

*“Asia is undergoing a rapid and strong economic, social, cultural and strategic resurgence – the sum of which is certain to redefine global affairs.”*

Susilo Bambang Yudhoyono, President of Indonesia

## **Macroeconomic Performance and Policy Challenges at the Subregional Level**

While the developing countries of Asia and the Pacific strengthened their growth performance substantially from 4.7% in 2009 to 8.8% in 2010, this region is so vast and diverse that aggregate figures mask the diversity in performance and challenges being faced at the subregion and country levels. Therefore, this chapter provides a more disaggregated analysis of macroeconomic performance and policy challenges at the subregional level with some details at the country level. In the *Survey*, the Asia-Pacific region is divided into five geographic subregions, namely East and North-East Asia, North and Central Asia, Pacific, South and South-West Asia and South-East Asia. An overview of the macroeconomic performance and policy challenges of all the subregions is followed by more detailed analysis.

## Divergent performance of subregions

The economic recovery in East and North-East Asia strengthened in 2010, while the primary channels of recovery tended to differ, reflecting the economic diversity in the subregion. Indeed, China emerged as the world's second largest economy in 2010, with its growth increasingly driven by robust domestic demand, particularly investment. The more export-oriented economies of Japan and the Republic of Korea benefited from a recovery in demand for key export products, especially durable consumer goods, while the commodity-based economy of Mongolia grew on the back of rising commodity prices and mining activities. Somewhat worryingly, inflation has also started to rise throughout the subregion, except in Japan. This phenomenon has been mainly due to the rebound in aggregate demand but has also been the result of increases in food and fuel prices driven up, in part, by speculation and excess liquidity in the market. Fiscal policy measures that were part of the stimulus packages introduced in 2008 and 2009 in China and the Republic of Korea are expected to be withdrawn gradually in 2011 so as to restrain the growth in public debt. On the other hand, the Government of Japan will still need to provide further support to the economy through the injection of public spending and other stimulus measures to rebuild the economy in the wake of the devastating earthquake and tsunami.

The North and Central Asian subregion consists of major energy and mineral exporters. Recovery in global demand for oil and gas, gold, cotton and other commodities in 2010, as well as higher prices for them, therefore, gave a strong boost to these economies. Domestic demand in several countries also benefited from a modest recovery in remittance flows from Kazakhstan and the Russian Federation, the two major economies of the subregion. The agricultural sector, however, contracted in several economies of the subregion due to poor weather conditions. Inflation rates were relatively high, over 5% in most countries, although they came down in 2010 in several countries. Countries with large

oil revenues have been able to cushion some of the budgetary shortfalls with transfers from State oil funds, while others have had to rely more on international assistance and are undergoing fiscal consolidation in consultation with the International Monetary Fund (IMF). Although oil and gas exporters continued to enjoy current account and trade surpluses to varying degrees, oil and gas importers have experienced deficits.

In the Pacific subregion, the Pacific island developing economies experienced sharp declines in GDP growth in 2009 on account of the global economic crisis. For 2010, however, the results appear to be mixed, with only Papua New Guinea, Palau and Solomon Islands recording a significantly improved GDP growth performance in 2010. Most of the other economies virtually stagnated, with the economy of Tonga actually contracting. There was some deceleration in inflation in some major economies. Most countries suffered deficits in their current account balances. Available data suggest a mixed picture in terms of budget performance for the economies in 2010 with Kiribati, Papua New Guinea and Solomon Islands recording balanced or surplus budgets while others expecting budget deficits. The economies of both Australia and New Zealand enjoyed positive growth in 2010 following the global economic crisis but with varying impacts on employment. Australia was much more successful in reducing unemployment than New Zealand.

The global economic crisis had a limited impact on the economies of South and South-West Asia because of their greater dependence on domestic than on external demand. With global economic recovery gathering pace in 2010, however, a surge in economic activities was witnessed in several economies, particularly in India, in 2010. Strong growth was driven by a revival in investment and private consumption, a growth in exports, a rise in industrial production and improved performance by the agricultural sector. Sustained high growth is critical to bring down poverty levels, which are still high compared to those in other subregions.

High inflation, however, remains a serious problem in the subregion. While monetary policy has been tightened in some countries to contain inflation, there is a greater need to address supply side issues. Moreover, as budget deficits remain high, there is a clear need for further fiscal consolidation to tackle the problem of inflation.

South-East Asia, after an earlier-than-expected recovery in 2009, once again exceeded expectations with strong, broad-based economic growth in 2010. With rising consumer and investor confidence, the private sector is driving the economies forward. Years of prudent macroeconomic management also paid off well. Unlike many developed economies, South-East Asia was able to sustain fiscal stimulus through much of 2010 until recovery became fully secured. Against the backdrop of an uncertain global outlook, monetary policy was also carefully managed so as to remain accommodative while keeping inflation in check. In some countries, measures were also taken to limit exposure to the short-term foreign capital that flooded the domestic equity, bond, and property markets.

## EAST AND NORTH-EAST ASIA

### Recovery gains momentum in 2010

The economies of East and North-East Asia, which started to recover from the global economic crisis during the second half of 2009, increased their growth momentum in 2010. The economies rebounded strongly, with manufacturing output and exports returning to near pre-crisis levels by the second quarter of 2010. Government stimulus spending played an important role in boosting economic growth, as did strong domestic demand, which benefited from broader social protection programmes, improvements in the labour markets and rising asset prices. Private investment also picked up, as most economies in the subregion maintained a relatively loose monetary stance to support economic growth. Led by strong growth in China, the subregion grew at 6.4% in 2010, after experiencing a negative growth of 1.0% in 2009 (see table 2.1).

The Chinese economy expanded by a remarkable 10.3% in 2010, after achieving GDP growth of 9.1%

**Table 2.1.** Rates of economic growth and inflation in selected East and North-East Asian economies, 2009-2011

(Percentage)

	Real GDP growth			Inflation <sup>a</sup>		
	2009	2010 <sup>b</sup>	2011 <sup>c</sup>	2009	2010 <sup>b</sup>	2011 <sup>c</sup>
<b>East and North-East Asia<sup>d</sup></b>	<b>-1.0</b>	<b>6.4</b>	<b>4.5</b>	<b>-0.2</b>	<b>1.2</b>	<b>2.4</b>
China	9.1	10.3	9.5	-0.7	3.3	4.5
Democratic People's Republic of Korea	-0.9	..	..	..	..	..
Hong Kong, China	-2.8	6.8	4.9	0.5	2.4	4.0
Japan	-6.3	3.9	1.5	-1.4	-0.7	0.6
Macao, China	1.3	35.0	9.2	1.2	2.8	3.4
Mongolia	-1.3	6.1	9.0	6.3	10.1	16.0
Republic of Korea	0.2	6.1	4.5	2.8	3.0	3.6

Sources: ESCAP, based on national sources; and CEIC Data Company Limited; data available from <http://ceicdata.com> (accessed 25 March 2011).

<sup>a</sup> Changes in the consumer price index.

<sup>b</sup> Estimates.

<sup>c</sup> Forecasts (as of 8 April 2011).

<sup>d</sup> GDP figures at market prices in dollars in 2009 (at 2000 prices) are used as weights to calculate the subregional growth rates.

in 2009. In 2009, urban fixed asset investments fuelled by government spending on infrastructure projects had provided much-needed support to economic expansion. In 2010, fixed asset investment continued to be the main contributor to growth, with real estate development becoming one of the key drivers of investment growth. China's real estate market started to recover during the second half of 2009, buoyed by favourable government policies, such as lower taxes on certain real estate transactions and lower down-payment requirements, as well as rising confidence in China's economic recovery. By the end of 2009, the rapid rise in property prices and concerns over speculative investment, however, prompted the government to reverse the incentive measures. Nonetheless, real estate investment increased by 33.2% in 2010, amid intensified measures to curb overheating. Retail sales of consumer goods increased sharply and the slack in external demand was picked up by domestic demand. Furthermore, in an effort to boost private consumption and promote a more equitable distribution of growth, minimum wages were increased in several provinces across China (for example, Hainan has raised the minimum wage by 37%).<sup>1</sup>

Aided by the strong domestic demand in China and recovery in the rest of the world, Hong Kong, China, rebounded strongly in 2010, with GDP growth reaching 6.8% after the 2.8% contraction recorded in 2009. Domestic demand growth was particularly strong throughout the year and retail sales also benefited from the robust growth of inbound tourism. Residential property sales, which recorded a rise of 28.5% in 2009, continued to increase sharply in 2010. The exchange rate policy of Hong Kong, China, pegging its currency to the dollar, has contributed to the boom in the property market, as the peg requires it to maintain negative real interest rates despite strong domestic growth. In Macao, China, the real GDP growth rate soared to 35.0% in 2010 from 1.3% in 2009, largely owing to a major increase in tourists from mainland China. The tourism and gaming sector constitutes the core of the economy.

Although the Democratic People's Republic of Korea does not publish official statistics, the economy most

likely contracted in 2010 due to the negative impact of unusually bad weather on the agricultural sector, which accounts for a large share of GDP. In addition, the economy suffered additional losses from disruptions in trade, aid and tourism from the Republic of Korea in 2010. Trade with the Republic of Korea accounts for approximately 50% of the country's exports.

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*The adverse economic impact caused by the devastating earthquake and tsunami in Japan will continue to be felt for many years to come*

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The Japanese economy, which contracted by 6.3% in 2009, bounced back after the second quarter of 2009 and continued to record positive growth in 2010, although the size of the economy still remained well below its pre-crisis level. Economic recovery decelerated in the second half of the year; nevertheless, GDP still grew by 3.9% in 2010. While growth continued to be heavily dependent on net export growth, domestic demand also contributed, albeit weakly. Domestic demand is led by the growth of private consumption, especially of durable goods, reflecting the subsidies for "green" durables as part of the fiscal stimulus. Growth of nominal wage income turned positive in 2010 after recording a more than 7% decline during 2009, thus contributing to the improvement in consumer confidence. Recovery of residential investment has stalled, however, hovering around the 2007 level when residential investment plunged due to regulatory changes. Corporate investment has continued to recover, reflecting an improvement in corporate profits and business sentiment.

Japan was hit by a massive earthquake and a devastating tsunami in March 2011. The Fukushima nuclear power plant crisis, as a result, caused a radioactive contamination scare and disruptions in the electricity supply. It is first and foremost a human tragedy in which thousands of people lost their lives and an even larger number were rendered

homeless, but the adverse economic impact caused by the extensive damage inflicted upon the coastal infrastructure in north-eastern Japan will continue to be felt for many years to come. According to some preliminary estimates by the Government, the economic damage could reach \$309 billion. Thus, huge resources will be required for reconstruction and rehabilitation activities. While these activities should compensate for some of the losses in GDP growth suffered as a result of the earthquake and tsunami, the enhanced government spending will add to the fiscal deficit and very high public debt. The Bank of Japan has already injected massive funds into the money market to shore up consumer confidence and maintain liquidity.

Mongolia's economy was hit hard in 2009 by collapsing mineral prices, contraction in the construction sector and a steep drop in external demand for major exports, such as cashmere. The contraction of the economy by 1.3% in 2009 was also due, in part, to the underlying weaknesses in the economic environment, as demonstrated by the sudden deterioration in fiscal and external balances and in the quality of bank balance sheets. The strong policy response by the government, however, aided by improved external conditions, particularly the rise in copper and gold prices, led to a rapid turnaround in 2010, with GDP growing by 6.1%. Significant progress has also been made in mining sector reform and development.

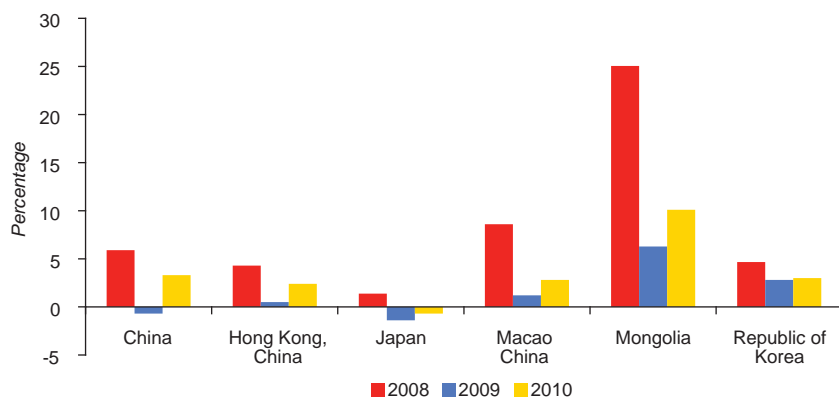
The economy of the Republic of Korea grew by 6.1% in 2010, up from 0.2% in 2009. Growth was supported by the recovery in demand for exports, growth in private consumption, fixed asset investment and stock-building. The country was among the first in the Asia-Pacific region to recover from the economic crisis. Economic output stabilized as early as the first quarter of 2009 and by July 2010 manufacturing activity had surpassed pre-crisis levels, with factories operating at 84.8% of capacity, the highest level since October 1987. Inventory-rebuilding, however, which had contributed significantly to economic expansion in early 2010, came to completion towards the beginning of the

third quarter, leading to the subsequent deceleration in economic activity to a more sustainable level. The stock market posted strong gains during the year but the housing market remained flat.

### **Inflation rises moderately but risks remain**

Inflation has picked up in the subregion, although at a modest and manageable rate. Higher international commodity prices, the absorption of excess capacity and strong domestic demand are putting upward pressure on prices but the appreciation of subregional currencies is having a tempering effect on imported inflation. Consumer prices in China and Hong Kong, China, increased by 3.3% and 2.4%, respectively, and inflation in Macao, China, rose to 2.8% in 2010 (see figure 2.1). Within the increase in inflationary pressure, the rapid rise in grain prices and other foodstuffs is a cause for concern. A series of natural disasters has led to poor harvests in many parts of the world. For example, floods along the Yangtze River system and in the north-east have devastated major corn-producing regions in China, and in August 2010, the Russian Federation banned grain exports for the remainder of the year due to the severe drought that had destroyed about 20% of its wheat crop.<sup>2</sup> In the Republic of Korea, inflation rose marginally to 3.0% in 2010, with food prices rising at even higher rates. As Mongolia relies on imports for much of its food and fuel, higher-than-expected rises in food prices had a substantial impact on overall inflation. The Mongolian agricultural sector was also adversely affected by weather conditions, which exacerbated inflationary pressures. In 2010, inflation rose to 10.1% from 6.3% in 2009.

In contrast, deflation has once again become a major concern for the economy in Japan. Consumer prices continued to decline, by 0.7% in 2010, although the pace was slower than the 1.4% decline recorded in 2009. While this current bout of deflation reflects the output gap stemming from the slower economic growth, it also reflects structural factors, such as market deregulation and competitive pressure from China, which is making it more difficult for producers

**Figure 2.1. Inflation in selected East and North-East Asian economies, 2008-2010**

Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 25 March 2011).

Note: Data for 2010 are estimates.

to increase prices. Other contributing factors include sluggish wage growth and the appreciation of the Japanese currency, which have brought down imported prices in yen terms.

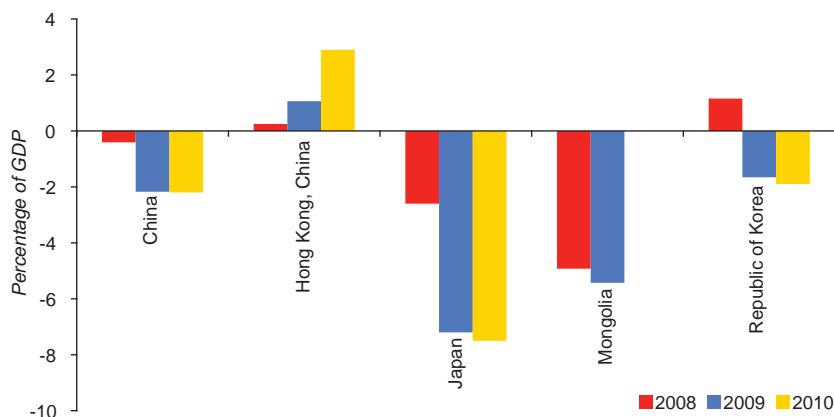
### Preparing for a normalization of fiscal policies

China and the Republic of Korea injected fiscal stimulus through spending on infrastructure projects and investment in agriculture, education and health care in 2009 and 2010, but with plans to unwind most of the stimulus spending in 2011. In China, the 2010 budget reflected a shift in focus away from short-term growth towards improving the quality of longer-term growth by strengthening rural sector investments and social welfare programmes. Due to the ongoing rollover of increased spending and reduced tax receipts, budget deficits have increased in China and the Republic of Korea to a slightly higher but manageable level of -2.2% and -1.9% of GDP, respectively (see figure 2.2). Japan, which had accumulated gross Government debt amounting to 217.5% of GDP in 2009, experienced a further rise to 225.0% in 2010. Interest and maturity payments on Government bonds alone came to 20% of the national budget in fiscal year 2010. Despite the growing need to consolidate its fiscal balance, the Government of

Japan launched a fresh fiscal stimulus package in late 2010 called The Three-Step Economic Measures for the Realization of the New Growth Strategy, in view of deflationary pressures and soft labour market conditions. The additional spending coupled with sluggish recovery and reduced tax receipts led the Government budget deficit to increase to 7.5% of GDP in 2010. The Government of Mongolia, which relies heavily on mining-related revenues, saw its fiscal deficit declining substantially in 2010 as a result of recovering commodity prices. The Government also introduced a new fiscal responsibility bill to reduce the budget deficit gradually and keep spending in check as it faces increasing pressure to redistribute the mining revenue to the public.

### Monetary tightening begins cautiously

After maintaining low interest rates for a year or longer, monetary policies in the subregional economies have begun to be tightened. Early signs of overheating in the property and stock markets, together with rising inflationary pressure, led the Government of China to increase the benchmark rates several times since October 2010. Similarly, the Bank of Korea adjusted its policy rate upwards from 2.00% to 3.00% in a series of moves beginning in July 2010, after keeping it on hold for 17 months. Going the other way, the

**Figure 2.2. Budget balance in selected East and North-East Asian economies, 2008-2010**

Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 16 February 2011).

Notes: Data for 2010 are estimates. Budget balance for Mongolia includes grants.

Bank of Japan announced further monetary easing in October 2010. The policy target rate was lowered from 0.1% to a range between 0.0% and 0.1% due to the re-emergence of deflation. The Bank of Japan stated that it would keep rates at virtually zero until prices had stabilized in the medium- to long-term and would consider further temporary measures to inject liquidity into the market, including a buy-back of Government securities and the purchase of other assets, such as corporate bonds and real estate investment. The central bank of Mongolia increased interest rates by 100 basis points in May 2010 to combat the return of double-digit inflation. While economies in the subregion look towards raising interest rates in 2011, a growing concern for the subregion is that rising interest rates are likely to attract an inflow of speculative capital from countries where interest rates are low, pushing asset prices higher and fuelling inflation.

### External sector returns to pre-crisis levels

Export growth rates returned rapidly to pre-crisis levels. In China, demand for consumer products, which had been extremely sensitive to the economic downturn, led the growth in exports. Over the years, Hong Kong, China, has moved away from the low-cost manufacturing of clothing and apparel to higher

value-added manufacturing. During this transition, the manufacture and export of a new range of products, including electronic and optical products, machinery and equipment, have increased. Along with strong gains in merchandise exports, the export of services maintained double-digit growth throughout the year, largely due to the increase in tourists from mainland China. Similarly, Macao, China, benefited from a large rise in tourists from mainland China. Japanese exports, which nose-dived at the beginning of 2009, bounced back despite the continued appreciation of the Japanese yen vis-à-vis the dollar. Export growth faltered in the third quarter of 2010, however, as the demand from Asia, which accounts for around half of Japanese exports, experienced a sharp slowdown. Exports from Mongolia increased in line with rising commodity prices. The Republic of Korea, whose key exports include semiconductors, electronics, automobiles, container ships and oil tankers, greatly benefited from the broad-based recovery of the global economy, as well as from specific incentive programmes, both at home and abroad, designed to boost demand for consumer goods, such as “Cash for Clunkers”<sup>3</sup> in the United States.<sup>4</sup> Exports from the Republic of Korea have also been helped by a relatively weak currency compared to the Japanese yen, given that the two economies share a broadly similar export basket.

In China, import growth was particularly strong during the first half of 2010, as restocking demand for raw materials, intermediate inputs and capital equipment increased in response to the global economic recovery. In addition, demand for imported durable consumer goods, such as vehicles and electronics, soared. Due to the large increase in imports, the current account surplus shrank considerably during the first half of 2010 but then bounced back; it did not, however, reach levels seen prior to the crisis. Japan also saw a steady increase of imports since the trough in 2009, although to a lesser extent than exports. The appreciation of the yen against the dollar brought down import prices in yen terms, resulting in a widening of Japan's current account surplus, despite the growth in imports. In contrast to the growth of the merchandise trade surplus, the deficit in services remained modest, with a relatively moderate recovery in overseas travel. Together with a large income surplus reflecting the substantial stock of overseas investment, the current account surplus remained well above 3% of GDP in 2010 (see figure 2.3). While China, Japan and the Republic of Korea were able to maintain a current account surplus in 2010, the strengthening of currencies vis-à-vis the dollar is likely to lead to a narrowing of the surplus in 2011. Mongolia is the exception, as its current account deficit widened as imports rose

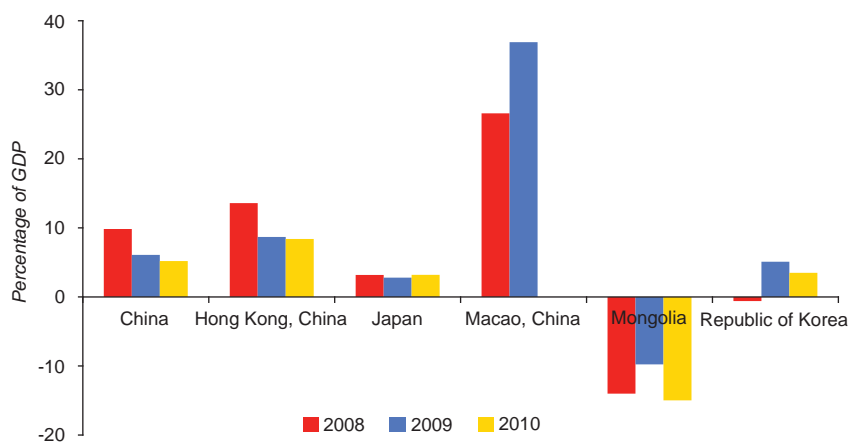
faster than exports, in part reflecting the need for machinery and equipment for the Oyu Tologoi project to develop the copper and gold mine.

