CHAPTER 2. SUBREGIONAL PERFORMANCE, CHALLENGES AND POLICIES

Widespread growth across Asia and the Pacific

The Asia-Pacific region grew strongly in 2006, with developing countries growing at a rate of 7.9% and developed countries by 2.2% (figure 2.1). In many respects, the region's economic performance reflected the ongoing rapid integration and growth of the global economy. North and Central Asia, Australia, the Islamic Republic of Iran and a number of other countries witnessed strong growth in commodity exports, while much of East Asia experienced strong demand for manufactured goods, such as electronics.

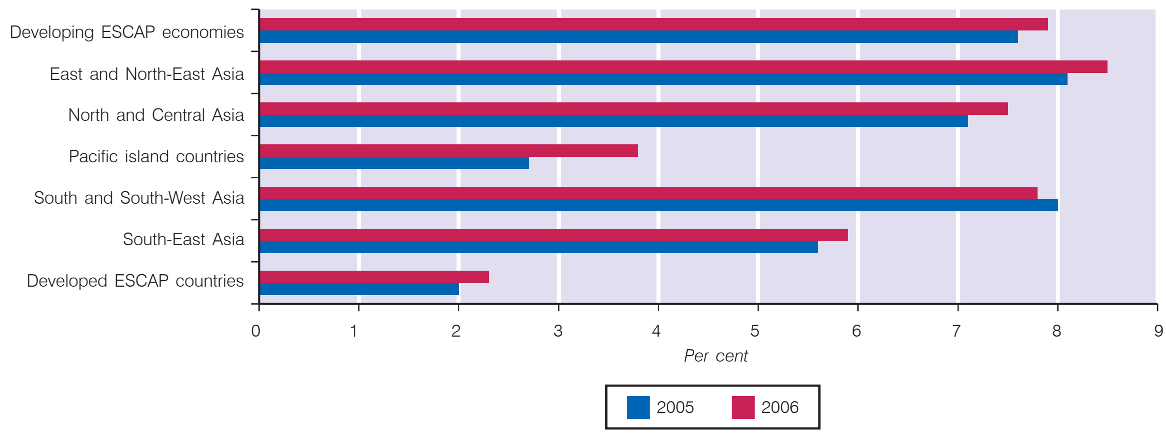
> *Growth momentum of the region is concentrated in the industrial and services sectors, with agriculture growing more slowly*

East and North-East Asia had stronger than expected growth of 8.5%. Investment continues to accelerate in China, while investment and consumption posted healthy gains in Hong Kong, China and Macao, China. Except in China, some important impediments still constrain domestic demand, leaving the region dependent on global growth to sustain its expansion. In China, consumption growth appears to have weakened, and although investment growth is rapid, concerns that it is being poorly allocated remain widespread. Elsewhere, particularly in the Republic of Korea, geopolitical uncertainties linger and consumption and investment remain fragile.

> *North and Central Asia enjoyed its seventh consecutive year of rapid growth*

Economic growth was also strong in North and Central Asia, averaging around 7%, its seventh

Figure 2.1. Rates of growth of real GDP in the ESCAP region, 2005-2006



Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, September 2006); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); and website of the Interstate Statistical Committee of the Commonwealth Independent States, available at <www.cisstat.com>, 26 February 2007; and ESCAP estimates.

Note: Data for 2006 are estimates.

consecutive year of rapid growth. High oil prices continued to fuel inflation and particularly the rapid growth of net oil exporters, such as Azerbaijan, Kazakhstan and the Russian Federation. But the oil boom raises concerns about "Dutch disease", which is examined below.

"Increased receipts from tourism helped Pacific island countries to maintain their balance of payments and foreign exchange reserves"

With few exceptions, Pacific island countries showed positive economic growth, ranging from slightly less than 2% in Tonga to more than 6% in Vanuatu. Growth was led by the primary sector in Papua New Guinea and the services sectors in the smaller countries. Most countries in the subregion maintained trade deficits as imports, pushed higher by rising oil prices, continued to outpace exports. In many countries, the trade deficit was financed largely by aid and remittances. Increased receipts from tourism and foreign direct investment are thus essential for them to maintain their balance of payments and foreign exchange reserves. But political instability in some countries threatens not only tourism but also agriculture, construction and financial services.

Strong economic growth continued in South and South-West Asia. India, the largest economy in the subregion, led the growth momentum by expanding 9.2%. Afghanistan, Bangladesh, Pakistan and Sri Lanka posted growth rates of more than 6.5%, with industry and services the major contributors. Exports increased in all countries in the subregion, but imports grew even faster, partly due to higher oil prices, widening the current account deficits in Pakistan, Sri Lanka and Turkey. The Islamic Republic of Iran, the only net exporter of oil in the subregion, grew by 6.1% and increased its current account surplus, thanks to higher oil prices.

Driven by strong external demand, economic growth in South-East Asia stood at a robust 5.9%, up from 5.6% in 2005. As in previous years, strong external demand, especially for electronics (and to a lesser extent, commodities), was the principal driver of growth. As a result, the current accounts of major economies in the subregion are estimated to have remained in surplus, ranging from 25.9% in Singapore to a modest 0.9% in Viet Nam.

"Many South-East Asian countries allowed their exchange rates to appreciate rather than relying solely on interest rate rises to cool their economies"

As in the other subregions, higher oil prices were a source of inflationary pressure. Many countries allowed their exchange rates to appreciate rather than rely solely on interest rate rises to cool their economies. Stronger currencies gave monetary authorities an opportunity to end the cycle of interest rate tightening that began in 2004.

All three developed countries in the region enjoyed modest growth. Capacity constraints tightened in Australia and New Zealand, creating inflationary pressure, while Japan still looked for firm signs of graduating from deflation with limited growth in wages despite signs of labour shortages. Higher labour incomes supported household consumption in Australia and New Zealand, while sluggish labour incomes eroded it in Japan. The fiscal positions of Australia and New Zealand remained strong due to the robust economic growth they have experienced in the past few years. But in Japan, the large public debt accumulated in the decade-long recession of the 1990s still haunted the fiscal outlook.

Despite high oil prices, growth continued and even picked up in many countries, and with oil prices stabilizing, inflationary pressure has eased. However, policymakers continue to face serious challenges in maintaining growth and development, and some of these are examined in detail in the policy research features and boxes in this chapter.

East and North-East Asia – external demand boosts growth

Growth jumped in East and North-East Asia from 8.1% in 2005 to an estimated 8.5% in 2006. Once again, China's relentless expansion dominated the picture, with growth of 10.7% (figure 2.2). The services sector is particularly notable for its increase to 10.3%. Services also showed good growth in the Republic of Korea (5.0%) and Hong Kong, China (6.5%).

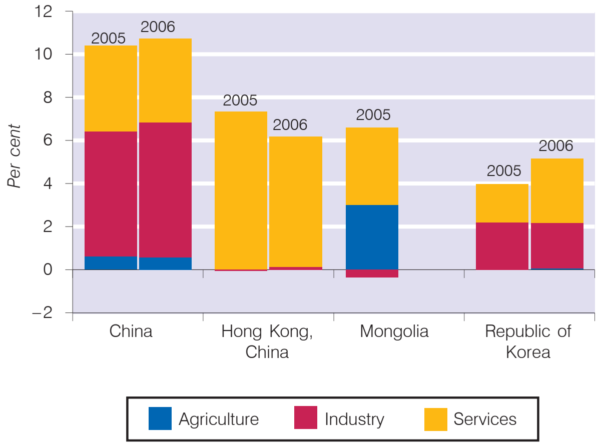
> *"China's relentless expansion continued, with growth of 10.7% in 2006"*

On the demand side, China's exports increased their share of GDP to 37%, although export growth decelerated slightly from 28.4% in 2005 to 27.2% in 2006. Gross fixed investment increased its share of GDP to 43.6% from 42.6% (figure 2.3). Reorientation of the economy towards consumer demand was yet to be seen as private consumption decreased its share of GDP from 38 to 37%.

China's rapid economic expansion has had an important impact on the country's environment. Economic losses from environmental pollution reached $65 billion in 2004 (China, 2006a). In response, the Government is actively pursuing a "green growth" strategy, with investments expected in wastewater treatment, air quality improvement, natural gas and renewable energy. Over the next five years it plans to reduce discharges of pollutants by 10%, and raise forest coverage to 20%.

Although the Republic of Korea grew faster, economic confidence wavered in 2006 as a result of political tensions with the Democratic People's Republic of Korea, higher oil prices and interest rates and industrial disputes. Thus domestic demand, while growing at a reasonable pace, it remains fragile. Consumption grew at 5% in the first quarter (year-on-year), but declined to a more modest 4.4% in the third quarter after industrial disputes in July and the nuclear test conducted by the Democratic People's Republic of Korea. Similarly, after growing at 3.8% year-on-year in the first quarter gross fixed capital formation dipped to 0.8% in the second quarter due to a collapse in

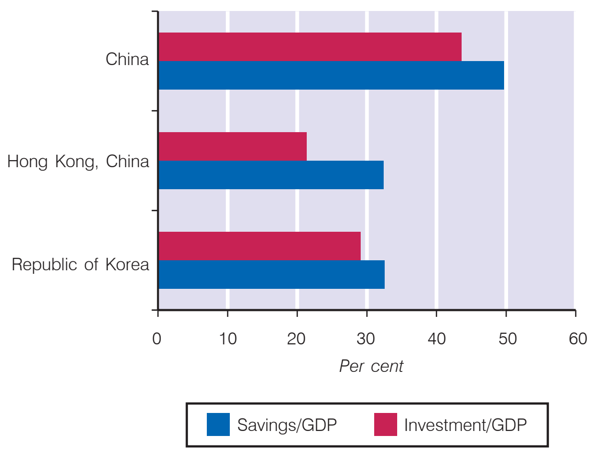
Figure 2.2. The move away from agriculture to industry and services



Sources: ESCAP data based on national sources.

Note: Data for 2006 are estimates.

Figure 2.3. Savings continue to outpace investment



Sources: ESCAP estimates.

Note: Data for 2006 are estimates.

construction. However, plant and equipment investment growth showed remarkable resilience and accelerated to 10.1% in the third quarter, laying the foundation for a rebound in gross fixed capital formation to 4%.

In keeping with the role of Hong Kong, China, as an intermediary facilitating the flow of goods trade and investment between China and the rest of the world, the most impressive service growth in the first half of 2006 was in finance (14% annualized) and transportation (9%) (China, 2006b). Service exports grew by an annual average of just over 9% in the first three quarters, contributing to a service export surplus of more than $25 billion in the first three quarters of 2006. Domestic demand was also strong, with growth in spending on machinery, equipment and computer software averaging a remarkable 19.5% over the first three quarters.

Macao, China, is growing rapidly by transforming itself into "Asia's Las Vegas"

Macao, China, is growing rapidly by transforming itself into "Asia's Las Vegas". It grew by 17.6% in the first half of the year and 11.4% in the third quarter. Much – if not all – of this growth is tied to its booming tourism and gaming sectors. Tourist arrivals were up by 17.7% in the first quarter of 2006 and 15.9% in the second quarter (year-on-year), while gambling revenues, estimated at $6.8 billion, are expected to exceed those of Las Vegas (estimated at $6.6 billion) (BBC News, 2006). Construction, aimed at expanding the number of hotel rooms, gaming facilities and theme parks, grew by a phenomenal 84% in the second quarter and contributed to strong gross fixed capital investment of 26.7% in the third quarter (China, 2006c and EIU, 2006a).

Mongolia, celebrating its 800th year of nationhood, posted a strong growth performance (estimated at 7.5%). Foreign tourists taking part in the national celebrations, as well as telecommunications, helped growth in services which is estimated to have contributed 4.2 percentage points to overall growth. The industrial sector (manufacturing in particular) also performed well, although there are indications that the expansion in mining may have largely stabilized following particularly strong growth in 2005.

Excess liquidity keeps the heat on

Inflation is generally low, but credit growth is proving to be a problem in China and the Republic of Korea (figure 2.4). In China, it has fueled investment and contributed to GDP growth. ESCAP analysis shows that overheating is not generalized but that it is affecting some sectors (ESCAP, 2006a).

Inflation in the Republic of Korea remained within the central bank's target range, but housing prices appeared to accelerate late in the year. Apartment prices in Seoul rose by more than 24% in 2006, and house prices rose nationally by more than 11% (see figure 2.5). The higher prices partly reflect supply constraints, but the rapid price increase has raised the spectre of a bubble, which could threaten economic and financial stability.

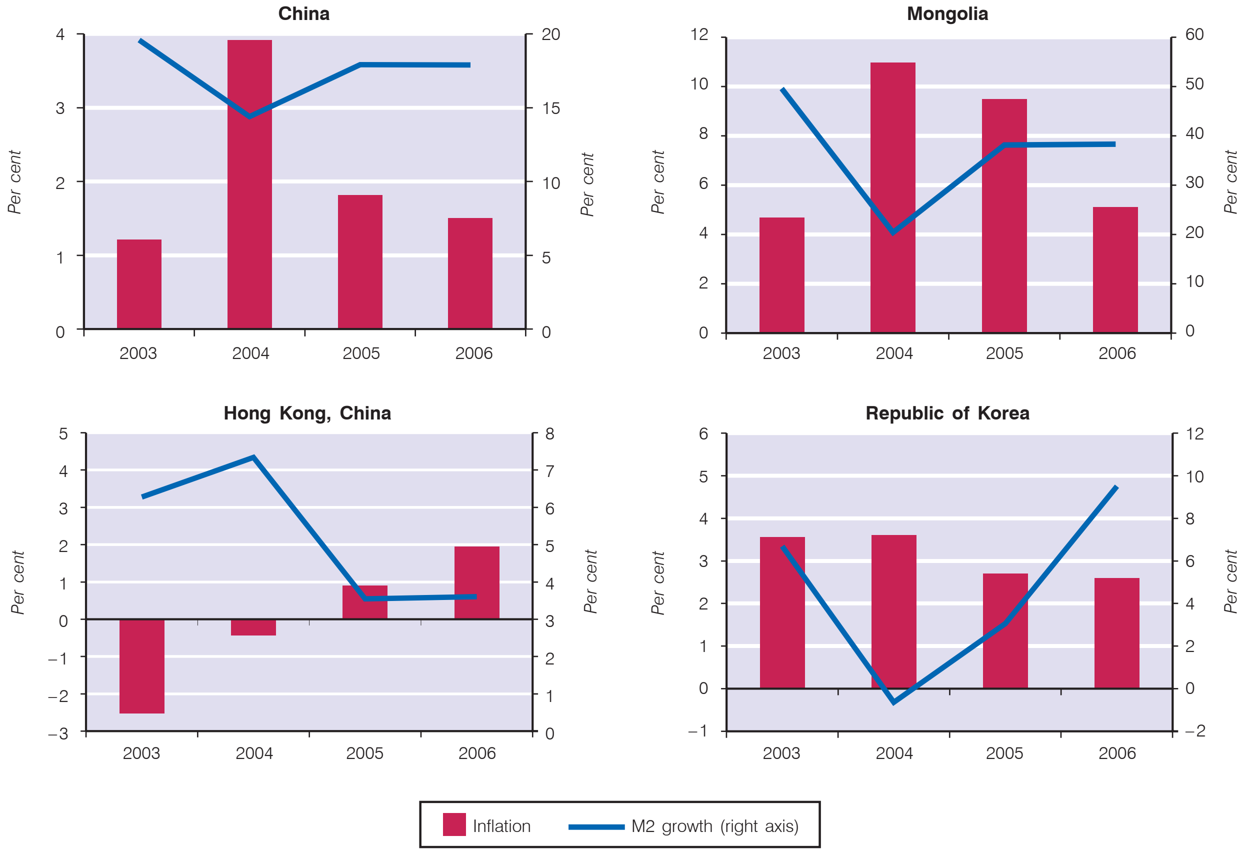
Credit growth is proving to be a problem in China and the Republic of Korea

China placed administrative curbs on investment by foreign investors and local governments in some sectors in response to the growing liquidity. Monetary measures included higher bank reserve requirements and two hikes in the lending interest rate. But GDP has nonetheless continued upward.

The Bank of Korea increased interest rates, allowed the won to appreciate and raised the reserve ratio on deposits. Its policy rate reached 4.5% in August before leveling off in December 2006. The won appreciated by about 8% for the year (see figure 2.6). Despite the appreciation, foreign reserves still rose by more than $21 billion ($9 billion in November and December), thereby expanding liquidity. The central bank did not want to raise interest rates further, which could dampen investment growth and stimulate additional financial inflows, or to allow a further appreciation, which could harm exports. So it took the unusual measure of increasing the required reserve ratio on demand and foreign currency deposits from 5 to 7%, the first time it had resorted to such measures since February 1990.[1]

[1] The Bank of Korea has cited the pressures associated with monetary expansion from the build-up of foreign exchange reserves as one reason for its decision.

Figure 2.4. Credit growth is a concern in China and the Republic of Korea



Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, September 2006); and ESCAP estimates.

Notes: Data for 2006 are estimates. Inflation refers to changes in consumer price index. Money supply for 2006 refer to the months from January to October and inflation refers to the months from January to June for Mongolia.

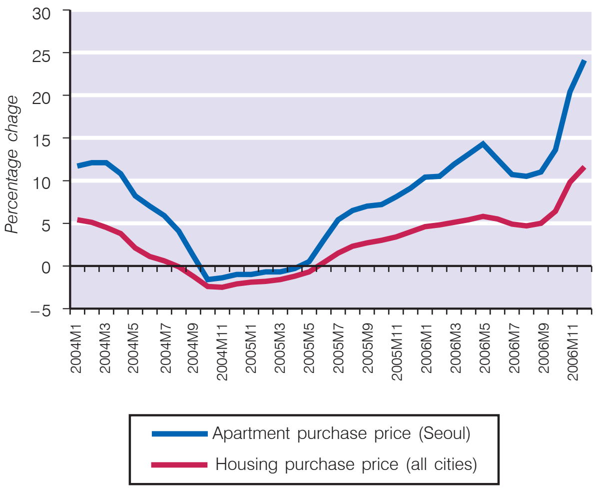
> *Cooling measures in China are beginning to feed into asset investment, industrial production and GDP growth*

In China, cooling measures are beginning to feed into fixed asset investment, industrial production and GDP growth. All three indicators slowed in recent quarters. The growth of credit and the M2 measure of money supply also slowed. But pressure remains on money growth due to potential liquidity injections from the buying of dollars to manage the exchange rate.

The Hong Kong Monetary Authority adjusted its base interest rate in step with increases in the United States federal funds rate, while the balance of payments surplus continued to generate a growing money base in Hong Kong, China. So inflation rose throughout 2006, stabilizing at 2% by year's end. Such a process was expected and, unlike in the Republic of Korea where inflationary pressures threatened the central bank's inflation target, the inflationary process is in keeping with the linked exchange rate system of Hong Kong, China, which explicitly pegs the Hong Kong dollar to the United States dollar. Consequently, inflationary expectations remain well anchored.

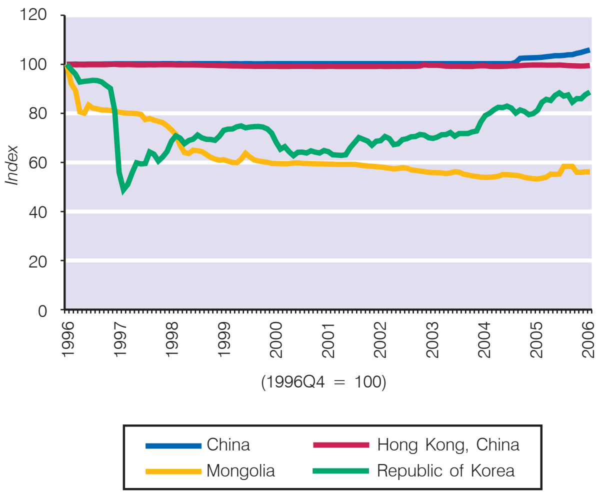
Compared with August 2005, when inflation was running at more than 11%, Mongolia's inflation rate fell dramatically to 4.7% in August 2006, but M2 grew by more than 35% in the first quarter (year-on-year).

Figure 2.5. Booming housing prices in the Republic of Korea



Source: Bank of Korea.

Figure 2.6. Index of exchange rates against the United States dollar of selected East and North-East Asian economies, 1996-2006



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); and *The Economist* databases.

Note: Data for 2006 are estimates.

Current accounts remain in surplus

China's current account surplus set record highs on booming exports and cooling imports (table 2.1), although as a proportion of GDP it remained steady. Trade between China and India is expected to reach $20 billion in 2007, a fourfold increase over 2002, making India China's eleventh largest trading partner and China India's second largest partner. China exports a wide variety of manufactured and resource-based goods to India, while India's exports are concentrated in primary and resource-based products, particularly iron ore. The comparatively low absolute value of bilateral trade between the two countries promises significant room for future increases (see the policy research feature below).

In 2006 came the inevitable moment when China's accumulation of foreign exchange reserves passed the $1 trillion mark. The forces contributing to reserve accumulation – i.e. the current account surplus, FDI net inflows and the managed exchange rate – are likely to remain in place in the near future. China is gradually moving away from generalized FDI and encouraging investment in particular sectors to upgrade quality. In 2006, FDI to China stabilized and decreased slightly. Even so, China remains Asia's premier FDI destination by a wide margin, and its outward FDI has grown at a fast pace, especially in the information, telecommunications, mining and manufacturing sectors.

In Hong Kong, China, although "total" exports of goods rose by an estimated 9.7%, "domestic" net exports, which exclude re-exports, contracted. Overall, the balance on the goods trade is in deficit, while the services trade is in substantial surplus, contributing to a current account surplus of about 10.1% of GDP.[2]

> *The current account surplus declined in the Republic of Korea due to the strong won and higher oil prices*

The current account of the Republic of Korea reached a modest $1.6 billion by the end of October, a much smaller amount than the $15 billion surplus recorded in the same period the year before. One of the reasons

[2] In 2005 the services surplus was three times the size of the goods trade deficit.

Table 2.1. Summary of external accounts for selected East and North-East Asian economies, 2005-2006

(Per cent)

	Exports/GDP		Imports/GDP		Current account balance/GDP	
	2005	2006	2005	2006	2005	2006
China	33.9	36.8	29.0	32.9	7.2	7.1
Hong Kong, China	162.9	167.6	167.1	175.0	11.1	10.1
Mongolia	55.4	..	61.6	..	5.5	..
Republic of Korea	36.1	50.9[a]	33.1	48.3[a]	2.1	0.4

	Growth rates (Per cent)					
	Exports			Imports		
	2004	2005	2006	2004	2005	2006
China	35.4	28.4	27.2	36.0	17.6	20.0
Hong Kong, China	15.9	11.6	9.7	16.9	10.5	11.6
Mongolia	41.2	22.4	43.6	27.5	16.0	25.7
Republic of Korea	31.0	12.0	14.4	25.5	16.4	18.4

Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); and ESCAP estimates.

Notes: Data for 2006 are estimates.

[a] Data refer to January-September.

was the strong won, which encouraged imports and foreign travel; the other reason was higher oil prices. Financial flows generated an overall financial and capital account surplus of $12.7 billion in the first 10 months (compared with $4.8 billion for the same period in 2005). The substantial inflow was largely due to short-term foreign currency borrowing, reflecting speculation that the won would appreciate.

Weaker global demand poses a risk for medium-term prospects

With growth widely supported by external demand, slowdown in the United States economy continues to be a major concern for growth in the subregion. It is clear that the United States will experience a decline in GDP growth in 2007. China is expected to be able to withstand a moderate slowdown, which would not have any significant impact on the country, however, a larger-than-expected decline in GDP growth would be of concern. For the other countries in the subregion, a sharp slowdown in the United States would have a double impact as it is a principal export market for these countries, and many of these countries are also producing intermediate inputs for final assembly by China to supply the United States market. Countries in the Asia-Pacific region accounted for 66% of China's imports in 2006.

To reduce its dependence on foreign demand, China is reorienting its growth and economic structure, as well as undertaking policy measures to alter the drivers of economic growth. The weight of credit and investment is being reduced to prevent overcapacity in some industrial products and overcome structural weaknesses in the banking sector. Instead, private consumption is expected to increase its share of the economy as employment, wealth and wages rise. The economy is also being guided towards less energy-intensive production to reduce dependence on imported fuel and other natural resources.

