ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

Economic and Social SURVEY of Asia and the Pacific 2004

Asia-Pacific Economies: Sustaining Growth and Tackling Poverty

UNITED NATIONS

ESCAP WORKS TOWARDS REDUCING POVERTY AND MANAGING GLOBALIZATION

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ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC 2004

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FOREWORD

Despite the war in Iraq and the SARS crisis, the ESCAP developing region continued to show robust growth in 2003. Regional growth was broad-based, while inflation remained low. Again, the main driving force behind the region's dynamic performance was intraregional trade and domestic demand.

Barring significant negative shocks, the collective growth rate in the ESCAP developing region should be largely sustained. Nevertheless, several issues require policy attention, including ways to maintain sound macroeconomic fundamentals and implement ongoing reform. In addition, cross-border collaboration and initiatives will be needed to foster and accelerate cooperation across a wide range of issues facing the region.

The region's greatest challenge, however, remains the fight against poverty. This year's *Survey* examines poverty reduction strategies adopted by members, with particular emphasis on their effectiveness in helping to reach the Millennium Development Goals. The multidimensional nature of poverty makes the work to address it a complex task. Achieving better methods for measuring progress is essential. And effective implementation requires a genuine partnership among all actors, north and south. Just as developing countries have to make hard choices to achieve their development goals, the international community needs to support their efforts by developing a global partnership for development. I hope the *Survey* will contribute to a greater understanding of the challenges facing the region, and help guide all stakeholders in their efforts to make a visible difference in people's lives.

Kofi A. Annan
Secretary-General

March 2004

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EXPLANATORY NOTES

The term "ESCAP region" is used in the present issue of the *Survey* to include Afghanistan; American Samoa; Armenia; Australia; Azerbaijan; Bangladesh; Bhutan; Brunei Darussalam; Cambodia; China; Cook Islands; Democratic People's Republic of Korea; Fiji; French Polynesia; Georgia; Guam; Hong Kong, China; India; Indonesia; Iran (Islamic Republic of); Japan; Kazakhstan; Kiribati; Kyrgyzstan; Lao People's Democratic Republic; Macao, China; Malaysia; Maldives; Marshall Islands; Micronesia (Federated States of); Mongolia; Myanmar; Nauru; Nepal; New Caledonia; New Zealand; Niue; Northern Mariana Islands; Pakistan; Palau; Papua New Guinea; Philippines; Republic of Korea; Russian Federation; Samoa; Singapore; Solomon Islands; Sri Lanka; Tajikistan; Thailand; Timor-Leste; Tonga; Turkey; Turkmenistan; Tuvalu; Uzbekistan; Vanuatu; and Viet Nam. The term "developing ESCAP region" excludes Australia, Japan and New Zealand.

The term "Central Asian republics" in this issue of the *Survey* refers to Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

Mention of firm names and commercial products does not imply the endorsement of the United Nations.

The abbreviated title *Survey* in footnotes refers to the *Economic and Social Survey of Asia and the Pacific* for the year indicated.

Many figures used in the *Survey* are on a fiscal year basis and are assigned to the calendar year which covers the major part or second half of the fiscal year.

Growth rates are on an annual basis, except where indicated otherwise.

Reference to "tons" indicates metric tons.

Values are in United States dollars unless specified otherwise.

The term "billion" signifies a thousand million. The term "trillion" signifies a million million.

In the tables, two dots (..) indicate that data are not available or are not separately reported, a dash (–) indicates that the amount is nil or negligible, and a blank indicates that the item is not applicable.

In dates, a hyphen (-) is used to signify the full period involved, including the beginning and end years, and a stroke (/) indicates a crop year, a fiscal year or plan year. The fiscal years, currencies and 2003 exchange rates of the economies in the ESCAP region are listed in the following table:

Country or area	*Fiscal year*	*Currency and abbreviation*	*Rate of exchange for $1 as at November 2003*
Afghanistan	21 March to 20 March	afghani (Af)	3 000.00
American Samoa	..	United States dollar ($)	1.00
Armenia	1 January to 31 December	dram	566.17
Australia	1 July to 30 June	Australian dollar ($A)	1.39
Azerbaijan	1 January to 31 December	Azeri manat (AZM)	4 910.00[a]
Bangladesh	1 July to 30 June	taka (Tk)	58.44
Bhutan	1 July to 30 June	ngultrum (Nu)	45.93
Brunei Darussalam	1 January to 31 December	Brunei dollar (B$)	1.73
Cambodia	1 January to 31 December	riel (CR)	3 985.00
China	1 January to 31 December	yuan renminbi (Y)	8.28
Cook Islands	1 April to 31 March	New Zealand dollar ($NZ)	1.56
Democratic People's Republic of Korea	..	won (W)	2.20
Fiji	1 January to 31 December	Fiji dollar (F$)	1.77
French Polynesia	..	French Pacific Community franc (FCFP)	103.80[b]

Country or area	Fiscal year	Currency and abbreviation	Rate of exchange for $1 as at November 2003
Georgia	1 January to 31 December	lari (L)	2.19
Guam	1 October to 30 September	United States dollar ($)	1.00
Hong Kong, China	1 April to 31 March	Hong Kong dollar (HK$)	7.76
India	1 April to 31 March	Indian rupee (Rs)	45.93
Indonesia	1 April to 31 March	Indonesian rupiah (Rp)	8 537.00
Iran (Islamic Republic of)	21 March to 20 March	Iranian rial (Rls)	8 308.90
Japan	1 April to 31 March	yen (¥)	109.50
Kazakhstan	1 January to 31 December	tenge (T)	146.61
Kiribati	1 January to 31 December	Australian dollar ($A)	1.39
Kyrgyzstan	1 January to 31 December	som (som)	43.91
Lao People's Democratic Republic	1 October to 30 September	new kip (NK)	10 630.00[c]
Macao, China	1 July to 30 June	pataca (P)	8.00
Malaysia	1 January to 31 December	ringgit (M$)	3.80
Maldives	1 January to 31 December	rufiyaa (Rf)	12.80
Marshall Islands	1 October to 30 September	United States dollar ($)	1.00
Micronesia (Federated States of)	1 October to 30 September	United States dollar ($)	1.00
Mongolia	1 January to 31 December	tugrik (Tug)	1 153.00[d]
Myanmar	1 April to 31 March	kyat (K)	5.93
Nauru	1 July to 30 June	Australian dollar ($A)	1.41
Nepal	16 July to 15 July	Nepalese rupee (NRs)	73.79
New Caledonia	..	French Pacific Community franc (FCFP)	103.80[b]
New Zealand	1 April to 31 March	New Zealand dollar ($NZ)	1.56
Niue	1 April to 31 March	New Zealand dollar ($NZ)	1.56
Northern Mariana Islands	1 October to 30 September	United States dollar ($)	1.00
Pakistan	1 July to 30 June	Pakistan rupee (PRs)	57.22
Palau	1 October to 30 September	United States dollar ($)	1.00
Papua New Guinea	1 January to 31 December	kina (K)	3.36
Philippines	1 January to 31 December	Philippine peso (P)	55.77
Republic of Korea	1 January to 31 December	won (W)	1 202.10
Russian Federation	1 January to 31 December	rouble (R)	29.74
Samoa	1 July to 30 June	tala (WS$)	2.84
Singapore	1 April to 31 March	Singapore dollar (S$)	1.73
Solomon Islands	1 January to 31 December	Solomon Islands dollar (SI$)	7.52[d]
Sri Lanka	1 January to 31 December	Sri Lanka rupee (SL Rs)	96.50
Tajikistan	1 January to 31 December	somoni	3.05[e]
Thailand	1 October to 30 September	baht (B)	39.87
Timor-Leste	1 July to 30 June	United States dollar ($)	1.00
Tonga	1 July to 30 June	pa'anga (T$)	2.14[a]
Turkey	1 January to 31 December	Turkish lira (LT)	1 458 790.00
Turkmenistan	1 January to 31 December	Turkmen manat (M)	5 200.00
Tuvalu	1 January to 31 December	Australian dollar ($A)	1.41
Uzbekistan	1 January to 31 December	sum (sum)	975.37
Vanuatu	1 January to 31 December	vatu (VT)	116.57[e]
Viet Nam	1 January to 31 December	dong (D)	15 557.00[a]

Sources: United Nations, *Monthly Bulletin of Statistics*, available at <http://esa.un.org/unsd/mbs/mbssearch.asp> (13 February 2004); IMF, *International Financial Statistics* (CD-ROM), January 2004; and Economist Intelligence Unit, *Country Reports,* available at <http://db.eiu.com/countries.asp> (22 January 2004).

[a] September 2003
[b] Average 2003.
[c] August 2003.
[d] July 2003.
[e] October 2003.

ABBREVIATIONS

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
c.i.f.	cost, insurance, freight
CD-ROM	compact disk read-only memory
CIS	Commonwealth of Independent States
CPI	consumer price index
ECO	Economic Cooperation Organization
EIU	Economist Intelligence Unit
EU	European Union
FDI	foreign direct investment
f.o.b.	free on board
FTAs	free trade agreements
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
HIV/AIDS	human immunodeficiency virus/acquired immunodeficiency syndrome
ICT	information and communication technology
IDA	International Development Assistance
IMF	International Monetary Fund
IT	information technology
M2	broad money supply
NPLs	non-performing loans
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
PPP	purchasing power parity
RTAs	regional trade agreements
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asian Free Trade Area

ABBREVIATIONS *(continued)*

SARS	severe acute respiratory syndrome
SMEs	small and medium-sized enterprises
SOEs	State-owned enterprises
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF	United Nations Children's Fund
VAT	value added tax
WHO	World Health Organization
WTO	World Trade Organization

I GLOBAL AND REGIONAL ECONOMIC DEVELOPMENTS: IMPLICATIONS AND PROSPECTS FOR THE ESCAP REGION[1]

THE GLOBAL SETTING

The global economy showed unexpected strength in 2003

Boosted by higher growth in the United States of America, Japan and China, the global economy, including the ESCAP region, showed unexpected strength in 2003. Indeed, initial estimates suggest that global GDP growth in 2003 will exceed the performance in 2002. Inflationary pressures have risen only slightly, despite higher commodity prices and volatility in the energy markets; as a result, monetary authorities virtually across the world have been able to maintain an environment of low interest rates. Buoyant global growth, already reflected in rising stock markets, is adding to business and consumer confidence and should translate into higher corporate investment activity, thus providing a platform for faster growth in the medium term. Assuming that there are no significant negative shocks, the prospects for the global economy in 2004 are broadly positive. Global GDP growth for the year as a whole could be 0.7 percentage points more than in 2003. Selected indicators of global economic conditions and forecasts for 2004 are given in table I.1.

However, at the same time as growth picks up steam, new policy issues will inevitably arise in the months ahead, including the impact of unexpected events such as animal pandemics. In addition, as explained in the concluding section of this chapter, short-term policy issues have to be placed within a longer-term continuum. Most countries in the ESCAP region have to confront major development challenges that go beyond short-term economic management and embody structural change, such as progress in poverty eradication, in accordance with internationally agreed goals and commitments, notably the Millennium Development Goals. However, these longer-term objectives may not be reached if there is preoccupation with the short term and in the absence of more explicit policy interventions involving the application of additional financial and non-financial resources.

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[1] This is a revised and updated version of "Global and regional economic developments: implications and prospects for the ESCAP region", in *Bulletin on Asia-Pacific Perspectives 2003/04* (United Nations publication, Sales No. E.03.II.F.52).

Table I.1. Selected indicators of global economic conditions, 2000-2004

		2000	*2001*	*2002*	*2003*[a]	*2004*[b]
Economic growth (percentage change of GDP)						
World						
At market exchange rates		3.9	1.4	1.7	2.5	3.5
At PPP exchange rates		4.6	2.2	2.7	3.3	4.0
Developed economies		3.4	1.0	1.2	2.0	3.0
Japan		2.8	0.4	–0.4	2.7	2.1
United States		3.7	0.5	2.2	3.1	4.5
European Union		3.6	1.7	1.1	0.9	2.2
Developing economies		5.7	2.1	3.2	3.8	5.0
Economies in transition		6.7	4.4	3.9	5.1	4.7
Developing economies in the ESCAP region		7.4	3.5	5.7	6.0	6.2
Growth in volume of trade (percentage)[c]						
World		12.6	0.1	3.2	2.9	5.5
Developed economies	Exports	12.0	–0.8	2.2	1.6	5.2
	Imports	11.9	–1.0	2.2	2.8	4.8
Developing economies	Exports	14.4	2.7	6.5	4.3	6.9
	Imports	16.1	1.6	6.0	5.1	7.8
Commodity prices (annual percentage change in dollar terms)						
Non-fuel primary commodities		4.5	–4.0	0.6	5.0	2.4
Oil		57.0	–14.0	2.8	14.2	–10.5
Inflation rate (percentage)						
CPI in the developed economies		2.2	2.2	1.3	1.5	1.3
CPI in the developing economies		5.8	5.8	6.8	7.4	6.5
Short-term interest rates						
United States		6.5	3.7	1.8	1.2	1.5
Japan		0.2	0.1	0.1	0.0	0.0
Euro area		4.4	4.3	3.3	2.3	2.0
Exchange rates (nominal units per dollar)[d]						
Yen per dollar		107.8	121.5	125.4	116.0	104.5
Euros per dollar		1.085	1.118	1.062	0.887	0.741

Sources: United Nations, *World Economic and Social Survey 2003* (advance copy); IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, IMF, 2003) and *International Financial Statistics*, vol. LVI, No. 12 (Washington, IMF, December 2003); OECD, *OECD Economic Outlook No. 74* (Paris, OECD, December 2003) at OECD web site <http://www.oecd.org/dataoecd/5/50/2483826>, accessed on 19 January 2004; *The Economist,* 10 January 2004; and national sources.

[a] Preliminary estimates.
[b] Forecast.
[c] Exports and imports (goods and services).
[d] Period average.

Within the ESCAP region, despite the rise in intraregional trade and the impact of domestic growth-enhancing measures, reliance on the United States economy remains significant; the United States still directly accounts for over 20 per cent of the exports of developing countries of the ESCAP region. The sharp weakening of the dollar in response to the growing fiscal and current account deficits of the United States and the appreciation of a number of regional currencies in recent months could pose new policy issues in 2004. Concurrently, in many developing economies of the region, while overall external positions remain favourable, domestic public debt is rising. This rising incidence of international and domestic macroeconomic imbalances could presage significantly increased instability in global financial markets in 2004, affecting business and consumer confidence alike. After the outbreaks of SARS in 2003 and avian influenza in early 2004, issues of public health and their implications for confidence have acquired new importance and urgency in the region.

Grounds for cautious optimism for 2004

In the near term, Governments of ESCAP member countries are faced with the policy challenges of sustaining the momentum of growth by preserving the rising business and consumer confidence, as manifested in buoyant stock markets, maintaining their commitment to the agenda of trade liberalization in the face of setbacks and difficulties in negotiations, such as those at the Fifth WTO Ministerial Conference, held at Cancún, Mexico, in September 2003, and coping with the rapid increase in bilateral trade agreements. While there are grounds for cautious optimism with respect to the near-term growth prospects on the assumption that the region does not have to deal with new negative shocks, it would be imprudent to postulate that all countries will be able to negotiate the next 12-18 months smoothly. As stressed by the ESCAP secretariat in previous issues of the *Economic and Social Survey of Asia and the Pacific,* individual Governments need to remain strongly committed to macroeconomic prudence, good governance and flexibility in day-to-day economic management and be alert to unforeseen dangers such as public health crises. Simultaneously, Governments must facilitate structural change to enable their economies to maintain competitiveness in a globalizing world economy. For the long term, the greatest challenges for the developing countries in particular emanate from meeting the Millennium Development Goals and agreements on sustainable development reached at the World Summit on Sustainable Development.

