30% or so rise in global prices will raise local prices by about 10%.

The same study estimates that a 10% rise in domestic food prices in developing Asia risks creating an additional 64 million people living on less than $1.25 per day, or pushing up the percentage of poor by about 2 points (Box table). The impact is even larger for a 20% and 30% increase in local food prices. Quite clearly, the impact of higher food prices on the region's poverty is substantial.

Given the growing frequency with which global food price shocks are hitting the region, policy makers should pursue short- and long-term policy responses to strengthen their food and energy security. A wide range of policies would better prepare developing Asia for a world of high and volatile global commodity prices.

In addition to domestic policy responses such as promoting agricultural investment and improving the domestic food supply chain, collective action can lessen vulnerability. National, regional, and global policy responses and coordination will help the region better cope with the impact of food price surges and volatility.

Impact of domestic food price increase on poverty for developing Asia

	Poverty before price increase	Poverty after food prices increase by:		
		10%	20%	30%
Proportion of poor (%)	27.1	29.0	30.9	32.9
Number of poor (million)	903	968	1,032	1,097
Change in number of poor (%)		7.2	14.3	21.4

Notes: Calculations are based on a $1.25-a-day poverty line. The estimates of poverty impact have been derived using the price elasticity of poverty, which indicates the percentage increase in poverty when food prices increase by 1%. This elasticity was estimated for both headcount ratio and poverty gap ratio for each of the 25 countries in Asia and the Pacific using the latest POVCAL database.
Source: ADB (2011).

Source

ADB (2011).

their income is spent on food, rising food prices mean they will have less for spending on other essentials. This limits their opportunities to engage in more productive activities. By narrowing economic opportunities, especially among the poor, inflation can undermine efforts to promote inclusive growth, which spreads the benefits of growth to the broader population.

High inflation is a direct threat to stable and inclusive growth since rising domestic prices can lead to social tensions. Indeed, rapidly soaring domestic prices have triggered social unrest in a raft of countries. For example, in 2008 rising soybean prices triggered riots in Indonesia and soaring rice prices in Bangladesh sparked large protests. More recently, in December 2010, India was hit by riots over high onion prices. Outside Asia, escalating food prices led to riots in Algeria and Tunisia.

In the case of the PRC, policy makers recognize high inflation as a risk to building a "harmonious society," a strategic policy shift geared toward spreading the benefits of economic development to maintain social harmony and stability. The authorities are pushing for more inclusive growth against the backdrop of inflation pressures and growing social problems. Since inflation is a major issue, the country's Economic and Social Development Plan for 2011 will focus on maintaining stable prices.

Looking ahead, there is a growing risk that nominal wage inflation will cause a wage–price spiral in developing Asia. The process may begin with workers demanding higher nominal wages to maintain or increase their real wages in the face of higher prices, which eventually forces firms to increase prices to protect their profit margins. A major cyclical driver of nominal wage increases is strong aggregate demand due to the region's robust and speedy recovery. A more structural factor is that developing Asia, labor abundant until now, may be reaching the end of surplus labor.

Surplus labor enables economies to maintain wages at relatively low and stable levels. As the surplus labor dissipates, however, developing Asia will have to grapple with rising wage pressures. The shift in Asia's demographic pattern from high to low fertility rates and population growth point to a gradual loss in surplus labor. Such a shift has led to a decline in the growth of the working-age population (Figure 1.3.3).

In the case of the PRC, the turning point is set to arrive after 2015. Between the mid-1980s and the late 1990s, about 30%–40% of the country's agricultural workers were considered surplus labor. Given demographic shifts and transfer of labor from agriculture to nonagriculture and from rural to urban areas, surplus labor has significantly declined (Cai, 2011). This decline, along with strong demand due to high economic growth, has increased the pressure for higher wages. Indeed, trends in 2000–2008 indicate fast-rising nominal wages in the PRC, averaging about 15% a year (Figure 1.3.4).

On the demand side, robust economic growth throughout Asia in 2010 seems to have pushed aggregate demand to catch up with, if not exceed, its potential output level by the start of 2011. The output gap has recently been positive in many countries, and is increasingly so (Figures 1.3.5 and 1.3.6). This suggests that countries have fully recovered from the recent crisis and are back to prior modes of operation with all their challenges, including labor market tightness (which could push wages higher) and domestic inflation pressures.

As demand pressures are already in play in most Asian economies, normal monetary policy operations are back. Given the mixed nature of Asia's recent inflation pressures, however, relying solely on monetary policy to curb inflation may have limitations since it will not be very effective to control cost-push inflation.

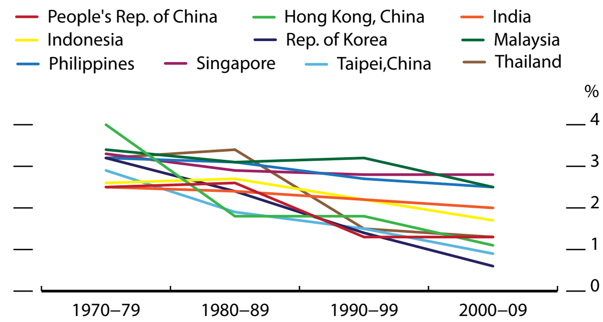
Monetary policy needs to react appropriately to inflation pressures in the region as it manages not only current inflation but also its expectations. If current inflation pushes up expectations, monetary policy should move immediately, but appropriately. This shift is required to signal that the monetary authorities will not be easy on future inflation. The move also has to be credible, and so has to be based on its likely impact on the economy in general.

Policy responses

To cope with international commodity price rises, most Asian economies have shown greater willingness to let their currencies appreciate, particularly after June 2010 (Figure 1.3.7).

In addition, authorities around the region have imposed tariff-relief measures to reduce the burden on prices for

1.3.3 Working-age population growth



Note: Refers to ages 15–64.

Sources: CEIC Data Company; World Bank. World Development Indicators online database. http://databank.worldbank.org (both accessed 16 March 2011).

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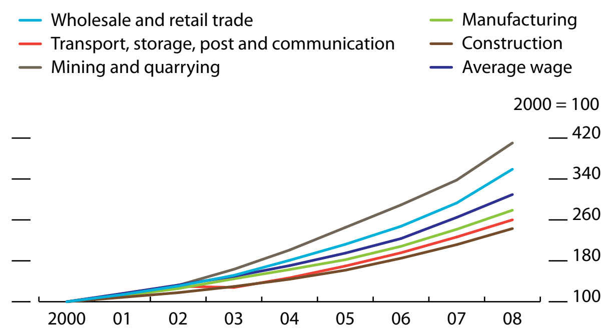
1.3.4 Average wage in the People's Republic of China



Source: CEIC Data Company (accessed 16 March 2011).

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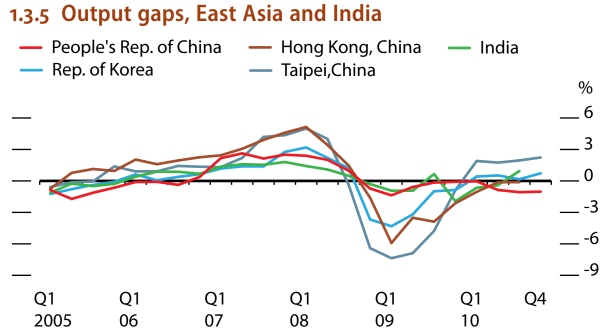
1.3.5 Output gaps, East Asia and India



Note: All the gaps are calculated as the relative difference between (X12 seasonally adjusted) actual output and its Hodrick-Prescott–filtered trend.

Source: ADB estimates.

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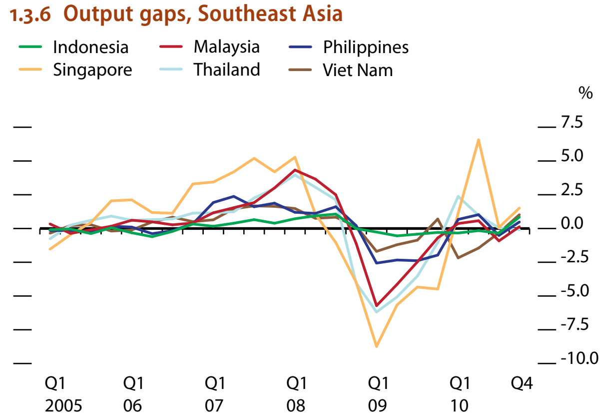
1.3.6 Output gaps, Southeast Asia



Note: All the gaps are calculated as the relative difference between (X12 sesonally adjusted) actual output and its Hodrick-Prescott–filtered trend.

Source: ADB estimates.

Click here for figure data

imported food components, with some even introducing export bans to guarantee the adequacy of domestic food supply (Table 1.3.1). The success of these measures, however, varies by country. For example, domestic food price inflation still dominates consumer price inflation in Indonesia and the Republic of Korea, but not the Philippines.

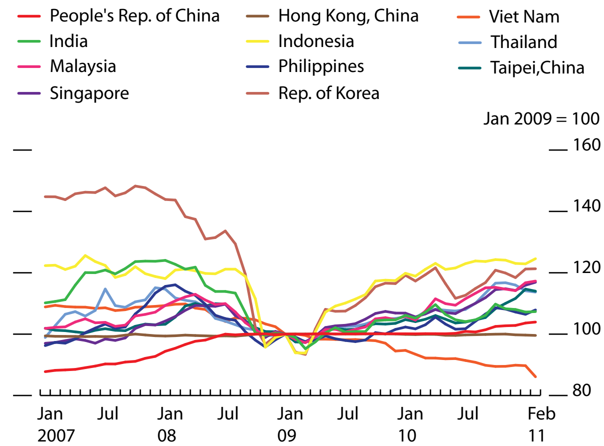
With food inflation in some countries still high, even after currency appreciation and tariff reductions, there may also be domestic factors propping up the price of food. Therefore, dealing with high domestic food inflation by addressing the external problems may not be enough. Resolving domestic hindrances like problems in the domestic supply chain and infrastructure shortfalls may also be required.

Responding to the stronger than expected recovery and recent inflation trends, emerging markets around Asia have started their monetary tightening cycle, with gradual increases in their benchmark interest rates, though at different speeds (Figure 1.3.8). Viet Nam, India, and Malaysia were among the first, in the first half of 2010, while Indonesia and the Philippines kept their benchmark rate unchanged, with Indonesia beginning to lift it only in February 2011 and the Philippines in March, pointing to a varied sense of urgency among monetary authorities.

Countries have also taken other tightening measures to manage the growth in aggregate liquidity that was partly attributable to the remnants of the massive liquidity expansion during the crisis. The PRC, India, and Indonesia, for example, raised their reserve requirements in 2010 to absorb the liquidity effect of expansionary monetary policy during the crisis. Malaysia and Viet Nam have also indicated their intention to follow suit in 2011 as a preemptive measure to contain excessive buildup of liquidity in the domestic financial system.

The task of managing high levels of liquidity in Asia is complicated by a strong domestic credit expansion following the region's rapid recovery, and huge net private capital inflows chasing higher returns in a region with stronger economic fundamentals and

1.3.7 Exchange rate index relative to the US dollar



Source: ADB estimates based on data from CEIC Data Company (accessed 15 March 2011).

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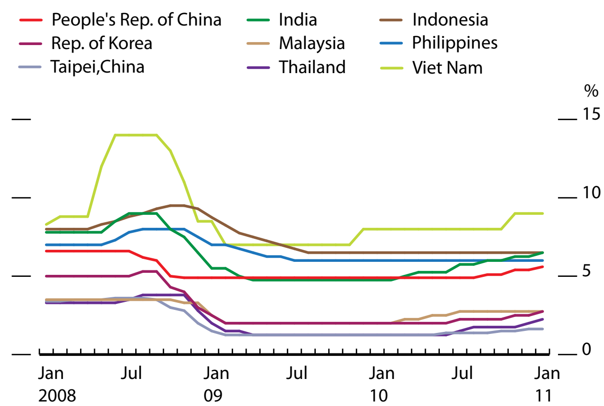
1.3.8 Benchmark rates in selected Asian economies



Source: CEIC Data Company (accessed 15 March 2011).

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Table 1.3.1 Actions taken in response to soaring international food prices

Country	Response to food price increases
Indonesia	Duties suspended on food-related items: products and materials, raw materials for animal feed and fertilizers (24 January–31 December 2011)
Korea, Rep. of	Tariff on flour cut from 4.2% to 2.5% (January–June 2011)
	Tariffs on corn, soymeal, and 32 other items to be reduced from 1% to 0% (March–December 2011)
	Tariff-free import limit for pork raised from 50,000 tonnes to 110,000 tonnes; for powdered milk raised from 21,000 tonnes to 30,000 tonnes (started February 2011, no specific duration)
Pakistan	Exports of onions via land banned
Philippines	Tariff lifted on refined sugar; zero tariff on milling wheat (29 January–31 December 2010)
Sri Lanka	Tariff on milk powder cut (amount not specified; beginning 24 January 2011)

Source: ADB staff compilation.

more favorable monetary settings than most of the rest of the world. Some countries have therefore imposed limited and targeted capital controls to reduce inflows of short-term capital (Table 1.3.2).

Table 1.3.2 Selected capital control measures in developing Asia

Instrument	Strengths	Weaknesses	Recent examples
Tax measures	Targeted measures can be more easily calibrated to size of risks	Calibration can be difficult in practice	*Korea, Rep. of*: Reimposition of 14% withholding and 20% capital gains taxes on foreign purchases of government bonds (18 November 2010) *Thailand:* 15% tax on interest income and capital gains earned by foreign investors (12 October 2010)
Minimum investment periods	Increase incentives to invest in longer-term assets	Reduce but do not eliminate the flow	*Indonesia:* 1-month minimum holding period for central bank money market certificates (16 June 2010)
Quantitative limits	Countries can directly control how much capital is let in	Allocation and monitoring of allowance can be difficult	*China, People's Rep. of*: Limits on Hong Kong, China banks' net open positions and ability to access yuan through the mainland's foreign exchange market (3 January 2011) *Indonesia:* Short-term external bank borrowing limited to 30% of capital (29 December 2010) *Korea, Rep. of:* Cap on banks' foreign exchange derivatives books (20 December 2010)

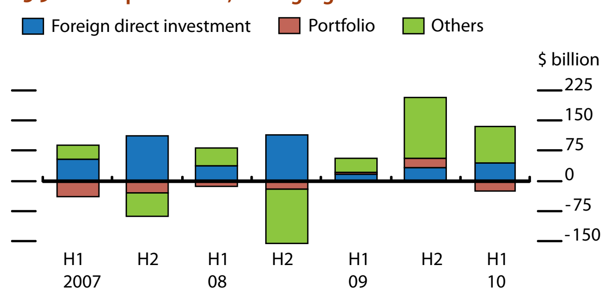
Source: Institute of International Finance (2011).

Figure 1.3.9 illustrates the amount of capital flows in eight developing Asian economies. Net inflows have been high since the second half of 2009 largely because since the crisis, most of Asia has been performing better than industrial economies, promoting greater returns differentials. Highly expansionary monetary policy stances in industrial economies, particularly quantitative easing in the US, has also supported the flow of capital to the region as some of the resultant liquidity is finding its way into emerging economies (Box 1.3.2).

More liquidity can, of course, buttress economic activity. Too much, however, can be damaging, tending to overheat an economy as it pushes demand ahead of what the economy can potentially supply. Unless managed appropriately, overabundant liquidity can destabilize an economy, and render a country's finance sector more vulnerable to a crisis.

The issue becomes thornier if some of the liquidity comes from short-term external flows, which can be volatile. This component has been quite significant in the composition of recent capital inflows to Asia. Figure 1.3.9 suggests that net inflows, in the form of portfolio and other flows through banking channels, have dominated the net influx of capital in the last 2 years. Not only are they potentially destabilizing for Asia's finance sector in general, but they can also contribute to speculative asset bubbles and inflation.

1.3.9 Net capital flows, emerging Asia



Note: Based on data for People's Rep. of China; Hong Kong, China; Indonesia; Rep. of Korea; Philippines; Singapore; Taipei,China; and Thailand.

Source: ADB estimates based on data from CEIC Data Company (accessed 22 March 2011).

Click here for figure data

1.3.2 Impact of quantitative easing in the United States on Asia

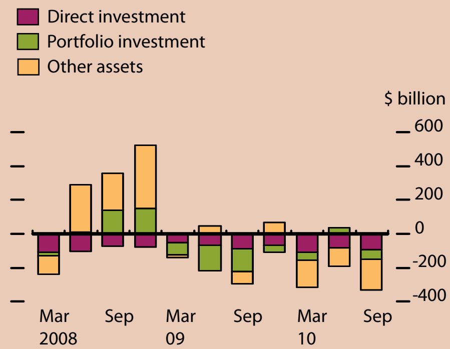
The adoption of quantitative easing by the United States (US) Federal Reserve in early 2009 aroused widespread concern in Asia and elsewhere over its possible impact on weakening the US dollar and stimulating capital outflows to emerging economies and possibly stimulating inflation pressures.

Quantitative easing consists in the Federal Reserve's two major programs of outright purchases of US Treasury notes and bonds, as part of its Large-scale Asset Purchases program, which includes agency securities and mortgage-backed securities. The first block of purchases of $300 billion of Treasury coupon securities was announced on 18 March 2009 and the first operation was conducted a week later. Purchases continued at a pace of about $10 billion a week over the subsequent 5 months, and then slowed through the end of October.

The second tranche of purchases of $600 billion of Treasuries was announced on 3 November 2010, and is expected to be completed by end-June 2011.

How did US capital outflows react during this period? The box figure shows that US gross outward portfolio investment in April–September 2009 returned to a large outflow of $280 billion, about double the quarterly rate of January–March of $73 billion, and a reversal of large withdrawals of capital the previous year. Other private assets showed a smaller outflow of $24 billion. This suggests that the liquidity created by the purchase operations leaked overseas.

Private gross capital outflows, United States



Source: CEIC Data Company (accessed 22 March 2011).

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The latest episode of increased US capital outflows corresponds to the return of high net inflows in Asia in the second half of 2009.

Although it is difficult to disentangle these flows from the general increase in economic optimism at the time, at least part of the leakage from quantitative easing does seem to have been channeled through to Asia.

Policy consistency and the dilemma for Asian policy makers

Managing current inflation pressures is not easy for Asian policy makers. Increasing benchmark policy rates to fend off potential demand pressures on inflation would prompt wider interest rate differentials between Asia and industrial nations, hence potentially attracting further volatile capital inflows. Such inflows would compound the difficulties of handling domestic demand pressures by creating greater liquidity in the system. They would also increase risk of capital reversals that could destabilize the finance sector.

The large inflows of capital to Asia will also increase pressure for Asian currencies to appreciate. Allowing the exchange rate to adjust would cushion the economy from the effects of excessive capital inflows. In fact, greater exchange rate flexibility is a sustainable response to a permanent increase in capital inflows by inducing a fundamental revaluation of domestic assets relative to foreign assets. Such flexibility introduces two-way risks for investors, hence potentially discouraging speculative capital inflows. Appreciation also helps fend off inflation pressures from increases in international commodity prices by keeping the local currency price of these goods down.

Appreciating their currency, however, may not appeal to policy makers who are concerned about the impact it would have on their export sector, particularly as the resurgence in exports supported the rapid pace of economic recovery in Asia. A unilateral currency appreciation is often undesirable since it hurts the export sector immediately by reducing the economy's international price competitiveness.

Avoiding appreciation in these circumstances requires policy makers to intervene in foreign exchange markets, but this raises two immediate issues. First, continued interventions could trigger a "currency war," as countries strive to maintain low exchange rates vis-à-vis their neighbors.

Second, interventions to avoid appreciation could be self-defeating. They will have an expansionary effect on domestic liquidity, hence further increase domestic inflation pressures, which would also damage international competitiveness in the longer run through real exchange rate appreciation.

Of course, the authorities may attempt to sterilize the expansionary domestic liquidity effects by reducing the domestic credit component of their monetary base. Such sterilization is, however, often only effective in the short run, difficult to execute, and costly to implement. Foreign exchange intervention against nominal appreciation therefore should not be a first-recourse option.

The nature of capital inflows is also a reason that Asian policy makers may hold back from relying only on exchange rate appreciation to deal with current inflows. Exchange rate flexibility may be an effective tool against a sustained surge of capital inflows. But using only this approach if the inflows are temporary may involve side effects to the economy. As the flow of capital reverses, the exchange rate will need to adjust to the opposite direction. With temporary capital flows, this implies high-frequency currency fluctuations, creating more problems since they tend to invite more speculative attacks.

Imposing selective and carefully designed temporary capital control measures on inflows may therefore be an option. With such measures in place, emerging Asian economies may gain room for managing their domestic inflation without exerting too much pressure on exchange rate appreciation. The effectiveness of capital control measures themselves, however, is debatable. Not only do they require a high degree of administrative capacity to implement, but they also should be exercised temporarily, as they tend to lose their effectiveness over time (Kawai and Takagi, 2008).

The above discussions provide possible policy responses to dealing with the problem of large capital inflows that is accompanying the quest to curb inflation pressures in Asia. Once a country can identify whether its influx of capital is permanent or temporary, it can take appropriate steps more easily. Unfortunately, such identification is difficult, so countries will have to decide on the nature of the problem while taking the necessary actions.

Possible solutions

The appropriate policy response for dealing with capital inflows therefore differs by the specific nature of the problem. The state of a country's current account imbalances and the alignment of its exchange rate with respect to its economic fundamentals offer a guideline for determining the appropriate steps.

Letting the exchange rate move more flexibly to avoid further disruptive capital inflows may be a better policy for countries that have undergone persistent current account imbalances and misalignment between the exchange rate and fundamentals. It may help these countries to realign the exchange rate to be more in line with fundamentals, hence promoting sustainable economic growth and stability. In contrast, countries without such symptoms may be better relying more on temporary policies, such as capital controls, that fend off excessive capital inflows. This policy, however, should not be used permanently as it will be unsustainable over the long run.

How to measure the extent to which a country falls under each category is complicated. It is also politically sensitive. No commonly agreed measures or guidelines have been developed. This highlights the need for countries to coordinate setting their policies, particularly when they deal with potentially disruptive capital flows. Any unilateral act to let the currency move more flexibly, or even to impose capital controls, can result in an unfavorable situation for the country taking that step, hence potentially leading to some kind of "prisoners' dilemma" type of solution.

Fortunately, G20 members have recently started efforts to work on introducing indicative guidelines that can be used to assess a set of indicators, including a country's current account imbalance by considering exchange rate and other macroeconomic policies and indicators. Such guidelines will be useful for differentiating countries. The guidelines will promote adoption of more appropriate policy by countries dealing with capital flows in a more coordinated manner, hence potentially being more effective. Asia has many lessons to offer that would be useful in introducing these practical guidelines.

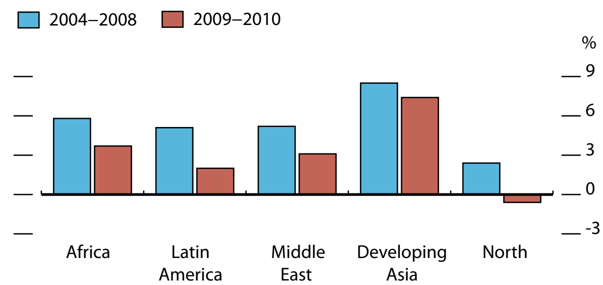
Rising inflation pressures coupled with potentially destabilizing capital inflows is an immediate challenge facing policy makers in the region. Another issue, though, is how to maintain regional growth in light of expected sluggishness in the major industrial countries. Looking to other developing-country markets may be promising.

Solid rebound in the non-Asian developing world

The world economy is in the midst of a two-speed recovery from the recent global crisis—a recovery in which developing countries are rapidly rebounding while industrial countries are still struggling to find their feet. The earlier analysis looked closely at developing Asia, but what about Africa, Latin America, and the Middle East?

In Africa, growth declined from an average of 5.8% in 2004–2008 to 2.7% in 2009 but bounced back to 4.7% in 2010. Latin America suffered a 1.8% contraction of output in 2009, from an average of 5.1% in 2004–2008. The region rebounded sharply, however, growing by 5.7% in 2010. In the Middle East, growth fell sharply from an average of 5.2% in 2004–2008 to 2.1% in 2009 but recovered strongly to 4.1% in 2010. The pattern of crisis and recovery is broadly similar across the three regions—a sharp deceleration followed by a robust upturn—and to that of developing Asia (Figure 1.4.1).

1.4.1 Average GDP growth



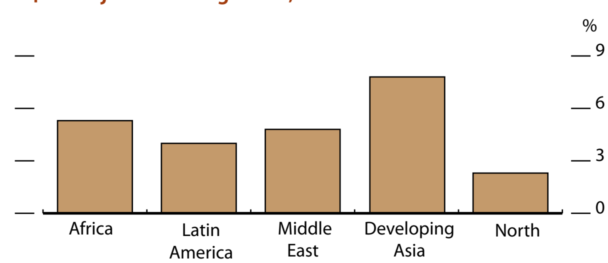
Source: ADB calculations based on data from International Monetary Fund. *World Economic Outlook,* October 2010; World Development Indicators online database (accessed 28 January 2011); and *Asian Development Outlook* database.

Click here for figure data

There have been a number of common factors behind the relatively quick recovery of Africa, Latin America, and the Middle East. Above all was the turnaround in the external environment and normalization of global trade. In particular, the sharp rebound in global commodity prices benefited all three regions since many countries in the non-Asian developing world are major commodity exporters. Another common driver of the recovery has been accommodative fiscal and monetary policies, which supported demand and growth. In some countries, an improved policy environment facilitated the stimulus. For example, many Latin American countries have pursued more prudent fiscal and monetary policies since the late 1980s.

At the same time, there were a number of differences across the three regions. For example, Africa, Latin America, and the Middle East differ substantially in the level of their integration into the global financial system. This explains why the national financial systems of Africa suffered relatively little damage from the crisis, and the region's financial markets continued to function. In contrast, the crisis had a major impact on the financial stability of Latin America due to its high degree of integration into that system. This helps to explain why the region's output contracted in 2009.

1.4.2 Projected GDP growth, 2011–2012



Source: ADB calculations based on data from: International Monetary Fund. *World Economic Outlook,* October 2010; World Development Indicators online database (accessed 28 January 2011); and *Asian Development Outlook* database.

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Despite such differences, the non-Asian developing world has by and large recovered swiftly and robustly from the global crisis. Developing Asia leads the global recovery but the South as a whole has outperformed the North since the start of the crisis and is projected to continue to do so in the near future (Figure 1.4.2).

The South has fared better during the crisis primarily because the nature of the crisis was fundamentally different for the two blocs.

For the North, in particular the US but also for the EU to some extent, the crisis was an internal financial crisis. These typically have lingering adverse effects. Past experience suggests (IMF, 2009) that recessions caused by financial crises tend to be more severe and protracted than crises arising from other shocks.[2] At the same time, recovery from financial crisis–related recessions tends to be slower because private consumption and investment remain depressed longer as firms and households deleverage and rebuild their balance sheets.

In contrast, the crisis for the South was largely an external trade shock with only temporary effects, primarily on the real economy. For such a shock, the economy gets back on its feet as soon as external demand recovers. This helps to explain why the South has roared back as global trade revived along with the recovery of the world economy. In short, the asymmetric North–South recovery is in part a consequence of the asymmetric nature of the global crisis—financial (North) and trade (South).

The South's limited financial links with the North and its consequent relative immunity to the financial contagion was, however, largely the consequence of its own financial underdevelopment. While this protected the South by chance this time around, it carries serious risks of its own, as evident in the Asian financial crisis of the late 1990s. Underdeveloped capital markets may also hinder the allocation of capital to its most efficient uses, thus inhibiting long-run growth. More generally, the South faces some serious challenges and risks to its own growth, even in the short term, and its continued robust growth is far from guaranteed.

But even with such risks and challenges, the South on balance is better positioned than the North to sustain growth in the short run for the reasons outlined above. Long-term structural factors such as the law of diminishing marginal returns to capital and technological catch-up also strongly favor the South, which still remains far poorer than the North.

Still, there is nothing automatic about the process: developing Asia must continue pursuing closer trade, investment, and other economic links with other parts of the South, an issue examined in Part 2. The fact that the non-Asian developing world's improved performance in recent years is partly due to stronger fundamentals and policies further reinforces the case for seeking closer ties.

While those links are underdeveloped at present, the global crisis highlighted the large potential for mutual benefit. For example, developing Asia (including the PRC) is likely to have been a major source of growth in global demand for commodities, a key export for the non-Asian developing world. Broader and deeper South–South links will not only benefit the South, but also the North and the world economy by strengthening the South.

Endnotes

1 This section is based on ADB (2011).

2 The definition of a financial crisis is based on Reinhart and Rogoff (2009) and Kaminsky and Reinhart (1999).

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SOUTH–SOUTH ECONOMIC LINKS

2

South–South economic links

The growing weight of the South

How is it that, until the last few decades, an area spanning more than three-fifths of the planet's land mass and encompassing the homelands of the majority of its human inhabitants figured so lightly in economic terms?

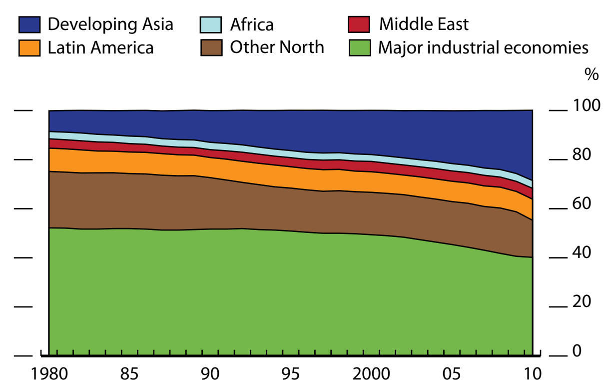
Yet since at least the mid-nineteenth century if not earlier, Africa, developing Asia, Latin America, and the Middle East—geographic regions that in this chapter are collectively referred to as the South[1]—have been poorer and less productive than their counterparts in the North. And even in 2009, a yawning gap in living standards remained: the combined per capita GDP of economies in the South—in purchasing power parity current international dollars—at $5,573, was not even a fifth of the North's $31,660.

Over the last three decades, however, the South has been gaining economic weight. Growing at an average annual rate of 4.8% during this period, by 2010 the combined economic output of the South accounted for 45% of world GDP, a remarkable achievement particularly when seen that, as late as 1980, the rest of the world's share was 71% (Figure 2.1.1).

Moreover, given its relatively higher population growth rates and rising average incomes, the South offers tremendous potential markets for trade and capital investment. As trade and nontrade barriers of Southern economies come down further, increased competition is likely to translate into efficiency gains in production, and expanded markets are likely to present opportunities for greater specialization to achieve scale economies in companies' operations—both of which will benefit consumers (in terms of lower prices and access to a wider range of goods and services).

As capital restrictions are relaxed, greater capital investment flows with their concomitant technology transfers and spillover effects are likely to translate into higher productivity and more job opportunities for workers, holding the promise of lifting millions of people out of poverty. As financial markets deepen,

2.1.1 Shares in world GDP



Note: Estimate of regional shares for 2010 calculated from the International Monetary Fund's World Economic Outlook database, as the World Development Indicators online database has data up to 2009 only. The two databases show minimal differences (less than 3 percentage points). GDP is based on purchasing power parity valuation.

Sources: For 1980–2009, ADB calculations using World Bank, World Development Indicators online database (accessed 21 March 2011); for 2010, ADB calculations using International Monetary Fund. World Economic Outlook database. October 2010 (accessed 21 March 2011).

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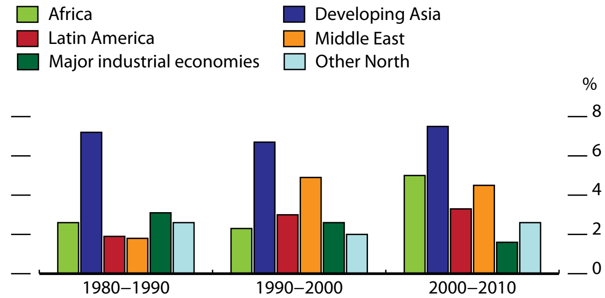
This chapter was written by Shikha Jha, Benno Ferrarini, and Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila. It draws on six background papers, listed at the end of the chapter.

more of the South's savings are likely to be mobilized within its regions (rather than be intermediated in the North), which can potentially set Southern economies on a higher growth trajectory and even help to address global imbalances.

Thus prospects are bright for the South to promote growth and productivity by improving market-oriented links that facilitate the exchange of goods and services as well as capital investment flows and transfers of technology. Moreover, in the aftermath of the global financial crisis, Southern economies have added incentives to enhance mutual economic welfare by diversifying economic and institutional links.

Indeed, given the prolonged slowdown in industrial countries of the North, the onus for taking global growth forward has fallen on the South (Figure 2.1.2). After all, the vibrant developing Asian region has been quick to recover from the crisis, with the emerging economies of Africa and the Middle East not far behind.[2] And despite being hit hard due to its strong links with industrial economies, Latin America weathered the crisis well and has recovered strongly.

2.1.2 GDP growth by region



Note: Data refer to 10-year averages of regional GDP growth rates weighted by gross national income (World Bank Atlas method).

Sources: ADB calculations based on data from International Monetary Fund. 2010. World Economic Outlook database. October (accessed 21 March 2011); World Development Indicators online database (accessed 15 March 2011); *Asian Development Outlook* database.

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The need for developing Asia to look South

Developing Asia has been instrumental in the rise of the South. Between 1980 and 2010, the region grew at an average annual rate of 7% and in 2010 accounted for more than 60% of the South's economic output. The stellar performances of the People's Republic of China (PRC) and India were major factors in this trend.

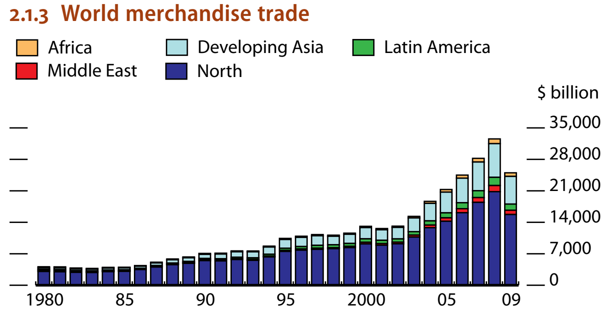
The contribution of the region to world output growth rose from 27% in 1981 to 51% in 2010 (although this increase is somewhat magnified by the global crisis). But even without the PRC and India, developing Asia's share of world GDP nearly doubled (from 5.1% in 1980 to 9.6% in 2010).

For developing Asia, looking South is becoming increasingly important for at least three reasons. First, large welfare gains are associated with more closely integrated Southern economies, particularly in view of "factory Asia" (see below) and developing Asia's emergent middle class. Second, developing Asia can be a primary resource for knowledge sharing. Third, a Southern hemisphere that is more economically open and diversified in trade relationships and investment flows can potentially address global imbalances.

Welfare gains

Given the potential gains, trade in goods and services will remain a key engine of growth for Southern economies, including developing Asia's. Driven by increasing demand from economies that have been growing at rates above the world average, by the proliferation of international production networks, and by the progressive dismantling of trade barriers, South–South trade has been expanding rapidly. In 1990–2009, its share in world trade rose by almost one and a half times, from 7% to 17% (Figure 2.1.3).

2.1.3 World merchandise trade



Source: ADB calculations using data from UNCTAD statistics. http://unctadstat.unctad.org/TableViewer/dimView.aspx (accessed 16 March 2011).

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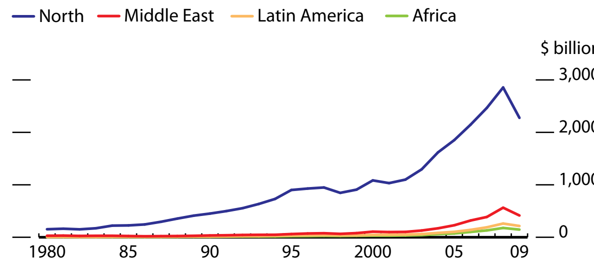
While the bulk of this trade remained confined to developing Asia, driven notably by the faster growth of exports, its rate of expansion can be attributed to the burgeoning commerce between developing Asia, on the one hand, and Africa, Latin America, and the Middle East, on the other (Figure 2.1.4).

2.1.4 Developing Asia's merchandise trade



Source: ADB calculations using data from UN Comtrade online database (accessed 7 March 2011).

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As these interregional trade relations intensify and proliferate among Southern economies, strengthening their links will help to realize the welfare benefits. With economic integration will come greater access to wider markets and resources for firms (which fosters specialization, affords scale economies, and promotes employment), more competitive and efficient market environments that benefit consumers, and more attractive rates of return on capital investments that encourage technology-transferring foreign direct investment (FDI)—all of which will translate into higher growth rates and improved well-being of the trading partners' populations.

Put differently, by combining their varied resources and markets, Southern countries will acquire a bigger platform from which to build physical, social, and institutional infrastructure; expand employment opportunities; accumulate capital; upgrade technology; diversify production; and raise income levels.

For developing Asia, two factors hold the potential of adding to the benefits of economic integration. First, there is the model of factory Asia, in which parts and components move through cross-border production networks with the PRC as the last-stage assembly hub for exporting final products to countries in the North. This phenomenon opened an opportunity for other countries in developing Asia with narrow export bases. The competitive position of the PRC and its growing economic muscle, in particular, brought numerous benefits to neighboring countries through employment creation in ancillary industries with their backward and forward links, greater access to regional markets, and higher growth.

These production networks are not, however, geared toward producing final goods for the price-sensitive consumers of developing countries—as they were primarily designed to produce high-quality products for consumers in the North.

There are currently no such networks spanning developing Asia, on the one hand, and the other regions of the South, on the other. Thus the concept and technologies of factory Asia can possibly be exported to, say, Africa and Latin America with the networks being designed to produce goods for the price-elastic markets in those regions. Not only will developing Asia's FDI in these new networks enhance employment opportunities, raise workers' incomes, increase domestic demand, and enhance growth prospects, it will also address in part global imbalances by recycling high savings in developing Asia into investment in the South.

Consider the prospects for Latin America, in particular. Most Latin American countries have attained middle-income status and are oriented to domestic expenditure. They are therefore prime markets for factory Asia. A problem is the large infrastructure investment needed to improve the links and reduce the costs of trade. If the high savings of developing Asia can be channeled to fund these infrastructure projects, however, trade costs may be sufficiently reduced to make the expansion of factory Asia to Latin America feasible.

The second factor is developing Asia's emerging middle class. These consumers are less sensitive to price differentials, and so are driving demand for high-quality products in the region. This group can possibly absorb part of the high-quality exports of Southern economies that used to go to the North.

Learning from peers

Greater integration will allow the economies of the South to share experiences and to learn from each other. In an interconnected world of multipolar growth, there is no "one-size-fits-all" model of development. This raises the imperative for countries to diversify sources of knowledge and share development experiences. Happily, as a consequence of rapid improvements in information and communications technology, North–South and South–South knowledge exchanges are becoming more frequent. Within the South, the specific expertise of Southern countries tends to be easier to adapt and use, providing efficient development solutions and complementing the ones available in conventional North–South cooperation.

Indeed, peer-to-peer learning (the sharing of know-how, good practices, and innovation) and technology transfer remain major motivators for South–South cooperation. Arenas include the Africa platform, the Ibero–American Program in Latin America and the Caribbean, and the South–South Knowledge Exchange Platform sponsored by the World Bank Institute.

Examples of successful partnerships in knowledge exchanges abound, especially between Africa and Asia (as discussed in *Wider economic links for development*, below).

Rebalancing

South–South links are creating new drivers of aggregate demand that are likely to foster a more resilient and balanced growth of the world economy. Having experienced significant economic setbacks during the recent crisis, industrial economies will take a while to reassume their role as the primary source of demand for the global economy.

At the same time, economies of the South have shown strong promise to grow rapidly (see Part 1 of this *Asian Development Outlook 2011*). The rising consumption of emerging economies and new investment flows within the South represent opportunities for more diversified drivers of global growth. To make these prospects a reality and to assist in the global recovery process, however, economies in the South will need to become more open to trade and capital flows from each other, and their domestic expenditures will have to increase—not just for consumption but also for investment—to help to drive South–South trade and FDI.

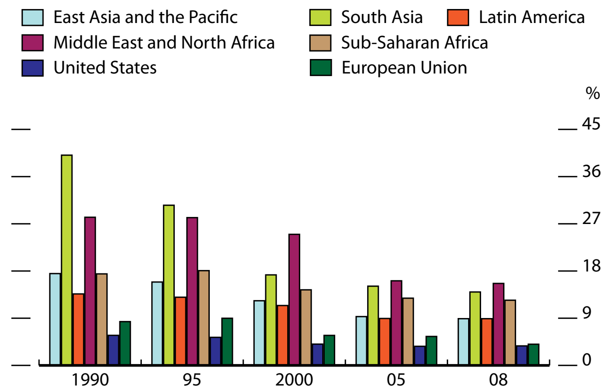
Impediments to tapping potential gains

That gains from closer economic integration within the South are not fully realized suggests that there are problems to be hurdled. These come in the form of persistent trade barriers and uncompetitive domestic industries that are likely to be dislocated and crowded out as economies adopt more open policies.

Countries across the South have become more open; still, numerous "behind-the-border" problems persist. Average tariff rates have declined across the globe over the last two decades (Figure 2.1.5), with the reductions more significant for the South. What has been overlooked, however, is that import duties that Southern countries impose on goods originating from other Southern countries are significantly higher than the rates levied on goods coming from Northern countries.

In addition, structural weaknesses (such as poor trade-related infrastructure and logistics) and nontariff barriers (inefficient administrative procedures, for example) continue to hinder the expansion of trade among Southern countries by adding significantly to transaction costs. Consequently, affluent markets in the North remain the preferred destination of the South's final-goods exports. In 2009, developing Asia's trade with other regions of the South was worth $780 billion—its trade with the North came to $2,280 billion.

2.1.5 Average tariff rates



Note: Data refer to the simple average of most-favored-nation rates for all products. Regional classification follows that of the World Bank.

Source: ADB calculations using UNCTAD's Trade Analysis and Information System (TRAINS) database through the World Bank's World Development Indicators online database (accessed 15 March 2011).

Click here for figure data

The elimination of tariff and nontariff barriers can therefore significantly expand South–South final goods trade and boost the growth of Southern economies over the medium term. Policies that lower trade barriers and implement trade-facilitating and customs-harmonizing initiatives will promote trade in final goods across Southern regions. In turn, this expansion in trade across the South will allow many of its developing economies to transition from labor-intensive to capital- and knowledge-intensive manufacturing, in effect setting them on a higher growth profile.

While expanding factory Asia to other regions in the South may raise incomes, improve employment opportunities, and increase growth rates in the long run, it may be dislocative in the short and medium run. Faced with more intense competition, domestic industries may be unable to thrive; undercapitalized, they may be crowded out of markets for scarce resources, such as skilled labor and capital equipment.

Hence industrial and regulatory policies may need to mitigate the initial ill-effects of opening up the more autarkic economies to trade and investment. Indeed, this can be a topic for knowledge sharing among policy makers in the South.

Importance of trade and foreign direct investment

Two avenues for South–South cooperation should be emphasized: trade and FDI. Both are private sector–led and market-oriented initiatives that promote economic efficiency. Moreover, as trade volumes and investment flows increase among countries, payoffs to maintaining and deepening ties rise correspondingly. Trade and FDI are usually forerunners of deeper and broader sociocultural and political international relations. Finally, as discussed above, trade and FDI are drivers of economic growth and development.

Why focus on South–South trade? For one overriding reason: trade will continue to be an engine of growth for Southern economies, though the largest marginal gains are not in North–South trade. As noted above, an issue that has gone under the radar is that South–South trade and nontrade barriers are now higher than those facing North–South exchange. Thus Southern countries need to lower tariffs on imports from other Southern countries, and construct trade-facilitating infrastructure to reduce transaction costs and open up more widely South–South trade routes.

As for capital investment, it is important to highlight South–South FDI for the following reasons. First, South–South FDI may be better suited to developing-country conditions. Perhaps introducing technologies that are not as advanced, capital investment from the South may be more labor intensive and require skill and education levels that are well within the capabilities and attributes of the workforce in a developing country.

Or the entrepreneurial experience of multinational companies from the South may allow them to better navigate developing-country markets and political conditions (Aykut and Goldstein, 2006). In addition, FDI from the South may be better able to produce products for the South's generally lower-income markets (Prahalad, 2004). A case in point: the $2,500 "People's Car" of India's Tata Motors.

Second, its cyclical fluctuations being different from those of North–South flows, FDI from the South may possibly reduce the volatility of total financial flows in the South—as observed in Africa, where investors from the PRC continued to undertake projects even at the height of the global crisis (Davies, 2010). If so, the more stable financial flows will promote greater economic stability in the FDI host countries.

Third, the size of South–South FDI flows is an indicator of the state of financial integration among the economies of the South. The hope is that, with deeper financial markets, closer financial integration, and improved institutions and investment climate, the South will see its savings channeled toward investment opportunities in the South rather than funneled to deficit spending in the North.

As trade and investment links among Southern countries flourish, wider economic links can be expected. Labor markets can become more unified, development experiences and technical cooperation initiatives can be more widely shared, and macroeconomic policies can be better coordinated. A more integrated South holds the promise of a sustainable path to growth and development.

South–South links as a sustainable path to growth and development

The region has grown rapidly in the past few decades and, together with Africa, Latin America, and the Middle East, has emerged as the driver of global growth while recovery in the North struggles. Within the South, Asia's role is becoming more prominent. The rise of developing Asia as a potential source of world demand and its growing economic links with Southern countries holds the promise of improving their prospects for growth and reducing global imbalances. But, can strengthening these links prove to be a harbinger of sustainable growth in developing Asia?

Developing Asia's links with the rest of the South have grown rapidly. Trade in goods and services by Southern economies has intensified to take advantage of its potential gains. In contrast to trade integration, financial integration has not happened as deeply although both inward and outward FDI links have grown within the South. These are especially evident in developing Asia in comparison with Africa, Latin America, and the Middle East. However, while Southern economies have emerged as important sources of outward FDI, the majority of global outward FDI flows and stocks still originate in the North.

Structural weaknesses in the South perpetuate its dependence on the North. In the real sector, the global crisis has highlighted the continuing dependence of the South on final demand from the North. And although tariffs have declined significantly, countries throughout the South still face numerous behind-the-border problems exacerbated by structural weaknesses and institutional failures.

The financial markets and regulatory structures in the South also remain underdeveloped. The economic crisis brought to the fore the South's heavy reliance on the North for parking its surplus savings into low-risk assets there rather than recycling the funds within the region. This, in turn, contributed to the expansion in global imbalances and also perpetuated the dearth of funds to finance crucial investment projects in the region.

One key challenge for policy makers in emerging nations is therefore to create a regional and domestic enabling environment that will attract finance to flow into local investments in the region. Even if these bottlenecks are eased, South–South cooperation cannot be a panacea for all development challenges. The dependence of growth of the economies of the South on markets of the industrial world is still high and raises concern about the sustainability of this growth if the North fails to revive from its slowdown soon.

Closer financial and real integration holds the promise of raising consumption and investment in the South, narrowing global imbalances, and sustaining growth in developing Asia. Closer financial market integration would ensure that surplus funds from the South are used to finance productive investments within the South. It would also break the vicious circle of vulnerability to the fortunes of the North. In the real sector, the South must carry on reducing bottlenecks to trade for expanding final goods trade within the region to make up for the slack in the North.

Fixing the real and finance sector problems will contribute to a rise in domestic expenditures in the South. In the short run, this would lead to a narrowing of global imbalances. In the longer term, closer links among Southern countries would foster the growth of new markets, improve trade in goods and services, expand investments, provide greater economic opportunities, and contribute significantly to their growth. Given developing Asia's dominant role in the South, this would put its growth on a sustainable path.

With continued high dependence of the South's economies on markets of the industrial world, these stronger economic links would build a platform on which the North and the global economy can grow again.

Expanding South–South economic links through trade

South–South trade in goods has expanded considerably during the last two decades. Its share of merchandise trade rose by a factor of 2.4, from about 7% in 1990 to 17% in 2009 (Table 2.2.1).[3] To a large extent, this trend was due to the emergence of factory Asia, fragmented-production networks that have the PRC as the last-stage assembly hub of production processes. The intermediate stages of the process are farmed out throughout Asia, including Japan, and the final outputs are intended mainly for export to affluent markets in the North (ADB, 2010a), particularly countries in the Organisation for Economic Co-operation and Development (OECD).

As the PRC rose as a leading exporter and world-trade powerhouse,

2.2.1 The rise of South–South trade (%)

GDP indicators[a]	1990–91	2000–01	2006–07	2008	2009
Share of world GDP held by:					
The South	27.8	33.6	38.4	39.7	41.3
Developing Asia	13.1	18.3	22.8	24.0	25.7
China, People's Rep. of	3.7	7.3	10.4	11.5	12.6
India	3.0	3.8	4.7	4.8	5.2
Trade indicators[b]	**1990–91**	**2000–01**	**2006–07**	**2008**	**2009**
South–South trade as share of world trade					
Exports	7.6	10.2	15.0	16.3	17.7
Imports	6.2	9.6	14.1	15.4	16.1
Trade	6.9	9.9	14.5	15.9	16.9
Developing Asia's share of South–South trade					
Exports	88.2	79.8	79.8	78.9	80.3
Imports	86.8	71.6	69.3	66.0	68.5
Trade	87.5	75.7	74.6	72.5	74.4
People's Republic of China's share of South–South trade					
Exports	35.5	35.1	40.8	41.2	41.6
Imports	43.9	36.9	37.8	34.4	38.4
Trade	39.7	36.0	39.3	37.8	40.0
India's share of South–South trade					
Exports	2.1	3.1	3.7	3.9	4.9
Imports	2.3	1.6	2.4	4.7	5.8
Trade	2.2	2.4	3.0	4.3	5.4
Other South's share of South–South trade					
Exports	11.8	20.2	20.2	21.1	19.7
Imports	13.2	28.4	30.7	34.0	31.5
Trade	12.5	24.3	25.4	27.5	25.6
Developing Asia's share of South–South trade (growth, %)[c]		12.0			22.8
Other South's share of South–South trade (growth, %)[c]		47.2			25.7

[a] GDP, purchasing power parity (current international $). [b] Nonfuel merchandise trade. [c] Average annual growth rate in 10 years (1990/91–2000/01); in 9 years (2000/01–2009).

Sources: Athukorala (forthcoming); ADB calculations using World Bank, World Development Indicators online database (accessed 21 March 2011).

developing Asia was transformed into an intricate web of regional trade in parts and components. And as developing Asia consolidated its dominant position in the world trade of manufactures, the share of South–South trade in global merchandise trade increased.

So dominant is developing Asia's role in South–South trade that the region accounts for about 75% of this commerce with the PRC alone taking up about 40%. Obviously, much of the traffic reflects the intraregional trade flows of factory Asia. But developing Asia's trade with other Southern regions has been expanding. With its growing appetite for primary commodities, which it needs to fuel its rapid economic expansion, developing Asia is driving up global demand for these goods, which come mainly from Africa, the Middle East, and Latin America. In turn, these markets' imports of Asian manufactures have been increasing as well.

Thus as several recent studies and reports have suggested—see, for example, Broadman (2007), Goldstein et al. (2006), and Santiso (2007)—the "China factor" (which is construed to include developing Asia) has proved to be both a boon and a bane for the rest of the South. For countries with narrow export bases in primary commodities, higher world demand in these goods—including developing Asia's import needs—has created windfall gains from higher prices. For other countries, factory Asia has been a powerful antagonist in third markets for manufactured goods, crowding out the exports of some countries or precluding entry altogether to industrialization's laggards.

The dilemma for the non-Asia South is therefore how to exploit gains from trade while avoiding the downside of specializing in natural resources.

Despite this quandary, there is scope for the South to accelerate its integration as a group and with the world economy by gradually clearing the remaining bottlenecks to trade. Indeed, the integration of the South presents large potential benefits. Although Southern countries have lowered the level of applied tariffs considerably, they are still high by standards of the North. Calculated from 2005–2008 data, average applied tariffs were 9.3% in the South, compared with 3.2% in the North.

Other trade costs also arise out of developing countries' weaker trade-related infrastructure and logistics, as well as institutional barriers. For example, in 2010 it took 11 days and fewer than five documents, on average, to export or import a standardized unit of cargo among OECD economies, but it took more than twice as many days for countries in East Asia and almost three times as long for those in South Asia, with more documents involved (World Bank, 2010).

Similar constraints were found in Latin American and Middle Eastern countries, and were most acute for the low-income economies of Sub-Saharan Africa. Hence, as may be expected, the industrial countries generally received the highest marks in infrastructure and logistics competence per the World Bank's Logistics Performance Index, with developing countries ranking much lower, with the notable exceptions of Hong Kong, China and Singapore, the world's top-rated trading hubs.

Assuming continued rapid economic growth in Asia and to a lesser extent in other developing countries, simulation analyses (see *A simulation of South–South trade*, below) using a global economy model suggests the following. First, the share of South–South trade in global trade is likely to double within the next two decades. Second, lowering tariff barriers on South–South trade to levels on South–North trade could bring as much as three-quarters of the welfare gains to Southern countries as generated by the global elimination of tariff rates: South–South trade would expand by 23%. Third, regional initiatives, such as the expansion of the Association of Southeast Asian Nations (ASEAN) free trade agreement to other countries in the Asia-Pacific region, can potentially bring about substantial gains for developing Asia and significantly expand South–South trade.

Trade reforms in support of South–South trade, however, must not come at the expense of continuing global integration. In view of the proliferation of regional trade agreements in Asia and elsewhere, it is becoming increasingly important for such pacts to be made as broad-based as possible and to be compatible with World Trade Organization (WTO) provisions.

A comparison of Asia's South–South FTAs with their North–South counterparts in five key areas—tariff liberalization, rules of origin, liberalization of trade in services, WTO notification, and deep integration—reveals that the latter are generally more consistent with WTO and other global rules. Ensuring comprehensive and compatible FTAs in the future and improving existing South–South agreements along similar lines offer Asia a promising path to follow toward freer trade.

The rise of South–South trade

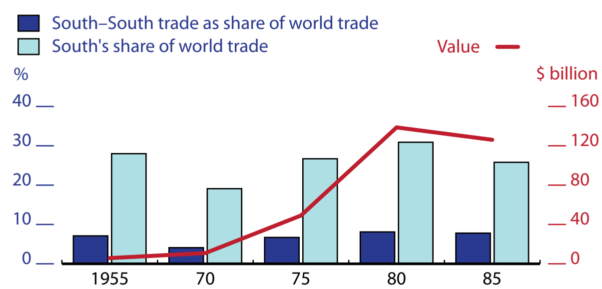
Until about two decades ago, South–South trade in goods was but a minor share of world trade. Records based on UNCTAD data spanning 1955 to 1985 reveal no discernible trend (Figure 2.2.1). By 1985, South–South trade as share of total world trade had increased only marginally, to 7.8%, from 7.1% in 1955, and South–South trade still represented less than a third of developing countries' total merchandise exports.

Starting around 1990, a rapid upward trend set in, which has since seen the growth of South–South trade outpacing that of total world trade in both exports and imports. During 2000–2009, the average growth of South–South trade accelerated to 16% a year, from 14% in 1990–1997. By comparison, the expansion of world trade was much slower during both periods, at 5.5% and 6%, respectively. Consequently, the share of South–South trade in world trade rose from 7.4% in 1990 to 10.3% in 2000 and 15.3% in 2007 (Figure 2.2.2). Due to emerging markets' higher resilience to the downturn of global trade during the recent crisis, world exports plunged more steeply than did South–South trade, as a result of which the share of South–South exports in world trade increased further, to 17.3% in 2009.

In parallel with this trend, South–South trade as a share of Southern regions' total trade also increased steadily between 2000 and 2009 (Figure 2.2.3).

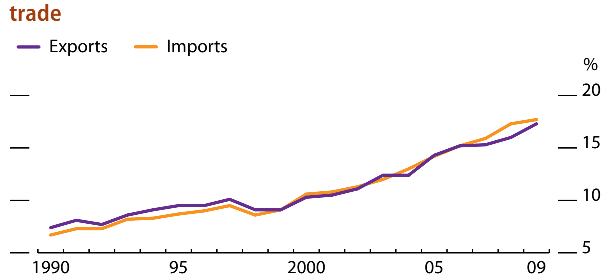
In the analyses that follow, trade in fuel (oil and gas) is excluded from total merchandise trade. This does not materially alter the trends just discussed, since, as seen from Table 2.2.1 above, the trade shares do not change by much.[4] Excluding

2.2.1 South–South merchandise trade



Source: Data taken from Table 1 of Athukorala (forthcoming).
Click here for figure data

2.2.2 Share of South–South trade in world merchandise trade



Source: Data taken from Table 2 of Athukorala (forthcoming).
Click here for figure data

trade in fuel, however, is standard practice in trade-flow analysis for two reasons.

First, it prevents the sharp fluctuations in fuel prices from affecting trade ratios and, in turn, their comparability across periods. Second, the incidence of fuel trade varies significantly among countries and regions, which tends to further blur secular trends in trade shares. Indeed, commodity-specific price deflators can alleviate this problem only to an extent.

Three factors seem to account for much of the rapid expansion of South–South trade from the early 1990s: strong economic growth in emerging economies, the rates of which were above the world average; the rise of fragmented production and trade networks; and the progressive dismantling of trade barriers.

As has been well documented, while the global economy expanded rapidly during the last 20 years or so, developing countries as a group grew even more impressively. As a result, Southern countries' share in world GDP, adjusted for purchasing power parity, increased to about 40% in the late 2000s, from nearly 28% in the early 1990s (Table 2.2.1 above).

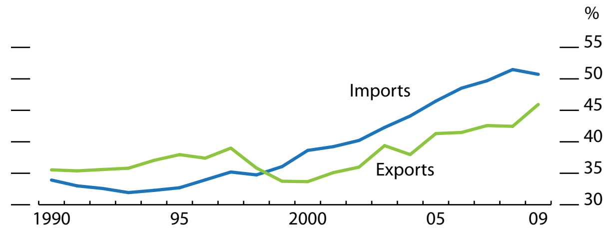
The expansion of global production sharing opened new opportunities for developing countries to partake in international production chains and trade networks. In its formative years in the early 1990s, production sharing involved moving small fragments of the manufacturing process to low-cost countries and importing their component outputs to the host country for the last-stage fabrication.

Later, production networks became more intricate, with firms in different countries having charge of different stages of production, thus resulting in product fragments crossing multiple borders prior to final-product assembly in the host country. More recently, with international supply networks of parts and components now well established, firms have also started setting up final-assembly processes for a broad range of consumer durables (such as computers, cameras, televisions, and automobiles) abroad, both to take advantage of cheap labor and to be closer and more responsive to niche markets.

Today, cross-border trade in parts and components has developed into a truly global phenomenon, although it plays a far more important role for developing Asia than for other developing regions, given the region's integration with the world economy (Box 2.2.1). Particularly with the emergence of the PRC as the premier final-assembly center of electronics and related products since the mid-1990s, intraregional flows of both parts and components and final goods have recorded phenomenal growth (see ADB, 2010a).

Finally, developing countries have made considerable progress in dismantling their tariff barriers, mainly in compliance with regional and WTO commitments. The WTO Information Technology Agreement of 2006 has been of particular relevance for the production networks of electronics and information technology goods of developing Asia. Not only did it free up commerce in this important segment of world merchandise trade, it also stimulated the type of FDI into the PRC that helped consolidate the country's role as the regional assembly hub. The

2.2.3 Share of South–South trade in total Southern merchandise trade



Source: Data taken from Table 2 of Athukorala (forthcoming).

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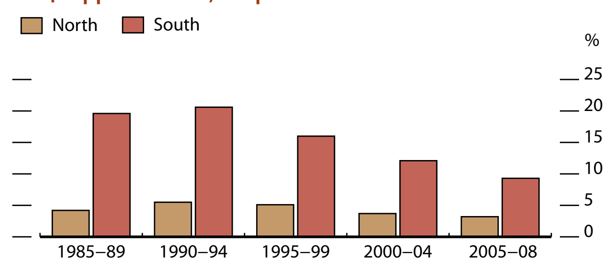
2.2.4 Applied tariffs, simple mean



Note: Data computed as 5-year averages except in 2005–08, which is a 4-year average.

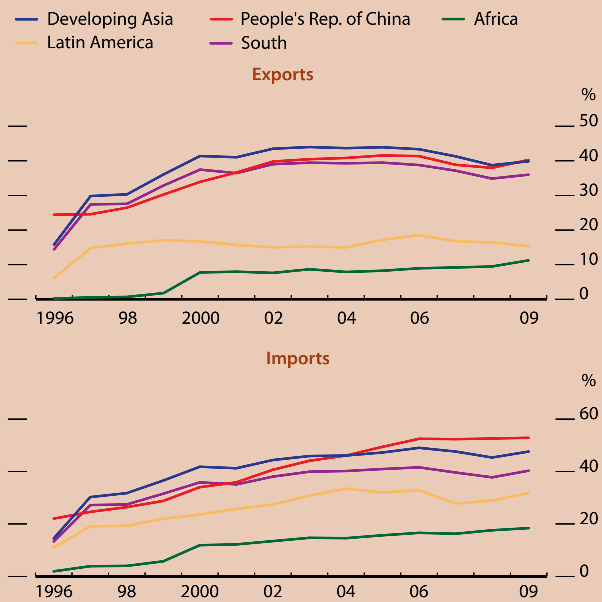
Source: ADB calculations using UNCTAD's Trade Analysis and Information System (TRAINS) database through the World Bank's World Development Indicators online database (accessed 15 March 2011).

Click here for figure data

2.2.1 Global production sharing and South–South trade

Two important structural features have characterized the expansion of South–South trade over the past two decades: its heavy concentration in Asia and the dominance of manufactures in Asia. The region's rapid growth in manufacturing trade has been underpinned by global production sharing,[1] which in turn is reflected in the surge of cross-border trade in parts and components (box figure).

Parts and components share in manufacturing trade



Source: Athukorala (forthcoming).

Click here for figure data

From 1996 to 1999, the share of parts and components in South–South trade jumped from about 13% to nearly 32% on the side of imports, and from about 14% to nearly 33% for exports. These shares are much larger in Asia than other regions. Latin America has the second-highest share of parts and components trade—15% for exports and 32% for imports in 2009—reflecting its participation in global value chains, particularly in Brazil and Mexico.

Component trade within global production networks naturally leads to double counting of trade flows, because parts and components, which are manufactured in different countries and at different stages of the production process, typically cross borders multiple times before assembly into the final product. This double counting can be avoided by netting out parts and components from total manufacturing trade.

When it is, the shares of South–South trade are lower than the estimates reported in this section (Athukorala, forthcoming). In the case of exports, the difference seems small. For 2006–2007, the (2-year averaged) adjusted South–South share in total world exports is 13.5%, down from 15%. For imports, however, the adjustment lowers the share to below 11%, from 16%, which reflects the relative importance of parts and components in intra-Asian import trade.

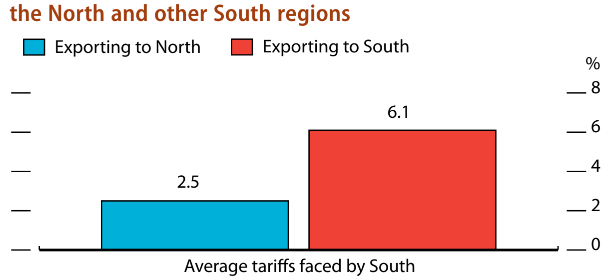
Thus global production sharing seems to introduce an upward bias in estimates of the world trade share of South–South trade and Asia's share in South–South trade. Still, additional analysis (Athukorala, forthcoming) suggests that overall trends in South–South shares are remarkably insensitive to the exclusion of parts and components. In other words, the findings of strong growth in the world trade share of South–South trade over the past decade or so and of Asia's dominant position in South–South trade are robust.

1. See Ando and Kimura (2010) and Athukorala (2009, 2010) and the works cited.

PRC's progressive reduction of tariffs and nontariff barriers, particularly after its WTO accession in 2001, was also a key factor that facilitated the emergence of Asia's trade networks and the multiple border-crossings of intermediate products that were associated with them.

Nonetheless, hindrances to trade persist. While average tariffs applied by the South in 2005–2008 came down to about half their levels of 1990–1994, they remain higher than the North's (Figure 2.2.4 above). Moreover, Southern exporters face higher tariffs when exporting to other countries in the South (6.1%), compared with shipping to the North (2.5%) (Figure 2.2.5).[5] And the evidence indicates that, where Southern liberalization has occurred, such preferential trade agreements tend to have a narrower coverage of goods and take longer to come into full effect than North–South agreements, which are also more compatible with global rules (Box 2.2.2).

2.2.5 Average tariffs faced by the South when exporting to the North and other South regions



Note: Derived from GTAP database in reference to year 2004.

Source: Data taken from Appendix Table A.9 of Anderson and Strutt (forthcoming).

Click here for figure data

2.2.2 Assessing South–South vs North–South Asian free trade agreements

The last decade has seen an unprecedented surge in free trade agreements (FTAs) in Asia as part of efforts to deepen regionalism by focusing on sophisticated production networks. There are over 60 concluded FTAs today compared with only three in 2000. While the factors driving the proliferation of FTAs in Asia have been scrutinized, little attention has been devoted to studying the evolution and anatomy of North–South and South–South FTAs, or the extent to which they are compatible with global rules and each other.

A structural shift in Asia's trade toward more South–South trade has accompanied the region's economic development. The proportion of Asia's South–South FTAs vs North–South FTAs (39 vs 22) reflects these evolving trade patterns. But quantity does not necessarily equal quality. In five key areas under review—tariff liberalization, rules of origin, liberalization of trade in services, World Trade Organization (WTO) notification, and deep integration—North–South FTAs were generally more compatible with WTO and other global rules.

Beginning with tariff liberalization, the General Agreement on Tariffs and Trade (GATT) Article XXIV states that "duties are eliminated [on] substantially all trade … within a reasonable length of time." Yet over one-third of all Asian South–South FTAs have only limited goods coverage, while another 40% eliminate tariffs on substantially all trade over a period lasting more than 5 years. In contrast, roughly one-third of North–South FTAs eliminate tariffs upon entry into force, while an additional 25% do so within 2–5 years.

Rules of origin determine the goods that enjoy preferential tariffs to prevent trade deflection (the entry of imports to a low-tariff member of an FTA, when their ultimate destination is a higher tariff member) among FTA members. In practice, such rules can actually raise transaction costs for firms and generate confusion over compliance. This is especially the case with rules of origin included in Asian South–South FTAs. According to data from Kawai and Wignaraja (2011), over 30% of firms view rules of origin as an impediment to using South–South FTAs, compared with only 13% for North–South FTAs.

Conformity with the General Agreement on Trade in Services (GATS) Article V requires FTAs not to include restrictions on the liberalization of such key services as business and professional, communications, financial, transport, and labor and business persons' mobility. Nearly three-quarters of Asian North–South FTAs liberalize trade in these five services—less than 20% of South–South FTAs do, while nearly half exclude services or have limited coverage of services at best. (The notable exceptions among South–South agreements are the Association of Southeast Asian Nations [ASEAN] FTA and other agreements involving Singapore.)

Some GATT provisions essentially require a member country to notify and submit details to the WTO with regard to FTAs and related interim agreements. The intent is to improve transparency in the global trading environment. Roughly two-thirds of South–South FTAs comply with these notification requirements, compared with 95% of North–South FTAs.

A thorny issue in the early days of the WTO Doha Round negotiations concerned the depth of economic integration as measured by the so-called Singapore issues: investment, competition policy, government procurement, and trade facilitation. While these issues were later dropped, they remain important for future trade policy negotiations. More than 80% of Asian North–South FTAs have at least some coverage of the Singapore issues, compared with only about 20% of South–South FTAs.

To address the incompatibilities between North–South and South–South FTAs, new Asian FTAs should adopt the following good practice guidelines for core areas, with modifications made to existing FTAs where reviews are possible:

- *Tariff liberalization.* Eliminate a minimum of 85% of all tariffs within 10 years.
- *Rules of origin.* Design and administer rules that are guided by Asia–Pacific Economic Cooperation (APEC) principles of simplicity and consistency, as well as WTO requirements of transparency and prospective application.
- *Services liberalization.* Incorporate at least five key services sectors—business, communications, financial, transport, and labor and business persons' mobility—and pursue reform of competition policy.
- *WTO notification.* Include procedural requirements to promote greater transparency and improve consistency with global rules.
- *Deep integration.* First incorporate good practices on investment and trade facilitation, and then address the more difficult issues of competition policy and government procurement.

In addition, the quality of FTAs in Asia can be enhanced by setting up a regional advisory center to address limited institutional and human resource capacities among some countries in the region. This center would engage legal advisors, train officials, and lead studies to help countries better design, negotiate, and implement WTO-compliant and WTO-plus FTAs.

In the medium to long term, a regionwide FTA would be an important means to better align compatibilities in global and regional rules among Asia's North–South and South–South FTAs. Depending on its scope, the basis for such a regionwide FTA might be either ASEAN+3 (ASEAN plus the People's Republic of China, Japan, and the Republic of Korea); ASEAN+6 (ASEAN+3 plus Australia, India, and New Zealand); or a Free Trade Agreement of the Asia–Pacific (APEC members). A practical first step might be to take the best features from current ASEAN FTAs and design a template consistent with global rules.

Source

Based on Wignaraja and Lazaro (2010).

The regional profile of South–South trade

South–South trade is dominated by developing Asia, in particular by its expanding international production networks. Complementarities are now emerging among the economies of the South.

Figure 2.2.6 shows just how dominant developing Asia's shares of South–South trade are compared with those of Africa, Latin America, and the Middle East. In 1990–1991 (2-year average), developing Asia accounted for about 88% of total South–South exports and almost 87% of total South–South imports.

By 2006–2007 (2-year average), however, these shares had declined to about 80% and 69%, respectively, due to the larger fraction taken up by Latin American exports and considerable increases in the proportions of the other regions' imports. Expanding at an average rate of nearly 26% a year in 2000–2009, South–South trade in these regions grew faster than in Asia, at 23% (Table 2.2.1 above).[6]

The asymmetric decline of developing Asia's export and import shares, however, actually points to the region's growing importance as a manufacturing assembly center of global production networks: that PRC's imports from other Southern regions increased rapidly in recent years but not as much as did its manufacturing exports to these regions means that non-Asia South's exports to the PRC (or the PRC's imports from the non-Asia South) are not growing as fast as the PRC's exports to non-Asia South (or non-Asia South's imports from the PRC).

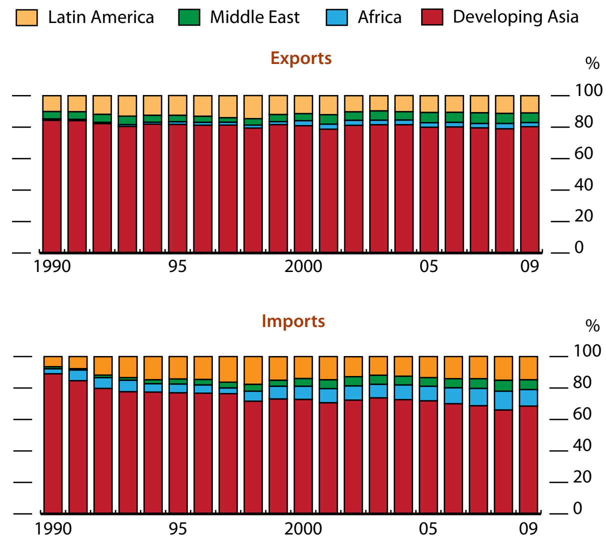
In the case of the shares of South–South trade in total trade, Figure 2.2.7 indicates that, for all the regions,[7] the proportions were higher for exports than for imports, although the gap narrowed over 1990–2009. In 1990–1991 (2-year average), South–South trade accounted for 42% of total exports and nearly 34% of total imports in Asia. By 2006–2007 (2-year average), the proportions had converged to about 50% and 49%, respectively.

This is explained by the higher demand for imports among Southern economies as a result of their strong growth performance and the emergence of greater trade complementarities between them, as their production structures became more diversified over time. Particularly for developing Asia, such complementarities have arisen out of the international division of labor within regional production networks.

The most striking development in South–South trade has been the PRC's rise as the regional hub of international production and trade networks. Between 1990 and 2009, the PRC's share of Asia's South–South trade rose from nearly 40% to almost 52% in the case of exports, and from 51% to 56% in the case of imports (Figure 2.2.8).

As a proportion of its total exports, the PRC's exports to the South increased from 37% in 1990 to almost 50% in 2009, while the comparable numbers for its imports are 46% for 1990 and 51% for 2009. That the import side has a larger Southern share reflects the PRC's reliance on other East Asian countries for parts and components used in final assembly as well as its dependence on other Southern countries for primary inputs.

2.2.6 South–South trade, regional shares

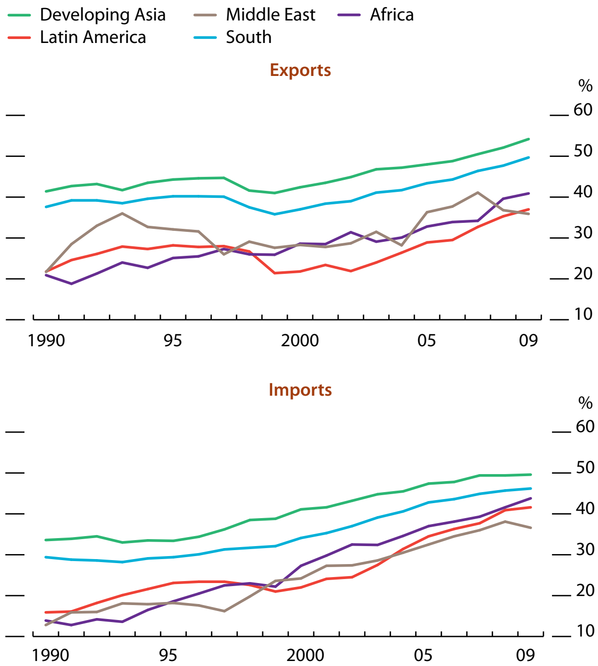


Note: Merchandise trade, nonfuel.

Source: Athukorala (forthcoming).

Click here for figure data

2.2.7 Share of South–South trade in total Southern merchandise trade



Note: Merchandise trade, nonfuel.

Source: Athukorala (forthcoming).

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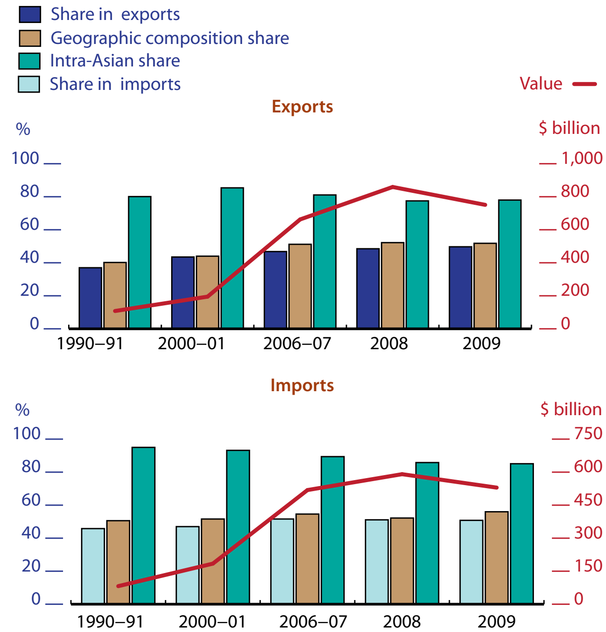
2.2.8 Share of developing Asia's South–South trade, People's Republic of China



Notes: Merchandise trade, nonfuel. Data computed as 2-year average except in 2008 and 2009.

Source: Athukorala (forthcoming).

Click here for figure data

The direction of South–South trade

Another characteristic of Asia's South–South trade is its heavy regional concentration, compared with the Middle East, Africa, and Latin America (Figure 2.2.9).

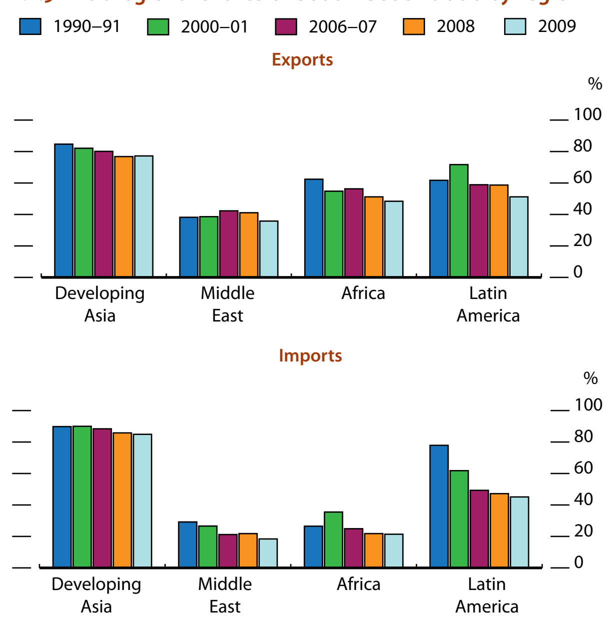
In the early 1990s, intra-Asian trade accounted for almost 85% and 90% of Asia's South–South nonfuel exports and imports, respectively. By 2008–2009 (2-year average), these shares declined only marginally, to about 77% and 85%, respectively. In comparison, the shares of intraregional trade of the other regions are considerably lower.

At the level of individual countries (not shown in the graphs), intraregional shares are highest among Asian countries, particularly for the high-performing economies of East Asia that are linked to the regional production networks.

Developing Asia is the prime destination of other regions' exports outside the regions themselves (Figure 2.2.10). In 2006–2007 (2-year average), it absorbed almost 16% of the exports of the Middle East and more than 9% of the exports of both Latin America and Africa. In contrast, these regions took small shares of Asian exports, with the Middle East the highest at only 4%.

A similar picture emerges for imports by origin: developing Asia's share in other regions' imports is substantial, ranging from 18% to 23%, whereas the regions themselves draw but a

2.2.9 Intraregional shares of South–South trade by region



Notes: Merchandise trade, nonfuel. Data computed as 2-year average except in 2008 and 2009.

Source: Athukorala (forthcoming).

Click here for figure data

minor share of Asia's total imports, which at 3% in 2006–2007 (2-year average) was highest for Latin America.

Recent trends in Asia's trade with non-Asian Southern markets, however, have been dominated by the PRC's rise as a powerhouse in global trade. The PRC's share of the region's total imports from the South outside Asia increased from about 15% in the early 1990s to about 38% by 2008–2009 (2-year average—Figure 2.2.11).

During this period, the PRC accounted for almost 80% of the total increment of developing Asia's imports from these regions. Indeed, its shares have increased rapidly across all three subcategories of imports (fuel, nonfuel primary commodities, and manufactures), with that of nonfuel primary products showing the sharpest increase (from 33% in the early 1990s to 61% in 2008-9).

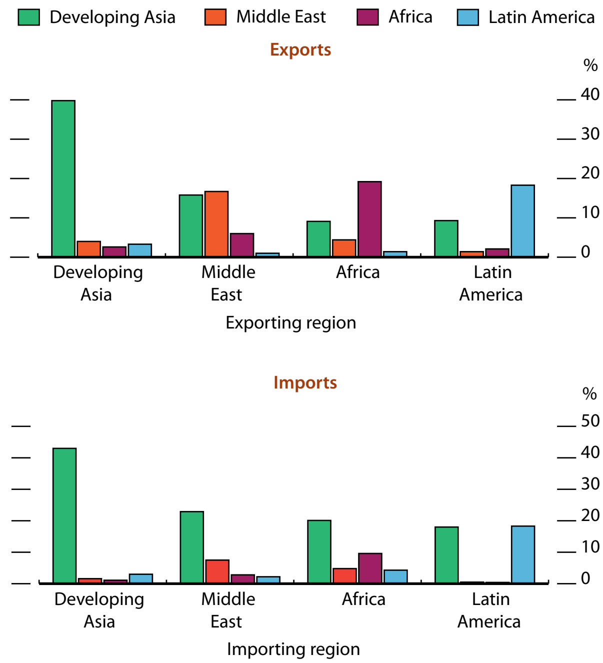
On the exports side, the PRC's share of the region's exports to Southern markets outside Asia increased from about 28% in the early 1990s to 48% in 2008–2009 (2-year average), driven predominantly by the rapid growth of manufacturing exports.

As for the PRC's trade ties with each of Southern regions, it turns out that the PRC's shares in developing Asia's trade with Africa and Latin America have grown the fastest. By 2008–2009, the PRC accounted for 58% and 65% of developing Asia's total imports from Africa and Latin America, respectively. On the export side, the PRC accounted for 51% of regional exports to Africa, up from about 30% in the early 1990s. For Latin America, these flows increased from 34% to 54%, and, for the Middle East, from 22% to 40% (Figure 2.2.12).

In 2008, total trade between the PRC and Latin America reached $138 billion, an increase of about 33% from a year earlier. This was more than three times the increase in Latin America's trade with the United States and Europe over the same period.[8] PRC's trade with Latin America is principally an exchange of primary commodities for manufacturing goods (as is its trade with Africa). Mining products account for nearly half of the region's exports to the PRC, followed by agriculture commodities, with a share of 35%.

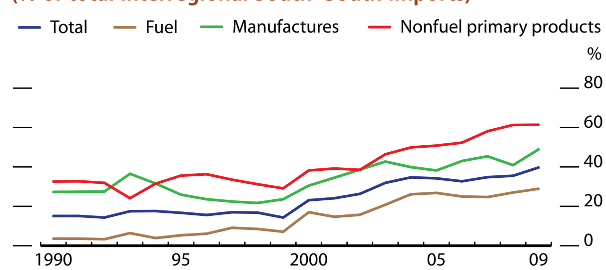
Approximately 90% of the region's exports to the PRC come from just four countries: Brazil (41%), Chile (23%), Argentina (16%), and Peru (9%) (IADB, 2010). Although PRC products are rapidly penetrating markets in all the Latin American countries, the natural-resource endowment of many countries does not allow them to capture a significant share of the PRC's demand. Consequently, some Latin American countries are accumulating trade deficits with the PRC, which in turn are reflected as developing Asia's persistent trade surpluses with Latin America, similar to Africa's, though thus far these are relatively mild. Only the Middle East as a region has been accumulating a sizeable trade surplus with Asia, mainly due to fuel.

2.2.10 Direction of trade, 2006–2007



Notes: Merchandise trade, nonfuel. Data computed as 2-year average.
Source: Athukorala (forthcoming).
Click here for figure data

2.2.11 Share of imports of the People's Republic of China (% of total interregional South–South imports)



Note: Merchandise imports.
Source: Athukorala (forthcoming).
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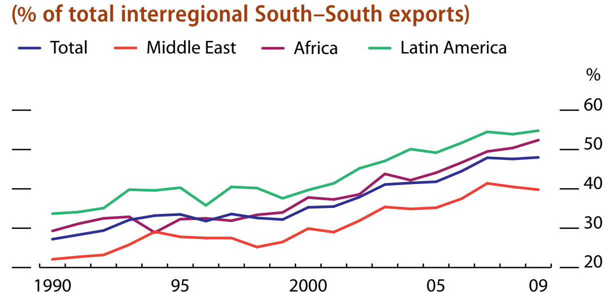
2.2.12 Share of exports of the People's Republic of China (% of total interregional South–South exports)



Note: Merchandise exports.
Source: Athukorala (forthcoming).
Click here for figure data

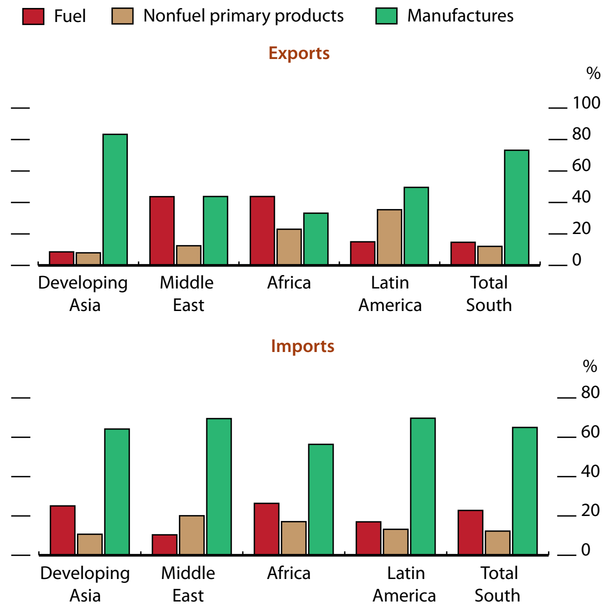
Commodity composition of South–South trade

The broad trends in the commodity composition in South–South trade may be described as follows. First, manufactured goods account for the majority of Asia's exports to the South. Rising steadily over the years, this share reached about 83% in 2006–2007. Export shares of other regions are considerably smaller (Figure 2.2.13 top panel).

Second, manufactures account for the largest share of Asian South–South imports—about 64% in 2006–2007. Asia's manufacturing share somewhat resembles that of the South as a whole. But Asia's imports of manufactures also include trade in parts and components for assembly and reexport in relation to factory Asia, while other regions are mostly at the receiving end of final goods (Figure 2.2.13 bottom panel).

Third, primary commodities, fuel in particular, constitute a substantial share of Asia's imports from the South. Although the share of commodities in Asia's imports is not very far from the average share of the South, these relative measures mask the scale of such imports by Asia. The PRC's imports of fuel and other primary commodities alone increased just over two-fold from the 2-year average for 1990–1991 and 2006–2007, from $52 billion to $163 billion.

2.2.13 Composition of South–South trade, 2006–2007



Notes: Merchandise trade. Data computed as 2-year average.
Source: Data taken from Table 7 of Athukorala (forthcoming).
Click here for figure data

Fourth, new developments are likely to emerge with the PRC's strengthening trade ties with other regions of the South, particularly Africa and Latin America. Driven by its increasing demand for primary resources, the PRC became Africa's largest trading partner in 2009, surpassing both the European Union and the United States. The exports of the five oil-rich countries (Angola, Equatorial Guinea, Nigeria, the Republic of Congo, and Sudan) represent as much as 85% of Africa's exports to the PRC (Hanson, 2008). Much of the recent growth in these flows is accounted for by oil imports from Sudan and other African nations, although PRC firms also import a significant amount of non-oil commodities, including timber, copper, and diamonds.

The PRC, however, recently began to import minerals, agricultural products, and some manufactured goods from Africa, such as processed food and household consumer goods. This last development reflects the budding interest of PRC firms in Africa as a growing market, for low-cost consumer goods, in which establishing a commercial presence through FDI might prove profitable. And it has been facilitated by the progressive opening up of African economies and the privatization of their industries.

Additionally, the PRC has invested massively in Africa's fuel and mineral sectors, particularly in Angola, Ghana, Nigeria, South Africa, Sudan, and Zambia. As these investment projects become operational, commodity exports to the PRC are bound to increase rapidly.

The scope for boosting Asia's South–South trade

Athukorala (forthcoming) estimates the intensity of bilateral trade flows during 1990–2008, among the 12 largest economies of developing Asia[9] and all their trading partners. Controlling for economic size, physical distance, and several other standard explanatory variables, he finds that the intensity of Asia's trade with Southern countries has been stronger than average trade with countries worldwide.

The results, however, also single out high tariffs and weak trade-related logistics and infrastructure as major hindrances to trade, particularly South–South trade. These factors are reflected in the model by trade-weighted average most-favored-nation (MFN) tariffs and the World Bank's Logistics Performance Index[10] (LPI), respectively.

Based on a worldwide survey of global freight forwarders and express carriers—and complemented by a number of qualitative and quantitative indicators of the trade and transport-related infrastructure, institutions, and the performance of supply chains—the LPI measures the comparative performance of countries in various dimensions on a five-point scale. For the 2010 survey, the LPI scores indicate that countries in the South, on average, continued to score considerably lower than those in the North, with Africa and the low-income countries having cellar rankings (Figure 2.2.14).

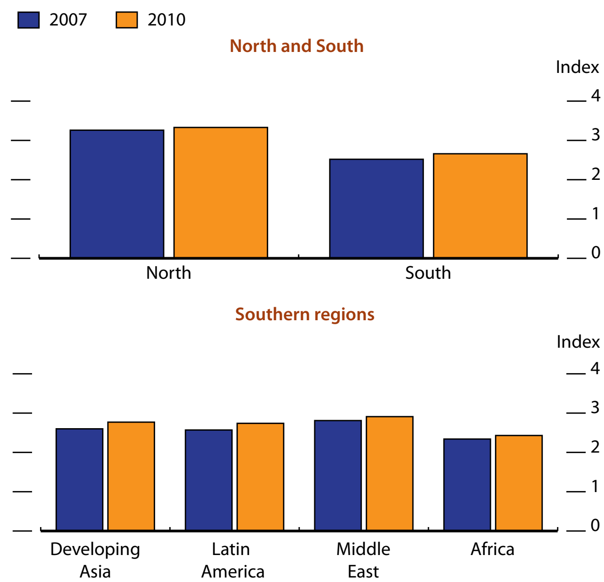
The rankings, then, confirm the well-known bottlenecks to trade that beset developing countries, in particular the poorest among them. In the context of South–South trade, however, easing these bottlenecks assumes greater importance in that the impediments exist on both sides of the trading relationship.

In other words, further tariff reductions and easier access to Southern markets through improved road and ports infrastructure, efficient logistics, and better customs procedures, among other factors, which in turn facilitate closer integration and more trade among countries in the South, are likely to generate benefits beyond those that accrue from the South's closer integration with the global economy in general.

Long-standing policy efforts at regional and multilateral levels—mainly under the auspices of the WTO Doha Development Round—have intensified trade facilitation efforts to improve the South's access to world markets and to lower its trade costs. The initial benefits of these measures, such as improved trade-related infrastructure and more efficient and timely handling of international shipments, are already coming through in the 2010 LPI scores.

Compared with 3 years earlier, the South's score shows a marked improvement, although it remains much below the North's performance (Figure 2.2.14). Continuing efforts at trade facilitation, with trade-related aid providing critical infrastructure in the poorer Southern countries, will be crucial to furthering the South's growing involvement in global trade along South–South lines.

2.2.14 Average Logistics Performance Index scores



Notes: The index is based on a score of 1 (lowest) to 5 (highest).

Source: ADB calculations using data from World Bank's Logistics Performance Index online database. http://info.worldbank.org/etools/tradesurvey/mode1a.asp (accessed 15 March 2011).

Click here for figure data

A simulation of South–South trade

To what extent can trade policy potentially foster integration among Southern markets? Anderson and Strutt (forthcoming) use a global-economywide computable general equilibrium (CGE) model (Box 2.2.3) to project outcomes to 2030 of various trade-reform scenarios and evaluate them against a core baseline setting.

Care must be taken, however, in interpreting the simulation results.

2.2.3 South–South trade in 2030: The Global Trade Analysis Project model and core modeling assumptions

The background study to this section (Anderson and Strutt, forthcoming) employs the standard Global Trade Analysis Project (GTAP) model (Hertel, 1997) and Version 7.1 of the GTAP database.

The GTAP database's current baseline depicts the world economy as of 2004. For the analysis discussed in this section, a new core baseline for 2030 is projected under the assumptions that each country's stock of agricultural land and trade-related policies do not change throughout the 26-year period of analysis, but that national real GDP, population, unskilled and skilled labor, capital, and other natural resources (such as oil, gas, and coal) grow at exogenously set rates (Box table).

The exogenous growth rates are based on Lee and Hong (2010), OECD, USDA, and World Bank projections, along with those of Tyers and Golley (2010), Valenzuela and Anderson (2010), and Walmsley and Strutt (2009), plus historical trends in mineral and energy raw material reserves from BP (2010) and the US Geological Survey (2010). Past annual rates of change in fossil fuel reserves since 1990 are assumed to continue for each country over the next two decades. For other minerals, in the absence of country-specific data, the unweighted average of the annual rate of growth of global reserves for iron ore, copper, lead, nickel, and zinc between 1995 and 2009 (US Geological Survey, 2010) is used for all countries.

Given those exogenous growth rates, the model derives implied rates of total factor productivity (TFP) and per capita GDP growth. For any one country, the rate of TFP growth is assumed to be the same in each of its nonprimary sectors and to be somewhat higher in its primary sectors. Higher productivity growth rates for primary activities were characteristic of the latter half of the 20th century (Martin and Mitra, 2001) and are necessary in this projection if real international prices of primary products (relative to the aggregate change for all products) are to follow a relatively flat trend. Once those higher TFP rates for primary sectors are determined, the uniform TFP rates for nonprimary sectors are recalculated to ensure that targeted GDP levels are obtained.

Average annual GDP and endowment growth rates, 2004–2030

GTAP regional agglomeration	GDP growth	Population growth	Unskilled labor	Skilled labor	Capital	Oil	Gas	Coal
Western Europe	1.72	0.12	-0.03	-0.68	1.80	2.81	0.77	-2.51
Eastern Europe[a]	3.52	-0.34	0.18	0.66	4.04	2.64	0.12	-1.86
United States and Canada	2.34	0.83	0.77	-0.20	2.54	1.00	-0.14	0.19
Australia and New Zealand	2.89	0.98	0.83	-0.17	3.32	1.49	6.10	3.55
Japan	1.04	-0.44	-0.71	-1.38	1.30	0.00	0.00	-9.34
China, People's Rep. of	6.63	0.29	0.49	2.35	8.00	-0.40	4.85	5.62
Rest of East Asia	3.69	0.38	-0.14	1.62	4.09	0.00	0.00	-1.59
Southeast Asia	4.60	1.04	1.06	2.82	4.67	1.31	1.48	11.71
South Asia	6.22	1.27	1.66	3.05	7.41	0.24	-0.47	4.83
Central Asia	4.53	0.73	0.52	0.59	4.50	2.81	0.77	-2.51
The Pacific	3.61	1.53	1.98	3.54	3.60	1.54	1.21	0.15
Latin America	3.99	1.01	1.33	2.76	4.11	3.29	-0.34	5.15
Middle East and Africa	4.34	2.03	1.89	2.09	4.33	1.27	3.64	1.89
North	**1.95**	**0.15**	**0.25**	**-0.51**	**2.08**	**2.07**	**0.40**	**-0.26**
South[b]	**4.83**	**1.10**	**1.03**	**2.36**	**5.52**	**1.48**	**2.24**	**5.57**
Of which: Developing Asia	5.40	0.83	0.66	2.24	6.41	0.72	0.93	5.93
Total	**2.54**	**0.91**	**0.38**	**-0.19**	**2.97**	**1.67**	**1.23**	**2.50**

[a] Includes the Russian Federation. [b] South comprises Africa, developing Asia, Latin America, and the Middle East. North covers all the other regions, that is, Western and Eastern Europe, United States and Canada, Australia and New Zealand, and Japan.

Source: Anderson and Strutt (forthcoming).

In particular, the outcomes must be considered exclusively in terms of relative changes in the relevant shares and figures rather than in absolute terms, for the following reasons. First, the dataset used in the simulations is aggregated and calibrated to fit the requirements of the CGE model and is not necessarily consistent with the historical time series.

Second, calibrated to the world economy as of 2004, the dataset does not reflect the effects of the recent crisis, particularly the slowdown in the industrial world and its concomitant effects on the relative shares of the North and South in global GDP and trade. To capture the influences of these developments at least to a degree, the growth assumptions of country aggregates are set to be fairly conservative in order to incorporate relative shifts over the long horizon of the simulations. (See the regional growth assumptions in Box 2.2.3.)

Third, in the simulations, the shares of regional aggregates relative to world trade or total South–South trade refer to total trade in goods and services. That is, they reflect a far broader category of trade flows and have different effects for aggregates of the North and South, where services trade is far smaller. These trade shares are also not directly comparable to those derived from the UN Comtrade database—the basis of the descriptive analysis above—which covers only merchandise goods. Unfortunately, the two series cannot be reconciled because historical data on services between pairs of countries are unavailable.

These caveats notwithstanding, the simulation analyses provide insights to the relative changes in the regions' GDP and trade shares as well as on shifts in bilateral trade shares under alternative sets of assumptions concerning the global outlook over a horizon of more than 20 years.

The core baseline projection: Sector and regional shares of GDP and trade

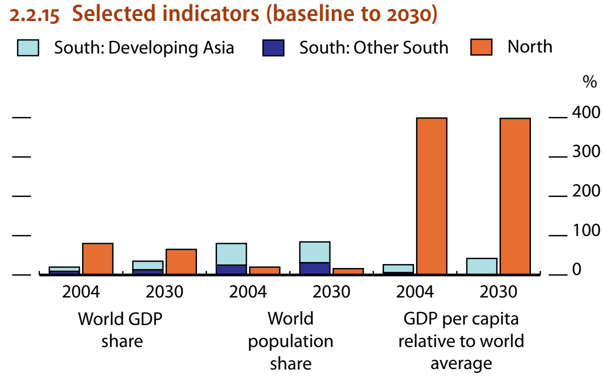
Box 2.2.3 summarized the assumptions on the growth of GDP and factor inputs underlying the core projection to 2030. Together, these assumptions set the parameters for the structures of production, consumption, and trade across sectors both in and between countries.

As for the outcomes, these may be described as follows. In aggregate, the faster-growing South—developing Asia in particular—accounts for much larger shares of the projected global economy (Figure 2.2.15). The South's aggregate share of world GDP rises from 20% in 2004 to 35% in 2030. For developing Asia, this proportion, when the PRC is included, goes from 11% to 22%, and when the PRC is excluded, from 4.1% to 10.6%. (In other words, more than half developing Asia's increasing share of world GDP is due to developing Asia other than the PRC.)

Population shares change much less. Over 2004–2030, it is projected that the South's share rises from 80% to 84% but developing Asia's falls somewhat, from 55% to 53%. Combined with the GDP growth assumptions, the net effect is that per capita incomes converge significantly: the ratio of the North's country average to the South's falls by almost a half by 2030. For developing Asia, per capita income rises from 20% to 42% of the global average.

The South's share of global exports nearly doubles, rising from 33% in 2004 to 55% in 2030 (Figure 2.2.16). The PRC's share

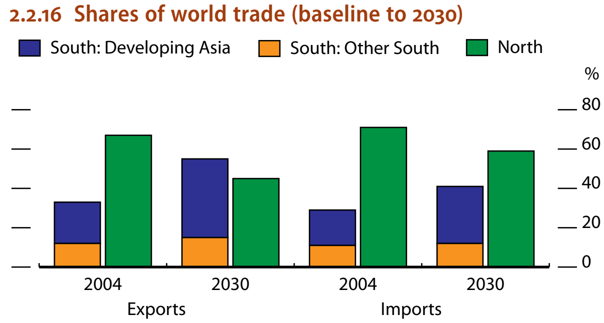
2.2.15 Selected indicators (baseline to 2030)



Source: Data taken from Table 1 of Anderson and Strutt (forthcoming).

Click here for figure data

2.2.16 Shares of world trade (baseline to 2030)



Note: Goods and services trade.

Source: Data taken from Table 2 of Anderson and Strutt (forthcoming).

Click here for figure data

alone grows from 7% to 20%, which comes entirely at the expense of the North, since the export shares of all other Southern regions grow as well. Similarly, the South's import share rises, albeit not as dramatically. For developing Asia, the ratio increases from 18% to 29%. Capital flows balance each region's global export and import shares.