### Return of capital inflows

Stronger economic fundamentals and expectations of higher returns have led to a rapid recovery in foreign direct investment (FDI) inflows to the subregion. In 2010, China maintained its position as the largest recipient of FDI in the world, with investment inflows increasing 12.0% year-on-year. After mainland China, Hong Kong, China, became the second largest recipient of FDI in Asia and the fourth largest in the world. The Republic of Korea, however, saw inbound FDI drop by 6.7% in the first half of 2010, mainly due to a fall in investment from Japan, the United States and Europe. The decrease in investment from developed countries was partially offset by a large increase in investment from emerging economies, including China and the Middle East. Macao, China, saw a return of FDI to the gaming and hospitality sector, as Mongolia did to its mining sector.

The inflow of portfolio investment is also on the rise, aided by stronger stock market performances in the economies of the subregion. Short-term capital inflows to China and the Republic of Korea were

Figure 2.3. Current account balance in selected East and North-East Asian economies, 2008-2010



Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 16 February 2011).

Note: Data for 2010 are estimates.

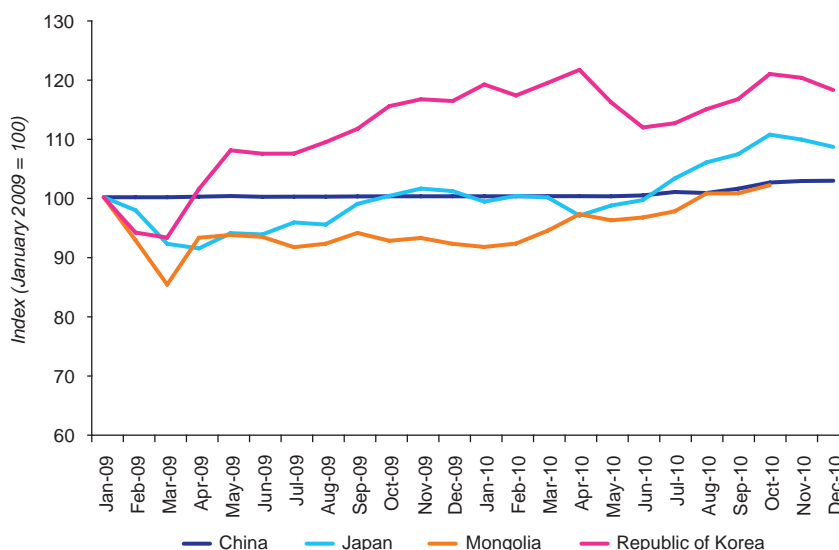
particularly strong during the post-crisis period. The position of foreign exchange purchases in China, for example, showed that the Chinese banking system had acquired \$78 billion in foreign exchange in October 2010 alone. While the position of foreign exchange purchases stems from both trade and investment flows, the fact that it continued to increase while the trade surplus declined between July and September indicates that short-term capital flows have, indeed, increased. The pattern of capital inflows also appears to be highly correlated with asset (primarily property) prices in China and poses a challenge as the Government attempts to rein in property prices and overall inflation.

### Appreciating currencies

All currencies in the subregion gained against the dollar in 2010, with the exception of those of Hong Kong, China, and Macao, China, which are pegged to the dollar (see figure 2.4). The Chinese yuan renminbi started to appreciate gradually following the move by the Government in June 2010 to loosen the dollar/yuan peg that had been in place since

July 2008. Despite weak economic prospects, the Japanese yen strengthened further to 83 yen per dollar in 2010, up by almost 10% since the beginning of the year and an over 30% appreciation since its recent low level of about 120 yen per dollar recorded in 2007. The rapid appreciation of the yen led the Bank of Japan to intervene in the foreign exchange market in September for the first time in six years, but with limited impact. The Mongolian togrog appreciated on the back of rising export values of gold and copper and increased foreign investment in mining activities. In the Republic of Korea, the won continued to experience volatile movements triggered by external events and swings in investor sentiment. In order to curb the potentially destabilizing effects of capital flows on currency movements, the Government of the Republic of Korea instituted capital controls, setting limits on the accumulation of foreign exchange derivatives. On the other hand, the Government of China lifted a series of restrictions that limited the flow of yuan renminbi into Hong Kong, China, resulting in a leap in yuan renminbi deposits in Hong Kong banks.<sup>5</sup> These reforms, together with the growing global significance

**Figure 2.4.** Index of exchange rate movements of domestic currencies against the dollar in selected East and North-East Asian economies, 2009-2010



Source: ESCAP calculations based on data from International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: A positive trend represents appreciation and vice versa.

of the economy of China, are likely to translate into increasing use of the yuan renminbi as a medium of exchange, especially in the subregion.

### Future outlook and policy challenges

The strong rebound in economic activity seen in the first half of 2010 for economies in the subregion appears to have decelerated with the slowdown in the global economic recovery, the completion of the inventory cycle and the gradual unwinding of Government stimulus spending. This trend is expected to continue into 2011, with all economies in the subregion forecast to grow at a slower rate. China is expected to grow at 9.5% and, at this rate, should continue to lead growth in the subregion. Hong Kong, China, should revert to its near-trend growth rate of 4.9%. Economic expansion in the Republic of Korea is also expected to decelerate to around 4.5%. On the other hand, Mongolia, whose mining sector is expected to strengthen in 2011 and to profit from the rise in export prices of gold and copper, should grow around 9%. Japan faces the grim prospect of slower economic growth, partly due to the damage caused to the economy by the devastating earthquake and tsunami. Economic growth is expected to slow to 1.5%.

Overall, the East and North-East Asian subregion is expected to continue on a firm recovery path. Nevertheless, a number of downside risks remain. One of the key risks facing the subregion is the rapid inflow of short-term capital due to the loose monetary policies in the developed economies. Short-term capital attracted by higher returns in the region is leading to exchange rate pressure and could spill over into asset bubbles, which fuel inflation and create market distortions. Furthermore, a mass repatriation of capital, once the bubbles deflate, could result in balance of payment problems and inject gratuitous financial instability. The economies in the subregion are already under intense pressure to curb property and stock prices. In this regard, the potential impact of further quantitative easing in the developed countries is a matter of major policy concern for asset prices in the economies of the subregion.

The subregion's dependence on trade with developed countries, in which recovery has been weak, is also an ongoing risk and source of uncertainty. Furthermore, as economies in the subregion increasingly rely on China to replace demand from traditional export markets, China's private sector demand will need to fill the gap left by the withdrawal of Government stimulus in 2011 to ensure continued growth in the subregion. In addition, the subregion also holds the key to rebalancing unsustainably large and increasing trade and current account imbalances in the global economy. For example, during the period 1996-2006, net exports contributed 13% of China's 9.3% growth rate, on average, while during the same period, household consumption growth only averaged 7.7% and the share of domestic consumption as a percentage of GDP was still very low.<sup>6</sup>

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*The subregion holds the key to rebalancing unsustainably large trade and current account imbalances in the global economy*

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By enhancing domestic consumption, economies in the subregion have an opportunity to boost their economic development processes while also contributing to the reduction of the global macro-economic imbalances. Furthermore, promoting investments in infrastructure, creating employment and business opportunities for the poor with an emphasis on those living in rural areas, enhancing social protection systems and fostering inclusive financial development are all policies that can contribute to both boosting economic growth and rebalancing the region's trade by enhancing domestic demand. Further loosening of the exchange rate may assist in this. In view of the need to address global imbalances, China is shifting its emphasis towards greater social protection and domestic market growth. In China's twelfth Five-Year Programme on National Economic and Social Development, which covers the period from 2011 to 2015, the expansion of domestic demand and household consumption was emphasized as a long-term growth strategy.

The generation of employment opportunities also remains an important challenge. While the impact of the crisis on labour markets in the subregion appears to have been limited, high unemployment among young people and increases in informal, more vulnerable forms of employment are a major economic and social concern. Moreover, as the official unemployment figures do not take into account those who have given up looking for jobs, actual unemployment rates could be higher when such hidden unemployment is included. In order to promote a more job-rich recovery, policies need to provide greater support, such as access to low-cost finance, to small and medium-sized enterprises, especially in the service sector.

## NORTH AND CENTRAL ASIA

### GDP growth receives a boost from higher oil and mineral prices

The North and Central Asian subregion registered GDP growth of 4.6% in 2010, in sharp contrast with 2009 when the economies of the subregion contracted by 5.4% (see table 2.2).

After years of strong GDP growth, Armenia's economy saw a sharp contraction of 14.2% in 2009 as a result of the global financial and economic crisis. Although the financial services sector is not internationally exposed to any great extent, the country relies heavily on inflows of remittances and official transfers, and much of its export revenue is generated by commodities, in particular non-ferrous metals, such as copper. In 2010, global recovery led to higher export earnings and remittances and, as a result, industrial output grew by 9.7%. The agricultural sector, however, contracted by 13.5% due to poor weather conditions. GDP grew by 2.6% in 2010. A narrow export base and geographical isolation (closed borders with Turkey and Azerbaijan) are sources of vulnerability.

In recent years, Azerbaijan has enjoyed large and growing oil exports and has been among the fastest growing economies in the subregion. However, as existing oilfields reach their productive capacity, oil output is slowing down. The hydrocarbon sector accounts for some 55% of GDP and over 80% of export earnings and, as such, GDP growth itself slowed to 5% in 2010 from over 9% in the previous two years. Greater efforts are needed to

**Table 2.2.** Rates of economic growth and inflation in North and Central Asian economies, 2009-2011

(Percentage)

	Real GDP growth			Inflation <sup>a</sup>		
	2009	2010 <sup>b</sup>	2011 <sup>c</sup>	2009	2010 <sup>b</sup>	2011 <sup>c</sup>
<b>North and Central Asia<sup>d</sup></b>	<b>-5.4</b>	<b>4.6</b>	<b>4.8</b>	<b>10.8</b>	<b>7.1</b>	<b>8.2</b>
Armenia	-14.2	2.6	4.0	3.4	8.2	7.0
Azerbaijan	9.3	5.0	5.5	1.5	5.7	7.0
Georgia	-3.9	6.0	5.0	1.7	7.1	8.0
Kazakhstan	1.2	7.0	6.2	7.3	7.1	8.0
Kyrgyzstan	2.3	-1.4	5.0	6.8	8.0	10.5
Russian Federation	-7.9	4.0	4.3	11.7	6.9	8.0
Tajikistan	3.4	6.5	6.0	6.5	6.5	9.0
Turkmenistan	6.1	8.0	9.5	10.0	12.0	14.0
Uzbekistan	8.1	8.5	8.5	14.1	9.3	10.0

Sources: ESCAP, based on national sources; and data from the Interstate Statistical Committee of the Commonwealth of Independent States. Available from [www.cisstat.com](http://www.cisstat.com) (accessed 16 February 2011).

<sup>a</sup> Changes in the consumer price index.

<sup>b</sup> Estimates.

<sup>c</sup> Forecasts (as of 8 April 2011).

<sup>d</sup> GDP figures at market prices in dollars in 2009 (at 2000 prices) are used as weights to calculate the subregional growth rates.

diversify the economy and institute market-based reforms to boost competitiveness. The agricultural sector has also been adversely affected by poor weather conditions, particularly flooding.

Recovery gathered pace in Georgia after it suffered from military conflict in 2008 and from sharp declines in FDI and remittances in 2009. GDP expanded by 6.0% in 2010, from -3.9% in 2009. Global recovery led to a rebound in exports and remittances and translated into strong manufacturing production and increased domestic demand. All the sectors of the economy expanded except agriculture, which suffered losses. Although far below pre-crisis levels, FDI also began to recover from the second quarter of the year.

In Kazakhstan, a strong Government response was vital in stabilizing the banking sector and turning the economy around. GDP grew by 7.0% in 2010, after a modest 1.2% in 2009. The strong rebound was partly driven by a recovery in external demand for oil and other mineral products. Meanwhile, growth in the non-oil sector, including construction, was more modest, owing to weak domestic demand, which was affected, in turn, by limited credit availability.<sup>7</sup> The agricultural sector and the grain harvest, in particular, were badly affected by a severe drought. As a result, the sector contracted sharply in 2010.

Kyrgyzstan, which suffered from widespread political and social instability in April and June, was the only economy in the subregion to contract in 2010, by 1.4%. Led by strong gold production and construction activity, the economy expanded at a rapid 16.4% in the first quarter, before civil unrest disrupted agriculture, trade and other services. Retail trade, for instance, was hit hard by the closure of the border with Kazakhstan and Uzbekistan. On the bright side, industrial output still managed to grow due to a higher output of gold and improved construction activity. Remittances and international assistance also played a supportive role.

The economy of the Russian Federation, which has a large impact on other economies in the

subregion through both trade and remittance channels, began a gradual recovery in 2010 after a 7.9% contraction in 2009. GDP increased by 4.0% in 2010. A large stimulus package and a strong Government response to stabilize the currency and the financial sector laid the groundwork for recovery, which received a boost from strengthening external demand for oil and gas and higher prices for them. Growth began to gain momentum in the second quarter, with tradable goods and manufacturing leading the way. This then translated into more broad-based domestic demand growth in the third quarter, when retail trade and construction expanded by 5.9% and 2.2%, respectively. The firming of the labour market also gave a boost to domestic demand and the unemployment rate fell to 6.7%. The financial sector, however, will take longer to recover due to the large share of bad loans. Despite rapid export growth, the contribution of net exports to GDP growth became less as imports gained rapidly as the year progressed. The agricultural sector was severely affected by the worst drought in decades.

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*The economy of the Russian Federation, which has a large impact on other economies in the subregion through both trade and remittance channels, began a gradual recovery in 2010*

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Tajikistan saw economic growth slow to 3.4% in 2009 owing to declines in aluminium exports and remittances. These two main drivers of growth saw a strong rebound in 2010. Aluminium and cotton remain the primary export items, while nearly half of the labour force works abroad, mainly in Kazakhstan and the Russian Federation. GDP grew by 6.5% in 2010. Industry continues to be susceptible to problems in the power sector, with the country facing periodic blackouts.

With sizeable gas and oil resources, Turkmenistan enjoyed over 10% GDP growth for several years,

but a disruption in the main gas pipeline to the Russian Federation led to slower growth in 2009. In late 2009 and early 2010, however, new pipelines to China and the Islamic Republic of Iran began to operate and, from the beginning of 2010, gas exports to the Russian Federation resumed. As a result, GDP growth bounced back to 8% in 2010. The hydrocarbon sector continues to drive the economy, but retail trade has also experienced double-digit growth, reflecting strong domestic demand.

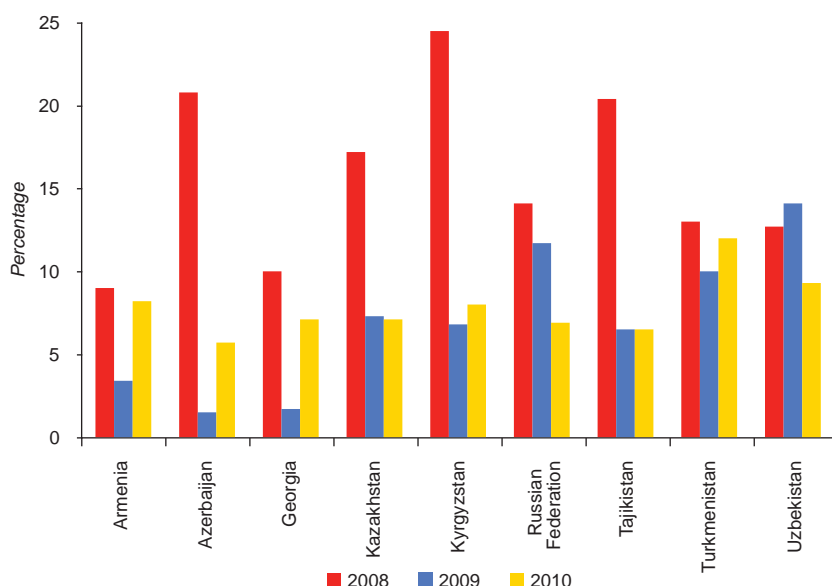
Uzbekistan has been the steadiest economy in the subregion, with GDP growing 8.5% in 2010 compared to 8.1% in 2009. Growth was broad-based, supported by both the industrial and services sectors. The agricultural sector also contributed positively to economic growth. Key commodities, such as cotton, gas and gold, received a boost from stronger commodity prices and external demand, while FDI into infrastructure projects and the hydrocarbon sector continued to rise, particularly from joint ventures with China and the Russian Federation.

### Inflation remains relatively high despite deceleration in some countries

Growing domestic demand and rising real wages, as well as higher food and energy prices, have put some upward pressure on inflation. In most countries, inflation was above 6% in 2010 (see figure 2.5). Inflation remained high in 2010 in Turkmenistan (12%) and Uzbekistan (9.3%), where Government stimulus measures have continued through 2010 at the risk of overheating.

The severe drought and wildfires in the summer of 2010 fed inflationary pressures in the Russian Federation. The Government introduced a ban on grain exports in order to avoid food price inflation. Consumer price inflation at 6.9% in 2010 was lower than the 11.7% recorded in 2009. The strengthening of the currency, low import prices and sluggish domestic demand, however, kept inflation from rising higher. Consumer price inflation in Kazakhstan reached 7.1% in 2010, within the Government target range

Figure 2.5. Inflation in North and Central Asian economies, 2008-2010



Sources: ESCAP, based on national sources; and data from the Interstate Statistical Committee of the Commonwealth of Independent States. Available from [www.cisstat.com](http://www.cisstat.com) (accessed 16 February 2011).

Note: Data for 2010 are estimates.

of 6%-8%. This outcome was helped by a relatively stable exchange rate and food prices. Global food and fuel prices influenced inflation in Tajikistan, as the country is forced to import much of its food and fuel. Consumer price inflation averaged 6.5% in 2010, the same rate recorded in 2009. Rising wages and remittance inflows, however, as well as higher global grain prices, increased inflationary pressure towards the end of 2010.

Kyrgyzstan was unable to avoid price hikes because of a poor domestic harvest and the drought in Kazakhstan and the Russian Federation. Planned increases in utility prices were cancelled, but inflation still reached 8% in 2010. Inflation picked up again in Turkmenistan in 2010 due to higher global prices for food and energy and increased investment in the energy sector. Inflation in Uzbekistan exceeded 9% in 2010 as a result of increased public sector wages and welfare benefits.

Armenia, Azerbaijan and Georgia, which experienced sharp deceleration in inflation during the global economic crisis, witnessed accelerated inflation in 2010. In Armenia, rising prices for imported gas and mineral products exerted upward pressure. Inflation moderated somewhat after monetary tightening at the beginning of 2010 but picked up again in the third quarter. Food prices witnessed a spike in September due to the ban on wheat exports from the Russian Federation. Inflation in Armenia for 2010 is estimated at 8.2%, somewhat higher than the Government target. Azerbaijan saw significant deceleration in inflation from 20.8% in 2008 to 1.5% in 2009, but it rose again to 5.7% in 2010. Higher prices of grain imports from the Russian Federation, among others, have exerted upward pressure, but the stable exchange rate pegged to the dollar and moderate expansion in credit have helped to keep inflation in check. In Georgia, inflation was low at the beginning of 2010 but picked up quickly in the second half of the year due to strong recovery in domestic demand, higher real wages and rising commodity prices. In response, monetary policy was tightened. Inflation rose to 7.1% for the full year.

## Fiscal and monetary policy responses

### *Improvement in fiscal balances*

In general, fiscal balances improved in 2010. Oil exporters, particularly the Russian Federation, Kazakhstan and Azerbaijan, received budgetary boosts from stronger global demand and higher oil prices. The Russian Federation saw its deficit fall from 5.9% of GDP in 2009 to 4.1% in 2010. At the same time, the Government has made a commitment to restore the non-oil fiscal balance, which improved only modestly in 2010 after deteriorating sharply in 2009. In addition to drawing support from the National Fund (the sovereign oil wealth fund), Kazakhstan raised export duties by almost 22% to cover additional social spending. Such measures, together with rising tax revenues from the recovery in economic activity, placed the budget deficit at 3.0% of GDP in 2010. The Government of Azerbaijan increased its transfers from the State Oil Fund in order to finance infrastructure and social programmes. While the central Government maintained a large budget surplus, it would be advisable for it to also make efforts to reduce its non-oil fiscal deficit, which stands at over 35% of GDP and is the highest in the subregion.

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*Oil exporters received budgetary boosts from stronger global demand and higher oil prices*

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Among the gas exporters, only Turkmenistan and Uzbekistan have surplus budgets. For Uzbekistan, the budget has been in surplus for most of the past decade, but increased infrastructure and social spending, as well as increased public sector wages, narrowed the surplus to near balance in 2010. In Turkmenistan, the budget has been in surplus owing to rapidly growing revenues from the hydrocarbon sector, which remains the main contributor to the government budget.

On the other end of the spectrum, the oil and gas importing countries had to struggle with wide budget deficits. In Armenia, additional public spending and

lower revenues widened the budget deficit to 5.2% of GDP in 2010 from 4.7% of GDP in 2009. To contain budget deficit, the Government instituted a three-year programme calling for the suspension of public sector salary increases and a cap on public spending. Efforts to improve the tax and customs administrations are also in place. Nevertheless, subsidies to local communities and expenditures on debt servicing continue to exert pressure. Georgia's budget benefited from strong economic activity and a new excise tax in 2010 and its budget deficit decreased to 6.6% of GDP in 2010.

