CHAPTER 2. SUBREGIONAL PERFORMANCE AND MEDIUM-TERM CHALLENGES

Robust growth despite slowing exports

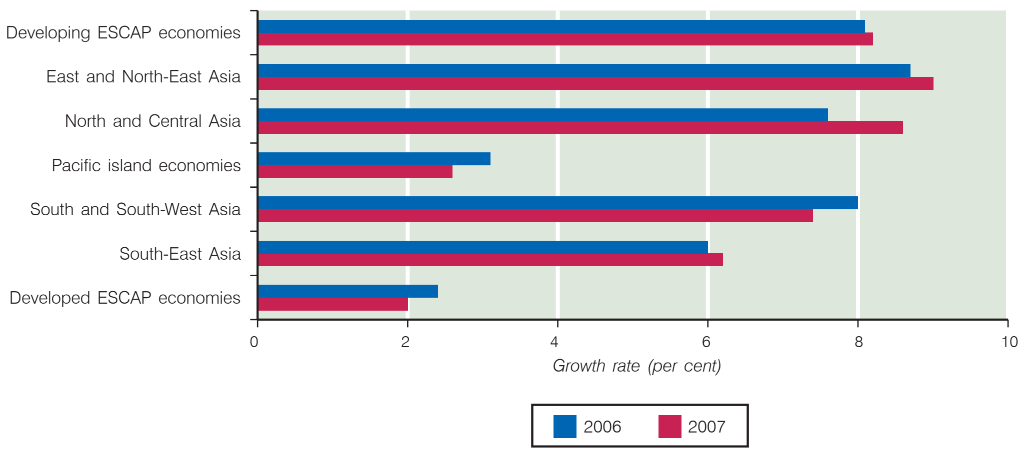
In 2007 the Asia-Pacific region continued its robust growth of the year before, despite a slowdown in export demand due to a slower growing United States (figure 2.1). Domestic demand was increasingly important for sustaining growth in most of the region: both investment and private consumption grew faster in 2007 than in 2006. Rising prices for oil and other commodities benefited some countries – the Russian Federation, Kazakhstan, the Islamic Republic of Iran and Papua New Guinea – even as they had an inflationary impact on others, such as China.

Although exports slowed in most countries, the Asia-Pacific region continued to receive large inflows of foreign exchange thanks to current account surpluses and capital inflows. Central banks intervened in the foreign exchange market, accumulating foreign exchange reserves, but most domestic currencies continued to appreciate. In some countries, particularly in South-East Asia, currency appreciation was large enough to dampen the inflationary effect of rising commodity prices. Indeed, most South-East Asian countries saw inflation decelerate – allowing central banks to cut interest rates and stimulate domestic demand.

East and North-East Asia grew at 9% in 2007, despite slower growth in the United States and sluggish performance in Japan and the European Union. Domestic demand, largely from investment and private consumption, proved effective in taking up the slack from slowing exports. And China's strong growth fuelled demand for exports from other East and North-East Asian countries. Should external-sector weakness exert a stronger effect on growth in 2008, the strong fiscal position of most governments in the subregion will create room for public spending.

Most countries in East and North-East Asia faced a growing inflation threat during 2007, chiefly because of rising international prices for food and oil. In 2007, China's inflation was the highest in 10 years. Inflation

Figure 2.1. Rates of economic growth in the ESCAP region, 2006-2007



Sources: ESCAP, based on national sources; IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007); ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); website of the CIS Inter-State Statistical Committee, <www.cisstat.com> (18 December 2007 and 5 February 2008); and ESCAP estimates.

Notes: Data for 2007 are estimates. Developing ESCAP economies comprise 38 developing economies including the Central Asian countries and calculations are based on the weighted average of GDP figures at market prices in the United States dollars in 2004 (at 2000 prices).

there has also been stoked by a continuing injection of liquidity from the management of currency appreciation.

For the economies of North and Central Asia, 2007 marked another year of strong growth performance due to large external surpluses and increasing international reserves. As in other recent years, high oil and commodity prices were key. However, domestic demand was important in 2007, with retail turnover growing at double-digit rates on the back of higher remittances from migrants working in the Russian Federation and Kazakhstan. Robust economic expansion and surging hard currency inflows stoked strong money supply growth, which accelerated consumer price inflation in many North and Central Asian countries in 2007. Most countries in North and Central Asia, if not all, face two macroeconomic policy challenges in the short to medium term: to achieve durable and stable growth, and to improve fragile fiscal and current account positions.

> *Vanuatu and the Solomon Islands performed well, with growth rates around 5%*

Economic growth in the Pacific region was uneven in 2007. Papua New Guinea more than doubled its growth from 2.6% in 2006 to 6.2% in 2007, on the back of high petroleum and mineral prices. But civil unrest in Tonga in November 2006 and a coup d'etat in Fiji in December 2006, caused a decline in tourism to both countries during 2007, lowering their GDP growth. Palau, Vanuatu and the Solomon Islands performed well, with growth rates around 5%. Samoa, Tuvalu, Kiribati and the Marshall Islands grew at lower rates of between 1% and 3%.

South Asia's strong aggregate economic growth rate of 7.4% for 2007 was spearheaded by India, which grew by 9% and appears to be moving on to a new, high-growth phase as rates of investment in the economy rise sharply. Bangladesh, Pakistan and Sri Lanka continued their growth momentum and grew by more than 6.5% for the year. A sharp increase in domestic demand, particularly investment, is helping these countries to achieve high economic growth rates. Bhutan and Maldives maintained strong growth. Nepal was expected to pick up and grow at a higher rate following the cessation of hostilities among rival political groups, but the actual growth rate remained low at 2.5%, partly because of continued unrest in some areas, and also because of low investment and adverse weather conditions that caused poor agricultural performance. The Islamic Republic of Iran, the only net oil exporter in the subregion, is expected to maintain robust economic growth at 5.8% due to rising oil prices.

Because of demand and supply pressures, inflation in most South Asian countries stayed high in 2007. Rising prices for oil and other commodities in international markets sustained those inflationary pressures. Food prices in general rose more rapidly than those of other items, imposing extra burdens on low- and fixed-income groups.

Strong domestic demand helped South-East Asia's economies continue their robust growth performance of 2006 into 2007. In all the South-East Asian countries with data available, except Thailand, domestic demand grew more rapidly in 2007 than in 2006. Investment accelerated most briskly in Indonesia, the Philippines and Singapore. In Indonesia, Cambodia, Singapore, and Malaysia, private consumption grew significantly more quickly in 2007 than in 2006. Strong domestic demand helped sustain South-East Asia's economic growth in the face of a weaker demand for exports from the United States and continued currency appreciation against the dollar.

> *All South-East Asian currencies, except the Indonesian rupiah, appreciated against the dollar in 2007*

All South-East Asian currencies, except the Indonesia rupiah, appreciated against the dollar in 2007 because of large foreign direct investment inflows and large surpluses in the current account, despite slowing exports. Central banks attempted to limit domestic currency appreciation by accumulating foreign exchange reserves. An increase in financial investments abroad, encouraged in some countries – such as Malaysia and Thailand – by regulatory changes, also contributed to limit exchange rate appreciation.

Among the developed economies of the region, Australia and New Zealand saw growth accelerating in 2007 compared to the previous year, while Japan grew at 1.8% down from 2.4% in 2006. Australia and New Zealand benefited from high commodity prices, while Japan's growth was largely attributable to export demand particularly from Asia. In all three countries, capacity constraints – in particular a tightening labour market – have become increasingly apparent. In Australia and New Zealand the increasing demand for labour pushed up wages, which supported household consumption while also putting inflationary pressure on production costs. These inflationary pressures remain a major concern, though strong currencies in both countries have cushioned the impact of high oil prices. In Japan the tight labour market has not been fully translated into wage growth. But increasing input prices and slow but steady wage increases have started to hurt business confidence, especially in small and medium-size enterprises.

East and North-East Asia: Growth supported by domestic demand and ties with China

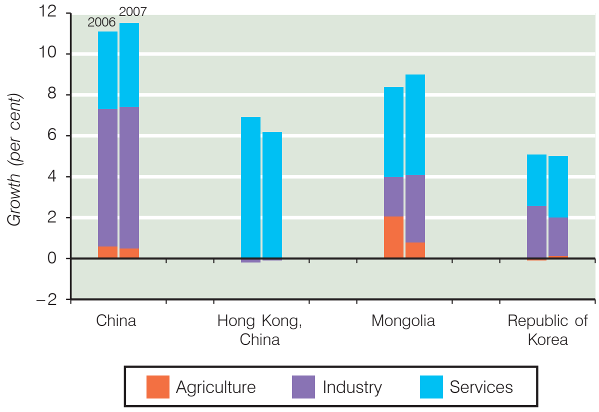
The economies of East and North-East Asia faced two challenges in 2007, both emanating from abroad. The first challenge was a global economic slowdown mostly attributable to the United States – though growth was also sluggish in Japan and the European Union. This more difficult external environment noticeably affected the export performance of the subregion's outward-looking economies. The second challenge was a growing threat of inflation. Inflationary pressure spiked in most countries of the subregion, mainly because of rising international prices for two basic commodities: food and oil.

Countries across the subregion have withstood these twin challenges fairly well (figure 2.2), due to the growing importance of domestic demand and increasingly close trade links with China. While the overall exports of most economies have been hurt, robust growth has continued because domestic demand – largely from private investment and consumption – has proved an effective substitute. The continued strong demand for exports to China, where growth is strong, has considerably moderated the effect of slowing developed country markets. In all East and North-East Asian countries, exports to China have grown as a proportion of total exports. The strong fiscal position of most governments in the subregion (figure 2.3) also offers scope for public spending, should external sector weakness exert a stronger effect on growth performance in the coming year.

The enduring strength of China's economy continues to set records. Its growth rate accelerated in 2007 to 11.4%, the fastest for China in 13 years, despite the slowdown in the country's major export markets. Investment continues to be the main driver of growth, remaining resilient despite government cooling measures and with support from low real interest rates.

Private consumption in China also performed strongly, with urban wage growth boosting consumer confidence. Retail sales towards the end of the year were the strongest in a decade. Domestic consumption is likely to remain strong in 2008, as the government's "harmonious society" policy leads it to spend more on social welfare and as rural consumers increase their spending power. The external sector will likely weaken during the year ahead, as demand weakens, domestic costs rise, the export VAT rebate system is revised and the currency continues to

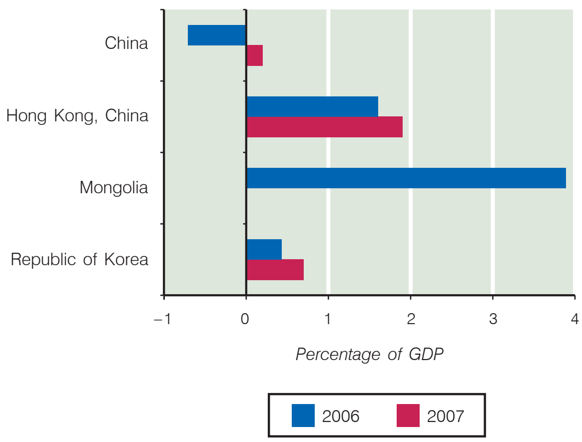
Figure 2.2. Contributions of agriculture, industry and services to GDP growth in selected East and North-East Asian economies, 2006-2007



Source: ESCAP calculations based on national sources.

Note: Data for 2007 are estimates.

Figure 2.3. A strong fiscal position for most governments in the subregion: Budget balance in selected East and North-East Asian economies, 2006-2007



Sources: ESCAP calculations based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007); and ESCAP estimates.

Notes: Data for 2007 are estimates. For Mongolia, budget balance includes grants.

appreciate. But resilient domestic demand will mostly mitigate the effects of a lower contribution from net exports.

Domestic demand fuelled growth

Strong domestic demand has enabled countries to overcome an increasingly difficult external environment. The highly export-dependent economy of Hong Kong, China, grew by 6.1%, with robust consumption and investment fuelled by lower interest rates (following lower United States rates under the territory's currency peg arrangement). Private consumption benefited from lower taxes and employment growth, while private investment was supported by high business confidence and large infrastructure projects. Growth in the Republic of Korea was stable in 2007 at 5%. Private consumption continued to grow steadily, having recovered strongly from the bursting of the household credit bubble in 2004. Consumer confidence was high, with household incomes rising – partly because of increased income from the rising stock market, and partly because unemployment in the Republic of Korea is at its lowest level since the Asian crisis of 1997.

> *Strong domestic demand has enabled countries to overcome an increasingly difficult external environment*

Growth in Taiwan Province of China increased in 2007, to 5.5%. Private consumption was an important driver of growth as unemployment fell and improved the health of the labour market. Firmer property prices and reduced political uncertainty also supported consumer confidence. Private investment also made a contribution, remaining robust due to healthy profits and continued economic expansion.

Mongolia's strong growth in 2007 was driven by strength in its mining sector. Growth in 2007 improved to 9.0%, with continued strong growth expected in the year ahead. The industrial sector has received strong inflows of foreign investment, particularly in mining – a result of the 2006 mining law. But the government still faces the need to clarify its approach to income from this potentially lucrative sector, as new investments are held up by uncertainty about the terms to be offered to investors. High growth in borrowing shows that business confidence is strong. The construction sector has been boosted by government housing and infrastructure projects, as Mongolia attempts to use its strong finances to reduce its high poverty level.

Growth in Macao, China, has exploded as its gaming industry expands. Growth for 2007 stood at 30.1%, having increased rapidly during the year. Visitor arrivals were maintained as several major new gaming establishments opened, culminating in August with the inauguration of the territory's first mega-resort. Its retail sales have also grown strongly as it becomes a major shopping destination for mainland visitors. Investment has soared through major construction projects, both for gaming resorts and for transport infrastructure.

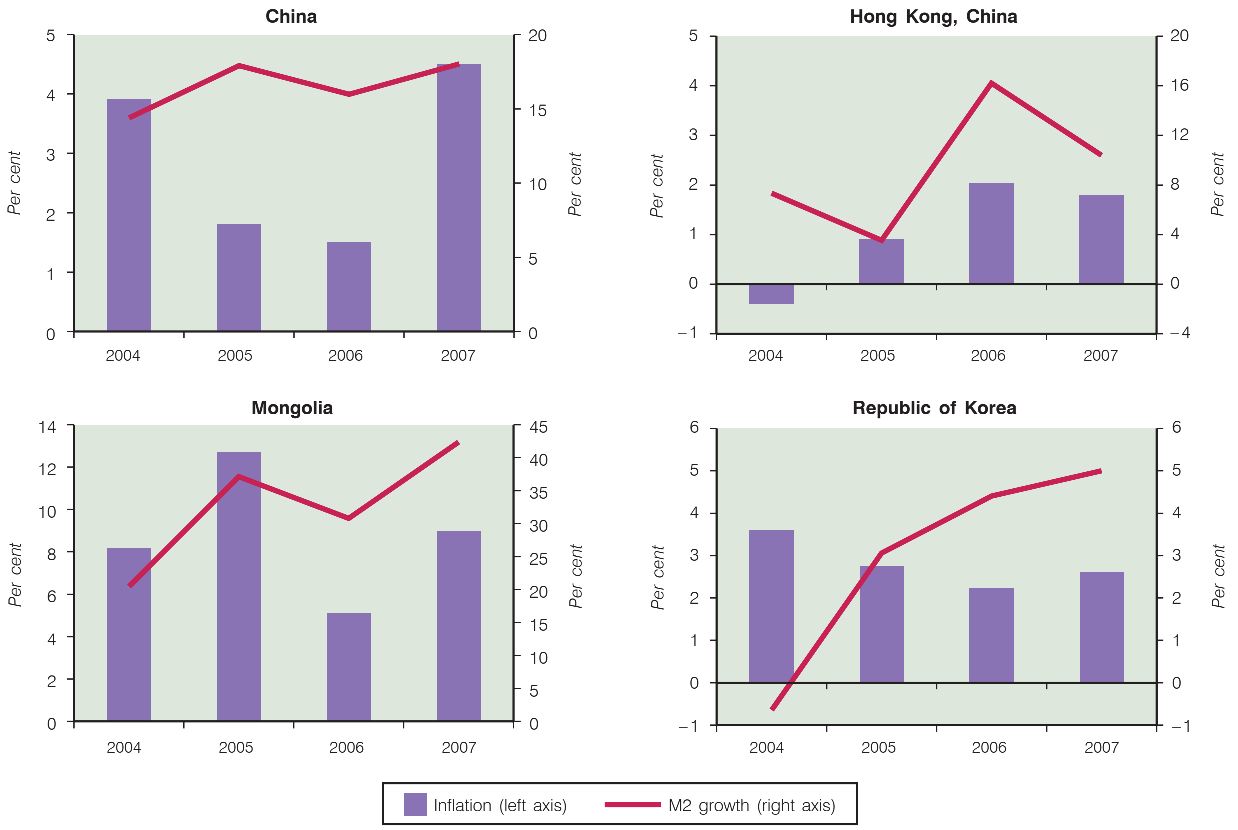
International commodity prices fuelled inflation

East and North-East Asia suffered in 2007 from the twin shocks of rising international oil and food prices, creating inflation pressures across all countries in the subregion (figure 2.4). Food prices rose in China, mainly for the staple goods of pork and eggs. Annual inflation in 2007 rose dramatically to 4.8% – the highest rate in 10 years and more than three times the 1.5% rate for 2006. Taiwan Province of China experienced increasing inflation in 2007, largely because of food and oil price increases. Inflation rose to 1.8% for the year – again, three times the 0.6% figure for 2006. And food prices in Hong Kong, China, exerted strong inflationary pressure towards the end of 2007, as produce from the mainland became more expensive. Wage growth also affected inflation over the course of the year, as did housing, the largest component of the territory's consumer price index.

> *East and North-East Asia suffered from the twin shocks of rising international oil and food prices*

Inflation in Mongolia rose to 9% for 2007 (up from 5.1% in 2006), primarily because of rising oil prices: oil-related increases in fuel, housing and utilities prices were the main driver of accelerated price increases. In the Republic of Korea, inflation accelerated in 2007 due to both rising global energy prices and strong domestic demand. Inflation rose to 2.6% for the year, driven by oil prices, rising utility bills and strong consumer spending.

Figure 2.4. Inflation and money supply growth (M2) in selected East and North-East Asian economies, 2004-2007



Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007); and ESCAP estimates.

Notes: Data for 2007 are estimates. Inflation refers to changes in consumer price index. Money supply for 2007 refers to January-September for Mongolia.

The pace at which currencies appreciate in East and North-East Asian countries is influencing their inflation performance (figure 2.5). Weakness in the Hong Kong dollar (which is pegged to the United States dollar) is making imports more expensive in the territory. Similarly, fairly weak currency performance has contributed to import inflation in Taiwan Province of China. But inflation in the Republic of Korea remained under control as a result of the continued appreciation of the won.

Inflationary expectations in the Republic of Korea also remained low due to the strong policy stance of the country's central bank. Inflation for 2007 remained relatively moderate, within the bank's target range of 2.5 to 3%. The Bank of Korea has been aggressive in controlling inflationary pressures. In August 2007 its benchmark overnight interest rate reached 5%, its highest level in six years.

In China, inflation was stoked by a continued injection of liquidity from the management of currency appreciation. The money supply continued to expand strongly (see figure 2.4), fuelling asset price rises in the property and equity markets. The Shanghai A-Share index increased by more than 80%. Despite monetary policy tightening through interest rate increases, real interest rates on deposits remain negative. Interest rates were increased five times during the year, in September reaching a deposit rate of 3.87% and a lending rate of 7.29%.

The unattractiveness of bank deposits in China has drawn China's public to invest in the asset markets. To control high levels of bank lending during a time of fairly low interest rates, the government has tried various non-interest rate mechanisms such as reserve ratio increases for banks and reducing the spread between deposit and lending rates. Reserve ratios have been increased 10 times during the year, leading to the highest level, 14.5%, since the required reserves system was modified in 1998 (Hang Seng Bank, 2007). But the host of cooling measures still has not affected bank lending. How much China's economy overheats will depend on how effective these mechanisms prove. For China's government, interest-rate raises remain an unlikely main policy tool, given the risk of greater hot money inflows and the debt position of some state-owned enterprises.

China's growth cushioned export impact

China's continued strong market growth has supported exports from the subregion in the face of weak international markets. The current account for Hong Kong, China, remained buoyant (table 2.1) because of investment services for China and mainland tourist arrivals. With the continued liberalization of trade through the Closer Economic Partnership Agreement, the territory's economic ties to the mainland remain vital. The most recent round of measures (CEPA IV) will open up 11 new service areas to trade.

Exports from the Republic of Korea remained strong, as China's growth offset both domestic currency appreciation and weak demand from the United States. Another cushion has been the backlog in shipping industry orders, which surged in 2004, with exports likely to last for a number of years.

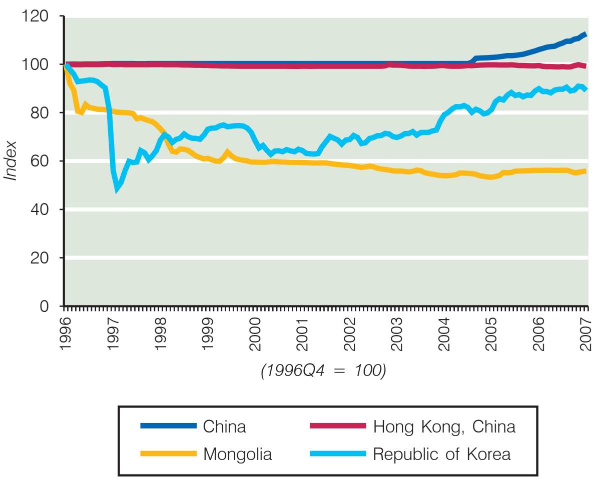
Exports from Taiwan Province of China to the United States and Japan were sluggish in 2007. But there was a strong increase in exports to China and Hong Kong, China, which expanded – to 40.7% – their share of total exports from Taiwan Province of China for the first 11 months of 2007 (Taiwan Headlines, 2007). Mongolia's export earnings were also supported in 2007 by buoyant demand from China (by far the country's major export market) as well as by strong copper prices.

"Exports from the Republic of Korea remained strong, as China's growth offset both domestic currency appreciation and weak demand from the United States"

China itself experienced high export growth despite weakness in its main international markets. Growth in exports to the United States, China's second largest export market, fell steadily during 2007. But exports to the European Union took up much of the slack (Financial Times, 2007). Merchandise exports for Hong Kong, China – including re-exports from China – reflected the same trend, with growth in the European Union offsetting weakness in the United States. As export growth exceeded import growth, China's current account surplus widened.

The yuan has appreciated somewhat against the United States dollar. But depreciation against the euro

Figure 2.5. East and North-East Asian exchange rates against the United States dollar, 1996-2007



Sources: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2007); and *The Economist Databases.*

Note: Data for December 2007 are estimates.

Table 2.1. Current account balance as a share of GDP in selected East and North-East Asian economies, 2004-2007

(Per cent)

	2004	2005	2006	2007
China	3.5	7.1	9.5	10.5
Hong Kong, China	9.5	11.4	10.8	11.1
Mongolia	3.9	4.0	11.4	11.1
Republic of Korea	4.1	1.9	0.7	0.7

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007); and ESCAP estimates.

Note: Data for 2007 are estimates.

is contributing to trade tensions with the European Union. Despite such concerns, it is not clear that China's currency management has been the major cause of its soaring trade surplus. The country's stellar productivity gains have done much to increase its competitiveness (Conference Board, 2007). And the government has actively tried to limit export growth – for example, by removing or reducing export rebates for many products. Growth in the surplus on the income account reflects China's rising earnings from foreign exchange reserves, as well as the income from rising outward FDI by Chinese enterprises.

Current account balances across the region were weighed down by the burden of high oil prices, which increased over the year. In Mongolia the price gains caused imports to rise: an effect amplified by government infrastructure projects and buoyant FDI. In Taiwan Province of China, rising imports – propelled, again, by the high oil prices and by strong domestic demand – squeezed the merchandise trade surplus. But the surplus on the income account remained higher thanks to repatriated profits and dividends from increasing outward FDI. Finally, high oil prices and strong domestic demand also ensured high merchandise imports to the Republic of Korea, where the services account balance remained negative in 2007 due to outbound tourism and royalty payments on overseas patents. But the income account stayed roughly neutral, as the outflow of profits from FDI was balanced by the rising stock of domestic residents' asset holdings abroad.

Medium-term prospects: coping with a marked United States slowdown

Should the United States economy slow down more than expected, countries in East and North-East Asia will not escape unharmed. In 2007, strong domestic demand helped the subregion weather the beginnings of a slowdown fairly well. But the evolving international outlook in 2008 will determine how well the subregion's economies can continue to cope.

Economies in the subregion are vulnerable because they remain highly export-dependent. Even though domestic demand can play a mitigating role in the short term, exports are still a high proportion of GDP in most East and North-East Asian countries. Sluggish export demand in the United States – a major market for all countries in the subregion – would significantly dampen subregional growth. No other country is expected to become a main export driver for the subregion during the year ahead. Its other chief export markets, Japan and the European Union, are predicted to grow only sluggishly and will grow even more slowly in the event of a sharp United States slowdown. In Japan – where domestic demand has yet to recover – the export-dependent economy means that slowed United States consumption would further inhibit growth. Exports from the European Union will suffer from depressed United States demand and, more importantly, from any prolonged international credit crunch.

Inequality and poverty remain long-term challenges

Sterling growth performance across East and North-East Asia in 2007 masks the fact that most countries there are struggling to distribute the benefits of development. Inequality is a major challenge across most countries in the subregion (ADB, 2007). Governments seek policies that will spread growth more evenly across different population segments and across the different regions within countries.

> *"Most countries are struggling to distribute the benefits of development"*

Inequality in the higher-income economies stems from a skills gap among citizens. The Republic of Korea has seen rising inequality resulting from structural changes in the economy: the high-technology export sector has grown more important in recent years, widening the gap between skilled workers in the export manufacturing sector and less skilled domestic service workers (OECD, 2007a). Skills differences are also exacerbating inequality in Hong Kong, China, where the economy is increasingly service-driven. The territory's government is combating the skills gap by improving education to benefit less skilled workers. And in Macao, China, while the gaming industry provides jobs and fairly high wages for the young and talented, older workers face unemployment and lower wages in the non-gaming-related economy. The local government is seeking to respond by providing public housing and establishing a central provident fund.

Inequality in China stems from differences in economic and human development among its regions – particularly between rural and urban areas. In recent decades employment in China's export-led manufacturing industry has been highly concentrated in the country's coastal regions, prompting migration from rural and lagging areas to the coast. The result: unmanageable urbanization and a hollowing-out of the workforce in the rest of China. In response to this challenge the government has enacted regional development policies (see policy research feature 2.1). Other recent policies, such as the "new socialist countryside" policy of 2006, are directed specifically at the rural-urban gap.

Only Mongolia has seen a reduction in inequality over the past decade. But the country is confronted by a more basic problem: high poverty. Its recent strong growth performance has yet to significantly reduce the proportion of poor Mongolians. Growth is concentrated in the mining sector, which provides few employment opportunities. The government is trying to use new money from growing mining revenues to help the poor.

Policy research feature 2.1: China's "Go West" policy to reduce inequality among provinces – and its benefits for Asia-Pacific economies

China's income inequality is among the highest in the world, higher than all other Asian countries except Nepal in 2004 (ADB, 2007). A major part of China's income inequality is interprovincial inequality, mirrored by inequality in human development across economic and social indicators (World Bank, 2007a). Divisions are most pronounced between coastal and western provinces (figure 2.6).

In response, China introduced its western development strategy, "Go West", in 1999. Its priorities are infrastructure construction, environmental protection, industrial upgrading, human capital accumulation, science and technology research, and opening the provinces to foreign direct investment (FDI).

The Government has also enacted policies to reduce inequalities in the north-eastern provinces in 2003 and the central region in 2005. But the focus here is on the "Go West" policy, whose longer existence makes detecting the preliminary impact easier. The analysis compares the western provinces with the coastal provinces, generally regarded as China's most developed. The analysis focuses on 22 jurisdictions in 2006, the most recent year with data: the six western provinces of Gansu, Guizhou, Qinghai, Shaanxi, Sichuan and Yunnan; the five autonomous regions of Guangxi, Inner Mongolia, Ningxia, Tibet and Xinjiang; the municipality of Chongqing; and the 10 coastal provinces not covered by any regional development plan, Beijing, Tianjin, Hebei, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan.[1]

The picture is somewhat encouraging. In recent years, the gap in GDP per capita has shown some signs of closing. In 2005/2006, three-quarters of the western provinces experienced higher growth than the majority of coastal provinces. Rural income per capita, of the greatest concern given the rural-urban income divide, grew more than the majority of coastal provinces in

Figure 2.6. Wide inequality in human development among provinces

Source: UNDP, *China Human Development Report 2005* (New York, 2005).

[1] For simplicity, "province" is used in the rest of the feature to include provinces, autonomous regions and municipalities.

two western provinces. In 2006, government spending was higher in three-quarters of the western provinces than in the majority of coastal provinces. Fixed-asset investment grew relatively rapidly in three-quarters of the western provinces. Final consumption increased more in a quarter of the western provinces than in the majority of coastal provinces. Foreign direct investment, a focus of the "Go West" policy, increased substantially in a quarter of the provinces. Another focus, research and development spending, increased substantially in a third of provinces.

Some reduction in inequality in western provinces

There are preliminary signs of faster economic development in some western provinces than in coastal provinces. Average per capita GDP growth in 2005/2006 was higher in 8 out of 12 western provinces (Inner Mongolia, Chongqing, Guangxi, Sichuan, Shaanxi, Gansu, Qinghai and Guizhou) than in the majority of the 10 coastal provinces – narrowing the gap in income per capita (figure 2.7).

The narrowing income gap is evident in figure 2.8, which plots average province GDP per capita growth in 2005/2006 against average GDP per capita in 1998/1999. The downward-sloping trend line indicates convergence in the aggregate. Shanghai, with relatively low average income per capita growth in 2005/2006, supports the case for convergence. Guizhou does not. The province had the lowest average income per capita in 1998/1999 and did not exhibit relatively fast growth in 2005/2006.

"There are preliminary signs of faster economic development in some western provinces than in coastal provinces"

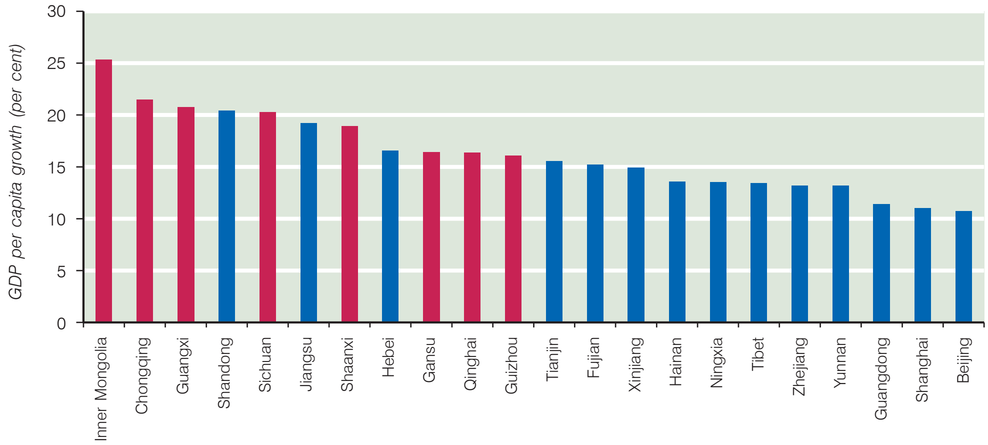
But despite faster comparative growth for many provinces in the aggregate, there appears to have been limited reduction in rural inequality in poorer provinces. Even within poorer provinces, urban areas are generally better off than rural areas. Tibet and Inner Mongolia are the only provinces with increases in rural income per capita in 2005/2006 greater than in the majority of the coastal provinces (figure 2.9).