> *The slowdown in the United States economy continues to be a major concern for the subregion*

Weakening external demand could also pose some challenges for the subregion's banking systems. In

Mongolia, concerns have been expressed about poor risk management and weak corporate governance in the banking sector, and that the financial system could be vulnerable to a downturn in global commodity prices. In response to these challenges, the authorities should continue efforts to improve bank supervision and ensure strict compliance with capital adequacy norms.

If external demand does not weaken, the economies of the subregion will have to deal with the ever-growing liquidity and inflation risks associated with their sizeable balance-of-payments surpluses. Policy-makers have a limited number of options. First, they could increase interest rates further. But doing so would probably be ineffective as higher interest rates would attract short-term capital inflows and add to excess liquidity. In the Republic of Korea, raising rates could also threaten the already fragile investment climate, something the central bank would prefer to avoid.

Second, the authorities could employ a wider range of fiscal and regulatory incentives. In China, for example, further controls could be placed on lending and investment in overheated assets and industrial sectors. In the Republic of Korea, the Government may want to consider initiatives that directly increase the supply of housing and reduce access to credit, such as further increases in the reserve ratio.

Continuing appreciation is the main alternative. However, in the Republic of Korea, investment demand is already weakened by geopolitical tensions, and export growth remains the foundation for economic growth in the country. The authorities will be reluctant to see the won appreciate too fast – as it is already weakening profits in some exporting sectors.

Policy research feature 2.1: China's wake-up call to exporters in the Asia-Pacific region

China's size and the rapid growth of its exports and imports are reshaping trade patterns in the Asia-Pacific region. China is now the world's third-largest trading nation, after the United States and Germany, accounting for about 7% of world trade. Its exports also compete with those of other countries in the region in third-country markets. But its imports offer opportunities for Asia-Pacific exporters.

China exerts stiff competition in international markets

Some countries in the region face stiff competition from China in third-country markets. Export competition with China is measured by comparing each country's main export products to third-country markets. All countries display some overlap of their top 10 export products with that of China in 2005, with the overlap depending roughly on their level of development and technological sophistication (table 2.2). For example, the exports of the high-income economies of Japan, the Republic of Korea and Singapore overlap with the exports of China in electrical machinery and equipment, as well as machinery and appliances. The low-income economy of Mongolia overlaps in apparel and clothing and knitted clothes.

China represents either a direct or potential export challenge for all countries in the region (table 2.3). Competition is direct when a country faces a loss in its world market share and China gains. Competition is potential when a country has a gain in its world market share less than China's. It is potential in the sense that without competition from China the share of a country's gain in world markets might have been

Table 2.2. Countries face competition from China in third-country markets: Export competition with China in country markets in 2005 and world market share change, 2001-2005

Indonesia	Japan	Republic of Korea	Mongolia	Malaysia
Electrical machinery and equipment products (–) Machinery and appliances (+) Apparel and clothing (+) Furniture (+)	Electrical machinery and equipment products (–) Machinery and appliances (+) Optical, photo (–) Articles of iron or steel (–) Plastics and articles (+)	Electrical machinery and equipment products (+) Machinery and appliances (+) Articles of iron or steel (+) Plastics and articles (+)	Apparel and clothing (–) Knitted clothes (+)	Electrical machinery and equipment products (+) Machinery and appliances (+) Optical, photo (+) Furniture (+)
Philippines	**Russian Federation**	**Singapore**	**Thailand**	
Electrical machinery and equipment products (–) Machinery and appliances (+) Apparel and clothing (+) Optical, photo (–)	Machinery and appliances (+) Minerals, fuels (–)	Electrical machinery and equipment products (–) Machinery and appliances (+) Optical, photo (–) Articles of iron or steel (–) Plastics and articles (+)	Electrical machinery and equipment products (+) Machinery and appliances (+) Plastics and articles (+) Knitted clothes (+)	

Source: ESCAP APTIAD database, 2006.

Notes: Change of percentage of world market share is shown between 2001-2005 by a (+) or (–) sign. Exports between China and the relevant country are excluded.

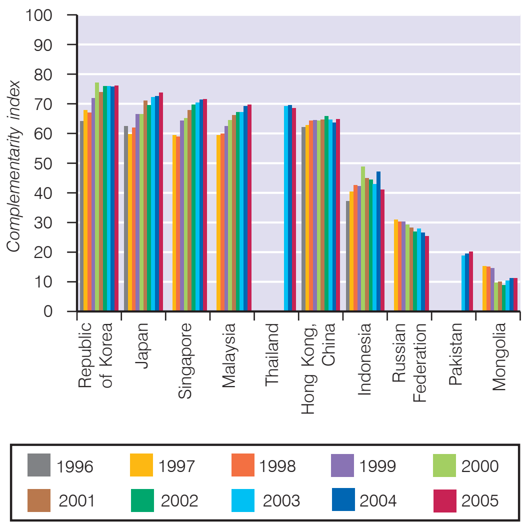
greater. All of China's top 10 export products in 2005 displayed large increases in world market share.

China represents either a direct or potential export challenge for all countries in the region

Many opportunities for Asia-Pacific countries to export to China

High and middle-income regional economies have great opportunities to export to China, this is measured by a complementarity index that shows the overlap between a country's export profile and China's import profile (figure 2.7). A high complimentarity index level indicates a higher potential for trade. The highest overlap is for Japan, the Republic of Korea and Singapore, followed by the middle-income ASEAN economies of Thailand and Malaysia. The lowest overlap is for Mongolia and Pakistan, followed by Indonesia.

Figure 2.7. High and middle-income economies have substantial opportunities to export to China: Trade complementarity of selected economies with China, 1996-2005



Source: ESCAP APTIAD database, 2006.

Note: The complementarity index has a maximum value of 100, which indicates a perfect overlap between the product export shares of an economy with those of China.

Overall export prospects differ greatly across products

There are clear export opportunities for countries in natural resource-related and agricultural products. China has emerged as a major importer of these products. For example, it is now the world's largest importer of logs. Major natural resource exporters include Indonesia, Mongolia and the Russian Federation. Agriculture is a major export for countries such as Thailand and Indonesia, as well as for many low-income countries in the region.

China is still not specialized in sophisticated hi-tech products, for which the high-income economies of Japan, the Republic of Korea and Singapore are the largest exporters and are therefore best placed to benefit.

Technology-intensive intermediate-input exports present a substantial opportunity for middle-income economies

Technology-intensive intermediate-input exports currently present a substantial opportunity for middle-income economies, as well as a possible future challenge. They are mainly intermediate inputs for China's production of technology-intensive final goods.

In 2005, China's imports of intermediate goods accounted for over 50% of its imports from a number of Asia-Pacific trading partners (see table 2.4). Viet Nam was an exception among China's trading partners as only 12% of its exports to China were intermediate products. Relatively technology-intensive intermediate goods, as seen through the imports of parts and components, constituted the majority of intermediate imports from middle-income countries. China's exports of intermediate goods to countries in the region were also high, generally accounting for close to 50% of the total (table 2.5). However, imports of intermediate goods from middle-income economies – with the exception of Thailand – strongly outweighed the export of intermediate goods to these economies. China's imports of final goods from its regional trading partners were distinctly smaller than its imports of intermediate goods except for Viet Nam, ranging from 13% for Malaysia to 38% for Singapore. China's exports of final goods were relatively high, ranging from 34% of total exports to the Philippines to 49% of total exports to Singapore.

Table 2.3. Potential and direct export competition with China, 2001-2005

Product	Potential	Direct
Apparel	Indonesia, Philippines	Mongolia
Electrical machinery	Republic of Korea, Malaysia, Thailand	Indonesia, Japan, Singapore, Philippines, Mongolia
Machinery and appliances	Indonesia, Japan, Malaysia, Philippines, Singapore, Thailand, Russian Federation	
Plastics	Japan, Republic of Korea, Singapore, Thailand	

Source: ESCAP APTIAD database, 2006.

Table 2.4. Intermediate goods are the main export of middle-income Asia-Pacific economies to China: China's imports by stages of production from selected countries, 2000 and 2005

(Per cent of total merchandise imports)

	Indonesia		Malaysia		Philippines		Singapore		Thailand		Viet Nam	
	2000	2005	2000	2005	2000	2005	2000	2005	2000	2005	2000	2005
Primary goods	27.3	29.3	9.9	5.4	4.6	1.4	0.4	0.2	11.5	10.0	88.0	76.0
Intermediate goods	66.7	54.5	76.1	81.9	74.4	75.9	59.6	61.6	72.4	58.5	8.0	11.7
Semi-finished	60.2	45.9	34.2	20.3	14.8	1.9	26.2	23.6	41.9	29.3	7.2	9.4
Parts and components	6.5	8.6	41.9	61.6	59.6	73.9	33.3	38.0	30.5	29.2	0.7	2.3
Final goods	6.0	16.3	14.0	12.7	21.0	22.7	40.0	38.2	16.0	31.6	4.0	12.3
Capital goods	3.5	10.9	10.5	9.9	16.0	20.9	21.7	20.4	7.8	24.6	0.4	3.1
Consumption goods	2.5	5.3	3.5	2.8	5.0	1.9	18.3	17.8	8.2	6.9	3.6	9.2

Source: United Nations Statistics Division, United Nations Commodity Statistics Database (UNCOMTRADE).

Note: Classification using the Broad Economic Category (BEC) classification of the United Nations Statistics Division.

Table 2.5. ... and distinctly outweigh China's exports of intermediate products to these countries: China's exports by stages of production to selected countries, 2000 and 2005

(Per cent of total merchandise exports)

	Indonesia		Malaysia		Philippines		Singapore		Thailand		Viet Nam	
	2000	2005	2000	2005	2000	2005	2000	2005	2000	2005	2000	2005
Primary goods	14.3	7.9	10.9	3.1	8.4	4.5	1.7	1.6	10.3	1.3	3.8	1.8
Intermediate goods	41.7	50.3	44.7	54.8	56.8	61.6	47.3	49.8	62.4	64.1	41.7	59.9
Semi-finished	27.9	35.5	21.7	19.4	29.1	9.1	16.5	14.8	35.4	41.8	36.5	50.9
Parts and components	13.8	14.9	23.0	35.4	27.8	52.5	30.8	35.1	27.0	22.3	5.2	9.0
Final goods	44.0	41.7	44.5	42.2	34.8	33.9	51.0	48.6	27.3	34.6	54.5	38.3
Capital goods	16.3	16.7	22.1	25.2	10.8	14.3	21.4	27.3	17.2	23.3	7.5	12.5
Consumption goods	27.7	25.0	22.4	17.0	24.0	19.6	29.6	21.3	10.1	11.3	47.0	25.8

Source: United Nations Statistics Division, United Nations Commodity Statistics Database (UNCOMTRADE).

Note: Classification using the Broad Economic Category (BEC) classification of the United Nations Statistics Division.

Over the past five years, China has increased its exports share of technology-intensive intermediate goods to middle-income countries. These goods categories continue to represent a substantial net export opportunity for the region's middle-income economies, as reflected in their share of exports and imports.

This pattern shows that China is the hub for assembling technology-intensive products that are then exported as final exports to the region and the rest of the world. China thus appears to display a comparative advantage in labour-intensive assembly processes that convert intermediate inputs into final goods for onward export. China has definitely not yet moved up the technological value chain to specialize in technology-intensive intermediate goods; this presents an opportunity for other countries to export these goods to China.

"Labour-intensive goods continue to account for many of China's main export subsectors"

China's exports to third markets present considerable challenges to labour-intensive products from regional economies. Although labour-intensive goods account for a declining share of China's exports, they nonetheless continue to account for many of the country's main export subsectors, such as apparel, knitted clothes, furniture, toys and footwear. Low-income countries in the region depend on unskilled labour-intensive manufactured exports, particularly in textiles and apparel (table 2.6). Until recently, they benefited from quotas on Chinese exports under the Multi-Fibre Agreement, which ended in 2005. Chinese textiles exports have since been restricted until 2008 by quota agreements with the European Union and the United States. Unless regional exporters can plan and implement strategies to counter them free trade in these goods may exert considerable challenges (box 2.1).

Meeting challenges – exploiting opportunities

ESCAP findings show that China's exports are still dominated by labour-intensive processes, even in technology-intensive subsectors. While China's exports to third countries indicate a growing presence in technology-intensive subsectors, ESCAP analysis of intra-industry trade within the region shows that China's role in technology-intensive exports is predominantly in the assembly of technology-intensive intermediate components from countries in the region. In this regard ESCAP analysis arrives at conclusions different from those contained in recent papers by Schott (2006) and Rodrik (2006), who propose that China's technology-intensive export structure indicates that it has rapidly moved up the ladder of technological sophistication. One reason for these different conclusions is that, in addition to considering China's export composition, ESCAP also evaluates the country's import composition. This additional information provides insights into China's prominence in assembly operations.

"China's exports are still dominated by labour-intensive processes, even in technology-intensive subsectors"

China's strength in labour-intensive production and processes is influencing export structures across the region. For high-income economies, such as Japan, the Republic of Korea and Singapore, China offers the opportunity to increase their export concentration in high-technology exports. For middle-income countries that are technology-intensive producers of intermediate inputs, such as Malaysia, Thailand and the Philippines, China's role as a hub for assembling technology-intensive products continues to offer considerable export opportunities. But competition is intense in low-skilled labour-intensive products in third markets, and China may be displacing regional competitors.

One of the reasons exporters are establishing bases in China is that it allows them to exploit economies of scale from the large domestic Chinese market. Exporting companies can benefit from economies of scale by both selling to the domestic market and exporting abroad. Similar conditions can be created for other countries by reducing trade barriers in the Asia-Pacific region, thereby increasing the size of the domestic Asian market for exporters based in the region. ASEAN, for example, represents a potential market of 500 million consumers. ASEAN countries could move rapidly to deepen and consolidate economic integration in order to form an integrated ASEAN common market and production base. This should lead to a true removal of trade restrictions, including tariff and non-tariff barriers (see the discussion on trade agreements in chapter 1).

Table 2.6. Low-income countries depend on unskilled labour-intensive exports: Export structure by relative factor intensities in selected economies, 2000 and 2004

(Per cent of total merchandise exports)

	China		Bangladesh	
	2000	2004	2000	2004
Agricultural resource intensive	6.6	4.0	8.5	9.8
Mineral resource intensive	6.3	5.8	0.3	0.8
Textiles/apparel	21.1	16.1	84.7	83.3
Other unskilled	18.5	14.5	3.6	4.9
Skill-intensive	15.9	17.2	0.4	0.7
Technology-intensive	1.3	42.1	2.5	0.4
	India		**Indonesia**	
	2000	**2004**	**2000**	**2004**
Agricultural resource intensive	14.1	10.7	12.5	19.2
Mineral resource intensive	22.9	30.3	30.9	25.6
Textiles/apparel	26.9	17.1	13.4	11.9
Other unskilled	5.1	4.5	13.2	11.5
Skill-intensive	14.0	19.3	11.0	13.0
Technology-intensive	14.8	17.0	18.4	18.5
	Pakistan		**Cambodia**	
	2000	**2004**	**2000**	**2004**
Agricultural resource intensive	13.4	11.7	3.8	2.9
Mineral resource intensive	1.8	3.5	0.0	0.0
Textiles/apparel	73.3	68.7	70.8	71.7
Other unskilled	6.5	9.6	4.4	1.9
Skill-intensive	1.1	1.9	20.1	23.0
Technology-intensive	3.7	4.5	0.4	0.4

Source: United Nations Statistics Division, United Nations Commodity Statistics Database (UNCOMTRADE).

Note: Classification based on Garnaut and Anderson (1980), Krause (1982) and Park and Park (1991).

“Countries should create the conditions for a competitive and flexible economy”

Countries could benefit from their comparative advantages by creating the conditions for a competitive and flexible economy. Countries in the region need to sharpen their competitiveness in order to compete on a level playing field with China and other economies. A conducive business environment that enhances firm flexibility is crucial. Exporters need to have access to both hard infrastructure, e.g. in transport (ports, roads, airports), communications and energy, and soft infrastructure in terms of adequate financial sector facilities and simplified rules and regulations. Countries should also ensure flexibility by transforming their export structure, which would be done by giving priority to education, both basic and technical, with the level of sophistication depending on the development levels of the countries in question.

Some countries have coped with export competition by identifying niches within specific product groups. A useful case study of measures which can be taken to cope in the face of strong Chinese competition is contained in efforts made by the textiles and apparel sector after the full phasing out of the Multi-Fibre Agreement on 1 January 2005, and before the imposition of export curbs on China later that year. While many producers suffered declining exports, some countries did better than expected. Cambodia identified an international niche in its production process by emphasizing socially responsible labour practices – a growing concern for developed country customers – and launched the "Better Factories Cambodia" project to enhance its labour standards, an important factor in maintaining its textiles and clothing exports. Sri Lanka weathered the new environment by focusing on quality products and innovation, particularly in the design and finishing of garments. It implemented a five-year strategy to shift from the low-end of the market to the middle and upper-end of the market (Kelegama, 2005).

Labour-intensive production in economies of the region may develop in response to rising wage costs in parts of China. Unskilled labour-intensive exports are very sensitive to labour costs. Wages have been rising in the southern coastal regions of China, where the majority of unskilled labour-intensive production has been based. The monthly average wage in southern China in 2006 was between \$160 and \$190, much higher than the \$90-\$110 paid for similar work in Viet Nam (JETRO, 2006). Although China has a large supply of low-cost unskilled workers, they are based further inland, and establishing production bases in these areas raises transport and other costs. There is some evidence of relocation of coastal production from China to lower wage-cost countries, such as Viet Nam and Cambodia. Countries creating a conducive business climate can hope to acquire the labour-intensive production that is becoming costly in parts of China.

This feature study raises important issues for further analysis. It has left aside the critical aspect of foreign investment in China's exports. Enterprises with some foreign participation account for the majority of China's exports. The interaction between the technology content of exports and foreign participation is of special importance. Policies towards foreign investment and technological transfer may become important in the technological upgrading of China's exports.

Box 2.1. Sri Lanka takes the initiative in textiles and apparel

Many analysts predicted that the full phasing out of the Multi-Fibre Agreement on 1 January 2005 would pose severe challenges for garment producers, exposing them to intense international competition. But Sri Lanka's garment industry formulated a comprehensive plan in 2002. A five-year strategy initiated by the Joint Apparel Association Forum analysed the strengths, weaknesses, opportunities and threats of the garment industry in the country. It recommended a strategy aimed at doubling turnover to \$4.5 billion by 2007 (representing an annual growth of 12%); moving from being a manufacturer to a provider of a fully integrated service; increasing penetration in premium market segments; gaining recognition as a superior manufacturer in specific product categories; and consolidating and strengthening the industry to meet the challenges of a quota-free era.

Although the growth of apparel exports has not reached the annual target of 12%, exports have nonetheless been steadily increasing. Large and middle-sized firms have established strong marketing links with buyers and entered the branded and high-value clothing markets. Developing a niche as a quality garment producer presents distinct industrial advantages. Labour standards and factory conditions have improved considerably, and compliance with international labour and environmental standards has helped the industry comply with the ethical requirements of the buyers. Efforts are currently being undertaken to diversify into high value-added products with improved technology. The threats to the garment industry are still real – but so is the optimism.

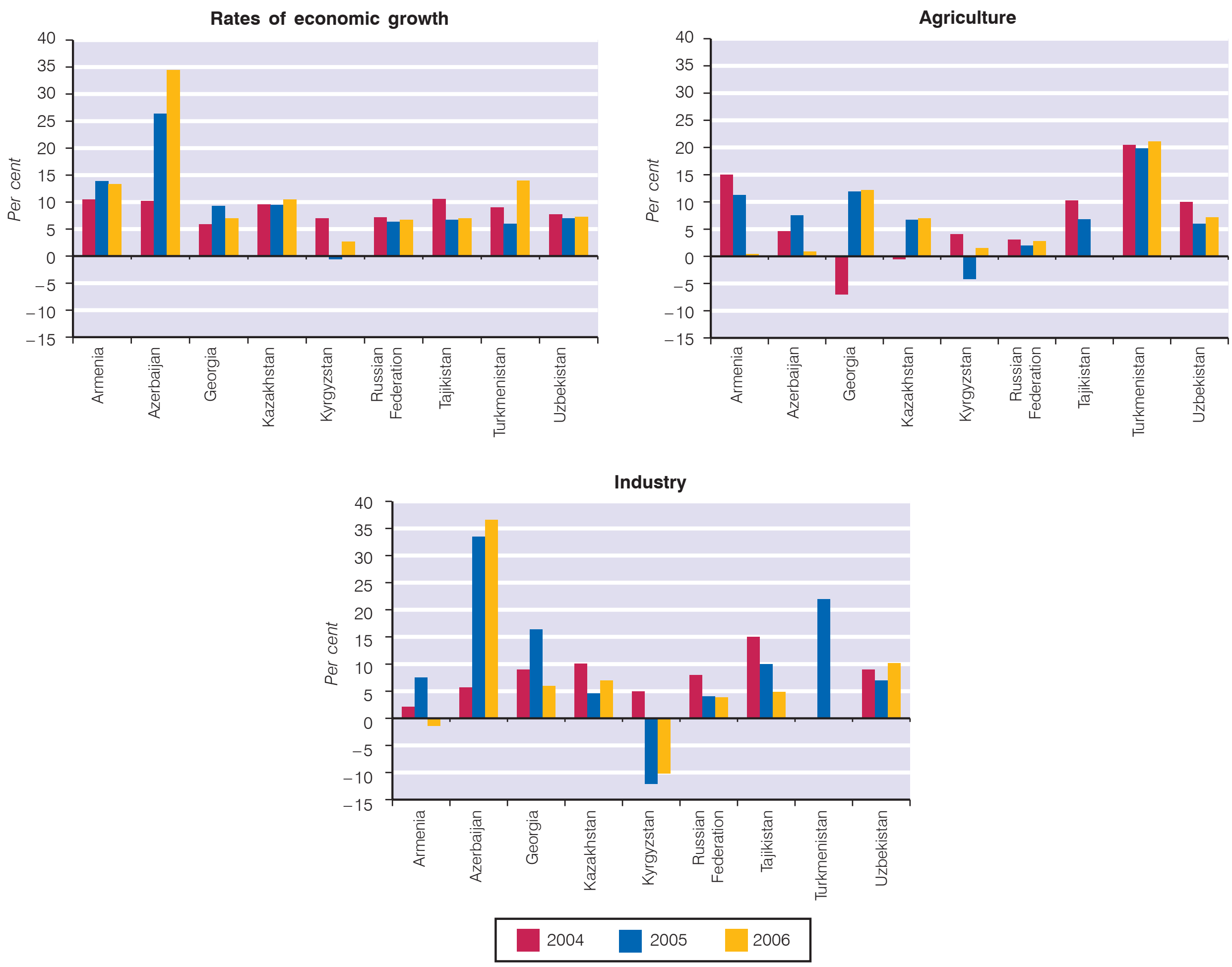
Sources: Kelegama (2005); and Institute of Developing Economies (2006).

North and Central Asia – oil and gas fuel spectacular growth

As oil prices soared, so did the gross domestic products of the oil and gas exporters in North and Central Asia, transforming it into one of the world's fastest growing regions. Heading the pack was the world's fastest growing country, Azerbaijan, which is estimated to have grown at the spectacular rate of 34.5% in 2006 (figure 2.8). The other major oil and gas exporters in the subregion also posted rapid expansions: Kazakhstan grew by an estimated 10.5%, the Russian Federation by 6.7% and Turkmenistan by 14%.

As the hydrocarbon sector grew, so did the demand for services and investment. In the Russian Federation, fixed capital expenditure grew by 13.5% in 2006 (year-on-year). There was also more demand for services. Retail trade grew by 13.5% in Azerbaijan, 13.0% in the Russian Federation in 2006, and 23.4% in Turkmenistan during the first half of 2006.

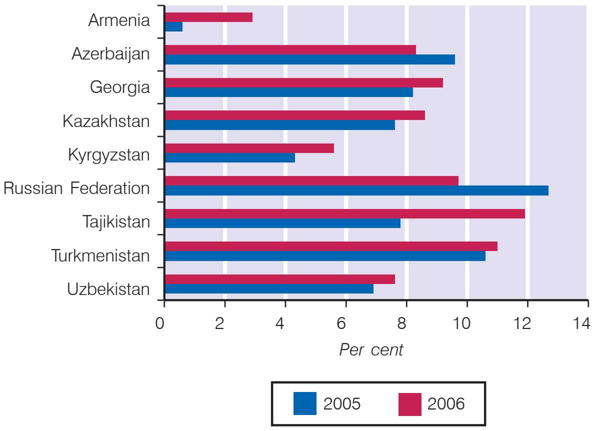
Figure 2.8. Azerbaijan leads the pack



Sources: ESCAP, based on data obtained on the website of the Interstate Statistical Committee of the Commonwealth of Independent States, <www.cisstat.com>, 26 February 2007; ESCAP estimates; and national sources.