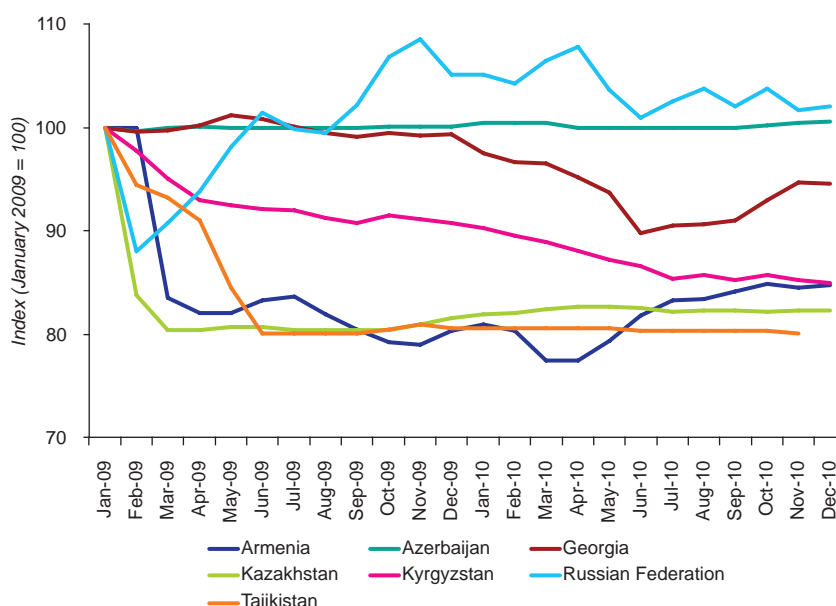
Despite a significant increase in revenues from aluminium and cotton exports, Tajikistan's overall tax base remained narrow and budgetary support from international donors was needed amid rising levels of social spending. Some deterioration in the budget deficit was estimated for 2010. The budget deficit of Kyrgyzstan widened from 1.5% of GDP in 2009 to 9% in 2010 mainly because of increased spending on wages for State employees, job creation measures, fuel imports and infrastructure improvements. Revenues

suffered from the social unrest in mid-2010, as retail trade underwent a sharp downturn and resulted in a sharp decline in value added tax (VAT) collection. The new tax code introduced in 2009 also reduced the VAT rate from 20% to 12%, and the unified tax on small businesses from 10% to 6%.

**Central banks take measures to contain inflationary pressures and maintain exchange rate stability**

The economic recovery provided a fresh impetus for the economies in North and Central Asia to focus on their exchange rates, a key policy issue being to maintain a nominally stable rate of exchange against the dollar. The national currencies of several subregional economies depreciated in 2010 (see figure 2.6) owing to downward pressure on foreign-exchange reserves and concerns about the loss of international competitiveness during the economic crisis. However, increasing export earnings, FDI and remittance inflows eased downward pressure. In addition, several central banks widened their trading bands for national currencies in order to rebuild foreign exchange reserves.

**Figure 2.6. Index of exchange rate movements of domestic currencies against the dollar in selected North and Central Asian economies, 2009-2010**



Source: ESCAP calculations based on data from International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: A positive trend represents appreciation and vice versa.

The Central Bank of Armenia raised its refinancing rate by a total of 275 basis points from January to September and broadened its policy instruments, such as the sale and repurchase of Government securities, in order to deepen the domestic debt market. To enable the domestic currency, the dram, to exchange at a free-floating rate, the Central Bank reduced its intervention in the foreign exchange market in 2010. Georgia's monetary policy in 2010 was aimed at stimulating the economy and reducing the pace of depreciation of the national currency, the lari. Improved economic conditions led the National Bank of Georgia to gradually tighten its monetary policy and resume the use of an inflation-targeting regime after midyear.

In Uzbekistan, the central bank allowed the sum to depreciate in order to support exports and boost the country's competitiveness in both the global and regional markets. Kazakhstan widened the trading band of the national currency from 127.5 to 165.0 tenge per dollar at the beginning of 2010 in order to prevent excessive real exchange rate appreciation. As a result, the tenge appreciated modestly against the dollar by the end of the year. In Kyrgyzstan, the national currency depreciated by more than 11% in 2010 due to a fall in foreign currency inflows and reduced cross-border trade with neighbouring countries from April to July. In response, the national bank made extensive foreign currency sales, an action which also helped it to control the money supply.

The central bank of the Russian Federation maintained a nominally stable rate of exchange for the rouble against a dual-currency basket consisting of 55% dollar and 45% euro. Currency strengthening remained one of the most effective ways to reduce inflationary pressure, which nevertheless led the rouble to strengthen against its target basket in real effective terms in 2010. A reduction of the excessive appreciation of the rouble, however, remained a key monetary policy objective in 2010. By mid-2010, the real effective exchange rate of the rouble was about 9% stronger than at the end of 2009.

Policy rates were raised in Azerbaijan and Tajikistan amid inflationary pressure concerns. The national currencies of the two countries were relatively stable owing to increasing foreign exchange inflows. In Tajikistan, growth in remittances, mainly from Kazakhstan and the Russian Federation, allowed the somoni to remain much more stable in the first half of 2010 than in 2009. Nevertheless, the national currency was around 5% lower against the dollar in annual average terms by the end of 2010.

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*Economic recovery and continued reform of the financial sector led to greater operational efficiency in the banking sector and increased public confidence*

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Economic recovery and continued reform of the financial sector led to greater operational efficiency in the banking sector and increased public confidence in 2010. The financial authorities of economies in the subregion committed to maintaining the stability of their banking systems and to ensuring sufficient liquidity in their financial systems, with a view to providing support to economic growth in the short and medium term. In Azerbaijan and Kazakhstan, reserve requirements for commercial banks were lowered to increase liquidity and support economic activities. The banking sector of Georgia increased its lending and started recording a net profit. The level of deposits in the banking system of Tajikistan bounced back rapidly at the beginning of 2010. The currency reform implemented by the Government of Turkmenistan in 2009 benefited the economic and financial development of the country. The banking system of Uzbekistan received an upgrade in Moody's ratings from "negative" to "stable" in 2010.

**Strong growth in trade driven by commodity exports**

Oil and gas exporters continued to enjoy current account and trade surpluses to varying degrees, while oil and gas importers suffered deficits. In

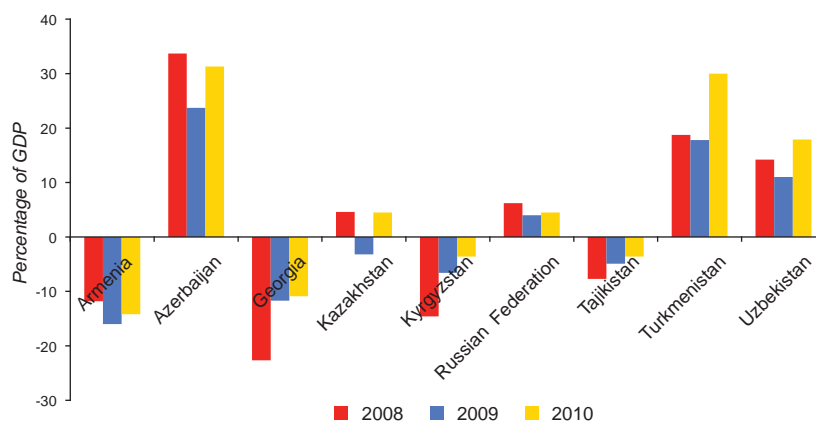
the case of the former, securing alternative export routes (gas pipelines) was important to avoid sharp disruptions in production and exports. In both groups, recovery in remittance inflows provided a modest boost to the current account balance, although the stronger domestic demand that followed led to faster growth in imports in some countries. Remittance inflows from the Russian Federation to the other economies in the subregion also saw a healthy recovery. The non-oil exporting economies in the subregion are still in short supply of FDI, though, and their external debts are high and rising.

In the Russian Federation, the current account surplus improved from 4.0% of GDP in 2009 to 4.5% in 2010 (see figure 2.7). The main country exports of oil and gas, about two thirds of total exports, benefited from higher prices. Kazakhstan turned its 2009 current account deficit into a surplus of 4.5% of GDP in 2010 as a result of rising oil exports. Exports expanded at a much faster rate than imports, resulting in a higher trade surplus. The large current account surplus of Azerbaijan rose further in 2010. Oil and refined petroleum products continue to account for the largest share of export earnings, which grew much faster than imports. Among the largest imports were food products and capital goods, such as machinery, metals and transport equipment.

Turkmenistan saw its current account surplus rise again as oil and gas exports recovered, after disruptions in gas exports to the Russian Federation in 2009 led to a narrowing current account surplus. Imports continue to be dominated by machinery and equipment for the gas sector and construction. The current account surplus of Uzbekistan remained high, at around 18% of GDP, in 2010 owing to a large trade surplus and increasing remittances, mainly from Kazakhstan and the Russian Federation. Rising global prices of principal export commodities, including gold, gas and cotton, increased export revenues by more than 22% in 2010. Hydrocarbons remain an important source of export earnings.

The oil and gas importers—Armenia, Georgia, Kyrgyzstan and Tajikistan—export other commodities, such as non-ferrous metals, aluminium and cotton, and they benefited from rising commodity prices but still suffered current account deficits. Armenia's wide current account deficit narrowed slightly from 16.0% to 14.2% of GDP in 2010, owing to higher prices and demand for metals and mineral products, as well as the economic recovery in the Russian Federation, its largest trading partner. Georgia saw its high current account deficit shrink to 11.7% in 2009, owing to sharp declines in imports. In 2010, the deficit stabilized around the previous year's level

Figure 2.7. Current account balances in North and Central Asian economies, 2008-2010



Sources: ESCAP, based on national sources and International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: Data for 2010 are estimates..

amid a general recovery in imports, as well as higher oil and gas import prices. Georgia's gold and base metal exports also benefited from higher prices, but the overall trade deficit widened. This was partially offset by recovery in remittance inflows.

In Kyrgyzstan, exports grew much faster than imports. The largest imports were food and fuel products, mainly from Kazakhstan and the Russian Federation. Meanwhile, due largely to the economic recovery in the Russian Federation, remittances were reported to have gone up 33% in the first eight months of the year. The country witnessed a reduction in its current account deficit in 2010 as compared to the previous year. The current account deficit of Tajikistan narrowed from 4.9% of GDP in 2009 to 3.6% in 2010, owing to increased remittances from Kazakhstan and the Russian Federation, as well as higher export earnings. The trade deficit narrowed, helped by slower growth in imports. Aluminium, cotton and electrical energy remain Tajikistan's key exports, while its largest imports are food and consumer goods.

### Future outlook and policy challenges

Following a long transition from the Soviet-era economic system, North and Central Asian economies have become progressively more integrated in the global economy. A degree of macroeconomic fragility, lack of financial depth and lack of competitiveness, however, make these economies vulnerable to external shocks. In this regard, despite the economic recovery and positive macroeconomic growth prospects following the global economic crisis, there is a risk of some slowdown in a few subregional economies, particularly due to volatile commodity prices and the knock-on effects of slower global economic recovery in the second half of 2010. Economies in the subregion tend to experience sharper declines and upswings due to their heavy reliance on oil and gas, metals and other commodities. Hence, diversifying the sources of economic growth, including through the development of the non-oil sector, will be important not only for future growth but also for greater socio-economic stability.

The economy of the Russian Federation is projected to grow by 4.3% in 2011. Key challenges will be to strengthen the investment climate, improve the situation in the food markets and lower inflation. In Kazakhstan, GDP is projected to expand by 6.2% in 2011, where Government plans to implement a five-year industrial development and diversification plan announced in 2010. The plan envisages diversification of the economy, improvement of labour productivity through investment in training and improvements to infrastructure. The pursuit of broad-based growth and the development of the non-oil sectors are also the principal economic policy challenges of the Governments of Azerbaijan and Turkmenistan. The National Socio-Economic Development Programme of Turkmenistan for 2011-2030 aims to diversify the economy to move it away from its reliance on natural gas, oil, liquefied natural gas, cotton and textiles. A variety of measures are planned to develop a new management cadre and a skilled labour force. GDP is expected to grow by 9.5% in 2011 owing to strong export earnings. In Azerbaijan, the Government is expected to use its State Oil Fund to finance social spending and infrastructure projects, and to increase investment in the non-oil sectors, such as agriculture and manufacturing. The GDP of Azerbaijan is expected to grow by 5.5% in 2011. Uzbekistan is expected to maintain its growth at 8.5%. Assuming political stability holds in Kyrgyzstan, the country is expected to register a positive growth of 5% in 2011, as opposed to 2010, when the economy contracted. Some slowdown in GDP growth in Georgia and Tajikistan is expected.

Rising dependence on imported energy has become a major concern for several economies in North and Central Asia, leading to the expectation that they will develop their energy resources and infrastructure, and increase energy self-sufficiency with technical and financial assistance from the Russian Federation. The entire subregion could, however, benefit from a strengthening of economic cooperation in the energy sector that would facilitate future economic dynamism in the subregion (see box 2.1).

### Box 2.1. Energy self-sufficiency and dependency in North and Central Asia

Before 1990, the Central Asian economies were integrated into the single national economy of the Union of Soviet Socialist Republics. While close linkages between these economies and with the Russian Federation continue, Kazakhstan, the Russian Federation and Turkmenistan are also now competitors in the global energy market.

#### Natural gas

The economies of North and Central Asia provide nearly 29% of world gas exports.<sup>8</sup> The subregion has a common legacy concentrated in physical energy infrastructure—a huge gas transport system connecting Central Asia with the Russian Federation and, further, with the European Union. The common interests of the subregion are the sustainability of gas extraction and gas transit. Gas supply sustainability has three key dimensions: (a) the stability of the gas transmission system; (b) opportunities to diversify routes; and (c) stable demand from China and the European Union, which would justify and support the longer-term investment required in gas exploration in North and Central Asia.

The most extensive gas pipeline system in the subregion starts in Turkmenistan—the country with the highest proven reserves—and has a capacity of approximately 80 billion cubic metres of natural gas per year. An ambitious project in the diversification of gas supplies has been undertaken by Kazakhstan, Turkmenistan and Uzbekistan, together with China, which should allow about 40 billion cubic metres of natural gas to be supplied annually from Central Asia to China as of 2013. The signing of another gas pipeline project by Afghanistan, India, Pakistan and Turkmenistan in December 2010 is expected to bring 33 billion cubic metres of natural gas per year from Turkmenistan to Pakistan and India via Afghanistan.

#### Electric power

Difficulties with electricity supplies affect all countries in North and Central Asia, particularly Kyrgyzstan and Tajikistan. The problem is in the particular features of the climate and agriculture of the subregion. Kyrgyzstan and Tajikistan generate almost all their electricity using only hydroelectric stations and only at certain times of the year. They now have an opportunity to manage their energy problems by using their hydropower potential more efficiently throughout the year, which could increase the well-being of the entire subregion. The achievement of this goal is connected with investment in new hydroelectric stations; the Russian Federation could play an important role in facilitating this process, both financially and by providing technical expertise.

#### Oil: balancing diverse interests

Oil production in Central Asia will grow substantially in the next two decades following the development of new oilfields, and much of the additional oil is expected to be exported. The main issues for intraregional relationships are the development of new export routes and timely investment in new projects. There are two giant oilfields currently under development in Kazakhstan that are likely to bring considerable additional volumes of oil to the world market. There is an obvious need to make this possible by renovating the tanker fleets of Kazakhstan's neighbours and enlarging pipeline capacity from Kazakhstan to its markets in China and Europe.

The development of a common infrastructure in the oil and gas industries is a key issue for strengthening cooperation in the energy sector in North and Central Asia. Specific policy areas to be addressed include the efficient management of the existing infrastructure and the creation and implementation of a joint development programme for oil, gas and electricity based on forecasts of subregional energy demand. Most important, it involves looking at the energy infrastructure as a systemic whole and preventing the accumulation of bottlenecks within the subregion.

Source: ESCAP.

Food security was another challenge faced by the North and Central Asian economies in 2010, with adverse weather conditions severely affecting grain production in Kazakhstan and the Russian Federation. The spike in grain prices triggered by crop failure in these economies led to the imposition of export restrictions. In particular, the poor harvest and subsequent wheat export ban by the Russian Federation pushed wheat prices to very high levels. The grain export restrictions were expected to be lifted once the final results of the 2010 harvest were known.

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*Food security was another challenge faced by the North and Central Asian economies in 2010, with adverse weather conditions severely affecting grain production*

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The Food and Agriculture Organization of the United Nations (FAO) forecasts that global food prices will be sustained at record levels in 2011,<sup>9</sup> which could have a severe impact, especially on the lower income economies of the subregion. In Tajikistan, for instance, the share of household income devoted to food purchases is around 60%. The Government of Tajikistan addressed the issue of food self-sufficiency in a new food security programme and introduced measures aimed at reducing food shortages in the country. Food imports accounted for more than half of all food products in the domestic consumer market in 2010. In addition to a poor domestic harvest in 2010, the economy of Kyrgyzstan suffered from border closures with its neighbouring countries. The Government of Uzbekistan stimulated the agricultural sector to ensure more ample local supplies in rural areas.

## PACIFIC

The subregion has been divided into two distinct groups for analytical purposes. One group consists of Pacific island developing economies and the other of Australia and New Zealand.

## Pacific island developing economies

### Diverse economic performance

There are good prospects for some Pacific island developing economies, particularly those that are resource-driven, but this masks the fact that the majority of them are barely growing. The GDP growth of these economies as a group averaged 4.3% in 2010, up from 2.2% in 2009 (see table 2.3). In recent years, Papua New Guinea, enjoying strong demand and prices for its exports (oil, gold, copper, coffee, cocoa and palm oil), has been the fastest growing economy. Furthermore, driven by the commencement of the Papua New Guinea liquefied natural gas project, the country's GDP grew by 7.1% in 2010 as compared to 5.5% in 2009. Solomon Islands suffered significantly reduced log exports when demand from China declined for some raw material imports. Its economy experienced a contraction of 1.2% in 2009, compared to a growth of 7.3% in 2008. Benefiting from higher commodity prices, particularly for logs, the Solomon Islands economy rebounded by 4.0% in 2010.

Tuvalu's economy contracted by 1.7% in 2009 and recorded no growth in 2010 due to slowdown in remittance flows into the country. Remittances contribute about 15% of Tuvalu's GDP. Vanuatu's GDP growth rate stood at 3.8% in 2009. In 2010, the economy expanded by 3.0%, a downward revision from the 4.6% 2010 budget growth forecast. The revision reflects lower than expected tourist numbers and delays in the implementation of infrastructure projects.

Fiji has experienced declining preferential European Union sugar prices, highly unfavourable weather conditions (severe flooding in early 2009 and the devastating cyclone Tomas in March 2010), a blow to investor confidence from the 2006 military coup and the continuation of the military-led Government.<sup>10</sup> The economy contracted by 3.0% in 2009 and virtually stagnated with a growth of 0.1% in 2010. Samoa continues to recover from the devastation of the September 2009 tsunami, which affected about 20% of its population and killed at least

**Table 2.3. Rates of economic growth and inflation in selected economies in Pacific, 2009-2011***(Percentage)*

	Real GDP growth			Inflation <sup>a</sup>		
	2009	2010 <sup>b</sup>	2011 <sup>c</sup>	2009	2010 <sup>b</sup>	2011 <sup>c</sup>
<b>Pacific<sup>d</sup></b>	<b>1.2</b>	<b>2.6</b>	<b>2.4</b>	<b>1.9</b>	<b>2.7</b>	<b>3.4</b>
<b>Pacific island developing economies<sup>d</sup></b>	<b>2.2</b>	<b>4.3</b>	<b>5.5</b>	<b>6.7</b>	<b>4.7</b>	<b>6.1</b>
Cook Islands	-0.1	0.5	2.0	6.6	3.5	4.2
Fiji	-3.0	0.1	1.3	6.8	4.0	3.0
Kiribati	-0.7	0.5	1.8	8.4	0.8	6.7
Marshall Islands	0.0	0.5	1.2	0.5	1.0	5.0
Micronesia (Federated States of)	-1.0	0.5	1.0	7.4	3.5	4.0
Nauru	0.0	0.0	4.0	2.2	-0.5	2.4
Palau	-2.1	2.0	2.0	5.2	3.8	4.0
Papua New Guinea	5.5	7.1	8.0	7.0	6.0	8.2
Samoa	-4.9	0.0	2.5	6.6	1.0	3.0
Solomon Islands	-1.2	4.0	7.0	7.1	3.0	4.2
Tonga	-0.4	-1.2	0.8	5.0	2.0	3.0
Tuvalu	-1.7	0.0	0.0	0.0	-1.9	1.5
Vanuatu	3.8	3.0	4.0	4.5	3.4	5.0
<b>Developed countries<sup>d</sup></b>	<b>1.2</b>	<b>2.6</b>	<b>2.3</b>	<b>1.8</b>	<b>2.7</b>	<b>3.4</b>
Australia	1.3	2.7	2.3	1.8	2.7	3.2
New Zealand	0.1	1.5	2.4	2.1	2.3	4.6

Sources: ESCAP, based on data from International Monetary Fund, *2010 Article IV Consultations*. Available from [www.imf.org/external/siteindex.htm](http://www.imf.org/external/siteindex.htm); Asian Development Bank, *Asian Development Outlook 2010 Update: The Future of Growth in Asia* (Manila, 2010). Available from [www.adb.org/Documents/Books/ADO/2010/Update/default.asp](http://www.adb.org/Documents/Books/ADO/2010/Update/default.asp); CEIC Data Company Limited, data available from <http://ceicdata.com> (for Australia and New Zealand) (accessed 25 March 2011).

<sup>a</sup> Changes in the consumer price index.

<sup>b</sup> Estimates.

<sup>c</sup> Forecasts (as of 8 April 2011).

<sup>d</sup> GDP figures at market prices in dollars in 2009 (at 2000 prices) are used as weights to calculate the subregional growth rates.

143 people. Damage and losses to the economy were estimated at \$124 million,<sup>11</sup> around 22% of GDP, with an expected contraction in GDP growth of 4.9%. Post-tsunami reconstruction stimulated the economy, as did the increase in remittances recorded after the tsunami. Nevertheless, it will take considerable time for the economic damage to be repaired, particularly that suffered by the tourism sector. Samoa's economy did not grow in 2010. Tonga's economy also continued to struggle to find its way back to full recovery following the tsunami that hit the country in September 2009. Moreover, the global economic crisis, which led to lower remittance inflows and lower tourism demand, has had a significant impact on the Tongan economy, with GDP contracting by 0.4% in 2009 and again by 1.2% in 2010. The Cook Islands was also affected

by natural disasters. After two years of economic contraction, the Cook Islands economy grew by 0.5% in 2010. The destruction caused by Cyclone Pat in February 2010 also hurt the tourism industry in the first quarter of 2010, but it recovered in the second quarter.