The South's share of primary-product exports rises slightly, while its share of manufactures exports soars (doubling in the case of Asia, as does its share of services exports—Figure 2.2.17). Likewise, the South's share of primary-product imports rises substantially (Figure 2.2.18), due largely to developing Asia's expected continuing rapid industrialization.[11]

In addition, the South increases its share of world imports by 44% and of manufactures imports by 25%. The increase in the latter is due to the ongoing fragmentation of the production of manufactured goods with its multi-component supply chain, each segment of which can be set up in a footloose fashion. Indeed, the simulation analyses do not fully capture the effects of these production networks because of the high degree of aggregation of manufacturing industries in the CGE model used.

The South's share of farm-product exports remains virtually unchanged (Figure 2.2.19). Its share of farm-products import, however, surges, due mainly to the PRC, but also because of India. Higher import demand for agriculture and food products is projected for these countries despite the fact that their shares of agriculture in GDP and of land in factor incomes are also expected to rise slightly, instead of falling in the usual way as economic development proceeds.

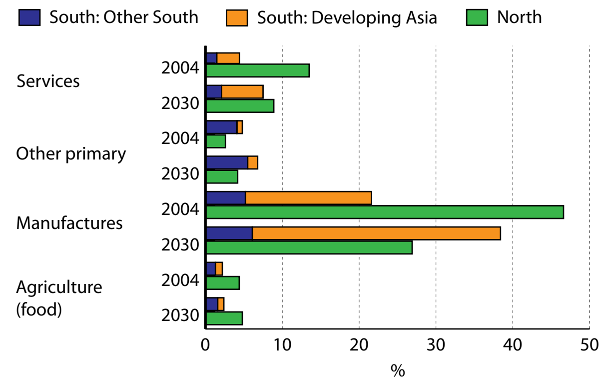
For the sector shares of trade at the country level (not shown in the chart), the consequences of continuing Asian industrialization are again evident: primary products are less important in the South's exports and considerably more important in its imports; conversely, nonprimary products figure more significantly in the South's exports and less so in its imports. Moreover, the increases in primary-product imports and nonprimary product exports are largest for developing Asia.

The opposite is true for the North, reflecting the fact that what one part of the world imports the remaining part of the world must export to maintain equilibrium. Newly industrializing countries are thus poised to become far more dependent on food imports, which may raise problems of sustainability.

On bilateral trade patterns, the core projection indicates that South–South trade as a share of global trade will double by 2030, rising from 12.8% to 26.5% (Figure 2.2.20a-b). Consonant with this trend, the trade share of Asia's developing countries more than doubles, while that of the rest of the South increases by two-fifths. By contrast, the share of North–North trade in global trade is projected to fall from 51.2% to 30.2%.

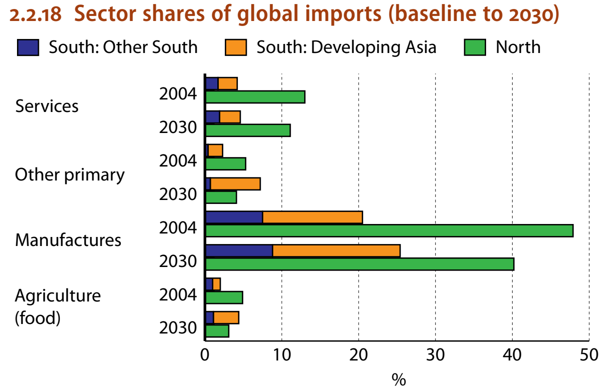
Finally, the core projection suggests that the global trade share of the North's exports to developing Asia will rise slightly by 2030, while that of developing Asia's exports to the North

2.2.17 Sector shares of global exports (baseline to 2030)



Source: Data taken from Table 4 of Anderson and Strutt (forthcoming).
Click here for figure data

2.2.18 Sector shares of global imports (baseline to 2030)



Source: Data taken from Table 4 of Anderson and Strutt (forthcoming).
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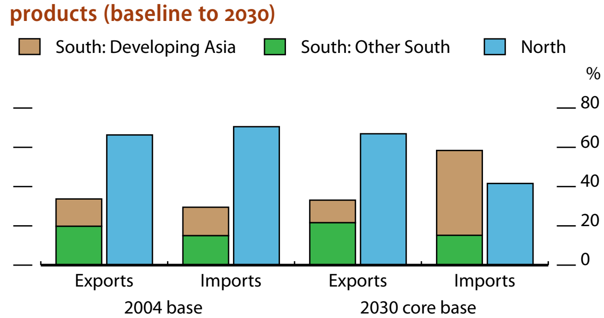
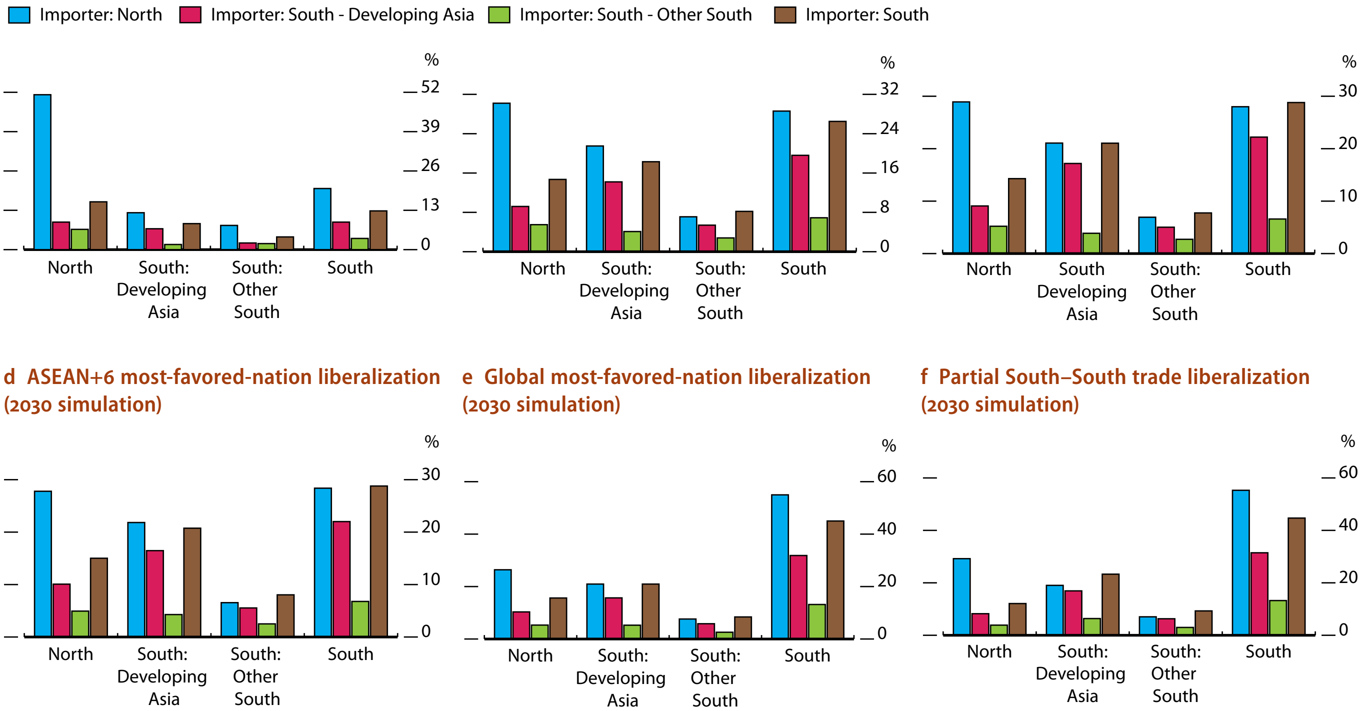
2.2.19 Shares of world trade in agricultural and food products (baseline to 2030)



Source: Data taken from Table 5 of Anderson and Strutt (forthcoming).
Click here for figure data

2.2.20 Core baseline projections for bilateral trade, by exporting region

a Global trade (2004 base)
b Global trade (2030 simulation)
c ASEAN+6 preferential liberalization (2030 simulation)
d ASEAN+6 most-favored-nation liberalization (2030 simulation)
e Global most-favored-nation liberalization (2030 simulation)
f Partial South–South trade liberalization (2030 simulation)



ASEAN+6 = Association of Southeast Asian Nations plus Australia, People's Rep. of China, India, Japan, Rep. of Korea, and New Zealand.
Source: Data taken from Table 8 of Anderson and Strutt (forthcoming).
Click here for figure data

will nearly double, from 12.2% in 2004 to 21.5% in 2030. This latter result is unsurprising, given that the share of developing Asia's exports in world trade doubles over the projection period, due not only to its high GDP growth rate but also its high and rising trade-to-GDP ratio.

Put differently, the expansion of South–South trade does not come at the cost of developing Asia's exports to the North, which will continue to prop up demand for output from factory Asia.

Scenarios for trade reforms

To gauge the potential gains from South–South integration, in view of the anticipated size and structure of global markets in 2030, four scenarios of policy reform[12]—out of many possible—are assessed relative to the core baseline projection.[13]

Scenario a: ASEAN+6 on a preferential basis (Figure 2.2.21a). This involves expanding the ASEAN free trade area to include the six countries now under consideration: Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand. The global gains, as measured by equivalent-variation-of-income estimates, are about $64 billion a year, most of which accrue to the new members of the trade bloc from the North, namely, Australia, Japan, and New Zealand. Similar gains are enjoyed in the South by current members of ASEAN. Apart from developing Asia, the rest of the South as a group is slightly worse off.

Scenario b: ASEAN+6 on an MFN basis (Figure 2.2.21b). If the reforms are on an MFN basis (that is, tariffs are eliminated for both members and nonmembers of ASEAN), the global gains more than double, to more than $153 billion a year by 2030, while developing Asia's gains at $56 billion a year are 50% higher. Non-Asia South gains are about $29 billion a year.

Scenario c: Global MFN liberalization (Figure 2.2.21c). This is an extreme reform scenario in which all countries eliminate their tariff barriers to merchandise trade. Welfare gains of almost $333 billion a year are generated—$130 billion for the North, nearly $138 billion for developing Asia, and about half those levels to the rest of the South.[14] Against scenario b, one sees that full liberalization of goods trade by ASEAN+6 goes a long way toward generating the potential benefits that come from global goods trade liberalization.

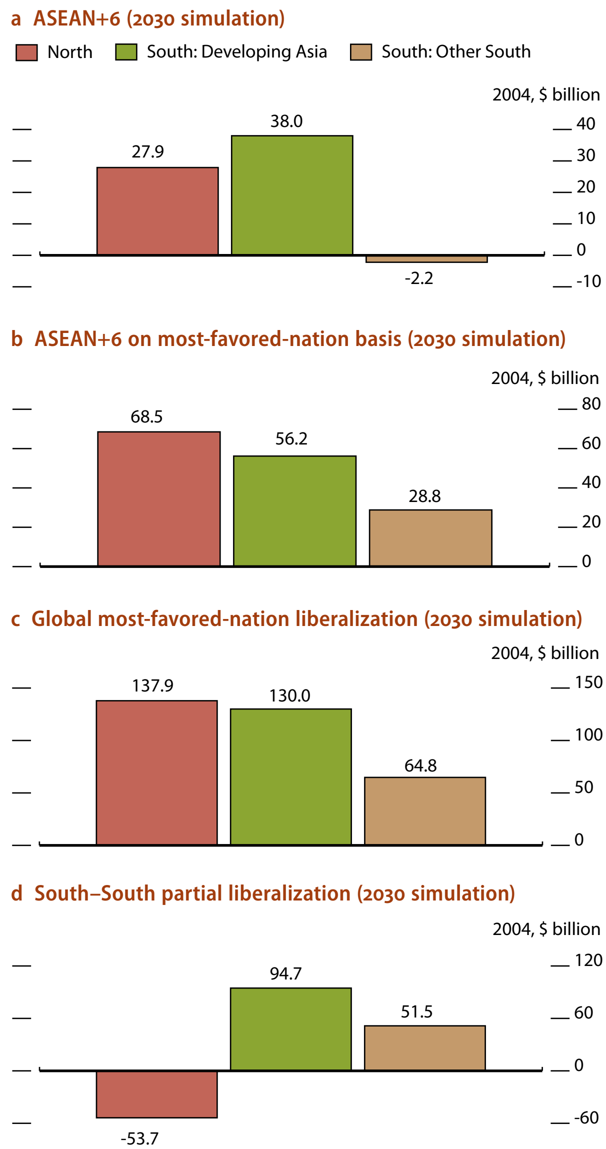
Scenario d: South–South partial liberalization (Figure 2.2.21d). This final and possibly most realistic scenario explores the impacts of reducing intra-South import tariffs to the average levels imposed on exports from the South to the North.[15] The outcome is that North is slightly worse off, while the South comes out much better off. Specifically, the gains to the South overall generate three-quarters of the benefits that the South obtains from a worldwide regime of zero tariffs (scenario c).

Thus each of these reforms raises the share of South–South trade above the core projection, albeit in varying degrees. Unsurprisingly, ASEAN+6 preferential trade reform (scenario a) increases developing Asia's intraregional trade share in global trade by almost 3 percentage points (Figure 2.2.20c above), and half a percentage point is taken off from this if ASEAN+6 lowers tariff rates to zero (scenario b—Figure2.2.20d above). But in both cases, the global trade share of South–South trade increases by 2.3 percentage points.

If all countries fully liberalize their goods trade (scenario c), the share of South–South trade increases by even more—that is, 2.9 percentage points (from 26.5% in the core projection to 29.4%—Figure 2.2.20e above). As may be expected, the highest increase in South–South trade's global trade share is achieved under broad South–South liberalization (scenario d above), which boosts the estimate by 6.1 percentage points, or 23%, above that of the core projection (Figure 2.2.20f above).

How are the other trade flows affected by increases in the world trade share of South–South trade? Under all scenarios considered, the share of North–North trade in world trade declines. In contrast, the world trade share of North–South trade increases under scenarios b and c, that is, with regional and global MFN liberalization, but decreases under scenarios a and d, that is, with preferential liberalization involving ASEAN+6 and the South as a whole. Perhaps not surprisingly, the declines in trade shares are more pronounced under South-wide tariff reductions, as a result of which the share of North-to-South exports and of South-to-North exports fall by 2.6 and 2.5 percentage points, respectively, relative to the core projection estimates.

2.2.21 Four scenarios for trade reform



ASEAN+6 = Association of Southeast Asian Nations plus Australia, People's Rep. of China, India, Japan, Rep. of Korea, and New Zealand.

Note: Bars refer to welfare gains, measured as equivalent variations in income.

Source: Data taken from Table 11 of Anderson and Strutt (forthcoming).

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Stress scenarios: Slower growth in the North and the alleviation of global imbalances

Given the importance of demand from the North as the ultimate driver of factory Asia's production network and the ramifications this has for developing Asia's intraregional trade, the following question arises: How does stronger South–South trade hold up against slower growth in the North?

The plunge in the industrial economies' demand for exports from the developing world during the recent crisis raised the need for developing Asia's economies to become more self-reliant and to adopt policies that broaden the scope and structure of their openness to trade and capital flows. To gradually shift developing Asia's supply and demand structures toward Southern and intraregional markets, however, far-reaching structural and macroeconomic adjustments are needed. On the supply side, for example, it has been argued that the value chains of PRC-centered international production networks have to overcome issues of production and product specificity as well as adjust their physical and human infrastructure to the new structure of demand (ADB, 2010b). On the demand side, in turn, household consumption has to be stimulated by transferring corporate saving to households and reducing precautionary saving (ADB, 2009).

The simulation framework adopted here is suitable neither for exploring these issues in their full complexity nor for drawing implications for developing Asia and the South more broadly. But to roughly gauge the implications for South–South trade of a weakening of demand from the North, the following stress scenario is tested: suppose the rates of growth of GDP and capital flows in the North are reduced by one-third compared with the core projection and, as a consequence, the South slows down by half the North's rate.

The results of the simulation exercise indicate that the South would be unable to simply rely on its higher growth momentum and, in turn, the share of South–South trade would not expand. Clearly, unless the South fully makes up for the lower demand from the North, it is likely that the dynamism and viability of factory Asia would come under stress.

A second stress test explores an issue related to the South's reliance on the North, namely, the gradual reduction in North–South imbalances. To the extent that South–South trade grows as a share of total trade, some of the largest imbalances at the bilateral level along North–South lines can be expected to fall. By the same token, imbalances among Southern regions are likely to widen, particularly if the commodity composition of interregional South–South trade remains largely unaltered and demand for Asia's manufactures exports continues to expand.

Again, the full implications cannot be explored within the simulation environment employed. To assess the robustness of South–South trade against global imbalances, the following two assumptions are imposed: both the PRC surplus and United States deficit are eliminated by 2030; and global growth rates are unaffected by the trade rebalancing.

Leaving the other assumptions from the core baseline unaltered and accommodating changes in the trade balance by allowing saving rates to decline in the PRC and increase in the United States, the simulation results suggest that, even under such extreme assumptions of complete expenditure switching in the PRC and a dramatic increase in the saving rate in the United States, the overall pattern of the main findings does not change. Most importantly, the South's share in global trade almost doubles as it did in the core baseline projection.

Three conclusions from the simulation results

First, the South has the potential to boost trade within the group. Lowering barriers to South–South trade, even to the levels prevailing in South–North trade, could bring three-quarters of the gains to Southern countries as would flow from a freeing of all countries' goods trade. The share of South–South trade in world trade would expand by 6.1 percentage points, or about one-quarter, compared with the core projection.

Second, to benefit the South as a whole, regional initiatives should be inclusive and eventually extend market access to other countries on an MFN basis. For example, it was shown that if an ASEAN+6 bloc were to trade freely on an MFN basis, this could generate for Asia almost half of what would accrue to the region if the whole world so liberalized. South–South trade would rise by 2.3 percentage points, or almost one-tenth, as a result.

Third, growth in the North and demand from that region will continue to play an important role for the South. This is particularly the case for developing Asia and its trade within the region, given that the final outputs of its production networks are still largely geared toward the North. A progressive shift of supply and demand structures toward increased regional demand will take time for Asia to accomplish, and until then the viability of factory Asia will continue to be linked to the vicissitudes of the North, albeit to a lesser and lesser extent as South–South economic integration advances.

Summary

South–South trade has expanded rapidly during the past two decades, with its share of merchandise trade rising from about 7% in 1990 to 17% in 2009. The main determinants of this trend have been the emerging economies' strong growth performance and rising share of world GDP, the rise of fragmented-production and trade networks, and the progressive dismantling of trade barriers.

As the leading proponent of international production networks in the South, developing Asia has been the main driver of South–South trade. The region as a whole now accounts for about three-quarters of the trade among Southern countries (although by and large the flows are confined within developing Asia).

The PRC alone accounts for about 40% of this intra-South traffic in goods. In large part, this share reflects the PRC's pivotal role as the last-stage assembly hub of the parts and components production networks referred to as factory Asia, the final output of which is exported predominantly to the affluent markets of the North.

At roughly one-quarter of South–South trade, the combined share of Latin America, Africa, and the Middle East is small. Since 2000, however, these regions' trade with the South has been expanding at an average annual rate of 26%—faster than Asia's 23%.

Developing Asia's trade with the other regions of the South has increased markedly during the past two decades. Of developing Asia's imports from the South, almost 80% was attributable to the PRC. Mainly consisting of primary commodities, these imports were used to fuel the country's economic expansion. In turn, the PRC's manufactures exports were increasingly absorbed by growing demands from Latin America, Africa, and the Middle East.

Although global trade as a whole stands to gain from further reductions of tariffs and other barriers to trade, which tend to be higher in the South, an abiding policy focus on lowering these remaining hurdles will spur South–South trade especially.

Average tariff levels in the South have come down dramatically over the past two decades, but they are still much higher than those in the North. Moreover, tariffs faced by exporters from the South are, on average, higher in the South than they are in the North. Logistics performance of the South, as measured in its various dimensions by the World Bank, has shown significant improvement since 2007; it is still not up to par, though, with the North.

There is therefore scope for developing Asia and other developing regions to deepen trade integration and further increase the volume of South–South trade through a gradual clearing of the remaining bottlenecks. Simulation analysis suggests that lowering tariff barriers to South–South trade even to just the levels prevailing in South–North trade could bring three-quarters of the gains to Southern countries as would be generated by the global elimination of tariff barriers, and South–South trade would expand as a result.

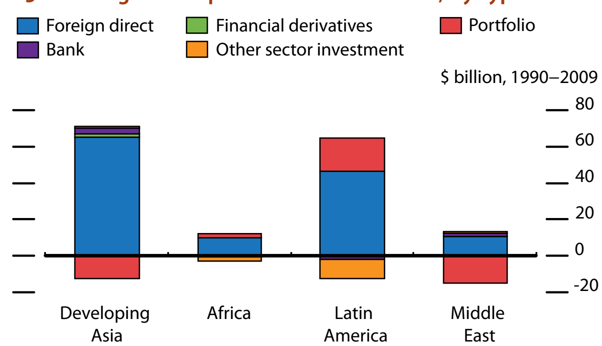
However, trade reforms in support of South–South trade must not come at the expense of continuing broader global integration. In view of the proliferation of regional trade agreements in Asia and elsewhere, it is increasingly important that the terms and conditions of future accords be made as broad-based and inclusive as possible, as well as consistent with WTO provisions. A comparison of Asia's North–South FTAs with their South–South counterparts reveals that the former are generally more compatible with WTO and other global rules (Box 2.2.2). Continuing its policy of open regionalism and ensuring that future FTAs are comprehensive and compatible with global rules are two strategies that offer Asia a promising path to take toward freer trade.

Expanding South–South economic links through investment

Attracted by the PRC's opening up to investment in 1978 and, in particular, by the establishment of export-processing zones in the country's coastal provinces, FDI spurred the PRC's rise as a world trade powerhouse. In turn, this spawned FDI-financed international production networks (which have the PRC as the hub of last-stage assembly of the final product) throughout developing Asia. The volume of investment for these networks intensified after the Asian financial crisis in the late 1990s as the networks expanded and became more intricate and fragmented. Recently, interregional FDI flows in the South have become more significant as well, with developing Asia's emergence as an FDI exporter to Latin America and Africa.

A measure of foreign ownership of productive assets (such as factories, mines, and land), FDI is a far more important source of capital to developing Asia than other types of foreign investment. Over the last two decades, FDI inflows to developing Asia have averaged $187 billion a year, while the combined flows of portfolio and bank investment have averaged only $126 billion a year. Among the regions of the South, developing Asia receives the largest inflows of FDI, far exceeding those to Africa, Latin America, or the Middle East (Figure 2.3.1).

2.3.1 Average net capital flows to the South, by type



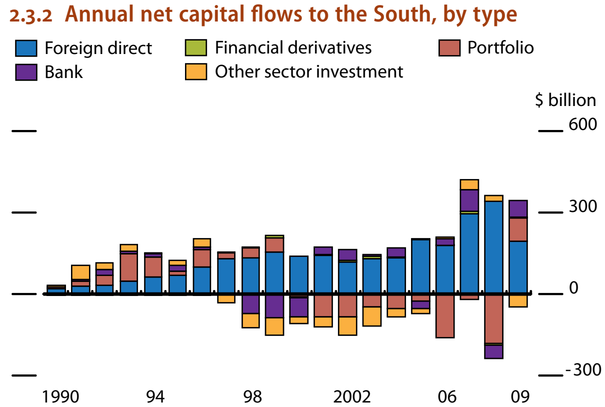
Source: ADB calculations based on data from International Monetary Fund. International Financial Statistics online database; and Directorate-General of Budget, Accounting and Statistics. National Statistics. http://eng.dgbas.gov.tw (both accessed 25 March 2011).

Click here for figure data

For the South as a group, FDI is important as it is a net inflow, whereas portfolio investment, for instance, is a net outflow. Moreover, FDI in the South has proved resilient to external shocks. Compared with portfolio and bank investment, both FDI inflows to and outflows from the South have tended to be more stable.

Indeed, net FDI inflows have been persistently large and positive over the last two decades, even with the financial crises that hit the South in the 1990s, the collapse of the IT bubble in the early 2000s, and the recent global financial crisis. In contrast, portfolio and bank flows have been much more volatile, their direction switching rapidly in response to shocks (Figure 2.3.2).

2.3.2 Annual net capital flows to the South, by type



Source: ADB calculations based on data from International Monetary Fund. International Financial Statistics online database; and Directorate-General of Budget, Accounting and Statistics. National Statistics. http://eng.dgbas.gov.tw (both accessed 25 March 2011).

Click here for figure data

These attributes were validated during the global financial crisis. Outward FDI from the South was less affected than that from the North. In 2008, global outward FDI contracted by around 15%, while the PRC's outward FDI nearly doubled. And FDI inflows to developing Asia in 2009 remained relatively high, even though its rate of growth slowed.

Historically, FDI flows from the capital-abundant North have proved beneficial to their Southern recipients in that they brought advanced technology and filled investment gaps.

Indeed, many developing Asian economies owe their high long-run growth profiles, in part, to such FDI and spillover effects.

The recent trend, however, is that the South is emerging as an exporter of capital both within and outside its own area, which has resulted in a surge of South–South FDI in particular. There are two reasons for this. Increasingly, Southern-owned multinational corporations are expanding their areas of operation, seeking efficiency gains and market opportunities globally, and state-owned enterprises and sovereign funds with abundant finance are seeking resources abroad. Although the magnitudes of these investments are still small relative to flows from the North, their significance and implications for the South cannot be overlooked.

As mentioned earlier, South–South FDI stands out for three reasons: being generally less capital intensive than the North's and more suited to conditions in the South, it may be easier to set up even in low-income countries, thereby increasing employment and income levels. It may also be more stable and resilient to economic crisis. And its volume is an indicator of financial integration of economies of the South.

Stylized facts about South–South links

The emergence of the South as a source of foreign direct investment

FDI has seen a dramatic expansion across the globe over the last two decades. Total stocks of world FDI surged by a factor of almost nine, from $2.1 trillion in 1990 to $19 trillion by 2009. This trend reflects the continuing integration of the world economy, which is facilitating the flow of foreign capital and funds, as well as expediting transfers of technology, skills, and job opportunities.

For Northern economies, the outward FDI stock is far larger than its inward stock, while the converse is true for developing Asia. This confirms, on the one hand, the North's role as a net capital exporter and implies, on the other, that developing Asia presents attractive investment opportunities (Table 2.3.1).

The PRC is becoming increasingly important as both a recipient and sender of FDI. Historically, Hong Kong, China and Singapore, the two regional financial centers of developing Asia, were also its largest players in both inward and outward FDI. Since 2006, however, the PRC has received more FDI than Singapore. Indeed, in the last 5 years, the PRC's inward FDI stock averaged $349 billion a year—an amount far larger than Japan's as well as those of the 27 countries in the eurozone and of the leading economies of Latin America and Africa. And while the PRC still lags behind Singapore as a sender of FDI, it has now surpassed Brazil in this respect.

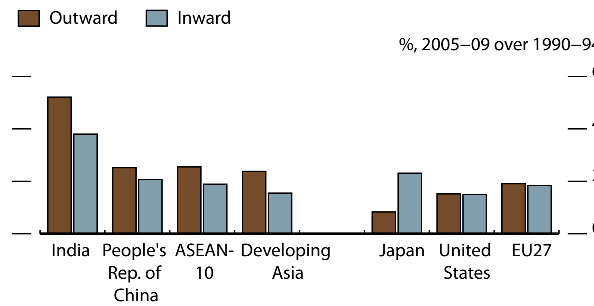
2.3.1 Inward and outward FDI stocks, 5-year average, selected economies, $ billion

Region/Country	Outward FDI		Inward FDI	
	1990–94	2005–09	1990–94	2005–09
India	0.2	44.1	2.3	101.4
China, People's Rep. of	9.7	120.8	43.9	348.6
ASEAN-10	2.7	34.2	8.7	58.0
Developing Asia	5.3	57.9	10.8	50.7
Brazil	42.3	129.8	47.9	280.0
South Africa	17.2	53.7	10.7	94.1
Japan	243.3	560.0	14.8	149.0
United States	9,06.8	4,158.0	686.2	3,076.2
EU27	44.6	300.0	39.3	248.1

Note: For ASEAN-10, developing Asia, and EU27, values are averages for the region.

Source: ADB calculations based on data from UNCTADstat. http://www.unctad.org/Templates/Page.asp?intItemID=1584&lang=1 (accessed 25 February 2011).

2.3.3 Growth of outward and inward FDI stocks, selected economies

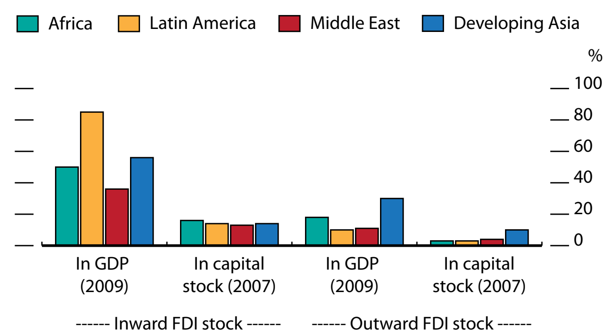


Note: Association of Southeast Asian Nations (ASEAN) 10 comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.

Source: ADB calculations based on data from UNCTADstat. http://www.unctad.org (accessed 25 February 2011).

Click here for figure data

2.3.4 Shares of inward and outward FDI stocks for the South



Note: Capital stock refers to physical capital stock data constructed using the perpetual inventory method, which is based on aggregate investment data in the Penn World Tables 6.3.3. (Lee and Hong, 2010).

Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org (accessed 25 February 2011); Lee and Hong (2010).

Click here for figure data

Significant developments are also occurring in India. Starting from the low base, India is now a key player after surpassing the average FDI stocks of the ASEAN-10 in the 2000s.

Southern countries emerged as recipients of FDI in the late 1980s, then became sources of outward FDI in the 2000s. Outward FDI stocks in developing Asia are growing much faster than those in the North (Figure 2.3.3). This is consistent with the notion that developing Asia is increasingly important as an FDI sender.

Total outward FDI flows from developing Asian economies to all regions generally surpassed outflows from Japan after 1995. In particular, Hong Kong, China and the PRC have emerged as leading sources of foreign investment. Other Asian economies, specifically, Taipei,China; Singapore; and Malaysia have also gained in importance, particularly after the Asian financial crisis in the late 1990s.

The significance of developing Asia as a capital exporter is not simply due to its rapid economic growth over the last decade. Outward FDI stock normalized by either GDP or the capital stock is much larger for developing Asia than for other regions in the South: at 30% of regional GDP, developing Asia's outward FDI is twice as high as those of other Southern regions; at 10% of its capital stock, it is three times as large.

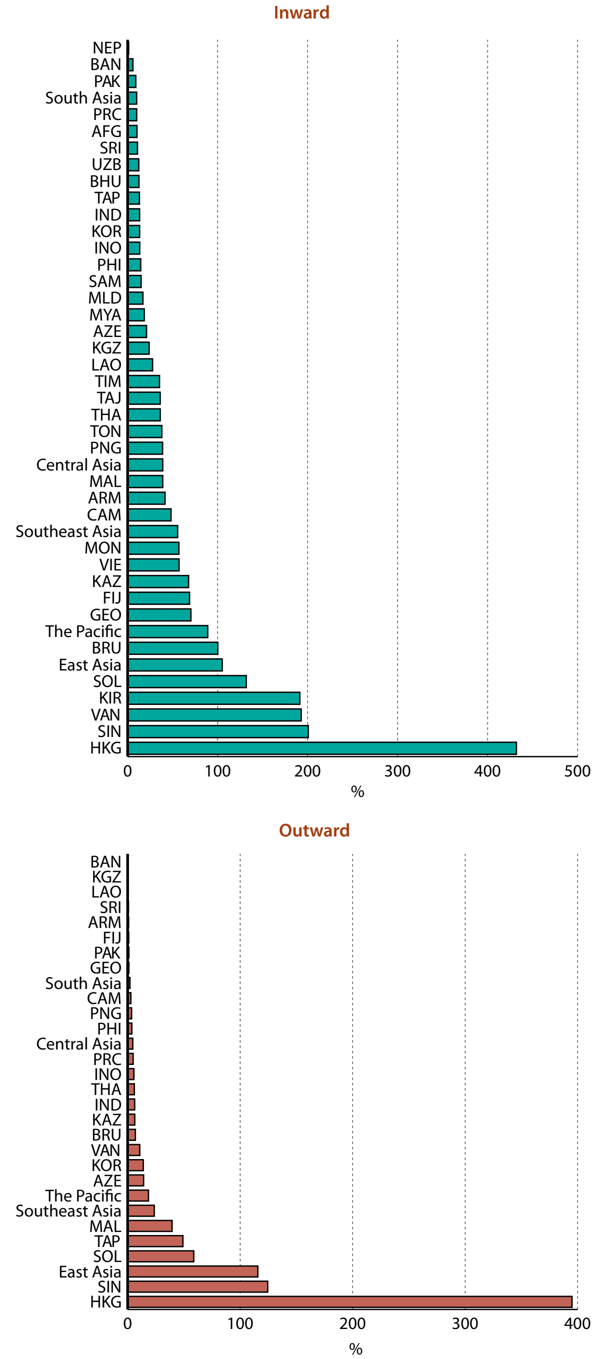
In contrast, developing Asia's normalized inward FDI stock—at 56% of regional GDP and 14% of capital stock—is not as impressive. Latin America's measures are larger at 85% of GDP and 14.2% of capital stock. Nonetheless, the inward FDI stock measures generally appear to be similar across Southern regions (Figure 2.3.4).

Large variations exist in normalized FDI stocks among the economies in developing Asia (Figure 2.3.5). For inward stocks of FDI, the relatively small and open economies in the Pacific stand out: their inward-FDI stock estimates at almost 90% of their GDP are far above the average for developing Asia and reflect the economies' reliance on foreign capital. In contrast, many South Asian economies have ratios to GDP of around 10%.

For East and Southeast Asia, the subregions' averages are driven up by their financial centers—Hong Kong, China and Singapore. Its large FDI stocks notwithstanding, the PRC has a disproportionately small inward FDI stock relative to its GDP or capital stock, given the huge size of its economy.

In the case of outward FDI stock, Taipei,China; Malaysia; and the Republic of Korea have large stocks relative to the size of their economies. In fact, they are the only economies in developing Asia whose outward stocks are larger than their inward stocks. (Another notable characteristic of these three net FDI exporters is the significant role played by their portfolio flows due largely to their deep and open financial systems.) Except for these economies, normalized outward FDI stocks are minimal in developing Asia.

2.3.5 FDI stock, ratio to GDP, 2009



AFG = Afghanistan; ARM = Armenia; AZE = Azerbaijan; BAN = Bangladesh; BHU = Bhutan; BRU = Brunei Darussalam; CAM = Cambodia; FIJ = Fiji; GEO = Georgia; HKG = Hong Kong, China; IND = India; INO = Indonesia; KAZ = Kazakhstan; KGZ = Kyrgyz Republic; KIR = Kiribati; KOR = Rep. of Korea; LAO = Lao People's Dem. Rep; MAL = Malaysia; MLD = Maldives; MON = Mongolia; MYA = Myanmar; NEP = Nepal; PAK = Pakistan; PHI = Philippines; PNG = Papua New Guinea; PRC = People's Rep. of China; SAM = Samoa; SIN = Singapore; SOL = Solomon Islands; SRI = Sri Lanka; TAJ = Tajikistan; TAP = Taipei,China; THA = Thailand; TIM = Dem. Rep. of Timor-Leste; TON = Tonga; UZB = Uzbekistan; VAN = Vanuatu; VIE = Viet Nam.

Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org (accessed 25 February 2011); Lee and Hong (2010).

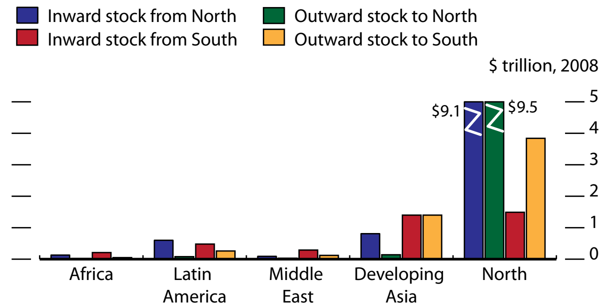
Click here for figure data

Direct investment among countries of the South

Since the mid-1980s, many governments in developing Asia have welcomed FDI, taking notable steps to liberalize capital account transactions, foreign-ownership and foreign-exchange policies, as well as related regulations, in order to help bring firms to their countries. Success has been such that Asian FDI flows are no longer dominated by the traditional North–South relationship but are increasingly South–South as well.

Hard data on South–South FDI flows are scarce. Nonetheless, balance-of-payments measures suggest that South–South FDI links are particularly strong in developing Asia compared with other Southern regions (Box 2.3.1). In 2008, both developing Asia's outward FDI stock to the South and the South's inward FDI stock to developing Asia were almost double the inward FDI stock from the North to developing Asia (Figure 2.3.6).

2.3.6 Inward and outward FDI stocks, South vs North, by source and destination



Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org; Organisation for Economic Co-operation and Development. http://www.oecd.org (both accessed 25 February 2011); Lee et al. (forthcoming).

Click here for figure data

Moreover, the South-to-developing-Asia and the developing-Asia-to-the-South FDI stocks were almost equal, in contrast to the other Southern regions where capital exports were not as strong. In fact, outward FDI from developing Asia of this magnitude was not observed in the 1990s. That it is relatively large in 2008 implies that developing Asia fared well

2.3.1 Problems of measuring foreign direct investment with balance-of-payments data

Balance-of-payments data are the only comprehensive records on world FDI activity. They are the starting point for estimating the size of South–South FDI and the share of South–South FDI in world FDI stocks or flows, even though balance-of-payments financial flows cannot be directly linked with measures of economic activity and the distinction between direct and portfolio investment is blurred in these accounts.

Measuring FDI based on balance-of-payments data has three serious problems. First, these data magnify the role of financial centers, which are conduits of financial flows, but are not necessarily connected to productive activity. Top recipients of FDI from Hong Kong, China and Singapore include the British Virgin Islands and Bermuda, while FDI from the PRC goes to the Cayman Islands as well.

But these types of FDI flows would almost completely disappear from any measure based on economic activity as they often represent bookkeeping entries in corporate accounts, rather than "real activity" such as labor employment, goods and services production, or physical-asset procurement.

Second, the distinction between direct and portfolio investment is blurred with the FDI of sovereign wealth funds (SWFs). While purchases of equity shares of 10% or more meet the IMF definition of FDI in terms of extent of ownership, SWF investments tend not to be motivated by standard FDI objectives such as exploiting the investing firm's specific advantages (like managerial style or corporate culture). Rather, SWFs rarely bring benefits beyond large amounts of capital; they generally do not seek control of firms they invest in; and they tend to move in and out of industries in pursuit of higher returns, much as private equity funds do. FDI by SWFs was a small part of FDI from developing countries through 2004, but it increased rapidly after that, reaching over $25 billion in 2009, or over 10% of all FDI outflows from developing countries (Lipsey and Sjöholm, forthcoming).

Third, in some developing and transitional economies much FDI takes the form of transactions known as "round tripping" (UNCTAD, 2006), in which domestic agents move capital funds to an offshore location and then remit them back as FDI to their own country. This practice is largely motivated by financial incentives intended exclusively for foreign investments and by a lack of effective institutions to intermediate the funds domestically.

For example, an estimated 25%–40% of the PRC's inward FDI comes from domestic firms round tripping funds through these foreign subsidiaries, especially in Hong Kong, China (Li, forthcoming). For the PRC, however, the problem is expected to become less serious after financial incentives for foreign firms were removed in 2008.

Nonetheless, round tripping, combined with the balance-of-payments convention measuring flows and stocks of FDI in terms of immediate rather than ultimate beneficial ownership of FDI assets, distorts the overall picture of the size, trend, and direction of South–South FDI.

amid the global financial crisis; outward FDI from developing Asia did not slow down as much as inward FDI to the region.

The factors driving South–South FDI in developing Asia are the regional financial centers—Singapore and Hong Kong, China—acting as intermediaries of funds from within and outside the region, thus amplifying intra- and interregional Southern relationships. Hong Kong, China is by far the largest player in the region.

But South–South links can still be observed even without the large players, albeit to a lesser extent (Figure 2.3.7). In East Asia without the PRC and Hong Kong, China, the South lateral links are seen in the forms of outward FDI from the Republic of Korea and Taipei,China. In Southeast Asia excluding Singapore, it appears as inward FDI from the South, its magnitude exceeding the inward stock from the North.

In other Southern regions, inward FDI stocks outweigh outward FDI stocks, with investment from the North particularly dominant in the case of Latin America. As with developing Asia, each Southern region has one or two key players driving both lateral intraregional and vertical FDI flows. These are Saudi Arabia in the Middle East, South Africa in Africa, and Mexico and Brazil in Latin America.

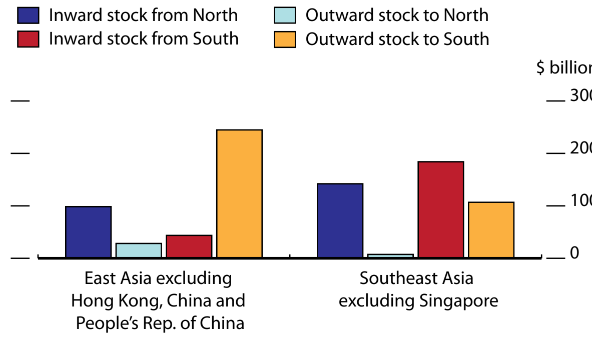
In the Middle East, Saudi Arabia has the largest FDI stock from the South, which in 2008 consisted of one-third of the total inward stock from the South to the region (Figure 2.3.8). In contrast, the region's outward FDI stock to the South in 2008 was less than half of its inward stock from the South, with more than half due to Saudi Arabia and the United Arab Emirates.

In Africa, the South–South link manifests itself in inward FDI as the region exports very little capital. Inward FDI stock from the South amounted to $340 billion in 2008, while the outward stock was less than a quarter of this. Major FDI recipients were Nigeria, Morocco, Tunisia, and South Africa. Together, these countries accounted for almost 60% of total inward stock in Africa (Figure 2.3.9).

The share of Southern countries' inflows of FDI to Africa rose from 18% in the late 1990s to 21% in 2000–2008. Developing Asia's share increased even faster, from almost 7% to 15%. Indeed, developing Asia, the PRC in particular, rather than Africa itself has been the main source of South–South FDI into African countries (Table 2.3.2).

In the case of Latin America, inward FDI stocks from the North, particularly from the United States and Spain, have dominated, with Brazil, Chile, Colombia, and Mexico receiving about 80% of this stock. On the South lateral link, the pattern is similar to Africa's, except that the stocks are much larger: Latin America, excluding offshore financial centers, has mainly inward FDI; inward stocks are about 50% higher than, and outward stocks more than three times as large as, Africa's. Major recipients of inward FDI stocks from the South are Mexico, Brazil, and Chile (Figure 2.3.10).

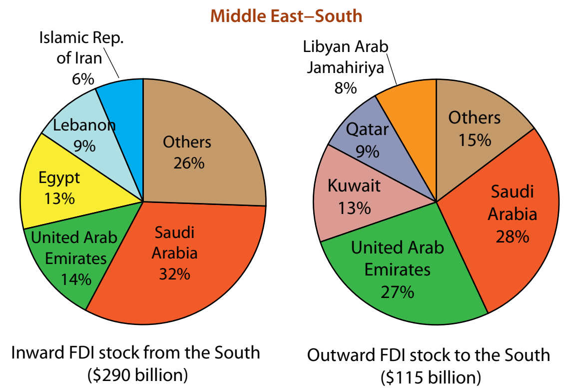
2.3.7 Inward and outward FDI stocks, East and Southeast Asia, by source and destination, 2008



Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org; Organisation for Economic Co-operation and Development. http://www.oecd.org (both accessed 25 February 2011); Lee et al. (forthcoming).

Click here for figure data

2.3.8 Middle East–South inward and outward FDI stocks, selected economies, 2008



Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org; Organisation for Economic Co-operation and Development. http://www.oecd.org (both accessed 25 February 2011); Lee et al. (forthcoming).

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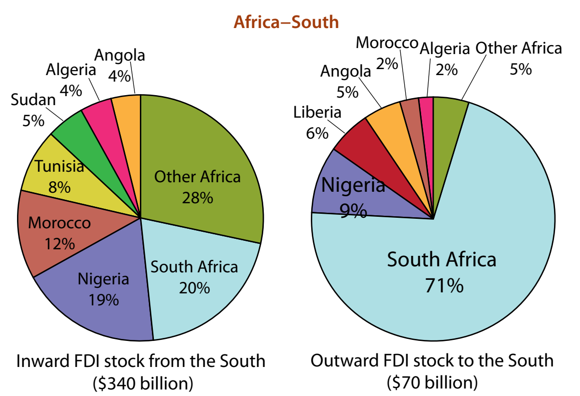
2.3.9 Africa–South inward and outward FDI stocks, selected economies, 2008



Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org; Organisation for Economic Co-operation and Development. http://www.oecd.org (both accessed 25 February 2011); Lee et al. (forthcoming).

Click here for figure data

Increasing intraregional foreign direct invetsment in developing Asia

While exploring Southern lateral investment flows is constrained by paucity of data, a few important observations can be made from the available information. First, over half of FDI inflows to developing Asia appear to originate in the South and mostly from the region itself (UNCTAD, 2006).

Indeed, the flows are concentrated in East and Southeast Asia, spurred most likely by regional integration efforts, expanding production networks, and plant relocations to lower-cost areas. Advances in transport and logistics as well as information and communications technologies have also created opportunities to better manage integrated but fragmented production networks in developing Asia. Asian FDI has become more intraregional, as production networks have deepened with the success of the factory Asia model (Figure 2.3.11).

Second, the FDI flows through offshore financial centers and from unknown sources increased their share of total inward FDI from 15% in 1991 to 32% in 2008. Since the North has better reporting systems, it seems reasonable that most such FDI flows come from Southern economies. If so, about 70% of inward FDI stock in developing Asia can be said to originate within the region (Lipsey, forthcoming).

In fact, the rise in the share of offshore financial centers and unknown sources is consistent with the growth of FDI flows from the PRC to ASEAN member states, which were negligible in 2001 but rose to about $2.5 billion in 2009 (UN, 2010).

Third, evidence from seven economies in developing Asia (the PRC; Hong Kong, China; India; the Republic of Korea; Malaysia; Taipei,China; and Thailand), which account for more than 70% of the region's total FDI and have detailed data for 2005–2009 (only for inward FDI for India and the Republic of Korea), supports the increasing significance of intraregional FDI. About 40% of outward FDI from these economies flowed to developing Asia, while 37% of inward FDI to these countries originated in developing Asia (Figure 2.3.12). In contrast, the North's share of inward FDI to these economies was only about 27%.

Fourth, when the sources of inward FDI to each of these seven countries are considered, it appears that intraregional FDI inflows are particularly significant for Hong Kong, China and for the PRC (Figure 2.3.13). As for the destinations of outward FDI from the five economies (that is, without India and the Republic of Korea), the data suggest that, while all of them invest substantially within the region, the flows are concentrated in Hong Kong, China, Thailand, and the PRC.

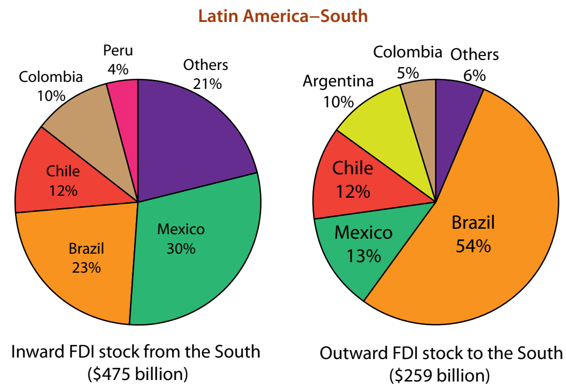
Fifth, while the share of FDI from the North has declined in general, the North still maintains a relatively important presence in some economies in developing Asia, such as the Republic of Korea and Taipei,China. This is consistent with the notion that the investments from the North tend to need highly skilled workers and to be in more capital-intensive sectors, where these relatively high-income economies in the region have a comparative advantage.

Table 2.3.2 Major Southern investors in Africa, FDI inflows, 2006–2008 ($ million)

South Africa	2,609
China, People's Rep. of	2,528
Malaysia	611
India	332
Taipei,China	48
Korea, Rep. of	45

Source: UN (2010).

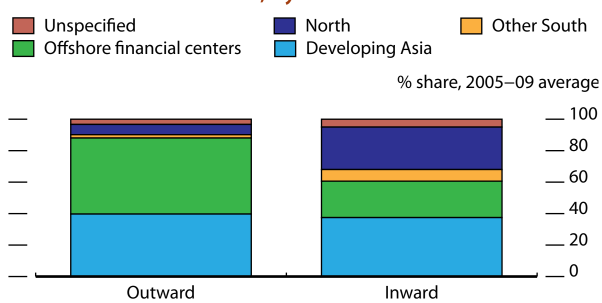
2.3.10 Latin America–South inward and outward FDI stocks, by country, 2008



Sources: ADB calculations based on data from UNCTADstat. http://www.unctad.org; Organisation for Economic Co-operation and Development. http://www.oecd.org (both accessed 25 February 2011); Lee et al. (forthcoming).

Click here for figure data

2.3.12 Distribution of outward and inward FDI flows, selected Asian economies, by source and destination



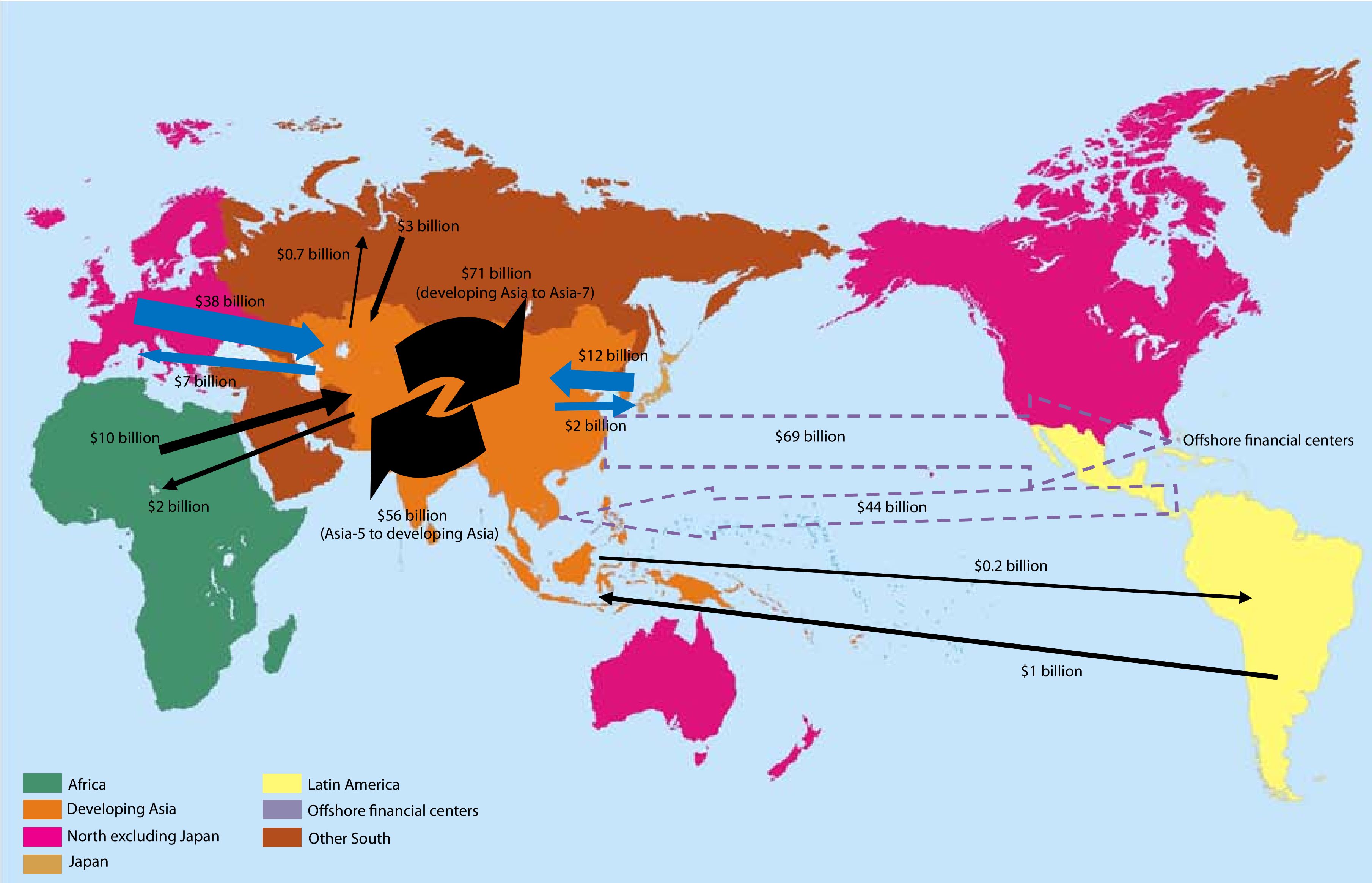
Notes: Inward FDI refers to data for seven economies namely, People's Rep. of China; Hong Kong, China; India; Rep. of Korea; Malaysia; Taipei,China; and Thailand. Outward FDI excludes India and Rep. of Korea.

Offshore financial centers comprise Bermuda, British Virgin Islands, Cayman Islands, Labuan Island, and Panama.

Sources: ADB estimates based on data from CEIC Data Company; Bank of Thailand. http://www.bot.or.th; UNCTADstat. http://www.unctad.org; Directorate-General of Budget, Accounting and Statistics, National Statistics. http://eng.dgbas.gov.tw (all accessed 25 February 2011); Li (forthcoming).

Click here for figure data

2.3.11 Source and destination of outward and inward FDI flows, selected Asian economies, 2005–2009



Direction of flows:

South to South

South to North (and vice versa)

South to offshore financial centers (and vice versa)

Notes: See Figure 2.3.12.

Sources: See Figure 2.3.12.

The drivers of South–South foreign direct investment

The macro view

What explains FDI? The literature offers at least three hypotheses. First, FDI may be motivated by the search for strategic natural resources. Firms with capital, technology, and access to markets undertake outward FDI to take control of immobile factors in host countries, such as oil and minerals, to secure supplies of raw materials or develop alternative supply sources as a hedge against shortages or price increases.

Second, FDI may be induced by the search for efficiency gains. Firms seek lower-cost locations or opportunities for exploiting scale economies in production. An economy with an overvalued currency, for instance, may cause firms to consider other locations to maintain their international competitiveness.

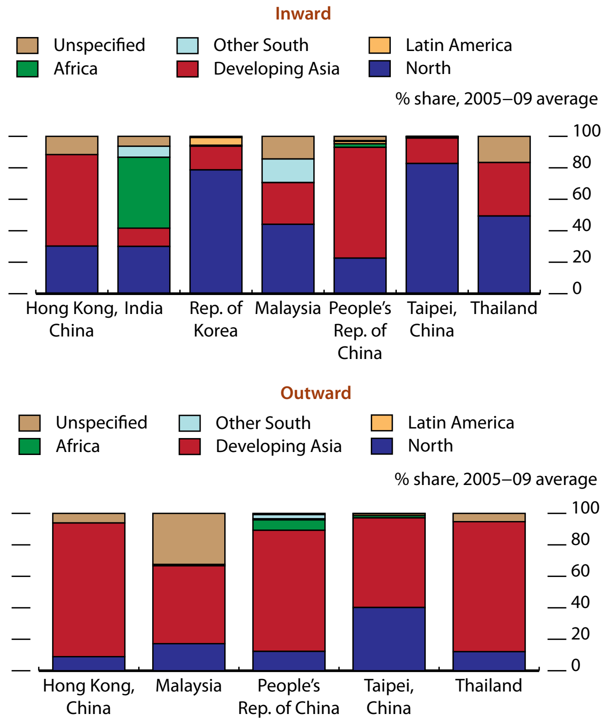
Third, FDI may be prompted by the search for markets. Firms undertake market-seeking FDI to exploit opportunities in host countries, particularly those with large markets and high incomes. Others do so to optimize returns on new technologies or marketing techniques that they have developed.

The anecdotal evidence is consistent with these motivations. FDI in natural resources was an early form of North-to-South direct investment. The North had capital, technology, and access to markets that the South host countries lacked. Thus the Netherlands invested in oil in the Middle East and the United Kingdom invested in tea plantations in Africa and South Asia. Similarly, the PRC has long invested in oil and other commodity industries in many countries—a trend that has intensified lately in Latin America and Africa. And this is because the PRC, relative to African host countries, has the capital, technology, and access to markets for these investments.

In the case of the Republic of Korea's multinational companies, their investments throughout developing Asia were apparently undertaken to take advantage of cheap labor (efficiency-enhancing), and to penetrate local markets (market-seeking). Lee et al. (forthcoming) also argue that these firms have increasingly engaged in outward FDI in part because of push factors, such as rapidly rising nominal wages and frequent labor-management conflicts at home—in other words, for efficiency gains and to maintain competitiveness.

FDI from the North and the South may have somewhat different emphases, however. Fung et al. (2002) contend that investments from Hong Kong, China and Taipei,China are efficiency-seeking, sensitive to infrastructure conditions and labor costs, whereas investments from Japan are market- and resource-seeking, focused on labor quality (skilled labor is a scarce resource and is a complement to advanced technology). In the same vein, Brooks and Hill (2004) claim that most Singaporean firms investing overseas, including the PRC, are actually high value-added manufacturers or service providers (seeking skilled labor to complement new technology).

2.3.13 Distribution of inward and outward FDI flows (excluding offshore financial centers), selected Asian economies, by source and destination



Notes: Offshore financial centers comprise Bermuda, British Virgin Islands, Cayman Islands, Labuan Island, and Panama.

Inward FDI refers to data for seven economies namely, People's Rep. of China; Hong Kong, China; India; Rep. of Korea; Malaysia; Taipei,China; and Thailand. Outward FDI excludes India and Rep. of Korea.

Sources: ADB estimates based on data from CEIC Data Company; Bank of Thailand. http://www.bot.or.th; UNCTADstat. http://www.unctad.org; Directorate-General of Budget, Accounting and Statistics, National Statistics. http://eng.dgbas.gov.tw (all accessed 25 February 2011); Li (forthcoming).

Click here for figure data

A variation on the motivations may explain the investment of Southern firms in the North. South-to-North FDI can be intended to acquire brands with established markets and technologies of production, distribution, and advertising that are unavailable in the South.

But FDI may be influenced by other factors as well. For instance, Singaporean investment in East and Southeast Asia was motivated in part by personal relations the firms had with local partners and customers. In some host countries, such as the PRC and Malaysia, ethnicity and social connections played a role for Singaporean investment as well. In the PRC, the drivers of FDI evolved over time as policy and the business environment became more conducive to foreign investment (Box 2.3.2).

In addition, other factors, such as the state of financial development, the quality of institutions, or the investment climate, can be crucial determinants of FDI flows. A financially deep market provides firms with access to capital for undertaking cross-border investment. Although it is well recognized that the banking sector is the primary source of funds for investors in developing countries, Brooks and Jongwanich (2010) maintain that financial depth in terms of stock and bond markets has begun to play a role in financing cross-border transactions in developing Asia as well.

2.3.2 Factors that influence inward foreign direct investment in the People's Republic of China

When the PRC opened up to investment in 1978, most FDI inflows came from Hong Kong, China. As financial integration progressed in the 1980s, multinational corporations from all over the world started to invest in the PRC—a trend that accelerated in the late 1990s, taking inward FDI to $45.5 billion in 1998.

In the PRC, policies to attract inward FDI were adopted and conducive conditions promoted. The international production networks constitute a case in point. The PRC established export processing zones soon after it liberalized investment. Within the zones, enterprises could import parts and components for assembly without duty—a policy that was later extended to all special economic zones in the southeastern provinces. FDI with labor-intensive technology, particularly in electronics, textiles, and apparel, came in to take advantage of the country's cheap labor.

The PRC's export and trade surplus grew in tandem with the increasing FDI inflows. Though the employment share of these foreign-invested enterprises is a minuscule 5% and their contribution to the PRC's GDP is only 3%–6%, their share of combined imports and exports reaches almost 55%.

In the past, most inward FDI consisted of greenfield investment. Most parent companies also created new long-term jobs locally. However, in the late 1990s to early 2000s, the share of mergers and acquisitions surged due to deregulation of such activity in the PRC and the entry of more investors from the North who were less inclined to start from scratch.

The PRC remains attractive to market-seeking FDI, but the coastal region has become less attractive to labor-intensive, efficiency-seeking FDI from Southern economies because of rising costs of production. Some low-end, export-oriented manufacturing activities have therefore shifted from coastal areas to other developing Asian countries. Efficiency-seeking FDI in coastal provinces has been upgrading to high-end products, and market-seeking FDI has been increasingly targeting inland regions.

From the mid-2000s, given the abundant liquidity in the country, doubts about the desirability of foreign investment have been voiced in the PRC. The inward FDI stock in the PRC is by no means large relative to the economy's size at about 10% of GDP, or 2% of the capital stock. Yet the slowing of inward FDI growth signals a possible policy shift to curbing competition from foreign-owned firms.

To avoid foreign monopoly power in some strategic sectors and to reduce dependence on inward FDI for economic growth, the FDI policy may be limited to investment in areas where the PRC needs foreign capital and associated know-how, such as high-tech and environmental industries.

Source

Li (forthcoming).

The micro view

At the industry or firm level of analysis, the rationale for FDI can arise from the many possible sources of differences, such as industry composition, average size, and labor or capital intensity, which affect the productivity and spillover or "technology-diffusing" effects of investment. Traditionally, microeconomic analysis of FDI focuses on productivity improvements in the host economy, not merely because FDI adds to the capital stock, but more important because it augments human capital, enhances productivity, and generates spillovers to local firms.

Spillover effects from foreign investment are hypothesized to be multifaceted. The entry of multinational companies can reduce the monopolistic power of local firms and improve market efficiency.

It can also improve production efficiency and enhance economic growth by clearing bottlenecks to investment; introduce new know-how by bringing in new products, production and marketing techniques (with their concomitant demonstration effects, and by training workers who later become employees in local firms); transfer techniques on inventory management and quality control; and force local firms to upgrade managerial quality, intensify managerial effort, or adopt the marketing techniques used by multinational companies, either in domestic markets or internationally.

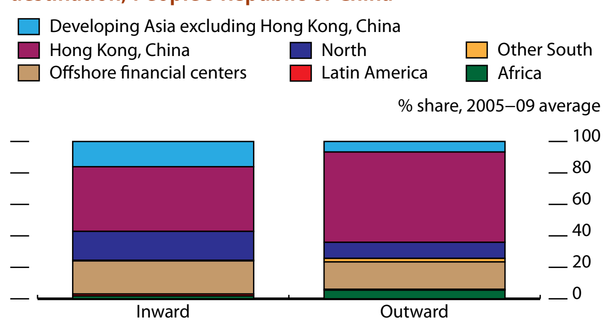
In turn, the more intense competition between such companies and local firms, as well as the demonstration and learning-by-doing effects of new production methods, lead to higher economywide productivity. Indeed, this is precisely why many countries offer special incentives to foreign enterprises, including lower income taxes or income tax holidays and import duty exemptions.

Spillover effects are not as readily apparent for North–North and South–South (lateral) FDI as they are for North-to-South (vertical) flows. Although only a few analyses exist on Southern lateral flows, the consensus is that South–South FDI generates weak spillover effects at best (from intermediate-input imports and higher labor employment rates). In contrast, for vertical investment, local firms seem to benefit more from Northern technology (Box 2.3.3).

Outward foreign direct investment from the People's Republic of China

Decomposition of recent FDI flows to and originating from the PRC suggests that Hong Kong, China and offshore financial centers are the PRC's dominant partners for both inward and outward FDI, with a combined average share of 61% for inward and 76% for outward FDI during 2005–2009. Hong Kong, China's role has steadily increased, while that of the offshore financial centers has diminished somewhat since the onset of the global crisis. Outside these two partners, popular destinations of PRC investment funds include economies in the North, the rest of developing Asia, and Africa (Figure 2.3.14).

2.3.14 Inward and outward FDI flows, by source and destination, People's Republic of China



Note: Offshore financial centers comprise Bermuda, British Virgin Islands, Cayman Islands, and Panama.

Sources: ADB estimates based on data from CEIC Data Company (accessed 25 February 2011); Li (forthcoming).

Click here for figure data

2.3.3 How do North–South and South–South foreign direct investment compare in industry distribution, productivity, and spillovers?

A few case studies[1] on developing Asia show industry, size, and productivity differences between Southern and Northern plants. FDI from sources in the South tends to be a major presence in textiles and apparel; food; wood and paper products; and rubber products. Firms from the North tend to be dominant in chemicals, transport equipment, and some types of machinery.

Although these are rather wide industry categories, it is fairly safe to characterize the second group of industries as being more capital-intensive and more technology-intensive than those of the first group.

Size characteristics, as measured by output and employment per plant, regardless of industry, show that plants with Northern owners are much larger than those with Southern owners from, for example, Hong Kong, China; Malaysia; Singapore; and Thailand. Since plant sizes differ widely by industry, and clothes factories are typically much smaller than those of auto plants, these differences reflect the industry distributions mentioned above. Margins are larger for output per plant than for employment per plant, pointing to productivity differences in addition to the industry mix.

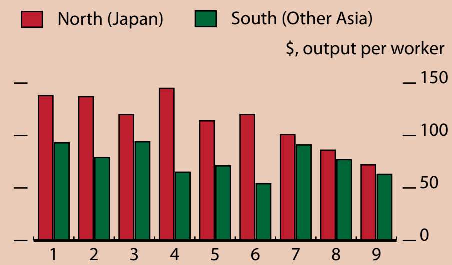
Do these industry distribution and size differentials point to distinct differences in productivity between foreign-owned and locally owned plants?

In an Indonesian case study, labor productivity in plants representing FDI from the North (Japan) was found to be significantly higher than in plants representing FDI from the South in a broad set of industries (Box figure). The exceptions to this pattern were foods, textiles, and wood/furniture—industries in which FDI from the South were a major presence.

In the two cases of Hong Kong, China and Singapore, compared with plants owned by Southern firms, those owned by Northern firms reported higher productivity of close to 20% (in Hong Kong, China) and of more than half for United States- and European-owned plants and close to a third for Japanese-owned plants (in Singapore).

An issue of interest to host FDI countries concerns the extent to which FDI technology is absorbed by local firms, which is a process referred to as spillovers and which comes in the form of increased competition; copy-catting of foreign firms' production techniques, products, and ways of doing business; and availability of a greater range of products or of products of better quality.

Labor productivitiy of foreign-owned plants in Indonesian manufacturing, 1997–2003



1 = Total manufacturing; 2 = Paper/printing; 3 = Chemicals; 4 = Nonmetallic minerals; 5 = Fabricated metal and machinery; 6 = Other manufacturing; 7 = Food; 8 = Textiles; 9 = Wood/furniture.

Source: Takii (2011).

Click here for figure data

Results reported in studies are mixed. Countries and firms differ in their ability to benefit from the presence of foreign-owned firms. Insignificant impacts seem to be driven by the fact that Southern lateral investment is mainly in labor-intensive industries, which are associated with relatively low productivity. This is consistent with the hypothesis that spillovers are larger for North–South FDI than for South–South FDI because Northern-owned firms are the original owners of technology in most industries.

It may, however, be true that the less advanced technologies used by Southern investors are more suited to the conditions of the host Southern countries, such as labor force or management skills, levels of education, or local customs, and might be more easily imitated or learned than those of the Northern firms.

In general, affiliates from Northern countries tend to be large, and can have many things to teach Southern host-country firms. But the latter may be too small to use the technologies suited to such larger affiliates.

1. Such as Ramsetter (2004, 1994) on Thailand; and Takii (2011) on Indonesia.

Source

Lipsey and Sjöholm (forthcoming).

The history of the PRC's outward FDI may be briefly described as follows. The PRC government deregulated outward FDI in 1976, allowing PRC firms to establish joint ventures abroad. These were initially seen in Hong Kong, China, and Sudan, where the motivation was trade-related and resource-seeking. The PRC's outward FDI did not show real increases, however, until 2003 when its investment in the nonfinance sector hit $2.9 billion and was followed by years of annual doubling until flows reached $59.0 billion in 2010.

Outward FDI from the PRC became noticeable in 2003, or about 3 years earlier than what Dunning's (1981, 1986) rule of thumb would forecast. Were this rule—that a country becomes a FDI exporter only after its per capita gross national income exceeds $2,000—correct, only in 2006 would the PRC have become a significant source of FDI. That it became so earlier is probably due to the role played by state-owned enterprises. From 2002 to 2003, outward FDI from the PRC increased from $0.98 billion to $2.85 billion, with 73.5% of the latter amount due to such enterprises. And in 2003–2009, they accounted for more than 80% of the PRC's outward FDI stock and flow, with funds coming from huge corporate savings. Investments from state-owned enterprises were primarily resource seeking, going to energy and mining, in both North and South (Table 2.3.3).

Table 2.3.3 Outward FDI from the People's Republic of China, by type

Motivation	Industry	Firms and characteristics	Location
Resources	Energy and resources (mining in particular) leasing and business services	Central state-owned enterprises	Worldwide
Market	Wholesale and retail trades, telecommunications, textiles, shoe-making, and car industry (labor intensive)	Small and medium-sized enterprises, except for a few big companies like Huawei and ZTE	Asia, Africa, and Latin America for local markets
Efficiency	Electronics, machinery	Green (air-conditioner maker), Sany (machinery manufacturer)	Mainly south, such as Latin America
Strategic assets	Research or design center, merger with or acquisition of technology-intensive competitor	Sany, Gily, Lenovo, Haier	Europe

Source: Li (forthcoming).

In contrast, outward FDI of private enterprises tended to come from small- and medium-size enterprises and in manufacturing. Foreign investments by private enterprises mostly sought to penetrate southern markets in industries such as telecommunications, textiles, and automobiles. Certain investments in Latin America were intended to reap efficiency gains through reductions in transport cost and by using local production centers as regional bases. Most investments were in labor-intensive industries. For example, the PRC's FDI in the South included investments in telecommunications, city-bus manufacturing, and infrastructure construction.

As a result of the surge in outward FDI, the PRC has become an important source of capital and technology for neighboring, low-income countries, thus promoting industrial migration.

Summary and key policy messages

The importance of South–South FDI is rising. While the majority of global outward FDI flows and stocks still originate in industrial economies, developing economies are emerging as important sources of outward FDI, with their share reaching 20% of the global total. Because of its high growth profile and accumulating financial resources, developing

Asia is becoming a major player in this trend, accounting for more than 70% of outward FDI stock from developing countries. Indeed, the region's significance was highlighted by the resilience of outflows from developing countries during the global financial crisis, in contrast to those coming from the North.

Over the past two decades, Asian FDI has become more intraregional as, driven by the success of factory Asia, international production networks have deepened. More than half of total FDI inflows to developing Asia are estimated to originate in the region. Recent evidence from seven economies of developing Asia (the PRC; Hong Kong, China; India; the Republic of Korea; Malaysia; Taipei,China; and Thailand) indicates that about 40% of their combined outward FDI (excluding India and the Republic of Korea) were directed to the region, while 37% of their inward FDI flows originated in the region.

Enterprises invested with foreign capital are known to introduce new products or technology and to enhance the quality of the labor force in the host economy. The evidence that South–South FDI does this, however, is mixed at best. To maximize the benefits of inward FDI, host economies ought, therefore, to design and adopt investment policies such that positive externalities are generated for both local firms and the labor force. More specifically, continued efforts should be made to improve the business environment, upgrade labor skills, foster technology transfer, and integrate FDI firms into local economies. In addition, policy makers in host economies should periodically scrutinize the effectiveness of trade policy to ensure that industries are not overprotected and that regulations are not constraining growth.

Developing Asia is playing an increasingly important role in filling the investment needs of other countries inside and outside the region and, in turn, improving the productive capacity of industries in those countries. Prospectively, outward FDI from the high-saving countries of developing Asia can also help to address the global current account imbalance to the extent that savings are invested in Southern countries rather than in low-risk assets in the North.

Northern FDI's strong suits—association with more advanced technologies and more effective management styles—remain indispensable. Northern and Southern FDI complement rather than substitute. Moreover, the low FDI-to-capital-stock ratio of many economies in developing Asia suggests that the quality of the capital stock (with implications for technology and other spillovers) can be vastly improved, which can best be addressed by Northern sources of capital.

Countries in developing Asia should therefore continue to promote investment-friendly policies to attract more FDI. These strategies include improving the investment climate to attract foreign capital in a broader set of industries; developing the finance sector, particularly equity and bond markets to facilitate flows of funds; and promoting capital-account openness.

Wider economic links for development

South–South economic links go beyond trade and investment. Labor movement and remittances, knowledge sharing, and macroeconomic policy coordination are other channels through which developing economies are benefiting from closer ties. For knowledge sharing and policy coordination, a wide range of cooperative activities is carried out each year, but their extent is unclear as systematic monitoring is lacking.

Labor movement and remittances

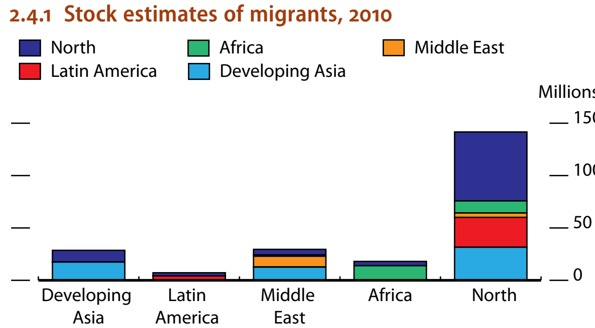
Just as globalization has opened up markets for goods and capital, so it has for labor. Freer cross-border movement of people has allowed labor markets of different countries to be more closely integrated. People are on the move, the streams reflecting divergences in circumstances and opportunities, which results in more efficient allocation of global resources. Out-migration from labor-surplus economies increases labor productivity; in-migration to labor-scarce countries provides either cheap or highly demanded labor. Ultimately, labor movements contribute to economic growth all round.

Industrial countries of the North remain the most sought-after destinations of migrant workers. But the economic success of the South has created rising demand for both unskilled workers and highly skilled professionals—the former to produce manufactures cheaply or provide low-skilled services, and the latter to complement new technology. Labor flows within the South accelerated in the early 1970s when the Middle East started attracting thousands of workers from Asia for construction work and domestic service as a result of the oil price boom.

In particular, the workers came from Bangladesh, India, Indonesia, Pakistan, the Philippines, and Sri Lanka. More recently, East and Southeast Asia have become major destinations for Asian workers, with their export-led model of development. Notable host countries in these subregions include the newly industrialized economies of Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China, as well as emerging economies of Malaysia and Thailand.

Among migrant settlers, North–North migrants constitute the largest group (Figure 2.4.1). This possibly reflects the freer labor movements within Europe and the North in general. North-to-developing Asia migrants make up the second-largest group. This may well stem from Asia's rising economic importance. Interestingly, for each region of the South, more emigrants relocate to the North than intraregionally. Outside the North, interregional migration from the South seems insubstantial. This trend may be indicative of physical, policy,

2.4.1 Stock estimates of migrants, 2010



Source: World Bank. *Bilateral Estimates of Migrant Stocks 2010*. http://www.econ.worldbank.org

Click here for figure data

and institutional constraints to interregional labor mobility or of preferences due to cultural and linguistic affinity of countries nearby.

Recently, however, rising labor mobility within the South has notably increased the South's migrant stock, bringing it rapidly closer to that of South–North flows (Figure 2.4.2).

Most countries' policies on labor flows are more restrictive than their rules for goods or capital movements. This is because, on the one hand, host countries require immigrants to have relevant skills and, on the other, countries of origin want to limit the brain drain, while simultaneously protecting the rights of their workers abroad. To ensure that labor movements are mutually beneficial, coordinated policies are needed.

Growing migration has gone hand in hand with rising flows of remittances, which contribute to the economic growth of recipient countries and provide an additional source of funds for their receiving households. A majority of the top 10 remittance-receiving countries in the world (India, the PRC, Mexico, the Philippines, Bangladesh, and Nigeria) are in the South, with developing Asia accounting for the lion's share of the total flows. Indeed, the rates of growth of remittance inflows to developing Asia are higher than those flowing into other parts of the South.

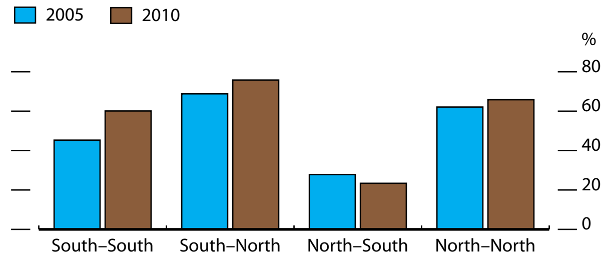
Total remittance inflows to all developing countries averaged around $315 billion annually in the 3 years to 2010 (Figure 2.4.3). The great bulk of these inflows went to middle-income countries, particularly to developing Asia, which received around $170 billion of these flows on an annual basis in the last few years. As a share of GDP, remittance receipts were especially important in Asia for Tajikistan, Nepal, the Kyrgyz Republic, Bangladesh, and the Philippines, as well as for several Pacific island countries.

Although North–South transfers of workers' remittances account for close to 45% of global flows, South–South transfers have also grown in importance. The economic resilience of the South manifested itself in the rising share of South–South remittances—from 18% in 2005 to 25% in 2010 (Figure 2.4.4).

In contrast, the North–North share declined from about 34% to 29% over the same period. As the major remittance-sending countries were hit by the global crisis, the growth in remittance flows slowed, but the flows to each Southern region generally did not decline. Indeed, the flows to developing Asia are apparently reverting to a higher trajectory.

Countries have undertaken various cooperative policy measures to improve the efficiency of remittance procedures. Indeed, the cost of making such transfers through formal channels has declined and led to a larger share being remitted through wire transfers, which are more easily recorded by central banks. Beyond this, tighter finance sector coordination would facilitate more secure ways of making transfers, while improving the accuracy of statistics on remittance flows.

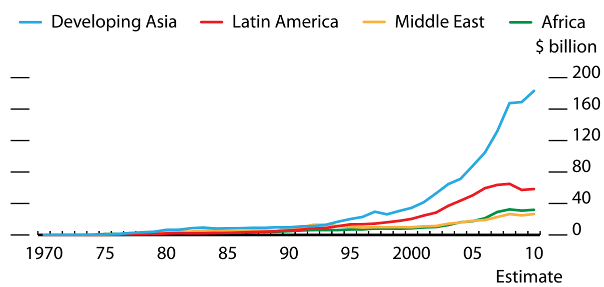
2.4.2 Stock estimates of migrants



Source: World Bank. *Bilateral Estimates of Migrant Stocks 2005 and 2010*. http://www.econ.worldbank.org

Click here for figure data

2.4.3 Remittance inflows



Source: World Bank. 2010. *Migration and Remittances Data*. November. http//www.econ.worldbank.org

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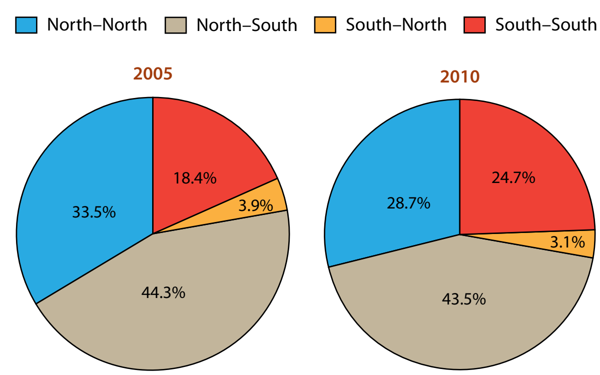
2.4.4 Shares of global remittance flows



Source: World Bank. *Bilateral Remittance Estimates for 2005 and 2010 using Migrant Stocks, Host Country Incomes, and Origin Country Incomes*. http://econ.worldbank.org

Click here for figure data

South–South knowledge sharing

Mobility of ideas across borders also reduces economic disparities among regions. New opportunities for global learning across regions and countries are opening up, and the sharing of development experiences (including through North–South, South–South, and triangular cooperation) to strengthen and broaden sources of knowledge for growth and development has expanded.

Commensurate with the economic growth of the South, South–South knowledge sharing has become an important part of international relations. Indeed, South–South knowledge exchange is one of the nine pillars of the G20 Development Consensus for effective collaboration among developing countries on development solutions. It can be enhanced through triangular cooperation arrangements, where a bilateral or multilateral donor teams with a more advanced developing country to provide lessons and advice to another developing country.

The United Nations Economic and Social Council (ECOSOC, 2008) gives examples of South–South knowledge sharing. These include technical cooperation programs of various countries, such as Argentina, Chile, Egypt, and Tunisia, as well as the PRC, India, the Republic of Korea, Singapore, and Thailand. It notes, however, that Southern multilateral institutions play only a limited role in technical cooperation and that Southern bilateral development cooperation is driven mainly by geographic proximity, except the PRC's.

Drawing a distinction between North–South and South–South cooperation, ECOSOC observes that projects supported by Northern donors focus more on social sectors, whereas Southern bilateral and multilateral institutions prefer projects in hard-core infrastructure sectors such as communications, energy, and transport.

For Asia, Schulz (2010) lists numerous examples of cooperation on knowledge-sharing spanning a wide range of areas such as poverty reduction, sector programs, local administration, microfinance, and aid management. The International Poverty Reduction Center, set up in 2005 in the PRC, promotes experience sharing with developing countries and assists them through training, research, and exchange events.

Prospectively, countries in the South can learn from each other on various other issues. Sharing best practices in environment-friendly management of solid and hazardous waste, for example, can enhance economic sustainability and reduce health care costs. Similarly, knowledge sharing on farming technology and practices that increase agricultural productivity, as well as on mitigating the impacts of global warming on agricultural production, can improve food security.

Knowledge-sharing mechanisms have mushroomed at all levels, but they lack harmonization, with communication and coordination among the layers limited. Building a strong architecture for South–South cooperation calls for systematically sharing these mechanisms.

Macroeconomic cooperation

Coordinating macroeconomic policies and institutional measures has become an effective means of economic cooperation. For example, G20's actions during the global crisis helped to synchronize fiscal and monetary stimuli across countries. And following the return to growth of the global economy, it is now focusing on how global imbalances are best addressed.

The recovery of the world economy underscored the value of South–North macroeconomic cooperation. South–South cooperation, however, is likely to figure more prominently in global rebalancing initiatives. Indeed, proposed solutions cannot focus on United States–PRC bilateral trade balances alone, because many developing Asian economies also have trade deficits with the PRC. Instead, coordinated exchange rate adjustments can mitigate the disruptive effects of, for instance, a unilateral exchange rate realignment on other economies.

Two other instances of macroeconomic and institutional cooperation involve countries adopting a common economic policy. Addressing short-term volatility in capital inflows by imposing temporary capital controls can be harmful for a country if it acts unilaterally. But the policy may be feasible if it is executed in an internationally coordinated manner. As mentioned in Part 1 of the *Asian Development Outlook 2011*, G20's plan to establish practical indicative guidelines for assessing a country's current account imbalances and set out principles for capital control is a useful start, to which the South, particularly Asia, can provide many lessons.

In a similar vein, using the South's savings to fund regional investment projects rather than placing them in safe assets in the North can contribute to global rebalancing. But this requires deepening the regional capital markets and adopting coordinated policies for capital market liberalization. Fortunately, regional financial institutions in the South have been taking steps to integrate with global markets, develop domestic capital and bond markets, and promote macroeconomic coordination.

Many efforts at macroeconomic cooperation are under way in the South. In Latin America and the Caribbean, initiatives include the proposal to establish a cohesion fund (a structural instrument intended to reduce economic and social gaps and to promote regional economic stability) for member states of the Central American Common Market, and the creation of the Mercosur Structural Convergence Fund (that also promotes competitiveness and social cohesion, particularly among economically smaller members).

In Asia, ASEAN+3 projects consist of setting up the informal ASEAN Surveillance Process (to monitor and exchange information on financial and economic developments); developing Asian bond markets; adopting the Economic Review and Policy Dialogue process (for exchanging views on global, regional, and country economic development issues as well as on risks affecting regional economies and the options for policy); and establishing the multilateralized Chiang Mai Initiative (a $120 billion reserve pool intended to provide short-term liquidity to supplement existing international financial arrangements).

Harnessing South–South cooperation to its full potential

South–South cooperation initiatives can be a powerful force for development and change. Closer ties will facilitate better sharing of goods and services, knowledge and technology, and even labor resources. This sharing, in turn, will afford more opportunities for countries in the South to grow economically. Integration of regional markets through the core areas of trade and investment will allow a better distribution of benefits from the growth process as well. Expansion of economic relations within developing Asia and across Southern countries will not only strengthen Asia's role as a driver of global growth, but also give its lagging states a chance to catch up with the leading ones.

To fully realize these benefits, however, the South needs to address numerous bottlenecks—including outdated laws, regulations, and standards; barriers to trade; poor investment climates; low-quality infrastructure; and shortages of capital and skilled labor—all of which hamper the deepening and expansion of links among its economies. Still, the fact alone that the South recognizes the challenge is a good start to bring back its growth to a sustainable path.

Endnotes

1 The South refers to Africa, developing Asia, Latin America, and the Middle East. *Africa* comprises Algeria, Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Republic of the Congo, Côte d'Ivoire, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mayotte, Morocco, Mozambique, Namibia, Niger, Nigeria, Reunion, Rwanda, Saint Helena, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Somalia, South Africa, Sudan, Swaziland, United Republic of Tanzania, Togo, Tunisia, Uganda, Western Sahara, Zambia, and Zimbabwe. *Developing Asia* refers to the 44 developing member countries of ADB including Brunei Darussalam, an unclassified member country. *Latin America* comprises Anguilla, Antigua and Barbuda, Argentina, Aruba, Bahamas, Barbados, Belize, Bermuda, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominica, Dominican Republic, Ecuador, El Salvador, Falkland Islands, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Martinique, Mexico, Montserrat, Netherlands Antilles, Nicaragua, Paraguay, Peru, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Turks and Caicos Islands, Uruguay, Bolivarian Republic of Venezuela, and Yemen. *Middle East* covers Bahrain, Egypt, Islamic Republic of Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Occupied Palestinian territory, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, and United Arab Emirates. The North is the residual.

2 The impact of recent developments in North Africa and the Middle East, however, is not yet clear.

3 Data for all economies other than Taipei,China are compiled from the UN Comtrade database, based on Revision 3 of the Standard International Trade Classification (SITC, Rev. 3). Data for Taipei,China are obtained from the trade database of the Council for Economic Planning and Development, Taipei,China. The data set spans from 1990 to 2009. The reported data refer to merchandise trade, not services trade, for which a comprehensive database of bilateral flows is not available. To facilitate the comparability of trade shares across regions over time in view of sharp price fluctuations, the discussion generally refers to merchandise trade net of fuel trade (oil and gas, SITC category no. 3), unless otherwise specified.

4 Although this exclusion introduces a downward bias to the share of the oil-exporting regions, it does not alter the basic conclusion on Asia's dominant role in South–South trade. In 2009, for instance, developing Asia's share in total South–South merchandise trade was 66% when fuel is included and 74% when fuel is excluded, and the PRC's corresponding shares were 37% and 40%.

5 While this is the case for average tariffs applied, it is also true that peak tariffs tend to be highest in the North, especially for products of key interest to Southern exports, such as food products.

6 The growth rate of non-Asian South–South trade was as high as 47.2% a year on average from 1990–1991 to 2000–2001, although its base was very small.

7 The exception is Latin America, whose South–South share of exports is below that of imports. This is explained by the inclusion of Mexico in the regional aggregate. As a member of the North American Free Trade Agreement, Mexico sends a large share of its exports to Canadian and United States markets. When Mexico is excluded, Latin America's patterns are consistent with those of the other Southern regions.

8 Based on data sourced from the *Latin Business Chronicle*, the US Census Bureau, and Eurostat.

9 People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

10 For a detailed description of the Logistics Performance Index, see http://info.worldbank.org/etools/tradesurvey/mode1a.asp.

11 Recall, though, that the model assumes that there are no changes in agricultural trade policies over the projection period. Perhaps more realistic scenario, especially for a rapidly growing Asia, is a steady rise in agricultural protection to slow the decline in food self-sufficiency—as happened over the past 50 years in the most advanced Asian economies (see, for example, Anderson and Nelgen, 2011).

12 In reality, some of these agreements have already been partly implemented and others, if implemented, will be staggered over time.

13 Although certainly indicative, the results are based on comparative static analyses that fail to capture additional dynamic gains from trade reform, which can be substantial.

14 This estimated global welfare gain from freeing all of the world's merchandise trade turns out to be small both in absolute terms and compared with the welfare effect of a GDP slowdown in high-income countries. As the caveats in the next section make clear, however, these gains from global trade reform are very much lower-bound estimates.

15 The South–North average tariffs for each commodity are implemented as a ceiling tariff for South–South trade, with any bilateral tariffs already lower than these remaining unaffected (the exception predominately farm products).

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ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA

3

CENTRAL ASIA

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

The economy came back from its sharp contraction of 2009, but only slowly owing to a sharp fall in agricultural output. As the recovery takes hold, the authorities will need to wind down their anticrisis measures and return to the stronger precrisis fiscal position while normalizing monetary policy. The outlook is for a gradual pickup in growth on the assumption that exports, foreign investment, and remittances continue to strengthen. Structurally, though, further acceleration of reforms is crucial for improving the business environment and boosting the economy's competitiveness.

Economic performance

The economy grew very rapidly in the early years of the decade, underpinned by the large inflows of foreign direct investment and remittances. Growth, however, plummeted in late 2008 and in 2009 under the weight of the global crisis. Countercyclical fiscal and monetary policies, as well as improved economic conditions around the world and in the Russian Federation particularly, have helped the country to stabilize and return to growth. GDP expanded by 2.6% in 2010, despite a slump in agriculture (Figure 3.1.1).

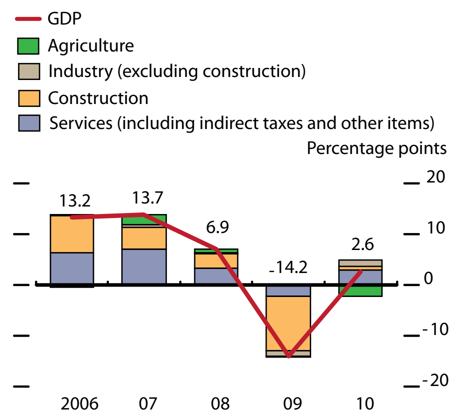
Agriculture contracted by 13.4%, reflecting poor weather that seriously damaged crops across the country. This left industry (excluding construction) to be the driving force of the recovery, expanding by 9.5%, much of which was generated by export-oriented mining and metallurgy. Increased volumes of foodstuffs, drinks, and pharmaceuticals helped buttress growth. Construction, which propelled high growth in earlier years before its collapse took down the economy by 14.2% in 2009 (Figure 3.1.2), expanded by 3.7% in 2010, mainly due to government anticrisis spending.

The trade and services sector grew by 4.4%, primarily on increased service volumes in such areas as financial, insurance and real estate activities and information and communications technology.

From the demand side, private expenditure and investment grew by an estimated 5%, reflecting the gradual recovery in global activity and its impact on the domestic economy. Remittance inflows from workers abroad picked up by 15.4% to $1.1 billion after a weak performance in 2009, though they remained below their 2008 peak level of $1.4 billion. Inflows of foreign direct investment amounted to around $750 million in 2010, up by 3.5% year on year, with communications, electricity, gas, and water the largest beneficiaries. Public consumption and investment moderated alongside a diminishing expansionary fiscal policy as anticrisis measures taken up a year earlier began to be wound down.

An inflation targeting framework underpins monetary policy. A

3.1.1 Contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 1 March 2011).

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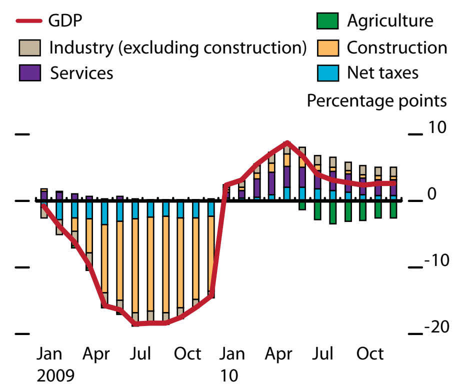
3.1.2 Monthly contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 1 March 2011).

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

sharp fall in domestic agricultural production and higher international wheat and other cereal costs led, however, to a spike in headline inflation to 9.4% in December 2010 from a year earlier (Figure 3.1.3), pushing inflation above the upper limit of the central bank's inflation target band (4% +/-1.5%). Average annual inflation was 8.2% for the year. Items keeping food inflation high were dairy, eggs, meat, and grain products, in that order, with price increases ranging from 18.7% to 13.1%. The higher food inflation was offset by moderating nonfood inflation, mainly due to weakening prices in private cars, medicines, garments and knitwear, footwear, detergents, and beauty items.

As inflation picked up, the central bank tightened monetary policy and gradually raised its refinancing rate by 225 basis points in January–May 2010 to 7.25% and kept it there through December. Despite this tightening and measures to de-dollarize the economy, the share of foreign currency loans in banks stayed high, increasing from 51.9% at end-2009 to 57.4% 12 months later, while the share of foreign currency deposits fell from 73.4% to 69.0%.

Broad money supply grew by 11.8% in 2010. Credit to the economy jumped by about 28%, reflecting positive macroeconomic trends and a slight decline in interest rates due to allocation of funds attracted by banks. The contribution of net foreign assets to monetary growth was negative, mainly due to the central bank's interventions, which aimed to smooth large exchange rate movements (Figure 3.1.4).

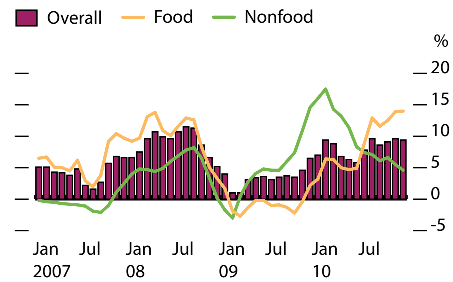
Fiscal policy aimed to continue supporting the recovery while addressing medium-term fiscal and debt vulnerabilities. A 14.5% increase in tax revenue and restrained spending have significantly eased the fiscal imbalance. Improvements in tax and customs administration, progress in introducing an electronic tax-filing system, and strengthened taxpayer services (such as "taxpayer service centers") along with greater economic activity boosted tax receipts. But despite climbing slightly from 16.7% in 2009 to 16.9%, the tax-to-GDP ratio is still low internationally. Total budget revenue rose by 10%, but as a share of GDP declined from 22.9% in 2009 to 22.2% in 2010.

Total expenditure increased by a mere 0.5% from 2009. A budget deficit of 4.9% of GDP recorded in 2010 was well below the 6% of GDP projected by the government in late 2009 and a sizable 7.6% recorded in 2009 (Figure 3.1.5). About 60% of the deficit in 2010 was financed through domestic resources.

Outstanding public external debt climbed quickly to nearly $3.0 billion in 2009 and rose by another $300 million in 2010, reaching about 35.1% of GDP (Figure 3.1.6), with about 22.5% coming from central bank borrowing. Domestic public debt edged up to $428 million in 2010, and is relatively small at 4.5% of GDP. Although the level of total public debt is high, given that most is on concessional terms, debt service is manageable. Debt projections from the International Monetary Fund indicate that the total debt ratio will move up to about 50% of GDP in 2012, reflecting an increase in external borrowing, before declining to 43.5% of GDP in 2013.

While the public finance situation is improving, weaknesses remain in the balance of payments. Exports surged by 46.9%, much of which was generated by export-oriented mining and metallurgy,

3.1.3 Inflation



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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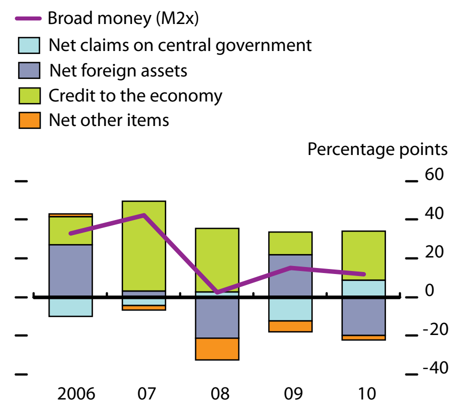
3.1.4 Contributions to money supply (M2x) growth



Source: Central Bank of Armenia. http://www.cba.am (accessed 1 March 2011).

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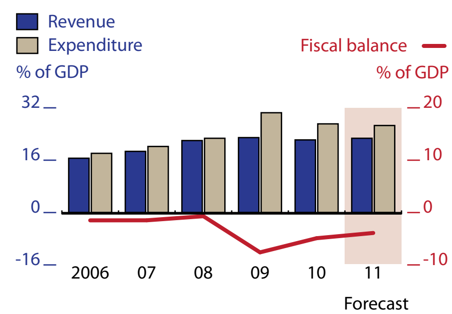
3.1.5 Fiscal balance indicators



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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3.1.6 External debt

Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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primarily due to soaring international prices of copper, molybdenum, and other nonferrous metals (but also due to a better global economic environment). After tumbling by 25.0% in 2009, imports showed growth of 19.8% in 2010, boosted by domestic demand that was lifted by improving investment and rebounding remittances.

The trade deficit pushed out slightly to an estimated \$2.3 billion, but larger remittances and factor income helped narrow the current account deficit to 14.6% of GDP in 2010 from 16.0% (Figure 3.1.7). The large current account gap was financed primarily by donor inflows and foreign direct investment.

The central bank maintains a floating exchange rate regime. Given the large import content of consumption, its interventions in the foreign exchange market aimed to prevent steep fluctuations in the value of the dram while safeguarding reserves. Over the year, the nominal effective exchange rate appreciated by 9.7%, and the real effective exchange rate by 11.4%, reflecting higher inflation in Armenia than in its main trading partners (Figure 3.1.8).

Gross international reserves contracted by about \$150 million to \$1.8 billion at end-December 2010, equivalent to about 5 months of import cover. Three-year arrangements equivalent to \$395 million with the International Monetary Fund were approved in June 2010, following a \$540 million stand-by arrangement approved in March 2009. These arrangements have helped to replenish reserves as the authorities seek to strengthen the external position. Their economic program aims to restore fiscal and external sustainability, preserve financial stability, and support growth and poverty reduction.

Economic prospects

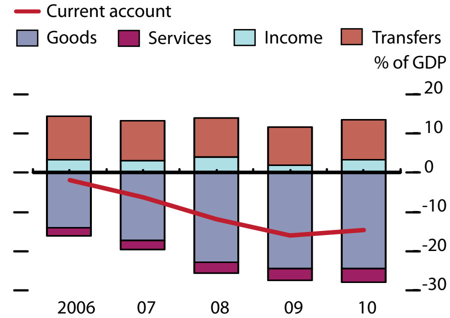
Continued growth in Armenia depends heavily on that in the Russian Federation. Strong performance there will boost foreign direct investment inflows, migrants' remittances, and demand for exports. As a result of improved external conditions—along with a rebound in agriculture, which is expected to grow by 10% this year—GDP is projected to expand by 4.0% in 2011 and 4.5% in 2012.

The government's efforts toward diversifying the economy and stimulating exports will provide additional impetus to growth and should make it less volatile. Investments in large-scale infrastructure, such as highways and rural roads, as well as the water-supply system, will continue to bolster public spending.