In the following pages, the differing roles of the developed and developing economies in terms of their participation in global trade and financial markets are analysed and the likely impact of prevailing global trends on the economies of the ESCAP region are assessed. Finally, the near-term policy issues and long-term development challenges facing the ESCAP region are considered.

DEVELOPED COUNTRIES

Despite a combination of low interest rates and higher government spending, output growth in the developed economies remained sluggish up to the middle of 2003. There were more visible signs of a pickup in the pace of growth in both the United States and Japan, particularly the former, but output growth in the European Union remained lacklustre in 2003. However, the consensus of opinion is that growth in the EU could gain momentum in 2004 despite the appreciation of the euro. Taking the triad of the United States, Japan and the EU together, there is now a degree of optimism that the next 12 months should see a steady improvement in GDP performance compared with 2003. While this assessment is the most probable scenario on the basis of currently available information, it is nevertheless subject to a number of risks.

Uncertain prospects for more robust growth in the United States in 2004

First, in the United States, household spending has been the principal driver of growth since the ending of the IT bubble in 2000. Corporate investment expenditure is now beginning to pick up significantly. Profitability is improving and this, combined with low borrowing costs, is expected to translate into higher investment expenditure in the months ahead. New capital equipment is also likely to be needed after two years of declining investment and on account of the rapid obsolescence of most ICT-related high-tech capital equipment.[2] Nevertheless, corporations remain saddled with enormous debts, a legacy of the post-bubble economy, and any broad-based investment upturn in the near term is likely to be tentative for now.

Second, while there are encouraging signs with regard to corporate capital investment, question marks hang over both the sustainability of household spending in the face of surprisingly weak employment data; the wider repercussions of the twin deficits, external and fiscal, on growth in the United States economy over the next 12 months are another concern. Consumer and business confidence revived strongly following the formal ending of military action in Iraq but subsequent events in that country have served to undermine both to some extent. As a result, there are signs that spending on durable goods is tending to weaken. In particular, remortgages, a major factor in sustaining consumer spending over the last two or three years, appear to be tailing off as a result of uncertainty on the jobs front. Growth in the United States economy in both 2002 and 2003 has not been accompanied by higher employment thus far. On the contrary, in November 2003 unemployment was at 5.9 per cent, as it had been in November 2002, and job losses continue to occur in the manufacturing sector although the rate appears to have declined following the weakening of the dollar in the second half of 2003.

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[2] The Semiconductor Industry Association was predicting growth of semiconductor sales by 10.1 per cent in 2003 and 16.8 per cent in 2004 (*Bangkok Post,* 6 August 2003).

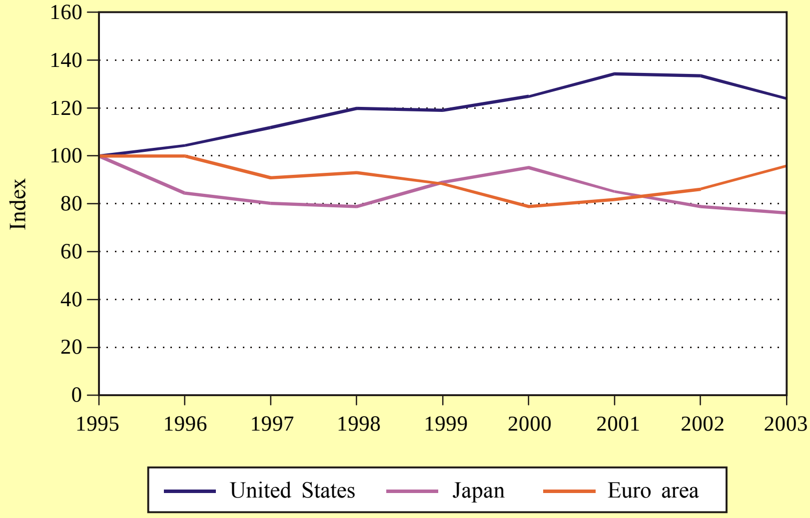
The current account and fiscal deficits in the United States are a worry

Third, with regard to the simultaneous emergence of the twin deficits, the situation has significant worrisome elements. The United States current account deficit of 5.2 per cent of GDP is the worst in the country's history and there is the likelihood of a further deterioration in 2004. Here the principal concern is that the appetite of foreigners to invest in United States assets could be flagging. In the last two years the composition of capital flows has changed significantly. FDI in the United States has become negative and private portfolio flows financed only about a quarter of the deficit up to mid-2003, the remainder being funded by short-term speculative capital flows and official purchases of bonds by foreign central banks. This lack of enthusiasm for United States assets has already revealed itself in the decline of the dollar trade-weighted exchange rate by more than 16 per cent (see figure I.1). A weakening dollar will further dampen capital inflows into the United States unless compensated by higher returns.

On the fiscal side, the deficit has risen above 4.5 per cent of GDP and is unlikely to come down significantly in the foreseeable future. In this regard, recent empirical evidence from the United States, and indeed elsewhere, indicates that budget deficits, over time, push up interest rates.

Figure I.1. Real effective exchange rate indices, 1995-2003

(1995 = 100)



Sources: IMF, *International Financial Statistics Yearbook 2002* (Washington, IMF, 2002) and *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003).

Notes: Data for 2003 are up to August. Real effective exchange rate indices in this figure are based on relative consumer prices.

Furthermore, there is a view, based upon macroeconomic simulations for a variety of differing scenarios, that deficits induced by tax cuts do, indeed, boost activity in the short term. However, the rise in long-term rates eventually negates the boost owing to the slower capital accumulation caused by higher interest rates that invariably follow.

Nevertheless, taking together the growing evidence of an upturn with the overall balance of forces operating in the United States economy, the overall view is that, while there is significant uncertainty in making an accurate assessment of prospects for 2004, the risks to growth at this stage are not immediate. It is possible, however, that with a resumption in capital spending, output growth could be at, or even exceed, the long-term trend rate of growth of the United States economy of around 3.5 per cent a year in 2004.

Japanese growth: how sustainable?

Japan has been mired in a low-growth syndrome for the better part of a decade (1.2 per cent a year over the last eight years). However, its economy has been showing signs of revival in recent months. By the third quarter of 2003, Japan had enjoyed seven consecutive quarters of growth. This unexpected change in the fortunes of the Japanese economy is best exemplified by the resurgence of profits of Japanese companies, the rise in the stock market of nearly 30 per cent in dollar terms since the end of 2002 and improved business confidence. In fact, there is patchy evidence that consumer demand is also reviving, after several years of decline or flat growth. By November 2003, wages and earnings had registered year-on-year growth of 2.4 per cent and unemployment had fallen marginally from 5.3 to 5.2 per cent. Observers hold the view that many Japanese consumers now feel that the worst is over and that unemployment has stabilized. As a result, they could become less reluctant consumers in the months ahead.

While the recent performance of the Japanese economy gives grounds for optimism in the near term, a number of important caveats need to be stressed. First and foremost, despite the improvement in consumer confidence, the recent revival of growth has been driven primarily by exports. In this process the yen exchange rate appears to have played a major part. On a trade-weighted basis, the rate has appreciated by less than 5 per cent in 2003, unlike, say, the euro, which has appreciated much more. The Bank of Japan has intervened on a massive scale in order to prevent the yen from appreciating, a process that cannot continue indefinitely.

Companies have begun to invest but these expenditures are viewed as being primarily in anticipation of higher export demand. Given this background, there are obvious doubts as to whether the contribution of net exports based upon a weak yen can be sustained for long. Second, the problem of deflation also continues essentially unabated. Indeed, should current forecasts be borne out, Japan will, in 2004, complete six years of falling price levels. The apparent revival of consumer confidence should be viewed in that context. Third, problems in the banking and corporate sectors, notwithstanding recent progress, remain daunting. The improved profitability of Japanese companies has not been reflected in any meaningful reduction in the non-performing loan problem, although the present Government has committed itself to a target of halving bad loans by March 2005. Provisioning against bad debts in the banking system is still low, the banking system is still minimally capitalized and most banks' capital is subject to a large measure of vulnerability emanating from fluctuating sentiment in the equity markets.

For these reasons, the overall judgement is that Japan will not be able to sustain growth at its present pace in 2004. Further, given the poor performance of the Japanese economy over a number of years and the massive build-up of public debt, its potential growth rate may now be significantly below the 4 per cent a year that Japan achieved in the 1980s. In other words, an upturn in Japanese GDP growth will only be an improvement on its recent performance and not a return to the robust growth of the 1980s.[3]

EU economic performance remains weak

In late 2002, there were signs that growth in the EU would become stronger in 2003. In the event, the most probable outcome is likely to have been a slight deceleration, with growth in France, Germany, Italy and the Netherlands slowing perceptibly in mid-2003. Only the United Kingdom of Great Britain and Northern Ireland is an exception to this trend but there too growth is turning out to be somewhat weaker than first forecast. Unemployment remains high in all the main EU economies, again with the exception of the United Kingdom.

The below-trend performance of the EU is turning out to be deeper and more prolonged than anticipated, especially following the introduction of the euro.[4] More disquieting, it is displaying some of the negative traits of the Japanese economy of the last decade. For example, there is general agreement that long-term structural factors, rather than cyclical forces or short-term geopolitical shocks and uncertainties, are hampering the revival of growth in the EU. This is most evident in Germany, the largest EU economy, where the high cost of the welfare State (severely compounded by the costs of reunification) has recently been exacerbated by the problems of an overvalued exchange rate. In 2003, the counterpart of a weakening dollar was a stronger euro, which saw its trade-weighted exchange rate appreciate by more than 10 per cent in the 12 months from

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[3] BIS, *73rd Annual Report* (Basel, BIS, 2003).

[4] IMF, *World Economic Outlook, September 2003* (Washington, IMF, 2003).

December 2002 to December 2003 and by much more against the dollar on a bilateral basis. Germany's problem is now likely to be experienced by the EU as a whole as a stronger euro reduces the potential for export growth outside the euro zone.

In virtually all EU economies, with the exception of the United Kingdom, considerable product and labour market rigidities also remain. These are reflected in low rates of corporate investment and of productivity growth, especially over the last five years. These rigidities came into sharp relief following the ending of the asset price bubble of the late 1990s, when unemployment climbed upwards and has remained high. More determined reform efforts in France and Germany have not yet garnered the required political support for implementation, while room for fiscal manoeuvre to stimulate growth is limited given the already high deficits in the EU. There is some scope for monetary easing given the undershooting of inflation targets, but the European Central Bank has not shown a willingness to cut interest rates pre-emptively in anticipation of the reduced price pressures that should follow the appreciation of the euro. This has almost certainly weakened the momentum of growth in the euro zone. Current forecasts suggest growth of over 2.0 per cent in 2004 in the 12 economies of the euro zone, but this appears optimistic.

DEVELOPING COUNTRIES

Divergent growth in developing countries

The rapid ending of military hostilities in Iraq in the first quarter of 2003 was followed by the SARS crisis in the second quarter. However, the two events are reckoned to have had only a small impact on the developing countries, even within the Asian and Pacific region. Growth rates dipped in the second quarter of 2003 but in the second half of the year growth more than offset the effects of the Iraq war and SARS-related slowdown earlier in the year. Indeed, according to World Bank estimates,[5] developing countries as a whole would exceed 2002 growth by 0.5 percentage points in 2003. Once again, the Asian economies will be the best-performing group, with other developing countries also improving upon their performance in 2002. Growth in the region is in part cyclical following the 2001 downturn and in part driven by rapidly shifting production patterns in East and South-East Asia.

Rapid growth of trade in developing countries

The recent performance of the developing countries owes much to the strength of world trade (see table I.2). The more rapid growth of international trade in the developing countries was particularly evident in

[5] World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, World Bank, 2003).

Table I.2. World trade and prices,[a] 1991-2003

	Annual percentage changes					
	1991-2000	*1999*	*2000*	*2001*	*2002*	*2003[b]*
Trade volumes	7.3	5.8	13.3	–0.6	3.3	2.9
Trade prices (in dollars)						
Manufactures	–0.9	–1.8	–4.7	–2.4	2.6	12.8
Oil	2.1	37.5	57.0	–14.0	2.8	14.2
Other commodities	–0.9	–6.7	4.5	–4.0	0.6	5.0
Terms of trade						
Developed economies[c]	0.2	–	–2.9	0.4	0.8	1.1
Developing economies	0.0	5.8	7.2	–3.9	1.8	–0.4

Source: IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, IMF, 2003).

[a] Goods only.

[b] IMF forecast.

[c] Advanced industrial economies plus newly industrializing Asian economies (Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China).

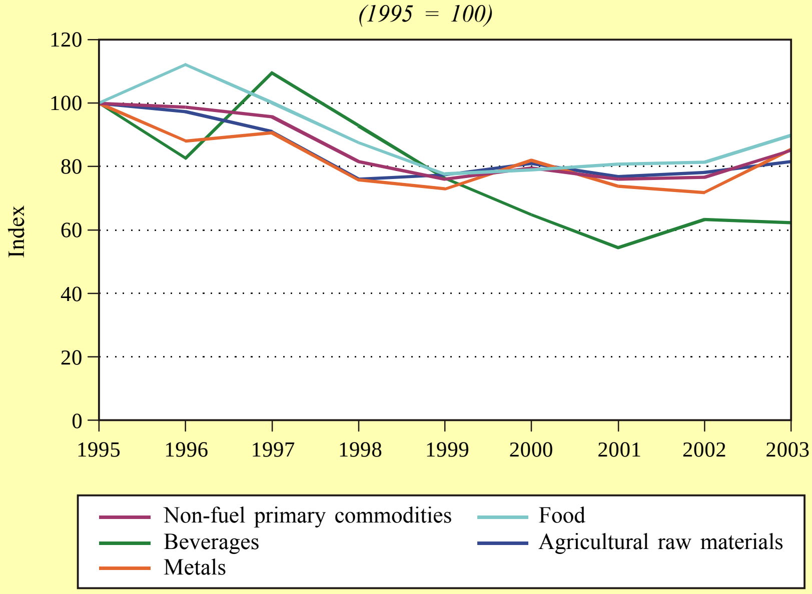
the Asian region, where the developing economies were again expected to outperform other developing countries in 2003. Broadly speaking, these trends are expected to continue into 2004.

Recovery in global high-tech markets played a pivotal role in world trade growth in 2002 and 2003. After the demand for semiconductors and related equipment collapsed in 2001, there was an expectation that recovery, when it came, would be sharp. ICT and its components are products with rapid obsolescence, a feature that leads to periods of very high growth followed by sharp slowdowns. Manufacturers are often reduced to being price takers as the amplitude of the production and demand cycles can, and has, led to overproduction. This is an area in which both East and South-East Asia have a strong competitive advantage. Furthermore, as noted in previous discussions on this subject, production of ICT is heavily “componentized”, leading to strong intraregional trade in inputs with the final product often, but not always, exported outside the region. The present phase in the ICT industry is one of strong recovery after the 2001 downturn.

In 2002, world trade volumes grew by around 3 per cent, following a small decline in 2001, and non-oil commodity prices recovered after more than a decade of decline (see figure I.2). Weakness in manufactured goods prices was also reversed, although prices firmed only marginally. The most striking feature of global trading trends in 2002 was that while import demand by the developed countries grew by 1.3 per cent, that by developing countries grew by 5.6 per cent. On the basis of currently available information, these trends strengthened significantly in 2003.

Figure I.2. Indices of commodity prices, 1995-2003

(1995 = 100)



Sources: IMF, *International Financial Statistics Yearbook 2001* (Washington, IMF, 2001) and *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003).

Note: Data for 2003 are up to October.