Kiribati's economy contracted by 0.7% in 2009 and is estimated to have grown by 0.5% in 2010. The economy of Nauru grew by 1% in 2008 and showed no growth in 2009 and 2010. Nauru continues to be heavily dependent on phosphate exports. Due to damage caused to the export facilities by stormy weather, phosphate exports have been irregular. The economies of the other small islands have also been stagnating in recent years. Tourism, which makes up more than 95% of service exports in Palau,

has been doing poorly as a result of the global economic crisis. Palau's economy grew by 2.0% in 2010 as compared to its contraction by 2.1% in 2009. The economies of the Marshall Islands and the Federated States of Micronesia remain flat. The economy of the Marshall Islands recorded no growth in 2009, while a slight improvement of 0.5% in GDP growth was observed for 2010. The economy of the Federated States of Micronesia grew by 0.5% in 2010, after contracting four years in a row. The pickup in activities in 2010 was mainly due to increased infrastructure investments, which increased employment opportunities and domestic demand.

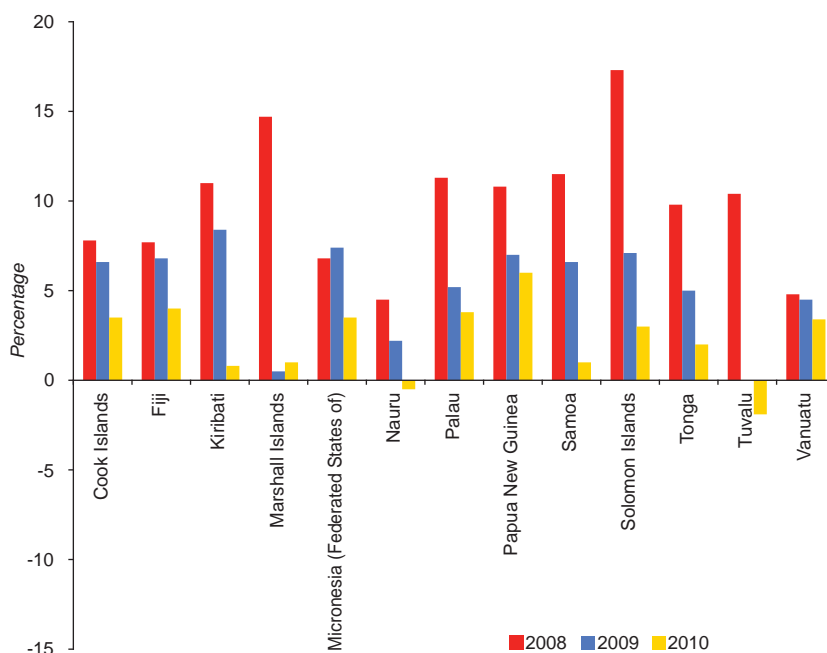
### Inflation driven by higher commodity and fuel prices

Inflation has been driven by higher global prices for oil and commodities, and by accelerating price pressures in some of the trading partners of the

Pacific island developing economies, particularly Australia and New Zealand. With the exception of the Marshall Islands, the remaining countries recorded lower inflation rates in 2010 as compared with 2009, with inflation pressures actually easing significantly in Kiribati and Samoa.

Papua New Guinea recorded the highest inflation rate in the subregion at 6% in 2010 (see figure 2.8). The global economic recovery in 2010, with higher food and commodity prices and increasing domestic demand associated with the Papua New Guinea liquefied natural gas project, contributed to this outcome. The inflation rate in Fiji declined to 4% in 2010 from 6.8% in 2009. Considering the 20% devaluation of the Fiji dollar in April 2009, the increasing global petroleum price and the increased minimum wage, this was a good performance. In Samoa, the rate of inflation for 2009 reached 6.6% because of the high global prices for food and other

Figure 2.8. Inflation in selected Pacific island developing economies, 2008-2010



Sources: ESCAP, based on data from International Monetary Fund, *2010 Article IV Consultations*. Available from [www.imf.org/external/siteindex.htm](http://www.imf.org/external/siteindex.htm); Asian Development Bank, *Asian Development Outlook 2010 Update: The Future of Growth in Asia* (Manila, 2010). Available from [www.adb.org/Documents/Books/ADO/2010/Update/default.asp](http://www.adb.org/Documents/Books/ADO/2010/Update/default.asp); International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 15 December 2010).

Note: Data for 2010 are estimates.

commodities, in combination with an expansionary budget. Since Samoa relies heavily on imports of basic food items, such as rice, flour and milk, the impact of inflation on lower-income households was substantial. Inflationary pressures eased significantly in 2010 to about 1%. This significant drop was due to lower international food and commodity prices as well as the tightening of monetary policy to reduce credit growth. In Tonga, inflation came down from 5.0% in 2009 to 2.0% in 2010. The main factors contributing to inflation in 2010 were an increase in transport costs and increases in the prices of food and household commodities. The inflation rate in Solomon Islands declined to 7.1% in 2009 and further to 3% in 2010, partly helped by tight monetary policy in combination with the cutting of government expenditure. In Vanuatu, the inflation rate declined from 4.5% in 2009 to 3.4% in 2010 due to increased international commodity prices.

### Key macroeconomic policy responses

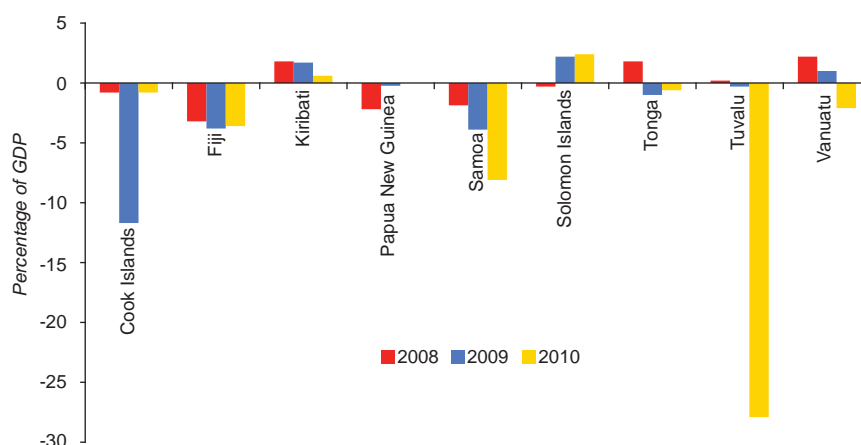
#### Reconstruction efforts lead to increasing budget deficits

Available data suggest a mixed picture in terms of fiscal performance for Pacific island developing

economies in 2010, with Samoa and Tuvalu recording larger budget deficits, while others, such as Fiji, Papua New Guinea, Solomon Islands and Tonga, were expecting improved budget performance. In Papua New Guinea, a balanced budget was estimated for 2010 after a small budget deficit of 0.2% of GDP in 2009 (see figure 2.9). In 2009, Vanuatu recorded a budget surplus of 0.7% of GDP. Due to higher-than-forecast grants and lower interest payments, the budget is estimated to have been in deficit of 2.1% of GDP in 2010.

In the 2009 budget, the Government of Fiji introduced some fiscal stimulus measures to respond to the global economic and financial crises. Debt servicing, which had already increased because of the effect of the April 2009 devaluation on foreign loans, increased further due to the higher domestic interest rates on Government bonds. Due to the shortfall in revenue and the widening of the budget deficit, the Government introduced a revised budget in June 2010 to tackle the negative fiscal developments. The budget deficit in Fiji reached 3.6% of GDP in 2010, slightly better than the 2009 budget deficit of 3.8% of GDP. In Samoa, the expansionary 2010 budget was a response to the economic and financial crises. The budget saw capital expenditure

Figure 2.9. Budget balance in selected Pacific island developing economies, 2008-2010



Sources: ESCAP calculations based on data from national sources; Asian Development Bank, *Key Indicators for Asia and the Pacific 2010* (Manila, 2010); and International Monetary Fund, *2010 Article IV Consultations*. Available from [www.imf.org/external/siteindex.htm](http://www.imf.org/external/siteindex.htm).

Note: Data for 2010 are estimates.

increasing even further, primarily on infrastructure, to be funded by a highly concessional loan from the Asian Development Bank and from donor grants. As a result, the budget deficit for 2010 accelerated to 8.1% of GDP compared to 3.9% of GDP in 2009.

In Tonga, provisional figures from the 2010/11 budget show that revenue and grants declined in 2009/10, mainly because of lower collections of taxes on goods and services. The continuing decline in remittances also played a large role in these falls, through its impact on the retail sector and on imports. In addition, the Government's removal of tariffs on some food items and on fuel for aviation and shipping reduced customs revenue. Due to the continuation of relatively large grant funding, and adjustments on the expenditure side, the overall budget was in deficit equivalent to 0.6% of GDP in 2010 compared to a deficit of 1.0% of GDP in 2009. Tuvalu recently began reform efforts to prepare for freer trade with Australia and New Zealand. The Government introduced a 3% consumption tax, which is set to be gradually adjusted in line with import tariff reductions. Government expenditures increased in 2010; the increase was mainly financed by Australia and New Zealand. Tuvalu's budget deficit increased sharply in 2010. In Solomon Islands, the budget surplus increased slightly from 2.2% of GDP in 2009 to 2.4% of GDP in 2010.

### ***Monetary policy aimed at control of the money supply***

Most of the countries in the subregion have used monetary policy measures to boost aggregate demand. As demand for credit is not very responsive to changes in interest rates, central banks in these countries do not place much emphasis on interest rates as a monetary policy instrument. Rather, they try to influence the expansion of the money supply, as seen from action taken on monetary policy in Fiji, Samoa, Solomon Islands and Vanuatu. In addition, commercial banks are encouraged to lend, as was the case in Fiji and Solomon Islands. This is not

a very effective instrument, however, particularly if there are few profitable investment opportunities on offer, and it could lead to the creation of credit bubbles, as it did in Tonga.

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*As demand for credit is not very responsive to changes in interest rates, central banks in these countries do not place much emphasis on interest rates as a monetary policy instrument*

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In Papua New Guinea, the Bank of Papua New Guinea has kept its main policy interest rate, the kina facility rate, at 7% since December 2009. The central bank is determined, however, to keep the inflation rate in the single digits, and it is wary of a rise in inflationary pressures owing to the current high level of government spending and the ongoing development of a large liquefied natural gas project. There was also a growing concern of inflationary pressures emanating from imported inflation, with the kina depreciating against its major trading partners and the excess liquidity within the economy. Fiji has faced considerable monetary policy challenges since the 2006 coup, which damaged investor confidence and generally reduced the supply response to any monetary policy actions. The Reserve Bank of Fiji raised the reserve requirement for commercial banks in two stages in June and July 2010 to reduce excess liquidity in the banking system. Credit to the private sector grew by only 1% in 2010, and credit fell in some months. The Reserve Bank of Fiji recognizes that, in the current climate, foreign reserves can be drawn down quickly; therefore the monetary policy stance remains tight.

In Samoa, credit growth slowed in 2010, which helped to slow inflation, as well. With inflation declining and economic output not improving, monetary policy was relaxed later in 2010 in order to increase liquidity in an effort to stimulate economic activity. In Tonga, the credit bubble ended as the

banking sector experienced liquidity problems in 2008 and saw a sharp rise in non-performing loans, which represented 20% of outstanding loans by the first quarter of 2009. Following large injections of capital into the two largest banks, the liquidity and the capital positions of the banking sector are now comfortable, but lending to the private sector has declined in recent years. The main reasons for the decline were weaker demand for loans and stricter lending standards. According to the Reserve Bank of Vanuatu, the strong performance of the Government and the fast growth in credit have driven growth in total money supply, which will help the economy as consumer spending increases.

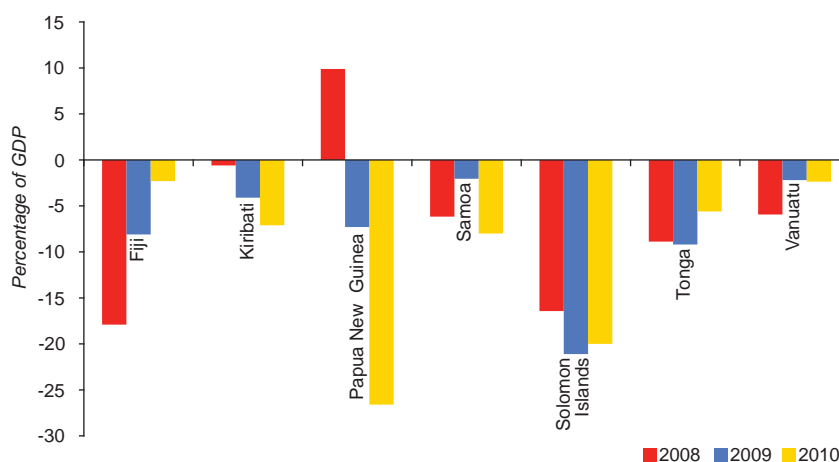
### Current account deficits widen

As in previous years, most countries had current account deficits for 2010, with deficits widening for Kiribati, Papua New Guinea and Samoa, as growth in imports of goods and services outpaced that in exports (see figure 2.10). The managed currencies of the countries are linked fairly closely to the dollar.

In 2009 and 2010, the dollar depreciated against most currencies and, as a result, although imports from these sources became more expensive, Pacific tourism became a better bargain. Pacific tourism therefore performed quite well in 2009 and 2010, despite the impact of the global economic crisis on important source markets. For many economies in the subregion, private inflows through home remittances are a more robust source of income than other private financial flows, such as foreign direct investment. Remittances vary hugely in importance among the countries in terms of the share of GDP: from 0.1% in Papua New Guinea to 25.9% in Samoa in 2009.

In Papua New Guinea, the kina was stable against the dollar while it depreciated by 14% against the Australian dollar in 2010. In the first nine months of 2010, total exports increased by 20.8% and imports by 26.3%. Reflecting these developments, the country's current account deficit is estimated to have widened considerably in 2010 to 26.6% of GDP after having been in deficit at 7.3% of GDP in 2009. By early 2009, the level of reserves in

Figure 2.10. Current account balance in selected Pacific island developing economies, 2008-2010



Sources: ESCAP calculations based on data from International Monetary Fund (IMF), International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf); IMF, 2010 Article IV Consultations. Available from [www.imf.org/external/siteindex.htm](http://www.imf.org/external/siteindex.htm); and Asian Development Bank, Key Indicators for Asia and the Pacific 2010 (Manila, 2010).

Note: Data for 2010 are estimates.

Fiji had fallen to about one month of import cover and in April 2009, Fiji devalued its currency. This action has increased tourist arrivals considerably by making Fiji more attractive to tourists from Australia and New Zealand. The devaluation has also helped to offset the decline in the European Union price paid for Fiji's sugar exports, increase the value in Fijian dollar terms of remittances and increase foreign reserves. Exports have grown faster than imports and the current account deficit was 2.3% of GDP for 2010, much lower than for the previous year.

Samoa has only a limited number of export products apart from the automobile wire harnesses assembled for export to Australia. The main import is petroleum products, which accounts for about 30% of the total. The huge merchandise trade deficit is largely offset by remittance inflows. Nevertheless, the current account deficit widened from 2.0% of GDP in 2009 to 8.0% of GDP in 2010. In Tonga, the negative trend in merchandise trade and remittances continued in 2009 and 2010. Estimates indicate that tourist receipts fell by 13.3% in the first six months of 2010. The current account deficit was 5.6% of GDP for 2010 compared to 9.2% of GDP for 2009. The capital account, however, has recently benefited from the injections of capital into the commercial banks and from foreign loans. By the end of June 2010, official reserves had increased to the equivalent of 7.1 months of imports.

A high level of inflation and continuing upward pressure on the real exchange rate, leading to pressure to devalue, has been a long-term problem in Solomon Islands. The exchange rate has not been devalued, however, as pressure on foreign currency reserves has been relieved by injections of donor funds and the general allocation of special drawing rights (SDRs) by IMF in late 2009. As a result, foreign reserves rose to 4.8 months of import cover by October 2009 and to 6-7 months of import cover by mid-2010. Still, the balance of payments outlook remains poor, particularly given the heavy reliance of output and export earnings on log exports and the threat that this industry

faces from over-exploitation. The current account deteriorated further in 2010, with an estimated deficit in excess of 20% of GDP, which is not sustainable and threatens to destabilize the economy. Vanuatu's current account deficit is estimated at 2.4% of GDP for 2010, not much different than the previous year. The country's foreign reserves were equivalent to 5.9 months of merchandise imports at the end of March 2010.

## Future outlook and policy challenges

The Pacific island countries are strongly linked to the neighbouring major economies of Australia and New Zealand. Both of these economies are projected to grow in 2011, which contributes to the positive outlook for small island economies. Papua New Guinea is again expected to lead this growth with 8.0% growth as investment accelerates in a large gas export project and several mining projects come on stream. The economy of Solomon Islands is also projected to grow by 7.0% in 2011, largely reflecting higher commodity prices, especially for logs. GDP growth of 4.0% is projected for Vanuatu in 2011. Compared to most other Pacific economies, Vanuatu has made good progress and has shown that the reform of the international air transport sector and of telecommunications, which in turn led to solid tourism growth from both fly-in tourists and visits by cruise liners, can offset the negative external shocks flowing from the global economic and financial crises. Nauru's economy is also expected to grow by 4% in 2011 after zero growth in 2009 and 2010, while Samoa's economy will also rebound with a 2.5% growth in 2011. Similarly, Tonga's economy is forecast to rebound with 0.8% growth in 2011 after contracting in 2010. The main stimulant of the economy is the work on the reconstruction of Nuku'alofa and continuing donor support. The loans (from Australia, China and New Zealand) for reconstruction will be spread over four years and some of the funds will be spent on imports of goods and services related directly to the project; reconstruction overall should have a significant positive impact. Most of the rest of the Pacific

island economies are also expected to grow in 2011, but by 2% or less.

Food and oil prices are showing an increasing trend. While the increase in commodity prices is good for producers and bad for consumers, it has to be managed by Governments in a sensible manner. For the larger resource-rich countries, such as Fiji, Papua New Guinea and Solomon Islands, there will be opportunities to increase exports of minerals, timber, and fish. Attention to enhancing the productivity of these industries would be beneficial. On the other hand, food and oil prices could put pressure on the economy and the fiscal balances of the countries. The impact of oil and food price increases could have serious negative consequences for the poor. Therefore, the challenge for Pacific governments would again be to devise appropriate social protection policies to protect the poor. While many governments adopted some good social protection policies in 2009 and 2010, they ought to evaluate further and refine them to ensure the maximum positive impact for the poor.

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*Tourism has become one of the most important income-generating sectors in many economies of the subregion*

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In recent years, tourism has become one of the most important income-generating sectors in many economies of the subregion. The recent growth in visitor numbers and revenue earnings from tourism has strongly supported economic growth in the Cook Islands, Fiji, Niue, Palau, Samoa, Solomon Islands, Tonga, and Vanuatu. In the medium term, political stability and development of the physical infrastructure and telecommunications would be critical to further expand earnings from tourism. At the same time, another policy challenge for these economies is to build strong linkages between the tourism sector and the local communities so that the benefits of tourism are widely shared among all stakeholders. Increasing dependence on tourism,

however, increases vulnerability to global economic shocks.

Pacific island developing countries face the ever-present challenges of diversifying their economies and developing high-end ecotourism, which puts less strain on the environment. One area that offers potential for diversification is agriculture. A large proportion of the population lives in rural areas and produces largely for a subsistence economy. There are a number of problems which must be addressed as a priority, though, if the productivity of the agricultural sector is to be increased. The involvement of the private sector is crucial. In this connection, the role of the government as a facilitator in improving agricultural productivity is important. Governments need to invest heavily in physical infrastructure (roads, ports, water and electricity) and in research and development. They must also ensure that farmers have access to financing, markets and information on commodity prices.

The impacts of natural disasters continue to affect the economic performance of several economies in the medium term. The effects of climate change and natural disasters on the island economies are well known and, for some of them, the implications are serious, as they not only affect their short-term growth and development prospects but could threaten their very existence if predictions of a rise in sea levels are borne out. Most economies are highly vulnerable to natural disasters. Samoa and Tonga were devastated by a tsunami in September 2009. Fiji experienced damaging flooding in January 2009 and two cyclones in December 2009 and March 2010. These events have and will continue to have a major impact on the economic situation for these small and vulnerable economies. A policy challenge for them is to focus on adapting to climate change and reducing their vulnerability to its effects, particularly in a manner that also mitigates it. In this context, the adoption of a green growth strategy could be one such policy initiative that the Pacific island developing economies could consider (see box 2.2).

## Box 2.2. Green growth in the Pacific island developing economies

In recent years, a new paradigm of economic growth combined with environmental sustainability has emerged. Most countries, however, are still grappling with the question of how to continue to grow and lift more people out of poverty. Green growth offers a solution.

### Sustainable development and green growth in the Pacific

Achieving sustainable development is critical for the Pacific island developing economies to meet such challenges as climate change, limited resource endowments and vulnerability to external economic shocks. Over time, these economies have faced increased vulnerability while their coping capacity has decreased. The green growth strategy, as articulated by ESCAP, provides a road map to fill the existing gaps while moving towards the achievement of sustainable development. The following six paths provide a useful framework within which each economy can design its unique policies.

*Sustainable consumption and production.* The green growth approach aims to shape economic incentives to ensure that consumption and production are sustainable. Agriculture and tourism offer the best overall opportunities for combining economic growth and environmental sustainability. Capitalizing on the relatively unspoiled environments of the Pacific, the further development of organic and fair trade certification could allow traditional farming practices to be scaled up into profitable and environmentally sustainable commercial production.<sup>12</sup>

*Greening business and the market.* The private sector is recognized as the key engine for growth in the Pacific.<sup>13</sup> Nonetheless, the role of government is crucial in creating a more favourable environment for green businesses to prosper. A green rating system for buildings and businesses could be adopted and promoted through tax incentives.

*Green tax and budget reform.* Green tax reform involves shifting tax revenues by lowering taxes on “goods” and increasing taxes on “bads”.<sup>14</sup> The main purpose is increased resource efficiency and environmental improvement, rather than simply raising more revenue.

*Sustainable infrastructure.* Many community-based projects operate in the Pacific to promote the use of renewable energy, waste-to-energy schemes and rainwater harvesting, and many electricity utilities are experimenting with biofuels. Such schemes need to be replicated widely in the subregion.

*Investment in natural capital.* Natural capital, such as mangrove forests and oceans, act as a carbon sink and a buffer against climate change impacts.<sup>15</sup> Investment in natural capital is an expenditure that results in more sustainable management of ecosystems and promotes green growth.