Fiscal policy is expected to be gradually tightened in 2011 and 2012 given concerns on the large buildup of external debt. This year's fiscal consolidation should be achieved through stronger revenue collection, stemming from the positive economic outlook and improving tax administration. The 3-year midterm spending program calls for suspension of public sector salary increases up to 2013 and freezing spending on purchases of equipment and property. The government envisages reducing the budget deficit to about 4% in 2011. The priority areas for expenditure include support for social programs and infrastructure.

Due to strengthening domestic activity and fast-rising global

3.1.7 Balance-of-payment components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011).

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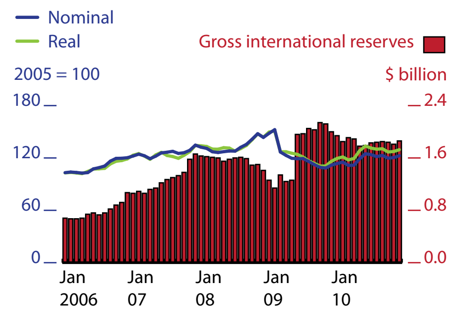
3.1.8 Effective exchange rates and reserves



Sources: International Monetary Fund. International Financial Statistics online database; Central Bank of Armenia. http://www.cba.am (both accessed 1 March 2011).

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3.1.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.0	4.5
Inflation	7.5	5.5
Current account balance (share of GDP)	-13.0	-12.3

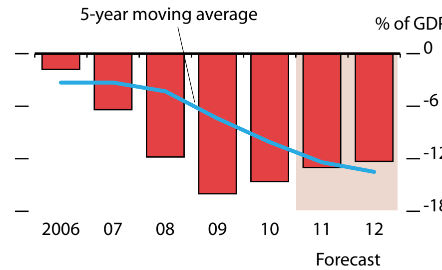
Source: ADB estimates.

commodity prices, inflation pressures will persist in 2011, though inflation is expected to come down from its 2010 high. Monetary policy is shifting to a tighter stance to combat these pressures: in February this year, the central bank increased the refinancing rate by 0.5 percentage points, to 7.75%. Inflation is forecast at 7.5% in 2011 and 5.5% in 2012.

Recovering remittance inflows and transfers as well as the large infrastructure projects are seen boosting domestic demand for imports, such that they rise by about 12.0% in 2011 and 10.0% in 2012.

Given the expected growth in major trade partners and expected outcomes of the government's export diversification and promotion actions, exports are expected to expand by 15.0% in 2011 and by about 10.0% in 2012. This increase will be backed by strengthening from new investments in chemicals and metallurgy. The trade deficit is seen narrowing moderately. Backed by the robust remittance inflows, the current account deficit is forecast to ease to 13.0% of GDP in 2011 and to 12.3% of GDP in 2012 (Figure 3.1.9).

3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2011); ADB estimates.

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Development challenges

The immediate to midterm macroeconomic challenges include tightening the monetary and fiscal stances, ensuring debt sustainability through concessional financing, and reducing external imbalances.

Fiscal consolidation will require action on both the revenue and expenditure sides. The authorities acknowledge the need for a faster pace of reforms in the areas of tax and customs administration.

Further efforts for better governance will likewise be important to improve social policy, improve the distribution of resources, and reduce poverty. The government is aware of oligopolies in key sectors of the economy that have strong links with entrenched elites. It therefore intends to continue its efforts to reduce corruption, enforce competition, modernize public expenditure management, and strengthen the civil service and judiciary.

For reducing reliance on minerals and metals, which account for the bulk of exports, the government needs urgently to take steps to diversify the industrial base. A one-stop shop for business registration is set to come into effect this year, which should reduce barriers to entry for new businesses.

Azerbaijan

Although growth in oil output slowed in 2010, higher oil prices led to a large balance-of-payments surplus, while a revival in the non-oil economy, driven by public expenditure, led to solid but slower overall growth. Growth and the balance of payments are both predicted to remain strong in 2011 and 2012. Inflation was moderate but local and external factors will stoke price pressures in 2011. Supporting growth in the non-oil sector and reducing dependence on oil revenue represent a significant long-term challenge.

Economic performance

GDP growth at 5.0% in 2010 was markedly lower than the very high rates of the previous few years when large investments rapidly expanded Azerbaijan's oil and gas resources. Growth in the oil economy (defined to include gas production) is estimated to have slowed to 1.8%. The non-oil economy performed well, growing by 7.9%, as it recovered from the headwinds of the global recession. With oil and gas production growth leveling off (oil production in 2010 was at 377.4 million barrels), the outlook is for moderate overall growth based largely on non-oil activity (Figure 3.2.1).

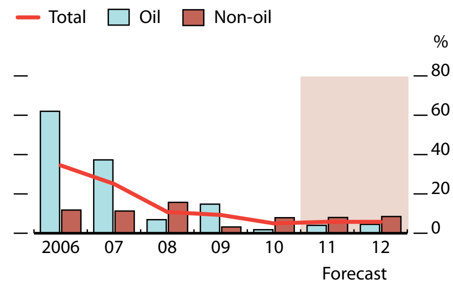
Robust growth in the non-oil economy in 2010 was driven largely by public investment, mainly in infrastructure projects that led to a 20.3% expansion in construction activity (Figure 3.2.2). This was a marked recovery from the 8.3% contraction in investment in 2009, when much lower oil prices and global crisis–related uncertainty reined in public and private investment. Non-oil manufacturing is estimated to have grown by about 6.8%, after 2009's 12.6% contraction. Several public and private industrial plants started operations and SOCAR, the state-owned oil company, expanded into non-oil manufacturing.

Services growth was robust at 7.2%, driven by the strong expansion in the non-oil economy as well as gains in gas transport services and new technologies in mobile communications and Internet access.

Agriculture performed poorly, contracting by 2.2% in 2010 after 3.5% growth in 2009. This reflected a 33% drop in grain production that was caused by flooding, a decline in the area cultivated, and falling yields. Production of other agricultural products such as cotton and tobacco picked up.

Public investment, mainly in the non-oil sector, rose to 13% of GDP, accounting for nearly three-quarters of overall domestic investment. Although private investment fell slightly as a share of total investment, it was well above its low of 2008. Foreign direct investment in oil has been declining since 2006 with the completion of large investment

3.2.1 Oil and non-oil GDP growth



Source: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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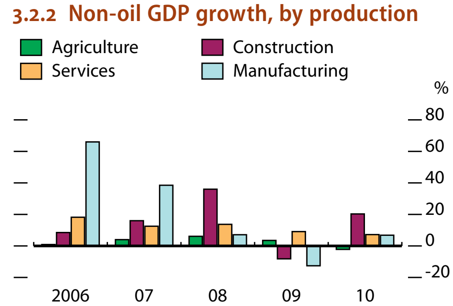
3.2.2 Non-oil GDP growth, by production



Source: State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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

projects as well as SOCAR's self-financing of new projects. Inflows into manufacturing, transport, and communications went up.

Inflation crept up steadily during the year, to 5.7% in December 2010 year on year from 1.5% in December 2009 (Figure 3.2.3). The upturn was largely driven by rising prices of basic food items, including wheat, reflecting both higher import prices and the poor grain harvest. Nonfood prices increased moderately over the year. Demand factors, such as a pay hike for public servants and a robust expansion in credit to the private sector, appear to have put some additional pressure on these supply-side factors.

The State Oil Fund of Azerbaijan (SOFAZ), set up to save a part of the nation's hydrocarbon earnings, is channeling some of its revenue to the budget for financing public investment projects. Despite large transfers of this nature in 2010, SOFAZ assets surged by 52.8% to $22.8 billion at year-end, buoyed by higher oil prices.

Budget expenditure rose by 11.3% in 2010, though as a share of GDP it moderated by about 1 percentage point to 28.3% (Figure 3.2.4). Besides the salary hike, 2010 saw markedly higher social and defense outlays; public investment came in at 13% of GDP. Tax collection increased by only 4.4% in 2010, as customs revenue contracted because of lower imports of machinery and equipment. Total budget revenue declined by 2 percentage points to 27.4% of GDP. The large gap between budget expenditure and revenue was again bridged by substantial SOFAZ transfers, keeping the overall budget deficit small (0.9% of GDP).

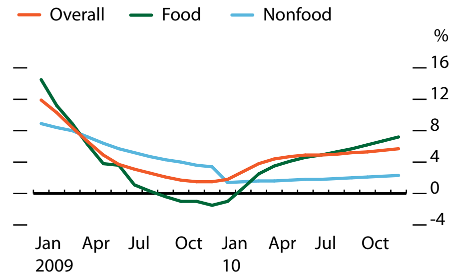
Without the SOFAZ transfers the deficit would have been 15.1% of GDP, and these transfers have been rising in absolute terms and relative to GDP in recent years. They now make up over one-half of the government resources that finance budget expenditure. To arrest this trend, the government would need to increase revenue from taxes and other charges, though a substantial move would stymie policies that seek strong expansion in non-oil economic activity.

The Central Bank of Azerbaijan adopted an expansionary monetary policy in 2009, aiming to counter the impact of the downdraft on growth from lower oil prices and an uncertain economic outlook. It set the refinancing rate at 2.0% and the reserve requirement at 0.5%. It raised the refinancing rate to 3.0% in November 2010 and to 5% in March 2011, responding to the strengthening in the non-oil economy and inflation pressures. It continues, however, to provide long-term loans and additional special financing support to private companies and banks at its discretion.

Evidence of recovery is seen in a 9.7% rise in credit to the private sector and a 24% expansion in the broad money supply (Figure 3.2.5), which in part reflected a rebound in net foreign assets as the overall balance returned to a large surplus. A sign of financial deepening and greater confidence in the banking system was that the ratio of broad money to GDP rose from 23.8% in 2009 to 25.3% in 2010.

In overseeing the commercial banks, the central bank is implementing Basel standards to improve banking regulation and stability, as well as to strengthen public trust in the banking system. Banks have therefore boosted their capital position. Similarly, to extend access to financial and banking services in rural areas particularly, the government has initiated

3.2.3 Monthly inflation



Sources: International Monetary Fund. International Financial Statistics online database (accessed 10 March 2011); State Statistical Committee of the Republic of Azerbaijan. http://www.azstat.org

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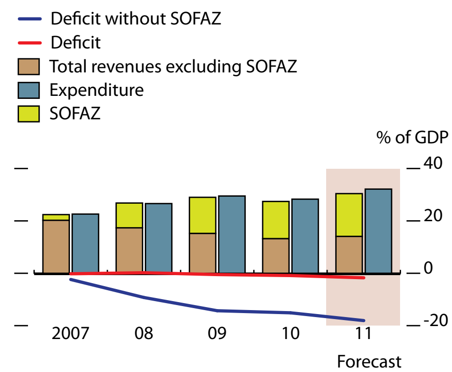
3.2.4 Fiscal indicators



SOFAZ = State Oil Fund of Azerbaijan.

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

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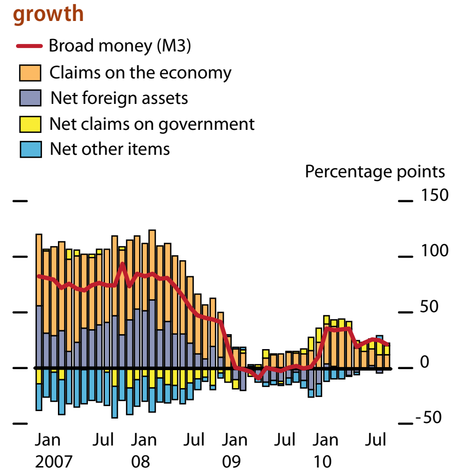
3.2.5 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 1 March 2011).

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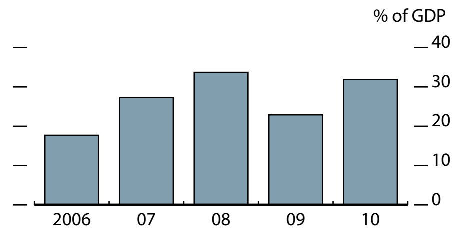
the Azerpost project, which offers services (including microcredit, money transfers, and distribution of pensions) through post offices.

On the external front, the marked global increase in oil prices led to an estimated 24% gain in exports (oil and gas account for about 95% of goods exports). Non-oil exports saw a small gain despite agriculture's contraction. Imports witnessed virtually no upturn despite the revival in non-oil growth.

Similarly, net services and income payments were little changed from a year earlier while workers' remittances, a marginal item in the balance of payments but an important source of support for rural households, tumbled. Resting mainly on strength in oil pricing, the current account surplus was boosted to $16.5 billion in 2010, about 31.9% of GDP, from $10.2 billion a year earlier (Figure 3.2.6).

Gross international reserves jumped by nearly 20% to $6.4 billion at end-2010. With the surge in SOFAZ assets, total foreign assets now amount to about 56% of GDP. Public external debt is relatively small at $3.7 billion, about 9% of GDP.

3.2.6 Current account balance



Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 1 March 2011).

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Economic prospects

As oil prices are projected to go up in 2011 and remain high in 2012, the main challenge for the government will be to maintain macroeconomic stability. Growth in oil revenue will allow a continued rise in social expenditure and investment in infrastructure that should spur private activity and improve the investment climate.

The hydrocarbon economy is expected to grow steadily at about 3%–4% in the forecast period as oil and gas development sets the stage for faster expansion in later years. Robust growth of the non-oil economy is expected to stay driven by public sector investment. The government is planning investment spending of $4.2 billion in 2011, which will drive a rapid expansion in construction with positive knock-on effects on the rest of the economy.

Agriculture is seen growing steadily on the assumption of good weather and continued government support, including reductions in value-added tax on agricultural inputs and in the lending rate of the main agro-leasing company, and completion of irrigation and infrastructure initiatives. Growth of 8% is foreseen in the non-oil sector in 2011 and 2012. Overall GDP growth is projected at 5.8% in both years.

The central bank will aim to meet the credit demands of the non-oil economy while keeping consumer price inflation in check, though price rises will probably be driven mainly by external factors. The exchange rate may come under some upward pressure because of larger surpluses in the balance of payments, but the bank will resist a marked appreciation as it would retard non-oil export development. Inflation is seen reaching 7.5% in 2011 as global price pressures increase, gliding down to 7.0% in 2012 as they moderate.

Higher oil export revenue will outweigh the import growth arising from strengthening investment and the rising income–related consumer spending. The current account surplus is expected to be 27.8% of GDP in 2011 and 25.0% in 2012, as import demand rises in response to growth of incomes and appreciation of the manat, and as growth in oil revenue slows.

3.2.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.8	5.8
Inflation	7.5	7.0
Current account balance (share of GDP)	27.8	25.0

Source: ADB estimates.

Development challenges

Developing the non-oil sector and diversifying the economy is the government's longer-term priority. Agriculture, manufacturing, telecommunications, and tourism all have potential for growth. Agriculture is particularly crucial, as 40% of the population still lives in rural areas. Although government programs have attempted to support the sector, the rural population depends largely on remittances. Further steps include rehabilitating and maintaining irrigation and other infrastructure, improving land-management practices, enhancing inputs as well as credit and agricultural services, and boosting incentives for private participation.

Improved physical infrastructure, particularly roads, railways, and energy, is also essential for the non-oil sector. Additionally, medium- and long-term private sector growth will depend on a stable macroeconomic environment and a better legal and regulatory framework, among other measures. Azerbaijan is now ranked 54 out of 183 in the World Bank's *Doing Business 2011* report, ahead of most countries in the region. This ranking reflects progress over the past year in providing access to credit and simplifying tax payment procedures.

The report shows that trade facilitation, too, requires work, as Azerbaijan is one of the 10 hardest countries from which to trade across borders. If it is to become a successful exporter, it needs to reduce both formal and informal barriers to trade. In addition, the procedures and permits required for certain sectors or operations need to be streamlined, while governance and transparency should be improved to ensure that the large public investment program provides its maximum potential benefit.

3.2.2 Global rankings on the ease of trading across borders, 2011

Niger	174
Burkina Faso	175
Burundi	176
Azerbaijan	177
Tajikistan	178
Iraq	179
Congo, Republic of	180
Kazakhstan	181
Central African Republic	182
Afghanistan	183

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.

Georgia

On the back of stronger trade demand and remittances, as well as a fiscal stimulus, the economy bounced back to solid growth in 2010, though inflation also accelerated, largely on global price pressures. The outlook is for measured growth with increased reliance on the private sector (including remittances from abroad) and for continued inflation pressures. Major risks relate to a weak recovery in foreign investment and other capital flows.

Economic performance

The economy recovered from the sharp contraction in the second half of 2008 and in 2009 to grow at 6.4% in 2010 (Figure 3.3.1). The broad-based recovery was underpinned by a marked pickup in export demand and robust remittances, strong government investment, and a rebound in credit to the private sector. A striking revival in gross fixed capital formation of 22.5%, after a 32.8% drop in 2009, was the main impetus.

On the production side, industry and services grew steadily at about the same pace. Industry advanced by 9.7%, led by high growth in manufacturing due to the rebound in export demand and to strengthening consumer demand. Services picked up by 7.1% on account of high growth in trade, transport, and tourism as Georgia's west coast tourist venues bounced back to a highly successful season. By contrast, agriculture contracted marginally. Once a strong exporter, it has become a low-profit sector as it cannot compete with grain and livestock imports.

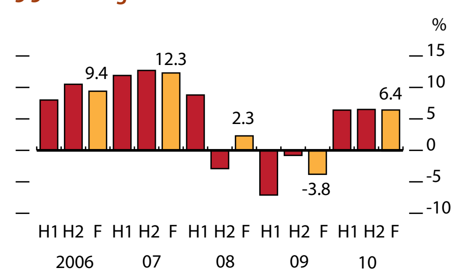
Headline inflation accelerated from around mid-2010 to 13.7% by February 2011 (Figure 3.3.2). The uptick was largely attributable to food items (with a weight of 40.5% in the index), which rose by 28.4% owing to mounting global food prices. Price increases in other sectors were moderate, pointing to limited pressures from the demand side.

In light of the renewed inflation pressures and economic recovery, the National Bank of Georgia switched to monetary tightening in the second half of 2010, raising the policy rate in steps to 8% by February 2011. It also doubled the reserve requirements to 10% on lari-denominated deposits in April 2010 and on deposits in other currencies to 15% in February 2011.

Despite these policies, credit to the economy grew by 20.4% in 2010 owing to rising business and bank confidence. The M3 broad money aggregate rose by 34.8% as both local and foreign currency deposits climbed (Figure 3.3.3). Dollarization of deposits declined by 1.3 percentage points to 72.1%.

Interest rates on both deposits and lending decreased during 2010, by 150 and 300 basis points, respectively (Figure 3.3.4). As with the reduction in dollarization, the change appears due to a lower risk perception, as the high uncertainty associated with the global downturn fades.

3.3.1 GDP growth



F = full year.

Source: National Statistics Office of Georgia. http://www.statistics.ge (accessed 15 March 2011).

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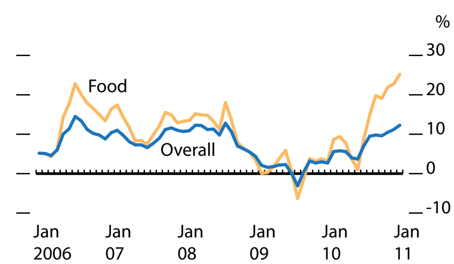
3.3.2 Inflation



Source: National Statistics Office of Georgia. http://www.statistics.ge (accessed 15 March 2011).

Click here for figure data

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

The change in the monetary policy stance is expected to have a greater impact on the economy in 2011. The upward revision in the policy rate has narrowed its gap with deposit rates, making it less attractive to use the refinancing facility. Increases in reserve requirements have reduced excess bank reserves, as apparently reflected in slowing loan volumes in early 2011, to a level that will make monetary control more effective.

The main prudential ratio in the financial system is well above the minimum requirement: the average risk-weighted capital adequacy ratio was 17.4% at end-2010. Moreover, the ratio of nonperforming loans to total loans declined to 11.6% at year-end and banks made an aggregate profit (after 2009's loss).

Recovery in economic activity along with improved tax administration brought about a revival in tax receipts and general government income (excluding grants). Total revenue increased by 11.4% year on year. On the expenditure side, the government raised social spending and salaries, adjusting largely by containing other current expenditure items such as spending on goods and services for public administration. Capital spending and net lending rose somewhat more than planned in the original program. Still, the deficit narrowed to 6.5% of GDP in 2010 from 9.2% a year earlier (Figure 3.3.5).

Foreign financing was much higher than a year earlier and provided more than 80% of the deficit financing, although Treasury bills remained important.

External public and publicly guaranteed debt increased from 31.4% of GDP in 2009 to 37.4% in 2010. The debt repayment burden will become very heavy in 2013, when a large Eurobond issue matures and significant repayment obligations to the International Monetary Fund fall due. Rapid fiscal consolidation is essential in preparing to make these payments.

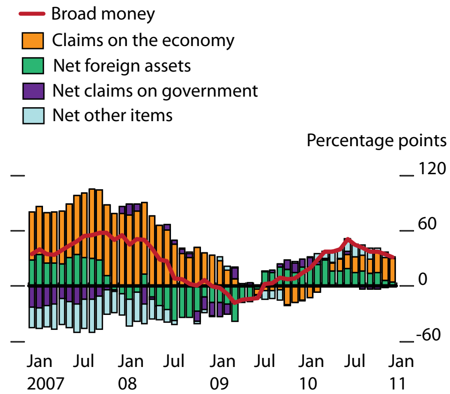
A recovery in global demand and higher prices of ferroalloys and nonferrous metals—the country's leading export commodities—helped to boost exports by 23.5%; imports grew by 15.8%. The trade deficit widened to $2.6 billion, though this was largely offset by stronger net remittances and services exports.

The current account deficit amounted to an estimated 11.4% of GDP in 2010, up from 11.2% in 2009 (Figure 3.3.6). Inflows of foreign direct investment (FDI), however, were disappointing. They had been expected to come back as the main source of growth, but missed the $600 million target.

The lari depreciated against the US dollar by about 5% in 2010. Weaker inflows in the first half of the year and banks' buildup of foreign exchange balances led to a larger depreciation in this period, but the currency subsequently strengthened (Figure 3.3.7) on improved earnings and capital inflows. Because of the steeper increase in domestic prices than in major trade partners, the real effective exchange rate appreciated by 2.8%.

Gross international reserves gained about $155 million, rising to $2.3 billion at end-2010, equivalent to about 4 months of 2011 estimated imports. Reserves were bolstered by drawing on funds from the International Monetary Fund made available under stand-by arrangements originally approved in 2008 and augmented in 2009 to a cumulative amount of about $1 billion.

3.3.3 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 17 March 2011).

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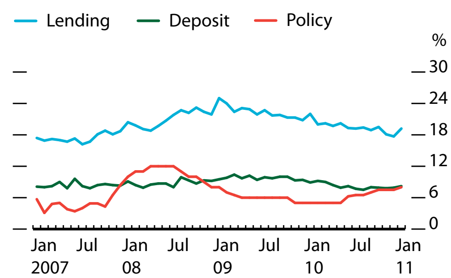
3.3.4 Interest rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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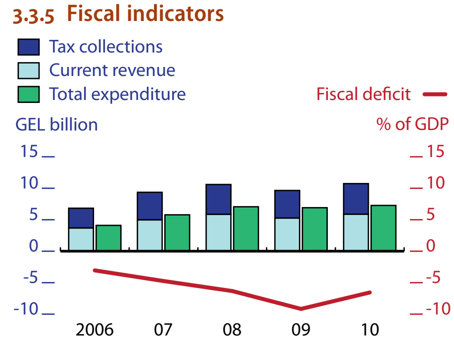
3.3.5 Fiscal indicators



Sources: International Monetary Fund. 2008. *Country Report* No. 08/328. October; 2009. *Country Report* No. 09/267. August; 2009. *Country Report* No. 09/331. December; 2011. *Country Report* No. 11/31. January. http://www.imf.org; Ministry of Finance of Georgia. http://www.mof.ge/en (accessed 17 March 2011).

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Economic prospects

Growth in 2011 will be measured because of the cyclical revival of 2010 and a phased withdrawal of fiscal stimulus in view of the need for consolidation. Hence more modest growth of 5.5% is projected. With greater reliance on the private sector as a driver, growth is forecast to be sustained at 5.0% in 2012.

Even though the growth of broad money is seen slowing to 20%–25% in 2011, the central bank's monetary program calls for a 15%–20% increase in credit to the private sector, which it perceives as appropriate for the growth target. The central bank is committed to a flexible exchange rate regime, and is moving to adopt inflation targeting.

Inflation is expected to be high in 2011 at 9.5% given the ongoing surge in global food and oil prices. It should edge down in 2012 on the view that food price rises will be largely over and that oil and other import prices increase only moderately.

A new tax code that was passed in September 2010 (effective 1 January 2011) should boost government revenue. Its impact, along with the government's continued commitment to containing current spending, is seen narrowing the fiscal deficit to 4.0% of GDP in 2011 and to 3.4% in 2012. Special measures to protect low-income families from high inflation, such as electricity vouchers introduced in February 2011 and food vouchers the following month, will require cuts in budgeted expenditure to maintain the 2011 deficit target. Fiscal adjustment, unlike in 2010, will involve holding back capital spending.

The current account deficit is expected to widen slightly to 12.6% of GDP in 2011 as rising food and oil prices add to the import bill. A steady stream of remittances and services surpluses as well as growing export revenue from a sustained global recovery will help to rein in the deficit. It is projected to narrow to 11.4% of GDP in 2012, largely reflecting a further narrowing of the trade gap. External financing requirements of the current account deficit will increasingly rely on private inflows, such as FDI, as official development assistance slows.

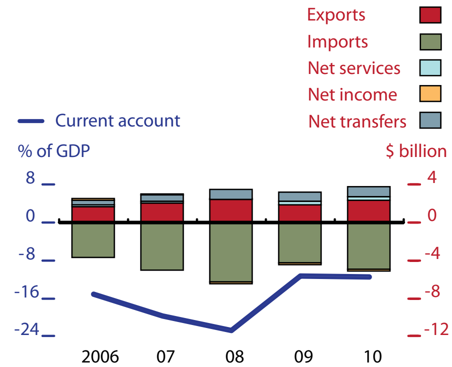
External risks associated with this outlook include a setback in the global recovery, higher than expected global commodity prices, and weaker FDI inflows. On the domestic front, the most significant risk is slow fiscal consolidation.

Development challenges

A key challenge is to make growth sustainable over the medium term. The country therefore needs to diversify its production structure and exports from traditional products. The current limited physical, financial, and human capital are key bottlenecks.

Further efforts are needed to improve the fiscal deficit and to continue implementing reforms so as to prevent systemic risks from developing in the private sector.

3.3.6 Current account components



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

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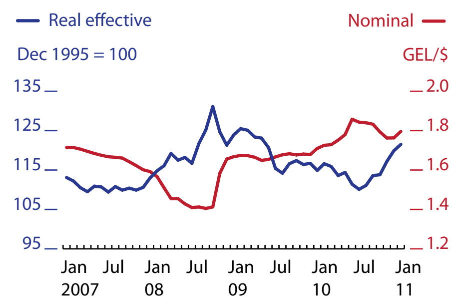
3.3.7 Exchange rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 17 March 2011).

Click here for figure data

3.3.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	5.0
Inflation	9.5	6.0
Current account balance (share of GDP)	-12.6	-11.4

Source: ADB estimates.

Kazakhstan

In 2010 the economy showed a V-shaped recovery, driven by a revival in external demand, higher oil prices, and anticrisis measures. The outlook is for steady moderate growth and a comfortable current account surplus. Nevertheless, limited credit availability from restructured but still weak banks and rising inflation are headwinds. To diversify the economy and raise productivity, the government is implementing an industrial-innovation program.

Economic performance

The recovery that started in the last quarter of 2009 continued into 2010, giving full-year growth of 7.0% (Figure 3.4.1). Improved global economic conditions, a revival in external demand for oil and minerals, and mounting oil prices all played a role, as did anticrisis measures put in place in 2009. Bank restructuring was also a positive factor, though private credit to the economy stayed weak.

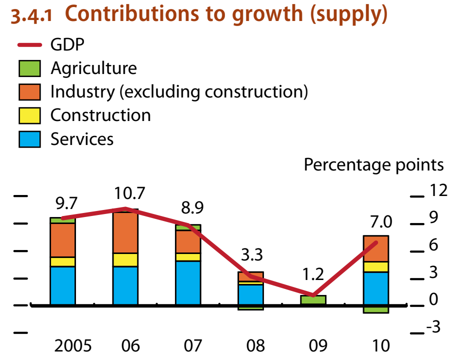
This solid growth performance was driven by 9.6% growth of industry. Manufacturing expanded by 18.4% and mining by 5.3%. Construction, which slowed sharply during 2007–2009, gained some momentum and grew at 1.0% in 2010. Agriculture contracted by 11.7% in 2010 as a result of damage that severe summer droughts caused to about 10% of arable land. With overall economic activity picking up, services expanded by 6.0%.

On the demand side, after a stagnant 2009 and with the recovery beginning to take hold, private consumption and gross fixed investment grew by 7.5% and 7.0%, respectively, in 2010 (Figure 3.4.2). Credit conditions stayed tight, which may have held back further increases in private consumption and investment. After the slump of 2009, export volume grew by 9.5% in 2010, as demand for oil and other key exports picked up. With rising consumption and investment, imports grew by 6.5% in 2010.

Overall average annual inflation reached 7.1% in 2010, remaining within the target band of 6%–8% of the National Bank of Kazakhstan (NBK). In January 2011, year-on-year headline inflation was, however, at 8.1%, 0.8 percentage points higher than a year earlier. This rise was largely due to the continued increase in prices of food items (Figure 3.4.3). The sharp drop in agricultural output as a result of the severe droughts that afflicted Kazakhstan and the Russian Federation in 2010 contributed to the food price surge. Inflation for nonfood items and services continued to moderate, indicating some slack in the economy.

With the economy beginning to gain traction but also showing signs of weak private sector activity, the NBK kept the refinancing rate at 7.0% during 2010, unchanged since September 2009. It also maintained the

3.4.1 Contributions to growth (supply)



Source: Agency of Statistics of the Republic of Kazakhstan.

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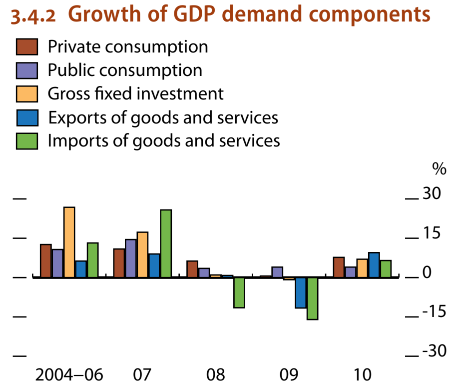
3.4.2 Growth of GDP demand components



Sources: Agency of Statistics of the Republic of Kazakhstan; Economics Intelligence Unit. 2011. *Kazakhstan Country Report*. March.

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This chapter was written by Utsav Kumar, consultant of the Central and West Asia Department, ADB, Manila; and Christopher T. Hnanguie and Manshuk Nurseitova of the Kazakhstan Resident Mission, ADB, Astana.

reserve requirements, which it had lowered to a historical low in March 2009, to boost liquidity. Broad money supply increased by 14.1% in 2010, largely on account of higher net foreign assets (Figure 3.4.4). Credit to the economy grew by 6%, though that to the private sector rose by only 0.8% in 2010, reflecting both weak private sector activity and risk aversion among banks.

After the onset of the financial crisis and with falling oil prices, foreign exchange reserves came under stress. The NBK devalued the tenge in February 2009 by about 20%, following a similar adjustment in the Russian Federation, from T120/$ in 2008 to T150/$, with a 3% band. As the economic recovery gathered pace and oil prices came back from their lows, the NBK introduced in February a wide, asymmetric trading band of +10%/-15% around T150/$. Over the course of the year, the nominal exchange rate appreciated marginally.

Budget revenue increased due to the improvement in economic activity, higher oil prices, and the reintroduction in mid-August 2010 of an oil export duty of $20 per ton. Transfers from the oil fund, the National Fund of the Republic of Kazakhstan (NFRK), were also used to support the budget. As a result, current revenue climbed by 28%.

Total expenditure increased by 21%: 19% on current items, due to higher social spending and wages; 55% on capital items, due to investments in priority projects. The fiscal deficit narrowed to 2.5% of GDP in 2010 from 2.9% a year earlier. Most of the deficit was financed through domestic sources, although foreign financing increased.

After a contraction in 2009, exports jumped by 38.5% in 2010 due to the improved global economic environment and higher oil prices. Imports recovered to grow by 10.3% in 2010. The modest pickup in imports points to weak private domestic demand as well as lack of credit. The $28.9 billion trade surplus was partly offset by a persistent services deficit, as well as by a negative balance in the income and current transfers accounts combined (Figure 3.4.5).

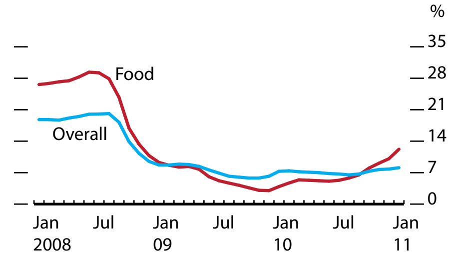
The current account balance moved back into positive territory from a deficit of $4.4 billion (3.8% of GDP) to a surplus of $4.3 billion in 2010 (3.0%). Gross international reserves at end-2010 climbed by 22.5% to $28.3 billion. Assets of the NFRK rose by 25.5% to $30.6 billion (Figure 3.4.6). An important development on the trade front was the formation of a three-country customs union (Box 3.4.1).

Total external debt grew rapidly from the early 2000s, reaching about 92% of GDP just as the global capital markets began to wobble in August 2007. The rapid increase in debt was due to external borrowing by banks to finance consumption and construction (Figure 3.4.7). The debt composition has changed significantly, with public and publicly guaranteed debt, always low, now accounting for only 4.3% of the total. Almost half the total private debt outstanding is intracompany debt, mainly reflecting liabilities for direct investment by oil companies.

The vulnerabilities of the banking system were exposed as the global crisis bit, putting pressure on foreign reserves as well as on the exchange rate. Banks' external debt came down after the crisis through September 2010.

The two largest banks had to be nationalized after the crisis, which had hit the banking system hard. The external debt obligations of these

3.4.3 Inflation



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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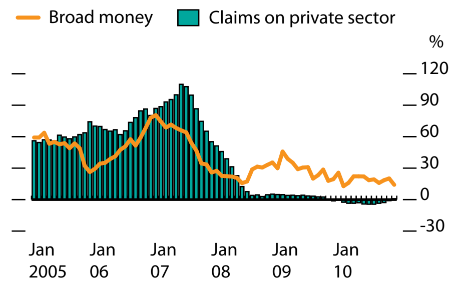
3.4.4 Growth of monetary aggregates



Note: Increase in private sector credit for February 2009–January 2010 were adjusted to exclude valuation changes on foreign currency–denominated loans stemming from the February 2009 devaluation.

Source: International Monetary Fund. International Financial Statistics online database (accessed 15 March 2011).

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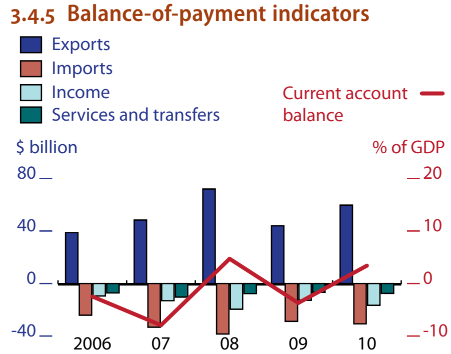
3.4.5 Balance-of-payment indicators



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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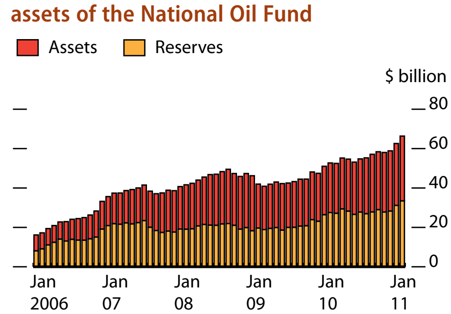
3.4.6 Official reserves and foreign exchange assets of the National Oil Fund



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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3.4.1 Customs union among Belarus, Kazakhstan, and the Russian Federation

The three countries formed a customs union in 2010. It removes duties on goods originating in member states and enforces a common external tariff for trade with third countries. It also establishes a common customs territory in which terminology, a customs code, and customs duties will be unified.

The union took effect on 1 January 2010 with a unified customs rate. At this first stage, the three countries removed most duties on trade among themselves.

On 1 July 2010, a customs code was launched between Kazakhstan and the Russian Federation, coming into force a few days later in Belarus. This second stage led to the adoption of common external tariffs.

In the third stage, customs clearance and control procedures at the Kazakh–Russian Federation border are scheduled to be abolished by 1 July 2011. (Such measures were implemented at the Belarus–Russian Federation border in July 2010.) By January 2012, a single economic space will be achieved among the three countries.

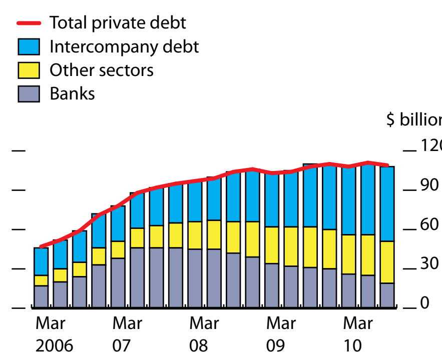
The tariff regime is based heavily on that in the Russian Federation, and Kazakhstan had to raise tariffs on around 45% of all imported items. The average common customs tariff rate is 10.6%, whereas previously Kazakhstan's simple most-favored-nation applied tariff was only 6.16%.

The value-added tax rate applied to third countries is 17%. Import customs duties from goods originating outside the union will be distributed among the three countries according to an agreed formula of 87.97% for the Russian Federation, 7.33% for Kazakhstan, and 4.70% for Belarus.

two banks and of two other smaller banks had to be restructured, resulting in debt relief of $11 billion. Overall, the share of nonperforming loans in the total loan portfolio is about 30%, and is a key factor hampering lending activity.

In addition, the restructuring of external debt has affected the private sector's access to international markets. The country's leading private bank, Kazkommertsbank, postponed its issuance of international bonds, citing unfavorable market conditions (although state-owned KazMunayGas and Kazakhstan Temir Zholy were readily able to raise money in international markets in 2010). Continued risk aversion has affected credit availability, in turn holding back private consumption and investment.

3.4.7 Private external debt



Source: National Bank of Kazakhstan. http://www.nationalbank.kz (accessed 15 March 2011).

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Economic prospects

The recovery of agriculture after the sharp contraction of 2010, capital expenditure by the government on priority projects in its program for 2010–2014, a sustained global recovery, and an increase in oil demand and prices will help run the growth momentum in 2011 and 2012. At the same time, banks' continued fragility and steep oil and food price rises may undermine the global economy and work against Kazakhstan's growth. The forecast is for GDP to grow by 6.5% in 2011 and 6.8% in 2012.

Construction will continue to face weaknesses as a result of lack of credit and the inability of the private sector to raise funds in international markets on attractive terms. Private consumption and total investment are expected to see continued growth in 2011 and 2012. Credit availability will be an important factor if higher growth rates are to be achieved. However, higher oil prices and external demand will help to boost consumption as well as investment in the oil sector.

The government is considering several programs that will help to support private consumption and investment over the projection horizon and beyond. One of them, Employment 2020, targets the self-employed, especially those in rural areas. It will provide support in the form of

3.4.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.5	6.8
Inflation	8.5	6.0
Current account balance (share of GDP)	3.5	3.5

Source: ADB estimates.

relocation from economically depressed regions, subsidized leases of property, and day care for children.

Another, the Business Roadmap 2020, for entrepreneurs and exporters in priority sectors, will provide assistance in the guise of subsidized interest rates, guarantees for bank credits, grants, cofinancing of investment projects, and rescheduling of certain tax payments.

An increase in oil exports coupled with a doubling of the oil export duty to $40/ton from 1 January this year is adding to state coffers. A concurrent shift from a personal income tax flat rate to a progressive income tax (with rates at 10%–20%) will also lift revenue, as will a decision to hold off reducing the corporate income tax rate (currently at 20%) until 2013. Both social and capital expenditure on priority projects will climb. Overall, the government is likely to achieve its target of narrowing the fiscal deficit to 2.2% in 2011 and 1.7% in 2012.

With the surge in global food prices and the region still reeling from the effects of the severe droughts, the prices of many food items are likely to rise further. In February 2011, the government introduced price ceilings for essential food items. A utility fee increase in January 2011 and a boost to consumption from wage increases in the second half of 2011 will add to inflation pressures.

Some slack still appears to be in the economy, however—as observed from moderate prices of nonfood items and services—and this will help to contain inflation this year, to 8.5%, as inflation pressures subside later in the year. Inflation in 2012 is expected to be 6.0%.

Though the trading band for the exchange rate was widened in February 2010, the NBK has intervened to prevent the tenge from appreciating sharply. On 28 February 2011, it abolished the corridor for the tenge/$ exchange rate and introduced a managed float regime. It is unlikely that the tenge will be allowed to breach T141/$, as further appreciation, combined with the inflation differential with the advanced countries, could result in a loss of competitiveness.

The current account balance is projected to remain positive in 2011 and 2012, at 3.5% of GDP. Imports will increase on the back of higher private consumption and investment as banks become more willing to lend, and of government investment in a variety of priority projects. Exports will markedly increase further due to higher oil prices and stronger demand for oil. The trade surplus will be offset by the deficit on other components of the current account.

Development challenges

Diversifying the economy's industrial base, lowering reliance on natural resources, and generating more balanced and equitable development constitute the premier development challenges. Another is to increase competitiveness (Box 3.4.2).

3.4.2 Accelerated Industrial and Innovative Development Program

The primary thrust of the government's industrialization program (released in March 2010) is diversifying the economy and reducing reliance on oil. The second is increasing national competitiveness.

The program lists the following (among others) as critical to success: developing the priority sectors of the economy (heavy machinery, information and communications, education, and health care); strengthening the "social effectiveness" of the priority sectors and investment projects; and creating a favorable industrialization environment.

The strategy identifies four sectors where the efforts of the state will be concentrated:

- Traditional industries: natural gas sector, mining and metallurgy, atomic energy, and chemical industry.
- High domestic demand: machine building, pharmaceuticals, construction, and building materials.
- Predominantly export oriented: agribusiness, light industry, and tourism.
- Sectors of the future: information and communications technology, biotechnology, alternative power engineering, nuclear energy, and space.

State support to the priority sectors includes provision of physical infrastructure (such as information and communications, energy, and transport) and social infrastructure (such as skilled human resources).

Such support also includes measures to reduce administrative barriers, guidelines on technical regulations, and providing a conducive environment for foreign direct investment.

Kyrgyz Republic

Sociopolitical protests in Bishkek in April 2010 that ousted the former president, followed by ethnic violence in the south in June, battered the economy. Disruption was then exacerbated by border closures with Kazakhstan and Uzbekistan, the main transport conduits for trade. The crisis has put public finances under severe stress, alleviated by a July 2010 $1.1 billion pledge of assistance from donors. The time taken to return to normality will depend heavily on the new government's ability to bring about and maintain political and social stability.

Economic performance

After modest growth of 2.9% in 2009, the country was recovering well from the global economic crisis as GDP growth bounded to 16.4% in the first quarter of 2010. But the closures of international borders following the April and June events stopped imports and exports at times, intensifying the impact of the internal disruptions on the economy. For all 2010, GDP dropped by 1.4% (Figure 3.5.1).

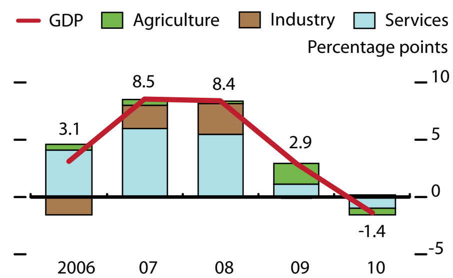
All sectors contracted in 2010, except for gold and other industrial production, which grew by 8% and 11.3%, respectively. Gold output climbed mainly because of a higher ore yield. Expansion in industrial production was largely attributable to a low 2009 base, reflecting the impact of global and regional recession. Some subsectors, however, showed strong outturns: garments were up by an estimated 50% and electricity, gas, and water services were together 11% higher.

Agricultural output fell by 2.8% largely due to delays in sowing crops (a knock-on effect of the disturbances) and an ensuing lower harvest in part caused by shortages of imported fuel. Construction output fell by 22.8%, as unrest and supply disruptions curtailed work, including that on large investment projects in the hydropower and mining subsectors.

The contraction in GDP would have been more severe without expanded gold production. Also of help was an estimated 25% increase in workers' remittances (from the Russian Federation and Kazakhstan, the country's main economic partners) that boosted a major source of income for the population, helping to ease the downward pressure on aggregate demand (Figure 3.5.2).

The imposition of duty by the Russian Federation on oil exports to the Kyrgyz Republic raised domestic oil-product prices by about 35%. This and increasing imported food prices, combined with lower domestic wheat production, have significantly added to inflation pressures. In the second half of 2010, inflation accelerated steadily and reached 19.2% at year-end, with food prices up by 27% (Figure 3.5.3). The April 2010 reversal of electricity and heating tariff increases to their 2009 levels (tariffs were

3.5.1 Contributions to growth (supply)



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 28 February 2011).

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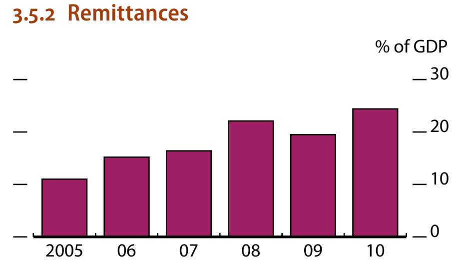
3.5.2 Remittances



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 11 March 2011).

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This chapter was written by Nurbek Jenish, consultant of the Kyrgyz Resident Mission, ADB, Bishkek.

doubled on 1 January 2010) helped to mitigate price escalation. Low inflation early in the year kept annual average inflation to 8.0%.

The April and June 2010 events have significantly increased budgetary expenditure on compensation to the families of victims; unplanned spending for the constitutional referendum and elections; outlays associated with rehabilitating damaged infrastructure and buildings; security expenditure; and subsidies for utility companies due to the tariff-hike reversal. On the revenue side, improved tax administration in the second half of the year helped to offset the negative impact of the crisis and border closure on value-added tax and customs collections.

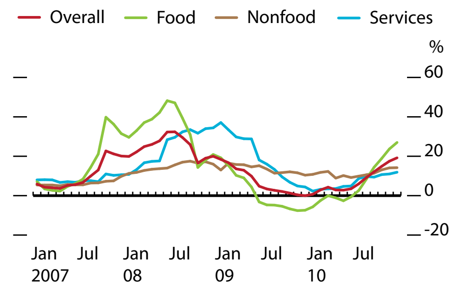
In 2010, the budget deficit widened to an estimated 6.5% of GDP (Figure 3.5.4). Assistance from both bilateral and multilateral donors as well as use of the $300 million Russian loan proceeds (received in 2009) covered financing needed for the enlarged deficit. Since some of the recent spending increases were one time (for rehabilitation and social protection, resettlement, and reconstruction), they can be unwound as the situation improves in 2011, though much rebuilding will still be needed in 2012. Reconstruction, alongside the government's plans to greatly increase salaries of teachers and other social sector workers from May 2011, will further widen the budget deficit. Government estimates of the budget deficit for 2011 are around 9%.

In July 2010, the donor community pledged $1.1 billion assistance over 30 months. External support will be critical in helping the authorities to deal with the consequences of the crisis. External—mainly concessional—borrowing increased publicly guaranteed external debt from around 53% in 2009 of GDP to an estimated 62% in 2010. The external debt ratio is forecast to reach 67% by end-2011. Although the International Monetary Fund rates the country's risk of debt distress as moderate, the government will need to follow prudent policies to ensure external debt sustainability.

In response to the crisis, the National Bank of the Kyrgyz Republic (NBKR, the central bank) eased its monetary stance by lowering the reserve requirement by 1.5 percentage points to 8.0% in May 2010, and adjusted the sale of its notes to changing monetary circumstances. Nevertheless, credit to the economy increased by only 2.7% due to weak demand and troubled banking conditions. The public's preference to increase its cash holdings at the expense of deposits surged after the April events, pressuring banking system liquidity and complicating the central bank's monetary operations. Despite the downturn in economic activity and banking sector problems, external finance of the fiscal expansion increased monetary aggregates. In 2010, money supply rose by 18.6%, primarily due to increased foreign assets (Figure 3.5.5).

The crisis shook financial stability. Loan quality has worsened dramatically—the ratio of nonperforming loans rose from 7.9% before April to an estimated 16% at year-end. The deterioration in quality has been mainly concentrated in loans for trade and commerce. The NBKR introduced temporary administration at seven banks (later reduced to four), including Asia Universal Bank—the largest bank with over 20% of bank deposits—after it experienced a large nonresident deposit outflow, allegedly linked to the previous regime. To mitigate deposit-run risks, the authorities nationalized the bank and created a new bank based on

3.5.3 Monthly inflation



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 28 February 2011).

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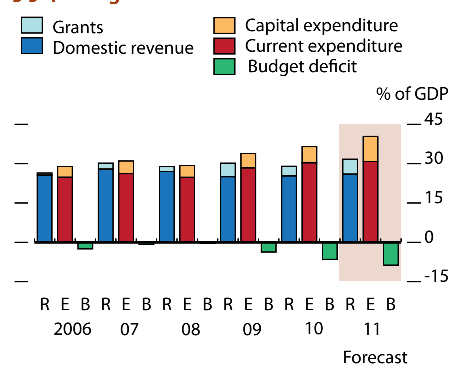
3.5.4 Budget indicators



B = Balance; E = Expenditure; R = Revenue.

Note: Domestic revenue includes capital receipts.

Sources: International Monetary Fund. 2008. *Country Report* No. 08/381. December; 2009. *Country Report* No. 09/209. July; 2010. *Country Report* No. 10/336. October. http://www.imf.org; Ministry of Finance.

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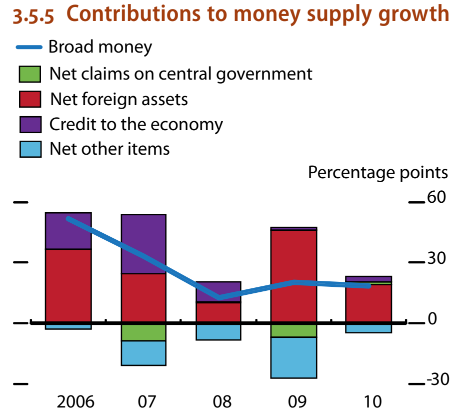
3.5.5 Contributions to money supply growth



Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 11 March 2011).

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the old one. Despite difficulties, the banking system remains adequately liquid and capitalized.

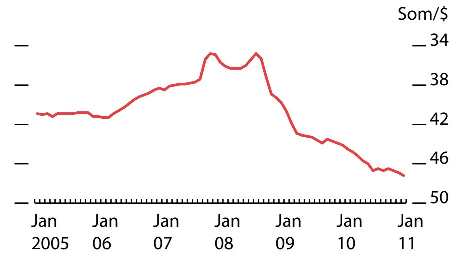
In April and May, the NBKR undertook large US dollar sales in the foreign exchange market to meet public demand and prevent an excessive depreciation of the local currency. For much of the rest of the year, it intervened to offset pressures for appreciation stemming from large donor-funded external budgetary support. Over the year, the som depreciated by around 7% against the dollar (Figure 3.5.6). In view of continued large expected inflows of external assistance in 2011, the NBKR plans to intervene to forestall an unwarranted appreciation of the exchange rate and reduce excess bank liquidity created by these operations.

Exporters did not fully benefit from the economic recovery in the Russian Federation and Kazakhstan in the wake of internal unrest and periods of closed borders. Further, the introduction of a customs union among the Russian Federation, Kazakhstan, and Belarus in July 2010 decreased the volume of Chinese goods that are reexported, as they now face higher duties into the union. Still, increased production of gold, the country's main export commodity, and rising gold prices helped to bolster export revenue that is estimated to have increased by 7.0% for the year.

Despite the border disruptions, imports are estimated to have increased by 15.0%. This expansion reflected higher import prices of food and fuel, though imports financed by donors and workers' remittances were also factors. The current account deficit is estimated at 5.0% of GDP in 2010, up from 2.4% a year earlier (Figure 3.5.7).

On the political scene, following the resignation of the former president in April, an interim government assumed power. It drafted a new constitution, which was adopted in a nationwide referendum in June, changing the country's political system into a parliamentary republic. (The country also elected an interim president, whose tenure will last until 31 December 2011. A presidential election under the new constitutional arrangement is scheduled for October 2011.) Parliamentary elections were held on 10 October 2010, with five parties winning seats. Following the creation of a majority coalition consisting of three parties in December 2010, Parliament elected a speaker and formed a government.

3.5.6 Exchange rate



Source: International Monetary Fund. International Financial Statistics online database (accessed 14 March 2011).

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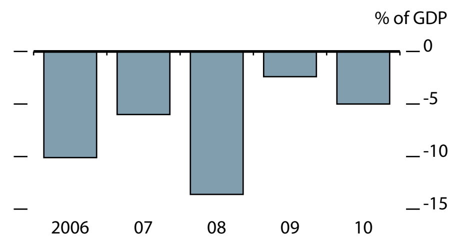
3.5.7 Current account balance



Source: National Bank of the Kyrgyz Republic. *Balance of Payments of the Kyrgyz Republic*. Various issues. http://www.nbkr.kg

Click here for figure data

Economic prospects

The economy is expected to pick up with GDP growing at around 5% in 2011 and 2012. The forecasts rest on expectations of a normal security environment, continued reconstruction works, full resumption of trade and services flows, and improved investor confidence. They also rely heavily on construction growing by about 40%, mainly due to large-scale reconstruction works in the south. Services and industry are seen growing by 6% and 4%, respectively.

Economic expansion of the Russian Federation and Kazakhstan will also contribute to growth through increased demand for the Kyrgyz Republic's exports and higher remittances from workers in those two countries.

Considerable fiscal challenges loom over the next 2 years. Much reconstruction is still needed, and the government plans to increase

3.5.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.0
Inflation	13.0	8.0
Current account balance (share of GDP)	-9.0	-9.0

Source: ADB estimates.

salaries of teachers, as well as medical and other social sector workers in 2011, yet is reluctant to cut down on pension and social protection spending as this might affect social stability. It therefore plans to improve tax and customs administration and cut nonpriority spending. Around 73% of the budget deficit will be financed by donors.

The pickup in economic activity with higher import prices for food and higher remittance spending will exert an upward pressure on consumer prices. The NBKR's monetary and exchange rate policies will aim to keep inflation in check by neutralizing the effects of large fiscal expansion yet support the postcrisis recovery. Cancellation of export duties on petroleum products by the Russian Federation from 1 January 2011 will help to mitigate upward pressures on prices. For 2011, average inflation is expected to move higher to 13.0% and then moderate to 8.0% in 2012 as global price pressures subside.

Extensive reconstruction works and a recovery in domestic demand will raise the import bill in the forecast period. Increases in global food and oil prices will also push imports higher. Gold prices are expected to rise by 5%–10% in 2011 and remain at historically high levels. Remittances are forecast to increase moderately, after their strong growth in 2010.

The current account deficit is projected at 9.0% of GDP in 2011 and 2012. Foreign direct investment is likely to remain low in the next 2 years due to the uncertain political and security situation, though large inflows of official external assistance are expected to finance the large current account deficit.

Development challenges

The country faces huge challenges in economic recovery, reconstruction, and social reconciliation. Success will not be easy given the considerable pressure on public financial resources in a weakened economy. Achieving sustainable robust economic growth remains the major challenge facing the country.

Tajikistan

Rising remittance inflows and strong industry and construction outturns revived growth in 2010, aided by a favorable climate that supported year-round hydropower output. The economy is projected to sustain growth in 2011–2012 despite risks from rising food and fuel prices, transport bottlenecks, and a poor investment climate.

Economic performance

GDP climbed to 6.5% in 2010 from 3.4% in 2009 (Figure 3.6.1). Industry grew by about 10%, as favorable weather allowed higher hydropower production (which accounts for most of the electricity generated), in turn allowing small and medium-sized enterprises to maintain continuous operations in winter. Thus industrial growth mainly came from these enterprises, particularly in light manufacturing and food processing, unlike previous years.

Aluminum production suffered due to limited imports of alumina, caused by intermittent disruptions to rail transit through Uzbekistan. These were largely resolved in the second half of the year. Indeed, the two countries have faced several bilateral issues over the years. At present, the main one relates to differences over managing riparian resources.

Public spending on key infrastructure projects, such as roads, tunnels, and transmission lines, grew, underpinning growth in construction.

Growth in agriculture slowed to a still strong 6.8% after an unusually high 10.5% gain in 2009 (due to a reallocation of land to noncotton agriculture). Slowing activity in retail trade, as disruption in rail transit restricted imports, held services growth to about 5%.

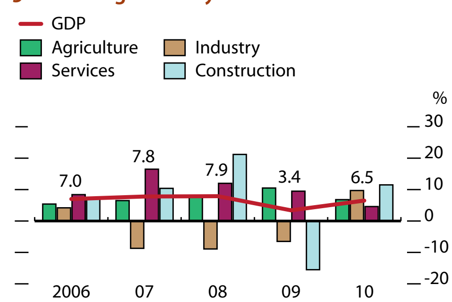
Economic recovery in the Russian Federation lifted remittances by 29% to $2.4 billion in 2010 (Figure 3.6.2), the equivalent of 40% of GDP. They remained a key factor in economic and social stability in Tajikistan, supporting domestic demand and private consumption.

The government launched a massive public campaign to collect funds for building the Roghun hydropower plant in January 2010. It believes that, if carried out, this project could end perennial winter power deficits and allow Tajikistan to become a substantial regional electricity exporter. The campaign targeted raising $1.4 billion to construct the initial phase of Roghun by selling shares to the public. But, after the campaign had raised more than $186 million by May, the government suspended it after seeing the adverse impact on household consumption and economic activity. It remains, however, committed to the project.

End-of-period inflation nearly doubled to 9.8% in 2010 from 5.0% in 2009 (Figure 3.6.3), mainly because of rising food prices—particularly of wheat, following the drought in and subsequent suspension of exports by

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

3.6.1 GDP growth by sector



Sources: Tajikistan State Statistics Agency. http://www.stat.tj; International Monetary Fund.

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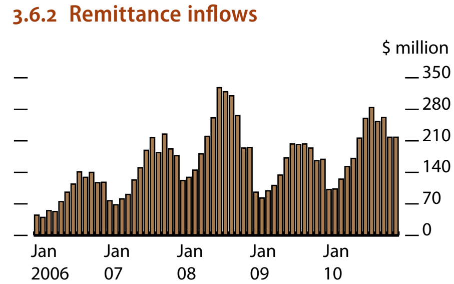
3.6.2 Remittance inflows



Sources: National Bank of Tajikistan; International Monetary Fund.

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the Russian Federation. Higher global fuel prices and the imposition by that country (the main supplier of petroleum) of export duty on hydrocarbons added a further supply-side push. Demand-side pressures from increased remittance spending also stoked inflation, which averaged 6.4% in 2010.

Banks continued to face tight liquidity conditions and high rates of nonperforming loans. They are constrained by a low deposit base and a limited ability to attract capital inflows, while they have significant exposure to risky credits in agriculture and a shortage of sound investment opportunities.

The government wrote off about $500 million of doubtful cotton sector loans. This move cut banks' ratio of nonperforming loans from 28% at end-2009 to about 18% a year later, but as their compensation was in the form of very low yielding T-bills it contributed little to their liquidity, income, and ability to take up new lending opportunities. Trade disruption and delayed cargo deliveries hit trade finance, a sizable part of banks' normal business given that imports are over one-half of GDP.

All these factors restrained credit expansion to the private sector. To mitigate banks' difficulties, the government deposited $50 million collected during the Roghun campaign at commercial banks to strengthen their reserves and add to lending capacity.

In response to rising inflation, the central bank lifted its refinancing rate from 8.0% to 8.25% in November 2010 and to 9.0% in March 2011. In 2010, bank lending rates varied around 25% while deposit rates varied around 6.5%, the large spread reflecting both high doubtful loans and structural difficulties.

Tajikistan continued to pursue fiscal policy aimed at macroeconomic stabilization while sustaining pro-poor programs. The government's postcrisis plan, adopted in early 2010, aimed to lift social expenditure to 11.5% of GDP in 2010, but could not meet the target. This was mainly because revenue collection was under stress in the first half of last year owing to reduced collection of value-added tax on imports and of customs duties, but revenue picked up after the easing of the transit bottleneck.

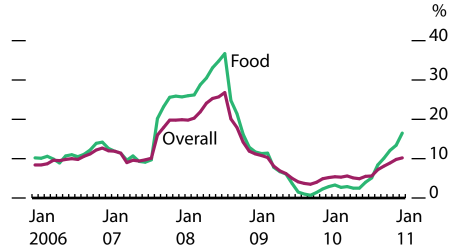
Although government revenue and expenditure did not fully reach budgeted levels, the overall deficit (excluding the public investment program and related grants) kept to the target of 1% of GDP in 2010 (Figure 3.6.4).

Recent fiscal deficits have been financed by external support, but borrowing capacity is low. The government's emphasis on completing infrastructure projects financed by external borrowing raised the debt-to-GDP ratio slightly to 34.4% of GDP in 2010 (Figure 3.6.5). The latest debt sustainability analysis from the International Monetary Fund (IMF), carried out in July 2010, puts Tajikistan at high risk of debt distress. The government is committed to controlling the debt level: its debt management strategy limits the ratio to 40% of GDP.

Higher global prices for aluminum and cotton underpinned a 40.9% surge in exports in 2010, a marked turnaround from the prior-year's 10.7% contraction. In volume terms, exports of aluminum rose moderately but cotton fell, as less land had been allocated to production. Imports grew by only 8.2%, mainly because of the rail disruptions.

The increase in export earnings outpaced the unusually small rise in imports and kept the trade deficit largely unchanged from the previous

3.6.3 Inflation



Source: Tajikistan State Statistics Agency. http://www.stat.tj

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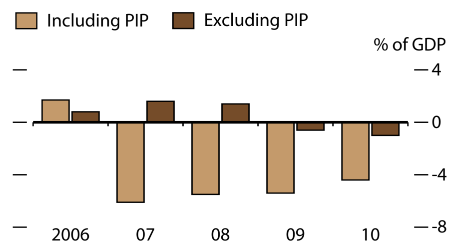
3.6.4 Fiscal balance



PIP = public investment program.

Source: International Monetary Fund. 2010. *Country Report* No. 10/374. December. http://www.imf.org

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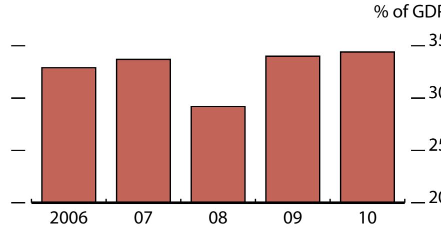
3.6.5 Public debt



Sources: International Monetary Fund; ADB estimates.

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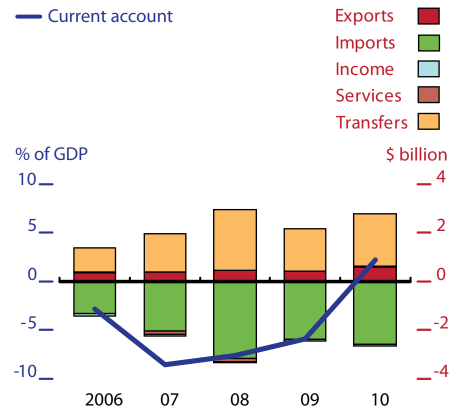
year. With the strong recovery in remittances, the current account is estimated to have moved to a surplus of 2.2% of GDP from a deficit of 5.9% of GDP in 2009 (Figure 3.6.6).

Following the large depreciation in 2009 that mirrored those of major trade partners, the somoni was stable against the US dollar in 2010, depreciating by only 0.7% (Figure 3.6.7). This reflected market conditions—good export performance and rising remittances in the face of restrained conditions on importing.

Foreign reserves picked up from $278 million in 2009 to $640 million. This increase was due to the improvement in the current account, while capital flows and credit disbursements, including those from the IMF, came in broadly as planned. But the level of foreign reserves remained low at year-end, equal to only 2.3 months of projected 2011 imports.

3.6.6 Current account balance



Sources: National Bank of Tajikistan; International Monetary Fund.

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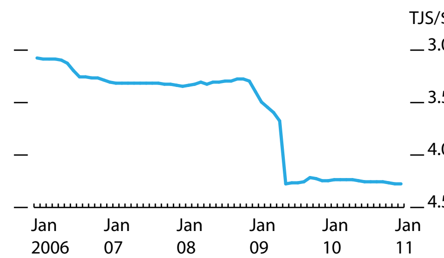
3.6.7 Nominal exchange rate



Source: Tajikistan State Statistics Agency. http://www.stat.tj

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3.6.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.8	7.0
Inflation	10.5	9.5
Current account balance (share of GDP)	-4.3	-6.4

Source: ADB estimates.

Economic prospects

Growth is projected to edge up to 6.8% in 2011 and 7.0% in 2012, fueled by continued remittance inflows and by increases in aluminum and cotton prices in 2011, both of which fall off but stay high in 2012.

Remittances are forecast to grow by about 7% each year, reaching their precrisis high in 2012. They will underpin rising private consumption expenditure, boosting imports and so buoying budget revenue.

Production of aluminum and cotton is projected to rise moderately, responding to higher global prices (as well as reallocation of land back to cotton), but limited aluminum production capacity and inefficient cotton financing will hold back a stronger response. Agricultural processing, light industry, construction, and services will likely continue their strong growth.

Inflation in 2011 and 2012 is projected to increase to 10.5% and 9.5%, reflecting rising global food and fuel prices. The authorities are committed to maintaining a cautious fiscal and monetary stance under their economic program with the IMF and have averred that they would tighten policies if nonfood price pressures emerge. The central bank has already raised its refinancing rate.

Rising remittance-fueled consumption spending and expanding public investment are projected to generate much stronger import growth in 2011 and 2012 of about 28% and 10%, assuming normal regional trade and cargo transit arrangements. Exports are set to rise, by around 25% and 1%, largely reflecting global price movements. The trade deficit will deteriorate, and even with expected higher remittances the current account balance will move to a deficit of 4.3% and 6.4% of GDP.

These projections are subject to several external and internal risks, including growth in the Russian Federation's economy; the level of precipitation, essential for agriculture and water accumulation for electricity generation; and political and social stability.

Development challenges

Tajikistan faces interrelated challenges that hinder reduction of widespread poverty and a move to higher and more sustainable growth. The first is its heavy reliance on remittances, which was keenly felt in 2009's global downturn. The second is its dependence on a few exportable commodities and very narrow production base. The government therefore needs to strengthen infrastructure and services, improve the business and investment climate, and diversify agricultural output.

Many aspects of doing business, such as business registration procedures, investment protection, and tax systems, need to be improved, as seen clearly in the World Bank's latest *Doing Business* report. The share of private activity in GDP is below half, which is very low internationally. Private investment has been stagnant at less than 5% of GDP over the last 5 years, reflecting an unfavorable business environment and lack of investor confidence.

To boost economic activity, the government needs to focus on reducing risks to private investors, through, for example, providing and enforcing property rights, reducing corruption, and enhancing necessary supporting infrastructure. Improving the security situation and maintaining stability are also important.

Stagnating tax revenue and a weak fiscal position call for reform in the public resource management system, particularly tax policy and administration. Policy makers need to focus on implementing the comprehensive 5-year Tax Administration Reform Strategy, approved in 2010, which has financial and technical support from various development partners. Complemented by more efficient and better governed state-owned enterprises, such an approach could sharply raise revenue performance and reduce the call on the state budget.

3.6.2 Central Asian rankings on the ease of doing business, 2011

Georgia	12
Kyrgyz Republic	44
Armenia	48
Azerbaijan	54
Kazakhstan	59
Tajikistan	139
Uzbekistan	150

Note: Out of 183 countries worldwide. No ranking for Turkmenistan.

Source: World Bank. *Doing Business 2011*.

Turkmenistan

Growth recovered to near double-digit levels in 2010 with resumption of gas exports and new gas pipelines, alongside large-scale public investments. The outlook is for continued strong growth and moderate inflation. But moving the economy from its heavy dependence on hydrocarbons requires a diversified base of industries and services, as well as a dynamic private sector.

Economic performance

The economy rebounded in 2010 with government sources estimating GDP growth at over 9%, close to the levels seen prior to the global recession (Figure 3.7.1). Much of the growth derived from the resumption of natural gas exports to the Russian Federation, which were suspended for much of 2009, and the opening of new gas pipelines to the People's Republic of China and the Islamic Republic of Iran. The strong growth also came from large-scale public investments, a surge in foreign direct investment, and rapid gains in construction, transport and communications, textiles, and agriculture.

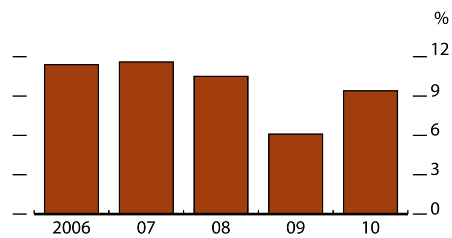
Natural gas remains the mainstay of the economy—hydrocarbon exports accounted for over 90% of exports in 2010. Moreover, hydrocarbon production is the main source of government revenue. Gas exports reportedly grew by 34% in 2010 from the previous year.

Consumer price inflation for the end of period was estimated to have risen from 0.1% in 2009 to 4.6% in 2010, giving a 2010 average of 3.9%, a switch from deflation of 2.7% in 2009 (Figure 3.7.2). The inflation partly reflects rising international food and grain prices, which went up by about 12% in 2010. Government controls over certain prices, wages, and pensions and a stable exchange rate helped to keep consumer prices in check.

The government's expansionary fiscal policy reduced the budget surplus from an estimated 7.8% of GDP in 2009 to 2.8% in 2010 (Figure 3.7.3). Much of the spending is guided by the National Program of Social and Economic Development, which was updated in mid-2010 to cover 2011–2030. The program entails large public investment in economic and social infrastructure.

The recovery in gas exports and increased earnings from higher oil export prices helped to narrow the current account deficit from an estimated 16.1% of GDP in 2009 to 4.7% in 2010 (Figure 3.7.4). The balance of trade in 2010 moved to a small surplus of $100 million, from a deficit of $1.8 billion in 2009. Estimated exports were $10.1 billion for the year, a slight increase from $9.5 billion in 2009. Imports were estimated to be $10.0 billion, down from $11.3 billion the previous year.

3.7.1 GDP growth



Sources: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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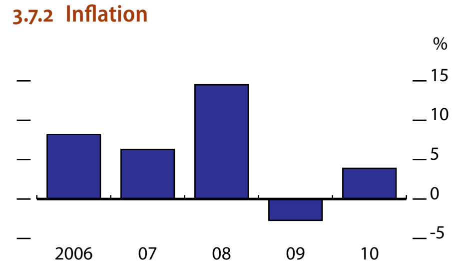
3.7.2 Inflation



Source: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org

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This chapter was written by Jennet Hojanazarova of the Turkmenistan Resident Mission, ADB, Ashgabat; and David Oldfield of the Central and West Asia Department, ADB, Manila.

Economic prospects

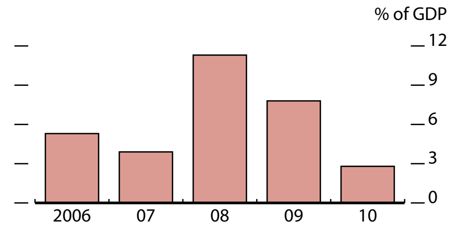
The outlook for 2011 and 2012 appears to be highly favorable, and growth is likely to be robust over the forecast period. The predicted growth rates will result from higher volumes of natural gas exports due to new pipelines with the People's Republic of China and the Islamic Republic of Iran, and continued implementation of the government's development policies. The global gas supply glut will likely peak in 2011 and gas prices will remain low, but demand by Turkmenistan's established buyers should stay strong.

Growing gas exports are necessary to finance the government's heavy spending on infrastructure and the social sector. It is expected to continue its fiscal stimulus, in line with the recently updated National Program. These measures, along with an expected rise in global food and other commodity prices, are likely to add to inflation in 2011, nudging it up to 5.0% in 2011 and 6.0% in 2012.

Trade with neighbors should receive a boost in 2012 if the construction of the new North–South railway linking Turkmenistan with Kazakhstan and the Islamic Republic of Iran is completed on schedule. Total exports are seen rising by nearly 24% in 2011, and imports by 4%. A potential trade surplus of over $2 billion in 2011 could lead to a current account surplus of 3.4% of GDP.

Long-term growth prospects are enhanced by the long-awaited agreement signed in December 2010 for the ambitious Turkmenistan–Afghanistan–Pakistan–India gas pipeline. While security challenges in two of the countries pose risks to construction and operation, the four countries have targeted a gas delivery date by 2015. On completion, the pipeline will deliver 33 billion cubic meters annually and increase Turkmenistan's total gas exports to Asia to over 90 billion cubic meters a year.

3.7.3 General government fiscal balance



Source: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org

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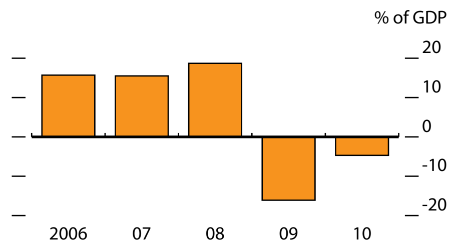
3.7.4 Current account balance



Source: International Monetary Fund. 2010. *Regional Economic Outlook, Middle East and Central Asia*. October. http://www.imf.org

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Development challenges

Highly dependent on exports of energy, Turkmenistan faces several challenges in diversifying the economy to high-value-added and technology-based goods and services. This requires numerous structural reforms—administrative, financial, and institutional, for example.

Successful diversification also requires efficient reallocation of resource revenue to productive sectors. The government will therefore have to make a thorough cost-benefit analysis and prioritize value-added investments, and, going beyond gas-related industries, create processing and manufacturing industries capable of generating new sources of income. Ongoing large government investment in mining, textiles, food processing, and tourism are a step in the right direction, but much more investment is required.

Turkmenistan also needs to develop a dynamic private sector. An adequate legal and regulatory framework for private business must be in place, along with an expanded banking sector that can provide financial capital. Additionally, the country needs to develop entrepreneurship and expertise in market principles in the public and private sectors.

3.7.1 Selected economic indicators (%)

	2011	2012
GDP growth	9.0	10.0
Inflation	5.0	6.0
Current account balance (share of GDP)	3.4	7.0

Source: ADB estimates.

Uzbekistan

Strong economic growth in 2010 was driven by expanded public investment, increased net exports, and a pickup in workers' remittances. The outlook is for sustained public sector–oriented growth, and continued strong fiscal and external positions. The authorities need to keep a close eye on inflation, though it is expected to remain moderate. Diversification from the commodity and energy sectors, alongside private sector development, would help to generate broad-based and sustained growth.

Economic performance

The economy continued to perform well in 2010, supported by the effects of a fiscal stimulus, the government's medium-term investment program, and the global economic recovery. Growth was driven mainly by industry (including construction) and services (Figure 3.8.1), with estimated annual growth rates of 8.3% and 11.6%, respectively.

In industry, growth was led by the chemical, machinery, light, and food industries, which together expanded by 12.0% and accounted for almost half of total industrial output. These industries benefited from the significant public investment and commercial bank lending provided under the government's 2009–2010 anticrisis and industrial modernization programs. The chemical and machinery industries are also attracting investment from Asia and the Middle East. Construction grew at 8.1%, largely due to government support to rural infrastructure and housing development, as well as greater foreign investment in hydrocarbons.

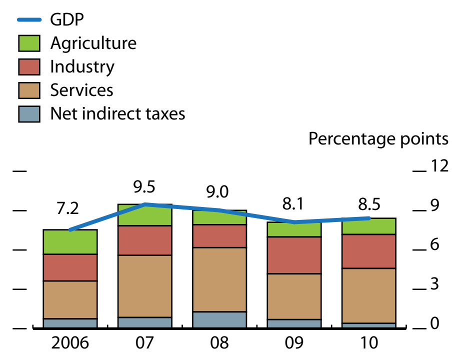
The expansion in services mainly reflected increases in government social spending for health care, especially in rural areas. Favorable weather and higher vegetable crop cultivation led to agricultural growth of 6.8%.

In 2010, the government continued implementing infrastructure programs aimed at developing rural areas and modernizing industry. The Fund for Reconstruction and Development (FRD) and state-owned banks allocated about $6.0 billion. Lending from commercial banks to the economy increased by one-third in 2010. Gross fixed capital investment rose by 9.2%, to the equivalent of around 30% of GDP (Figure 3.8.2). According to the government, about $3.9 billion, or 25.1%, was foreign.

The majority of foreign investment goes into fuel, energy, telecommunications, and automobile manufacturing. The government reported that it plans to attract up to $50 billion in foreign investment during 2011–2015. Notable projects include a joint venture with Daimler on bus assembly and expansion of production lines at GM Uzbekistan (a joint venture between General Motors and the state-owned Uzavtosanoat company). Under government initiatives to encourage use of natural gas in vehicles, a new joint venture between Uzbekistan and the Republic of Korea will construct gas compressor stations for cars.

In February and October 2010, the authorities raised utility prices

3.8.1 Contributions to growth (supply)



Sources: State Statistics Committee of Uzbekistan; ADB estimates.

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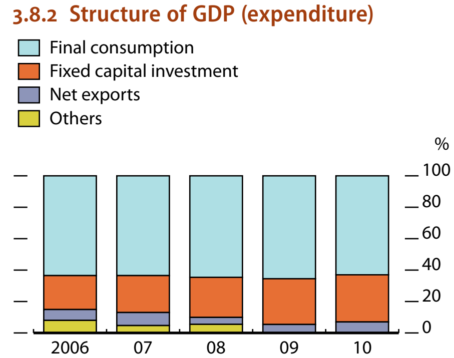
3.8.2 Structure of GDP (expenditure)



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

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

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

for heating, hot water, and electricity by a cumulative 18%–30% in an attempt to bring them closer to cost-recovery levels. The increases, with depreciation of the local currency and a 30% annual hike in public wages and pensions, put upward pressure on inflation. The central bank sought to mitigate this pressure by slowing broad money growth to 34.6% from its peak of 43.8% in 2009. The government reported year-end inflation of 7.3%. The latest estimate from the International Monetary Fund for average inflation is 10.6% (Figure 3.8.3).

The local currency depreciated by 8.3% against the dollar in 2010. On 1 January 2011, the central bank reduced its benchmark refinancing rate from 14% to 12% to reduce the rates of loans provided under its programs for industrial modernization, rural housing construction, and small and medium-sized enterprises.

The general government budget is estimated to be in balance in 2010. Taking into account the FRD, the consolidated budget is estimated to have a surplus of 2.5% of GDP (Figure 3.8.4). The steep wage and pension hike, greater support for health care, as well as the rural development program have lifted budget spending to an estimated 34.6% of GDP. The government also provided tax exemptions for enterprises operating under investment and localization programs, but revenue gains from commodity exports and the utility price adjustments were enough to offset the increased expenditure.

In line with the policy of reducing direct taxation to encourage economic activity, in 2010 the government reduced the rates of both corporate and personal income taxes by 1 percentage point to 9% and 11%, respectively. The fiscal authorities also reduced the rate of the unified tax paid by micro and small firms from 8% to 7%. The share of direct taxes in GDP decreased from 7.1% in 2008 to an estimated 5.9% in 2010.

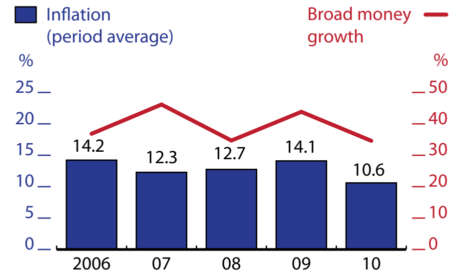
Reflecting the increased infrastructure development and subsequent rise in foreign financing, including government-guaranteed foreign debt, total external debt is estimated to have risen to 14.9% of GDP, slightly above the 2009 figure of 14.6%.

The international prices of gas, cotton, and gold, Uzbekistan's main export commodities, were historically high throughout 2010, leading to goods and services export growth of 10.8%. That growth was also aided by recovery in the Russian Federation, with the share of machinery, including passenger vehicles, in total exports more than doubling in 2010. Stronger growth in the Commonwealth of Independent States sharply boosted foodstuff exports.

The government reported that imports of goods and services fell by 6.8% in 2010. Imports of machinery and equipment, 44% of the total, dropped by 27.3%. Official import restrictions reduced imports, especially from countries in the Commonwealth of Independent States. Reflecting a pickup in global food prices as well as stronger consumption demand, the share of foodstuffs in imports climbed from 10.3% in 2009 to 10.9% in 2010.

Remittances sent to Uzbekistan from the Russian Federation rose by an estimated 22% in 2010 to $1.4 billion (to around 3.7% of GDP), given the economic pickup in that country. Due to improved exports and remittances, the current account surplus is estimated to have increased to 15.6% of GDP in 2010, from 11.0% of GDP in 2009 (Figure 3.8.5).

3.8.3 Inflation and money supply



Sources: International Monetary Fund. 2010. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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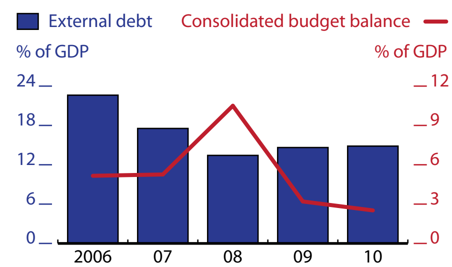
3.8.4 Fiscal and debt indicators



Sources: International Monetary Fund. 2010. *Regional Economic Outlook: Middle East and Central Asia*. October. http://www.imf.org; ADB estimates.

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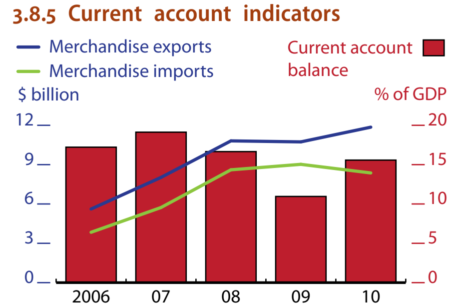
3.8.5 Current account indicators



Sources: International Monetary Fund. 2008. *Article IV Consultation*. July. http://www.imf.org; ADB estimates.

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Economic prospects

Greater investment and infrastructure development will sustain GDP growth at 8.5% in 2011 and 8.4% in 2012. Industry (particularly construction) and services are expected to be the major contributors. Industrial output will be driven by domestic lending and foreign investment, while services will expand in line with higher domestic demand. Increasing lending coupled with favorable international prices will stimulate output of energy, machinery, and metals. Agriculture is expected to be driven by higher vegetable and fruit output, while grain production will improve moderately.

The share of investment in GDP is expected to climb rapidly in the forecast period, partly because the government is seen pursuing the infrastructure development programs faster. On 15 December 2010, it adopted a presidential decree that envisages spending $30 billion on 259 industrial projects and $23.1 billion on new construction in 2011–2015. Most financing for both sets of programs is planned to come from enterprises' own resources, loans from domestic banks, and FRD resources.

The government plans to direct up to 60% of budget spending ($6.2 billion) toward social programs—outlays on which are expected to rise by 14%—at the same time as raising allocations for investment (by 37%). It is also seen further reducing the tax burden and strengthening revenue collection. The consolidated budget, including the FRD, is forecast to post a surplus of 2.4% in 2011 and 2.0% in 2012.

Higher public sector wages and social payments alongside a gradual recovery in remittance inflows will sustain domestic consumption, as will government plans to create many jobs through infrastructure. Higher import costs, a more accommodative fiscal policy, and further depreciation of the local currency will stoke price pressures in 2011–2012. To counter them, the authorities are likely to adopt a monetary policy that slows money supply growth. Inflation is forecast at 8.8% in 2011 and 8.5% in 2012.

International prices for gold and cotton are seen peaking in 2011, but staying high. Uzbekistan's export prices for natural gas, which have approached international levels, are likely to stay at these high levels. Exports are forecast to grow at 14.0% in 2011 and 3.1% in 2012, supplemented by a gradual improvement in remittance inflows. The steep rise in public investment will likely offset the slower export growth in 2012 in terms of contribution to GDP.

Growth in imports will be driven by expansion of infrastructure development and by increases in global energy and food prices. Since machinery and equipment are the main import items, the post-2011 investment surge will drive imports even higher. Import growth is therefore put at 11.9% in 2011 and 16.3% in 2012. The current account surplus is projected at 16.3% and 12.6% of GDP.

The downside external risks to the forecasts are related to the pace of economic recovery in Uzbekistan's main trading partners as well as uncertainty in global financial markets. The immediate challenge is to manage rising pressures from fiscal expansion and global food price increases. To prevent unwanted fiscal-led pressure on monetary policy, the authorities are ready to adapt the structure of budget expenditure and the pace of nominal depreciation of the currency.

3.8.1 Development challenges

With one eye on the long-term goal of diversifying the economy, the government has designated 2011 as the year of small businesses and private entrepreneurs.

According to official statements, these two groups contributed more than half of total GDP and employed more than 70% of the total labor force in 2010. The central bank reported that total lending to both groups jumped by 40% that year to $1.7 billion. As well as lowering taxes, the government's program for 2011 targets better access to capital for them and simpler reporting requirements.

Sources of export income, too, need to be broadened and natural resources prudently managed, as the current resource-based approach is susceptible to volatility in global commodity prices.

Effective banking supervision and improved prudential banking requirements will help to guard against potential risks associated with rapid credit growth and greater commercial bank lending to state-owned enterprises.

Improving access to credit for small and medium-sized enterprises will widen the range of banking assets while benefiting the broader population through job opportunities.

3.8.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.5	8.4
Inflation	8.8	8.5
Current account balance (share of GDP)	16.3	12.6

Source: ADB estimates.

EAST ASIA

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

People's Republic of China

Strong investment, supported by an expansion of private consumption and net exports, powered a return to double-digit growth. The authorities ended the fiscal stimulus program and, with inflation pressures building, tightened monetary policy. GDP growth is forecast to moderate both this year and next. Inflation will rise in 2011, then likely decelerate in 2012. Going beyond the next 2 years, the new 5-year plan puts more emphasis on consumption and services as drivers of growth and on reducing both income inequality and pollution.

Economic performance

Brighter than expected economic growth in the second half of 2010 lifted the full-year rate of expansion in the People's Republic of China (PRC) to 10.3% in a return to the pre–global recession double-digit pace. All sectors recorded solid growth, led by industry with a 12.2% increase that contributed about two-thirds of total GDP growth. Services expanded by 9.5% and agriculture by 4.3% (the grain harvest was good, despite harsh weather).

From the demand side, investment and consumption explained 92% of total growth, investment being the main contributor (Figure 3.9.1). Still, the winding back of the aggressive fiscal stimulus put through during the global recession slowed the growth of fixed asset investment in nominal terms from the very high 31.0% seen in 2009 to 24.4% in 2010.

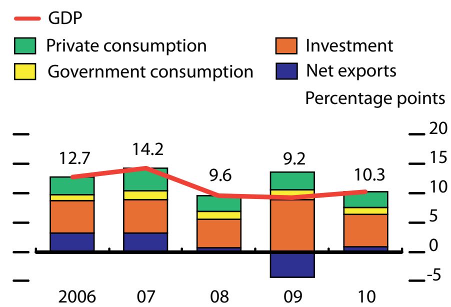
Private consumption grew by 11.0% in nominal terms (9.3% in real terms), supported by higher incomes. Sales of household appliances and furnishings benefited from heavy investment in housing, while sales of automobiles continued to surge. Despite several years of solid growth in private consumption, however, it remains low as a share of expenditure-based GDP at 34%.

Net exports contributed positively to GDP growth in 2010 (by 0.8 percentage points), unlike 2009 when net exports fell as global trade slumped.

Monetary policy supported growth, even as the authorities reined in the highly expansionary stance taken during the global recession. While broad money supply (M2) growth decelerated to 19.7% in 2010 from 27.7% in 2009, it was above the 17.0% target for 2010 of the People's Bank of China (the central bank).

Growth in bank credit at CNY8 trillion also exceeded its target, by CNY0.5 trillion, although it was well below 2009's outturn (Figure 3.9.2). This measure of credit is likely to understate the total as it excludes loans channeled through trust companies. Several

3.9.1 Contributions to growth (demand)



Sources: National Bureau of Statistics of China; ADB estimates.

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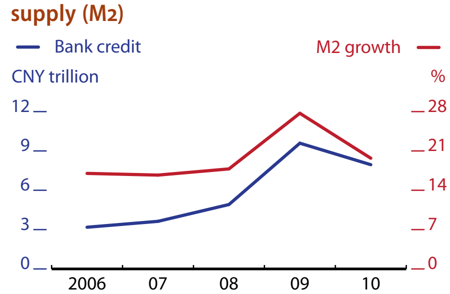
3.9.2 Growth in bank credit and money supply (M2)



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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

estimates suggest that these off-balance-sheet loans amounted to about CNY3.8 trillion in 2010.

Abundant liquidity, rising food prices, and higher costs of imported oil and commodities pushed up consumer prices during 2010 (Figure 3.9.3), when inflation averaged 3.3%.

The government changed some of the weights in the consumer price index basket in early 2011, lowering that for food and raising the one for housing. Yet despite this, the index is still seen as understating inflation because its composition and weights have not been significantly adjusted to reflect the major changes in consumption patterns in the last decade.

Moving to stem inflation, the central bank raised the reserve requirement for banks six times in 2010 and three times in the first quarter of 2011 (to 20.0% for large banks). It also lifted the benchmark interest rate twice in 2010 and once in the first quarter of 2011 (by a total of 75 basis points to 6.06%—Figure 3.9.4). The government imposed price controls on some food items and increased subsidies for low-income earners.

Prices of residential property in cities rose strongly, propelled by rising incomes, investment demand, and the abundant liquidity. Overall property prices climbed by an average of 10.0% in 70 major cities. Real estate investment surged by 33.5% in nominal terms, outpacing overall investment growth. Government actions to curb house prices included raising both mortgage interest rates and down payments as well as directing banks not to lend for purchases of third (or more) homes. These changes damped the rate of increase during the year (Figure 3.9.5).

Fiscal policy was supportive of growth in 2010, although less so than in 2009 as the massive CNY4 trillion fiscal stimulus program launched in late 2008 came to an end. Fiscal revenue and expenditure rose by 21.3% and 17.4%, respectively, well above the government's traditionally conservative targets. The strong revenue performance was a consequence of the robust economic growth and higher prices. The budget deficit narrowed to the equivalent of 2.1% of GDP from 2.9% in 2009.

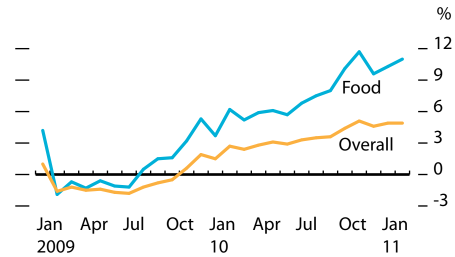
Global recovery in trade last year saw the country's trade flows soar by nearly 35% to about $3 trillion. Merchandise exports in nominal US dollar terms rebounded by 31%. Imports rose even faster (Figure 3.9.6), reflecting strong demand and higher prices for oil, other commodities, and capital goods. The trade surplus at $254 billion was little changed from 2009.

The PRC is diversifying its export markets in light of the slowdown in major industrial economies. It became Brazil's top trade partner in 2009 with bilateral trade showing a more than 12-fold increase in value since 2001. Some 85% of its exports to Brazil are manufactured products, while soybeans and minerals account for two-thirds of its imports.

Foreign direct investment (FDI) reached $105.7 billion in 2010, up by 12.4% from the previous year. By sector, manufacturing, real estate, and services attracted the most FDI. The leading sources of FDI were (in order) Hong Kong, China; Taipei,China; Singapore; Japan; the United States; the Republic of Korea; and the United Kingdom.

The PRC's direct investment abroad increased by 23.4% to $59 billion in 2010. It targeted energy, mining, and agriculture. Asia remained the top regional destination, although flows to South America and Africa

3.9.3 Monthly inflation



Source: CEIC Data Company (accessed 16 March 2011).

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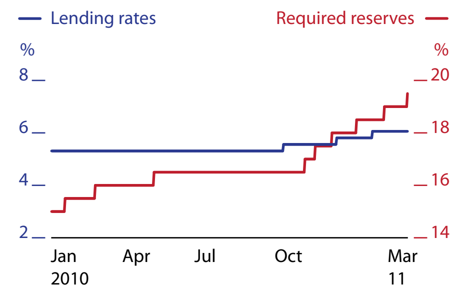
3.9.4 Monetary indicators



Source: CEIC Data Company (accessed 25 March 2011).

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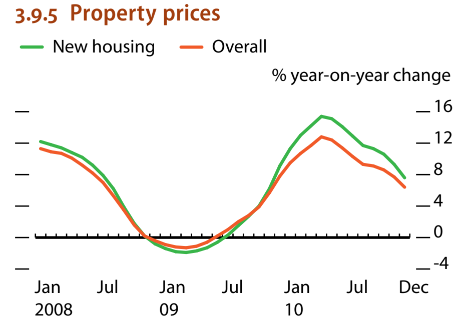
3.9.5 Property prices



Note: Overall are both residential and nonresidential.

Source: CEIC Data Company (accessed 16 March 2011).

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picked up. Large investments in energy-related projects in some Central Asian countries have turned the PRC into the second-largest investor there, after the Russian Federation.

The PRC is also gaining prominence as a lender to developing countries: its lending in the past 2 years exceeded that from the World Bank (excluding the International Development Association, which makes grants and low-interest loans). These operations included loan-for-oil deals with Brazil, the Russian Federation, and Venezuela; power-related projects in India; and infrastructure investments in Argentina and Ghana.

The current account surplus increased to $306.2 billion, but as a ratio to GDP it declined to 5.2%. This surplus, coupled with the FDI inflows and central bank purchases of foreign exchange to manage the exchange rate, pushed up foreign exchange reserves by 19% to $2.85 trillion. The yuan appreciated against the US dollar by 3% in nominal terms during the year (Figure 3.9.7), after the authorities indicated in June 2010 that they would gradually allow greater flexibility in the exchange rate. In real effective terms the yuan appreciated by 4.2% in 2010.

Efforts to internationalize the currency resulted in much higher levels of yuan-denominated trade, estimated at CNY70 billion in 2010 compared with just CNY0.5 billion in 2009.

About 11.7 million new jobs were generated in urban areas last year, above the official target but fewer than the average 24 million new job seekers who enter the labor market each year. Average minimum provincial wages rose by 24%, illustrating government efforts to raise living standards and foster consumption.

Economic prospects

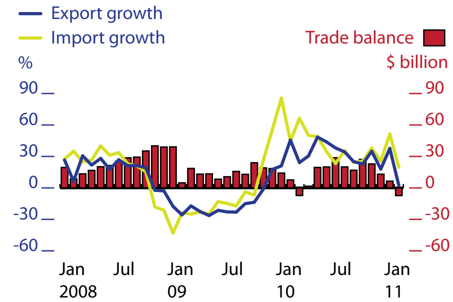
The 12th Five-Year Plan (2011–2015), approved in March 2011, seeks to rebalance the pattern of growth. Its targets indicate that the authorities are willing to forgo some speed of GDP growth to enhance its sustainability (see below).

Fixed asset investment is expected to remain the main driver of growth in 2011 and 2012, decelerating to 22% in 2011 and to 20% in 2012 (Figure 3.9.8). The expiration of the fiscal stimulus package in 2010 will reduce such investment by CNY2 trillion this year (or 7% of the total in 2010). Monetary tightening under way will also damp the high rates of investment. Further, the central government is scrutinizing local government finances and investment more closely.

Fiscal policy will be broadly expansionary, with a higher priority on education, health care, low-cost housing, and research and development. The overall budget deficit is projected to be little changed at about 2% of GDP.

Inflation pressures are prompting the authorities to tighten monetary policy, but their stance is expected to remain supportive of growth. They have trimmed the target for growth in M2 money supply to 16% for 2011; a similar rate is assumed for next year. For new lending, the central bank has opted not to provide an annual target ceiling on new bank loans for 2011. It will instead target a new measure of total credit, "total social financing," which includes loans from trust companies, corporate bonds,

3.9.6 Trade indicators



Source: CEIC Data Company (accessed 16 March 2011).
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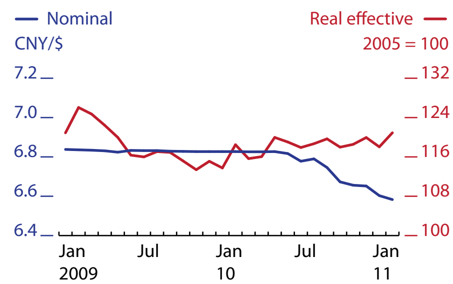
3.9.7 Exchange rates



Source: CEIC Data Company (accessed 16 March 2011).
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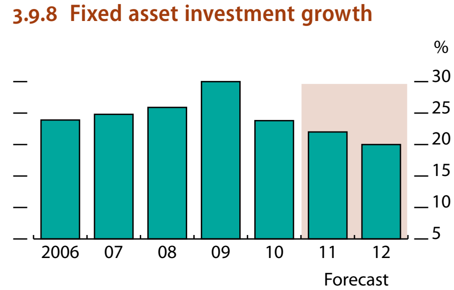
3.9.8 Fixed asset investment growth



Sources: CEIC Data Company (accessed 20 March 2011); ADB estimates.
Click here for figure data

and equities of nonfinancial companies. It has not yet disclosed the numerical target.

Private consumption growth is expected to accelerate to 12.6% this year in nominal terms, a consequence of rising incomes and expanding state provision of education, health care, and pensions.

The contribution of net exports to GDP growth will moderate from 2010 owing to the base effect, still subdued demand from major export markets, and the expiry of tax rebates on some PRC exports. The increase in merchandise exports is forecast to slow to about 20% in nominal terms this year and 18% in 2012, below the near 30% average pace seen in the 5 years before the global recession.

Based on these projections, GDP is forecast to grow by 9.6% in 2011, easing to 9.2% in 2012 (Figure 3.9.9) on expectations that industrial production and fixed investment will continue to moderate.

Industrial production is expected to slow over the 2 years owing to relatively soft external demand, overcapacity in some manufacturing subsectors, and government efforts to reduce carbon emissions and other environmental damage. Nevertheless, in the first 2 months of this year, industrial output grew by 14.1%, slightly above the rate in December 2010.

In further signs of a solid start to 2011, fixed asset investment rose by about 25%, investment in real estate surged by 35%, and retail sales increased by 16% in the first 2 months (all in nominal terms).

Inflation is forecast to accelerate to 4.6% on average in 2011 (Figure 3.9.10), a result of higher global prices for food and oil, rising wages, and robust domestic demand. For the first 2 months of this year it averaged 4.9%, exceeding the full-year official target of 4.0%. The pace is expected to ease later in 2011 mainly because of the base effect.

In 2012, inflation is projected to ebb to 4.2% owing to the anticipated leveling off of global oil and commodity prices as well as tighter domestic monetary policy. Although the authorities are tightening to address inflation, they face difficulties in controlling bank liquidity and in managing inflation expectations without a nominal inflation anchor (Box 3.9.1).