Government spending helping poorer provinces

Government spending, the main instrument of the "Go West" policy, is showing signs of going more to western provinces. Data for 2006 show higher provincial government spending growth, as compared to the majority of coastal provinces, in 7 of the 12 western provinces (Xinjiang, Shaanxi, Qinghai, Sichuan, Gansu, Chongqing and Ningxia) than in the majority of coastal provinces (figure 2.10).

Provincial governments are responsible for most spending on health, education and welfare and some

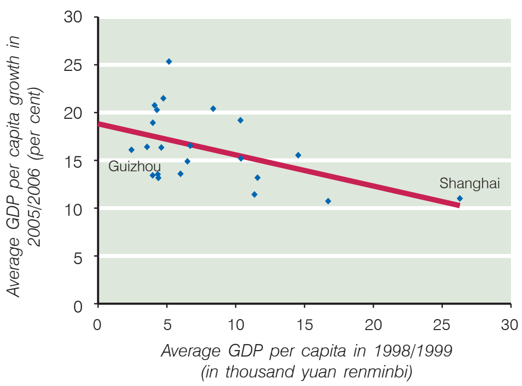
Figure 2.7. Faster per capita income growth in a majority of western provinces in 2005/2006



Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2006* (China Statistics Press, 2006); and CEIC Data Company Ltd.

spending on infrastructure, making trends in central government transfers to provinces important – especially after China's 1994 tax sharing reform re-centralized revenues with the central Government but left expenditure responsibilities with local authorities. Central government direct spending on the provinces is largely on infrastructure.

Figure 2.8. The income gap is narrowing faster in the lowest income provinces

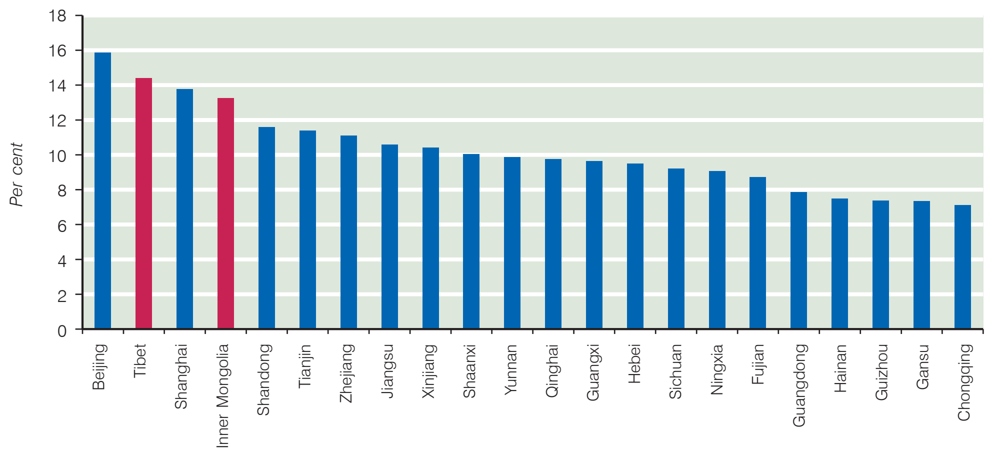


Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2006* (China Statistics Press, 2006); and CEIC Data Company Ltd.

> *Transfer funds for poorer regions, while growing rapidly, are lagging behind those for richer regions*

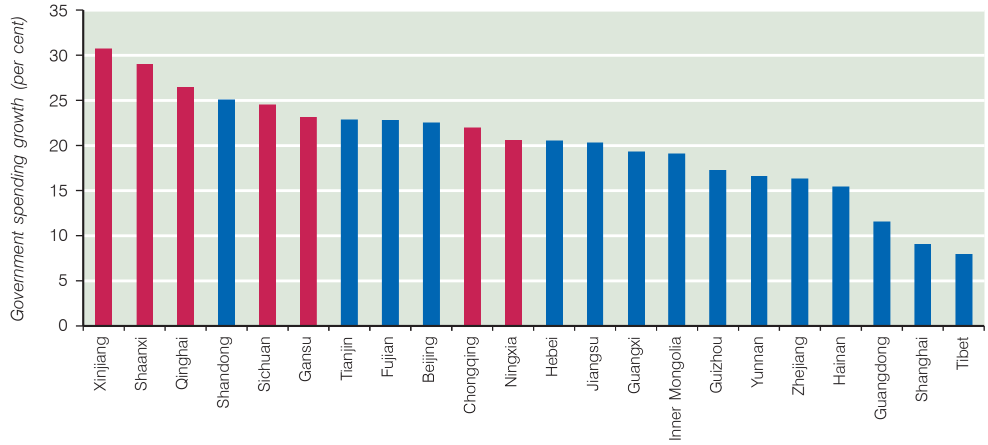
Due to the country's method of fiscal decentralization, funds for poorer regions, while growing rapidly, are lagging behind those for richer regions. Analysis of absolute levels of central government transfers in 2004 shows a limited degree of relationship between transfers and the affluence of provinces (Shah and Shen, 2006). The lack of a stronger link between central government transfers and regional development is due to a relatively high proportion of transfers going to provinces as tax-related revenue sharing and tax rebates, which are regressive because richer provinces are returned more money. Progressive transfers to the regions have come mainly from equalization transfers and ad-hoc transfers, with ad-hoc transfers or "earmarked grants" accounting for the largest share.

Figure 2.9. Rural income gap narrowing for a few western provinces



Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2006* (China Statistics Press, 2006); and CEIC Data Company Ltd.

Figure 2.10. Government spending went more to poorer provinces in 2006



Source: CEIC Data Company Ltd.

These transfers are program-based and include funding for infrastructure construction and for assisting lagging regions.

Infrastructure investment, one focus of central government spending in the western provinces, is growing relatively quickly in many provinces. Provincial data for fixed-asset investment reflects a narrowing investment gap with coastal provinces in all provinces except Ningxia, Xinjiang and Gansu in 2006 (figure 2.11). On final consumption, three western provinces – Xinjiang, Inner Mongolia and Qinghai – grew more rapidly than the majority of coastal provinces (figure 2.12).

Research and development spending, another focus of the “Go West” policy, has grown more rapidly in 4 of the 12 western provinces (Ningxia, Tibet, Inner Mongolia and Xinjiang) than in the majority of coastal provinces (figure 2.13).

Particularly notable has been a more rapid rise in exports in most western provinces than in coastal provinces, albeit from a far lower base. Nine western provinces had an above-median increase in exports in 2006: Tibet, Qinghai, Gansu, Xinjiang, Sichuan, Ningxia, Guangxi, Chongqing and Yunnan (figure 2.14).

There has been modest improvement in FDI in western provinces, another objective of the “Go West” policy. Although the scale of the inequality in FDI inflows between the richest and poorest provinces remains enormous, there are signs of a rapid recent increase in FDI in Sichuan, Inner Mongolia and Shaanxi (figure 2.15).

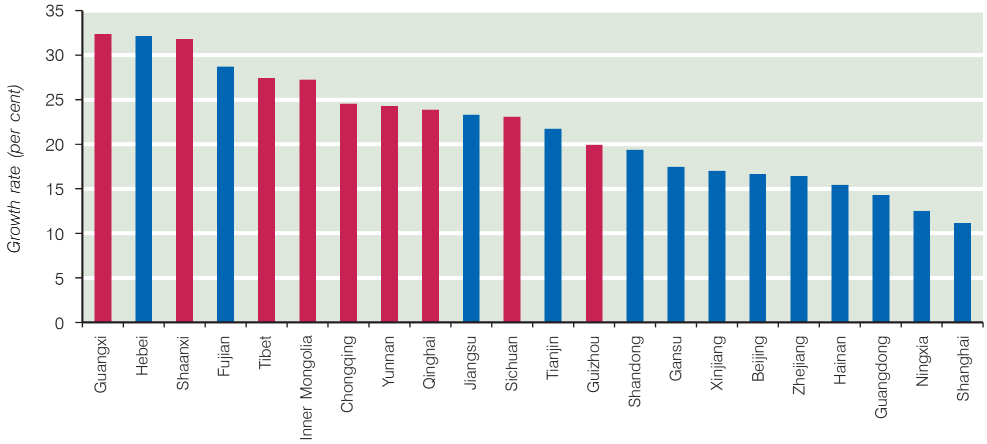
Asia-Pacific countries benefit from trade with China’s western provinces

The development of China’s western provinces offers a comparative case study for other Asia-Pacific regional development policies (see box 2.1) as well as directly benefiting neighbouring countries. A particularly encouraging trend for China’s neighbours is the relatively rapid export growth seen in many western provinces. The Government is encouraging this trend through extensive infrastructure projects to improve cross-border transportation.

> *“A particularly encouraging trend for China’s neighbours is the relatively rapid export growth seen in many western provinces”*

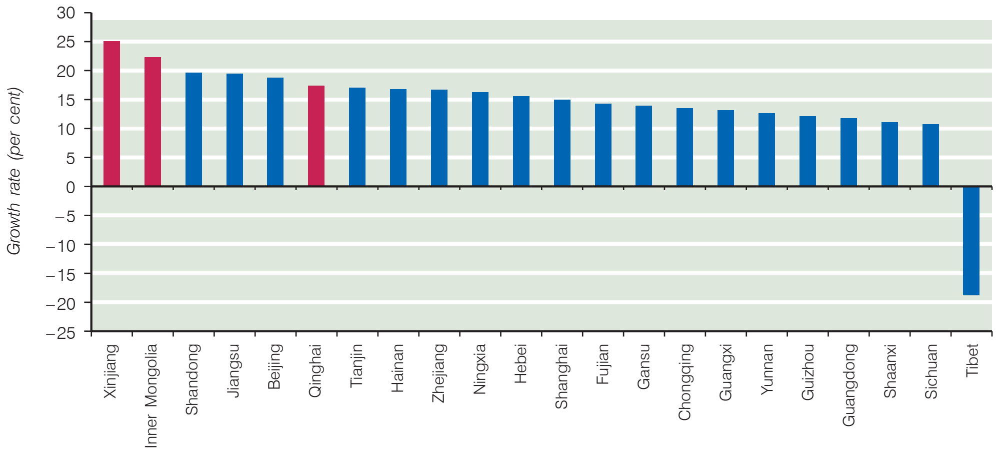
Sharing borders with Afghanistan, Kazakhstan, Kyrgyzstan, Mongolia, India, Pakistan, the Russian Federation and Tajikistan, Xinjiang is becoming China’s gateway to Central Asia. The province’s total trade with Central Asia has tripled since 2002, reaching a record $9 billion in 2006 (China View, 2007a). Most of Xinjiang’s trade is with Kazakhstan, followed by Kyrgyzstan and Pakistan. The province exports its own products and is a conduit for products from the rest of the country.

Figure 2.11. Fixed-asset investment is increasing quickly in many provinces



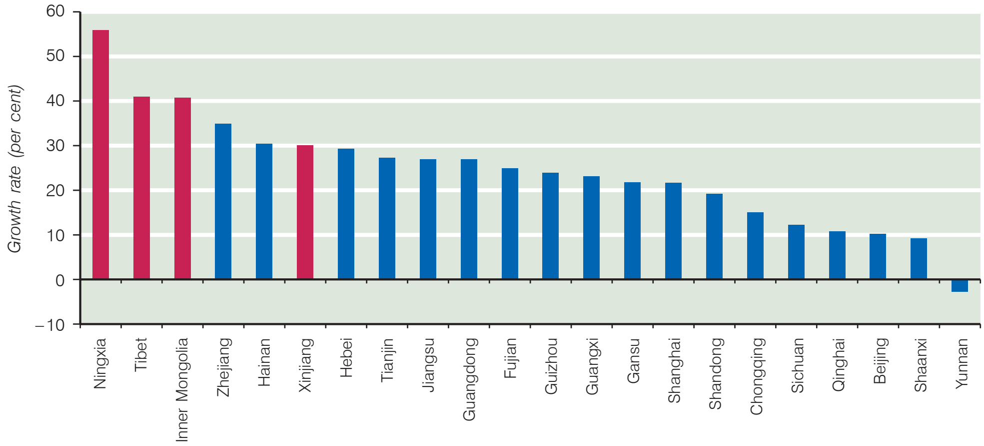
Source: CEIC Data Company Ltd.

Figure 2.12. Final consumption growth is fast in a few provinces



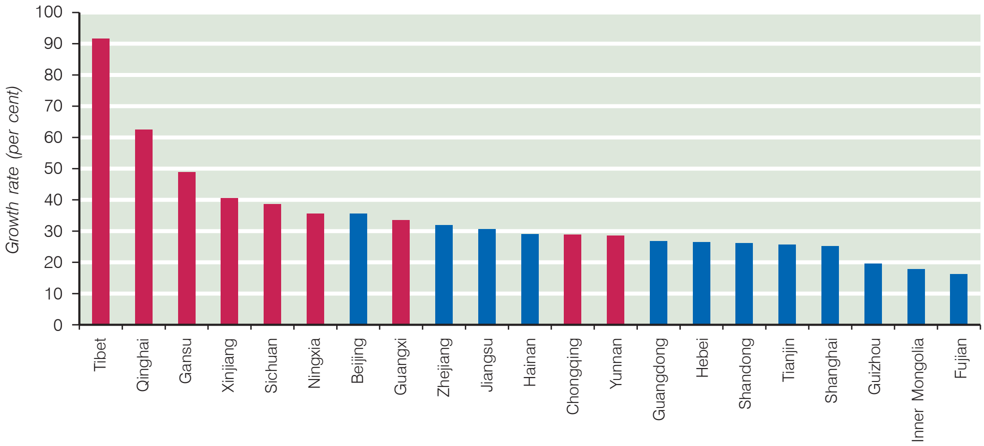
Source: CEIC Data Company Ltd.

Figure 2.13. Research and development is growing faster in a few provinces



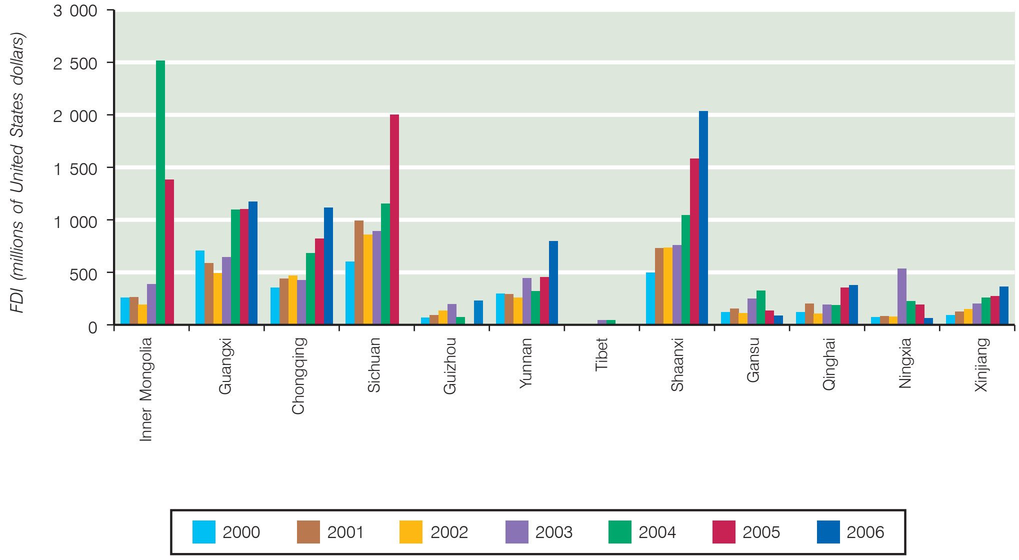
Source: CEIC Data Company Ltd.

Figure 2.14. Exports are growing rapidly in most provinces



Source: CEIC Data Company Ltd.

Figure 2.15. FDI is increasing markedly in a few provinces



Source: CEIC Data Company Ltd.

Tibet, which borders India, Myanmar and Nepal, has also experienced rapid growth in trade with neighbouring countries. Trade grew by 60% in 2006 to reach $222 million (China View, 2007b). Trade with India is forecast to grow with the opening of border trade in 2007, and Tibetan goods can now reach the Indian port of Kolkata, four times closer than the closest port in China, more than 4,000 kilometers away in Tianjin.

Guangxi is rapidly boosting its cross-border trade with Viet Nam, currently Guangxi's largest trade partner. Trade grew by nearly 50% in 2006 to $1.8 billion, four times larger than in 2000. In 2006, trade with Viet Nam accounted for 80% of Guangxi's import-export turnover. Machinery and electrical appliances have been the major exports for Guangxi. Imports have been mainly raw materials and commodities, such as minerals, fruit, rubber, starch and cooking oil.

Yunnan has developed extensive trade links with its southwestern neighbours, the Lao People's Democratic Republic, Myanmar and Viet Nam, all of them members of ASEAN. Yunnan's ties with Viet Nam are expanding rapidly, with $500 million in trade in 2006 (Viet Nam, 2007). Myanmar has been the largest trading partner of Yunnan in recent years. Half of China's trade with Myanmar, nearly $700 million in 2006, passes through Yunnan (China View, 2007c).

Mongolia and the Russian Federation have rapidly increased trade with neighbouring Inner Mongolia. In 2006, Inner Mongolia's trade rose by 58% with Mongolia and by 31% with the Russian Federation (China.org.cn, 2007). Inner Mongolia now accounts for 40% of China's trade with Mongolia, with trade worth $580 million in 2006.

Development in China's western provinces ties in closely to similar initiatives in neighbouring countries to encourage development in lagging border regions through cross-country trading ties. India is promoting trade for its north-eastern states, which border Myanmar and Bangladesh and are close to Yunnan, China. As in China, a primary tool is infrastructure development. Plans have been outlined for a range of cross-country road and rail links passing through the north-eastern states.

Viet Nam is also trying to reduce interprovincial inequality, and increased ties with Guangxi are part of the country's strategy to develop its mountainous northern provinces. Viet Nam has also targeted infrastructure development as key to cross-border trade. Plans are under way for further improvement in road and rail links, both to connect to other parts of Viet Nam and for onward transport to other ASEAN countries.

Box 2.1. Regional development strategies elsewhere in Asia and the Pacific

As in China, many of the largest economies in Asia and the Pacific are grappling with regional inequality following rapid development. The characteristics of that inequality and the policy solutions pursued by governments, however, differ.

Economic liberalization in the Russian Federation, as in China, has resulted in uneven development within the country in response to business opportunities. Growth at the provincial level has been concentrated in a few locations – Moscow, Saint Petersburg and parts of the Urals and Siberia – in line with the development of the finance and energy sectors (Galbraith, Krytynskaia and Wang, 2004). Provinces that are primarily agricultural or industrial are in relative decline, with the growth gap particularly stark for southern regions.

As in China, the Russian Federation has instituted a far-reaching programme of financial transfers to lagging regions. The equalization effect is considerable: 70 regions of 88 receive net subsidies from the centre. Federal transfers to the regions rose to about a third of federal spending in 2005, up from 9 per cent in 1999 (Petrov, 2006). The central Government is striving to improve business opportunities in poorer regions by creating growth clusters and improving transport infrastructure.

The nature of the inequalities in India differs from that in China. While in China the division is between coastal and inland provinces, in India the gap is widest between southern and western states, on one hand, and northern states, on the other. Growth in India, dominated by services exports, has resulted in state-level development being tied to population skills, disadvantaging the north. The economy of China, in contrast, is led by manufactured exports, which ties provincial growth to the availability of transport linkages.

During India's reform, investment licensing was eliminated, and the Government lost control over the location of private investment, which then flowed to states with more skilled workers, good infrastructure and communications, and good governance. As in the Chinese experience, FDI and private corporate investment have been skewed towards a few states. The central Government has thus tried to improve state-level development resources through tax sharing and transfers from the centre. The country's effort to reduce its fiscal deficit at the central and state levels will, however, continue to hamper attempts to boost resources for lagging regions.

In Indonesia, poverty and inequality vary widely between the western provinces and the poorer eastern provinces. As in China, inequality in provincial income growth was driven by the geographic focus of export-led industrialization, concentrated in Java.

Indonesia recently embarked on a far-reaching system of fiscal decentralization. Under the new system, devolution of powers to local governments is accompanied by transfers of significant resources to poorer regions through the General Allocation Fund (Dana Alokasi Umum, or DAU). The fiscal transfer system has been highly redistributive. For example, the DAU increased by 64 per cent in 2006, with some of the poorest provinces, such as Aceh, Papua and Maluku, receiving more than 100 per cent increases in their allocation over the previous year (World Bank, 2007b).

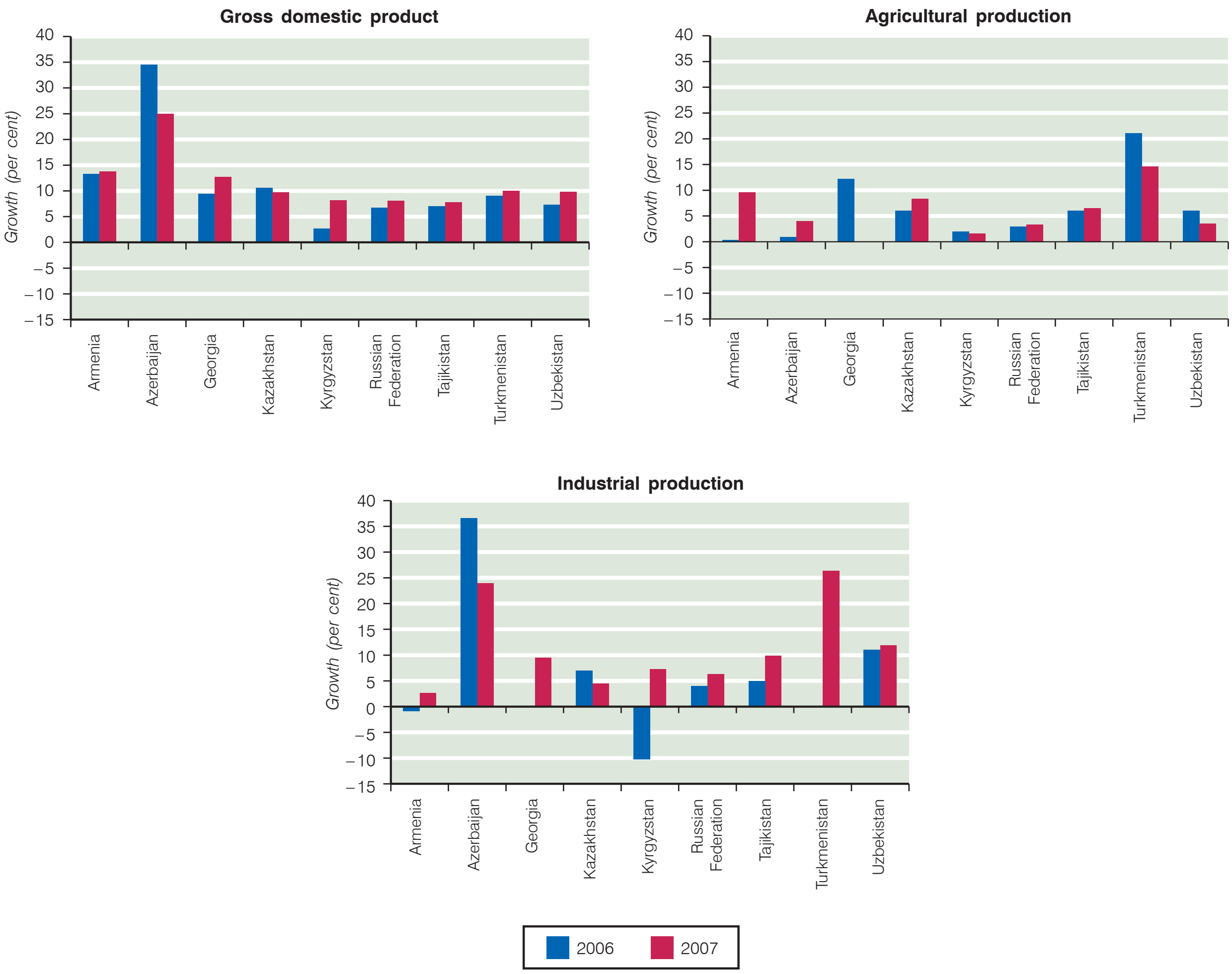
As countries across the region face the common challenge of devising the appropriate mix of policies and financial resources to address spatial inequality, a cautionary note is that transfers to regional governments, while appearing highly equalizing, may not always be effective, as responsibility for long-term regional policies, such as infrastructure investment, may continue to lie with the central Government.

North and Central Asia: Among the most dynamic in the region

Most economies in North and Central Asia are expected to have expanded at double-digit rates in 2007 (figure 2.16). Azerbaijan's growth – at 25.0% of GDP in 2007 – remains among the most rapid in the world. Armenia's GDP grew by 13.8% in 2007.

The construction, agriculture and services sectors contributed most to GDP growth in Armenia and Azerbaijan. Growth in construction was strong, thanks to new investment in industrial production and to a boom in office and residential development. Kazakhstan's GDP grew by 9.7% in the first nine

Figure 2.16. Rapid growth in North and Central Asia: Real GDP and sectoral growth in North and Central Asian economies, 2006-2007



Sources: ESCAP, based on CISSTAT, *Database Statistics of the CIS* (Moscow, 2007 and 2008); and ESCAP estimates.

Notes: Growth rates for 2007 are estimates. GDP growth data for 2007 for Georgia, Kazakhstan and Uzbekistan refer to January-September. Agricultural production growth for 2007 for Turkmenistan refers to January-June while agricultural growth for Uzbekistan refers to January-September. Industrial growth rates for 2007 for Turkmenistan and Uzbekistan refer to January-October and January-September respectively while industrial growth for Georgia refers to January-June.

months of 2007, with a good wheat harvest at more than 20 million tons in 2007 – 3 million tons more than in 2006. And Kazakhstan's retail trade grew by 10.0% in 2007, as domestic demand advanced swiftly despite banking sector problems. The GDP of Turkmenistan is expected to grow by 10.0% in 2007 because of increased hydrocarbons production.

"Economic growth remains impressive despite rising inflation"

Domestic demand helped to speed GDP growth in the Russian Federation and Tajikistan. The GDP of the Russian Federation grew by 8.1% in 2007, mainly because of strong domestic demand and investment in construction. Household demand rose by 15.2%, and fixed investment by 21.1% in 2007. Tajikistan's GDP grew by 7.8% in 2007, with 9.9% growth in industrial production and 6.5% growth in agricultural output. Fuelled by rising household incomes and remittances, Tajikistan's retail trade grew by 5.2% in 2007.

The industrial sector was the main contributor to strong economic growth in Georgia, Kyrgyzstan and Uzbekistan in 2007. Georgia's GDP grew by 12.7% in the first nine month of the year, thanks to growth in industry and transportation services. But the financial and banking sectors were also major contributors to GDP growth in Georgia. In Kyrgyzstan industrial production grew by 7.3% in 2007. Both utilities and manufacturing showed strong growth. Along with a growing services sector and rising remittance inflows, Kyrgyzstan's expanding industrial output helped to fuel an 8.2% rate of growth in the country's GDP in 2007. Uzbekistan increased its industrial output by 11.9% in the first nine months of 2007. During the same period the country's GDP grew by 9.8% – the highest rate since the beginning of the 1990s – while agricultural production increased by 3.5% in 2007.

Surging food prices accelerated consumer price inflation

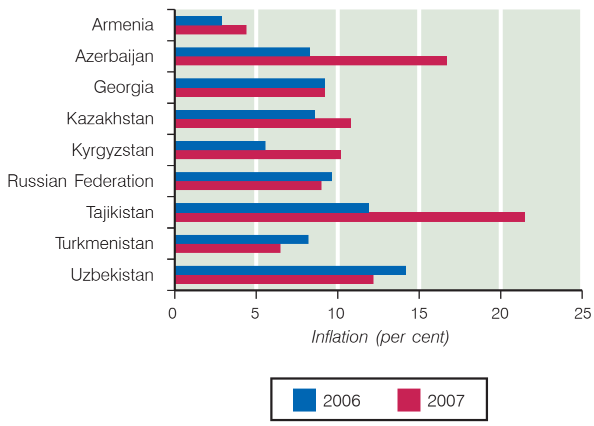
In 2007 all North and Central Asian countries experienced the highest inflation rates seen in recent years. Consumer prices rose by double digits in Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan in 2007 (figure 2.17). In the subregion's many oil- and gas-producing countries, the rise in consumer price inflation can be traced partly to increasing government expenditures and high inflows of foreign exchange from commodity exports. Other factors include rising prices for food, services and utilities.

Consumer price inflation was expected to rise in Tajikistan from 11.9% in 2006 to 21.5% in 2007, in Azerbaijan from 8.3% in 2006 to 16.7% in 2007. Tajikistan's especially high annual inflation was expected to exceed the government's target due to rising prices for imported gas, food and electricity. In Kazakhstan, annual consumer inflation was expected to rise from 8.6% in 2006 to 10.8% in 2007.

Consumer inflation in Georgia, after peaking at 9.2% in 2006, fell to 8.8% in the first 10 months of 2007. But rising gas prices and transportation costs could drive up the inflation rate to more than 9% by the end of the year. In Kyrgyzstan a surge in food prices raised the inflation rate from 5.6% for 2006 to 10.2% in 2007. Remittance flows into the country created additional inflationary pressure. In Armenia high import prices and rapidly expanding monetary aggregates helped raise inflation from 2.9% in 2006 to 4.4% in 2007.

In the Russian Federation, despite increasing food prices, inflation was expected to decelerate from 9.7% in 2006 to 9.0% in 2007. The government introduced price controls on foodstuffs in October 2007, both to lower food costs and to keep inflation in check.

Figure 2.17. Rapid inflation across North and Central Asia, 2006-2007



Sources: ESCAP, based on CISSTAT, *Database Statistics of the CIS* (Moscow, 2007 and 2008); and ESCAP estimates.

Notes: Inflation rates for 2007 are estimates. Inflation rates refer to percentage changes in the consumer price index.

High global commodity prices caused exports earnings to surge

Azerbaijan, Kazakhstan, the Russian Federation, Turkmenistan and Uzbekistan owed their substantial foreign trade surpluses for 2007 to rising volumes of oil and gas exports and high global hydrocarbon prices. These increased trade surpluses are expected to yield large current-account surpluses for 2007 (tables 2.2 and 2.3).

Azerbaijan ran a $408.4 million trade surplus in the first nine months of 2007 – lower than its $1.1 billion surplus for the first nine months of 2006, but still substantial. Oil and refined petroleum products accounted for the largest share of export earnings. Export revenue from non-oil sectors grew by about 11% in the first eight months of 2007. Merchandise imports rose in the first nine months of 2007 by 46.7% to $3.9 billion. Among the largest imports were food products and capital goods such as machinery, metals and transport equipment. Countries within the Commonwealth of

Table 2.2. External accounts in North and Central Asia, selected economies, 2006-2007

(Per cent)

	Exports (share of GDP)		Imports[a] (share of GDP)		Current account balance (share of GDP)	
	2006	2007	2006	2007	2006	2007
Armenia	15.9	11.3	30.0	25.9	–1.4	–2.5
Azerbaijan	65.6	67.2	26.5	20.0	18.6	25.7
Georgia	21.6	21.7	47.9	53.7	–16.1	–15.7
Kazakhstan	48.2	43.7	30.0	29.4	–2.2	–3.6
Kyrgyzstan	29.0	30.6	64.0	73.8	–14.8	–21.3
Russian Federation	30.9	28.2	16.7	17.8	9.7	6.3
Tajikistan	54.0	51.1	69.8	69.3	–2.9	–11.6
Turkmenistan	76.1	76.4	53.4	47.9	15.3	12.4
Uzbekistan	37.3	36.8	24.7	25.2	18.8	16.1

Sources: CISSTAT, *Database Statistics of the CIS* (Moscow, 2007); EIU, *Country Reports* (London, 2007), various issues; IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007), and *World Economic Outlook Databases* (Washington, D.C., 2007); and ESCAP estimates.