Developing economies of the ESCAP region to enjoy stronger growth in 2004

What impact will these developments have on developing countries in general and on the Asian economies in particular? As already observed, sharply varied growth patterns are likely to characterize economic activity across countries and regions in the short run. For instance, growth prospects in East and South-East Asia and, to a somewhat lesser degree, South Asia, are more buoyant than in other developing countries. These countries are both major centres of manufacturing and important commodity producers. Aided by a low interest rate environment and the inventory dynamics of low working capital costs, production of ICT is on a rising trend. As costs and prices have declined, the demand for new consumer products, such as mobile telephones, personal computers and household electronics, has risen rapidly. In addition, buoyancy in the manufacturing sector has spilled over into services. The resultant strong GDP growth has translated into rising incomes; these in turn have boosted the demand for, and the production of, a broader range of goods, particularly cars, and this has resulted in remarkable vibrancy in intraregional trade in East and South-East Asia.

This positive overview should not, however, be construed to imply that, from a forward-looking perspective, risks for developing countries of the region are now non-existent or negligible. The recent trading dynamism of China, for example, has been built upon a rapid increase in the global market share for a wide range of products. Although China's market share still constitutes only 5 per cent of global exports, it has already generated a degree of resentment and retaliatory action in some countries. The dynamics of high-tech markets, with their history of boom and bust, is another potential hazard. Intraregional trade itself owes some of its recent strength to the growth of household incomes, reflected in buoyant consumer demand, in the developing countries of Asia. This demand has been stimulated in part by looser fiscal and monetary policies. It is self-evident that there are limits beyond which the easing of fiscal and monetary policies is neither possible nor desirable. Hence, all developing countries in the Asian and Pacific region are faced with major policy trade-offs in maintaining the momentum of growth in 2004. The likely impact of the global economic environment and the policy issues it raises for the various subregions of ESCAP are discussed more fully in chapter II.

FINANCIAL MARKET AND RELATED DEVELOPMENTS

The international financial system ...

Side by side with trade, financial markets play an important role in the global economy. Apart from the provision of finance, financial markets are a medium for the transmission of the collective sentiments of investors and, as such, they act as monitors and bellwethers, not merely in matters of corporate performance but also in the performance of national Governments. With the rapid spread of globalization since the early 1990s, financial markets, despite bringing in a wider pool of investors and savers within their ambit, have been seen to be prone to excessive swings in sentiment.[6] In consequence, their ability to provide appropriate pricing information to investors has been adversely affected. Over the years, markets have also developed a tendency to overshoot or undershoot equilibrium values, be it equity or bond prices or exchange rates. The functioning of financial markets in themselves thus creates significant policy issues for countries. Regardless of their deficiencies, however, financial markets are the primary interface between the real economy and the preferences of savers and investors all over the world. As much as the real economy drives financial markets, the latter equally have an impact on the real economy.

... shows considerable resilience ...

The bursting of the equity bubble, unfavourable geopolitical developments and corporate governance scandals have severely tested global financial markets in recent years. By and large, however, the markets have shown considerable resilience in coping with these events. In fact, by December 2003, stock markets virtually across the world had risen by

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[6] IMF, *Global Financial Stability Report: Market Developments and Issues* (Washington, IMF, September 2003).

nearly a third, reflecting markedly increased confidence in the future.[7] Bond markets had also risen, but by less, as investors were beginning to discount the likelihood of further decreases in interest rates. Indeed, yields on long-dated bonds had begun to rise in mid-2003 as investors realized that the large United States fiscal deficit would inevitably mean higher interest rates at the longer end of the time spectrum in due course. Major exchange rate realignments also took place, primarily the depreciation of the United States dollar and appreciation of the euro, but these did not plunge the markets as a whole into turmoil.[8]

A part of the mood of optimism that began in 2002 has been based upon real improvements in corporate balance sheets and performance, a process aided by the low interest rate environment. Another part, however, is based upon the way investors have been reacting to the prospect of a prolonged period of low interest rates; they are being pushed, willy-nilly, into seeking higher yields for their savings and risk aversion is becoming less strong, though in an uneven fashion. In the process, however, there is a danger that both equity and bond prices may be bid up, once more, to values above those that could be justified by underlying corporate earnings. In other words, the equity and bond markets may be becoming excessively inflated, a phenomenon that is evident in both developed and developing economies.

... although private capital flows to developing economies are likely to decline in 2004

As a result of the upsurge in the equity and bond markets in 2002 and 2003, private capital flows to developing countries, as well as those in Asia, rose significantly, with portfolio flows and FDI proving particularly buoyant (see table I.3). The former are usually of a short-term nature and can be easily reversed. Moreover, they are usually instrumental in inflating asset price bubbles. FDI flows, by contrast, are long-term, usually with an ongoing contribution to both production and exports. FDI in Asia has been buoyant for some time, with China leading the way. Manufacturing continues to shift to the region to take advantage of good infrastructure, large domestic markets and productive, low-cost labour. However, prospects for 2004 indicate that some decline is on the cards in view of the apparent overcapacity in many manufacturing activities. At the same time, the emergence of large imbalances in the global economy, such as the United States current account and fiscal deficits and how the two are likely to be financed, may presage a period of heightened exchange rate instability with investors seeking safe-haven-type outlets for their savings, such as precious metals. In such a scenario, investors could eschew cross-border transactions with developing countries or demand extra returns, but, in fact, sovereign credit ratings improved and credit spreads narrowed in 2003.

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[7] BIS, *BIS Quarterly Review, December 2003* (Basel, BIS, 2003).

[8] BIS, *BIS Quarterly Review, June 2003* (Basel, BIS, 2003).

Table I.3. Net capital flows[a] to developing countries and to developing Asia, 1996-2004

(Billions of US dollars)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total for all developing countries[b]									
Net private capital flows[c]	226.5	132.6	77.8	86.7	47.1	42.7	80.3	113.1	93.8
Net private direct investment	116.2	143.9	156.0	175.4	165.7	180.9	142.9	143.9	145.2
Net private portfolio investment	83.2	63.3	11.0	19.5	–3.8	–51.2	–52.9	–22.9	–16.8
Net other private capital flows	27.1	–74.6	–89.2	–108.2	–114.9	–87.1	–9.7	–8.0	–34.6
Net official flows	–1.8	42.6	57.6	7.6	–12.8	21.1	7.1	10.1	–16.0
Changes in reserves[d]	–104.6	–71.1	–49.7	–88.4	–117.2	–122.4	–211.6	–255.1	–148.5
Developing Asia[e]									
Net private capital flows[c]	124.6	10.8	–42.1	4.6	–3.3	25.2	57.0	62.4	13.7
Net private direct investment	55.0	59.8	60.9	60.6	58.4	50.9	57.8	66.5	59.6
Net private portfolio investment	30.0	7.3	–17.2	11.5	4.3	–13.5	–21.1	–10.9	–16.5
Net other private capital flows	39.6	–56.3	–85.8	–67.5	–66.0	–12.2	20.2	6.8	–29.4
Net official flows	–13.0	17.1	26.1	3.9	1.9	–9.7	–9.9	–7.1	–7.6
Changes in reserves[d]	–46.9	–15.1	–67.8	–78.9	–49.0	–84.9	–167.1	–159.9	–93.7
Memorandum:									
Hong Kong, China									
Net private capital flows[c]	–7.1	10.8	–8.5	1.1	4.2	–6.6	–24.9	–27.7	–25.6

Source: IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, IMF, 2003).

Note: Data for 2003 and 2004 are estimates.

[a] Net capital flows comprise net direct investment, net portfolio investment and other long- and short-term net investment flows, including official and private borrowing.
[b] Excluding Hong Kong, China.
[c] Because of data limitations, "Net other private capital flows" may include some official flows.
[d] A minus sign indicates an increase.
[e] Including Republic of Korea, Singapore and Taiwan Province of China.

Exchange rates of Asian currencies are tending to appreciate

Up to the end of 2003, realignments in exchange rates had been borne primarily by the euro, aided by a number of smaller developed and developing country currencies. Any further depreciation of the United States dollar in the months ahead would, of necessity, involve a wider range of economies and currencies. In those circumstances, Asian economies would be directly affected, given the size of the external trade in their economies and the persistence of large current account surpluses, which have resulted in the build-up of massive foreign exchange reserves in some economies of the Asian and Pacific region. The export sectors in most Asian economies play a much bigger role than in the developing countries as a group and any significant realignment of exchange rates, especially those in which a degree of overshooting is involved, could imply significant short-term changes in competitiveness and, perhaps, in trade flows. For most developing countries, this process, already in evidence to some extent, could then involve changes in the output mix and redeployment of productive resources compressed into a short period of time.

One of the puzzles in the current situation relates to the behaviour of real estate, particularly housing prices. Housing and real estate prices have risen in virtually all countries of the world and their future course has important policy implications. Equity holdings and housing are the largest components of household wealth in developed countries, and increasingly so also in developing countries, and their values tend to move together over long periods. The same relationship holds true in the developing countries of the ESCAP region, where, if anything, the scarcity premium on urban real estate is even higher. However, three years after the equity markets began to decline real estate prices have continued to rise in most countries. Despite some cooling-off in recent months, the prices remain at historical highs in relation to disposable earnings. Indeed, there appears to be no immediate prospect of a price correction in most countries.

Low interest rates fuelling the real estate boom

A key factor in the housing boom has been the low interest rate environment in the region. The low rates have allowed borrowers to take on more loans relative to income, given the lower cost of servicing their debts. In the process, they have added to the market demand for housing and for real estate in general. Low interest rates have also forced savers to switch investments from financial assets to bricks and mortar. Rising house prices have added to the wealth effect. Some observers fear the creation of a bubble in housing with its attendant downside risks, as an increasing proportion of banking assets are, once again as in 1995-1997, invested in real estate. The majority of housing loans are tied to long-term interest rates and these had risen by approximately 40 basis points in the United States relative to 12 months previously.[9] As already mentioned, in an integrated global financial system the changing structure of interest rates in the United States will not remain confined to that country and will inevitably spill over into other markets. A firming trend in long-term interest rates will have an impact not only on the housing market but also on household consumption, especially debt-financed consumption. In other words, sustaining global growth in the months ahead could become problematic and require a policy approach which would involve the continuation of the low interest rate environment and simultaneously grappling with the possible emergence of asset bubbles in a number of economies.

[9] *The Economist,* 3 January 2004.

PROSPECTS FOR THE ESCAP REGION

Investment pickup to strengthen growth momentum in the ESCAP region

Taking 2003 as a whole, despite the war in Iraq and the SARS crisis, the developing countries of the ESCAP region experienced collective GDP growth higher than the rate achieved in 2002, when they were the fastest-growing economies in the world. Furthermore, on current trends, growth is expected to pick up additional momentum in 2004 should the global economy build up steam as posited earlier, via strong household consumption and higher corporate investment expenditures, in 2004.

Need for developing economies of the ESCAP region to stabilize public debt and restrain credit growth

Domestic demand has been stimulated by explicit growth-enhancing domestic policies in the shape of higher fiscal spending and lower interest rates. After nearly three years of fiscal and monetary easing, additional scope in both areas of policy is limited and new demands for additional spending can arise unexpectedly, for instance in public health. Public debt as a proportion of GDP has risen significantly in a number of countries and is perhaps already close to its upper limit. Although inflation remains low and most countries run balance-of-payments surpluses, additional fiscal or monetary stimulus is nonetheless conditioned by external market perceptions. Market participants, rightly or wrongly, take a negative view of rising domestic debt; this could impinge upon the ongoing debt restructuring of corporations and banks in the region. Thus, new public debt has to form part of a longer-term strategy of keeping the debt-to-GDP ratio stable. The same constraints apply to the continuation of low interest rates. These have been accompanied in some countries by unsustainably rapid credit growth that will require corrective policy action before too long. However, by and large, the balance of risks vis-à-vis the near-term outlook remains neutral, with some likelihood of growth accelerating in the second half of 2004.

NEAR-TERM POLICY ISSUES

The year 2003 saw a relatively quick end to the war in Iraq, with minimal disruption of the energy markets and limited impact of the SARS crisis. This suggests, on the face of it, that the main uncertainties facing the ESCAP region in 2003 were easily resolved. Both consumer demand and fixed investment should benefit, particularly in countries where such spending has been weak in recent months. In addition, the need to rebuild inventories from the current low levels should also contribute to output growth. The failure of the Fifth WTO Ministerial Conference to push forward the Doha Development Agenda might suggest systemic weaknesses in the WTO-driven model of trade negotiations, reflected also perhaps in a preference for bilateral trade agreements. A further failure at WTO could also undermine cross-border investment flows to a significant extent.

The global economy faces a number of uncertainties

A degree of circumspection is therefore needed. Some of this circumspection relates to the aftermath of the twin bubbles, the Japanese bubble of the 1980s and the United States dot com bubble of the late 1990s, and their residues of high corporate debt levels, excess production capacity, especially in manufacturing, and low equity valuations. Both the Japanese and United States experiences indicate that the ending of asset bubbles tends to feed back into the real economy and the ensuing indebtedness and systemic problems in the financial sector can take a very long time to resolve. Another underlying fear could perhaps be of a new terrorist outrage, an event that makes investors and consumers nervous by its very unpredictability.

At the international level, the unwinding of external and fiscal imbalances in the United States, the EU and Japan will have implications for the Asian and Pacific region over the medium term. These imbalances, reflecting the growing external deficit of the United States, virtually the world's single engine of growth, has already contributed to volatility in global exchange rates, in particular the depreciation of the dollar. However, even large exchange rate adjustments cannot correct global external imbalances on their own. Furthermore, faster growth alone in the United States will not significantly reduce the fiscal and external deficits in that country in the short term. This implies the need for a more coordinated and smooth adjustment process in which both developed and developing economies are involved. The global situation thus rightly places a high premium on greater international and regional cooperation through both formal and informal channels.

The hard tasks of external and internal adjustment on a global scale also need to be viewed against the background of the forces of globalization. Globalization has accelerated, with startling speed, the shift of a whole host of manufacturing activities away from their traditional centres, that is, the developed countries, to some developing countries. The process implies that traditional producers now have to move into other areas of manufacturing, such as new products, new applications of technology, products higher up the value chain, or into services, much faster than before. In fact, the move is not likely to be limited to the developed countries. All countries, developed and developing, must adapt to the rapidly growing importance of China in the global economy. Unless the process of shifting simultaneously generates new jobs, or wage rates become more flexible in all economies, there could be a significant increase in unemployment in several economies, at least in the short term. Broadly speaking, therefore, the need to be able to respond with speed and flexibility to the rapidly changing global economic environment has never been greater. The alternative could be the rebirth of protectionist tendencies, concerns about which have been heightened by the failure at Cancún.

Reduced vulnerability of the global financial system to external shocks

One welcome aspect of recent developments has been that the global financial system has coped reasonably well with the strains put on it over the last two or three years. Large-scale bankruptcies in ICT companies and weaknesses in the equity markets have not created major systemic problems in the financial sector. That sector, for its part, has not engaged in any marked retrenchment of credit, the credit crunch problem of recent years being both a supply- and demand-driven phenomenon. In fact, the financial sector in the ESCAP region has speedily redeployed its resources to finance housing and personal consumption and has thus successfully stimulated higher levels of activity in several economies of the region.

Nevertheless, it would be prudent for policy makers to monitor the health of the financial system more closely. Banks in the ESCAP region, especially those in the economies affected by the 1997 crisis, have for the most part not yet fully tackled the problems of impaired asset quality built up over the years. New bad loans would make them acutely vulnerable to insolvency, with serious spillovers into the real economy in the event of a slowdown. Asia’s financial markets still face unresolved problems of fragmentation and a lack of depth centring around an overdependence on bank finance.