Imports are expected to increase faster than exports during the forecast period, largely owing to high prices for imported energy and commodities. The current account surplus is projected to fall to 4.6% of GDP this year and 4.2% next, continuing a decline from a recent peak of 10.6% in 2007 (Figure 3.9.11) brought about mainly by faster growth in the value of imports than exports.

Downside risks to the economic outlook relate mainly to the fragility of external demand (exacerbated by the modest recovery in the United States), fiscal and debt concerns in the European Union (the PRC's largest trading partner), and now Japan. Although data are inadequate at present to assess the impact of the massive earthquake and tsunami on the PRC economy, they may have a short-term effect on bilateral trade, to a degree because Japanese companies in the PRC rely on spare parts and materials imported from Japan.

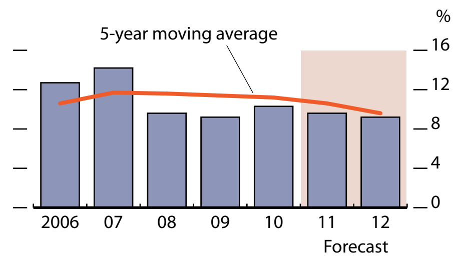
The rapid increase in local government debt to an estimated CNY7.6 trillion, stemming from the stimulus program begun in late 2008, is likely to lead to some rise in nonperforming loans at banks, given that about one-third of the debt is estimated to be at risk. This risk is, though,

3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	9.6	9.2
Inflation	4.6	4.2
Current account balance (share of GDP)	4.6	4.2

Source: ADB estimates.

3.9.9 GDP growth



Sources: National Bureau of Statistics of China; ADB estimates.

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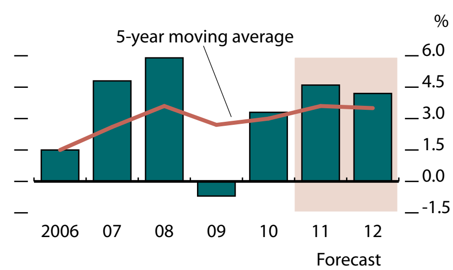
3.9.10 Inflation



Sources: National Bureau of Statistics of China; ADB estimates.

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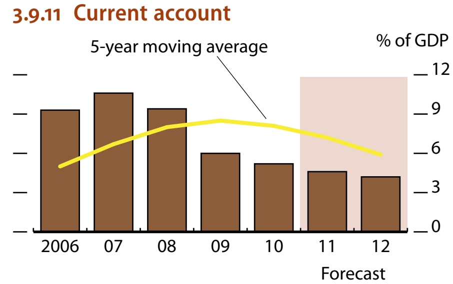
3.9.11 Current account



Sources: CEIC Data Company (accessed 16 March 2011); ADB estimates.

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mitigated by the current moderate level of nonperforming loans (1.1% of total lending), larger provisions for bad loans, and more stringent bank capital-adequacy requirements in recent years.

Failure to decisively implement the government's agenda to rebalance the economy risks jeopardizing the sustainability of growth in the longer term. Rapid growth over three decades has allowed for transition from a low- to a middle-income country, but has also generated imbalances such as heavy reliance on investment, relatively low levels of private consumption, underdeveloped services, widespread environmental damage, and expanding income gaps.

Development challenges

Implementing the 12th Five-Year Plan will be a major challenge. Its main policy directions include the following: a better balance in the drivers of growth among investment, consumption, and exports, with services playing a more important role; a stronger emphasis on improving living standards and narrowing income inequalities; newly designated strategic industries—a modern energy industry, a comprehensive transport system, information-based industries, and biotechnology—to promote innovation; and plans to combat global warming and reduce carbon intensity, including ambitious emission-reduction targets, a carbon tax, new indicators for pollutants, and carbon-trading programs.

The plan sets quantitative targets on key economic, social, and environmental indicators. It trims the GDP growth target of 7.0% for 2011–2015 from 7.5% in the previous plan, a move aimed to signal the government's willingness to sacrifice speed of growth for the sake of sustainability (actual GDP growth in the previous plan was 11.2%).

Critical among the objectives is changing the growth pattern toward a model oriented more to services and consumption from the past emphasis on industry and capital investment. Economic rebalancing was an objective in the previous plan, and indeed some progress was made in, for example, curbing energy consumption and pollutants and expanding the coverage of urban and rural health care.

Yet there was limited progress on major rebalancing targets. Consumption, for instance, substantially lagged investment (with average contributions of 41% and 54% to annual GDP growth in the past 5 years). On the production side, services' share of GDP is relatively low at about 43% (Figure 3.9.12).

The need to transform the pattern of economic growth is stronger now than in 2006 both because the external imbalances have become more pronounced, and because the recent global recession highlighted the risks of the export-led growth paradigm. Moreover, the implications of population aging in the PRC threaten the sustainability of growth and complicate the reform agenda.

Rebalancing is, however, unlikely to occur without significant policy adjustments, including shifting the emphasis of public spending from investment to public services, liberalizing the finance sector, developing capital markets to help small and medium-sized enterprises and the self-employed to access credit, and facilitating a greater role for private players in the economy.

3.9.1 Anchoring inflation expectations

Climbing consumer and asset prices in the country risk raising inflation expectations, and so encouraging new rounds of price increases that further heighten expectations. Such spirals have occurred in the past, leading to 20% inflation in 1988.

International experience suggests that the best way to control inflation expectations is to anchor them, preferably with inflation targeting rather than monetary targeting.

Inflation targeting allows the monetary authorities to use all available information, not just monetary variables, to determine monetary policy settings.

It is also transparent and readily understood by the public, increases central bank accountability (because its performance can be measured against a clearly defined target), and can help focus the political debate on the main role of the central bank in the long run (controlling inflation instead of boosting economic growth).

A central bank's credibility is indispensable in inflation targeting, so as to keep expectations well anchored.

In the People's Republic of China at the moment, accelerating inflation and difficulties of managing the high levels of bank liquidity suggest that some anchoring of expectations might now be appropriate. And although it would be premature for the central bank to adopt formal inflation targeting—given its limited independence and government controls on interest rates—it could consider some features of an anchoring system, such as announcing an explicit inflation objective or target range, and committing to achieve it for several years.

To increase the central bank's credibility, it would need full control over managing its reserves, more leeway to liberalize interest rates, and greater exchange rate flexibility. Managing inflation expectations would also require it to more clearly flag its monetary intentions to financial markets.

As the new plan reflects these reforms to some degree, the key challenge lies in how to successfully carry them out in a period of political transition to a new generation of leaders in 2012–2013. Moreover the intended reforms, although necessary, are not risk free, and might create or exacerbate policy-making trade-offs.

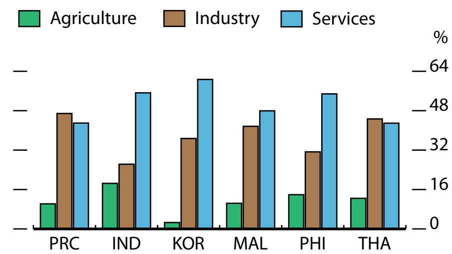
For instance, promoting services as a source of growth and employment may entail short-term side effects such as increased unemployment (until the full benefits unfold in the medium to longer term, when excess labor is absorbed through implementation of adequate supportive policy measures, including education and training).

Further, promoting consumption as a driver of growth would require larger salary increases, as supported in the plan, which could generate a wage-price spiral in the economy, trapping policy makers in a difficult choice between rebalancing and price stability.

Closing the income gaps is another major challenge. The benefits of rapid growth in the PRC have not been evenly distributed among regions, resulting in a skewed distribution of income in favor of coastal cities and urban citizens. The Gini coefficient, a measure of income inequality (zero indicates perfect equality and 1 absolute inequality) has worsened from 0.16 in 1978 to the current 0.47.

The PRC's rapid development has also come at a significant environmental cost. Heavy dependency on coal as an energy source has led to high levels of air and water pollution. The additional tens of millions of new automobiles on the roads in the past few years have taken carbon dioxide emissions to alarming levels. Against this background, government plans to accelerate urbanization—as stated in the new plan—require greater efforts to facilitate a sustainable process of urbanization in the framework of a low-carbon economy.

3.9.12 Sector shares in current GDP, 2010



PRC = People's Rep. of China; IND = India; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; THA = Thailand.

Note: Data for India are based on advance estimates. Data for the Republic of Korea refer to 2009.

Source: Asian Development Outlook database.

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Hong Kong, China

Coming out of contraction the economy grew robustly in 2010, driven by recovery in goods and services trade that spurred growth in consumer spending and investment. Inflation rose from low levels, and is forecast to speed up in 2011. Economic growth will moderate this year and next. Low interest rates and abundant liquidity have contributed to a property-price spurt that the authorities are trying to damp with macroprudential measures and increased supply of land for housing.

Economic performance

This services-driven economy made a solid comeback in 2010 as it recovered from contraction in 2009. GDP picked up by 6.8%. From the demand side, consumption, investment, and net exports all contributed to growth (Figure 3.10.1).

Private consumption grew by 5.8% and was responsible for more than half the GDP growth. Consumption spending was supported by a pickup in employment and buoyant stock and property markets. Retail sales were boosted by a 22% jump in visitor arrivals to 36 million.

Government consumption made a small contribution to the expansion. Budget spending in FY2010 (ending 31 March 2011) came in below allocation, while revenue burgeoned alongside the recovery in economic activity and asset prices. The budget was in surplus to the tune of an estimated 4% of GDP.

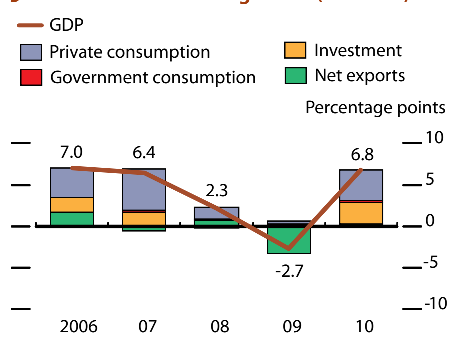
After 2 weak years, fixed investment rebounded by 8.1% in 2010, accounting for about one-quarter of GDP growth. Private investment in machinery, equipment, and computer software was strong, especially in the first half (reflecting the low base). Several large-scale projects boosted public construction, including the Guangzhou–Shenzhen–Hong Kong express rail and the Hong Kong–Zhuhai–Macao bridge.

With the revival of global trade, exports of goods bounced back to record 17.3% growth in real terms, from a double-digit contraction a year earlier. Exports to the People's Republic of China (PRC) and other major Asian markets (Japan; the Republic of Korea; Singapore; and Taipei,China) saw growth of 15%–23%. Exports to the United States and Europe also rose, but failed to scale 2008's precrisis peak. Imports of goods in real terms rose by 18.1%, reflecting growth in private consumption and the pickup in investment.

Services exports grew by 15.0% in real terms in 2010 as financial and professional services, trade services, transport, and tourism all benefited from the recovery in global trade and deepening integration with the rapidly growing PRC.

The important financial and insurance subsector grew by 7.5%

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

Click here for figure data

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

in 2010. Equity capital raised through initial public offerings rose to HK$449.5 billion (US$57.9 billion), making Hong Kong, China the world's biggest center for such capital raising last year. The subsector is benefiting from wider external use of the yuan. The number of authorized financial institutions participating in yuan business increased from 61 to 115 and their total deposits increased almost fivefold.

A resumption of employment gains in 2010 (after net job losses in 2009) lowered the seasonally adjusted unemployment rate to 4.0% in the fourth quarter (Figure 3.10.2). But real earnings grew by just 0.1% during the year.

Inflation quickened over the year to 3.1% in December 2010 owing to rising domestic demand, a softer US dollar, higher prices for imported food, and rising housing costs (Figure 3.10.3). It averaged 2.4% for the year.

Very low interest rates and abundant liquidity, coupled with strong underlying demand for housing, propelled prices of all categories of property in 2010. Residential property prices rose by 20.4% in the 12 months to December 2010, following a gain of 28.5% a year earlier. A housing affordability index shows that houses became more expensive in relation to incomes (Figure 3.10.4).

Concerned that the sharp runup in prices was spilling over from the high-end property sector to the broader residential market, the authorities directed banks to lower their loan-to-value ratios and raised stamp duty on high-end housing. As prices continued to trend up, the government in November 2010 imposed a special stamp duty on residential property resold within 24 months of acquisition. To add to the supply of housing in the medium term, it increased the land available for residential construction. By year-end, these measures appeared to damp speculation, as reflected in fewer transactions.

In the external accounts, a sharply wider merchandise trade deficit and lower surplus in the income account offset a larger services trade surplus in 2010. The current account surplus declined to US$14.8 billion (6.6% of GDP).

Economic prospects

In light of projected slower global trade and moderating PRC growth, Hong Kong, China will see its expansion ease this year and next.

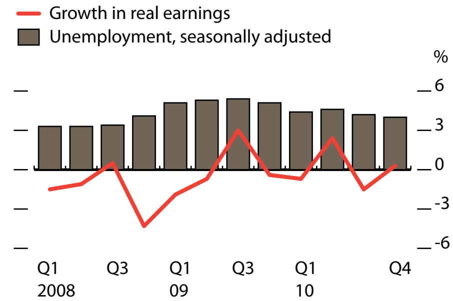
Private consumption is expected to remain healthy in 2011, based on growth in employment and incomes, and be the main contributor to growth in the economy. Retail sales in volume terms rose by 23.6% in the first month of 2011 (Figure 3.10.5) aided by inbound tourism.

Business investment will likely expand moderately this year, supported by low interest rates. Major public infrastructure projects begun in the past 2 years will continue contributing to growth in the forecast period.

Slower growth in world trade and the ending of the low-base effect on 2010's outturn are expected to bring down growth in merchandise exports to about 7.5% in nominal terms in 2011 from 22.4% in 2010. Robust growth is foreseen for services exports, particularly to the PRC.

The budget for FY2011 includes an increase in spending of nearly 25%, and projects a small budget deficit. Spending on capital works is budgeted to rise to US$7.5 billion this year and will likely exceed this amount in

3.10.2 Unemployment and earnings



Source: Census and Statistics Department. http://www.censtatd.gov.hk/ (accessed 28 March 2011).

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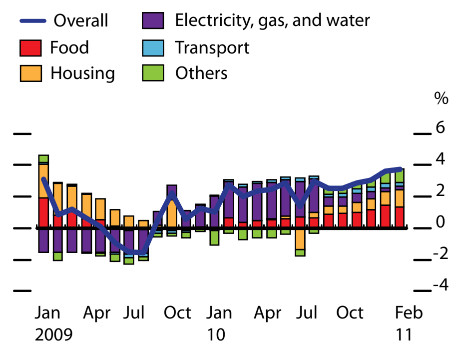
3.10.3 Sources of inflation



Source: CEIC Data Company (accessed 28 March 2011).

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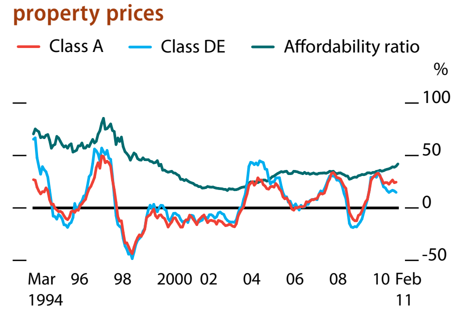
3.10.4 Affordability ratio and growth of property prices



Notes: Class A refers to residential properties less than 40 square meters in size. Class DE refers to residential properties above 100 square meters. Affordability ratio refers to the ratio of mortgage payments (for a 45 square meter apartment) to the median income of all households.

Source: CEIC Data Company (accessed 28 March 2011).

Click here for figure data

2012. Major infrastructure projects to begin in 2011 include extensions of mass transit rail lines.

On the balance of these factors, GDP growth is forecast at 5.0% in 2011, easing to 4.7% in 2012, as the economy is expected to stabilize around its longer-term growth trend. Current account surpluses equivalent to 7.2%–7.5% of GDP are projected for the forecast period.

Inflation this year will be well above the average rate of just over 2% of the past 5 years. Hong Kong, China imports most of its food from the PRC, where food prices have been rising. Further, the yuan has steadily climbed against the Hong Kong dollar (Figure 3.10.6), raising the cost of all purchases from the mainland. Higher global fuel and food prices, rising housing costs, and a likely increase in wages add to inflation pressures. Inflation was 3.7% in February 2011 and is forecast to average 4.5% for the year.

In 2012, inflation is seen easing to 3.3% as global food prices decelerate and the housing market stabilizes, the latter aided by the policies introduced in 2010.

Development challenges

The Hong Kong dollar's link to the US dollar through a currency board framework constrains the authorities from using interest rates as a tool to curb property booms. Monetary policy is tied to that of the US Federal Reserve, which is not expected to tighten much during the next 2 years. The government is therefore relying on macroprudential measures to rein in speculation and to ensure prudent mortgage lending by banks, while it increases the supply of land for housing.

Acknowledging the risk of a property bubble, the financial secretary said in March 2011 that the government stands ready to take further action to calm the housing market.

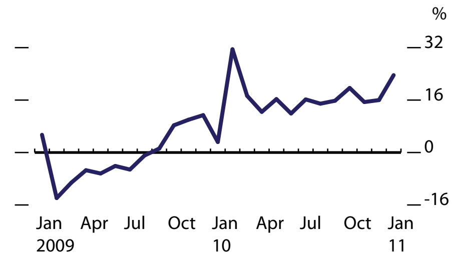
As for inflation more broadly, the FY2011 budget provides several one-time measures aimed at helping the population cope with rising costs of living. They include a subsidy for each residential electricity account capped at HK$1,800, waived rates (property taxes) up to HK$6,000, and 2 months' rent exemption for public housing tenants. The government also proposes to give a HK$6,000 cash payment to permanent residents aged 18 and above, and an income tax rebate up to a maximum of HK$6,000. These two measures will, however, add to domestic demand and, potentially, inflation.

3.10.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	4.7
Inflation	4.5	3.3
Current account balance (share of GDP)	7.2	7.5

Source: ADB estimates.

3.10.5 Retail sales volume growth



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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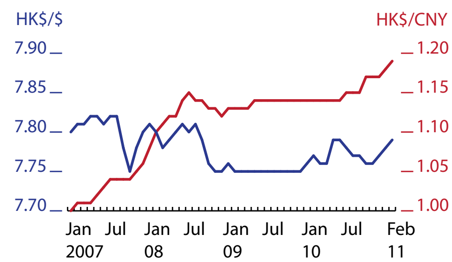
3.10.6 Exchange rates



Source: Census and Statistics Department. http://www.censtatd.gov.hk (accessed 14 March 2011).

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Republic of Korea

Robust economic recovery continued through 2010, when a strong export performance and healthy domestic demand underpinned the steepest rise in GDP for nearly a decade. Growth is expected to moderate to a more sustainable pace in 2011. The paramount near-term challenge is to contain emerging inflation pressures. A key development challenge is to create more job opportunities for those seeking work.

Economic performance

Economic recovery gained traction in 2010 in the Republic of Korea, as GDP rose by 6.1%, the sharpest increase since 2002. The exceptional growth largely reflects a rebound from below-trend growth of 2.3% in 2008 and 0.2% in 2009. The recovery was broad-based and rested on both external and domestic drivers. Externally, exports surged in tandem with the rebound in the world economy and trade. Domestically, private demand replaced fiscal and monetary policy stimulus pushed through during the global recession. Figure 3.11.1 shows the trajectory of quarterly growth during 2008–2010.

Among the different sources of growth in 2010, robust investment played the dominant role, accounting for over two-thirds of the year's expansion (Figure 3.11.2). Surging exports of manufactured goods drove the sharp rise in investment. Private consumption accounted for the rest of GDP growth. Government consumption contributed less than a tenth, mirroring the transformation from policy-led recovery to growth based on private demand. The impact on GDP of the stronger total demand was partly offset by a surge in imports of goods and services.

As global trade volume swung from sharp contraction in 2009 to expansion in 2010, it propelled a 29.6% rise in merchandise exports in US dollar terms. Export performance was strong throughout the year (Figure 3.11.1). Information technology-related products such as semiconductors and liquid crystal displays performed particularly well. Exports of autos, auto parts, and general machinery also grew rapidly. In terms of export destinations, demand from the People's Republic of China (PRC) and Southeast Asia drove growth in the first half and held up well in the second. Demand from Japan and the United States also picked up last year from 2009.

Mirroring the strong recovery of demand, imports rose sharply by 31.9%. The merchandise trade surplus rose to about $42 billion, but the deficit in services trade nearly doubled to $11 billion. The current account surplus fell to 2.8% of GDP, from 3.9% in 2009.

An outstanding feature of growth in 2010 was the acceleration of equipment investment, which soared by 24.5%, though it partly reflects a base effect from 2009, when such investment fell by 9.1%. Companies

3.11.1 GDP and merchandise export growth

Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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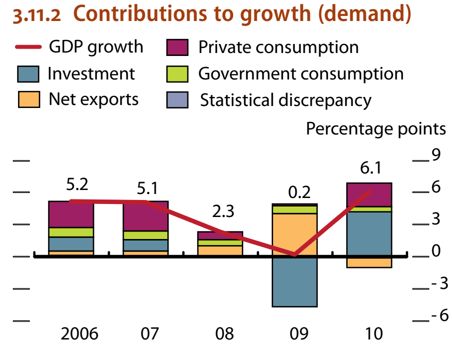
3.11.2 Contributions to growth (demand)



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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

in export-oriented industries regained their appetite for investment as global demand for their products recovered. Companies were also spurred to expand facilities by a rise in manufacturing capacity utilization from an average of 74.6% in 2009 to 81.8% in 2010 (Figure 3.11.3). Further, an appreciating won against the US dollar in the second half of the year lowered the cost of imported capital goods. Imports of machinery rose sharply, although those of transport equipment grew much less quickly.

Construction investment contracted by 2.3% in 2010, after growing by 4.4% in 2009 on the back of public works. The weakness in construction reflected a sluggish housing market, where the inventory of unsold housing continued to build.

Private consumption bounced back (Figure 3.11.4) to grow by 4.1% in 2010, after feeble growth in 2009, supported by a stronger labor market. Employment rose by 323,000, even as the government scaled back job creation programs. Real wages increased by more than 3%, after contracting by 6% in 2009. Gross domestic income rose by 5.8%, the fastest pace in 8 years. An upturn in the stock market and appreciation of the won contributed to stronger consumer sentiment.

The unemployment rate nudged up to 3.7% from 3.6% in 2009, mainly a result of more Koreans looking for work in light of the improved outlook.

In terms of economic sectors, manufacturing stood out with a 14.6% increase in production last year, fueled by surging export demand. Services expanded by a healthy 3.5%.

Despite the strong economic growth, average inflation rose only slightly in 2010, to average 2.9%, within the Bank of Korea's target band of 2.0%–4.0%. As economic recovery gained traction, the central bank started to edge up its policy interest rate from the record low 2.0% set during the global recession. From July 2010 to March 2011, the Bank of Korea raised the rate in four steps to 3.0%.

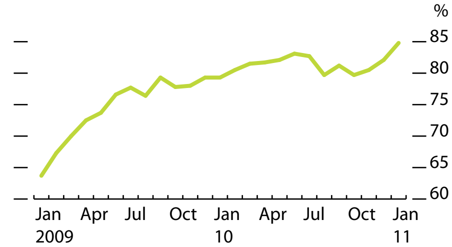
Economic prospects

Exceptionally strong growth in 2010 was based to a large extent on a one-time base effect due to weak performance of 2009. Consequently, the economy is expected to decelerate this year to more sustainable levels around the potential growth rate, estimated at 4.3%–4.9%. A generally benign global outlook will support exports and healthy private investment, and consumption will underpin growth. The consolidation of growth and the emergence of inflation pressures mean that inflation is set to replace growth as the priority of policy makers.

Merchandise exports are projected to grow by more than 10% in 2011. Demand from industrial economies will likely be subdued, but developing countries are forecast to grow rapidly and provide a more certain source of demand. The country has diversified its export markets in recent years, with the PRC in particular providing an important export market during the global recession (Figure 3.11.5).

Exports to the PRC have traditionally been dominated by high-tech parts and components for assembly and reexport to industrialized countries. Increasingly, however, the PRC is becoming a direct consumer of final goods, which helps to explain why the the Republic of Korea's exports to that market held up so well in 2009–2010.

3.11.3 Manufacturing capacity utilization



Source: CEIC Data Company (accessed 11 March 2011).

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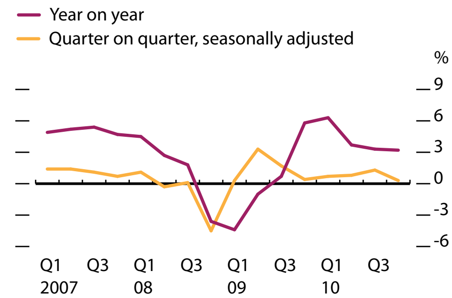
3.11.4 Private consumption growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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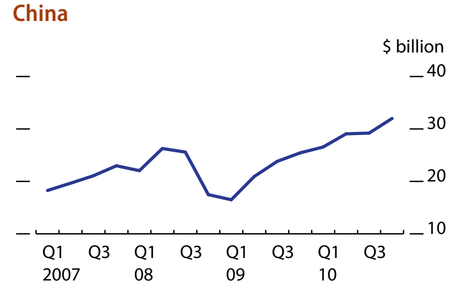
3.9.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.6	4.6
Inflation	3.5	3.0
Current account balance (share of GDP)	1.8	1.7

Source: ADB estimates.

3.11.5 Exports to the People's Republic of China



Source: CEIC Data Company (accessed 11 March 2011).

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Still, several factors will damp growth in exports in 2011. First, the country's exports, especially durables and capital goods, are sensitive to the global business cycle, so the expected easing in world trade growth will act as a drag on exports. After past global downturns, exports initially responded elastically to the recovery of global growth, but lost some momentum as recovery moderated.

Other constraining factors for growth are an expected appreciation of the won and likely weakness in unit prices of exports. (Foreign competitors have expanded production capacity for semiconductors, liquid crystal displays, and other key items, which sets an upper bound to their prices.)

On the domestic front, strong consumer and business confidence will buttress growth in private consumption and investment (Figure 3.11.6). High corporate profits in 2010 and prospective foreign capital inflows have enabled firms to invest. However, as pent-up demand for investment postponed during the global slump was largely satisfied in 2010, equipment investment is likely to moderate to a more sustainable level of about 8% this year.

Construction investment will likely grow at the sluggish pace of about 3%. A significant inventory of unsold housing in the Seoul area will constrain construction, as will large debts of private housing companies and the government's Land & Housing Corporation. The corporation's debts are an example of a more general problem of high and growing debt burdens of state-owned firms (Box 3.11.1).

Private consumption is projected to expand by 4.0%–4.5% in 2011, bolstered by growth in incomes. The labor market looks set to remain strong (up to 250,000 jobs will likely be generated, down a bit from last year owing to the expected moderation in growth of exports industries). Softness in export unit prices will weigh on terms of trade and gross domestic income. But gains in corporate profitability in 2010 will pave the way for more robust wage growth. A decline in housing prices that bottomed out in the second half of 2010 should support consumer confidence.

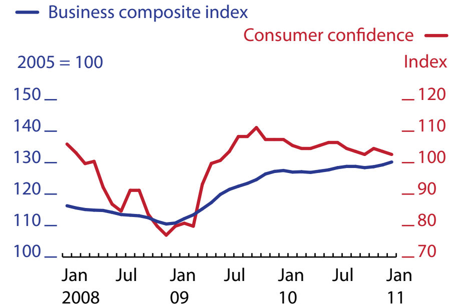
Inflation pressures surfaced toward end-2010 and are expected to intensify this year. Major price indicators are on the rise (Figure 3.11.7), with inflation breaching the central bank's target band in January and February this year. Inflation in 2011 is forecast at 3.5%. It is expected to ease a little in 2012, when monetary policy will be tighter and global prices for oil and food are expected to decelerate.

Cost-push factors such as higher global oil and food prices have contributed to the rise in inflation, though aggregate demand is also putting upward pressure on prices. Additionally, as actual output has surpassed potential output since the first quarter of 2010 (Figure 3.11.8), it is likely that monetary policy will be tightened further to contain inflation.

The authorities are also using administrative measures to control prices of specific items, especially food. Further, in February 2011 the government advised that it would minimize increases in public utility charges.

The fiscal stimulus has been withdrawn as the economic recovery gathered pace. The overall fiscal deficit was reined in last year to 2.3%

3.11.6 Confidence indicators



Note: Data for January 2008–August 2008 refer to the Consumer Expectations Index; values after that were derived from the Composite Consumer Sentiment Index.

Sources: CEIC Data Company; Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (both accessed 11 March 2011).

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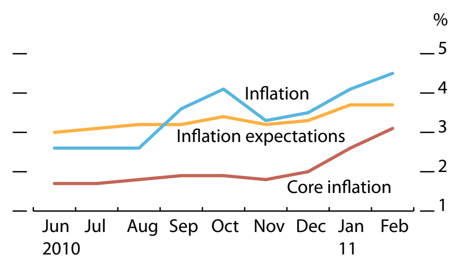
3.11.7 Inflation indicators



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011).

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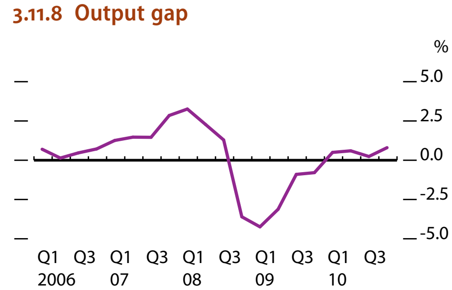
3.11.8 Output gap



Source: ADB estimates.

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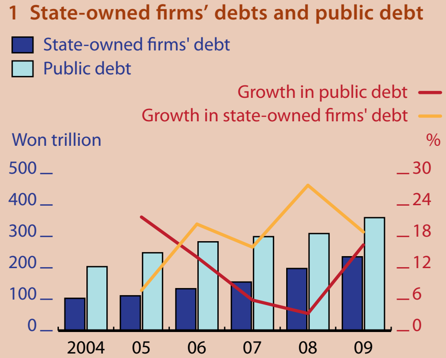
3.11.1 The rising debts of state-owned firms

The rapid increase in debt of state-owned firms may have damaging implications for future fiscal health. Public debt levels are low relative to Europe, Japan, and the United States, and public finances are generally in good shape.

This benign picture ignores, however, large and growing debts of 21 firms owned by the central government. Such debts are not part of the International Monetary Fund's definition of public debts, but still represent contingent liabilities for the government.

As at end-2009, these firms' total debt reached 235.1 trillion won ($201.4 billion), equivalent to 65.4% of public debt. Further, their debt grew by an average of 17.9% a year between 2004 and 2009, significantly faster than the growth in public debt (12.0%) (Box figure 1).

1 State-owned firms' debts and public debt



Source: Korea Development Institute.

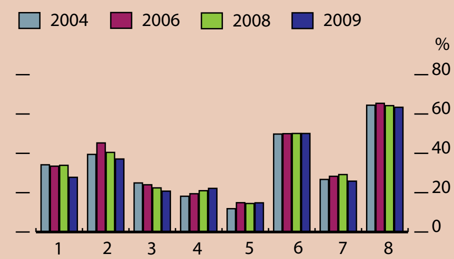
Click here for figure data

A study by the Korea Development Institute assessed the extent to which the debts of state-owned firms pose a risk to financial sustainability. The study was based on an analysis of six of the larger firms—in land and housing, gas, electricity, railways, highways, and petroleum—which together account for 87.5% of state-owned firms' total assets and 92.9% of their total debts. As much of their growth has been financed by borrowing, the weighted debt-to-capital ratio of the six rose from 106.3% in 2004 to 196.8% in 2009.

A high debt burden is not necessarily a concern, however, if there is enough liquidity to deal with short-term financial difficulties. Also, if profitability is high enough to allow for a gradual reduction of the debt burden, the risk that burden poses to fiscal sustainability is limited.

Critically, the ratio of short-term debt to total debt among state-owned firms is relatively low (Box figure 2) and the duration of borrowing is relatively long. They tend to have higher credit rating than private firms, facilitating their access to long-term credit, but few have "quick" assets that can be converted to cash at short notice. Their average ratio of current assets to short-term debt stood at 61.1% at end-2009, comparing unfavorably with the overall corporate average of 99.1%.

2 Short- to long-term debt ratio



1 = Land and housing; 2 = Gas; 3 = Electricity; 4 = Railways; 5 = Highways; 6 = Petroleum; 7 = Average of six state-owned firms; 8 = Average of private and 21 state-owned firms.

Source: Korea Development Institute.

Click here for figure data

State-owned firms generally have low profit rates, although with wide variations. Of the six, the highways and petroleum firms have low debt and high profits. Profitability of the other four has declined in recent years due to excessive business expansion and restrictions on public utility tariff increases.

Without a severe shock, the risk of liquidity problems or bankruptcy among the 21 firms owned by the government appears limited in the short run.

In the long run, however, they should strive to improve profitability so as to gradually reduce their debt burdens. While they are somewhat constrained from raising prices by public interest considerations, they should nevertheless operate along more commercial lines. (For political reasons the government is unlikely to be able to privatize them.)

It would therefore be helpful if the government allowed a gradual liberalization of public utility tariffs. Such firms should also become much more transparent about their financial health.

of GDP, from 5.1% in 2009. The government aims to further narrow the deficit in 2011 and it targets a balanced budget by 2014.

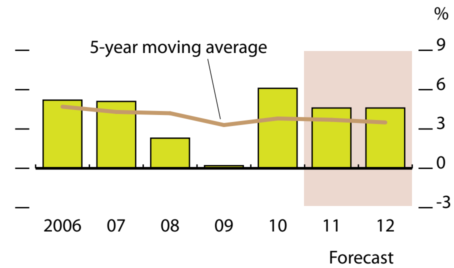
On the basis of the above factors, GDP growth for 2011 is projected to moderate to 4.6% (Figure 3.11.9), slightly exceeding the average of 4.3% during 2003–2007. Both exports and domestic demand will increase healthily, and contribute to broad-based growth. Year on year, the second half will outperform the first, largely owing to the base effect. The outlook for 2012 is expected to be broadly similar to 2011's.

The primary source of uncertainty involves monetary policy. The cost of keeping interest rates low, in terms of the impact on inflation, is likely to be significantly higher than in 2010. The GDP outcome will therefore partly depend on how the central bank resolves the trade-off between growth and inflation.

The large size and volatility of capital inflows remain a risk, although macroprudential measures adopted by the authorities are mitigating it. For example, tax exemptions for foreign investors that were introduced in May 2009 to promote bond market development are being rolled back, and the government has set a ceiling on foreign exchange–related derivatives to limit banks' short-term foreign borrowing. External risks center on the trajectory of global commodity prices and recovery of industrialized countries.

The impact of the Japanese disaster will be limited and temporary. While exports that compete with Japan, such as autos and electronics, may benefit, disruptions to imports of capital goods will hurt manufacturers.

3.11.9 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr (accessed 11 March 2011); ADB estimates.

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Development challenges

A key driver of private consumption growth in 2010 was the strong labor market. Growth of employment and wages is also expected to be a major positive factor in 2011, but paradoxically many job seekers cannot find work. A broad definition of work seekers includes the unemployed, those who work fewer than 36 hours a week and want to work more, and people who have never been employed or been out of the workforce for a long time but want to work. Their number shot up by 19.1% in 2009 to 1.8 million people, and rose by a further 5.4% in 2010, despite the economic recovery (Figure 3.11.10).

Several policy options can be considered. First, specialized skill training programs at small and medium-sized enterprises could be promoted for youths, especially high-school graduates, along with retraining for older individuals. This is important because youths and older people together accounted for around one fourth of work seekers in 2010, according to a study by Hyundai Research Institute.

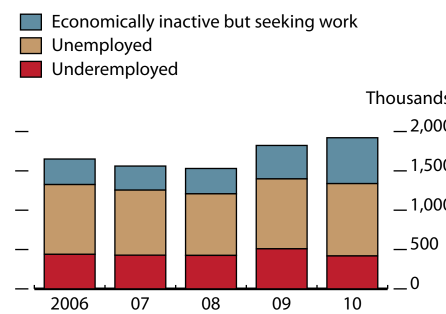
Second, an expansion of public child care facilities would enable more women with children to stay in work (the share of females in work seekers rose from 39% in 2009 to 43% in 2010).

Third, given that unemployment became more prevalent among those, especially females, with junior college or higher education, education must become better aligned with the needs of employers. Employment information, too, should be made more widely available at universities and colleges.

Fourth, efforts should be made to facilitate the employment of those work seekers formerly employed by public job-creation programs.

Fifth, internship programs in both public and private sectors should be expanded as they give valuable work experience to those who have never worked before (individuals unemployed for less than a year accounted for the largest share of work seekers).

3.11.10 Work seekers



Source: Hyundai Research Institute.

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Mongolia

Rising global prices of minerals and strong investment in mining contributed to a return of economic growth in 2010. These factors, coupled with a surge in fiscal spending, will spur higher GDP growth this year, too. Inflation accelerated to double-digit-levels in 2010 and is expected to be even higher this year. Rapidly rising prices and fiscal discipline are near-term challenges for policy makers.

Economic performance

A 6.1% recovery in GDP in 2010 was driven by growth in the minerals sector, high prices for mineral exports (Figure 3.12.1), and support from development partners. The outcome was a turnaround from a 1.3% contraction in the economy in 2009.

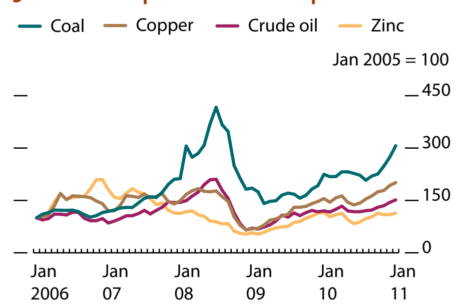
Mining benefited from a rebound in copper prices, strong external demand for coal and iron ore, and construction at Oyu Tolgoi, which will be one of the world's biggest copper and gold mines. Copper prices returned to 2008 levels early last year and rose to over $9,000 a ton in December 2010. Copper export volumes in 2010 were little changed from 2009, but their value jumped by more than 50%; export volumes of coal and iron ore more than doubled in 2010. Strong economic growth in the People's Republic of China (PRC), Mongolia's major trading partner, underpinned the increase in mineral exports.

Industry as a whole contributed nearly half the growth in GDP in 2010 (Figure 3.12.2) as construction and manufacturing expanded, along with mining. Services accounted for the rest of GDP growth: wholesale and retail trade recovered strongly as the economy bounced back.

Agriculture, however, which directly supports about one-third of the population of 2.8 million, was hit by severe winter conditions (a *dzud*) that reduced livestock numbers by about a quarter to 32.7 million. The sector's overall output contracted by nearly 17%. An estimated 10,000 households headed by livestock herders lost their livelihood and migrated to urban areas. The livestock losses also hurt the cashmere industry, reducing production of raw cashmere by 13.2% and output of cashmere sweaters by 20%.

Economic recovery was supported by an SDR 153.3 million (about $229 million) 18-month stand-by arrangement with the International Monetary Fund, completed in September 2010. Under this arrangement, Mongolia borrowed $185.4 million from the Fund and received commitments for $184 million for budget support from development partners. This financing, and associated policy actions taken by the government, bolstered both the budget and external positions and restored confidence in the currency (the togrog).

3.12.1 Global prices of main exports



Source: International Monetary Fund. International Financial Statistics online database (accessed 12 March 2011).
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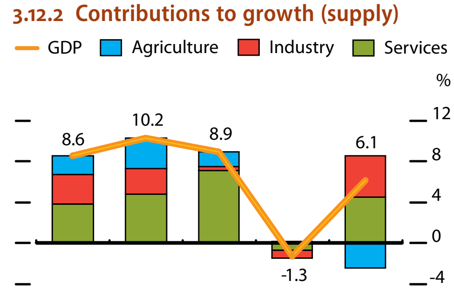
3.12.2 Contributions to growth (supply)



Source: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn.
Click here for figure data

This chapter was written by Bayasgalan Rentsendorj of the Mongolia Resident Mission, ADB, Ulaanbaatar.

External trade rebounded last year from a sharp slump in 2009. Merchandise exports and imports in US dollar terms both jumped by about 53%, exports propelled by higher copper prices and increased coal and iron ore volumes and prices. Higher imports stemmed from the need for equipment in the mining industry, as well as rising prices of oil and food.

Deficits in trade in goods and services caused the current account gap to widen to 15.3% of GDP in 2010 (Figure 3.12.3). A surge in foreign direct investment to $1.6 billion, largely into mining, and in portfolio investment boosted gross international reserves to $2.2 billion at end-2010, equivalent to about 8 months of imports. (Reserves were just $637 million at end-2008.)

Inflation accelerated to nearly 13% by end-2010 (Figure 3.12.4), and averaged 10.1%. The loss of livestock during the *dzud*, coupled with an outbreak of hoof-and-mouth disease, caused a sharp runup in food prices. Strengthening domestic demand was reinforced in October when the government raised public sector wages by 30%. M2 money supply surged by nearly 63% over the year.

Inflation would have been higher had it not been for a 13% appreciation in the togrog against the US dollar in 2010 (the country has a managed floating exchange rate). As the economy recovered and inflation quickened, the Bank of Mongolia in May 2010 raised its policy interest rate from 10.0% to 11.0%.

Higher commodity prices and cash prepayments from the Oyu Tolgoi mine contributed to a 54.5% surge in government revenue in 2010. Government spending went up by 31.7%, largely the result of cash transfers and increases in public sector wages and pensions. The budget was roughly in balance (Figure 3.12.5).

Economic recovery generated jobs and lowered the unemployment rate, though it was still high at 8.6% at end-2010. Poverty remains widespread, with about one-third of the population living below the national poverty line. There has been progress on the Millennium Development Goals related to education and health, but achievements on the poverty, malnutrition, and environmental goals are trailing.

Improvements in business optimism and in public trust in banks encouraged a recovery in lending and strong gains in togrog deposits. Nonperforming loans and loans in arrears fell to about 15% of total loans. New banking and central bank laws were approved in February 2010 to improve bank regulation and supervision. A bank-restructuring strategy, drafted by the central bank, awaits approval by Parliament.

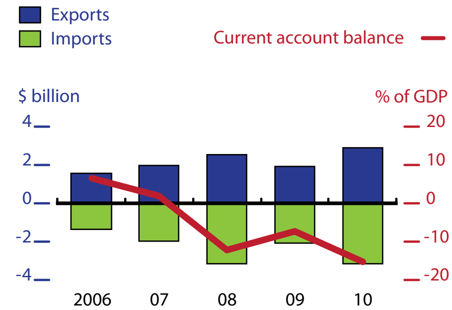
Economic prospects

Growth is expected to accelerate in 2011 and 2012, supported by high global mineral prices, development of new mines, and fiscal spending.

Mining is the key driver. Investment in the Oyu Tolgoi copper and gold mine is projected to total more than $4 billion over the next 2 years. The mine is scheduled to start production in 2013.

Preparations are being made to develop the coal deposits of one of the largest undeveloped coalfields in the world, Tavan Tolgoi. Like Oyu Tolgoi, these deposits are near the border with the PRC, a potential

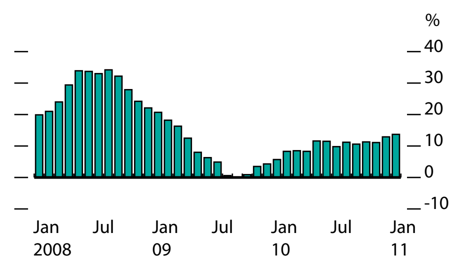
3.12.3 Current account and trade indicators



Sources: Bank of Mongolia. 2011. *Balance of Payments Report*. January. http://www.mongolbank.mn; ADB estimates.

Click here for figure data

3.12.4 Monthly inflation



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

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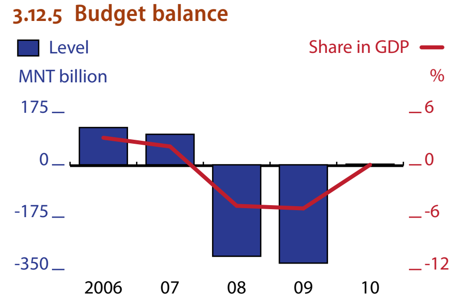
3.12.5 Budget balance



Source: Bank of Mongolia. 2011. *Statistical Bulletin*. January. http://www.mongolbank.mn

Click here for figure data

market for the minerals. At full capacity, Tavan Tolgoi could produce 15 million tons of coal a year. A state-owned company is expected to mine in one part of Tavan Tolgoi from this year, and international mining companies are bidding to develop another part.

The government has ambitious plans for a new rail line linking into the Russian Federation's rail network and so through to its Pacific ports. It also plans to build an industrial complex, including a copper smelter, oil refinery, and facilities to process metals and produce construction materials. The aim is to reduce the country's dependence on exports of raw materials. The rail line and industrial complex would, however, require investment of more than $10 billion, and their economic viability and financing are uncertain.

Fiscal policy is highly expansionary this year. The 2011 budget, with a deficit equivalent to almost 10% of GDP, includes a 35% boost in spending. Cash allowances through the government's Human Development Fund are budgeted to almost double from 2010. Disbursements include a monthly cash allowance of MNT21,000 (about $16) for every citizen and partial tuition support for each college student. Government expenditure overall is projected to rise from 37.3% of GDP in 2010 to 52.0% in 2011, while revenue is set to climb from 37.3% to 42.0%.

Agriculture is expected to recover from the impact of last year's severe weather. The government is providing support for farm-based livestock husbandry, attempting to mitigate weather-related risks.

Taking these factors into account, GDP growth is forecast to grow by a rapid 10% in 2011. High rates of inflation and an increasingly negative real policy interest rate suggest that the central bank will tighten monetary policy. It raised the reserve requirement for banks from 5.0% to 9.0% in February 2011. Further tightening is likely to contribute to a moderation in GDP growth in 2012, projected at about 8.0%.

High food prices, hikes in government spending (notably the cash payments), and the increasing cost of imported fuel are likely to result in very high inflation in 2011, averaging 17%. On the assumption of further monetary tightening this year, inflation should decelerate in 2012, but is projected to remain elevated at 14.0% (Figure 3.12.6).

Robust mineral exports projected for 2011 will be offset by an increase in imports of supplies and equipment for mining, as well as the rising cost of imported food and fuel. The current account deficit is seen at about 15% through the forecast period. Its main sources of financing will be foreign direct investment and public and private sector borrowing from abroad.

The togrog could come under further upward pressure, undermining nonmineral industries, including cashmere and textiles.

Parliament last year enacted a fiscal stability law to improve the management of volatile revenue inflows from minerals and to help avoid the boom–bust instability that is common in mineral-based economies.

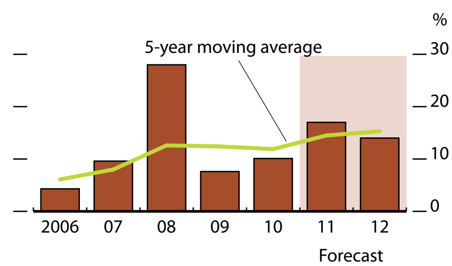
The law should foster budget discipline by effectively placing ceilings on spending growth, the fiscal deficit, and public debt. It also requires cost estimates for spending proposals to ensure consistency with the medium-term fiscal framework. A fiscal stability fund will be established to accumulate revenue saving, to be tapped during economic downturns. Most of the fiscal stability law's measures do not apply until 2013, however.

3.12.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	8.0
Inflation	17.0	14.0
Current account balance (share of GDP)	-15.0	-14.0

Source: ADB estimates.

3.12.6 Average inflation



Sources: National Statistical Office of Mongolia. 2010. *Monthly Statistical Bulletin*. December. http://www.nso.mn; ADB estimates.

Click here for figure data

As for monetary policy, the new central bank law mandates the Bank of Mongolia to focus solely on price stability. Inflation targeting, coupled with a flexible exchange rate, should provide an appropriate monetary framework, which will take some time to establish. The monetary authorities have a tentative timetable to introduce inflation targeting in 2012.

Development challenges

The direction of fiscal policy is of increasing concern. Very high levels of government expenditure planned for 2011 are procyclical and may become a source of macroeconomic instability by fueling inflation, demand for imports, and exchange rate volatility.

Policies to develop minerals and promote economic diversification need to be balanced with sound macroeconomic management and prevention of boom–bust cycles. It is important to bring fiscal policy into line with the fiscal stability law and establish a sound medium-term budget framework.

Protecting the poor from the impact of rising prices and enabling their full inclusion in economic growth through greater employment are other objectives. Proposed measures to better target entitlement payments would mitigate the impact of high inflation.

Putting the banking system on a stronger foundation will require follow-through on the structural reforms proposed for the sector.

The “Dutch disease” risk common to mineral-based economies is likely to remain on the horizon. In this scenario, rapid increases in exports of minerals put upward pressure on the exchange rate and inflation, draw resources away from nonmineral sectors, and generate a stream of government revenue available for subsidies and handouts. The outcome can be uncompetitive nonmineral industries and overextended government budgets (particularly when global mineral prices turn down).

Taipei,China

A powerful recovery last year reflected a rebound in domestic demand and a surge in exports. Growth will moderate this year, owing to the high base set in 2010. Inflation has picked up, but is forecast at relatively modest levels. The outlook is improved by tariff reductions on exports to the People's Republic of China (PRC) and the opening of more industries to investment from there.

Economic performance

This trade-dependent economy rebounded vigorously from recession in 2009. Surging demand for its manufactured exports in 2010 drove a burst of investment and supported increased private consumption. The 10.8% rise in GDP—the fastest in almost a quarter century—was partly a result of the low-base effect from the contraction in the previous year.

Private investment soared by nearly 33% in 2010, after contracting in 2009, with substantial increases in manufacturing, information and communications, and construction. Public investment also rose, albeit modestly, as the authorities continued with infrastructure spending, including reconstruction in areas hit by the severe Typhoon Morakot of August 2009. Overall, higher gross fixed capital formation contributed most of the boost to GDP in 2010 (6.1 percentage points of the total) (Figure 3.13.1).

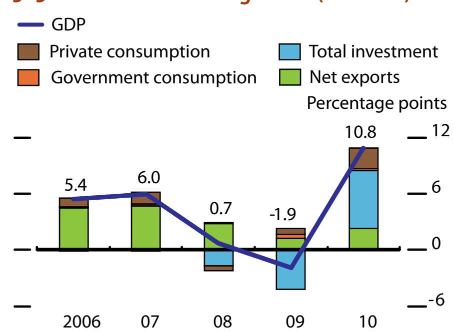
Rebounding exports and manufacturing spurred employment and income growth, in turn buttressing private consumption. Unemployment declined to 4.7% by end-year, from 5.7% the previous year. Real average monthly earnings in manufacturing rose by 7.5% in 2010, after declines in the 2 previous years. The stronger labor market buoyed consumer confidence (Figure 3.13.2). Private consumption grew by 3.7% in 2010 and added 2.1 percentage points to GDP growth.

Sectorally, growth was dominated by manufacturing (constituting about 84% of industry), which surged by 26.8% and contributed 7.2 percentage points to GDP growth. Construction increased by 10.9%, though its contribution to GDP was slight, as it is a much smaller industry. Services grew by 4.8%, with wholesale and retail trading the major contributors to growth in this sector.

Strong global demand for manufactured goods drove growth of nearly 40% in exports of electronic products and chemicals, and increases of over 30% in metal products and plastics. Total exports shot up by nearly 35% in United States (US) dollar terms. The major markets were the PRC; Hong Kong, China; and the US, which collectively took 53% of total exports (Figure 3.13.3). Merchandise imports bounced back even more,

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

3.13.1 Contributions to growth (demand)



Source: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011).

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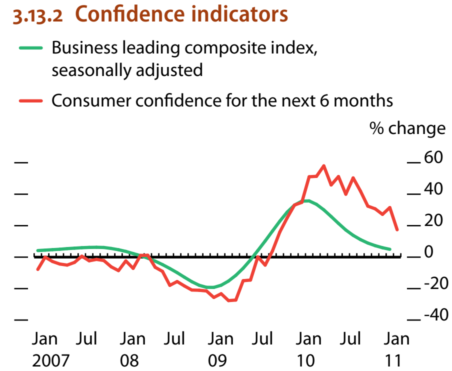
3.13.2 Confidence indicators



Source: CEIC Data Company (accessed 16 March 2011).

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by 43.2%, fueled by imported materials for manufacturing industries and capital goods required by the investment boom.

The merchandise trade surplus therefore fell by 12% to US$26.9 billion. After accounting for small surpluses in services and income, the current account surplus declined, to a still significant 9.4% of GDP. The overall balance of payments was in surplus and international reserves rose to US$382 billion by end-2010.

On the back of tighter economic links with the PRC through the Economic Cooperation Framework Agreement signed last year and abundant global liquidity, short-term portfolio inflows picked up and reached US$10 billion in the fourth quarter of 2010. A rapid increase in purchases of government bonds by foreign institutional investors, speculating on an appreciation of the NT dollar, prompted the monetary authorities in November 2010 to put limits on short-term debt that foreigners can hold. The local currency appreciated against the US dollar from NT$35.2 in March 2009 to NT$29.1 by end-2010.

After cutting interest rates in 2008 and 2009, the monetary authorities started to normalize rates as the economy rebounded. From June 2010, they raised the discount rate in three steps to 1.625% by year-end. Bank credit grew by 7.8% in 2010, after it had declined by 1.4% in 2009 (Figure 3.13.4). M2 money supply growth averaged 5.3% for the year, within the 2.5%–6.5% target range set by the central bank.

Consumer prices also turned up last year, although average inflation was just 1.0%. Of greater concern was a surge in residential property prices (Figure 3.13.5) caused mainly by speculative buying. The authorities moved to curb bank lending for second homes and directed banks to reduce loan-to-valuation ratios for such properties, which helped to damp speculation.

Government expenditure fell by 0.8% in 2010 from 2009, as the authorities gradually withdrew 2009's fiscal stimulus measures. Revenue also declined, by 0.4%, and the budget deficit narrowed only slightly in terms of the ratio to GDP, to 3.2% from 3.5% in 2009. Outstanding government debt rose to 33.6% of GDP, though still below a 40% limit set by law.

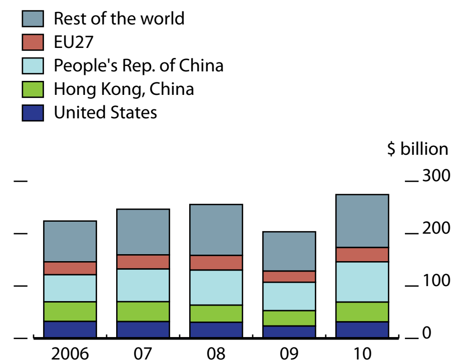
Economic prospects

Further growth in world trade in 2011 (though moderating from 2010's sharp rebound) and continuing expansion of the PRC economy will underpin growth in 2011. The pace will be around trend, however, as the base effect from the 2009 recession that propelled the 2010 outturn dissipates. Growth is expected to be broad-based, with contributions from both domestic and external demand.

The Economic Cooperation Framework Agreement with the PRC will support growth. (The PRC and Hong Kong, China together account for about 40% of Taipei,China's exports.) The first set of tariff reductions under the agreement came into effect in January 2011. Nearly 2,000 certificates of origin valued at over US$400 million, about 5% of merchandise exports to the PRC, were issued in January–February 2011 for Taipei,China products that receive preferential duties from the PRC.

The number of visitors from across the strait surged by 68% in 2010,

3.13.3 Total exports, by major trading partners



Source: Department of Statistics, Ministry of Economic Affairs. http://2k3dmz2.moea.gov.tw/gnweb/English (accessed 1 March 2011).
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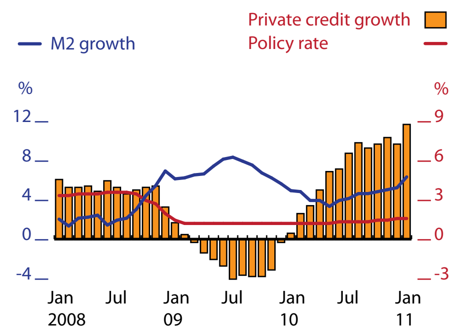
3.13.4 Credit indicators



Source: CEIC Data Company (accessed 16 March 2011).
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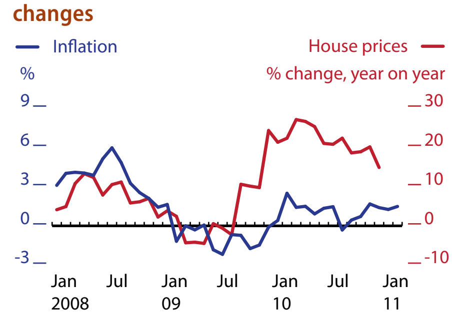
3.13.5 Monthly inflation and house price changes



Source: CEIC Data Company (accessed 16 March 2011).
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3.13.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.8	5.0
Inflation	2.8	2.9
Current account balance (share of GDP)	6.9	7.0

Source: ADB estimates.

and further growth in inbound travel is expected as more tourist groups from the PRC are allowed to visit this year.

Further, the authorities in March 2011 opened up more industries to PRC investors, including the semiconductor and flat-panel subsectors, which were excluded in the first round of investment liberalization last year. PRC investment in these subsectors is expected to lead to increases in exports to the mainland.

Growth in export orders for manufactured goods (such as mobile telephones and tablet computers) moderated to about 5% in the first 2 months of 2011 compared with the prior-year period (Figure 3.13.6). Merchandise exports increased by about 21% in January–February 2011, year on year.

Private consumption is expected to grow by 1.2% in 2011, against the background of a firm labor market. Businesses in sectors with strong external demand—semiconductors and telecommunications equipment for example—are likely to increase investment, but private investment overall is projected to contract by 2.3% this year from the high base set in 2010.

On the balance of these influences, GDP is forecast to grow by 4.8% in 2011 and about 5.0% in 2012 (Figure 3.13.7). Downside risks to this outlook come from higher than expected global oil and commodity prices, any significant slowdown in the PRC, and a prolonged supply disruption to manufactured components from plants in Japan affected by the earthquake and tsunami.

Global price increases for commodities, food, and oil will likely mean that the value of imports rises faster than exports in 2011. (The import bill rose by 25.0% year on year in the first 2 months.) The trade surplus is forecast to fall and the current account surplus decline to 6.9% of GDP.

The higher costs of imports will put upward pressure on inflation, which is projected at around 2.8% in the forecast period (Figure 3.13.8). The NT dollar appreciated by 2.7% against the US dollar from the start of 2011 to mid-March, and is expected to remain firm. Given that forecast GDP growth is broadly in line with trend potential, the monetary authorities are expected to edge up interest rates to contain inflation.

Public investment will play a smaller role in the next 2 years. About US$3.6 billion is allocated for public infrastructure this year, compared with US$5.1 billion in 2010. General government revenue is expected to outpace expenditure, narrowing the fiscal deficit.

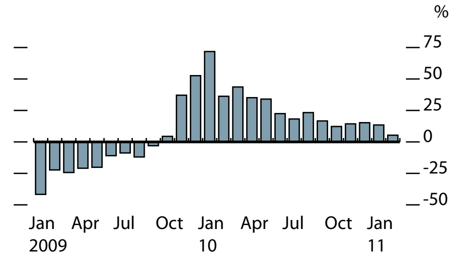
Development challenges

Longer-term growth potential is constrained by an aging, and shrinking, labor force.

The ranking of sources of GDP growth, in terms of production factors, in the decades of fast growth in the 1980s and 1990s put growth of the capital stock first, followed by total factor productivity, labor, and education. In 2000–2007, the capital stock was still the largest growth contributor; labor and education were equal second.

The labor force is projected to decline to below 10 million workers by 2030, from 11.1 million in 2010, and the age-dependency ratio could triple in that period.

3.13.6 Growth in export orders



Source: CEIC Data Company (accessed 16 March 2011).

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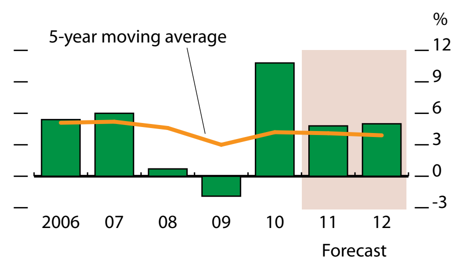
3.13.7 GDP growth



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011); ADB estimates.

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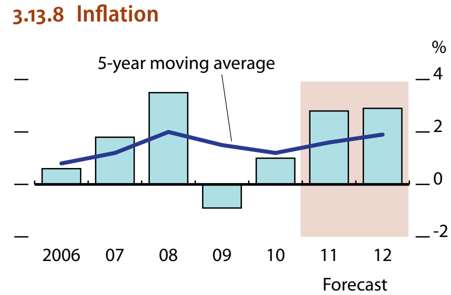
3.13.8 Inflation



Sources: Directorate-General of Budget, Accounting and Statistics. http://eng.dgbas.gov.tw (accessed 16 March 2011); ADB estimates.

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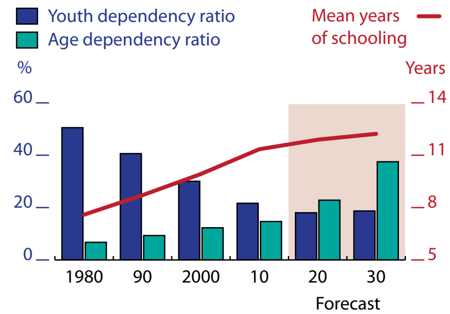
Taipei,China's labor force participation rate, at 58% of the working-age population, is the lowest among newly industrialized economies and almost 10 percentage points lower than Singapore's. The population in Singapore is aging faster, but an active immigration policy there means that labor is projected to add to its growth in the long term, while the reduction in the Taipei,China labor force will lower its growth.

To address this issue, some local authorities, such as Taipei city, are providing conditional cash transfers to households with pre-school-age children to encourage women, in particular, not to quit work when they have children. Such measures could be rolled out more widely to raise labor force participation.

With regard to education, the average number of years of schooling in Taipei,China is expected to reach developed-country levels of 12 years by 2030 (Figure 3.13.9). Hence, there is probably greater room to enhance growth potential by focusing on policies that raise the labor force participation rate, stimulate investment, and foster advanced technology.

The reductions in tariffs on exports to the PRC may well encourage some of the manufacturers that relocated factories to the PRC to bring back some production to the island. Further, the eased tariffs, proximity to the PRC, and a cut in the corporate tax rate to 17% last year all improve the odds of broadening the investor base by attracting firms from rapidly developing countries, such as India, that aim to produce for the large PRC market.

3.13.9 Dependency ratios and years of schooling



Sources: J.-W. Lee and R. Francisco. 2010. Human Capital Accumulation in Emerging Asia 1970–2030. *ADB Economics Working Paper Series* No. 216. Asian Development Bank, Manila; Population Division of the Department of Economics and Social Affairs of the United Nations Secretariat, *World Population Prospects: The 2008 Revision*. http://esa.un.org/unpp (accessed 28 April 2010).

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SOUTH ASIA

Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Afghanistan

Despite deteriorating security, the economy grew steadily in 2010. Inflation increased (toward fiscal year-end), driven largely by import prices. The fiscal position continued to improve but a run on deposits at the leading private bank revealed a significant macroeconomic risk. The government presented an Afghan-led plan for development at the Kabul Conference of donors, but low implementation capacity, weak public sector governance, and perceptions of widespread corruption raise concerns over implementation. Sustainable, self-reliant growth requires significant improvements in security, progress in the Afghan-led reconciliation process, and a better private sector environment.

Economic performance

GDP continued to grow strongly, at 8.2% estimated for FY2010 (ending 20 March 2011), following high growth of 20.4% in FY2009 (Figure 3.14.1). Private consumption remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction. The wheat harvest was above average, but agricultural growth was below FY2009's record.

The size of the opium economy (not included in the official figures for economic activity) had been declining since 2007 because of crop-substitution policies, but in 2010 its farm gate price more than doubled, owing to plant disease–related lower production levels. This boosted farmers' opium-sourced income, likely complicating the already slow pace of poppy eradication.

In the early months of FY2010 the price deflation of the previous fiscal year continued. Prices began to rise from about May 2010, heavily influenced by food and then by fuel, reflecting rising import prices. Although inflation is projected to average 8.2% in FY2010, in February 2011 prices were 17.9% higher than a year earlier (20.9% food and 13.7% nonfood—Figure 3.14.2).

Afghanistan maintains a managed floating exchange rate regime. The afghani appreciated by around 10% against the US dollar over the period January 2010–February 2011, on high inflows of foreign exchange in the form of donor grants and remittances and on increased demand for domestic currency (Figure 3.14.3). This appreciation, alongside inflation now higher than among trade partners, is causing the real effective exchange rate to appreciate as well, potentially undermining exports.

To achieve stability both in domestic prices and the exchange rate, Da Afghanistan Bank, the central bank, targets reserve money (bank reserves and currency in circulation) as its key monetary tool, relying on the issue of its capital notes and foreign currency auctions to control the

3.14.1 GDP growth

Source: Ministry of Finance.

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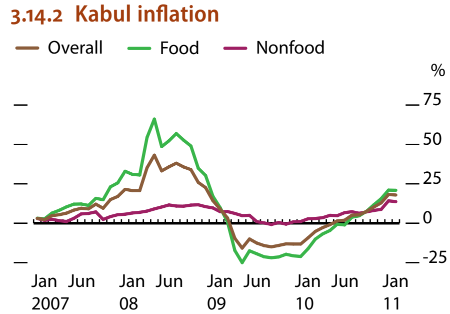
3.14.2 Kabul inflation



Sources: Ministry of Agriculture, Irrigation & Livestock. *Agricultural Commodity Price Bulletin*. http://mail.gov.af; Central Statistical Office of Afghanistan; Da Afghanistan Bank.

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This chapter was written by Rehman Rahmani and Tia Raappana of the Afghanistan Resident Mission, ADB, Kabul; and Nina Clare Fenton of the Central and West Asia Department, ADB, Manila.

money supply. The absence of price pressures at the start of the fiscal year allowed it to adopt a relatively expansionary monetary stance for FY2010, in order to accommodate an increase in demand for money stemming from expected economic growth. It targeted reserve money growth in FY2010 at 18.9%, 1.8 percentage points higher than in FY2009.

In view of inflation pressures, however, the central bank is expected to increase interventions in the market. Gross international reserves climbed to $5.0 billion at end-March 2011 (a rise of 19% from 12 months earlier), reflecting higher donor inflows. Reserves are sufficient to finance 14.3 months of imports and can facilitate market intervention to stabilize the economy and currency.

A run on deposits at Kabul Bank, the largest private bank, in the second half of 2010 raised concerns about financial stability, highlighting the need to strengthen central bank supervision (Box 3.14.1). Although the government took steps to stabilize the crisis, the bank's losses (stemming from serious weaknesses in its corporate governance and management) could constitute a heavy fiscal burden.

Following a surge in domestic revenue collection in FY2009, the government continued to improve in this area, and collection is expected to reach 9.8% of GDP in FY2010 (Figure 3.14.4). The good performance was driven by improved tax administration, including a levying of business receipts tax at borders and other structural reforms. Still, the fiscal position (excluding grants) remains among the world's weakest. Development expenditure is almost fully funded by external assistance while fiscal sustainability—domestic revenue as a share of recurrent spending—is expected to decline to around 65% in FY2010 from 72% a year earlier.

This decline is due to upward pressures on recurrent spending, mainly from the higher wage bill owing to the expansion of the Afghan security forces and the rollout of pay and grading reforms for civil servants. Steps toward fiscal sustainability are particularly important given plans to transit to Afghan-led security, since most International Security Assistance Force nations are setting dates for withdrawing their troops.

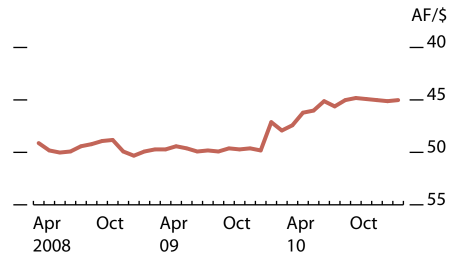
At conferences in London and Kabul in January and July 2010, the government presented refinements to its Afghan-led medium-term plan for development and announced results-based national priority programs to meet its objectives. It also set out public financial-management reforms.

Only an estimated 20% of donor funds are channeled, however, through the government budget, and to increase this share (as committed at the Kabul Conference), the government needs to greatly improve its implementation capacity. It also needs to address broader issues of transparency and accountability in the public sector, including strengthening audits on the use of domestic funds.

The current account deficit (excluding grants) is estimated to have narrowed from 43.6% to 37.6% of GDP in FY2010 (Figure 3.14.5). The narrowing trend reflects the fact that grant-related imports (and grant financing), though increasing in US dollars, are falling relative to nominal GDP. Including grants, the current account balance varies only slightly: it is expected to run a small surplus of 1.9% of GDP in FY2010, switching from a deficit of 1.4%.

During the fiscal year imports increased by 3.7%. The rise was

3.14.3 Nominal exchange rate



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

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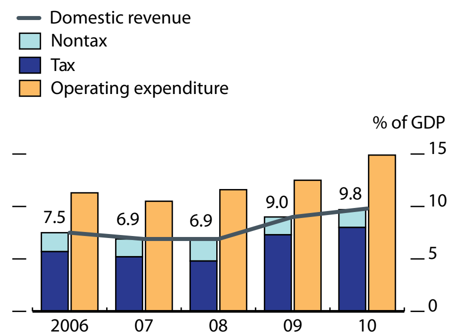
3.14.4 Domestic revenue and operating expenditure



Sources: International Monetary Fund. 2008. *Country Report No.* 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.

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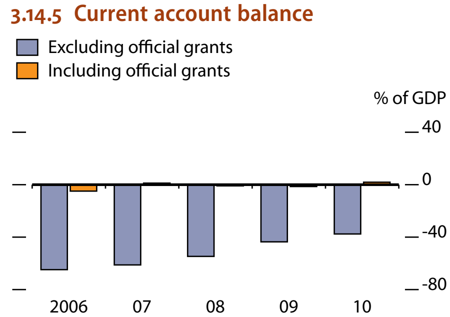
3.14.5 Current account balance



Sources: International Monetary Fund. 2008. *Country Report* No. 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.

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attributed to continued high demand from donor-funded projects, particularly for fuel, capital equipment, and food, which together make up almost 80% of imports. Exports (much smaller than imports) rose by 6.9%; the main items remained dried fruits, carpets, and furs.

Economic prospects

GDP growth rates for FY2011 and FY2012 are projected at 8.0% and 8.5%, respectively. These estimates assume that substantial development-partner funding continues; agriculture and services perform well; the resolution of the Kabul Bank crisis is not disruptive; and industry improves, aided by mining-related construction.

If managed effectively, mining has the potential to grow robustly, although its contribution to the budget over the next few years is likely to be modest. The World Bank estimates that even in a low-impact scenario the first significant investment, the Aynak copper mine, could generate budget revenue of around $155 million a year in the construction phase (2011–2015), increasing to $365 million from royalties once the mine is operating. The Hajigak iron ore mine, too, may bring in revenue of $89 million a year after it starts construction in 2013. In the early years of development, combined receipts from these two mines could therefore be over 1% of GDP, but that amount is contingent on strong management.

The government expects in the next few years to make progress on revenue collection, particularly by the possible introduction of a value-added tax, and to increase its fiscal sustainability ratio to above 70%. The tax take should also benefit from increased mining activity, largely through indirect tax revenue in the construction phase. Meeting the 70% target will, though, be challenging under continued pressure on recurrent expenditure. Although external assistance is set to gradually decline, it is likely to be needed to cover at least part of such spending for several years.

Foreign aid will continue to plug the balance-of-payments gap. The current account surplus is expected to fall slightly in FY2011, to 1.4% of GDP (including official transfers), driven by increased imports as international commodity prices rise. Excluding official transfers, the balance should continue its gradual improvement to a deficit of 34.4% of GDP as development assistance falls relative to the size of the economy (though nominally it expands).

Inflation is projected to average 9.8% and 9.1% in FY2011 and FY2012, assuming that prudent monetary policy is adopted as planned and that it can mitigate the impact of rising international commodity prices.

The previous program of the International Monetary Fund ended in September 2010; the government has therefore requested a new Extended Credit Facility, though the Kabul Bank crisis has delayed a board decision.

The government's economic program is likely to set out key actions on resolving Kabul Bank's position and strengthening broader financial supervision measures, while keeping a focus on macroeconomic stability objectives and measures toward fiscal sustainability.

This outlook is subject to several risks, such as worsening security conditions, political instability, weak governance, loss of export

3.14.1 Kabul Bank crisis

Fraudulent loans came to light at Kabul Bank in September 2010, triggering a run on deposits. Despite this huge change to its financial position, the bank still has the largest deposits and branch network in the country, and performs crucial functions such as paying civil service salaries.

The central bank initially placed Kabul Bank under a conservatorship until the bank could be sold to a qualified buyer, or, in the worst case, liquidated.

The government has so far guaranteed $400 million of the bank's deposits but it will probably also need to finance any remaining unfunded liabilities at the time of a sale.

An alternative option, proposed by the International Monetary Fund, would be to place the bank in receivership, which could be expected to ensure more transparent, legally secure, and potentially faster resolution.

Importantly, any improper financial and legal interests would be unquestionably resolved and any further losses prevented. The government's financial exposure could also be limited to a predetermined level. In March 2011, the option of receivership was being considered by the Afghan authorities.

3.14.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.5
Inflation	9.8	9.1
Current account balance (share of GDP)	1.4	-0.8

Source: ADB estimates.

competitiveness, and new barriers to trade with neighboring countries. The debt relief granted to Afghanistan under the extended heavily indebted poor countries initiative in 2010 has relieved the debt burden by $1.6 billion, taking it to a sustainable level (around 8% of GDP). Still, Afghanistan will stay at high risk of debt distress, particularly if foreign grants (expected to decrease gradually in the medium term) fall heavily.

Development challenges

It is important that the government continues to undertake a strong reform agenda and implement the commitments made at the Kabul Conference. A particular focus should be on strengthening governance, implementation capacity, and accountability of public institutions. The government's development plan should help to ensure that the budget is clearly focused on key policy objectives. Capacity should be strengthened to increase development budget implementation by at least 10%–20% annually, as committed to at the Kabul Conference. At the same time, the national budget process should build on existing systems to better monitor spending effectiveness.

If significant progress were made on all these fronts, development partners would channel more funds through the government budget, helping to align development priorities and increase aid effectiveness.

External assistance is expected to decline over the long term, hence the government needs to focus on the transition to fiscal sustainability. It is expected to continue improving its position by increasing domestic revenue and controlling public expenditure through a robust budget-formulation process.

The government will also want to improve the overall investment climate, so as to encourage private sector growth, promote exports, and reduce dependence on external assistance. The country still ranks the lowest in the region for ease of doing business, according to the World Bank's *Doing Business 2011* report, and this needs to change. Managing the potential mineral wealth well will also be critical.

3.14.2 South Asian rankings on the ease of doing business, 2011

Pakistan	83
Maldives	85
Sri Lanka	102
Bangladesh	107
Nepal	116
India	134
Bhutan	142
Afghanistan	167

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.

Bangladesh

A strong export rebound will push up growth in FY2011, but a slowing remittance expansion will damp domestic demand. Next year could see better prospects with higher external demand. A major challenge for policy makers will be to balance the needs for taming inflation and for ensuring that credit to the private sector is not stifled. To harness the country's medium-term growth potential, removing infrastructure gaps will be essential, as will enhancing the supply of skilled human resources.

Economic performance

At 5.8% in FY2010 (ended June 2010), GDP growth was marginally higher than the 5.7% of FY2009 (Figure 3.15.1). Helped by favorable weather and continued government support, strong performance by the crop and horticulture subsector boosted agriculture's expansion. This offset a decline in industrial growth due to a fall in external demand and continued shortages of power, gas, and transport facilities. Services also grew only marginally.

On the demand side, growth was again driven by private consumption aided by higher credit flows to the private sector (supporting job creation) and by a boost to public sector wages. Total fixed investment, after remaining stagnant over the past half a decade, rose from 24.4% of GDP in FY2009 to 25.0% in FY2010. The rise in private investment provided the main impetus to performance.

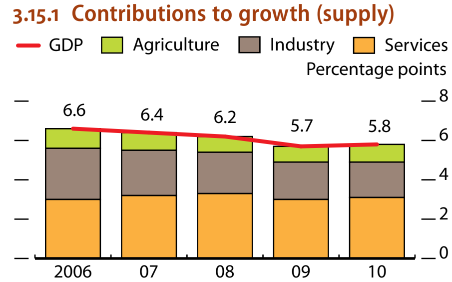
Foreign direct investment is stagnant at less than $1 billion a year. It could see a notable rise, however, if the government makes progress in awarding contracts for gas exploration and in setting up a floating liquefied natural gas terminal, as called for in its plans to address growing power and gas shortages. Foreign as well as local investment could also be lifted by the Special Economic Zone Act that Parliament passed in 2010, which aims to attract more private capital.

Annual average inflation edged up to 7.3% in FY2010 from 6.7% in FY2009 owing to a rapid rise in food prices in the first part of the year; nonfood inflation moderated. In FY2011, year-on-year inflation fell to 7.3% in July (Figure 3.15.2), from 8.7% in June but subsequently trended upward (with some volatility) to reach 9.0% in January 2011. The rise in global food and commodity prices, a continued rapid expansion in private credit, and depreciation of the taka pushed up prices.

To help the poor and vulnerable cope with higher food prices, the government stepped up food distribution operations, strengthened open-market sales of its inventories, and introduced a food-ration system for the ultra-poor.

FY2010's rapid growth in broad money continued into FY2011, reaching 21.7% in December 2010 (Figure 3.15.3), significantly above the

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November.

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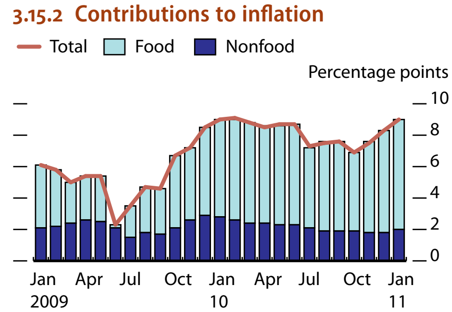
3.15.2 Contributions to inflation



Sources: Bangladesh Bureau of Statistics. *Consumer Price Index (CPI) and Inflation*. Various issues. http://www.bbs.gov.bd

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

central bank's annual program target of 15.2%. Private credit, up by 27.6% year on year in December 2010 (against the target of 16.0%) was the main contributing factor. The central bank's tightening of policy rates had little effect on credit expansion. The average lending and deposit rates also remained largely unchanged at 11.2% and 6.0%, respectively, in June–December 2010.

Revenue collection rose briskly with the revenue-to-GDP ratio climbing to 11.5% in FY2010—meeting the budget target—as domestic economic activity picked up a little and tax administration improved. Total spending jumped from 14.3% of GDP in FY2009 to 16.0% in FY2010 as the government adopted an expansionary fiscal stance to offset the impact of the global recession. Spending fell short, however, of the budget target as the annual development program remained underspent because of the lingering weak capacity in key implementing agencies. The fiscal deficit of 4.5% of GDP was well within the target of 5.0%.

After declining in the first half of FY2010, exports grew consistently year on year during the second half, posting growth of 4.2% for the full year (but still much lower than the previous year's 10.1%). Readymade garment exports moved up by only 1.2%, shaving their dominant share of total exports by 2 percentage points to 77.1% in FY2010. Exports of jute goods, petroleum by-products, and engineering products rose briskly.

Imports contracted during the first 3 quarters but reversed this trend in the fourth to show full-year growth of 5.4%, as imports of capital machinery picked up. Import bills for rice and for consumer and intermediate goods fell from their year-earlier levels. Remittance growth, robust at 22.8% in the first half of the fiscal year, decelerated sharply later, posting only 13.4% full-year growth, down from 22.4% the previous year.

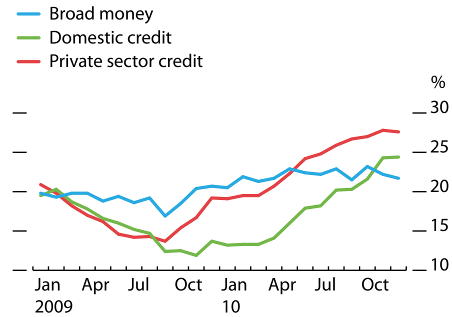
Still, the small expansion in the trade deficit was more than offset by remittance inflows, boosting the current account surplus to $3.7 billion (3.7% of GDP) from $2.4 billion (2.7%) in FY2009 (Figure 3.15.4). The improved position, alongside the lower deficit in the combined capital and financial account, pushed the overall balance-of-payments surplus to $2.9 billion and foreign exchange reserves to $10.7 billion (Figure 3.15.5) at end-June 2010, raising import cover to about 5 months. In the first half of FY2011 foreign exchange reserves showed little increase as the current account surplus largely fell away.

The nominal taka–dollar exchange rate remained stable in FY2010, but depreciated by 2.6% in the first 8 months of FY2011. Nonetheless, with domestic inflation higher than in major trading partners, the real effective exchange rate appreciated by 1.8% year on year in January 2011, implying some erosion in export competitiveness.

The Dhaka Stock Exchange general index more than doubled during FY2010 (Figure 3.15.6). The price–earnings ratio climbed from 18.4 to 24.1 and market capitalization doubled, reaching $38.6 billion (about 39% of GDP). The bullish trend in stock prices continued into the first half of FY2011 as the general index peaked on 5 December—44.0% higher than its end-June 2010 level. Then, a price correction set in, and the index fell by 41.7% by end-February as commercial and merchant banks moved to heavy selling, booking large profits. Nervous retail investors followed suit.

To stabilize the market and shore up investor confidence, the government announced measures including advising commercial and

3.15.3 Growth of monetary indicators



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

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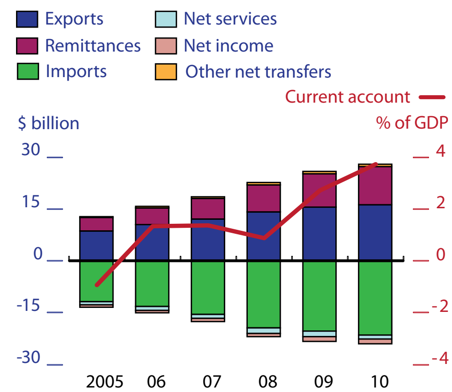
3.15.4 Components of the current account balance



Source: Bangladesh Bank. *Annual Report 2009–2010*. http://www.bangladesh-bank.org

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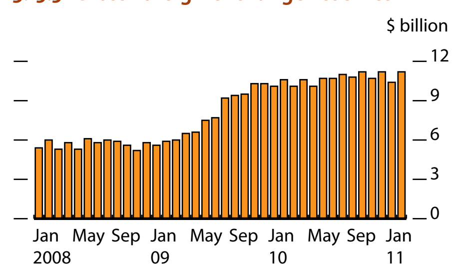
3.15.5 Gross foreign exchange reserves



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

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merchant banks to reinvest their profits, instructing merchant banks to stop the practice of forcing margin clients to sell shares, and removing the index's circuit breaker. The state-owned Investment Corporation of Bangladesh, with seven other state-owned financial institutions, are creating a Tk50 billion (about $715 million) open-ended mutual fund (the Bangladesh Fund) to prop up the market. The government also formed a committee to investigate the causes of market instability.

Economic prospects

Economic forecasts for FY2011 and FY2012 rest on several assumptions. The policy focus on accelerating growth while strengthening efforts to tame inflation will continue, the momentum of budget revenue growth will be maintained, and it will be possible to mobilize more external financing. The government will step up initiatives to boost power generation (including commissioning rental power plants), thereby easing power supply shortages, and will take action to address gas shortfalls. A stable political environment and normal weather conditions are assumed.

GDP growth in FY2011 is projected to climb to 6.3% from 5.8% the previous year. The strong rebound in exports under way will support higher growth, offsetting the effects on domestic demand of the sharp slowdown in remittance growth. The pickup in export-linked domestic industries and tax incentives for domestic industries provided in the FY2011 budget are also expected to bolster economic activity. GDP growth in FY2012 is seen rising further, to 6.7% (Figure 3.15.7), with a continued policy focus on growth and a pickup in external demand.

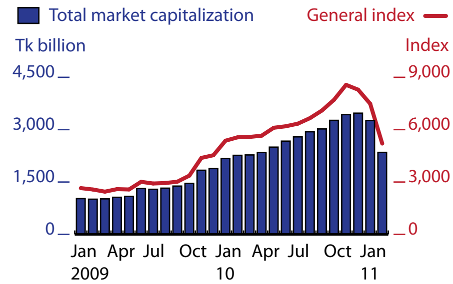
Agricultural growth in FY2011 is expected to ease to 4.1% because of lower acreage sown for the *aus* (summer crop), shrinkage in acreage and inadequate rainfall for the *aman* (monsoon crop), and the high base following the previous year's growth of 4.7%. In FY2012, the sector's growth is expected to strengthen to 4.3%, responding to higher prices following a tighter supply situation in FY2011 and continued policy support.

Industrial growth is expected to rise to 7.5% in FY2011, reflecting higher production for exports and domestic capacity expansion after the previous year's higher investment. Export performance was buoyant in the first 8 months of the fiscal year, recording 40.3% growth (Figure 3.15.8), with all major items growing strongly. Rapid growth in imports of raw materials and capital machinery also point to a better industrial performance. An improvement in the power supply and a rise in business confidence, too, are likely to boost activity. In FY2012, industry is expected to grow strongly at 7.8%, reflecting a rise in external demand and higher domestic capacity.

In FY2011, services growth is forecast to rise slightly to 6.7% from 6.4%, mainly on the strength of industrial and trade and transport activity, as the pulse of trade quickens. Sector growth will rise further to 7.2% in FY2012, reflecting industrial and agricultural strengthening.

The rise in year-on-year inflation is pushing up the 12-month average. Although the central bank's January 2011 monetary policy statement forecast 7.0% inflation for FY2011, it may well come in at 8.0%, rising

3.15.6 Dhaka stock exchange indicators



Source: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February. http://www.bangladesh-bank.org

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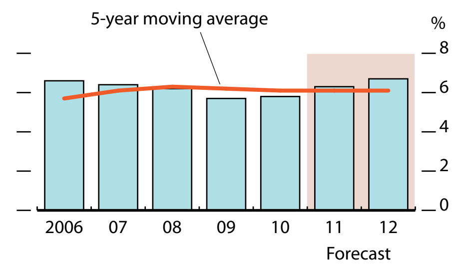
3.15.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.3	6.7
Inflation	8.0	8.5
Current account balance (share of GDP)	0.2	-0.3

Source: ADB estimates.

3.15.7 GDP growth



Sources: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November; ADB estimates.

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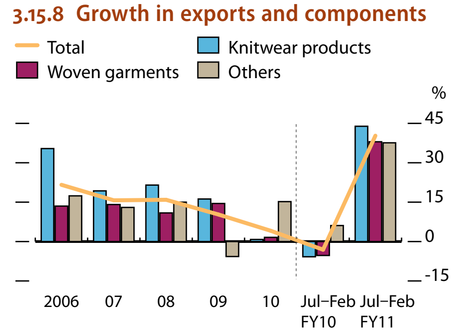
3.15.8 Growth in exports and components



Sources: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February; *Annual Report 2009–2010*. http://www.bangladesh-bank.org

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further to 8.5% in FY2012 (Figure 3.15.9). The central bank instructed commercial banks to rein in credit growth and set a deadline for cutting the credit-to-deposit ratio. The marked rise in global commodity prices, the likely further depreciation in the taka, a power tariff increase in February 2011, and expected hikes in fuel and compressed natural gas prices are all seen exerting upward supply-side pressures. Monetary policies are unlikely to fully counter them.

The slower growth in remittance inflows that began around February 2010 intensified in FY2011. Overseas workers remitted $7.5 billion during the first 8 months of FY2011, for growth of only 2.5%—a startling drop from a 19.0% gain in the year-earlier period. The decline is a concern as healthy remittance growth helps to underpin consumer spending and is a key source of domestic demand. Job placements for Bangladeshi workers, who are mostly low-skilled, declined by 10.9% in the first 8 months of FY2011 (Figure 3.15.10), continuing the declines of the previous 2 years. Remittances are likely to grow at very modest rates of 3.0% in FY2011 and 4.0% in FY2012. The latest developments in the Middle East could also affect remittances.

The continued robust performance in export earnings that started in March 2010 raised the prospect of exceeding the FY2011 annual export target of $18.5 billion. In the first 8 months of FY2011, rapid growth in readymade garment exports (woven by 38.0% and knitwear by 43.9%), representing over three-fourths of total exports, was partly due to importing countries replenishing their inventories, though it also reflected a sharp rise in wages in some other garment-exporting countries. Although industry's agreement to raise monthly wages—to about $43–$133 for garment workers—has by and large been pushed through following frequent worker unrest over the past couple of years, it hardly dented wage differentials with competitors.

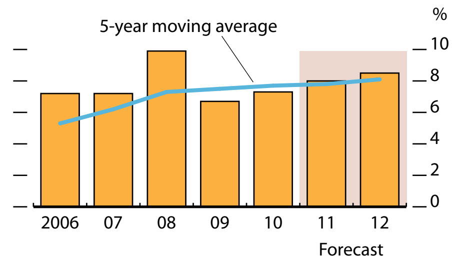
Exports of other items such as frozen foods and jute also grew strongly. Very high export growth in the first part of FY2011 is expected to moderate as inventory rebuilding comes to an end, pointing to a 21.0% expansion in exports for all FY2011. In FY2012, exports are projected to grow by 22.0%.

Exports to the European Union will benefit from relaxed rules of origin (introduced 1 January 2011) under the Generalized System of Preferences. Bangladesh readymade garments are also diversifying their export destinations to countries such as Japan, the Republic of Korea, South Africa, and Turkey.

In tandem with the rise in exports—a large part of which was based on imported raw materials—import payments rose by 40.7% in the first 7 months of FY2011. Imports of food items, industrial raw materials, and capital machinery grew rapidly. Growth in overall imports is set to moderate over the rest of the fiscal year as imports of raw materials for the readymade garment industries slow. The import bill for fuel will rise, however, reflecting volume and price increases. Imports are forecast to grow by 23.0% in FY2011 and 24.0% in FY2012.

The external current account is seen showing a smaller surplus of 0.2% of GDP in FY2011, and then turning into a deficit of 0.3% of GDP in FY2012 (Figure 3.15.11), reflecting slow remittance growth and a widening trade gap.

3.15.9 Inflation



Sources: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org; ADB estimates.

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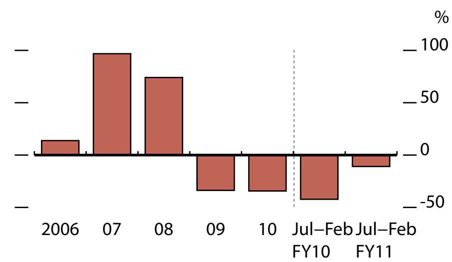
3.15.10 Growth in out-of-country employment



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

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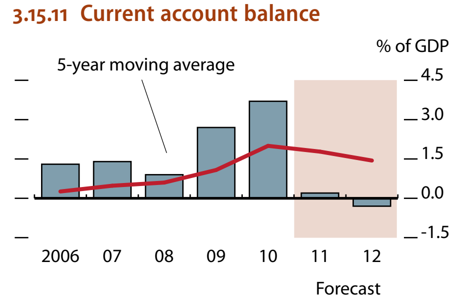
3.15.11 Current account balance



Sources: Bangladesh Bank. 2011. *Annual Report 2009–2010*. http://www.bangladesh-bank.org; ADB estimates.

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A 3-year program arrangement is expected to be finalized with the International Monetary Fund under its Extended Credit Facility, which will help Bangladesh tackle its growing balance-of-payments needs. The program is expected to catalyze financing and support policy adjustments and reforms conducive to boosting growth, while strengthening the external position (Box 3.15.1).

3.15.1 The Extended Credit Facility

Under a proposed program for a SDR640 million (about $1 billion) loan from the Extended Credit Facility of the International Monetary Fund, the government plans to undertake major reforms to put Bangladesh on a higher growth trajectory.

For raising tax revenue by around 3 percentage points as a share of GDP, it is expected to deepen tax administration reforms, including enacting value-added and income-tax laws. It aims to improve public financial management and operationalize the public–private partnership program for boosting public and private investment.

Reforms under the program are expected to improve monetary and foreign exchange operations, strengthen the finance sector and its oversight (focusing on financial conditions of state-owned commercial banks and the compliance by all banks with new capital-adequacy requirements), and promote the country's integration into the regional and global economy through a more open trade and investment regime.

For containing inflation pressure, the central bank is seen tightening monetary policy, aided by greater interest- and exchange-rate flexibility. It is also likely to work closely with the Securities and Exchange Commission to ensure appropriate actions by commercial banks and their subsidiaries to limit risks from stock market volatility.

The operating losses of the larger power and energy utilities are expected to be brought on the government budget.

Tax collection grew robustly by 28.4% during the first 7 months of FY2011 over the year-earlier period—direct taxes and domestic indirect taxes contributed most to the rise in revenue, although import-based indirect taxes also improved well. The expansion in domestic economic activity and better tax compliance, aided by reforms, are the main factors.

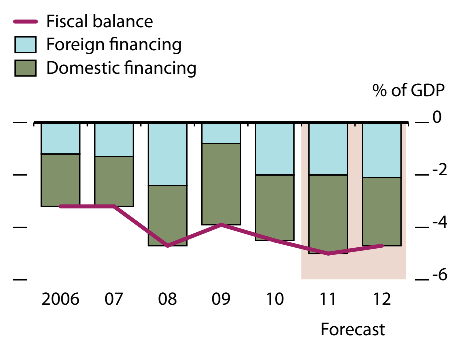
The annual development program's utilization rate in the first 8 months of FY2011 did not improve relative to the previous year, and its annual allocation is unlikely to be fully spent, despite recent government measures such as forming a task force to beef up implementation and progress monitoring.

Nor have any of the sizable resources earmarked for the Bangladesh Infrastructure Finance Fund, set up in the FY2011 budget to finance projects under the public–private partnership mechanism, been drawn on. Although budgetary allocations for food, fuel, fertilizer, and other agricultural inputs will be larger than in FY2010, the chronic underspending of investment allocations is expected to keep the fiscal deficit within its budgeted level of 5.0% of GDP (Figure 3.15.12).

The 11.0% increase in bulk power tariffs in February 2011 will help to cut Bangladesh Power Development Board's losses. The 5.0% hike in retail tariffs will improve the financial performance of power distribution companies.

The Bangladesh Petroleum Corporation (BPC) is nursing sizable losses as the government made no adjustment in domestic administered prices for fuels, even though global oil prices climbed sharply. BPC's losses will rise further as its imports are expected to soar to meet the needs of new power plants using diesel and fuel oil. BPC has arranged additional financing (of about $1.4 billion) from the Islamic Development Bank and

3.15.12 Fiscal balance



Source: Asian Development Outlook database.

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has requested assistance of $500 million from the central bank. It is also looking into additional financing from foreign commercial banks.

For the meantime, the government in the FY2011 budget made initial allocations of Tk25 billion (about $357 million) and Tk15 billion (about $214 million), as loans, to BPC and the Bangladesh Power Development Board.

Several downside risks could derail the projections. A slackening of the global recovery would likely slow export growth and heavily curtail remittances. Higher than projected domestic inflation could affect macroeconomic stability and discourage investment. Finally, inability to bring the planned short-term addition to power supply, such as the commissioning of small, private diesel and fuel-oil generators, and slippage in addressing gas shortages would also slow growth, mainly through their impact on industry.

Development challenges

Two critical challenges to exploit Bangladesh's growth potential are to upgrade infrastructure and to ensure a large, skilled workforce.

A major step in upgrading infrastructure was taken recently: three independent power producer contracts were awarded for generation. Once completed, they will add over 1 gigawatt to the grid, helping to relieve a bottleneck for industrial and employment expansion. Efforts are still needed to take advantage of the public–private partnership mechanism to create projects in infrastructure and to make the Bangladesh Infrastructure Finance Fund operational.

Bangladesh could reap a rich demographic dividend by transforming its large young population into a productive human resource through better education and health care. A balanced combination of public and private sector initiatives in delivering these services is needed.

Another issue is ensuring the availability of land for public and private sector projects. The rapidly declining land available per capita, exacerbated by poorly maintained land records, is making it increasingly difficult to buy land for infrastructure or industrial and commercial use.

A linked emerging challenge is urban congestion, in Dhaka and Chittagong especially, but also in other urban areas. Rapid urbanization is stretching too thin cities' capacity to provide urban services. For easing traffic gridlock in cities, one option is to develop mass rapid transit systems and satellite townships near the major urban areas. Rural and semi-urban areas need to be made more livable with expanded opportunities for better livelihoods.

Bhutan

The economy, which has vast hydropower potential, is driven by the cycle of hydropower building and output. Two hydropower stations are being built and two other projects started preconstruction work in May 2010, ensuring strong growth for the medium term. The main challenges for the government are to try and diversify the economy and create job opportunities.

Economic performance

Growth is estimated to have accelerated to 7.0% in FY2010 (ended 30 June 2010) from 5.7% in FY2009 (Figure 3.16.1). Construction revived with work on the Punatsangchhu I (1,200 megawatts [MW]) and Dagachhu (114 MW) hydropower stations. Services, accounting for nearly two-fifths of GDP, contributed the bulk of the GDP gain, mainly construction related. Agriculture's growth was solid. Despite generating only about 16% of GDP, it engages over 65% of the labor force.

The electricity and water sector—nearly a quarter of GDP—did not contribute to the expansion, as no additional generation capacity has been added since Tala hydropower station came online in FY2007. Tourism was also a drag on growth due to the global downturn: visitor arrivals dropped by 9.3% and foreign exchange earnings by 12.4%.

As Bhutan is linked with India through trade (93.5% of exports and 77.7% of imports) and a currency peg, rising consumer prices in India tend to spill over. Year-on-year inflation rose to 6.1% in the fourth quarter of FY2010 from 3.0% a year earlier (Figure 3.16.2).

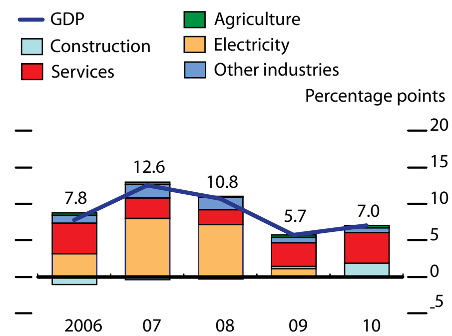
With a pickup in economic activity, growth in broad money accelerated to 30.1% from 24.6%, as domestic assets expanded. Domestic credit, primarily to the private sector, grew by 38.6% in FY2010 from 31.1% in the previous year, reflecting surging personal loans and credit to manufacturing. The sectorwide distribution of credit remained mostly to housing (about one-quarter of the loan portfolio), followed by manufacturing, personal loans, and services (including tourism).

Credit quality improved as nonperforming loans as a share of the total narrowed to 10.1% in June 2010 from 18.3% the previous year, reflecting a fall in such loans in manufacturing, where several export-oriented firms saw an upswing in sales. Banks are well capitalized with a capital-adequacy ratio of 17.1% at end-FY2010.

The budget deficit in FY2010 is estimated at around 6% of GDP, reflecting revisions that sharply raised capital expenditure despite a fall in nontax revenue (Figure 3.16.3). These adjustments stemmed from additional construction spending, including a monastery and other public buildings.