Notes: Data for 2007 are estimates.

[a] Import value in free on board.

Table 2.3. Export and import growth in North and Central Asia, selected economies, 2005-2007

(Per cent)

	Exports			Imports		
	2005	2006	2007	2005	2006	2007
Armenia	36.2	1.1	9.1	33.2	21.6	1.9
Azerbaijan	104.4	46.6	23.2	21.4	25.0	46.7
Georgia	34.8	14.8	26.5	33.8	47.8	39.4
Kazakhstan	37.4	37.3	22.9	30.1	36.5	45.2
Kyrgyzstan	33.3	18.2	38.6	98.7	56.0	50.3
Russian Federation	32.9	24.8	9.8	28.7	39.5	48.1
Tajikistan	15.9	53.9	8.9	97.0	29.5	35.5
Turkmenistan[a]	27.6	16.9	22.3	9.6	11.5	9.0
Uzbekistan[a]	11.6	19.6	16.5	8.1	13.9	20.4

Sources: CISSTAT, *Database Statistics of the CIS* (Moscow, 2007); and EIU, *Country Reports* (London, 2007), various issues.

Notes: All figures refer to January-September except in the cases of Turkmenistan and Uzbekistan, for which figures are whole year estimates.

[a] Import value in free on board.

Independent States (CIS) became Azerbaijan's main export partners in 2007 as it increased its exports to Georgia and the Russian Federation.

Kazakhstan recorded a $10.1 billion merchandise trade surplus in the first nine months of 2007 (compare with $11.9 billion for 2006). The surplus on trade in goods is expected to grow further in 2008-2009, to $16 billion, as a result of rising oil prices and growth in oil export volumes.

"High oil prices sustained trade surplus"

The foreign trade surplus of the Russian Federation was expected to exceed $100 billion in 2007. Its export volume rose by 9.8% in the first nine months of the year, to $242.8 billion. During the same period its expenditures on imports shot up by 48.1%, to $136.8 billion.

Turkmenistan was expected to record a trade surplus of $2.23 billion in 2007 thanks to high prices for its main export commodities, oil and gas. Export earnings were estimated to have grown by 22.3% in 2007, merchandise imports by 9.0%. Similar to Azerbaijan, capital goods accounted for 60-75% of Turkmenistan's total merchandise imports.

Uzbekistan was expected to record a trade surplus in 2007 because of high commodity prices and import controls. Export earnings were estimated to have grown by 16.5% in 2007, with increased exports of gas and cars to the Russian Federation and rising revenue from cotton fibre sales. Merchandise imports were expected to grow by 20.4% in 2007. Again, the growth in import spending remained high as capital goods, machinery and equipment were needed for large projects in the country's industrial sector.

Other North and Central Asian economies continued to have trade deficits in 2007, some showing slight increases over the corresponding figures for 2006 due to falling exports and rapidly rising imports. For example, weakened growth in Tajikistan's main export item, aluminium, kept export revenues down to $1.1 billion in the first nine months of 2007 – a growth rate of 8.9% (compared with 53.9% in 2006). Meanwhile its import expenditures rose by 35.5%, to $1.67 billion, chiefly because of higher fuel prices, strong domestic demand and large infrastructure projects. The result: Tajikistan's merchandise trade deficit widened in the first nine months of 2007 to $577.5 million, or more than two and a half times its $214.6 million deficit for the same period in 2006.

"Considerable remittances and FDI contributed to growth"

Georgia's narrow export base and increasing merchandise imports caused its trade deficit to rise from $1.9 billion in 2006 to $2.7 billion in the first nine months of 2007. Export revenue grew by 26.5%, to $884.6 million, in the first nine months of 2007. But import expenditure grew in the same period by 39.4%, reaching $3.6 billion, propelled by rising prices for the economy's main import categories: gas, crude oil and petroleum.

Despite a 9.1% increase in Armenia's merchandise exports, the country's trade deficit widened considerably from $826 million in 2006 to almost $1.4 billion in the first nine months of 2007. Imports of mineral products, machinery and equipment for construction projects caused merchandise imports to rise by 1.9% during this period, to $2.2 billion.

In the first nine months of 2007, Kyrgyzstan showed a 38.6% increase in export earnings against a 50.3% rise in import expenditure, and the country narrowed its trade deficit to $860 million from $1.1 billion in 2006. But Kyrgyzstan's narrow export base and higher import prices for consumer and investment goods left it vulnerable to changes in the external economic environment.

Remittances had a significant macroeconomic impact

Remittances from migrants and temporary workers abroad have become a major source of money for Central Asia's economic development. Remittances to Armenia reached $424 million in the first half of 2007, accounting for 15% of the country's GDP, and were expected to grow to $1.35 billion by the end of the year. Remittances to Georgia grew by 57.5% in the first nine months of 2007, chiefly from migrants working in the Russian Federation. Remittance flows from the Russian Federation and Kazakhstan also benefited Kyrgyzstan, Tajikistan and Uzbekistan in 2007.

Foreign direct investment continued to help economies develop and modernize

FDI inflows continued to play a key role in developing and modernizing the economies of North and Central Asia in 2007. In the Russian Federation, with its strong market opportunities, FDI in the first half of 2007 reached $25 billion. FDI inflows in Uzbekistan doubled in the first nine months of 2007, after a new agreement was reached with the General Motors Corporation to build cars in that country. More than half of Georgia's FDI went to its banking, tourism and manufacturing sectors. Armenia's FDI inflows grew in the first half of 2007 by 33.0%, reaching $148 million. Most of the new foreign investment was directed towards financing the country's current-account deficit.

Foreign investment in Azerbaijan declined from $2.4 billion in the first six months of 2006 to $2 billion in the first half of 2007, as construction projects in the oil and gas sectors were completed. But these sectors continued to receive large FDI inflows. FDI in Tajikistan rose to $33 million in the first quarter of 2007 – still a low figure compared with those for other Central Asian countries.

High commodity prices and tax reforms stabilized some countries' fiscal positions

Budget revenues for oil- and gas-producing countries benefited in 2007 from high commodity prices. Energy-related earnings continued to buttress the Russian Federation's solid budget performance. Its federal budget surplus is expected to account for 3.0% of GDP in 2007.

In addition, many North and Central Asian economies continued to improve revenue collection and tax administration in 2007, stabilizing their fiscal positions. For example, when unexpectedly high revenues from oil export volumes brought Azerbaijan's state budget a surplus equal to 4% of GDP in the first eight months of 2007, taxes on corporate profits in construction and communications ensured that the rising prices resulted in higher government revenues. Azerbaijan's budget was expected, though, to revert to a deficit of 2% of GDP by the end of 2007, after increases to the minimum wage and to public sector salaries.

Georgia's budget deficit, caused by social welfare obligations, was expected to shrink in 2007 (from the 2.8% of GDP recorded for 2006) as the government tried to reduce poverty and unemployment by tightening its fiscal policy – one of its main budget priorities for 2007. When the Government of Kyrgyzstan similarly tightened its fiscal policy in response to the 2007 surge in consumer price inflation, its budget deficit target for the year was revised down from 3.1% to 2.5% of GDP.

Kazakhstan was expected to have a small deficit in 2007 (0.8% of GDP) after increases to public sector wages, agricultural subsidies and government spending on regional development. Uzbekistan's 2007 budget performance was strong and its budget deficit was modest, thanks to high commodity prices (especially for gold and cotton).

Although countries in the subregion continued to reform their tax policies, working to ease tax burdens and to make tax structures conform better to a market-based system, the pace of such reforms slackened in 2007 and progress was uneven. Tajikistan was expected to have a budget deficit of 4.2% of GDP for the year because of the country's narrow tax base and its increased spending on health and education. To finance the deficit, the government has continued to depend (despite ongoing tax reforms) on external borrowing, international grants and credit from multilateral agencies.

Tax collection remained a serious problem in Armenia. After the government raised spending on social programmes, the state budget deficit for 2007 was expected to equal 1.5% of GDP – an amount to be covered by international financial institutions and government securities.

Higher remittances and foreign direct investment meant stronger currencies

The economies of North and Central Asia in 2007 had two key monetary policy targets: to curb rising inflation and to prevent excessive real exchange rate appreciation. Governments tightened their monetary policy by increasing bank and government deposits, and by periodically raising the benchmark interest rates and refinancing rates of the central banks.

The Central Bank of Armenia raised its refinancing rate to 5% and increased the use of domestic instruments, such as repo operations (sale-and-repurchase agreements), in 2007. To keep rising inflation under control, the national banks of Azerbaijan and Tajikistan raised their annual refinancing rates to 13%. But in these countries weak institutional capacity, low capitalization and an underdeveloped financial sector continued to constrain the use of sound monetary policy.

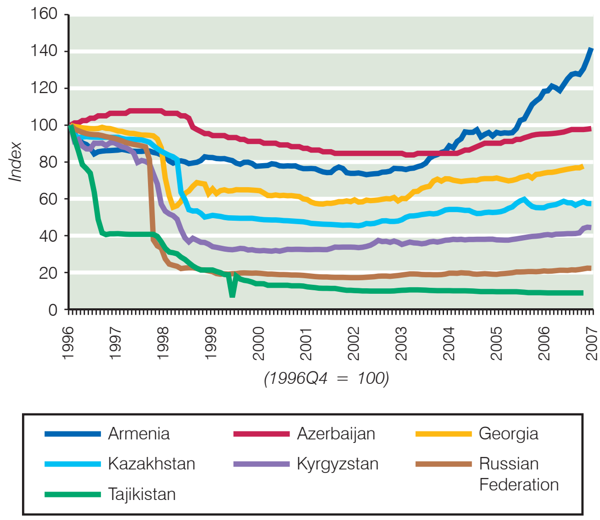
Georgia's monetary policy in 2007 was aimed at keeping inflation in the single digits and preventing real appreciation of the national currency, the lari. But an increase in FDI and remittance inflows led the lari's exchange rate to appreciate in both nominal and real terms in 2007 (figure 2.18). In both Kazakhstan and Uzbekistan massive foreign exchange inflows caused rapid growth in monetary aggregates. Uzbekistan's central bank continued to remove excess liquidity in 2007 as part of its drive to keep inflation in single digits. It resumed issuing bills, and it increased bank and government deposits, tightening monetary policy to slow expansion in the money supply – which is nonetheless expected to grow rapidly in 2008-2009, fuelled by higher commodity prices.

> *Kazakhstan was hit by the international liquidity crisis after a major growth in credit financed by foreign banks*

Kazakhstan was hit by the international liquidity crisis after a major growth in credit financed by foreign banks. The banking sector's liquidity problems drove up the people's demand for foreign currency. A growth of monetary aggregates, sparked by increased bank lending, in turn put upward pressure on prices. The government intervened quickly to stabilize the slowdown in banking sector credit growth, with a positive effect on prices. But tighter lending policies risked dampening growth in the non-oil economy, thereby jeopardizing the diversification targets identified in the government's published development strategy (Kazakhstan 2030). Growth in monetary aggregates was expected to slow in 2008 owing to increased reserve requirements for commercial banks.

The Russian Federation's monetary policy continued to focus on its exchange rate. A key policy issue for its central bank was to maintain a nominally stable rate of exchange for the ruble against a dual-currency basket, 55% of which would be United States dollars and 45% euros. But currency strengthening remained the best way to dampen inflation in the economy, and the inflationary pressures of 2007 forced the ruble to strengthen against its target basket in real effective terms. Meanwhile, as tighter global credit conditions sparked ongoing domestic liquidity concerns, the central bank cut its reserve requirements and expanded its refinancing operations to boost liquidity if needed.

Figure 2.18. Exchange rates against the United States dollar for selected North and Central Asian economies, 1996-2007



Sources: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2007); and *The Economist Database.*

Note: Data for 2007 are estimates.

In other North and Central Asian economies, national currencies were strengthened by large-scale foreign-exchange inflows and the weakening of the United States dollar on world markets. The Azerbaijan manat was stronger by 3% in real terms in November 2007 than it had been a year before. Kyrgyzstan's currency, the som, appreciated by almost 7% in the first eight months of 2007, reflecting robust remittance inflows and rising business activity in the country. In Tajikistan, continued growth in remittances from the Russian Federation and Kazakhstan allowed the somoni to remain stable in nominal terms against the United States dollar in the first half of 2007. Real appreciation of the national currency was a key concern for the National Bank of Tajikistan in 2007.

Sound monetary policy and continued tax reforms will maintain robust economic performance in 2008-2009

Food prices increased significantly throughout North and Central Asia in 2007, making sound monetary policy a main policy challenge for all countries in this subregion. The governments of Georgia and Tajikistan both faced the policy challenges of strengthening revenue collection and improving public expenditure policy. Georgia's government took measures to improve legislation and tax administration, to strengthen the financial, energy and health-care sectors and to implement privatization programmes. Tajikistan's state enterprises continued to run large tax arrears, which reached about $70 million in the first nine months of 2007. In Uzbekistan, the government sought to reinvigorate its privatization programme by undertaking preparatory measures to sell about 700 state-owned firms in the food, energy, chemical and automotive sectors. A new decree on privatization allowed the State to retain a 25% "golden share" in the privatized firms.

GDP growth in the economies of North and Central Asia in 2008-2009 will be closely linked to global commodity prices and to the economic performance of the subregion's largest investors and trading partners, such as the Russian Federation and Kazakhstan – the most important destinations for exports and migrants within the subregion. For example, increased investment in hydrocarbons and telecommunications from the Russian Federation and other Asian countries could push Uzbekistan's GDP up by about 7% in 2008-2009. High international prices for hydrocarbons should also drive economic growth in Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan.

Growth is expected to remain strong in 2008-2009

Azerbaijan's GDP growth is expected to slow from an estimated 25% in 2007 and 2008 to about 10.5% in 2009 – still a vigorous rate, thanks to private consumption and investment spending. Kazakhstan 's growth is expected to slow from an estimated 9% in 2007 to 8.0% in 2009, with rising inflation and banking sector liquidity problems. Annual average consumer price inflation in Kazakhstan could decelerate to 8.0% in 2008 (from an estimated 10.8% in 2007), as demand-side pressures increase following public-sector wage hikes and rising social expenditures. Armenia's so-called second-generation reforms programme, intended to reduce poverty and ensure continued economic growth, envisages good governance and 9% GDP growth in 2008 and – in each of the next four years – an annual economic growth rate of at least 8%.

GDP growth is expected to slow to 6.5% in 2008-2009 in the Russian Federation, where tighter liquidity could dampen investment and consumption. In 2008, to improve budget planning and transparency, the government will begin operating on a three-year budget basis. Energy-related earnings will be separated from other revenue inflows. The federal budget surplus is expected to shrink in 2008-2009, with high growth in expenditure and a declining growth rate for energy earnings. High energy prices and fiscal loosening will prevent consumer price inflation in the Russian Federation from falling below 7.5% by the end of 2009. By that time, strong imports and moderate export growth could reduce the country's current account surplus.

Tajikistan's new country development strategy for 2008-2015 envisages balanced investment in energy, infrastructure and human development. To realize sustainable long-term gains, the government is expected to focus on ensuring external debt sustainability through a debt strategy with a manageable debt/GDP ratio as a ceiling, and through creating favourable private-sector development conditions that encourage both foreign investment and small and medium-sized enterprises. Two stated government priorities are gender equality (in both the public and private sectors) and a deepening of ongoing public administration reforms. Such reforms would ensure the delivery of basic services and offer aid donors the confidence they need to justify their financial support.

Kyrgyzstan has attained macroeconomic stability. Investment in its economy is growing. And its export potential is increasing. It has made the energy and transportation sectors priorities for increased foreign investment. Kyrgyzstan also has a new development strategy for economic reforms aimed at reducing poverty. The government will seek to reduce overall poverty from 41% to 30% over a three-year period. But it do this only with annual economic growth of 8% or 9% – and reduced gold exports are expected to lower Kyrgyzstan's GDP growth to 7% in 2008 and 4.5% in 2009.

Social reforms will present a central policy issue for North and Central Asian economies in 2008-2009. So far, such reforms have appeared to lag behind macroeconomic reforms. Although governments have taken many positive measures to channel the benefits of economic growth towards improved living standards, strategic investments are needed to reverse rising inequality and deterioration in the subregion's education and health-care systems (see policy research feature 2.2).

Policy research feature 2.2: Poverty, education and health challenges during economic transition in North and Central Asia

In the aftermath of the break-up of the former Union of Soviet Socialist Republics in 1991, the countries of North and Central Asia confronted new economic and social challenges, losing about half of their 1989 GDP. But since the mid-1990s, the achievements of transition have been considerable. By 2007, five economies of the subregion had grown beyond their 1989 GDP (figure 2.19), and the Russian Federation is expected to have done so by the end of 2007.

Economic improvements had a significant impact on poverty reduction

Achievements in education and health are impressive, with high literacy and high life expectancies. But the newly independent States of the former Soviet Union have grappled with complex social challenges. Compounding the collapse of the economic system were a deterioration in living conditions and sharply lower funding for social protection, education and health. No country was able to maintain the social infrastructure or the quality of education and health services inherited from the former Soviet Union.

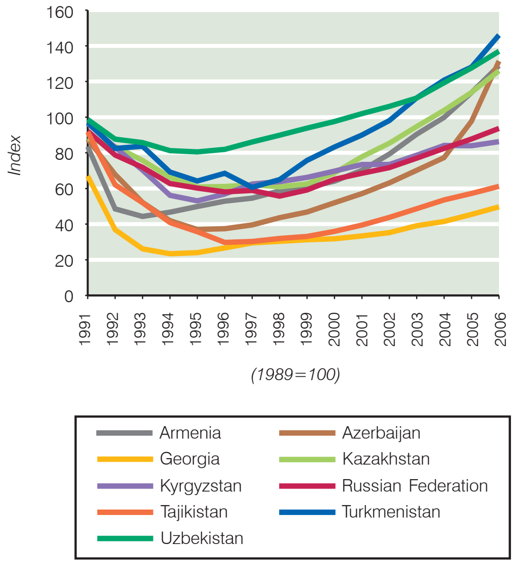
Poverty's many dimensions in North and Central Asia

The transition to a market economy brought severe hardships for most people, and living standards collapsed in all of North and Central Asia. Over most of the 1990s, poverty sharply increased, the result of contracting GDP, galloping inflation, widening unemployment and falling real wages and incomes. Poverty incidence reached 62% in Azerbaijan (1995), 55% in Armenia (1998), 43.4% in Kazakhstan (1998), 64.1% in Kyrgyzstan (1999) and 83% in Tajikistan (1999).

As the economies of the North and Central Asia started to recover in the late 1990s, poverty came down. The proportion of people living below the national poverty line fell to 29.3% in Azerbaijan (2005), to 34% in Armenia (2005), to 18.2% in Kazakhstan (2006), to 45.9% in Kyrgyzstan (2004), and to 64% in Tajikistan (2003). More impressive has been progress at reducing extreme poverty. In Kyrgyzstan, dollar-a-day poverty fell from 20.3% in 1996 to about 2% in 2003. In Tajikistan, it fell from 13.9% in 1999 to 7.4% in 2003.

Poverty is about more than income. Some social indicators in North and Central Asia remain impressive (table 2.4). Adult literacy rates are close to 100% in most countries. But life expectancy at birth decreased in Kazakhstan, the Russian Federation and Turkmenistan. The UNDP *Human Development Report 2007/2008* also shows declining human development for some North and Central Asian countries, the result

Figure 2.19. Turbulence during economic transition: Index of real GDP in North and Central Asian developing economies, 1991-2006



Sources: ESCAP, based on website of the CIS Inter-State Statistical Committee, <www.cisstat.com> (28 November 2007); and ECE, *Economic Survey of Europe 2004,* No. 1 (United Nations publication, Sales No. E.04.II.E.7).

Table 2.4. Challenging times for human development in North and Central Asia

	Adult literacy rate (% ages 15 and above)	Life expectancy at birth (years)		Infant mortality rate (per 1 000 live births)		Human development index	
	2004	1990-1995	2000-2005	1990	2004	1992	2005
Armenia	99.4	68.7	71.4	52	29	0.739	0.775
Azerbaijan	98.8	65.6	66.9	84	75	0.696	0.746
Georgia	100.0	70.5	70.5	43	41	0.709	0.754
Kazakhstan	99.5	65.2	63.2	53	63	0.798	0.794
Kyrgyzstan	98.7	65.8	66.8	68	58	0.717	0.696
Russian Federation	99.5	66.8	65.4	23	17	0.849	0.802
Tajikistan	99.5	63.1	63.5	99	91	0.643	0.673
Turkmenistan	98.8	63.3	62.4	80	80	0.739	0.713
Uzbekistan	99.3	66.2	66.5	65	57	0.706	0.702

Sources: UNDP, *Human Development Report 2007/2008;* and ESCAP, *Economic and Social Survey of Asia and the Pacific 2007* (United Nations publication, Sales No. E.07.II.F.4).

of lower life expectancies and incomes. And though the region's economies continue to be classified as having medium human development, their rankings have fallen, with the Russian Federation ranked 67 of 177 countries, Kazakhstan 73, Uzbekistan 113 and Tajikistan 122 (UNDP, 2007).

Income inequality worsened in all of North and Central Asia after 1990, with initial improvements recorded only over 1996-1998. In Kyrgyzstan, the Gini coefficient (a measure of income inequality, with higher values denoting more unequal incomes) increased from 26.0 in 1988 to 40.5 in 1997. Only in 2003 did it come down to 30.3, still above the 1988 level. In Uzbekistan, the Gini coefficient rose from 25.0 in 1988 to 45.4 in 1998 before coming down to 36.7 in 2003. In the Russian Federation, the coefficient rose from 23.8 in 1988 to 46.2 in 1996 before dropping to 39.9 in 2002. If North and Central Asia is to make progress towards a full market economy, income inequality remains a major challenge.

Funding shortfalls in education

Since the transition to a market economy, education has been deprived of resources, and the standard of education has declined. In Armenia, spending on education was 6.6% of GDP in 1990, but by 2005 it plummeted below 3%. In Kazakhstan, spending fell from 3.9% of GDP in 1999 to 3.5% in 2005. In Azerbaijan, government spending on education fell to 2.7% of GDP in 2006 from 7.7% of GDP in 1990. In Kyrgyzstan, spending fell from 6.5% of GDP in 1995 to 3.5% in 2005. In Uzbekistan, spending dropped from 12% of GDP in 1992 to 6.3% in 2005. The Russian Federation is the exception. There, spending rose from 3.0% of GDP in 2000 to 3.7% in 2006. Significant attention was also given to teachers and academics, whose salaries had lagged behind the national average.

Funding shortfalls have led to a staffing crisis in most of North and Central Asia. The salaries of teachers were so low that many highly qualified teachers and university professors left the system for better paying jobs. Many school teachers in Central Asia supplemented their salaries by working in agriculture, raising animals or selling goods. Budget cuts have also reduced the funding for training teachers and purchasing textbooks.

"Enrolment rates in pre-primary education have declined in all countries"

The dramatic drop in education funding has made it difficult to maintain universal general education – and to meet the requirements of emerging market economies. From 1990 to 2005, enrolment rates in pre-primary education declined in all countries, and enrolment in basic education fell in Armenia and Turkmenistan. Upper secondary enrolment fell in Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. During the same period, however, enrolment in higher education increased in most of North and Central Asia. Over 1990-2005, enrolment in universities increased from 18.7% to 44.7% in

Kazakhstan, from 12.9% to 37.2% in Kyrgyzstan, and from 24.6% to 47.2% in the Russian Federation.

The transition's challenges for health: funding and service quality

Post-independence economic conditions placed new demands on health systems – and revealed inefficiencies. In the mid-1990s, life expectancy dropped in all of North and Central Asia. Most economies ultimately recovered, but from 1990 to 2005, life expectancy dropped from 68.9 years to 65.5 in the Russian Federation, from 68.3 to 66.2 in Kazakhstan and from 69.2 to 67.4 in Uzbekistan. The patterns are the same for both male and female life expectancy.

Government health expenditure as a proportion of total budgeted expenditure rose slightly after 1999, but the rate of increase is limited and spending remains short of the pre-transition level. Per capita total health expenditures and per capita government health expenditures at international dollar rates over 2000-2004 have only slightly increased or have plateaued in Kyrgyzstan, Tajikistan and Uzbekistan. There has been a more significant increase in Armenia, Kazakhstan and the Russian Federation (figure 2.20).

Total expenditures on health rose by more than 188 international dollars in the Russian Federation over 2000-2004, by 94.6 dollars in Kazakhstan, by 75.7 dollars in Armenia, by 69.3 dollars in Georgia and by 15.3 dollars in Uzbekistan. In the Russian Federation, Kazakhstan and Uzbekistan, more than half the increase came from government sources (table 2.5). But in the other six countries, the increase was due largely to higher private health expenditure – indicating that out-of-pocket spending is rising in most of the countries and a sign that inequities in health services could continue to increase.

When the centrally planned system disintegrated, most of the formal hierarchy stayed in place but the quality of services and infrastructure plummeted. From 1990 to 2003, the number of physicians per 1,000 people fell from 4.9 to 4.1 in Georgia, from 3.4 to 2.6 in Kyrgyzstan, from 2.6 to 2.0 in Tajikistan and from 3.4 to 2.7 in Uzbekistan. In Central Asia, trained personnel in rural areas left their jobs to seek employment elsewhere, leaving a shortage of doctors. From 1990 to 2005, the number of hospital beds per 1,000 people declined from 9.8 to 3.8 in Georgia, from 12.0 to 5.1 in Kyrgyzstan, from 11.5 to 4.9 in Turkmenistan and from 12.5 to 5.2 in Uzbekistan. The ratio of physicians to people in the Russian Federation increased, however, owing to an expansion in private practitioners.

Policy issues and challenges

Lack of financial, human and institutional resources to support education and health hampers social development in North and Central Asia. Macroeconomic reforms to support the market transformation since 1991 have included measures to reduce poverty and to improve education and health care. Education and health have benefited from changed government expenditure priorities through new teacher training programmes, hospital renovations and more financing for primary health care:

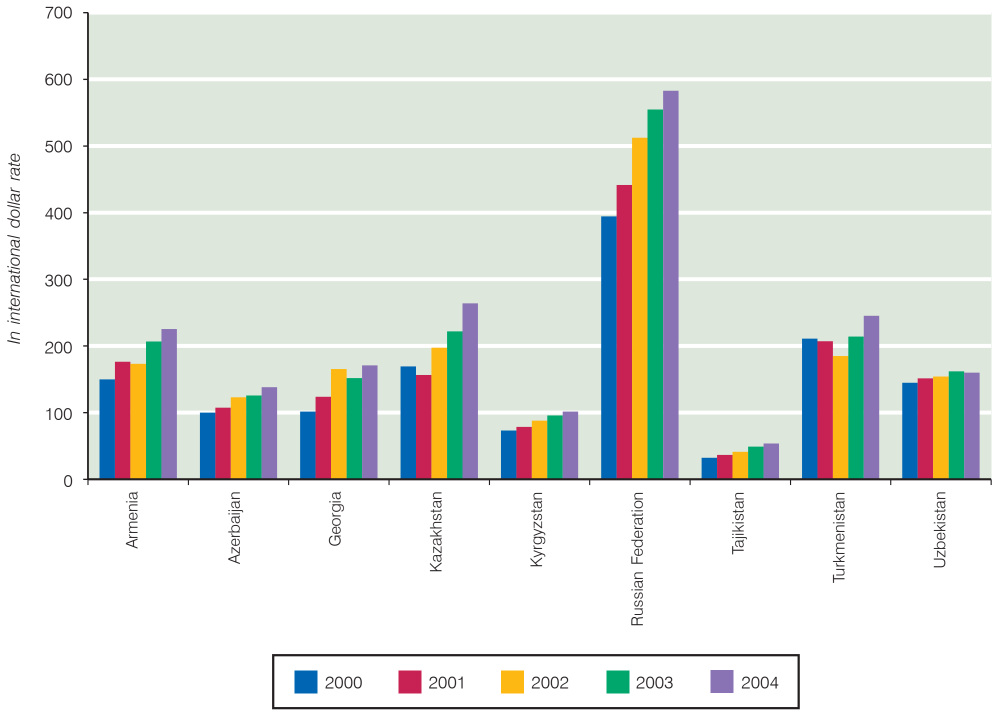
- Tajikistan's draft budget for 2008 envisages a 41% increase in spending on education and a 44% increase on medical care, much of it earmarked for pay raises for medical personnel and teachers.
- Armenia is expected to increase spending on education and health care by 20% in 2008.
- The Russian Federation has made education a "national project" for priority government expenditure.
- Azerbaijan launched a 10-year education reform programme to address declining standards. With financial assistance from international organizations, the programme focuses on financing and budget reforms, enhancing the quality of the curriculum, increasing access to education for children from deprived areas and strengthening school management.
- Turkmenistan reinstated a compulsory tenth year of schooling and abolished the requirement for students to work before embarking on tertiary education.

Governments have promoted private schools and universities and encouraged parents to participate in financing their children's education, though the State continues to allocate resources for basic education. Private educational establishments have been set up in most of the subregion.

But challenges remain. Private education accounts for a small share and does not yet play a significant role. Enrolment in private institutions does, however, increase with the level of education. In the Russian Federation, private schools accounted for almost 40% of all higher education establishments in 2005.

From 2001 to 2005, health facilities became semi-autonomous and more responsible for their own financing. Regional and local health officials are responsible for national programmes and for enforcing

Figure 2.20. Health spending in North and Central Asia is rising more quickly in some countries than in others: Per capita health spending at international dollar rates



Source: World Health Organization, *Core Health Indicators,* <www.who.int/whosis/database/core/core_select.cfm>.

Table 2.5. The government contribution to higher per capita spending on health, 2000-2004

	Increase in per capita total expenditure on health at international dollar rate	Increase in per capita government expenditure on health at international dollar rate	Proportion of increase contributed by the government
Armenia	75.7	34.1	45.0
Azerbaijan	38.4	13.8	36.3
Georgia	69.3	20.0	28.9
Kazakhstan	94.6	74.6	78.8
Kyrgyzstan	28.5	6.4	22.4
Russian Federation	188.5	112.0	59.4
Tajikistan	21.5	4.1	19.1
Turkmenistan	34.3	12.4	36.2
Uzbekistan	15.3	9.5	62.1

Source: World Health Organization, *Core Health Indicators,* <www.who.int/whosis/database/core/core_select.cfm>.

policies and regulations. State health agencies are the principal public buyers of health services and handle State health-care funds. Some health facilities in Azerbaijan have been privatized, but the State remains the principal provider of health care, and the system is highly centralized. Georgia hopes to attract private investment in health care through the "100 New Hospitals" programme, launched in 2007. Through this programme, private funding is expected to make 7,800 more hospital beds available by 2009.

"Unless addressed, inequality in access to health services could continue to increase"

Kazakhstan, Kyrgyzstan, the Russian Federation and Turkmenistan have instituted compulsory health insurance plans. Tajikistan and Uzbekistan continue to rely mainly on government sources. Even so, insurance has been unable to increase health-sector revenues significantly, handicapped by the same limitations that affect tax collection. But social health insurance may change health systems in other ways, for example by introducing new provider payment systems and setting standards that may, in the long run, lead to better efficiency and quality.

Again, challenges remain. Introducing health insurance for a select group of people who would then have access to better health care risks excluding the poor and vulnerable from health services. The need is a funding system that protects everyone's interests while ensuring quality.

What will it take for progress on poverty, education and health? Macroeconomic performance is critical for reducing poverty and implementing policy reforms in education and health. With the countries of North and Central Asia becoming increasingly reliant on remittances, such inflows could contribute to resolving these problems. The inflow of remittances into Armenia increased by about 40% to $424 million, in the first half of 2007. Remittances accounted for more than 30% of GDP in Kyrgyzstan in 2006 and could reach a new high in 2007. In Tajikistan, remittance payments increased by 57% – from $150 million in the first quarter of 2006 to $237 million in the first quarter of 2007.