*Eco-efficiency indicators.* Eco-efficiency indicators measure how the environment is used and how it is affected by an economic activity. The development of measures of vulnerability, resilience and progress is currently a focus area for small island developing States. The United Nations is developing vulnerability-resilience country profiles based on a range of previous initiatives in this area. Indicators relating to green growth will be incorporated into this work to improve policies in individual countries.

Effective implementation of the green growth strategy will involve more research on the options for each country. It will also require recognition by policymakers that green objectives are key elements of macroeconomic policy and particularly of fiscal policy.

Source: ESCAP.

## Australia and New Zealand

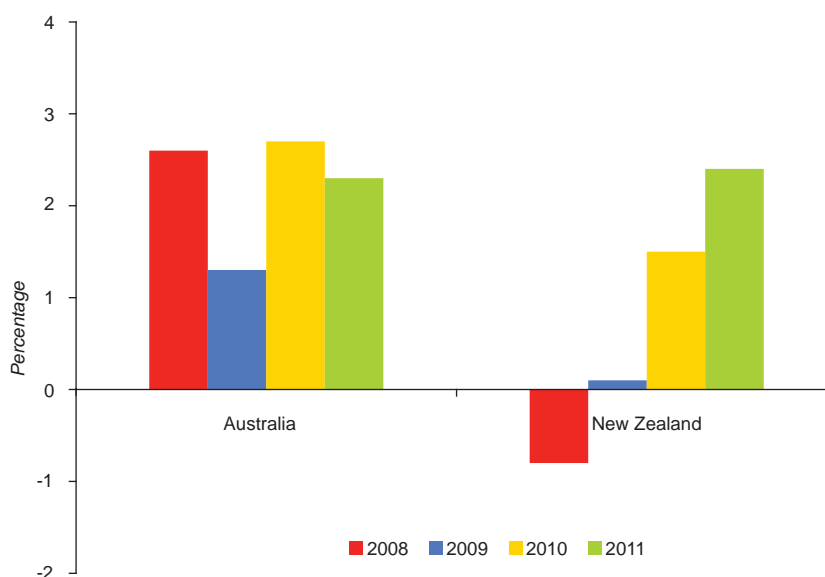
### Recovery continues

Australia marked an extraordinary 17 years of continuous economic expansion when its economy grew by 2.7% in 2010 after a growth of 1.3% in 2009 (see figure 2.11). Australia was one of the few developed countries that had weathered the global economic crisis and achieved positive growth during the 2008/09 economic downturn. Moreover, growth in 2010 was broad-based, with the public sector making a major contribution to the process as the result of a sizeable economic stimulus package that buoyed demand and income in both the public and private sectors. Household consumption was also buoyed by the wealth effect of rising asset prices and by employment growth. The relatively strong growth of domestic demand was, however, offset to some extent by the growth of net imports, reflecting both higher consumption demand emanating from households and investment demand from companies, particularly in the mining sector. The expanding Australian economy, which has been driven by strong external demand for raw materials, such as coal and iron ore, helped

to generate employment, with the mining sector leading growth in this area. With higher demand for labour in the economy, the unemployment rate fell to a low of 5.1% in December 2010.

The New Zealand economy grew 1.5% in 2010 after virtually stagnating in 2009, although the pace of growth in 2010 decelerated in the middle of the year. The slowdown of growth mainly reflected sluggish private consumption, as households rebalanced their consumption expenditures and mortgage debt in the face of declining house prices and less favourable tax conditions for mortgages. Stagnant house prices also reduced the ability of households to access credit. The resultant weaker private consumption was offset partly by higher levels of investment and partly by export growth, which benefited from an increase in commodity prices. However, a devastating earthquake hit New Zealand's second largest city, Christchurch, in September 2010, with substantial damage to local infrastructure estimated at around 2% of GDP. Given the weakness in private consumption, the unemployment rate in the country remained high, fluctuating between 6% and 7% over much of 2010.

Figure 2.11. Economic growth of Australia and New Zealand, 2008-2011



Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 25 March 2011).

Note: Real GDP growth rates for 2010 and 2011 are estimates and forecasts respectively.

## Modest inflationary pressure

Both Australia and New Zealand witnessed modest increases in inflation in 2010. Inflation in Australia rose to 2.7% in 2010 from 1.8% in 2009, reflecting, in part, the effect of the looser monetary and fiscal policies of the last two years in response to the global economic crisis. In addition, the marked increase in global commodity prices in 2010 fed into domestic price pressures. Import prices have been, by and large, contained due to the strong Australian dollar; consequently, consumer price inflation has been broadly restrained in the economy. Inflation in New Zealand increased to 2.3% in 2010 from 2.1% in 2009. The rate of inflation in non-tradable goods and services went up in 2010, reflecting price rises in rents, house construction and property maintenance, along with the effects of tax changes and of overall economic recovery. Wages have started to rise despite still sluggish employment growth in 2010.

## Export growth turns trade balance into surplus

In both Australia and New Zealand, the trade balance turned from deficit to surplus in 2010, buoyed by the strong demand for raw materials and commodities from the Asia-Pacific region aided by higher prices of a wide range of commodities produced by the two countries. The strong growth in exports from Australia reflected acceleration in the growth of export volumes and the strong recovery of commodity prices. Australia's growing trading links with Asia-Pacific countries, led by demand from China, supported the continued growth of its exports even during the economic crisis of 2008/09 in Europe and North America. For instance, China's share in Australia's exports has grown from around 5% to over 20% in the past 10 years. China, Japan and the Republic of Korea together absorbed half of Australia's exports in 2009. New Zealand, too, enjoyed export growth, with buoyant external demand and higher prices for its main commodities, dairy products. Its export growth was also supported by

the growth of the Australian economy, the major export partner of New Zealand.

It should be stressed that, despite its impressive growth and export performance, Australia ran a deficit in its current account of around 2.7% of GDP in 2010. It therefore has to deal with a significant external financing gap whose counterpart is its relatively low domestic savings rate, a matter requiring policy attention in 2011 and beyond. Like Australia, New Zealand, too, has a current account deficit of around 3.4% of GDP. Although financing it has not been an issue in the past, in the more uncertain, risk-averse global financial environment that is likely to persist for some time, access to external financing could potentially become problematic.

The currencies of both countries appreciated against the United States dollar, in line with global trends. The Australian dollar has steadily appreciated against the United States dollar since the beginning of 2009, by over 50% by the end of 2010, while the New Zealand dollar appreciated by 40% over the same period.

## Fiscal consolidation policies

Australia's fiscal position has been relatively favourable compared to the dire state of public finances in many other countries of the Organization for Economic Cooperation and Development (OECD), particularly in Europe. The Government ran a budget surplus of about 1.00%-1.75% of GDP for six years prior to the global economic crisis, leaving substantial fiscal space to launch a large fiscal stimulus package to pre-empt the effects of the 2008/09 global recession. Fiscal stimulus in Australia amounted to over 4% of GDP in the two years ending in June 2010, above the G20 average in this regard. The stimulus package led to a budget deficit of about 2.4% of GDP in 2009 and 4.1% in 2010. Damage caused by floods and cyclones in early 2011 will put further pressure on fiscal balance. In New Zealand, the fiscal deficit widened to 5.3% of GDP in 2010 from 3.7% in 2009. Government expenditures are expected to

increase in the 2010/11 fiscal year as the Government continues its stimulus package to ensure that the economic recovery and reconstruction of earthquake-hit areas continues apace.

### Tightening of monetary policies

In Australia, monetary policy has been progressively tightened since October 2009, much earlier than in other OECD countries. By November 2010, the cash rate had been gradually raised to 4.75%. In the view of the Reserve Bank of Australia, the historically favourable terms of trade, increasing private investment and a firming labour market pose a medium-term risk of higher inflation. In New Zealand, the easing of monetary policy was even more extensive, with the cash rate slashed from 8.25% in June 2008 to 2.50% by April 2009, before it was gradually tightened to 3.00%.<sup>16</sup> The rate was lowered to 2.50% in March 2011 to lessen the adverse economic impact of the devastating earthquake in the country the previous month.

### Future outlook

The Australian economy is projected to grow at 2.3% in 2011, driven by continuing investment growth buoyed by the strong demand for mining sector products in the Asia-Pacific countries. Higher investment expenditures, in turn, should have positive knock-on effects for the rest of the economy. Consequential employment and income growth should support continued growth of household consumption. The economic damage and fiscal burden related to the large-scale flooding and cyclones in Australia in the first quarter of 2011 will have a significant impact on the above prospect. The economic losses are expected to run into several billions dollars. The Government introduced a flood tax for reconstruction. The New Zealand economy is expected to strengthen in 2011, with the projected growth of 2.4%, reflecting the continuation of strong export demand, principally from the Asia-Pacific region and, in particular, from Australia. However, the devastating earthquake that occurred in February 2011 could dampen economic growth.

## SOUTH AND SOUTH-WEST ASIA

### Growth remains strong and accelerates in some major economies

In general, the growth prospects of economies in South and South-West Asia improved in 2010. The subregion is estimated to have grown at 7.5% in 2010 as compared to 3.9% in 2009, with India leading this growth momentum (see table 2.4).

Afghanistan's economy is estimated to have grown by an impressive 8.9% in 2010 despite serious security concerns. This expansion was supported by strong investment in construction, much of which was linked to donor-led projects, and by private consumption. Performance in 2010 follows GDP growth at an exceptional 22.5% in 2009 that was largely driven by the performance of the agricultural sector and greater spending by both the Government and foreign donors. Agriculture grew by 53.0% as a result of good weather in the year and the base effect of a poor harvest in the previous year. Growth in services had also reached double digits in 2009. By contrast, manufacturing and construction growth was modest. The new three year economic programme that was agreed with IMF in July 2010 contains policies to keep inflation low, strengthen banking supervision and regulation, achieve sustained increases in fiscal revenues, ensure transparency in the mining sector and improve efficiency in the budget process and public spending while protecting the poor.

The economy of Bangladesh demonstrated considerable resilience despite the global economic crisis. GDP grew at 5.8% in 2010 on top of the 5.7% growth achieved in 2009. In both years, agriculture expanded by over 4%, helped essentially by favourable weather conditions and the Government's broad-based support for the agricultural sector. Industrial sector growth slightly decelerated from 6.5% in 2009 to 6.0% in 2010, mainly due to sluggish growth in the manufacturing subsector, which was a delayed effect of the global economic recession. The services sector grew by over 6% in both years. The growth of services was broad-based in 2010, with strong growth in key

**Table 2.4. Rates of economic growth and inflation in South and South-West Asian economies, 2009-2011**

(Percentage)

	Real GDP growth			Inflation <sup>a</sup>		
	2009	2010 <sup>b</sup>	2011 <sup>c</sup>	2009	2010 <sup>b</sup>	2011 <sup>c</sup>
<b>South and South-West Asia<sup>d,e</sup></b>	<b>3.9</b>	<b>7.5</b>	<b>6.8</b>	<b>11.0</b>	<b>10.3</b>	<b>8.6</b>
Afghanistan	22.5	8.9	6.8	-8.3	8.2	9.5
Bangladesh	5.7	5.8	6.4	6.7	7.3	7.2
Bhutan	6.7	6.8	7.2	3.0	6.1	7.5
India	8.0	8.6	8.7	12.4	11.0	7.4
Iran (Islamic Republic of)	1.5	3.0	3.5	10.8	12.0	17.0
Maldives	-2.3	4.8	4.0	4.0	6.0	7.2
Nepal	4.0	3.5	4.0	13.2	10.7	8.0
Pakistan	1.2	4.1	2.8	20.8	11.7	15.5
Sri Lanka	3.5	8.0	8.0	3.4	5.9	7.5
Turkey	-4.7	8.1	5.0	6.3	8.6	6.0

Sources: ESCAP, based on national sources.

<sup>a</sup> Changes in the consumer price index.

<sup>b</sup> Estimates.

<sup>c</sup> Forecasts (as of 8 April 2011).

<sup>d</sup> GDP figures at market prices in dollars in 2009 (at 2000 prices) are used as weights to calculate the subregional growth rates.

<sup>e</sup> The estimates and forecasts for countries relate to fiscal years. The fiscal year referred to as 2009 in the table is defined as follows: 21 March 2009 to 20 March 2010 in the Islamic Republic of Iran; 1 April 2009 to 31 March 2010 in India; 1 July 2008 to 30 June 2009 in Bangladesh and Pakistan; and 16 July 2008 to 15 July 2009 in Nepal.

sectors, such as hotels and restaurants, transport and communications, real estate, public administration and defence, education, and health and social services. On the expenditure side, both private and public consumption contributed strongly to growth and the rise in consumption was driven by the remittances of overseas workers, which induced demand. This was supported by a budgetary stimulus package that included higher social safety net spending.

In Bhutan, the completion of the Tala hydroelectric project in 2007 provided a boost to electricity exports to India and, consequently, to Government revenues. As a result, GDP growth had accelerated to a high of 17.9% in 2007 but it returned to a more normal level of 4.7% and 6.7% in 2008 and 2009, respectively. Economic growth rose to 6.8% in 2010 with the start of construction work on two more large hydroelectric projects. A new economic development strategy finalized in March 2010 aims to diversify the economy, generate employment opportunities, promote exports and entrepreneurship, and enhance economic self-

reliance. It also emphasizes sustainable development so that economic growth is not achieved at the cost of environmental degradation.

The economy of India maintained a strong and steady growth momentum throughout the current global economic crisis, unlike many other emerging market economies where growth decelerated sharply and, in some cases, turned negative. GDP growth of 8.0% in 2009 is estimated to have strengthened to 8.6% in 2010. Growth prospects for the agricultural sector were boosted by the relatively good monsoon season, which increased agricultural output in 2010, as the deficient monsoon in 2009 had limited agricultural growth to only 0.4%. The performance of the industrial sector indicates that the 2009 momentum was consolidated, leading the economy to converge rapidly to a longer-term trend towards growth. The industrial production index depicts robust growth of 8.6% over the first nine months of the fiscal year in 2010, while the services sector grew by 9.6% in 2010. With a share of over 57% in GDP, the services sector has been fuelling economic growth.

On the demand side, a rise in savings and investment and a pickup in private consumption contributed to strong GDP growth. Growth in government consumption moderated somewhat, reflecting its fiscal consolidation programme.

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*The economy of India maintained a strong and steady growth momentum throughout the current global economic crisis*

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The Islamic Republic of Iran is the net oil exporter of the subregion. Its economy remains highly dependent on oil revenues, which provide over 80% of government revenues. Higher oil prices in 2010 contributed to a higher growth rate of GDP at 3.0%, as compared to 1.5% in 2009. The hydrocarbon industry, however, continues to suffer from a lack of foreign investment, which is adversely affecting prospects for a sustainable increase in the output of oil and gas over the long term.

In Maldives, after contracting by 2.3% in 2009, GDP grew at 4.8% in 2010, based on a rebound in tourism and construction. Both of these sectors had registered negative growth in 2009 and their performance in 2010 exhibited significant positive trends in line with broader trends in the subregion and globally.

In Nepal, GDP growth slowed to 3.5% in 2010 from 4.0% in 2009. This relatively low growth rate is partly due to frequent strikes in the country, persistent labour problems and severe electricity shortages. It is also due to adverse weather conditions on account of which growth in the agricultural sector decelerated in 2010. There was some deceleration, too, in the growth of services. On the other hand, the industrial sector expanded by 3.9% in 2010 as compared to the negative growth it experienced in 2009.

In Pakistan, despite challenging security conditions and severe energy shortages, domestic economic activity rebounded to some extent in fiscal year 2010, with economic growth accelerating to 4.1% from

1.2% in 2009.<sup>17</sup> This improved GDP performance was led by a recovery in large-scale manufacturing, a reasonable harvest of major agricultural crops and improved performance in the services sector. On the expenditure side, growth was largely due to a substantial increase in public sector consumption and investment expenditures. Severe floods across the country from August to October 2010, however, added to the existing difficulties of the economy. More than 20 million people (or more than 10% of the population) were affected by the floods, which also severely damaged housing, businesses, agricultural crops and physical infrastructure. Private and public losses due to floods are estimated at \$9.7 billion. Indeed, the impact of the floods on the economy will continue to be felt in the coming years as damaged infrastructure will not only need to be repaired but also upgraded to meet the needs of a modern economy.

In Sri Lanka, the economic recovery that began in the second half of 2009 gained momentum and GDP growth is estimated to have accelerated sharply to 8.0% in 2010 from 3.5% in 2009. With the end of the country's civil war in May 2009, the strong recovery is being supported by robust growth in agricultural output and a surge in domestic trade and transport activities. Growth in industrial production has also picked up, supported by strong growth in investment, particularly private investment. Total gross investment is estimated to have increased to 27.8% of GDP in 2010 from 24.5% in 2009.<sup>18</sup> Increased tourist arrivals and reconstruction of the war-torn Eastern and Northern provinces and their integration into the rest of the country also supported growth momentum. Damage caused by heavy rains and widespread floods may affect growth prospects for 2011.

The economy of Turkey, whose trading links are primarily with European Union countries, contracted sharply in 2009 due to the global economic crisis. The sound macroeconomic policy and reforms carried out in the past, however, helped to limit financial system stress by keeping the balance sheets of banks and households strong and successfully containing interest and exchange rate volatility. Business and

consumer confidence remained high, which helped the economy to grow faster. The economy grew by 8.1% in 2010, aided by a strong recovery in domestic and external demand, as well as a surge in private investment. The relaxation of fiscal, monetary and financial policies also contributed to the recovery.

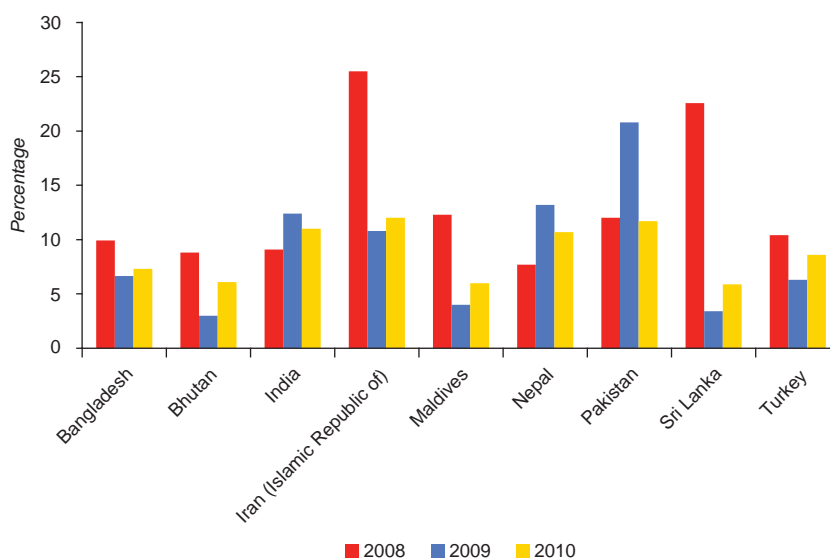
### High inflation is a major challenge as food prices rise rapidly

Of greater concern in the subregion is high inflation, especially as it concerns food prices. As food inflation affects the poor disproportionately, it is a serious problem for countries with a high incidence of poverty. Reducing inflation is and will remain the key macroeconomic challenge for this subregion.

A sharp increase in inflation in India in 2010 has been a particular cause for concern following a major surge in food prices in 2009 (see figure 2.12). Average inflation in 2009 was in the double digits. Consumer price inflation (for industrial workers) is estimated at 11.0% for the first nine months of fiscal year 2010 and food prices, which are heavily weighted in the consumer price basket, remained elevated in 2010. Deficient monsoon rains in 2009

contributed to higher food inflation. Rapid economic recovery has also generated inflationary pressures due to significant supply-side constraints in the economy. What was initially a process driven by food prices gradually became more generalized, as reflected in the sharp increase in inflation for non-food manufactured products. The increasing generalization of inflation required appropriate policy actions to anchor inflation expectations.<sup>19</sup> It was thus a major challenge for the monetary authorities to moderate inflationary pressures through the judicious use of monetary policy without disrupting the momentum of growth. Monetary policy was tightened gradually and included several policy rate increases. Inflation appears to have stabilized in recent months, although the rate may remain high for some time. The early signs of a downturn in non-food manufacturing inflation suggest that recent monetary actions are having an impact on both inflationary expectations and demand in a non-disruptive manner. In addition, a normal monsoon in 2010 led to a rebound in agricultural output, boosting food supplies and overall GDP growth and easing inflation somewhat in the process. High international oil and commodity prices, however, are keeping upward pressure on inflation.

Figure 2.12. Inflation in selected South and South-West Asian economies, 2008-2010



Sources: ESCAP, based on national sources.

Notes: Data for 2010 are estimates. Inflation refers to the consumer price index for industrial workers for India and to Colombo for Sri Lanka.

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*A major challenge for the monetary authorities is to moderate inflationary pressures through the judicious use of monetary policy without disrupting the momentum of growth*

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Pakistan has been experiencing double-digit inflation over the past three years. In 2010, inflation stood at 11.7%, having decelerated from 20.8% in 2009. Increases in electricity and natural gas charges and upward revisions in petroleum prices influenced production and transport costs, causing prices of other consumer price index items to rise, as well. This cost-push pressure on inflation was the result of a pressing need to reduce government subsidies in order to contain the budget deficit, which has been one of the major factors responsible for high inflation. Ironically, efforts in this case to contain the budget deficit have also led to inflationary pressures. Food prices rose more sharply not only due to the increased cost of transport but also because of a surge in the prices of imported food commodities, mainly pulses, spices and milk powder. Inflationary pressures increased further due to the devastation caused by the floods. Further increases in electricity and natural gas charges and reforms in the generalized sales tax will automatically contribute to keeping inflation high, at least over the medium term.

Inflationary pressures also re-emerged in the Bangladesh economy as the consumer price index increased by 7.3% in 2010 against 6.7% in 2009. The increase in commodity prices, particularly in neighbouring India, contributed to an increase in domestic prices in Bangladesh. Food price inflation rose at an even higher rate. To check this upward trend of prices, the Government took several steps, including ensuring an improved supply of commodities, allowing the sale of essential commodities in open areas, and closely monitoring the price situation and demand-supply gaps. At the same time, the Government attempted to keep inflation at a tolerable level by pursuing a less accommodative

monetary policy by mopping up excess liquidity due to the upsurge of inflows from overseas worker remittances. In addition, the Bangladesh Bank, the central bank of the country, raised its policy rate in May 2010 to contain inflationary pressures.