Nontax revenue declined because of a 1-year gap in dividend receipts. (Druk Holding and Investments was set up to own all major state-owned

3.16.1 Contributions to growth (supply)



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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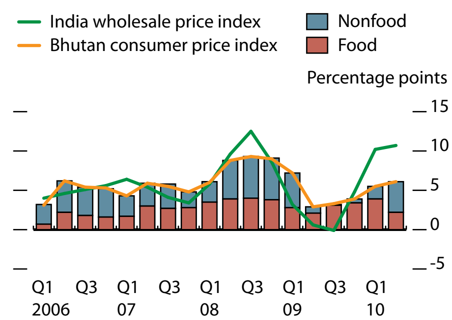
3.16.2 Contributions to inflation



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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3.16.1 Selected economic indicators (%)

	2011	2012
GDP growth	7.5	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-20.0	-20.0

Source: ADB estimates.

This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

enterprises, including Tala Hydroelectric Project Authority, such that dividends were not immediately passed through to the budget.) The final figure of the fiscal deficit in FY2010, may, however, be substantially lower due to underimplementation of capital investment projects. The fiscal deficit in FY2011 is estimated at 4.4% of GDP. A civil service wage hike effective January 2011 will increase current spending in FY2011 and FY2012.

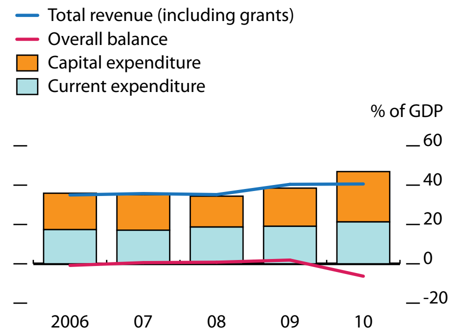
The government has announced tax incentives to stimulate private investment. Foreign direct investment (FDI) projects in FY2010 with an estimated investment of Nu1.1 billion (equivalent to $23.6 million) included an IT park and an agro-industry project.

The trade deficit is estimated to have worsened to 21.5% of GDP in FY2010 from 7.5%, as growth in merchandise imports accelerated markedly (Figure 3.16.4). Imports climbed by 39.0%, mainly because of heavy needs for machinery, transport vehicles, and base metals for the hydropower projects and housing.

Exports rose by only 5.5% as sales of hydropower to India (about two-fifths of total exports) were pretty flat as capacity production has been reached. A jump in budgetary grants, mainly from India, held the current account deficit to 13.5% of GDP in FY2010 from 1.6% the previous year.

The capital and financial account surplus—about half in capital grants and half in borrowing and FDI—nearly offset the current account deficit. The overall balance of payments was in surplus by $94 million, giving an unusually large positive errors and omissions item. Gross international reserves rose to the equivalent of $868.1 million at end-FY2010, equivalent to about 12 months of merchandise imports.

3.16.3 Fiscal indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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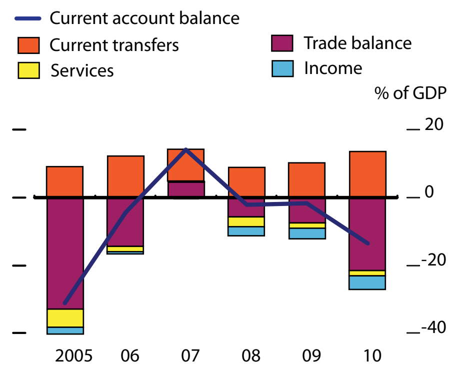
3.16.4 Current account indicators



Source: Royal Monetary Authority. 2011. *Annual Report 2009/10*. http://www.rma.org.bt

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Economic prospects

In addition to the construction of two hydropower stations, preconstruction works for Punatsangchhu II (990 MW) and Mangdechhu (720 MW) projects started in May 2010. Hydropower construction will therefore fuel GDP growth for the next 5 years, even as additional power production capacity and exports come online. Indeed, the government plans by 2020 to see new power stations increase generation capacity to 10,000 MW, about seven times the present level. Accordingly, GDP is estimated to grow by 7.5% in FY2011 and 8.0% in FY2012.

High inflation in India, especially of food, is a concern. Projected higher global commodity price hikes will indirectly affect Bhutan, where inflation is expected to reach 8.0% in FY2011 and moderate to 7.5% in FY2012.

The current account deficit will deteriorate, mainly owing to imports of construction materials for power stations, as well as higher import prices of fuel. Export growth will likely be limited in the next couple of years. Expansion will need to come mainly from manufactured and commodity exports, as no additional power generation capacity will come online.

Although tourism revenue will grow, soaring imports are expected to push the current deficit out to around 20% of GDP in both years. As with past projects, capital inflows from India to finance power plant construction, combined with development assistance, FDI, and some other borrowing, will likely suffice to finance the current account deficit.

3.16.1 Development challenges

The slowdown in economic growth in FY2009, when neither new construction or new production in the power sector were strong, indicates that growth is not being led by productivity improvements or new business ventures. The government's decision to undertake the Thimphu Technology Park and Education City projects are attempts to foster economic diversification by moving toward a knowledge-driven economy.

Generating jobs is hard, as hydropower has small backward linkages and is capital intensive. Speeding up private sector development is therefore crucial to expand job opportunities and diversify the economy.

The government has announced Fiscal Incentives 2010—a broad array of general and sector-specific tax incentives—as well as Foreign Direct Investment Policy 2010, to promote private sector investment.

India

The Indian economy experienced high and broad-based growth over the past fiscal year. Inflation has been the main challenge for policy makers, with the observed pattern of price increases highlighting the need to tackle decisively weaknesses along the domestic agricultural supply chain. Weaker global trade growth and a necessary further tightening of fiscal and monetary policies will slow economic growth marginally in the new fiscal year. However, progress on fiscal consolidation and success in easing supply-side constraints will pay off the following year.

Economic performance

The economy grew by 8.6% in FY2010 (ending March 2011) according to the government's advance estimates. Growth has been broad-based and driven by a solid recovery in agriculture and continued good performance of industry and services (Figure 3.17.1).

Helped by a good monsoon that boosted the *kharif* (summer) crop, agriculture is estimated to grow by 5.4% in FY2010, after 0.4% in FY2009, when a deep and widespread drought (and subsequent flooding) held back farming. Foodgrain production, estimated at 232 million tonnes in FY2010, is 6.4% higher than FY2009's output (though still lower than the record 234 million tonnes in FY2008).

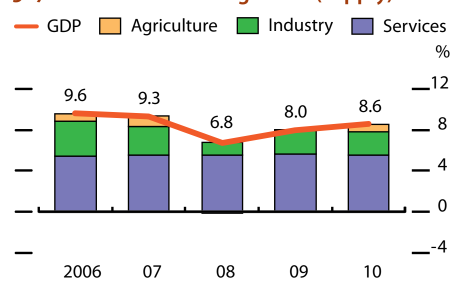
While industry is estimated to record healthy growth of 8.1% in FY2010, the second half saw a moderation of growth. In particular, after growth of 10.1% in the first half, industrial output growth slowed to single-digits in the second.

The main contributors to strong growth in the first half of FY2010 were consumer durables and capital goods. Important infrastructure sectors, such as crude oil, petroleum refining, electricity, and steel, also performed well. Apart from the base effect, the deceleration in the second half has been driven by a slowdown in capital goods production owing to a slowdown in investment. While it is difficult to pin down the exact cause of the investment slowdown, delays in obtaining environmental clearances, difficulties with land acquisition, and the lack of progress on some expected policy reforms may have played a role.

Services are estimated to grow by 9.6% in FY2010, a little lower than the 10.1% growth registered in FY2009. Key drivers included the trade; hotels; transport and communications; and finance, insurance, real estate, and business subsectors. Given the dominance of services, their healthy performance is crucial for high overall growth. This sector accounted for 64% of overall GDP growth in FY2010, down from 71% in FY2009.

The drivers of growth from the expenditure side have also been broad-based (Figure 3.17.2), with healthy contributions from private

3.17.1 Contributions to growth (supply)



Source: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011).

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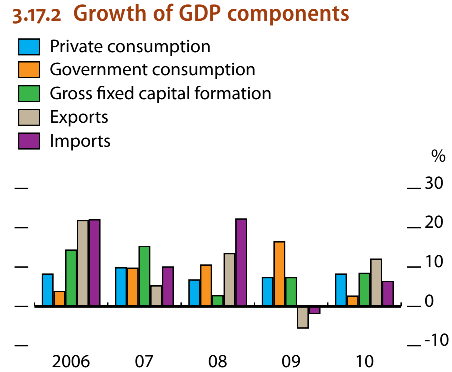
3.17.2 Growth of GDP components



Sources: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in (accessed 8 March 2011); ADB estimates.

Click here for figure data

This chapter was written by Rana Hasan of the India Resident Mission, ADB, New Delhi.

consumption, investment, and exports. While total consumption growth slowed from 8.7% in FY2009 to 7.3% in FY2010, this stemmed from a concurrent sharp decline in growth of government consumption from 16.4% to 2.6%; growth in private consumption—which accounts for more than four-fifths of total consumption—rose from 7.3% to 8.2%.

Similarly, although growth in gross capital formation slowed from 13.8% to 8.8% over the same period, fixed capital formation edged up from 7.3% to 8.4%. Nevertheless, the full figure for FY2010 masks a slowdown in the second half when fixed capital formation growth dropped from double digits in the first half to 6% in the third quarter. In contrast, exports picked up significantly in the second half, leading net exports to contribute positively to growth for the first time in many years.

With the onset of global recovery, investment registered a marked increase from 34.5% of GDP in FY2008 to 36.5% in FY2009, driven by a rise in corporate sector investment of 1.7 percentage points of GDP. The investment rate is estimated by the Economic Advisory Council of the Prime Minister to have increased to 37%. The saving rate recovered somewhat in FY2009 to 33.7% of GDP and appears to have risen marginally to 34% in FY 2010. Both saving and investment remain, however, below their precrisis highs (Figure 3.17.3).

Inflation has been a major concern in FY2010. While monthly year-on-year rates moderated from the double-digits reached in mid-2010, they are estimated to have been 9.2% for the fiscal year. Food inflation has been an important driver, accounting for between a quarter and a third of monthly wholesale price inflation in FY2010.

Much of the initial surge in food inflation in FY2010 (Figure 3.17.4) came from the weak FY2009 monsoon's impact on output and prices of cereals, pulses, and sugar. It has later been driven by subcontinent-specific weather shocks and demand–supply mismatches, as rising incomes and shifting dietary patterns increased demand for vegetables, fruits, and high-protein items. These factors have highlighted the need for dramatically improving production and distribution systems in agriculture.

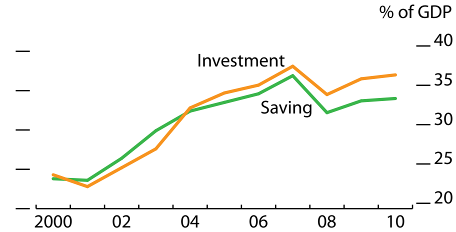
Finally, as the product-based breakdown of the figure shows, price increases in manufactured products have been important and have contributed to worries that inflation expectations are becoming entrenched.

Tackling the problem of high inflation has turned out to be complex. In response to rising inflation and a recovering economy, the Reserve Bank of India (RBI) reversed its accommodative policy stance in March 2010. The RBI has raised the repo rate (the rate at which banks borrow from it) eight times by 200 basis points in FY2010, which now stands at 6.75%; it has also raised the reverse repo rate (the rate at which it borrows money from banks) over the same period, and that now stands at 5.75% (Figure 3.17.5). The central bank also raised the cash-reserve ratio from 5.5% to 6.0% in April 2010.

The RBI recognizes that monetary policy may not be the most effective instrument to deal with supply-side pressures on inflation. But its concern is that the repeated supply shocks that have affected the economy, along with recent petroleum price increases, have generated expectations of high inflation and may contribute to future inflation. The increase in key policy rates has been partly carried out to contain such expectations.

Liquidity tightened considerably owing to an increase in credit growth

3.17.3 Saving and investment ratio



Source: *Asian Development Outlook* database.

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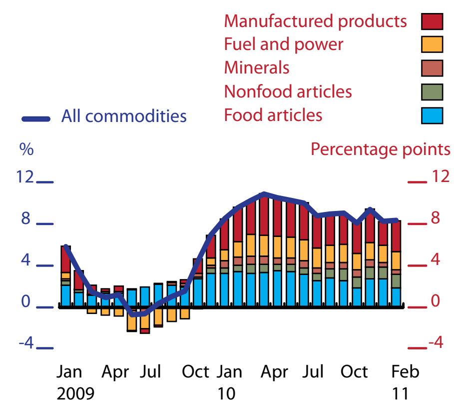
3.17.4 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 17 March 2011).

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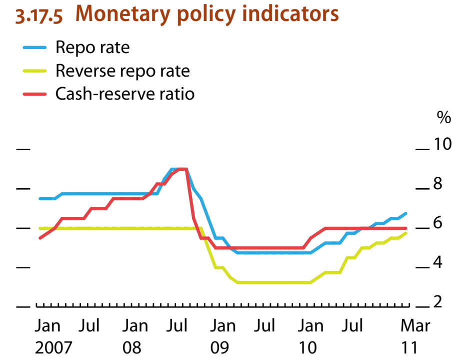
3.17.5 Monetary policy indicators



Source: CEIC Data Company (accessed 18 March 2011).

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and a fall in the deposit growth rate. The latter was driven by depressed real interest rates, withdrawal of deposits by telecoms companies to pay third-generation license fees, and purchases related to initial public offerings. To bolster deposits, banks have begun revising deposit rates upward by 50–75 basis points.

Merchandise exports are expected to climb from $175 billion in FY2009 to $230.3 billion in FY2010, but rising oil prices and resurgent domestic demand have taken imports from $295.5 billion to $362.3 billion (Figure 3.17.6), pushing out the trade deficit from $120.5 billion to $132 billion in FY2010. The first half of FY2010 also recorded sluggish performance of invisibles, largely due to the nonsoftware component of services.

As a result of these trends, the current account deficit is estimated to increase from $38.4 billion in FY2009 to $50.3 billion in FY2010. But a stronger currency and high nominal GDP growth in FY2010 means that, as a share of GDP, the current account deficit is estimated to be around 3.0%, a little higher than FY2009's 2.8%.

The capital account surplus is estimated to have improved from $47.8 billion in FY2009 to $64.6 billion in FY2010. Much of this gain is based on higher portfolio and debt flows, with the former increasing from $32.3 billion during FY009 to $38.8 billion in FY2010. These flows tend to be volatile, however, as seen by a net outflow of portfolio investment of $19.8 billion in November 2010 (Figure 3.17.7).

The upsurge in portfolio inflows was largely due to a global risk rally, leading to higher capital flows to emerging markets and interest shown in some public offerings. These flows helped the stock market to put on 30% in May–October 2010, though it has since declined by about 12.7% (Figure 3.17.8). In contrast, foreign direct investment (FDI) inflows slowed notably, from $35.6 billion in FY2009 to $27.6 billion in FY2010. The deceleration can only partly be explained by a still weak global recovery. Difficulties in land acquisition and environmental issues and slow progress of liberalization of certain sectors such as retail and insurance are likely also to have played a role.

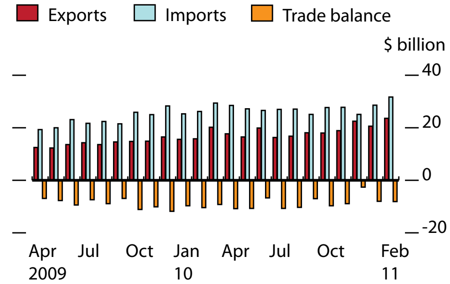
The excess of capital flows over the current account deficit resulted in accretion to foreign exchange reserves, which rose by $17.8 billion to exceed $300 billion in March 2011 (Figure 3.17.9). A part of this rise was due to valuation change as some of the major currencies appreciated against the US dollar during the year.

The rupee has remained quite stable in FY2010. It rose marginally against the US dollar. Inflation higher than in trading partners has led to a modest rise in the real effective exchange rate (Figure 3.17.10).

Better than expected revenue from the sale of third-generation spectrum for high-speed telephony and broadband services, as well as robust GDP growth, helped to reduce the central government's fiscal deficit from 6.4% of GDP in FY2009 to 5.1% in FY2010, thereby restricting the combined deficit of the center and states to around 8.1% (Figure 3.17.11). The ratio of central government gross tax revenue (including states' share) to GDP increased to 10% in FY2010, improving from 9.5% in FY2009, but it remains much lower than the 11.9% achieved in FY2007.

Despite India's strong resilience to the crisis and its ability to post robust growth rates, it has made little progress in some reforms. Moves to increase

3.17.6 Merchandise trade



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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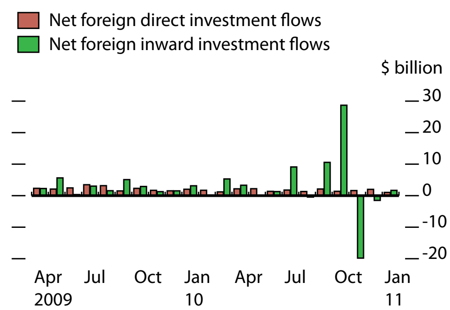
3.17.7 Investment



Source: Reserve Bank of India. http://www.rbi.org.in (accessed 26 March 2011).

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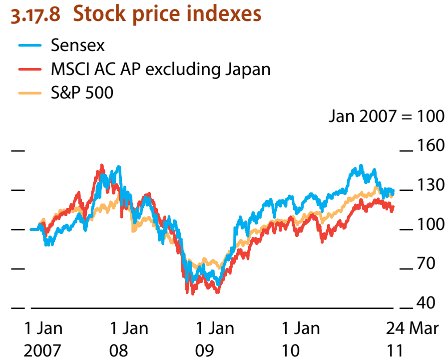
3.17.8 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.

Source: Bloomberg (accessed 24 March 2011).

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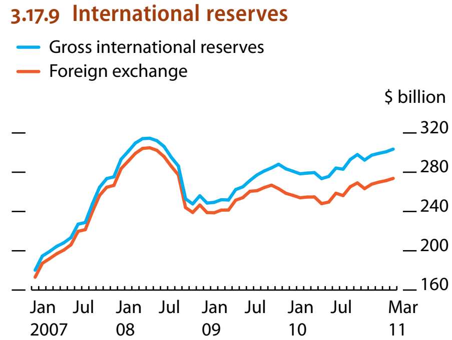
3.17.9 International reserves



Note: Gross international reserves includes gold and SDRs.

Sources: CEIC Data Company; Reserve Bank of India. http://www.rbi.org.in (both accessed 26 March 2011).

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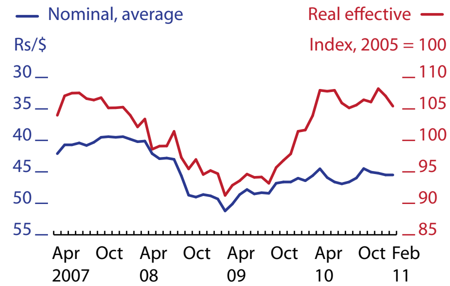
the limit of foreign investment in sectors such as retail and insurance stalled in FY2010. Also, some major industrial projects faced difficulties in getting the required clearances from the environment ministry.

Finally and critically, the move toward a unified goods and services tax (GST), which is an important step for fiscal consolidation, slowed, with the center and states gridlocked in negotiations. The states have been concerned about losing their fiscal autonomy, which would follow from a loss of power to change tax rates. They also have anxieties that a GST would raise their dependence on central government transfers. The center and states are also discussing GST rates, as some states view the proposed revenue-neutral rates as too low. Moreover, they disagree over the taxes to be subsumed under the GST system.

Recent months have, however, seen positive steps on some of these issues. A renewed effort is under way to allow greater FDI in retail and insurance in a phased manner. The environment ministry has allowed through (with conditions) some of the projects initially denied environmental clearance but has asked promoters for some of the others to apply afresh.

On the fiscal front, there is an attempt to move toward direct cash transfers for subsidized fertilizer, liquefied petroleum gas, and kerosene, which are expected to contain the waste and misdirection of these commodities. Last, the government on 21 March introduced to Parliament a constitution amendment bill to facilitate implementation of the GST.

3.17.10 Exchange rates



Sources: CEIC Data Company; Bank of International Settlements. http://www.bis.org; (both accessed 26 March 2011).

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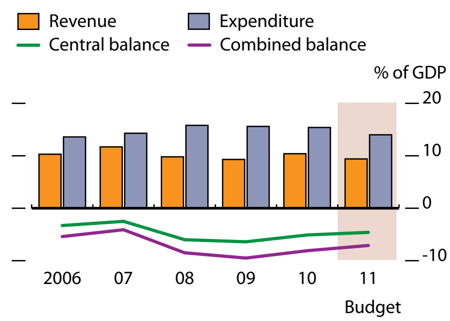
3.17.11 Fiscal indicators



Note: FY2010 is a revised, estimated budget outcome that includes the proceeds from telecoms auctions.

Source: Ministry of Finance. http://indiabudget.nic.in (accessed 21 March 2011).

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Economic prospects

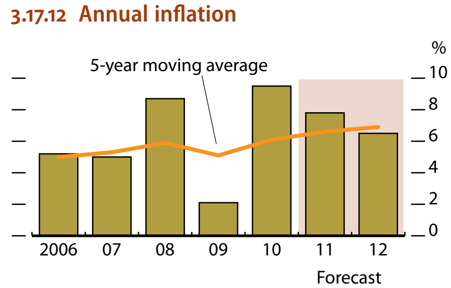
The following forecasts for FY2011 and FY2012 make several assumptions, in addition to those given in the baseline table 1.1.1 in part 1: the monsoons in both 2011 and 2012 will be normal; monetary tightening will continue in FY2011; and the government will broadly adhere to the rigorous fiscal consolidation road map suggested by the 13th Finance Commission.

While domestic pressures on inflation are expected to ease on account of normal monsoons and payoffs from the government's efforts at improving the agricultural supply chain, elevated international oil prices will exert upward pressure on prices. On balance, average inflation for FY2011 and FY2012 is expected to decline to 7.8% and 6.5%, respectively (Figure 3.17.12) on account of a high-base effect and further tightening of monetary policy by the RBI to anchor expectations.

Along with higher input prices due to rising oil prices, monetary tightening will tend to further damp private investment, which was slowing toward the end of FY2010. The government's efforts at fiscal consolidation will, however, help to provide some relief. Especially if consolidation proceeds largely as spelled out in the government's budget for FY2011—spending on subsidies is kept in check and planned infrastructure investment is not compromised—private investment may experience some "crowding in," even as the government reins in its overall spending.

Of course, elevated oil prices suggest that the government may not be able to hit its target for reducing subsidies by 12.5% in FY2011. Even with the move in 2010 to deregulate gasoline (petrol) prices, other fuel prices and natural gas remain under administrative control and the government

3.17.12 Annual inflation



Source: Asian Development Outlook database.

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is unlikely to raise their prices one-on-one with market conditions. Nevertheless, some reduction in subsidies should be possible and the government's intended move toward direct cash transfers of fuel-related subsidies could have far-reaching consequences in the medium term.

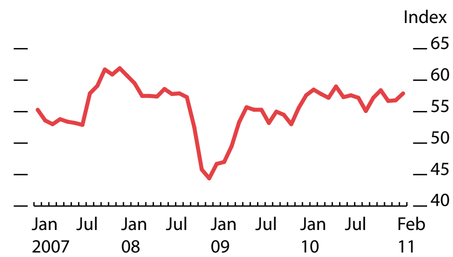
Based on the assumption of normal rainfall and with higher base, agriculture is expected to expand by 3%–4% in FY2011 and FY2012. In addition, proposed increases in public investment in the sector should provide it with a boost. But industry and services will remain the key drivers of growth.

At the same time, some large greenfield manufacturing projects have faced hurdles in terms of acquiring land and obtaining environmental clearance. Although these cases involve complex trade-offs between development, traditional livelihoods, and the environment, policy and regulatory clarity on these issues is crucial.

Yet the government's intention of streamlining the regulatory burden on Indian firms, and the expectation that current restrictions on FDI in multi-brand retail will be relaxed, augur well for both industry and services, especially by FY2012.

Sustaining growth also depends on external demand, which is assumed to moderate marginally following a rise in global economic risks. A survey by the HSBC Markit Purchasing Managers' Index for both manufacturing and services released in March 2011 shows some improvement, largely due to increase in orders and expansion in new business activity (Figure 3.17.13).

3.17.13 HSBC India manufacturing purchasing managers index



Source: Bloomberg (accessed 21 March 2011).

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But there are strong downside risks, notably inflation pressure from rising oil prices. In view of the *Asian Development Outlook 2011*'s assumptions for oil prices, as well as monetary and fiscal tightening, GDP growth is expected be a little lower in FY2011 than in FY2010 at 8.2%. It should rise to 8.8% in FY2012 as reform efforts and regulatory clarity boost investment and economic activity more generally.

The current account deficit is very likely to widen over the next 2 years—fairly sharply to 3.5% of GDP in FY2011—driven by a deteriorating trade deficit and moderate growth in invisibles. While foreign capital inflows have covered this deficit relatively comfortably in recent years, trends in FY2010 flag a cause for concern.

As is well known, international flows of portfolio capital can exhibit considerable volatility and thus the slowdown in inflows of FDI to India—in contrast to the pickup observed in other emerging economies—is troubling. The recent budget has relaxed norms for foreign institutional investors in order to attract more foreign capital, especially in infrastructure. But these also need to be backed by an improvement in the regulatory environment in which firms—domestic and foreign—operate.

3.17.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.2	8.8
Inflation	7.8	6.5
Current account balance (share of GDP)	-3.5	-3.3

Source: ADB estimates.

Development challenges

Sustaining high growth and ensuring that it is inclusive remains India's foremost development challenge. Even with the tremendous dynamism exhibited by services—a sector that has contributed almost two-thirds of GDP growth in recent years and now accounts for 55% of GDP and 25% of total employment—it is difficult to see how India will be able to sustain inclusive growth without boosting agricultural productivity and further strengthening manufacturing. The latter is crucial for employing a young and growing workforce—including those released from farm work—with productive and well-paying jobs.

Agriculture has suffered a secular decline in public investment since the mid-1990s, as well as a steady increase in input subsidies such as those for power and fertilizer. The country is behind comparable countries in investing in new technology, research and development, and infrastructure. For example, it invests only 0.5 % of its agricultural GDP in agricultural research, compared with 0.7 % in developing countries as a whole and as much as 2–3 % in developed countries.

A silver lining to the high food inflation over the past year is the urgency it has generated among policy makers to engineer a second green revolution in India (Box 3.17.1).

The task of transforming manufacturing also deserves the attention of policy makers. A defining feature of India's manufacturing is the overwhelming importance of small firms and the informal sector in jobs (also known as the unorganized sector). Thus 84% of India's manufacturing employment is estimated to be in firms with fewer than 50 workers (Figure 3.17.14), whereas the corresponding shares are 25%–47% for economies such as the PRC; the Republic of Korea; Malaysia; Taipei,China; and Thailand. At small scales of operation, firms can often get caught in a vicious circle of reliance on traditional, low-productivity technologies with limited earnings and few growth prospects.

At the same time, larger enterprises—those operating in the formal (or organized) sector where both productivity and wages tend to be relatively high—have often been stymied by infrastructure and regulatory bottlenecks from expanding. As a result, although employment in the subsector grew robustly in 2004–2008, it still stood at only some 11 million (around 2.5% of the labor force).

From a policy perspective, there are two broad challenges for transforming manufacturing. For the formal subsector, much policy reform has already taken place—such as industrial delicensing in the 1990s and large-scale cutbacks in small-scale sector reservations in the early to mid-2000s.

What remains to be tackled are infrastructure bottlenecks, features of India's labor regulation that impinge on the adjustment of labor use within and across plants and sectors, and difficulties in the acquisition of land and environmental clearances for industrial activity. The government's recent announcement on a manufacturing policy that will tackle various regulatory issues is an opportunity to make headway on difficult institutional and politically sensitive issues.

For the informal subsector, and small and medium-sized enterprises in the formal sector, imperfections in credit markets and lack of awareness and access to markets and technologies add to the infrastructure-related difficulties that these firms face. While the government has in place a variety of interventions for assisting such firms in these areas, the key challenge lies in effectively delivering program services to target enterprises. To make sure that public financing is not wasted, clear benchmarks for success and failure must be adopted, and rigorous monitoring and evaluation systems must be built into the government's programs.

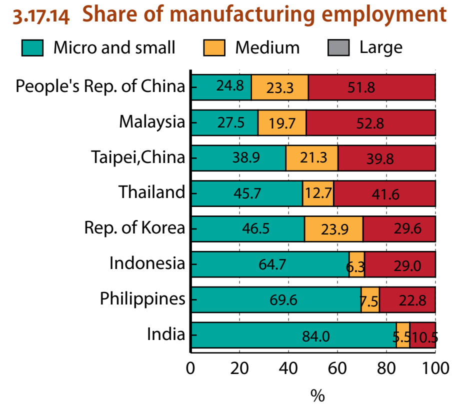
3.17.1 Transforming agriculture

The government has announced higher funding for a slew of programs aimed at dealing with production and distribution bottlenecks for fruits, vegetables, milk, meat, poultry, and fish—items that have been particularly susceptible to large price increases.

Efforts for developing "mega food parks" (for reducing wastage of fruit and vegetables for lack of storage facilities) and augmenting storage capacity and cold chains through public–private approaches are also being promoted. The government will recognize cold chains and postharvest storage facilities as an infrastructure subsector in its own right, making it eligible for any special benefits that apply.

Careful monitoring and evaluation of these efforts is needed to ensure that they have the intended effects. At the same time, state governments must review the operation of the Agricultural Produce Market Committee Act. Revamping this act would allow, for example, agro-processors, private markets, corporations, and exporters to directly deal with farmers and ease restrictions that apply to contract farming and the movement of agricultural produce from one location to another.

3.17.14 Share of manufacturing employment



Notes: Micro and small: 1–49 in all countries except Thailand (1–50 workers); Medium: 50–199 in all countries except Thailand (51–200 workers); Large: 200 or more workers in all countries except Thailand (more than 200 workers)

Source: Rana Hasan and Karl Robert Jandoc. 2010. The distribution of firm size in India: What can survey data tell us? *ADB Economics Working Paper Series* No. 213. Asian Development Bank, Manila.

Click here for figure data

Maldives

The Maldives is attempting to push through major fiscal reform, but government efforts to implement deficit-reduction measures have been impeded by political sensitivities. The passage of new tax bills in 2010, although it took longer than scheduled, will generate revenue gains in the near term. Nevertheless, the government will need to formulate a strong medium-term adjustment strategy in order to get its economic program supported by international financial institutions.

Economic performance

The government struggled to implement fiscal reforms in 2010. Since the president's party is in the minority in the *Majlis*, it faced difficulties in pushing reforms through Parliament. The agenda included a Tourist General Service Tax (T-GST) and Business Profit Tax (BPT). As the political situation worsened from midyear—the cabinet resigned en masse—progress in fiscal reforms has slowed, especially in the area of expenditure reduction.

The T-GST was, however, passed in August, becoming effective in January this year; the BPT was passed in December and takes effect in July this year. The fiscal gap would have been larger had it not been for a temporary cut in civil servants' wages. An improvement in revenue on the back of a rebound in tourist arrivals also helped to narrow the budget deficit for the year.

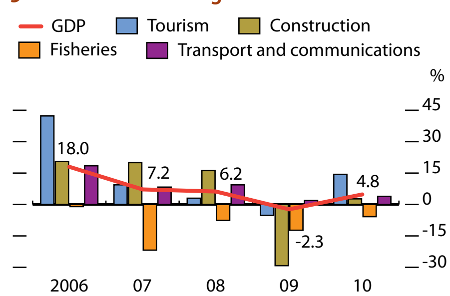
Against this backdrop, GDP growth recovered to 4.8% in 2010 after contracting by 2.3% in 2009 (Figure 3.18.1). A key driver was a better than expected upswing in tourism, which accounts for almost a third of GDP. Tourist arrivals registered a rebound of 20.7% in 2010. An influx of visitors from the People's Republic of China, the Republic of Korea, India, and other Asian countries outpaced a slower renaissance in European arrivals, a market usually accounting for around two-thirds of total visitors (Figure 3.18.2). As tourism gathered momentum, its linked sectors—transport and communications, and wholesale and retail—saw growth of 3.9% and 4.8%.

Fisheries have been performing poorly since 2006, reflecting a decline in the fish catch, and, contracting by 5.8%, were a drag on growth. Despite constituting only 3.2% of GDP, the industry is a major source of employment in many of the outer atolls.

Due to the country's import-dependent nature, rising international prices for fuel and food exerted upward pressure on domestic prices in the second half of 2010 (Figure 3.18.3). Inflation was 5.1% in December 2010, 1.1 percentage points higher than a year earlier.

While credit to the private sector continued to fall (by 2.4% year on

3.18.1 Selected GDP growth indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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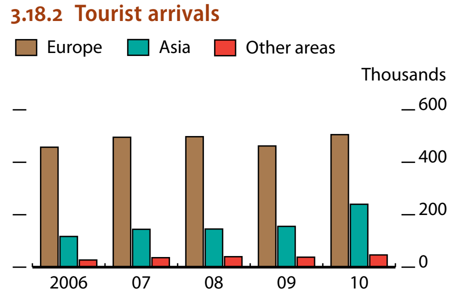
3.18.2 Tourist arrivals



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

Click here for figure data

This chapter was written by Eleanor Bacani and Tadateru Hayashi of the South Asia Department, ADB, Manila.

year in December 2010), Treasury bills held by banks rose by 28.4% as part of a 32.9% expansion in net credit to the government. Broad money increased by 16.5%. The interest rate on T-bills declined in the first half of 2010, but partly came back during the second (Figure 3.18.4).

The fiscal deficit is estimated to have narrowed to 16.4% of GDP in 2010 from 30.9% in 2009 (Figure 3.18.5). Although total revenue (excluding grants) is expected to have picked up by 14.6%, reflecting a rebound in tourism-related earnings and profits received from the airport concession, it was 11% below the original projection after the T-GST and BPT did not materialize in time to boost 2010 revenue as planned. Expenditure dropped by 10.2% as the government put through temporary fiscal austerity measures, such as wage cuts for public servants.

The Rf12.37 billion ($962.6 million) budget for 2011, passed in December 2010, sets only a slight reduction in the deficit to 15.3% of the GDP. Upfront payments by resort islands for lease extensions, from 25 to 50 years, as well as new tax measures, will increase fiscal revenue. But there is so far no clear road map for long-term expenditure saving.

On the external front, the current account deficit is estimated to have slightly narrowed to 31.3% of GDP in 2010 from 31.8% in 2009, as the gain in tourism receipts was outweighed by higher imports (Figure 3.18.6). While reserves declined through most of the year they spiked in November, on a $74 million upfront payment by the airport concession. This transaction helped to push the overall balance of payments into surplus, lifting gross international reserves by about one-third to $349.9 million in 2010, yielding 3.3 months of import cover. The Maldives Monetary Authority continued its currency peg to US dollar at a rate of Rf12.8, though foreign exchange shortages and a parallel market premium persisted during the year.

Economic prospects

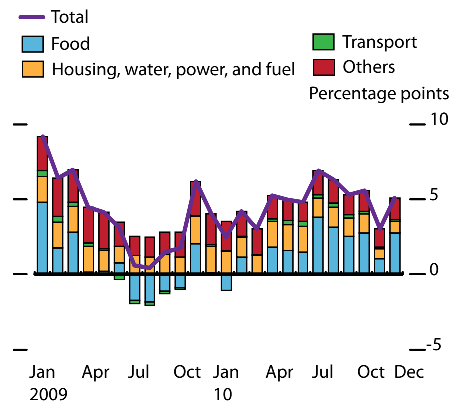
Tourism is likely to lead economic growth. Tourist arrivals from Europe should continue recovering, and the number of Asian tourists will continue growing, as their disposable incomes improve.

The 2011 budget plans about a 25% increase in total expenditure, and the medium-term fiscal framework projects the same level of expenditure in 2012, a marked turnaround from the near 12% decline a year earlier. At nearly three-fifths of GDP if fully carried out, these plans represent a marked expansion in domestic demand. On the basis that planned expenditure is scaled down and tourism makes further gains, GDP is expected to grow by 5.0% in each of the next 2 years.

On the assumption that the global oil and food prices rise substantially in 2011 and moderate in 2012, and budget expenditure pressures on domestic inflation. It is projected that inflation will rise to 8.0% or more in 2011, and moderate to 7.0% in 2012.

Steady economic growth, primarily due to the tourism rebound, and higher international commodity prices will buttress merchandise import growth. Assuming that the currency peg to the US dollar continues, growth in imports will continue to outpace tourism receipts, the current account deficit is expected to widen to 35% of GDP in 2011 and will remain at this level in 2012.

3.18.3 Contributions to inflation



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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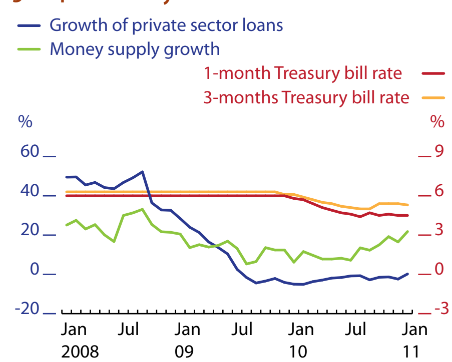
3.18.4 Monetary indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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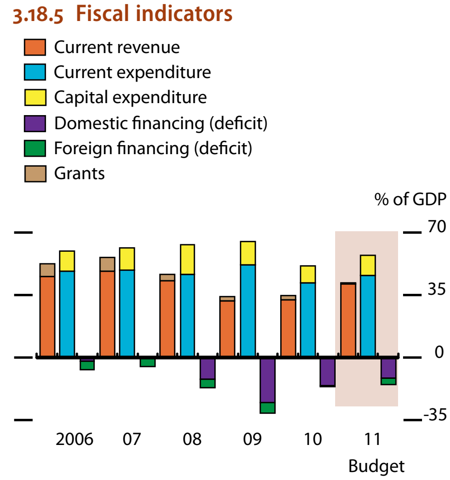
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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Development challenges

Persistent fiscal and external imbalances have rendered the country vulnerable to external shocks. International financial institutions have therefore been supporting the government's reform initiatives, including a stand-by arrangement with the IMF. The lack of a political consensus has prevented agreement on the next steps in the country's medium-term adjustment strategy, though these are expected to be resolved in due course.

Reducing income disparities between Malé and the atolls is important. Private sector development, especially promotion of micro-, small- and medium-sized enterprises outside Malé, is therefore critical. Such promotion is also an important mandate of the government through its decentralization policy.

Weak institutions and human resources are major constraints. Public sector institutions face capacity constraints, since pay in the civil service lags far behind the private sector, and second jobs among public employees are common. While heavy reliance on expatriate labor has allowed the Maldives to grow strongly for many years, the downside is that existing institutions do not have adequate capabilities.

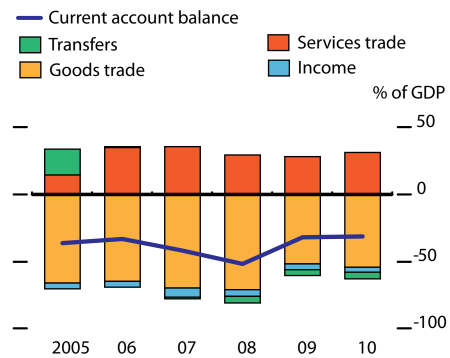
As one of the world's most vulnerable nations to sea-level rise, the government has announced plans to become the first carbon-neutral country in the world within a decade. It is preparing an investment plan along these lines, and hopes that it will not only serve as a blueprint for other nations but also draw world attention to climate change.

3.18.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.0
Inflation	8.0	7.0
Current account balance (share of GDP)	-35.0	-35.0

Source: ADB estimates.

3.18.6 Current account indicators



Source: Maldives Monetary Authority. 2011. *Monthly Statistics*. February. http://www.mma.gov.mv

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Nepal

Political uncertainties, unfavorable weather, and weakening remittances from workers abroad restrained economic growth in FY2010. Fiscal prudence continued. Growth will fall below the 5-year average of 4.0% in FY2011, primarily reflecting the protracted postconflict transition process, but a modest pickup is foreseen in FY2012, supported by tourism and more vibrant construction activity. Key risks to growth are further delay to completing the transition, high food and oil prices, and potential impact of unrest in the Middle East.

Economic performance

GDP growth inched up to 4.0% in FY2010 (ended 15 July 2010) from 3.8% in FY2009 (Figure 3.19.1). The marginal improvement was made possible by a turnaround in growth in the relatively small industry sector (helped by fewer political strikes), and sustained expansion of services. A deceleration in remittance inflows due to the lagged impact of the global financial crisis weighed on economic activity, as did slowing agricultural output (for a second year) due to a sparse monsoon.

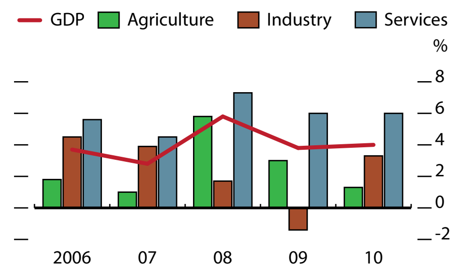
The deceleration in remittance growth, alongside commercial banks' excessive lending to real estate and reduced liquidity in banking, drove interbank borrowing rates to a record high. Inflation stayed close to double digits owing to high food prices in the first half of FY2010 (Figure 3.19.2), which in turn originated in a low domestic crop and India's high food-inflation.

Exports as a share of GDP have been dwindling in the last few years, because low productivity and infrastructure bottlenecks have undermined competitiveness. Conversely, imports as a share of GDP have been showing a trend increase over several years, with growth more pronounced in FY2010, as gold imports swelled. (Gold was the investment of choice, given paucity of attractive alternatives in a correcting real estate market.)

The widening trade deficit, coupled with slowing remittances, took the current account deficit to 2.7% of GDP in FY2010 from a surplus of 4.2% of GDP the year before. This led to a $113 million decline in official reserves. The authorities accessed $42 million from the International Monetary Fund through its Rapid Credit Facility, which provides concessional assistance to low-income countries to tide them over external shocks.

Previous years' fiscal stability was maintained, with the deficit narrowing from 3.3% of GDP in FY2009 to 2.0% of GDP, though this apparent improvement stems from delayed approval of the FY2010 budget and from a continued difficult environment for implementing projects, which kept capital spending to only 70% of target. Revenue collection

3.19.1 GDP growth by sector



Source: Central Bureau of Statistics.

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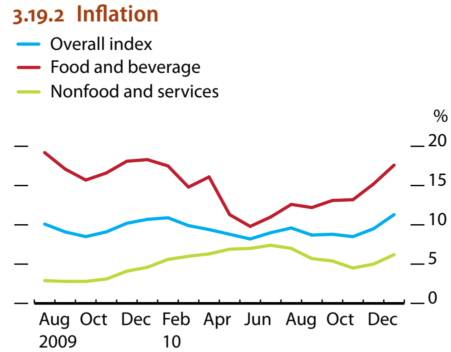
3.19.2 Inflation



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

Click here for figure data

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

preserved its recent positive momentum, helping to offset the continued surge in recurrent spending, notably on civil servants' and teachers' salaries. Small fiscal deficits and large grants by multilateral agencies have helped to improve the public debt position in recent years (Figure 3.19.3).

Despite a challenging political environment, the share of the population living below the national poverty line of about $160 a year is estimated to have declined to 25% in 2010 from 31% in 2004, largely owing to robust remittance inflows, rapid urban growth, a decline in fertility, and rising agricultural wages.

Strides have also been made in other Millennium Development Goals, such as child and maternal mortality, although greater efforts are needed to achieve similar progress in areas such as productive employment and child malnutrition. Efforts are also needed to reduce inequality—currently the highest in South Asia, with a Gini coefficient of 0.47.

Economic prospects

Economic performance in FY2011 and FY2012 will rest primarily on progress in the postconflict transition process—currently slow as seen in the 1-year extension, to May 2011, of the tenure of the Constituent Assembly that was elected to draft a new constitution. The political vacuum and drift created following the Government's resignation in June 2010 ended only in February this year. The FY2011 budget was promulgated only by ordinance 4 months into the fiscal year.

All these delays reflect the difficult transition that Nepal is suffering. With little time left for writing the constitution, many of the contentious issues, such as army integration and state restructuring, have yet to be resolved.

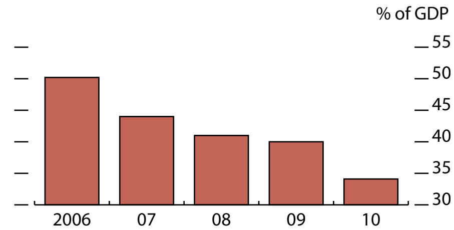
The protracted transition and the associated political disruptions have hit the economy. The delay in announcing the FY2011 budget, for example, has undermined solid progress made recently in revenue mobilization, which achieved 25% average annual growth in the last 4 years (Figure 3.19.4). More important, it has deprived the population of a much hoped-for peace dividend, including greater capital spending (Figure 3.19.5) and development benefits.

GDP growth is forecast to weaken slightly to 3.8% in FY2011. Agriculture is expected to grow by 4.0% in FY2011 (up from 1.3% in FY2010), largely due to a weather-induced recovery in the output of key summer crops (Figure 3.19.6). This improvement will not, however, be enough to offset the deceleration in nonfarm activities.

Political uncertainty, as well as power cuts (lasting as much as 14 hours a day since mid-February this year) will continue to take a toll on nonfarm activities. The tightening FY2011 monetary policy of Nepal Rastra Bank (NRB, the central bank), aimed at stabilizing the real estate market, will further curtail services expansion, to 4.5% growth in FY2011, down from 6.0% in FY2010. A slowdown in construction activity and higher fuel costs will limit industry's growth to 1.0% in FY2011, compared with 3.3% a year earlier.

GDP growth is expected to improve modestly to 4.0% in FY2012 (assuming continued normal weather conditions). A pickup in tourism-related activities driven by the Nepal Tourism Year 2011 campaign should

3.19.3 National debt



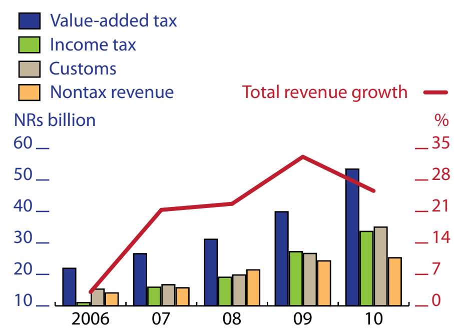
Sources: Ministry of Finance. Financial Comptroller General Office; ADB estimates.

Click here for figure data

3.19.1 Selected economic indicators (%)		
	2011	2012
GDP growth	3.8	4.0
Inflation	10.0	8.0
Current account balance (share of GDP)	-0.5	-0.5

Source: ADB estimates.

3.19.4 Revenue indicators



Source: Ministry of Finance. 2010. *Economic Survey Fiscal Year 2009/10*. July. http://www.mof.gov.np

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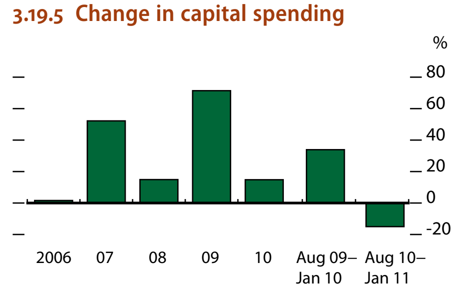
3.19.5 Change in capital spending



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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raise services growth to 5.5%. A modest uptick in construction activity, as NRB's policy is absorbed, should lift industry's growth to 1.5%.

Year-on-year inflation reached 11.3% in January, largely reflecting food and fuel price increases. A revision of the consumer price index—lowering the weight for food in line with the Fourth Household Budget Survey, 2005/06—has pulled calculated inflation down by about 1 percentage point relative to the previous method.

Average inflation for FY2011 is expected to be 10.0%. High food and oil prices and the domestic distortions such as power cuts will continue to exert upward pressure, only part of which will be offset by the good harvest. With likely moderation in Indian prices (see the chapter on India) and the government's measures to prohibit transport syndicates' restrictive practices (which have contributed to higher prices), 8.0% average inflation is expected in FY2012.

It is assumed that NRB will not tighten monetary policy further in the rest of FY2011 and FY2012 for two main reasons. First, the current policy stance has already considerably slowed real estate activity. A further tightening could trigger a disruptive correction in house and land prices, worsening the quality of commercial banks' loan portfolios and potentially posing a threat to macroeconomic stability.

Second, the expected moderation of Indian inflation will probably obviate any need for monetary tightening. NRB's attention is likely to be focused on establishing confidence in the banking system and enhancing its supervision capacity. The vulnerability of the commercial banking system has increased significantly in recent years due to a rapid emergence of other financial institutions (Figure 3.19.7). Recurring bank liquidity crunches are manifestations of this vulnerability, as deposits have reportedly been shifted from major commercial banks toward smaller financial entities that offer higher deposit rates, are difficult to supervise, and appear to take on riskier lending.

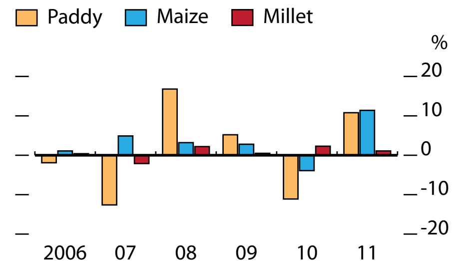
After sharply deteriorating in FY2010, the external position has since recovered significantly (Figure 3.19.8). Although the oil import bill is soaring because of higher prices, overall import growth has slackened, mirroring remittance inflows.

Exports have picked up, partly in response to the tax incentives for exporters announced in the FY2011 budget. As a result, the merchandise trade deficit has been limited to $2.0 billion in the first half of FY2011. Remittances and tourism receipts have offset 90% of this deficit. After an approximate 4% fall in FY2010, external reserves recovered this loss in the first half of FY2011, to reach $2.8 billion in January 2011, worth about 6 months of imports (Figure 3.19.9).

Both domestic and external factors will challenge any further strengthening of the balance of payments in FY2011. Domestic manufacturing is plagued by low productivity and poor infrastructure. Import growth will likely accelerate on higher oil prices, although it will be somewhat offset by remittance inflows, which were growing at about 18% in the first half (Figure 3.19.10). A current account deficit of 0.5% of GDP is expected in FY2011 and FY2012, reflecting little change in trends.

An escalation in political disruptions, if the peace process bogs down, is the key downside risk to growth prospects. A further risk is an abrupt downward correction in the real estate market, which would

3.19.6 Change in summer crop output



Source: Ministry of Agriculture and Cooperatives.
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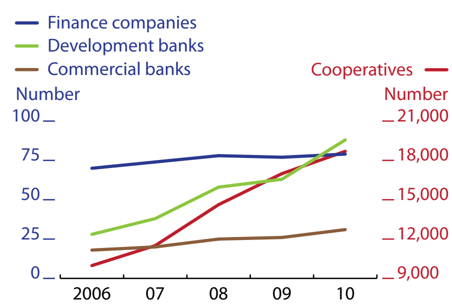
3.19.7 Financial institutions



Source: Nepal Rastra Bank. 2011. *Banking and Financial Statistics*. January.
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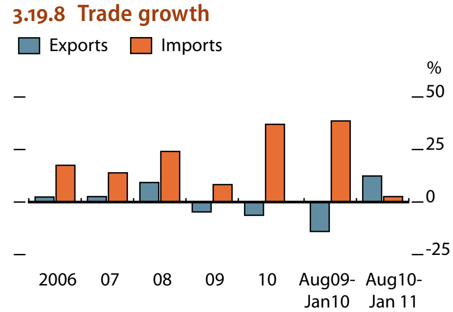
3.19.8 Trade growth

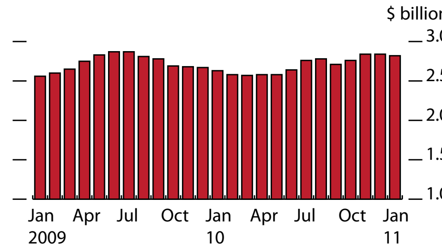


Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np
Click here for figure data

no doubt severely undermine revenue mobilization efforts and put many construction-related jobs in jeopardy. Given the high volume of commercial bank lending for real estate, surging loan defaults would repress normal financial activity.

Externally, the unrest in the Middle East is an emerging risk to the steady remittance inflows as the region is a key destination for Nepalese migrant workers. The recent earthquake in Japan could also hit Japanese tourist arrivals and aid flows to Nepal. An additional external risk is the surge in oil prices which could severely strain Nepal's external position and cause a supply shock if domestic prices are not adjusted accordingly. Nepal also remains vulnerable to high global food prices.

3.19.9 Foreign exchange reserves



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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Development challenges

Creating jobs for the country's burgeoning young population is a major challenge; unless managed properly, it could put at risk the country's economic growth prospects. Some 450,000 workers enter the labor market annually. More than half of them seek—and get—jobs in the Middle East and East Asia, particularly low-end work in construction and manufacturing. But it is Nepal that bears the social costs.

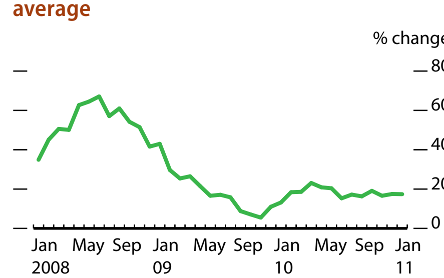
While under- and unemployment are widespread in all segments of the population, the position is particularly depressing for youth. Their nationwide unemployment rate is twice the national average. It is even worse in urban areas, where the decade-long conflict, lack of job opportunities in rural areas, and the concentration of higher level education institutions there have contributed to an influx of younger people.

Labor laws in Nepal—the most rigid in South Asia—are a major block to job creation, and need to be reformed to facilitate quicker recruitment and release of workers. Moreover, the academic curriculum needs to be modified to reflect labor market needs and to facilitate self-entrepreneurship, in part to capitalize on close ties to India and its prominence as a business services hub.

Progress toward completing the peace process, thereby leading to stronger investor confidence, will be important for faster job creation. The policy agenda should aim to strengthen business security, reduce red tape on firms' entry and exit, and scale up current initiatives, such as incentives for entrepreneurs in tourism.

Finally, the authorities should continue to work on developing a clear policy for public–private partnerships. It would assist the country to unlock the massive hydropower potential, paving the way for large infrastructure projects—their implementation has so far remained elusive.

3.19.10 Remittance inflows, 5-month moving average



Source: Nepal Rastra Bank. 2011. *Recent Macroeconomic Situation*. January. http://www.nrb.org.np

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Pakistan

Pakistan's economy faces considerable challenges. Floods in summer 2010 hit agricultural output and damaged transport and communication. Still high inflation, though recently falling, may well accelerate. Fiscal developments are worrisome: the rollback in recent oil price rises, a partial increase in electricity tariffs, delays in carrying out revenue-increasing measures, broad tax exemptions for residents of flood-affected areas, and continued heavy fiscal support to state-owned enterprises add to pressures on the fiscal deficit. The current account balance is improving, but capital and financial inflows continue to decline. Still, despite devastation and economic distress, growth will likely stay positive.

Economic performance

Pakistan's economic performance in FY2010 (ended June 2010) and into FY2011 reflects largely the same structural weaknesses that contributed to its FY2008 macroeconomic crisis. Energy shortages and security issues held the economic rebound for FY2010 to 4.1% (Figure 3.20.1), slowing growth for FY2008–FY2010 to an average of only 3%, well below the 8% needed to create jobs for the predominately young population.

Little recent progress has therefore been made in raising per capita incomes or reducing poverty. Delays in implementing policy measures and fiscal management practices necessary for macro stability have undermined investment in infrastructure and production capacity.

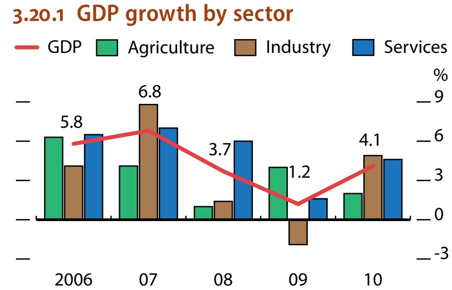
The modest expansion in FY2010 benefited from fiscal and monetary policies in FY2009 that eased macroeconomic imbalances by year-end, and from a decline in inflation that improved consumer confidence. Higher remittances provided additional support to an expansion of private consumption, as did improvements in rural income from increases in administered commodity prices. Heightened security concerns lifted public consumption, pushing total consumption's contribution to growth to nearly 80%.

From the supply side, transitory improvements in large-scale manufacturing partly reversed 2 years of declines and supported a recovery in services, led by wholesale and retail trade. Agriculture expanded by a modest 2%, due to weak performance by major crops.

The fragility of the recovery was underscored by continued investment contractions. Infrastructure shortages and security issues contributed to a 5.1% decline of gross private capital formation. Gross fixed capital formation contracted by 2.0% in FY2010, coming on the heels of an 11.3% decline the previous year.

FY2010 also saw a third consecutive year of declines in investment in large-scale manufacturing (down 15.4%) and electricity and gas (11.0% lower). Overall, the steady decline in total gross fixed investment as a

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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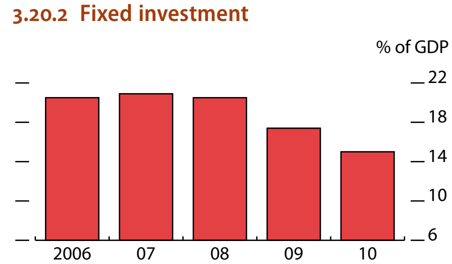
3.20.2 Fixed investment



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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This chapter was written by Dawn Elizabeth Rehm of the Central and West Asia Department, ADB, Manila; and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

share of GDP from 20.5% in FY2006 to 15.0% in FY2010 will crimp future growth prospects (Figure 3.20.2). Private savings have similarly declined, owing in part to the failure of key asset rates to keep pace with inflation, leading to either negligible or negative real returns.

Pakistan's fiscal balance deteriorated in FY2010, reflecting delays in putting through planned policy measures to improve revenue performance and limit the burden on the deficit of losses at state-owned enterprises (SOEs) and of energy-related subsidies. It widened from 5.3% of GDP in FY2009 to 6.3% in FY2010 (Figure 3.20.3), well in excess of the (revised) target of 5.1%. Revenue targets in the FY2010 budget, too, were missed and Federal Board of Revenue (FBR) tax receipts continued to decline as a share of GDP, reaching a 30-year low of 9.0% in FY2010.

Pakistan's current budget expenditure is relatively rigid, and it is difficult to offset overruns in one category with reductions in another. Inflexible current expenditure (such as security, interest, and pensions) alone absorbed revenue of 7.4% of GDP in FY2010, or about 82% of FBR tax receipts. Subsidies amounted to another 1.7% of GDP.

The government sharply curtailed the federal public sector development program (PSDP) to 3.5% of GDP to ease deficit pressure. Federal government borrowing from the State Bank of Pakistan (SBP), the central bank, as well as from commercial banks rose to PRs339.7 billion (2.3% of GDP), reflecting a widening deficit and lower external financing. Escalating losses from SOEs reached an estimated 1.7% of GDP for FY2010, adding to pressures.

Inflation fell to 11.7% in FY2010 from 20.8% in FY2009 (Figure 3.20.4). As it moderated, the SBP lowered the policy rate in steps from 14% to 12.5%. Broad money expanded by 12.5%, much faster than the 9.6% of the previous year.

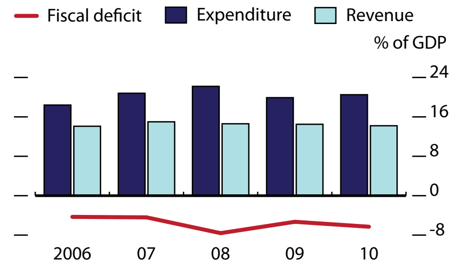
Developments in the external balances were mixed (Figure 3.20.5): the current account deficit narrowed, as imports declined by 1.7% with weaknesses in key industries (such as steel and oil refining) and a slump in investment; exports expanded by a modest 2.9% on higher exports of textiles, rice, and pharmaceuticals. Improvements in the service and income accounts contributed.

Yet financing the current account deficit became more difficult over the year: the capital and financial accounts fell by almost 13.4%, after a 26.2% decrease the year before. Foreign direct investment flows continued their downward path in response to infrastructure and security concerns, with communications, transport, and power accounting for much of the decline.

Gross reserves improved, benefiting from International Monetary Fund (IMF) releases under a stand-by arrangement, rising to $16.8 billion by end-FY2010. The nominal exchange rate depreciated by 6.3%, but inflation—high relative to trading partners'—lifted the real exchange rate by 1.0%.

Pakistan's public debt (excluding guarantees) as a share of GDP continued to climb in FY2010 (Figure 3.20.6). Government domestic debt amounted to 37.0% of GDP, including commodity debt and liabilities of SOEs. External debt rose to 31.9% of GDP, including 0.6% of GDP in external liabilities of SOEs. Interest payments due on domestic debt represent a heavy burden, accounting for 3.9% of GDP in FY2010, or

3.20.3 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and Fiscal Operations July to June 2009–10. http://www.finance.gov.pk

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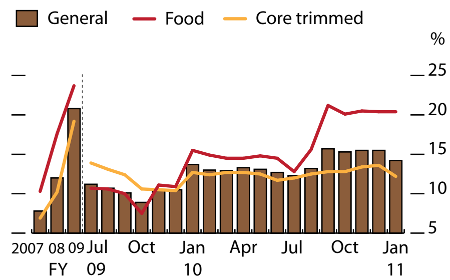
3.20.4 Year-on-year inflation



Note: Core trimmed inflation eliminates extreme outlying sample observations from the calculated average.

Sources: State Bank of Pakistan. *Annual Report 2009–2010* and Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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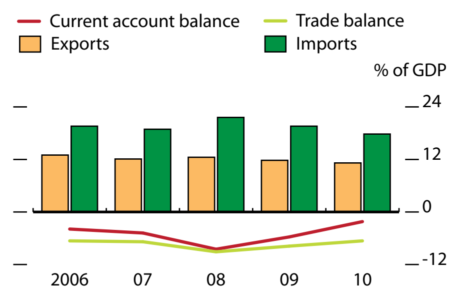
3.20.5 Current account indicators



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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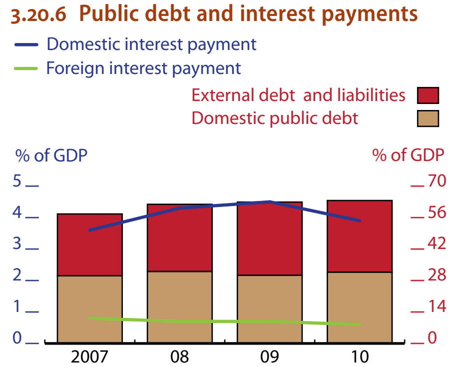
3.20.6 Public debt and interest payments



Sources: State Bank of Pakistan. *Annual Report 2009–2010* and *Statistical Bulletin March 2011*. http://www.sbp.org.pk.

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43% of FBR revenue. External debt amortization payments, excluding amounts owed to the IMF, are relatively stable for FY2010–FY2013 at about $3.3 billion. Amounts due for FY2012 and beyond will be raised substantially by repayment obligations to the IMF.

Government borrowing in the form of advances for commodity operations rose sharply in FY2009, in response to the bumper crop and increases in government-set procurement prices for wheat. With domestic prices higher than international prices, excess inventory was not sold. As this inventory looked as if it would not be sold nor loans repaid, banks' lending rates for government commodity operations rose, to exceed those for the private sector.

Prospects

Severe floods in July–August 2010 have affected FY2011's prospects. Damage was less severe than initially feared, but agriculture and communications were hit hard. Total damage is put at more than $10 billion, half in agriculture. For other areas, notably power and transport, damage was mild but widespread.

Information for the first 6 months of FY2011 points to a 1.7% contraction of large-scale manufacturing centered on textiles, food processing, and petroleum products, bringing the large-scale manufacturing index for September 2010 to its lowest since July 2007 (Figure 3.20.7).

With growth prospects reduced to 2.5% for FY2011 (Figure 3.20.8), average growth for FY2008–FY2011 is seen falling to 2.9%. Persistent energy shortages and security issues are expected to hold growth to 3.7% for FY2012, providing scant improvement on recent trends.

Inflation accelerated after the floods, to 15.7% in September, reflecting actual and expected shortages. It remained above 15% through December, falling to 14.2% in January owing to a government-freeze on oil and electricity prices. It is expected to stay high through FY2011, for an average annual 16.0%, and is then expected to recede in FY2012 to 13.0% (moderation in international food prices is likely to be at least partly offset by electricity price rises).

Pakistan began FY2011 with a budget that was based on policy measures that proved difficult to carry out. Revenue targets called for 26% growth of tax receipts, well over the 5-year average of 14%. Meeting them would have been hard even if a reformed General Sales Tax had come into effect. A reformed tax was initially scheduled for July 2010, but the process remains politically contentious, and any changes to the tax will have a limited effect on FY2011 receipts.

This tardiness, combined with the impact of the floods and wide tax exemptions for those in flood-affected areas, held FBR tax revenue growth to 10.9% in the first 7 months of FY2011, making a further decline in the tax-to-GDP ratio likely (Figure 3.20.9). (Total fiscal resources have also been affected by declines in nontax revenue.)

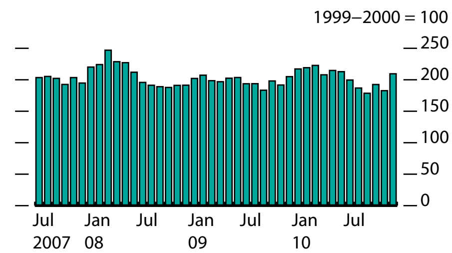
Current expenditure was under pressure due to a 50% wage increase for government workers, exacerbated by government failure to budget adequately for subsidies needed to cover the gap between notified and cost-recovery electricity tariffs. An annual budget allocation of

3.20.1 Selected economic indicators (%)

	2011	2012
GDP growth	2.5	3.7
Inflation	16.0	13.0
Current account balance (share of GDP)	-1.7	-2.3

Source: ADB estimates.

3.20.7 Large scale manufacturing index



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; Federal Bureau of Statistics. http://www.statpak.gov.pk (accessed 11 March 2011).

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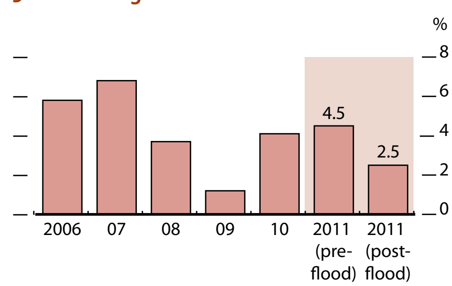
3.20.8 GDP growth



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; ADB estimates.

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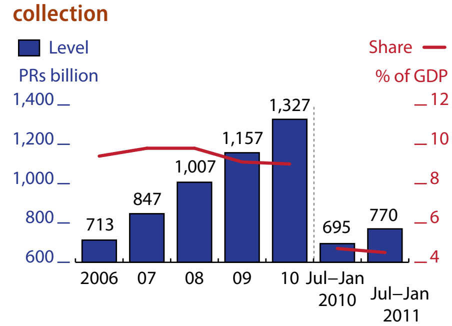
3.20.9 Federal Board of Revenue tax collection



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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PRs30 billion to cover the tariff differential turned out well short of expected cost, and because of lack of policy measures total energy-related subsidies are expected to reach PRs200 billion. Part of this gap was to be covered by 2% monthly increases in electricity tariffs to bring them into line with cost recovery. Energy-related circular debt (due to payment arrears in the sector), which stood at PRs446 billion at end-FY2010, is expected to surge by end-FY2011.

For a third year, overruns on recurrent spending were met with a compression of the federal PSDP (Figure 3.20.10). For the first half of FY2011, only PRs66 billion was made available for PSDP activities, less than 25% of the PRs280 billion earmarked in the FY2011 federal budget, with spending limited to key projects and priority development programs. The federal PSDP for FY2011 faced a further cut of PRs100 billion on a lack of resources. The government is giving priority to completing projects. The remainder of the PSDP (PRs373 billion) in the combined provincial budgets is also under substantial pressure from resource constraints.

With a fiscal deficit at 2.9% of GDP in the first half of FY2011, the annual fiscal target was also revised to 5.5% under the weight of higher international food and energy prices, escalating subsidies, and subdued revenue performance.

With lower foreign funding, deficit financing is expected to rely heavily on the domestic banking system. After easing in FY2010, government borrowing from that source has surged in FY2011, reaching PRs379 billion by 12 February, compared with PRs330.4 billion for FY2010 as a whole (Figure 3.20.11). Of this, about 34% reflected borrowing from the SBP, consistent with commitments from the government in late January to roll back borrowing from the SBP to September 2010 levels.

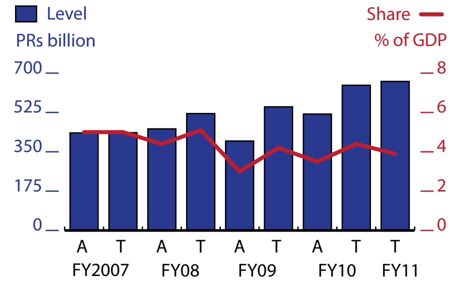
Credit to the private sector picked up but remained on the low side for various reasons. Banks expressed a preference for low-risk lending to government to offset flood-related increases in nonperforming loans, while weak postflood economic activity and rising borrowing costs held back demand for borrowing.

The pace of government borrowing from the banking system has supported a rapid expansion of broad money and reserve money: broad money growth for FY2011 through 26 February 2011 was much higher (7.7%) than in the same period of FY2010 (5.7%); the equivalent figures for reserve money were 14.9.% and 10.6%.

In response to the increase in inflation and growing evidence of its likely persistence, the SBP increased the policy rate in three successive 50 basis point increments from August 2010 to end-November 2010, bringing the rate back to 14.0% and reversing the cuts of FY2010 (Figure 3.20.12). In January 2011, the SBP left the policy rate unchanged, partly on the basis of commitments from the government to limit borrowing from the central bank.

Fiscal prospects for FY2012 are likely to improve as the political environment eases sufficiently to implement the revenue-enhancing and fiscal-management initiatives. Progress is expected in implementing reforms for the energy sector consistent with a move toward financial viability with a phased elimination of subsidy requirements, leaving enhanced fiscal space for development programs.

3.20.10 Public sector development program



A = Actual; T = Target.

Source: Ministry of Finance. *Fiscal Operations*. Various issues. http://www.finance.gov.pk

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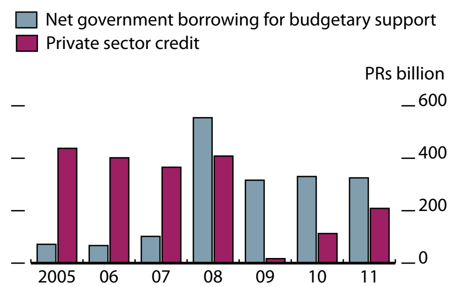
3.20.11 Budgetary and private sector credit



Note: 2011 data cover the period July 2010 to February 2011.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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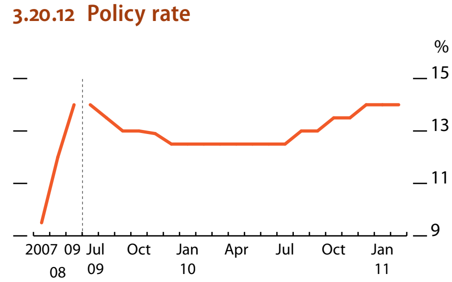
3.20.12 Policy rate



Source: State Bank of Pakistan. *Annual Report 2009–2010*. http://www.sbp.org.pk

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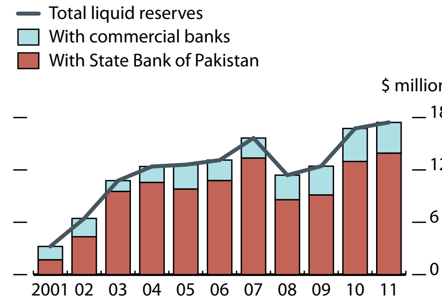
The extensive pickup of Treasury bills bought by the SBP through December 2010 reflected government reluctance to allow auction cutoff rates to rise enough for commercial banks to participate. Without a sufficient increase in 1-year bill rates, most purchases have shifted to shorter maturities of 3 and 6 months. In recent auctions, most banks' bids for bills with a maturity longer than 6 months have not been high enough to be accepted. But with an average maturity falling to 1.5 years, the possibility of roll-over risk and disorder in the auction market rises. The likely outcome is that, in time, the government will have to pay higher interest rates to fund its borrowing requirements.

Pakistan's external reserves reached a record high of $17.4 billion in early February 2011 (Figure 3.20.13), amounting to more than 5 months of imports of goods and services. This buildup essentially reflects IMF releases of $7.1 billion under the stand-by arrangement, an additional $450 million in emergency support in September 2010, and support from the Coalition Support Fund ($633 million) at end-December 2010. The central bank's holdings of liquid foreign exchange reserves ended FY2010 at $13.9 billion.

While import growth remains modest, a significant expansion of exports during the first 7 months of FY2011 moved the current account deficit into near balance, at 0.5% of GDP, but it is expected to widen to 1.7% for full-year FY2011, reflecting higher international food and commodity prices. For the first 7 months of FY2011, exports of textiles and rice showed strong growth in value terms, mainly on higher world prices. Remittances increased further, broadly in line with inflation, but non-debt-creating inflows continued to decline, with private FDI inflows about 16% below the same period of the previous year (Figure 3.20.14).

The current account deficit is expected to edge upward in FY2012 to 2.3% of GDP as projected declines in global food and commodity prices are more than offset by the impact of improved growth and increased demand for imports, including for postflood reconstruction.

3.20.13 Foreign exchange reserves



Note: Data for 2011 are as of 12 February.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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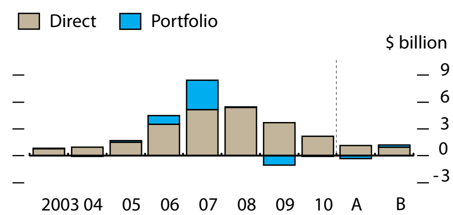
3.20.14 Foreign direct and portfolio investment, net inflows



A = July 2009–Jan 2010; B = July 2010–Jan 2011.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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Development challenges

The government recognizes that current subsidy requirements and support for SOEs are incompatible with creating the fiscal space needed to support investment in infrastructure and technology for a diversified and higher-value-added export base. The current pattern of lower imports, lower development spending, and exploding unproductive current outlays undermines domestic and external confidence in the economy's prospects and deters investment. Pakistan therefore needs to develop a systematically transparent revenue policy, and operate it effectively.

Elsewhere, energy shortfalls are lowering real growth by at least 2 percentage points annually. While the federal government increased electricity tariffs by 37% in FY2010, its decision not to push through with incremental monthly step-ups represents a reversal of its efforts to reach cost recovery. Again, it will be critical to design and implement policies that bring the sector to financial viability.

Sri Lanka

The economy bounced back strongly in 2010, reflecting post–civil war optimism and the global recovery. The outlook, too, is positive for healthy growth provided the fiscal consolidation process meets targets and the burgeoning inflation pressures are addressed. The medium term presents a need to greatly lift private investment, if the country is to reap the full rewards of the peace dividend.

Economic performance

The economy rebounded in 2010, with GDP growth estimated at 7.6%, after 3.5% in 2009 (Figure 3.21.1). Continued benefits from the end of the long-running civil conflict in 2009, such as improved business and tourist confidence plus more land available to agriculture, as well as the global return to growth, underpinned the strong performance. The overall optimism was reflected in the stock market's doubling.

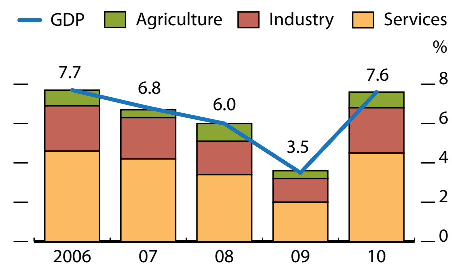
With the revival of paddy and fisheries production in the former conflict areas of Northern and Eastern provinces, agriculture grew at 6.5% in 2010. Good weather and fertilizer support by the government helped. With the improved domestic business climate, the upturn in domestic and external demand, and gradually improving infrastructure, industry grew by 8.0%.

Services, which account for nearly 60% of GDP, recorded growth of 7.6%. This was mainly due to the expansion of wholesale and retail trade, revival in tourism—which contributed to robust performance in hotels and restaurants—and the impressive performance of the banking, insurance, and real estate subsector. Tourist arrivals leaped by 46% to 654,477 in 2010, the highest number on record.

Annual average inflation as measured by the Colombo Consumer Price Index reached 5.9% in 2010, up from a 25-year low of 3.4% in 2009. Import duty reductions and subsidies that maintained stable fuel prices partly reined in rising global commodity prices' impact on domestic inflation. Nevertheless, overall inflation increased steadily from midyear to reach 7.8% in February 2011, with the rise due to escalating food prices that were 13% higher than a year earlier (Figure 3.21.2). Core inflation was on a downward trend throughout 2010 that continued in the first 2 months of 2011.

Commercial banks' average weighted prime lending rate continued to decline gradually in 2010 to 9.3% by year-end (Figure 3.21.3). The central bank reduced the reverse repurchase rate, the main policy rate, twice (and again in January 2011 to 8.5%). As interest rates edged down, growth in credit to the private sector came back strongly after 2009's shrinkage,

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.gov.lk; ADB estimates.

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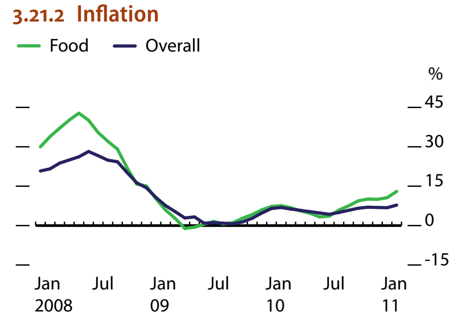
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 2 March 2011).

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This chapter was written by Nimali Hasitha Wickremasinghe and Savindi Jayakody of the Sri Lanka Resident Mission, ADB, Colombo.

reflecting commercial banks' improved lending appetites. Credit to the private sector increased by 25.1%, and broad money by 15.8%.

Per plan, the government tightened the budget deficit to 8.0% in 2010 from 9.9% in 2009 (Figure 3.21.4). It took minor steps to expand the revenue base, preferring to focus on simplifying the tax system, including reducing customs duty bands from five to four, removing the import duty surcharge, revising taxes relating to imports of motor vehicles and selected electronic items, and revising cess rates. Domestic revenue as a share of GDP at 14.6% was only marginally above 2009's. Grants added 0.4% of GDP to budget revenue.

The deficit narrowed therefore through current expenditure being cut by 1.5 percentage points as a share of GDP. All major categories of current expenditure saw a reduction as a share of GDP, including salaries and wages, interest payments, and transfers and subsidies. As a share of GDP, public investment was lower than in 2009, at 6.5%. Total expenditure was 23% of GDP in 2010.

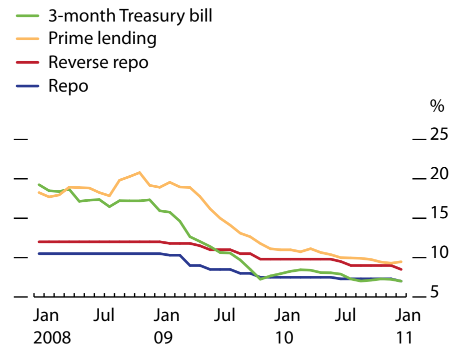
The ratio of government debt to GDP fell to an estimated 84% at end-2010 from 86% a year earlier but the total stock of government debt increased by 11%. While the debt ratio has fallen in recent years, the structure of debt has adversely changed, as the mix shifted from concessional external borrowing to higher-cost domestic and nonconcessional external borrowing. By August 2010, the share of concessional debt had declined to 68% from 72.2% at end-2009. In September 2010, the government issued its third international sovereign bond offering of $1 billion, after issues in 2007 and 2009. This issue was oversubscribed six times, with a yield substantially lower than the two previous issues.

After a 12.7% fall in 2009, exports recovered to expand by 17.3% in 2010. Industrial exports accounted for 74% of export earnings (of which more than half came from textiles and clothing) and agricultural exports 25%. Exports to major regions increased even though the European Union withdrew concessions under its Generalized System of Preferences Plus in August 2010. As the economy recovered in 2010 there was a marked increase in imports (about 32%), though this upsurge in large part reflected higher global prices, especially of oil. The steeper rise in imports than exports pushed out the trade deficit to 10.5% of GDP, from 7.5% a year earlier.

The strong resurgence in tourism as well as freight- and port-related activities brought an upturn in the services sector surplus. Growth momentum in remittances continued, reaching 24%. These items helped to counterbalance the large trade deficit to hold the current account deficit to 3.8% of GDP (Figure 3.21.5). Supported by healthy capital flows, the balance of payments recorded an estimated overall surplus of about 1.8% of GDP in 2010. Foreign direct investment strengthened sharply, to an estimated $500 million from $384 million in 2009, though at only about 1% of GDP it is very low for an economy of Sri Lanka's size and development level.

Investor sentiment was strengthened by the simultaneous approval of the third and fourth tranches of the International Monetary Fund (IMF) stand-by arrangement in June, and the fifth tranche in September, 2010. Both Standard and Poor's and Moody's raised the country's outlook to

3.21.3 Interest rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 February 2011).

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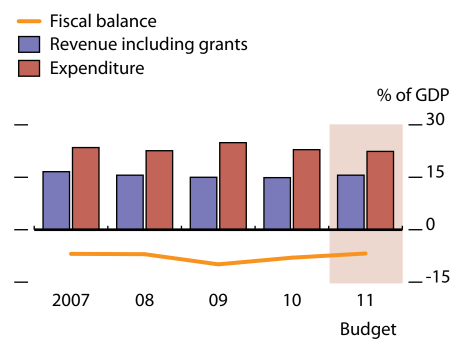
3.21.4 Fiscal indicators



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. *Budget Speech 2011*. http://www.treasury.gov.lk

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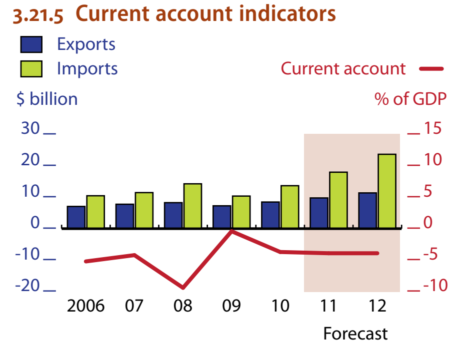
3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2010 and Prospects for 2011*. http://www.cbsl.gov.lk; ADB estimates.

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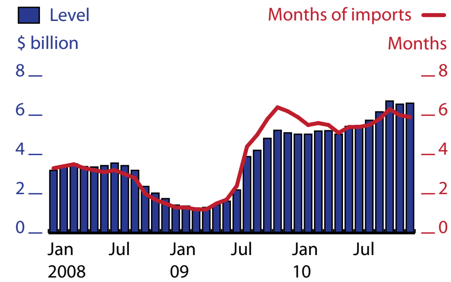
stable, and Fitch to positive. Supported by the success of the bond issue and the release of IMF funding tranches, gross official reserves reached $6.6 billion, covering 5.9 months of imports (Figure 3.21.6).

The Sri Lanka rupee climbed gradually against the US dollar by about 3% to reach SLRs111.1 by end-2010 (Figure 3.21.7). The real effective rate appreciated by about 5% because of higher inflation than in trade partners. The central bank intervened to buy foreign currency, though this move created excess rupee liquidity in the economy, leading to inflation concerns.

3.21.6 Gross official reserves



Source: Central Bank of Sri Lanka. Weekly Economic Indicators. Various issues. http://www.cbsl.gov.lk

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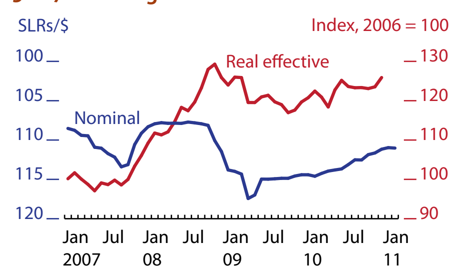
3.21.7 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 March 2011).

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Economic prospects

After last year's rebound, the economy is expected to show continued high growth of 8.0% in 2011, supported by some strengthening in external demand, and maintain growth at that level in 2012. Sustaining such performance will require fiscal consolidation, state enterprise and finance sector reforms, as well as flexible exchange rate management.

Services and industry will lead growth in 2011; agriculture is likely to be hampered by heavy rains and consequent flooding that affected several provinces in January–February 2011. Continued and planned infrastructure- and tourism-related building will support construction growth, while services, especially hotels and restaurants, will perform well, catering to the likely prolongation of the tourist boom.

Rising global food and oil prices and a shortfall in domestic supply of agricultural produce due to the flooding will stoke inflation, but only up to around 8%. In January 2011, the government reduced customs duty on gasoline from SLRs15 a liter to SLRs5 to avoid passing through global price rises. As with similar tariff-lowering steps on some imported food items, the fiscal implications are unclear. A recent hike in electricity prices will also contribute to upward price pressures this year.

In a surprise move, the central bank cut policy rates in January even though inflation was on an upward trend, reasoning that the prevailing economic conditions provided the space for monetary relaxation to facilitate greater private investment without creating inflation pressures. With the economy now on a higher growth trajectory and inflation pressures rising, however, monetary tightening may well be needed later in the year.

3.21.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-4.0	-4.0

Source: ADB estimates.

The budget deficit is expected to come down to 6.8% of GDP from 8.0% in 2010, split equally between a 0.6% increase in revenue and a 0.6% cut in expenditure. Revenue buoyancy is likely, stemming from budget measures to simplify the tax system and move from tax concessions as the principal tool for attracting investment to increased economic activity.

Expenditure is forecast to rise moderately in nominal terms as the government is looking to cap public investments at around the 2010 level of 6%–7% of GDP. A sharp one-third increase in private investment is seen driving growth higher.

The budgeted fiscal consolidation is prudent, but meeting its target will require further measures as the costs of the humanitarian and reconstruction expenses related to the flooding in 2011 and the reduction in customs duty on gasoline were not provided for in the budget adopted in 2010.

The government expects to move to a 5% of GDP deficit target in 2012. To achieve this it would be necessary to look closely at closing loopholes in the tax system and to improve efficiency in tax collection, together with further steps to broaden the tax base. Moreover, with infrastructure development a compelling priority, expenditure rationalization would have to focus rigorously on recurrent expenditure.

Export performance will depend on the recovery in Sri Lanka's major markets and is likely to grow by, say, 16% in 2011 and 2012. Rising global prices, especially of food items and petroleum, as well as high domestic demand, are expected to push up imports by around one-third in 2011 and 2012. Higher remittances and net services receipts are expected to hold the current account deficit to some 4% in both years.

FDI is projected to increase, supported by policy measures reinforced in the 2011 budget, including streamlining the role of the Board of Investment and ensuring that incentives to unproductive investments are canceled. The government wants FDI to hit about 3% of GDP this decade. The reserve position is likely to remain strong, supported by capital flows and the IMF program.

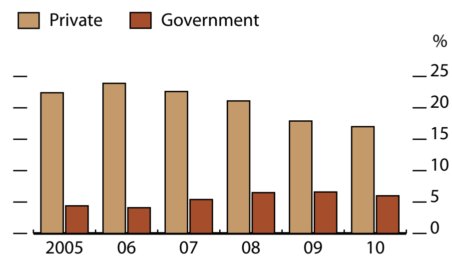
Development challenges

Investment is too low to achieve national development goals, and private investment in particular needs to be scaled up substantially (Figure 3.21.8). But several areas need to improve to secure an investment climate conducive to large-scale private investments. The 10-year development plan, the Mahinda Chintana, emphasizes the need to improve the business environment more widely. The World Bank's *Doing Business 2011* report ranks Sri Lanka at 102 out of 183 economies, suggesting the need to eliminate red tape. It also includes strengthening institutions, building human resources capacity, and simplifying procedures.

The finance sector requires development, as part of the thrust toward macro stability and hence greater investment. Improvements are needed in the legal framework for financial services and commercial transactions, and more generally in strengthening and enforcing prudential norms. The challenge for Sri Lanka will be enforcing different institutional and regulatory policy reforms in ways that are effective but without excessive bureaucracy.

It is also important to encourage both competition and consolidation in various parts of the finance sector to achieve efficiency and economies of scale. The capital markets are underdeveloped. Developing the corporate bond market is important to diversify funding sources in order to reduce reliance on banks and the equity market.

3.21.8 Fixed investment



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; ADB estimates.

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SOUTHEAST ASIA

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

Brunei Darussalam

Recovery in 2010 stemmed from higher oil and gas production coupled with moderate growth in the nonenergy private sector. Inflation remained subdued. Growth in the near term is projected to return to slightly higher than recent trend levels, in a context of low but rising inflation. The major challenge remains diversifying the sources of growth

Economic performance

The economy recovered by an estimated 2.0% in 2010, driven by higher production of oil and natural gas, stronger energy demand from traditional export markets such as Japan and the Republic of Korea, expansion of liquefied natural gas (LNG) production, and the opening of a new methanol plant in May 2010. Production of hydrocarbons, including LNG, accounts for nearly half GDP. Nonenergy-related private sector activity picked up moderately.

On the demand side, recovery benefited from estimated rises of 12% in private consumption and 10% in exports of goods and services. Investment was likely flat.

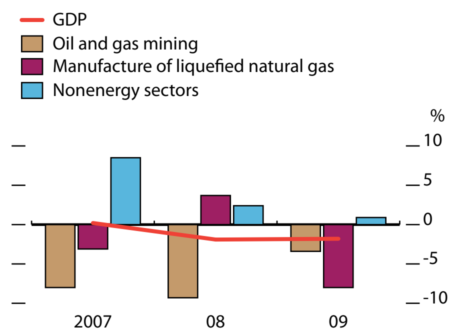
The GDP contraction in 2009 was revised to 1.8%. In that year, production of oil and gas fell by 3.4%, and LNG output by 8.0% (Figure 3.22.1), largely a consequence of weaker external demand and maintenance-related stoppages. Growth in the nonenergy sector in 2009 slowed to 0.9%, reflecting the impact of the global recession on trade, tourism, and manufacturing.

Contracting economic activity in 2009, with lower global commodity prices and a broadly stable Brunei dollar, brought inflation down to 1.0%. Official data for the first 8 months of 2010 indicate that inflation eased further, but the consumer price index likely picked up after that, in tandem with global commodity prices (most commodities are imported). Average inflation for 2010 is estimated at 1.5%.

Preliminary and unadjusted data indicate that the budget recorded a deficit of US$192 million in FY2009 (ended 31 March 2010), or 1.7% of GDP. This was on the back of sharply lower tax and nontax revenue (dividends and royalties) from oil and gas, as well as higher current and capital spending. In FY2010, available data indicate that the budget returned to surplus of US$860 million in the first half of the fiscal year. The turnaround reflects a combination of higher tax revenue, lower current expenditure, and a cut in capital spending.

Broad money supply increased by 8.2% in the 12 months through June 2010, marking a continued buildup in net foreign assets and an expansion of domestic credit. Credit to the private sector rose by 20.9%, while net

3.22.1 GDP growth by sector



Source: Brunei Darussalam Department of Economic Planning and Development (JPKE).

Click here for figure data

3.22.1 Selected economic indicators (%)		
	2011	2012
GDP growth	1.7	1.8
Inflation	1.5	1.5
Current account balance (share of GDP)	50.0	50.0

Source: ADB estimates.

This chapter was written by Eric Sidgwick of the Southeast Asia Department, ADB, Manila.

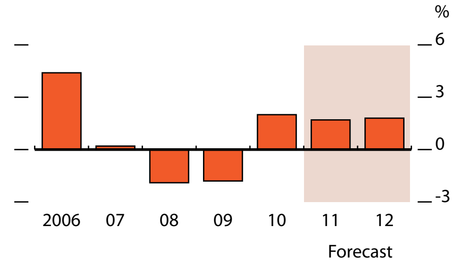
claims on the government declined (government deposits in the banking system expanded) as the budget returned to surplus.

Exports of oil and gas, which represent over 90% of total exports, slumped by 33.1% to US$7.2 billion in 2009. This was due to both lower export volumes and prices. Exports of LNG to Japan, which accounted for about 30% of Brunei's GDP in recent years, declined by 21.8%. Imports also dropped sharply, by 20.1%, due to the downturn in economic activity. It is estimated that the current account surplus fell by over US$3 billion to around US$4 billion (but still high at 37% of GDP).

Data on the capital and financial accounts are not available but international reserves, excluding amounts held by the Brunei Investment Agency, were estimated at US$1.4 billion at end-2009.

For the first half of 2010, exports of oil and gas picked up by 14.1%, and imports increased slightly. The current account surplus rose to US$5.4 billion in January–June 2010 and is estimated to have totaled about the same amount for the full year (43% of GDP).

3.22.2 GDP growth



Sources: Asian Development Outlook database; ADB estimates.

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Economic prospects

The outlook for the forecast period is based on the *ADO 2011* assumptions of continued modest growth in industrial economies and significantly higher global oil prices through 2012.

As the high-base effect from the rebound in 2010 dissipates, economic growth is projected at the slightly higher than trend rates of 1.7% in 2011 and 1.8% in 2012 (Figure 3.22.2), reflecting buoyant global energy markets and an increase in domestic demand. Oil and gas production is expected to rise moderately and the new methanol plant will contribute a full year's production to GDP.

Private consumption is forecast to rise and investment to pick up this year as a result of construction projects and an improving business environment. Projects include the Pulau Muara Besar port (scheduled to be completed by end-2012), an upgrade of the international airport, and a power transmission line between Brunei and Malaysia.

Inflation is seen rising in the forecast period, mainly due to higher prices for imported food. Still, it should remain relatively low at 1.5%, given the government's policy to subsidize many consumer items and the currency's peg to the Singapore dollar.

The current account surplus is likely to return to levels reached before the economic contractions of 2008 and 2009—about 50% of GDP—on the back of higher export receipts from oil and gas and a rebound in net income inflows from the recovery in foreign asset prices. Demand from Japan for LNG could increase owing to damage to its nuclear industry from the March 2011 earthquake.

A maritime border agreement reached with Malaysia will encourage exploration and foreign investment in oil and gas. Drilling has begun in two offshore exploration zones and an international company plans to bring a new gas discovery into production in about 3 years.

3.22.1 Development challenges

The long-term challenge is to make the economy less dependent on oil and gas. The increase in the global price of oil this year and next will likely lead to moderately higher levels of production, but could also quicken the depletion of hydrocarbon reserves (unless offset by new discoveries).

A gradual transition to more diversified sources of growth will require progress in fostering a more conducive business environment for the private sector, improvements in the institutional capacity of the government, including service delivery, and finance sector development.

The authorities seem to have made a start: according to the World Bank's *Doing Business 2011* report, Brunei Darussalam was in the top 10 countries to have improved its business environment over the previous year. The country climbed 19 places in ease of starting a business (to 133 out of 183 countries)—though this is still a poor ranking—and ranks relatively well in ease of paying taxes (22) and trading across borders (52). However, the ranking remains low in investor protection (120), ease of obtaining credit (116), and ease of doing business (112).

As part of finance sector development, the government set up a Brunei Monetary Authority in January 2011 to improve regulation and supervision of the financial system.

Cambodia

Based on a rebound in tourism and clothing exports, recovery in 2010 was also supported by a good year in agriculture. However, there are indications that poverty has increased in recent years. The pace of economic growth is expected to pick up in the forecast period. Inflation will also rise. A new effort to promote rice production and exports goes some way to addressing the need to diversify sources of growth and reduce rural poverty.

Economic performance

A bounceback in tourism and clothing exports, coupled with increased production of paddy rice, drove a 6.3% recovery in GDP last year (Figure 3.23.1) from a sharp slowdown in 2009 caused by the global economic crisis.

The primary sector, producing about a third of GDP, grew by an estimated 4.2% in 2010. Paddy rice output rose by about 5% to 7.9 million tons, mainly a result of favorable weather and better access by farmers to fertilizers and higher quality seeds. Livestock production increased by about 5.5%, whereas forestry and logging and fisheries output registered only slight growth.

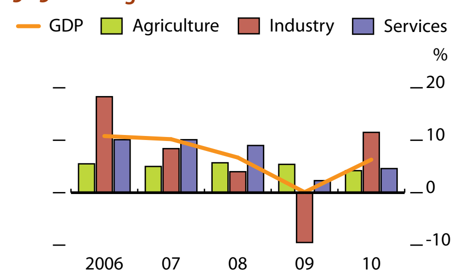
Recovery in global travel saw tourist arrivals rise by about 16% to 2.5 million, and tourism receipts by 14.5% to $1.78 billion (Figure 3.23.2). The sharpest gains were in arrivals from Asia, including Viet Nam (up 48% to 466,700), the Republic of Korea (up 47% to 289,700), and the People's Republic of China (PRC—up 39% to 177,700). This rebound in tourism contributed to estimated growth of 4.3% for services.

Industry was the main contributor to GDP growth in 2010, expanding by an estimated 11.6% (it had contracted in 2009). External demand for Cambodian garments, principally from the United States (US) and the European Union (EU), rebounded. Data from the US Department of Commerce showed that US garment imports from Cambodia rose by 19% in US dollar terms in 2010 (Figure 3.23.3). Construction activity remained sluggish, reflecting a fall in foreign investment in property during the global crisis and slow pickup in residential building.

Increased deposits of foreign currency at banks drove a 20.0% year-on-year increase in M2 money supply in December 2010. Bank lending to the private sector picked up from 6.5% year on year at end-2009 to 27% 12 months later, reflecting the economic recovery. The riel appreciated by 2.4% against the US dollar over 2010.

A less expansionary fiscal stance saw the overall budget deficit trimmed to an estimated 6.0% of GDP, from 6.4% in 2009. Domestic revenue bounced back to the equivalent of 12.7% of GDP, higher than the

3.23.1 GDP growth



Sources: National Institute of Statistics; ADB estimates.

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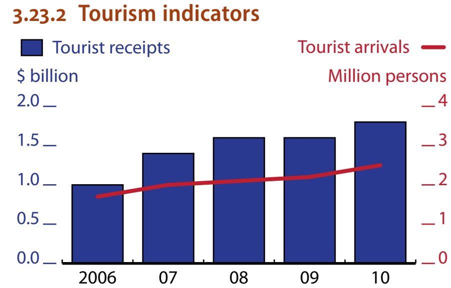
3.23.2 Tourism indicators



Source: Ministry of Tourism.

Click here for figure data

This chapter was written by Peter Brimble and Poullang Doung of the Cambodia Resident Mission, ADB, Phnom Penh.

budget plan of 12.3% and the 2009 outturn of 11.9%. Given that revenue collection is still relatively low, the government aims to raise it by 0.5 percentage points of GDP a year over the medium term.

Government expenditure amounted to an estimated 18.6% of GDP, somewhat above the 17.6% budget target but lower than the 2009 peak of 20.5%. The higher than target spending was due principally to externally financed capital works. The deficit was largely financed by grants and concessional loans, with the drawdown of government bank deposits estimated at 0.5% of GDP, much lower than the 2009 outturn of 2%.

Consistent with a modest recovery in domestic demand, inflation in 2010 averaged 4.0% (Figure 3.23.4), a turnaround from 2009 when the consumer price index fell slightly in year-average terms.