Low inflation and low interest rates have not eliminated cyclical fluctuations in economic activity

The last few years have seen policies to lower inflation being remarkably successful, with some minor exceptions. Nevertheless, low inflation by itself has not minimized fluctuations in levels of output and activity. In theory, low inflation should have laid the basis for more stable growth and less variation in exchange rates. Together, these should have lowered risk premiums on investments. This rosy scenario has not, however, materialized. Low inflation has undoubtedly delivered benefits such as low interest rates, which have certainly boosted consumption expenditures. However, when invoking the test of promoting or impeding overall economic stability, the answer is more equivocal. Low inflation and low interest rates have proved to be necessary but not sufficient conditions for moderating the amplitude of fluctuations in key economic aggregates. Paradoxically, the low cost of borrowing probably stimulates the creation of asset bubbles in real estate and in the equity markets. Regardless of whether problems of instability are considered to be permanent or temporary, how to minimize fluctuations in the economy remains an important policy question. More particularly, the question of how and when to intervene in the deflation of asset bubbles to prevent large-scale unwinding of corporate balance sheets at a subsequent stage still has no satisfactory answer. Monetary authorities primarily focusing on low inflation thus face difficult policy dilemmas during the build-up of an asset price boom, whether in the stock markets or in real estate.

The importance of encouraging structural change

Structural changes in the real economy are always difficult to push through, even if the direction and specifics of change are reasonably well known. This is unfortunate, as experience shows that flexible economies grow faster, have lower unemployment and can adjust to shocks more quickly. From an Asian perspective, the need for continued structural reform is paramount. A concentration on export-led growth has delivered handsomely in terms of rapid output growth and efficiency, though perhaps not to the least developed countries, which continue to suffer from market access problems, in addition to their own limited ability to respond to trading opportunities in the global economy. It is perhaps time now to shift the focus to more sustainable, more domestically driven growth, which, in the case of the least developed countries, will require significant external support in the form of ODA but also much better governance.

Against this background, domestic policy priorities will vary widely across the ESCAP region. In some economies, the recent appreciation in exchange rates, and their implied policy tightening, suggests that there is additional room for monetary easing. But simultaneously, it is vital that Governments not discount the need to have in place credible programmes of fiscal consolidation. As explained in previous issues of the *Survey*, most economies in the region need to approach the issue of long-term public debt within an ongoing programme of fiscal reform, to reduce the burden of indirect taxation, improve incentives for production and re-examine their patterns of expenditure.

Problem of appreciating exchange rates and rising foreign reserves

At the international level, much of the burden of dollar depreciation has been borne by the euro, with the yen giving some ground recently. In the event of further downward pressure on the dollar in the coming months, it would be both appropriate and desirable from a regional perspective that the burden be shared more widely. In these circumstances, it may be useful for the authorities in countries where reserves and current account positions have strengthened to consider the policy option of greater exchange rate flexibility, as is being urged in different forums. Such a policy option would reduce the need for sterilizing financial inflows and would automatically have the effect of tightening policy without having to raise interest rates when the need arises. It is true that exchange rates exercise some influence on competitiveness, but not a decisive one. Long-term competitiveness is more a matter of product differentiation, quality control and timely delivery to customers rather than price competitiveness per se. It would be appropriate, too, for exchange rate policies to be coordinated within the region so that they are not used as proxies for improved competitiveness.

In the ESCAP region there has been a rapid accumulation of reserves in the last few years. Very large reserves, while clearly providing effective insurance against a foreign debt crisis, also have opportunity costs. It is true that the absorptive capacity of most economies of the ESCAP region, in terms of deploying substantial additional financial resources in the public sector in a cost-effective manner, is limited. Nevertheless, the accumulation of reserves beyond what might be warranted by the need to meet immediate trading and debt service needs is questionable. In fact, beyond a certain point large foreign reserves can make the exchange rate inflexible in practice with the burden of macroeconomic adjustment falling on the price level, as has happened in Hong Kong, China, and Taiwan Province of China, and perhaps even in China itself. By and large, excessive reserve accumulation may also reflect some degree of undervaluation of the exchange rate. More flexible exchange rates are thus a policy option worth considering in the current situation. Exchange rate stability is an important policy objective. With stable or falling price levels, some flexibility in exchange rates would expand the range of policy options in macroeconomic management.

The Doha Development Agenda: option for developing economies of the ESCAP region

A major policy issue facing all developing countries is the question of trade liberalization under the Doha Development Agenda. While the onus of success in this regard lies primarily with the developed countries, especially in the need to remove barriers to trade in agricultural commodities, developing countries for their part should do everything possible to remove impediments to trade in agriculture between them. The remarkable growth of intraregional trade and the rapid expansion of subregional trading agreements, such as those between ASEAN, China, Japan and the Republic of Korea and now between ASEAN and India, are testimony to the scope for enhancing trade not merely in manufactured goods but also in a wider range of agricultural commodities and services. Developing countries should not become hostage to the pace of liberalization at WTO but take initiatives themselves to lower barriers and promote trade in different areas.

LONG-TERM DEVELOPMENT CHALLENGES

Sustaining development so as to meet the Millennium Development Goals and the objectives of the World Summit on Sustainable Development

The objectives of development are relatively invariant over time. These can be summarized as promoting economic growth, delivering improvements in the quality of life of the people and promoting fairness and equity in the distribution of the rewards generated by growth so as to make the growth process sustainable. Environmental considerations are a recent addition. The relative emphasis placed upon these objectives can and has varied over time and in different countries depending upon their stage of development and the prevailing socio-political ethos of the country concerned. The new challenge that all developing countries face is that these objectives have to be pursued in a world economic environment defined by intensified globalization and competition between countries. The trade liberalization agenda at WTO sets the parameters within which developing countries have to function in the spheres of trade in goods, services and FDI. International agreements or compacts such as the Millennium Development Goals and the objectives of the World Summit on Sustainable Development provide benchmarks against which the performance of all countries will be measured in relation to the eight Goals and the key outcomes of the World Summit. Indeed, the international community has also identified, through the Monterrey Consensus reached at the International Conference on Financing for Development, the appropriate means and policies to achieve the Goals and the objectives of the World Summit over a defined time-span.

In the real world, the pursuit of development is rarely a smooth or effortless exercise. Quite apart from the impact of unpredictable events, such as drought, disease, floods and acts of terrorism, policy makers in Governments are often constrained by the power of vested interests, hamstrung by weak institutions and a lack of information that induces policy errors and misjudgements and leads to poor policy implementation. In fact, democratic politics itself creates a bias in favour of shorter time horizons for decision-making, as the typical life of an elected Government is no more than five years before it must renew its mandate with its electors. Long-term objectives are often pushed into the background as a result. Policies whose impact creates winners and losers are difficult to implement if the losers cannot be compensated in some way. There is the perennial problem of balancing centralized control over resources against their decentralized distribution. Above all else, poor governance in which weak leadership is combined with a lack of motivation among employees, especially in public sector bodies, can negate the gains of development, even in societies apparently run by democratically elected Governments.

Against such a complex background, it is a major challenge for any Government to look at the short term as an integral stage in the pursuit of long-term goals and thus to pursue a development agenda primarily determined by long-term objectives. Yet, for development to succeed in a demonstrable way, Governments need to combine short-term economic management with a long-term strategy in which realistic goals are laid out and society as a whole can see, and identify with, the direction and pace of long-term change and development.

Development necessitates structural change

All development is ultimately structural change. Some of the driving forces of structural change are external, consisting of the changing patterns of international trade and investment; others are driven by changes in technology whereby technological change and innovation make particular production techniques and goods obsolete. Governments should therefore facilitate structural change and not resist it, although it is essential that there be arrangements to protect workers who lose their jobs in the process; robust institutions and adequate resources will also be needed to retrain such workers. In a globalizing world, structural change, in turn, will be based upon countries being able to maintain and, indeed, enhance their international competitiveness as the ratio of trade to GDP rises. Productivity and efficiency are vital prerequisites for competitiveness and growth; these involve investment in public and merit goods that enhance skills and education, provide for public health and foster the relevant arrangements and institutions for their long-term development. In other words, the role of the public sector, taken in its widest significance, is critical in this process. The public sector has not only to provide leadership in terms of setting objectives but also to simultaneously provide crucial inputs for meeting them, in the form of rules, regulations and oversight. In all developing countries the constraint on financial resources is a fact of life that cannot be wished away. The public sector has therefore to facilitate the involvement of private sector skills and resources in meeting long-term objectives, such as through public-private partnerships.

In this context it is worth stressing that because resources are scarce Governments should target their expenditures more carefully. By and large, they should avoid activities that the private sector is able and willing to carry out. Such expenditures tend to have high opportunity costs and any gains accruing to the national balance sheet are purely technical, as the private sector would have carried out such investments anyway. Governments should invest more in such areas as infrastructure and public education, which then attract or “crowd in” additional private investment. Empirical research for East Asian economies indicates that there have been substantial gains in terms of investment and growth from the positive externalities generated by the public sector.[10]

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[10] World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, World Bank, 2003).

There are currently a number of fundamental long-term objectives that all developing countries have agreed to pursue, those constituting the Millennium Development Goals and those contained in the Plan of Implementation agreed at the World Summit on Sustainable Development. Without going into detail, the two together oblige Governments to have a long-term development strategy that enables them, inter alia, to halve poverty between 1990 and 2015 and to pursue sustainable development, broadly defined to include poverty reduction, protection of the natural resource base and ensuring the health of the people; all this is to be achieved in a rapidly globalizing world economy.

The goals of poverty reduction ...

What are the policy challenges that Governments will have to contend with in pursuit of these objectives? There are no precise answers and individual Governments will have to look at their specific circumstances to decide how to meet the challenges. For instance, costing the Millennium Development Goals raises complex issues of unreliable data, the clear need for substantial extra financial and non-financial resources and changes required in the priorities of government expenditures. Recent research suggests that there are difficulties in determining the exact relationship between a given level of financial resources and the corresponding reduction in the level of income poverty. In the light of this uncertainty, within the limits of given financial resources, which interventions aimed at poverty reduction should then be assigned priority? Moreover, on equity grounds it would seem self-evident that policy interventions in poverty reduction should benefit all the poor equally. What would be the policy implications of ensuring such an outcome? It is clear that greater financial resources alone are not going to guarantee the achievement of the Goals. The effective and efficient utilization of these resources, as well as well-targeted policies and programmes and investment in human capital, will also be needed. Governments of the region thus need to critically reassess their policy approaches in this area and discuss them, both formally and informally, in regional forums, to develop the most effective means of achieving the Goals. One long-term route to poverty reduction is cross-border migration within the region. If organized in a sensible way it could be implemented without the feared political upheavals or difficulties, as has been done by the EU.

... and sustainable development

The objective of sustainable development similarly creates major policy dilemmas. Thus, for instance, while the linkage between economic growth and poverty reduction is obvious, the relationship between economic growth and the environment is less clear and might even work in the opposite direction. In fact, judging by the experience of the ESCAP region, rapid economic growth has been often accompanied by a range of adverse environmental impacts. Moreover, the poor tend to be disproportionately affected by environmental deterioration. There is thus a strong need to establish robust mechanisms and institutions to coordinate national economic policy-making in different areas. These fall into two broad genres, the first the so-called command and control measures that utilize the authority of the Government in forcing economic agents to adhere to sustainable environmental practices, and the second market-based instruments, consisting of interventions in relative prices with taxes and subsidies to bring private and social costs more into line. Both approaches are equally valid and useful according to the circumstances and the prevailing institutional capacity of individual countries. The policy dilemma consists in their impact on levels of poverty. Here, too, the problem essentially lies in substantial gaps in the analytical knowledge of the impact of various policies. These arise from gaps in data that properly capture environment-poverty interlinkages. The relatively intangible nature of environmental costs and the negative externalities that they generate are difficult, if not impossible, to subsume within a practical matrix of impact assessment exercises. Formulating effective policies would be more difficult still. Nevertheless, Governments must take action within these limitations and the most practical approach would be to learn from the successes of countries in the region. Regional cooperation in this sphere would thus be very useful.

Finding the resources for development: the Monterrey Consensus

Finally, how do the Millennium Development Goals and the objectives of the World Summit link up with the issues raised at the International Conference on Financing for Development and embodied in the Monterrey Consensus? The Consensus recognizes that each country has the primary responsibility for its own social and economic development. Primary responsibility refers here to policy approaches: it does not refer to a sufficiency of resources. Few, if any, developing countries, especially least developed countries, have the resources to successfully meet the Goals and the objectives laid out at the World Summit. But extra resources, especially raised in the form of debt obligations, will create their own problems. The Asian economic crisis of 1997 and the current situation in South Asia are testimony to the dangers inherent in this area of policy. In the crisis countries, excessive external debt plunged the countries into a crisis that sharply increased poverty; in South Asia, the combined effect of internal and external indebtedness has been to raise the cost of capital. Overall GDP growth has suffered as a result. Moreover, countries with high domestic debt are now facing a new resource crunch, in the form of a rising burden of debt-servicing. In the past, these countries have not invested enough in education, health and infrastructure, with the result that there is no secure foundation for long-term growth. The Monterrey Consensus spells out the need for countries to substantially enhance the funding of education, health and infrastructure. Millennium Development Goal 8 refers to developing a global partnership for development, that is, raising ODA and expanding market access, particularly at a time when textile and garment quotas come to an end at the beginning of 2005. To what degree, and how, these daunting challenges of development can be met should become the subject of debate and discussion in the region so that Governments can devise realistic approaches for long-term development.

II MACROECONOMIC PERFORMANCE, ISSUES AND POLICIES

REGIONAL OVERVIEW

Strong economic performance in the ESCAP region in 2003

In 2003, despite the war in Iraq and the SARS crisis, the developing countries of the ESCAP region continued to show strong growth, exceeding the pace achieved in the previous year by almost half a percentage point. Performance in 2002 itself had significantly exceeded expectations so that by the end of 2003 ESCAP developing countries had enjoyed two years of buoyant economic expansion combined with low inflation, following the 2001 slowdown. From a regional perspective, growth has been broad-based, with all subregions, except one, experiencing a higher pace of economic activity. Experience with inflation has also been mixed, with two subregions having somewhat higher inflation in 2003, compared with 2002, albeit at a low absolute level with the exception of some economies in the Pacific islands subregion (see table II.1).

Buoyant growth in the ESCAP developing countries represents not only an impressive turnaround after the 2001 slowdown but shows as well that the process is becoming less dependent upon global economic trends. ESCAP developing countries as a group are growing faster than both the global economy and other groups of developing countries. As such, growth is becoming more autonomous in that it is the result primarily of forces within the region, such as intraregional trade and strong domestic demand, although exports to the rest of the world continue to play a significant part in sustaining the overall momentum of growth.