In Sri Lanka, improved domestic supply conditions and supportive fiscal policies helped to limit inflation to 5.9% in 2010. Domestic supply conditions improved due to improved performance by the agricultural sector and an increased supply of food commodities, mainly from the north and east of the country, due to the improved security situation in those areas. The continued stability of the domestic currency cushioned the price increases of imported commodities, while measures taken by the Government, particularly downward adjustments to tariffs applicable to imported commodities, helped to reduce price pressures further. The unchanged domestic prices for petrol and diesel during the year helped to contain inflation.

Inflation in Bhutan and Nepal is closely linked to inflation in India because of the fixed exchange rates between the currencies of these countries as well as the close economic ties among them. In Nepal, there was some deceleration in inflation in 2010 as compared to the previous year, but it remained high at 10.7%. Moreover, food prices rose at a much higher rate. Inflation increased somewhat in Bhutan in 2010. Inflation in Maldives increased to 6.0% in 2010 from 4.0% in 2009.

Inflation in Turkey also picked up, rising to 8.6% in 2010 as compared to 6.3% in 2009. Large excise tax increases and food price shocks in early 2010 caused a temporary spike in inflation that also raised inflationary expectations. Food prices witnessed sharp increases and volatility over the year. In the Islamic Republic of Iran, which had been experiencing high inflation for several years, inflation fell sharply to 10.8% in 2009 due to lower international commodity prices and a good agricultural crop. Nevertheless, it was in the double digits in 2010, due partly to a gradual reduction in subsidies on consumer goods and partly to the fiscal policy,

which continued to be expansionary, albeit not to the extent of previous years.

## Monetary and fiscal policy responses

### Monetary policy tightened

Governments in South and South-West Asia, as in other subregions, used expansionary monetary policies to counter negative fallout from the global slowdown and moderate the decline in GDP growth. Monetary policy is being tightened in most countries, though, to contain growing inflationary pressures. It was tightened in Bangladesh, India and Pakistan by raising key policy interest rates. In India, policy rates have been raised several times. The Central Bank of Sri Lanka, on the other hand, eased its monetary policy in July 2010 and January 2011 as a result of a deceleration in inflation. In Pakistan, the monetary policy debate has been complicated by the worsening of most macroeconomic aggregates. On the one hand, there is the argument that the central bank should respond to rising inflationary pressures and the excessive increase in the fiscal deficit with higher interest rates; on the other hand, the demand shock stemming from the flood damage argues for

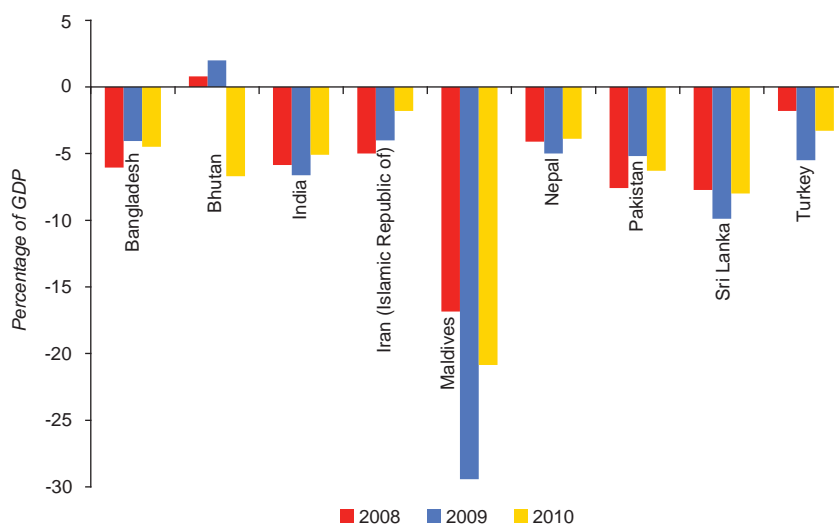
a degree of countervailing easing of monetary policy to help revive the faltering economy.<sup>20</sup>

### Budget deficits remain high and fiscal consolidation is taking place in some countries

Although budget deficits were already high prior to the global crisis, governments had little choice but to run up yet higher deficits as a means of countercyclical stabilization (see figure 2.13). Persistent large fiscal deficits, however, carry several adverse macroeconomic risks, including higher inflation, lower savings, crowding-out pressures on private investment, upward pressure on interest rates and a worsening of external imbalances. These concerns may be largely absent in the short term in a phase of economic slowdown that requires the use of fiscal stimulus. In the medium term, however, such risks often materialize if the fiscal deficit is not brought down significantly under a credible fiscal consolidation strategy.

It is important that governments prepare and implement fiscal consolidation plans to contain their budget deficits and growing public debt. India has

Figure 2.13. Budget balance in selected South and South-West Asian economies, 2008-2010



Sources: ESCAP, based on national sources.

Note: Data for 2010 are estimates.

already devised such a plan, within which a budget deficit of 5.1% of GDP in 2010 was well within the target of 5.5% of GDP. The deficit is expected to come down further to 4.6% of GDP in 2011. In June 2010, the Government of India took a bold decision to decontrol petrol and diesel prices to reform its fuel subsidy programme for fiscal consolidation. Moreover, a higher-than-expected realization on third-generation and broadband wireless access licence auctions combined with buoyant tax revenues helped the budget deficit to perform better than had been targeted in 2010.

In Pakistan, lower revenue generation and higher current expenditures are the underlying reasons for the stressed fiscal position. The tax-to-GDP ratio has fallen to a low of around 10% and, without substantially increasing the resource envelope, it would be difficult to sustain the fiscal deficit at manageable levels. Similarly, the Government must carefully scrutinize and reprioritize spending to create room for public investment to support growth. The budget deficit, at 6.3% of GDP in 2010, will face further pressure in 2011 as a result of the devastation wreaked on the economy by the severe floods and the consequential need for rehabilitation and reconstruction activities.

In Bangladesh, the budget deficit deteriorated slightly to 4.5% of GDP in 2010. The fiscal situation is expected to deteriorate further in 2011 as the Government attempts to tackle a complex array of problems, ranging from shortages of power, gas and water to the need for enhanced welfare spending. The sectoral outlays of public expenditure in the fiscal year 2011 budget contain distinct inclusive features that aim to combat poverty, with one third of total outlays going to social infrastructure, including nearly one fourth for human development (health, education, science and technology, and other related subsectors).

In Sri Lanka, the budget deficit is estimated at 8% of GDP for 2010 as compared to the 2009 deficit of 9.9%. The improvement in the fiscal situation was helped by the considerable recovery in government revenue due to the expansion of economic activities

and through savings in government expenditure in certain areas, which was achieved while maintaining public investment at the targeted level. Further reductions in budget deficit are expected in 2011. Defence spending may fall with the improvement in the security situation, but infrastructure projects launched for reconstruction will keep capital spending high.

In Nepal, with growing tax revenues, the tax-to-GDP ratio has been improving and it stood at over 13% in 2010. The budget deficit fell from 5.0% in 2009 to 3.9% of GDP in 2010. Maldives, on the other hand, has been experiencing very high budget deficits in recent years. Some reduction in the budget deficit of 29.4% of GDP in 2009 was expected in 2010 due to an increase in revenue on account of higher import duties and tourism-related revenues associated with the economic recovery.

The Government of the Islamic Republic of Iran has been undertaking measures to strengthen its fiscal position. The system of indirect taxes is being modernized with the introduction of a value added tax and other measures to improve tax policy and administration. The parliament has approved a bill to increase energy prices and phase out subsidies on several other commodities and services. In Turkey, the budget deficit fell to 3.3% of GDP in 2010 from 5.5% of GDP in 2009, helped by indirect tax increases, the favourable impact of low global and domestic interest rates on borrowing costs and the rise in tax revenues resulting from a solid recovery in economic activity.

### Exports revive but imports grow more rapidly

In the wake of the global economic crisis, there were unprecedented falls in the merchandise exports and imports of all countries in the subregion. Both exports and imports started to pick up again in late 2009, but growth in imports has been faster than that in exports, leading to widened trade deficits. Large remittances from overseas workers are still growing, albeit at a slower rate; for Bangladesh,

growth is estimated at 13.4% in 2010 against 22.4% in 2009.<sup>21</sup> Growing worker remittances will help to contain the current account deficits that are expected to rise somewhat in the subregion (see figure 2.14).

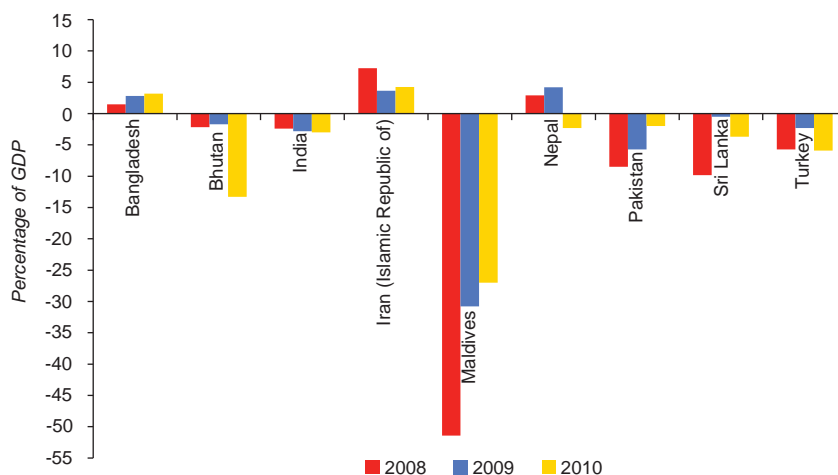
In India, exports and imports began to expand from October/November 2009 after a continuous decline for nearly a year. In fiscal year 2010, export growth exceeded import growth. Due to the significantly larger size of imports, however, the trade deficit widened. The net invisible surplus also shrank. As a result, the current account deficit could increase in 2010 to around 3.0% from 2.8% of GDP in the previous year. Financing of the current deficit was not a problem in 2009 due to stronger capital inflows, but capital inflows in the initial months of fiscal year 2010 moderated somewhat. Given the strong growth outlook of India, capital inflows are expected to accelerate in 2011. In theory, volatile capital flows can be a potential source of instability, as their costs can be alarming for an economy during periods when capital flows are either too small or too large unless they are managed judiciously. To deal with the adverse ramifications of capital flows, India has, in the past, used a mix of a flexible exchange rate, sterilization of the impact

of inflows on domestic liquidity, a cautious approach to the liberalization of the capital account and the cushion of its large foreign exchange reserves. This approach is expected to continue in 2011.

In Pakistan, the external current account deficit came down to 2.0% of GDP in 2010 from 5.7% of GDP in 2009. The improved performance in 2010 was helped by the relatively strong recovery of exports, which grew at 9.4% in 2010, while imports continued to contract, although at the much smaller rate of 0.3%. While the increase in exports was largely due to a higher quantum of goods, the fall in the import bill was mainly a result of lower prices. Overseas worker remittances grew by 14% and reached close to \$9 billion in 2010, helping to reduce the current account deficit. The financial account recorded a surplus, mainly due to disbursements by IMF under a standby arrangement. With the overall balance of payments in surplus, foreign exchange reserves reached an all-time high of about \$17 billion by the end of fiscal year 2010.

In Bangladesh, after witnessing a slump during the first half of fiscal year 2010, exports picked up in the second half of the year and registered an overall

Figure 2.14. Current account balance in selected South and South-West Asian economies, 2008-2010



Sources: ESCAP, based on national sources; and International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: Data for 2010 are estimates.

growth of 4.1% in the full fiscal year. While exports of jute goods, engineering and electronic goods, textiles and garments experienced an increase, exports of chemical products, frozen food and tea fell sharply. Total imports grew faster than exports, thus widening the trade deficit. Remittances from overseas workers continued to grow, albeit at a slower rate. They reached close to \$11 billion in 2010 and not only closed the gap on merchandise trade but also helped to post a surplus in the current account balance.

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*Remittances from overseas workers continued to grow, albeit at a slower rate*

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Foreign trade witnessed a sharp boost in Sri Lanka. While exports grew at a double-digit rate in 2010, import growth was even faster due to increased economic activity and infrastructure investment. Exports grew at 17.3% and imports at 32.4% in 2010. While the growth in exports of textiles and garments was relatively small, agricultural and manufactured goods registered strong growth. On the import side, growth was generally more broad-based, with consumer goods registering the highest growth rate. With recovery in tourism and continued strong worker remittances, the current account deficit was expected to stabilize around 4% of GDP in 2010. Foreign exchange reserves reached \$6.6 billion by end of the year

In Nepal, while exports contracted, imports grew at a faster rate in 2010, which led to a wider trade deficit. At the same time, growth in worker remittances slowed. As a result, the current account balance turned into a deficit in 2010 from the surplus of the previous few years. Obstacles in the movement of goods due to strikes, the deterioration of industrial relations and the uncertainty of energy supplies are factors that have been detrimental to export promotion. In Maldives, both exports and imports improved in 2010, the latter at a faster rate. As a result, the current account deficit remained high at about 27% of GDP in 2010. Foreign exchange

reserves, however, are expected to improve with enhanced private capital inflows supplemented by financial support from IMF.

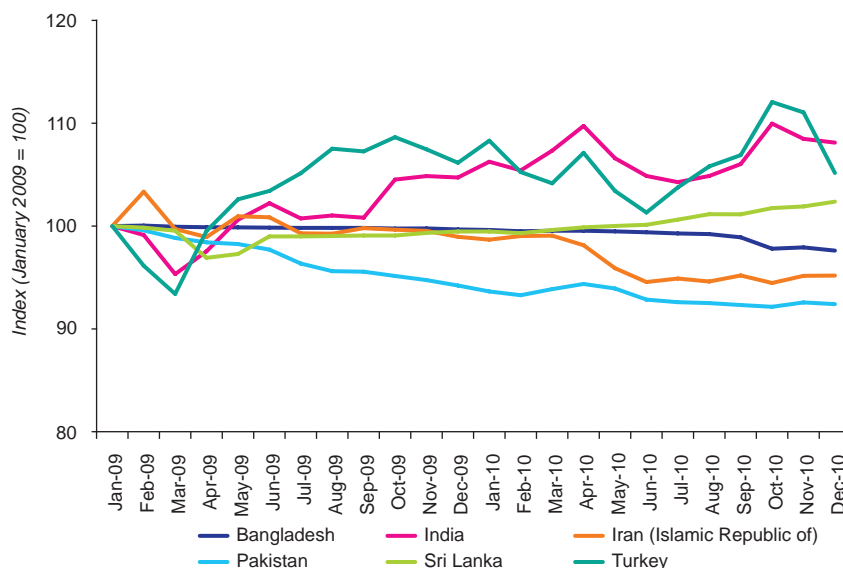
In Turkey, strong growth in imports widened the current account deficit from 2.3% of GDP in 2009 to 5.9% of GDP in 2010. Containing this external imbalance by avoiding a heavy dependence on potentially unstable external financing will be important for sustained economic recovery, given the uncertain global outlook. In contrast, due to higher oil prices, the current account surplus of the Islamic Republic of Iran is expected to widen in 2010 compared to 2009.

As in other subregions, some domestic currencies have appreciated against the dollar. With a strong growth outlook and continued capital inflows, the Indian rupee witnessed some fluctuations over the year but appreciated by about 2% between January and December 2010 but appreciating again in 2011 (see figure 2.15). The Sri Lanka rupee gained marginally while the taka of Bangladesh remained relatively stable over the same period. Deterioration in the macroeconomic aggregates of Pakistan, including higher inflation, contributed to continuous depreciation of the rupee. The Turkish lira fluctuated over the year but the average exchange rate between 2009 and 2010 remained relatively stable. Bhutan and Nepal have pegged their currencies to the Indian rupee and Maldives maintains a fixed exchange rate against the dollar.

### Future outlook and policy challenges

Amidst uncertainties surrounding global economic recovery, the subregion is nevertheless expected to maintain its growth momentum into 2011. India will lead this growth dynamism, with its economy projected to grow at 8.7% in fiscal year 2011, with private consumption and investment demand being the two major drivers of growth. In Bangladesh, projected GDP growth for 2011 at 6.4% is expected to be supported by improved growth in the agricultural sector, recovery in export growth with diversification into new markets, including the

**Figure 2.15.** Index of exchange rate movements of domestic currencies against the dollar in selected South and South-West Asian economies, 2009-2010



Source: ESCAP calculations based on data from International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: A positive trend represents appreciation and vice versa.

emerging economies, and an improved situation in power and gas supplies. With the end of the civil war in Sri Lanka, reconstruction activities in the war-torn areas and enhanced tourist arrivals are expected to provide a further boost to economic growth, which should reach 8% in 2011. Damage caused by severe floods in the country in the first quarter of 2011 could have dampening effect on growth, though. In Nepal, GDP is projected to grow at 4% in 2011, somewhat higher than the 2010 rate. Economic revival in the country hinges in large part on the ability of the government to improve law and order, as Nepal's poor security and political instability limit the government's capacity to spend money and boost rural incomes. Devastation caused by severe floods in Pakistan has dampened its immediate growth prospects and GDP growth is expected to fall to 2.8% in 2011. Reconstruction activities should provide some support in achieving even this low growth. A firming of oil prices may help the Islamic Republic of Iran to improve its growth rate in 2011. The current draft of the Fifth Five-Year Development Plan, covering the period of 2011/12-2015/16,

puts forward ambitious macroeconomic objectives, including 8% GDP growth and a comprehensive structural reform agenda. Turkey, which has strong economic ties with European Union countries, may face a slowdown in GDP growth to 5.0% in 2011 as external demand softens.

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*High inflation rates in the subregion can compromise the achievement of sustained high growth rates*

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High inflation rates in the subregion can compromise the achievement of sustained high growth rates. Containing inflationary pressures should therefore be a priority in the policy agenda of governments. Both demand- and supply-side factors have contributed to inflationary pressures in the subregion. High budget deficits in most countries have been instrumental in increasing liquidity and have generated price pressures in the face of supply constraints. There is an urgent need to bring budget deficits down to a

more sustainable level. Some countries have been tightening monetary policy to alleviate pressures on inflation from the demand side but a combination of monetary, fiscal and other measures is needed to reduce price pressures in the subregion (see box 2.3). Repeated supply shocks pose a constant challenge to sustaining a low inflation regime. A more medium-term approach is needed in order to augment the supply of items of mass consumption by addressing structural supply constraints. Moreover, food prices are, in part, being driven by structural imbalances between demand and supply as, for instance, increasingly affluent consumers diversify their dietary patterns away from cereals towards protein sources, which calls for an effort to increase the supply of such items rapidly. The success of this effort will largely determine the longer-term outlook for food price inflation.

Strong and sustained growth momentum is needed in the subregion to tackle the long-term problem of widespread poverty. Over the past few years, most countries have made progress in reducing poverty. Even today, however, at least one in every three persons in South Asia is classified as poor. The fight against poverty therefore must continue. Countries need to continue pursuing economic reforms to improve productivity, strengthen public institutions, improve economic governance, and build social safety nets to protect the more vulnerable segments of the population. To promote more inclusive growth, the provision of basic services such as health and education and the generation of ample employment opportunities should remain the principal priority in the policy agenda of the governments. Growth cannot be sustained in the long run if it is not inclusive.

Remittances from overseas workers are quite large and play an important role in the economies of South Asian countries. A large number of South Asian workers (more than 5 million, most of whom are unskilled or low-skilled) are employed in oil-rich Middle Eastern countries. Despite the global economic crisis, remittances from these countries have been growing in recent years, although the

rate of growth is slowing. One of the main issues that should be addressed is the transfer of these remittances through informal channels. To take full advantage of these resources, policymakers need to take steps to promote the use of formal channels by lowering their transaction costs. There is also need to create a commission that can present a united stance of countries in the subregion to oversee migration and enhance its positive aspects.<sup>22</sup> The South Asian Commission can help in protecting workers' rights and enhancing their social protection. The Commission can also work to ensure that the workers' remittances and their savings when they return can be invested in productive areas. The South Asian countries need to provide a diverse pool of investment and savings options for this purpose.

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*To promote more inclusive growth, the provision of basic services such as health and education and the generation of ample employment opportunities should remain the principal priority in the policy agenda of the governments*

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On the physical infrastructure side, one of the biggest challenges being faced by several countries is improving the electricity supply. Electricity supply disruptions are common in Bangladesh, Nepal and Pakistan. Electricity outages that last many hours have been affecting productivity in all sectors of these economies. Businesses and even households use small electricity generators, operated on imported fuel, to meet their electricity needs. This raises the cost of production, which leads to higher inflation and adds to the import bill. Exports from these countries are also being affected due to high production costs and low outputs. Disruptions in the electricity supply are adversely affecting both the quality of life and the development of human capital. Without addressing the severe electricity problem, the full potential of economic growth in some of these countries cannot be realized.

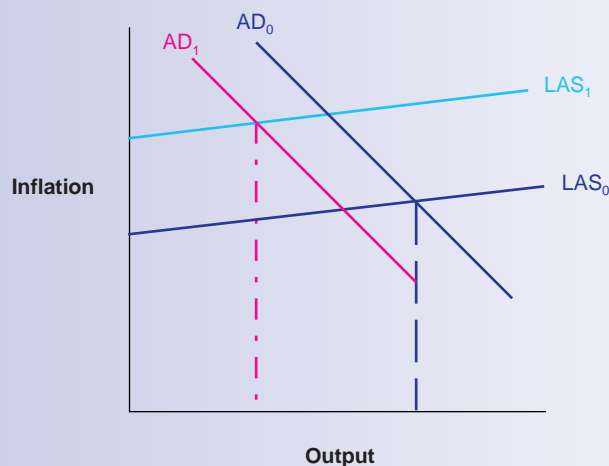
### Box 2.3. Some policy options to contain inflationary pressures in South Asia<sup>23</sup>

Spikes in food and fuel prices in 2008 caused inflation rates to increase in most Asian countries. With the onset of the global financial crisis in 2008/09, however, price pressures subsided rapidly across the region, except in South Asia. Indeed, India and Pakistan are experiencing double-digit inflation driven mainly by food. Given the high incidence of poverty in the region, higher food and overall inflation rates disproportionately affect the poor. Moreover, because of the large share of food in the average household consumption budget, a sustained rise in food prices tends to put upward pressure on wages and, with a time lag, on general inflation.