In the external accounts, merchandise exports rose by an estimated 20.8% in US dollar terms, largely reflecting growth in garment exports to the US. Imports rose by an estimated 15.9%, mainly on increases in oil and in raw materials for garments. Overall, the 2010 current account deficit (excluding official transfers) narrowed slightly to an estimated 11.0% of GDP.

Foreign direct investment inflows rose by about 50% to $801 million, reflecting strong growth in agriculture and garments. Special economic zones are attracting investments in light industry, especially those in Phnom Penh, Sihanoukville, and Svay Rieng. Donor inflows remained buoyant, and gross international reserves increased by 12% over the year to $2.65 billion, equivalent to 4.7 months of imports of goods (Figure 3.23.5).

Current levels of public debt are considered manageable. External public debt is estimated at $3.5 billion and domestic debt is very small. The PRC accounted for about 58% of total bilateral loan disbursements in 2010.

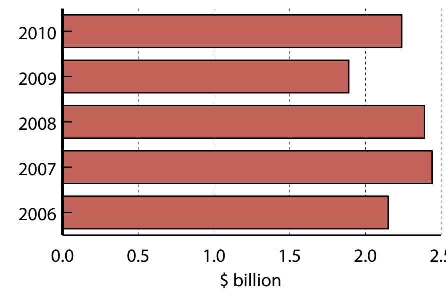
Latest available data show that 30% of the population lived in poverty in 2007, with the majority of the poor and vulnerable in rural areas. There are indications that poverty has increased since 2007 as a result of sharply higher food prices in 2008 and the economic slowdown in 2009. In response, the government has drafted a social protection strategy, expected to be launched in 2011. Immediate priorities of this strategy involve the expansion of targeted programs such as free health care for the poor, and the pilot testing of programs including conditional cash transfers and labor-intensive public works.

The government last year adopted an ambitious plan to increase paddy rice production and promote the milling of rice for export, which should benefit the 70% of the population that earns a living from rice. Targeting 1 million tons of milled rice exports by 2015 (compared with just 13,000 tons in 2009, according to the official estimate), the plan includes steps to expand irrigation facilities; improve the use of water, seed, fertilizer, and equipment; provide credit to farmers; encourage the private sector in rice processing and export; and reduce transport costs.

Longer-term measures in the rice plan will focus on improving farm yields and export competitiveness, for example by building roads, railways, and ports, and by improving land management.

Reflecting the gradual expansion of the private sector, the number of licensed enterprises grew to 38,023 at end-2010 from 36,116 in 2009. The government is eager to encourage new firms and new industries, but

3.23.3 United States imports of textiles and clothing from Cambodia



Source: US Department of Commerce.

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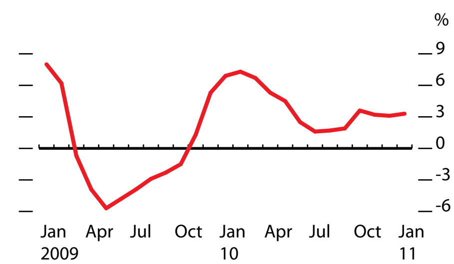
3.23.4 Inflation



Source: National Institute of Statistics.

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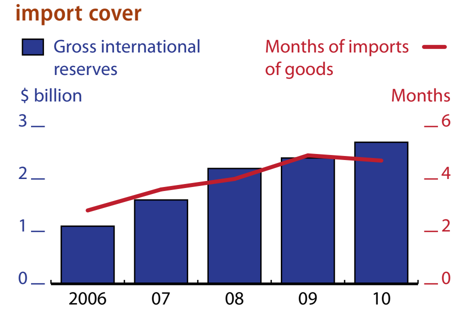
3.23.5 Gross international reserves and import cover



Source: National Bank of Cambodia.

Click here for figure data

developing the private sector is constrained by infrastructure deficiencies, including the high cost of electricity and lack of access to affordable finance, especially for small and domestically focused firms.

The government adopted an anticorruption law in 2010 which, if well implemented, could significantly reduce the costs of doing business, strengthen the country's competitiveness, and improve public sector governance. A stock market is scheduled to open in 2011, with three selected state-owned enterprises planned for listing.

Economic prospects

Assuming global economic growth in line with the *Asian Development Outlook 2011* assumptions, as well as favorable weather for agricultural production, GDP is projected to expand by 6.5% in 2011 and 6.8% in 2012 (Figure 3.23.6).

Growth in industry is projected at 10.8% in 2011, based largely on external demand for Cambodian garments from the US and EU. US garment imports from Cambodia in January jumped by 41% to $214 million. A relaxation of EU rules of origin under the Generalized System of Preferences from January this year gave Cambodian garments duty-free access to the EU, regardless of the origin of the fabric. Cambodian milled rice also received preferential access to the EU. Consequently, milled rice exports to that market rose by 228% to 10,495 tons in the first 2 months of this year from the prior-year period.

Construction is projected to expand by a modest 3% this year. The government in 2010 liberalized restrictions on foreign ownership of apartments, which is expected to help stimulate some additional demand. Offshore oil and gas production is expected to come on stream in late 2012.

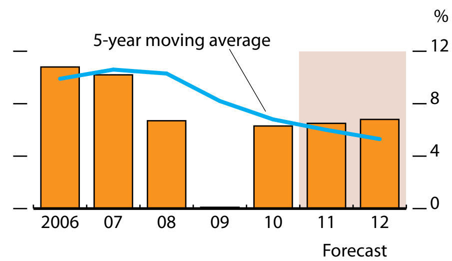
Growth in services looks set to pick up to about 5% this year. Tourist arrivals rose by 18% in January 2011 from the prior-year period, while trade and transport and communications are likely to continue expanding, as domestic consumption and the business outlook improve. Agricultural production is seen increasing by 4.3%, supported by the government's commitment to promote rice production and exports.

Government spending is forecast to grow marginally faster than revenue in 2011, owing to increases in capital outlays, and the budget deficit is expected to be 6.2% of GDP. External financing (concessional loans and grants from bilateral and multilateral lenders) will cover most of the deficit, leaving a shortfall equivalent to 0.9% of GDP (compared to an estimated 0.5% of GDP in 2010) to be financed by drawdowns on government bank deposits at the central bank.

Upward pressure on prices will be generated by the strengthening domestic demand, generally expansionary fiscal policy, and higher global prices for food and fuel. Inflation is forecast to average 5.5% (Figure 3.23.7).

The planned increase in domestic financing of the budget, coupled with the quickening of economic growth and inflation, suggests the need for a gradual tightening of monetary policy during the forecast period. However, the high degree of dollarization of the economy (amounting to as much as 95% of currency in circulation) limits the effectiveness of monetary policy.

3.23.6 GDP growth



Source: Asian Development Outlook database.

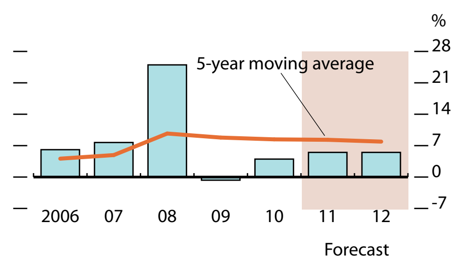
Click here for figure data

3.23.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.5	6.8
Inflation	5.5	5.5
Current account balance (share of GDP)	-10.7	-10.2

Source: ADB estimates.

3.23.7 Annual inflation



Source: Asian Development Outlook database.

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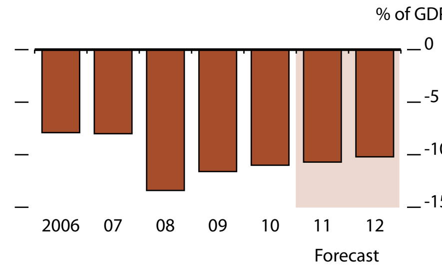
The trade deficit is expected to remain substantial, in part a result of the higher cost of imported oil in 2011. On the positive side, a rise in tourism receipts will contribute to a surplus in services trade. The current account deficit (excluding official transfers) is forecast at 10.7% in 2011 and 10.2% in 2012 (Figure 3.23.8). Gross international reserves are projected to rise to $2.84 billion in 2011.

Risks to the forecasts center on external events, such as unexpected global economic weakness or higher than assumed oil prices, which could hurt the prospects for Cambodia's tourism and clothing exports and push up inflation. Tourism could also be affected by any intensified conflict on the border with Thailand or by renewed political strife in Thailand. Lack of progress on fiscal consolidation, with low tax revenue and absence of government debt securities, may lead to problems in funding the fiscal deficit. The relatively low involvement of Japan in Cambodia's trade, tourism, and foreign investment suggests a modest effect on the economy from the earthquake in Japan in March 2011.

3.23.8 Current account balance



Source: *Asian Development Outlook* database

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Development challenges

The impact of the global recession on the economy highlighted the need for Cambodia to reduce vulnerability to external shocks by accelerating economic diversification and improving competitiveness of industries.

Sources of growth in recent years—garments, tourism, and construction—were all hit hard by the global downturn. A stronger agriculture sector would not only diversify sources of growth but also help to extend development to rural areas where 90% of the poor live. Food exports to Asian markets such as the PRC would reduce the heavy reliance on the US and EU clothing markets—hence the government's efforts to promote rice production and milled rice exports.

The clothing and tourism industries are hampered by high costs for electricity, until Cambodia builds its generation and distribution capacities, and for trade, which involves numerous bureaucratic procedures and unofficial fees. These industries need to raise the quality of their products and services and develop skills to support higher-value-added activities.

Cooperation is increasing with neighboring countries to enable Cambodia to tap into growing markets through increased connectivity. The country lies at the heart of the Greater Mekong Subregion southern economic corridor extending from Thailand to Viet Nam through highways and railway links that form part of the Singapore–Kunming rail project. To meet competition in these markets and to strengthen value chains in agriculture, manufacturing, and tourism, Cambodia needs to intensify efforts to reduce transport and logistics costs, especially at ports and border crossings.

Indonesia

A welcome increase in investment and expansion of private consumption contributed to a quickening in GDP growth in 2010, as external trade rebounded. Economic growth is forecast to step up this year and next. Near-term challenges are to curb inflation and manage surges in capital inflows, while reaching the government's medium-term growth target requires higher levels of investment in infrastructure.

Economic performance

A pickup in economic growth last year was driven by strong private consumption, buoyant investment, and robust recovery in export demand. GDP increased by 6.1%, recovering from a slowdown during the global recession in 2009 (Figure 3.24.1).

Private consumption, supported by a strengthening labor market and rising prices for agricultural commodities, increased by 4.6% and contributed 2.7 percentage points of GDP growth.

Fixed capital investment grew by 8.5% and contributed 2.0 percentage points to GDP growth. Investment in machinery and equipment rebounded by 17.1%, from a contraction in 2009, while that in buildings, including infrastructure, grew by 7.0% in 2011. Investment's healthy rise was underpinned by improvements in the domestic and global investment climate, an appreciation of the rupiah, and growth in credit. Gross fixed capital formation as a ratio to GDP rose to 32.2% (Figure 3.24.2).

Net exports also contributed to GDP growth, but government consumption did not, as the authorities unwound fiscal stimulus and lagged in disbursement of capital spending.

From the supply side, services again came in with the strongest expansion, at 8.4%, contributing 3.8 percentage points to GDP growth. Transport and communications recorded double-digit strengthening. Industry grew by 4.7%, reflecting a modest recovery in manufacturing, offset in part by slower growth in mining and quarrying. Manufacturing is still hindered by poor infrastructure and stringent labor regulations, while mining activity slowed during periods of unusually heavy rain last year.

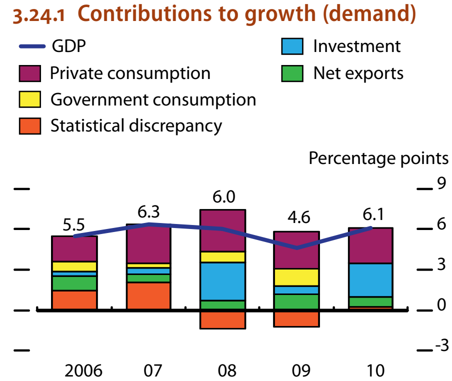
Agriculture grew by 2.9%, the weakest increase in 5 years, as it, too, was set back by heavy rain.

Food supply disruptions caused by the bad weather and by infrastructure weaknesses drove inflation up from 2.8% in late 2009 to 7.0% in December 2010 (Figure 3.24.3). It exceeded the central bank's target of 4.0%–6.0% in some months (the year-average rate was 5.1%). Food price inflation was running at nearly 16% late in 2010.

Faced with rising inflation and a surge of capital from abroad, Bank

This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

3.24.1 Contributions to growth (demand)



Source: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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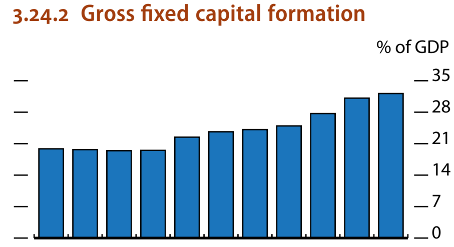
3.24.2 Gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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Indonesia left its policy interest rate unchanged at 6.5% for 18 months (after cutting it by 300 basis points during October 2008–August 2009). Only in February 2011 did the central bank start to return the policy rate to more normal levels, edging it up by 25 basis points.

Bank Indonesia did, though, raise the reserve requirement for commercial banks, from 5.0% to 8.0% in November 2010. This measure absorbed an estimated Rp53 trillion of excess liquidity in the banking system (equal to about 3% of total bank lending). A 4.5% appreciation of the rupiah against the US dollar in 2010 provided some cushion against imported inflation.

Commercial banks passed on to borrowers only part of the central bank's policy rate cuts through August 2009. Credit growth was low until mid-2010, when it accelerated with economic activity, and was running at about 22% by year-end (Figure 3.24.4). That was still a little below Bank Indonesia's target, in part because lending rates remained relatively high. Banks' gross nonperforming loans fell by 1 percentage point in 2010, to 3.4% of total loans.

Recovery in world trade and higher commodity prices produced a 32% surge in merchandise exports to $158.2 billion in 2010 (Figure 3.24.5). Exports of natural rubber more than doubled, and exports of palm oil rebounded by about one-third. The value of metal ore and coal shipments jumped by 32%. Imports rose even faster than exports, by 42% to $127.1 billion, reflecting strong demand for intermediate and capital goods.

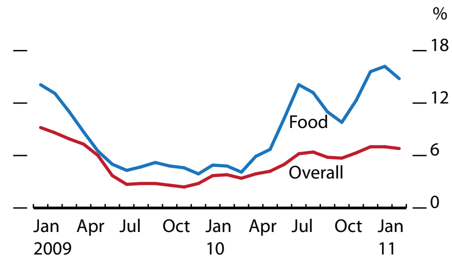
Nevertheless, the trade surplus rose to $31.1 billion in 2010 owing to a higher base for exports. The current account surplus moderated to $6.3 billion (0.9% of GDP). The transfers account recorded a marginally greater surplus, owing to growing remittances from migrant workers. However, the surplus was fully offset by widening deficits in the income and services accounts, due to higher interest payments and dividends to foreign investors and steeper freight costs attributable to a larger volume of exports.

The capital and financial account recorded a $26.2 billion surplus in 2010, up significantly from $5.0 billion in 2009, driven by higher inflows of portfolio and foreign direct investment. Portfolio inflows surged by 47.1% to $15.2 billion. Net foreign equity purchases estimated at $23 billion pushed the Jakarta Stock Exchange index of share prices up by 46% in 2010. Foreign holdings of government rupiah bonds increased by the equivalent of about $9.8 billion (81.3%—Figure 3.24.6) and their yields fell steeply.

Foreign direct investment more than doubled to $12.7 billion, reflecting the better domestic and international investment climate. Gross international reserves climbed by over $30 billion, to $96.2 billion at year-end, covering 7.1 months of imports and government debt payments.

More new jobs were generated in 2010 than new entrants to the labor market, helping to lower the unemployment rate to 7.1% in August 2010 from 7.9% a year earlier (Figure 3.24.7). This played a role in bringing back into the formal sector many of the workers who had been laid off from that sector during 2009's slowdown and had been working informally. Most new jobs created were in services. The employment share of the informal sector remains high, though, at around two-thirds.

3.24.3 Monthly inflation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2011).

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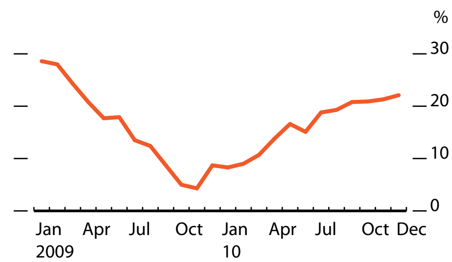
3.24.4 Credit growth



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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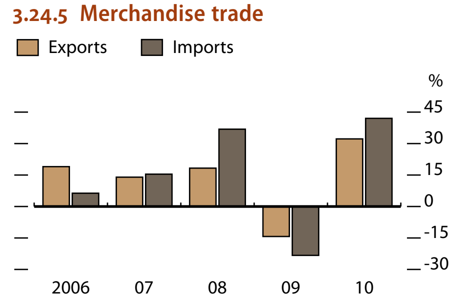
3.24.5 Merchandise trade



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 March 2011).

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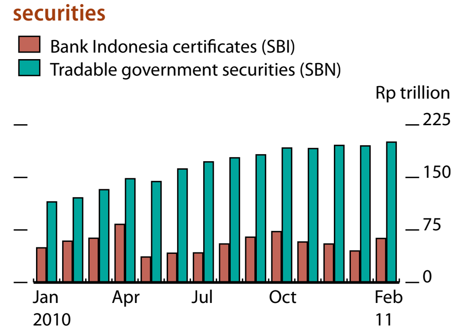
3.24.6 Foreign ownership of government securities



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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Household survey data show that poverty incidence fell to 13.3% in March 2010 from 14.1% in March 2009, and the number of poor in both rural and urban regions fell below 2004's levels for the first time.

Lower than budgeted spending, an increase in the tax-to-GDP ratio, and the impact of higher commodity prices on revenue tightened the budget deficit to an estimated 0.6% of GDP in 2010, well below the government's 2.1% of GDP projection. Central government revenue rose by 19.5% from the previous year. Government spending was 6.5% below projection, mainly because capital expenditure fell 20.6% short of budget.

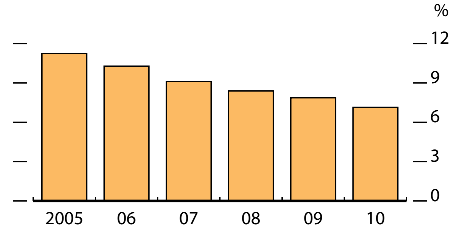
Total spending on subsidies reached Rp214.1 trillion (3.4% of GDP), 6.4% more than projected, due to higher electricity subsidies and expansion of a program that provides rice to the poor. As a share of GDP, central government debt fell to about 26%, less than half its proportion in 2004 (Figure 3.24.8).

Efforts to improve the investment climate were illustrated by a reduction in the corporate income tax rate to 25% in 2010, the opening of a few more sectors to foreign investors, and new tax concessions for certain investments. The government launched a new system to reduce the time and costs of importing and exporting by allowing single submission, processing, and approval of import and export documents.

Recognizing such improvements (as well as the macroeconomic performance) the World Economic Forum's *Global Competitiveness Report* upgraded Indonesia's ranking by 10 places in 2010 to 44.

Standard & Poor's raised its long-term foreign currency credit rating on the country's debt from BB- to BB in March 2010, and Moody's upgraded its rating in January 2011 from Ba2 positive to Ba1 stable. Fitch raised its BB+ rating outlook from stable to positive in February 2011, which suggests an upgrade to investment grade within 12 months.

3.24.7 Unemployment rate



Source: CEIC Data Company (accessed 14 March 2011).

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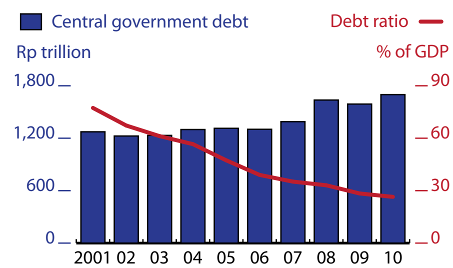
3.24.8 Government debt



Source: Directorate General of Debt Management. http://www.dmo.or.id (accessed 14 March 2011).

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Economic prospects

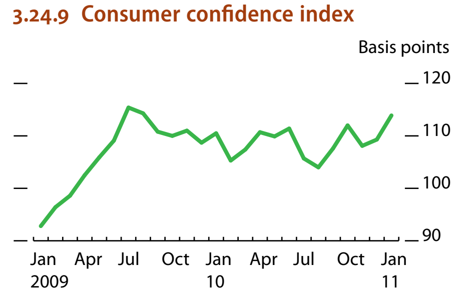
Forecasts assume that the government will continue to improve the investment environment, and that last year's bad weather (which hurt agriculture and mining) is not repeated in 2011.

Private consumption is forecast to expand on the back of increases in incomes brought about by the stronger labor market and high prices for agricultural commodities. Bank Indonesia's consumer confidence index rose sharply in January 2011 (Figure 3.24.9).

Private investment is expected to remain robust, given projected growth in domestic consumption and in external demand for agricultural products and minerals. Investment is supported by the growth in credit and higher levels of confidence in the country.

As for public investment, the government has budgeted for a near 30% rise in capital expenditure this year from the 2010 allocation, aimed at addressing infrastructure bottlenecks. Given chronic weakness in implementing capital works programs, the budgeted amount is unlikely to be fully drawn. To address this issue, the government is simplifying budget execution procedures and strengthening procurement capacity in spending agencies. It is also targeting higher overall spending and a wider budget deficit, equivalent to 1.8% of GDP, which should support GDP growth.

3.24.9 Consumer confidence index



Note: The index is constructed from a survey of Bank Indonesia among households. An index above 100 indicates optimism about the economy.

Source: CEIC Data Company (accessed 14 March 2011).

Click here for figure data

From the production perspective, signs point to manufacturers in several important subsectors preparing for higher levels of output: investment in machinery has increased in some industries, including paper and printing, rubber, plastics, food and beverages and, to a lesser extent, the labor-intensive industries of textiles, leather, and footwear.

A survey by the statistics office in March 2011 showed that business managers expect business conditions to continue to improve in the second quarter (Figure 3.24.10).

Growth in services will be underpinned by the forecast rise in domestic demand. Agriculture and mining are likely to put in better performances than last year on the basis of better weather and high global prices for agricultural commodities, energy, and metals.

On this basis, GDP is forecast to expand by 6.4% in 2011 and 6.7% in 2012 (Figure 3.24.11), stepping up from average growth of 5.6% over the past 7 years. The growth forecast for the next 2 years would be the best rates achieved since 1996.

Merchandise export growth is forecast to decelerate to about 15% this year, given the high base set by the rebound in 2010. The earthquake in Japan will likely have a brief and modest impact on exports (Japan accounts for about 12% of exports). Reconstruction there will stimulate demand for Indonesia's energy and raw materials. Imports are projected to increase by about 17%, attributable to robust investment and consumer demand.

The trade surplus is expected to rise modestly, but deficits in the services and income accounts will widen due to higher freight costs associated with larger trade flows and repatriation of profits and dividends. The current account surplus is seen declining to 0.5% of GDP in 2011 and 0.1% in 2012. The overall balance of payments is forecast to remain in surplus as a result of continued (but moderating) portfolio inflows and foreign direct investment.

Inflation was about 7% in the first 2 months of 2011 and is likely to remain relatively high through the first half of the year before moderating in the second half on base effects and an expected improvement in domestic food supplies. For the full year, inflation is forecast to average 6.3%. It will subside a little in 2012 if global food and commodity prices decelerate as projected (Figure 3.24.12).

Deviations in inflation from Bank Indonesia's 4.0%–6.0% target risk eroding the credibility of monetary policy, thus entrenching expectations of higher inflation. If the current inflation pressure persists, the central bank is expected to gradually raise its policy interest rate to more normal levels and is likely to allow the rupiah to appreciate further.

To address localized food shortages, the government has directed its rice procurement agency Bulog to intervene in the market to ensure adequate supplies. It has also expanded a program that distributes 15 kilograms of rice each month to 17.5 million poor households and has suspended import duties on some food items.

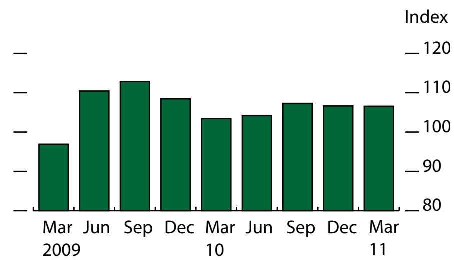
But inflation still poses a risk to the economic outlook. An unexpected sharp acceleration in prices could cloud the prospects for growth in private consumption, prompt a faster tightening of monetary policy, and raise fiscal outlays on subsidies, possibly at the expense of capital spending.

3.24.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.4	6.7
Inflation	6.3	5.8
Current account balance (share of GDP)	0.5	0.1

Source: ADB estimates.

3.24.10 Business tendency index



Note: An index higher than 100 means that business managers think that the current quarter will be better than the previous one.

Source: CEIC Data Company (accessed 14 March 2011).

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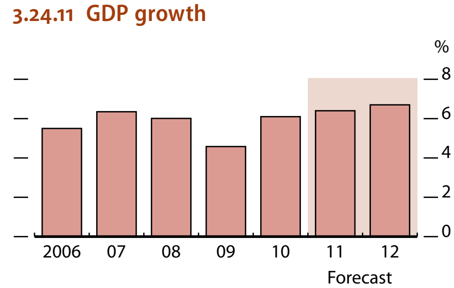
3.24.11 GDP growth



Source: Asian Development Outlook database.

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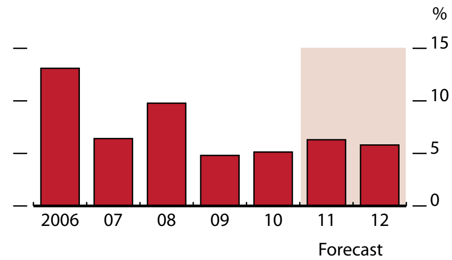
When combating inflation, the authorities must also manage surging capital inflows that exacerbate inflation and make the economy vulnerable to swings in investor sentiment. The focus has been on macroprudential regulation to damp short-term inflows. Bank Indonesia last year imposed a minimum 30-day holding period for central bank certificates (SBIs), changed auctions of these securities to monthly from weekly, issued longer-maturity SBIs, and introduced a new term-deposit facility for commercial banks to reduce the need to issue SBIs. The central bank introduced higher reserve requirements for foreign currency deposits and stepped up its monitoring and reporting of foreign exchange transactions and capital inflows.

In the first quarter of 2011, Bank Indonesia limited banks' short-term foreign loans to a maximum of 30% of their capital and decided to rely more on 9-month SBIs, further discouraging short-term investments.

Concerns over the rise in inflation, coupled with international financial markets jitters in early 2011, resulted in some reversal of short-term capital inflows.

For its part, the government proposed measures to Parliament to cushion the local-currency government bond market from capital flight. Under them, funds from state-owned enterprises and the budget can be used to buy bonds in the event of a sudden capital reversal. In addition, Bank Indonesia can draw on the country's foreign exchange reserves and bond buyback funds allocated in the 2011 budget to support the bond market.

3.24.12 Inflation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 14 March 2011).

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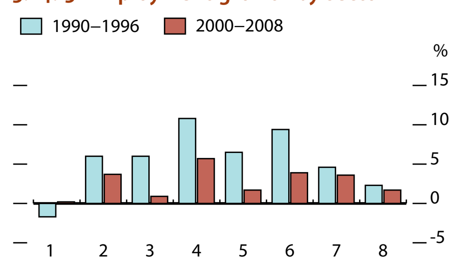
3.24.13 Employment growth by sector



1 = Agriculture; 2 = Mining and utilities; 3 = Manufacturing; 4 = Construction; 5 = Wholesale trade; 6 = Transport; 7 = Other activities; 8 = Total.

Source: ADB Statistical Database System.

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Development challenges

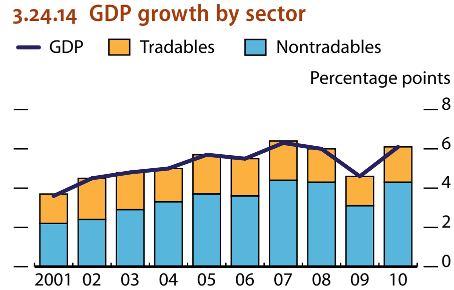
Although economic growth averaged 5.2% in the past decade, it remains below the 7%–8% rate recorded before the Asian financial crisis. This slowing of growth since the mid-1990s has been accompanied by lower growth in employment (Figure 3.24.13). The contribution of investment to growth has declined: the share of gross fixed investment in GDP fell from 26% in 1991–2000 to around 24% in 2001–2009 (although it has recently picked up to 32.2% in 2010). The contribution of private consumption has risen.

From the production side, growth has been driven by the nontradable sector (Figure 3.24.14), mainly services, while the performance of tradables, particularly manufacturing, has been lackluster. Employment generation in manufacturing has been stagnant, so that a large proportion of the labor force works in the informal sector, where wages and conditions are usually poor. Exports have become more dependent on volatile world commodity markets.

Significant gains in investment and exports are required if the government is to achieve its 2014 GDP growth target of 7%–8%. Investment is needed in infrastructure particularly, which would support growth of the more productive tradable sector. Government infrastructure spending as a share of GDP has fallen by nearly 50% from the first half of the 1990s and is well below that for faster-growing Asian economies. Logistics costs in Indonesia are estimated at about 14% of total production costs, compared with about 5% in, say, Japan.

Given that fiscal policy has focused on limiting budget deficits and

3.24.14 GDP growth by sector



Note: Tradables refer to agriculture, mining and quarrying, and manufacturing. Nontradables refer to utilities, construction, wholesale trade, transport, and other activities.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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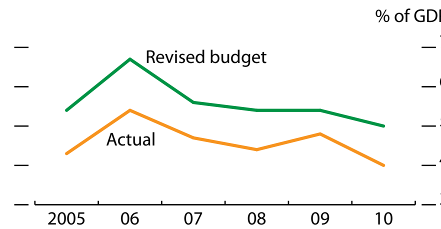
reducing public debt, at the same time as reorienting spending toward education and poverty reduction, the government needs to create greater budget resources (after accounting for essential spending) to lift infrastructure investment. Such space in the budget in the past 5 years has been low, at the equivalent of 4%–5% of GDP (Figure 3.24.15).

Pursuing reforms in tax administration would help generate such resources. The number of registered taxpayers increased by about 13 million in 2006–2010 and the tax-to-GDP ratio rose from 11.0% in 2009 to 11.7% in 2010. What is needed now are systems and procedures to increase compliance with tax laws, including a better tax database and modern information systems, risk-based compliance enforcement, and improvements in tax staff training and probity.

On the expenditure side, interest costs will fall if the government continues to bring down public debt as a ratio to GDP, and as a result of upgrades in the sovereign credit rating. Savings could also be made by better targeting of subsidies and avoidance of duplication across different levels of government.

Yet budget resources that were available were not always fully used. Indeed, the government has missed its budget deficit target by an average of 1% of GDP annually over the past 5 years, mainly because of an inability to complete spending programs. Moreover, a large proportion of budget spending is pushed through in the last quarter of each year. Efforts to improve budget execution by the public sector are getting greater attention from the authorities.

3.24.15 Discretionary expenditure



Sources: Ministry of Finance; ADB estimates.

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Lao People's Democratic Republic

Strong demand for exports of metals and electricity, coupled with a recovery in tourism, spurred GDP growth in 2010. Similar factors are forecast to underpin a slightly higher expansion this year and next. But inflation has been rekindled, so far at moderate levels. A central challenge is to preserve macroeconomic stability while pursuing growth.

Economic performance

After decelerating a little during the global recession, economic growth picked up to 7.5% in 2010 (Figure 3.25.1), returning to the average expansion rate of 2004–2008. This prolonged period of growth mainly reflects substantial investment in mining and hydropower.

Industry, representing about one-quarter of GDP, grew by 18.0% in 2010 and contributed most of the growth. Output of electricity more than doubled as the Nam Theun 2 hydropower plant, the biggest in the country at 1,070 megawatts, reached full capacity in April. Some smaller new plants, including Xeset 2 and Nam Leuk 1 and 2, also started generating power. Most of their output is exported to Thailand (Figure 3.25.2).

Mining production rose by 19.0% last year, spurred by higher global metal prices. Output of copper from the two main mines—Phu Bia and Sepon—rose by 21.0% to 147,500 tons. Gold production rose by 7.0% to 173,000 ounces and silver by 13.5% to about 500,000 ounces.

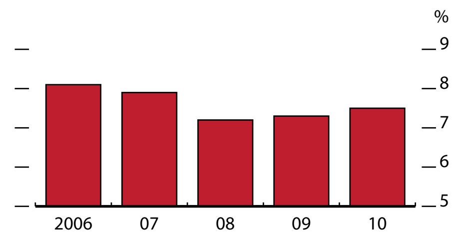
Construction activity benefited from expansionary fiscal and monetary policies.

The global recovery in travel lifted the number of tourists by about 25% to 2.5 million in 2010, with a strong rebound in tourism from Europe and the United States. That supported growth of 6.0% in the hotel and restaurant industry. Other services to grow by at least 6% were financial services, wholesale and retail trading, and transport and communications (boosted by the introduction of third-generation mobile telephone and Internet services). Services as a whole grew by 5.0%.

Agriculture, in contrast, which accounts for a third of GDP but employs about three-fifths of the workforce, suffered from bad weather (droughts followed by floods) as well as from diseases in pigs and cattle. Production of rice, the main crop, increased by about 4% to 3.26 million tons and fisheries recorded solid growth of 7.0%. The sector as a whole, though, grew by just 2.0%.

Consumer prices were on an upward trajectory last year, putting average inflation at 6.0%. Higher global oil prices pushed up the cost of fuel and transport, and bad weather and animal diseases disrupted food supplies, raising food prices. Strengthening domestic demand, the rollout of a value-added tax from April 2010, and growth in credit also fueled

3.25.1 GDP growth



Sources: Lao Statistics Bureau; Asian Development Outlook database.

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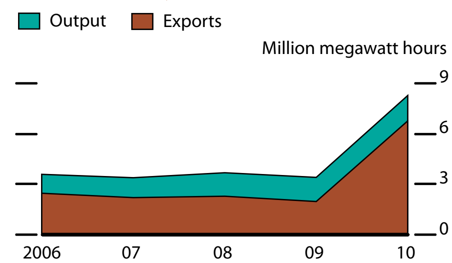
3.25.2 Electricity indicators



Source: Ministry of Energy and Mines.

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This chapter was written by A. Barend Frielink and Soulinthone Leuangkhamsing of the Lao Resident Mission, ADB, Vientiane.

inflation. Bank credit expanded by 46% last year, moderating from over 80% in 2008 and 2009. Growth in M2 money supply quickened to 39% in 2010 from 31% in the previous year (Figure 3.25.3).

Moving to counter inflation pressures, the Bank of the Lao PDR in September 2010 raised its policy interest rate, from 4.0% to 5.0% for loans of less than 1 week. It phased out direct lending for off-budget infrastructure projects, which had been a cause of high rates of growth in credit. However, disbursement of central bank lending committed in 2009 continued to feed credit growth.

The central bank also uses exchange rate policy to address inflation, aiming to limit fluctuations in the Lao kip to 5% a year against major currencies. In 2010, the kip rose against the US dollar by 3.0% but fell by 5.0% against the Thai baht (Thailand is a major source of imports).

The effectiveness of monetary policy is hampered by the widespread use of the US dollar. To promote use of the kip, the government has directed most of its revenue departments to accept only that currency and has asked wholesalers and retailers to use it for quoting prices. Such measures have helped to lower the level of dollarization to below 50% in 2010, from a peak of 79% in 1999.

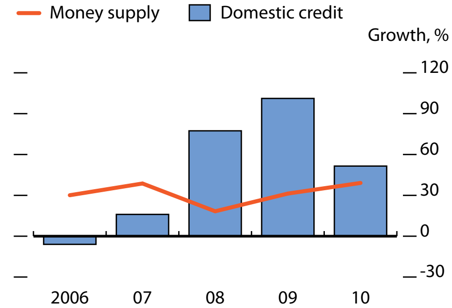
Strong growth in government revenue, in part a result of high global prices for copper and gold, helped to rein in the budget deficit in FY2010 (ended 30 September 2010). Growth in spending moderated relative to FY2009, when the government had lifted outlays to cushion the impact of the global recession. The budget deficit, including grants but excluding off-budget spending, narrowed to an estimated 3% of GDP from 5.1% in FY2009. Including off-budget spending, it was close to 5%.

Higher metal production and prices, along with the start of exports from Nam Theun 2, raised the US dollar value of merchandise exports by an estimated 30% to $1.9 billion in 2010. Mineral exports exceeded $1 billion for the first time and electricity exports rose to $375 million. Shipments of clothing increased in value by about 14% to $184 million, mainly on better demand from Japan and the Republic of Korea.

Merchandise imports rose by an estimated 13.5% to $2.8 billion. The trade and current account deficits narrowed, the latter to an estimated 9% of GDP from 12% in 2009 (Figure 3.25.4). After accounting for capital inflows, gross international reserves climbed to $727 million at end-2010, sufficient for about 3.5 months of nonresource imports.

As part of a more than decade-long effort to join the World Trade Organization, the government made progress in bringing foreign exchange, investment, tax, and trade regulations into line with the organization's requirements, and completed bilateral goods and services agreements with the People's Republic of China and Japan.

3.25.3 Monetary indicators



Source: Asian Development Outlook database.

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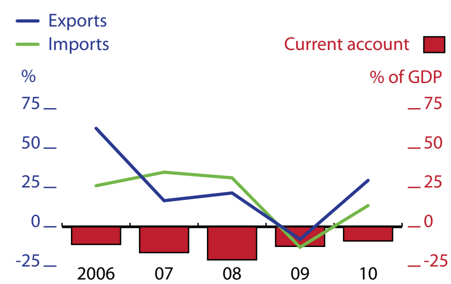
3.25.4 Current account indicators



Sources: Asian Development Outlook database.

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Economic prospects

The government's Seventh Socio-Economic Development Plan (2011–2015) strongly emphasizes growth, targeting annual average GDP expansion of 8% and moving the country from least developed country status by 2020.

Scheduled hydropower and mining activity in 2011 and 2012 will underpin growth. Nam Theun 2 will contribute to GDP for a full year from this year, and another relatively large new plant, Nam Ngum 2

3.25.1 Selected economic indicators (%)

	2011	2012
GDP growth	7.7	7.8
Inflation	6.5	6.0
Current account balance (share of GDP)	-9.0	-10.0

Source: ADB estimates.

(615 megawatts) is expected to be running at full capacity from April this year. Construction is set to start on a Nam Ngum 3 plant by midyear.

The Phu Bia and Sepon mines are scheduled to increase output this year, and construction is getting under way at the Hongsa coal-fired power plant (1,878 megawatts) and an associated coal mine. This project will cost more than $3 billion and is scheduled to generate electricity, mainly for export, from 2015.

A potash mine is being brought into production and a new rail line from the capital Vientiane to Yunnan province in the People's Republic of China is scheduled to be built by companies from that country. If this 5-year rail project starts as planned, it will likely have only a small impact on GDP this year but a greater contribution from 2012.

Services and construction are expected to maintain solid growth, bolstered by expansion of domestic demand and of tourism. Export orders suggest that clothing shipments will increase by about 10% in 2011.

Further, agriculture is expected to return to trend growth of about 2%, if weather permits, while higher global prices for cassava, corn, and sugar are likely to encourage wider planting. Private investment in plantation and contract farming is laying the basis for production gains for coffee, sugarcane, and some other crops in the years ahead.

Taking these factors into account, GDP growth is forecast to edge higher to 7.7% in 2011 and to 7.8% in 2012.

The government has budgeted to increase spending by 23% in nominal terms in FY2011, and it expects revenue to rise by about 27% owing to projected high prices for metals and April's rollout of the value-added tax. This would put the budget deficit at about 3% of GDP. On monetary policy, the target is to restrain growth in M2 money supply to 20% and in credit to 25% in 2011. The phasing out of central bank lending for off-budget projects should facilitate this tightening.

Higher prices for imported oil, coupled with growth in credit and a possible further depreciation of the kip against the Thai baht, will maintain upward pressure on inflation, which is projected at about 6.5% in 2011.

Merchandise exports are forecast to rise by about 25% in value this year, reflecting buoyant copper and gold prices and higher exports from the Nam Theun 2 and Nam Ngum 2 power plants. Exports of clothing and farm products, too, are projected to increase. Merchandise imports will likely grow at a slower rate than exports this year, but imports of machinery and materials for new projects are expected to pick up in 2012. The current account deficit is forecast to remain at around 9% of GDP in 2011 before widening in 2012 as imports accelerate.

The stock of external public debt, most of which is on concessional terms, has increased to $3.3 billion in absolute terms, but as a share of GDP it has declined to 52% from 82% over 5 years, owing to the growth in the economy and the kip's appreciation.

3.25.1 Development challenges

A central challenge is to pursue growth, as called for in the new development plan, while preserving macroeconomic stability.

A related issue is banking system soundness: high rates of growth in credit and a rapid expansion in the number of banks (from 13 to 23 in the 3 years to 2010) has increased risks for the banking system, which need to be addressed through vigilant supervision and a recapitalizing of state-owned banks.

Enduring challenges involve reducing poverty (the incidence was about 27% in 2008) and, related to this imperative, diversifying the economy's narrow base. Mining and hydropower have limited potential for job creation, and a heavy reliance on mining leaves the economy and the budget vulnerable to the inevitable downswings in global metal prices.

These twin goals therefore require investment and reforms in agriculture, which still supports the majority of the population, and improvements in the business environment to encourage a vibrant private sector.

Progress on the latter depends heavily on reforms in public sector management (including state-owned enterprises) and in public service delivery, as well as a more transparent and predictable policy and legal environment. The country is near the bottom (171 out of 183 countries) in the World Bank's *Doing Business 2011* ranking.

Transparency International places the country 154 out of 178 on its 2010 Corruption Perceptions Index, partly because the implementation or enforcement of approved laws and regulations remains weak.

The government has strategies to address governance and corruption, which focus on the public service, public participation, rule of law, and public finance. Their success will, though, depend on commitment from political leaders to ensure enforcement.

Malaysia

A robust recovery in 2010 was driven by stronger domestic demand and a recovery in exports. Domestic demand is expected to stabilize and GDP growth will moderate in 2011. Inflation is forecast to rise from low levels, but remain contained. The official goal to reach high-income country status by 2020 rests on effective implementation of a landmark but intricate structural reform program launched in 2010.

Economic performance

Strong domestic demand and a recovery in merchandise exports drove a 7.2% rebound in GDP in 2010 (Figure 3.26.1), after the global recession had pushed the economy into a 1.7% contraction in 2009.

Private consumption rose by 6.6% in 2010, buoyed by positive consumer sentiment, favorable labor market conditions, and rising credit to households and businesses. Public consumption was flat, reflecting reductions in operational expenditure as part of the government's fiscal consolidation efforts, which resumed (after a recession-related hiatus) in 2010.

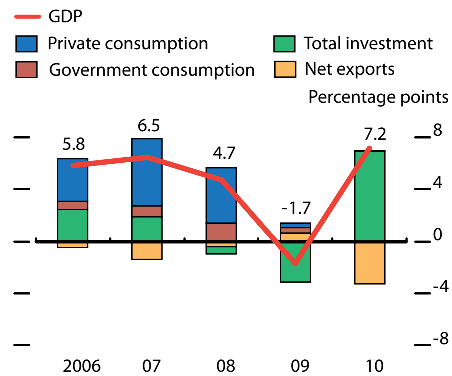
Investment, as measured by gross fixed capital formation and including public investment, surged by 9.4% and contributed most of the total growth in GDP last year. Private investment benefited from an expansion in production of domestically oriented manufacturing. The increase in exports of goods and services (9.8% in real terms) was more than offset by stronger growth of imports of goods and services (14.7%).

On the supply side, growth was supported by a relatively strong recovery in manufacturing output (11.4%) and by robust growth in services (6.8%) and construction (5.2%) (Figure 3.26.2). The recovery in manufacturing, which accounts for just over a quarter of total output, was driven by the strong growth in domestically oriented industries, notably those supplying construction and consumers. Export-oriented manufacturing was led by a surge in electrical and rubber products, and a more moderate expansion in chemical products.

Services, which account for 57% of GDP, experienced broad-based growth. The strongest gains were in real estate and business services, transport and storage, and wholesale and retail trade. Construction activity reflected a recovery in residential building, expansion in office and retail spaces, and progress in infrastructure projects. Agriculture, however, was subdued, as a rise in natural rubber production was largely offset by declines in crude palm oil and cocoa, while mining output was stagnant largely as a result of a 3.3% decline in crude oil production.

Inflation increased to average 1.7% in 2010, mainly owing to higher prices of food and drink and nondurable goods. Rising global commodity and energy prices lifted inflation to 2.4% year on year in January 2011 (Figure 3.26.3). An increase in the administered price of sugar in late 2010

3.26.1 Contributions to growth (demand)



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; Department of Statistics Malaysia. http://www.statistics.gov.my (both accessed 16 March 2011).

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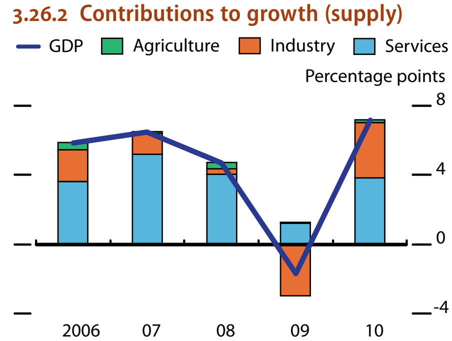
3.26.2 Contributions to growth (supply)



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; Department of Statistics Malaysia. http://www.statistics.gov.my (both accessed 16 March 2011).

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This chapter was written by Eric Sidgwick of the Southeast Asia Department, ADB, Manila.

contributed to inflation. Core inflation, which excludes the more volatile food and drinks, has been edging up steadily since February 2010.

Residential property prices rose quite sharply in 2010, with the house price index up by about 6% through end-September (the latest available data) reflecting higher prices in Kuala Lumpur and Selangor state.

As private sector demand rebounded, Bank Negara Malaysia, the central bank, unwound a good part of the monetary stimulus injected in 2009. It raised the overnight policy rate three times during March–July 2010, by a cumulative 75 basis points, to 2.75%, and kept it there through the rest of the year. The economy's output was still below its potential and there were no strong signs that rising inflation stemmed from demand pressures. Moreover, the appreciation of the ringgit against trading partner currencies, of around 10% in 2010, helped to damp imported inflation.

Labor market conditions generally mirrored the rebound in domestically generated economic activity. While the labor force increased by 2.2% in 2010, to 11.7 million, the number of people employed rose by 2.5%, to 11.3 million. The unemployment rate fell to 3.2% in December 2010, from 3.4% at end-2009.

In United States (US) dollar terms, total merchandise exports rebounded in 2010, by 26.4%, to $198.6 billion (Figure 3.26.4)—following a contraction of 21.1% in 2009—recovering 2008's level of exports. Shipments of electrical and electronic products (40% of total exports), rose by 20%, and other manufactured exports by about 30%. Exports of petroleum products, palm oil, liquefied natural gas, and crude petroleum (together a quarter of total exports) recorded surges of 33%–44%. The top five export destinations—Singapore, the People's Republic of China, Japan, the US, and Thailand (in that order)—represented just over half of total exports.

Imports rebounded faster than exports, surging by 33.6% to $156.2 billion, more than offsetting the 21.0% contraction in 2009. Imports of intermediate goods, which account for over two-thirds of the total, rose by about 34%. The trade surplus of $42 billion remained broadly unchanged from 2009 in US dollar terms.

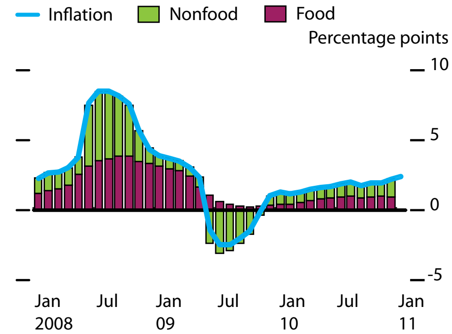
Higher payments for transport and other services linked to the initial sharp pickup in trade caused the services account to deteriorate. Deficits on the income and transfers accounts widened, the latter owing to higher remittances from foreign workers in Malaysia. As a result of these moves, the current account surplus declined by 11.7% to $28.1 billion, equivalent to 11.8% of GDP.

The capital and financial account deficit narrowed greatly, owing to lower net foreign direct investment (FDI) outflows, and a surge in portfolio inflows of $14.0 billion (Figure 3.26.5), reflecting a strengthening ringgit and sharply higher equity inflows, mostly from Europe, into government securities, corporate bonds, and stocks.

Inward FDI climbed to $8.6 billion, with a particularly steep rise in investment in services, while outward FDI surged to $13.2 billion. Other capital outflows decreased slightly, on account of lower private capital outflows. International reserves at end-February 2011 were up to $109.8 billion, sufficient to finance 8.1 months of retained imports and equivalent to 4.3 times short-term external debt.

Following an expansionary fiscal policy in 2009, consisting of two

3.26.3 Monthly contributions to inflation



Sources: Bank Negara Malaysia. 2011. *Monthly Statistical Bulletin*. January. http://www.bnm.gov.my; Department of Statistics Malaysia. http://www.statistics.gov.my (both accessed 16 March 2011).

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3.26.4 Trade growth

Source: CEIC Data Company (accessed 16 March 2011).

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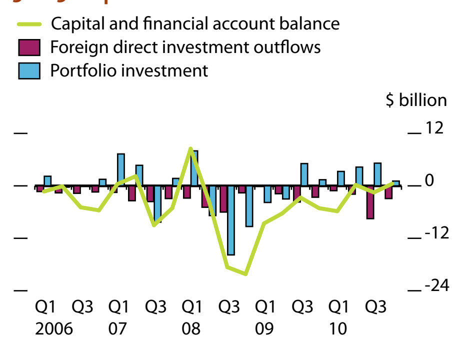
3.26.5 Capital account indicators



Source: CEIC Data Company (accessed 16 March 2011).

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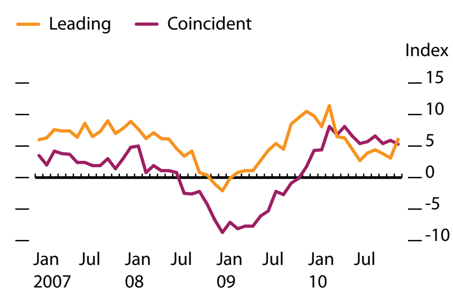
3.26.6 Growth of leading and coincident indexes



Source: CEIC Data Company (accessed 16 March 2011).

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fiscal stimulus packages that widened the overall federal budget deficit to 7.0% of GDP, preliminary figures indicate that the deficit narrowed in 2010 to 5.6% of GDP, as budgeted. This outcome was achieved mostly through a modest increase in revenue and restrained operational spending.

By mid-2010, direct subsidies had risen to nearly 11% of federal government operating expenditure, with over half going for fuel subsidies. Moving to rein in this cost to the budget, three times in 2010 the government raised fuel prices (they are still lower than in neighboring countries) and sugar prices by just over 10%.

Reflecting the reduction in the federal budget deficit, the ratio of federal government debt to GDP declined from 54.0% in 2009 to 51.3% in 2010. Only 3.5% of the public debt was external.

Economic prospects

The outlook for the forecast period are predicated on two key assumptions (in addition to the *Asian Development Outlook 2011* baseline for the global economy). First, the surge in mostly short-term capital inflows stabilizes and does not generate inflation pressures. Second, the government can quickly start carrying out its structural reform program (Box 3.26.1), which will require not only effective horizontal coordination across line ministries and agencies but also vertical coordination between the federal and state governments.

On this basis—and against the backdrop of slowing growth in external demand from major industrial countries, continuing domestic fiscal consolidation, and dissipating base effects—GDP growth is projected to moderate to 5.3% in 2011.

Domestic demand is likely to be the key driver of growth, reflecting broadly positive consumer and investor sentiment. Net exports are expected to exert a continued (though lightening) drag as the rate of growth of imports of goods and services stabilizes following the rebound in 2010.

Private consumption is seen staying robust and benefiting from relatively favorable employment, good real wages in manufacturing, rising commodity prices, and the accommodative financing environment. Consumer sentiment, for example, rose in the fourth quarter of 2010.

Private investment is expected to pick up later in 2011—the Department of Statistics' leading index rose by 2.7% in December last year (Figure 3.26.6). With ample liquidity, private investment is seen gathering momentum as the government starts implementing its structural reforms.

Exports are projected to rise moderately in 2011, by 8.0%, as softer demand from Japan and the US is only partly compensated by more robust demand from Asia. Imports are foreseen to rise by 10.0%, reflecting continued imports of capital equipment and intermediate goods. The current account surplus is likely to decline further in 2011, to 10.0% of GDP. The capital and financial account deficit is set to shrink, on the back of healthy portfolio inflows and FDI, bringing about an increase in international reserves.

In 2012, growth is forecast to remain at 5.3%, as the projected modest rise in export growth is offset by the anticipated adverse impact on inflation and domestic demand stemming from increased global food prices this year. Also in 2012, higher capital imports associated with

3.26.1 Structural change

The goal of the structural reform program launched by the government in 2010 is to enable Malaysia to break free of a middle-income trap and reach high-income country status by 2020.

The intended structural sea-change is to be achieved by four main approaches:

- generating growth that is more inclusive and sustainable, through the implementation of eight "strategic reform initiatives" to ease constraints to higher private investment;
- implementing market-friendly affirmative action programs that target the bottom 40% of households, many of which are in Sabah and Sarawak;
- improving public service delivery while reducing large and persistent fiscal deficits stemming in part from high subsidies; and
- placing equal emphasis on protecting the environment and economic growth.

An Economic Transformation Program prepared with private sector input identifies about 130 projects that involve huge, primarily private, investment over 10 years. Another 60 projects have been identified for subsequent implementation.

The success of the structural transformation, the first phase of which begins under the recently endorsed Tenth Malaysia Plan 2011–2015, will be measured against set objectives and delivery of impacts over the next decade.

In the nearer term, the credibility of the program will be judged on how well strategic reform initiatives improve the investment environment, and how effectively the associated projects are implemented, as measured by consumer and investor sentiment and higher actual investment.

stronger private investment are likely to outweigh the rise in exports, and the current account surplus is expected to narrow to around 9.0% of GDP (Figure 3.26.7).

The 2011 budget aims for a slight reduction in the federal government deficit to 5.4% of GDP by reducing gross development expenditure by 9% in ringgit terms from the 2010 outturn.

Inflation is seen rising this year, mainly reflecting global increases in food and fuel prices and reductions in fuel subsidies domestically. Average inflation is put at 3.0% in 2011 and 2012 (Figure 3.26.8).

While the monetary stance remains accommodative, large shifts in global liquidity—including from potentially volatile portfolio inflows—are building liquidity in the domestic financial system. Bank Negara Malaysia, in a preemptive bid to help offset the risks of economic and financial imbalances arising from such a buildup, doubled the statutory reserve requirement of commercial banks to 2%, from 1 April this year. It had already indicated in March that it might need to raise interest rates if domestic demand rose and put upward pressure on prices.

The economy relies heavily on external markets, and the main downside external risk to the forecasts is a lower than expected recovery in demand from major industrial countries. The competitiveness of manufactured exports could be dented by further real appreciation of the ringgit.

Domestic risks center on any apparent lack of progress by the government's structural reform program, which includes steps to quickly improve the investment climate. Such perceptions could drag down investor sentiment, inhibiting the required increase in private investment.

Development challenges

Over three decades, Malaysia has largely eradicated poverty, built a world-class infrastructure, and become a major exporter. Yet the country is stuck in a middle-income trap—per capita gross national income was around $7,350 in 2009—in which the strategies adopted to attain the current level are inadequate to take it to the next stage.

The ratio of private investment to GDP has stagnated at below 25% of GDP for a decade, compared with rates of over 30% of GDP in the mid-1990s, partly because doing business in Malaysia is still too difficult. The country is also losing its attractiveness as an investment destination, seen in its falling ranking in the Global Competitiveness Index—26 in 2010 (Figure 3.26.9).

Another vulnerability is that exports are heavily concentrated in electrical and electronic products—eventually destined for industrial-country markets where demand is volatile—and primary commodities (such as petroleum and palm oil) whose prices are volatile. Both types of export generate little value added and employ workers mainly of low-skills on low-wages. And although labor productivity is growing, it is doing so slowly, inhibiting creativity and innovation. Socially, the gap between rich and poor is widening.

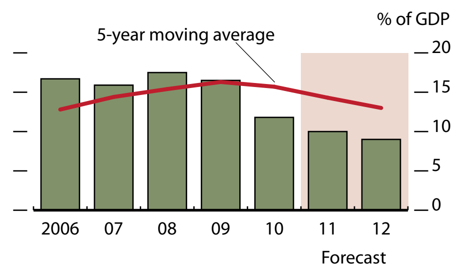
It is in this context that the government has embarked on its ambitious structural reform program (Box 3.26.1).

3.26.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.3	5.3
Inflation	3.0	3.0
Current account balance (share of GDP)	10.0	9.0

Source: ADB estimates.

3.26.7 Current account balance



Sources: Asian Development Outlook database; ADB estimates.

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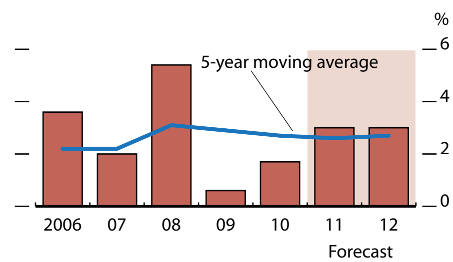
3.26.8 Annual inflation



Sources: Asian Development Outlook database; ADB estimates.

Click here for figure data

3.26.9 Global competitiveness

Note: The Global Competitiveness Index covers 139 economies.

Source: World Economic Forum. *Global Competitiveness Report*. Various years. http://www.weforum.org

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Myanmar

Economic growth edged up over the past 2 years, accompanied by relatively modest inflation. The economy is expected to grow moderately over the forecast period, supported by foreign investment in construction and higher levels of credit to agriculture. The government that took office in March 2011 faces an extensive agenda of reforms if the country is to reach its potential.

Economic performance

Growth recovered to an estimated 5.1% (Figure 3.27.1) in the fiscal year ended 31 March 2010 (FY2009), after slowing in the previous year owing to the impact of Cyclone Nargis and weakness in demand for imports from neighboring economies. The recovery in FY2009 was led by improved results from agriculture, mining, manufacturing, and the transport and communications subsectors. Living standards remain low, however.

Agriculture, including fisheries, forestry, and livestock, accounts for over half of employment and about 40% of GDP. Production from this sector picked up in FY2009 as areas damaged by the cyclone, mainly in the Ayeyarwady and Yangon divisions, were gradually rehabilitated.

More recently, economic growth edged up to an estimated 5.3% in FY2010 (ending 31 March 2011), with a solid contribution from construction, particularly in Naypyidaw, the new capital, and Mandalay (a highway connecting these cities was under construction). Economic recovery in neighboring countries that import goods including food and natural gas from Myanmar supported the lift in growth in FY2010.

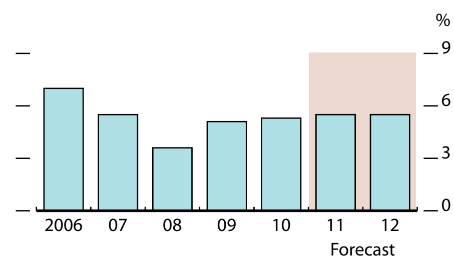
Agriculture in FY2010 was sluggish, however, a result of persistent drought in the central region and residual soil salinity in cyclone-affected areas.

(Official GDP growth figures, which are considerably higher than these unofficial estimates, are inconsistent with variables that are closely correlated with economic growth, such as energy use. Economic data are not timely either, making it difficult to assess economic developments.)

The government has financed part of its fiscal deficit through Treasury bond issues in the past 3 years, rather than relying completely on money creation to finance the fiscal gap. This approach has contributed to lowering inflation from over 20% to single digits in that period. Average inflation was estimated at 8.2% in FY2009 and 7.3% in FY2010.

Export income from natural gas continued to support the external accounts. Export prices for gas fell by about 20% in FY2009, dragging down earnings from this source, but receipts recovered to $2.7 billion in FY2010 as demand from Thailand picked up. However, higher levels of

3.27.1 GDP growth



Source: Asian Development Outlook database.

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This chapter was written by Alfredo Perdiguero of the Southeast Asia Department, ADB, Manila.

imports of construction materials and equipment widened the current account deficit to the equivalent of 2.2% of GDP in FY2010, from 1.3% in FY2009.

Inflows of foreign direct investment into the hydrocarbon sector helped to lift international reserves to about $5.3 billion at end-FY2010, equivalent to 7 months of imports (Figure 3.27.2). The market exchange rate of the kyat appreciated from about MK1,000/$1 to MK830/$1 in the year to January 2011.

Estimates of the consolidated fiscal deficit, covering the central government and state economic enterprises, indicate it widened to 5.7% of GDP in FY2010 from 5.4% in FY2009 (Figure 3.27.3). Expenditure on the construction of Naypyidaw remained a drain on the budget, while revenue growth was sluggish. The practice of valuing exports of state enterprises at the official exchange rate of MK5.5/$1 (as opposed to the market rate) undervalues revenue available for spending.

High administered bank interest rates (17% for lending and 12% paid on deposits) discourage banks from buying the lower-yielding Treasury bonds. Consequently, bond issues funded only about one-third of the fiscal deficit in FY2010.

The government privatized several state assets in 2010, including an airline, 243 gasoline stations, public buildings, and rice distribution operations. Further asset sales are expected.

Economic prospects

Forecasts assume both normal weather patterns and a start to gradual economic reforms by the government that took office in March 2011.

A modest increase in rural incomes, owing to increased exports and prices of cash crops, is expected to underpin private consumption in FY2011.

The Myanmar Agriculture Bank doubled credit to farmers in 2010. Further increases are planned in the next 2 years, going some way to addressing severe shortages of credit to agriculture. These moves, coupled with the gradual easing of controls on agriculture over recent years, are expected to stimulate production.

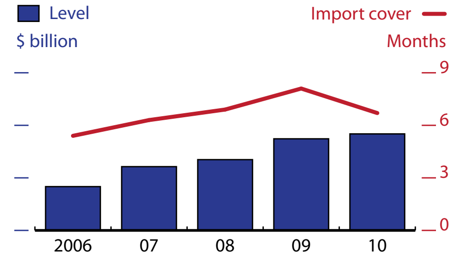
Investment is projected to rise in the forecast period, notably in construction. Projects planned or under way include new hydropower plants, gas fields, and oil and gas pipelines to the People's Republic of China, largely financed by foreign investment. A Thai company agreed last year to build a port, power plant, and industrial estate in Dawei in southern Myanmar starting this year, and a company from the People's Republic of China signed a contract to build an airport at Naypyidaw.

Gas production is projected to be fairly flat in the forecast period, before new projects come on stream in about 3 years. Gas export prices will likely rise, together with global energy prices and solid demand from Thailand. (This will have a limited impact on GDP because gas income is converted at the official exchange rate rather than the market rate.)

On the balance of these factors, GDP is forecast to grow by about 5.5% in the next 2 years.

Inflation is projected at 8.0% in the forecast period (Figure 3.27.4), reflecting higher domestic demand and increased global prices of food

3.27.2 International reserves



Sources: *Asian Development Outlook* database.

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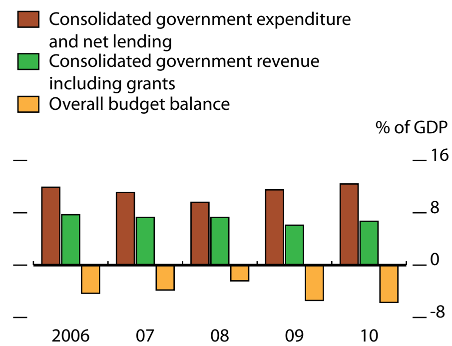
3.27.3 Fiscal indicators



Source: *Asian Development Outlook* database.

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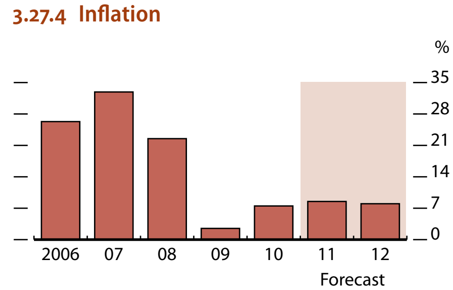
3.27.4 Inflation



Sources: *Asian Development Outlook* database.

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and fuel. The domestic price of rice surged in early 2011. A government decision to suspend rice exports in March 2011 is expected to moderate price increases, but much rice is still exported illegally.

The current account deficit is seen widening to 4.1%–4.7% of GDP (Figure 3.27.5). Increases in export earnings from gas and food crops will likely be offset by stronger imports of capital equipment and construction materials.

3.27.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	5.5
Inflation	8.0	8.0
Current account balance (share of GDP)	-4.1	-4.7

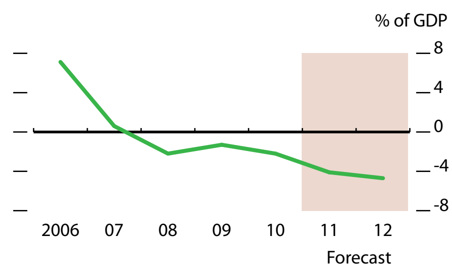
Source: ADB estimates.

Development challenges

The country faces an extensive agenda of reforms to realize its potential. It lags its neighbors in living standards and poverty reduction, requiring a steep increase in economic growth, as well as a more equal distribution of income and wealth, to narrow this gap.

A comprehensive process of reforms includes improving the climate for investment, generating fiscal resources to expand social and infrastructure expending, unifying the exchange rate, developing the finance sector, strengthening macroeconomic management, and liberalizing agriculture and trade.

3.27.5 Current account



Source: Asian Development Outlook database.

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The finance sector is undeveloped but has considerable potential to support economic growth. Four new banks and 49 new bank branches were approved in 2010, helping lift private credit significantly. However, banking assets remain low and only about one-third of all private financing is sourced from the formal sector. Expanding access to formal finance involves allowing state banks to operate on a fully commercial basis, liberalizing interest rates, easing collateral requirements, and relaxing bank deposit-to-capital ratios.

Agricultural credit is inadequate, despite last year's improvement. Farmers are often unable to afford sufficient farm inputs and have reduced the intensity of land cultivation. Eliminating barriers for private banks to expand in rural areas, introducing crop insurance, and issuing land-use certificates to farmers could be useful reforms to expand credit. Such measures could be complemented by public investment in rural infrastructure.

Privatizing state assets has the potential to encourage private sector development if the outcome leads to greater competition and investment. Making the process more transparent would improve investor confidence and asset valuations. Developing the private sector more generally depends on upgrading the regulatory, legal, and policy environment, as well as introducing higher standards of governance.

Gas export income adds to foreign exchange reserves, but has little impact on GDP or the budget owing to conversion at the official exchange rate. Such income would greatly lift government revenue if it was converted at the market exchange rate, enabling increases in expenditure on health, education, and infrastructure (social spending as a ratio to GDP, at about 1%, is well below that of most developing countries).

Further in this direction, unifying the multiple exchange rates would create additional fiscal resources, as would broadening the tax base (with fewer tax exemptions), a simplified tax structure, and greater emphasis on direct (rather than indirect) taxes, which are fairer to the poor.

Philippines

Robust private consumption alongside recoveries in exports and investment drove a vigorous economic rebound in 2010, while inflation remained moderate and the external position strengthened. Yet progress remained slow in reducing poverty and generating jobs. The forecast is for solid economic growth this year and next, and sustained increases in investment now appear achievable—provided that the government pushes through with policy and governance reforms.

Economic performance

A strong recovery in 2010 lifted GDP by 7.3%, as private consumption accelerated and exports and investment rebounded from a slump in 2009 (Figure 3.28.1). Nearly 60% of total growth came from private consumption, which rose by 5.3%. Remittances from overseas workers remained a key support to consumption, growing by 8.2% to $18.8 billion (the increase in peso terms was 2.4%).

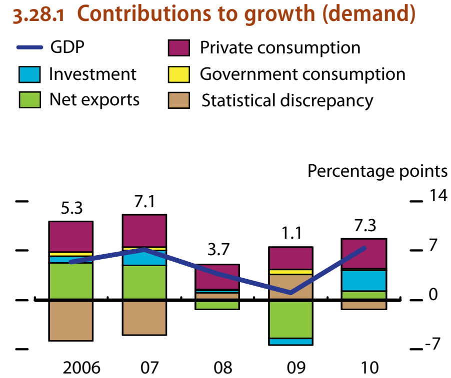
Investment contributed about 40% of total growth, the highest proportion in 10 years. Fixed capital outlays climbed by 17.1%, with equipment investment surging by 25.7%. Double-digit growth was recorded for investment in a broad range of equipment, including that for agriculture, construction, mining, metalworking, transport, and telecommunications. Fixed investment as a ratio to GDP edged up to 15.7%, the strongest rate in 6 years (Figure 3.28.2).

Recovery in exports and robust consumption underpinned this strong investment, with support from higher corporate earnings and low interest rates. Presidential and legislative elections in May 2010 went smoothly, and businesses generally were optimistic about the new government's commitment to improve the business climate. Surveys on business expectations showed steady gains in confidence throughout the year. Net exports, which had been a drag on GDP growth during the global recession, also made a positive contribution.

Government expenditure rose in the first half, before the new administration reined in some spending in the second half to curb the fiscal deficit.

On the production side, industry was the main contributor to growth (Figure 3.28.3), overtaking services. Manufacturing output increased by 12.3%, after shrinking in 2009. Export-oriented electrical machinery manufacturing shot up by nearly 33%, and industries such as food processing, petroleum products, and textiles recorded significant output gains. Construction activity rose by 10.5%, driven by strong demand for office space, particularly from the business process outsourcing subsector, and for housing. Low interest rates also stimulated construction.

3.28.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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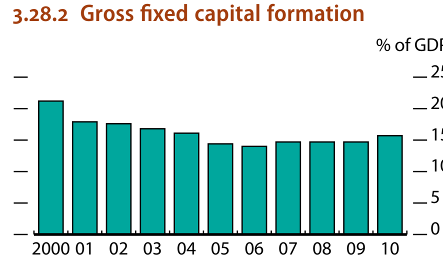
3.28.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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This chapter was written by Teresa Mendoza and Norio Usui of the Philippines Country Office, ADB, Manila.

Services, still the biggest sector and generating about half GDP and employment, grew by 7.1% last year. Much of the growth came from retailing, which is bolstered by remittance inflows. Other high-growth components were business process outsourcing, finance, and real estate.

Dry weather caused by an El Niño weather pattern cut agricultural output, however, by 0.5%, a second consecutive year of weak performance (production was flat in 2009 mainly owing to severe tropical storms). Agriculture's share of GDP fell to just under 17%, although the sector still accounts for about a third of employment.

The strong economic rebound did not spark inflation (Figure 3.28.4): consumer prices rose by an average of 3.8%, within the 3.5%–5.5% target range set by Bangko Sentral ng Pilipinas, the central bank. Higher global oil prices pushed up transport costs (although an appreciating peso helped to damp imported price pressures) and electricity costs rose as the dry weather limited output from hydropower plants. Food price rises were relatively subdued, in part because rice imports countered local production shortfalls caused by the bad weather.

With moderate inflation, the central bank kept policy interest rates in 2010 at the low levels it set during the global downturn—the overnight borrowing rate at 4.0% and the overnight lending rate at 6.0%. Pressures to raise rates to more normal levels as the economy rebounded were lessened by the appreciation of the exchange rate and the fact that real policy rates remained positive. The central bank did, however, withdraw some of the liquidity-enhancing measures that it took during the recession. Domestic liquidity rose by about 11%, a moderate increase given the strength of the economic recovery.

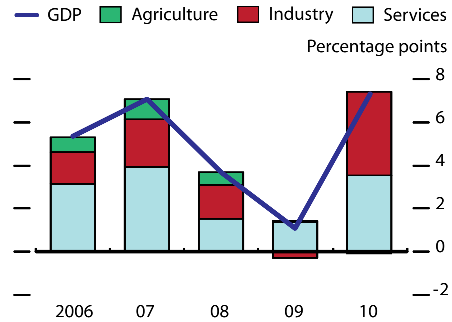
Merchandise exports shot up by 34.8% to $50.7 billion in 2010 (an increase of $13.1 billion over 2009), recovering from a 22% plunge in 2009 (Figure 3.28.5). Electronic products including semiconductors (three-fifths of total exports) surged by 40% as global demand bounced back. Shipments to the People's Republic of China and Southeast Asia nearly doubled from 2009, on healthy recovery there. The People's Republic of China accounted for 11.1% of total exports, well up from 7.6% in 2009, while Southeast Asia's share went up to 22.5% from about 15%. The share of exports going to the United States fell to 14.7% from 17.7%.

Imports rose by 31.5% or by $14.6 billion, reflecting strong demand for capital equipment, consumer goods, imported inputs for export-oriented manufacturing, and dearer oil. The deficit in merchandise trade widened by 17% to $10.4 billion, reflecting the higher growth in imports than exports.

The current account posted a surplus of $8.5 billion, equivalent to 4.5% of GDP, as a result of higher services receipts (mainly from business process outsourcing) and remittances. Coupled with the turnaround to net inflows in the capital and financial account in 2010, the overall balance-of-payments surplus rose to 7.6% of GDP.

Net portfolio investment amounted to $4.0 billion, driven by renewed global appetite for emerging markets. Partly on these inflows, stock prices soared by 38% and total stock market capitalization by 47% in 2010. The yield spread between United States and Philippine government bonds narrowed further (Figure 3.28.6). Still, net foreign direct investment remained low by regional standards, at $1.2 billion in 2010.

3.28.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011).

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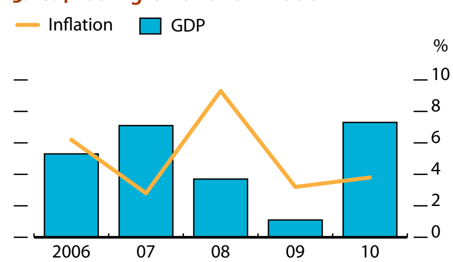
3.28.4 GDP growth and inflation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 1 February 2011); National Statistics Office. http://www.census.gov.ph (accessed 10 March 2011).

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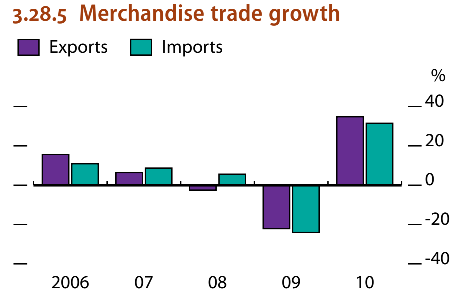
3.28.5 Merchandise trade growth



Sources: Bangko Sentral ng Pilipinas. http://www.bsp.gov.ph; CEIC Data Company (both accessed 26 March 2011).

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Robust external accounts supported a 41% increase in gross international reserves to $62.4 billion at end-2010, equivalent to more than 10 months of import cover. The strong current account and capital inflows also drove a 5% appreciation of the peso against the US dollar in 2010. To temper gains, the central bank approved higher ceilings on foreign exchange purchases such as those for outward investment and import payments, and it encouraged the public and private sectors to prepay foreign currency–denominated debt.

Successful issuance of sovereign bonds eased concerns about financing the fiscal deficit. The government sold its first issue of peso-denominated global bonds in September 2010, and followed up with another large issue (equivalent to $1.25 billion of 25-year bonds priced to yield 6.25%) in January 2011. These issues, sold at a time of relatively low global interest rates, helped to reduce the government's foreign exchange risk and lengthen its debt profile. The government further raised $1.5 billion from the issuance of 15-year US dollar global bonds in March 2011. These issues were heavily oversubscribed.

Economic prospects

The outlook for this year and next assumes that the government follows through on its commitments to improve the fiscal position, governance, and the business environment, and that some of its planned public–private partnership projects start in the forecast period.

On fiscal policy, the government pulled back the deficit in 2010 to 3.7% of GDP from 3.9% in 2009. It trimmed noninterest expenditure in the second half by 0.4% year on year, after 15.8% growth in the first half (Figure 3.28.7). It also showed some progress in strengthening tax collection: tax revenue for the year rose by 11%, but was still short of target.

Fiscal policy will likely be less stimulative to the economy in 2011, given that the authorities aim to reduce the deficit to 3.2% of GDP (Figure 3.28.8). The budget approved in December 2010 restrains growth in public spending, but also puts greater emphasis on social services such as conditional cash transfers to the poor. It reduces infrastructure spending as the government looks to the private sector to play a greater role.

Five initial infrastructure projects (including construction of expressways and the privatization of light railway operations in Manila) are to be put out for bidding by midyear under public–private partnership arrangements.

The forecasts assume that monetary policy will be tightened gradually, continuing the first step made in March 2011 when the central bank raised the policy rates by 25 basis points to 4.25% for the overnight borrowing rate and to 6.25% for the overnight lending rate. They also assume that political uncertainties and natural disasters in countries that host many Filipino workers do not seriously hurt remittance inflows (about 16% comes from the Middle East and around 5% from Japan—Figure 3.28.9).

Sustained business optimism points to further growth in private investment. The outlook for business confidence for the second quarter of 2011 rose to the highest level since the survey started in 2001

3.28.6 Sovereign risk spreads

Source: Bloomberg (accessed 11 March 2011).

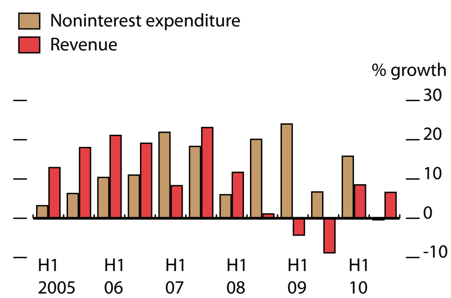
Click here for figure data

3.28.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.0	5.3
Inflation	4.9	4.3
Current account balance (share of GDP)	4.1	3.9

Source: ADB estimates.

3.28.7 Fiscal indicators



Sources: CEIC Data Company; Bureau of the Treasury. http://www.treasury.gov.ph (both accessed 11 March 2011).

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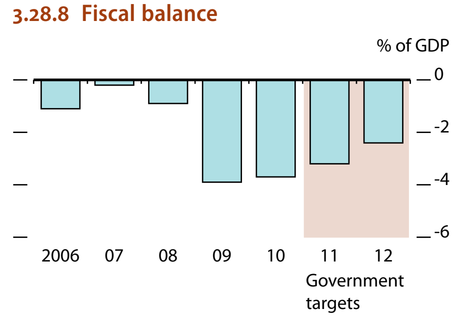
3.28.8 Fiscal balance



Sources: CEIC Data Company; Bureau of the Treasury. http://www.treasury.gov.ph (both accessed 11 March 2011).

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(Figure 3.28.10). Investment pledges reported by government agencies rose by 73% in 2010, mainly for manufacturing, utilities, and real estate. Capacity utilization in some manufacturing industries is at high levels, which is conducive to investment.

Upgrades by credit rating agencies support the investment environment. Standard & Poor's raised the Philippines' long-term foreign currency debt rating in November 2010 to BB, or two notches below investment grade, at par with Fitch's. Moody's, which rates the Philippines Ba3, in January 2011 lifted its outlook on the country's foreign- and local-currency bonds to positive, from stable, citing the stronger external position, well-managed inflation expectations, and improved prospects of economic reform.

On the supply side, services will benefit from growth in private consumption and investment. Manufacturing will get support from increased domestic and export demand, though its growth will decelerate after last year's strong bounce. Private construction is seen remaining healthy because of sustained demand for office space and housing. Agriculture is projected to recover from last year's contraction, but a La Niña weather pattern evident early in 2011 could bring heavier rainfall than usual for part of this year.

Taking into account these factors and the base effect of the strong recovery in 2010, GDP growth is projected at 5.0% in 2011, quickening to 5.3% in 2012 (Figure 3.28.11) on the assumption that good progress is made on starting some public–private projects.

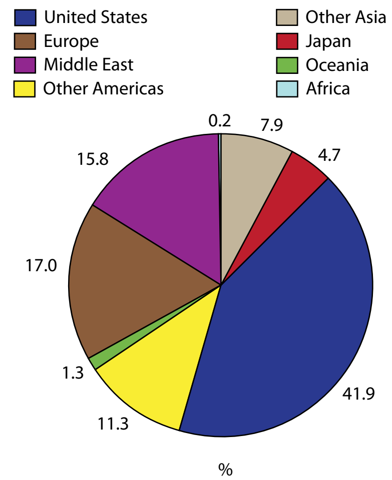
Inflation is forecast to rise to 4.9% in 2011 (it was 3.9% in the first 2 months). This projection reflects, besides higher prices for imported oil, hikes for utility charges and public transport fares. Higher global food prices will also put upward pressure on inflation, although this is cushioned by rice inventories and expectations of an improved harvest. On the basis of a deceleration in global commodity prices, inflation in 2012 is forecast to ease to 4.3% (Figure 3.28.12).

Growth in merchandise exports is seen pulling back from last year's levels to about 11% in the forecast period. Imports will likely grow slightly faster than that on the back of the projected growth in consumer demand and investment, as well as higher oil and commodity prices. The trade deficit is set to widen, but the services account will remain in surplus, largely because of growth in business process outsourcing. Remittances will remain a significant contributor to current account surpluses, which are forecast at about 4% of GDP during the forecast period (Figure 3.28.13).

In the context of still high national government debt (equivalent to 55.4% of GDP in 2010) the government has committed to reduce the budget deficit to 2.0% of GDP by 2013 and the debt to 47% of GDP by 2016. The focus on the revenue side of the budget is to raise the tax-to-GDP ratio from 12.8% in 2010 to 16%–18% over several years, through (at least for now) tighter tax administration and reforms to excise tax and investment incentives, rather than increases in tax rates.

For spending, the plan is to weed out programs that are no longer relevant or efficient and to strengthen the finances of government-controlled corporations. The government is also pushing for a fiscal responsibility law, under which proposals to grant fiscal incentives or

3.28.9 Remittances by region, 2010



Source: CEIC Data Company (accessed 11 March 2011).
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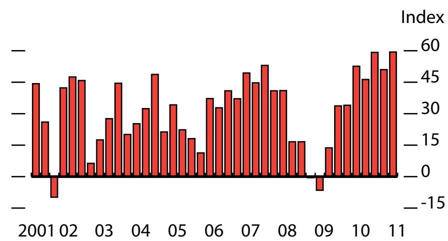
3.28.10 Business expectations index



Notes: Represents index for the next quarter. 2001 data is for June.
Source: CEIC Data Company (accessed 11 March 2011).
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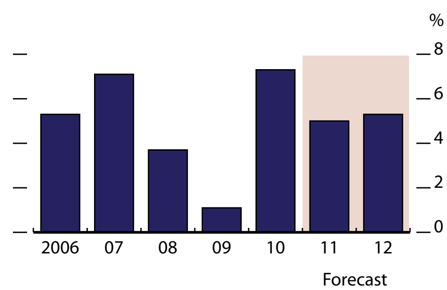
3.28.11 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 11 March 2011).
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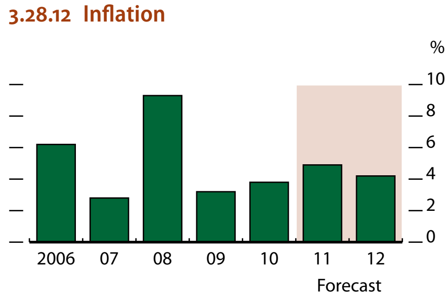
3.28.12 Inflation



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 11 March 2011).
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permanent increases in national government expenditure would require supporting revenue-raising measures or offsetting spending cuts.

Risks to the growth and inflation forecasts on the downside are global economic growth that is weaker than expected, interruptions to remittance inflows, and higher than forecast increases in global oil and food prices. There is a risk that the disruption to supply chains after the Japanese earthquake could dent manufacturing production and exports in 2011. Electronics and semiconductors, major export industries in the Philippines, depend heavily on components from Japan. Lack of progress in the public–private partnership program or in efforts to improve governance and public finances would likely undermine business confidence. A severe La Niña could delay agriculture's recovery.

Development challenges

Lackluster growth in employment is a chronic problem. Despite strong economic growth last year, the unemployment rate fell only slightly to 7.3% (Figure 3.28.14). Young people aged 15–24 account for about half the unemployed. The underemployment rate also remained high at about 20%. The proportion of workers classified as vulnerable—unpaid family members and the self-employed, most of whom are in the informal sector—has declined since 2006, but remains high at nearly 42%. Moreover, the lack of jobs drives large numbers of Filipinos to work abroad.

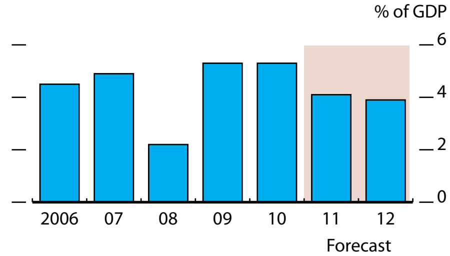
Weak employment generation and low productivity equate with slow reductions in poverty. The number of people living in poverty increased by 3.3 million to 23.1 million in the 6 years to 2009, when the incidence of poverty rose to 26.5% from 24.9%. Progress has been slower than hoped for on the Millennium Development Goals relating to poverty, maternal health, and primary education.

Much remains to be done to improve the business environment so that private investment and employment grow consistently. According to the World Economic Forum, the global competitiveness ranking of the Philippines in 2010/11 was 85 (out of 139 countries), compared with Malaysia (26), Thailand (38), Indonesia (44), and Viet Nam (59). Investors cited concerns such as poor infrastructure and policy instability.

The World Bank's *Doing Business 2011* report also showed the Philippines below these countries, ranked 148 out of 183, and slipping from the previous year's 146. Transparency International's 2010 Corruption Perceptions Index had the Philippines scoring just 2.4 out of 10 (Figure 3.28.15), where zero represents highly corrupt.

Against this backdrop, one key policy challenge is for the government to sustain the higher level of investor confidence built up last year by pushing ahead with policy and governance reforms. Another is to raise state revenue so as to fund the social development and infrastructure programs required to reduce poverty and underpin a stronger private sector.

3.28.13 Current account



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 26 March 2011).

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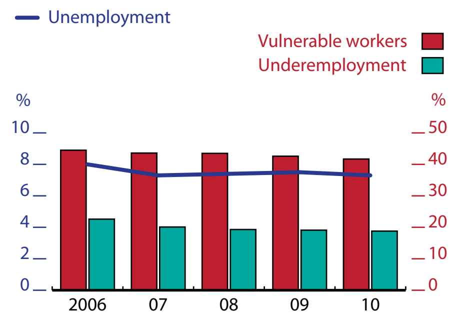
3.28.14 Labor indicators



Sources: CEIC Data Company (accessed 11 March 2011).

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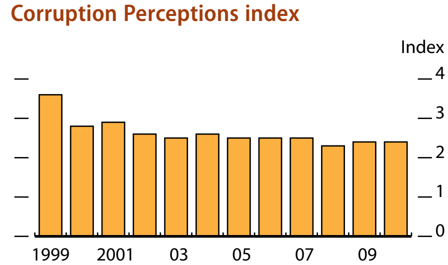
3.28.15 Transparency International's Corruption Perceptions index



Note: The index focuses on corruption in the public sector. It ranges from 0 to 10, with 0 the most corrupt.

Source: Transparency International. http://www.transparency.org/policy_research/surveys_indices

Click here for figure data

Singapore

The economy recovered to grow at a blistering pace in 2010. A rebound in exports revived manufacturing, investment, and private consumption. Inflation increased, mainly owing to higher costs for transport, housing, and food, and it will quicken through the first half of 2011. GDP growth will moderate this year and next. With the strong rebound bringing the economy back to its potential output, an immediate challenge is to expand production capacity.

Economic performance

This open economy rebounded to the scorching pace of 14.5% in 2010. Export-oriented manufacturing and financial services rode the global recovery in trade and investment. Growth was particularly strong in the first half of 2010, given the low base set by the contraction a year earlier (Figure 3.29.1).

Exports of goods and services in real terms grew by 19.2%, driven by chemicals and electronic components and parts. Imports rose by 16.6%, with sharp increases in imports of raw and intermediate materials and capital goods. Net exports of goods and services rose by 38% to contribute the bulk of total GDP growth (10.5 percentage points).

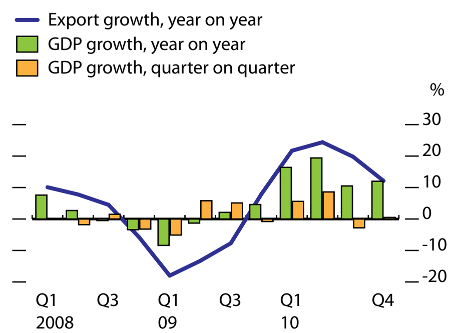
The impact of rebounding external trade and manufacturing spilled over into private consumption and investment. Private consumption increased by 4.2% in 2010, adding 1.6 percentage points to total growth. A stronger labor market lifted employment and wages. Visitor arrivals jumped by 20.2%, helping to fuel a 7.1% rise in retail sales in real terms.

Fixed investment increased by 5.1%, adding 1.4 percentage points to GDP growth. That reflected public and private sector investment in buildings as well as business investment in machinery, equipment, and software. Government consumption rose by 11.0%, accounting for 1.2 percentage points of the GDP growth, largely on increased social spending in education, health, and public housing.

On the production side, the more export-oriented sectors saw the fastest growth. Manufacturing accounted for nearly half the GDP growth, after contracting in 2008–2009 (Figure 3.29.2). Precision engineering and electronics posted gains of 40% and 35%, respectively, on the back of revitalized export demand for semiconductor-related equipment and consumer electronics. The biggest surge was in biomedical manufacturing, which jumped by 50% owing to higher production of pharmaceutical ingredients and a more diverse production mix. Growth in overall manufacturing peaked at 41.5% in June 2010, on a 6-month moving average basis (Figure 3.29.3).

Resumption of growth in consumer spending boosted wholesale and

3.29.1 GDP and net export growth



Source: CEIC Data Company (accessed 14 March 2011).
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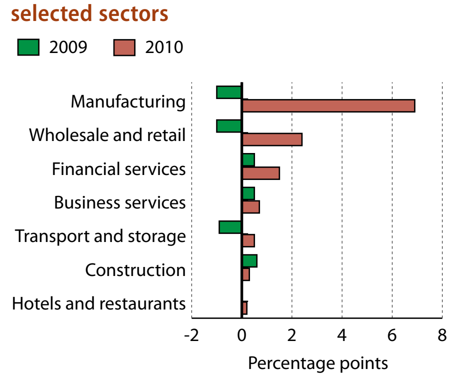
3.29.2 Contributions to growth (supply), selected sectors



Source: Singapore Ministry of Trade and Industry. 2010. *Economic Survey of Singapore*. http://www.singstat.gov.sg
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This chapter was written by Arief Ramayandi and Aleli Rosario of the Economics and Research Department, ADB, Manila.

retail trading, which grew by 15% and contributed 2.4 percentage points to GDP growth. Significant gains were seen in sales of such items as household furnishings, clothing, and footwear (Figure 3.29.4). Financial services accelerated by 12.2% in 2010, accounting for 1.5 percentage points of GDP growth, because of increased nonbank and business lending and expansion by investment banks.

Growth in construction moderated to 6.1% in 2010 from 17.0% in the previous year, as some major public projects were completed. Private construction picked up for housing (due to rising house prices) and for commercial and industrial buildings (benefiting from the economic recovery). Construction contracts awarded to private-sector firms doubled in value in 2010, to US$14 billion.

Services, accounting for 70% of total employment, generated nearly all the new jobs last year. The number of people employed rose by 112,500 to 3.1 million. The overall unemployment rate, including foreign workers, declined to 2.2% (3.1% for citizens and permanent residents).

The rapidly expanding domestic and external demand was accompanied by a rise in inflation to 4.6% by year-end (Figure 3.29.5); inflation averaged 2.8% in 2010. Major causes were an increase in the cost of automobile certificates of entitlement and rising prices for housing, which contributed to higher accommodation costs. Food prices also started to pick up from about April 2010, and by year-end contributed about one-tenth of overall inflation.

The Monetary Authority of Singapore (MAS) tightened its policy stance as recovery took hold and inflation picked up. The MAS sets policy by managing the Singapore dollar in a band against a basket of currencies by changing the midpoint, slope, or width of the band. In April 2010 it recentered the band, providing more room for the Singapore dollar to appreciate. Later in the year, as the labor market tightened and capacity utilization rose, the MAS steepened and widened the band, allowing for still further appreciation. During 2010, the currency appreciated by 6.8% against the US dollar. Liquidity in the economy remained high, and broad money grew by 8.6%.

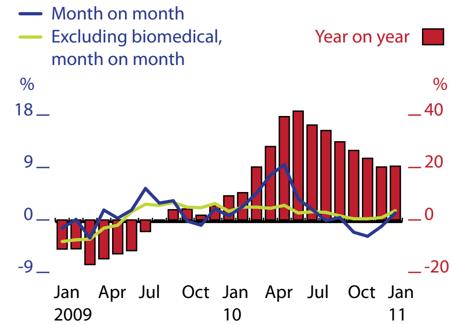
In the external accounts, a 31.1% rise in merchandise exports in 2010 outpaced a 27.6% increase in merchandise imports (both in US dollars), and the trade surplus rose to US$46.6 billion. Together with the external balances for services and income, the current account surplus climbed to the equivalent of 22.2% of GDP. International reserves rose by about 20% to US$225.7 billion (cover for 6.6 months of goods and services imports).

Economic prospects

Global economic growth, in particular projected strong expansion in much of Asia, lays the ground for solid growth in Singapore this year and next. However, growth in net exports will moderate substantially in 2011 due to base effects and higher imports to support investment.

Expected growth of manufacturing suggests that industries, including electronics and biomedical, will need to invest in capacity expansion. Investment will remain strong in construction, given solid demand for residential and commercial buildings and extension of the mass transit rail system.

3.29.3 Manufacturing growth, 6-month moving average



Source: Singapore Economic Development Board. *Monthly Manufacturing Performance, January 2011*. http://www.edb.gov.sg

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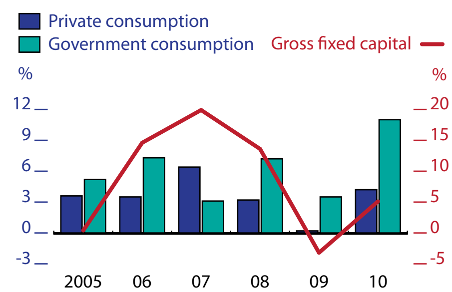
3.29.4 Growth in consumption and investment



Source: CEIC Data Company (accessed 12 March 2011).

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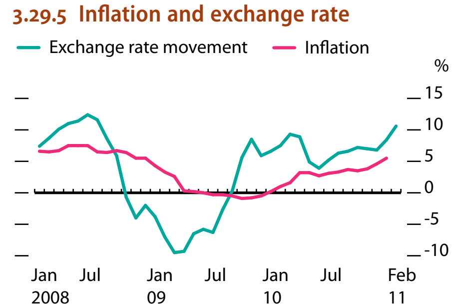
3.29.5 Inflation and exchange rate



Source: CEIC Data Company (accessed 14 March 2011).

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The low rate of unemployment, however, coupled with a government commitment to restrict the use of low-skilled foreign labor (in moves to raise productivity) will put upward pressure on costs and could act as a drag on some industries.

Retail sales, excluding automobiles, rose by 13.5% in real terms in January 2011. Further growth in incomes and the upward trend in visitor arrivals will continue to stimulate growth in retail sales this year.

Monetary policy is expected to tighten further. Strong recovery in 2010 put the economy back on, if not above, its potential output, so that further growth this year is likely to exert pressure on inflation. The monetary authorities will likely consider steepening the slope of the currency's trading band, giving more room for it to appreciate.

Fiscal policy, in contrast, is likely to have a neutral impact on the economy. Operating expenditure in FY2011 (ending 31 March 2012) has been increased to support social spending in education, health, and public housing. Growth in development expenditure is budgeted to decelerate, since some transport projects have been completed. The government is making a cash transfer to citizens this year, but the amount is relatively small.

Once these strands are woven, the economy is forecast to grow by 5.5% in 2011, with the potential to surprise on the upside (if a better than expected performance by industrial economies and Asian trading partners materializes). In 2012, growth is forecast to moderate further to 4.8% (Figure 3.29.6) as the economy returns to its long-run trajectory.

Inflation quickened to 5.5% in January 2011, driven by rising costs of transport and housing (Figure 3.29.7). It is seen staying relatively high through the first half of 2011 before moderating. Year-average inflation is put at 3.2%, easing in 2012 as the rate of cost increases of imported food and fuel decelerates.

Growth in merchandise exports is forecast to slow to 13% in nominal terms this year and imports to just below 17%. (Exports increased by 17% year on year in January 2011.) The current account surplus as a share of GDP is expected to decline to about 19% in the forecast period, reflecting the impact on trade of higher prices for imported fuel and food, imports of capital equipment, and the firmer Singapore dollar.

Risks are both on the down- and upside. As well as the tight domestic labor market that could retard expansion in some industries this year, higher than assumed global commodity prices would hurt manufacturing industry, as would weaker than projected global trade. The impact on supply chains from the March earthquake in Japan is unclear, but Singapore's direct trade with that country is now low (as a proportion of total trade, exports to Japan averaged 5.8% in the past decade, down from 7.4% in the 1990s, while imports declined to an average of 10.5% from 18.0%).

On the upside, a better performance by industrial economies and Singapore's Asian trading partners would likely have a significant impact on this open economy.

Development challenges

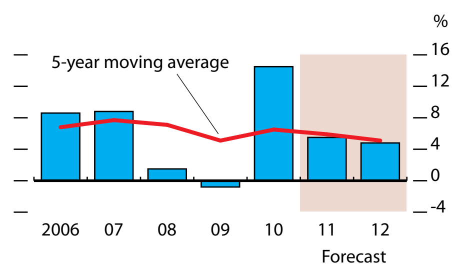
Expanding the economy's capacity is an immediate imperative. Even moderate economic growth will likely push up prices and costs of

3.29.1 Selected economic indicators (%)

	2011	2012
GDP growth	5.5	4.8
Inflation	3.2	2.0
Current account balance (share of GDP)	18.8	19.2

Source: ADB estimates.

3.29.6 GDP growth



Sources: Singapore Department of Statistics. http://www.singstat.gov.sg (accessed 14 March 2011); ADB estimates.

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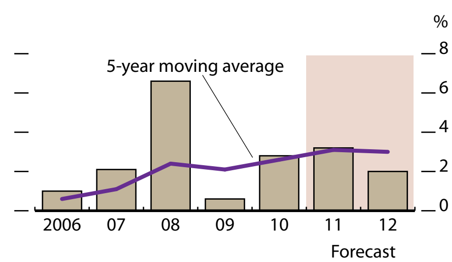
3.29.7 Inflation



Sources: Singapore Department of Statistics. http://www.singstat.gov.sg (accessed 14 March 2011); ADB estimates.

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production. The government's strategy, laid out in 2010, is to pursue policies that raise productivity by 2%–3% a year over the next 10 years, more than double the rate of increase in the past decade.