Notes: Growth rates for 2006 are estimates. Agricultural growth rates for Turkmenistan refer to January-September.

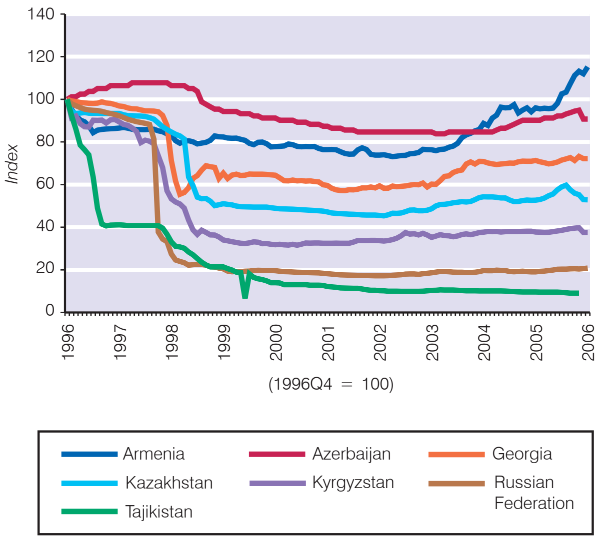
Figure 2.9. Inflation – generally high and rising



Sources: ESCAP, based on data obtained on the website of the Interstate Statistical Committee of the Commonwealth of Independent States, <www.cisstat.com>, 26 February 2007; and ESCAP estimates.

Notes: Inflation rates refer to percentage changes in the consumer price index. Data for 2006 are estimates.

Figure 2.10. Oil and gas revenues pushed some currencies higher against the dollar



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, September 2006); and *The Economist* databases.

Note: Data for 2006 are estimates.

"Another year of sustained high economic growth performance"

Growth was also strong elsewhere in the subregion:

- Armenia grew by 13.4%, owing mainly to a construction boom.
- Georgia's economic expansion continued, with 7.0% growth.
- Uzbekistan continued its strong economic performance, growing by an estimated 7.3% in 2006.
- Tajikistan's GDP is expected to have increased by 7.0%.
- Kyrgyzstan is expected to have expanded by a modest 2.7%, owing to positive trends in agriculture, construction and trade – reversing the decline in 2005.

High and rising inflation widespread

Monetary policy was generally targeted at stabilizing currencies and containing inflation, which was generally high and rising (figure 2.9). For non-oil exporting countries, such as Georgia and Tajikistan, rising oil prices and lax monetary policy in the first half of the year contributed to an increase in inflation. For oil and gas exporters, the substantial increase in export revenues contributed to inflation, while at the same time pushing currencies higher against the dollar (figure 2.10). Higher oil prices, the rapid growth in the oil sector and rising real exchange rates for the region's oil exporters raised concerns about the possible occurrence of "Dutch disease" (see box 2.2).

"Export revenues contributed to inflation"

The exception was Armenia, where consumer price inflation rose by a modest 2.9% in 2006. One reason has been the willingness of the authorities to allow the national currency, the dram, to appreciate significantly. Since the end of 2003, the value of the dram increased by more than 40% in United States dollar terms, owing mainly to a substantial increase in remittance flows into the economy. Although the appreciation of the dram kept prices down, it hurt local exporters and Armenian citizens dependent on external remittances for daily expenses.

Box 2.2. Is there evidence of "Dutch disease" in North and Central Asia?

Economic progress in the oil-exporting countries of North and Central Asia has been very impressive over the past five years, mainly driven by high oil prices since 2001. However, there are concerns regarding the forces behind the economic success, especially in Azerbaijan, Kazakhstan and the Russian Federation.

High economic growth and record current account surpluses are presenting challenges for subregional Governments on how they should handle rising inflation, resulting from huge foreign currency inflows, which in turn increased money supply and led to an appreciation of national currencies in real terms. As this could cause a decline in non-oil sector exports, concern has been voiced that these economies are affected by "Dutch disease".

In general, "Dutch disease" creates unbalanced growth in the booming hydrocarbon export sector, at the expense of the tradable goods sector. Non-tradable sectors, such as retail trade, restaurants, hotels and construction, have also flourished as a result of additional spending of oil wealth. The prices of non-tradable goods are expected to rise and the real exchange rate is expected to appreciate. The resultant real appreciation of currency will affect the competitiveness of the tradable goods sectors, particularly exports.

In the Russian Federation, the increase in oil prices has led to a surge in trade and current account surpluses. High inflation has resulted in a real effective appreciation of the rouble by more than 50% between 2000 and 2006, leading to reduced profit margins in the industrial sector. However, the structure of the economy has not changed over time. The share of industry and services in GDP remained relatively unchanged between 2000-2005, and the strongest industrial sector growth has been registered in the construction sector, whose share in GDP increased from 6.6% in 2000 to 7.4% in 2004. Manufactured and agricultural exports remained relatively competitive in 2000-2005. However, the share of manufactured exports in total merchandise exports declined to 24.1% in 2005 from 30% in 2000.

Azerbaijan's current account was in a slight deficit in 2001 but turned around to a 1.3% of GDP surplus in 2005 owing to large inflows of oil export revenue. The national currency, the manat, appreciated 7.2% in real terms in 2006, as compared with 2005. The Government allowed the exchange rate to appreciate in nominal terms against the United States dollar in order to restrain the expansion of the money supply and keep inflation under control. As a result, the real effective exchange rate remained below its level in 2000. The share of the industrial sector in Azerbaijan's economy increased from about 40% of GDP in 2000 to more than 60% in 2005, and industry has been the main contributor to the country's economic growth. Azerbaijan's export revenues grew by about 2.5 times between 2000-2005 owing to increased demand for crude oil and refined products. Oil products remained the country's largest export and accounted for 85.1% of total export revenues in 2000 and 76.8% in 2005. Manufactured goods accounted for 7% of merchandise exports in 2000 and 12.4% in 2005.

High inflation in Kazakhstan from 2000 to 2004 forced the Government to shift its priority from focusing on exchange rate policy to maintaining price stability. The real effective exchange rate appreciated significantly during this period. High oil prices in the meantime led to a doubling of merchandise export revenues between 2000 and 2004. Greater reliance on hydrocarbon resources has adversely affected the structure of the economy of Kazakhstan and has exacerbated the differences between the oil and non-oil sectors. Between 2000 and 2005, the contribution of agricultural and industrial sectors to GDP fell by 2 and 1 percentage points, respectively. The construction sector benefited from the effects of rapid oil sector growth. Its share in GDP increased from 5.3% in 2000 to 6.2% in 2004. In the exports sector, oil remained the country's principal export, its share in total export revenues increased from 52% in 2000 to 64.7% in 2004. And the share of manufactured exports in total merchandise exports fell from 31.8% in 2000 to 24.2% in 2004, reflecting the impact of oil-led currency appreciation on this sector.

(Continued on next page)

Box 2.2 *(continued)*

All three Governments undertook tight monetary and fiscal policies along with other macroeconomic measures to address symptoms of "Dutch disease". Relevant measures have been undertaken to keep macroeconomic fundamentals within permissible limits and create stabilization funds to sterilize a large part of oil revenue. The State Oil Fund of Azerbaijan (SOFAZ) set aside a share of the oil profits for long-term investment in public infrastructure and social welfare projects. Through the Fund, the Government is expected to develop the economy, particularly the non-oil sector, build up the country's infrastructure and reduce poverty, as well as improve the country's business climate. The Russian Federation's stabilization fund was expected to reach more than $90 billion by the end of 2006 in order to meet the Government's commitments to the pension fund and pay its outstanding debt to the Paris Club of leading creditor countries ahead of schedule. The National Oil Fund of Kazakhstan had assets in excess of $14 billion by the end of 2006 and used some of them to reduce its foreign debt.

The above analysis on the economic situation of the net oil-exporting countries in North and Central Asia shows that there is some evidence of "Dutch disease" in Azerbaijan, Kazakhstan and the Russian Federation. However, Azerbaijan seems to have successfully avoided "Dutch disease" through its tight monetary policy and effective sterilization of hard-currency inflows into the stabilization fund. The Russian Federation shows some signs of "Dutch disease". However, the country has the largest and most diversified economy of all the countries in the subregion, and is therefore much less dependent on oil exports. Kazakhstan seems to rely more heavily on the export of hydrocarbon resources than other countries in the subregion and derives a large portion of its GDP from oil and gas revenues. It is therefore likely that "Dutch disease" will represent a more serious issue for the country's economy.

Current account surpluses for oil exporters – workers' remittances boost external revenues for others

Again, rising oil and gas revenues dominated the current accounts of the major hydrocarbon exporters. Azerbaijan is expected to record a surplus of 11.2% of GDP (table 2.7).

Higher revenues from oil and gas contributed to current account surpluses

In Kazakhstan, where income payments abroad kept the 2005 current account in deficit, higher oil prices increased the trade surplus from $7.9 billion recorded in the first nine months of 2005 to $11.0 billion during the corresponding period in 2006. As a result of better exports, the current account was estimated to have moved into surplus in 2006.

The Russian Federation expected a current account surplus of 10% of GDP in 2006, owing mainly to a rise in the foreign trade surplus.

Turkmenistan was expected to keep its current account in surplus, with export earnings up by 9.6%, to $4.9 billion. Uzbekistan expected a current account surplus of 10.7% of GDP, owing to a large trade surplus and an increase in workers' remittances from abroad. Armenia, Georgia, Kyrgyzstan and Tajikistan were also helped by remittances from workers abroad.

Foreign direct investment flows in

Foreign direct investment (FDI) is an important contributor to the balance of payments in North and Central Asian economies, most of it flowing into hydrocarbons. Azerbaijan received $4.5 billion in FDI in 2005, while oil and gas in Kazakhstan attracted over one half of gross FDI inflows in the first quarter of 2006.

There has been a large inflow of FDI into oil-producing countries

Foreign direct investment in the Russian Federation reached more than $20 billion in the first nine months of 2006 alone, reflecting new opportunities for entrepreneurs active in special economic zones, concessions and other government business development initiatives. However, it is expected that regulations restricting foreign investment in strategic enterprises will be prepared in the course of 2007. Capital inflows were significantly weaker in the non-oil exporting economies.

Foreign debt burden eases

In August 2006, the Russian Federation paid off the final installment of its $23 billion debt to the Paris Club of creditor countries. An agreement with the Paris Club enabled it to repay its foreign debt ahead of time, saving around $7.7 billion in debt service.

"External debt ratios show marked improvement"

Kyrgyzstan's external debt of about $2 billion in 2006 was equivalent to 90% of its GDP. It was expected to apply to IMF and the World Bank for assistance under the enhanced heavily indebted poor countries (HIPC) initiative and reduce its foreign debt by $1 billion in

Table 2.7. Summary of external accounts for North and Central Asian economies, 2005-2006

(Per cent)

	Exports/GDP		Imports/GDP		Current account balance/GDP	
	2005	2006	2005	2006	2005	2006
Armenia	19.4	17.5	36.1	37.7	–3.9	–5.6
Azerbaijan	34.8	64.0	33.7	26.0	1.3	11.2
Georgia	..	..	..	..	–11.7	–10.0
Kazakhstan	50.1	83.0	31.2	48.2	–0.9	0.2
Kyrgyzstan	38.6	51.8	57.2	85.8	–8.4	–12.8
Russian Federation	31.9	..	18.0	..	10.9	10.0
Tajikistan	..	..	..	..	–0.8	2.6
Turkmenistan	..	..	..	..	1.9	2.6
Uzbekistan	..	..	..	..	10.1	10.7

	Growth rate (per cent)					
	Exports			Imports		
	2004	2005	2006	2004	2005	2006
Armenia	6.0	36.2	–1.1	5.8	33.2	19.7
Azerbaijan	42.6	104.4	94.1	31.5	21.4	17.2
Georgia	31.4	34.8	20.7	36.7	33.8	56.3
Kazakhstan	55.7	37.4	39.0	44.6	30.1	32.0
Kyrgyzstan	24.2	33.3	16.3	24.9	98.7	47.0
Russian Federation	34.8	32.9	28.7	28.0	28.7	36.2
Tajikistan	14.8	15.9	55.8	56.1	97.0	28.9
Turkmenistan	6.6	27.6	9.6	32.2	9.6	5.3
Uzbekistan	32.4	14.9	11.8	27.2	13.1	15.3

Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); website of the Economic Commission for Europe, <http://w3.unece.org/pxweb/Dialog/Saveshow.asp>, 12 December 2006, and *Economic Survey of Europe*, 2005, No. 2; website of the Interstate Statistical Committee of the Commonwealth of Independent States, <www.cisstat.com>, 12 December 2006; and ESCAP estimates.

Notes: Data for 2006 are estimates. Trade figures for 2006 refer to January-September, except for Turkmenistan and Uzbekistan whose estimates are for the whole year. All import data are expressed in f.o.b. Exports/GDP and imports/GDP for 2006 refer to the first three quarters.

2006. Tajikistan improved its debt-GDP ratio from 90% in 2000 to 32% in September of 2006 after bilateral restructuring agreements with the IMF, the Russian Federation, Pakistan and the Islamic Republic of Iran. The World Bank was expected to write off more than $300 million of Tajikistan's debt in 2006. The gross external debt of Georgia amounted to $1.7 billion by mid-2006, equivalent to about 23% of GDP.

Medium-term prospects are strong

Prospects in North and Central Asia remain strong and growth should continue in 2007-2008. But because it is a major commodity-exporting region, those prospects depend on trends in global commodity prices. The Russian Federation's performance (the subregion's largest trading partner and an important investor in the economies of the region) will also be important.

> *Strong growth momentum is to be maintained*

Strong domestic demand and increased oil and gas production should enable the Russian Federation to continue its expansion in 2007-2008. Annual GDP growth rates could average more than 5%. Inflationary pressures could accelerate due to a surge in fiscal expenditure, increased inflows of foreign exchange and domestic demand. Because growth has so far largely been due to the modernization of older factories, further institutional reforms are necessary to attract new investment to sustain growth.

Robust growth is expected to continue in other oil-exporting countries. As discussed in box 2.2, "Dutch disease" could pose some challenges.

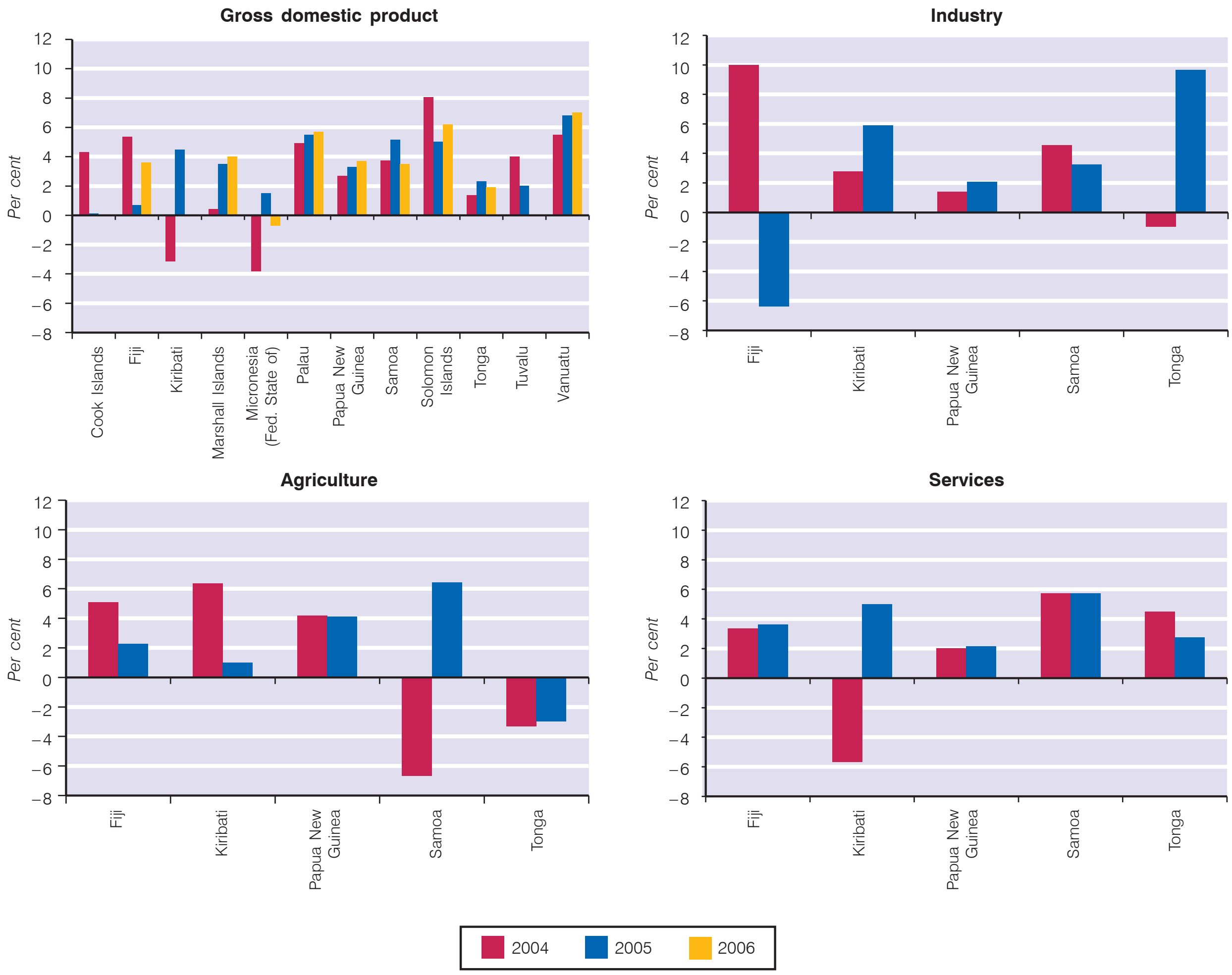
- Azerbaijan is forecast to grow by 30% in 2007, its main policy challenge will be to maintain macroeconomic stability.
- Kazakhstan is expected to achieve 10% GDP growth in 2007. The sharp rise in GDP and the steady increase in the inflation rate both suggest that the economy may be "overheating".
- Turkmenistan's annual GDP growth is forecast at around 8% in 2007-2008, and inflation has already risen to double digits. To ease inflationary pressure and reduce risks of a downturn in fuel prices, it may be prudent to pursue a moderate fiscal policy and a tough monetary policy.
- GDP growth in Armenia is expected to remain at 8% in 2007.
- Tajikistan is expected to grow by 7% in 2007.
- Kyrgyzstan expects the investment climate to improve and GDP growth to increase to 6% in 2007. As the economy stabilizes and growth picks up, inflation could rise, boosted by rising inflows of workers' remittances.
- Uzbekistan's average annual GDP growth in 2007-2008 is expected to be higher than in 2006, owing to favourable trends in global commodity prices.

Pacific island countries – robust growth, continuing challenges

The economies of Melanesia – Fiji, Papua New Guinea, Solomon Islands and Vanuatu, together with New Caledonia – grew strongly despite their internal and external challenges (figure 2.11).

Before the political impasse late in 2006, real GDP growth in Fiji was projected to pick up from an estimated 0.7% in 2005 to 3.6% in 2006. The services sector dominated growth and expansion was registered in construction, electricity, water, transport, communication and finance, which all performed well on the back of a strong tourism sector. On the demand side, economic growth in Fiji was largely driven by increased consumption (financed from credit and re-

Figure 2.11. Real GDP and sectoral growth in selected Pacific island economies, 2004-2006



Sources: ESCAP, based on national sources; Department of Treasury and Planning, Papua New Guinea, *2006 National Budget* (Port Moresby, November 2005); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006).

Notes: Growth rates for 2006 are estimates. Fiji's economic growth refers to real GDP at factor cost. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

mittances) and investment in resort and retail centre development. Inflation remained fairly low, reflecting the fixed exchange rate anchor on prices, modest wage demands and good supply conditions for local produce. Real GDP growth was expected to slow to 2% in 2007 as construction of resort hotels by the private sector tapers off. Uncertainties associated with the political impasse, however, may push this number lower, especially if tourist numbers fall.

> *Economic growth in Fiji was largely driven by increased consumption and investment in resort and retail centre development*

Real GDP in Papua New Guinea rose by an estimated 3.7% in 2006 as higher commodity prices and better weather bolstered the mining and agriculture sectors. As a result, the primary sector's share of GDP, which includes mining, continued to rise, although actual mining output fell. The expansion of the country's primary industry is set to continue. Two new gold mines started operations in 2006. The Queensland-Highland gas project, which involves the construction of a gas pipeline to northern Australia, is expected to offset declining proceeds from the oil sector. Growth in real GDP is expected to increase to 4.5% in 2007.

Real GDP in Solomon Islands was expected to rise from 5% in 2005 to 6.2% in 2006 despite the riots that occurred following the general election in April 2006. Log exports accounted for two thirds of total exports, 14% of tax revenue and 10% of GDP. Since the harvest of 1.1 million cubic metres in 2005 is considered unsustainable, new sources of private sector growth are now considered essential for the country's economy. The inflation rate in 2006 remained at 7%, the same average rate as in 2004 and 2005.

Real GDP growth in Vanuatu was estimated at 7% for 2006, up slightly from 2005. As in Fiji, tourism has been important for growth as it generates three quarters of export earnings and accounts for one sixth of the economy.

Micronesia comprises Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru and Palau, together with the Commonwealth of the Northern Mariana Islands and Guam. Economic activity consists primarily of subsistence farming and fishing, in addition to public sector activities.

- Real GDP in Kiribati rose by more than 4% in 2005 owing to strong growth in the services sector. The government sector accounted for slightly less than half of real GDP, followed by agriculture, including fisheries and seaweed production, construction and wholesale and retail trade.
- Real GDP in the Marshall Islands rose from 3.5% in 2005 to 4.0% in 2006 owing to an expansionary fiscal stance and improvements in agriculture. However, high government wages and public sector employment discourage private sector growth, and nearly a third of the labour force is unemployed. As a consequence, the government sector (centred predominantly in Majuro and Ebeye) accounts for more than 70% of GDP, and economic activity is vulnerable to fluctuations in government expenditure and external grant flows.
- Real GDP growth in the Federated States of Micronesia declined from 1.5% in 2005 to –0.7% in 2006. The medium-term economic outlook appears fragile owing to reductions in United States assistance, as well as slow public sector growth.
- Economic activity in Palau rose by an estimated 5.5% in 2005 owing to an increase in visitor arrivals, with the start of new airline routes and externally funded government projects.

> *Real GDP growth in Tonga slowed as a result of the downsizing of government services*

Polynesia comprises Samoa, Tonga and Tuvalu, together with American Samoa, the Cook Islands, French Polynesia and Niue.

- Real GDP in Samoa grew by 5.1% in 2005, the highest rate since 2001. Agricultural production picked up from the devastation by Cyclone Heta, while construction, commercial and tourism activities were strong as Samoa prepared for the South Pacific Games. But real GDP growth still slowed in 2006.
- Real GDP growth in Tonga slowed from 2.3% in 2005 to an estimated 1.9% in 2006, and is forecast to slow even further to 0.9% in 2007 with the downsizing of government services. The political violence in November 2006 also hurt growth, especially in sectors linked to the already stagnating tourism sector.

External sector set to gain from the partnership with the European Union

The Cook Islands, the Federated States of Micronesia, Fiji, Kiribati, Nauru, Niue, Papua New Guinea, the Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu negotiated an Economic Partnership Agreement with the European Union in November 2006. Parties to the agreement endorsed the appointment of a Chief Trade Negotiator to represent these countries in negotiating free trade agreements with Australia and New Zealand. They also requested the Pacific Islands Forum Secretariat to implement recommendations on trade with China and Japan, and asked the Forum Representative to the WTO to work closely with other WTO Members to ensure that fisheries access fees were not considered as subsidies.