#### Causative factors of inflation

An analytical and empirical examination of the causative factors of inflation can be divided broadly into two categories, demand and supply. The analysis shows that demand components have tended to fluctuate with output levels and growth rates but they have not been major independent sources of price shocks. The major sources of price volatility have been from the supply side. Although longer-run aggregate supply in South Asian countries is elastic given youthful populations in transition to more productive occupations, it is subject to frequent negative supply shocks (see figure). Demand contractions tend to amplify these shocks. South Asian economies are supply constrained in the sense that, while output is largely determined by demand, inefficiencies on the supply side tend to perpetuate inflation by creating shortages of goods and services from time to time.

Figure. Aggregate demand and supply



With a supply shock, the aggregate supply curve in the figure shifts upward, leading to higher inflation. If, in response, a demand contraction shifts the aggregate demand curve downward, this reduces inflation only marginally and at a high cost in terms of output lost. Therefore, the use of restrictive demand-side policies to tackle inflation when its causes are primarily on the supply side may not help much in reducing overall inflationary pressures. Both formal econometric tests and analysis of shock episodes based on Indian data support this analysis.

In South Asia, the food price-wage cycle is an important mechanism for propagating price shocks and creating inflationary expectations in response to a supply shock, which acts as an inflation trigger. The political economy of farm price support, consumption subsidies and wage support, with built-in waste, inefficiencies and corruption, contributes to chronic cost-push

**Box 2.3** *(continued)*

pressures. Poor targeting of consumption subsidies implies nominal wages rising with a time lag, pushing up costs and generating second-round inflationary pressures from a temporary supply shock.

The political economy of the subregion informally indexes wages with food price inflation. If the rise in average wages exceeds that of agricultural productivity, however, prices of food will inevitably go up, propagating more generalized inflation. Populist policies that provide short-term subsidies but raise indirect costs also contribute to cost-push pressures. For example, neglected infrastructure and poor public services increase overall costs in the economy. The power shortages from which most South Asian countries suffer are a case in point.

Virtually all countries in the subregion have shifted to more flexible exchange rates that are managed to varying degrees. Bangladesh and Sri Lanka avoided significant exchange rate depreciation during the global crisis and their inflation rates dropped into the low single digits in 2009. Elsewhere, however, food inflation has remained high. These differential outcomes indicate a more strategic use of exchange rates in anti-inflation policy.

**Policy options**

Once the nature and structure of shocks and elasticities of aggregate demand and supply are identified, certain policy implications follow: a shift down the supply curve in response to a supply shock; avoidance of an excessively large demand contraction; and the identification and removal of propagation mechanisms. Above all, a hasty tightening of monetary policy will, in all likelihood, involve a large output cost with little effect on inflation.

*Temporary shocks*

Mild but early monetary tightening after a supply shock can prevent inflationary wage expectations from becoming entrenched and further pushing up the supply curve. Given this, a first-round price increase from a supply shock might be allowed, but a second-round wage-price increase should be prevented inasmuch as possible. A nominal appreciation of the exchange rate can serve to push down the supply curve.

Short-term fiscal policies to push down the supply curve include tax and tariff cuts and freer imports. These policies can also lower inflationary expectations. Trade policy works best for individual country shocks that are not globally correlated. Nimble private trade can defeat speculative hoarders. It should be stressed that short-run policies are likely to work only for a temporary shock. A long-lasting shock requires a longer-term productivity response.

*Preventing chronic cost-push*

Food prices play a central role in propagation mechanisms since they raise nominal wages with a time lag. A fundamental reason for chronic supply-side inflation is that real wages tend to exceed labour productivity. The solution is to raise labour productivity, especially in agriculture.

Following liberalization, as farm produce has become part of the wider traded economy, border prices have begun to affect domestic food prices. In such a situation, the exchange rate can affect food prices and overall inflation. Conflict between a depreciated exchange rate to encourage exports and an appreciated exchange rate to increase real wages can contribute to a wage-price cycle, with depreciation raising nominal wages and prices and leading to real appreciation. Attempts to dampen exchange rate appreciation sustain the cycle. Only improvements in productivity can close the demand-supply gap and break this inflation propagation mechanism.

**Box 2.3** *(continued)*

Capital inflows will tend to appreciate the exchange rate, thus satisfying the wage target, and finance the accompanying rise in imports. But a widening current account deficit is risky even though it might allow gross investment to exceed domestic savings. It would be preferable to set a sustainable current account deficit and meet it by raising productivity in the economy. Rising productivity increases the level of capital inflows that can be safely absorbed at a reasonable current account deficit. In this regard, better governance and improved delivery of public services improve productivity in the economy and, within the corpus of governance, reform of food policy is especially urgent given the economy-wide impact of food inflation.

*Governance in food policy*

Developing East Asian countries with large food components in household budgets have successfully moderated food inflation by focusing on raising agricultural productivity. India moved early to agricultural subsidies together with implicit taxes generated through the imposition of restrictions on different activities within the agricultural sector, including public distribution schemes. Procurement prices were raised with the rise in border prices but did not fall with them, thus imparting generalized cost-push pressures in the economy and creating unnecessarily large food stocks in costly and dysfunctional food support programmes. If

the procurement price becomes a true support price, food stocks should come down in a bad agricultural season when market prices rise and go up as market prices fall in a good year. Through such a policy, farmers would receive some assured income support even as a removal of restrictions on the movement and marketing of agricultural goods and better infrastructure allowed them to diversify their crops.

With lower average stocks, the public distribution scheme should focus more on remote, inaccessible areas. Food coupons or cash transfers directed primarily to female members of households can provide food security to the poor while allowing them to diversify their food consumption basket. Since the income elasticity of demand for food is still high, more moderate nominal price increases could serve to incentivize higher agricultural output and income growth.

Political jostling when deciding on food policy, in general, and procurement prices, in particular, ignores their negative long-term effects. Poor coordination means that multiple agencies do not factor in each other's costs or consider the wider picture. Until thorough food policy reform occurs, a possible nominal appreciation of the nominal exchange rate can prevent a sharp rise in border prices from triggering multiple interest group actions resulting in complex domestic distortions.

*International*

Emerging markets must find non-distortionary ways to respond to spikes in food and commodity prices. Large global spikes imply distortions beyond supply shocks, which should be prevented. Policies that are driving up prices across all asset categories, such as excessive liquidity creation in some of the developed countries that is directing large funds into commodities, might be re-examined at a subregional or regional level and its impact modified through some form of collective action.

Futures markets help output planning through better information on future demand and supply and the hedging of risk, but any overreaction implies that prices in financial markets do not reflect their real determinants. The answer is not to ban such markets but to improve their working and regulation. Progressive convergence towards common global regulatory standards can prevent arbitrage. Participation by more diverse groups in commodity trading could be encouraged within a framework of rules that discourage market abuses and thereby limit volatility.

*Source:* ESCAP.

Both short-term and long-term measures are needed to tackle the electricity problem. To boost electricity supply in the short term, Bangladesh and Pakistan are implementing rental power projects, where the private sector quickly installs small thermal power generation units and sells electricity to the government. This is clearly an expensive stop-gap option and, in the long term, much greater attention would need to be paid to renewable sources of energy. It is useful to note that the Government of Bangladesh plans to generate 5% of its total electricity from renewable energy sources by 2015 and 10% by 2020. In the subregion, transmission and distribution losses vary from 20% to 40% in different countries and theft of electricity is a major problem. There is therefore a need for greater efficiency on both the generation and distribution sides.

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*Promotion of regional cooperation in the energy sector can benefit the participating countries enormously*

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Concerning electricity pricing, some countries have been providing substantial subsidies, but they are being withdrawn. This process has been raising the cost of living, though, and there is a need to provide some form of protection to the poor. Tariff rates somehow need to be kept affordable for small consumers. It is also worth considering a more targeted approach to providing subsidies following the pattern of food stamps, where electricity stamps or coupons can be given to the poor to pay their electricity bills.

Finally, the promotion of regional cooperation in the energy sector can benefit the participating countries enormously. The signing of a gas pipeline project in December 2010 by Afghanistan, India, Pakistan and Turkmenistan will bring 3.2 billion cubic feet of natural gas per day from Turkmenistan to Pakistan and India via Afghanistan. Along with economic benefits, this project should contribute to peace and stability in the region.

## SOUTH-EAST ASIA

### Growth remains robust despite some cooling off

In 2009, South-East Asia posted a mere 1% GDP growth. With the recovery in global trade and boosted by bold stimulus packages, however, GDP growth steadily improved over the second half of 2009 and reached its peak in the first half of 2010, when such countries as Singapore and Thailand grew by over 10%. Due to a lower base effect and weaker demand for exports, growth decelerated in the second half of the year. Nevertheless, domestic demand remained robust and the 11 South-East Asian economies grew by an estimated 8.1%, on average, in 2010 (see table 2.5).

After three years of weak growth and contraction, Brunei Darussalam saw its economy expand by 2.0% in 2010, supported by small increases in oil and gas production, which accounts for some 50% of real GDP, 95% of total exports and 90% of government revenue. Stronger economic expansion from higher global oil and gas prices should be taken as an opportunity to accelerate investment in the non-energy sector, which remained subdued despite fiscal stimulus measures. Some early progress was seen with a new methanol plant in 2010.

One of the hardest hit economies in 2009, Cambodia, benefited from a rapid recovery in tourism, a modest rebound in garment exports and higher agricultural output in 2010, when the economy expanded by 6.0%. The construction sector, however, which contracted by some 40% in 2009, remained subdued due to delays in major property projects. Government efforts to strengthen trade ties with neighbouring Asian countries need to be accelerated, as a narrow export base with heavy reliance on the markets of developed countries in the West poses significant risks. Export items could also be diversified into areas of comparative advantage, including rice, footwear and low-end electronics. The rice harvest, for instance, was reported to have reached nearly 8 million tons in 2010, but suffered from a shortage of processing facilities.

**Table 2.5. Rates of economic growth and inflation in South-East Asian economies, 2009-2011***(Percentage)*

	Real GDP growth			Inflation <sup>a</sup>		
	2009	2010 <sup>b</sup>	2011 <sup>c</sup>	2009	2010 <sup>b</sup>	2011 <sup>c</sup>
<b>South-East Asia<sup>d</sup></b>	<b>1.0</b>	<b>8.1</b>	<b>5.5</b>	<b>2.3</b>	<b>4.0</b>	<b>4.8</b>
Brunei Darussalam	-1.8	2.0	1.7	1.8	1.8	2.1
Cambodia	-2.0	6.0	6.2	-0.7	4.1	6.0
Indonesia	4.5	6.1	6.5	4.8	5.1	6.2
Lao People's Democratic Republic	7.6	8.0	8.3	0.0	5.4	6.1
Malaysia	-1.7	7.2	5.2	0.6	1.7	3.0
Myanmar	4.9	5.5	5.8	8.0	7.9	9.1
Philippines	1.1	7.3	5.2	3.2	3.8	4.5
Singapore	-0.8	14.5	5.0	0.6	2.8	3.3
Thailand	-2.2	7.8	4.5	-0.8	3.3	3.5
Timor-Leste	11.6	7.9	8.2	0.7	6.5	7.5
Viet Nam	5.3	6.8	6.2	6.9	9.0	11.0

Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 25 March 2011).

<sup>a</sup> Changes in the consumer price index.

<sup>b</sup> Estimates.

<sup>c</sup> Forecasts (as of 8 April 2011).

<sup>d</sup> GDP figures at market prices in dollars in 2009 (at 2000 prices) are used as weights to calculate the subregional growth rates.

Indonesia, with its large domestic market, was among the fastest growing major economies in 2009 at 4.5% and grew even faster, by 6.1%, in 2010. The economy benefited from continued strength in household consumption, robust exports and improving investment. Private consumption was supported by the availability of consumer financing and low household debt and mounting consumer optimism. Meanwhile, investment benefited from a recovery in lending to the private sector as well as increased FDI inflows. On the production side, the services sector, including retail and telecommunications, saw a sharp rebound compared to the more modest and steady recovery in industry. Overall confidence in the economy also increased, as reflected in the credit rating upgrades. Strong capital inflows and rising commodity prices, if well managed, should provide additional resources to narrow the social and infrastructure gaps.

The Lao People's Democratic Republic has been enjoying steady growth in recent years, with most of its trade done with neighbouring China, Thailand and Viet Nam. The economy, which expanded

by 8.0% in 2010, received a boost from a surge in the global price of minerals, especially gold and copper, which together account for over half of export earnings, and from a new hydropower facility which began to operate in March. These developments, in turn, helped to attract further inflows of private investment and donor aid. As the only landlocked country in the subregion, the Lao People's Democratic Republic stands to gain from rising intraregional trade as a "land-linking" country, but customs modernization and upgrading of railways need to be accelerated.

After contracting in 2009, the economy of Malaysia expanded by 7.2% in 2010, with double-digit growth in exports and manufacturing in the first half of the year. Amid concerns over currency appreciation and weak demand from the United States, growth clearly moderated in the second half. Private consumption remained strong, however, and on the supply side, services continued to grow robustly, bolstered by retail trading as well as financial and insurance activities. Expenditure on machinery and equipment also picked up. Gross

domestic investment, however, remains low at some 20% of GDP, behind other major economies in the subregion. This is a key challenge for Malaysia, and implementation of structural reforms as envisioned in the Government's New Economic Model will be vital for its future growth.

Myanmar saw its economy slow down sharply in 2009, but with new foreign investments in oil and gas, electric power and mining, growth picked up again and reached 5.5% in 2010. It was reported that FDI, mostly from Asia, reached a record \$16 billion in the first 11 months of 2010.<sup>24</sup> A special economic zone law was enacted in January 2011 in a bid to attract more foreign capital. Plans are also under way to promote tourism and to expand banking, telecommunications, shipping and agriculture. Nevertheless, the overall domestic economy still suffers from restrictive measures, such as licensing, which pose barriers to the agricultural and manufacturing sectors in gaining access to inputs and equipment.

After a modest 1.1% growth in 2009, the Philippines benefited from a revival of exports and manufacturing, especially in electronic goods, which account for over 60% of its export earnings. The economy exceeded expectations with a 7.3% growth in 2010, despite adverse weather conditions hitting the agricultural sector and rice production hard. Private consumption, which accounts for over 70% of GDP, received a boost from strong remittance inflows and pre-election spending as well as an accommodative monetary policy. Early progress in the new administration's efforts to improve the fiscal balance has also led to improved investor perceptions. The business process outsourcing industry also continued to grow rapidly. Gross domestic investment remains among the lowest in the subregion, however, and greater efforts are needed to improve the business environment and basic infrastructure.

Singapore, one of the most open economies in the world, was also one of the fastest growing in 2010 at 14.5% after contracting by 0.8% in 2009. A sharp revival in exports led to over 40%

growth in manufacturing in the first half of 2010 and this, in turn, had positive effects on the large services sector, including wholesale trade, transport and financial services. Industry growth markedly decelerated in the third quarter but bounced back in the fourth quarter, led by the biomedical industry. Singapore continues to rank at the top in terms of competitiveness and enjoys prudent macroeconomic management. The Government plans to focus more on productivity growth, for example by strengthening human capital development.

Thailand, which suffered a 2.2% contraction in 2009, grew robustly by 7.8% in 2010. The economy benefited from a revival in merchandise exports and decisive policy responses, including a record low policy rate and an estimated fiscal stimulus of 3% of GDP.<sup>25</sup> There was a minor bit of a time lag, but private consumption and investment eventually began to expand from the second quarter and remained robust despite the political instability in May. Services were hit hard, however, albeit temporarily, with hotels and restaurants posting a sharp drop. Growth decelerated in the third quarter, owing to slowing demand for exports and a drop in agricultural production due to bad weather and plant diseases. The economy picked up again in the fourth quarter owing to the continued strong performance of the major trading partners in Asia and a steady high level of future orders for key exports items.

Boosted by oil revenues, the economy of Timor-Leste has been growing steadily in recent years and expanded by 7.9% in 2010. Public spending accounts for about half of non-oil and gas GDP and plays a critical role in effectively spreading the benefit of its petroleum wealth to the wider population. The national oil fund was reported to stand at about \$7 billion. Sound management of the fund will be important in achieving the national development plan, which envisions sharp reductions in the poverty rate.

Viet Nam, which came out strongly in 2009 with 5.3% growth, continued to expand at a faster pace

throughout 2010 amid concerns about the economy overheating. Manufacturing benefited from the global recovery in demand for exports but also from the growing domestic consumer market. Production of garments, shoes, motorcycles, refrigerators and air conditioners all grew at a rapid pace, while the value of retail sales expanded by 24.5% for the full year. With high inflation, however, there are clear signs of overheating. Large public sector-led investments in the areas of transportation and industry and trade, while contributing much to economic growth, have also resulted in fiscal deterioration and raised questions over the quality of investments. The economy grew by 6.8% in 2010 but could benefit more if accompanied by macroeconomic stability, which would further boost business confidence.

### Price stability remains vital to rising confidence

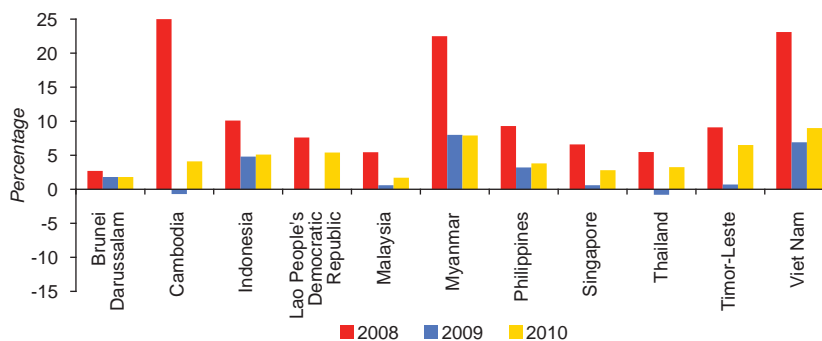
With the narrowing of output gaps, inflation picked up across the subregion, but at an overall modest and manageable rate (see figure 2.16). Inflation is not the primary challenge for South-East Asia at the moment, except in Viet Nam. There is no doubt, however, that buoyant domestic demand and rising consumer and investor confidence were possible because of price stability. Moreover, given that several countries in the subregion have recent histories of

high inflation,<sup>26</sup> it is possible that confidence could be easily affected even by signs of its modest resurgence. As such, any risk factors should be carefully monitored and necessary actions taken in a timely manner.

Driven by a credit expansion boom, inflation in Viet Nam was at 28.3% as recently as mid-2008. After moderating to 6.9% in 2009, prices began to climb up again to reach an average 9.0% in 2010, with the December figure hitting a 22-month high at 11.9%. Inflationary pressure is also rising in Indonesia amid surging food prices and rises in transportation costs. Inflation in December 2010 reached around 7.0%, although the average for the year was 5.1%. Food commodities, in particular rice, dominate the list of commodities contributing most to inflation. Rise in electricity tariffs have also led to some upward pressure. Inflation in Malaysia is among the lowest in the subregion, but the phasing out of price controls and subsidies could result in upward pressure in 2011.

After experiencing relative stability in 2009, food prices increased across the subregion in 2010, partly due to lower agricultural output caused by adverse weather conditions. Food accounts for a large portion of consumption in low-income households, and governments should be vigilant against a possible resurgence of food price pressure hikes. In the

Figure 2.16. Inflation in South-East Asian economies, 2008-2010



Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 25 March 2011).

Note: Data for 2010 are estimates..

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*After experiencing relative stability in 2009, food prices increased across the subregion in 2010*

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Philippines, the Government was able to alleviate upward pressure on food prices by supplementing national stocks with a record 2.45 million tons of rice imports in 2010. The Indonesian Government is also beginning to scale up rice imports. Rice import duties were suspended in January 2011 in a bid to boost rice stockpiles to 2 million tons from 1.5 million tons.<sup>27</sup> In contrast, prices of foodstuffs rose in Myanmar when the Government closed the border-trade checkpoint with Thailand. High inflation in the Lao People's Democratic Republic was also affected by high food prices, in addition to strong money supply growth fuelled by foreign investment in the extractive sector.

In several economies, the steady appreciation of local currencies since mid-2009 has helped to contain imported inflation, including in commodities. In contrast, Viet Nam has been more vulnerable to imported inflation due to their weak currencies and wide current account deficits. Viet Nam risked further inflation by devaluing its currency twice in 2010 and again in February 2011.

### **Fiscal and monetary policies remain supportive of growth**

#### *Fiscal policy*

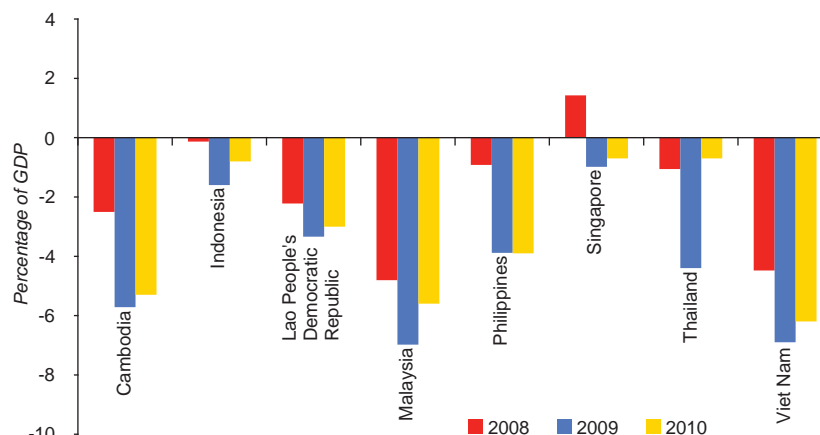
The South-East Asian countries at large were able to implement bold stimulus packages through 2009 and much of 2010, thanks to healthy fiscal balance sheets. Such measures were vital in supporting domestic demand in the face of external demand shocks. A number of countries, including Malaysia and Thailand, introduced a second stimulus package following the initial one launched in early 2009. As the recovery became more entrenched, several countries started a gradual exit from policy support in 2010, although in some cases, it was postponed

until 2011. In addition, such countries as Indonesia and the Philippines are aiming to front-load public expenditure in 2011, as their economies in the first half of the year are generally expected to be more sluggish than in the second half, when exports and manufacturing activities are expected to bounce back.

Even with recent fiscal expansions, fiscal positions remain relatively sound in most countries, and deficits narrowed as economic expansion led by the private sector set in (see figure 2.17). Nevertheless, efforts have been under way to rebuild the buffers for future crises and, moreover, to create fiscal space to finance growing social programmes and address infrastructure gaps. Some countries are also pushing for fiscal consolidation to further reduce public debt. To this end, most Governments included in their 2011 budget plans to strengthen the tax administration and, in some cases, to increase taxes and/or introduce new taxes.