Effective use of the region's large intellectual potential should be integral to subregional economic and social cooperation, especially on education. Since 1991, the countries of North and Central Asia have passed laws to change the content of training programmes and textbooks, widen the networks of high schools and universities to better respond to emerging skill needs, and introduce national languages in education. But the isolation of national educational systems creates difficulties in exchanging students and in establishing the equivalency of certificates, which affect the common labour market. A coordinated approach to these problems is needed.

"Economic and social cooperation between countries in the subregion is necessary for making progress on the social agenda"

Public health programmes remain underfunded in most economies. A major challenge everywhere is financing and delivering health services in an efficient and equitable way. Reforms in health-care systems are aimed at obtaining additional financing through non-budgetary sources, including insurance funds; reducing pressure on the national budget by decentralizing health-care financing to the regional and local levels; improving service delivery by restructuring it to favour primary care; promoting general and family medical practice; and eliminating unneeded hospital capacity.

Pooling financial and technological resources could help the subregion progress in education and health. To do this, the countries of North and Central Asia have to coordinate work and establish new organizational structures and procedures for joint activities. The private sector could also be important in mobilizing financial resources.

Pacific island developing countries: Modest growth

In contrast to Asia's robust economic growth, the island developing countries of the Pacific experienced an overall growth rate of less than 3% in 2007.

Growth was stronger in Melanesia than in Polynesia or Micronesia

In Melanesia, the economies of Papua New Guinea, Solomon Islands and Vanuatu, together with that of New Caledonia, continued to grow strongly at rates of around 5% or more. But a contraction was expected in Fiji in 2007. In Micronesia, only Palau showed strong projected growth, while Polynesia's island economies all grew modestly or contracted (figure 2.21).

Melanesia. Real GDP for Fiji was projected to fall by 3.9% in 2007. The coup d'etat in December 2006 created uncertainty, leading to declining tourist arrivals, worker layoffs, a fall in the wholesale and retail trades and a freeze on private-sector investment projects. Before this contraction, in 2006, Fiji's growth rate had been 3.6%. Growth in Fiji's real GDP is expected to recover to 2.2% in 2008.

Papua New Guinea continued to benefit from mineral and petroleum prices, which have been rising since 2003. The country's real GDP was estimated to have risen by 6.2% in 2007 – its highest rate since 2003, and twice the country's population growth rate (3.1%). The government has done a generally good job at managing this financial windfall. It has used new funds to strengthen public assets and reduce the public debt. Inflation has receded to historically low levels. The economic boom has spilled into the non-mining sector, which includes retail, construction, agriculture, forestry and fisheries. Growth in the non-mining sector rose from an estimated 3.7% in 2006 to 6.5% in 2007. Still, constraints on business – such as weak governance, poor law and order, poor infrastructure and expensive and unreliable utilities – continue to limit interest in investment outside the mining and telecommunication sectors. Real GDP was projected to grow by 6.6% in 2008.

Real GDP in Solomon Islands was estimated to grow by 5.4% in 2007, with increased logging and log exports. As logging continues at a rate estimated to be five times the sustainable rate, growth may suffer from any decline in this sector. An earthquake of magnitude 8.1 on the Richter scale struck Solomon Islands in April 2007. Despite the physical destruction it caused, international aid minimized the harm to economic growth.

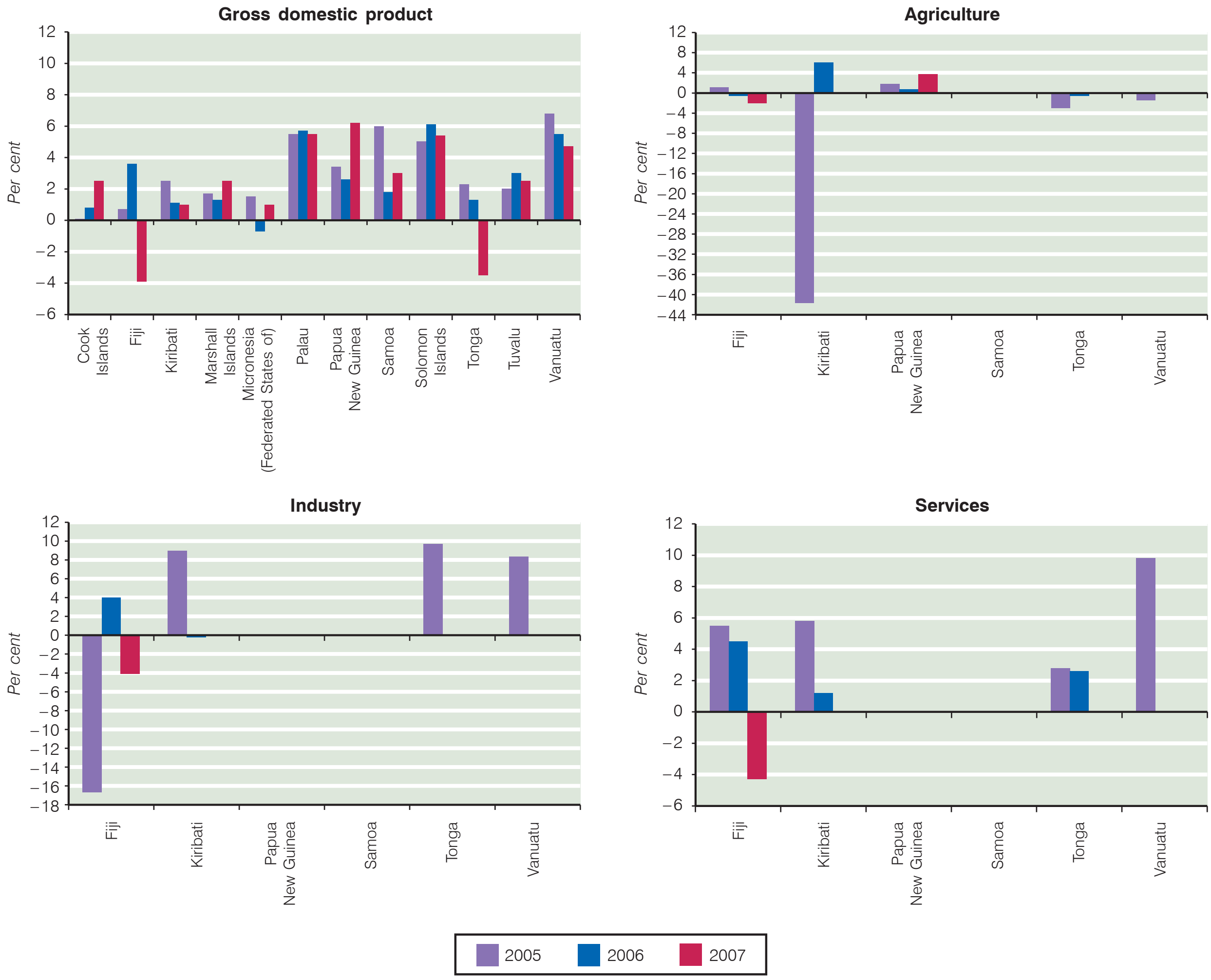
Vanuatu's real GDP growth for 2007 is projected at 4.7%. Since 2002 its growth rate has consistently exceeded its annual population growth rate (2.6%), as construction and tourism-related services expand to meet growing demand from new tourist arrivals. But small-scale agriculture still supports two thirds of the island's people, and a recovery in the agricultural sector in 2006 was crucial to the country's economy. Vanuatu became the first recipient in the Pacific of the United States Millennium Challenge Account. It will receive a grant of nearly $66 million from 2006-2010.

> *"Papua New Guinea grew at 6.2% in 2007 – highest since 2003"*

Micronesia. Guam, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Northern Mariana Islands and Palau together comprise Micronesia. In these countries and territories the public sector accounts for a large share of GDP. In Kiribati projected real GDP growth for 2007 was 1.0%. Kiribati continues to be highly reliant on income in the form of fees for fishing licences. In the Marshall Islands real GDP is estimated to have grown by 2.5% in 2007, while economic growth in the Federated States of Micronesia was projected at 1.0%. The Marshall Islands and the Federated States of Micronesia both rely heavily on grants from the United States under the Compact of Free Association. But this support has started to decline and is expected to fall to zero by 2023. Under the Compact, trust funds have been established to ensure budgetary self-sufficiency in these countries and territories when their grants expire.

With the near exhaustion of phosphate reserves, the dependence of Nauru on mining is shifting to reliance on international assistance. After three years without any economic growth, real GDP rose in 2006 as a result of investments in phosphate mining infrastructure. But negative growth is expected in 2007 and 2008.

Figure 2.21. Real GDP and sectoral growth in selected Pacific island economies, 2005-2007



Sources: ESCAP, based on national sources; Department of Treasury and Planning, Papua New Guinea, *2008 National Budget* (Port Moresby, November 2007); Ministry of Finance and National Planning, *Republic of Fiji; Economic and Fiscal Update, Supplement to the 2008 Budget Address* (Suva, November 2007); ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007), and *Asian Development Outlook 2007 Update* (Manila, 2007); IMF, *Samoa: 2007 Article IV Consultation Staff Report,* IMF Country Report No. 07/185 (Washington, D.C., June 2007); IMF, *Solomon Islands: 2007 Article IV Consultation Staff Report,* IMF Country Report No. 07/304 (Washington, D.C., September 2007); and IMF, *Tonga: 2007 Article IV Consultation Report,* IMF Country Report No. 07/297 (Washington, D.C., August 2007).

Notes: Growth rates for 2007 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power, and construction.

In Palau, real GDP is estimated to have grown by 5.5% in 2007 and projected to grow by 4.8% in 2008, as tourism grows and as externally funded infrastructure projects are implemented. Like some other Micronesian countries, Palau depends heavily on assistance from the United States. Its long-term growth prospects are closely tied to future grants.

Polynesia. The small islands in the ESCAP region that comprise Polynesia are Samoa, Tonga and Tuvalu, together with American Samoa, the Cook Islands, French Polynesia and Niue. Economic growth in Samoa is estimated to have risen to 3.0% in 2007, from 1.8% in 2006. The country's tourism and construction sectors grew, despite the scale-down of Yazaki Samoa (which produces automotive harness products for the Australian market) and a slow-down in the agricultural sector. One cause of growth was the Thirteenth South Pacific Games, which were held in Samoa in September 2007. Samoans living abroad sent home remittances equal to a quarter of GDP. Annual real GDP growth of 3 to 4% is projected in Samoa over the next three years.

Real GDP in Tonga was projected to fall by 3.5% in 2007, as a fire caused by civil unrest in Nuku'alofa in November 2006 severely damaged the business district. Both commerce and tourism fell sharply. These effects should be temporary, as reconstruction efforts will restimulate economic activity. But with weak growth of 0.8% forecast for 2008 in Tonga (and 1.3% for 2009), per capita income is still expected to continue its decline. A large inflow of remittances, equivalent to 45% of GDP in 2005, sustains the Tongan economy.

The economy of Tuvalu grew by 3% in 2006 and 2.5% in 2007, supported by the construction of the Funafuti power station and the upgrade of the Tuvalu Maritime Training Institute. Steady remittances continued to arrive from seafarers working on international vessels.

Difficult times for exports meant trade deficits

Imports of goods to Pacific countries often exceed exports because of their small and narrowly based economies (table 2.6). Some Pacific countries are seeking to improve market access for their exports. For example, they are bringing commercial relationships into line with World Trade Organization rules, negotiating Economic Partnership Agreements with the European Union and discussing ways to ensure free trade with Australia and New Zealand.

Melanesia. Papua New Guinea is among the few countries in the Pacific with a trade surplus, estimated at $1.3 billion in 2007 – an effect of high commodity prices. Still, the current account surplus of $100 million in 2007 reflects a decline from 7.4% of GDP in 2006 to 2.5% of GDP in 2007. The account surplus decline resulted from net outflows in services and increased imports.

Fiji and Solomon Islands continued to have trade deficits in 2007. Fiji's commodity exports declined by an estimated 7.9% in 2007, while its imports declined by 5.4%. A World Trade Organization ruling against preferential sugar prices (formerly extended by the European Union) is expected to hurt Fiji's sugar industry. Exports of fish, lumber, fruits and vegetables, coconut oil and kava are expected to rise. Gold and garment exports are expected to fall.

Since log exports account for 10% of GDP, 15% of tax revenues and 70% of the Solomon Islands' total exports, export diversification is essential. Higher

Table 2.6. Merchandise trade and current account balances in selected Pacific island economies, 2004-2007

(Percentage of GDP)

	2004	2005	2006	2007
Merchandise trade balance				
Fiji	–20.6	–23.6	–28.0	–26.6
Papua New Guinea	19.0	16.3	26.1	23.8
Samoa	–35.8	–38.8	–44.0	–47.4
Solomon Islands	–9.2	–27.6	–38.8	–40.3
Tonga	–37.5	–40.7	–45.4	–45.7
Vanuatu	–21.0	–23.5	–26.3	–30.9
Current account balance				
Fiji	–11.0	–11.4	–21.1	–19.6
Papua New Guinea	2.2	3.8	7.4	2.5
Samoa	–1.6	–4.6	–6.1	–8.1
Solomon Islands	3.1	–24.2	–26.5	–40.0
Tonga	4.2	–2.6	–8.2	–10.5
Vanuatu	–7.3	–10.0	–8.0	–13.2

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); ADB, *Asian Development Outlook 2007 Update* (Manila, 2007); Ministry of Finance and National Planning, *Republic of Fiji: Economic and Fiscal Update: Supplement to the 2008 Budget Address* (Suva, November 2007); Department of Treasury and Planning, Papua New Guinea, *2008 National Budget* (Port Moresby, November 2007); IMF, *Samoa: 2007 Article IV Consultation Staff Report,* IMF Country Report No. 07/185 (Washington, D.C., June 2007); IMF, *Solomon Islands: 2007 Article IV Consultation Staff Report,* IMF Country Report No. 07/304 (Washington, D.C., September 2007); IMF, *Tonga: 2007 Article IV Consultation Report,* IMF Country Report No. 07/297 (Washington, D.C., August 2007); and IMF, *Vanuatu: 2006 Article IV Consultation Report,* IMF Country Report No. 07/92 (Washington, D.C., March 2007).

Note: Data for 2007 are estimates.

prices for logs, fish and palm oil can partly explain why these products were increasingly exported in 2007. Imports rose in 2007, due to higher fuel prices and freight costs as well as a growth in domestic demand. The country's current account balance is projected to have deteriorated in 2007. But its overall balance of payments is expected to be positive, as a result of international assistance and investment inflow related to the Gold Ridge mine rehabilitation. Gold exports are expected to resume in 2008.

"Solomon Islands is highly dependent on log exports for growth and tax revenues"

Vanuatu's exports increased in 2006 with a recovery in copra and cocoa exports and a rise in exported timber, beef and kava. But coconut oil exports declined to one fifth of their 2004 level. Imports increased, mainly because of an increase in construction and higher priced fuel, and the trade deficit showed a consequent slight increase. Kava exports may have suffered from an Australian ban on commercial kava imports in 2007 (following earlier bans by France, Germany and United Kingdom). Although Vanuatu's current account deficit increased in 2007, its overall balance of payments is expected to remain positive thanks to inflows from grants and FDI.

Micronesia. Because countries in Micronesia are small, dispersed and geographically isolated, there are few opportunities for import substitution or export diversification. Micronesian countries need to import most essential goods and are highly dependent on aid.

Kiribati's major revenue sources include fishing license fees along with fish, copra and seaweed exports. In the Federated States of Micronesia, exports have declined with the loss of textile trade preferences. Meanwhile, a decrease in international flights has hurt tourism. Nauru resumed its phosphate exports; reserves are expected to last at least until 2009. Although Nauru has no fishing industry of its own, fishing licence fees are an important source of foreign exchange for Nauru.

Polynesia. Polynesia's small island countries have a narrow export base. To cover the cost of imports these countries depend on aid, remittances and receipts from tourism.

Samoa increased its imports rapidly in 2007, driven by robust economic activity and a rise in public sector wages. Most exports declined. But fish exports are expected to rebound after modernized fishing facilities are completed. Tourism receipts and remittances contributed towards maintaining the balance of payments.

Exports from Tonga – chiefly products from fisheries and agriculture – have declined since 2004. Despite the large inflow of remittances, the current account deficit in 2007 was equal to 10.5% of GDP. In July 2007 Tonga acceded to the World Trade Organization and made commitments to liberalize its trade regime.

Political conditions affect economic growth in the Pacific

The private sector can drive economic growth, but this can only happen where investors confidently expect a stable macroeconomic environment. Recent events in the Solomon Islands (April 2006), Tonga (November 2006) and Fiji (December 2006) have once again shown that political uncertainties can inhibit long-term economic growth. To encourage private investment, some Pacific island countries need to address governance issues – in particular accountability – and to strengthen the legislative and regulatory environment (the rule of law).

Another urgent issue for investment in Pacific island countries is service quality – a critical factor affecting investment decisions. Most Pacific island countries have public monopolies in water and electricity supplies and port and inter-islands shipping services. The public and semi-public utilities (and other monopolies) are maintained with fiscal support. Even so, they are often inconsistent and expensive. To make the utilities more efficient, international donors and development agencies have often proposed privatization or international private participation, but such measures have yet to be introduced in most countries.

Tourism, telecommunications and agriculture could drive future growth

The countries of the Pacific could grow more rapidly through development in tourism, agriculture and telecommunications. In recent years tourism has led growth in several Pacific island countries. In Fiji this sector has been well-developed for many years. But tourism-related economic activity has become more important in the other countries only recently – a change facilitated by international air service liberalization in the Pacific.

A liberalized Pacific telecommunications market could lower service costs and mitigate the effects of geographic isolation. Both Papua New Guinea and Samoa have introduced competition into the mobile telephone market, causing prices to fall significantly. Such a move could create efficiencies for sectors that depend on these services, such as tourism and agriculture. And if the cost of telecommunications should fall to globally competitive levels, some countries might be able to develop viable industries in information and communication technology.

> *Liberalization of telecommunications could lower prices and improve services*

In Melanesia's fairly well-populated countries, a high proportion of the rural population is living at subsistence levels. These countries will experience a large "youth bulge" over the next 25 years. Without great changes most of these young Melanesians will be unable to find formal employment. For these large rural populations to be able to increase their incomes and living standards, agricultural productivity will have to increase significantly. Rising agricultural productivity, with its backward and forward linkages, could be an excellent basis for economic growth in these countries.

Pacific island developing countries face multiple challenges that have limited their economic growth. Such challenges include geographic dispersion, distance from major markets, small domestic markets, largely unskilled populations and – with the exception of Papua New Guinea – limited natural resource endowments. Limited labour markets present particular difficulties (see policy research feature 2.3). In addition, the high cost of petroleum has been a significant handicap for non-oil-producing countries in the Pacific in recent years. Some of the constraining factors, such as geography and a narrow resource base, cannot be changed. But others can – including poor governance, political uncertainties, costly and unreliable utilities, high transportation and telecommunication costs, rigid customary land tenure systems and an unwelcoming investment environment. To change these circumstances may be politically difficult. But it is not impossible.

Policy research feature 2.3: Improving employment opportunities in Pacific island economies

Demographic changes are pushing more people into the labour market in the Pacific island developing countries and territories. To ensure that new entrants into the labour market succeed, governments need to implement coherent macroeconomic and social policies to encourage growth in employment, especially in the private sector.

Fast-growing labour markets, limited employment prospects

Population growth in the Pacific will be rapid for the foreseeable future, except in countries with significant emigration. The implication will be more pressure on fragile ecosystems and the limited available land, as well as on infrastructure such as water supply and on public services such as education and health. There will also be greater difficulty in finding employment for the growing number of young and educated people with aspirations beyond village-based and family-oriented agriculture and fishing. These problems are of particular concern in the more populous countries of Melanesia, which, unlike most Micronesian and Polynesian countries and territories, do not enjoy historical migration outlets to other countries.

The populations of Papua New Guinea, Solomon Islands, Vanuatu, Kiribati and the Marshall Islands are forecasted to grow significantly by 2029 (table 2.7). In contrast, the population of Cook Islands is expected to contract because of high emigration rates. That of Tonga will experience relatively slow growth. Changes in migration patterns, mortality and fertility trends could affect the projections.

Formal sector employment prospects are poor, owing to the moderate economic growth expected (table 2.8).

Table 2.7. Rapid population growth in much of the Pacific: Forecast percentage population change in selected Pacific island developing economies, 2004-2029

(Per cent)

Melanesia		***Micronesia***		***Polynesia***	
Fiji	25.5	Kiribati	72.7	Cook Islands	–29.6
New Caledonia	37.5	Marshall Islands	82.4	French Polynesia	40.9
Papua New Guinea	72.2	Micronesia (Federated States of)	59.6	Samoa	24.5
Solomon Islands	75.3	Nauru	26.0	Tonga	9.2
Vanuatu	89.7			Tuvalu	32.2

Source: H. Booth, G. Zhang, M. Rao, F. Taomia and R. Duncan, *At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labour Mobility* (Washington, D.C., World Bank, 2006).

Table 2.8. Only moderate employment growth expected: Forecast changes in formal sector employment in selected Pacific island developing economies

	2004	***2015***	***Change (per cent)***
Cook Islands	5 900	6 000	1.7
Fiji	122 000	145 880	19.6
Marshall Islands	10 480	11 270	7.5
Micronesia (Federated States of)	15 350	16 470	7.3
Papua New Guinea	205 870	226 460	10.0
Samoa	59 000	63 425	7.5
Solomon Islands	30 070	32 360	7.6
Tonga	35 820	37 610	5.0
Vanuatu	16 300	17 820	10.0

Source: H. Booth, G. Zhang, M. Rao, F. Taomia and R. Duncan, *At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labour Mobility* (Washington, D.C., World Bank, 2006).

A 20% increase in employment in Fiji between 2004 and 2015 is plausible if tourism growth continues. But in the smaller countries, such as the Federated States of Micronesia and the Marshall Islands, the prospects for employment growth are weak. Public sector employment is not likely to grow much further against a backdrop of declining aid and public sector reforms, while private sector activity is limited. Formal sector employment growth will continue to be slow in Papua New Guinea, Solomon Islands and Vanuatu. Without substantial improvements in the investment environment in these countries, the prospects for private sector growth will remain slight.

Varied labour market characteristics

Labour force participation varies significantly among Pacific island economies and between men and women (table 2.9). Vanuatu has participation above 80% for both men and women. Male participation rates are comparatively high in Fiji and Solomon Islands. In contrast, participation rates are low in the Marshall Islands, particularly for women, and in the Federated States of Micronesia. However, much of the difference among countries may be due to measurement differences. Some countries include all people engaged in subsistence activities as economically active, while others only include those who indicate that they are working for cash. The treatment of women's activities also varies.

Table 2.9. Highly variable labour force participation rates in the Pacific islands, selected economies

(Per cent)

	Female	Male	Year
Cook Islands	61	76	2001
Fiji	55	83	2005
Guam	50	62	2002
Kiribati	56	72	2005
Marshall Islands	35	66	1999
Micronesia (Federated States of)	50	67	2000
Niue	49	75	2001
Northern Mariana Islands	78	85	1999
Palau	60	77	2005
Papua New Guinea	73	75	2005
Samoa	43	81	2005
Solomon Islands	56	83	2005
Tokelau	47	80	2001
Tonga	53	75	2003
Vanuatu	80	89	2005

Source: ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007).

The labour force in most Pacific island developing economies has a large unskilled component, reflecting the dual nature of labour markets there. Most rural employment is informal or based on subsistence production and cash cropping. Formal sector employment, concentrated in urban areas, is dominated by the public sector. In the larger economies, there is substantial formal and informal employment in the private sector. The informal sector, often ignored, absorbs the unemployed and many who leave the rural agricultural sector. Papua New Guinea became the only Pacific island developing country to adopt legislation recognizing the contribution of the informal sector to employment growth when it adopted the Informal Sector Development and Control Act in 2004.

The urban-rural distribution of employment varies widely across the region (table 2.10). In Papua New Guinea, where the majority of the population is engaged in subsistence agriculture and small-scale cash cropping in the informal sector, about 90% of the 2.3 million workers are employed in rural areas. In contrast, in Fiji more than half of those employed are in urban areas.

Table 2.10. Urban employment dominates in some Pacific island developing economies, rural employment in others

	Total	Rural	Urban
American Samoa	12 902	..	..
Cook Islands	5 928	1 359	4 569
Fiji	219 314	107 853	111 461
Guam	54 980	..	..
Kiribati	39 912	21 505	18 407
Marshall Islands	10 141	3 218	6 923
Micronesia			
(Federated States of)	29 175	..	..
Niue	663	403	260
Northern Mariana Islands	42 753	3 530	39 223
Palau	9 383	1 213	8 170
Papua New Guinea	2 344 734	2 157 500	187 234
Samoa	50 325	37 933	12 392
Solomon Islands	57 472	..	..
Tokelau	542	..	..
Tonga	34 560	..	..
Tuvalu	3 237	1 816	1 421
Vanuatu	75 110	61 865	13 245
Wallis and Futuna	2 465	2 033	432

Sources: Compiled from the Secretariat of the Pacific Community, Pacific Regional Information System database, available at <http://www.spc.int/prism>; and the University of the South Pacific, Employment and Labour Market Studies Program database.

Unemployment, underemployment and migration

Reported unemployment varies considerably, in part because each country has its own criteria for determining who counts as unemployed. In Fiji, Papua New Guinea, Samoa and Solomon Islands, the unemployed are people in the labour force who are currently not working but are actively seeking work. In Tonga, the unemployed also include people not actively looking for a job. Because "unemployment" is hard to define in the rural areas of the Pacific, the region needs some agreed definitions in order to reflect the realities of rural life.

Underemployment is likely widespread in most countries, and many people are engaged in subsistence and small-scale cash-cropping activities.[2] Although many would be willing to take other income-earning opportunities, they are often hampered by lack of skills and access to high-quality education and training facilities.

Disadvantaged in Pacific labour markets, women are underrepresented in formal employment, except for occupations regarded as traditional for women. They are important in informal and cash-cropping activities in many countries. Lack of serious attention to gender issues in the labour market has often resulted in low labour force participation among women.

With 45% of the population in the 15-24 age group, the labour force in most Pacific island developing countries is young. Unemployment in this age group is widespread, and many youths are underemployed in subsistence work or the informal sector. In Solomon Islands and Vanuatu, youth unemployment is especially acute. In Fiji, 16,000 school graduates enter the labour market each year. Because opportunities for formal employment are limited, most have no choice but to join the informal sector.

The migration of skilled workers for permanent or temporary work overseas is a common feature of some Pacific island developing countries. Although generally leading to a greater inflow of remittances, such practices also reduce the pool of human resources. Many workers from Fiji, the Federated States of Micronesia, the Marshall Islands, Palau, Samoa and Tonga have used bilateral and preferential channels to migrate to such countries as Australia, New Zealand and the United States of America. Citizens of Kiribati and Tuvalu have a long-standing tradition of working overseas as seamen. Remittances now account for a high proportion of the gross national income in these countries.

"Widespread unemployment among youth"

The few migrants from three of the Melanesian countries (Papua New Guinea, Solomon Islands and Vanuatu) reflect the limited opportunities available to the many unskilled people in these countries, as well as cultural barriers to migration. The Pacific Island Countries Trade Agreement (PICTA) is designed to facilitate the free movement of goods within the subregion. But countries without substantial goods exports, such as Kiribati and Tuvalu, would benefit if labour was also included.

Policy issues and challenges

All Pacific island developing economies have legislation to frame labour market operations. But its reach tends to be restricted to the formal sector, which represents only about 10-15% of the labour force in most countries. The majority of the workforce is employed in the informal sector, not governed by workplace legislation. Except for Tonga, Pacific island countries have employment ordinances and legislation on trade unions. Those countries also usually have workmen's compensation acts that specify the definitions and conditions of various employee entitlements.

"Fiji has recently passed new labour legislation to eliminate gender discrimination and workplace harassment"

Many Pacific island developing economies are revising and updating their labour legislation and regulations to reflect changing labour market conditions. Fiji has recently passed new labour legislation, due to come into effect in 2008, that includes provisions to eliminate gender discrimination and workplace harassment.

Most Pacific island developing economies do not have social security arrangements or unemployment benefit

[2] Underemployment refers to people who work fewer hours than they would be willing and able to work or are working in positions requiring less skill than they possess.

schemes.[3] Many have national provident funds, provided for by acts of Parliament, requiring employees and employers to contribute. But because these schemes cover only formal sector employees, most people working in the informal sector are not covered.

Some countries have recognized the need to improve labour market flexibility while maintaining adequate protection for workers. The institutional changes required to make the labour market more efficient, however, will require considerable political will. An additional difficulty is the lack of comprehensive and timely statistics on labour markets, which hampers informed discussion.

Economic structures have changed over the last decade. But skill development and training have often failed to adapt. Agricultural productivity and the contribution of the primary sectors to the gross domestic product have declined. The cost disadvantages for small Pacific island States in manufacturing and even agriculture mean that they must rely on services for growth and jobs (Winters and Martins, 2004). Tourism, one sector that has proved internationally competitive, offers the greatest prospect for economic growth for Pacific island developing countries. But cost advantages could be eroded if skills needed by the tourism industry are not available and if overprotective labour market regulations slow growth.

Governments are vital in promoting efficient labour markets. Legislation for labour and employment needs to be reviewed and updated to respond to changing macroeconomic and business conditions. Critical issues include:

- Undertaking macroeconomic and structural reforms to boost economic growth.
- Cutting high rates of unemployment, especially among youth.
- Formulating policies for the informal sector.
- Addressing the lack of jobs for women and their low wages.
- Remedying skill mismatches and expanding training.
- Promoting key industries, such as tourism.

[3] Countries in the northern Pacific have generally established social security schemes, as have countries in the south that are in free association with New Zealand.

South and South-West Asia: Strong growth continues

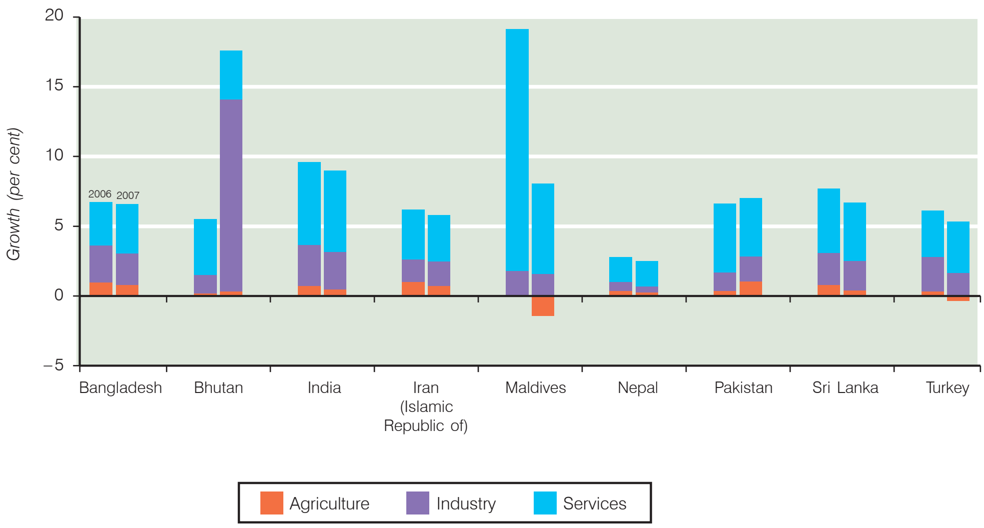
The economy of India appears to have moved on to a new phase of high growth, with an average growth rate of 8.8% over the last five years as investment in the economy has risen sharply. India's 9.6% GDP growth rate for 2006 reflected double-digit growth in the industrial and services sectors. For 2007 the estimated growth rate was 9% (figure 2.22).