> *"Exports in Fiji were hit by the sharp decline in garment exports following the expiry of the Multi-Fibre Arrangement"*

Fiji. Exports were hit by the sharp decline in garment exports following the expiry of the Multi-Fibre Arrangement and the long-term fall in sugar production (table 2.8). Business and unit labour costs have remained high when compared with other garment-manufacturing countries; and establishing niche markets for specialized products requires greater expertise in product design and marketing. Import values have increased owing to higher petroleum prices, more import of materials and equipment for construction of resorts and office buildings and growth in consumption financed by credit and remittances. Remittances from expatriate Fijians working abroad as nurses, teachers and army and security personnel rose sevenfold between 2000 and 2005.

Papua New Guinea. Even with the liberalization of trade and exchange controls, restoration of confidence kept the balance of payments in surplus in 2006. As a result, the kina appreciated by 15% against the United States dollar. The Government announced temporary tariff increases on some imports after industry calls for tariff reforms to be abandoned. Gross international reserves reached a record $1.2 billion in September 2006.

Solomon Islands. Imports increased sharply in 2005 with the rising cost of fuel, price increases in machinery and transport equipment for aid-related projects and the relaxation of foreign exchange controls. Foreign exchange reserves rose to the equivalent of 5.7 months of imports of goods and non-factor services in June 2006. Agreements between the Solomon Islands and the Honiara Club in 2005 helped to reduce its debt service burden.

Table 2.8. Summary of external accounts for selected Pacific island economies, 2005-2006

(Per cent)

	Growth rates				Current account balance/GDP	
	Exports		Imports			
	2005	2006	2005	2006	2005	2006
Fiji	–6.8	–11.3	2.6	13.2	–17.1	–6.2
Papua New Guinea	28.4	15.0	4.6	–12.2	13.1	4.5
Samoa	0.9	–15.0	20.9	21.9	–7.5	..
Solomon Islands	33.6	20.7	51.6	17.5	0.7	–15.8
Tonga	15.9	–0.6	27.3	8.2	–4.8	–6.2
Vanuatu	14.3	..	14.1	..	–11.3	–8.8

Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006).

Notes: Data for 2006 are estimates. Trade figures for 2006 refer to January-March for Papua New Guinea, January-June for Fiji, January-October for Samoa and whole fiscal year for Tonga. Trade figures for Tonga are preliminary estimates for 2004 and 2005 and projections for 2006. Import values are in f.o.b. for Samoa and Vanuatu. Current account balance for 2006 refers to March for Fiji.

Vanuatu. Agricultural exports declined in 2005 with falls in coconut oil, cocoa and copra output. Although Vanuatu has the largest coconut production and processing capacity among Pacific island countries, its output has declined because of an industrial dispute that forced the closure of its main processing mill. Cocoa exports also fell as a result of a decline in export prices. The tourism sector and financial inflows to purchase real estate were major sources of foreign exchange.

> *The tourism sector and financial inflows to purchase real estate were major sources of foreign exchange for Vanuatu*

Micronesia. The limited scope for export diversification has led to significant trade deficits in Micronesia.

- Exports from *Kiribati,* consisting mainly of aquarium fish, copra, seaweed and bêche-de-mer (sea cucumber), covered 5% of its food, machinery and transport equipment and mineral fuels imports. Property income credits and current transfers from the official sector reduced the overall balance of payments deficit.
- *Marshall Islands* exports consist of coconut oil, fish and re-exports of diesel fuel to fishing boats. Nearly all raw materials and consumer and capital goods are imported. The trade deficit widened in 2005 with higher import growth.
- In the *Federated States of Micronesia,* food and beverage imports accounted for nearly a third of total imports in 2004. Major exports included offshore fish, garments and betelnuts to the United States, Japan and Guam.
- Primary imports to *Palau* were machinery, fuels, food and chemicals from the United States, Singapore, Guam and Japan. Foreign direct investment into the country was negatively affected by a ban on foreigners owning land or using it as collateral and the requirement that one fifth of all employees should be Palau nationals.

Samoa. As a result of the robust economic activity in the largely externally financed construction sector and the public sector wage hikes, imports to Samoa increased rapidly. In 2005, the merchandise trade balance worsened. Exports of noni juice, which represent a quarter of Samoan exports, also increased, while fish exports declined. Remittances to Samoa increased by a quarter in 2005 and accounted for a quarter of GDP, while tourism receipts accounted for another sixth of GDP. Even so, both the current account and the overall balance of payments showed deficits at the end of 2005. The balance of payments deficit increased during the first quarter of 2006, and foreign exchange reserves fell to 3.7 months of import coverage.

Tonga. Exports of agricultural and fishery products, representing more than three quarters of all exports, recovered in 2006. Tonga relies heavily on remittances to finance its balance of payments. In order to maintain foreign exchange reserves at a level above the equivalent of three months of import cover, the exchange rate of the pa'anga is periodically adjusted by up to 5% per month relative to its currency basket. The stability of the nominal exchange rate since 2004 suggests a real appreciation of the pa'anga as it has a higher inflation rate relative to its main trade partners.

Tuvalu. Exports covered less than 1% of imports, which are mainly composed of fuel, prepared foodstuffs, machinery, live animals and vegetables from Australia, Fiji, New Zealand and Japan.

Impact of higher oil prices

High oil prices pose considerable challenges for policymakers in Pacific island countries. For Papua New Guinea, which is both a producer and refiner, high oil, copper and gold prices have boosted government revenues. In previous commodity booms, revenue windfalls were seldom well managed, and recurrent expenditures rose to unsustainable levels. In this cycle, however, Papua New Guinea is devoting most of its revenue – beyond those amounts allocated in the 2006 budget – to investments in transport infrastructure, education, health, law and justice. In the 2007 budget, the windfall revenues expected from high copper and oil prices will be spent on equity injections into State-owned enterprises and natural gas pipeline projects, and repayments of public debt.

> *Papua New Guinea is devoting most of the revenue windfalls from high oil prices to investments in transport infrastructure, education, health, law and justice*

But for other Pacific island countries, high oil prices have reduced their terms of trade and led to a deterioration in their trade balances and current accounts.

The 250% rise in the price of West Texas Intermediate petroleum has translated into sharply higher import bills and to higher costs for businesses and consumers, thereby reducing incomes and stoking inflationary pressures. And the cost of international air travel is rising just as tourism was beginning to improve in several Pacific countries.

Fiji, Samoa and Tonga have absorbed the fuel price increase by reducing their foreign exchange reserves. The Solomon Islands and Vanuatu have kept their reserves steady, thanks to aid inflows and limited reliance on imported oil. None of the five countries have devalued their currencies to lessen any negative impact on their terms of trade. To reduce demand for imports Fiji, Samoa and Tonga have tightened their monetary policy by increasing interest rates or restricting liquidity. Such policies would, however, reduce the investment needed to promote economic growth.

Pacific island countries have begun to focus on alternative sources of energy, such as biofuels, solar and wind power and hydropower. A coconut oil-diesel fuel blend is being promoted as a biofuel substitute for electricity generation in Samoa and Vanuatu, while *bagasse,* a by-product of sugar production, is being used to generate electricity in Fiji. Wind and solar power could substitute for imported oil in smaller and more remote Pacific islands.

Policy research feature 2.2: The challenge of urbanization

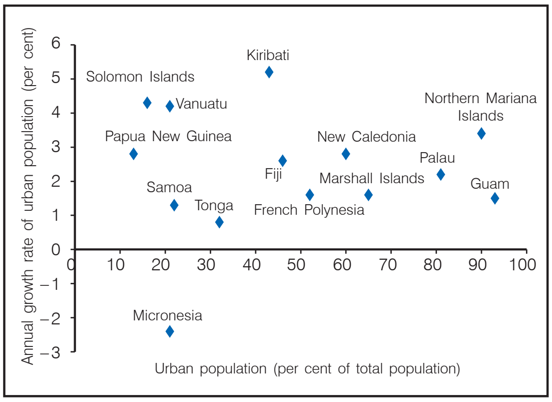
Pacific island developing countries are urbanizing at an alarmingly rapid pace, as can be seen in cities from Port Moresby to Majuro, and from Suva to Koror. In Guam 93% of the population live in towns because there is no land left for other activities (figure 2.12). Kiribati's annual population growth, a staggering 5% a year, would double the urban population in 15 years – to more than 72,600, or more than two thirds of the national population of 108,800 then.

Urban poverty on the rise

Poverty – the preferred term in the subregion is hardship – is definitely on the rise. In early 2006, Tuvalu and Kiribati had to absorb returning citizens following the closure of the phosphate industry in Nauru. And the lack of access to basic services is severe in Port Moresby, Lae, Suva, Port Vila and Honiara. Without external assistance, countries have practically no capacity to deal with major health threats, such as HIV/AIDS, avian influenza and lifestyle diseases.

Among the hardest hit are the unemployed and landless. The subregion's unemployment rate is 25-35%,[3] suggesting that between 1.1 and 1.6 million people are unemployed at any given time, most of them in urban areas.[4] Other vulnerable groups include women, especially single mothers, youth, orphaned or abandoned children and elderly widowers without support.

Figure 2.12. Moving to towns and cities



Source: Secretariat of the South Pacific Community, *Pacific Island Populations 2004* (Noumea, SPC)

"Without external assistance, many countries have no capacity to deal with major health threats, such as HIV/AIDS and avian influenza"

Underemployment and unemployment contribute to the growth of informal sectors, which have their own rules and livelihoods. A big issue is how Governments can support people and activities in the informal sector, while not whittling away the informality that keeps the parallel economy ticking.

In Fiji, urban poverty was estimated at 28% of the population in 1997, and in 2006 at 33-35%. In both Kiribati and Vanuatu, more than half of the urban population is considered to be poor (Storey, 2005, p.11). Urbanization's impact on infrastructure, utilities and housing is the most visible and controversial issue facing local authorities. A 2003 study by the Squatter Resettlement Unit in Fiji and the ESCAP Pacific Operations Centre found 82,350 people living in 182 squatter settlements in Fiji. The squatter population in Suva increased by 73% between 1996 and 2003. By 2006, it is estimated that there will be 90,000 people (10% of Fiji's population) living in informal settlements in the Suva-Nausori urban corridor (Jones, 2003, p. 11).

The quality of housing is low, and housing often has no access to municipal water and sewage systems. Most Governments and municipal authorities do not regard it their responsibility to provide housing for squatters in peri-urban areas outside town boundaries.

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3 The percentage of the labour force (15-65-year-olds) not in regular waged work, whether or not they are actively looking for work.

4 Computed from country statements presented at the EU/University of the South Pacific Regional Conference on Institutions, Globalization and their Impacts on Labour Markets in Pacific Island Countries, University of South Pacific, Suva, Fiji, October 2006.

> *Urbanization's impact on infrastructure, utilities and housing is the most visible and controversial issue facing local authorities*

Where housing is provided, as in Fiji, it only meets less than 2% of the demand for squatter houses. One survey found the average number of people per dwelling in poor households was 11.7 compared to 7.7 per household in high-income residential areas. In Vanuatu almost 80% of informal dwellers in some parts of peri-urban Port Vila rent their dwellings, and a rentier/landlord class has emerged. The Kiribati Housing Corporation estimates that 1,038 houses were needed to meet demand on South Tarawa, where around one third of the urban population is squatting (Eritai, 2003).

Effective institutions needed for urban planning and management

Towns and cities in the subregion have not only been badly planned but many have also been poorly managed since independence. Routine municipal tasks such as garbage collection are major achievements, not to speak of more complex activities such as awarding contracts for municipal projects and businesses. Some countries have proper legal frameworks in place, including town planning regulations and policies, but urban management and enforcement are pivotal.

> *Public utilities and infrastructure are creaking, schools are overcrowded, health facilities inadequate and land for housing is not readily available*

Most towns and cities are a patchwork. Public utilities and infrastructure are creaking under the weight of population demands for services. Schools are overcrowded, health facilities inadequate and land for housing is not readily available. The provision of affordable piped water, sewage systems, roads, electricity and communications infrastructure would have the greatest impact on the poor.

Land is scarce and not readily available for development because a large part of it is held under traditional kin ownership, as in Fiji.[5] Even where agreement has been secured to lease land, landowners keep pressing for higher rental prices, especially when investors appear to be making profits from the land. In urban areas in the subregion, land is needed for both settlement and commerce; for locating factories and building roads, health and educational facilities and other essential amenities for the bourgeoning urban populations. As long as prospects for change in the land tenure system remain dim, urban demand for land will not be met, and a comprehensive approach to urban planning and development will not be possible.

Because of the difficulties of servicing scattered communities, most commercial, financial and industrial activities are in one centre, usually in the capital and seat of government. Such concentration benefits urban centres, not least because of the economies and synergies that result, but it also contributes to congestion and an array of undesirable social and environmental costs.

Sub-centres, normally smaller towns, such as Ba, Labasa and Nadi in Fiji and Christmas Island in Kiribati, are essential service distribution nodes. They also provide other support to the main centre as residential corridors and industrial sites, as in the case of the towns of Lami and Nasinu, near Suva. In countries where populations are scattered over wide expanses of sea, sub-centres are essential. To work well as service distributors, sub-centres need to be well serviced from the centre, with proper infrastructure, including administrative and legal frameworks.

Land and the environment are under severe stress from the growing towns and cities. The small size of most of Pacific island countries, especially the atoll countries and their restrictive land tenure systems only makes matters worse, particularly in atoll countries where the land is degraded, water tables are polluted and exhausted and the foreshores eroded, increasing vulnerability to tidal surges. In Tuvalu, the use of foreshore material for construction over the past 20 years has removed protection against tidal surges in the country's only town. Lagoons in several atoll urban centres are also overfished, their carrying capacities exceeded several times over.

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[5] A total of 88% of Fijian land is "native land", 7% is freehold and 5% is "crown land".

Policy analysis and conclusions

The first policy issue in tackling urban poverty is for national and municipal planners and decision makers to appreciate that economic policies have social impacts that can be measured at the level of the poorer households. Urban poverty is multifaceted, so holistic approaches are needed to resolve it. Successful pro-poor policies ensure that the poor are involved in all stages of developing policy, from formulation and implementation to monitoring and evaluation. The way informal communities organize themselves according to "wantokism" or "islandism"[6] has proved effective in securing results. Another aspect of poverty in Pacific island countries that is not usually cited is that "hardship" does not exist in squatter settlements only. In Samoa, there are no visible "squatter" settlements, yet families experience much hardship (Jones, 2003, p. 14).

"The multiple roles that Governments play in urban development as planners, regulators and service providers create duplication and confusion"

Part of the problem lies in the multiple roles that Governments play in urban development as planners, regulators and service providers. The unclear demarcation of responsibilities and functions of government, local authorities and traditional governance institutions leads to duplication and conflict. In those countries where these functions are clearly defined, enforcement has sometimes been weak. For the informal sector a clearer understanding of the operation of governance mechanisms in squatter settlements could contribute to improved policy.

Many of the Pacific island countries have made some headway in merging imported decision-making structures with local governance institutions (Fiji's parliament and Great Council of Chiefs or Vanuatu's parliament and Chief's *nakamal*). In some countries, local institutions have been empowered to make laws and national law-making processes include requirements for all bills to be referred to traditional governing institutions before the legislature passes them into law. Public consultations on major policies, such as a national sustainable development strategy, are standard in some countries, although other countries in the subregion have yet to adopt them.

In many Pacific island countries, town planning concepts, such as "zoning" are often misunderstood and ignored. In small atoll countries, the limited amount of land makes it difficult to implement adequate land zoning for purposes other than residence. The result is a total disregard for urban planning regulations where they exist and an unsightly mish-mash of industrial and commercial activities in residential areas. The town planning function has been reduced to settling land boundary disputes and checking compliance with building codes – to the detriment of overall strategic planning and policy.

The responsibility for managing the provision and delivery of urban services is another issue that needs to be addressed. In some countries of the subregion local governments and municipalities are responsible, but cannot afford to provide the required infrastructure because they lack the necessary resources. A few countries have tried privatizing certain public infrastructure services formerly provided by the Government. Efforts to privatize power, water and telephones services proved profitable in Vanuatu and Fiji but most "squatter" dwellers still cannot afford them. However, these achievements are not easily replicated in other countries.

"Efforts to privatize power, water and telephones services proved profitable in Vanuatu and Fiji but most "squatter" dwellers still cannot afford them"

Town planning and the planning process typically focus on the demarcation of town boundaries, the regulation of land use and the assessment of land and property values. Both legislation and practice are silent on what happens on the other side of the town boundary, which often directly affects the life of the town. In Fiji, the eviction of cane farmers after the non-renewal of farm leases led to the growth of marginal settlements in peri-urban areas outside many towns. Squatters could avoid municipal regulations, including local taxes, while continuing to enjoy the amenities towns offer.

6 Wantokism or islandism is the practice of grouping according to a person's village of origin, language and culture. It takes precedence over nationalism.

Another related issue is that town planning and environment departments are separate entities in many local governments. So the critical link or impact of urban development activities on the economic, social and environment tends to be overlooked by both. The Millennium Development Goals urge the States Members of the United Nations to meet targets to provide secure tenure to at least 100 million slum dwellers by 2020 and to raise the proportion of urban and rural populations with access to improved sanitation and water.

All Pacific island developing countries need to develop a clearer vision of where they want their urban development to go in the future, how they might get there and who will be responsible for the different tasks. Policies aimed at poverty reduction could first aim at rehabilitating those in dire danger of losing their lives due to extreme poverty – and second at providing sustainable income-generating opportunities. Some of the key policy recommendations arising from this policy research feature are listed below:

Stronger urban institutions and governance

- Urban planning needs to be fully participatory, and urban planners should be accountable to the people affected by their plans.
- The roles and responsibilities of national and local authorities for urban planning and management should be more clearly defined and performed and monitored more diligently by the responsible authorities.
- Urban planning functions should be set up in national and local authorities and staffed by trained professionals. Town planning is linked to sustainable environmental development and the two functions should be integrated.
- Encourage greater use of communal modes of operation, including squatter community governance systems and consultations with all stakeholders.
- A national association of squatter settlers could be set up by squatter dwellers to voice their concerns more clearly in public and national policy arenas.
- Urban planning and policies could be made more realistic with better information and knowledge about towns and cities.

Improved access to housing, services and infrastructure

- Governments and NGOs can provide more active support to those prepared, on a self-help basis, to commit themselves to building dwellings in line with agreed housing and utility service standards.
- Building homes could become more affordable through the provision of simple and functional house designs and the use of appropriate technology, low-priced construction materials, community labour and affordable financing.
- Utility services, especially water and electricity, should be more affordable and more widely available in squatter settlements.
- The provision of housing and services could be privatized, with government subsidies being allocated to the poor.

Broader access to land

- Governments should support community efforts to secure access to land, including titles to land and dwellings in informal settlements.
- Consultations should be encouraged between landowners and tenants using traditional or local communication or negotiating channels to secure agreement on issues related to tenancy and land use.
- Lease and tenancy agreements need to be legally enforceable – and to ensure flexibility they should first be reviewed within a reasonable period of time, say within the lifetime of the lessor.

South and South-West Asia – growth momentum sustained

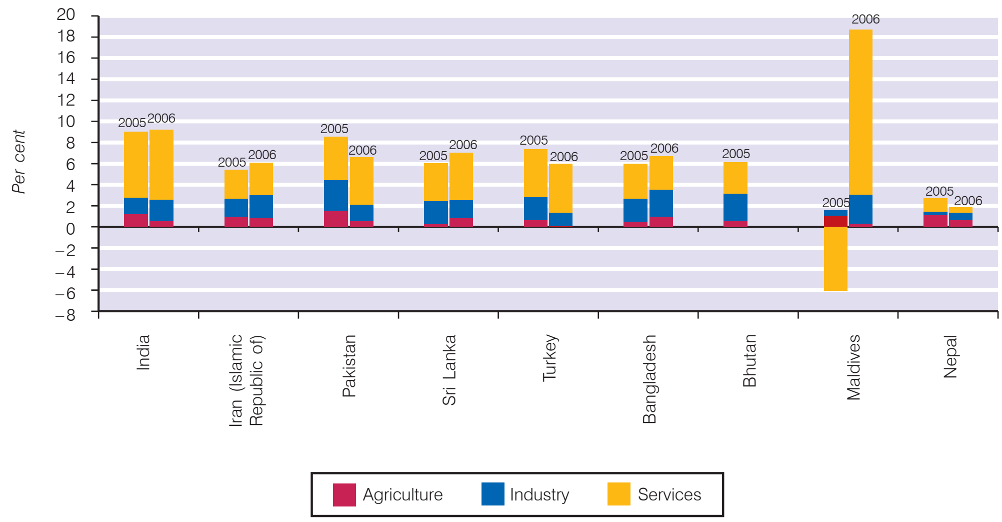
India maintained its growth momentum in 2006 with GDP growing at 9.2%, – a higher percentage than the 9.0% achieved in 2005 (figure 2.13). While there was some deceleration in agriculture, both industry and services performed well over the year. Having concluded that the country's physical infrastructure is not sufficiently developed to sustain high growth, the Government is therefore promoting large-scale infrastructural development projects. Rural infrastructure remains a key issue (see policy research feature 2.3).

> *India's impressive growth is driven by industry and services*

India's strong economic performance has generated growing private sector demand for transport, communications, financial services and trade-related activities. This – together with the rapid increase in spending on public administration, social services, rural extension services and defence – has pushed up the share of services in GDP to 55.1% in 2006. Investment demand is also up – with gross domestic investment increasing from 33.8% of GDP in 2005 to 35.1% in 2006 (figure 2.14).

Pakistan's economy has grown at an average of more than 7.5% over the last three years, although it moderated to 6.6% in 2006. The slowdown in 2006 reflected the extraordinary surge in oil prices, the devastation caused by the October 2005 earthquake and adverse weather conditions. Agriculture grew at just 2.5% in 2006, down from 6.7% in 2005, with negative downstream impacts on the textile and sugar industries. Large-scale manufacturing grew by 9%, down from 15.6% the previous year. Services improved from 8% in 2005 to 8.8% in 2006 and investment hit a record high of 20% of GDP.

Figure 2.13. Industry and services perform well: Economic growth rates and sectoral contributions in selected South and South-West Asian countries, 2005-2006



Sources: ESCAP, based on national sources; Bangladesh Bank, http://bangladesh-bank.org (accessed 6 December 2006); Royal Monetary Authority of Bhutan, *Selected Economic Indicators* (Thimphu, June 2006); Maldives Monetary Authority, *Monthly Statistics,* vol. 7, No. 12 (December 2006); State Bank of Pakistan, *Statistical Bulletin, November 2006* (Islamabad, 2006); Central Bank of Sri Lanka, *Recent Economic Developments Highlights of 2006 and Prospects for 2007* (Colombo, 2006); Central Bank of the Republic of Turkey, *Annual Report 2005* (Ankara, 2006).

Note: Data for 2006 are estimates.

"Growth in Pakistan remains strong despite some deceleration"

Despite internal difficulties, Sri Lankan economy expanded by 7% in 2006, up from 6% in 2005. Agriculture performed better, with higher output of major crops and fisheries, confirming its recovery from the devastating Tsunami in December 2004. Export-oriented industries and domestic market-oriented industries, along with the continued expansion in construction, bolstered industry. Trade, telecommunication, transportation and financial services supported the expansion in services.

The Islamic Republic of Iran is the subregion's only net exporter of oil. High oil prices coupled with an expansionary fiscal policy and an accommodative monetary policy are continuing to fuel strong GDP growth of 6.1%, up from 5.4% in 2005.

Turkey has enjoyed high growth over the past few years; in 2006 its rate of growth fell to 6%, down from 7.4% in 2005, a result of higher inflation and rising interest rates. Tighter monetary conditions hit both private spending and investment at a time of already tight government spending.

Least developed countries forge ahead

Despite a difficult security environment, GDP growth in Afghanistan remained strong, fuelled by an inflow of resources from the foreign donor community. GDP was estimated to have grown by 8% in 2006, slower than the 14% growth rate registered in 2005. Construction and services performed most strongly, while agricultural output (mainly cereals) contracted due to poor weather conditions. Opium production, not counted in official GDP measures, increased significantly in 2006.