In addition, a number of countries have plans to reorient public expenditure away from poorly targeted subsidies and tax breaks to a more direct delivery of education, health and anti-poverty programmes. The implementation of such plans will require not only strong political will, however, but also capacity-building of the civil service.

Thailand's large fiscal support programme known as "Strong Thailand (TKK)" focuses on infrastructure, agriculture, education and health. It is estimated to have added some 2.3 percentage points to economic growth in 2010 and is expected to continue to contribute to growth in 2011.<sup>28</sup> To finance such programmes, the Government may need to cut down on a number of tax breaks and allowances, particularly those favouring the relatively wealthy. With a view to boosting its competitiveness and balancing its budget by 2020, Malaysia is gradually reducing its subsidy bills, starting with sugar and energy, and reviewing all areas of government expenditure to prevent waste from inefficiency. In an effort to widen its tax base,<sup>29</sup> it further plans to gradually implement a value added tax.

**Figure 2.17. Budget balance in selected South-East Asian economies, 2008-2010**

Sources: ESCAP, based on national sources; and CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 16 February 2011).

Note: Data for 2010 are estimates.

In the Philippines, government efforts to rein in tax evasion saw early progress in the second half of 2010. Government revenue is still low as a proportion of GDP and it may be necessary to introduce new taxes to boost revenues and continue making progress in reducing public debt, which is still above 50% of GDP. The Government also introduced plans to rationalize spending by cutting down on inefficient programmes and instead putting in place a larger conditional cash transfer programme. Indonesia has successfully reduced its public external debt to below 30% of GDP from almost 90% in the past decade. The fiscal deficit is also gradually narrowing to near balance, making it cheaper for the Government to raise funds. In 2010, it began to take steps to reduce the subsidy bill, which took up 4% of GDP, on average, from 2007 to 2009. The Government has also proposed boosting capital expenditure to finance infrastructure development and continue pro-poor social programmes.

Viet Nam has the highest fiscal deficit in the subregion and a growing public debt, which now exceeds 50% of GDP. Much of this debt can be attributed to economic growth, which is largely

driven by public investment that is often channelled through inefficient State-owned enterprises in need of streamlining. These enterprises account for some 40% of GDP, and questions about their solvency led to a credit downgrade at the end of 2010. The Government aims to reduce its fiscal deficit from some 6.2% of GDP in 2010 to 4.5% by 2015. In Cambodia, the Government introduced a tax on property and doubled the road tax on vehicles. The Lao People's Democratic Republic has also been more proactive in its revenue-raising efforts, with the VAT reinstated in January 2010 and plans for taxes on land and inheritances. In addition, the new hydropower dam is expected to contribute significantly to the national budget. There are no timely fiscal data on Myanmar, but it is likely that the country is continuing to run a large fiscal deficit.

### *Monetary policy and financial markets*

The aggressive easing of monetary policy through lowered policy interest rates and bank reserve requirements was also vital in sustaining domestic demand amid external demand shocks. As output gaps narrow, inflationary pressures have returned

and the focus of monetary policy has largely been refocused on maintaining price stability even as authorities are careful not to disrupt the recovery amid uncertainties in the global economy. Simultaneously, major economies in the subregion are facing massive capital inflows resulting in a surge in equity and property prices, with most stock markets in the subregion reaching record levels in 2010.

In response to the faster- and stronger-than-expected recovery, Malaysia quickly raised its policy rate three times between March and July 2010, by a total of 75 basis points. Thailand also raised its policy rate five times between July 2010 and March 2011 by a total 125 basis points. Further tightening could take place, but with concerns in both countries that further increases in interest rates could attract even greater foreign capital inflows and that growth in the key export markets remains subdued, there will need to be a careful balancing act in this area. Meanwhile, Singapore has allowed a gradual rise in the nominal effective exchange rate to curb inflationary pressure.

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*Boosted by strong foreign capital inflows, South-East Asian stock exchanges were among the best performers in the Asia-Pacific region in 2010*

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Indonesia and the Philippines, on the other hand, kept policy interest rates unchanged through 2010 at record low levels. In Indonesia, bank reserve requirements were raised from 5% to 8% in November 2010, but the policy rate remained at 6.5% until February 2011, when a 25 basis point hike took place amid concerns over rising inflation. To encourage banks with sufficient reserves to continue lending, including to micro-, small and medium-sized enterprises, banks with loan-deposit ratios below 78% face a penalty beginning in March 2011. In the Philippines, the policy interest rate remained unchanged, but other measures to increase credit flow, such as lower bank reserve requirements, were rolled back at the beginning of 2010. In Viet Nam, despite signs of

excessive credit in the economy, the base interest rate was left unchanged through most of 2010. As inflationary pressure mounted, however, strong policy measures were introduced between November 2010 and March 2011, including significant hikes in the refinancing and discount rates.

Boosted by strong foreign capital inflows, South-East Asian stock exchanges were among the best performers in the Asia-Pacific region in 2010. Indonesia's stock market surged 46%, Thailand was up 41%, the Philippines 38% and Malaysia 19%. Singapore's Straits Times Index gained 10%. In January 2011, however, stocks dropped in major stock markets as capital outflows led to a weaker baht in Thailand and fear of rising inflation led to a sell-off in Indonesia. Meanwhile, Viet Nam did not benefit from strong capital inflows in 2010 due to such risk factors as declining foreign exchange reserves, high inflation and a weak currency. In the Lao Peoples Democratic Republic, the first stock exchange began to operate in January 2011, initially with two State-owned companies listed. Similarly, Cambodia is expected to launch its first stock exchange in July 2011.

### **External sector poised for rebalancing, with strong currencies and intraregional trade**

#### ***Current account balances***

Most countries in South-East Asia used to have current account deficits until the Asian financial crisis resulted in a turnaround in surpluses and sharp declines in investment rates (while savings rates remained roughly the same). Due to their high reliance on exports, however, countries suffered more from the recent fluctuation in global demand, which has led to renewed interest among policy-makers in rebalancing strategies geared toward boosting domestic demand, both consumption and investment.

There is early evidence that rebalancing is taking place in South-East Asia in the post-crisis period.

Current account surpluses narrowed, on average, in 2010, owing to a faster rise in imports supported by robust domestic demand as well as recovery in exports requiring imported inputs. At the same time, gross domestic investment is also rising or is expected to rise due to brighter economic prospects, increased public infrastructure spending and capital inflows.

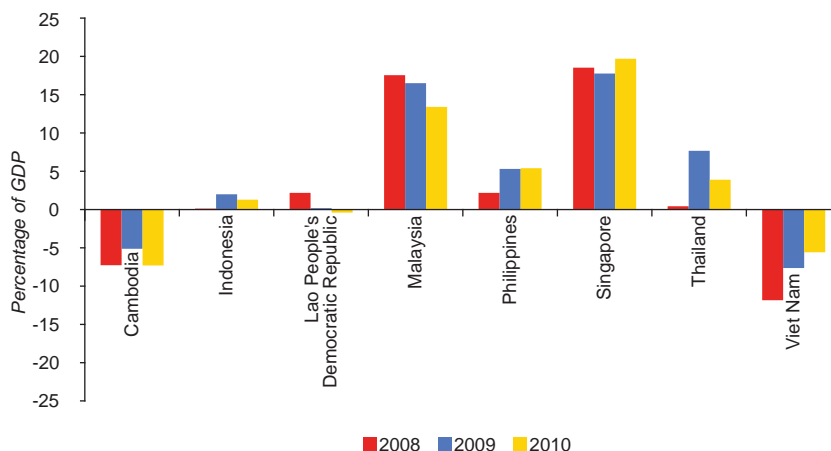
Malaysia and Singapore continued to post large current account surpluses of over 13% of GDP, while the Philippines and Thailand maintained surpluses at more modest levels in 2010 (see figure 2.18). Thailand saw its current account surplus cut by half from 2009, due to strong domestic demand and input demand for electronics and vehicle exports. As for the Philippines, merchandise trade was in deficit but there was a large surplus in services from overseas worker remittances. Indonesia saw its trade surplus rise in 2010, but with rapidly growing imports driven by a large and buoyant domestic market, the current account balance may turn negative within a few years.

On the other end of the spectrum, Cambodia and Viet Nam continued to post large current account

deficits in 2010, while the Lao People's Democratic Republic recorded more modest deficit. Viet Nam's trade deficit rose slightly from 2009 levels, despite the fact that the dong was devalued twice in 2010. In Myanmar, major foreign investment projects rapidly increased capital imports in 2010, so the current account was likely to be in deficit.

Broader trends affecting South-East Asian exports are sluggish demand in the developed countries, offset by rising demand from China and India. This holds true even after taking into account that a bulk of the electronic parts and components are eventually re-exported from China to the United States and Europe. In particular, under the Association of Southeast Asian Nations (ASEAN)-China free trade agreement, which came into effect in January 2010, South-East Asian countries are likely to see an increase in raw materials, food and natural resource-based exports to China. There are also concerns, however, that cheaper manufacturing goods from China will threaten the development of domestic industries in the subregion. What has received less attention is the rising trade with India, which actually ran a larger trade deficit than China with the six largest South-East Asian economies<sup>30</sup>

Figure 2.18. Current account balance in selected South-East Asian economies, 2008-2010



Sources: ESCAP, based on national sources; and International Monetary Fund, International Financial Statistics online database. Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: Data for 2010 are estimates.

in 2009.<sup>31</sup> While China's total trade with South-East Asia is almost five times that of India's, given India's rapidly expanding economy, the country will increasingly become a key source of export growth for South-East Asia. Finally, intra-ASEAN trade is continuing to rise rapidly. Trade cooperation among Cambodia, the Lao Peoples Democratic Republic and Viet Nam is also increasing.

### *Capital flows and foreign reserves*

In some countries, measures were also taken to limit exposure to short-term foreign capital, which flooded the domestic equity, bond and property markets. Indonesia introduced restrictions on foreign purchases of short-term bonds issued by the central bank in June 2010, followed by additional measures to slow the currency appreciation introduced in December 2010. Similarly, Thailand reinstated a tax on foreign investors' capital gains and interest from bonds issued by the Government, State-owned enterprises and the central bank in October 2010. It is more difficult, however, to curb the flows into equities, and regional stock exchanges are expected to see further, albeit smaller, rises in 2011, not least due to the second round of quantitative easing in the United States.

After suffering a decline in 2009, FDI is also returning to South-East Asia. In Indonesia, FDI inflows more than doubled to \$12.8 billion in 2010 from \$4.9 billion in 2009, while Malaysia saw a rise from \$1.4 billion to \$7 billion over the same period. In fact, in a sign of resilience, its share of global FDI actually increased from 2.8% in 2008 to 3.6% in 2009, even as the amount itself was down during the global economic crisis.<sup>32</sup> In 2009, countries in the subregion received about \$40 billion in FDI, with approximately half of it coming from OECD countries. South-East Asia is enjoying a rise in South-South investment, with intra-ASEAN direct investment becoming more prominent in recent years and China also becoming an important source of investment as observed in chapter 1.

Official development assistance (ODA) remains important for the least developed countries in the

subregion, which benefit less from private capital inflows than the emerging market economies. In 2008, ODA was equivalent to about 16% of GDP in Timor-Leste and about 9% in Cambodia and the Lao People's Democratic Republic. ODA to Myanmar doubled after Cyclone Nargis in 2008 to around 2% of GDP, but it is still relatively low compared to the amount received by other least developed countries. Although Viet Nam is not a least developed country, it received ODA equivalent to approximately 4% of GDP.

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*Official development assistance remains important for the least developed countries in the subregion*

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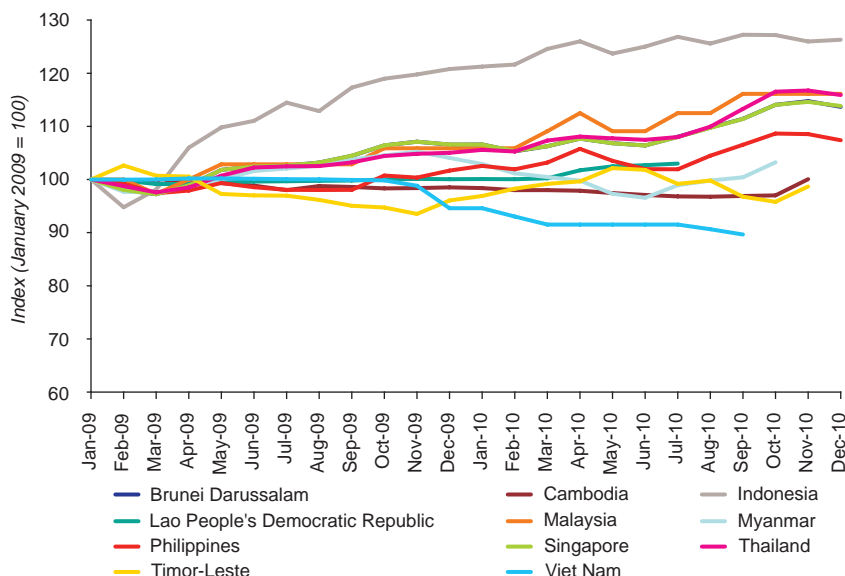
With surpluses in both current and capital accounts, several South-East Asian economies saw their official foreign reserves rise rapidly in 2010. With a few exceptions, such as Viet Nam, most countries are at comfortable levels and are able to cover several months of imports and servicing of official external debt. In particular, Thailand saw its reserves more than double between 2008 and 2010. Indonesia, Malaysia, the Philippines, Singapore and Thailand together have some \$630 billion<sup>33</sup> in reserves, which is comparable to the total reserves of about \$710 billion in the entire euro region.

### *Exchange rates*

Fuelled by massive capital inflows, the ASEAN-5 economies saw their currencies appreciate substantially against the dollar in 2010: the Malaysian ringgit gained 11.8%, the Thai baht 11.0%, the Singapore dollar 9.6%, the Philippine peso 5.7% and the Indonesian rupiah 4.6% (see figure 2.19). In the case of Indonesia, currency appreciation was more modest in 2010 after sharper rises in 2009. The currencies of major South-East Asian economies are expected to see further appreciation in 2011.

Currency appreciation has raised concerns about losing competitiveness, but the slowdown in export

**Figure 2.19.** Index of exchange rate movements of domestic currencies against the dollar in South-East Asian economies, 2009-2010



Sources: ESCAP calculations based on data from CEIC Data Company Limited, data available from <http://ceicdata.com> (accessed 16 February 2011); and International Monetary Fund, International Financial Statistics online database). Available from [www.imfstatistics.org/imf](http://www.imfstatistics.org/imf) (accessed 16 February 2011).

Note: A positive trend represents appreciation and vice versa.

growth in the third quarter of 2010 appears to be due more to weaker demand in the developed countries. Nevertheless, certain sectors and small business exporters were hit harder than others and several governments introduced support measures, such as encouraging State banks to offer dollar loans and to help companies with forward contracts. At the same time, however, currency appreciation has its positive side. In addition to taming imported inflation, stronger local currencies, if they are broadly in line with fundamentals, could provide an opportunity to develop the domestic market and replace old plants and machineries to boost productivity. This, in turn, should help to rebalance the global economy, which is desirable.

The Vietnamese dong, on the other hand, was devalued for the fourth time since November 2009 in February 2011, weakened by a cumulative 13.6% against the dollar, making it the sharpest depreciating Asian currency. The Cambodian riel appreciated slightly against the dollar in 2010, despite its large

current account deficit. Lao People's Democratic Republic, which also saw the kip gain against the dollar, tried to maintain a stable exchange rate vis-à-vis the Thai baht. These economies are also highly dollarized,<sup>34</sup> and a weaker dollar could mean a loss of purchasing power and higher imported inflation from neighbouring countries whose currencies have strengthened against the dollar. Meanwhile, in Myanmar, the multiple exchange rate system continues to create economic distortions and an inefficient allocation of resources.

### Future outlook and policy challenges

South-East Asian countries will continue to see their economies expand at healthy rates in the coming years. Of course, there are risk factors which could upset the positive momentum. As one of the most open areas in the world, the subregion will inevitably be affected if there is a slowdown in the United States or turbulence in the European financial markets. China's possible slowdown due

to monetary tightening to curb inflation could also affect the subregion's growth. On the other hand, currency appreciations may be less of a problem if they are in line with the fundamentals and supportive of rebalancing. Domestic sources of risk vary from country to country. For instance, Thailand could suffer a fall in investor and consumer confidence if political instability rises again, while in Viet Nam, high inflation and wide fiscal and trade deficits continue to be sources of instability.

In 2011, Indonesia is expected to see growth accelerate slightly to 6.5%. The more export-driven economies of Malaysia, Singapore and Thailand are likely to see growth slow more in the first half of the year than in the second. Malaysia and Singapore are forecast to see around 5.0% growth in 2011, while Thailand is expected to see 4.5% growth. The Philippines, after posting strong growth in 2010, will see growth moderate to 5.2%. Growth in Viet Nam is expected to slow slightly to 6.2%, which is still higher than the subregional average. Cambodia is expected to grow faster at 6.2% as recovery gains hold, while the Lao People's Democratic Republic will maintain high growth at 8.3%. The projection for Myanmar is 5.8%, but this could improve if substantial reforms are introduced in the wake of the general elections in November 2010. The oil-driven economies of Brunei Darussalam and Timor-Leste are expected to see growth at 1.7% and 8.2%, respectively.

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*If the priority during the economic crisis was to keep jobs, in the post-crisis period the focus should be on improving the quality of jobs*

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Growth dynamics are closely related to the labour market. While unemployment has fallen to pre-crisis levels in many countries, the formal sector has seen less improvement, as many of the workers who had been laid off were absorbed by the informal sector during the crisis. For instance, a 2010 labour survey in the Philippines found that the ratio of workers earning wages and salaries—as opposed to

the self-employed and unpaid family workers—had fallen from 55.3% a year earlier to 53.2%.<sup>35</sup> In several countries, including Malaysia, Indonesia and Viet Nam, this change was often reflected in a decline in employment in the high value added manufacturing jobs and a rise in low value added activities in services and agriculture.

The informal sector, however, suffers from lower productivity, lower wages, poorer working conditions, lower employment protection and minimum levels of social protection. The International Labour Organization (ILO) estimated that over 60% of all workers in ASEAN countries were in the informal sector in 2009. From 2007 to 2009, average annual labour productivity in the subregion contracted by 0.3%, while the ratio of the working poor (earning less than \$2 per day) in the total labour force rose from 51% to 57%.<sup>36</sup> This implies that informal sector employment has had serious implications not only for poverty but also for the future growth potential of the subregion. Hence, if the priority during the economic crisis was to keep jobs, in the post-crisis period the focus should be on improving the quality of jobs.

To this end, human resources and skills development—including strengthened education, technical and vocational training and lifelong learning—is vital for sustained dynamism in South-East Asia. Such efforts will also help to tackle high youth unemployment in the subregion. For instance, Thailand's youth unemployment rate was 3.6 times higher than the total unemployment rate in 2009. Moreover, considering that labour is one of the few assets of the poor, creating more and better jobs will help the poor to earn their way out of poverty. In this regard, economic policies should be tailored towards expanding opportunities for poor workers to move into better jobs in the formal and non-agricultural sectors.

## Endnotes

<sup>1</sup> Xin, 2010.

<sup>2</sup> Hernandez, Robles and Terero, 2010.

- <sup>3</sup> The Consumer Assistance to Recycle and Save Act of 2009, or “Cash for Clunkers”, offered consumers in the United States up to \$4,500 when they traded in their older vehicles for more fuel efficient models.
- <sup>4</sup> Crawley, 2010.
- <sup>5</sup> Cooks, 2010.
- <sup>6</sup> ESCAP calculations (also see United Nations, Economic and Social Commission for Asia and the Pacific, 2010b).
- <sup>7</sup> Non-performing loans remained high, at 25.8% of total loans, as of September 2010.
- <sup>8</sup> International Energy Agency, 2010a..
- <sup>9</sup> Hornby, 2011.
- <sup>10</sup> Prasad, 2010.
- <sup>11</sup> Samoa, 2009.
- <sup>12</sup> Earth Systems, 2010.
- <sup>13</sup> Pacific Islands Forum Secretariat, 2010.
- <sup>14</sup> Koo, 2006.
- <sup>15</sup> United Nations, Economic and Social Commission for Asia and the Pacific, 2009c.
- <sup>16</sup> New Zealand, Reserve Bank of New Zealand, n.d.
- <sup>17</sup> Pakistan, Ministry of Finance, 2010.
- <sup>18</sup> Sri Lanka, Central Bank of Sri Lanka, 2010.
- <sup>19</sup> India, Reserve Bank of India, 2010.
- <sup>20</sup> Pakistan, State Bank of Pakistan, 2010.
- <sup>21</sup> Bangladesh, Bangladesh Bank, 2010.
- <sup>22</sup> Kelegama, 2011.
- <sup>23</sup> This box is based on detailed analysis contained in Goyal, 2011.
- <sup>24</sup> Myanmar, Central Statistical Organization, n.d.
- <sup>25</sup> After a first stimulus package worth \$3.4 billion, a bigger and more medium-term targeted second package named “Strong Thailand” was introduced in October 2009.
- <sup>26</sup> During the 2008 global food and fuel crisis, Cambodia, Myanmar and Viet Nam had inflation rates higher than 20%. Prices were also unstable in Indonesia in the years preceding the global financial crisis, with inflation exceeding 10% in 2005, 2006 and 2008.
- <sup>27</sup> Chatterjee, 2011.
- <sup>28</sup> Estimate of the National Economic and Social Development Board of Thailand, as quoted in Theparat, 2010.
- <sup>29</sup> At present, the national oil company, Petronas, supplies over 40% of fiscal revenues.
- <sup>30</sup> Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam.
- <sup>31</sup> Hui, 2010.
- <sup>32</sup> United Nations Conference on Trade and Development, 2010b.
- <sup>33</sup> At the end of 2010, Singapore had \$207 billion, Thailand had \$174 billion, Malaysia had \$106.5 billion, Indonesia had \$96.2 billion and the Philippines \$54 billion.
- <sup>34</sup> About 20% of all currencies in circulation in Viet Nam are foreign currencies (mostly the dollar), as are 50% in the Lao People’s Democratic Republic and 90% in Cambodia, according to a recent Asian Development Bank publication (Capannelli and Menon, 2010).
- <sup>35</sup> Philippines, Bureau of Labor and Employment Statistics, 2010.
- <sup>36</sup> International Labour Organization, 2010c.