India's continued high growth in 2007 resulted from steady gains in the rate of savings and investment, consumption demand, addition of new capacity and the more intensive and efficient use of existing capacity. Strong growth in the industrial and services sectors supported the high overall rate, more than compensating for an agricultural slowdown.

The economy of Pakistan maintained its growth momentum in 2007, growing by 7%, slightly more than the 6.6% for 2006. Agricultural sector growth recovered sharply, from 1.6% in 2006 to 5% in 2007. Manufacturing sector growth continued at 8.4% in 2007, slightly more moderate than the 10% for 2006. Services grew at 8% in 2007, down from 9.6% in 2006. Exports were sluggish in 2007; economic growth was driven mainly by strong domestic demand. Investment overtook consumption, helped by a surge in domestic private investment and record FDI flows. In 2007, investment in real terms increased by more than 20%.

Sri Lanka's GDP growth in 2007 remained strong despite high international oil prices and an unsettled security situation. The country's GDP is estimated to have grown by 6.7% in 2007, down from 7.7% in 2006. Growth in the industrial and services sectors slowed slightly, but these sectors still expanded by more than 7%. Agricultural growth decreased more sharply with adverse weather conditions. On the demand side, investment rose: it is estimated to have reached 29% of GDP in 2007, compared with 28.4% in 2006 (figure 2.23).

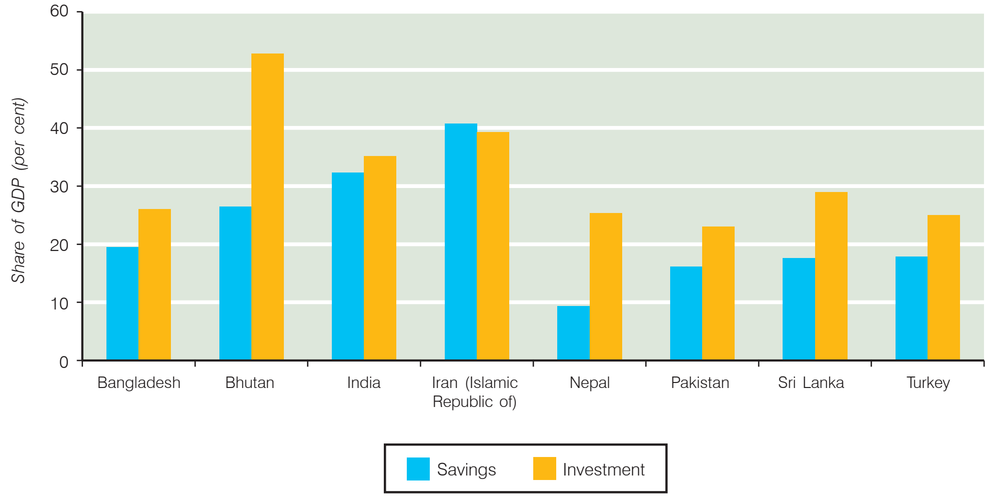
Figure 2.22. Industry and services perform well: Economic growth rates and sectoral contributions in selected South and South-West Asian countries, 2006-2007



Sources: ESCAP calculations based on national sources; and ESCAP estimates.

Notes: Data for 2007 are estimates. The GDP growth rates for India, the Islamic Republic of Iran and Pakistan refer to real GDP at factor cost. The GDP growth rates for Bhutan refer to real GDP at purchasers' prices and GDP growth rates for Nepal refer to real GDP at producers' prices.

Figure 2.23. Investment higher than savings, except in the Islamic Republic of Iran, 2007



Sources: ESCAP, based on national sources; and ESCAP estimates.

Note: Data for 2007 are estimates.

In the Islamic Republic of Iran, GDP grew by 5.8% in 2007, slightly down from 6.2% in 2006. The country's GDP growth is set to remain fairly strong, supported by continued exceptionally high oil prices. Increased oil earnings will allow the government to press on with its expansionary fiscal policies. That in turn will increase private consumption. But the country faces constraints on future oil production, which cannot increase without massive investment in its ageing oilfields. Foreign investment has not been forthcoming - or else it has been slow to arrive.

"Least developed countries maintained growth momentum amidst challenges"

Turkey's economy has experienced an impressive revival in recent years, supported by political stability, sound economic policies and favourable external conditions. The private sector has become more vibrant and the economy more open to foreign trade and investment. The main drivers of growth have been surging private consumption and investment, fuelled by declining real interest rates, rising capital inflows, rapid credit expansion and rising productivity. GDP is estimated to have grown by 5.0% in 2007, down from 6.1% in 2006. Consumer spending – especially for durables and fixed investments – has been adversely affected since mid-2006, when Turkey severely tightened its monetary policy to contain inflation.

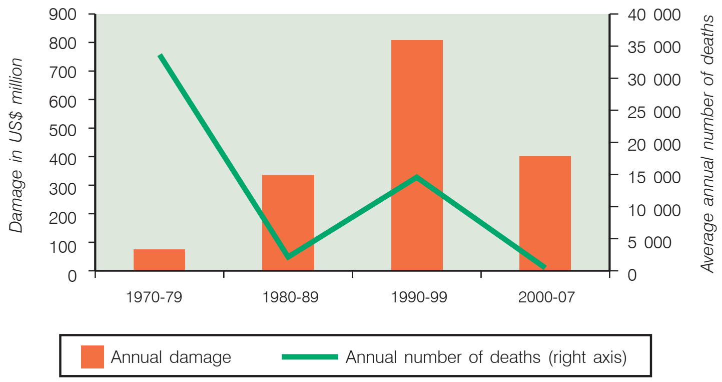
Despite Afghanistan's security challenges and difficult political situation, its GDP is estimated to have grown by 13% in 2007, rising sharply from 7.5% in 2006. Since the economy is heavily dependent on the agricultural sector, the 2007 increase is attributed mainly to improved weather conditions that supported agriculture. Sustained growth in the construction and services sector has also been contributing to the rapid GDP growth.

In Bangladesh, despite the uncertain political climate, GDP grew by 6.5% in 2007 – a rate virtually unchanged from 2006. The 2007 expansion was propelled by higher growth in the manufacturing sector, which grew by 11.2%, and in services, which grew by 6.8%. Industrial growth was broadly led by continued domestic demand and buoyant external demand. Agriculture grew more slowly. The economy suffered losses from the severe floods of July-September 2007 (which caused considerable human distress, damage to infrastructure and immediate economic dislocation) and from a November 2007 cyclone (which killed several thousand people and damaged property and infrastructure in affected coastal areas; see box 2.2). But because the economy of Bangladesh has developed a resilience to such calamities, and authorities have improved their ability to respond to them, the overall macroeconomic impact will likely be modest.

Box 2.2. Socio-economic impact of natural disasters in Bangladesh

Cyclone Sidr, a Category IV storm, made landfall in Bangladesh on the evening of 15 November 2007 with wind speeds of up to 250 km per hour. Approximately 31 of the country's 64 districts were affected, mostly in the administrative divisions of Barisal and Khulna. The Bangladesh Government stated on 14 December 2007 that the number of deaths had reached to 3,347, with 8.9 million people (2 million families) affected. The tropical cyclone inflicted massive casualties and damage to crops, houses, livestock, educational institutions, roads and embankments. Even so, Bangladesh has made progress towards mitigating the effects of such natural disasters. It has reduced the number of people killed by cyclones, which over the past four decades caused 97.6% of deaths from natural disasters and 96.8% of the damage from such disasters. A Cyclone Preparedness Programme has saved lives by establishing effective early warning systems, with wider community participation. Success at containing annual economic damage, however, has been much slower (see figure).

Figure. Socio-economic impacts of cyclones and floods in Bangladesh



Source: EM-DAT, *International Disaster Database,* <www.em-dat.net>, Université Catholique de Louvain, Brussels, Belgium.

In the past two decades, tropical cyclones led to three major floods: those of 1988, 1998 and 2004. The socio-economic impact of such floods (see table) far exceeds that of the storms that cause them.

Table. Consequences of floods in Bangladesh, selected years, 1988-2004

Consequence	***1988***	***1998***	***2004***
Inundated area (per cent)	61	68	38
Duration of flood (days)	23	72	21
Persons affected	45 million	31 million	30 million
Total deaths	2 335	918	329
Loss of income and assets	$330 million	$2 billion	$7 billion

Source: Q.M. Ahmed and others, *Macroeconomic Impacts of Floods in Bangladesh: Some Thoughts and Recommendations,* September 2004.

With the 2004 floods causing $7 billion in losses to income and assets in Bangladesh, it is important to be able to assess both the direct and the indirect socio-economic effects of natural disasters. ESCAP has recently developed the Disaster Impact Calculator to help developing countries in the region perform such assessments. The calculator is based on methodology that the World Bank, the Asian Development Bank and the Japan Bank for International Co-operation used to assess impacts from the 2004 tsunami.

Bhutan's GDP growth rose dramatically from 5.5% in 2006 to 17.6% in 2007. The spike in growth reflected private investment in housing, public investment in infrastructure and, most importantly, continued work on the Tala hydropower project. The construction of such projects has governed the rhythm of economic activity in Bhutan for several years, and will likely continue to determine it for several more. Services maintained robust performance in 2007, driven chiefly by the trade and financial sectors.

The economy of Maldives bounced back dramatically in 2006, growing by 19.1%. This spurt followed a contraction of 4.6% in 2005, when the country was suffering the effects of the December 2004 tsunami. Tourism accounts for about a third of Maldives' GDP. By the end of 2006 the tourism sector had recovered to its pre-tsunami levels, and along with reconstruction activities, spurred the country's unprecedented 2006 growth rate. GDP for 2007, still sustained by booming tourism and construction sectors, grew by an estimated 6.6% – a rate more similar to the pre-tsunami years.

In Nepal, optimism followed the restoration of peace and security in 2007. But economic activity did not improve much. GDP growth slowed further in 2007, to 2.5%. Growth in the agricultural sector was marginal, at just 0.7%, while non-agricultural sector growth stood at 3.6%. Harsh weather devastated agricultural production, particularly the paddy crop. But the services sector remained fairly buoyant, growing by 4.1% with the rapid expansion of transport, telecommunications and mobile telephone service.

High international prices for commodities added to inflationary pressures

Inflation in India, as measured by the consumer price index for industrial workers, rose from 4.4% in 2005 to 6.7% in 2006 (figure 2.24). The increase mainly reflected higher food prices, with demand-supply gaps in the domestic production of major food grains and oilseeds amid rising global prices. But 2006 also saw other inflationary pressures on the demand side, including elevated asset prices, high investment and consumption demand and strong growth in credit and monetary aggregates. To contain inflation the government adopted a tight monetary policy and took various fiscal and supply-side measures in 2006.

Inflation in India is estimated at 5.5% for 2007, slowing somewhat from its 2006 rate. But inflationary pressures could persist as international commodity prices, in particular oil prices, harden further. A continuous vigil by all concerned – with appropriate policy actions – would be needed to stabilize prices and anchor inflationary expectations in a sustained fashion.

Pakistan's inflation in 2007 remained virtually unchanged from the 2006 rate, standing at 7.8%. Food inflation was even higher, at 10.3%, bringing pain to people living on low or fixed incomes. The inflation was fuelled by global increases in some commodity prices, by a hike in utility tariffs, and by local supply- and demand-driven factors. To contain food inflation Pakistan's government expanded the public-sector utility-store network, extending it even into rural areas. Through the network the government provides large subsidies for the sale of essential edibles. The central bank responded to high inflation by tightening monetary policy: it simultaneously raised the discount rate, the cash requirement on demand deposits and the statutory liquidity requirement of demand and time deposits.

“Food inflation hits the poor in South Asia”

Sri Lanka's inflation continued to rise, reaching an annual average of 15.8% in 2007 – up substantially from 10.0% in 2006. The increase reflected three factors: state-mandated hikes in fuel prices, supply shortages in domestic food crops (stemming from unfavourable weather) and sharply rising demand-induced inflationary pressures. The government used a restrictive monetary policy to contain inflation. But in countries with high public debt, raising interest rates is problematic. Sri Lanka needs to balance its concern with inflation against the rising cost of public debt-servicing that has accompanied higher interest rates. The country's central bank will continue to mop up excess liquidity through open-market operations.

In the Islamic Republic of Iran, inflation rose from 13.6% in 2006 to an estimated 17% in 2007. The spike reflects expansionary fiscal and monetary policies and a continuous rise in public wages. Surprisingly, the government cut lending rates in 2007 despite strong inflationary pressures. Its aim was to make credit cheaper, boost economic activity and generate employment. But in May 2007, gasoline rationing and a cut in fuel subsidies added to the inflationary pressures. High inflation is becoming a serious problem in the country and will dampen its growth prospects. A move to reduce inflation by tightening monetary policy is urgently needed.

Turkey has used monetary and fiscal policies judiciously in recent years to bring inflation down from its former levels, which were very high. In 2006 rising energy prices and the depreciation of the lira caused inflation to rise again, to 9.6%. The government adopted even stricter monetary policies that helped to bring inflation back down to an estimated 8.6% for 2007. Food prices continued to increase with adverse weather, while higher oil prices drove up energy prices. The government's target is to reduce inflation to 4% within a couple of years.

In Bangladesh, inflation remained at 7.2% in 2007, unchanged from the previous year. Possibly driving inflation were three key factors: supply-side constraints, political and market uncertainty and strong aggregate demand (the last resulting from economic growth and the remittances of workers abroad). To restrain inflation the government has followed a tight monetary policy, reduced or withdrawn tariffs on some essential goods and taken other administrative measures (breaking up trading cartels, selling essential goods on the open market at discounted prices).

Price changes in Bhutan and Nepal largely follow those in India, a country with which both nations have close trade and financial links. Their domestic currencies are pegged to the Indian rupee. Inflation in Bhutan has hovered around 5% in recent years. In Nepal, inflation dropped to 6.4% in 2007 from 8% in 2006. The deceleration in price increases was broad-based, covering both food and non-food items. Although the exchange rate peg promotes trade and speeds up monetization, bringing benefits to Bhutan and Nepal, it can also limit the scope for independent monetary policy formulation: to avoid interest rate arbitrage, interest rates in both countries must be closely aligned to those in India.

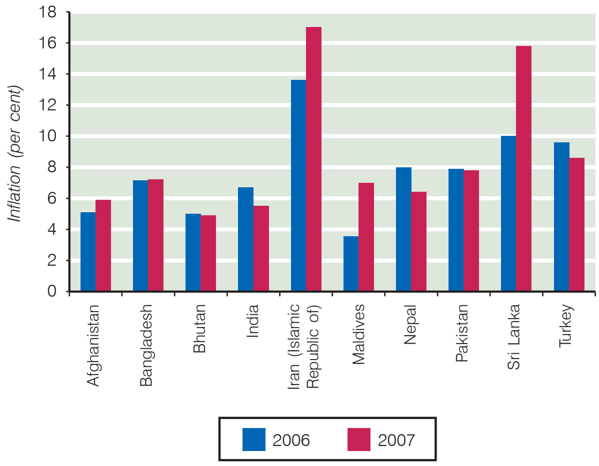
Inflation in Maldives doubled from 3.5% in 2006 to 7% in 2007. The sharp increase was partly fuelled by an expansionary fiscal policy. But other factors contributed to the inflation: rising food prices, housing rent increases, growing health-care fees.

Inflation in Afghanistan rose slightly, from 5.1% in 2006 to 5.9% in 2007. Higher prices for imported foodstuffs contributed to an increase in consumer prices.

Fiscal deficits remained high

The Indian central government's fiscal deficit fell in 2006, to 3.7% of GDP. It is budgeted to drop to 3.3% in 2007 (figure 2.25). Essentially revenue-led, the government's deficit reduction strategy focuses on improving allocative efficiencies in public spending. Its policy

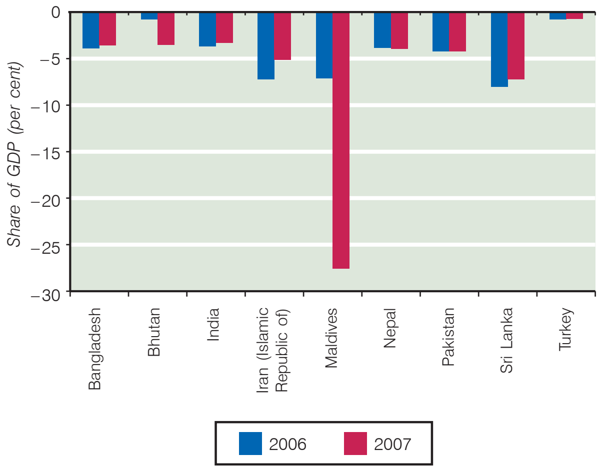
Figure 2.24. Inflationary pressure persisted in South and South-West Asian countries in 2006-2007



Sources: ESCAP, based on national sources; IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2007); and ESCAP estimates.

Notes: Data for 2007 are estimates. Inflation refers to changes in the consumer price index. In the case of India, it refers to consumer prices for industrial workers and it refers to Colombo for Sri Lanka.

Figure 2.25. Budget deficits remained a serious problem in South and South-West Asian countries in 2006-2007



Sources: ESCAP, based on national sources; and ESCAP estimates.

Notes: Data for 2007 are estimates. Budget balance excludes grants for Bangladesh, Islamic Republic of Iran, Pakistan and Sri Lanka.

of reprioritizing expenditure has led to higher outlays for the social sector.

Pakistan's government has maintained an expansionary fiscal stance, seeking to promote more investment for growth and more pro-poor spending. In recent years development expenditure has become a higher proportion of overall expenditure. The central government's budget deficit in 2007 remained at 4.2% of GDP, unchanged from 2006. Fiscal policy for 2008 could build on reforms to the tax system, broadening the tax base and further improving tax compliance.

Sri Lanka's budget deficit came down from 8.1% in 2006 to 7.2% in 2007. This figure remains large, partly because of Sri Lanka's large public debt and because of its security costs (a result of the country's ongoing ethnic conflict). The total revenue-to-GDP ratio in 2007 rose for the third consecutive year, benefiting from measures to broaden the tax base, rationalize tax rates and strengthen tax administration. The government's target is to bring the budget deficit down further in 2008, to 7%.

"Turkey succeeded in bringing down the fiscal deficit"

In the Islamic Republic of Iran, the government has adopted an expansionary fiscal stance to sustain growth, create jobs and reduce disparities among the country's various regions. Much of the added revenue from high oil prices is going to finance increased government spending. In May 2007 it rationed the sale of petrol and raised heavily subsidized petrol prices by 25%. The government plans to reduce subsidies gradually on some consumer items. Also, its agenda for the coming months includes introducing a value added tax.

Turkey's tight fiscal policy has helped not just to generate primary fiscal surpluses, but also to bring down the overall fiscal deficit to a very low level – less than 1% of GDP in 2006 and 2007.

In Bangladesh the budget deficit for 2007, at 3.6% of GDP, was slightly higher than the deficit for 2006. In 2008 it is expected to increase to 5.6% of GDP – mostly because the country's liabilities for accumulated fuel subsidies are to be included in the 2008 budget. In addition, the 2007 cyclone and floods will require the government to spend heavily on restoring health, sanitation and water and rehabilitating the damaged infrastructure. The budget deficit for 2009, however, is expected to revert to a normal level of 3.8%.

Bhutan's overall budget deficit, excluding income from grants, is quite large. If grants are included it becomes more manageable. The budget deficit including income from grants rose to 3.5% of GDP in 2007, from 0.8% in 2006. With the Tala hydropower project coming on stream, a significant increase in government revenue is expected to lower the deficit.

Fiscal expenditures in Maldives increased sharply in the years following the December 2004 tsunami disaster. The fiscal deficit rose from 1.6% of GDP in 2004 to 10.9% in 2005, then fell slightly back to 7.1% in 2006. The country strengthened its expansionary fiscal stance in 2007 as its deficit climbed into double digits.

In Nepal, despite rising tax revenues, the budget deficit increased marginally to 4% in 2007 from 3.8% in 2006. The country pushed up tax revenue as a percentage of GDP by broadening the tax base, strengthening tax administration and raising customs duties on selected commodities.

High oil prices pressured trade and current account balances

In India both exports and imports continued to grow strongly. Imports increased more than exports, deepening the trade deficit. As a result of continuing buoyancy in the net invisible surplus, India's current account deficit remained unchanged in fiscal 2006, at 1.1% of GDP (tables 2.11). Net capital inflow to India remained buoyant in 2006, at 4.9% of GDP, far more than the country's current account deficit. Higher capital inflows for 2006 were attributable to strengthening macroeconomic fundamentals, greater investor confidence and ample global liquidity. Net FDI inflows in 2006 reached $19.4 billion. For 2007, both exports and imports are estimated to have grown by more than 24%. Foreign exchange reserves stood at $267 billion at the end of December 2007, and the Indian rupee had appreciated sharply against the United States dollar.

Growth in Pakistan's exports and imports slowed sharply in 2007: the rate for exports fell to 3.4%, for imports to 6.9%. Growth in rice and textiles exports dropped, with adverse weather damaging the rice and cotton crops and competition rising on the international market for textile products. A huge trade deficit was partly covered by remittances from migrant workers abroad, which increased in 2007 to a record amount of $5.5 billion. The country's current account deficit further widened to about 5% of GDP. Net inflows of foreign investment almost doubled from 2006 to 2007, reaching $8.4 billion. Pakistan's foreign exchange reserves were over $16 billion in November 2007.

Table 2.11. Summary of external accounts for selected South and South-West Asian economies

(Per cent)

	Exports/ GDP		Imports/ GDP		Current account balance/GDP	
	2006	**2007**	**2006**	**2007**	**2006**	**2007**
Bangladesh[a,b]	15.1	16.9	23.8	25.3	0.9	1.4
Bhutan[a,c]	33.9	31.2	46.8	43.9	−2.0	8.6
India[a,c]	13.9	15.7	20.9	23.7	−1.1	−1.4
Iran (Islamic Republic of)[a]	33.8	..	22.5	..	9.1	8.8
Maldives[d,e,f]	21.6	24.3	87.4	87.9	−39.8	−45.0
Nepal[a,c]	9.3	8.4	26.9	25.8	2.3	0.5
Pakistan[a,c]	13.8	12.5	24.0	22.5	−4.0	−5.0
Sri Lanka[f]	24.5	23.6	36.5	34.9	−4.7	−4.3
Turkey	21.3	..	34.7	..	−8.2	−7.3
	Growth rates					
	Exports			**Imports**		
	2005	**2006**	**2007**	**2005**	**2006**	**2007**
Bangladesh[a,b]	13.8	21.6	15.7	20.6	12.2	16.3
Bhutan[a,c]	34.5	47.2	64.5	75.5	–5.6	20.6
India[a,c]	23.4	22.5	24.3	33.8	27.8	24.4
Iran (Islamic Republic of)[a]	46.8	16.4	..	12.8	15.4	..
Maldives[d,e,f]	−10.7	39.4	15.5	16.1	24.4	13.0
Nepal[a,c]	13.0	2.2	3.6	13.8	15.8	13.2
Pakistan[a,c]	16.9	14.3	3.4	32.1	38.8	6.9
Sri Lanka[f]	10.2	8.4	10.0	10.8	15.7	8.9
Turkey[g]	14.6	18.9	24.8	19.7	19.5	21.5

Sources: Bangladesh Bank website <http://www.bangladesh-bank.org/pub/monthly/econtrds/econtrdsiv.html> (29 January 2008); Reserve Bank of India website <http://www.rbi.org.in/home.aspx> (20 November 2007); Maldives Monetary Authority website <http://www.mma.gov.mv/statis.php> (5 November 2007); Central Bank of Sri Lanka website <http://www.centralbanklanka.org/> (7 November 2007); Central Bank of the Republic of Turkey website <http://www.tcmb.gov.tr/yeni/eng/> (24 January 2008); IMF, *World Economic Outlook Database* (October 2007); and *International Financial Statistics* (CD-ROM) (Washington, D.C., 2007); national sources; and ESCAP estimates.

[a] Data in fiscal year.
[b] Exports and imports for 2007 are provisional.
[c] Exports and imports for 2007 are estimates.
[d] Imports value in f.o.b.
[e] Exports and imports for 2006 are estimates.
[f] Exports and imports for 2007 are projections.
[g] Exports and imports for 2007 refer to the first 11 months.

In Sri Lanka in 2007, estimated export earnings rose by 10% and import earnings by 8.9%. Workers' remittances increased significantly and helped to contain the current account deficit, which is estimated to fall to 4.3% of GDP in 2007 (from 4.7% in 2006). FDI and financial flows to the government increased substantially, yielding a surplus in the overall balance of payments. Gross official reserves increased to $3.08 billion by the end of 2007, up from $2.53 billion at the end of 2006.

The Islamic Republic of Iran's current account surplus is expected to remain high in 2007 as rising global oil prices lift oil export earnings (and in spite of stagnating oil export volumes). In addition, the government's petrol rationing has curbed the demand for imported petrol, slowing import growth and further supporting the surplus.

Turkey has made good progress in achieving sustained high economic growth. But it still must struggle to contain inflation and its high current account deficit on the balance of payments. Because of strong private investment and increased energy prices, import growth has outpaced export growth. In 2006 and 2007 the current account deficit remained high, at more than 7% of GDP. The large capital inflows which have helped to finance Turkey's current account deficit have made its economy more and more dependent on such inflows, exposing it to sudden shifts in market sentiment. Turkey's government should maintain monetary and fiscal discipline and preserve the floating exchange rate as a useful shock absorber.

> *Large remittances from workers abroad provide cushion to balance of payments in Bangladesh and Nepal*

In 2007, large remittances from workers abroad contributed to current account surpluses in Nepal and Bangladesh. Exports from Nepal grew by 3.6% in 2007 – far more slowly than imports to the country, which grew by 13.2%. But thanks to large remittances, the country achieved a current account surplus of 0.5% of GDP (down from 2.3% in 2006). Bangladesh, by contrast, maintained rapid growth in both exports and imports in 2007. Exports grew by 15.7%, still relying heavily on the ready-made garment sector (an average 75% of total exports from the country in recent years). Imports grew by 16.3%. Workers' remittances rose to nearly $6 billion, and in 2007 Bangladesh exceeded slightly its 2006 current account surplus of about 1% of GDP.

Bhutan's trade balance improved in 2007, with large exports of electricity to India and much of the Tala hydropower project coming on stream. The country's current account balance turned to a surplus in 2007, and is expected to remain a surplus in the near future.

In Maldives, where the tourism sector has been recovering swiftly in the wake of the 2004 tsunami, the current account deficit widened in 2006 with rapid increases in imports related to tourism and construction. In 2007 it remained high, at about 40% of GDP. The country's dollar-pegged exchange rate regime caused its domestic currency to depreciate against other major currencies.

Strong economic growth is expected to continue in 2008

GDP growth for India over the next few years is projected to remain at between 8.5% and 9.5%. Concerns have been expressed about whether the country is growing beyond its growth potential thereby straining its labour force and capital stock, and engendering inflationary instabilities. The government has a strategy for maintaining high growth while keeping prices fairly stable: it will increase productivity, ameliorate skills shortages and add capacity through investments. Monetary policy will continue to play a critical role in maintaining price stability. But the sustainability of high economic growth with moderate inflation will depend critically on fiscal prudence and high investment levels. India could achieve and sustain a 10% growth rate by further improving the country's business environment, by developing its infrastructure and reforming the labour market.

Supported by all sectors, Pakistan's economic growth is expected to remain strong at 6.5% in 2008. In just a few years, sound macroeconomic policies have transformed Pakistan's consumption-led growth impetus to one in which investment-led growth can assume a more important role. But recent political uncertainty and violence related to the general election could slow the economy. Sri Lanka's GDP growth is expected to remain about 7% in 2008, with productivity improvements in all three sectors of its economy. Several large planned infrastructure projects would boost aggregate demand and output if speedily implemented. But the outlook for Sri Lanka remains vulnerable to any further escalation in the country's ethnic conflict.

The outlook for the Turkish economy remains positive, with GDP expected to grow by 5.5%. In the Islamic Republic of Iran, GDP growth is expected to fall slightly to 5.0% in 2008 as oil prices rise less rapidly and constraints on oil production consequently lowering export volumes. Should global oil prices fall, however, the economy will suffer markedly. And with economic sanctions related to the country's nuclear programme already in place, any intensification in the dispute over this programme could hurt future growth prospects.

Bangladesh, Bhutan, Maldives and Nepal are the least developed countries in South and South-West Asia. The Bangladesh government's target is to raise GDP growth to 7% in 2008. But with continuing political uncertainty, this target may prove elusive and GDP growth may remain at about 6.5%. The interim government's anti-corruption drive is expected to improve the country's business environment in the coming years, attracting FDI and helping the Bangladesh economy to grow. In Bhutan the construction of two new hydropower projects will help to sustain real GDP growth over the medium term. GDP is expected to grow at about 10% in 2008. In Maldives a further slowdown in the growth of the economy will continue in 2008, as reconstruction work in response to the 2004 tsunami nears completion. In Nepal, with the peace process moving forward, GDP growth is expected to increase to 4% in 2008. Tourism, services and transportation appear to be reviving. More government spending could support economic activity, as budgetary capital spending on rural infrastructure is expected to pick up. But since Nepal is still in transition politically, its economic situation remains vulnerable.

The main challenge for countries in South and South-West Asia is to sustain their growth momentum in the face of high oil prices. Should oil prices remain very high, they will compromise economic growth while putting pressure on budgets, inflation rates and the balance of payments in countries throughout the subregion. So, some measures must be taken to hedge the risk of continued high oil prices and – more importantly – to contain oil imports through selective energy conservation measures.

The current account deficit is already a serious problem in some South and South-West Asian countries. The abolition of the Multi-Fiber Arrangement (MFA) regime at the end of 2004 had a mixed effect on countries in the subregion. The MFA abolition might have further adverse medium-term effects as quota restrictions on Chinese exports are lifted in 2008, creating stiff competition from Chinese exports. To reduce the risk of depending too heavily on a single sector, export diversification should remain an important part of government strategies.

With large budget deficits accumulating, public debt is serious problem for many South and South-West Asian countries. And the share of domestic public debt in total public debt is on the rise (see policy research feature 2.4).

Policy research feature 2.4: Fiscal deficit and public debt sustainability in South Asia

Despite recent improvements, public debt remains a serious problem for most countries in South Asia. External debt is high, with domestic debt becoming a larger component of public debt. Domestic debt has received relatively less attention despite its serious economic implications. Excessive reliance on debt, whether domestic or external, carries macroeconomic risks that can hinder economic development.

"High public debt constrains flexibility in the use of macroeconomic policies"

In the presence of high public debt macroeconomic policies, including fiscal, monetary and exchange rate policies, can not be used freely and effectively to achieve desired objectives. For example, high public debt demand can increase the domestic interest rate, thereby crowding out private investment. Under such circumstances, it is extremely difficult for monetary authorities to lower interest rates in order to stimulate private investment. When a major share of budget is devoted to debt servicing, fiscal policy loses its flexibility, which hinders its capacity to promote macroeconomic stability, employment generation, poverty reduction and social development. An escalating external public debt stock increases the probability of default, causing creditors to raise their interest risk premium. In extreme cases, Governments can be forced into defaulting on public debt, which tarnishes a country's international reputation and makes further borrowing difficult. While defaulting on domestic debt can be avoided by printing money, it can lead to very high inflation, with serious economic and social consequences.

High public debt, with a growing domestic share

At 93% of GDP in 2006, the public debt in Sri Lanka was the highest in the subregion, the result of years of high fiscal deficits. When concessional foreign financing became scarce, government debt service ballooned and government reliance on shorter term domestic debt instruments increased. The debt-GDP ratio has come down recently, but this reflects fast nominal GDP growth rather than improved debt dynamics (IPS, 2007).