"Bangladesh continues to enjoy robust growth"

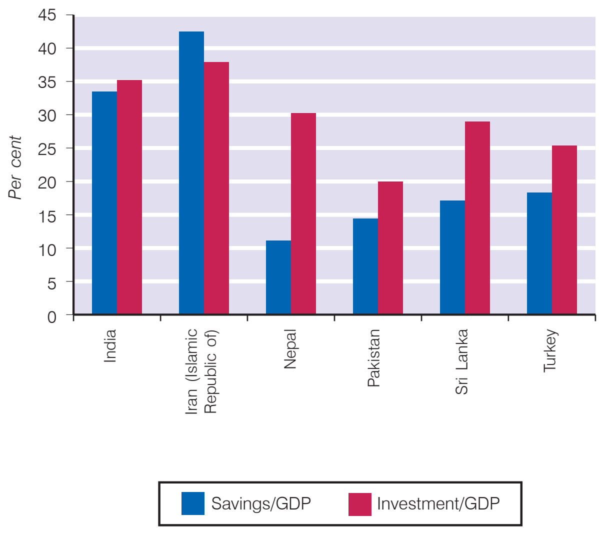
Bangladesh's economy grew by 6.7%, despite persistent high oil prices and the phasing out of the Multi-Fibre Agreement. Agriculture rebounded sharply after the flood-related setbacks of 2005 and industry expanded as a result of export-oriented manufacturing. Buoyant private consumption led the growth momentum, while investment grew at 8%.

Bhutan's GDP grew by 10% in 2006, largely due to the commissioning of the Tala hydroelectric project, a major project which the Government hopes will place the country's economy on a more sustainable path and create a more diversified economy with increased business activities and linkages to the rural economy. Mining, quarrying, manufacturing, electricity, water and construction also grew robustly, as did services, reflecting strength in tourism.

The Tsunami that hit Maldives in December 2004 caused great damage and brought the country's decade-long expansion to an abrupt halt; GDP contracted by 4.5% in 2005 and tourism, which accounts for one third of GDP, contracted 33%. The strong pickup in tourist arrivals and recovery in the fisheries sector, resulted in GDP growing at an estimated 18.7% in 2006.

The political stalemate and escalating conflict in Nepal, continued to impede growth, which remained unchanged at an estimated 1.9% in 2006 – the average growth rate of the past few years. The recent peace agreement has, however, brought new hope and growth is expected to improve.

Figure 2.14. Investment higher than savings, except in the Islamic Republic of Iran, 2006



Sources: ESCAP, based on national sources; India, Ministry of Finance, *Economic Survey of India 2006-2007* (New Delhi, 2007); Central Bank of the Islamic Republic of Iran, *Economic Trends* (Tehran, 2006); Pakistan, *Economic Survey of Pakistan 2005-06* (Islamabad, 2006); Central Bank of Sri Lanka, *Annual Report 2005* (Colombo, 2006); Central Bank of the Republic of Turkey, *Annual Report 2005* (Ankara, 2006).

Note: Data for 2006 are estimates.

High oil prices sustained inflationary pressures

Most countries felt inflationary pressures in 2006 on the back of high oil prices. Food prices also rose significantly in several countries, hurting the poor particularly:

- In India, inflation rose to 6%, led by sugar and other food items, petroleum products, chemicals and chemical products and cement.
- Prices in Pakistan rose to 7.9%, with higher aggregate demand compounded by shortages of principal commodities.
- A shortfall in cereal production contributed to inflation in Afghanistan.
- In Bangladesh, inflation marginally increased to 7.2% in 2006.
- In Nepal, inflation went up by 3.5 percentage points to 8% in 2006, driven mainly by rising petroleum and food prices.
- Inflation in Sri Lanka increased to 13% in 2006, with upward adjustments in retail oil prices, rapid credit expansion and higher civil service wages contributing to inflationary pressures.
- Inflation remained high at 11% in the Islamic Republic of Iran, with the Government spending a large part of the oil price windfall and an accommodative monetary policy.
- Turkey brought down inflation from 45% in 2002 to 8.2% in 2005, but energy prices and the depreciation of the lira pushed it higher to 9.5% in 2006.

> *“Countries pursued tighter monetary policies to contain inflation”*

To contain inflation, most countries in the subregion pursued tighter monetary policies. In India, the Government’s anti-inflationary policies included effec-

Figure 2.15. Inflation and money supply growth (M2) in selected South and South-West Asian economies, 2003-2006

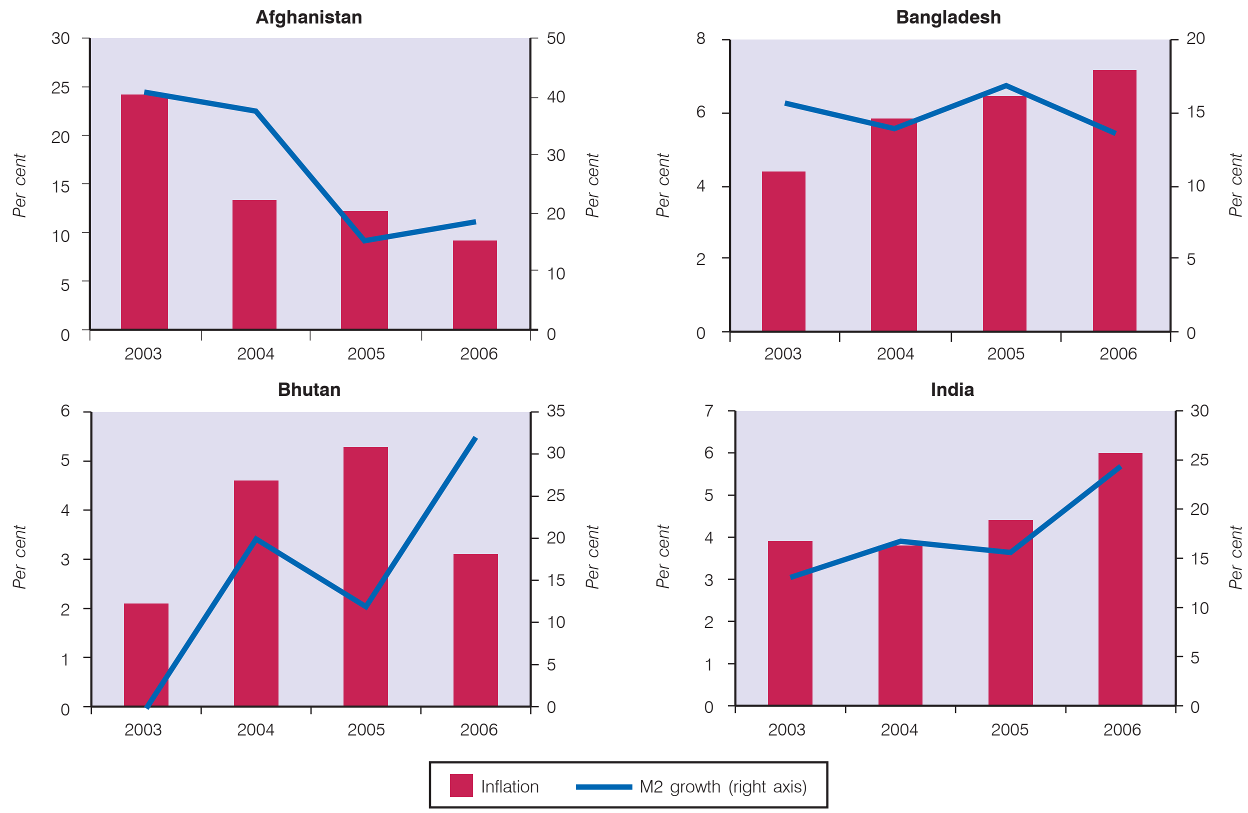


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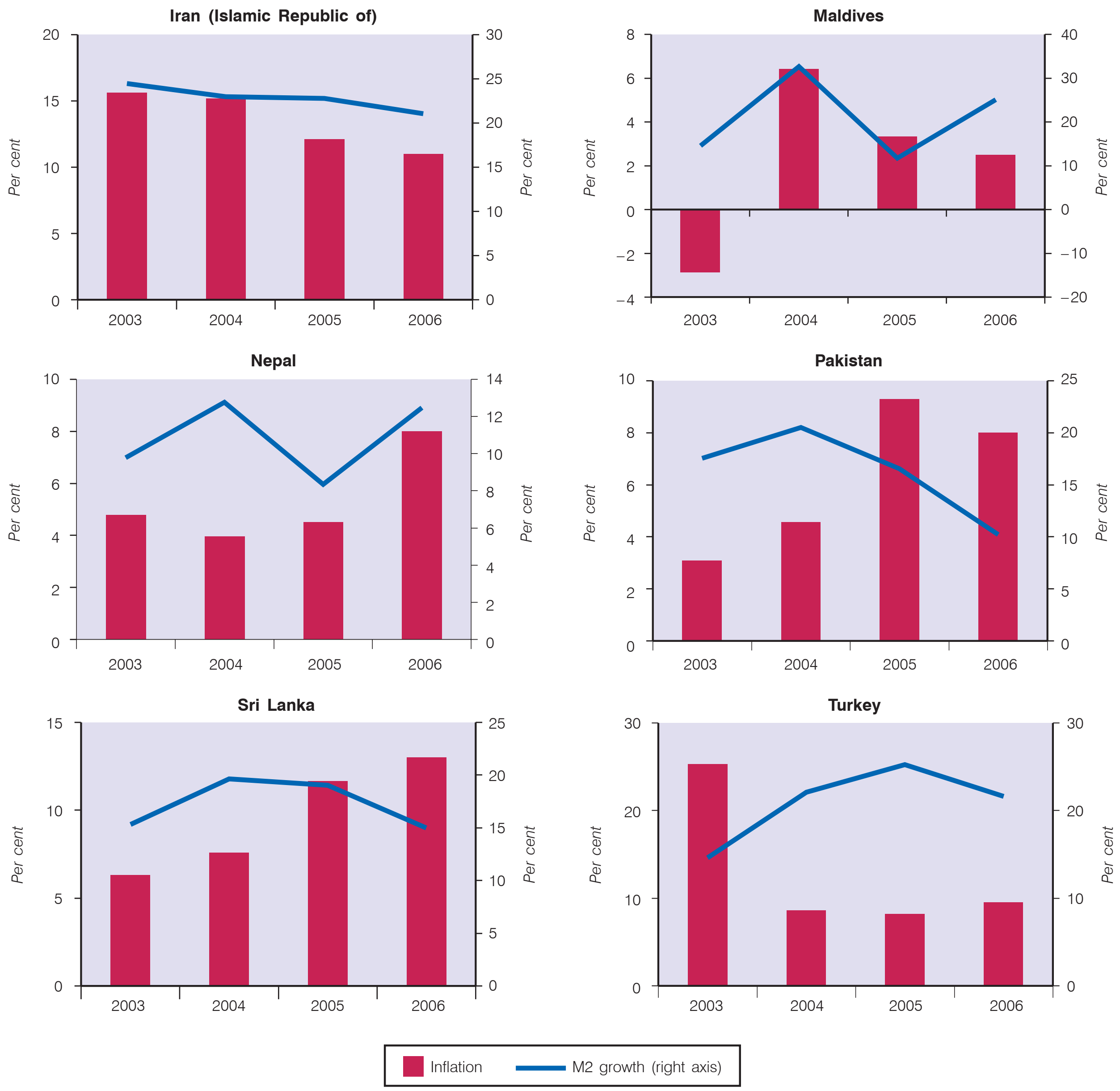
Figure 2.15 *(continued)*



Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006), "Islamic Republic of Afghanistan: Seventh review under the staff-monitored program and request for a three-year arrangement under the poverty reduction and growth facility", and *IMF Country Report No. 06/251* (Washington, D.C., IMF, July 2006); and ESCAP estimates.

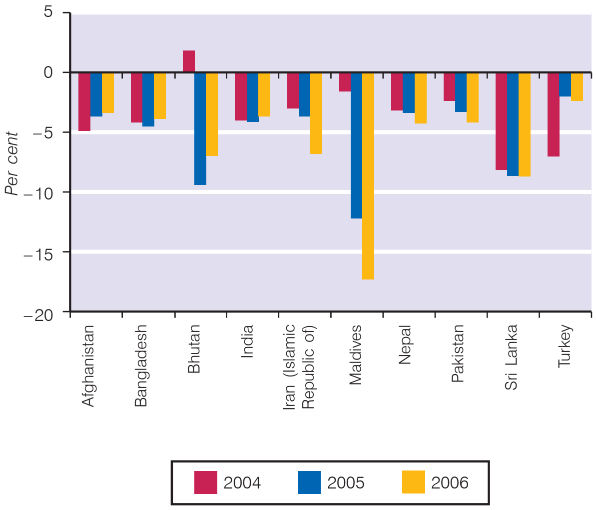
Note: Data for 2006 are estimates. Inflation refers to changes in the consumer price index. For India it refers to consumer prices for industrial workers and for Sri Lanka to Colombo. Money supply growth rates for 2006 refer to January-April for India, January-February for the Islamic Republic of Iran, January-June for Maldives and January-March for Nepal.

tively managing supply and demand for essential consumer goods and raw materials by means of a liberal imports policy and strengthening the public distribution system for food grains, sugar and kerosene oil. Similar measures were taken by other countries. The Islamic Republic of Iran has a vast system of subsidies in place on petroleum products and food items to check increases in the price of essential items.

Budget deficits – a serious problem in several countries

Budget deficits remain high and public debt is a serious problem throughout the subregion. In India, the fiscal deficit of the Central Government in 2006 was contained at 3.7% of GDP, compared with 4.1% in 2005 (figure 2.16). Recent budgets increased expenditure on social services, especially rural employment, irrigation, drinking water, education and health, and improved both rural and urban infrastructure to make development and growth more inclusive. However, persistent fiscal deficits have led to a steady accumulation of public debt. The high GDP growth rate, however, is expected to bring the debt-GDP ratio down to 64% of GDP by the end of March 2007; about 5% of this debt is external debt.

Figure 2.16. Budget balance as a per cent of GDP in selected South and South-West Asian countries, 2004-2006



Sources: ESCAP, based on national sources; India, Ministry of Finance, *Economic Survey of India 2006-2007* (New Delhi, 2007); Central Bank of the Islamic Republic of Iran, *Economic Trends* (Tehran, 2006); Pakistan, *Economic Survey of Pakistan 2005-06* (Islamabad, 2006); Central Bank of Sri Lanka, *Annual Report 2005* (Colombo, 2006); and Central Bank of the Republic of Turkey, *Annual Report 2005* (Ankara, 2006).

Notes: Data for 2006 are estimates. Budget balances exclude grants in the cases of the Islamic Republic of Iran, Pakistan and Sri Lanka.

The budget deficit widened in Pakistan and Sri Lanka. In Sri Lanka, the budget deficit remained high at 8.7% of GDP in 2006, partly as a result of higher military spending. In fiscal 2006, Pakistan's fiscal deficit was estimated at 4.2% of GDP, higher than the 3.3% of GDP in the previous year. The higher deficit in 2006 owed to an increase in expenditure following the October 2005 earthquake. Following the debt reduction strategy, the public debt-to-GDP ratio fell from 85% in June 2000 to 65% by June 2005 and to 59% by June 2006.

> *Budget deficit increased in Pakistan and Sri Lanka*

In Bangladesh, the budget deficit fell from 4.5% in 2005 to 3.9% in 2006, partly due to a shortfall in development expenditure. Public sector debt, comparatively low, stands at 47.1% of GDP, with the external debt component hovering around 30% of GDP, largely on concessional terms. In Bhutan, fiscal restraint reduced the budget deficit in 2006. With increasing revenues from electricity sales to India, the fiscal situation is expected to further improve in the coming years.

In Nepal, the fiscal situation remains weak with growing recurrent expenditure, low capital spending and a high budget deficit, which increased to 4.3% in 2006 from 3.4% in 2005. The budget deficit in Maldives remains in the double digits, partly due to the post-Tsunami reconstruction effort. There is an urgent need to bring it to a more sustainable level by broadening the tax base and containing expenditures.

> *The Islamic Republic of Iran pursues an expansionary fiscal policy financed by high oil prices*

In the Islamic Republic of Iran, the Government's top priority is to tackle unemployment through job creation in the non-oil sector; an expansionary fiscal policy financed by high oil revenue is being pursued to this end. However, fiscal restraint is required to help monetary policy reduce high persistent inflation and to build fiscal savings to cushion against an unexpected downturn in oil prices.

Current account deficits widen due to high oil prices

India's current account deficit in 2006 remains manageable at 1.6% of GDP. High oil prices contributed to an estimated 31.5% increase in imports (table 2.9). But exports also grew at close to 30%, reflecting good performance in the key exporting sectors of engineering goods, chemicals, automobiles, ore and minerals and basic metals and petroleum products. The significant growth in research and development, information technology, IT-enabled services and offshoring activities that India has experienced in recent years have contributed to a boom in services exports. India is now the 18th largest exporter of services in the world, with its share in world exports rising from 0.6% in 1990 to 1.8% in 2004.

In Pakistan, exports and imports continued to grow at double digit rates. The trade deficit widened to a record $8.4 billion, with 45% of the increase due to a higher import bill for crude oil and petroleum products. Imports of raw material and machinery also increased sharply. Even so, the current account continued to benefit from large remittances from expatriate workers, estimated at $4.6 billion in 2006. On the financial account, foreign direct investment, at $3.5 billion in 2006, was the highest ever recorded.

Table 2.9. Summary of external accounts for selected South and South-West Asian economies, 2005-2006

(Per cent)

	Exports/GDP		*Imports/GDP*		*Current account balance/GDP*	
	2005	**2006**	**2005**	**2006**	**2005**	**2006**
Bangladesh	14.3	17.0	21.8	23.8	–0.9	0.9
Bhutan	25.8	28.2	56.9	58.7	–22.0	–15.1
India	13.0	15.1	19.5	22.8	–1.1	–1.6
Iran (Islamic Republic of)	31.8	..	21.7	..	7.5	7.4
Maldives	21.5	24.8	99.2	102.2	–33.6	–36.2
Nepal	11.1	10.1	28.3	28.8	2.2	2.4
Pakistan	13.8	13.5	19.7	23.5	–1.4	–3.9
Sri Lanka	27.0	26.2	37.6	39.8	–2.8	–5.3
Turkey	20.3	20.9	32.3	34.7	–6.4	–7.9
	Growth rates Percentage)					
	Exports			*Imports*		
	2004	**2005**	**2006**	**2004**	**2005**	**2006**
Bangladesh	16.1	13.8	21.6	12.9	20.6	12.2
Bhutan	39.7	18.0	25.3	29.2	67.6	18.0
India	28.5	23.4	30.0	48.6	32.0	31.5
Iran (Islamic Republic of)	29.0	36.9	38.0	29.2	7.3	30.6
Maldives	19.1	–10.7	39.7	36.3	16.1	26.5
Nepal	8.9	14.8	–1.1	10.6	15.6	11.2
Pakistan	10.3	16.9	14.3	27.6	32.1	38.8
Sri Lanka	12.2	10.2	9.1	19.9	10.8	18.9
Turkey	33.7	16.3	13.4	40.7	19.7	17.8

Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006).

Notes: Data for 2006 are estimates. Trade figures for Bangladesh, Bhutan, India, the Islamic Republic of Iran, Nepal and Pakistan are for the fiscal year. Trade figures for 2006 refer to first two quarters for the Islamic Republic of Iran, January-September for Turkey. Import value in f.o.b. for the Islamic Republic of Iran.

Considerable remittances from workers were also important in Bangladesh and Nepal, which both recorded current account surpluses in 2006. Exports in Bangladesh, helped by a sharp depreciation of the domestic currency in the previous year, grew by 21.6%, imports by 12.2%. The country has successfully weathered the phasing out of the Multi-Fibre Agreement, with garment exports seeing robust growth. More than 70% of the country's total exports consist of textiles and clothing.

> *Considerable remittances helped to contain a current account deficit in Pakistan and contributed to a current account surplus in Bangladesh and Nepal*

In Sri Lanka, export earnings grew by 9.1% in 2006, led by tea, rubber, textiles and garments. Imports grew much faster at 18.9%, reflecting strong domestic demand for intermediate and investment goods in the manufacturing and construction industries. The current account deficit widened to 5.3% of GDP, while the capital account recorded a surplus with higher foreign direct investment and project-related flows to the Government.

Bhutan's very high current account deficit of recent years is mainly due to imports of construction material for hydropower projects. More than 50% of its export earnings come from selling electricity to India. With the commissioning of a large hydropower project in 2006, those earnings should increase significantly. Expanding tourism will also dampen the current account deficit.

In Maldives, the recovery of the tourism sector did not alleviate the current account deficit, which stood around 36% of GDP; this was largely due to post-Tsunami construction of 46 new resorts and record high fuel costs.

The Islamic Republic of Iran's current account surplus increased to 7.5% of GDP in 2005. The country's exports rose by 36.9% in 2005, around 80% of which were oil and gas-related products. Imports grew by 7.3%. In 2006, the current account surplus remained essentially unchanged at 7.4% of GDP on the back of high oil prices.

> *Turkey recorded a high current account deficit*

In Turkey, the current account deficit stood at 7.9% of GDP in 2006. High oil prices, strong investment demand and a strong currency contributed to the deficit. The energy import bill, for example, almost doubled between 2003 and 2005. Despite this worrying picture, capital inflows comfortably financed the deficit. Foreign direct investment tripled to $10.7 billion in 2005, and reached close to $9 billion in the first six months of 2006.

Outlook for 2007 – growth expected to remain strong

India is expected to grow around 9% in 2007, underpinned by a strong performance by the industrial and services sectors. The Government's target is to increase growth to 10% in coming years. Growth prospects for Pakistan are fairly promising and a small increase to 7% in 2007 is expected following a recovery in agriculture and improved performance of the manufacturing sector. To sustain future growth rate of 7-8%, more investment is needed to develop human resources and physical infrastructure. Given the recent escalation of ethnic conflict and violence, Sri Lanka's growth is expected to slow to 6.5% in 2007. In the Islamic Republic of Iran, volatile oil prices and international tensions over its nuclear programme have created uncertainties for the economic outlook. In Turkey, high inflation and rising interest rates will continue into 2007, with its GDP forecast to grow by 5%.

Among the least developed countries, GDP growth in Bangladesh could moderate to around 6% in 2007, reflecting political uncertainties related to the elections. In Bhutan, construction of new hydropower projects are expected to keep growth strong. With the peaceful resolution of the armed insurgency, Nepal is now looking for new momentum, with its GDP expected to grow by 4.3% in 2007. GDP growth in Maldives is expected to moderate to a more normal 7% in 2007.

Maintaining reform momentum to sustain high growth

Reform needs to be maintained to sustain high growth and rapid poverty reduction. With fiscal adjustment still a challenge, more progress is needed in tax collection and resource mobilization to reduce large budget deficits. This will allow redirecting resources from servicing public debt to economic development and social programmes, while at the same time creating an enabling environment for private investment. An increase in consumer prices is a genuine concern in most countries. Striking an appropriate balance between promoting economic growth and price stability remains a challenge because inflationary pressures accompany rapid economic expansions. As the current account deficit is becoming serious in some countries, this will have implications for the balance of payments. If oil prices remain high, they will have to devise ways to contain their deficits.

The lack of physical infrastructure also constrains growth, so investment in physical infrastructure should remain a priority to reduce poverty in much of the subregion (policy research feature 2.3).

Policy research feature 2.3: Electricity and roads to reduce rural poverty

Infrastructure reduces poverty in two ways. It promotes growth, which generally benefits the poor. And it directly benefits the poor by improving their incomes and the quality of their lives. Physical infrastructure that directly benefits the poor is more likely to reduce poverty, whereas growth may not always do so. Since most of the poor still live in the rural areas, rural infrastructure is key to reducing poverty.

Rural physical infrastructure covers roads, electricity, irrigation, telecommunications and much more. The impact of various types of infrastructure on rural economies and poverty reduction is maximized when provided in unison. Prioritizing the different types of infrastructure that should be provided is difficult as different localities and areas have different needs and would view one type of infrastructure as more important than another. However, the present study is focused on rural roads and electricity.

> *Together, rural roads and electricity improvements had a significant impact on poverty reduction in India, China and Thailand*

In South Asia, only 65% of the rural population lives within two kilometres of an all-weather road, far less than the 95% in East Asia. Only 43% of the population has access to electricity, far less than the 88% in East Asia (Jones, 2006). Access varies from 15% in Nepal to 67% in Sri Lanka, with access in India and Pakistan having around at 53-56% mark (Bhattacharyya, 2006). A recent comprehensive study assessed the impact of transport and energy on poverty in India, China and Thailand (ADB, DFID, JBIC and WB, 2005). It concludes that improvements in rural transport have a significant impact, although the evidence for electricity is less conclusive. Together, however, rural roads and electricity improvements had a significant impact on poverty reduction.