The Chinese economy played a major role in sustaining growth in the region

China's remarkable performance has been central in sustaining the momentum of growth in the region as a whole, with its GDP expanding by just under a quarter in the three years 2001-2003 on the basis of strong investment and consumption demand. During this period, China also increased total imports by more than $160 billion, some two thirds of which have come from the region. China is now the fourth-largest trading nation in the world, thus helping to stimulate output growth across a broad front in the regional economy. Similar trends are visible in several other economies of the region where robust growth has resulted from a combination of higher net exports and domestic demand. The former is the result partly of higher commodity prices and partly of higher growth of

Table II.1. Selected economies of the ESCAP region: rates of economic growth and inflation, 2002-2006

(Percentage)

	Real GDP					*Inflation*[a]				
	2002[b]	*2003*[c]	*2004*[c]	*2005*[c]	*2006*[c]	*2002*[b]	*2003*[c]	*2004*[c]	*2005*[c]	*2006*[c]
Developing economies of the ESCAP region[d]	5.7	6.0	6.2	6.0	6.0	5.5	3.6	3.0	2.7	2.3
South and South-West Asia[e]	5.2	6.6	5.8	6.3	6.4	14.4	10.6	7.9	6.5	5.0
Bangladesh	4.4	5.3	5.7	6.0	6.5	2.4	5.1	4.5	4.0	4.0
Bhutan	7.7	7.0	7.5	8.0	8.5	2.7	3.6	..	..	..
India	4.3	7.5	6.0	6.6	6.7	4.0	4.8	4.0	3.5	3.0
Iran (Islamic Republic of)	6.5	6.9	7.1	8.1	8.2	15.8	16.8	17.0	16.0	13.0
Nepal	−0.6	2.4	3.5	4.5	..	2.9	5.0	4.8	..	..
Pakistan	3.4	5.1	5.3	5.8	6.0	3.5	3.1	4.0	4.0	4.0
Sri Lanka	4.0	5.5	6.0	6.5	7.0	9.6	6.3	6.0	5.5	5.0
Turkey	7.8	5.3	5.1	5.1	5.1	45.0	25.3	14.4	9.8	6.2
South-East Asia	4.2	4.5	5.8	5.7	5.8	4.6	3.3	3.7	3.7	3.1
Cambodia	5.5	5.0	5.6	5.5	..	3.4	1.7	4.3	5.0	..
Indonesia	3.7	4.1	4.8	4.4	4.5	11.9	6.6	6.2	6.0	4.1
Lao People's Democratic Republic	5.9	5.9	6.1	6.0	6.3	10.6	13.5	9.0	5.0	5.0
Malaysia	4.1	5.2	5.5	6.0	5.5	1.8	1.2	1.8	2.2	2.0
Myanmar	5.3	5.1	4.3	..	..	57.1	52.8	44.0	40.0	..
Philippines	4.4	4.5	5.4	5.8	6.3	3.1	3.1	4.5	4.0	3.5
Singapore	2.2	1.1	4.7	4.4	4.9	−0.4	0.5	1.1	1.5	1.9
Thailand	5.4	6.3	8.0	7.5	7.5	0.7	1.8	2.4	2.5	2.8
Viet Nam	7.0	7.2	7.5	8.0	8.0	3.9	3.0	4.3	4.8	4.9
East and North-East Asia	6.4	6.0	6.6	6.1	6.2	0.1	1.4	1.3	1.2	1.2
China	8.0	9.1	8.5	8.0	7.8	−0.8	1.2	1.0	0.8	0.5
Hong Kong, China	2.3	3.0	5.1	4.0	3.4	−3.1	−2.6	−0.5	0.3	1.0
Mongolia	4.0	5.0	5.3	5.5	5.5	1.5	5.0	5.0	5.0	5.0
Republic of Korea	6.3	3.0	4.5	4.2	5.0	2.7	3.6	2.7	2.4	2.5
Taiwan Province of China	3.6	3.3	5.4	4.9	4.7	−0.2	−0.3	0.4	0.9	1.0
North and Central Asia	5.4	7.7	5.1	4.6	4.2	14.3	11.5	10.6	8.8	8.1
Armenia	12.9	13.9	7.7	7.5	..	1.0	4.7	3.3	4.0	..
Azerbaijan	10.6	11.2	8.7	12.0	..	2.8	2.2	3.0	3.6	..
Georgia	5.6	8.6	6.5	12.0	..	5.7	4.8	5.2	6.0	..
Kazakhstan	9.8	9.2[f]	8.3	9.5	6.5	6.0	6.4	6.4	6.4	6.0
Kyrgyzstan	−0.5	6.7	4.4	5.5	..	2.1	3.1	3.5	3.6	..
Russian Federation[g]	4.7	7.3	4.8	4.1	4.1	15.1	12.0	11.1	9.0	8.2
Tajikistan	9.5	10.2	6.0	6.0	..	10.2	17.1	15.0	10.0	..
Turkmenistan	21.2	23.1	9.8	10.0	..	10.6	10.5	11.5	12.0	..
Uzbekistan	4.2	4.4	3.0	3.0	..	24.2	13.9	10.0	11.0	..

(Continued on next page)

Table II.1 *(continued)*

(Percentage)

	Real GDP					Inflation[a]				
	2002[b]	2003[c]	2004[c]	2005[c]	2006[c]	2002[b]	2003[c]	2004[c]	2005[c]	2006[c]
Pacific island economies	0.5	2.8	3.1	2.2	2.5	8.4	12.7	7.8	..	..
Cook Islands	2.2	1.8	0.2	..	..	3.9	2.4	1.8	..	..
Fiji	4.1	5.0	4.1	3.5	3.6	0.8	3.8	3.0[h]	..	..
Papua New Guinea	−0.8	2.0	2.8	1.7	2.1	11.8	17.5	10.1	11.8	..
Samoa	1.8	3.5	3.5	..	..	8.1	4.1	2.8	..	..
Solomon Islands	−2.0	1.9	3.1	..	..	9.8	12.1	11.0	..	..
Tonga	1.6	1.9	2.6	..	..	10.3	10.5	13.8	..	..
Vanuatu	−2.8	1.0	2.0	2.6	2.8	2.2	2.5	2.9	..	..
Developed economies of the ESCAP region	−0.1	2.7	2.2	1.6	1.1	−0.6	−0.1	0.0	−0.05	−0.05
Australia	3.6	2.8	3.6	3.7	3.7	3.0	2.7	2.3	2.7	2.5
Japan	−0.4	2.7	2.1	1.4	0.9	−0.9	−0.3	−0.2	−0.3	−0.2
New Zealand	4.2	2.7	3.1	3.1	3.2	2.6	1.7	2.2	2.4	2.3

Sources: ESCAP, based on national sources; IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, EIU, 2003 and 2004), various issues; and web site of the CIS Inter-State Statistical Committee, <www.cisstat.com>, 4 February 2004.

[a] Changes in the consumer price index.
[b] Estimate.
[c] Forecast/target.
[d] Based on data for 38 (developing) economies representing more than 95 per cent of the population of the region (including the Central Asian republics); GDP figures at market prices in United States dollars in 2000 (at 1995 prices) have been used as weights to calculate the regional and subregional growth rates.
[e] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2003/04 = 2003 for India, the Islamic Republic of Iran and Myanmar; and fiscal year 2002/03 = 2003 for Bangladesh, Nepal and Pakistan.
[f] January-November.
[g] In the case of inflation, figures for 2002-2003 refer to year-end rates.
[h] Year-end figure.

ICT components plus a wide range of finished consumer goods, especially household electronics. Higher exports have also been the result of strong demand from within the region and further boosted by stronger growth in the United States economy, to which approximately a fifth of the region's exports remain destined. Robust domestic demand owes much to higher fiscal spending as well as increased corporate and household expenditure that has been facilitated by the low inflation and low interest rate environment.

Growth momentum should be sustainable in 2004

Although prospects for each subregion are different, broadly speaking, the trends outlined above are expected to continue over the next 12 months in the ESCAP region as a whole; this is subject to the absence of new negative shocks to the regional economy in 2004. The expectation is that, barring any significant negative shocks, the collective GDP growth rate in the ESCAP developing countries should be the same or higher in 2004. In this context, it is worth noting that at the time of writing the incidence of avian influenza had affected 10 economies in the region, mainly in East and South-East Asia, resulting in the culling of millions of chickens on poultry farms across the region and in a number of human deaths. The future course of this problem, particularly its wider economic repercussions in the region, is difficult to predict with precision for the time being. However, assuming that the disease remains confined to poultry farms and is contained, say, by the end of April, its impact on regional growth is likely to be negligible and could even be made up by faster growth in the second half of the year, as happened with SARS in 2003.

Some caveats and risks

Nevertheless, this optimistic scenario should be qualified with risks that could operate on the downside. In the first place, from a global standpoint, the later part of 2003 has witnessed the emergence of major global imbalances already discussed in chapter I. The unravelling of these imbalances, especially in the form of rapid fluctuations in exchange rate parities, could spill over into greater instability in the financial markets, thereby undermining business and consumer confidence alike. Second, the danger of protectionist tendencies cannot be ruled out given the implicit changes in relative competitiveness via exchange rate changes superimposed upon the failure of the WTO negotiations at Cancún in September 2003. Third, the stimulation of domestic demand by higher fiscal spending and low interest rates for three years or more has raised both public debt and personal indebtedness to uncomfortably high levels in a number of economies. Many of them thus do not have significant additional scope to further stimulate growth through these means. Fiscal consolidation and some degree of monetary tightening may soon become unavoidable. The following paragraphs outline briefly the performance and prospects for each subregion followed by a discussion of the principal policy issues facing the region in the near term.

Strong growth in China but slowdown in the Republic of Korea

In East and North-East Asia, the rapid growth of the Chinese economy was not able to fully offset the marked slowdown in the Republic of Korea and weaker growth in Taiwan Province of China. Hence, it was the only subregion to experience a slowdown in the overall GDP growth rate in 2003 compared with 2002. Inflation rose, but at 1.4 per cent it remains low by historical standards and lower than in the other developing economies of the region. Prospects for 2004 are for a modest acceleration in the collective growth rate even though China's economy is expected to slow marginally from its present high rate of expansion. Thus, the pickup in regional growth will be on account of the higher momentum of growth in the other economies of the subregion.

Need for fiscal consolidation

Despite the robust GDP growth, persisting and rising fiscal deficits are the central near-term policy issue of concern in the subregion. Domestic savings rates are high and financing these deficits does not pose an immediate problem. However, the effective pre-emption of resources on a large scale by the Governments of the subregion reduces the policy space to address urgent problems in the financial sector, as, for instance, in China, or to promote structural change and improve competitiveness, as, for instance, in Hong Kong, China, and the Republic of Korea. Furthermore, the accumulating public debt is almost certainly bound to create upward pressure on interest rates in due course, thus putting at risk long-term investment expenditure in the various economies. Some restructuring and reform of the fiscal system are needed to stabilize the public debt-to-GDP ratio over the medium term. Furthermore, a shift from indirect to direct taxes is needed on equity grounds.

Robust growth in North and Central Asia

Collective GDP growth in North and Central Asia accelerated by an impressive 2.3 percentage points in 2003. The already high rates of growth prevailing in the smaller economies, such as Armenia, Azerbaijan, Georgia, Tajikistan and Turkmenistan, went up further in 2003, Kazakhstan continued to make progress in developing its energy resources and maintained its robust growth of recent years, Kyrgyzstan emerged smartly from negative growth while Uzbekistan improved upon its somewhat modest 2002 growth rate. The economy of the Russian Federation exceeded all expectations by achieving growth considerably in excess of the rate predicted as recently as 6 months previously and 2.6 percentage points more than in 2002. This stellar performance was driven by the traditionally strong energy and other natural resource sectors aided by the continued diversification of the economy. Overall industrial production stood nearly 8 per cent higher in December 2003 on a year-on-year basis. Prospects for 2004, however, suggest that current rates of growth are unlikely to be sustained, with all economies expected to experience some slackening in the pace of growth in the coming months as energy and commodity prices soften.

Need for stronger public institutions and a stronger financial sector

The economies in transition in this subregion face a very different set of qualitative issues of day-to-day management and of long-term development compared with the other ESCAP subregions. Transition from the command economy to a market-based one is taking longer than initially expected. Deregulation of the price system is still incomplete and progress in reducing the role of the Government in production and distribution has some way to go. Deregulation of the price system is needed for the elimination of repressed price pressures and for the achievement and maintenance of longer-term macroeconomic stability. Meanwhile, improved policy transmission is predicated on a reduction in the role of the Government and the establishment of stronger oversight institutions accompanied by the wider application of market-sensitive prices and instruments. Progress is being made on both fronts as can be seen in the declining rates of inflation, lower fiscal deficits and improved current account positions in all except three countries in North and Central Asia. This progress is providing greater stability in exchange rates and a more stable environment for investment, both domestic and foreign. However, institutional progress has been slower and more uneven, especially in the financial sector, a key interface between the real economy and the saving and investment decisions of individuals. Market signals tend to operate poorly in capital allocation decisions, leading to waste and inefficiency.

Pacific island economies emerge from recession

The Pacific island economies emerged from two years of low growth in 2003 as firmer agricultural commodity prices stimulated higher output growth in the subregion. At the same time, however, inflationary pressures intensified, especially in the larger economies of Papua New Guinea and Fiji, on account of higher energy prices feeding into higher production and transport costs. Prospects for 2004 suggest an easing of both GDP growth and price pressures.

The adverse effects of poor governance

Several economies run fiscal deficits and remain dependent on outside assistance for budgetary support, a phenomenon that remains a key area of concern in this part of the world. The existence of inefficient State-owned firms and poor governance aggravates the fiscal problem significantly, while the shortage of public resources has meant chronic underinvestment in physical infrastructure, especially communications, a critical necessity given the physical remoteness and vulnerability to natural disasters of the island economies. The aggregate impact of these shortcomings has led to an increase in poverty and growing social instability in several parts of this subregion. Substantial and sustained investment in physical infrastructure and in education and health facilities is vitally needed to improve economic performance and the quality of life of the citizens of Pacific island countries in the coming years.

South and South-West Asia enjoys stronger growth ...

In South and South-West Asia, there was a marked improvement in the collective GDP growth rate in 2003, compared with 2002, along with the abatement of inflationary pressures over much of the subregion. The higher GDP growth was almost exclusively accounted for by India, the largest economy in the subregion, which improved its GDP growth rate by over 3 percentage points. Pakistan, Bangladesh and Sri Lanka also experienced better GDP growth rates to varying degrees. The smaller economies likewise did well, with Nepal emerging from negative growth in 2002. The improved growth performance in India and Pakistan was occasioned by more favourable weather, which aided strong output growth in agriculture. Exports also benefited, particularly in Pakistan. Higher output and better commodity prices raised agricultural incomes and this, in turn, stimulated the production of manufactured goods. Investment levels also went up in these two economies. Elsewhere, the Islamic Republic of Iran, too, improved on its 2002 performance on the basis of strong demand, and continuing high prices, for oil and gas in 2003. Turkey's economy, however, registered a fairly sharp slowdown, primarily on account of negative growth in agriculture. Prospects for 2004 are for an easing of the collective growth rate of the subregion. India's agricultural sector is expected to slow somewhat after its impressive performance in 2003 and Turkey's economy is expected to come up against sluggish growth in the EU, its principal trading partner.

... but still faces daunting challenges

Despite steady GDP growth over the last three years, this subregion is faced with a number of daunting challenges. For instance, income poverty levels remain high and access to essential social services such as education and health and to clean drinking water remains limited. The recent improvement on the macroeconomic front suggests that most, though not all, economies of the subregion have taken an important step in the right direction in improving the environment for investment decisions and, hence, for stronger long-term growth. At the same time, however, as GDP growth rates trend upward in the years ahead, the Governments of the subregion need to ensure that there is no slippage in the momentum. The emphasis on structural reform and improved governance that has already provided a significant uplift to economic performance must be maintained. In addition, Governments must ensure that the higher growth translates into more resources for the provision of social services and for infrastructure investment, two long-neglected areas of public policy over the years.

South-East Asia overcomes the effects of SARS

Despite the impact of SARS, collective GDP growth in South-East Asia in 2003 exceeded the pace achieved in 2002. Indonesia, Malaysia, Thailand and Viet Nam maintained their 2002 pace of rebound following the 2001 slowdown, while Cambodia, the Lao People's Democratic Republic, Myanmar and Singapore experienced reductions in their growth rates. With the exception of the Lao People's Democratic Republic and Myanmar, where inflationary pressures remained high, the subdued pace of price increases slowed further in the South-East Asian economies. In virtually the entire subregion, GDP growth was stimulated by the contribution of intraregional trade and by domestic demand, both investment and consumption. The service sector was hit by SARS but the adverse effects were confined to the second quarter of 2003 and were reversed in the second half of the year. Prospects for 2004 are positive, with GDP growth expected to pick up further momentum in all countries in the subregion. Inflationary pressures, however, are likely to increase modestly as higher raw material and commodity prices enter the production chain.