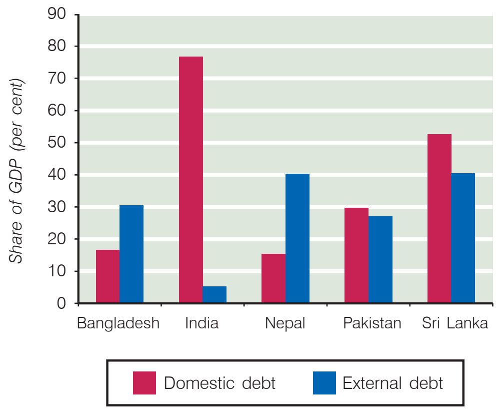
In India, high fiscal deficits increased the combined debt of the central and state governments from about 70% of GDP in 1990 to about 87% over 2002-2004. Public debt, on the decline more recently, is estimated at 82% for fiscal 2006. The central government share in public debt is much higher than that of state governments.

In Pakistan, debt growth during the 1990s was unprecedented. A credible debt reduction strategy and fast growth cut the public debt burden from 84% of GDP in 2000 to 57% in 2006. Pakistan reduced its external debt burden through rescheduling, a debt swap for social spending, debt cancellation and prepayment of expensive debt.

In Bangladesh, public debt has stabilized below 50% of GDP, estimated at 47% in 2006. Public debt in Nepal, coming down of late, stood at 56% of GDP in 2006.

The share of domestic debt in public debt has grown. In India, Pakistan and Sri Lanka, the share of domestic debt in public debt exceeds that of external debt (figure 2.26). In India, domestic debt made up 94% of public debt. External debt dominates in Bangladesh and Nepal.

Figure 2.26. Differing shares of domestic and external debt as a share of GDP, 2006



Sources: Data for Bangladesh are from *IMF Statistical Appendix* (June 2007), and IMF Country Report No.07/229 (Washington, D.C., 2007); data for Sri Lanka are from Central Bank of Sri Lanka, *Annual Report 2006;* data for Pakistan are from State Bank of Pakistan, *Annual Report 2005-06;* data for India are from Ministry of Finance, *Economic Survey 2006-07;* and data for Nepal are from *IMF Article IV Consultations* (June 2007).

Domestic public debt includes internal borrowing through long-term bonds, short-term bills and loans from banking institutions, and small savings (mainly post office deposits and medium-term certificates) and provident funds. In Sri Lanka, 24.6% of domestic public debt in 2006 was held by the banking sector (8% by the central bank and 16.6% by commercial banks). The rest was held by provident and pension funds (31.8%), private businesses and individuals (25.2%) and savings institutions (11.3%). In Pakistan, the share of the banking sector in domestic public debt is rising, and commercial banks are becoming major players; in 2007, the share of commercial banks reached 65%, compared with 35% for the central bank.

Debt servicing – the real cost of debt

The real burden of public debt is in its servicing. In Sri Lanka, more than 90% of government revenues went to debt servicing in 2006 (table 2.12). In India, interest payments alone consumed more than 28% of the revenue of the central and state governments in 2005, more if repayments of principal are included.[4] The debt service ratio has substantially declined in Pakistan over 2000-2006, though about 30% of government revenues remain allocated to debt servicing. In Nepal, debt servicing stabilized at about 29% of total government revenues in 2006. In Bangladesh, interest payments consumed about 18% of government revenues.

Is public debt in South Asia sustainable?

Judging the sustainability of public debt is tricky, especially because defaults occur in countries with lower debt-to-GDP ratios, as well as in more indebted countries (IMF, 2003). On average, however, emerging market country defaulters since 1998 have a higher ratio of public debt to GDP, a higher debt-to-revenue ratio and a higher proportion of external debt in total public debt.

Table 2.12. Debt can weigh on government budgets: Costs to service the public debt in South Asia, 2000-2006

(Per cent)

	2000	2001	2002	2003	2004	2005	2006
Bangladesh							
Share of GDP	1.6	1.8	1.9	1.6	1.7	1.8	1.9
Share of government revenue	14.3	17.8	18.3	16.1	15.9	16.9	18.4
Share of government expenditure	11.0	12.6	13.8	12.3	12.0	13.0	13.7
India							
Share of GDP	5.8	6.2	6.3	6.4	6.0	5.9	..
Share of government revenue	31.2	32.8	31.9	33.1	30.0	28.1	..
Share of government expenditure	19.9	20.7	21.3	22.0	20.3	19.8	..
Nepal							
Share of GDP	..	2.5	2.9	3.7	3.5	3.7	3.5
Share of government revenue	..	21.9	25.1	31.0	28.7	28.6	28.7
Share of government expenditure	..	14.2	16.8	21.4	22.6	22.5	21.4
Pakistan							
Share of GDP	9.8	8.3	10.0	6.2	5.3	4.8	4.1
Share of government revenue	72.4	62.5	70.3	41.6	37.9	34.8	29.6
Share of government expenditure	52.3	48.1	53.1	33.3	31.4	28.0	22.7
Sri Lanka							
Share of GDP	14.0	12.7	17.9	19.6	14.8	14.3	15.9
Share of government revenue	83.2	76.4	108.6	124.6	96.5	91.0	93.1
Share of government expenditure	38.7	38.3	49.8	54.1	45.7	42.6	44.1

Sources: Data for Bangladesh are from *IMF Statistical Appendix* (June 2007), and IMF Country Report No.07/229 (Washington, D.C., 2007); data for Sri Lanka for 2003-2006 are from Central Bank of Sri Lanka, *Annual Report 2006;* data for 2001-2002 are from Central Bank of Sri Lanka, *Annual Report 2004;* data for Pakistan are from State Bank of Pakistan, *Annual Report 2005-06;* data for India are from Ministry of Finance, *Economic Survey 2006-07;* and data for Nepal are from *IMF Article IV Consultations* (September 2003, February 2006 and June 2007).

Note: For India and Bangladesh, public debt servicing includes interest payments only due to lack of data on repayment of principal.

[4] For India and Bangladesh, data on principal repayments are not readily available from published sources.

For Sri Lanka, the country with highest public debt in the subregion, IMF debt sustainability analysis shows that if GDP growth and primary balances continue at the average of the last decade, an already high debt-to-GDP ratio would continue rising – an unsustainable situation. But fiscal consolidation and improved growth can bring the debt ratio down to more sustainable levels. GDP growth of 7% over 2006-2010 and 6% through 2026, combined with sustained fiscal consolidation, could lower central government debt from 94% of GDP in 2005 to 74% in 2010 and 48% in 2026. This would cut the ratio of debt service to government revenue from 93% in 2006 to 68% in 2010 and about 50% in 2026.

If India's high GDP growth and fiscal consolidation continue, the debt-to-GDP ratio will fall by 10 percentage points over the next five years. If key variables (particularly GDP growth and primary balances) continue at the average level of the last decade, however, there will be no reduction in the debt-to-GDP ratio.

If Pakistan follows its historical growth path, its debt-to-GDP ratio will continue to decline over the next five years. But an upsurge in the primary deficit would slow the reduction. Because of a growing budget deficit, the improvement in the ratio of domestic public debt to GDP since 2001 appears to have bottomed out. The country is likely to face a higher external debt-servicing burden as repayments of the rescheduled non-ODA Paris Club stock resume in 2008 and some foreign currency bonds mature. A sustained high current account deficit could also hurt the external debt-to-GDP ratio, which may start rising in the medium term.

If Nepal follows its historical growth path, no reduction in the debt-to-GDP ratio is expected in the medium term. Because external debt dominates public debt, the IMF found that the external debt-to-export ratio in 2005 was high and could remain so in the medium term under various scenarios, especially if growth is low and donor grant support inadequate.

> *"Lower debt servicing means more funding for education, health and development"*

The debt sustainability analysis by IMF shows that the ratio of public debt to GDP and the ratio of public debt service to government revenue can be reduced significantly over the medium term by promoting growth and adopting fiscal consolidation policies. In the case of Sri Lanka, which has high public debt, the ratio of public debt service to government revenue can be reduced by more than 20% within five years. The financial resources from lower debt servicing can be devoted to education, health or other development activities. An ESCAP analysis shows that a 20% decrease in the public debt service ratio in Sri Lanka can make resources available to raise development expenditure by 50%, expenditure on education by 114% or expenditure on health by 152% from the existing level.[5] In Nepal, a 20% reduction in the debt service ratio could raise spending on health by 50%. Pakistan increased its development expenditure from about 2% of GDP in 2001 to about 5% of GDP in recent years, mainly after the Government reduced its debt burden, partly due to external debt relief. A further 20% decrease in the debt service ratio could increase development spending by 24%.

Policy issues and challenges

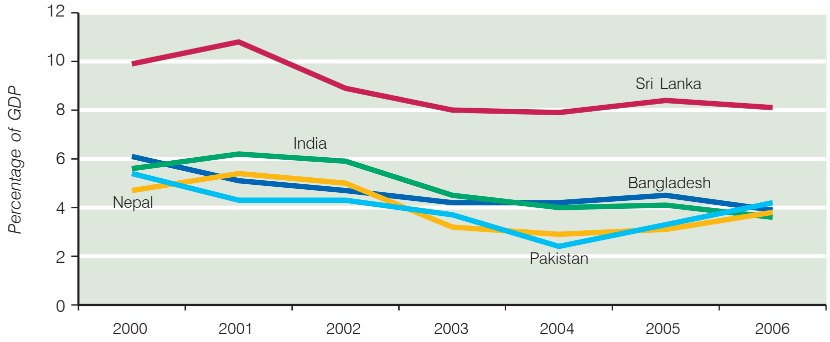
Making South Asia's public debt sustainable requires three sets of actions:

- Controlling fiscal deficits.
- Expanding government revenues.
- Prioritizing development spending on key areas.

Cutting deficits. Countries in the subregion are taking various measures, including the introduction of legislation, to bring fiscal deficits down to a sustainable level. India's Fiscal Responsibility and Budget Management Act, passed in August 2003, requires that the fiscal deficit of the central government not exceed 3% of GDP by 2007/2008 (later amended to 2008/2009). It also requires that the deficit on the revenue account be eliminated by the same date. The fiscal deficit of the central Government was 3.7% of GDP in 2005/2006 (figure 2.27) and is budgeted at 3.3% for 2007/2008. The target of 3% in 2008/2009 is expected to be met. The act requires that the central government not directly borrow from the Reserve Bank of India after 31 March 2006, though borrowing for ways and means advances is permitted. Similar fiscal responsibility acts have been implemented by India's highly autonomous states.

[5] Financial resources released as a result of a reduction in the public debt service to government revenue ratio by 20% from the existing level in 2006 are computed first and then added separately to expenditure in 2006 on development, education and health. The results indicate the increase in expenditure that would be possible in each category alone, not all three collectively.

Figure 2.27. Central government budget deficit as a share of GDP, 2000-2006



Sources: Data for Bangladesh are from Bangladesh Bank, *Annual Report 2005-2006;* data for Sri Lanka for 2003-2006 are from Central Bank of Sri Lanka, *Recent Economic Developments: Highlights of 2007 and Prospects of 2008;* data for 2001-2002 are from Central Bank of Sri Lanka, *Annual Report 2004;* data for Pakistan are from State Bank of Pakistan, *Annual Report 2005-06;* data for India are from Ministry of Finance, *Economic Survey 2006-07;* and data for Nepal are from Ministry of Finance, *Economic Survey 2006/07.*

Pakistan's Fiscal Responsibility and Debt Limitation Act 2005, approved on 13 June 2005, requires that the federal government cut the public debt below 60% by 2013 – and keep it there. That requirement was met by the end of June 2006, when the public debt fell to 56%, from 75.1% in 2003. The act mandates annual cuts in the public debt of at least 2.5% of GDP through 2013. Over 2005-2006, the debt-to-GDP ratio fell 5.5 percentage points, more than double the minimum required by the law. The act also requires that no new guarantees be issued (or existing guarantees be renewed) for more than 2% of GDP in any fiscal year, including for rupee lending, bonds, rates of return, output purchase agreements and other claims.

Sri Lanka passed the Fiscal Management (Responsibility) Act in early 2003 with the aim of containing the budget deficit to 5% of GDP and debt to 85% of GDP by the end of 2006. These targets, however, could not be met, and in 2006, the terminal date was changed to 2008.

Many countries in the world have adopted a rule-based fiscal policy for maintaining macroeconomic stability. However, not every country successfully implemented a rule-based fiscal responsibility framework (Kopits, 2007). Those frameworks cannot succeed without the political will to enforce them.

Expanding tax revenues. The capacity of a government to service public debt depends on its revenues, particularly tax revenues. Tax revenues have been rising in nominal terms, but their share in GDP has shown little improvement. At about 15%, the tax-to-GDP ratio in Sri Lanka is the highest in the subregion.

In India, the tax-to-GDP ratio of the central government hovers around 10%. In Bangladesh, Nepal and Pakistan, tax-to-GDP ratios are also low, ranging from 9% to 11% without much improvement over time.

Major tax reforms have been carried out everywhere since the 1990s. Trade taxes have been drastically cut to enhance competitiveness and efficiency. The result: a shift from trade taxes to domestic taxes. The value added tax (VAT), or general sales tax, is emerging as a major revenue source. In Sri Lanka, VAT collections are the largest tax category, accounting for more than 40% of tax revenues in 2005. To make the tax system more progressive, there is now more emphasis on direct taxes, and the transition from trade taxes to domestic taxes is keeping tax buoyancy low (Pinto and Zahir, 2004).

“Tax rates are not low, but inefficient tax systems and corruption keep revenues low”

Tax revenues can be enhanced by broadening the tax base and strengthening tax administration. Expanding the taxation of services is a key measure for broadening the tax base. Eliminating excessive tax exemptions and holidays is another key. Broadening the VAT base and extending it to wholesale and retail, though difficult in the short term, should remain part of the agenda.

Strengthening tax administration is crucial. Tax rates are not low in the subregion, but inefficient tax systems and corruption keep revenues low. A simpler tax system, with fewer exemptions, less discretion and better compliance, should be a focus. Improving documentation will also help. Greater use of information technology could strengthen administration. For income tax, greater reliance on self-assessment and risk-based auditing will make tax machinery more efficient and taxpayer friendly. Establishing separate offices for large taxpayers can improve services to clients and auditing of tax returns.

Prioritizing government spending. Widespread poverty and lack of basic services mean that demand for public spending is high. The challenge for governments is to contain wasteful public spending and orient it towards priority sectors. Public expenditure should promote pro-poor growth; basic services, such as education, health, sanitation and housing, should be a priority. As budget deficits widen, governments sometimes try to contain them by slashing development spending. In Pakistan, development spending dropped to less than 2% of GDP in 2001, but reprioritization of public expenditure, helped by a reduced public debt burden, has raised development spending to about 5% of GDP.

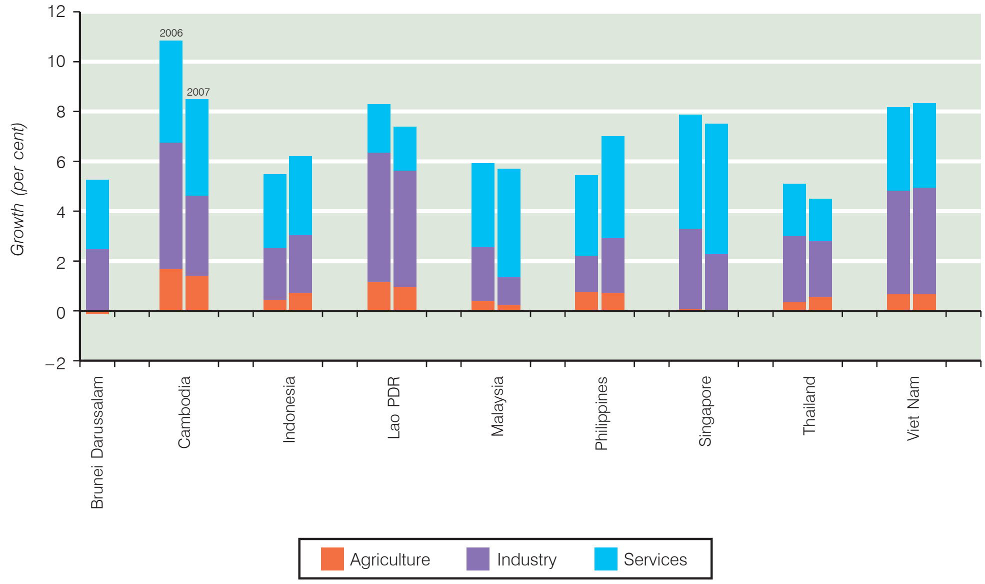
Lowering high public debt ratios is essential to avoid adverse economic and social consequences. Domestic public debt, on the rise in the subregion, carries a much lower risk of default and may be preferred over external debt for this reason. But the adverse impact of high domestic public debt is not much different from that of external public debt: higher interest rates and lower private investment; higher debt servicing costs and less funding for basic services; and in the most severe cases, inflation, a debt trap, economic collapse and widespread poverty.

South-East Asia: Domestic demand supports GDP growth despite a small decline in export dynamism

In 2007 the economies of South-East Asia continued to show robust GDP growth, as they had in 2006 (figure 2.28). GDP growth rates for the Philippines and Indonesia increased between 2006 and 2007 – from 5.4% to 7.0% in the Philippines, and from 5.5% to 6.2% in Indonesia. Growth in Thailand and Malaysia declined slightly, from 5.1% to 4.5% in Thailand and 5.9% to 5.7% in Malaysia. Cambodia and the Lao People's Democratic Republic also grew less rapidly in 2007 than in 2006, but these least developed countries remained among the subregion's fastest-growing economies in 2007: Cambodia grew by 8.5% and the Lao People's Democratic Republic by 7.4% (see policy research feature 2.5). GDP growth data for two other least developed countries, Myanmar and Timor-Leste, are not available. But indirect evidence (such as increases in bank loans and motor vehicle imports) suggests that Timor-Leste's economy performed very well in 2007, as it recovered from the previous year's violent outbreaks.[6] Myanmar's rate of GDP growth is likely to have suffered in 2007 from an August increase in subsidized fuel prices, which – combined with ongoing price inflation for food and other essential items – reduced its private domestic consumption.

In most countries investment grew more rapidly in 2007 than in 2006 (figure 2.29). The main exception was Thailand, where the investment growth rate fell to 1.3% in 2007 (from 3.8% in 2006) and the consump-

Figure 2.28. Economic growth remained robust in 2007

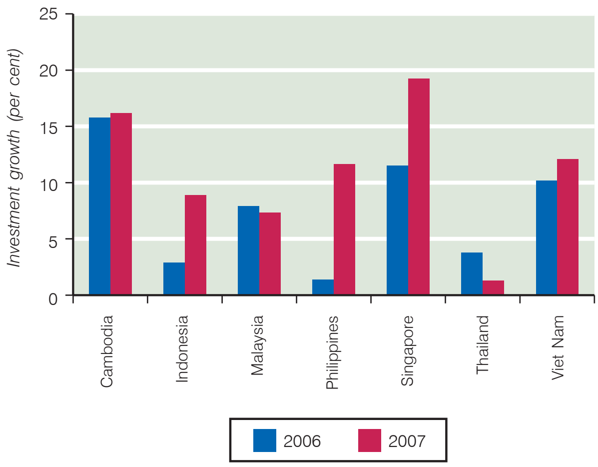


Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); and ESCAP estimates.

Notes: Growth rates for 2007 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power, and construction. Agriculture of Singapore also includes quarrying.

6 In its 2006 Article IV Consultation, IMF projected a rate of growth of 32.1% for 2007 for the non-oil GDP.

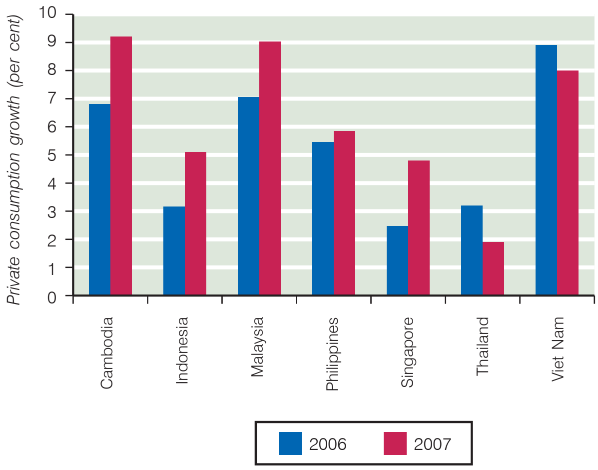
Figure 2.29. Investment accelerated in the Philippines, Indonesia and Singapore in 2007



Sources: ESCAP calculations based on data from Oxford Economics and Economist Intelligence Unit.

Note: Growth rates for 2007 are estimates. Investment refers to gross fixed investment.

Figure 2.30. Private consumption grew more rapidly in most South-East Asian countries in 2007



Sources: ESCAP calculations based on data from Oxford Economics and Economist Intelligence Unit.

Note: Growth rates for 2007 are estimates.

tion growth rate fell to 1.9% (from 3.2% in 2006). The declines reflect low consumer confidence and political uncertainty in Thailand since September 2006, when a coup brought an interim military government to power. But they also show the effects of a 2006 tightening in monetary policy. On the upside, investment has rebounded dramatically in the Philippines: after declining 6.6% in 2005, it grew 1.4% in 2006 and 11.6% in 2007. The acceleration reflected a very strong investment in construction, especially public construction. Rates of investment growth also increased sharply between 2006 and 2007 in Indonesia and in Singapore: in Indonesia they rose from 2.9% to 8.9%, in Singapore from 11.5% to 19.3%. Finally, Cambodia maintained consistently high investment growth, with a rate of about 16% in both 2006 and 2007.

"Domestic demand accelerated in the major South-East Asian countries except Thailand"

Private consumption, a major component of aggregate demand, grew more rapidly in 2007 than it had in 2006 for most South-East Asian countries (figure 2.30). Cambodia's and Singapore's private consumption growth rates increased by 2.4 percentage points each, Indonesia's and Malaysia's by 2.0 percentage points each. In Thailand and Viet Nam, however, growth in private consumption slowed.

The government consumption growth rate increased in Thailand from 2.3% in 2006 to 10.2% in 2007. The Philippines also saw government consumption accelerate significantly between 2006 and 2007. But the rate of growth in government spending fell in Indonesia, from 9.6% to 5.6%, and in Singapore from 11.2% to 3%.

Based on our preliminary figures, domestic demand – the sum of gross fixed investment, public consumption and private consumption – grew more rapidly in 2007 than in 2006 in all East Asian countries for which data is available, with the exception of Thailand.

The economies of South-East Asia remain chiefly export-oriented. Export/GDP ratios range from about 50% for Indonesia and the Philippines to 70% for Thailand, 78% for Cambodia, 96% for Viet Nam, 122% for Malaysia and 270% for Singapore. However, export growth decelerated in all countries in the region during 2007. The fall in the export growth rate between 2006 and 2007 was particularly strong in Malaysia (from 18.1% to 7.4%), the Philippines (from 14.6% to 6.5%)

and Cambodia (from 26.9% to 16.8%). A weakened United States economy and local currency appreciation combined to inhibit the dynamism of electronic product exports from Malaysia and the Philippines. Cambodia's export growth is particularly fragile due to its concentration in the garment industry, where low-cost competitors from Viet Nam and India are gaining market share. The end of restraints on garment exports from China to the European Union (scheduled for the end of 2007) and to the United States (scheduled for the end of 2008) makes Cambodia's need to diversify its exports more urgent.

The deceleration of South-East Asian exports in 2007 is expected to continue in 2008, given the dollar's weakness and the prospect of growth in the United States continuing to slow down. So, the faster growth in domestic demand for the Asian and Pacific region in 2007 is encouraging: it suggests that the region's economies can keep up their robust growth performance despite an expected slowdown in external demand for 2008.

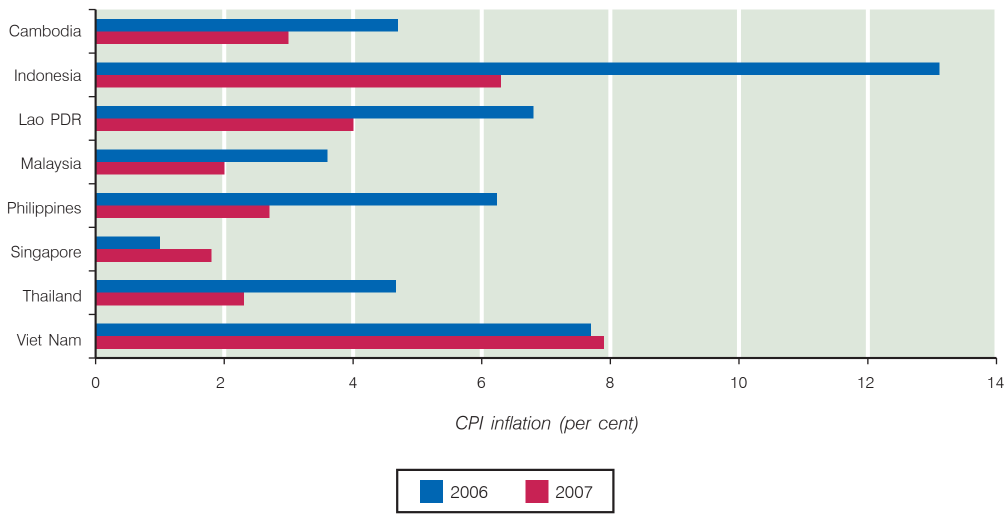
Inflation decelerated in most countries

Inflation fell in most South-East Asian countries during 2007 (figure 2.31). The drop in the inflation rate between 2006 and 2007 was particularly significant for Indonesia (from 13.1% to 4.7%), the Philippines (from 6.2% to 2.7%) and Thailand (from 4.7% to 2.3%). Inflation fell by about 2 percentage points in Cambodia, Malaysia and the Lao People's Democratic Republic, remained stable in Viet Nam, and increased slightly in Singapore (from 1% to 1.8%). The only country where inflation seems to have risen significantly is Myanmar, where prices increased at an annual rate of 37% in the first quarter of 2007 – up from an average rate of 25.7% in 2006 (and 10.7% in 2005). The August 2007 increase in subsidized fuel prices, which triggered large-scale anti-government protests and consequently a brutal crackdown, may have contributed to a further increase in inflation during the rest of the year.

> *Most South-East Asian currencies appreciated against the dollar, none against the Euro*

The reasons for the drop in inflation varied across countries. Good harvests helped to keep food price inflation down in Indonesia and the Philippines. Another inhibitor of inflation in the Philippines was appreciation in the peso, which restrained the prices of imported goods. And appreciation in the currencies of Malaysia, Thailand and the Lao People's Democratic Republic partly explains those countries' reduced inflation rates.

Figure 2.31. Inflation fell in most South-East Asian countries in 2007



Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007); and ESCAP estimates.

Notes: Data for 2007 are estimates. Inflation refers to changes in consumer price index.

Subdued inflation rates allowed some countries' central banks to ease their monetary stances. Bank Indonesia cut its reference rate 13 times, for a total of 450 basis points, between May 2006 and July 2007. The Bank of Thailand cut its policy interest rate – the one-day repurchase (repo) rate – from about 5% in January to 3.25% in July 2007. Interest rates also fell in the Philippines and Singapore, and remained stable in Malaysia and Viet Nam (figure 2.32).

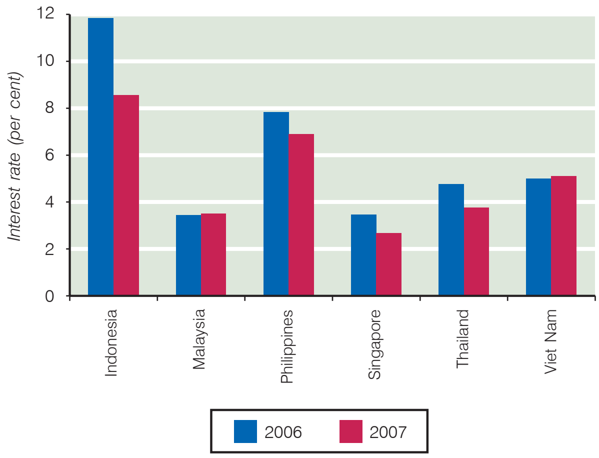
Exchange rates appreciated and foreign exchange reserves accumulated

In 2007 the currencies of South-East Asian countries continued to appreciate against the United States dollar, with the sole exception of the Indonesian rupiah (figure 2.33). The rate of currency appreciation since the start of 2007 was highest for the Philippines followed by Singapore, Malaysia, Thailand and the Lao People's Democratic Republic. Over the two-year period from January 2006 to November 2007, the cumulative appreciations of the Philippine peso and the Thai baht against the United States dollar were 22% (Phillipine peso) and 17% (Thai baht). For both the Malaysian ringgit and the Singaporean dollar this figure was around 12%. South-East Asian currencies appreciated somewhat less during these two years against the Japanese yen. In contrast, all the South-East Asian currencies depreciated against the euro which meanwhile appreciated 22% against the dollar.

Currency appreciation in the South-East Asia subregion during 2006 and 2007 reflected large inflows of foreign exchange. The largest contributions to these inflows came from surpluses in the current account and from FDI (table 2.13, columns 1 and 2). But during these two years, financial investments abroad by South-East Asian residents exceeded financial investments by foreigners in South-East Asia, helping to soften the impact of the current account surpluses and FDI inflows on exchange rates (table 2.13, column 3). In some countries these investments were encouraged by regulatory changes. For example, Malaysia increased its limit on holdings of foreign assets by some institutional investors and investment trusts from 10% to 30% in 2005, and again to 50% in 2007. And in 2007 the Bank of Thailand liberalized regulations on the holding of foreign assets by Thai individuals or businesses.

While increased financial investments abroad helped to counteract upward pressures on domestic currencies, central banks in South-East Asia continued to intervene in foreign exchange markets by accumulating international reserves (table 2.13, column 5). The cumulative increase in international reserves from the beginning of

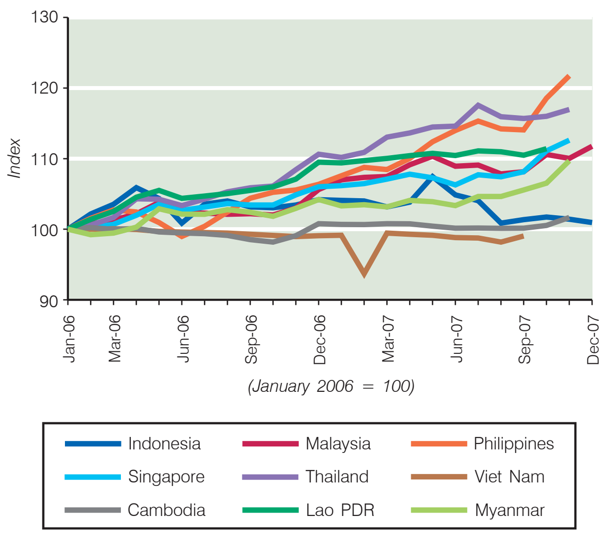
Figure 2.32. Interest rates in 2007 were lower than in 2006 or stable



Sources: ESCAP, based on data from Oxford Economics and Economist Intelligence Unit.

Note: Interest rate refers to the 14-day repo rate in Thailand, interbank call loan rate in the Philippines, one-month treasury notes in Indonesia, overnight interbank rate in Malaysia, three-month interbank rate in Singapore, and money market rate in Viet Nam.

Figure 2.33. The nominal exchange rate continued appreciating against the United States dollar



Source: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2007).

Notes: Data for November to December 2007 are estimates for Indonesia and Malaysia. Data for 2007 are through November for Cambodia, Myanmar, Philippines, Singapore and Thailand. Data for 2007 are through October for Lao People's Democratic Republic. Data for 2007 are through September for Viet Nam.