Progress in providing roads

The transport sector has attracted a great deal of interest for investment from the private sector. Promoting public-private partnerships in transport can help reduce the burden on the public sector and can help public resources for investment in priority areas such as rural roads, which the private sector finds less attractive. China's success suggests that private financing can have a significant role in the development of major road networks. This freed some public resources for developing rural and feeder roads and had a strong poverty reduction impact.

> *In India, a million rupees spent on roads led to seven times the poverty reduction as a million rupees spent on anti-poverty programmes*

In the Lao People's Democratic Republic, rural poverty fell by 9.5% between 1997 and 2003 – 13% of this decline could be attributed to improved access to roads alone (Warr, 2005). In Viet Nam, poor households living in rural communes with paved roads had 67% higher chance of escaping poverty than those without paved roads (Jones, 2006). In India, a million rupees spent on roads led to seven times the poverty reduction as a million rupees spent on specific anti-poverty programmes (Weiss, 2003). In China, the situation repeated itself, though the gain was of a smaller magnitude.

Often poorly targeted and governed, anti-poverty programmes could not match the simple effectiveness of building roads. The logic is simple: roads are the arteries that go where poor people live, improving their lives in concrete, immediate ways:

- Reducing the cost of transporting input and outputs.
- Saving precious time that the poor can spend on farm or household work.
- Increasing the availability and accessibility of education and health care services in rural areas.
- Boosting the productivity of agriculture by enabling shifts from subsistence to higher-earning commercial farming.
- Spreading access to employment opportunities in urban areas, increasing rural wages and incomes.

Some successes in electrifying rural areas

To distribute electricity to smaller populations scattered over vast areas through conventional means, such as extending the electricity grid, can be complex and expensive. More preferred is distributing energy by using locally available resources, mainly renewable resources such as small hydropower, solar power, wind power and biomass power. Some innovative ways to provide rural populations with an off-grid, decentralized supply of electricity are highlighted below (ESCAP, 2006b, pp. 14-16).

> *"Providing rural populations with an off-grid, decentralized supply of electricity is a key to success"*

Bangladesh. More than two thirds of Bangladeshis live in rural areas, lacking access to the electricity grid. But under the Power Development Board, cooperatives, called "Palli Bidyut Sangstha" (rural electrification societies), supply electricity to a substantial share of rural households. Several other organizations are targeting the remaining populations through off-grid solutions using renewable energy. The Local Government Engineering Department provides electricity through mostly solar home systems. Grameen Bank's "Grameen Shakti" programme provided financing for 16,500 solar home systems. The Government intends to expand these programmes to supply electricity to all households by 2020.

China. The Government has very ambitious programmes of renewable energy sources, particularly for rural areas. In 2001, it launched a renewable energy-based rural electrification programme, "Song Dian Dao Xiang" (sending electricity to townships). Electricity generated from the programme consisted of 20 megawatts from photovoltaic sources, 840 kilowatts from wind sources and 200 megawatts from small hydropower sources. The Government provided $240 million to subsidize the capital costs of equipment and drafted guidelines for tariffs and system ownership. The Village Electrification Programme 2005-2010 will electrify another 20,000 villages in China's off-grid western region.

China's Renewable Energy Law, which came into effect in early 2006, requires power grid operators to purchase electricity from registered renewable energy producers. The law also provides for a national fund to foster renewable energy development and discounted lending and tax benefits for renewable energy projects. The Government plans to boost the use of renewable energy capacity from 7% to 16% by 2020. About 30 million people, mostly in remote and rural areas, still are not connected to the power grid. Village photovoltaic and wind power systems provide a cost-effective alternative to these areas.

India. The Government established the Department of Non-conventional Energy Sources in 1982 and upgraded it to a full-fledged ministry in 1992, alongside other energy ministries. The Indian Renewable Energy Development Agency provides technology, finance (based on cost recovery) and technical services. The Government targets providing electricity to all households by 2009-2010, a tremendous task that will inevitably involve the private sector.

Policy conclusions

Countries in the subregion are aware of deficits in infrastructure. India, for example, has estimated that it will take $320 billion over the next five years to expand and upgrade physical infrastructure.[7] Megaprojects may be essential to accelerate growth, but projects that directly benefit the rural poor should be given equal importance, if not more. Some broad policy recommendations:

- ***In the absence of interest from the private sector, more public investment should go to rural infrastructure.*** In Asia's developing countries, the private sector financed less than 30% of infrastructure investment, much of it concentrated in a few countries in East Asia. With concessional aid covering 3%, the public sector financed the bulk of the residual (Weiss, 2003).
- ***Physical infrastructure for the poor should be a donor priority.*** The current situation is not promising. The share of the transport and energy sectors in official development assistance to South Asian countries fell from 27.1% in 1990-1995 to 15.3% in 2000-2004 ($15.4 billion to $7.6 billion).
- ***Governments should set up an effective regulatory framework.*** This includes independent regulatory agencies to protect consumers and ensure financial transparency and a fair return on investment. To deal with electricity losses and theft, electricity should be generated and distributed by separate government departments. Later privatization of electricity distribution can help reduce losses and improve services.
- ***Pricing is complex because of efficiency and equity.*** Tariff rates should be competitive and reflect market conditions, with some provisions for poor households. Tariff rates should be kept low, affordable for small consumers. To cover the losses of public utilities, the Government can allocate a certain amount of subsidy in its general budget and pass it on to public utilities distributing electricity. A more targeted approach of giving vouchers to the poor so that they can pay electricity bills at market rates is worth considering. Poor households can be asked to pay a fixed percentage of the electricity bill, with the remainder covered through the voucher.
- ***Reach the extreme poor.*** Microcredit programmes can help in buying energy-efficient equipment and appliances, and electricity connection charges can be recovered through a small monthly rental fee affordable by poor.

7 "Prime Minister inaugurates Conference on Infrastructure", 7 October 2006, available at <http://pmindia.nic.in/speech/content4 print.asp?id=414>.

South-East Asia – growth accelerates on the back of strong exports

The economy of South-East Asian countries is estimated to have grown by 5.9% in 2006, up from 5.6% in 2005. Singapore and Viet Nam experienced GDP growth of more than 7%, on the back of impressive performances in industrial production. Indonesia, Malaysia, the Philippines and Thailand registered GDP growth of 5-6%, with fairly rapid growth in services (figure 2.17). Despite higher oil prices, oil-rich Brunei Darussalam grew at just under 3%.

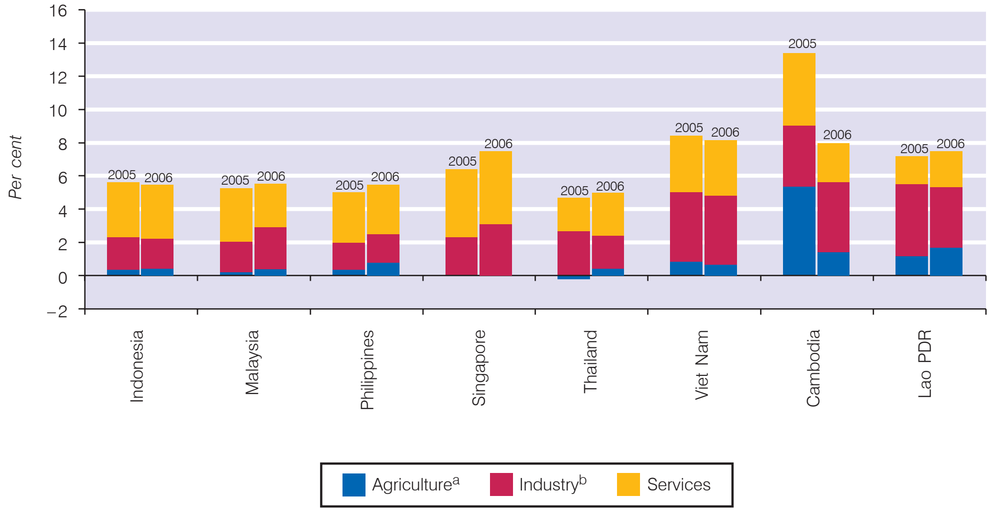
With strong global growth for electronics and commodities, export growth generally accelerated in 2006. It was strongest in Singapore (21.2%) and Viet Nam (21.9%), and weaker in Malaysia (13.4%), the Philippines (15.5%), Indonesia (16.2%) and Thailand (16.8%). But for all these countries, export growth was stronger than in 2005, except for Indonesia.

GDP growth in the subregion's least developed countries was impressive:

"GDP growth in South-East Asian least developed countries was impressive"

- Having grown at 13.4% in 2005, Cambodia's real GDP grew by a more modest 8% in 2006.
- The Lao People's Democratic Republic, which had grown by 7.2% in 2005, grew by 7.5% in 2006.
- Myanmar's GDP grew by 13.6% in fiscal 2004; it has not been possible to assess macroeconomic performance in subsequent years because of a lack of data.
- Timor-Leste looked poised to post a year of reasonable economic growth in 2006, but was hampered by the violent political and social crisis that erupted in April.

Figure 2.17. Industry and services drive growth: Rates of economic growth and their sectoral contributions in selected South-East Asian countries, 2005-2006



Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); and ESCAP estimates.

Note: Growth rates for 2006 are estimates.

[a] Agriculture for Singapore includes quarrying.

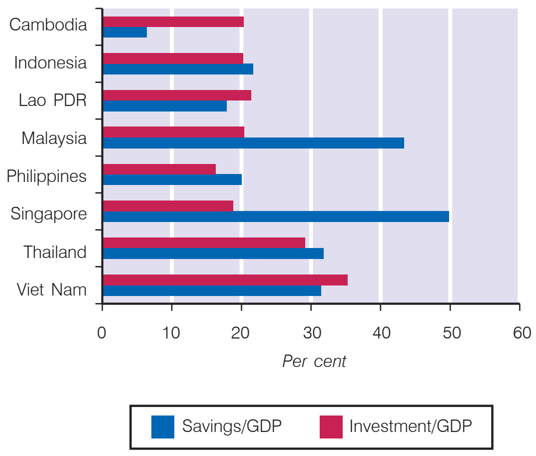
[b] Industry comprises mining and quarrying, manufacturing, electricity, gas and power and construction.

“Viet Nam’s strong economic performance is expected to receive an additional boost from its accession to WTO in January 2007”

Investment grew relatively modestly or slipped in 2006, constrained by political factors and higher oil prices and interest rates (figure 2.18).

- In Indonesia, investment contracted by about 0.3% over the first three quarters (year-on-year). In the Philippines, investment contracted by about 2.5% in the first two quarters of 2006.
- In Thailand, private investment increased by 4.4% in the first three quarters of 2006, down from 12% in 2005 (Thailand, 2006).
- In Malaysia, investment grew at 10.1% in 2006, up from 8.5% in 2005.
- In Singapore, private investment picked up from a low base – it had contracted by 1.4% in 2005 – to average close to 16% in the first three quarters of 2006 (Malaysia, 2006 and Singapore, 2006a).
- In Viet Nam, investment growth is estimated at 10.2% for 2006 (EIU, 2006b). The country’s strong economic performance is expected to receive an additional boost from its accession to WTO in January 2007.

Figure 2.18. Lagging investment in middle-income South-East Asian economies, 2006



Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); and ESCAP estimates.

Note: Data for 2006 are estimates.

Higher oil prices – a catalyst for rethinking monetary policy

With oil prices on the rise, 2006 started amid concerns about inflation exceeding 10% in Indonesia, 7% in the Philippines and 5% in Thailand. Central banks in the region, which had raised interest rates in 2004 and 2005, also allowed their exchange rates to appreciate to offset inflationary pressures. Between January and May, both the Malaysian ringgit and the Singapore dollar appreciated by more than 5%, the Thai baht by more than 8%, and the Indonesian rupiah by 11%.

But following the unexpected increase in United States interest rates on 10 May 2006, many markets in South-East Asia experienced an increase in gross portfolio outflows, a widening of interest rate spreads on foreign currency debt and a fall in equity prices. Currencies were also allowed to depreciate, which had the effect of erasing earlier gains (figure 2.19).[8] As the situation settled, interest rate spreads returned to historic lows and equity prices rose. The Philippine peso and the Thai baht regained lost ground, followed by other currencies, such as the Singapore dollar.

“Despite the currency appreciations, foreign exchange reserves had also grown, suggesting that authorities were managing currencies through official intervention”

By year’s end, most exchange rates had appreciated significantly against the United States dollar. The stronger currencies alleviated inflationary pressures by reducing the cost of imports (especially oil) and allowing monetary policy to be somewhat more accommodative than in the past. As a result interest rates flattened (except in Indonesia, where they had already begun to fall), and real (ex-post) interest rates remained low or even negative. Despite these currency appreciations, foreign exchange reserves had also grown dramatically, suggesting that authorities were attempting to limit upward pressure on the region’s currencies through official interventions.

On 19 December 2006, the Bank of Thailand decided to limit capital inflows by requiring that 30% of all

8 See ESCAP (2006c) for a detailed discussion of this topic.

new foreign financial investments be held in an interest-free deposit at the central bank. The Thai stock market lost more than 14% of its value in one day as a result. Although markets improved the next day, when the authorities effectively reversed the measure by exempting equities, the move highlighted the dilemma the authorities face when they have both an inflation target and an exchange rate target (box 2.3)

External sector helped by strong global economy

Apart from the adjustment to the external financial conditions in May and June, generally favourable external conditions left much of the region with a balance of payments surplus in 2006 (table 2.10). The growing demand for electronics remains a crucial component of the subregion's export performance. Its electronics production accounts for roughly 10% of global electronics output (table 2.11). Most is exported to major markets, such as Japan and the United States, but some goes to China as intermediate goods to be incorporated in China's exports to the country markets (see the policy research feature 2.1).

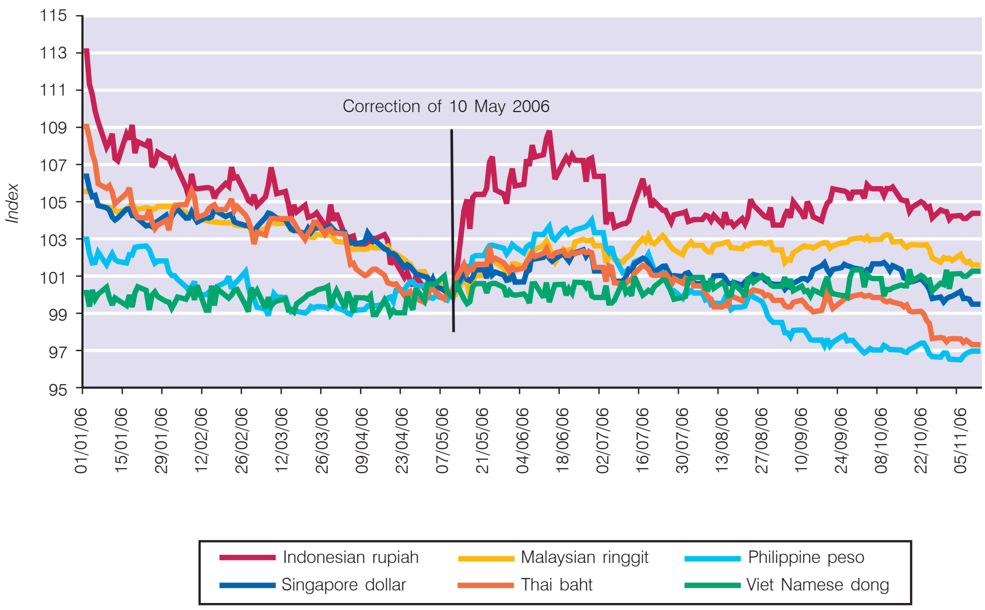
"The steady expansion in tourism earnings, healthy exports and an increased inflow of FDI helped Cambodia to cope with the rising cost of oil during 2006"

Exports and foreign direct investment boost least developed countries

Although Cambodia's current account deficit remained large, the steady expansion in tourism earnings, healthy exports and an increased inflow of FDI helped it cope with the rising cost of oil in 2006. Gross official reserves rose from $915 million in 2005 to around $1 billion at the end of the first quarter of 2006. In the Lao People's Democratic Republic, exports of mineral products, particularly gold, continued their upward trend in 2006, reflecting the buoyant global demand for gold and copper. Imports also grew sharply, dominated by imports of equipment and machinery investment in the mining and hydropower sectors. The trade deficit was about $500 million in 2006.

Figure 2.19. By the end of 2006 currencies regained strength

(Local currency per United States dollar)
(Base: 10 May 2006 = 100)



Source: Calculated based on data from International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006).

BOX 2.3. The impossible trinity and the monetary regime in South-East Asia

In principle, monetary authorities can choose any two of three options: monetary autonomy (for example discretion in setting short-term interest rates); an exchange rate target; and capital account convertibility (i.e. no capital controls). Choosing all three options is likely to fail, hence the term “impossible trinity”.

If the authorities wish to counter an inflationary shock, and also maintain the exchange rate at its current level and there are no impediments to capital controls, the central bank could lose control over its monetary policy. And it will be ineffective in containing inflation.

If the authorities increase interest rates to cool the economy, they risk generating short-term capital inflows that the central bank would then be obliged to purchase to keep the exchange rate at its desired level. If the central bank purchases the foreign exchange with domestic currency, the expansion in the money supply would push down domestic interest rates and offset the original monetary intervention aimed at cooling the economy. But if the authorities sterilize the capital inflows by expanding the stock of sovereign bonds, the intervention will keep the domestic interest rate differential above its long-run equilibrium level, generating an ongoing inflow and growing sovereign bond issuance. This could ultimately pose challenges for the banking system and create difficulties for the authorities as they seek to unwind their positions in the future.

Another strategy could consist of raising interest rates and allowing the exchange rate to appreciate. The appreciation would ease inflationary pressure by reducing import prices and export demand. It would also reduce some of the pressure on the authorities to raise interest rates, thereby reducing the negative impact on investment spending.

A third possibility could be to peg the exchange rate while raising interest rates but to restrict capital inflows. If the capital controls bite, the authorities could pursue both a high interest rate and the exchange rate target. But capital controls carry certain costs, such as weakening financial sector development, particularly if the controls are maintained over an extended period of time. For example, attempts to develop a regional bond market would be hindered by capital market restrictions.

After the 1997 crisis, Malaysia adopted the third option, Singapore and Thailand pursued the first, and Indonesia and the Philippines adopted a variant of the second option. Recently, the monetary authorities have leaned towards adopting the second alternative of more flexible exchange rates and open capital accounts, granting them more independence in monetary policy.

The move towards adopting relatively flexible exchange rates is a major departure from the previous practice by the monetary authorities in the subregion. The reduced weight placed on a nominal exchange rate anchor suggests a move towards other nominal targets, such as an inflation target, as shown in the case of Indonesia, the Philippines and Thailand. Such a change can produce benefits over the longer term but brings challenges in the short term.

For example, if the central bank has a reputation for pursuing a monetary policy consistent with an inflation target, the authorities could respond to weakening external demand by letting the exchange rate depreciate and possibly lowering interest rates to stimulate aggregate demand, even if this results in temporary inflation. The central bank’s reputation for pursuing low inflation gives it some discretion to temporarily pursue a stabilization policy without creating the expectation of an ongoing increase in prices.

However, if the central bank lacks credibility, its commitment to low inflation may be discounted by the market, and the depreciation and lower interest rates could be viewed as a signal that inflation will persist. Capital flight may ensue. In such a situation, the central bank may instead find itself having to raise interest rates and defend the currency, even if it results in a recession.

Another factor determining whether a central bank can lower interest rates and allow the exchange rate to depreciate is the currency of borrowing. If it has borrowed in local currency from an overseas source, it is insulated from exchange rate fluctuations. If it has borrowed in a foreign currency, the value of corporate liabilities would rise with the depreciation, possibly placing the corporate sector under financial stress.

Interestingly, research (see the policy research feature 2.4) shows that a firm’s ability to obtain financing in a domestic currency is also linked to the credibility of the central bank’s commitment to a sound monetary policy. The implication of this is that the manner in which a central bank responds to a negative external shock is likely to depend crucially on the credibility of its commitment to a sound monetary policy.

Medium-term prospects – dependence on global demand raises concerns

Since the Asian crisis, the subregion has experienced strong export-led growth based on maintaining exchange rates conducive to large trade and balance of payments surpluses. This strategy, however, leaves the subregion exposed to certain risks.

First, the heavy dependence on exports has left the subregion vulnerable to a downturn in global demand. Softening global GDP growth may have already revealed itself in electronics. Analysts point to a weakening in the book-to-bill ratio, which measures the value of orders on the books of electronics producers relative to the amounts which have been billed. In addition, technology stocks in the region experienced sharp corrections in response to poor earnings reports and expectations of a moderation in demand. A further sign of an expected downturn in electronics

Table 2.10. Summary of external accounts for selected South-East Asian economies, 2005-2006

(Per cent)

	Exports/GDP		Imports/GDP		Current account balance/GDP	
	2005	2006	2005	2006	2005	2006
Cambodia	47.0	49.7	63.4	70.1	–4.3	–5.5
Indonesia	30.1	27.7	24.7	21.5	0.1	0.8
Lao People's Democratic Republic	17.6	..	28.2	..	–6.7	–10.0
Malaysia	107.7	107.7	87.5	88.6	15.7	13.2
Myanmar	..	..	..	..	0.1	..
Philippines	45.2	46.1	54.5	52.9	2.5	2.4
Singapore	196.8	210.1	171.4	184.8	28.5	25.9
Thailand	62.4	63.8	66.9	64.6	–2.1	1.2
Timor-Leste	..	..	..	..	42.7	..
Viet Nam	69.9	74.7	61.3	74.1	0.4	0.9
	Growth rates (per cent)					
	Exports			Imports		
	2004	2005	2006	2004	2005	2006
Cambodia	24.1	12.4	22.2	22.5	20.2	22.1
Indonesia	12.6	20.1	16.2	28.0	26.2	15.6
Lao People's Democratic Republic	8.3	52.2	29.5	54.2	23.8	36.1
Malaysia	20.8	11.0	13.4	26.4	8.5	14.1
Myanmar	14.1	14.5	9.4	7.1	1.5	11.9
Philippines	9.5	4.0	15.5	8.8	7.7	9.0
Singapore	24.2	15.7	21.2	27.4	15.3	21.6
Thailand	20.6	14.9	16.8	25.7	25.9	7.1
Timor-Leste	14.3	25.0	0.0	–8.6	5.9	1.9
Viet Nam	31.4	22.4	21.9	26.7	15.7	20.1

Sources: ESCAP, based on national sources; Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2006* (Manila, ADB, 2006); International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006), *Democratic Republic of Timor Leste: 2005 Article IV Consultation, IMF Country Report No. 05/245* (2005), *Direction of Trade Statistics* (CD-ROM) (Washington, D.C., IMF, 2006), *Public Information Notice* (PIN), No. 05/92; and ESCAP estimates.

Notes: Data for 2006 are estimates. Trade figures for 2006 refer to January-March for Brunei Darussalam and Myanmar, January-October for Philippines exports, Malaysia, Thailand, January-September for Philippines imports and Singapore, and whole year projections for Indonesia. Cambodia's trade figures for 2005 are estimates and those for 2006 are projections. For Timor-Leste, trade figures for 2004 are estimates and those for 2005-2006 are projections. Trade figures for 2006 are estimates for Lao People's Democratic Republic and Viet Nam. Import value in f.o.b. for Cambodia, Indonesia and Singapore. All exports/GDP and imports/GDP for 2006 refer to the first three quarters except for Viet Nam, the data refer to the first quarter. The current account for Cambodia includes transfers. Calculations for Myanmar's current account are based on official exchange rates. The current account of Timor-Leste includes international assistance.

Table 2.11. Electronics production in selected South-East Asian economies, 2002-2005

(Millions of United States dollars)

	2002	2003	2004	2005[a]
Indonesia	9 446	8 941	9 454	9 734
Malaysia	38 571	41 318	45 905	47 435
Philippines	11 332	11 415	12 597	13 426
Singapore	36 383	39 396	44 101	45 477
Thailand	15 728	17 675	20 096	21 071
Viet Nam	1 548	1 671	1 846	1 926
Total	113 008	120 416	133 999	139 069
Total (world)	1 056 755	1 142 996	1 275 634	1 338 894

Source: Scottish Enterprise, *Global Electronics Report* (Glasgow, Scottish Enterprise, June 2006).