By making low-skilled foreign labor more costly—it is increasing levies on companies that employ foreign, low-skilled workers—the government is encouraging employers to focus on improving productivity. This year's budget reiterates the government's 2010 commitment to provide incentives for firms to automate operations and invest in skills development.

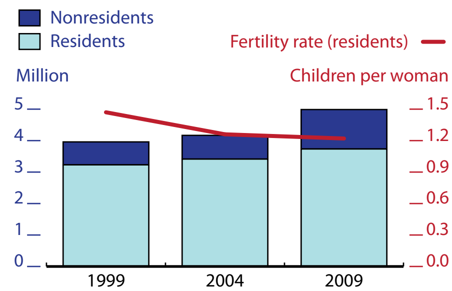
Discouraging the use of foreign workers in less productive tasks, at a time of strong economic growth, has tightened the labor market and raised operating costs, particularly for small and medium-sized businesses that employ cheap foreign labor. But as there will be a lag before the productivity gains feed through, measures may be needed to soften the policy's impact on firms during that period.

Singapore's aging population is another challenge. The old-age support ratio (the number of people 15–64 years relative to those 65 years and over) has declined from 10.1 in 1999 to 8.3 in 2009. Economic and social development has been associated with a decline in the fertility rate of residents. From 1.5 in 1999—already well below the replacement rate—it fell to 1.2 in 2009 (Figure 3.29.8).

To meet the labor requirements of an expanding economy, in past years Singapore turned to immigration and recruitment of foreign workers. Concerns about the increasing number of such workers (now at least one-third of the labor force) and the aging population have led the government to seek new ways to encourage population growth. The National Population and Talent Division, created in 2010, has been tasked with formulating policies and overseeing population programs to achieve a sustainable and integrated population.

Sharp increases in prices of housing last year (about 14% for public and nearly double that for private housing) prompted the government to act several times to curb speculative demand. It introduced a seller's stamp duty, paid if a property is resold within 1 year (as prices continued to rise it extended this period to 4 years and raised the rate of stamp duty); increased minimum downpayments; and lowered loan-to-value ratios. On the supply side, it accelerated its release of land for both public and private housing.

3.29.8 Population and fertility rate



Source: Statistics Singapore. *Population in Brief 2010*. http://www.singstat.gov.sg

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Thailand

Vigorous growth in private consumption and investment contributed to a strong economic recovery in 2010, though growth will moderate this year and next, reflecting more subdued external demand and a base effect. Inflation is forecast to be higher this year, prompting the central bank to maintain a tightening monetary stance. In the social arena, the government is drawing up programs to address differences of income and opportunity, including a stronger social safety net and investment in transport infrastructure.

Economic performance

A strong recovery from a contraction in 2009 propelled GDP growth to 7.8% in 2010. Rebounding demand for exports spurred a pickup in manufacturing and bolstered both consumer and business confidence. Political tensions that led to 7 weeks of violent demonstrations in central Bangkok during April and May 2010 had a limited and temporary impact on economic recovery.

The biggest contributor on the demand side came from a bounce in investment, which added 5.2 percentage points of GDP growth (Figure 3.30.1). Investment had slumped in 2009 and been slack for several years before that.

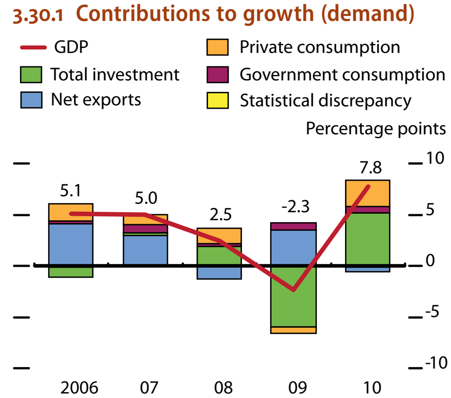
Private fixed investment grew by 13.8% in 2010, mainly in export-oriented manufacturing. As export orders picked up, higher capacity utilization in industries such as automobiles and electrical machinery prompted investment in new equipment, which rose by 14.7% for the year. Private construction expanded by 10.6%, supported by low interest rates.

Private consumption, which had also declined in 2009, rose by 4.8% last year and contributed 2.5 percentage points to GDP growth. Its rise was assisted by a strengthening of the labor market and higher farm incomes, owing to increases in prices for agricultural commodities. Consumer sentiment weakened in the second quarter when the violence broke out, but it recovered after that.

Public consumption spending also contributed to economic growth as the government continued to disburse the fiscal stimulus measures initiated in 2009.

Public fixed investment in 2010 was slightly below prior-year levels. Lower investment from the budget and by state-owned companies was partly offset by outlays on the Thai Khem Kaeng (Strong Thailand) infrastructure program. This program, involving projects that could cost more than $40 billion over 3 years, started in October 2009. Of B350 billion ($10.2 billion) budgeted to be spent on infrastructure last year, about 74% was disbursed, after some delays during the political unrest in the first half.

3.30.1 Contributions to growth (demand)



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 11 March 2011).

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This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

On the supply side, industry generated most of the GDP growth. Manufacturing production surged by about 20% in the first half, then moderated to 8% growth in the second because of a base effect and softer global demand. Automobile production jumped by about 60% owing to a rebound in both domestic and export demand. Manufacturing contributed 5.4 percentage points of GDP growth, and industry as a whole added 6.0 percentage points.

Services contributed about 2 percentage points to total growth. Hotel and restaurant services expanded by 8.4%, supported by a pickup in tourism in the second half (arrivals had fallen during the protests in the capital—Figure 3.30.2). Tourist arrivals for the full year rose by 11.7% from 2009. Financial services grew by 8%, in line with expansion of business and consumer credit.

Agriculture, though, had another bad year because of drought, followed by floods. The sector contracted by 2.2%. Production fell for cassava, corn, fruit, palm oil, sugarcane, and rice.

Interruptions to food supplies caused by the bad weather added to inflation pressures induced by rising global prices for commodities and oil and stronger domestic demand. The consumer price index rose by 3.2% on average in 2010, after a period of deflation in 2009 (Figure 3.30.3). A 9.6% appreciation of the baht against the US dollar last year helped to temper the impact of rising import prices.

As economic recovery gained traction and the political situation settled in the second half of 2010, the Bank of Thailand started to normalize its policy interest rate (it had lowered the rate by 250 basis points to 1.25% during the global crisis). The central bank raised the rate five times between July 2010 and March 2011 (Figure 3.30.4) to 2.5% (still below the inflation rate).

Lending by commercial banks increased by 11.3% in 2010 (it had contracted by 1.8% in 2009), as business and consumer confidence improved, banks became more confident about the economy, and interest rates remained relatively low.

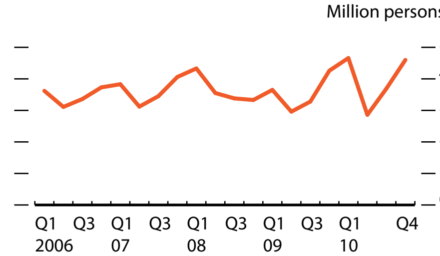
External trade rebounded (Figure 3.30.5). Merchandise exports rose by 28.5% to $193.7 billion, reflecting strong external demand for both agricultural and manufactured goods. Shipments of manufactured items, including autos and components, computers, electrical appliances, and machinery, rose by about 31%, agricultural products by 36%.

By destination, exports to the People's Republic of China, India, and Southeast Asia all jumped by about 35%, while those to major industrial economies (the European Union, Japan, and the United States) together rose by nearly 24%.

Recovery in domestic and external demand caused a near 37% surge in imports to $179.6 billion in 2010. Imports of raw materials and intermediate goods needed for export-oriented industries shot up by 42%, and the recovery in investment drove a 27.7% rise in imports of capital goods. Higher prices for imported oil added to the import bill. Surging imports brought down the merchandise trade surplus to $14.0 billion.

After taking into account a larger surplus in services, countered by a wider income deficit, the current account was in surplus equivalent to 4.7% of GDP. The capital and financial account recorded a net inflow of $15.6 billion.

3.30.2 Tourist arrivals



Source: Bank of Thailand, available http://www.bot.or.th (accessed 28 March 2011).

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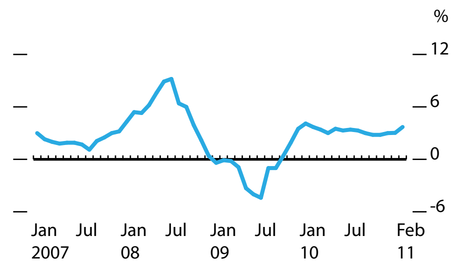
3.30.3 Monthly inflation



Source: CEIC Data Company; Bureau of Trade and Economic Indices. http://www.price.moc.go.th (both accessed 28 March 2011).

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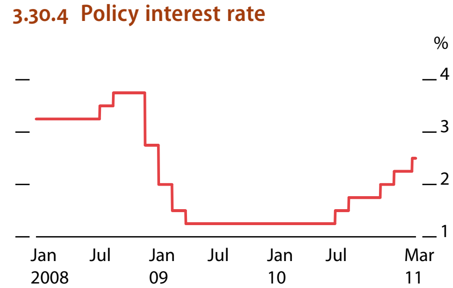
3.30.4 Policy interest rate



Source: Bloomberg (accessed 20 March 2011).

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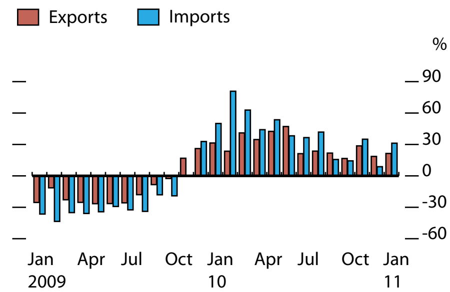
Current account surpluses and buoyant capital inflows into equity and debt securities ($55.2 billion in 2010) fueled the appreciation of the baht. To reduce that upward pressure, the Bank of Thailand liberalized restrictions on capital outflows, and the finance ministry removed a withholding tax waiver on bonds held by foreigners.

Foreign currency reserves rose by 24% to $165.7 billion in 2010, reflecting surpluses in the current, capital, and financial accounts as well as central bank purchases of foreign exchange to manage upward pressure on the baht. Reserves were equivalent to 9.5 months of imports of goods and services.

The government trimmed its budget expenditure in FY2010 (ending 30 September 2010) although total public spending increased, taking into account both on-budget and off-budget spending under the Thai Khem Kaeng program. Revenue collection was stronger than expected and exceeded the target by 10%, reining in the fiscal deficit to 2.1% of GDP from 4.8% in FY2009.

Public debt as a ratio to GDP fell to 42.5% at end-2010 from 43.9% in 2009, mainly the result of the larger GDP in 2010.

3.30.5 Merchandise trade growth



Source: Bank of Thailand. http://www.bot.or.th (accessed 28 March 2011).

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Economic prospects

The government has indicated that national elections will be held in June 2011. Forecasts assume that the elections go smoothly and there are no serious disruptions that affect the economy.

Last year's strong rebound in GDP came from a low base brought about by the economic contraction in 2009. Consequently, economic growth will moderate considerably in 2011. Moreover, expected slower growth in major trading partners—the PRC, Southeast Asian neighbors, and major industrial countries—will damp the expansion in Thailand, as will the substantially higher cost of imported oil.

Merchandise exports are projected to increase by about 13% in nominal terms this year, less than half the rebound pace of 2010.

Private fixed investment is seen growing by about 9% in real terms, also below last year's pace. Capacity utilization rates suggest that some manufacturers will need to expand facilities to accommodate expected increases in domestic and external demand. Appreciation of the exchange rate has lowered the cost of imported machinery and equipment. Additionally, relatively low interest rates are conducive for investment.

An index of business sentiment in January 2011 indicated that business managers were confident about the outlook for orders and production, although they were concerned about rising costs.

Private consumption is forecast to grow by about 4% in real terms, due to growth in incomes. That marks a deceleration from 2010 but would still make a solid contribution to GDP growth. The labor market has tightened (businesses complain that they face difficulties in recruiting both skilled and unskilled labor), so that wages will likely increase.

Further, the government has said that it plans to raise minimum wages by 25% over 2 years if reelected, which would be on top of an increase in minimum wages in late 2010. Most government employees received a 5% wage increase from April 2011. Rural incomes are benefiting from high prices for many agricultural commodities.

3.30.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.5	4.8
Inflation	3.5	3.0
Current account balance (share of GDP)	2.0	1.0

Source: ADB estimates.

A new round of concessions for low-income households will also support consumption. The government unveiled in January 2011 a package of "new year's gifts" that included subsidies on cooking gas, diesel fuel, electricity, and public transport. The authorities have extended price controls on a range of food staples and animal feeds and directed state banks to set aside B5 billion ($166 million) for low-interest loans to taxi drivers and street vendors, who might otherwise find it difficult to borrow because they are not salary earners and do not have collateral. Unsurprisingly, consumer confidence is buoyant (Figure 3.30.6).

While fiscal policy is expected to be mildly expansionary in the forecast period, monetary policy seems set to continue tightening. The government has budgeted to increase spending in FY2011 by about 22%, and widened the deficit target to 4% of GDP. Budget disbursements in the fiscal first quarter exceeded the target for that period. The rest of the Thai Khem Kaeng program will be funded through the budget, rather than mainly by off-budget expenditure as was the case last fiscal year. The fiscal deficit is expected to narrow to 3.2% in FY2012.

The Bank of Thailand is likely to gradually raise interest rates further during the forecast period and it will probably allow a gradual appreciation of the baht to help keep imported inflation in check.

Taking into account the outlook for domestic and external demand, the base effect, and the policy stance, GDP is forecast to grow by 4.5% in 2011 and 4.8% in 2012 (Figure 3.30.7).

Inflation was 3.0% in the first 2 months of 2011. Domestic food prices climbed, partly a result of bad weather. Higher global food and oil prices are adding to price pressures, but the subsidies and price controls should alleviate the impact of inflation on low-income households. For all 2011, inflation is forecast at 3.5% (Figure 3.30.8). It will ease next year, if global food and oil prices decelerate and the policy stance tightens as anticipated.

Volatile capital inflows are expected to ease this year. To manage the flows the central bank is likely to focus on relaxing rules for overseas investment and hedging by domestic businesses, rather than on controls on inflows.

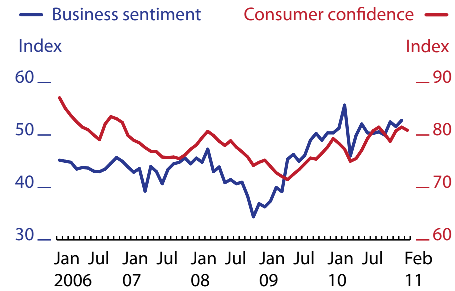
Higher prices for imported commodities and oil will likely mean that merchandise imports outpace exports in the forecast period. The trade surplus will decline slightly and the current account surplus is seen subsiding to about 2.0% of GDP in 2011 and 1.0% in 2012. Tourism, an important contributor to the surplus in services trade, got off to a good start in January 2011, when arrivals rose by 11.6% from the prior-year period.

Domestic risks to the outlook center on political uncertainty, which can have an impact on business and consumer confidence, and further bouts of bad weather (the south of the country saw extensive flooding in March 2011), which may reduce economic growth.

Development challenges

Political unrest over recent years, culminating in last year's violent demonstrations, has brought into focus gaps in incomes and opportunities in Thailand. The richest 20% of households account for

3.30.6 Confidence indicators



Note: A reading of less than 50 for business sentiment and less than 100 for consumer confidence denotes a deterioration.

Sources: Center for Economic and Business Forecasting; Bank of Thailand, http://www.bot.or.th (both accessed 28 March 2011).

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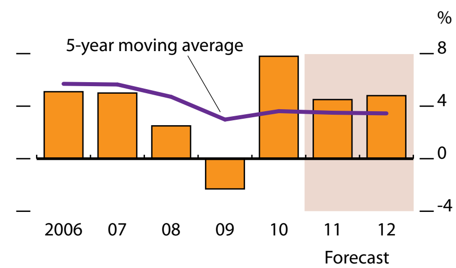
3.30.7 GDP growth



Source: Asian Development Outlook database.

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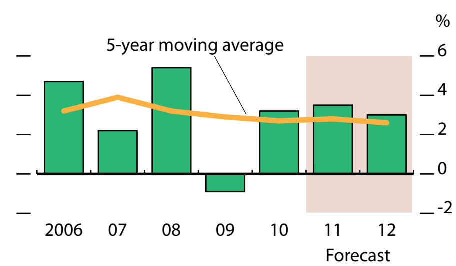
3.30.8 Annual inflation



Source: Asian Development Outlook database.

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nearly half of total household incomes and the Gini coefficient, a measure of income inequality, for the country is high at 0.51 (where 0 is perfect equality and 1 is absolute inequality).

Tackling regional inequality, the government is ramping up investment in transport infrastructure (roads, rail, and ports), which should encourage businesses to expand and generate employment outside the Bangkok area in the longer term. Faster decentralization should be used alongside this investment boost, giving local governments greater authority to make decisions over infrastructure and services to attract development to their areas as well as the fiscal resources to support this responsibility. (A decentralization act was passed in 1999, but implementation has lagged.)

Another government approach to mitigating inequality is to build a stronger social safety net. The draft 11th National Plan (2012–2016), to be finalized this year, includes a strategy to create a more equitable society. Based on this strategy, the government is setting up a voluntary pension fund for the informal sector and expanding social security benefits to people in that sector. The challenge is to design and operate programs that are well targeted and fiscally sustainable.

The cabinet has approved in principle the establishment of a Post Bank, using the post office network to provide low-interest loans of up to B10,000 ($330). Other microfinance arrangements are under consideration to assist low-income households.

Additionally, the government plans to distribute community land-title deeds to more than 200,000 landless people and farmers living on plots owned by the state.

Viet Nam

GDP growth quickened in 2010, supported by recovery in exports and an accommodative monetary policy. Inflation hit double-digit rates by year-end, and the currency slid. Moving to restore macroeconomic stability, the authorities in February 2011 unveiled comprehensive measures including tightened fiscal and monetary policies. Partly as a consequence, economic growth is forecast to moderate this year, then pick up next year. Inflation is seen subsiding late in 2011 and further in 2012. The immediate challenge is to follow through on the policy tightening; the longer-term one is to reinvigorate structural reforms.

Economic performance

Growth picked up to 6.8% in 2010 (Figure 3.31.1), supported by recovery in the global economy, the residual impact of domestic fiscal stimulus in 2009, and an accommodative monetary policy. Strong consumption growth of 9.7% stimulated private sector investment.

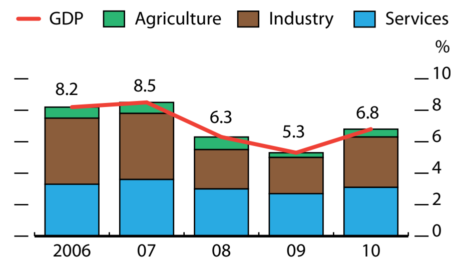
By sector, industry expanded by 7.7% and contributed 3.2 percentage points of total GDP growth. Stronger external demand spurred 8.4% growth in manufacturing, and public infrastructure investment pushed up growth of construction by 10.1%. Services grew by 7.5%, contributing 3.1 percentage points of GDP growth. Wholesale and retail trading climbed by 8.1%, reflecting the expansion in private consumption, and hotels and restaurants picked up by 8.7%, assisted by a steep 34.8% increase in visitor arrivals. Agricultural output was subdued, though, edging up by 2.8% in 2010, owing to flooding in central regions followed by drought in the north.

Faster economic growth helped to reduce urban unemployment, and poverty incidence fell to 10.6% from 12.3% in 2009, based on the official poverty measure.

Inflation accelerated to 11.8% in December 2010, averaging 9.2% for the year, the highest in Southeast Asia. By March 2011, it was running at 13.9% year on year (Figure 3.31.2), with rising food prices and school fees leading causes. Credit grew by 32.4%, above the official target of 25% but slightly slower than 39.6% in the previous year.

Concerns among the general population over loss of purchasing power, together with a slide in the currency—the dong—boosted purchases of gold and US dollars. Foreign currency deposits climbed by 21% in 2010. The currency came under steady depreciation pressure from about midyear, reflected in the spread between the black market rate and the reference rate of the State Bank of Viet Nam (SBV, the central bank); the spread increased to over 10% in January 2011. The SBV devalued the dong by 9.3% in February 2011, and narrowed the trading band for the dollar–dong exchange rate from ±3% to ±1%. During November 2009–

3.31.1 Contributions to growth (supply)



Source: General Statistics Office of Viet Nam. http://www.gso.gov.vn (accessed 14 March 2011).

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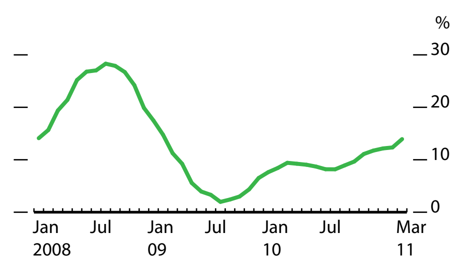
3.31.2 Inflation



Sources: General Statistics Office of Viet Nam; ADB estimates.

Click here for figure data

This chapter was written by Dominic Mellor, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

February 2011, the authorities devalued the dong, in four steps, by a total of about 20% against the US dollar (Figure 3.31.3).

Lack of clarity over the direction of monetary policy further eroded confidence. The SBV started to withdraw monetary stimulus from late 2009, raising its base rate and ending interest rate subsidies and caps, but in 2010 it urged banks to moderate lending-rate rises. With inflation accelerating, the SBV in November 2010 raised policy rates again. That tightening seemed insufficient to counter what was by then double-digit inflation or market expectations of further dong depreciation.

The SBV's capacity to support the dong was constrained by relatively low holdings of foreign exchange reserves, estimated at $12.4 billion at end-2010 (about 1.9 months of import cover—Figure 3.31.4).

A rebound in exports last year, reflecting recovery in global trade, reined in the deficit in merchandise trade to $7.1 billion on a balance-of-payments basis, from $8.3 billion in 2009. Exports rose by 26.4% in US dollars. Customs data showed strong increases in exports of textiles (up by 23%), footwear (25%), and electronics and computers (29%). Crude oil exports fell, however, by 20%, as volumes plunged by 40% owing to depletion of oil fields. Imports rose by 21.2%, reflecting demand for inputs for manufacturing and the country's reliance on imported capital equipment.

Trade with the People's Republic of China (PRC), Viet Nam's largest trading partner, was boosted by a free-trade agreement between the Association of Southeast Asian Nations and the PRC, from January 2010. Customs data show that imports from the PRC increased by 23% to about $18.0 billion and exports there shot up by 49% to $6.3 billion.

After increases in remittances and tourism receipts, the current account deficit contracted to $4.3 billion, equivalent to 4.0% of GDP, its narrowest in 4 years. The overall balance of payments showed a deficit of $1.8 billion in 2010 (Figure 3.31.5).

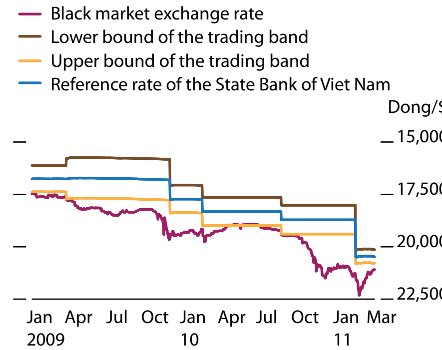
Net foreign direct investment (FDI) inflows rose by about 3% to $7.1 billion in 2010. FDI approvals at $18.6 billion missed the target, however, and were well below 2009's, likely reflecting investor uncertainties over policy direction. FDI approvals for real estate projects fell, but approvals for manufacturing more than doubled.

With most fiscal stimulus measures taken during the global recession expiring at end-2009, the overall fiscal deficit in 2010 narrowed to 8.0% of GDP. In real terms, government expenditure was estimated to be little changed from 2009, but revenue and grants rose by about 10%, reflecting stronger non-oil tax receipts.

Total public debt and publicly guaranteed debt, excluding state firms' contingent liabilities, is estimated to have declined by 1 percentage point to 51.5% of GDP in 2010, still above the government's target ceiling of 50%. Weakness in the stock market over the past 2 years (the VN Index of share prices fell by 2.0% in 2010) has hindered government plans to sell shares in state-owned enterprises.

State-owned Viet Nam Shipbuilding Industry Group (Vinashin) defaulted in late 2010 on a repayment of $60 million relating to a $600 million syndicated loan. Some international credit rating agencies downgraded Viet Nam's ratings, citing the government's contingent liabilities and the macroeconomic stresses.

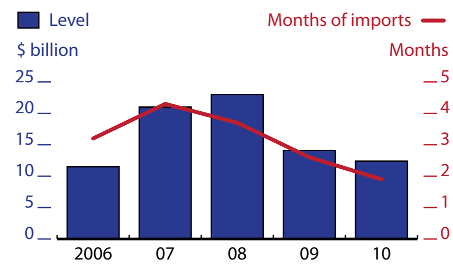
3.31.3 Exchange rates



Sources: State Bank of Viet Nam; ADB observations.

Click here for figure data

3.31.4 Gross official reserves



Note: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations.

Sources: State Bank of Viet Nam; ADB estimates.

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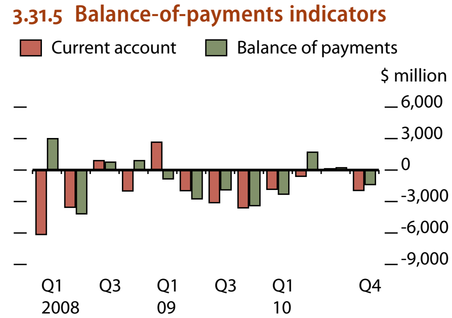
3.31.5 Balance-of-payments indicators



Source: State Bank of Viet Nam.

Click here for figure data

The government indicated it would not bail out Vinashin, signaling to other state-owned firms that they would be held accountable if they overextended their borrowing. Vinashin will be restructured over 3 years to put its finances on a firmer footing.

Viet Nam's ranking in the World Bank's *Doing Business 2011* report rose to 78 from 88 the previous year. This reflected significant gains in the ease of starting a business, obtaining construction permits, access to credit, and tax administration. A government drive called Project 30, to reduce bureaucratic procedures for business, also helped.

Economic prospects

The Socioeconomic Development Strategy for 2011–2020, approved by the Communist Party of Viet Nam in January 2011, targets rapid average GDP growth of 7%–8%. In February, however, the government indicated that it was prepared to give a higher priority to stability than growth in the near term, when it committed to restore stability through a package of policies (Resolution 11—Box 3.31.1), notably tighter fiscal and monetary policies in 2011 aimed at curbing inflation and stabilizing the external position. Restoration of solid investor confidence will require sustained and consistent policy actions until inflation is subdued.

The SBV lifted its refinancing rate from 9.0% to 12.0% and its rediscount rate from 7% to 12% in the first quarter of 2011, although it

3.31.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.1	6.7
Inflation	13.3	6.8
Current account balance (share of GDP)	-3.8	-3.6

Source: ADB estimates.

3.31.1 Resolution 11

Resolution 11, issued on 24 February 2011, contains six sets of policy measures to restore macroeconomic stability and maintain social security: tightening monetary policy; tightening fiscal policy; containing the trade deficit; increasing electricity prices while shielding the poor and using a more market-based mechanism for petroleum pricing; strengthening social security; and improving dissemination of policy information.

On 1 March 2011, the SBV issued a directive to implement Resolution 11. It included a credit growth target ceiling of 20% (reduced from an original target of 23%) and a 15%–16% target for growth in M2 money supply in 2011 (down from 21%–24%). Both targets are considerably below the outcomes in 2010, when credit grew by 32.4% and M2 by 33.3%.

To achieve these targets, the SBV instructed banks and other credit institutions to curb credit growth to less than 20%. These institutions were also instructed to limit credit outstanding to "nonproductive" activities such as real estate and marketable securities to 22% of total lending by end-June 2011 and 16% by end-2011.

The SBV intends to penalize institutions that fail to meet these targets by doubling their required reserve ratios. It also is restricting foreign currency lending on imports of specified nonessential goods, including all consumer goods. The SBV aims to limit the import of gold to a few firms and to eventually prohibit trading in gold bars in the parallel market. These actions are intended to reduce speculative foreign exchange and gold transactions and so help to stabilize the dong.

On the fiscal side, the Ministry of Finance revised the 2011 budget deficit target to below 5.0% of GDP (down from an original 5.3%). Ministries and line agencies were told to withhold 10% of nonessential current expenditure (excluding salaries and wages) for the rest of this year.

The budget revenue target for 2011 was revised up by 7%–8%. The government aims to collect higher taxes through improved tax administration enforcement. It also intends to closely scrutinize all investments made by public agencies and state-owned firms.

The Ministry of Industry and Trade is developing a plan to contain the trade deficit. It will try to improve the efficiency of export production, while restricting certain imports.

Strengthening social security involves measures to shield vulnerable groups from the impact of the increase in electricity tariffs, as well as other targeted support.

The Ministry of Information and Communication has been directed to disseminate timely information on policy actions.

maintained the base rate at 9.0%, below the inflation rate (Figure 3.31.6). The refinancing rate was further increased to 13.0% on 1 April 2011. The higher rates increased the cost to commercial banks of borrowing dong from the central bank. The SBV is aiming to balance the need to tighten policy with the likely impact on firms that already face high dong-denominated borrowing rates of close to 20%.

Proposed policy actions include both market-based instruments and administrative controls. Such controls will likely have some temporary impact, but may not be effective further out. For example, controls on gold trading usually lead to increased illicit trading. They also create market distortions.

The forecasts assume that the government will follow through with the policy tightening until macroeconomic stability is restored. That will slow consumer spending and domestically financed investment.

Forecasts also take into account developments in the first quarter of 2011. Preliminary data show that GDP rose by 5.4% year on year in January–March 2011, slowing from 7.3% in the fourth quarter of 2010. Agriculture increased by 2.0%, industry by 5.5%, and services by 6.3%. Solid expansion in the first quarter was seen elsewhere: industrial production at 14.0%, retail sales at 9% in real terms, international visitor arrivals at 12%, and merchandise exports on a customs basis at 44%. For the whole year, crude oil production is projected at 15 million metric tons, similar to 2010.

Against this background, GDP is forecast to grow by 6.1% in 2011 (Figure 3.31.7). Growth is expected to pick up to 6.7% in 2012 as a more stable economic environment stimulates consumption and investment.

Inflation is projected to remain high through 2011, peaking at about 16% year on year in the third quarter and averaging 13.3% (Figure 3.31.8). Underpinning high inflation (which averaged 10.3% in the first quarter of the year) are a lagged pass-through of currency depreciation and hikes in price-controlled electricity (by 15.3%) and fuel (by about 30%) in March, as well as the base effect of low inflation in April–September 2010.

Sustained policy tightening will damp domestic demand and help to stabilize the dong exchange rate. Bringing year-on-year inflation down to single digits by end-2011 will require the average month-on-month rate to be below 0.4% for the rest of the year.

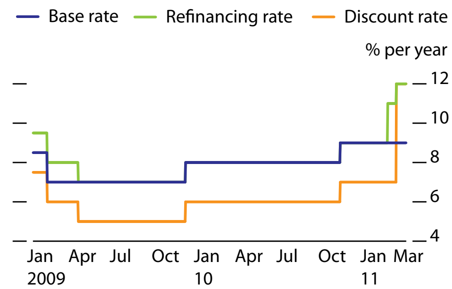
A deceleration in world trade from the rebound rates of 2010 alongside the impact of policy tightening on imports will contribute to slower growth in external trade this year. After inflows from tourism and remittances, the current account deficit is forecast at 3.8% in 2011 and 3.6% in 2012 (Figure 3.31.9).

The more stable macroeconomic situation should stimulate FDI in the forecast period. The overall balance of payments is expected to improve.

Risks to the outlook center on implementation of Resolution 11. Insufficient policy tightening or premature easing—or perception of easing—of policies would keep inflation high for longer and could lead to a deterioration of the external accounts. Such an outcome could require another round of policy tightening in a year or two.

Another domestic risk relates to state-owned enterprises. Vinashin needs to negotiate a debt rescheduling. Further evidence of debt distress among this or other state-owned firms would hurt investor confidence.

3.31.6 Interest rates



Source: State Bank of Viet Nam.

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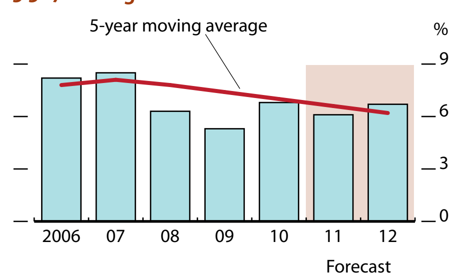
3.31.7 GDP growth



Source: Asian Development Outlook database.

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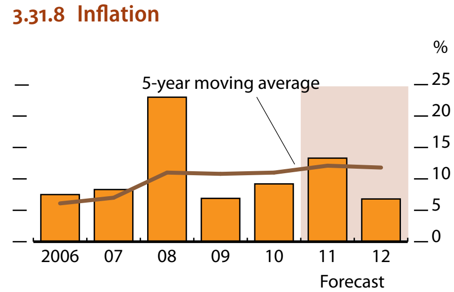
3.31.8 Inflation



Sources: General Statistics Office of Viet Nam; *Asian Development Outlook* database.

Click here for figure data

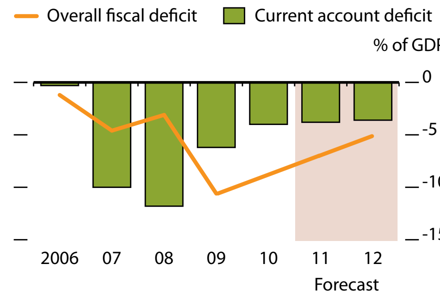
The large increase in the domestic credit stock, of about $100 billion during 2007–2010, raises concerns over banking asset quality, as does bank exposure to real estate and state-owned enterprises.

US dollar borrowing jumped in early 2010 as borrowers took advantage of new regulations that allowed firms earning dong revenue to borrow in US dollars (at lower rates than in dong). But such borrowing comes with a currency risk, and after the currency devaluations some firms might now face much bigger debt in dong terms.

There is also a risk that the supply of manufactured components from Japan for Viet Nam's export industries, or exports to that market, could be disrupted by the impact of the 11 March earthquake for longer than currently anticipated.

Overall, though, the change in policies this year has reduced domestic risks. The medium-term outlook remains favorable, with the proviso that macroeconomic stability is restored and maintained. Viet Nam remains an attractive destination for foreign investors, and is well positioned to benefit from economic developments in the PRC. Rising labor costs there will divert some FDI to other developing Asian economies, and growing domestic PRC consumption will increase its demand for imports.

3.31.9 Current account and fiscal balance



Source: Asian Development Outlook database.

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Development challenges

Much has been achieved in lifting the economy to lower-middle-income status in 2010 and in reducing poverty over two decades. High inflation, especially for food, puts poverty-reduction gains at risk, however. The immediate challenge is to restore stability in the economy by fully implementing the policy directives of February 2011.

Maintaining price stability and economic growth in the longer term requires further improvements in efficiency, particularly in the state-owned sector; development of the financial system; and heavy investment in infrastructure and education to address supply-side bottlenecks.

State-owned firms are a drag on the economy. They absorb many of the available resources but their efficiency is much lower than among private firms. Hence a better performance from them would stimulate economic growth and release budget resources for more productive uses. Regardless of ownership, putting them on a commercial footing, exposing them to competition, and holding them financially accountable—particularly for noncore activities—would improve their efficiency.

Further reforms are needed to safeguard the financial system (the SBV took the important step of raising minimum capital requirements in 2010). Supervision of banks would be strengthened if the capacity of the SBV to provide regulatory oversight were upgraded and if a risk-based supervision framework were adopted (shifting from a compliance-based approach). A move toward international standards for bank provisioning would also strengthen banks' stability.

Finally, timely publication of economic and financial data would help to build public and investor confidence.

THE PACIFIC

Fiji
Papua New Guinea
Timor-Leste

Cook Islands
Kiribati
Marshall Islands
Federated States of Micronesia
Nauru
Palau
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

Fiji

After contracting in 2009 the economy achieved slight growth in 2010, based largely on a recovery in tourism and some goods exports, though the sugar industry weakened for a fourth consecutive year. Low levels of growth are forecast for 2011–2012, accompanied by moderate inflation. Reforms to improve the investment environment are key to generating stronger growth and reducing poverty.

Economic performance

Minimal GDP growth of 0.1% in 2010 continued the pattern of recent years—a period of contraction followed by slight growth—leaving GDP virtually unchanged since 2005. (Official revisions to GDP estimates for 2006–2009, due to rebasing, resulted in growth of 0.2% in 2008 and a contraction of 3.0% in 2009—Figure 3.32.1.)

In 2010, the impact of growth in tourism, mineral water exports, fisheries, and gold mining slightly outweighed downturns in agriculture; transport, storage, and communication; real estate and business services; health and social work; and other community services (these latter two on the back of reduced government expenditure).

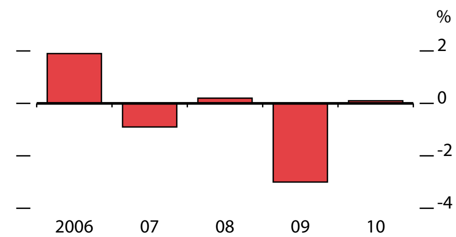
Visitor arrivals rose by 16.5% to a record 633,000 in 2010 (Figure 3.32.2). Increases were notable from Australia (helped by its buoyant economy) and from the People's Republic of China and India (reflecting marketing efforts). Despite a 20% devaluation of the Fiji dollar in April 2009, price discounting meant that growth in tourism earnings only kept pace with tourist arrivals.

Gold production from the Vatukoula mine rose by nearly 80% to 59,000 grams in the 12 months to August 2010, and is expected to reach an annual rate of 100,000 grams in 2011. Mineral water exports recovered from a downturn during the global recession, and fisheries benefited from favorable weather.

On the negative side, agriculture suffered from a cyclone in March 2010, then a drought. The sugar industry, which supports about a quarter of the population, has declined in recent years as the European Union phased out preferential prices it paid to certain nations, including Fiji. The European Union was to provide assistance to the country's sugar industry, but postponed the plan after a military coup in 2006.

Last year, the government initiated a sugar industry reform program that included funding for new cane planting, but farmers continued to leave the industry and cane production fell by 19%. Breakdowns at sugar mills caused production of raw sugar to slide by 20.8% (Figure 3.32.3). Fiji Sugar Corporation, after accumulating losses of more than F$200 million in 2009–2010, is being taken over by the government, and the firm's operations are now funded through the national budget.

3.32.1 GDP growth



Source: Fiji Islands Bureau of Statistics; Ministry of Finance. *Budget Supplement 2010* and *Budget Supplement 2011*. http://www.mfnp.gov.fj

Click here for figure data

3.32.2 Tourism growth

Sources: Fiji Islands Bureau of Statistics; Ministry of Finance. *Budget Supplement 2011*. http://www.mfnp.gov.fj

Click here for figure data

This chapter was written by Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva.

Private consumption was supported by the increase in tourism and a rise in remittances. Remittances in US dollar terms rose by about 14% in the 7 months to July 2010. But investment remained low, reflected in a 0.5% fall in imports of investment goods and a 1.1% decline in new lending for investment.

Inflation accelerated early in 2010, propelled by the impact of the devaluation and then shortages caused by the cyclone, as well as by higher global oil prices. After peaking at 10.5% year on year in April, it slowed as the devaluation effect waned, but then picked up again to 5.0% in December, after some price controls on food were removed and electricity tariffs were put up. For the year, inflation averaged 7.8%.

The Reserve Bank of Fiji absorbed excess liquidity in the banking system by twice raising the statutory reserve deposit requirement for commercial banks in 2010, to 10.0%. It also implemented an overnight policy interest rate to signal the monetary policy stance. Late in the year it lowered that rate to 2.5% from 3.0% and relaxed exchange controls. The Fiji dollar firmed against the US dollar (by 4.5%) in 2010 and against the euro, but eased versus the yen and the Australian and New Zealand dollars.

Government data indicate that the budget deficit widened from the equivalent of 3% of GDP in 2009 to 3.6% in 2010 (Figure 3.32.4). Both revenue and expenditure targets were met, although it seems likely that some planned capital expenditure was used for operating expenses. Public debt rose to the equivalent of 58.0% of GDP, or 91.5% of GDP if government-guaranteed debt is included (Figure 3.32.5). The government took onto its books the debt of Fiji Sugar Corporation, a reminder of the risks posed by contingent liabilities.

Preliminary official figures indicate that merchandise exports rose by about 25% in 2010, assisted by higher output and prices of gold. Imports were subdued by slack domestic demand. On this basis, the trade and current account deficits likely narrowed. Foreign exchange reserves rose to US$672 million (about 4 months of imports).

Economic prospects

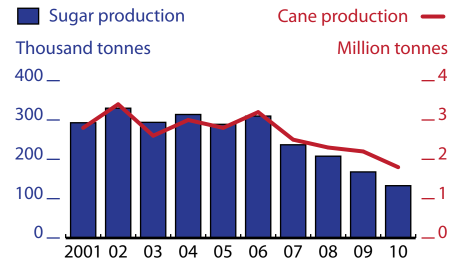
The outlook in the forecast period depends heavily on prospects for the sugar and tourism industries. Reforms in the sugar industry that started in 2010 are assumed to make slow progress, in view of capacity constraints in the government and the need to consult many stakeholders.

Visitor arrivals are influenced by marketing, and while it is assumed the government will continue to fund the Fiji Visitors Bureau, several other Pacific island economies have stepped up their marketing programs. The outlook also assumes no severe cyclones or other natural disasters.

Expected modest economic growth for many of the country's trading partners in 2011 clouds the prospects for both tourism (where deep discounting is set to continue) and merchandise exports. On the balance of these factors, GDP growth is forecast to remain low at 0.5% this year, picking up to 0.8% in 2012 if the sugar industry's reforms gain traction.

The 2011 budget targets a deficit of 3.5% of GDP (the same target set in 2010). It assumes a 16.0% revenue gain from actual levels last year, driven by an increase this year in the value-added tax to 15.0% from 12.5% and a new capital gains tax of 10.0%. It projects expenditure to rise by

3.32.3 Sugar and cane production



Sources: Ministry of Finance. *Budget Supplement 2008, 2009, 2010, 2011.* http://www.mfnp.gov.fj; Fiji Sugar Corporation.
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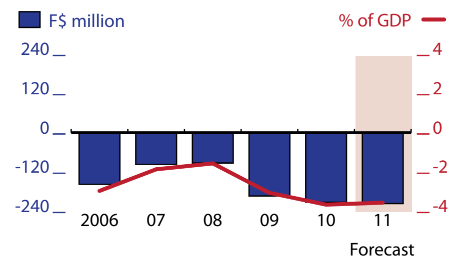
3.32.4 Budget balance



Source: Ministry of Finance. *Budget Supplement 2009, 2010, 2011.* http://www.mfnp.gov.fj
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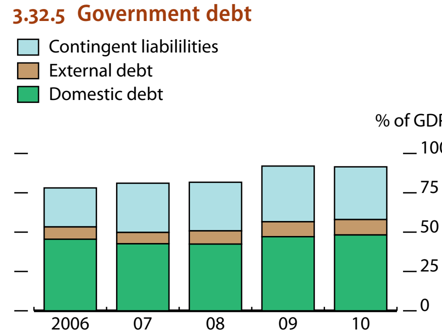
3.32.5 Government debt



Source: Ministry of Finance. *Economic and Fiscal Update. Supplement to the 2011 Budget Address.*
Click here for figure data

14.4%, partly reflecting transfers to Fiji Sugar Corporation for operating expenses and mill repairs. The budget also assumes that GDP growth will quicken to 1.3% in 2011. Failure to meet this target would dent projected revenue and probably require spending cuts to be prolonged.

Ample liquidity is expected in the banking system in 2011, but growth in credit to the private sector will likely remain slow in view of forecast low investment levels. The Reserve Bank of Fiji lowered the overnight policy rate in February 2011, to 2.0% from 2.5%, to support growth in light of what it described as "still very weak domestic economic conditions."

Inflation rose to 5.9% in January 2011, from 5.0% in December 2010, mainly reflecting the increase in the value-added tax and higher global oil prices. For this year, inflation is projected to average 4.0% (Figure 3.32.6).

The government plans to roll over a US$150 million sovereign bond that matures in September 2011, which would delay the need to repay the bond (it represents 55% of total public external debt). Last year, the authorities discussed with the International Monetary Fund a possible stand-by credit arrangement that would bolster foreign exchange reserves, targeted primarily at debt repayment, but they put the idea of a program led by the institution on hold.

Imports will increase faster in 2011 than last year, according to official projections, while growth in exports will moderate. Foreign exchange reserves are likely to come under pressure.

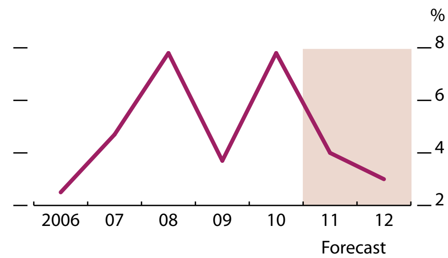
These forecasts are vulnerable to external risks, including oil prices (every US$10 a barrel increase in oil prices raises the cost of oil imports by about US$50 million, or 26% of 2010's total import bill) and weaker than anticipated earnings from tourism. Lack of progress on sugar reforms poses a domestic risk to the outlook.

3.32.1 Selected economic indicators (%)

	2011	2012
GDP growth	0.5	0.8
Inflation	4.0	3.0
Current account balance (share of GDP)	-2.2	-2.1

Source: ADB estimates.

3.32.6 Inflation



Sources: Ministry of Strategic Planning, National Development & Statistics; Reserve Bank of Fiji. *Quarterly Review.* September 2010. http://www.reservebank.gov.fj; ADB estimates.

Click here for figure data

Development challenges

Weakness in investment confines the economy to a low-growth path. Public and private investment combined is estimated to have fallen to 14% of GDP in 2010, from an average of 18% in 2000–2005. Private investment is estimated at the low level of 3% of GDP.

The return of significant donor assistance for infrastructure and other projects, largely withheld since the 2006 coup, depends on new elections. The government is adamant, however, that it will not call them until 2014.

Investor concerns include an opaque and uncertain regulatory environment, as illustrated by foreign exchange controls, price controls, and unpredictable policy decisions. For example, a government decree in 2010 required media organizations to ensure that their directors and 90% of the beneficial shareholders are Fijian citizens permanently residing in the country, which forced a divestment by a foreign firm.

Deficiencies in infrastructure and the poor performance of government-owned enterprises also hurt the investment climate. The need to spur growth is pressing in light of rising poverty, estimated to affect 35%–40% of the population. The authorities have provided some targeted social welfare and have expanded price controls. But the sustainable remedy to poverty—job creation—is unlikely without higher rates of investment.

Papua New Guinea

Economic growth accelerated in 2010 as construction started on the country's largest resource project and incomes benefited from the recovery in global commodity prices. Growth is forecast to quicken in 2011, underpinned by investment in resources and gains in production of metals and agricultural commodities. Reforms to public financial management and the business environment should be stepped up if the full benefits of a coming surge in revenue from resources are to be realized.

Economic performance

The start of construction on a $15 billion liquefied natural gas (LNG) project and recovery in global commodity prices benefited this resource-rich economy in 2010. GDP growth was estimated at 7.1%, marking almost a decade of uninterrupted expansion averaging about 4.4%.

Industry, including minerals, grew by an estimated 9.3% and was the major contributor to GDP growth (Figure 3.33.1). This mainly reflected a construction boom in Port Moresby and Lae, and an increase in mine production, after several years of contraction in mineral output. Services expanded by an estimated 8.5%, with strong growth in telecommunications and transport. Agricultural output rose by 3.5%.

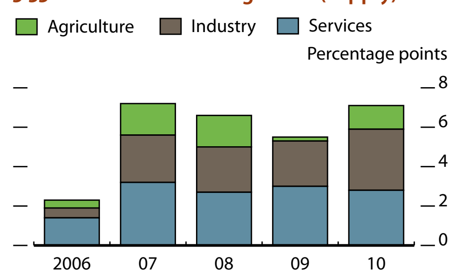
Private consumption was supported by higher incomes, partly attributable to the recovery in commodity prices (most people are farmers who produce primarily for their own consumption plus some cash crops such as cocoa, coffee, and copra).

Progress on securing finance for the LNG plant and starting the construction bolstered private investment and buoyed investor sentiment. The plant is expected to begin production of LNG for export in 2014 or 2015, and full operating capacity will be 6.6 million tons a year. Strong investment helped to offset a decrease in government expenditure of 4.1% in real terms in 2010.

The rebound in commodity prices lifted the value of merchandise exports in US dollars by about 27% in 2010 (Figure 3.33.2). Mining (mainly copper and gold) and crude oil exports together climbed by about 30% in value, despite declines in export volumes of gold (4%) and oil (9%). Agricultural exports shot up in value by about 45%: palm oil 51%, coffee 20%, and copra 87%. (The increase was achieved despite a sharp fall in cocoa exports due to bad weather and disease.) The value of forestry products shipments rose, too, but fisheries and other marine exports fell.

After a highly expansionary fiscal stance in 2009, when the government drew down heavily on savings accumulated in public trust funds during past commodity boom years, the authorities reduced trust-fund drawdowns and spending in 2010. Revenue, including

3.33.1 Contributions to growth (supply)



Source: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*.

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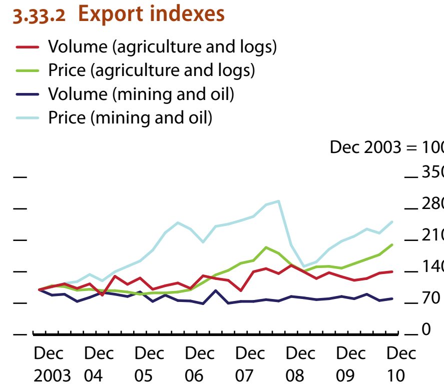
3.33.2 Export indexes



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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This chapter was written by Dominic Mellor of the Viet Nam Resident Mission, ADB, Ha Noi.

foreign grants, increased in real terms by 17%, mainly due to the higher commodity prices. As a result, the fiscal deficit narrowed significantly to 0.5% of GDP, including off-budget items (Figure 3.33.3). Excluding off-budget spending from trust funds, the budget again showed a near-balanced outcome.

Inflation eased for a second year to average 6.0% in 2010, in large part a result of a pullback in food-price inflation (Figure 3.33.4). However, there are concerns that the consumer price index might understate inflation because its composition is outdated. The index excludes housing costs, thus direct effects of surging rents in urban centers are not captured.

Growth in private sector credit slowed to a still high 17% in 2010 and broad money supply growth subsided to 12.5%. The Bank of Papua New Guinea raised the cash-reserve requirement for commercial banks in October 2010 to 4.0% from 3.0% to reduce excess liquidity, but kept its policy interest rate steady at 7.0% throughout the year. The kina exchange rate depreciated by 8% in 2010 against a trade-weighted basket of currencies, mainly due to the strength of the Australian dollar.

A surge in imports of equipment for the LNG plant, mainly funded by foreign direct investment, more than offset higher export receipts in 2010. The merchandise trade deficit widened to about 11% of GDP and the current account deficit to an estimated 27% of GDP. An increase in gross foreign exchange reserves to $2.6 billion (equivalent to 15.3 months of nonmineral imports of goods and services) was attributable to inflows of foreign direct investment.

The government in 2010 decided to move new public trust accounts to the central bank, a move that should give the monetary authorities better control over banking sector liquidity. Existing trust fund balances, however, remain in the commercial banking system.

In another important policy development, the government established a working group, chaired by the Treasury, to oversee establishment of a sovereign wealth fund. The plan is to manage revenue from resources through the offshore fund, with drawdowns to be channeled through the budget. This should help to shield the economy and the budget from the impact of swings in global commodity prices.

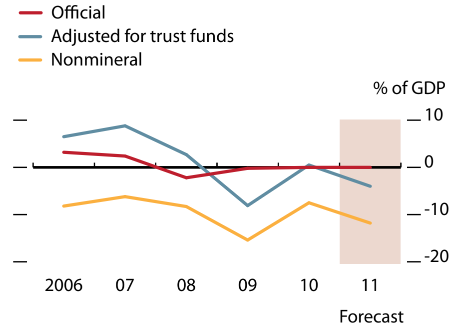
Economic prospects

Plans have been disclosed for a second LNG project, to cost $4 billion, and its developers have said construction could start late this year. Given uncertainty about the construction timetable, the outlook does not factor in any direct impact from this proposal.

Construction of the first LNG plant will accelerate this year (it faced some delays in 2010 owing to land access and compensation issues), thereby increasing activity in the construction and transport industries in particular. Still, the government estimates that only 4.5% of project investment will be retained in the domestic economy because most of the outlays are for imported goods and services.

The $1.4 billion Ramu nickel–cobalt mine, delayed last year over environmental concerns, is assumed to start production in 2011. Output from some operating mines is projected to rise, too. However, crude oil extraction rates will continue to fall as fields mature.

3.33.3 Budget balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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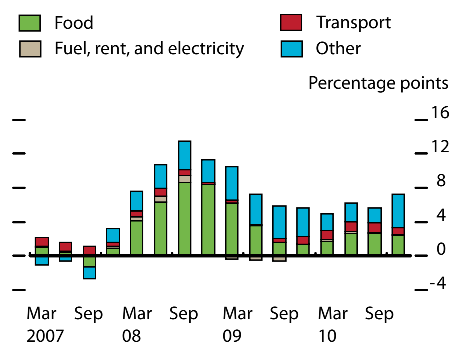
3.33.4 Contributions to inflation



Source: National Statistical Office.

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3.33.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.5	6.5
Inflation	8.0	7.5
Current account balance (share of GDP)	-35.9	-34.2

Source: ADB estimates.

High global prices for agricultural commodities will likely stimulate their production in 2011. Cocoa output is expected to rebound after it suffered from disease in 2010, and coffee production will rise, weather permitting.

On the balance of these factors, GDP growth is forecast to step up to 8.5% in 2011 (Figure 3.33.5), then ease to about 6.5% in 2012 when construction of the first LNG plant starts to taper off.

Price pressures will intensify this year in view of the demands on labor and resources from the first LNG plant. Supply-side constraints are apparent in construction and transport, the property markets in Port Moresby and Lae, and in skilled labor.

Higher global food and oil prices, coupled with last year's depreciation of the kina (against the Australian dollar especially) will fuel inflation, which is projected to accelerate to average about 8.0% this year and be near this rate in 2012. The central bank is expected to tighten monetary policy as inflation pressure builds.

The 2011 budget targets a balanced position, excluding trust fund expenditure. Nevertheless, there may be pressures on the government to spend more from trust funds ahead of elections expected in 2012. Further, a large portion of previous years' trust fund withdrawals may yet be spent. Such expenditure would result in a fiscal deficit and add to inflation pressures.

A buildup in net foreign assets has partially offset the impact of a reduction in net domestic assets on growth in money supply (Figure 3.33.6). This could add to inflation if the trend continues in 2011.

In the external accounts, higher levels of imports for resource projects will continue to widen the current account deficit, to around 35% of GDP in 2011 and 2012 (Figure 3.33.7). This gap will be largely financed by foreign direct investment. Foreign reserves are expected to remain adequate in terms of import cover.

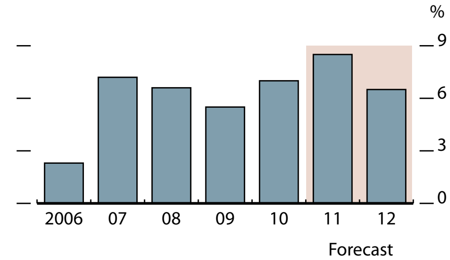
Risks to the forecasts on the upside would come from an early start to work on the second LNG plant or from higher than expected prices for export commodities. The main downside risk is seen in further delays to large resource projects from disputes over land and compensation for landowners.

In the medium term, production from the first LNG plant will underpin growth in GDP, but the likelihood of more such plants is uncertain. There are also uncertainties over mineral production: several large mines are forecast to close sometime in 2012–2015. It will be important that the authorities are cautious about committing to any substantial increases in expenditure, given that they will not receive significant revenue from the first LNG plant until 2018 and that receipts from mining depend on global prices and the life of the mines.

Development challenges

Although the economy has experienced sustained economic growth, driven primarily by development of minerals, the direct contribution of minerals to reducing poverty is limited. Few of the poor depend directly on mining and the links between mining and the rest of the economy are weak. There is currently no official measure of poverty but social

3.33.5 GDP growth



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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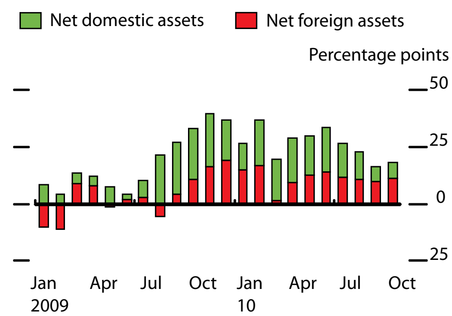
3.33.6 Contributions to money growth



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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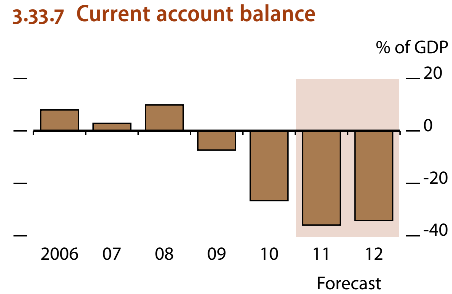
3.33.7 Current account balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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indicators are below those of other countries with similar per capita incomes. Indeed, Papua New Guinea is not expected to meet any of the Millennium Development Goals by 2015, and is ranked 137 out of 169 countries in the 2010 human development index compiled by the United Nations Development Programme.

The government will have an opportunity to improve living standards by rehabilitating infrastructure and upgrading basic services when substantial revenue starts to flow to the budget from LNG projects. It will also have funds to meet adjustment costs of structural reforms to open business sectors controlled by state-owned enterprises, such as ports and electricity, to private competition.

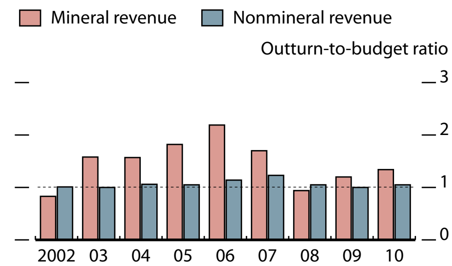
The government's medium-term development plan for 2011–2015 recognizes these challenges and paves the way for a stronger effort to address them. It puts more emphasis on policy achievements and results-based monitoring of the public service. Government commitment to the plan will be critical if agencies are to be held accountable for underperformance. Further, realizing the plan's goals will require marked improvements in the public service and public financial management.

Managing volatile flows of revenue from resources is a continuing challenge. The government has usually erred on the side of caution, under-forecasting commodity prices so that mineral revenue has tended to exceed budget targets (Figure 3.33.8). This generates large windfall revenue that has been directed to discretionary capital spending in supplementary budgets.

It would, though, be helpful if the supplementary budget process was more flexible, to allow some of these funds to be spent on rehabilitation and maintenance of public infrastructure. The plan to manage resource revenue through a sovereign wealth fund should help to smooth revenue flows to the budget.

Improvements to the business environment, including reforms of state-owned enterprises, are required to generate sustainable growth and employment in nonmineral sectors. The World Bank's *Doing Business 2011* report ranks Papua New Guinea 103 out of 183 countries, up from 108 in 2010. The improvement in the overall ranking stemmed from easier availability of credit (though its ranking dropped for other sub-indicators). The lack of enforcement of contracts is, in particular, a deterrent to investment.

3.33.8 Budget revenue forecasts



Note: If the ratio is greater than 1, the outturn is larger than the budget target.

Source: ADB estimates using Papua New Guinea budget documents, 2002–2010.

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Timor-Leste

Driven by increases in government expenditure, this petroleum-dependent economy grew rapidly in 2010 and is forecast to record double-digit growth in 2011 and 2012. Higher oil prices are positive overall for the country, but they have also fueled inflation. Longer-term prospects rest on using government investment to build human and physical capital and to trigger a transition to private sector–led growth.

Economic performance

Economic momentum generated by a rapid buildup in government spending has resulted in the preferred measure of GDP—excluding offshore petroleum production and the United Nations (UN) peacekeeping mission—averaging double-digit growth in 2007–2010. This measure of GDP rose by 9.5% in 2010, moderating from a very high rate in 2009.

Government expenditure, funded mainly by income from offshore petroleum production, increased steeply from about $220 million in 2006 to around $825 million in 2009, and was budgeted at $967 million for 2010 (although actual outlays probably fell short of the budget) (Figure 3.34.1).

Much of the additional government spending was on items that fed quickly into the local economy. Private consumption was boosted in 2010 by a continued rise in public sector wages and salaries, as well as cash transfers provided in rural areas through a wide-ranging social safety net. There was a further large expansion last year both in small, rural infrastructure projects and in larger public projects in the capital, Dili.

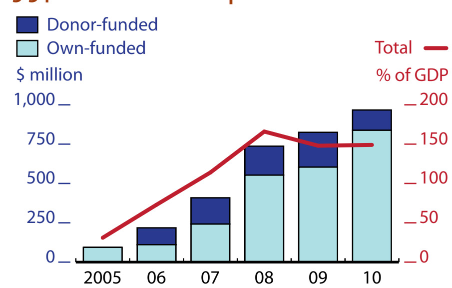
Private investment also climbed as local and overseas-owned businesses geared up to take advantage of the opportunities presented by rising public investment and buoyant consumer spending.

A high level of aggregate demand is reflected in a range of indicators, including new vehicle registrations, electricity use, and mobile phone subscribers (Figure 3.34.2), albeit with some sign of an easing in growth in 2010.

Construction expanded alongside rising investment. Agricultural output, which contributes around 30% of GDP, barely rose in 2010 because of bad weather and continuing transport problems. This followed 2 years of 13% growth in the sector, when it was bolstered by government-led distribution of better seeds and of tractors, and by the introduction of extension services. The Ministry of Agriculture estimated that rice production declined by 6.4% in 2010. Maize production, though, rose by an estimated 10.5%, and coffee exports rose from an unusually low 10,000 tons in 2009 to 25,600 tons in 2010.

Merchandise exports, mainly coffee, represent less than 10% of the

3.34.1 Government expenditure



Note: Nonpetroleum, non-UN GDP.

Source: ADB estimates based on Government of Timor-Leste. 2009. *General Budget of the State* and *State Plan for 2010*. October.

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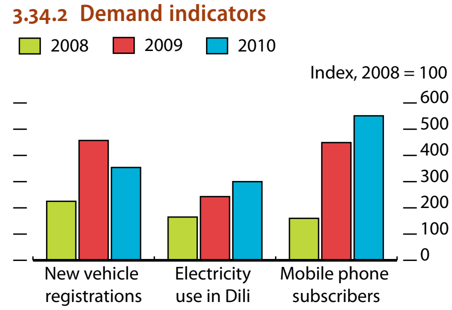
3.34.2 Demand indicators



Source: ADB estimates from Timor-Leste National Directorate of Statistics data.

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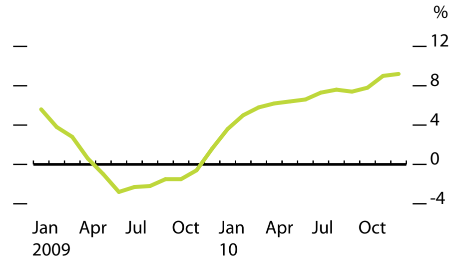
This chapter was written by Craig Sugden of the Special Office in Timor-Leste, ADB, Dili.

value of merchandise imports. The wide trade deficit, in the order of 65% of nonpetroleum, non-UN GDP, is outweighed by a surplus in the income account attributable to petroleum revenue. In 2010, such revenue rose to an estimated $2.1 billion, and provided for a current account surplus equivalent to 238% of nonpetroleum, non-UN GDP.

Growth in broad money supply slowed to a more normal 9.7% in 2010, from the exceptional 39.6% in the previous year when the banking system saw a buildup of unspent government funds. Bank lending remained constrained by a backlog of nonperforming loans and a continuing problem of securing land as collateral. Consequently, commercial bank credit to the private sector was unchanged in 2010 from 2009.

Inflation accelerated to average 6.8% in 2010 and was running at 9.2% year on year in December (Figure 3.34.3). Rising food prices were the main reason, themselves largely due to higher international prices. Inflation was lower for prices set by domestic rather than international conditions, suggesting that inflation was cost push rather than demand pull.

3.34.3 Year-on-year inflation



Source: Timor-Leste National Statistics Directorate. Consumer Price Index. http://dne.mof.gov.tl (accessed 25 February 2011).

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Economic prospects

Outlooks for the short and medium term rest heavily on developments in government expenditure. The government has budgeted to boost its own-funded spending by about 50% to $1.27 billion in 2011. Much of the increase is for a multiyear national electrification project and will not be fully spent in 2011, but a sizable increase in actual expenditure is projected for 2011. The government has foreshadowed that its own-funded spending will rise to about $1.45 billion by 2015. Total infrastructure investment over 2011–2015 is projected to exceed $3 billion.

This surge in government outlays will continue to support aggregate demand and construction. Barring disruptive shocks, economic growth is likely to remain high at around 10% over the forecast period (Figure 3.34.4).

The UN mission is phasing down toward a scheduled departure at end-2012, which will have a damping effect on growth, mainly in 2013. Until then, expansion in government expenditure will more than offset that effect.

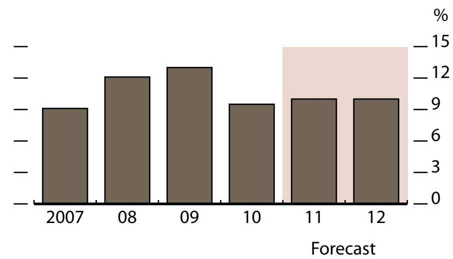
High world oil prices are boosting public saving, providing the financial resources to sustain the investment surge. The nation's Petroleum Fund held $6.9 billion in offshore investments at end-2010, and even with large withdrawals planned to finance the budget, the value of the fund is projected to rise above $14 billion by 2015.

Petroleum income exceeding $2 billion annually is likely to lead to further large budget and current account surpluses in 2011 and 2012. The budget surplus is, however, projected to decline this year as the expansion in government expenditure is expected to outweigh the additional revenue provided by higher world oil prices. From 2012, restraint in recurrent spending and a planned leveling off in public investment are seen easing the downward trend in the budget surplus (Figure 3.34.5).

Inflation is forecast to average 7.5% in 2011, before decelerating in 2012 as upward pressure on commodity prices eases.

While the rise in oil prices is a positive factor overall for this economy, the government needs to carefully manage the resultant

3.34.4 GDP growth



Note: Nonpetroleum, non-UN GDP, annual growth.

Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.

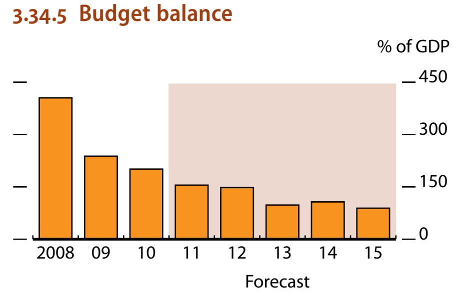
Click here for figure data

3.34.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	10.0
Inflation	7.5	5.3
Current account balance (share of GDP)	233.7	205.8

Source: ADB estimates.

3.34.5 Budget balance



Note: Ratio to nonpetroleum, non-UN GDP.

Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.

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inflation. It should avoid continually adjusting public sector wages to compensate for the higher cost of living, which could result in a wage–price spiral. That would have the potential to turn what is largely a problem of imported inflation into a deeper risk to macroeconomic stability.

The high rate of economic growth projected for the medium term will see further inroads into poverty. Average household incomes rose by about 20% in 2007–2009, helping to reduce the incidence of poverty from an estimated 50% to a still high 41%. The rate of progress in poverty reduction will rest on success in continuing to expand basic public services and in providing economic opportunities in rural areas.

Development challenges

Development is being fast-tracked through the conversion of petroleum wealth into physical and human capital. The surge in government expenditure funded from petroleum revenue is enabling a rapid expansion in public services and has provided a public social safety net for many. After ranking 150 of 159 countries in the United Nations Development Programme's 2005 human development index, Timor-Leste's position improved to 120 of 162 in the 2010 index.

Still, development challenges are daunting. Income from petroleum lifted Timor-Leste to lower-middle-income country status in 2007, but other indicators of development generally remain those of a low-income country. Of the 21 measurable Millennium Development Goals, about half are unlikely to be met by the target date of 2015, notably those relating to poverty and nutrition. The coverage of electricity, water, and telecommunications infrastructure has expanded, but access and service quality are below potential. Most of the road network is in poor condition.

Public investment needs are likely to stay high over the next decade and beyond (Box 3.34.1). Fiscal constraints will, however, ultimately limit public investment's ability to support the economy. Sustaining a high rate of economic growth will rest on a transition from public to private sector–led investment. As the domestic private sector is still emerging and not yet ready for major investments, there is likely to be a gap that will need to be filled by foreign inflows. The country's success in establishing itself as one of developing Asia's investment destinations will therefore be pivotal to its growth path.

Ideally the level of public investment will be responsive to the returns that it generates. The fundamental rule of public investment is that it should generate an economic return—broadly defined to capture the full range of factors that determine community welfare—at least as high as the economic cost of funding. Most public investment will need to be funded by withdrawals from the Petroleum Fund. Such investment should aim for a return that exceeds the cost of withdrawals, being the financial return that would have been earned if savings had remained in the fund.

The government has flagged the prospect of borrowing on concessional terms to fund public investment. Similarly, any public investment funded from borrowing should aim for a return higher than the interest rate paid, plus any other costs. Borrowing makes sense if it allows savings to be kept in the Petroleum Fund to earn a return higher than the cost of the debt.

3.34.1 How much investment does Timor-Leste need?

An economy's longer-term investment needs can be understood through growth accounting, which decomposes growth into its components: the accumulation of capital and labor, and productivity improvements.

For Timor-Leste, projections prepared in this way highlight the economy's potential to grow robustly over the next two decades. Factors in Timor-Leste's favor include a growing labor force, an ability to fund a high rate of public investment from petroleum revenue, and the potential for a quick catch-up in education and technology.

A continuation of recent double-digit rates of economic growth would probably require investment rising above $1 billion annually within 5 years and above $1.5 billion within 10 years (in 2010 prices). This would be a very large increase on the 2010 investment level of about $300 million.

Projections made using the growth accounting framework show that lower, but still internationally high, rates of economic growth could be achieved if investment was around half these levels. This lower estimate of annual investment—at least $500 million and $750 million—sets a minimum target.

Source: C. Sugden. Forthcoming. *Timor-Leste: Economic Growth to 2030.* Asian Development Bank, Manila.

Small Pacific countries

Seven of the 11 small Pacific economies grew in 2010, albeit slightly, and GDP was estimated to be flat in three. GDP fell in one (Tonga), in contrast to 2009 when the global recession contributed to contraction in seven economies.

The pickup in global travel in 2010 helped some countries. Government infrastructure projects, mostly donor financed, also supported economic activity, notably in the Cook Islands, the Marshall Islands, and the Federated States of Micronesia. Export receipts remained weak, however (except for Solomon Islands). Inflation decelerated from 2009 levels for most economies.

The economic outlook is more positive for 2011 on the back of continued global recovery. This will contribute to increased tourism earnings, export receipts, and remittances. Several economies will benefit from greater spending on public infrastructure. Growth is forecast to pick up in eight countries this year and, and for about half of them, edge still higher in 2012.

Inflation is projected to increase in all 11 countries this year, primarily owing to higher global food and fuel prices for these import-dependent economies, before price pressures ease for most of them in 2012.

Cook Islands

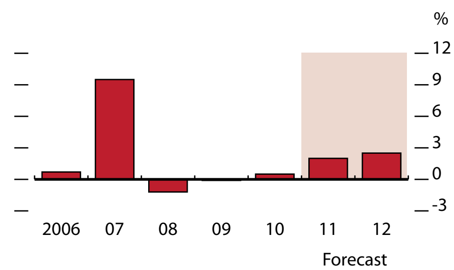
After 2 years of contraction, this economy grew by 0.5% in FY2010 (ended 30 June 2010), supported by expansion of tourism and fisheries, as well as the start of construction on some donor-financed infrastructure projects.

Visitor arrivals and expenditure rose by 2.7% and 2.6%, respectively. Exports of fish (54% of total exports) increased by 15.9%. These performances offset a 10.1% decline in pearl exports caused by a shortage of skilled pearl-seeding technicians.

Growth is projected to pick up to 2.0% in FY2011 (Figure 3.35.1), as infrastructure projects, including development of Avatiu port, gain momentum. However, tourism is subdued because of softness in consumer spending in New Zealand, the main source of visitors. Growth prospects are more positive for FY2012, on the expectation that tourism will pick up and infrastructure investment will increase. GDP growth is forecast to rise to 2.5% that year.

Inflation moderated to 3.5% in FY2010, but will likely quicken to average 4.0% in FY2011. Higher prices for imported oil and commodities, coupled with increased construction activity, have pushed up prices for food, housing-related costs (including electricity), and transport.

3.35.1 GDP growth, Cook Islands



Sources: Ministry of Finance and Economic Management. *Budget Estimates 2010/11: Part 1 Appropriation Bill Appropriations and Commentary*. http://www.mfem.gov.ck; ADB estimates.

Click here for figure data

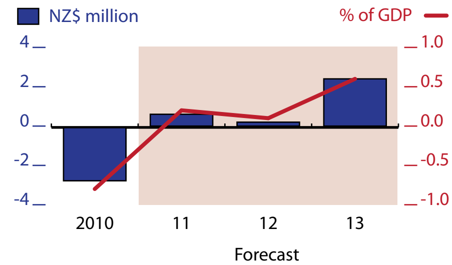
This chapter was written by Stephen Pollard and Elbe Aguba of the Pacific Department, ADB, Manila; Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva; Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Rommel Rabanal, consultant.

Merchandise exports fell by 21% in FY2010, largely owing to the problems with pearl production, while imports rose by 42%. The trade deficit widened, and is expected to worsen as import growth, driven mainly by materials for projects that donors are financing, outpaces exports.

Government revenue exceeded budget estimates by 4.3% in FY2010, a result of better than expected receipts from company tax and one-time revenue from fines for illegal fishing. Expenditure was 9.6% over budget, partly on account of supplementary appropriations to cover cyclone recovery expenses and subsidies for Air New Zealand flights from Rarotonga to Sydney and Los Angeles. Still, the budget deficit of NZ$2.7 million (0.8% of GDP) narrowed sharply from 11.7% in FY2009.

The FY2011 budget projects an operating surplus of 0.2% of GDP (Figure 3.35.2), but this was framed against an earlier backdrop of a more positive tourism outlook. Consequently, revenue collections will need to be revised down. The government is aiming to trim expenditure by 1.5% relative to FY2010. Public debt is projected to fall by NZ$30 million to NZ$114.8 million in FY2011 (equivalent to 34% of GDP), mainly due to movements in exchange rates.

3.35.2 Fiscal balance, Cook Islands



Source: Ministry of Finance and Economic Management. 2010. *The Cook Islands Half Year Economic and Fiscal Update for the Financial Year 2010/2011*. December. http://www.mfem.gov.ck

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Kiribati

This economy, too, performed better in 2010, following 2 years of contraction (Figure 3.35.3). Estimated GDP growth of 0.5% was attributable mainly to additional spending by the public sector and to some pickup in private sector activity, especially in construction and retailing. This performance offset a fall in remittances and copra production.

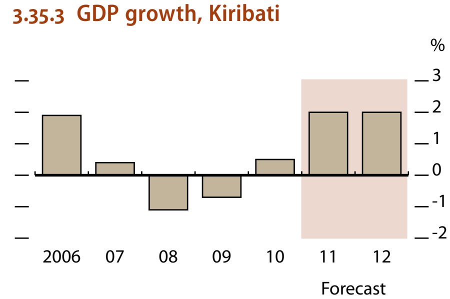
Remittances from the country's seafarers, which account for about 7% of GDP, fell by an estimated 13% in 2010 because of weakening demand for the country's seafarers and greater supply of such workers from other nations. Production of copra declined owing to bad weather.

Wage increases for the public service and higher subsidies for copra production were major factors in widening the budget deficit to an estimated 15% of GDP in 2010. The 2011 budget projects a further rise in public service wages, and in infrastructure investment, pushing the deficit out to 19% of GDP. The gap is to be financed from the country's wealth fund and short-term loans.

The value of the wealth fund—the main source of deficit financing—declined from A$637 million (420% of GDP) in 2007 to A$571 million (350% of GDP) in 2009, primarily due to losses on investments, as well as drawdowns that averaged around 19% of GDP annually from 2007 to 2010. Although the fund's investments recovered marginally last year, concerns remain about its sustainability. The International Monetary Fund recommends that the budget deficit be limited to 6.0% of GDP to preserve long-term financial sustainability.

Fiscal risks are likely to worsen if the government undertakes substantial external borrowing to fund capital works, and if drawdowns from the wealth fund remain high. The government has adopted a medium-term fiscal framework that should help to maintain fiscal discipline.

3.35.3 GDP growth, Kiribati



Sources: International Monetary Fund. *Kiribati: 2009 Article IV Consultation—Staff Report*; ADB estimates.

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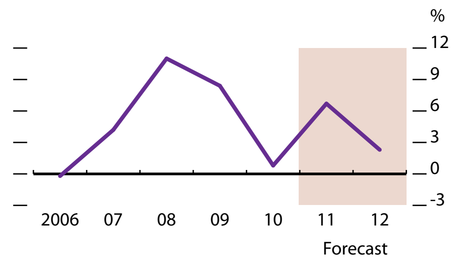
Economic growth is likely to pick up to about 2% in 2011 and 2012 as large, mostly donor-funded, capital works get under way. These include revamping the international airports in Tarawa and Kiritimati, upgrading the South Tarawa Road, and extending Betio port.

Inflation slowed to average 0.8% in 2010 (Figure 3.35.4), reflecting appreciation of the Australian dollar and the lagged pass-through from international to domestic prices. This year, though, inflation is expected to accelerate to 6.7%, driven by higher prices for imported fuel and food.

The current account deficit is set to widen from about 14% of GDP in 2010 to about 23% in 2012, in part a result of lower investment income from the wealth fund as drawdowns become smaller.

3.35.4 Inflation, Kiribati



Sources: International Monetary Fund. *Kiribati: 2009 Article IV Consultation—Staff Report*; ADB estimates.

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Marshall Islands

Supported by grant-financed increases in government spending and expansion in fish processing, the economy grew by an estimated 0.5% in FY2010 (ended 30 September 2010). This represented a turnaround after 2 years of declining GDP (Figure 3.35.5). Higher global prices of copra and coconut oil—the country's major agricultural exports—contributed to some increase in export receipts.

The fiscal balance improved, posting a surplus of about 0.3% of GDP in FY2010 (compared with a deficit the previous year), owing to improved tax collection and an increase in fishing fee income. Inflation quickened to 1.0% on higher prices for fuel, electricity, and transport.

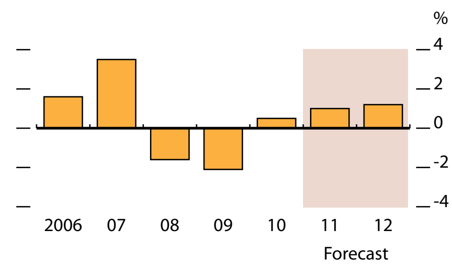
In preparation for when grants under the Compact of Free Association with the United States (US) expire, scheduled for 2024, the government is implementing tax reforms this year that aim to improve the fiscal position, including by raising revenue. It has taken some measures to trim expenditure, but needs to make more cuts for long-term fiscal sustainability. Such reductions could include allowances for civil servants and public officials and assistance to state enterprises.

Economic growth is expected to pick up marginally to 1.0% in FY2011 and 1.2% in FY2012. The outlook is supported by additional grants from Taipei,China and the European Union, which will partly offset the impact of a 5.5% cut in government spending this year. Fisheries, a key source of income, could benefit from planned subregional collaboration on managing fish-stocks.

Inflation is forecast to accelerate to about 5.0% in FY2011 on rising food and oil prices, coupled with some renewed demand-side pressures as the economy grows, before moderating to 3.8% in FY2012 as global commodity price pressures subside (Figure 3.35.6).

Risks to the outlook center on rising prices for commodities, a possible further downsizing of the US military base on Kwajalein, and the pace of phasing down compact-related grants from the US.

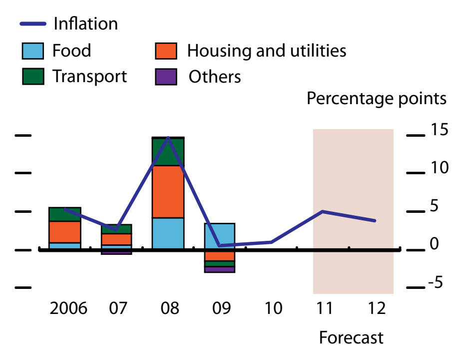
3.35.5 GDP growth, Marshall Islands



Sources: Republic of the Marshall Islands Fiscal Year 2009 Economic Review; ADB estimates.

Click here for figure data

3.35.6 Contributions to inflation, Marshall Islands



Sources: Republic of the Marshall Islands Fiscal Year 2009 Economic Review; ADB estimates.

Click here for figure data

Federated States of Micronesia

Growth of an estimated 0.5% in FY2010 (ended 30 September 2010) followed a similar increase in GDP in FY2009 (revised from a previously estimated slight contraction).

The modest expansion was driven by public infrastructure projects, including extension of Pohnpei airport and the expansion of the fiber-optic communications network. The reopening of a fish-processing plant in Kosrai and an increase in small-scale agriculture stimulated by rising commodity prices helped the economy, as did some uplift in remittances and tourism receipts.

Inflation subsided to about 3.5% in FY2010, owing to lower prices for imported food and energy in the early part of the year.

Reflecting a general weakness in consumption spending, food imports from the US, the main trading partner, fell by 6.7% in value in FY2010.

The government trimmed expenditure by 3.6% in FY2010, cutting capital spending by almost 20% while raising current spending by 2.1% (for the public wage bill and subsidies). Tax revenue growth of 7.9% helped to generate a small fiscal surplus.

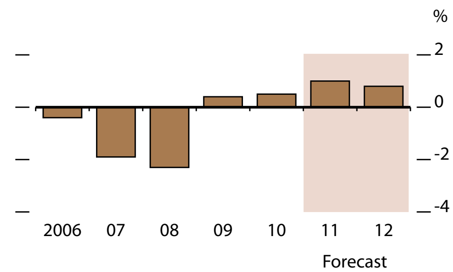
The fiscal situation has improved markedly since FY2009, in part because of efforts by state governments to raise revenue collection and cut spending. Nevertheless, much further progress is needed before FY2023, when grants expire under the Compact of Free Association with the US.

GDP growth is expected to pick up to 1.0% in FY2011 (Figure 3.35.7), based on a pipeline of infrastructure projects and the release of infrastructure funds delayed in previous years. With the Pohnpei airport extension scheduled for completion in mid-2011, improved direct flight connections could expand opportunities for tourism and exports. GDP growth is forecast at 0.8% in FY2012.

Inflation will likely inch up to 4.0% in FY2011 owing to higher global commodity prices, before easing to 3.0% in FY2012.

Sluggish development of the private sector, which is hindered by inadequate infrastructure, lack of skilled labor, and investment restrictions, remains an impediment to growth.

3.35.7 GDP growth, Federated States of Micronesia



Sources: Federated States of Micronesia Fiscal Year 2009 Economic Review; ADB estimates.

Click here for figure data

Nauru

GDP was likely flat in FY2010 (ended 30 June 2010) (Figure 3.35.8) because storm damage to the port and weak demand restricted exports of phosphate.

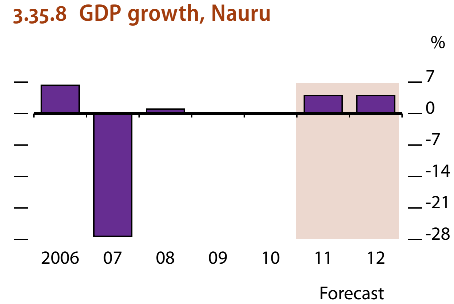
Repairs to the port, funded by the Russian Federation, with modest recovery in world phosphate demand, are expected to support a return to economic growth in FY2011 and FY2012. GDP growth of about 4% is forecast for each year.

Consumer prices declined by an estimated 0.5% in FY2010. The cost of telecommunications fell as a result of the entry of a new mobile telephone and Internet service provider. In FY2011 and FY2012, however, higher global food and fuel prices are expected to induce inflation of 2.5%.

The FY2010 budget outturn was a net cash position of A$7.7 million, with the surplus achieved after own-funded expenditure of A$20.2 million and donor-funded expenditure of A$11.2 million. This fiscal year's budget maintains the prudent fiscal management adopted since 2004. Spending in FY2011 is budgeted at A$29.0 million (excluding donor-funded projects), down by 9% from FY2010. Donor-funded expenditure is expected to total A$31.0 million. Without donor support, per capita GDP (estimated at US$2,240 in 2009) would fall by more than half.

Nauru faces an enormous debt burden as a result of poor

3.35.8 GDP growth, Nauru



Sources: Asian Development Bank. 2007. *Country Economic Report*. August; ADB estimates.

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decisions by previous governments. Total government external debt in 2010 was estimated at A$261 million. In addition, A$265 million is owed domestically by the government, mainly to depositors at the insolvent Bank of Nauru, and state-owned enterprise debts total about A$368 million. Total external debt is more than eight times GDP.

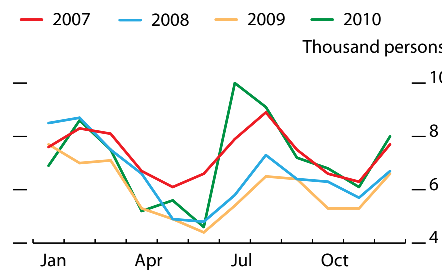
Over the medium term, the economy will remain heavily dependent on donors. Longer-term prospects depend on government reforms both to improve public financial management and the performance of state-owned enterprises, and to revitalize mining and quarrying, which now include coral aggregate used in construction (as well as phosphate). Tourism and fisheries offer untapped opportunities for greater economic self-sufficiency.

Palau

An upturn in tourism compensated for cuts in public expenditure to drive growth estimated at about 2.0% in FY2010 (ended 30 September 2010). This was the first year of growth after 4 consecutive years of contraction.

Tourism, which accounts for around half GDP, had seen visitor arrivals drop by a cumulative 16.5% over the previous 2 years. In FY2010, arrivals picked up by 11.7% as a result of the global economic recovery, new airline and charter connections to Palau, and intensified advertising and promotion. Growth was particularly strong in arrivals from Taipei,China. Arrivals from Japan, the largest source of visitors, rose sharply during the northern summer months. Total monthly arrivals recovered to 2007's levels by the second half of 2010 (Figure 3.35.9).

3.35.9 Visitor arrivals, Palau



Source: Palau Visitors Authority. http://www.visit-palau.com (accessed 16 March 2011).

Click here for figure data

Domestic demand appears to have picked up a little last fiscal year. Consumption spending, as measured by the value of monthly food imports from the US, was just above the previous year's level. However, public investment on infrastructure projects remained low.

Inflation slowed to an estimated 3.8% on average from 5.2% in FY2009, due primarily to lagged effects of lower international prices of fuel and other commodities early in the year. Transport and household costs declined in the first quarter before climbing steadily.

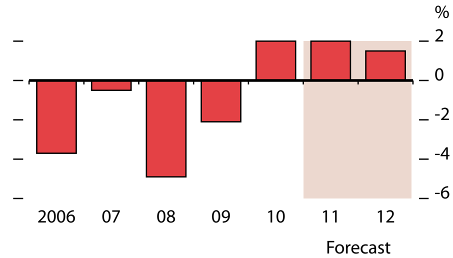
The original budget for FY2010 intended to reduce public expenditure by about 10%, as a start toward bringing outlays down to more sustainable levels. In a reversal of a recent trend of overoptimistic revenue projections, which had led to drawdowns in cash reserves and accumulation of public debt, the revenue shortfall was budgeted to narrow in FY2010.

However, a supplementary budget passed later in the year partly reversed the spending cuts and restored current expenditure to about the FY2009 level. Given the scheduled ending in FY2024 of grants from the US under the Compact of Free Association, it will be important to gradually reduce current expenditure to more sustainable levels, particularly the wages bill for the public service and purchases of goods and services. Otherwise, more severe spending cuts will be needed later. These reductions should be put through in parallel with increases in government revenue. Raising utility charges to eventually reflect the cost of service delivery would help.

Economic prospects remain largely dependent on the outlook for tourism. Visitor arrivals are projected to increase by around 7% in FY2011 (the first-quarter performance was strong), followed by another 5% gain in FY2012. Such expansion in tourism would help take GDP growth to 2% in FY2011 and 1.5% in FY2012 (Figure 3.35.10).

Inflation is projected at about 4.0% in FY2011, lifted by higher global food and fuel prices, easing to 2.5% in FY2012 as commodity price increases moderate.

3.35.10 GDP growth, Palau



Sources: International Monetary Fund. 2010. *Country Report* No. 10/116. May; ADB estimates.

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Samoa

Declines in agriculture, tourism receipts, and remittances offset growth in construction, manufacturing, and transport and communications in FY2010 (ended 30 June 2010), leaving GDP flat.

Even though visitor arrivals rose by 3.5% to 131,300, earnings from tourism fell by 6.0% to $130 million owing to a decrease in tourist spending per head. Remittances fell by 5.3% to $148.8 million.

Merchandise exports increased by 18.8% to $12.2 million in FY2010, led by strong performances from nonu fruit and coconut oil. Merchandise imports picked up by 14.1% to $261.6 million, reflecting higher costs of petroleum and food. A wider trade deficit, coupled with reduced remittances, saw the current account deficit worsen to 8.1% of GDP.

However, the overall balance of payments was in surplus due to net disbursement of government loans for tsunami reconstruction (a tsunami hit coastal areas in September 2009). Foreign exchange reserves of $165.7 million at June 2010 were equivalent to 7.6 months of import cover.

Inflation slowed to average 1.2% in FY2010. The deceleration was a result of falling commodity prices and subdued domestic economic activity.

Fiscal policy was exceptionally expansionary in FY2010, with a budget deficit equivalent to 8.1% of GDP. Spending was boosted by measures to counter the impact of the global recession on the domestic economy, coupled with post-tsunami reconstruction. These steps were largely funded by grants and concessional borrowing. External debt levels went up to about 43% of GDP by end-FY2010 (Figure 3.35.11), exceeding the government's 40% target.

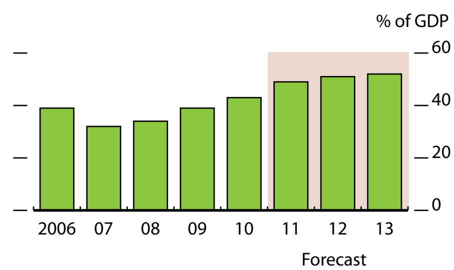
The FY2011 budget continues high levels of expenditure, reflecting the reconstruction effort and increases in public sector wages and pensions. The fiscal deficit is projected to widen to 9.3% of GDP.

The rise in government spending, and in private consumption to a lesser degree, are expected to produce a return to economic growth in FY2011, forecast at 2.1%. A stronger tourism marketing effort is likely to have some positive impact in FY2011, and private remittances should benefit from economic growth in Australia. For the first 7 months of FY2011, earnings from tourism and remittances rose by 4.0% and 1.1%, respectively.

Growth is seen rising to 3.0% in FY2012 on continued post-tsunami reconstruction and an expected increase in tourism.

Inflation is projected to increase to around 3.0% this year as domestic economic activity picks up and as a result of higher global food and fuel prices.

3.35.11 Total debt, Samoa



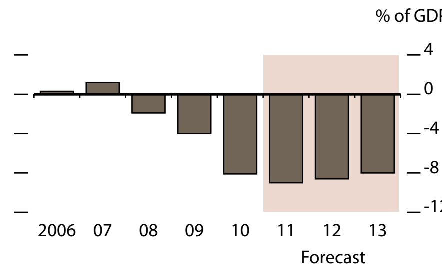
Source: Ministry of Finance. 2010. *Fiscal Strategy Statement Budget 2010/11*. 28 May.

Click here for figure data

The government intends to run fiscal deficits of over 8% of GDP through FY2013 (Figure 3.35.12). Although the deficits are to be financed through concessional borrowing and grants, sustaining such a stance holds risks—the government would find it hard to adjust to any external shocks, for example.

Structural reforms to improve the commercial focus of state-owned enterprises and to increase access to, and economic use of, customary land are needed for the potential benefits of public investment to be realized.

3.35.12 Budget balance, Samoa



Source: Ministry of Finance. 2010. *Fiscal Strategy Statement Budget 2010/11*. May.

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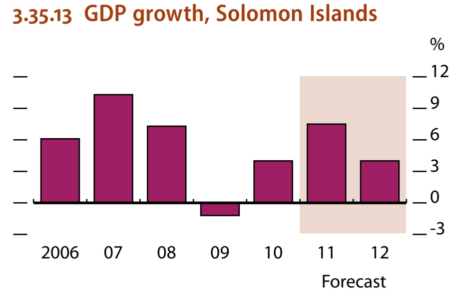
Solomon Islands

This economy recovered in 2010, growing by an estimated 4.0% after contracting by 1.2% in 2009 (Figure 3.35.13). Logging led the upturn. After a poor year in 2009, log export volumes rose by about 30% in 2010, a result of recovering demand in Asia that also helped to lift international log prices. Production of palm oil and cocoa, as well as the size of the fish catch, also increased, although copra production declined.

The services sector was sluggish in the first half of 2010, but business conditions improved in the second half according to a business expectations survey. Building activity indicators suggested expansion in construction as well.

GDP growth is forecast to accelerate to 7.5% in 2011, when the Gold Ridge mine in Guadalcanal is due to start producing and exporting gold. Logging is expected to decline during the forecast period, owing to falls in logging resources, but stronger global demand for other commodity exports, such as palm oil and copra, will bolster growth. Other positive factors include an expected rise in foreign investment in mining, including a new copper mine, and in telecommunications. Growth of about 4.0% is projected for 2012.

3.35.13 GDP growth, Solomon Islands



Sources: Central Bank of Solomon Islands. *Quarterly Review September 2010*. http://www.cbsi.com.sb; ADB estimates.

Click here for figure data

Inflation eased to average about 3.0% in 2010, largely due to a 40% fall in the price of rice caused by greater competition in food imports (rice constitutes around 18% of the consumer price index). Looking ahead, though, inflation is expected to accelerate to 4.2% this year and 6.3% in 2012, as a result of higher global prices for fuel and commodities and stronger domestic demand as the economy grows.

At an estimated 20% of GDP, the current account deficit remained wide in 2010, reflecting high levels of imports of mining and telecommunications equipment. The start of gold exports this year, coupled with growth in agricultural exports, is seen pulling back the deficit to 15% of GDP.

Despite the trade and current account deficits, foreign reserves rose to the equivalent of about 9 months of import cover, a consequence of large inflows of donor funds and the first tranche of a US$18.3 million stand-by credit facility approved by the International Monetary Fund in June 2010. Half this credit was disbursed in 2010 and the rest is scheduled for 2011. Foreign reserves are expected to remain strong in 2011, at about 6 months of import cover.

A tight fiscal situation for much of 2010 led to restrictions on expenditure until the fourth quarter and a government recruitment freeze. Budget support from donors, including large sums in the second half of the year, together with a better than expected revenue performance, resulted in a budget surplus.

After elections in August 2010, the incoming government was unable to draft a full budget before year-end, and instead passed a supplementary appropriations bill that enabled spending to continue in the first 3 months of 2011, at no higher than in the same period of 2010.

Tonga

Weakness in remittance and tourism contributed to a 1.2% contraction in GDP in FY2010 (ended 30 June 2010). Remittances fell by 10.0% and earnings from tourism fell by 13.3% owing to slow recovery in source countries, particularly New Zealand and the US. GDP has contracted in 3 of the past 4 years (Figure 3.35.14).

Private sector credit fell by around 13% in December 2010, in part reflecting consolidation in the banking sector and the write-off of bad debts.

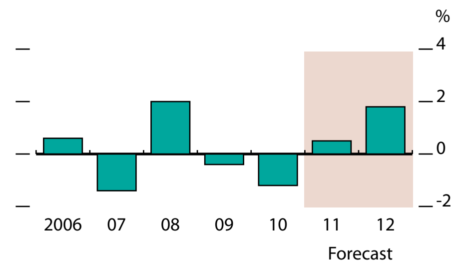
The government trimmed its nonwage operating costs and own-funded capital spending in FY2010, in response to a 4.0% decline in revenue (it fell short of the target by more than 20%). Budget support from donors limited the deficit to about 1.0% of GDP; without that support the gap would have been 2.3%.

In the external accounts, increased receipts from exports of sea cucumber more than made up for declines in fish and agricultural products in FY2010, so that total exports grew by 2.2%. Imports fell sharply, by 21.0%, reflecting weak domestic demand. The current account deficit narrowed to $16.6 million from $24.8 in FY2009. Official foreign reserves amounted to $98 million at end-December 2010, equivalent to 7.9 months of imports (Figure 3.35.15).

Donor-funded infrastructure activities are expected to support a return to economic growth of about 0.5% in FY2011. Government spending is budgeted to rise by 14.9%, based on commitments from donors, and will contribute to aggregate demand through higher public sector wages. Revenue, excluding grants, is to remain weak.

Inflation eased to 2.0% last year, mainly the result of better supplies and a related fall in prices for domestically produced food, as well as lower school fees. It is forecast to rise to about 3.0% in FY2011 on upward pressure from world oil prices and higher prices for imports from New Zealand, in part a result of exchange rate movements.

3.35.14 GDP growth, Tonga

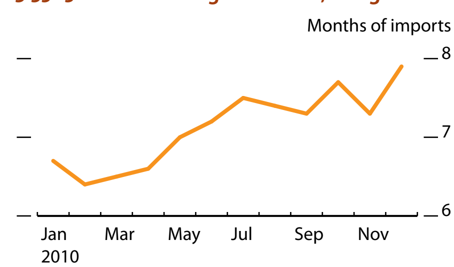


Note: Fiscal year ending June.

Sources: Ministry of Finance. *Budget Statement: Review of the Tongan Economy and Outlook*. Various years. http://www.finance.gov.to; ADB estimates.

Click here for figure data

3.35.15 Official foreign reserves, Tonga



Source: National Reserve Bank of Tonga. *Official Foreign Reserves December 2010*. http://www.reservebank.to

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Tuvalu

This economy continued to feel the impact of the global recession in 2010. Even with higher government spending, GDP was estimated to be unchanged from 2009.

Seafarer employment—a significant income source for households—was weak and is likely to remain so due to subdued demand for Tuvaluan seafarers. Income from the ".tv" domain name and fisheries licenses fell as the Australian dollar (which Tuvalu uses) gained parity with the US dollar. The Australian dollar's strength also had an impact on consumer prices: they eased from mid-2009, with the average decline in 2010 estimated at 1.9%.

The government continued to support the economy through spending. It approved three supplementary appropriation bills, together accounting for about 10% of GDP, in 2010. These were used to pay for the government's guarantee of an Air Fiji loan (Tuvalu is the biggest shareholder in the airline) and to increase capital spending by 15.7% from the original estimate.