Table 2.13. Foreign exchange reserves accumulations mostly reflected surpluses in the current account

(Billions of United States dollars)

		Current account balance [1]	Net foreign direct investment [2]	Increase in foreign financial liabilities minus foreign financial assets [3]	Net errors and omissions [4]	Accumulation of foreign exchange reserves [5]=[1]+[2]+[3]+[4]
Indonesia	2006	9.9	2.9	−3.9	−2.0[b]	6.9
	2007	10.2	2.7	−6.1[a]	..	6.8
Malaysia	2006	25.5	0.0	−11.9	−6.7	6.9
	2007	26.1	0.5	−7.9[a]	..	18.7
Philippines	2006	5.0	2.2	−2.9	−1.4[b]	2.9
	2007	7.2	2.1	−1.3[a]	..	8.0
Singapore	2006	36.3	15.6	−36.5	1.7	17.0
	2007	44.0	11.8	−38.4[a]	..	17.4
Thailand	2006	3.2	10.0	−2.1	1.6	12.7
	2007	8.7	10.0	−8.6[a]	..	10.1

Sources: ESCAP calculations based on IMF, *International Financial Statistics* (Washington, D.C., 2007); Economist Intelligence Unit; and Oxford Economics.

[a] Includes errors and omissions.
[b] Includes exceptional financing and use of the IMF credit and loans.

2006 to the end of 2007 was close to 60% for the Philippines and Cambodia, about 54% for Indonesia and Thailand, 38% for Malaysia and 27% for Singapore.

The fact that the exchange rates appreciated against the dollar in most South-East Asian countries, despite the accumulation of reserves, reflects a move towards a more flexible management of exchange rates. ESCAP (2007a), commented on the complications created for monetary policy when countries try to target the nominal exchange rate while inflows of foreign exchange are strong. Accumulations of foreign exchange reserves remained very important in 2007. But most countries allowed their exchange rates to appreciate, intervening less than would have been necessary to keep the rates fixed. Changes in regulations to facilitate financial investments abroad represent another step towards flexibility.

> *Regional trade integration is expected to support economic growth in the medium run*

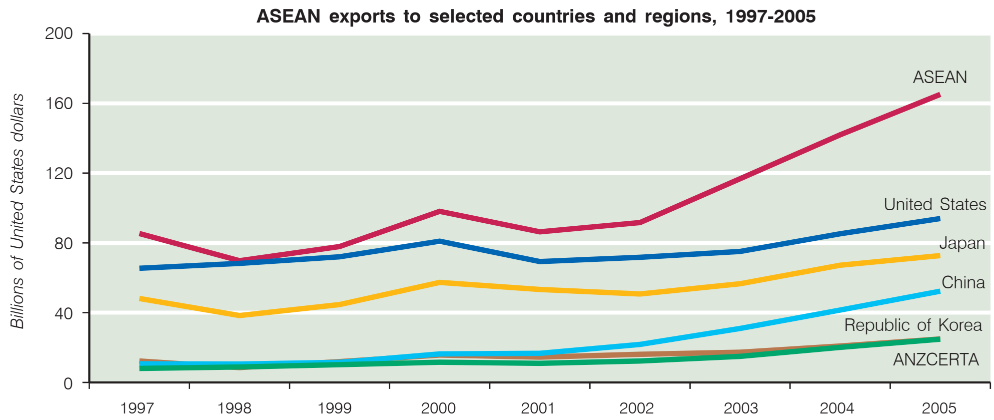
Not all countries in the subregion have moved towards greater exchange rate flexibility. The Vietnamese currency has been held tightly by the monetary authorities at a target rate of about 16,000 dong/dollar since January of 2005. However, in 2007 Viet Nam's successful efforts to prevent the dong from appreciating were complicated by the country's large capital inflows. The State Bank of Viet Nam tried to sterilize those inflows by selling bonds. That caused a rise in domestic interest rates, which in turn attracted more capital inflows. Nonetheless, the bank did manage to keep the inflation rate in check in 2007.

Solid macroeconomic fundamentals leave countries well prepared for a slowdown in export demand

Countries in the region appear well prepared to face the slowdown in export demand that is expected to result from slower economic growth in the United States and other industrial countries. First, foreign exchange reserves are at very high levels, allowing countries to withstand a deterioration in their current accounts. Second, the importance of domestic demand growth increased from 2006 to 2007. Further domestic demand growth can help sustain GDP growth, should export demand continue to slow down during 2008. Third, lower inflation rates during 2007 allowed countries to lower interest rates in 2007. Continued monetary stability in 2008 will help to support investment and private consumption as increasingly important drivers of GDP growth. Finally, the growing importance of Association of South-East Asian Nations

(ASEAN) countries and China as destinations for ASEAN exports (figure 2.34), together with current efforts towards regional trade liberalization (see box 2.3), suggest that in the medium to long term regional trade will play an ever-larger role in supporting economic growth in South-East Asia.

Figure 2.34. Intraregional trade becoming more important for ASEAN countries



Source: IMF, *Direction of Trade Statistics* (CD-ROM) (Washington, D.C., 2007).

Note: ANZCERTA is the Australia New Zealand Closer Economic Relations Trade Agreement.

Box 2.3. Gains from greater regional integration

Regional integration in East Asia intensified recently, reflecting a desire to strengthen economic cooperation after the economic crisis of 1997/1998; to increase bargaining power in multilateral negotiations with the North American and European regional blocs (Stubbs, 2002); to consolidate earlier gains through regional trade agreements (RTAs; Kawai and Wignaraja, 2007); and to spread the gains from economic prosperity to the region's least developed countries (ESCAP, 2007b).

A precursor was the ASEAN Free Trade Area (AFTA), signed in 1992 by the six members of ASEAN at that time – Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei Darussalam (ASEAN 6) – and expanded in the second half of the 1990s to the new ASEAN members – Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam (CLMV). AFTA aims at lowering rates to zero by 2010 for ASEAN 6 and by 2015 for CLMV. ASEAN has recently expanded its regional integration efforts through the ASEAN-China Free Trade Agreement, the ASEAN-Korea Free Trade Agreement, and the ASEAN-Japan Comprehensive Economic Partnership Agreement. These bilateral agreements could be consolidated into an ASEAN+3-wide RTA. A more ambitious proposal is to expand ASEAN+3 to Australia, India and New Zealand to form an ASEAN+6 RTA.

Do regional trade agreements improve welfare? Welfare gains from trade creation may be outweighed by losses from trade diversion, as members switch imports from more efficient producers outside the union to less efficient producers inside (Viner, 1950). Would this happen in East Asia? Consider an ESCAP simulation

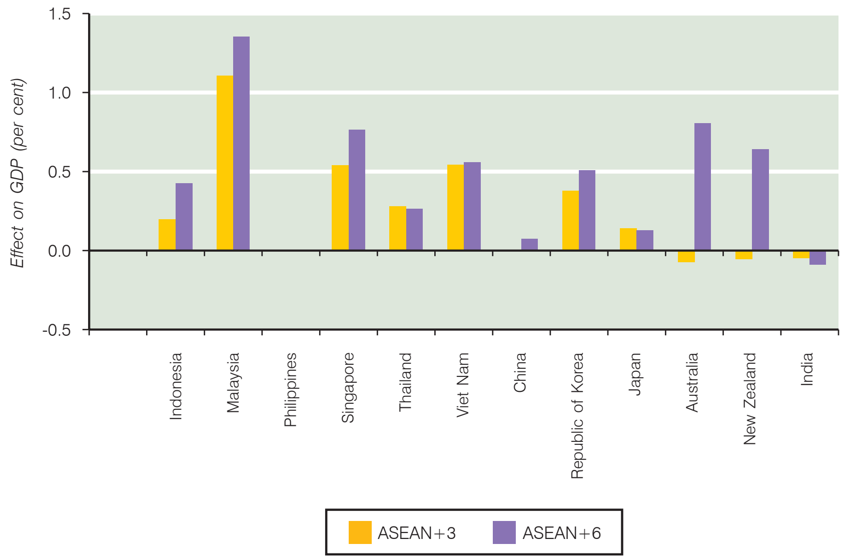
(Continued on next page)

Box 2.3 *(continued)*

of two scenarios, ASEAN+3 and ASEAN+6, using the Global Trade Analysis Project (GTAP) model to estimate the welfare effects.[a]

In both, the effects are small (see figure below). The largest welfare improvement is for Malaysia under the ASEAN+6 scenario, where GDP is estimated to increase by 1.35%. The median improvement in GDP for the participating countries is only 0.4% under ASEAN+3 and 0.55% under ASEAN+6. But though small, the welfare effects of cutting tariffs are overwhelmingly positive, suggesting that trade-creation gains outweigh trade-diversion losses. The exceptions are the Philippines, with no gains under either scenario, China, with no gains under ASEAN+3, and India, with a small loss under ASEAN+6.[b] ASEAN+6 brings larger improvements in welfare to all countries except Thailand, India and Japan. The varying extent of welfare gains from these agreements could be due to many factors, including the complementarity of trade among the countries concerned and the level of existing tariff protection.

Figure. ASEAN+3 and ASEAN+6 are welfare-improving: Simulated welfare effects on selected countries



Source: ESCAP calculations based on data described in the text.

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[a] The simulations assume that all the products of all the countries are transferred to the inclusion list. The GTAP model does not include Brunei Darussalam, Cambodia, the Lao People's Democratic Republic or Myanmar; so, for the purposes of the simulation, ASEAN comprises only Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam. The assumption is that AFTA's tariff cuts are completed in the base case.

[b] Not surprisingly, Australia, India and New Zealand experience welfare losses under the ASEAN+3 scenario because they lose market access to China, Japan and the Republic of Korea.

(Continued overleaf)

Box 2.3 *(continued)*

Such simulations should be taken with great caution: differences in assumptions, databases, and scenarios can change the results. Compared with results for ASEAN+3 obtained by other researchers, those here, with a median-country welfare gain of 0.4% of GDP, are at the bottom end of the spectrum (table a). Kawai and Wignaraja's (2007) results, with a median-country welfare gain of 4.8% of GDP, are at the high end. The disparities can be partly explained by differences in the modelling assumptions. For instance, ESCAP's simulations capture just static gains from trade and are based on the assumption that only goods trade is liberalized through tariff cuts. In contrast, Kawai and Wignaraja's (2007) simulations allow trade to affect capital stocks through investment activities, assume that both goods and services trade is liberalized, and consider the impact of trade facilitation measures.[c] However, the other studies support the finding of welfare gains from ASEAN+3 and suggest that further gains are possible if liberalization beyond trade in goods and the removal of other forms of trade barriers are taken into account.

Does cutting tariffs reduce poverty? The answer depends on how trade liberalization affects incomes and prices in the consumption basket of the poor. ESCAP used the ratio of unskilled workers' wages to the prices of primary commodities and textiles as a rough measure of the real consumption of the poor, and consumption-to-poverty elasticities to estimate the final impact on headcount poverty ratios, following Anderson et al. (2006). The analysis suggests that ASEAN+3 could reduce the number of people living on less than a dollar a day by 9.3% (2.7 million people) in Indonesia, Malaysia, Philippines, Thailand and Viet Nam, with over 80% of the reduction in Viet Nam and Indonesia.

Table a. Simulations agree on welfare gains from ASEAN+3, disagree on the magnitude

(Per cent)

	Urata and Kiyota (2003)	Gilbert et al. (2004)	Mohanty et al. (2006)	Joint Expert Group (2006)	Plummer and Wignaraja (2007)	Kawai and Wignaraja (2007)	ESCAP	Median
Indonesia	4.9	0.4	1.8	1.7	0.4	2.6	0.2	1.7
Malaysia	2.2	0.4	1.9	5.8	4.6	5.5	1.1	2.2
Philippines	0.8		1.3	4.0	0.5	2.6		1.3
Singapore	3.7	2.5	3.1	4.2	1.5	4.8	0.5	3.1
Thailand	12.5	1.6	2.8	4.5	3.0	12.1	0.3	3.0
Viet Nam	6.6	3.1		2.8	3.3	7.4	0.5	3.2
China	0.6		0.6	1.7	−0.2	1.3		0.6
Japan	0.2	0.1	2.5	0.4	0.3	1.5	0.1	0.3
Republic of Korea	1.8	0.7	3.0	3.5	3.5	6.2	0.4	3.0
Median	2.2	0.7	2.2	3.5	1.5	4.8	0.4	2.2

Notes: Data for Mohanty et al. (2006) are based on ASEAN+4 (ASEAN+3 + India). For Plumner and Wignaraja (2007), China includes Hong Kong, China. Numbers below 0.1% in absolute value not shown.

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[c] Another reason for the disparities is that ESCAP's baseline scenario is based on the latest tariff data, which includes reductions agreed under the Uruguay Round. With lower baseline tariffs, the gains from additional trade liberalization are diminished.

(Continued on next page)

Box 2.3 *(continued)*

ASEAN+3 is estimated to reduce the number of people living on less than 2 dollars a day in these countries by 3.5% (6.7 million people), suggesting that the impact of ASEAN+3 on poverty reduction is about three times greater than that of just completing AFTA. And ASEAN+3 is estimated to reduce the number of people living under a dollar a day in China by 1.2% (2.1 million people). Although ASEAN+6 is expected to slightly reduce India's GDP, ESCAP estimates that it would reduce the number of people living under a dollar a day by 1.2% (4.1 million people).

Should regional trade agreements be the end goal? Additional simulations show that the gains from global free trade are substantially larger than those from regional trade agreements. Overall, welfare and the potential for poverty reduction increase as economic integration expands from the completion of AFTA, to ASEAN+3, ASEAN+6, and global free trade (table b). This is true both for ASEAN countries, its new partners, and the world at large. Therefore, while the current efforts towards increased regional trade integration are steps in the right direction, multilateralization should continue, despite the difficulties of the Doha Round.

Table b. Global free trade gains exceed those from regional trade liberalization

	Completion of AFTA	ASEAN+3	ASEAN+6	Global free trade
Effects on welfare (millions of United States dollars)				
ASEAN	580	2 170	2 940	4 900
China, Republic of Korea, and Japan	–340	6 950	8 260	27 400
Australia, India, and New Zealand	–50	–510	2 830	3 900
World	–200	3 800	8 100	59 800
Poverty reduction (millions of persons living under $1/day)				
ASEAN	0.9	2.7	3.3	7.2
China	–0.1	2.1	2.5	17.3
India	–0.1	–0.2	4.1	6.6

Sources: ESCAP simulations based on GTAP model.
Note: ASEAN under effects on welfare excludes Brunei Darussalam, Cambodia, Lao People's Democratic Republic and Myanmar.

Policy research feature 2.5: Can the least developed countries of Asia and the Pacific escape the vulnerability trap?

Asia-Pacific, the world's most dynamic region, hosts some of the world's most vulnerable countries, vulnerable to climate change, imperiled by rising sea levels or unable to break the vicious circle of conflict and poverty.

There are enormous differences among Asia-Pacific's 14 most vulnerable – and least developed – countries. One group has successfully started transforming economic structures, some with the potential to become Asia's next newly industrializing countries. Another group is still in conflict or just emerging, leaving a weak and vulnerable economic base. A third group, the Pacific island countries, is wealthier but highly vulnerable, suffering from frequent shocks that imperil development.

How can economic vulnerability be measured?

Economic vulnerability, one criterion for classifying a country as least developed, is measured in the United Nations System by a "economic vulnerability index" that includes economic structures, such as export concentration and the share of agriculture in GDP; population; remoteness from major markets; the number of people displaced by natural disasters and instability of agricultural production and exports of goods and services.

But the index has to be improved. Based on data with a time lag, it fails to portray the full threat of climate change. It does not distinguish between country-inherent vulnerability, such as geography, and structural vulnerability, which can be reduced through policy interventions (Briguglio, 2005). And the index does not capture internal vulnerability – civil war, political unrest, financial crises.

Of the region's least developed countries, Bangladesh is the least economically vulnerable. The Pacific island least developed countries have the highest vulnerability but the highest per capita incomes and human development (table 2.14). Incomes in the Pacific islands have frequent spikes and setbacks. In Kiribati, Solomon Islands and Vanuatu incomes were lower in 2004 than in 1980. Over the same period many other least developed countries have grown enormously. Empirical studies have also shown that countries with higher growth

Table 2.14. Wealth, human assets and vulnerability in the least developed countries in Asia and the Pacific

	Population 2004 (millions)	Per capita gross national income (United States dollars)	Human assets index	Economic vulnerability index
Afghanistan	29.9	122	11.5	60.3
Bangladesh	141.8	403	60.1	25.8
Bhutan	2.2	690	44.4	46.6
Cambodia	14.1	303	46	52.3
Kiribati	0.1	917	90.5	84.3
Lao PDR	5.9	350	54	57.9
Maldives	0.3	2 320	81.9	50.5
Myanmar	50.5	167	68.4	42.2
Nepal	27.1	243	56	37.4
Samoa	0.2	1 597	90.4	64.7
Solomon Islands	0.5	557	70.6	56.9
Timor-Leste	0.9	467	55.3	65.2
Tuvalu	0.01	1 267	89.7	91.9
Vanuatu	0.2	1 187	66	64.3

Source: Committee for Development Policy (2006), "Report on the eighth session", *Official Records of the Economic and Social Council, 1999, Supplement No. 13* (E/2006/33).

volatility tend to have lower long-term growth (Ramey and Ramey, 1995; Guillaumont, 1999 and 2006).

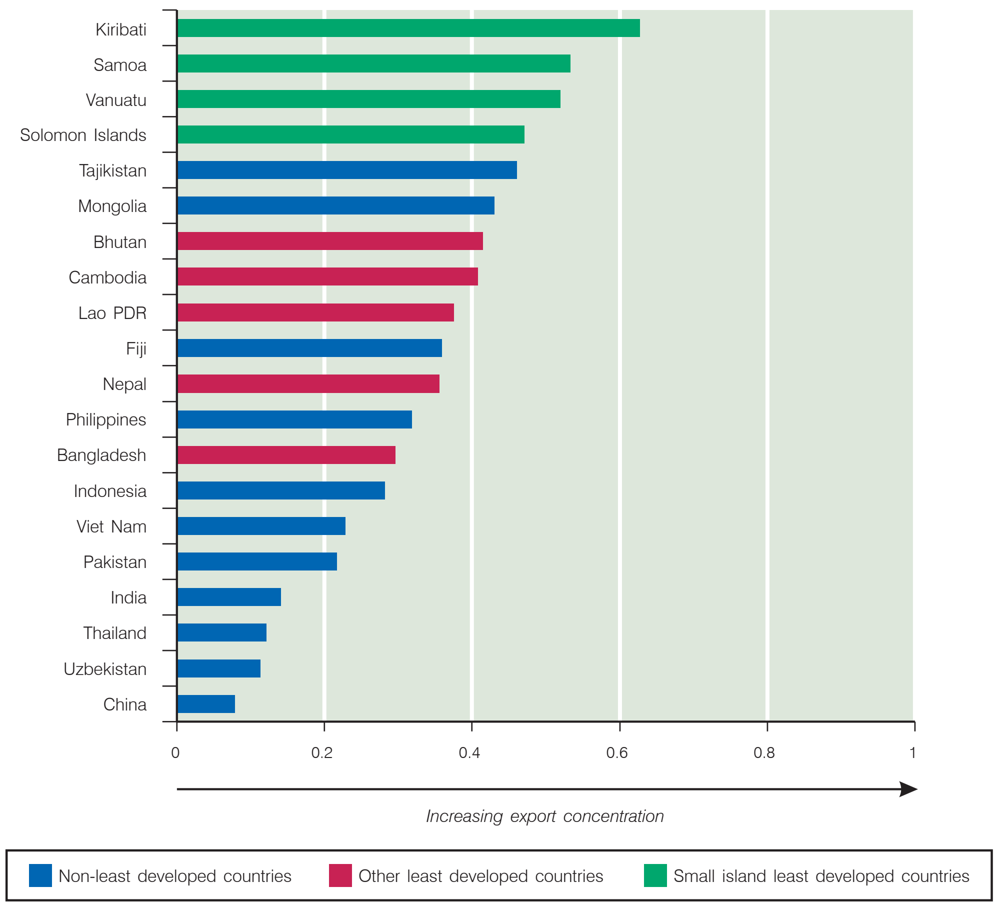
Geography traps: small, remote, sea-locked

The Asia-Pacific region hosts geographic extremes: six countries consist of small islands, four are landlocked. The geographic disadvantages of Pacific island countries are evident in their economic structures, skewed towards exports in vulnerable sectors, such as agriculture or tourism, leading to highly volatile export yields. The result is macroeconomic instability, with chronic trade deficits that can be sustained only by capital inflows.

Small size hinders economies of scale, which restricts development and makes public goods more expensive. The world's successful small countries have mitigated the negative impact by finding economic niches, harnessing the potential of surrounding economies or, if lucky, exploiting natural resources. The Pacific islands, however, are small, sea-locked, resource-poor and remote (Briguglio, 2004).

Pacific island States also have the highest export concentration-measured by the Hirshman-Herfindahl-Index of export concentration-among the region's low-income and lower middle-income countries, concentration that has barely decreased over time (figure 2.35). Empirical studies have found a correlation between export concentration and growth volatility (Jansen, 2004).

Figure 2.35. Export concentration for selected Asian and Pacific countries (Hirshman-Herfindahl-Index, average over 1980-2004)



Source: UNCTAD Handbook of Statistics 2006-07 Online.

Note: Data are unavailable for Afghanistan, Maldives, Myanmar and Timor-Leste.

Export earnings have also been highly volatile in Pacific island States; in other countries, whether least developed or not, earnings tend to have grown consistently (figures 2.36 and 2.37).

The threat from climate change

Natural disasters are another source of vulnerability, their increasing frequency often attributed to climate change. Such disasters reduce growth and exports and undermine the balance of payments (Auffret, 2003; Crowards, 2000; Gassebner, 2006). Small countries, especially small islands, are hit harder by natural disasters. A major disaster in a large country will usually be confined to a relatively small area and affect only a fraction of its people. The cyclone that hit Samoa in 1990 inflicted damage equivalent to 100% of GDP, affecting nearly all its people (table 2.15). As both least developed countries and small island developing States, Pacific island countries need special attention and international support to tackle these threats.

Economic transformation in many Asia-Pacific least developed countries, but not all

Asia-Pacific least developed countries in general still have a higher share of agriculture to GDP than the comparator countries in the region, exposing them to weather conditions and dependence on world prices. Afghanistan, the Lao People's Democratic Republic, Myanmar and Nepal have a share approaching or exceeding 40%.

> *Economic transformation remains elusive in the Pacific, Afghanistan, Myanmar and Timor Leste*

Many Asia-Pacific least developed countries have initiated an economic transformation over the last quarter-century, reducing the share of agricultural raw material in merchandise exports – from 48% in 1980 to 1% in 2004 in Nepal (World Bank, 2006). Economic transformation remains elusive in two groups of countries: Pacific island countries and Afghanistan, Myanmar and Timor-Leste.

The share of agriculture in GDP is relatively low in the Pacific islands, but economic transformation remains limited. Agricultural productivity has fallen, and output

Figure 2.36. Kiribati's export earnings were volatile over 1980-2000…

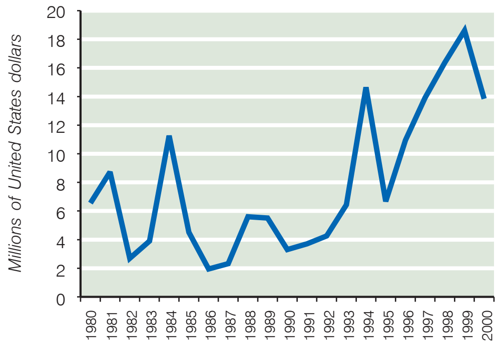
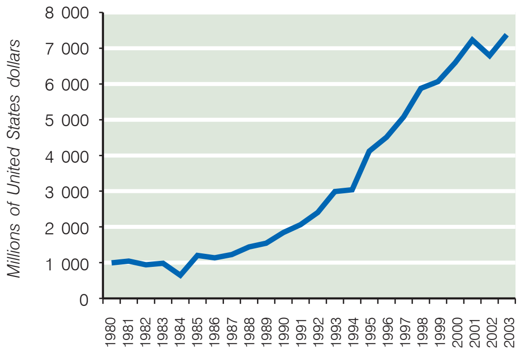


Figure 2.37. …but Bangladesh's grew steadily



Source: World Bank, *World Development Indicators Database.*

Table 2.15. Worst natural disasters in the low-income countries of the Asian and Pacific region, 1980-2003

			Total persons affected		Estimated damage	
		Event	Number (thousands)	Population affected (per cent)	Value (millions of United States dollars)	Share of GDP (per cent)
Samoa+	1990	Cyclone Ofa	170	100.0	200	105.5
Kiribati+	1999	Drought	84	95.0		..
Vanuatu+	1985	Cyclone Eric & Nigel	118	91.0	173	109.2
Samoa+	1991	Cyclone Val & Wasa[a]	85	52.8	278	150.1
Cambodia	1994	Drought	5 000	46.0	100	4.1
Bangladesh	1988	Flood[a]	45 000	42.9	2 137	7.9
India	1987	Drought	300 000	37.6	..	..
Fiji+	1998	Drought	263	33.0	..	..
Solomon Islands+	1986	Cyclone Namu	90	32.0	..	..

Sources: EM-DAT, *Emergency Disasters Database;* and World Bank, *World Development Indicators Database.*

Notes: Bold indicates a least developed country. A "+" indicates a small island developing country.

[a] Same disaster accounts for the highest percentage of the population affected and damage/GDP.

is volatile, with slow average growth over the last 20 years. The high agricultural volatility is closely related to natural disasters. And the overall contribution of agriculture to the economy is much higher than its share of GDP because most manufactured exports are based on processing agricultural goods.

The second group has barely transformed because of governance factors. Afghanistan's long conflict has not been fully resolved. Timor-Leste, also with a long history of conflict, has only recently gained independence. These are not economies where a manufacturing sector can be established. In Myanmar, the share of agriculture in GDP has increased from 46% in 1980 to 57% in 2000. In 1992, the last year with data, the share of agricultural raw material in exports was 35%, by far the highest share of Asia's low-income and lower middle-income countries (Hauff, 2007).

Remittances and aid can reduce vulnerability – or increase it

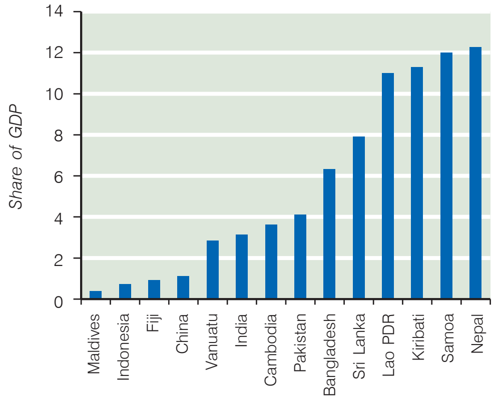
Inflows from aid or remittances can mitigate trade deficits and help balance the current account. But they can also be volatile, potentially increasing vulnerability. In Samoa, remittances are an important contributor to the economy and, in absolute numbers, have been stable over time. In Bangladesh, the Lao People's Democratic Republic and Nepal, remittances in absolute numbers and as a share of GDP are becoming more important (figure 2.38).

Whether remittances cushion economic shocks is debated. If remittances are driven by altruism, the diaspora may increase flows during a major economic shock. Empirical studies on Bangladesh, however, found little evidence that remittances rise in response to an internal economic shock (IMF, 2007). Remittances have, however, cushioned oil price shocks, perhaps driven less by altruism than by the fact that most Bangladeshi workers migrate to oil-rich Arab countries. In Nepal, remittances sustained the economy during the recent political crisis and prevented larger losses in growth. Nepal had GDP growth of -0.6% in 2002, but remittances sharply increased.

The major official development assistance (ODA) recipients in the region are Afghanistan, Solomon Islands and Timor-Leste, all of them conflict or post-conflict countries. ODA dependence in these countries also reflects their narrow economic base, and concerns about Dutch disease have already been raised (EIU, 2007). Although Pacific island countries receive high amounts of ODA per capita due to their small populations, ODA represents only about 10% of GDP, similar to Bhutan, Cambodia and the Lao People's Democratic Republic (figure 2.39).

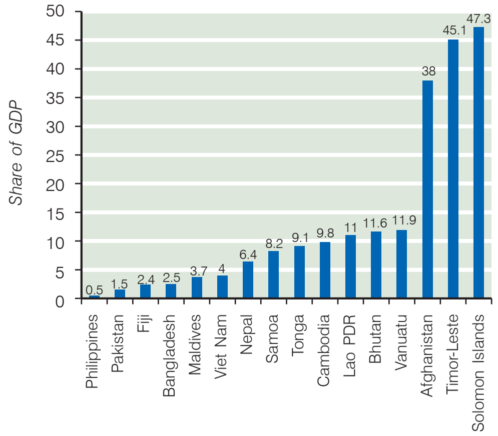
Most least developed countries in Asia-Pacific that have initiated economic transformation are no longer dependent on ODA. In Bangladesh, the ratio of ODA to GDP is only 2.5%. ODA in these countries has been volatile, however, because of emergency aid after floods and cyclones.

Figure 2.38. Remittances as a share of GDP in selected Asian and Pacific countries, 2004



Source: ESCAP calculations based on World Bank, *World Development Indicators Database.*

Figure 2.39. Aid dominates economies in Afghanistan, Solomon Islands and Timor-Leste: ODA receipts as a share of GDP, 2004



Source: ESCAP calculations based on World Bank, *World Development Indicators Database.*

Weak economic environments, persistent economic vulnerability

A capable State is better able to mitigate economic shocks and promote economic transformation, reducing vulnerability. Small countries may have advantages here: research has found that small countries tend to develop better institutions because enforcement is likely to be more effective (Fors, 2006).

The World Bank's Doing Business rankings, one indicator of the institutional environment, reveal that, among Asia-Pacific least developed countries, the institutional environment is most conducive in the Pacific islands. These countries have mitigated their geographic disadvantages by making it easier to do business. But there is still room for improvement. Timor-Leste, a conflict country until recently, ranks 174 of 175 countries surveyed. No survey has not been conducted for Afghanistan or Myanmar, but anecdotal evidence suggests a difficult security situation and widespread corruption in Afghanistan and a restrictive macroeconomic environment in Myanmar (Hauff, 2007).

"Improving the business environment a key challenge for LDCs"

Infrastructure and human capital are also essential for a conducive economic environment, necessary to kick-start an economic transformation – and to reduce vulnerability. Human assets, including health and education, are low in Afghanistan and Timor-Leste but disproportionately high in Myanmar (see table 2.14). The Pacific island countries have the highest human asset indicators in the group of Asia-Pacific least developed countries. Having improved the institutional environment within their control, they are trapped by geographic disadvantages.

Infrastructure – the road network, electricity supply and information and communications technology coverage – is particularly weak in Afghanistan, Myanmar and Timor-Leste. Afghanistan's road density is among the lowest in the region, as is its number of Internet users (0.9 users per 1,000 people). Myanmar has the second lowest number of Internet users in the region (1.3 users per 1,000 people) and by far the lowest share of mobile phone subscribers (1.8 users per 1,000 people) (World Bank, 2006).

Improving the business environment is among the key challenges for the large group of least developed countries that have embarked on economic transformation and that will likely find ways out of the vulnerability trap (Bhutan, for example, ranks 138). For the landlocked countries in the group, this will also mean improving integration with the global trade system and improving transportation.

The vicious circle of conflict and poverty

Some countries in Asia-Pacific, notably Afghanistan, have been hard hit by repeated conflicts and seem to be trapped in a vicious circle of conflict and poverty. The effects of civil wars and other conflicts can be similar to those of economic shocks and natural disasters, with growth reduced by 2.2% a year during conflict (Collier, 1999). And it can take much longer to recover from a civil war, as spending shifts from social to military, lowering human capital and increasing poverty. Cambodia still suffers from the long-term loss of human capital under the Khmer Rouge regime (de Walque, 2004). Even after a conflict, the government priority is often physical infrastructure, leaving little room for social spending. If the problems that led to the conflict are not addressed, rising social tensions can lead to social mobilization and raise the spectre of a new conflict.