[a] Estimated.

exports was reflected in Singapore's October production figures, which saw electronics production fall by 14.3%. Although the decline masks a 14% year-on-year gain in semiconductor output, the production of computer peripherals and data storage equipment contracted sharply (Singapore, 2006b).

The growing trade in raw commodities and more sophisticated intermediate goods between China and Asia-Pacific countries poses another risk (see the policy research feature 2.1). The resilience of this trade to a significant appreciation of the yuan, or for that matter a downturn in the economy of China, is untested but both risks loom. An ESCAP simulation found that a slowdown in China's GDP growth would hurt countries in South-East Asia, primarily through a fall in export demand (ESCAP, 2006a).

> *"It is unlikely that export-fuelled growth can continue indefinitely without additional growth in investment spending"*

Second, it is unlikely that export-fuelled growth can continue indefinitely without additional growth in investment spending. At some point, resource constraints will become binding due to insufficient capital and infrastructure.

Third, balance of payments surpluses create liquidity problems that central banks must, at some future date, have to deal with. Authorities in the subregion have looked to greater exchange rate flexibility to ease persistent balance of payments surpluses. Currency appreciation is expected to reduce the cost of imported machinery and equipment, and other goods and services, as well as stimulate investment and consumer spending. In addition, greater exchange rate flexibility would offer central banks greater flexibility in monetary policy, which can also stimulate domestic investment.

Although authorities in the subregion have already taken the necessary first steps, more could be done. On monetary policy, they need to be clear about their policy objectives. They must also ensure that market participants understand those objectives, and pay specific attention to potential conflicts between, say, an exchange rate objective and an inflation or other nominal target. Avoiding ambiguity in monetary objectives can prevent unnecessary and unwanted currency speculation and better anchor expectations.

Financial sector development, and development of particularly the bond markets, is also seen as an important part of the solution. By assisting firms in tapping into domestic savings, better bond markets can raise investment growth and reduce dependence on exports.

There are other risks, of course. Political risks seem to be ever-present in some form throughout much of the subregion. Cambodia faces a possible breakdown in its fragile political stability, and it is unclear how the political situation in Thailand will play out.

Policy research feature 2.4: Developing East Asian corporate bond markets 10 years after the crisis

It has been 10 years since the Asian financial crisis rocked South-East Asian and other nations in East Asia. Policymakers were quick to identify a lack of bond markets as one of the reasons the crisis had such devastating effects (Greenspan, 2000). Since then, emerging East Asian (EEA) bond markets have grown by more than 180%.[9] Despite their rapid growth, they continue to attract considerable attention among policymakers and market players. Concerns remain that bond markets are illiquid and not a good source of investment finance. This section provides an overview of the current state of bond markets and re-examines the role of public policy. The main focus is on the corporate bond market rather than government bond markets.

Bond markets became the focus of attention in the wake of the 1997-1998 Asian crisis because it was thought that the region had become overreliant on the banking system and that local currency bond markets appeared to be missing. As a result, firms had difficulty borrowing money on a long-term basis in a domestic currency, resulting in maturity and currency mismatches – two factors thought responsible for the crisis. This missing or incomplete markets hypothesis raised questions as to why bond markets had failed to develop and what public policy could do to promote them (Eichengreen and Hausmann, 1999).

Although corporate bond markets have grown since the 1997 crisis, they are not channeling funds to firms to the same extent as equity markets, and also lack liquidity

Although corporate bond markets have grown in recent years, they are not channeling funds to firms to the same extent as equity markets, and also lack liquidity. This feature highlights the need for policy responses aimed at creating an environment that reduces key risks associated with holding long-dated financial securities. These include currency risk, which reduces the willingness of the market to hold domestic currency bonds and credit risk.

Bond markets – growing but still undeveloped and lacking liquidity

The state of bond market development within the region varies dramatically and has changed over time. All measures tell a similar story. There has been rapid growth in the stock of both government and corporate bonds. The average amount of total bonds on issue in 2001-2005 ranges from 33% of GDP for Indonesia to more than 120% for Malaysia, up from 3% and 87% respectively in 1991-1995. Government debt on issue, while less than that in other emerging markets and advanced economies (reflecting a history of prudent fiscal policies), now generally exceeds 20% of GDP, excepting Hong Kong, China, where it averages 10%. Corporate bonds in 2001-2005 exceed 50% of GDP in the Republic of Korea and Malaysia and less than 25% in most other markets (figure 2.20).

Asian economies make less use of bond markets to finance investment than might be suggested by the size of their economies

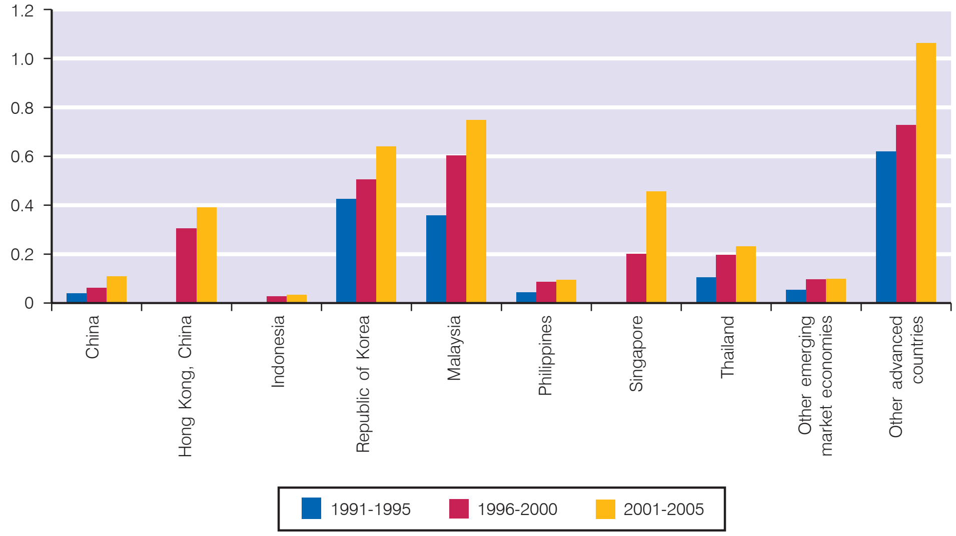
Outstanding debt relative to annual investment tells a similar story. Asian economies make less use of bond markets to finance investment than might be suggested by using GDP as a measure, and correspondingly resort less to using bond markets to finance investment than advanced economies (figure 2.21). But the corporate bond markets of Malaysia and the Republic of Korea look more like advanced economy markets when measured against the size of bank credit (figure 2.22). Most other countries in the region continue to look "over-banked" in relation to the average in advanced economies.

Portfolio allocations and flows – bond markets are not a key source of foreign funds

The ability to mobilize local savings to finance investment within the region is another indicator of Asian bond market development. Ignoring official reserve holdings, overall portfolios are roughly balanced. At

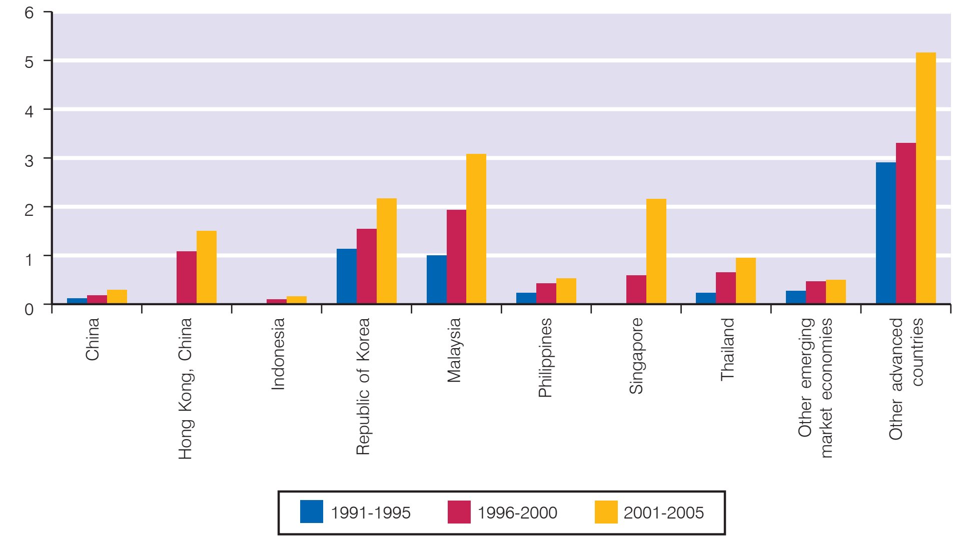
9 In this study the emerging East Asia region refers to the economies of China, Hong Kong, China, Indonesia, Republic of Korea, Malaysia, Singapore and Thailand. For some of the analysis countries may have to be dropped if data limitations do not allow for consideration of all countries.

Figure 2.20. Ratio of non-government debt to GDP increasing



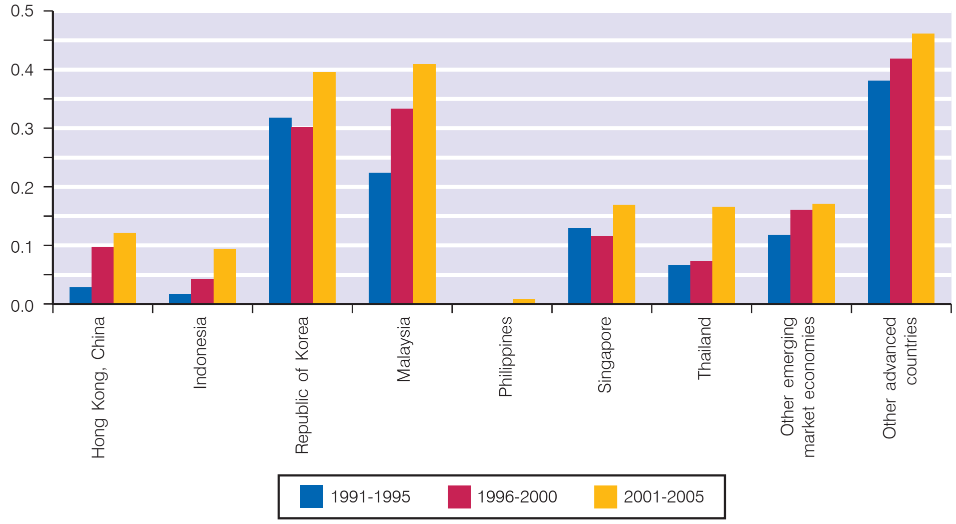
Sources: Bank for International Settlements, tables 12 and 16, except for Hong Kong, China, Indonesia and Singapore 1991-1995 from World Bank Financial Structure Database; GDP data from *World Bank Development Indicators;* and ESCAP estimates.

Figure 2.21. Ratio of non-government debt to investment rising over time



Sources: Bank for International Settlements, tables 12 and 16, except Hong Kong, China, Indonesia and Singapore 1991-1995 from World Bank Financial Structure Database; GDP data from *World Bank Development Indicators;* and ESCAP estimates.

Figure 2.22. Ratio of private domestic bonds on issue relative to bank credit



Source: World Bank, *Financial Structure Database* (Washington, D.C., World Bank, 2006).

the end of 2004, EEA economies held about $380 billion in advanced economy assets, while advanced economies held about $393 billion of EEA assets. However, EEA investors seem to prefer holding advanced economy bonds, while advanced economies prefer not to hold the region's bonds. EEA, for example, held about $268 billion in advanced economy bonds, compared to the holdings of advanced economies of just $78 billion of EEA debt securities. On the other hand, the stock of EEA equities held by advanced economy investors was about $311 billion, while EEA investors held about $111 billion of advanced economy equities. This suggests that bond markets channel capital out of the region, while equity markets attract funds into the region.[10]

Balance of payments flow data, which break down portfolio flows into equity and bond flows, tell a similar story (table 2.12). On the whole, the region experienced an outflow of capital though net purchases of foreign bonds and an inflow through foreign net purchases of domestic equities.

Market liquidity – the main problem

A lack of liquidity can also be a problem: the market is illiquid, participants find it difficult to buy and sell bonds and the market ceases to be a true market. So liquidity is probably the best indicator of bond market development. Bid-ask spreads, i.e. the difference between the buyer's bidding price and the seller's asking price, are a common measure of liquidity, with a smaller spread indicating a more liquid market.

> *Market liquidity is a significant problem in China, Indonesia, the Republic of Korea and Thailand*

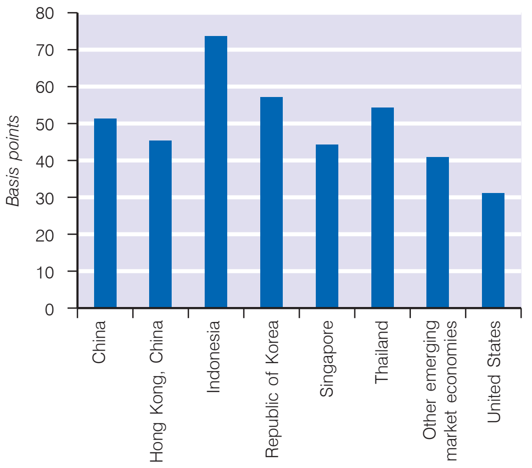
Figure 2.23 presents raw bid-ask estimates for corporate bond markets. According to this measure, all bond markets are less liquid, including the United States market and other emerging markets as well.[11]

[10] These statistics are based on the International Monetary Fund Consolidated Portfolio Investment Survey. Note: there is no data for China. For this study, the advanced economies consist of Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Isle of Man, Italy, Japan, Liechtenstein, Luxembourg, Netherlands, New Zealand, Spain, Sweden, Switzerland, United Kingdom and the United States of America.

[11] The other emerging markets in figures 2.23 and 2.24 are: Argentina, Brazil, Chile, India, Kazakhstan, Mexico, Poland, Russian Federation and South Africa. Some caution is required in comparing markets because the credit risk in the sample is not the same across countries, e.g. the United States market contains bonds of lower credit quality than emerging markets, such bonds typically have higher bid-ask spreads.

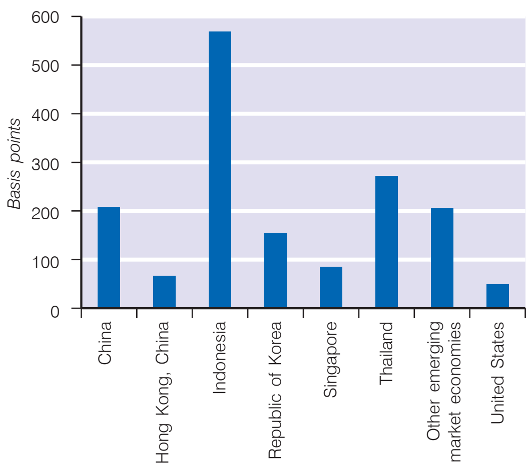
However, the raw bid-ask measure is sometimes considered biased as it ignores cases when no bids or offers are made on a potentially tradable bond. The LOT liquidity measure (limited dependent variable model) (figure 2.24) accounts for this by including estimated shadow bid-ask spreads (see Lesmond *et al,* 1999). Once the adjustment is made, the markets of Singapore and Hong Kong, China appear much more liquid, but less liquid than the United States markets. Liquidity, by either measure, is a significant problem in China, Indonesia, the Republic of Korea and Thailand.

Figure 2.23. Raw bid-ask spreads on corporate bonds – most markets less liquid



Sources: Hund and Lesmond (2007); Chen, Lesmond and Wei (2007); and ESCAP calculations.

Figure 2.24. Shadow bid-ask spread on corporate bonds – Singapore and Hong Kong, China more liquid



Sources: Hund and Lesmond (2007); Chen, Lesmond and Wei (2007); and ESCAP calculations.

The market participant's view – reforms to creditor rights and exchange rate regimes are critical

A recent survey assessed how the current policy environment could be improved to promote commercially viable local currency bond markets in the Asia-Pacific region (Parrenas, 2006).[12] It found that capital market development was a problem in the Asia-Pacific region, and particularly for East Asia. The survey score measuring successful capital market development was 2.49 out of a possible 4 for the Asia-Pacific region (reflecting a view by survey respondents that the policy objective was just "partially to mostly met") and 2.37 for East Asia. The survey also found the objective of deep and liquid markets to be particularly poor; for the Asia-Pacific region the average survey score was 2.27, and for East Asia, 2.09.

"Market liquidity, creditor rights, well established government bond markets identified as most critical"

The survey also asked participants to identify the areas in which reform was most critical, regardless of the degree to which the objectives had been successfully attained (see figure 2.25). Aside from market liquidity, which was perceived as requiring the most urgent attention across all markets, three other areas were identified. For less developed markets, clearly defined creditor rights, better insolvency proceedings

[12] Conducted by the APEC Business Advisory Council, the Pacific Economic Cooperation Council and the Asian Bankers' Association, the survey included respondents from 14 emerging markets in the Asia-Pacific region and received responses from 40 private financial sector institutions, more than two-thirds of whom were banks.

Table 2.12. Cumulative net portfolio flows in East Asia, 2001-2005

(Millions of United States dollars)

	Non-government bonds	All bonds	Equities
China	−25 379.2	−21 411.3	42 128.2
Hong Kong, China	−80 329.3	−80 329.3	−85 166.7
Indonesia	3 071.9	9 463.1	4 258.4
Malaysia	176.8	2 626.3	5 484.7
Philippines	−3 257.0	1 842.0	2 767.0
Republic of Korea	19 365.3	8 593.6	26 621.0
Singapore	..	..	..
Thailand	−2 482.1	−2 206.8	7 598.9
Total	−88 833.5	−81 422.4	3 691.6
Total excluding China	−72 548.0	−68 952.0	3 181.0

Source: International Monetary Fund, *Balance of Payments Statistics* (Washington D,C., IMF, September 2006).

and effective enforcement of creditor rights were seen as being most critical for bond market development.[13] In East Asia, these areas were of less concern in the more developed markets of Hong Kong, China, Malaysia and Singapore, but were clearly viewed as areas that required improvement in most of the other economies. Survey participants highlighted the benchmark government yield curve as an area requiring the most urgent attention of policymakers for the more advanced markets.[14] In East Asia, the objective of having a well established benchmark yield curve was seen as needing improvement in most markets, with an average score of 2.33 out of 4.[15]

The survey respondents from the most advanced markets also highlighted the need for the market to be opened up to many players (both domestic and foreign), continuity in economic policies and an exchange rate regime conducive to capital flows, as critical to local currency and regional bond market development. These responses suggest that market respondents are concerned with the "impossible trinity" discussed in box 2.3. That is, monetary policy needs to be consistent with the exchange rate regime and international capital mobility. Certainly monetary credibility and soundness are often identified in the theoretical literature on the subject (Eichengeen and Hausmann, 1999).

The lack of liquidity in East Asian markets is generally attributed to a preference for "buy and hold". Institutional investors, such as pension funds, buy long-dated fixed income securities to match their liabilities and have relatively little need to redeem them until maturity (IMF, 2005). But in corporate bond markets, weak creditor rights could be another reason for the apparent buy and hold strategy – the need to privately enforce one's creditor rights can make a bond too risky to hold for all but a limited number of "related" investors. For example, Malcolm (1997) reports on liquidity problems in the pre-crisis Hong Kong, China "Dragon Bond" market, where the lack of mechanisms to protect investors from credit risk, and keep them informed of such risks, meant that large banks, which had the resources to actively monitor and evaluate the activities of the borrowers, were the main buyers of bonds. Consequently, there was very little secondary trading, and the bond market acted as a quasi-banking sector.

Reforms to creditor rights and monetary policy could help

The foregoing review of the region's illiquid and relatively small corporate bond markets suggests some role for public policy to improve their functioning:

- establishing and maintaining a benchmark government yield curve;
- pursuing sound monetary policy;
- improving creditor rights.

[13] Less developed markets include China, Indonesia, Mexico, Peru, Philippines, Russian Federation, Thailand and Viet Nam.

[14] These markets included Chile, as well as the East Asian economies of Hong Kong, China, Republic of Korea, Malaysia, Singapore and Taiwan Province of China.

[15] Hong Kong, China, Singapore and Malaysia achieved the highest scores, suggesting that the objective had been mostly met in these countries, while China, Indonesia, Republic of Korea and Thailand received the lowest scores suggesting considerable room for improvement there.

Benchmark government yield curve

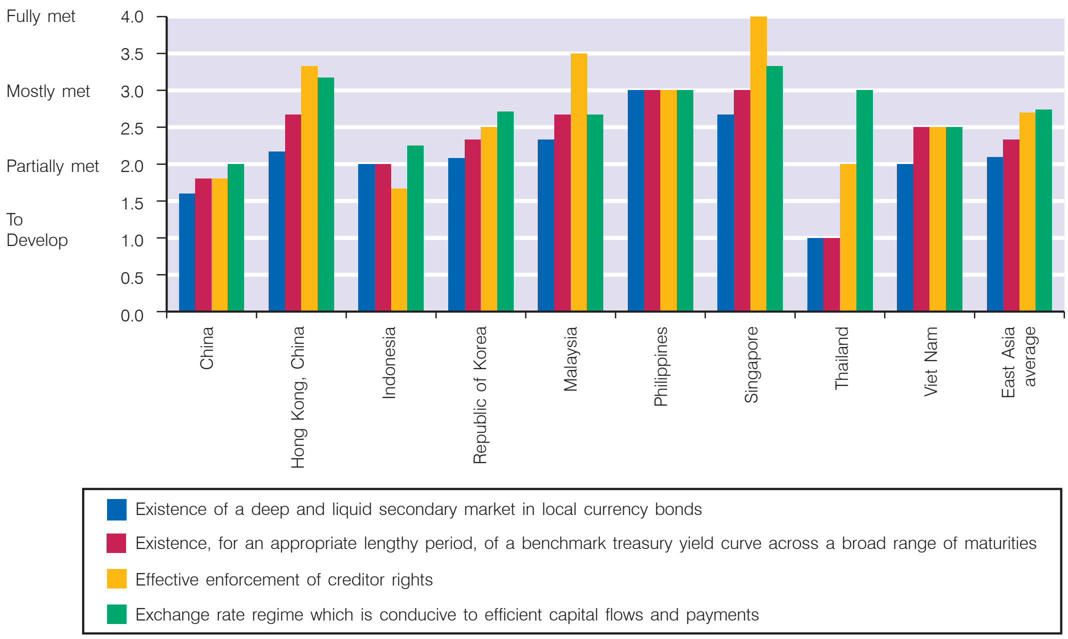
The theoretical benefits of a benchmark yield curve stem from the flow of information on the cost of funds and sovereign risk. Sovereign bonds are relatively well suited for this role because of their fairly straightforward nature. They are easy to price, straightforward to understand and, when market-determined, provide markets with important benchmark information. Since information has "public good" characteristics, the case for Governments to establish these markets as a means of providing this information is relatively uncontroversial. Moreover, the existence of a benchmark Government security can help investors to hedge against macroeconomic risks. Using data from emerging bond markets, Dittmar and Yuan (2006) found that the issuance of benchmark government bonds enhances corporate bond markets by providing more information, stimulating information production and improving liquidity in emerging corporate bond markets.

Sound monetary policies

Creating demand for local currency bonds (both corporate and government) involves adopting policies that produce what Caballero, Cowan and Kearns (2005) refer to as currency trust, i.e. the confidence of investors in the monetary authority's ability to commit to a sound monetary policy. If domestic borrowers are able to issue bonds in domestic currency, they are insured against external shocks that may cause volatility in the exchange rate. Foreign investors will offer this insurance only if they trust that the central bank will not behave opportunistically. If the market lacks confidence that the central bank can guarantee stable monetary policy, lenders will be reluctant to hold bonds denominated in domestic currency (box 2.3 elaborates on some aspects of monetary policy credibility).

Jeanne (2003) develops a formal model to explain why countries with no currency trust face higher local currency borrowing costs, which in turn leads to domestic borrowers preferring to borrow in foreign currency. Burger and Warnock (2006) test the currency trust hypothesis by using a data set that covers 49 domestic bond markets. They find that a history of high inflation volatility (a proxy for poor currency trust) significantly impedes the development of the local bond market and the share of a country's outstanding bonds dominated in local currency. An ESCAP analysis of the effect of past inflationary experience on the currency composition of debt finds that lower money supply growth, lower inflation and less variable inflation are all associated with a greater issuance of domestic

Figure 2.25. Areas where reform is most critical – the degree of policy success



Source: Parrenas (2006).

corporate debt relative to the total amount issued; the association is statistically significant.[16]

Creditor rights

The foregoing discussion suggests that better creditor rights and the enforcement of those rights are important for corporate bond market development and liquidity. This view is consistent with the findings of La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998), who showed that legal protection of creditor rights is important in the development of financial markets. The argument has also been applied to the development of corporate bond markets, and several commentators have claimed that improving and enforcing creditor rights is important in the development of the corporate bond market and market liquidity (see Knight, 2006; and Sundaresan, 2006). The paucity of good and reliable data has not made it possible to conduct an empirical analysis of the effects of creditor rights on corporate bond market liquidity. However, ESCAP analysis, based on a limited set of available data, supports the view that creditor rights are important for emerging bond market liquidity. Again, the association is statistically significant.[17] Further research in this area is crucial to determine what aspects of creditor rights are most important for liquidity and to generalize the findings to a wider range of countries.