Need for fiscal reform

South-East Asian countries have been some of the best-performing economies in the ESCAP region for many years and have made good progress in reducing poverty in the process. The 1997 crisis and the 2001 downturn have not only reduced growth and worsened the macroeconomic situation but also undone much of the impressive progress made in poverty reduction in the 1980s and early 1990s. The policy issues facing the subregion consequently consist of regaining the pre-crisis momentum of growth and making up lost ground in the area of poverty reduction. However, this will involve the resolution of significant structural problems that came to light following the 1997 crisis and where much still remains to be done, notwithstanding considerable progress over the last six years. First and foremost is the need to speed up reform of the corporate and financial sectors and deal conclusively with the issues of lingering corporate balance sheet weakness and impaired assets in the financial sector. Without progress in this area a major upturn in corporate investment levels and technological upgrading is unlikely to take place on a durable basis.

The second major and interconnected issue is that of public finance. Governments have run public debt up to a high level in refinancing the financial sector and in supporting the momentum of growth. There now needs to be a time-bound programme of fiscal consolidation together with a rebalancing of direct and indirect taxes and of expenditure to promote equity and enhance the provision of public and merit goods. Third, in a rapidly changing regional environment, especially the challenge posed by China's rapid growth, the subregion needs to direct resources towards enhancing competitiveness through skills upgrading and the development of more domestic technology.

Growth revives in Japan; Australia and New Zealand maintain momentum

In the developed countries of the region, 2003 saw a revival of strong growth in Japan, the world's second-largest economy, that for the first time in a decade bears the promise of durability. Australia and New Zealand continue to show strong GDP expansion so that there is a basis for all three economies to achieve output growth at, or near to, their long-term potential for a number of years. As Japan's economy is a major source of demand for the region's exports and a major provider of FDI for the region, these developments augur well for the future.

The key policy objective in 2004 for this group of countries is to sustain growth. In Japan, this requires decisive action on the domestic policy front to resolve long-standing problems in the banking sector, in the massive public debt and in the chronic deflationary pressures which prevent a durable recovery of consumption expenditure in the economy. In Australia and New Zealand, the problems have to do with the maintenance of prudent macroeconomic aggregates in the near term, namely, containing the current account deficit, so that the pace of growth does not slacken in the coming years.

POLICY ISSUES AND CHALLENGES

Even with the relatively buoyant growth that the region is currently enjoying, new policy issues and challenges are sure to arise. Some will emanate from adverse changes in the global environment, where national policies can only play an attenuating role. Others will arise that are more domestic in both origin and import; here national policies can be more normative and directly address the issues that have arisen.

The challenge of global imbalances

As discussed in chapter I, some of the potential and problematic policy issues facing the region, such as the unwinding of global imbalances and the weakening of the dollar, are primarily international in character but individual economies should nonetheless take appropriate action to shield themselves from their deleterious effects. Acting together in cooperation will be more effective than acting alone. Other potential and problematic policy issues, such as the appreciation of regional exchange rates, will require flexibility of response and alertness buttressed by stronger regional cooperation so that, should difficulties arise, corrective action can be taken in time.

Need for more regional cooperation

Another area requiring policy attention is the possible emergence of asset bubbles in stock markets and in real estate and whether pre-emptive action is the right course to adopt given the level of uncertainty involved in how bubbles come about in the first place and the efficacy in dealing with them of traditional policy instruments such as interest rate changes. In this context, the accumulation of large foreign exchange reserves, apart from raising the question of opportunity costs, given the low returns available on them, has also constrained somewhat the freedom of the authorities in the conduct of monetary policy by putting upward pressure on exchange rates. Yet others are regional issues such as the incidence of avian influenza, where action has to be national, but without strong subregional and regional cooperation in containing the spread of the disease such action might be of little use. Finally, all Governments need to place short-term issues within their longer-term commitments such as those made in accepting the Millennium Development Goals.

In the following paragraphs, the principal policy issues facing the region are discussed against this background. These issues have been discussed in previous issues of the *Survey* but the passage of time often provides fresh insights and a better understanding of the underlying policy trade-offs.

Predictability in public finance

The need for fiscal consolidation is becoming paramount. Last year it was stressed that Governments in the region should announce credible targets and supporting policies to stabilize public debt vis-à-vis GDP at a sustainable level. There is a need now perhaps for Governments to adopt more formally debt-to-GDP ratios and annual budgetary deficits as the EU has done in its Stability and Growth Pact. If implemented with flexibility rather than mechanically, such targets could introduce a useful element of predictability in their public finances, thereby providing a more secure and informed basis for investment decisions in the economies concerned.

Governments must tackle corruption

The consolidation of public debt should ideally be approached within a long-term programme of fiscal reform. All national tax systems in the region need to be defined by the aim to make them more equitable and efficient. One problematic element in the administration of national tax systems is the discretionary powers given to tax officials. These tend to dilute accountability, open up opportunities for corrupt practices and lower efficiency. There are no easy solutions to these problems, especially if they have existed for a long time. Nevertheless, the ongoing improvement in equity and efficiency in the area of public finance should be a long-term, focal objective. Corruption is a serious barrier to effective resource mobilization and allocation and diverts resources away from activities that are vital for sustainable development. Even small incremental steps in reducing corruption will have a major cumulative impact on public resource generation and allocation. One obvious route to greater accountability is transparency in the award of major public sector contracts.

More regional linkages in financial markets

Corporate and financial sector reform has made significant progress in the region as a whole. However, there is still a case for speeding up the pace of reform in most economies of the region, in particular in those countries that appear to be lagging in the implementation process. In this regard, the reform programme could perhaps be linked to initiatives for the development of financial markets in the region. As local bond markets grow in individual countries and new sources of finance for SMEs such as venture capital become increasingly available, it may be worthwhile to simultaneously facilitate regional or subregional linkages between these national markets. Developing regional or subregional markets will foster a broader investor base and reduce risk and uncertainty. Countries in the region should identify the impediments to the development of regional markets and seek to remove them. ICT offers a means of integrating national markets that was not available before.

Developing human resources ...

The key to steady development in the medium term is maintaining and enhancing competitiveness, a process requiring a stable macroeconomic environment, and a continuing programme of investment in infrastructure and in public goods. Investment in human resources development is a critically important element in this regard and, in this connection, the main challenge is to improve the quality of education at the primary and secondary levels, reduce dropout rates and enhance the performance of underachievers. Many countries in the region are not doing enough in this area and clearly risk falling behind in competitiveness. One of the Millennium Development Goals calls for the achievement of universal primary education by 2015. Merely fulfilling this quantitative target will not be enough; Governments should lay equal stress on the quality of primary education so that the number of children going on to secondary education goes up and all school-leavers acquire the skills that will both enhance national competitiveness and provide them with good employment opportunities.

... and improving SME performance

SMEs in most economies of the region are a major source of employment and output. However, financial market infrastructure is poorly developed to assist such enterprises in growing to an efficient size. The persistence of capital market imperfections makes it more difficult for small firms to access financing in order to upgrade or expand. There is also resistance on the part of owners to providing reliable balance sheet information in order to gain improved access to finance. Many small firms thus find it difficult to reach a minimum efficient size and are prone to financial difficulties causing wasted or misallocated capital. Governments should reinvigorate existing programmes of training, technology transfer, information dissemination and the formation and deepening of clusters and networks to improve the performance of SMEs.

Poor governance, a major impediment

Governance remains an ongoing policy challenge virtually over the entire region. Despite good progress in establishing sound frameworks for improved private and public sector governance over the last decade or so, the quality of implementation remains uneven. Lack of access, or differential access, to administrative or legal redress when citizens are confronted by problems or are involved in contractual disputes lowers the overall efficiency of investment, makes investors risk-averse and almost certainly reduces total factor productivity. Governments must take due cognizance of and correct the most obvious shortcomings, such as an unresponsive State bureaucracy and interminable delays in the legal process. Having the right laws is not enough; they must be seen to be effective in practice. Corporate malfeasance and corruption by public officials need to be tackled vigorously across the region.

DEVELOPING ECONOMIES OF THE ESCAP REGION

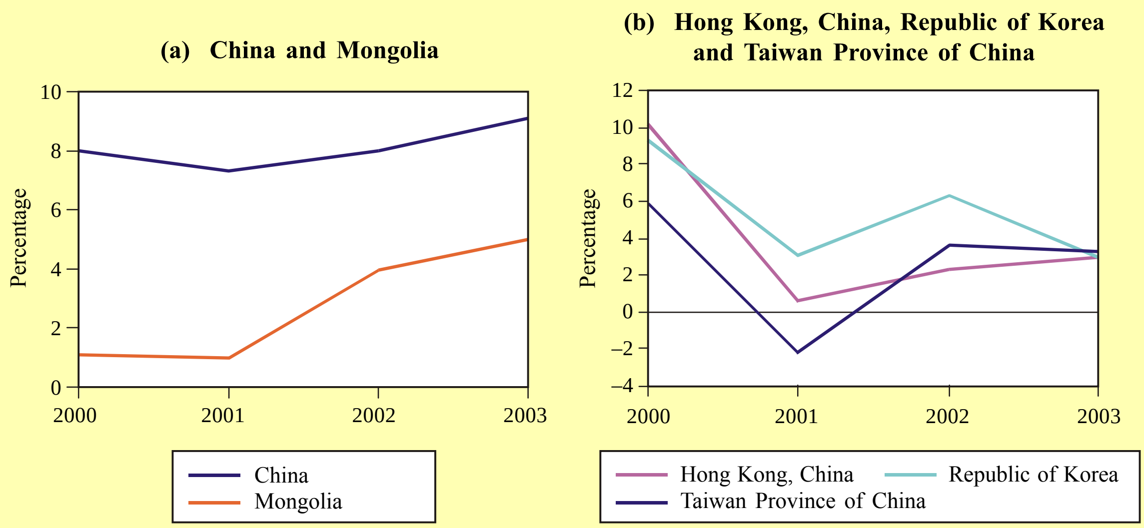
East and North-East Asia

Subregional overview and prospects

Subregional growth momentum was maintained except in the Republic of Korea

The improved global economic environment contributed to better economic performance in East and North-East Asia in 2003, compared with a year earlier, with the Republic of Korea being the exception (figure II.1). The outbreak of SARS briefly interrupted growth in China and had a pronounced impact on tourism and the retail trade in Hong Kong, China, in the first half of 2003, but the effects were short-lived. Stellar export performance, coupled with strong investment expenditure, significantly propelled aggregate output in China, while economic activities in Hong Kong, China, and Mongolia were stimulated principally by higher exports. However, sluggish consumption and investment expenditure pushed the economy of the Republic of Korea into recession. Fiscal policy was generally expansionary in the subregion in 2003, thus causing a deterioration in the budget position with all countries recording a slightly increased deficit.

Figure II.1. Rates of GDP growth in selected East and North-East Asian economies, 2000-2003



Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

China's strong economic expansion induced a scaling back of the policy stimulus to rein growth in to a sustainable rate without significantly dampening it. Measures taken so far have been moderate in magnitude and directed at sectors that appeared to be overheating, such as real estate, steel and automobiles. While fixed investment was starting to ease, higher incomes and expanding home ownership are expected to fuel strong growth in private consumption over the near future. GDP growth was projected to edge down to 8.5 per cent in 2004 with the modest policy tightening. GDP in Hong Kong, China, is expected to grow by just over 5 per cent in 2004, provided that the external environment continues to improve. The medium-term outlook of Hong Kong, China, depends on how well it adapts to integration with China and to rising regional competition.

Somewhat faster growth expected in the Republic of Korea and Mongolia in 2004

The Republic of Korea's economy slowed down sharply in 2003 owing to sluggish domestic expenditure, including investment in equipment, and it could take some time before the economy regains momentum. Exports (especially those to China) are likely to remain the principal source of growth but accumulated household debt is a constraint on consumer spending. Investment will be hampered by poor business confidence and investor sentiment on concerns over the slow pace of the recovery, political uncertainty and the ongoing shift of production capacity to China. GDP growth is expected to improve to 4.5 per cent in the Republic of Korea in 2004, along with a gradual pickup in the global economy. The strong balance of payments, stable interest rates and upward pressure on the won are expected to induce an increase in capital inflows and modest gains in equity prices.

Aggregate production in Mongolia was estimated to have accelerated in 2003, based on robust growth in industry and services, and is likely to improve to 5.3 per cent in 2004 along with the progress in broad-based reform. Government revenues came from a few key commodities such as copper, gold and cashmere, which are also the country's main sources of foreign exchange earnings. This narrow export and fiscal base has made Mongolia highly vulnerable to the whims of nature and to price volatility in world commodity markets.

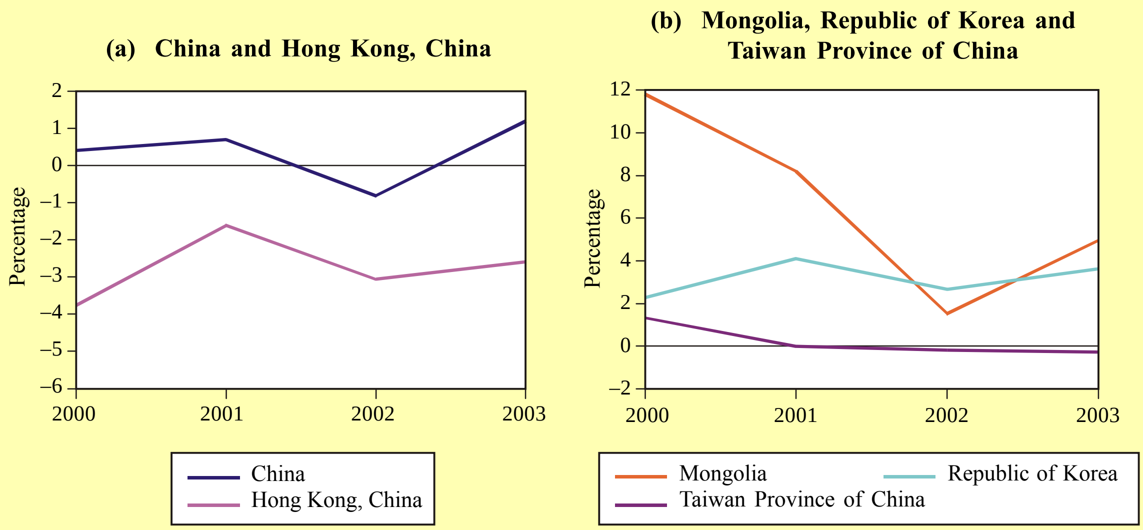
Higher consumer prices in the subregion with the exception of Hong Kong, China

Strong economic growth put an end to deflationary pressures in China, with inflation at just over 1 per cent in 2003. Despite renewed upward pressures, especially from the costs of food and services, the average increase in consumer prices is expected to remain around 1 per cent in 2004, owing to weakness in the prices of most manufactured goods created by excess capacity and strong competition. The decline in consumer prices eased off somewhat in Hong Kong, China, although that economy experienced deflation for the fifth consecutive year in 2003 (figure II.2). Deflation is expected to ease to 0.5 per cent in 2004 from 2.6 per cent in 2003, as weak property prices, high unemployment and other structural factors are likely to continue to dampen both domestic demand and the overall level of prices. Inflation in the Republic of Korea and Mongolia was relatively modest in 2003, despite rapid expansion of the money supply, although the increase in consumer prices was relatively sharp in the latter country, compared with 2002. The inflation rate is projected to slow down to 2.7 per cent in the Republic of Korea but to continue to be somewhat high in Mongolia in 2004.