> *Economic transformation is impossible in conflict-torn LDCs*

Economic transformation is impossible in such circumstances. Establishing peace and security and making a commitment to equitable and inclusive development must therefore be the first step towards more sustainable – and less vulnerable – economies. Priority must also be given to reducing the risk of reigniting a civil war.

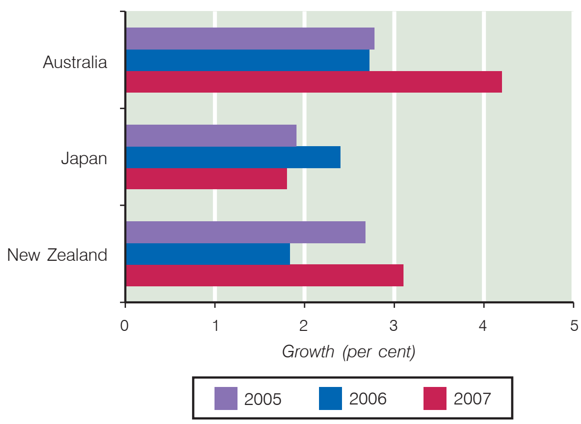
Developed economies: Continued growth heightens capacity constraints

After growing at 2.4% in 2006, the Japanese economy – the largest in the region – continued to grow modestly at 1.8% in 2007 (figure 2.40). Profit growth continued in the corporate sector, thanks to solid business sector growth and rebounding export growth from Asia in the third quarter. But Japan's economy also faced significant challenges. Household consumption decelerated in mid-year. And, starting in July 2007, a plunge in construction further deteriorated private investment.

> *The troubled US credit market did not slow investment demand growth in the developed economies in 2007*

A rapidly ageing society (see policy research feature 2.6), Japan faces the major policy challenge of making its social security system work despite massive public debt. The government had envisaged achieving a primary budget balance in 2007, but in fact the pressure on public finances remained intense and Japan's fiscal position got worse. The net public debt for 2007 stood at over 180% of GDP. Yet any attempt at fiscal consolidation might seriously damage fragile consumer confidence.

Figure 2.40. Economic growth in developed ESCAP countries, 2005-2007



Sources: ESCAP, based on national sources; and ESCAP estimates.

Note: Data for 2007 are estimates.

Economic growth gained speed in Australia and New Zealand in 2007. The Australian economy recorded its 17th consecutive year of expansion, led by renewed strength in household consumption and by continued private investment growth. Its overall GDP growth rate was 4.2% in 2007, up from 2.7% in 2006. But strong growth in non-farm sector production was partly offset by a large drop in farm sector production, reflecting the drought. New Zealand, with nearly a decade of growth behind it, maintained strong growth momentum. Its GDP growth rate was 3.1% in 2007, up from 1.8% in 2006. As in Australia, household consumption – encouraged in New Zealand by continued wage growth and a tax policy on disposable income – led growth in domestic demand. Export demand also remained robust.

Growth was supported by domestic demand

The troubled United States credit market has not yet slowed investment demand growth in the developed economies. In Japan, continued corporate profit growth and a relatively optimistic view of future growth prospects encouraged further investment in 2007. With external demand still solid, the business sector, particularly large manufacturers, enjoyed strong profit growth and remained generally optimistic about their prospects. Investment growth was modest in 2007, however, compared with that of past years. The increasing cost of production has progressively squeezed profits in the business sector, especially for small and medium-sized enterprises, as competitive pressures prevent firms from passing on increased production costs to consumers. And private investment suffered a major setback after June 2007, when a revised building standards law took effect, precipitating a sharp decline in construction starts. In September 2007, non-residential construction dropped by 54% (though this is considered a temporary impact, and construction starts are expected to rebound in 2008). Finally, according to the Tankan Survey, a short-term economic survey of enterprises in Japan conducted by the Bank of Japan and released in December, uncertainty about the effect of the subprime loan crisis on the United States economy has eroded business confidence (Bank of Japan 2007).

In Australia, as commodity prices level out and investment opportunities in natural-resource-based sectors become increasingly scarce, a moderation in private fixed investment has resulted. In addition, credit conditions have tightened. The problem of the United States credit market has not directly affected business sector investment decisions, and strong profit growth still whets the appetite for investment in the non-mining sector. But tighter conditions in the global money market have led domestic banks to meet strong demand for credit by switching from external funding to domestic sources, pushing up the interest rate in the second half of 2007.

Wage growth stimulated household consumption

Household consumption supported growth in all three developed economies, though not by the same amount in each. In Japan, household consumption growth remained modest. But rising business profits have slowly increased household income through employment growth and dividend payments to shareholders. Private consumption therefore continued to grow moderately, though sluggish wage growth and high oil prices discouraged consumer confidence. As with non-residential construction, housing construction also dropped suddenly in July 2007 in Japan – with largest fall during September by 44%.

"Household consumption supported growth in all three developed economies"

Australia's household consumption regained strength in 2007. A tax cut, and continued growth in employment and wages, drove disposable income up. The rise in disposable income outweighed consumption growth, yielding a modest rise in household savings. Factors that had militated against consumption growth in 2006 were absent in 2007, as increased housing prices added to household wealth while a strong Australian dollar cushioned the economy against the impact of high oil prices.

Despite wage growth in New Zealand, household consumption there is showing signs of slowing down. As the housing market cools, households find it increasingly difficult to balance expenditure with rising debt service costs. Household debt has risen with rising interest rates – from 100% of disposable income in 2003 to 160% in 2007. But continued growth in wages and employment has partly offset the problem.

A tight labour market led to wage growth in Australia and New Zealand but not in Japan

The tightening of labour markets has become a source of concern for all three developed economies. Japan's tight labour market has not caused wages to grow. Although the unemployment rate fell to a 10-year low, the demand for labour was largely met by an increase in the number of part-time workers, who earn much less than regular workers. More downward pressures have accompanied the retirement of the baby boomers, who typically earn much more than younger workers under Japan's chiefly seniority-based wage system. If Japan's tight labour market inspires more rapid wage growth in the coming years, consumer demand will grow along with it.

In Australia and New Zealand – unlike Japan – the tight labour market did prompt wage growth. Australia's labour shortage continued in 2007. Its unemployment rate reached 4.3% in the third quarter of 2007, a multi-decade low, and the labour participation rate was at a record high. Firms' intention to recruit remained high. Regions benefiting from the commodity price boom contributed most to the trend. In New Zealand, in the third quarter of 2007, the unemployment rate fell to a historical low of 3.5%. The business sector found it more difficult to find skilled and unskilled labour. But New Zealand's employment growth did not indicate a rise in full-time employment. Instead it reflected additions to the number of part-time workers, which outpaced a reduction in the number of regular workers.

The tightening labour markets in the three developed economies differed qualitatively in one respect: employment growth in Australia was associated with an increase in full-time employment, but only part-time employment increased in Japan and New Zealand.

Inflationary pressure remained a concern in Australia and New Zealand; production costs increased in Japan

Japan's corporate price inflation remained at about 2% in 2007, reflecting high oil prices and an increase in commodity prices combined with a weaker exchange rate. With tightening labour market conditions, the hourly wages of part-time workers have been increasing more rapidly than those of regular workers. Price increases at the producer level, however, were not passed on to consumers due to downward price pressures from market competition. Consumer price inflation in Japan continued to hover around 0% in 2007 (figure 2.41).

"Inflationary pressure continued to cause concern for both Australia and New Zealand in 2007, leading to monetary tightening"

By contrast, inflationary pressure continued to cause concern for both Australia and New Zealand in 2007, leading to monetary tightening in both countries. At the end of the year consumer price inflation appeared to have been contained. Australia's consumer price inflation rate, after peaking at 4% in mid-2006, decelerated to 1.9% by the third quarter of 2007. Thus consumer price inflation in Australia fell from 3.5% in 2006 to 2.4% in 2007. Because the decrease largely reflected the price volatility of few items, such as oil and fruit, inflationary pressure remained a concern – particularly while the labour market was tight and capacity use was high – and the Reserve Bank of Australia continued to tighten its monetary policy in 2007, raising the official cash rate to 6.75%. New Zealand's consumer price index fell from 3.4% in 2006 to 2.4% in 2007, but the drop is likely a temporary effect of changes in government policy. Capacity constraints and high prices for inputs, such as oil and dairy products, drove output prices up. Gradually the increase was passed on to consumers. The Reserve Bank of New Zealand tightened its monetary policy four times during 2007, bringing the overnight cash rate to 8.25%.

Figure 2.41. Inflation in developed ESCAP economies, 2005-2007

Sources: ESCAP, based on national sources; and ESCAP estimates.

Notes: Data for 2007 are estimates. Inflation rates refer to percentage changes in the consumer price index.

The trade surplus increased in Japan, while Australia and New Zealand remained in deficit

Japan's trade surplus expanded in 2007. Strong export growth continued, but import growth slowed reflecting rising import prices and subdued growth in domestic demand. Although demand for Japan's exports weakened in the United States, demand from other parts of the world remained solid in 2007. By 2006 the share of export demand from Asia had already increased to 46%, led by rapidly growing demand from China. Whereas the share of demand for Japanese exports from China and Hong Kong, China, had stood at 12% in 2000, by 2006 this figure had risen to 20% – almost equal to the 22% share of export demand from the United States in 2006.

The sources of Japan's export growth have diversified in the past five years among China, other Asian countries and the European Union. While almost 30% of export growth was attributed to United States demand in 2000, this share had shrunk to less than 10% by 2006. So, the direct impact of the United States economic slowdown on Japanese exports has been partly offset by the growth of demand from other regions. But there is still uncertainty about the magnitude of the slowdown's effects, as it is likely to reduce United States demand for Asian products.

Australia's current account deficit has widened, as has its trade deficit (table 2.16). Import growth exceeded export growth. Export volumes continued to grow in all but rural sectors. From mid-2005 to September 2007, resource sector exports expanded by 22%. But their growth has still been constrained by production capacity – as was seen, for example, in mining production – though continued investment in recent years has gradually eased those constraints. Import growth in 2007 was supported by strong domestic demand and a strong exchange rate. All the major components of imports increased. Capital import was particularly strong, reflecting still-robust investment growth. The net income deficit remained high, at 4.5% of GDP, reflecting the high equity payments of foreign companies operating in Australia and the high interest payments due to a rising stock of net debt.

In New Zealand export growth exceeded import growth, reducing the current account deficit. The strong growth in exports reflected robust external demand. Moreover, export volume soared as dairy product prices increased. But the high exchange rate partly offset commodity price increases in domestic

Table 2.16. Budget and current account balances in developed ESCAP countries, 2004-2007

(Percentage of GDP)

	2004	2005	2006	2007
Budget balance				
Australia[a]	2.0	2.4	1.6	0.8
Japan	−6.2	−4.8	−4.1	−3.9
New Zealand[b]	4.6	5.7	5.0	2.9
Current account balance				
Australia	−6.0	−5.8	−5.5	−5.8
Japan	3.7	3.6	3.9	4.9
New Zealand	−6.6	−8.9	−9.0	−8.1

Sources: ESCAP, based on IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., September 2007) and *World Economic Outlook Databases* (Washington, D.C., October 2007); and ESCAP estimates.

Notes: Data for 2007 are estimates. Budget balance is the general government fiscal balance as a percentage of GDP. Current account balance is as a percentage of GDP.

[a] Data exclude net advances (primarily privatization receipts and net policy-related lending).

[b] Government balance is revenue minus expenditure plus balance of State-owned enterprises, excluding privatization receipts.

currency. Demand for imported capital goods was modest, while the higher exchange rate muted the value of the imports volume.

Growth is expected to slow in 2008-2009

Developed economies in the region are expected to grow more slowly in the coming years. A moderation of external demand is expected in Japan. In Australia and New Zealand, private consumption is expected to cool in response to tight monetary policy.

Japan's economy is forecast to slow to 1.4% in 2008, and to 1.3% in 2009, as external demand softens. Demand from China will become more moderate. And the United States economic slowdown may directly and indirectly moderate demand from other trading partners in Asia. Nevertheless, construction starts are expected to grow strongly in 2008, as plans that were delayed because of the 2007 construction law revisions are gradually implemented. And household expenditure will support domestic demand – if the tight labour market translates into wage growth.

In Australia, economic growth is expected to slow to 3.2% in 2008 and 2.8% in 2009. Private consumption, buoyed by disposable income growth from tax cuts and wage and employment growth, is expected to support overall economic growth – though a tighter monetary policy would gradually decelerate consumption growth. Private investment is likely to slow down with tighter monetary conditions and fewer opportunities to invest in the mining sector.

New Zealand's economic growth is also expected to become more moderate, at 2.3% in 2008 and 2.7% in 2009. With tight monetary policy continuing and debt-laden households bearing a heavier burden of interest payments, household consumption will be subdued.

> *Despite the rising importance of China, Japanese economy still linked closely to the United States*

There are still considerable uncertainties over the magnitude of the slowdown in the United States economy, as it may gradually erode economic growth in these countries in 2008 through reduced demand for their exports and uncertainties in global credit markets, although the short-term impact on the three economies has been limited so far.

For instance, the increasing reliance of the Japanese economy on Asia, particularly China, has given rise to the notion that Japanese economy may be decoupling from the United States economy. Japanese export growth in the past five years is largely attributable to the demand from Asia, most notably from China. One-fifth of Japanese exports are destined to the United States markets, while another one-fifth goes to China and Hong Kong, China. Nonetheless, a significant amount of Japanese exports to Asia, particularly China, is likely to end up in the United States, as Asian countries process intermediary goods imported from Japan and export them to the United States. Thus the impact of the United States economy slowdown will be felt directly as well as indirectly through the reduced demand from Asia for Japanese products. ESCAP analysis shows that 1 percentage point reduction of United States GDP growth will reduce Japan's GDP growth by 0.3 percentage points, while it will reduce the growth of China by 1.2 percentage points. Still if China manages to withstand the United States slowdown and continues to accelerate its economic growth by 1 percentage point above the baseline projection, the impact on Japan would be negligible. It suggests that despite the rising importance of the Chinese economy for Japanese trade, prospects of the Japanese economy may be linked more closely with the United States economy. It should be noted, however, that the model may not fully capture the reactions of financial sector nor the impact of the shocks on consumers and business confidence.

Policy research feature 2.6: How secure is retirement in Japan?

Near the top of the list of countries with ageing populations, Japan faces monumental challenges in its public pension system. Despite low incomes, Japan's elderly seem, on average, to be able to maintain living conditions similar to those before their retirement. But averages can mislead. Disaggregated data show that a possibly significant proportion of elderly people experience difficulties in maintaining a minimum standard of living – particularly those unable to earn additional income beyond the basic pension.[7]

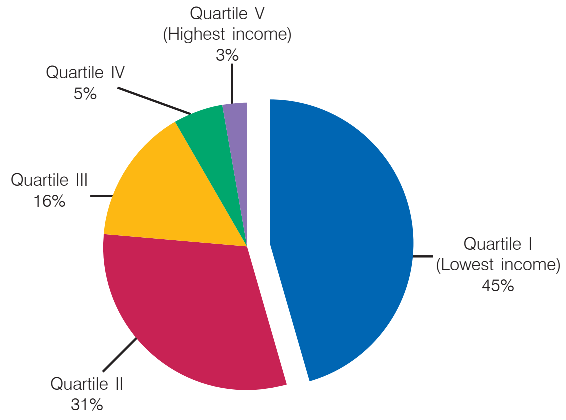
Socio-economic change has eroded the traditional family support system and increased the number of households with only one or two elderly people. Longer life expectancy means that elderly people must have the means to support themselves, either on their own or through institutional support, long after retirement. The public pension, including the universal basic pension, is an important source of income for elderly people and reduces the number of low-income households. But the basic pension alone is insufficient for an adequate living standard, and a large proportion of elderly people rely solely on it. Although a social safety net is in place, its stringent eligibility criteria discourage many from applying. While the heavy burden of social expenditure leads to the charge that current pensioners enjoy an affluent retirement life at the cost of future generations, there have been surprising reports on the "poverty" of elderly people.[8]

Income, consumption and savings among Japan's elderly

Elderly people tend to have lower incomes than the working age population because many of them withdraw from the labour market. Of Japan's elderly households, 45% belong to the lowest income quartile (figure 2.42). In 2002, more than 20% of elderly people in Japan had incomes below the poverty line, compared with 13.5% among the working age population.

In disposable incomes, however, elderly people as a group are not particularly worse off. Disposable income tends to decline with age, but elderly people in Japan still have about 80% of the working-age disposable income. A disproportionate share of single-person households are in the low-income group (figure 2.43).

Figure 2.42. Nearly half of Japan's elderly households are low income: Distribution of elderly households by income quartile



Source: Calculations based on Ministry of Health, Labour and Welfare, *Comprehensive Survey of the Living Conditions of the People 2005* (Tokyo).

> *In 2002, more than 20% of elderly people in Japan had incomes below the poverty line*

Older couples maintain consumption similar to that of younger couples, if with different patterns. Older people spend significantly less on housing than younger people, reflecting the high rate of home ownership (Yamada and Casey, 2002). Almost 30% of elderly single-person households (65 and older), however, do not own a home; among larger households, home ownership exceeds 90%. The expenditure of single households without real estate is about the half the elderly average, suggesting financial constraints on their consumption.

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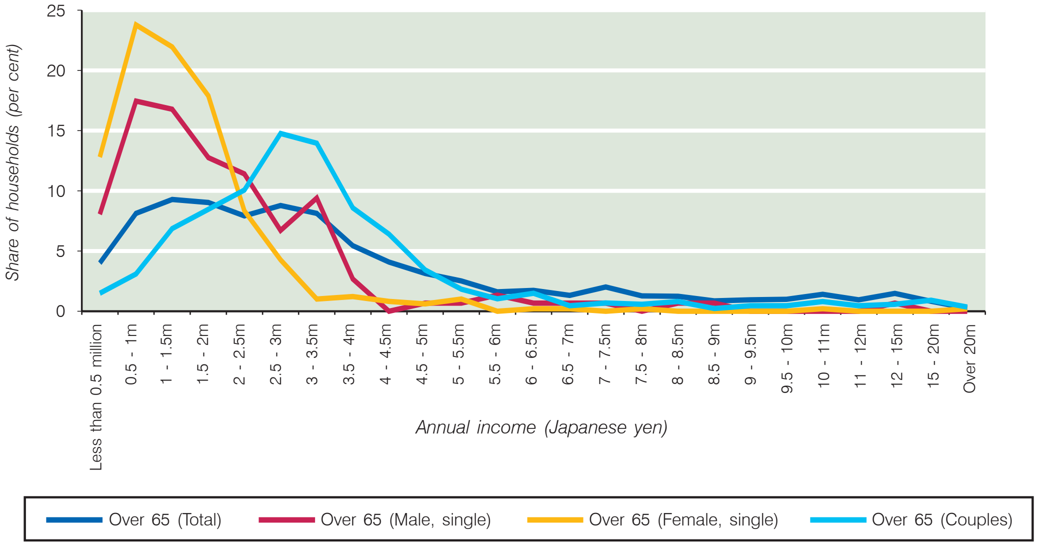
7 "Elderly" in this feature refers to people older than 65 unless indicated otherwise.

8 Poverty in the context of developed economies refers to the minimum living standard vis-à-vis the survival living conditions used in the context of developing economies.

Figure 2.43. Single-person households are often poor: Distribution of elderly households by type and level of income (over 65)



Source: Calculations based on Ministry of Health, Labour and Welfare, *Comprehensive Survey of the Living Conditions of the People 2005* (Tokyo).

Many elderly people maintain their consumption by using financial assets to supplement low incomes. With many employees receiving large lump-sum retirement payments, elderly households appear to have large enough savings to support themselves – at least as a group (figure 2.44). But the averaged data mask uneven distribution. A third of elderly households have savings over ¥20 million ($165,300), but another quarter have savings of less than ¥7.5 million ($62,000), less than twice the average annual earnings of regular workers. One survey indicates that as many as 20% of people older than 60 have no savings (Japan, 2005). And the savings rate among elderly households is declining – from over 20% in the 1990s to just over 10% in the early 2000s). A considerable proportion of elderly people appear to have insufficient funds to support themselves for their two decades of average expected life after retirement.

Income in old age – labour and pensions

A notable feature of elderly people in Japan is their long labour participation beyond retirement age, until age 69 on average (OECD, 2005). To supplement old-age pensions, many people (mostly men) continue to work at lower paying activities after retiring from their main occupation. More than 70% of men ages 65-69 are employed or willing to work, but many of them have already retired (Japan, 2004a). Labour income is a major determinant of income inequality among the elderly in Japan, putting those without labour income at a disadvantage.

> *Many people continue to work after retiring from their main occupation*

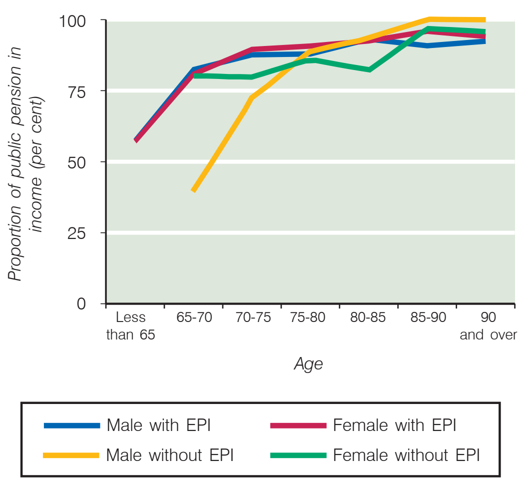
Many people in their 60s stay in labour market. More people, however, cease earning income as they age and come to depend solely on pension benefits. Despite the labour income of "younger" retirees, the dependency of elderly people on pensions is significant. For almost three-quarters of pensioners over 65, pension benefits contribute more than 80% of income (figure 2.45).

The two major financial sources of support for elderly people who withdraw from the labour market are savings and pension payments. A high pension payment can supplement low savings and vice versa, but in reality, low pension earners tend to have smaller

Figure 2.44. Income, savings and liabilities by age group

Source: Calculations based on Cabinet Office Statistical Bureau, *Household Savings Survey 2004* (Tokyo).

Figure 2.45. Single elderly people often depend on pensions



Source: Calculations based on Ministry of Health, Labour and Welfare, *Comprehensive Survey on the Public Pension System 2005* (Tokyo).

Note: EPI is the Employees Pension Insurance Scheme, a pension that covers some private sector workers. With higher contributions made during the working period, workers receiving this pension tend to be better off than those who do not at their retirement.

savings, partly due to the earnings-related public pension system (figure 2.46). More than 30% of the lowest public pension earners have no savings, while over 40% of high public pension earners have savings of more than ¥20 million ($165,300).

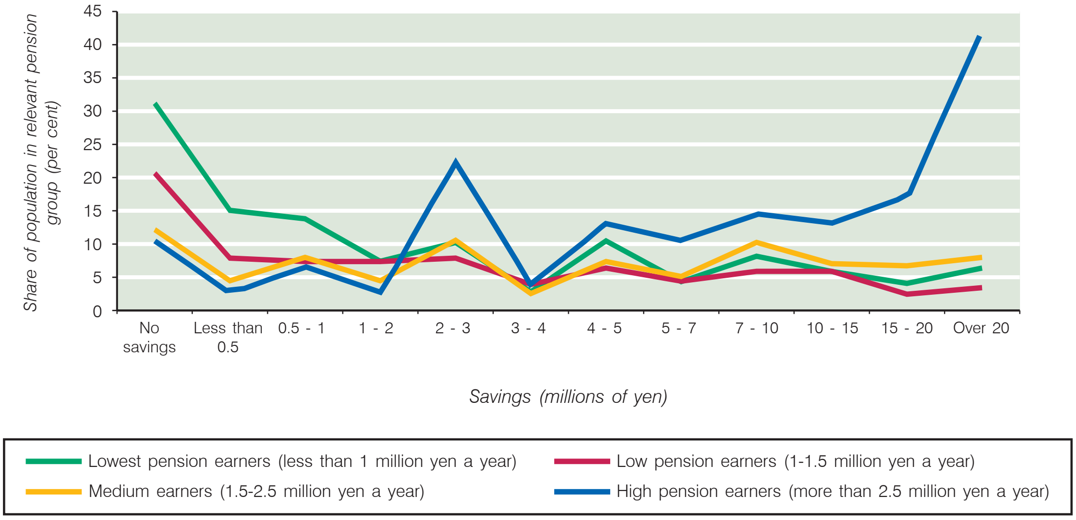
Japan's public pension system – and those it leaves behind

Pensions become the major source of income for "older-old" households. But the amount of benefit varies significantly under Japan's public pension structure.

How Japan's public pensions work. The Japanese public pension system has two tiers: the Employees Pension Insurance Scheme (EPI) for many private sector employees and the National Pension System (a basic pension), which consists mostly of self-employed people, farmers and many of the non-regular workers not covered under the EPI.[9] The EPI combines an earnings-related component and a flat-rate basic pension component. The National Pension System is a basic, flat-rate and universal scheme intended to cover all residents over 20 years old. Benefits are

[9] Public sector employees are covered by a mutual aid pension scheme, which is similar to the EPI scheme. Both schemes belong to the same group (Category II) in the public pension system.

Figure 2.46. Single households with lower pension benefits have lower savings



Source: Calculations based on Ministry of Health, Labour and Welfare, *Comprehensive Survey on the Public Pension System 2005* (Tokyo).

paid from age 65 with a minimum of 25 years of contributions, but full benefits require more than 40 years. About a third of people are covered under the National Pension System.

The higher premium contribution under the EPI is reflected in pension payouts. Average employees under the EPI receive 59% of pre-retirement earnings (Japan, 2004b). Full basic pension benefits correspond to 14% of average earnings.

The basic pension does not promise a minimum standard of living

The large earnings-related component of the EPI means that the public pension system is not very progressive and does not facilitate income redistribution from high- to low-income groups. The basic pension does, however, contribute to poverty reduction among households (Tachibanaki, 2006).

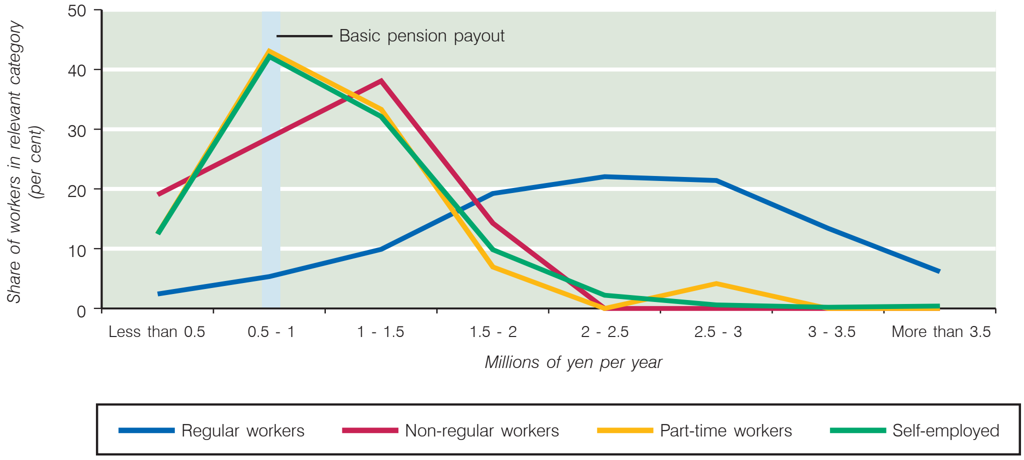
Under the EPI, pre-retirement income determines pension payouts. Employment status during working life makes a big difference in payouts, preserving the wage inequality between regular and non-regular workers. Despite significant variation in pension payouts among former regular workers, most receive pension benefits well above the basic pension (figure 2.47). Pension receipts by people of other employment status are concentrated around the basic pension payout.

Although the basic pension is the main source of income for many elderly and a big contributor to poverty reduction, it does not promise a minimum standard of living. As part of the social safety net, Japan has a livelihood assistance programme, designed to ensure a minimum living standard, that differs from the basic pension in scope, eligibility criteria and benefits (table 2.17). The basic pension alone does not guarantee sufficient income to support the minimum standard, particularly for single households. Failure to meet the requirement of 40 years of contributions further reduces payouts.

Because livelihood assistance is meant for the poor, the system is difficult for normal households to use. Eligibility requires stringent means and asset tests.[10] Compounded by the stigma of the scheme, this means that only a small portion of those eligible apply.

10 The applicant must use all available resources, including assets, ability to work and family support. Land, houses and farms must be sold, and those who are considered capable of working may not be eligible for the assistance, given only to those who have exhausted all these possibilities (National Institute of Population and Social Security Research, 2007a).

Figure 2.47. Distribution of male pensioners by pension benefits and pre-retirement occupation



Source: Calculations based on Ministry of Health, Labour and Welfare, *Survey of Old Age Pensioners: Distribution of Pensioners by Pension Benefit Level and by Type of Pre-retirement Employment Status* (Tokyo).

Table 2.17. Eligibility criteria for the livelihood assistance programme and basic pension benefits: Two examples

(Japanese yen per month)

Type of household	***Threshold income for livelihood assistance programme (example)***		***Basic pension payment (full payment)***
	Urban areas	***Rural areas***	
Single person, age 68	80 820	62 640	66 000
Couple, ages 68 and 65	121 940	94 500	132 000

Sources: Social Insurance Agency website <http://www.sia.go.jp/e/np.html>; and Ministry of Health, Labour and Welfare website <http://www.mhlw.go.jp/bunya/seikatsuhogo/seikatuhogo.html>.

Note: Because threshold for livelihood assistance is determined by age, the size of the household and location, the information here is for comparison only.

"The pension system has created pockets of population that are excluded from benefits"

In 2001, about 5% of the elderly population received livelihood assistance (National Institute of Population and Social Security Research, 2007b). A much larger elderly population has income meeting the eligibility criteria – 28% of elderly single households and 11% of elderly couples by some estimates (Tachibanaki and Urakawa, 2006).

Who the public pension system leaves behind. The public pension system is meant to be universal. In theory, anyone older than 20 who is not part of the EPI is covered under the basic pension (Abe, 2003). But the system has created pockets of the population that, for one reason or another, are wholly or partly excluded. First, people who do not meet the minimum requirement of 25 years of contributions receive no pension. Second, people who are granted an exemption from contribution payments receive a reduced pension if the exemption is too long (the exemption period counts for only a third of a paid period). As of 2005, 25% of those under the contributory basic pension scheme (category I) were exempted from contribution payments. While the exemption is given to disadvantaged groups and those in temporary financial difficulties, the design penalizes them in payouts. Third, more people are defaulting on their premium payments. As of 2004, the default rate of the basic pension – the portion of the expected monthly payment not collected – was 36.4% (Social Insurance Agency, 2007). In a survey of defaulters, almost two-thirds across all age groups cited economic difficulties as the reason for defaulting. For many basic pension participants, exemptions and defaults are temporary, but they run the risk of having little or no entitlement to a basic pension benefit on retirement.

The need to define the role of social insurance

Countries in the region would be able to draw lessons from the Japanese experience in creating a universal pension scheme and the challenges it faced in developing a coherent and effective social insurance scheme. For example, a clear definition is needed of the role and the target group of the public pension system for poverty reduction, income redistribution and compulsory old-age savings. If the basic pension is to ensure a minimum living standard for all, it will need change. The current system has created pockets of people who, for one reason or another, are wholly or partly excluded. For instance, if affordable, New Zealand's far less complicated system, New Zealand Superannuation (NZS), may be one to consider. A flat-rate basic pension provided regardless of other pension income, NZS is an entitlement for everyone older than 65 who satisfies the residential requirement, without asset or income tests. A contribution is not required for eligibility. Benefits are affected only by marital status. The result is that poverty among older generations has been eliminated (OECD, 2007b).

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