Lessons

East Asian bond markets have grown rapidly in recent years, but nonetheless remain underdeveloped, and have not realized their full potential. They are not attracting foreign savings in the same manner that the region's equity markets do, and are not as liquid as might be hoped. Market participants have identified reasons, but among those needing most urgent attention are the lack of a well established government benchmark bond yield curve, concern that the exchange rate regime may not be compatible with capital flows, and weak creditor rights and ineffective enforcement of these rights. These concerns are consistent with available data and economic theory.

In many respects, the recommendation that Governments develop better government bond markets, improve monetary policy and develop better creditor rights is not new. Even so, the foregoing discussion suggests that these issues remain critical if bond markets are to deepen in the East Asian region. Although there are a number of important issues for policymakers to tackle, such as removing taxes and impediments to capital flows, encouraging fair and unbiased credit rating systems and developing the micromarket structure, many of these efforts will fail to bear fruit as long as underlying credit and currency risks remain.

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16 The data set covered the period 2001-2005 for 39 emerging market and advanced economies.

17 The data set covers 14 emerging markets and uses liquidity measures taken from Hund and Lesmond (2007) and a variety of creditor rights and investor protection measures.

Developed countries – modest growth but Japan's revival bodes well for the Asia-Pacific region

In Australia, the economy grew by 2.5%, marking 16 years of expansion (figure 2.26). As in 2005, better terms of trade and strong business investment led the growth in domestic demand. The Japanese economy expanded by 2.2% in 2006, up from 1.9% in the previous year. Business investment was particularly important (see box 2.4). New Zealand continued to expand but at a weaker pace than in 2006, following the considerable slowdown it had experienced in 2005. Domestic demand, the key component of demand growth since 2002, remained weak, prompting a contraction of imports.

> *Australia's exports to China grew at 22.5% per year from 2000 to 2005 while exports to India expanded at 28.8%*

Australia's exports to Asia expanded at 5.9% per year in 2000-2005. Exports to China grew by 22.5% per year in the same period. Exports to India expanded at 28.8% in 2001-2005, jumping from 13th place to the 7th largest export partner of Australia. The growth in the value of exports was outpaced by strong imports in 2006. The current account deficit improved to 5.7% of GDP in 2006 (table 2.13).

For Japan, too, Asian economies, notably China, account for a larger share of trade in recent years. Almost half of Japanese exports go to East Asia, the source of more than 40% of Japanese imports. Export demand recorded double-digit growth in the second half of 2005 and the first half of 2006.

Strong export growth was exceeded, however, by robust merchandise imports in 2006, driven by higher prices for oil and raw materials. Continuing growth of domestic demand, in particular in business investment, also contributed to the strong growth of imports.

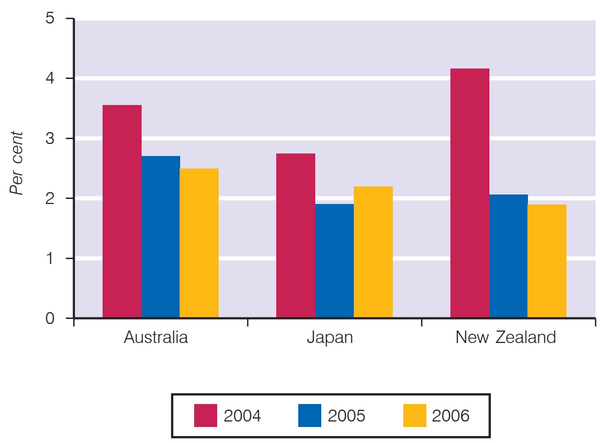
> *Almost half of Japanese exports go to East Asia, the source of more than 40% of Japanese imports*

In New Zealand, the trade deficit has narrowed since late 2005. International prices of the country's key primary commodities have risen to near historical highs in recent years, reflecting tight supplies. The growth of agricultural exports, however, was muted by weak manufacturing exports, which struggled with a strong currency, international competition and increasing input costs. Imports slowed significantly mainly as a result of reductions in capital equipment and intermediate goods, thereby continuing the decline that had begun in late 2005. The current account deficit remained alarmingly high at 8.1% of GDP in 2006.

Inflation pressure appeared to be looming in Australia, reflecting the combination of higher commodity prices and tight capacity. Consumer price inflation was contained, although the high prices of oil and bananas pushed the consumer price index from 2.7% in 2005 to 3.9% for the year to September 2006.

Japan appeared to have finally moved out of a seven-year-long period of deflationary pressure. Corporate

Figure 2.26. Economic growth picks up in Japan



Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); and ESCAP estimates.

Note: Data for 2006 are estimates.

Box 2.4. Asia-Pacific economies set to benefit from Japan's revival

The end of deflation has confirmed the recovery of the Japanese economy. GDP growth has continued to be robust this year, following on the good performance of the three previous years. Consumer price inflation was positive in the first half of 2006, following seven years of negative price growth. Japan's low but positive inflation rate augurs well for the healthy functioning of the economy as falling prices had discouraged investment and firms experienced eroding profitability and rising real debt burdens.

Japanese growth is being supported by increasing private consumption. Exports fuelled economic development in the past few years as the domestic economy remained subdued. Japanese enterprises are once again beginning to hire new workers following buoyant corporate profits.

Japan's revival will help the Asia-Pacific region to counteract the effects of a slowing United States economy, which remains the main market for most Asian economies. The size of the Japanese economy, the world's second largest and about twice the size of China, implies that even a modest expansion will have enormous effects on the region.

ESCAP simulations show that, if Japanese consumption were to grow at the same average annual rate of 4.4% as it did in the late 1980s, GDP growth in Japan and developing Asian economies would increase by 1.4 and 0.2 percentage points, respectively. Net exports of developing Asian economies would improve by 2.3 percentage points, while their current account balance as a percentage of GDP would increase by 0.1 percentage point.

Japan's economic revival is both a cause and consequence of China's success; Japanese enterprises are producing final goods in China, which have been assembled using inputs from Japan, and being sold in the United States. China was Japan's second largest trading partner in 2005, representing 17% of Japan's total trade – a slightly lower share than its total trade with the United States. Japan is China's third largest trading partner – with close to 13% of China's total trade – after the United States and the European Union. China is by far Japan's largest source of imports, accounting for 21% of Japan's total imports in 2005. These developments confirm how the economic prospects of Japan and China are now inextricably linked.

Renewed economic vigour in Japan has created significant export opportunities for other Asian economies as well. East Asian exports (excluding those of China) to Japan have increased by 32% in the past five years and accounted for more than 20% of Japanese imports. These exports have been driven by increased demand for primary commodities, as well as surging consumer demand for final goods. Commodity-producing economies, such as Indonesia and some of the Central Asian countries, will continue to benefit from this development. Increased demand for consumer goods will also benefit ASEAN economies. These countries are particularly favoured by Japanese enterprises as overseas manufacturing bases to satisfy demand for home electronics in Japan.

With the growing importance of Asian countries as trade partners, a solid recovery of Japanese economy will benefit the countries in the region, while the sustainability of the current growth depends largely on the growth of Japan's domestic consumer demand.

price inflation, which registers changes in wholesale prices, was growing fast, while consumer price inflation was hovering around zero. In New Zealand, the consumer price index recorded an annualized increase of 4% in the second quarter of 2006, followed by 3.5% in the third quarter.

In Australia, economic growth is expected to continue in the coming years, expanding at around 3%. Domestic demand is expected to remain strong. In Japan, growth is also expected to continue in the coming years, although at less than 2%. The performance of the corporate sector will remain favourable, while the growth of consumer expenditure may depend on income growth. In New Zealand, weaker consumer demand and business investment will drag GDP growth to around 1.8% in 2007, with an expected rebound the following year.

Table 2.13. Current accounts improve

(Per cent)

	Exports/GDP		Imports/GDP		Current account balance/GDP	
	2005	**2006**	**2005**	**2006**	**2005**	**2006**
Australia	15.4	17.7	17.4	19.0	−6.0	−5.7
Japan	12.5	14.0	10.4	12.3	3.6	3.7
New Zealand	20.0	22.0	24.2	25.1	−8.8	−8.1
	Growth rates (per cent)					
	Exports			**Imports**		
	2004	**2005**	**2006**	**2004**	**2005**	**2006**
Australia	−2.9	14.7	22.6	−3.4	7.5	16.7
Japan	20.5	5.4	7.5	19.3	15.8	13.6
New Zealand	15.9	9.4	−4.2	20.7	14.5	−2.1

Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2006); and ESCAP estimates.

Notes: Data for 2006 are estimates. Trade figures for 2006 refer to January-October, except New Zealand which refers to January-September. New Zealand's import values are expressed as f.o.b. Exports/GDP and imports/GDP for 2006 refer to the first three quarters.

Policy research feature 2.5: Are inequality and poverty rising in Japan?

Recent increases in the Gini coefficient and relative poverty rate are leading observers to conclude that inequality and poverty are on the rise in Japan (OECD, 2006). This contrasts with the perception of Japan as an egalitarian society with most Japanese considering themselves as "middle class". Some observers see the deterioration of living conditions as more psychological rather than actual, with higher unemployment, declining household income and more homeless people in urban areas.[18] Others see the inequality and poverty that became prevalent during the decade-long recession as serious. Japan's challenges may be a signal of what other countries may have to face in the future: an ageing population; an unsustainable social security scheme to support the elderly; economic recessions prompting budget deficits and social spending on the unemployed.

> *Some observers see the deterioration of living conditions as more psychological than actual*

A less equal society? Income inequality is rising

The inequality of household income, as measured by the Gini coefficient, has been increasing gradually in Japan since the 1980s and is now rising much faster than the average in the OECD countries (OECD, 2006). Other measures, such as the P90/P10 decile ratio,[19] reflect similar trends.

This development is considered as a reflection of changing demographic and household composition.[20] Older people typically exhibit wider income inequality within their own age group because many of them do not receive any wage income. So an increase in the size of the elderly population increases the weight of low-income groups, thereby pushing up the Gini coefficient. Moreover, observations of household sizes indicate a growing number of one-person households and thus low-income households, contributing to the higher Gini coefficient.

> *The widening wage disparity among young people is a great concern as it reflects a rising number of lower paid non-regular workers*

Japan's ageing population and inequality among the elderly is creating a growing pool of poor and old people. Moreover, the widening wage disparity among young people is of great concern as it reflects a rising number of lower paid non-regular workers (Ota, 2005). In the long run, their limited income prospects could translate into wider and more persistent inequality among the population as a whole (Japan, Ministry of Health, Labour and Welfare, 2006a).

Wage inequality, too, is rising

The inequality of individual wages has also increased in the past decade, particularly among younger generations. The Gini coefficient of wage income for those aged 25-34 increased from about 0.22 in 1994 to about 0.25 in 2005, while that of those aged 45-54 remained about 0.3 (JRI, 2006). This trend reflects an increase in non-regular workers, who typically earn much lower salaries than regular workers, as well as a large increase in non-regular workers among the young. The wages for non-regular workers are on average 40% lower than those of regular workers, and many do not have the same social security coverage that regular workers enjoy. The number of non-regular workers has doubled in the past five years and many of them hold part-time jobs (figure 2.27). The increase in part-time workers among younger age groups is particularly significant, as reflected in the proportion of male part-time workers aged 20-24, which jumped from around 3% in 1990 to almost 25% in 2005.

The above observations prompt concern over a further widening of inequality. Many young low-income earners live with their parents or expect some support from them, so the impact on household inequality has not yet become apparent. Non-regular workers seeking regular employment face towering barriers.

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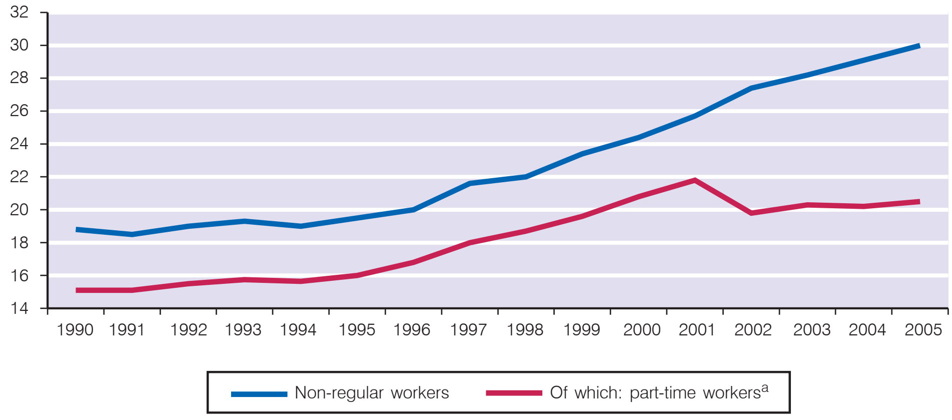
18 Ministry of Health, Labour and Welfare website, <www.mhlw.go.jp/houdou/2003/03/no326-5.html>.

19 The ratio of the lower bound value of the top income decile to that of the bottom.

20 Japan, Cabinet Office website, reference material for Monthly Economic Report, <http://www5.cao.go.jp/keisai3/getsurei-s/0601/pdf>, January 2006.

Figure 2.27. The share of non-regular workers

(Per cent of total employed persons)



Source: Organisation for Economic Co-operation and Development, *Economic Survey: Japan* (Paris, OECD, 2006).

[a] The significant fall in the number of part-time workers in 2002 and the rise in the other categories is thought to be due to a change in the questionnaire.

Young regular workers can expect higher incomes as they approach retirement, while the wages of those in part-time work will remain almost flat until their retirement (figures 2.28 and 2.29). For non-regular full-time workers, the hourly wages are not necessarily lower than those of regular workers. But their limited social security coverage – either because they were themselves unwilling to seek proper coverage due to a reluctance on the part of the employers – and limited on-the-job training opportunities inject uncertainty into their earning prospects.

> *Young people who missed the opportunity to start their career as regular workers during the recession are continuing to experience difficulties in transferring to regular employment*

Recent data show some increase in regular employment along with economic recovery, with the share of part-time workers unchanged or declining among the young. However, the share of part-time workers aged 25-29 is still edging up, suggesting that those who missed the opportunity to start their career as regular workers during the recession may be continuing to experience difficulties in transferring to regular employment.

Employees receive fewer benefits of growth

Despite the economic recovery, employees do not seem to have shared the benefits. The share of employee income in the national income has declined over the past five years as corporate income has increased steadily (figure 2.30).[21]

Evidence of poverty

Relative poverty.[22] Examining poverty in a developed country requires different indicators from those for developing countries. According to the OECD, the relative poverty rate increased in Japan from 11.9% in the mid-1980s to 15.3% in 2000. Poverty gaps – the extent to which the average income of the poor falls below the poverty threshold – has also increased. A combination of these two indicators rates Japan as having the third highest incidence of poverty among the 27 OECD countries, following Mexico and the United States.[23]

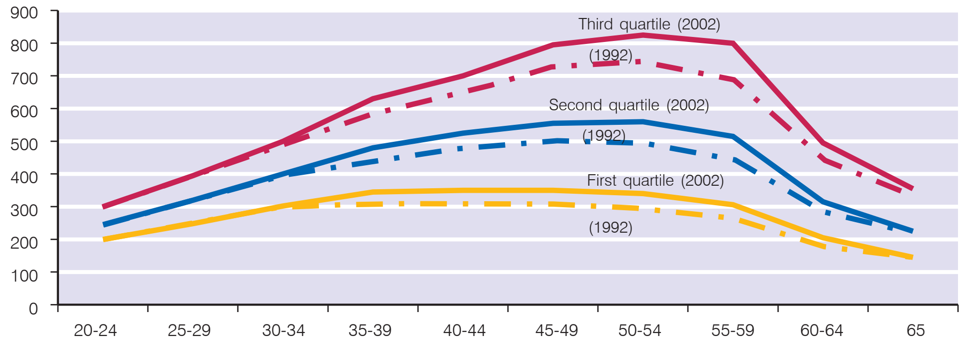
[21] Japan, Cabinet Office website, <http://www.esri.cao.go.jp/en/sna/h16-kaku/96ffm2_en.xls>.

[22] The relative poverty rate is the share of people with equalized disposable income less than half of the median income.

[23] It is the poverty rate multiplied by the poverty gap, measuring the size of the income transfer required to raise all those in poverty up to the poverty threshold.

Figure 2.28. Annual income of regular workers

(10 000 yen)

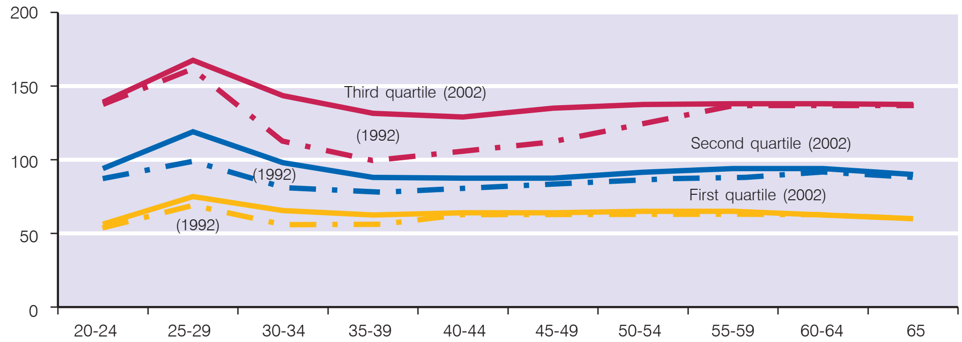


Source: Japan, Ministry of Health, Labour and Welfare, *Analysis of Labour Economy* (Tokyo, 2006).

Note: The data above shows the annual income (2002 in solid line and 1992 in broken line) for the lowest three quartiles of population by income.

Figure 2.29. Annual income of part-time workers

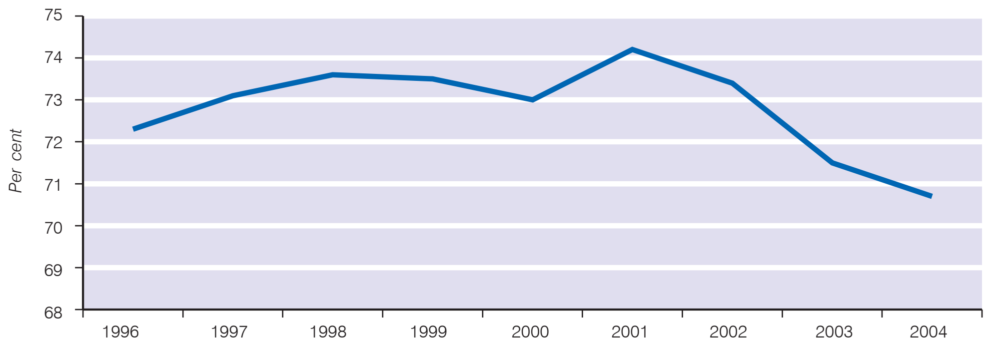
(10 000 yen)



Source: Japan, Ministry of Health, Labour and Welfare, *Analysis of Labour Economy* (Tokyo, 2006).

Note: The data above shows the annual income (2002 in solid line and 1992 in broken line) for the lowest three quartiles of population by income.

Figure 2.30. Share of wages and salaries and employers' social contribution in national income



Source: Japan, Cabinet Office, *Distribution of National Income and National disposable Income* (Tokyo, 2006).

> *"Using the threshold for social assistance for different types of households, poverty rates increased from 7.5% in 1995 to 10.8% in 2001"*

Absolute poverty. While there is no clearly defined national poverty line in Japan, the criterion for assistance under the social welfare scheme, those persons who are unable to provide a minimum living standard – may be considered as a proxy for the absolute poverty line. The threshold amount varies depending on the size of households, age of family members and geographic locations. For instance, in 2004, it was set at ¥162,170 for a household with three family members in a large city, and ¥62,640 for a household of one elderly person in a rural area.[24] Using the threshold for social assistance for different types of households, one study estimates that poverty rates increased from 7.5% in 1995 to 10.8% in 2001, and from 7.5% to 16.5% for working age one-person households (Tachibanaki and Urakawa, 2006).

More dependence on social security

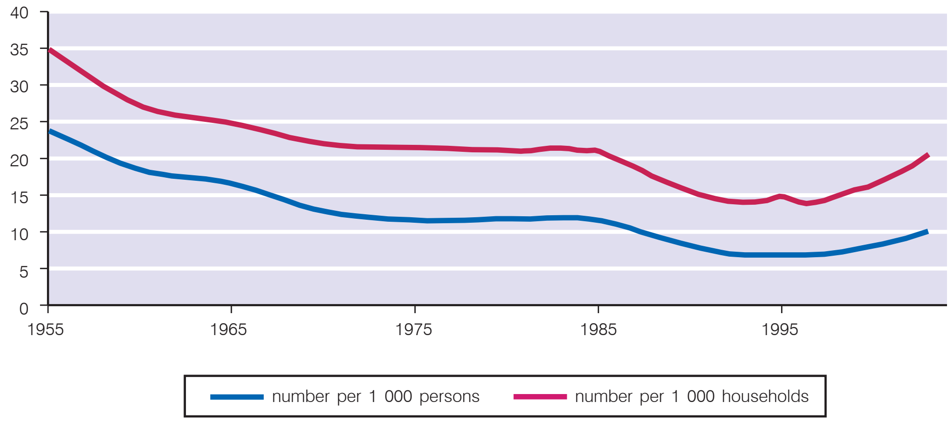
The number of people relying on social security has increased since the mid-1990s. The number of beneficiaries rose from less than 0.6% to more than 1% of total population (figure 2.31). By 2005, more than 1.2 million people received income support. And according to some estimates, the actual number of beneficiaries is less than 20% of those eligible.

Fewer households saving

In 2003, one household in five said it had no savings. The ratio of total savings to GDP has fallen from around 16% in 1992 to just around 6% in 2002. And the share of households with no savings or financial assets has increased to 21.8% in 2003, a sharp contrast to the 5-10% in the 1970s and mid-1980s. The increase is particularly significant among the young, partly reflecting consumption patterns and the rise in low-paid part-time work.

The over 60 age group has reduced its savings rate in the past 10 years, while other age groups maintained more or less similar trends, suggesting that the older generations were obliged to dissave to meet pressing needs.

Figure 2.31. Share of beneficiaries of social assistance



Source: Japan, National Institute of Population and Social Security Research.

Note: The long-term decline over the last 50 years reflects the income level at the time as well as changes in the coverage of the scheme in terms of income thresholds and eligibility criteria.

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24 Japan, Ministry of Health, Labour and Welfare website, <http://www.mhlw.go.jp/bunya/seikatsuhogo/seikatuhogo.html>.

More people without State pensions

The population not covered by any pension scheme has increased from 31.2% (male) and 36.6% (female) of the total population in 1995 to 36.3% and 41.4% in 2004 (Japan, Ministry of Health, Labour and Welfare, 2006b). Those receiving State pensions, including many non-regular workers, are receiving pensions that are lower than the threshold for social assistance. This contrasts starkly with pensions for regular workers who receive a basic pension in addition to a pension based on their earnings, which is on average three times the amount of the basic pension.[25]

Fewer opportunities to move out of poverty?

Some argue that income inequality is not a major issue as long as there is reasonable equality in mobility opportunities among the different income groups. But there are difficulties in moving from non-regular employment, or unemployment to regular employment, which around 70% of young people (20-34 years old) prefer (Japan, 2005). And employers are still reluctant to take on more regular workers and convert non-regular workers into regular workers. Higher education will not resolve this problem as the cost is prohibitively high for low-income households, which in turn limits their opportunities and their prospects for higher incomes.

25 Japan, Tokyo Metropolitan Government, Bureau of General Affairs website, <http://www.toukei.metro.tokyo.jp/ssihyou/ss05qd0100.pdf>.

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