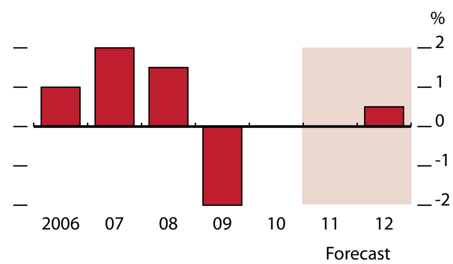
The fiscal deficit is estimated to have widened sharply to almost 30% of GDP in 2010, owing to lackluster domestic revenue and increased expenditure. Revenue is estimated to have declined by 17%, in part due to weak offshore income from all sources. Public debt (including guarantees) is about 44% of GDP, which is high for this small economy.

The value of the Tuvalu Trust Fund likely stabilized in 2010, after falling during the global recession. However, no distributions from this fund to the budget were made or are expected while international financial markets are volatile.

The economy is projected to stay flat in 2011 (Figure 3.35.16) as fiscal adjustments, mainly spending cuts, are made to ensure longer-term fiscal sustainability. Growth is expected to resume at about 0.5% in 2012 when donor-financed public works employing local workers are scheduled to start. Rising global food and fuel prices are likely to rekindle inflation, forecast at 1.5% in 2011 and 2.0% in 2012.

The number of households living in poverty has increased to about 20%, based on a 2010 household survey, from 14% in 2004. Declining remittances is the major cause. One way to ensure that funds are available to meet basic health and education needs for the poor would be selective cuts to other spending, such as medical insurance and scholarship programs, that benefit only a narrow section of the population.

3.35.16 GDP growth, Tuvalu



Sources: Central Statistics Division, Government of Tuvalu; ADB estimates.

Click here for figure data

Vanuatu

Growth slowed to an estimated 3.0% in 2010 from an average of 5.7% in the previous 7 years. Agricultural production and construction increased, but tourism and retailing were soft.

The prolonged period of growth (8 years in a row) is attributable to increases in private investment, underpinned by policy reforms that included the opening of the aviation and telecommunications markets.

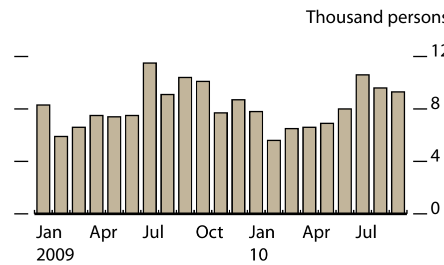
Last year, tourist arrivals declined by an estimated 2.6%, from record numbers in 2009 (Figure 3.35.17). The decline was largely due to a recovery in tourism to Fiji, which had lost market share to Vanuatu in 2009 (because of flooding and political uncertainty in Fiji).

Construction benefited from projects funded by the US Millennium Challenge Corporation as well as from some work on tourist facilities. Buoyed by higher prices for copra, coconut oil, and beef, agriculture recovered from a poor performance in 2009.

Inflation eased to average 3.4% last year. In the external accounts, the current account deficit likely widened to 2.4%, a result of lower tourism receipts.

The Reserve Bank of Vanuatu began to withdraw stimulus measures that it had implemented during the global financial crisis. It lifted

3.35.17 Visitor arrivals, Vanuatu



Source: Vanuatu National Statistics Office. *Tourism and Migration July 2010.* http://www.spc.int/prism/country/VU/stats

Click here for figure data

the statutory reserve requirement for banks to 6% from 5% in August (still below the 8%–10% range of 1999–2008) and foreshadowed further monetary tightening as global economic conditions improve.

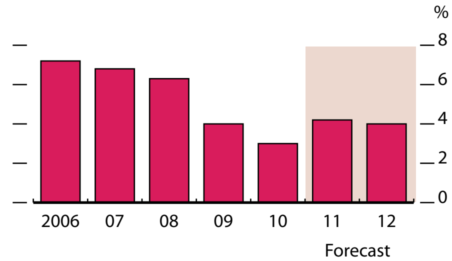
A near balanced budget was anticipated for 2010. Fiscal policy will likely remain broadly neutral in 2011, as the government is required under law to target budget surpluses.

GDP growth this year is forecast to rise to 4.2% (Figure 3.35.18), based on an expected increase in tourist arrivals—particularly from Australia—driven by robust economic conditions, a strong Australian dollar, and increased flights from that country. Agriculture is expected to pick up owing to high commodity prices. GDP growth of around 4.0% is expected in 2012, on continued gains in tourism and agriculture.

Higher food and fuel prices are forecast to raise inflation to 5.0% in 2011, before it eases to 4.0% in 2012. The current account deficit is expected to widen in 2011 and 2012 to 3.8% and 4.7% of GDP, respectively, as the pickup in domestic demand lifts imports.

Inadequate transport infrastructure and services hinder development of rural areas and outer islands, where income-generating opportunities are scarce. These areas need improved ports, wharves, and jetties, as well as more reliable and affordable shipping services. The country's road network is also inadequate: out of about 1,800 kilometers of roads, less than 100 kilometers is paved and about 400 kilometers is gravel surfaced.

3.35.18 GDP growth, Vanuatu



Sources: Reserve Bank of Vanuatu. 2010. *Quarterly Economic Review*. September. http://www.rbv.gov.vu; ADB estimates.

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STATISTICAL APPENDIX

Statistical notes

The statistical appendix presents selected economic indicators for or 44 developing member economies of the Asian Development Bank (ADB) and for Brunei Darussalam, an unclassified regional member in a total of 23 tables. The economies are grouped into five subregions: Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. Virtually all the tables contain historical data for 2006–2010; nearly half have forecasts for 2010 and 2011.

The data were standardized to the degree possible in order to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. The national income accounts section is based on the United Nations System of National Accounts, while the balance-of-payments data are based on International Monetary Fund (IMF) accounting standards. Historical data were obtained from official sources, statistical publications and databases, and documents of the ADB, IMF, and World Bank. Projections for 2011 and 2012 are generally staff estimates made on the basis of available quarterly or monthly data, although some projections are from governments.

Most countries report on a calendar-year basis. Some economies record their government finance data on a fiscal year basis, such as: Armenia; Azerbaijan; Cook Islands; Hong Kong, China; Kazakhstan; Kyrgyz Republic; the Lao People's Democratic Republic (Lao PDR); Samoa; Singapore; Taipei,China; Tajikistan; Thailand; and Uzbekistan. Federated States of Micronesia, Nauru, the Marshall Islands, and Palau report government finance and balance-of-payments data on a fiscal year basis. South Asian countries (except for Maldives and Sri Lanka), Myanmar, and Tonga report all variables on a fiscal year basis.

Regional and subregional averages/totals are provided for nine tables (A1, A2, A8, A10, A11, A12, A13, A14, and A15). For tables A1, A2, A8, and A15, the averages are computed using weights derived from levels of gross national income (GNI) in current United States dollars (US$) following the World Bank Atlas method. The GNI data for 2006–2009 were obtained from the World Bank's World Development Indicators online. Weights for 2009 were carried over through 2012. The GNI data for Cook Islands and Tuvalu were estimated using the Atlas conversion factor. Myanmar and Nauru have no GNI data. For tables A10 and A12, the regional and subregional averages were 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. Data for Myanmar and Nauru are excluded from the computation of all subregional averages/totals.

Tables A1, A2, A3, A4, A5, and A7. These tables show related data on output growth, production, and demand. Changes to the national income accounts series for some countries have been made owing to a change in source, methodology and/or base year. The series for Bhutan, reflects fiscal rather than calendar year data, while those for Timor-Leste reflects non-oil, non-United Nations GDP.

Table A1: Growth rate of GDP (% per year). The table 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. Constant 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 countries use constant market price valuation. Fiji, India, Pakistan, and Sri Lanka use constant factor costs, while Maldives and Nepal use basic prices.

Table A2: Growth rate of per capita GDP (% per year). The table provides the growth rates of real per capita GDP, which is defined as GDP at constant prices divided by the population. The series for most of the Pacific countries were revised due to a change in source of population data. Data on per capita gross national product in US$ terms for 2009, sourced from the World Bank, World Development Indicators online, are also shown. Per capita GNP for Cook Islands and Tuvalu are estimated based on derived GNI data, while those for Hong Kong, China and Taipei,China refer to 2008.

Table A3: Growth rate of value added in agriculture (% per year). The table shows the growth rates of value added in agriculture and its corresponding share in 2009. The agriculture sector comprises agricultural crops, livestock, poultry, fisheries, and forestry.

Table A4: Growth rate of value added in industry (% per year). The table provides the growth rates of value added in industry and its corresponding share in 2009. This sector comprises manufacturing, mining and quarrying, construction, and utilities. However, construction in Uzbekistan is included in the services sector.

Table A5: Growth rate of value added in services (% per year). The table gives the growth rates of value added in services, as well as its corresponding share in 2009. Subsectors generally include trade, banking, finance, real estate, public administration, and other services.

Table A6: Unemployment rate (%). The unemployment rate is the percentage of the labor force that actively seeks work but is unable to find work at a given time. The age of the working population ranges from 15 to 65, except for Bangladesh where the labor force covers those aged 10 and above. The unemployment rates of the People's Republic of China (PRC) and Viet Nam refer to unemployment in urban areas only.

Table A7: Gross domestic investment (% of GDP). This table provides the ratio of gross domestic investment (GDI) to GDP. GDI is the sum of gross fixed capital formation plus changes in inventories. Gross fixed capital formation is measured by the total value of a producer's acquisitions, less disposals, of fixed assets in a given accounting period. Additions to the value of nonproduced assets, e.g., land, form part of gross fixed capital formation. Inventories are stocks of goods held by institutional units to meet temporary or unexpected fluctuations in production and sales. For India, GDI includes valuables and errors and omissions.

Table A8: Inflation (% per year). Data on inflation rates represent period averages. Except for India, which reports the wholesale price index, inflation rates presented are based on consumer price indexes. The consumer price indexes of the following countries are for a given city or group of consumers only: Afghanistan is for Kabul, Cambodia is for Phnom Penh, Marshall Islands is for Majuro, Solomon Islands is for Honiara, Timor-Leste is for Dili region, and Nepal is for urban consumers.

Table A9: Growth in money supply (% per year). This table tracks the annual percentage change in the end-of-period supply of broad money as represented by M2 (for most countries). M2 is defined as the sum of M1 and quasi-money where M1 denotes currency in circulation plus demand deposits and quasi-money consists of time and savings deposits including foreign currency deposits.

Tables A10, A12, A13, A14, A15, and A16: Balance of payments. This set of tables shows selected international economic transactions of countries as recorded in the balance of payments (BOP). These items cover annual flows, except for some countries which show data as of a specified period only.

Tables A10 and A12: Growth rates of merchandise exports and imports (% per year). The annual growth rates of exports and imports, in terms of merchandise goods only, are shown in these tables. Data are in million US$, primarily obtained from the balance-of-payments accounts of each country. Exports are reported on a free-on-board (f.o.b.) basis. Import data are generally reported on an f.o.b. basis, except for Afghanistan, Bhutan, Cambodia, India, the Lao PDR, Myanmar, the Philippines, Samoa, Singapore, Solomon Islands, and Thailand, which value them on a cost, insurance, freight (c.i.f.) basis.

Table A11: Direction of exports (% of total). This table shows the exports of developing Asian economies. Data are sourced from IMF, Direction of Trade and Statistics, CD-ROM (February 2011), except for Taipei,China, which were sourced from CEIC Data Company, Ltd. This table shows the percentage share of exports of each economy to other economies in developing Asia excluding the PRC; PRC only; US; Japan; European Union (EU); and others (or rest of the world). Exports to the rest of the world are derived as total exports to the world minus exports among themselves, and to US, Japan, and EU.

Table A13: Trade balance (US$ million). The trade balance is the difference between merchandise exports and merchandise imports.

Figures in this table are based on the exports and imports levels used to generate Tables A10 and A12.

Table A14: Current account balance (US$ million). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. In the case of Cambodia, the Lao PDR, and Viet Nam, official transfers are excluded from the current account balance.

Table A15: Current account balance (% of GDP). The values reported in Table 14 are divided by GDP at current prices in US$.

Table A16: Foreign direct investment (US$ million). Foreign direct investment refers to equity capital, reinvested earnings, investment in debt securities, and other capital associated with the transactions of the enterprises, net of repatriations and intercompany loan repayments. For the PRC, foreign direct investment refers to investments of foreign enterprises, economic organizations, and individuals through joint ventures and cooperation; reinvested earnings; and enterprises' borrowings from abroad under approved investment projects. For Cambodia, this refers to foreign investments to the economy. The 2010 data for India and Tajikistan are based on estimates.

Table A17: External debt outstanding (US$ million). For most economies, external debt outstanding—public and private—includes medium- and long-term debt, short-term debt, and IMF credit. For Cambodia, Georgia, and the Lao PDR, only public external debt is reported. For Azerbaijan; India; Kyrgyz Republic; Malaysia, the Philippines; and Singapore the figures for 2010 are as of end-September.

Table A18: Debt service ratio (% of exports of goods and services). This table generally presents the total debt service payments of each economy, which comprise principal repayments (excluding on short-term debt) and interest payments on outstanding external debt, as a percentage of exports of goods and services. For Cambodia and the Lao PDR, debt service refers to external public debt only. For Papua New Guinea, Samoa, and Viet Nam, exports of goods are used as the denominator in the calculation of the ratio; for the Philippines, exports of goods, services, and income are used as the denominator. For Bangladesh, the ratio represents debt service payments on medium- and long-term loans as a percentage of exports of goods, nonfactor services, and workers' remittances; while for Azerbaijan, the ratio represents public and publicly guaranteed external debt service payments as a percentage of exports of goods and nonfactor services.

Table A19: Exchange rates to the US dollar (annual average). The annual average exchange rates of each economy are quoted in local currencies per US dollar. The rate for 2009 for India is for the period 1 April 2010–18 March 2011.

Table A20: Gross international reserves (US$ million). Gross international reserves are defined as the US$ value of holdings of foreign exchange, special drawing rights (SDR), reserve position in the IMF, and gold at the end of a given period. For Turkmenistan, gold is excluded in the computation. For Marshall Islands; Samoa; Solomon Islands; Taipei,China; Tonga; and Vanuatu, this heading refers to foreign exchange reserves only. In some countries, the rubric comprises foreign assets and reserves of national monetary authorities and national oil funds, i.e., foreign assets of the Maldives Monetary Authority, net foreign reserves of the State Bank of Pakistan, assets of the National Oil Fund of Azerbaijan, and official external assets of Kiribati. The data for India are as of 11 March 2011.

Tables A21, A22, and A23: Government finance. This set of tables refers to the revenue and expenditure transactions as well as the fiscal balance of the central government expressed as a percentage of GDP in nominal terms. For Cambodia (since 2006), PRC, India, Kazakhstan, Kyrgyz Republic, Mongolia, and Tajikistan, transactions are those reported by the general government. For the Republic of Korea, government revenues exclude social security contributions.

Table A21: Central government expenditures (% of GDP). Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a share of GDP at current prices. For Thailand, expenditures refer to budgetary expenditures excluding externally financed expenditures and corresponding borrowing; while that for Tajikistan includes externally financed public investment programs. One-time expenditures are excluded for Pakistan.

Table A22: Central government revenues (% of GDP). Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a percentage of GDP at current prices. For the Republic of Korea, revenues incorporate the repayment on government-guaranteed debts but exclude social security contributions. For Singapore, revenues refer to receipts credited to the three accounts listed for the previous table, including investment income, capital receipts, and investment adjustments. Grants are excluded in Cambodia, the Lao PDR, Malaysia, Singapore, and Thailand; revenues from disinvestment are included for India; only current revenues are included for Bangladesh; and grants and privatization proceeds are excluded for Sri Lanka. For Cambodia, the proceeds of the IMF debt relief program are reflected in their revenues for 2006.

Table A23: Fiscal balance of central government (% of GDP). Fiscal balance is the difference between central government revenues and expenditures. The difference is also computed as a share of GDP at current prices. 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 and nonbudgetary balances. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan.

Table A1 Growth rate of GDP (% per year)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	13.3	12.0	6.1	3.2	6.6	6.7	6.9
Armenia	13.2	13.7	6.9	-14.2	2.6	4.0	4.5
Azerbaijan	34.5	25.1	10.8	9.3	5.0	5.8	5.8
Georgia	9.4	12.3	2.3	-3.8	6.4	5.5	5.0
Kazakhstan	10.7	8.9	3.3	1.2	7.0	6.5	6.8
Kyrgyz Republic	3.1	8.5	8.4	2.9	-1.4	5.0	5.0
Tajikistan	7.0	7.8	7.9	3.4	6.5	6.8	7.0
Turkmenistan	11.4	11.6	10.5	6.1	9.4	9.0	10.0
Uzbekistan	7.2	9.5	9.0	8.1	8.5	8.5	8.4
East Asia	10.1	11.3	7.3	6.8	9.6	8.4	8.1
China, People's Rep. of	12.7	14.2	9.6	9.2	10.3	9.6	9.2
Hong Kong, China	7.0	6.4	2.3	-2.7	6.8	5.0	4.7
Korea, Rep. of	5.2	5.1	2.3	0.2	6.1	4.6	4.6
Mongolia	8.6	10.2	8.9	-1.3	6.1	10.0	8.0
Taipei,China	5.4	6.0	0.7	-1.9	10.8	4.8	5.0
South Asia	9.0	8.8	6.3	7.1	7.9	7.5	8.1
Afghanistan	8.2	14.2	3.4	20.4	8.2	8.0	8.5
Bangladesh	6.6	6.4	6.2	5.7	5.8	6.3	6.7
Bhutan	7.8	12.6	10.8	5.7	7.0	7.5	8.0
India	9.7	9.2	6.7	8.0	8.6	8.2	8.8
Maldives	18.0	7.2	6.2	-2.3	4.8	5.0	5.0
Nepal	3.7	2.8	5.8	3.8	4.0	3.8	4.0
Pakistan	5.8	6.8	3.7	1.2	4.1	2.5	3.7
Sri Lanka	7.7	6.8	6.0	3.5	7.6	8.0	8.0
Southeast Asia	6.1	6.7	4.2	1.2	7.8	5.5	5.7
Brunei Darussalam	4.4	0.2	-1.9	-1.8	2.0	1.7	1.8
Cambodia	10.8	10.2	6.7	0.1	6.3	6.5	6.8
Indonesia	5.5	6.3	6.0	4.6	6.1	6.4	6.7
Lao People's Dem. Rep.	8.1	7.9	7.2	7.3	7.5	7.7	7.8
Malaysia	5.8	6.5	4.7	-1.7	7.2	5.3	5.3
Myanmar	7.0	5.5	3.6	5.1	5.3	5.5	5.5
Philippines	5.3	7.1	3.7	1.1	7.3	5.0	5.3
Singapore	8.6	8.8	1.5	-0.8	14.5	5.5	4.8
Thailand	5.1	5.0	2.5	-2.3	7.8	4.5	4.8
Viet Nam	8.2	8.5	6.3	5.3	6.8	6.1	6.7
The Pacific	1.5	5.0	5.3	4.2	5.2	6.3	5.4
Cook Islands	0.7	9.5	-1.2	-0.1	0.5	2.0	2.5
Fiji	1.9	-0.9	0.2	-3.0	0.1	0.5	0.8
Kiribati	1.9	0.4	-1.1	-0.7	0.5	2.0	2.0
Marshall Islands	1.6	3.5	-1.6	-2.1	0.5	1.0	1.2
Micronesia, Fed. States of	-0.4	-2.0	-2.3	0.5	0.5	1.0	0.8
Nauru	6.3	-27.3	1.0	0.0	0.0	4.0	4.0
Palau	-3.7	-0.5	-4.9	-2.1	2.0	2.0	1.5
Papua New Guinea	2.3	7.2	6.6	5.5	7.1	8.5	6.5
Samoa	0.3	6.6	-3.2	-1.7	0.0	2.1	3.0
Solomon Islands	6.9	10.3	7.3	-1.2	4.0	7.5	4.0
Timor-Leste	-5.9	9.1	12.2	12.7	9.5	10.0	10.0
Tonga	0.6	-1.4	2.0	-0.4	-1.2	0.5	1.8
Tuvalu	6.6	4.9	1.3	-1.7	0.0	0.0	0.5
Vanuatu	7.2	6.8	6.3	4.0	3.0	4.2	4.0
Average	9.4	10.1	6.7	5.9	9.0	7.8	7.7

- = not available.

Table A2 Growth rate of per capita GDP (% per year)

	2006	2007	2008	2009	2010	2011	2012	Per capita GNP, US$, 2009
Central Asia	11.9	10.8	5.0	1.9	5.2	5.1	5.6	
Armenia	13.1	13.6	6.7	-14.4	2.3	3.8	4.0	3,100
Azerbaijan	31.6	23.6	9.6	8.3	4.7	5.6	5.6	4,840
Georgia	7.4	12.5	2.6	-3.9	7.1	6.2	5.7	2,530
Kazakhstan	9.6	7.7	2.2	-0.1	5.3	4.1	5.2	6,920
Kyrgyz Republic	2.1	7.8	6.8	1.7	-2.3	4.0	4.0	870
Tajikistan	4.8	5.5	5.6	1.3	4.1	4.5	4.7	700
Turkmenistan	9.9	10.1	9.0	4.7	7.9	7.5	8.5	3,420
Uzbekistan	6.0	8.0	7.3	6.3	5.7	6.6	5.8	1,100
East Asia	9.6	10.7	6.8	6.3	9.1	7.9	7.6	
China, People's Rep. of	12.2	13.6	9.0	8.7	9.7	9.0	8.7	3,650
Hong Kong, China	6.3	5.3	1.5	-3.0	5.8	4.3	3.9	31,420
Korea, Rep. of	4.8	4.8	2.0	-0.1	5.8	4.4	4.4	19,830
Mongolia	7.3	8.7	6.1	-3.2	4.5	8.2	6.1	1,630
Taipei,China	4.9	5.6	0.4	-2.3	10.6	4.6	4.8	17,930
South Asia	7.4	7.2	4.8	5.6	6.5	6.0	6.6	
Afghanistan	6.0	12.3	1.3	18.0	6.1	6.0	6.3	-
Bangladesh	5.2	5.1	4.8	4.4	4.5	4.9	5.3	580
Bhutan	6.4	11.0	9.2	-	-	-	-	2,030
India	8.1	7.7	5.2	6.5	7.2	6.7	7.3	1,180
Maldives	15.3	5.7	4.5	-3.8	3.1	3.3	-	3,970
Nepal	1.8	0.9	3.9	1.9	2.1	2.4	2.9	440
Pakistan	3.8	4.9	1.9	-0.5	2.4	0.8	2.0	1,000
Sri Lanka	6.5	6.1	4.9	2.4	6.5	6.9	6.9	1,990
Southeast Asia	4.6	4.9	2.3	-0.3	6.5	4.2	4.4	
Brunei Darussalam	0.9	-1.6	-3.9	-3.7	1.8	-	-	-
Cambodia	9.8	9.3	4.9	-0.9	5.0	-	-	610
Indonesia	4.8	5.0	4.7	3.3	5.6	5.3	5.6	2,050
Lao People's Dem. Rep.	6.0	3.6	5.5	5.3	6.2	5.7	5.8	880
Malaysia	3.1	5.1	3.4	-3.0	5.8	3.8	3.8	7,350
Myanmar	4.9	3.4	1.6	3.0	3.2	-	-	-
Philippines	3.3	5.0	1.7	-0.9	5.3	2.9	3.2	2,050
Singapore	5.3	4.4	-3.8	-3.7	12.5	3.1	2.4	37,220
Thailand	4.8	4.3	1.6	-3.1	5.8	3.9	4.4	3,760
Viet Nam	7.0	7.3	5.2	4.2	5.7	5.0	5.6	930
The Pacific	-0.1	3.4	3.4	2.5	3.2	4.5	3.7	
Cook Islands	-8.6	23.6	-6.1	-2.8	-2.2	-0.8	-0.3	-
Fiji	1.3	-1.8	-0.2	-3.4	-0.3	0.0	0.4	3,840
Kiribati	1.5	-1.3	-2.8	-2.4	-1.2	0.1	0.3	1,830
Marshall Islands	0.9	2.8	-2.9	-3.1	-1.0	0.0	0.5	3,060
Micronesia, Fed. States of	0.2	-1.5	-1.8	1.0	-7.6	-	-	2,500
Nauru	8.6	-28.7	-0.9	-1.9	0.0	1.9	-	-
Palau	-4.5	-1.1	-5.5	-2.7	1.4	-	-	6,220
Papua New Guinea	0.1	4.8	4.3	3.2	4.8	6.2	4.2	1,180
Samoa	0.2	6.2	-3.6	-2.0	-0.3	1.8	2.7	2,840
Solomon Islands	4.3	7.6	4.8	-3.4	1.6	5.2	1.8	-
Timor-Leste	-8.1	6.5	9.6	10.0	6.8	7.4	7.4	-
Tonga	0.2	-1.8	1.6	-0.7	-1.5	0.2	-	3,260
Tuvalu	5.1	-1.7	2.2	-2.2	-0.5	-0.5	0.0	-
Vanuatu	4.6	4.2	3.6	3.6	0.7	1.4	1.2	2,620
Average	8.5	9.2	5.8	5.1	8.2	7.0	6.9	

- = not available.

Table A3 Growth rate of value added in agriculture (% per year)

	2006	2007	2008	2009	2010	Sector share 2009, %
Central Asia						
Armenia	0.5	10.4	3.3	-0.1	-13.4	21.2
Azerbaijan	0.9	4.0	6.1	3.5	-2.2	5.6
Georgia	-11.7	3.3	-4.4	-6.8	-1.7	11.5
Kazakhstan	5.9	9.7	-6.1	13.8	-11.7	7.9
Kyrgyz Republic	1.7	1.6	0.9	6.7	-2.8	28.0
Tajikistan	5.4	6.5	7.8	10.5	6.8	-
Turkmenistan	-	-	-	-	-	-
Uzbekistan	6.2	6.1	4.7	5.7	6.8	32.4
East Asia						
China, People's Rep. of	5.0	3.7	5.4	4.2	4.3	8.7
Hong Kong, China	-3.3	-4.4	-17.0	-4.5	-5.1	0.1
Korea, Rep. of	1.5	4.0	5.6	1.6	-4.9	3.3
Mongolia	6.5	14.4	4.7	3.6	-16.8	22.6
Taipei,China	13.8	-2.4	0.1	-3.0	-0.9	1.5
South Asia						
Afghanistan	-11.3	20.6	-21.3	53.1	6.5	27.6
Bangladesh	4.9	4.6	3.2	4.1	4.7	20.5
Bhutan	1.8	1.7	0.8	1.7	1.5	16.7
India	3.7	4.7	1.6	0.4	5.4	14.6
Maldives	-0.3	-14.9	-4.5	-7.6	-2.9	5.9
Nepal	1.8	1.0	5.8	3.0	1.3	35.6
Pakistan	6.3	4.1	1.0	4.0	2.0	21.9
Sri Lanka	6.3	3.4	7.5	3.2	6.5	12.0
Southeast Asia						
Brunei Darussalam	-9.8	-4.5	3.8	5.6	-	1.2
Cambodia	5.5	5.0	5.7	5.4	4.2	30.1
Indonesia	3.4	3.5	4.8	4.0	2.9	13.6
Lao People's Dem. Rep.	3.5	6.2	2.0	2.3	2.0	33.6
Malaysia	5.2	1.3	4.3	0.4	1.7	7.5
Myanmar	-	-	-	-	-	-
Philippines	3.8	4.9	3.1	0.0	-0.5	18.1
Singapore	3.3	1.5	-4.2	-1.7	-0.1	0.0
Thailand	5.0	1.2	4.2	1.3	-2.2	9.2
Viet Nam	3.7	3.8	4.7	1.8	2.8	17.1
The Pacific						
Cook Islands	-4.6	-11.9	-3.7	-	-	-
Fiji	5.0	-4.9	5.0	-11.9	-5.2	13.2
Kiribati	7.9	0.2	1.8	1.4	-	25.5
Marshall Islands	11.2	6.0	-2.4	-	-	-
Micronesia, Fed. States of	0.5	5.4	-0.3	-2.2	-	26.0
Nauru	-	-	-	-	-	-
Palau	24.6	-14.9	-7.1	6.0	-	6.7
Papua New Guinea	1.0	4.2	4.3	0.7	3.5	36.1
Samoa	-4.1	6.9	-8.5	-	-	-
Solomon Islands	6.2	-	-	-	-	-
Timor-Leste	0.1	-5.4	13.3	12.3	0.4	30.8
Tonga	-0.3	1.7	0.6	-1.3	-	19.4
Tuvalu	7.2	3.0	0.4	-	-	-
Vanuatu	2.4	2.2	5.0	1.7	2.2	15.7

- = not available.

Table A4 Growth rate of value added in industry (% per year)

	2006	2007	2008	2009	2010	Sector share 2009, %
Central Asia						
Armenia	16.6	11.7	7.8	-30.5	6.2	34.9
Azerbaijan	49.8	32.9	9.7	10.6	4.4	70.7
Georgia	13.5	14.5	-3.9	-3.5	9.7	26.0
Kazakhstan	14.2	9.2	2.7	-0.3	9.6	44.6
Kyrgyz Republic	-6.9	10.3	14.0	-0.3	0.6	22.8
Tajikistan	4.2	-8.7	-8.9	-6.5	9.7	-
Turkmenistan	-	-	-	-	-	-
Uzbekistan	7.4	8.3	6.5	9.7	8.3	35.9
East Asia						
China, People's Rep. of	13.4	15.1	9.9	9.9	12.2	58.7
Hong Kong, China	-3.0	-0.4	1.7	-4.7	7.2	7.2
Korea, Rep. of	6.6	6.0	2.0	-0.6	11.1	37.9
Mongolia	6.3	7.0	-0.8	-0.4	7.7	31.6
Taipei,China	7.8	9.0	0.2	-4.3	24.2	32.1
South Asia						
Afghanistan	20.1	7.3	7.0	5.3	5.0	24.8
Bangladesh	9.7	8.4	6.8	6.5	6.0	29.9
Bhutan	8.6	25.4	20.4	4.8	8.2	45.9
India	12.7	9.5	3.9	8.0	8.1	28.0
Maldives	15.8	10.1	8.4	-11.2	2.4	15.6
Nepal	4.5	3.9	1.7	-1.4	3.3	15.4
Pakistan	4.1	8.8	1.4	-1.9	4.9	25.0
Sri Lanka	8.1	7.6	5.9	4.2	8.0	28.6
Southeast Asia						
Brunei Darussalam	2.9	-5.6	-5.4	-5.0	-	53.0
Cambodia	18.3	8.4	4.0	-9.5	11.6	26.8
Indonesia	4.5	4.7	3.7	3.5	4.7	41.7
Lao People's Dem. Rep.	21.5	6.5	10.0	17.0	18.0	25.0
Malaysia	4.5	3.0	0.7	-7.1	8.6	36.6
Myanmar	-	-	-	-	-	-
Philippines	4.5	6.8	4.9	-0.9	12.1	32.1
Singapore	10.6	6.9	-1.4	-1.4	25.1	30.4
Thailand	5.6	5.8	3.2	-5.0	12.8	46.6
Viet Nam	10.4	10.2	6.0	5.5	7.7	41.6
The Pacific						
Cook Islands	1.5	29.6	-0.5	-	-	-
Fiji	0.7	-5.2	-1.4	-2.3	3.4	17.9
Kiribati	11.0	12.7	-7.1	-1.6	-	7.4
Marshall Islands	-4.6	6.0	-2.4	-	-	-
Micronesia, Fed. States of	-16.5	-5.4	9.5	33.0	-	7.0
Nauru	-	-	-	-	-	-
Palau	-25.2	-24.3	-30.7	-11.6	-	6.8
Papua New Guinea	1.5	7.3	7.0	6.9	9.3	35.0
Samoa	-2.9	13.3	-10.4	-	-	-
Solomon Islands	4.2	-	-	-	-	-
Timor-Leste	-21.6	43.7	19.7	20.2	21.6	13.1
Tonga	-0.9	-2.0	1.7	3.0	-	19.5
Tuvalu	28.3	30.8	-8.2	-	-	-
Vanuatu	7.0	10.4	13.1	6.9	9.2	11.1

- = not available.

Table A5 Growth rate of value added in services (% per year)

	2006	2007	2008	2009	2010	Sector share 2009, %
Central Asia						
Armenia	15.5	13.8	5.0	0.0	4.4	44.0
Azerbaijan	17.4	12.4	14.0	9.1	7.2	23.7
Georgia	14.5	13.0	7.4	-3.4	7.1	62.5
Kazakhstan	10.1	12.8	4.7	-0.2	6.0	47.5
Kyrgyz Republic	9.0	12.6	11.0	2.3	-1.8	49.2
Tajikistan	8.4	16.5	12.0	9.5	4.6	-
Turkmenistan	-	-	-	-	-	-
Uzbekistan	8.8	17.4	15.3	9.3	11.6	31.7
East Asia						
China, People's Rep. of	14.1	16.0	10.4	9.6	9.5	32.6
Hong Kong, China	7.0	6.9	2.5	-1.6	6.8	92.7
Korea, Rep. of	4.4	5.1	2.8	1.0	3.5	58.8
Mongolia	7.6	11.9	16.6	0.8	4.6	45.8
Taipei,China	4.4	4.6	1.3	-0.3	4.8	66.4
South Asia						
Afghanistan	16.9	14.2	16.0	16.2	11.0	47.6
Bangladesh	6.4	6.9	6.5	6.3	6.4	49.7
Bhutan	11.2	7.1	5.3	9.1	9.1	37.4
India	10.2	10.5	9.8	10.1	9.6	57.5
Maldives	21.3	9.1	6.6	0.0	5.9	78.5
Nepal	5.6	4.5	7.3	6.0	6.0	49.0
Pakistan	6.5	7.0	6.0	1.6	4.6	53.1
Sri Lanka	7.7	7.1	5.6	3.3	7.6	59.3
Southeast Asia						
Brunei Darussalam	7.4	9.2	2.6	2.1	-	45.8
Cambodia	10.1	10.1	9.0	2.3	4.3	43.2
Indonesia	7.3	9.0	8.7	5.7	8.4	44.7
Lao People's Dem. Rep.	5.3	12.1	9.7	4.4	5.0	41.4
Malaysia	7.4	10.2	7.4	2.6	6.8	55.9
Myanmar	-	-	-	-	-	-
Philippines	6.5	8.1	3.1	2.8	7.1	49.8
Singapore	7.8	9.1	4.1	-0.7	10.1	69.5
Thailand	4.5	5.0	1.3	-0.2	4.6	44.3
Viet Nam	8.3	8.9	7.4	6.6	7.5	41.4
The Pacific						
Cook Islands	1.5	11.2	-0.9	-	-	-
Fiji	1.5	1.3	-0.3	-1.2	0.2	68.8
Kiribati	0.5	-0.1	2.6	-2.2	-	67.1
Marshall Islands	4.0	6.0	-2.4	-	-	-
Micronesia, Fed. States of	1.7	-3.6	-3.7	-1.4	-	66.9
Nauru	-	-	-	-	-	-
Palau	-1.7	4.8	-1.9	-1.8	-	86.5
Papua New Guinea	4.8	10.7	8.9	9.4	8.5	28.8
Samoa	2.9	3.3	1.7	-	-	-
Solomon Islands	7.9	-	-	-	-	-
Timor-Leste	-6.3	12.6	10.1	11.3	11.6	56.1
Tonga	1.5	-1.9	2.2	-0.7	-	61.2
Tuvalu	4.9	1.0	3.9	-	-	-
Vanuatu	8.7	7.4	4.3	3.8	4.4	73.2

- = not available.

Table A6 Unemployment rate (%)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	7.4	7.1	6.3	7.0	7.0
Azerbaijan	1.3	1.2	1.0	1.0	2.0
Georgia	13.6	13.3	16.5	16.8	-
Kazakhstan	7.8	7.3	6.6	7.2	5.5
Kyrgyz Republic	8.3	8.2	8.2	8.4	-
Tajikistan	2.3	2.6	4.8	-	-
Turkmenistan	-	-	-	-	-
Uzbekistan	-	-	-	-	-
East Asia					
China, People's Rep. of	4.1	4.0	4.2	4.3	4.3
Hong Kong, China	4.8	4.0	3.6	5.4	4.3
Korea, Rep. of	3.5	3.2	3.2	3.6	3.7
Mongolia	3.2	3.0	3.0	4.0	5.0
Taipei,China	3.9	3.9	4.1	5.9	5.2
South Asia					
Afghanistan	-	-	-	-	-
Bangladesh	4.2	-	-	5.0	-
Bhutan	2.3	3.2	3.7	4.0	-
India	-	-	-	-	-
Maldives	-	-	-	-	-
Nepal	-	-	-	-	-
Pakistan	7.7	6.1	5.3	5.2	5.4
Sri Lanka	6.5	6.0	5.4	5.9	-
Southeast Asia					
Brunei Darussalam	4.0	3.4	3.7	-	-
Cambodia	-	-	-	-	-
Indonesia	10.3	9.1	8.4	8.4	8.4
Lao People's Dem. Rep.	-	-	-	-	-
Malaysia	3.3	3.2	3.3	3.7	3.4
Myanmar	4.0	4.0	4.0	-	-
Philippines	8.0	7.3	7.4	7.5	7.3
Singapore	2.7	2.1	2.2	3.0	2.2
Thailand	1.5	1.4	1.4	1.5	1.0
Viet Nam	4.8	4.6	4.7	4.6	4.4
The Pacific					
Cook Islands	-	-	-	-	-
Fiji	7.3	-	-	-	-
Kiribati	-	-	-	-	-
Marshall Islands	30.9	30.9	-	-	-
Micronesia, Fed. States of	-	-	-	-	-
Nauru	-	-	-	-	-
Palau	-	-	-	-	-
Papua New Guinea	-	-	-	-	-
Samoa	4.0	-	-	-	-
Solomon Islands	-	-	-	-	-
Timor-Leste	-	-	-	-	-
Tonga	-	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	-	-	-	-	

- = not available.

Table A7 Gross domestic investment (% of GDP)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	35.9	37.8	40.9	33.8	-
Azerbaijan	29.9	21.3	18.7	18.3	-
Georgia	30.9	32.1	26.0	13.0	12.9
Kazakhstan	33.9	35.5	27.5	28.1	22.1
Kyrgyz Republic	24.2	26.6	28.9	-	-
Tajikistan	-	-	-	-	-
Turkmenistan	18.3	19.0	37.1	47.4	49.2
Uzbekistan	21.1	22.6	26.8	29.2	-
East Asia					
China, People's Rep. of	43.0	41.7	44.0	48.2	50.7
Hong Kong, China	21.7	20.9	20.4	21.3	23.8
Korea, Rep. of	29.9	29.4	31.2	25.9	-
Mongolia	35.9	38.7	43.6	39.0	40.0
Taipei,China	22.7	22.1	22.4	17.7	22.6
South Asia					
Afghanistan	40.5	36.8	32.3	27.2	25.1
Bangladesh	24.7	24.5	24.2	24.4	25.0
Bhutan	49.0	-	-	-	-
India	35.7	38.1	34.5	36.5	37.0
Maldives	-	-	-	-	-
Nepal	26.9	28.7	30.3	31.9	38.2
Pakistan	22.1	22.5	22.1	19.0	16.6
Sri Lanka	28.0	28.0	27.6	24.5	27.8
Southeast Asia					
Brunei Darussalam	10.4	13.0	13.7	17.6	-
Cambodia	22.5	21.2	18.6	21.4	17.2
Indonesia	25.4	24.9	27.8	31.0	32.5
Lao People's Dem. Rep.	-	-	-	-	-
Malaysia	20.5	21.6	19.3	14.5	21.3
Myanmar	-	-	-	-	-
Philippines	14.5	15.4	15.3	14.6	15.6
Singapore	21.0	21.1	30.2	26.4	23.8
Thailand	28.3	26.4	29.1	21.2	26.0
Viet Nam	36.8	43.1	39.7	38.1	38.9
The Pacific					
Cook Islands	-	-	-	-	-
Fiji	-	-	-	-	-
Kiribati	-	-	-	-	-
Marshall Islands	57.0	-	-	-	-
Micronesia, Fed. States of	33.4	32.9	33.7	33.6	-
Nauru	-	-	-	-	-
Palau	35.0	25.4	31.1	-	-
Papua New Guinea	-	-	-	-	-
Samoa	-	-	-	-	-
Solomon Islands	-	-	-	-	-
Timor-Leste	25.1	26.2	-	-	-
Tonga	17.1	16.1	17.2	-	-
Tuvalu	-	-	-	-	-
Vanuatu	23.9	25.8	-	-	-

- = not available.

Table A8 Inflation (% per year)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	9.0	11.2	16.5	5.9	7.1	8.2	6.6
Armenia	2.9	4.4	9.0	3.4	8.2	7.5	5.5
Azerbaijan	8.3	16.7	20.8	1.5	5.7	7.5	7.0
Georgia	9.2	9.2	10.0	1.7	7.1	9.5	6.0
Kazakhstan	8.6	10.8	17.3	7.3	7.1	8.5	6.0
Kyrgyz Republic	5.6	10.2	24.5	6.9	8.0	13.0	8.0
Tajikistan	10.0	13.2	20.4	6.5	6.4	10.5	9.5
Turkmenistan	8.2	6.3	14.5	-2.7	3.9	5.0	6.0
Uzbekistan	14.2	12.3	12.7	14.1	10.6	8.8	8.5
East Asia	1.6	4.0	5.5	-0.1	3.1	4.3	3.9
China, People's Rep. of	1.5	4.8	5.9	-0.7	3.3	4.6	4.2
Hong Kong, China	2.0	2.0	4.3	0.5	2.4	4.5	3.3
Korea, Rep. of	2.2	2.5	4.7	2.8	2.9	3.5	3.0
Mongolia	4.3	9.6	28.0	7.6	10.1	17.0	14.0
Taipei,China	0.6	1.8	3.5	-0.9	1.0	2.8	2.9
South Asia	5.7	5.7	9.5	4.3	9.3	8.7	7.3
Afghanistan	5.1	13.0	26.8	-12.2	8.2	9.8	9.1
Bangladesh	7.2	7.2	9.9	6.7	7.3	8.0	8.5
Bhutan	4.9	5.2	6.4	7.1	4.7	8.0	7.5
India	5.2	5.0	8.7	2.1	9.2	7.8	6.5
Maldives	3.5	7.4	12.3	4.0	4.5	8.0	7.0
Nepal	8.0	6.4	7.7	13.2	10.5	10.0	8.0
Pakistan	7.9	7.8	12.0	20.8	11.7	16.0	13.0
Sri Lanka	10.0	15.8	22.6	3.4	5.9	8.0	7.5
Southeast Asia	6.8	3.9	8.6	2.5	4.0	5.1	4.2
Brunei Darussalam	0.1	1.0	2.1	1.1	1.5	1.5	1.5
Cambodia	6.1	7.7	25.0	-0.7	4.0	5.5	5.5
Indonesia	13.1	6.4	9.8	4.8	5.1	6.3	5.8
Lao People's Dem. Rep.	6.8	4.5	7.6	0.0	6.0	6.5	6.0
Malaysia	3.6	2.0	5.4	0.6	1.7	3.0	3.0
Myanmar	26.3	32.9	22.5	8.2	7.3	8.0	8.0
Philippines	6.2	2.8	9.3	3.2	3.8	4.9	4.3
Singapore	1.0	2.1	6.6	0.6	2.8	3.2	2.0
Thailand	4.7	2.2	5.4	-0.9	3.2	3.5	3.0
Viet Nam	7.5	8.3	23.0	6.9	9.2	13.3	6.8
The Pacific	3.2	3.7	9.8	5.0	5.9	6.5	5.6
Cook Islands	3.4	2.5	7.8	6.6	3.5	4.0	3.5
Fiji	2.5	4.7	7.8	3.7	7.8	4.0	3.0
Kiribati	-0.2	4.2	11.0	8.4	0.8	6.7	2.3
Marshall Islands	5.3	2.6	14.7	0.5	1.0	5.0	3.8
Micronesia, Fed. States of	4.4	3.6	6.8	7.7	3.5	4.0	3.0
Nauru	3.5	2.3	4.5	2.2	-0.5	2.5	2.5
Palau	4.8	3.0	11.3	5.2	3.8	4.0	2.5
Papua New Guinea	2.4	0.9	10.8	6.9	6.0	8.0	7.5
Samoa	3.8	5.5	11.5	6.6	1.2	3.0	2.5
Solomon Islands	11.3	7.7	17.3	7.1	3.0	4.2	6.3
Timor-Leste	3.9	10.3	9.0	0.7	6.8	7.5	5.3
Tonga	7.0	5.1	9.8	5.0	2.0	3.0	2.0
Tuvalu	3.8	2.2	10.4	-0.1	-1.9	1.5	2.0
Vanuatu	2.1	4.0	4.8	4.5	3.4	5.0	4.0
Average	3.3	4.4	6.9	1.2	4.4	5.3	4.6

- = not available.

Table A9 Change in money supply (% per year)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	32.9	42.5	2.3	15.1	11.8
Azerbaijan	86.8	71.4	44.0	-0.3	24.3
Georgia	39.7	49.7	6.9	8.2	34.8
Kazakhstan	78.1	25.9	35.4	19.5	14.1
Kyrgyz Republic	51.6	33.3	12.6	20.4	18.6
Tajikistan	63.3	78.8	6.3	38.9	20.2
Turkmenistan	55.9	72.2	62.8	10.9	20.9
Uzbekistan	36.8	46.2	34.7	43.8	34.6
East Asia					
China, People's Rep. of	17.0	16.7	17.8	27.7	19.7
Hong Kong, China	15.4	20.8	2.6	5.3	8.1
Korea, Rep. of	12.5	10.8	12.0	9.9	6.0
Mongolia	34.8	56.3	-5.5	26.9	62.5
Taipei,China	5.3	0.9	7.0	5.7	5.3
South Asia					
Afghanistan	39.7	0.9	31.0	35.9	39.1
Bangladesh	19.3	17.1	17.6	19.2	22.4
Bhutan	41.4	8.6	2.3	24.6	30.1
India	21.7	21.4	19.3	16.8	17.0
Maldives	18.9	24.1	21.8	12.4	16.5
Nepal	15.4	14.0	25.2	27.3	14.1
Pakistan	15.1	19.3	15.3	9.6	12.5
Sri Lanka	17.8	16.6	8.5	18.6	15.8
Southeast Asia					
Brunei Darussalam	-3.9	4.6	21.6	-	-
Cambodia	38.2	62.9	4.8	36.8	20.0
Indonesia	14.9	19.3	14.9	12.4	15.9
Lao People's Dem. Rep.	30.1	38.7	18.3	31.3	39.1
Malaysia	17.1	9.5	13.4	9.5	7.1
Myanmar	27.1	20.9	23.4	34.2	17.3
Philippines	22.7	10.6	15.6	8.3	10.6
Singapore	19.4	13.4	12.0	11.3	8.6
Thailand	8.2	6.3	9.2	6.8	10.9
Viet Nam	33.6	46.1	20.3	29.0	33.3
The Pacific					
Cook Islands	22.4	-5.8	4.0	66.7	-2.8
Fiji	19.8	10.4	-6.9	7.4	3.7
Kiribati	-	-	-	-	-
Marshall Islands	-	-	-	-	-
Micronesia, Fed. States of	-8.5	4.6	-	-	-
Nauru	-	-	-	-	-
Palau	-	-	-	-	-
Papua New Guinea	38.9	27.8	7.1	21.8	12.5
Samoa	13.7	11.0	5.8	9.1	-
Solomon Islands	26.4	21.7	8.0	16.8	9.7
Timor-Leste	8.6	0.9	29.9	39.6	9.7
Tonga	14.4	14.1	8.3	-1.9	5.1
Tuvalu	-	-	-	-	-
Vanuatu	7.0	21.7	8.0	0.5	-7.9

- = not available.

Table A10 Growth rate of merchandise exports (% per year)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	40.0	33.9	42.7	-31.6	27.5	7.2	6.5
Armenia	2.1	16.7	-7.1	-32.7	46.9	15.0	10.0
Azerbaijan	70.1	63.4	43.8	-31.0	24.0	-6.2	8.7
Georgia	13.2	25.3	16.3	-22.0	23.5	10.8	8.1
Kazakhstan	37.0	24.7	48.9	-39.0	38.5	8.5	6.1
Kyrgyz Republic	31.9	47.7	40.1	-9.6	7.0	8.0	12.0
Tajikistan	1.2	10.0	18.7	-10.7	40.9	24.5	0.6
Turkmenistan	51.7	26.7	29.5	-22.8	6.3	23.8	0
Uzbekistan	18.0	42.9	34.7	-0.7	10.5	14.0	3.1
East Asia	20.0	19.2	13.1	-16.2	30.1	15.7	14.7
China, People's Rep. of	27.2	25.8	17.6	-16.1	31.4	19.8	18.0
Hong Kong, China	9.7	8.9	5.6	-11.9	22.4	7.5	10.5
Korea, Rep. of	16.1	15.8	11.6	-17.6	29.6	12.7	8.2
Mongolia	44.6	26.4	29.5	-25.5	53.8	-	-
Taipei,China	12.8	10.1	3.4	-20.2	34.9	9.5	11.4
South Asia	20.6	24.5	14.1	-6.3	26.2	24.1	19.2
Afghanistan	0.9	1.3	18.9	12.8	6.9	5.4	14.0
Bangladesh	21.5	15.8	17.4	10.1	4.2	21.0	22.0
Bhutan	47.2	83.7	4.4	-13.8	5.5	-	-
India	22.6	28.9	13.7	-7.4	31.6	26.7	19.5
Maldives	39.4	1.2	45.2	-49.0	6.5	-	-
Nepal	2.4	2.6	9.3	-4.7	-6.3	-	-
Pakistan	14.3	4.4	18.2	-6.4	2.9	1.7	15.0
Sri Lanka	8.5	11.0	6.2	-12.7	17.3	16.0	16.0
Southeast Asia	17.1	12.2	14.6	-17.2	30.5	12.9	13.9
Brunei Darussalam	21.7	0.8	39.8	-33.1	14.8	-	-
Cambodia	26.9	10.7	15.1	-10.9	20.8	15.0	16.0
Indonesia	19.0	14.0	18.3	-14.3	32.2	15.2	17.8
Lao People's Dem. Rep.	62.6	16.6	21.5	-8.0	29.5	25.3	27.3
Malaysia	12.9	9.4	13.2	-21.1	26.4	8.0	8.6
Myanmar	47.4	23.9	15.5	4.4	4.8	12.5	12.9
Philippines	15.6	6.4	-2.5	-22.1	34.8	10.6	11.0
Singapore	18.0	10.3	13.1	-20.4	31.1	13.0	12.7
Thailand	17.0	18.2	15.9	-14.0	28.5	12.8	14.0
Viet Nam	22.7	21.9	29.1	-8.9	26.4	10.0	14.0
The Pacific	20.2	13.7	21.3	-24.2	26.8	-	-
Cook Islands	8.1	35.7	-	-	-	-	-
Fiji	-2.6	9.4	19.9	-28.4	25.0	8.9	6.2
Kiribati	-39.3	21.9	23.1	-16.7	-	-	-
Marshall Islands	-23.7	2.5	18.5	1.7	-	-	-
Micronesia, Fed. States of	2.7	39.0	5.0	-8.8	-	-	-
Nauru	85.6	618.6	-	-	-	-	-
Palau	1.4	-20.4	4.4	-	4.2	-	-
Papua New Guinea	26.8	13.2	21.4	-24.3	26.9	26.0	-3.4
Samoa	-13.7	33.7	-11.4	-16.0	18.8	-	-
Solomon Islands	10.3	44.3	27.9	-22.3	-	-	-
Timor-Leste	12.5	-22.2	100.0	-28.6	140.0	-	-
Tonga	-6.1	-10.2	-5.8	-55.0	2.2	-	-
Tuvalu	640.1	-7.2	-	-	-	-	-
Vanuatu	-1.1	-21.8	41.6	33.2	-	-	-
Average	19.6	18.0	14.3	-16.4	29.8	15.4	14.6

- = not available.

Table A11 Direction of exports (% of total)

To / From	Developing Asia		China, People's Rep. of		Japan		United States		European Union		Others	
	2000	2009	2000	2009	2000	2009	2000	2009	2000	2009	2000	2009
Central Asia	9.2	11.2	4.1	10.5	0.5	0.6	1.7	5.5	28.1	34.0	56.4	38.3
Armenia	7.8	12.5	0.2	2.5	0.1	0.1	12.6	9.4	36.9	43.5	42.5	32.0
Azerbaijan	7.1	18.3	0.3	0.8	0.0	0.0	0.5	11.4	63.6	41.7	28.6	27.8
Georgia	16.2	28.4	0.3	0.5	0.1	0.4	2.2	3.2	24.0	20.8	57.2	46.6
Kazakhstan	5.4	4.5	6.8	15.6	0.1	0.8	2.1	4.0	23.0	36.6	62.6	38.5
Kyrgyz Republic	29.0	45.3	8.8	4.6	0.1	0.0	0.6	0.6	37.6	4.0	23.9	45.5
Tajikistan	16.5	13.4	0.4	39.8	-	0.3	0.1	0.1	30.1	10.7	52.9	35.7
Turkmenistan	6.4	17.4	0.3	1.2	-	0.0	0.5	3.0	21.5	24.4	71.3	53.9
Uzbekistan	23.6	23.2	0.5	6.5	3.2	1.9	1.5	1.7	26.8	8.2	44.3	58.5
East Asia	25.9	28.1	11.7	14.3	11.4	6.9	21.8	15.0	15.2	16.1	13.9	19.6
China, People's Rep. of	32.9	33.5	-	-	16.3	8.0	20.4	18.0	16.1	19.3	14.3	21.2
Hong Kong, China	10.2	10.6	34.1	51.0	5.5	4.4	23.0	11.5	15.5	12.4	11.8	10.1
Korea, Rep. of	23.8	21.7	10.2	22.6	11.3	5.7	20.9	9.9	13.7	12.2	20.2	28.0
Mongolia	4.0	1.3	49.8	73.9	1.5	0.2	24.3	0.7	7.7	11.9	12.6	12.0
Taipei,China	38.2	34.9	2.9	26.6	11.2	7.1	23.6	11.6	15.2	10.4	8.8	9.4
South Asia	17.3	20.8	1.6	5.4	3.6	1.7	24.2	12.6	26.3	23.7	26.9	35.8
Afghanistan	46.0	58.0	3.4	0.3	0.3	0.1	1.9	24.9	35.3	4.3	13.1	12.5
Bangladesh	5.4	5.8	0.2	0.7	1.2	0.8	31.7	20.2	40.1	47.9	21.5	24.6
Bhutan	-	-	-	-	-	-	-	-	-	-	-	-
India	19.2	22.4	1.8	6.1	4.1	1.9	21.1	11.0	24.1	20.9	29.8	37.7
Maldives	32.0	33.6	-	0.1	4.1	1.3	44.0	2.5	18.5	53.9	1.4	8.6
Nepal	44.5	66.2	-	0.7	1.4	1.6	27.4	8.2	23.0	14.2	3.7	9.2
Pakistan	18.5	19.3	2.6	5.5	2.6	0.5	24.9	18.0	27.7	24.3	23.6	32.3
Sri Lanka	8.6	11.1	0.1	0.9	4.2	2.3	40.1	20.5	28.2	38.7	18.9	26.6
Southeast Asia	37.4	41.9	3.7	9.9	12.6	9.4	18.2	9.9	14.4	11.2	13.7	17.7
Brunei Darussalam	36.2	33.7	1.8	4.0	40.7	46.8	12.0	0.6	3.6	0.5	5.8	14.4
Cambodia	8.2	46.5	2.1	0.3	0.9	1.6	65.4	31.1	20.5	14.3	2.9	6.3
Indonesia	33.1	40.6	4.2	9.4	22.1	15.3	13.0	8.9	13.7	11.2	13.7	14.5
Lao People's Dem. Rep.	43.4	44.3	1.5	20.0	2.8	1.6	2.2	2.7	26.0	11.4	24.1	20.0
Malaysia	40.3	41.6	2.9	11.8	12.3	9.6	19.5	10.7	13.3	10.6	11.7	15.8
Myanmar	35.2	71.0	5.6	9.8	5.4	5.2	22.0	0.0	16.4	3.3	15.5	10.7
Philippines	30.5	31.8	1.6	7.3	13.4	15.5	27.3	16.8	16.5	19.5	10.7	9.0
Singapore	44.1	52.1	3.8	9.6	7.3	4.5	16.7	6.4	13.5	9.4	14.7	18.0
Thailand	30.8	34.1	3.9	10.4	14.2	10.1	20.5	10.8	15.7	11.6	15.0	23.1
Viet Nam	25.8	22.7	10.3	8.5	17.2	10.8	4.9	19.6	20.0	16.2	21.9	22.3
The Pacific	11.2	12.5	5.2	5.2	10.3	7.3	5.3	2.7	11.1	8.5	56.9	63.8
Cook Islands	-	-	-	-	-	-	-	-	-	-	-	-
Fiji	14.3	16.8	0.0	0.1	4.1	4.4	21.1	14.5	16.5	11.4	44.0	52.9
Kiribati	-	-	-	-	-	-	-	-	-	-	-	-
Marshall Islands	-	-	-	-	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-	-	-	-
Palau	-	-	-	-	-	-	-	-	-	-	-	-
Papua New Guinea	7.6	10.6	6.5	4.1	11.2	7.9	1.3	1.2	10.2	8.1	63.2	68.1
Samoa	18.1	11.5	0.1	5.4	0.3	0.6	10.6	3.8	3.0	1.0	67.9	77.7
Solomon Islands	42.3	17.7	12.0	52.9	20.7	2.0	0.7	0.3	10.6	8.9	13.6	18.2
Timor-Leste	-	-	-	-	-	-	-	-	-	-	-	-
Tonga	6.3	42.7	-	0.4	48.5	12.8	30.0	23.8	6.5	1.9	8.7	18.4
Tuvalu	-	-	-	-	-	-	-	-	-	-	-	-
Vanuatu	60.7	64.2	0.4	0.7	18.7	13.2	9.7	1.1	5.7	15.1	4.8	5.7
Developing Asia	29.2	30.8	8.4	12.5	11.3	7.1	20.3	13.3	15.6	15.7	15.1	20.6

- = not available.

Table A12 Growth rate of merchandise imports (% per year)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	30.4	36.9	27.3	-14.2	4.4	11.6	8.5
Armenia	20.6	45.6	35.0	-25.0	19.8	12.0	10.0
Azerbaijan	21.1	14.7	25.3	-14.0	1.2	28.3	10.4
Georgia	37.2	35.2	25.6	-31.4	15.8	9.5	3.9
Kazakhstan	34.2	37.9	15.6	-24.7	10.3	9.5	5.7
Kyrgyz Republic	62.1	45.8	43.6	-25.0	15.0	10.0	15.0
Tajikistan	38.0	54.0	54.4	-24.9	8.2	28.4	10.2
Turkmenistan	22.2	36.1	59.2	44.9	-11.5	4.0	-
Uzbekistan	16.0	49.2	50.2	4.8	-7.3	11.9	16.3
East Asia	16.7	15.8	15.8	-15.6	35.6	17.3	15.9
China, People's Rep. of	19.7	20.3	18.7	-11.1	39.1	22.7	20.0
Hong Kong, China	11.6	10.3	6.2	-10.2	25.3	7.1	10.8
Korea, Rep. of	18.7	15.5	21.9	-25.4	31.9	14.5	8.8
Mongolia	23.6	44.7	60.7	-34.3	53.2	-	-
Taipei,China	11.5	8.2	9.4	-26.9	43.2	11.0	12.5
South Asia	21.1	29.6	21.1	-5.1	19.6	22.5	22.8
Afghanistan	10.0	15.7	14.1	-2.5	3.7	9.2	5.9
Bangladesh	12.1	16.6	25.6	4.2	5.4	23.0	24.0
Bhutan	-5.6	21.1	27.4	-9.6	39.0	-	-
India	21.4	35.1	19.8	-4.2	22.6	24.2	22.8
Maldives	24.4	18.3	26.6	-30.3	14.9	-	-
Nepal	17.5	13.9	24.1	8.3	37.0	-	-
Pakistan	31.6	8.0	31.2	-10.3	-1.7	1.7	22.1
Sri Lanka	15.7	10.2	24.7	-27.6	32.4	32.0	32.0
Southeast Asia	13.6	12.8	22.3	-21.4	32.7	15.4	15.4
Brunei Darussalam	11.9	25.9	43.5	-20.0	2.5	-	-
Cambodia	21.8	13.8	19.8	-10.4	15.9	14.0	14.0
Indonesia	6.3	15.4	36.9	-23.3	42.0	17.1	23.7
Lao People's Dem. Rep.	26.1	34.7	31.1	-13.0	13.5	18.9	22.0
Malaysia	13.9	12.1	7.1	-21.0	33.6	10.0	10.0
Myanmar	48.0	88.0	25.6	1.9	10.0	26.6	18.6
Philippines	10.9	8.7	5.6	-24.0	31.5	11.3	11.4
Singapore	18.3	10.4	22.9	-22.6	27.6	16.6	13.1
Thailand	7.9	9.1	26.8	-25.2	36.8	14.0	16.0
Viet Nam	22.1	38.5	27.9	-13.3	21.2	12.0	10.0
The Pacific	18.4	18.3	21.4	-18.5	33.1	-	-
Cook Islands	11.7	45.3	-	-	-	-	-
Fiji	12.1	0.3	25.2	-36.9	2.3	5.7	4.5
Kiribati	-19.0	10.5	8.7	-21.3	-	-	-
Marshall Islands	-3.9	7.1	3.1	7.4	-	-	-
Micronesia, Fed. States of	3.0	0.7	12.5	4.2	-	-	-
Nauru	17.1	11.1	-	-	-	-	-
Palau	6.7	-6.7	21.1	-20.6	9.6	-	-
Papua New Guinea	30.6	32.5	18.6	-8.5	52.9	38.6	-1.5
Samoa	16.7	3.7	-1.1	-99.0	559.7	-	-
Solomon Islands	62.0	33.9	11.6	-18.2	-	-	-
Timor-Leste	-9.8	85.0	66.4	24.1	11.2	14.1	14.3
Tonga	12.9	-8.2	29.9	-5.0	-21.0	-	-
Tuvalu	-24.9	25.2	-	-	-	-	-
Vanuatu	7.4	23.7	38.9	-1.9	-	-	-
Average	16.5	16.8	18.3	-15.9	32.1	17.3	16.5

- = not available.

Table A13 Trade balance (US$ million)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	23,273	29,766	52,139	21,886	43,191	43,734	42,899
Armenia	-896	-1,600	-2,664	-2,081	-2,290	-2,532	-2,785
Azerbaijan	7,745	15,224	23,012	14,583	19,560	16,061	17,329
Georgia	-2,019	-2,896	-3,833	-2,399	-2,630	-2,847	-2,851
Kazakhstan	14,642	15,091	33,519	14,969	28,881	31,000	33,000
Kyrgyz Republic	-886	-1,276	-1,879	-1,120	-1,423	-1,602	-1,901
Tajikistan	-986	-1,673	-2,721	-1,979	-2,007	-2,600	-2,933
Turkmenistan	3,900	4,600	4,500	-1,800	100	2,100	-
Uzbekistan	1,774	2,296	2,205	1,712	3,000	4,153	3,040
East Asia	259,536	363,246	360,575	290,879	279,523	285,858	295,163
China, People's Rep. of	217,746	315,381	360,682	249,509	254,000	265,067	280,197
Hong Kong, China	-14,029	-19,699	-23,128	-26,861	-42,965	-44,533	-50,613
Korea, Rep. of	31,433	37,129	5,170	37,866	41,904	39,623	39,970
Mongolia	189	-11	-627	-189	-278	-	-
Taipei,China	24,197	30,445	18,478	30,553	26,862	25,701	25,609
South Asia	-83,656	-116,787	-155,893	-150,685	-165,500	-194,025	-247,913
Afghanistan	-4,933	-5,968	-6,720	-6,221	-6,371	-7,058	-7,251
Bangladesh	-2,889	-3,458	-5,330	-4,710	-5,152	-6,662	-8,653
Bhutan	-123	47	-72	-90	-299	-	-
India	-61,782	-91,467	-119,520	-120,500	-132,000	-158,187	-203,882
Maldives	-590	-737	-890	-682	-798	-	-
Nepal	-1,528	-1,837	-2,410	-2,733	-4,139	-	-
Pakistan	-8,441	-9,711	-14,970	-12,626	-11,536	-13,920	-15,762
Sri Lanka	-3,370	-3,656	-5,980	-3,122	-5,205	-8,199	-12,365
Southeast Asia	107,885	115,574	81,245	104,761	120,366	106,452	106,235
Brunei Darussalam	6,026	5,677	7,862	4,884	5,888	-	-
Cambodia	-1,078	-1,343	-1,800	-1,634	-1,689	-1,874	-2,020
Indonesia	29,661	32,753	22,916	30,148	31,093	33,404	30,568
Lao People's Dem. Rep.	-469	-837	-1,224	-985	-881	-925	-1,002
Malaysia	37,428	37,668	51,179	40,215	42,400	42,667	43,843
Myanmar	2,266	924	507	703	363	-688	-1,337
Philippines	-6,732	-8,391	-12,885	-8,842	-10,384	-11,912	-13,472
Singapore	42,565	46,780	27,842	29,190	46,642	41,501	45,319
Thailand	994	12,782	-371	19,388	14,031	13,672	11,490
Viet Nam	-2,776	-10,438	-12,782	-8,306	-7,097	-9,392	-7,155
The Pacific	331	149	187	-473	-346	-1,016	-1,096
Cook Islands	19	13	10	12	11	-	-
Fiji	-969	-911	-1,179	-670	-544	-550	-561
Kiribati	-60	-66	-72	-56	-	-	-
Marshall Islands	-64	-69	-69	-75	-	-	-
Micronesia, Fed. States of	-111	-104	-119	-128	-138	-	-
Nauru	25	35	-	-	-	-	-
Palau	-101	-96	-119	-92	-101	-	-
Papua New Guinea	2,216	2,126	2,655	1,518	1,182	-	-
Samoa	-208	-213	-212	-219	-249	-	-
Solomon Islands	-82	-97	-82	-76	-	-	-
Timor-Leste	-92	-180	-297	-376	-405	-465	-535
Tonga	-104	-96	-129	-129	-101	-	-
Tuvalu	-9	-12	-	-	-	-	-
Vanuatu	-103	-145	-201	-182	-	-	-
Total	307,370	391,948	338,253	266,367	277,235	241,003	195,288

- = not available.

Table A14 Current account balance (US$ million)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	6,346	5,850	25,593	3,445	22,699	23,314	25,274
Armenia	-117	-589	-1,382	-1,369	-1,370	-1,412	-1,485
Azerbaijan	3,708	9,019	16,454	10,173	16,528	13,095	13,283
Georgia	-1,174	-2,009	-2,915	-1,210	-1,330	-1,587	-1,551
Kazakhstan	-1,999	-8,322	6,326	-4,359	4,319	6,600	8,500
Kyrgyz Republic	-286	-227	-701	-111	-298	-469	-522
Tajikistan	-79	-319	-392	-295	123	-290	-489
Turkmenistan	3,360	4,030	3,553	-2,979	-935	799	1,908
Uzbekistan	2,933	4,267	4,650	3,595	5,663	6,578	5,629
East Asia	316,804	454,377	485,594	390,507	388,898	395,158	430,703
China, People's Rep. of	253,268	371,833	426,107	297,142	306,200	322,701	352,292
Hong Kong, China	22,935	25,545	29,475	18,005	14,799	17,650	19,000
Korea, Rep. of	14,083	21,770	3,198	32,791	28,214	20,120	20,873
Mongolia	218	76	-690	-342	-932	-	-
Taipei,China	26,300	35,154	27,505	42,911	40,617	34,687	38,539
South Asia	-17,139	-24,565	-45,237	-45,558	-53,111	-61,122	-63,936
Afghanistan	-379	117	-105	-202	331	296	-181
Bangladesh	824	936	702	2,416	3,734	223	-380
Bhutan	-38	145	-27	-20	-188	-321	-371
India	-10,954	-17,034	-27,766	-38,400	-50,300	-55,211	-55,440
Maldives	-302	-438	-647	-419	-463	-559	-
Nepal	197	-13	366	541	-436	-	-
Pakistan	-4,990	-6,878	-13,874	-9,260	-3,935	-3,400	-5,200
Sri Lanka	-1,497	-1,401	-3,886	-214	-1,855	-2,149	-2,365
Southeast Asia	86,149	107,951	65,415	103,761	104,976	84,815	83,208
Brunei Darussalam	6,462	4,805	6,959	3,992	4,918	-	-
Cambodia	-577	-692	-1,381	-1,203	-1,229	-1,366	-1,454
Indonesia	10,860	10,492	125	10,192	6,294	4,304	485
Lao People's Dem. Rep.	-398	-672	-1,075	-690	-591	-610	-642
Malaysia	26,179	29,727	38,864	31,815	28,100	27,140	27,907
Myanmar	1,032	112	-694	-454	-966	-2,082	-
Philippines	5,341	7,112	3,627	9,358	8,465	8,759	9,229
Singapore	35,099	48,477	27,620	34,904	49,454	45,500	48,150
Thailand	2,315	15,682	2,157	21,866	14,784	7,165	3,867
Viet Nam	-164	-7,092	-10,787	-6,020	-4,253	-3,995	-4,335
The Pacific	192	682	1,866	282	-1,394	-	-
Cook Islands	19	13	10	12	11	-	-
Fiji	-599	-480	-646	-230	-69	-70	-69
Kiribati	-3	-1	-1	-4	-	-	-
Marshall Islands	-4	-2	-2	-24	-17	-	-
Micronesia, Fed. States of	-32	-22	-39	-51	-49	-	-
Nauru	-5	-2	-	-	-	-	-
Palau	-37	-14	-38	-29	-21	-	-
Papua New Guinea	443	186	791	-583	-2,525	-3,793	-3,884
Samoa	-45	-23	-35	-14	-47	-81	-
Solomon Islands	-43	-81	-124	-121	-158	-	-
Timor-Leste	539	1,167	2,023	1,363	1,514	1,708	1,729
Tonga	-23	-24	-32	-25	-17	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-24	-37	-40	-13	-16	-	-
Total	392,352	544,294	533,231	452,437	462,069	439,930	473,026

- = not available.

Table A15 Current account balance (% of GDP)

	2006	2007	2008	2009	2010	2011	2012
Central Asia	3.4	1.9	9.1	1.3	7.8	7.8	7.1
Armenia	-1.8	-6.4	-11.8	-16.0	-14.6	-13.0	-12.3
Azerbaijan	17.7	27.3	33.7	22.9	31.9	27.8	25.0
Georgia	-15.2	-19.7	-22.8	-11.2	-11.4	-12.6	-11.4
Kazakhstan	-2.5	-7.9	4.7	-3.8	3.0	3.5	3.5
Kyrgyz Republic	-10.1	-6.0	-13.6	-2.4	-5.0	-9.0	-9.0
Tajikistan	-2.8	-8.6	-7.6	-5.9	2.2	-4.3	-6.4
Turkmenistan	15.7	15.5	18.7	-16.1	-4.7	3.4	7.0
Uzbekistan	17.2	19.1	16.7	11.0	15.6	16.3	12.6
East Asia	7.5	8.8	7.7	6.1	5.1	4.4	4.1
China, People's Rep. of	9.3	10.6	9.4	6.0	5.2	4.6	4.2
Hong Kong, China	12.1	12.3	13.7	8.6	6.6	7.2	7.5
Korea, Rep. of	1.5	2.1	0.3	3.9	2.8	1.8	1.7
Mongolia	6.4	1.8	-12.3	-7.5	-15.3	-15.0	-14.0
Taipei,China	7.0	8.9	6.9	11.4	9.4	6.9	7.0
South Asia	-1.5	-1.7	-3.0	-2.7	-2.6	-3.1	-3.1
Afghanistan	-4.9	1.2	-0.9	-1.4	1.9	1.4	-0.8
Bangladesh	1.3	1.4	0.9	2.7	3.7	0.2	-0.3
Bhutan	-4.4	14.2	-2.1	-1.6	-13.5	-20.0	-20.0
India	-1.2	-1.4	-2.4	-2.8	-3.0	-3.5	-3.3
Maldives	-33.0	-41.5	-51.4	-31.8	-31.3	-35.0	-35.0
Nepal	2.2	-0.1	2.9	4.2	-2.7	-0.5	-0.5
Pakistan	-3.9	-4.8	-8.5	-5.7	-2.2	-1.7	-2.3
Sri Lanka	-5.3	-4.3	-9.5	-0.5	-3.8	-4.0	-4.0
Southeast Asia	8.2	8.6	4.5	7.6	6.3	5.0	4.6
Brunei Darussalam	56.3	39.2	48.3	37.2	42.6	50.0	50.0
Cambodia	-7.9	-8.0	-13.4	-11.6	-11.0	-10.7	-10.2
Indonesia	2.9	2.4	0.0	1.9	0.9	0.5	0.1
Lao People's Dem. Rep.	-11.2	-16.4	-21.0	-12.4	-9.0	-9.0	-10.0
Malaysia	16.7	15.9	17.5	16.5	11.8	10.0	9.0
Myanmar	7.1	0.6	-2.2	-1.3	-2.2	-4.1	-4.7
Philippines	4.5	4.9	2.2	5.8	4.5	4.1	3.9
Singapore	24.2	27.3	14.6	19.0	22.2	18.8	19.2
Thailand	1.1	6.3	0.5	8.3	4.7	2.0	1.0
Viet Nam	-0.3	-10.0	-11.8	-6.2	-4.0	-3.8	-3.6
The Pacific	12.7	35.9	74.7	36.9	28.0	24.9	21.5
Cook Islands	10.4	6.5	4.7	6.3	4.9	-	-
Fiji	-19.3	-14.1	-18.1	-8.1	-2.3	-2.2	-2.1
Kiribati	-3.0	4.8	6.4	-8.0	-13.7	-21.3	-22.7
Marshall Islands	-3.1	-1.6	-1.3	-15.4	-10.5	-	-
Micronesia, Fed. States of	-12.8	-8.4	-15.0	-18.6	-17.0	-	-
Nauru	-18.4	-10.3	-	-	-	-	-
Palau	-17.8	-6.4	-17.9	-13.7	-9.5	-	-
Papua New Guinea	8.0	2.9	9.9	-7.3	-26.6	-35.9	-34.2
Samoa	-9.9	-4.1	-6.4	-2.8	-8.1	-12.9	-
Solomon Islands	-1.6	-8.2	-16.4	-21.1	-20.0	-15.0	-15.0
Timor-Leste	181.4	326.2	455.0	244.4	238.0	233.7	205.8
Tonga	-9.3	-9.1	-10.6	-9.2	-5.6	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-5.7	-7.4	-7.1	-2.2	-2.4	-3.8	-4.7
Average	5.9	6.8	5.5	4.7	4.1	3.3	3.0

- = not available.

Table A16 Foreign direct investment (US$ million)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	450	701	925	725	750
Azerbaijan	-584	-4,749	15	2,899	2,272
Georgia	1,186	1,675	1,523	659	553
Kazakhstan	6,663	7,966	13,118	10,653	2,155
Kyrgyz Republic	182	208	377	190	-
Tajikistan	66	160	190	100	160
Turkmenistan	731	804	820	1,355	-
Uzbekistan	174	700	711	838	944
East Asia					
China, People's Rep. of	72,715	83,521	108,312	94,065	105,735
Hong Kong, China	45,058	54,343	59,622	52,394	68,903
Korea, Rep. of	3,586	1,784	3,311	2,249	-150
Mongolia	290	328	845	570	1,635
Taipei,China	7,424	7,769	5,432	2,805	2,481
South Asia					
Afghanistan	238	243	300	201	220
Bangladesh	743	793	748	961	636
Bhutan	6	73	30	15	11
India	7,693	15,893	19,816	35,600	27,600
Maldives	64	91	135	112	164
Nepal	-6	5	5	24	38
Pakistan	3,521	5,140	5,410	3,720	2,151
Sri Lanka	451	548	691	384	500
Southeast Asia					
Brunei Darussalam	70	260	237	-	-
Cambodia	483	867	815	539	801
Indonesia	4,914	6,929	9,318	4,878	12,736
Lao People's Dem. Rep.	650	790	930	769	394
Malaysia	6,060	8,594	7,242	1,430	8,584
Myanmar	428	715	976	963	958
Philippines	2,921	2,916	1,544	1,963	1,713
Singapore	29,056	37,033	8,589	15,279	38,638
Thailand	9,460	11,330	8,539	4,976	6,668
Viet Nam	2,315	6,516	9,279	6,900	-
The Pacific					
Cook Islands	-	-	-	-	-
Fiji	-	-	-	-	-
Kiribati	1	0	0	-	-
Marshall Islands	-1	7	6	3	-
Micronesia, Fed. States of	-	-	-	-	-
Nauru	-	-	-	-	-
Palau	-	-	-	-	-
Papua New Guinea	-	-	-	-	-
Samoa	-	-	-	-	-
Solomon Islands	29	52	91	-	-
Timor-Leste	-	-	-	-	-
Tonga	-	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	-	-	-	-	-

- = not available.

Table A17 External debt outstanding (US$ million)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	1,206	1,449	1,577	2,967	3,299
Azerbaijan	1,879	2,442	3,001	3,422	3,734
Georgia	1,697	1,790	2,691	3,382	4,366
Kazakhstan	74,014	96,893	107,713	113,229	119,243
Kyrgyz Republic	2,212	2,418	2,524	3,048	-
Tajikistan	924	1,253	1,498	1,692	1,942
Turkmenistan	706	624	608	500	1,771
Uzbekistan	3,853	3,913	3,748	4,800	5,400
East Asia					
China, People's Rep. of	325,260	373,773	378,245	428,442	-
Hong Kong, China	516,415	711,103	663,415	668,527	804,012
Korea, Rep. of	225,200	333,428	317,370	345,391	359,985
Mongolia	1,414	1,529	1,610	1,818	1,767
Taipei,China	85,833	94,525	90,361	81,958	-
South Asia					
Afghanistan	11,971	2,014	2,061	1,147	1,339
Bangladesh	18,603	19,355	20,266	20,859	21,792
Bhutan	780	724	819	-	-
India	139,114	172,360	224,500	261,500	295,847
Maldives	558	828	894	933	943
Nepal	3,157	3,341	3,197	3,495	3,442
Pakistan	36,389	39,508	44,867	51,059	55,626
Sri Lanka	12,214	14,252	15,077	-	-
Southeast Asia					
Brunei Darussalam	-	-	-	-	-
Cambodia	2,245	2,555	2,808	3,054	3,514
Indonesia	132,633	141,180	155,080	172,871	200,050
Lao People's Dem. Rep.	2,471	2,853	2,564	2,679	3,270
Malaysia	52,245	56,690	68,219	68,079	73,391
Myanmar	7,303	7,567	8,103	8,602	9,191
Philippines	53,897	55,470	54,328	54,856	59,771
Singapore	273,807	340,996	420,461	412,504	498,749
Thailand	61,027	61,873	65,225	70,016	-
Viet Nam	15,641	19,253	21,816	27,929	-
The Pacific					
Cook Islands	-	-	-	-	-
Fiji	445	247	299	269	282
Kiribati	13	13	10	10	-
Marshall Islands	102	112	99	96	-
Micronesia, Fed. States of	64	67	70	83	68
Nauru	-	310	-	-	-
Palau	18	23	-	-	-
Papua New Guinea	1,185	1,065	1,040	1,009	891
Samoa	161	182	229	214	-
Solomon Islands	155	149	135	134	-
Timor-Leste	-	-	-	-	-
Tonga	82	84	86	101	130
Tuvalu	11	11	14	10	10
Vanuatu	86	-	-	-	-

- = not available.

Table A18 Debt service ratio (% of exports of goods and services)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	3.9	2.9	3.1	5.4	5.1
Azerbaijan	1.5	0.6	0.9	1.3	-
Georgia	7.8	3.5	3.4	5.2	5.2
Kazakhstan	28.5	49.0	41.6	63.2	31.7
Kyrgyz Republic	11.0	14.0	18.2	40.4	9.2
Tajikistan	17.7	13.0	19.9	37.5	12.3
Turkmenistan	-	-	-	-	-
Uzbekistan	12.7	8.6	7.7	12.7	13.5
East Asia					
China, People's Rep. of	2.6	2.4	2.2	3.1	-
Hong Kong, China	-	-	-	-	-
Korea, Rep. of	7.4	7.5	10.2	10.5	9.1
Mongolia	1.8	2.4	2.4	4.2	2.1
Taipei,China	3.2	1.7	4.3	2.7	-
South Asia					
Afghanistan	1.6	1.1	1.1	1.6	1.2
Bangladesh	4.1	3.7	3.2	3.2	3.0
Bhutan	7.6	3.6	18.3	30.5	29.5
India	4.7	4.8	4.4	5.5	-
Maldives	4.1	4.5	5.1	6.1	5.6
Nepal	9.3	10.3	9.6	10.2	12.1
Pakistan	9.7	8.2	7.8	15.3	18.0
Sri Lanka	12.7	13.0	14.3	-	-
Southeast Asia					
Brunei Darussalam	-	-	-	-	-
Cambodia	1.0	1.0	0.9	1.1	1.0
Indonesia	24.8	19.4	18.1	23.2	21.5
Lao People's Dem. Rep.	4.5	4.3	4.6	6.5	-
Malaysia	7.3	2.6	3.1	6.8	-
Myanmar	10.6	4.6	5.1	4.3	3.4
Philippines	12.0	10.1	9.6	10.3	8.7
Singapore	-	-	-	-	-
Thailand	11.3	11.7	7.0	6.7	-
Viet Nam	5.3	5.5	6.5	7.5	8.5
The Pacific					
Cook Islands	-	-	-	-	-
Fiji	1.8	3.9	2.7	-	-
Kiribati	1.1	2.9	2.1	2.5	-
Marshall Islands	22.9	59.4	23.2	22.7	-
Micronesia, Fed. States of	5.8	5.1	5.4	6.2	-
Nauru	-	-	-	-	-
Palau	1.0	0.9	-	-	-
Papua New Guinea	2.9	3.6	3.0	1.4	1.2
Samoa	3.2	3.2	3.6	78.6	-
Solomon Islands	3.5	6.7	6.8	-	-
Timor-Leste	-	-	-	-	-
Tonga	9.3	10.5	8.5	8.7	8.8
Tuvalu	14.1	16.1	17.2	22.8	39.4
Vanuatu	1.7	1.4	-	-	-

- = not available.

Table A19 Exchange rates to the US dollar (annual average)

	Currency	Symbol	2006	2007	2008	2009	2010
Central Asia							
Armenia	Dram	AMD	416.0	342.1	306.0	363.3	373.7
Azerbaijan	Azerbaijan new manat	AZN	0.9	0.9	0.8	0.8	0.8
Georgia	Lari	GEL	1.8	1.7	1.5	1.7	1.8
Kazakhstan	Tenge	T	126.1	122.6	120.3	147.5	147.4
Kyrgyz Republic	Som	Som	40.2	37.3	36.6	42.9	46.0
Tajikistan	Somoni	TJS	3.3	3.4	3.4	4.1	4.4
Turkmenistan	Turkmen manat	TMM	10,881.9	10,690.0	13,041.5	2.9	2.9
Uzbekistan	Sum	SUM	1,218.9	1,263.5	1,319.6	1,465.6	1,587.5
East Asia							
China, People's Rep. of	Yuan	CNY	8.0	7.6	6.9	6.8	6.8
Hong Kong, China	Hong Kong dollar	HK$	7.8	7.8	7.8	7.8	7.8
Korea, Rep. of	Won	W	954.2	929.1	1,100.5	1,275.0	1,155.4
Mongolia	Togrog	MNT	1,179.6	1,181.2	1,165.8	1,437.8	1,357.9
Taipei,China	NT dollar	NT$	32.5	32.8	31.5	33.1	31.6
South Asia							
Afghanistan	Afghani	AF	49.9	49.8	51.0	49.3	45.8
Bangladesh	Taka	Tk	67.1	69.0	68.6	68.8	69.2
Bhutan	Ngultrum	Nu	44.7	44.2	40.4	47.8	46.7
India	Indian rupee/s	Re/Rs	45.2	40.1	46.5	48.0	46.0
Maldives	Rufiyaa	Rf	12.8	12.8	12.8	12.8	12.8
Nepal	Nepalese rupee/s	NRe/NRs	72.0	70.2	64.7	76.6	74.2
Pakistan	Pakistan rupee/s	PRe/PRs	59.9	60.6	62.5	78.5	83.8
Sri Lanka	Sri Lanka rupee/s	SLRe/SLRs	104.0	110.6	108.3	114.9	113.1
Southeast Asia							
Brunei Darussalam	Brunei dollar	B$	1.6	1.5	1.4	1.5	1.4
Cambodia	Riel	KR	4,107.0	4,060.0	4,060.0	4,142.7	4,188.3
Indonesia	Rupiah	Rp	9,020.0	9,136.2	9,678.3	10,398.6	9,084.6
Lao People's Dem. Rep.	Kip	KN	10,159.9	9,603.2	8,744.2	8,516.0	8,254.8
Malaysia	Ringgit	RM	3.7	3.4	3.3	3.5	3.2
Myanmar	Kyat	MK	5.8	5.6	5.4	5.5	-
Philippines	Peso	P	51.3	46.1	44.5	47.6	45.1
Singapore	Singapore dollar	S$	1.6	1.5	1.4	1.5	1.4
Thailand	Baht	B	37.9	34.5	33.3	34.3	32.2
Viet Nam	Dong	D	15,994.3	16,105.0	16,302.0	17,065.0	19,589.0
The Pacific							
Cook Islands	New Zealand dollar	NZ$	1.5	1.4	1.4	1.6	1.5
Fiji	Fiji dollar	F$	1.7	1.6	1.6	2.0	1.9
Kiribati	Australian dollar	A$	1.3	1.2	1.2	1.3	1.1
Marshall Islands	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Micronesia, Fed. States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	1.3	1.2	1.2	1.3	1.1
Palau	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Papua New Guinea	Kina	K	3.1	3.0	2.7	2.8	2.7
Samoa	Tala	ST	2.8	2.6	2.6	2.7	2.5
Solomon Islands	Sol. Islands dollar	SI$	7.6	7.7	7.8	8.0	8.1
Timor-Leste	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Tonga	Pa'anga	T$	2.1	1.9	1.8	2.0	2.0
Tuvalu	Australian dollar	A$	1.3	1.2	1.2	1.3	1.1
Vanuatu	Vatu	Vt	110.5	103.2	101.4	105.9	97.4

- = not available.

Table A20 Gross international reserves (US$ million)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	1,072	1,659	1,407	2,004	1,859
Azerbaijan	2,500	4,273	6,467	5,364	6,409
Georgia	931	1,361	1,480	2,110	2,265
Kazakhstan	19,127	17,629	19,872	23,091	28,291
Kyrgyz Republic	817	1,177	1,225	1,588	1,719
Tajikistan	111	85	150	278	640
Turkmenistan	8,059	13,222	-	-	-
Uzbekistan	4,665	7,510	9,534	12,226	13,542
East Asia					
China, People's Rep. of	1,068,490	1,530,280	1,949,260	2,416,040	2,900,000
Hong Kong, China	133,210	152,702	182,539	255,816	268,731
Korea, Rep. of	238,956	262,224	201,223	269,995	291,571
Mongolia	687	975	637	1,294	2,197
Taipei,China	266,148	270,311	291,707	348,198	382,005
South Asia					
Afghanistan	2,040	2,784	3,591	4,209	5,027
Bangladesh	3,484	5,077	6,149	7,471	10,750
Bhutan	479	600	646	728	868
India	191,924	299,230	251,985	278,193	301,838
Maldives	232	308	241	261	350
Nepal	1,789	1,999	2,477	2,872	2,759
Pakistan	10,765	13,345	8,577	9,118	12,958
Sri Lanka	2,837	3,508	1,753	5,097	6,600
Southeast Asia					
Brunei Darussalam	514	667	751	1,357	-
Cambodia	1,097	1,616	2,164	2,367	2,653
Indonesia	42,586	56,920	51,639	66,105	96,207
Lao People's Dem. Rep.	328	528	636	632	727
Malaysia	82,237	101,532	91,648	96,744	106,560
Myanmar	2,503	3,638	4,042	5,233	5,514
Philippines	22,967	33,751	37,551	44,243	62,373
Singapore	136,261	162,957	174,196	187,809	225,754
Thailand	66,985	87,455	111,008	138,418	167,530
Viet Nam	11,483	20,964	23,022	14,148	12,382
The Pacific					
Cook Islands	-	-	-	-	-
Fiji	515	805	559	557	672
Kiribati	531	586	412	414	-
Marshall Islands	5	3	2	-	-
Micronesia, Fed. States of	47	50	45	-	-
Nauru	-	-	-	-	-
Palau	-	-	-	-	-
Papua New Guinea	1,415	1,998	2,022	2,621	2,600
Samoa	74	88	88	132	166
Solomon Islands	104	118	90	146	257
Timor-Leste	1,096	2,316	-	-	-
Tonga	40	47	48	68	87
Tuvalu	13	17	26	24	23
Vanuatu	102	110	87	117	-

- = not available.

Table A21 Central government expenditures (% of GDP)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	18.1	20.2	22.7	30.5	27.1
Azerbaijan	20.2	21.4	26.8	29.7	28.3
Georgia	29.7	34.0	37.0	38.4	34.7
Kazakhstan	22.1	24.1	27.2	23.5	22.4
Kyrgyz Republic	28.9	31.0	29.3	36.1	38.1
Tajikistan	21.9	28.6	28.0	28.6	26.9
Turkmenistan	14.9	13.4	12.3	14.7	15.6
Uzbekistan	30.9	30.2	33.2	34.2	34.6
East Asia					
China, People's Rep. of	18.7	18.7	19.9	23.0	23.0
Hong Kong, China	15.5	14.5	18.8	18.0	17.4
Korea, Rep. of	22.7	21.5	23.3	25.7	22.7
Mongolia	30.5	35.3	37.6	35.2	37.3
Taipei,China	13.4	12.8	13.9	16.0	14.5
South Asia					
Afghanistan	19.6	19.7	19.3	19.1	21.6
Bangladesh	13.9	13.4	15.8	14.3	16.0
Bhutan	35.9	35.1	34.4	38.6	39.5
India	25.8	26.3	28.4	29.0	25.3
Maldives	59.3	60.8	63.1	64.9	51.2
Nepal	14.5	15.9	17.4	19.9	20.2
Pakistan	18.4	20.8	22.2	19.9	20.5
Sri Lanka	24.3	23.5	22.6	24.9	22.9
Southeast Asia					
Brunei Darussalam	31.4	32.6	29.3	42.3	-
Cambodia	14.2	14.7	16.1	18.3	18.6
Indonesia	20.0	19.2	19.9	16.7	16.4
Lao People's Dem. Rep.	18.0	19.1	19.4	21.1	20.7
Malaysia	24.8	25.0	26.4	30.3	26.8
Myanmar	11.9	11.1	9.6	11.5	12.4
Philippines	17.3	17.3	17.2	18.5	17.9
Singapore	14.5	13.1	16.9	17.8	17.6
Thailand	17.6	18.3	17.3	20.4	17.3
Viet Nam	30.9	34.0	32.4	37.3	34.7
The Pacific					
Cook Islands	33.8	38.2	41.9	46.6	32.0
Fiji	31.9	31.4	25.1	26.5	27.1
Kiribati	74.8	67.5	62.5	55.0	50.0
Marshall Islands	64.3	70.8	65.6	69.5	-
Micronesia, Fed. States of	60.8	59.3	58.9	56.6	62.2
Nauru	92.8	82.9	125.2	85.8	-
Palau	43.8	48.0	43.1	44.8	43.2
Papua New Guinea	34.2	34.8	35.0	30.2	29.4
Samoa	31.8	35.4	34.4	42.7	56.1
Solomon Islands	26.3	29.1	30.4	31.4	-
Timor-Leste	73.5	114.2	165.8	148.0	172.1
Tonga	38.5	33.3	26.5	35.5	30.8
Tuvalu	107.5	120.7	85.7	84.4	91.6
Vanuatu	21.4	24.0	26.6	25.9	26.8

- = not available.

Table A22 Central government revenues (% of GDP)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	16.6	18.7	22.0	22.9	22.2
Azerbaijan	20.6	21.2	26.8	29.0	27.4
Georgia	26.7	29.3	30.7	29.3	28.2
Kazakhstan	22.9	22.5	25.1	20.6	20.0
Kyrgyz Republic	26.4	30.2	29.9	32.2	31.7
Tajikistan	23.6	22.5	22.1	23.4	22.5
Turkmenistan	20.2	17.3	23.6	22.4	18.4
Uzbekistan	31.4	31.7	34.5	34.8	34.8
East Asia					
China, People's Rep. of	17.9	19.3	19.5	20.1	20.9
Hong Kong, China	19.5	22.2	18.9	19.6	21.4
Korea, Rep. of	20.1	21.9	21.2	20.6	20.4
Mongolia	33.6	37.3	32.9	30.2	37.3
Taipei,China	12.6	12.7	13.0	12.5	11.4
South Asia					
Afghanistan	16.8	17.9	15.6	17.9	21.4
Bangladesh	10.7	10.2	11.1	10.4	11.5
Bhutan	35.0	35.7	35.2	40.4	33.2
India	20.5	22.2	19.9	19.5	17.2
Maldives	52.5	56.1	46.2	34.0	34.8
Nepal	12.9	14.1	15.4	16.6	18.2
Pakistan	14.1	15.0	14.6	14.5	14.2
Sri Lanka	17.3	16.6	15.6	15.0	14.9
Southeast Asia					
Brunei Darussalam	50.4	55.1	55.8	40.6	-
Cambodia	11.5	11.9	13.3	11.9	12.7
Indonesia	19.1	17.9	19.8	15.1	15.8
Lao People's Dem. Rep.	12.5	13.6	14.4	14.9	15.7
Malaysia	21.5	21.8	21.6	23.3	21.2
Myanmar	7.7	7.3	7.3	6.1	6.7
Philippines	16.2	17.1	16.2	14.6	14.2
Singapore	14.5	16.0	17.0	17.5	17.6
Thailand	17.4	17.2	16.9	16.0	16.9
Viet Nam	29.7	29.4	29.3	26.7	26.7
The Pacific					
Cook Islands	38.0	40.0	42.8	37.4	40.6
Fiji	25.6	25.6	25.6	24.0	23.6
Kiribati	73.1	70.2	64.3	56.7	50.6
Marshall Islands	65.6	71.0	69.3	67.7	-
Micronesia, Fed. States of	55.5	56.8	57.1	55.0	60.0
Nauru	56.6	87.7	125.8	86.2	-
Palau	42.9	42.2	40.0	41.9	40.7
Papua New Guinea	39.2	41.3	37.5	15.9	29.2
Samoa	32.3	36.5	32.8	35.3	42.6
Solomon Islands	27.1	29.6	30.4	31.5	-
Timor-Leste	255.8	412.0	570.7	385.5	372.3
Tonga	33.7	34.9	28.3	34.5	30.2
Tuvalu	91.7	101.7	85.9	84.1	63.7
Vanuatu	21.8	22.6	28.8	26.9	24.7

- = not available.

Table A23 Fiscal balance of central government (% of GDP)

	2006	2007	2008	2009	2010
Central Asia					
Armenia	-1.5	-1.5	-0.7	-7.6	-4.9
Azerbaijan	0.4	-0.2	0.0	-0.7	-0.9
Georgia	-3.0	-4.7	-6.3	-9.2	-6.5
Kazakhstan	0.8	-1.7	-2.1	-2.9	-2.5
Kyrgyz Republic	-2.5	-0.8	0.0	-3.7	-6.5
Tajikistan	1.7	-6.1	-5.5	-5.4	-4.4
Turkmenistan	5.3	3.9	11.3	7.8	2.8
Uzbekistan	2.2	2.3	4.5	0.6	0.3
East Asia					
China, People's Rep. of	-0.8	0.6	-0.4	-2.9	-2.1
Hong Kong, China	4.0	7.7	0.1	1.6	4.1
Korea, Rep. of	-2.6	0.4	-2.0	-5.1	-2.3
Mongolia	3.1	2.1	-4.7	-5.0	0.0
Taipei,China	-0.7	-0.1	-0.9	-3.5	-3.2
South Asia					
Afghanistan	-2.9	-1.8	-3.7	-1.2	-0.2
Bangladesh	-3.2	-3.2	-4.7	-3.9	-4.5
Bhutan	-0.8	0.6	0.8	1.9	-6.3
India	-5.3	-4.1	-8.5	-9.5	-8.1
Maldives	-6.8	-4.7	-16.9	-30.9	-16.4
Nepal	-1.6	-1.8	-2.1	-3.3	-2.0
Pakistan	-4.3	-4.4	-7.6	-5.3	-6.3
Sri Lanka	-7.0	-6.9	-7.0	-9.9	-8.0
Southeast Asia					
Brunei Darussalam	19.0	22.5	26.5	-1.7	-
Cambodia	-2.7	-2.9	-2.8	-6.4	-6.0
Indonesia	-0.9	-1.3	-0.1	-1.6	-0.6
Lao People's Dem. Rep.	-5.6	-5.5	-5.0	-6.3	-5.0
Malaysia	-3.3	-3.2	-4.8	-7.0	-5.6
Myanmar	-4.3	-3.8	-2.4	-5.4	-5.7
Philippines	-1.1	-0.2	-0.9	-3.9	-3.7
Singapore	0.0	2.9	0.1	-0.3	-0.1
Thailand	0.1	-1.1	-0.3	-4.8	-2.1
Viet Nam	-1.2	-4.6	-3.1	-10.6	-8.0
The Pacific					
Cook Islands	2.6	0.1	-0.8	-11.7	-0.8
Fiji	-2.9	-1.8	-1.5	-3.0	-3.6
Kiribati	-1.7	2.7	1.8	1.7	0.6
Marshall Islands	1.3	0.2	3.7	-1.8	0.3
Micronesia, Fed. States of	-6.4	-3.3	-2.0	1.6	0.7
Nauru	-36.3	4.8	0.6	0.4	14.2
Palau	-0.9	-5.8	-3.1	-2.9	-2.4
Papua New Guinea	5.1	6.4	2.5	-14.3	-0.5
Samoa	0.3	1.2	-1.9	-4.0	-8.1
Solomon Islands	0.8	0.5	0.0	1.6	2.4
Timor-Leste	182.4	297.8	404.9	237.6	200.2
Tonga	-4.8	1.6	1.8	-1.0	-0.6
Tuvalu	-15.8	-19.0	0.2	-0.3	-27.9
Vanuatu	0.4	-1.4	2.2	1.0	-2.1

- = not available.

Asian Development Outlook 2011

The annual *Asian Development Outlook* provides a comprehensive analysis of economic performance for the past year and offers forecasts for the next 2 years for the 45 economies in Asia and the Pacific that make up developing Asia.

This edition sees developing Asia consolidating its recovery from the effects of the recent global financial crisis and extending this momentum into the next 2 years. Policy makers in the region now have to face the challenge of managing inflation pressures. These are being pushed by rising demand from the swift regional rebound and resurgent international commodity prices.

Looking ahead, the region must develop new avenues to sustain its growth over the long term. Tapping the potential of dynamic emerging markets through stronger "South–South" economic links could create new growth drivers—which not only help widen developing Asia's avenues of growth, but also contribute to a more balanced global economy.

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