The external trade performance of North-East Asian countries was strong

External trade in East and North-East Asia expanded strongly in 2003, along with the upturn in the global economy, and is expected to continue to grow in 2004. Merchandise exports of all countries in the subregion grew at a faster rate in 2003, compared with the previous year (figure II.3), as did merchandise imports, with the exception of Mongolia (figure II.4). China had the strongest trade performance in the subregion, but exports also rebounded strongly in Mongolia and the Republic of Korea in 2003.

Figure II.2. Inflation[a] in selected East and North-East Asian economies, 2000-2003

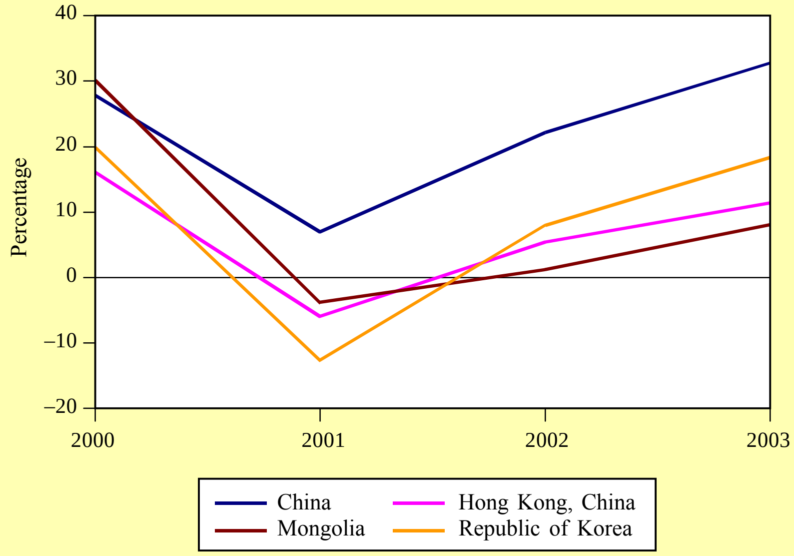


Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.

Figure II.3. Growth rates in merchandise export earnings of selected East and North-East Asian economies, 2000-2003



Sources: IMF, *Direction of Trade Statistics* (CD-ROM), December 2003; Hong Kong Census and Statistics Department web site <http://www.info.gov.hk/censtatd/eng/public/index2_fp.html>, 26 January 2004; Republic of Korea, *Economic Bulletin,* various issues; and Economist Intelligence Unit, *China Country Report* (London, EIU, December 2003).

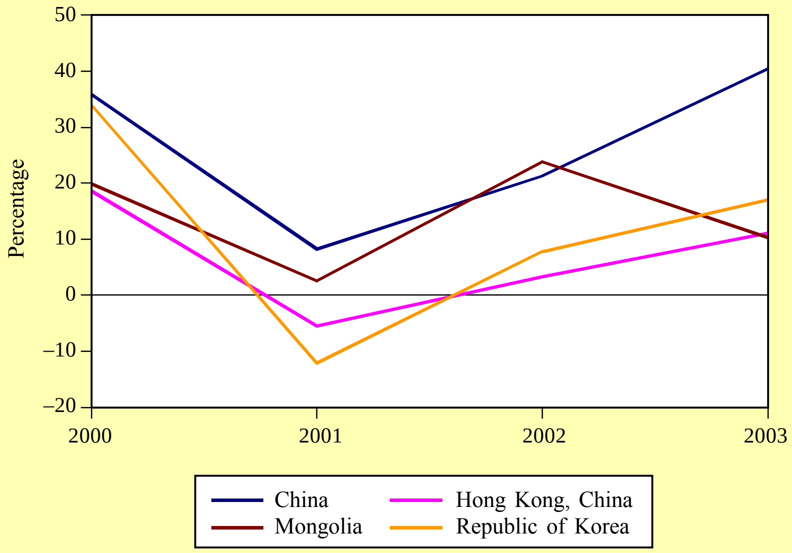
Note: Data for 2003 refer to January-October for China, January-July for Mongolia and January-November for Hong Kong, China, and the Republic of Korea.

FDI inflows into China were sustained in 2003 but decreased in other economies of the subregion

The maintenance of strong economic growth in China, coupled with the attraction of lower-cost labour, saw a further rise in FDI flows to that country in 2003, while a lower inflow was experienced in the Republic of Korea and Hong Kong, China. China is likely to remain the largest recipient of FDI among developing countries, including those in Asia. FDI inflows into East and North-East Asia are likely to continue to rise in 2004 as transnational corporations seek to lower costs and expand markets; subregional and regional production networks would continue to develop driven in part by bilateral and regional agreements and the regional integration process.

With the exception of the Mongolian tugrik, currencies remained stable or appreciated in the subregion (figure II.5). The upward pressures on the fixed exchange rate in China were from the strong balance-of-payments position, and Hong Kong, China, maintained its currency board arrangement with the United States dollar. There was a substantial increase in international reserves in both economies. In 2003, the won appreciated against the United States dollar but to a lesser extent than

Figure II.4. Growth rates in merchandise import spending of selected East and North-East Asian economies, 2000-2003



Sources: IMF, *Direction of Trade Statistics* (CD-ROM), December 2003; Hong Kong Census and Statistics Department web site <http://www.info.gov.hk/censtatd/eng/public/index2_fp.html>, 26 January 2004; Republic of Korea, *Economic Bulletin,* various issues; and Economist Intelligence Unit, *China Country Report* (London, EIU, December 2003).

Note: Data for 2003 refer to January-October for China, January-July for Mongolia and January-November for Hong Kong, China, and the Republic of Korea.

in 2002; it depreciated against the Japanese yen. However, the Mongolian tugrik depreciated against the United States dollar at a somewhat faster rate in 2003.

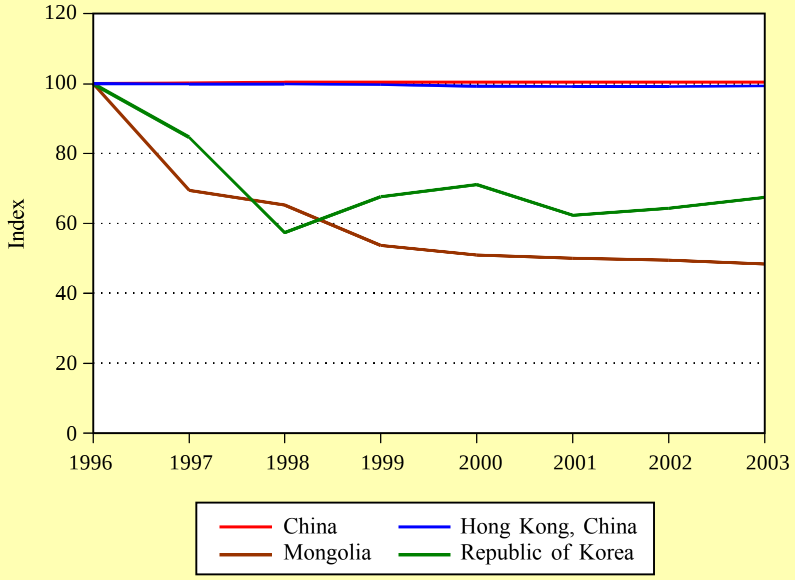
GDP performance

Strong expansion in investment, exports and economic activities continued in China

After going up by 8.5 per cent in the first three quarters of 2003, total output accelerated in the last quarter so that GDP growth in China reached 9.1 per cent for the year as a whole, an improvement of 1.1 percentage points over 2002 (table II.2); it was also the fastest growth rate since the 8.8 per cent achieved in 1997. Gross fixed investment and exports were estimated to have risen by 25-27 per cent in 2003, although agricultural production, including forestry and fishery, was estimated to have grown at the rate of 2.5 per cent in 2003. Agricultural productivity has increased steadily over the past two and a half decades, resulting in excess supply of some agricultural products, especially grains. In 2003, however, government forecasts indicated that overall grain production could fall to its lowest level in recent years and, in response, incentives were provided to farmers for the expansion of grain cultivation.

Figure II.5. Index of exchange rates against the United States dollar in selected East and North-East Asian economies, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Note: Data for 2003 are estimates.

Growth in the industrial sector in China reached 12.5 per cent in 2003. In the first 10 months of the year, the pace of expansion was the fastest since 1995, driven by increasing demand for high-quality consumer goods and a high level of demand for capital goods. In January-October, for example, production of colour televisions, cameras, refrigerators and video sets was up by more than 20 per cent, compared with the same period a year earlier. ICT hardware registered even stronger growth in output, with sectors such as microcomputers, integrated circuits and optical communication equipment rising between 30 and 100 per cent year on year. Production of passenger cars expanded by about 30 per cent, while output of steel and steel products and of aluminium increased by 20 per cent and just under one third respectively, in line with the rapid expansion of heavy industry. Driven by strong economic activities, electricity generation was 15.4 per cent higher in the first three quarters of 2003, up 6.6 per cent compared with the same period the previous year. Nevertheless, a number of regions experienced power shortages at peak periods and the problem is expected to persist for a few more years.

Table II.2. Selected East and North-East Asian economies: growth rates, 2000-2003

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
China	2000	8.0	2.4	9.6	7.8
	2001	7.3	2.8	8.7	7.4
	2002	8.0	2.9	9.9	7.3
	2003	9.1	2.5	12.5	6.7
Hong Kong, China	2000	10.2	..	..	..
	2001	0.6	4.1	–4.5	1.4
	2002	2.3	4.1	–3.1	3.2
	2003	3.0	–0.1	1.0	4.5
Mongolia	2000	1.1	–14.9	1.6	18.6
	2001	1.0	–18.5	16.2	8.2
	2002	4.0	–10.5	5.0	12.1
	2003	5.0	4.0	..	..
Republic of Korea	2000	9.3	2.0	11.9	7.9
	2001	3.1	1.9	2.9	3.4
	2002	6.3	–4.1	6.1	7.6
	2003	3.0	0.5	4.9	0.4

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Forecasts (*London, EIU, 2003), various issues.

Notes: Data for 2003 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

China's service sector is estimated to have posted a growth rate of 6.7 per cent in 2003, down marginally from 7.3 per cent in 2002. The outbreak of SARS had an adverse effect on this sector, especially tourism, which accounted for half of China's total service exports, which, in turn, fell 20 per cent in the first half of 2003. There was a consequent decline in new job offers in the service sector. Meanwhile, China's savings rate continued to increase in 2003 to reach 40.3 per cent of GDP, almost 1 percentage point higher than in 2002 and one of the highest in the world (table II.3). Nevertheless, it was still less than the investment rate for three consecutive years.

The economy of Hong Kong, China, recovered through a strong export performance

As the global economy gained strength, economic activities in Hong Kong, China, rebounded robustly and GDP growth was estimated reach 3 per cent in 2003, despite the severe setback caused by SARS in the second quarter. Sectors related to travel and tourism, however, were revived in the second half of 2003 by a sharp increase in visitor arrivals

Table II.3. Selected East and North-East Asian economies: ratios of gross domestic savings and investment to GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Savings as a percentage of GDP				
China	38.9	38.5	39.4	40.3
Hong Kong, China	32.9	31.6	33.9	35.6
Mongolia	10.4	5.7	4.1	7.9
Republic of Korea	32.6	30.5	29.3	30.1
Investment as a percentage of GDP				
China	36.3	39.0	41.0	42.1
Hong Kong, China	28.1	26.5	24.2	23.4
Mongolia	36.2	35.8	29.0	27.3
Republic of Korea	28.2	26.9	26.0	26.3

Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003).

Note: Data for 2003 are estimates.

from the mainland of China. Consumption spending began to increase again in the third quarter for the first time in two years along with the improved business outlook. However, the savings rate of 35.6 per cent of GDP in 2003 continued to exceed by a wide margin the investment rate of 23.4 per cent. Gross fixed investment showed tentative signs of an upturn during the year and despite the SARS setback, there was an encouraging rise of 4.9 per cent year on year in investment in machinery, equipment and computer software in the third quarter (although there might have been some distortion in the overall picture owing to the delivery of new aircraft in that quarter). Investment in new buildings and construction continued to fall during 2003, however.

The agricultural sector of Hong Kong, China, was by and large stagnant; its output contracted for 2003, a sharp contrast from the average 4.1 per cent growth in 2001-2002. Value added in the industrial sector went up marginally (by 1 per cent) in the same year, thus reversing two consecutive years of decline. Growth in the service sector has been accelerating since 2000 and increased further to 4.5 per cent in 2003 in part owing to improved, post-SARS tourism.

Robust economic growth along with the ...

GDP went up by 5 per cent in Mongolia during 2003, a percentage point higher than the previous year's level. There was a remarkable upturn in agriculture, which expanded 4 per cent in 2003 owing to good weather conditions and presented a sharp contrast to the preceding three

... agricultural turnaround in Mongolia

years of double-digit falls in output of almost 44 per cent. The output of grains, potatoes and fodder increased exceptionally rapidly, albeit from a low base, although the harvest in 2003 was projected to meet just 52 per cent of Mongolia's demand for potatoes and only 31 per cent for vegetables, with the balance being imported from China and the Russian Federation along with wheat.

The manufacturing sector expanded by a robust 4.6 per cent in the first 8 months of 2003 compared with the same period in the previous year. Food processing and textiles were the two best performers in this sector while production in the mining sector fell by 2.8 per cent in the same period; this sector accounted for over 53 per cent of industrial output and provided three fifths of export revenues. Mining activities were expected to become increasingly important for GDP growth in coming years, however. Total industrial output stagnated in the first 8 months of 2003 but construction provided some growth momentum to the economy.

The Republic of Korea experienced a recession in the first half of 2003

Economic performance in the Republic of Korea worsened in 2003, when GDP growth declined to 3 per cent, compared with 6.3 per cent in the previous year. Private consumption, which had boosted GDP growth in 2002, was down for the first 9 months of 2003 reflecting rising household debt and credit card delinquencies. Department store sales, which traditionally were fairly robust over the business cycle, fell continuously in the first 7 months of 2003 and consumer confidence was shaken further by the impact of typhoon Maemi, which hit the Korean Peninsula in September, killing more than 100 people and leaving more than 4 trillion won of damage in its wake. The aggregate savings rate rose to 30.1 per cent of GDP in 2003, while the investment ratio remained around 26 per cent, close to what it had been in 2002.

Gross fixed investment contracted in the first three quarters of 2003 and investment in property slowed as the residential housing market cooled down after the 2001-2002 boom, which had been fuelled by low interest rates and easy access to credit. Investment in plant and equipment was sluggish owing to the uncertain business climate while frequent labour strikes further damaged business confidence. Investment in light manufacturing, particularly textiles and shoes, slumped in the face of increasing competition from China and Viet Nam. While investment by SMEs suffered as a result of their low profitability and high leverage, larger companies found the relocation of production to China an increasingly attractive proposition.

Export performance was relatively good compared with domestic demand in 2003 although earnings on exports contracted in the second quarter and remained depressed thereafter, owing to the appreciation of the won and labour strikes that temporarily paralysed the country's main port of Busan in the south. The fall-off in export growth was, however, more than offset by an even steeper contraction in imports of goods and services on concerns related to SARS and the build-up to the war in Iraq.

Agriculture contracted sharply in 2002, when output fell 4.1 per cent, and was largely stagnant in the following year. With the opening of the domestic agricultural market to foreign competition, the sector is expected to shrink further in the near future. Meanwhile, growth in industry declined by 1.2 percentage points in 2003 to reach 4.9 per cent, and the service sector was the worst performer as growth collapsed from the 7.6 per cent achieved in 2002 to a mere 0.4 per cent in 2003.

Inflation

China's deflation ended in 2003

Consumer prices in China increased by 1.2 per cent in 2003, up by 2 percentage points from the previous year's deflation of 0.8 per cent (table II.4). China had been facing deflationary pressures since 1998 with surplus production of consumer goods and fierce price competition being among the causal factors. With WTO accession, large reductions in import tariffs forced local producers to cut prices in order to compete, thereby aggravating the downward pressures on prices. The downward trend in consumer prices was reversed in 2003, however, as a shortfall of grain raised food prices and strong demand for education, housing and medical services boosted prices charged in the service sector. More expensive petroleum products also contributed to the updrift in prices. In spite of the rapid growth in the broad money supply (M2) and in credit, an upward spiral in inflation is unlikely to occur in China because the existence of excess production capacity from the recent surge of investment is likely to keep non-food prices soft for some time. Inflation is expected to ease to 1 per cent in 2004.

Hong Kong, China, has been experiencing deflation for five years

The year 2003 witnessed the fifth consecutive annual fall, estimated at 2.6 per cent, in consumer prices in Hong Kong, China, although the deflation was less severe than in the previous year. The outbreak of SARS added to the downward pressure on prices as local retailers and service providers cut prices in the hope of stimulating sales, causing, for example, a sharp fall in the prices of consumer durables. Meanwhile, housing costs (accounting for almost 30 per cent of the consumer price index) fell even more steeply as rentals remained subdued in line with wages. The weakness of the United States dollar, to which the Hong Kong dollar is pegged, is unlikely to have a significant impact on deflation through higher import prices, as China is the principal source of imports and the yuan renminbi is also pegged to the United States dollar. Moreover, weak demand has limited the ability of retailers to pass higher prices for imports from Europe and Japan onto customers. In 2004,

Table II.4. Selected East and North-East Asian economies: inflation and money supply growth (M2), 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Inflation[a]				
China	0.4	0.7	−0.8	1.2
Hong Kong, China	−3.8	−1.6	−3.1	−2.6
Mongolia	11.8	8.2	1.5	5.0
Republic of Korea	2.2	4.1	2.7	3.6
Money supply growth (M2)				
China	12.3	15.0	19.4	20.5[b]
Hong Kong, China	9.3	−0.3	0.5	3.0[c]
Mongolia	17.6	27.9	42.0	33.1[d]
Republic of Korea	25.4	13.2	11.0	9.1[c]

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] January-September.
[c] January-August.
[d] January-June.

deflationary pressures are expected to diminish further (to 0.5 per cent) in Hong Kong, China, along with the economic upturn, even though consumer confidence remains relatively weak.

Consumer price inflation was moderate in Mongolia

Inflation in Mongolia depends largely on the behaviour of food prices, which are, in turn, greatly affected by weather conditions such as drought and severe cold. Consumer prices were projected to increase by 5 per cent in 2003, up from 1.5 per cent in the previous year. In recent years, there has been a downward trend in inflation, from 36.6 per cent in 1997 to 8.2 per cent in 2001. However, monetary growth has picked up since 2001, reaching a range of 33-42 per cent in 2002 and 2003, thus contributing some upward pressures on prices as well. Inflation is expected to remain at 5 per cent in 2004.

Inflationary pressures remained stable in the Republic of Korea

In the first 10 months of 2003, consumer prices were up by 3.6 per cent year on year in the Republic of Korea and were expected to remain at that level for the full year. Among the cost-push factors were rising international oil prices and higher fees for some services as well as the adverse effects on the prices of agricultural products owing to the severe damage caused by the typhoon that struck in September.

Demand-pull factors remained weak owing to depressed consumer confidence and dampened business sentiment. Inflation is expected to decline to 2.7 per cent in 2004, in line with falling world oil prices and an appreciation of the won against the United States dollar.

Foreign trade and exchange rates

China recorded both soaring export earnings and spending on imports

Foreign trade in China has expanded at an average annual growth rate of 15 per cent in nominal terms since 1978, when the ratio of the total value of foreign trade to GDP was only 9.3 per cent, compared with 50.2 per cent in 2002. The country was expected to become the fourth largest in the world in terms of trading volume in 2003. Export growth rates in China have increased by more than 10 percentage points each year since the slowdown in 2001 (table II.5). The value of merchandise exports reached $348.6 billion during the first 10 months of 2003 and the laggards in China's export portfolios that year were prepared foodstuffs and footwear, with sales abroad of each category increasing by less than 20 per cent year on year during January-October 2003. Even exports of garments tended to underperform in comparison with overall exports with overseas sales of garments and clothing accessories increasing about 25 per cent year on year in the same period. Meanwhile, exports of machinery and electronic products, particularly telecommunication equipment and computers, and vehicles expanded strongly, each by more than 40 per cent year on year in the first 10 months of 2003. Machinery and electronic products now account for almost two fifths of China's earnings on merchandise exports, up from just 20.6 per cent in 1996. Exports of

Table II.5. Selected East and North-East Asian economies: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Exports (f.o.b.) Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003[a]*
China	325 711	27.8	7.0	22.1	32.8
Hong Kong, China	200 092	16.1	–5.9	5.4	11.4
Mongolia	454	30.1	–3.8	1.2	8.1
Republic of Korea	162 471	19.9	–12.7	8.0	18.4

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), December 2003; Hong Kong Census and Statistics Department web site <http://www.info.gov.hk/censtatd/eng/public/index2_fp.html>, 26 January 2004; Republic of Korea, *Economic Bulletin,* various issues; and Economist Intelligence Unit, *China Country Report* (London, EIU, December 2003).

[a] Data for 2003 refer to January-October for China; January-July for Mongolia; and January-November for Hong Kong, China, and the Republic of Korea.

digital data-processing machines (such as computers) more than trebled in value in the first 10 months of 2003 and overseas sales of computer display units and mobile phones soared within the range of 40-50 per cent in the same period.

Growing intraregional trade between East and South-East Asia

Import growth accelerated with the implementation of market-opening measures related to China's accession to WTO as well as a general strengthening of domestic demand. In particular, the value of merchandise imports rose even faster than that of exports in the first 10 months of 2003, expanding 40.4 per cent year on year to $333.7 billion (table II.6). Spending on imports exhibits a similar pattern as earnings on exports in terms of composition, albeit with a greater share of raw materials and inputs needed in manufacturing. In the first 10 months of 2003, oil imports surged by 55.8 per cent, as a result of a sharp increase in both volume and price, while outlays on imported base metals and steel products were up by almost 50 and 63 per cent respectively to satisfy the rapid growth in domestic investment and car production. At the same time, imports of prepared foodstuffs and textiles increased by just 5 and 12.6 per cent respectively, and those of machinery and electrical equipment and vehicles by 41 and 61 per cent year on year respectively in the same period. Notably, during the first 10 months of 2003, China purchased over 83,000 passenger cars from abroad, at a total cost of $2.4 billion. Growing intraregional trade between China and Japan, the Republic of Korea and ASEAN led respectively to an increase of 28.3 per cent in exports to, and 43.8 per cent in imports from, those markets on an annual basis in the same period.

Table II.6. Selected East and North-East Asian economies: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Imports (c.i.f.)*			
		Annual rate of growth (percentage)			
	2002	*2000*	*2001*	*2002*	*2003*[a]
China	295 440	35.8	8.2	21.3	40.4
Hong Kong, China	207 644	18.5	–5.5	3.3	11.0
Mongolia	780	19.8	2.6	23.8	10.2
Republic of Korea	152 126	34.0	–12.1	7.8	17.0

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), December 2003; Hong Kong Census and Statistics Department web site <http://www.info.gov.hk/censtatd/eng/public/index2_fp.html>, 26 January 2004; Republic of Korea, *Economic Bulletin,* various issues; and Economist Intelligence Unit, *China Country Report* (London, EIU, December 2003).

[a] Data for 2003 refer to January-October for China; January-July for Mongolia; and January-November for Hong Kong, China, and the Republic of Korea.

During the first 10 months of 2003, China recorded a merchandise trade surplus of just $14.9 billion, down from the $24.8 billion in the same period a year earlier; the full-year surplus was estimated at $32.8 billion in 2003, down from $44.2 billion in 2002. Because of the deficits on the services and income accounts, the current account surplus fell from 2.9 to 1.1 per cent of GDP between 2002 and 2003. Despite Government efforts to slow domestic investment growth and dampen imports in 2004, the trade surplus is expected to narrow further while the deficits on the services and income accounts are expected to remain substantial, owing largely to imports of trade-related services and repatriation of profits by foreign investors. Although China's overall trade surplus has been on the decline, the country has a $47.4 billion trade surplus with the United States, which served to offset the trade deficits China had with other countries, particularly in East Asia, in the first 10 months of 2003.

International pressure for a revaluation of the yuan renminbi has intensified recently because of China's large current account surplus. However, even without a change in the current exchange rate, the current account surplus as a percentage of GDP narrowed sharply in 2003 (table II.7) and is expected to remain small in 2004. Thus, a major adjustment in the exchange rate is not expected in 2004 and a significant revaluation of the yuan renminbi could threaten the export dynamism that has been pivotal to China's development process. However, the Government might begin to reform its exchange rate system gradually, for example, by widening the narrow band within which the currency can trade.

Robust gains in exports from Hong Kong, China, notwithstanding the SARS epidemic

The value of merchandise exports from Hong Kong, China, was up by 11.4 per cent in the first 11 months of 2003, from just over $200 billion in 2002. The driving force behind this strong performance was the double-digit growth in exports to major regional markets such as China, Indonesia, Japan, the Republic of Korea, Singapore and Thailand. However, there was a contraction in exports to Malaysia and the Philippines while those to North America slackened, falling 6.3 per cent in real terms in the same period because of a deceleration in demand in the United States. By contrast, exports to the EU held up well, with a 10.6 per cent rise in real terms in the third quarter of 2003 over a year earlier, largely because of enhanced price competitiveness brought about by the appreciation of the euro against the United States dollar. Exports of services bounced back from the SARS-related plunge in the second quarter of 2003, thanks to the swift revival of inbound tourism and the continued buoyancy of offshore trade, to increase by 1.9 per cent in real terms in the first three quarters of 2003 from the same period in 2002.

Merchandise imports grew 11 per cent in January-November 2003, from $207.6 billion in 2002. Imports of services recovered in the third quarter from the plunge brought about by SARS in the second, but declined by 7.3 per cent in real terms in the first three quarters of 2003 from the same period a year earlier. The visible trade deficit of Hong Kong, China, shrank to $27.2 billion in the first 9 months of 2003, from $33.8 billion in the same period in 2002. However, the invisible trade surplus widened to $105.6 billion from $98.2 billion in the respective periods. The overall current account balance was in surplus, amounting to 10.2 per cent of GDP, only slightly lower than the 10.7 per cent in 2002.

Meanwhile, confidence in the durability of the currency link system has increased recently along with a more favourable external environment and the improved prospects for the Hong Kong economy.

Imports outstripped exports in Mongolia

Mongolia's merchandise exports increased by 8.1 per cent in the first half of 2003, from $454 million in 2002, while spending on merchandise imports was up by 10.2 per cent in the same period, from $780 million in 2002. There were higher exports of minerals, textiles, skins and hides but lower earnings were expected on precious metals, live animals and animal products. Outlays on imports have been partly driven by increased investment demand, including for the development of Mongolia's mining sector. Mongolia is also heavily dependent on food imports. Currently, trade liberalization talks between Mongolia and the Russian Federation are in progress and the latter would consider tariff cuts on imports of products of animal origin, such as meat, wool and carpets, and also an increase in imports of beef from Mongolia. Since the negotiations will probably take some time, trading volumes between the two countries are not expected to change significantly in the near future.

Mongolia launched a "Visit Mongolia" campaign in 2003 but the number of foreign visitors fell 21 per cent year on year in the first 7 months of 2003, causing a decline in tourist income of 26 per cent (to $16 million), because of the negative impact of the SARS outbreak in Asia. The numbers of high-spending tourists from Japan, which has been the largest source of overseas visitors, were particularly affected during the period.

Mongolia's exports earnings had stagnated in 2002, because of weak external demand and low world prices for copper and cashmere, and the strong expansion in import demand enlarged the trade deficit from 15 per cent of GDP in 2000 to 20 per cent of GDP in 2002; the trade shortfall was expected to widen further in 2003. The overall current account deficit as a percentage of GDP narrowed, from 16.3 per cent on average in 2001-2002 to 15.0 per cent in 2003. Mongolia has a flexible exchange rate system, and the currency depreciated at a somewhat faster rate in 2003.

The Republic of Korea recorded an expansion in merchandise exports of 18.4 per cent in the first 11 months of 2003, from $162.5 billion in 2002, and in merchandise imports of 17.0 per cent, from $152.1

Surging exports from the Republic of Korea to China

billion in the previous year. One reason for the buoyant exports was the strong demand in China for IT products, such as semiconductors, mobile telecommunication equipment and personal computers, and steel. In the first 8 months of 2003, for example, earnings on exports to China surged nearly 50 per cent year on year, to reach $21 billion, almost the same as the value of exports to the United States. By the end of the year, however, China was expected to be the largest export market for the Republic of Korea. Meanwhile, there was also an increase in exports of 13 per cent (to $10.8 billion) to Japan in the first 8 months of 2003 in response to the Japanese economic recovery.

Most export categories from the Republic of Korea recorded double-digit increases in value terms, except for those from declining industries such as textiles. In the first 8 months of 2003, for example, exported passenger cars, one of the country's mainstays, were up by an annualized 24 per cent despite the strikes plaguing the automobile sector in July and August. Electronic products also performed well, expanding 16 per cent year on year during January-August 2003, while exports of ICT equipment recorded growth of 24 per cent largely owing to strong demand from China. The expansion in export earnings on chemicals and chemical products and on machinery and equipment was in the range of 18-23 per cent in the same period.

The surplus on merchandise trade in the Republic of Korea amounted to $14.0 billion in January-September 2003, but the services account deficit widened (to reach $6.9 billion) despite the fall-off in the number of outbound tourists because of SARS-related concerns. The income account registered a modest surplus of $160 million, a reflection of the low global interest rates that helped to reduce interest payment outflows. All in all, in the first three quarters of 2003, there was a current account surplus of $4.9 billion; as a percentage of GDP, the current account surplus was estimated to rise by 1 percentage point to 2.3 per cent in 2003. As to the exchange rate, the won slipped to 1,230 to the United State dollar in March and April 2003 before continuing the steady appreciation that had begun in 2001; the won averaged 1,191.7 to the dollar during the year, an appreciation of nearly 5 per cent from the annual average in 2002. The central bank has been intervening in currency markets in order to slow down the won appreciation but it apparently has derived some comfort from the yen's more rapid rise against the dollar; indeed, the won depreciated nearly 3 per cent against the yen in 2003.

Capital flows and external debt

In China during the first 9 months of 2003, the amount of committed FDI reached $79.2 billion and that of disbursed FDI $40.2 billion, respectively about 36 and 12 per cent higher than the levels recorded in

Higher foreign exchange reserves and short-term external debt in China

the same period of 2002 despite a slowdown at midyear owing to the SARS outbreak. The rush by multinational corporations to expand their activities in China showed no sign of ebbing as evidenced by the substantial backlog of new investment commitments. There was also an upward trend in portfolio investment as reflected by the increase in current and planned listings overseas by Chinese companies.

China's total external debt went up from $170 billion at the end of 2002 to $182.6 billion (or around 14 per cent of GDP) at the end of the first half of 2003 as the prospects of a rise in international interest rates led to a sharp increase in external borrowing in 2003, much of it being short-term. Short-term debt accounted for approximately 35 per cent of the total external debt, and its upswing was attributable partly to a rise in trade-related debt linked to the sharp increase in exports and imports, and partly to a change in the method of debt calculation. Additionally, there was also a higher level of lending in foreign currency by overseas financial institutions operating in China to companies in China which sought to take advantage of lower overseas interest rates. China also got a lift in 2003 from residents repatriating their assets held abroad and exporters repatriating their earnings in response to relatively high domestic interest rates and rising expectations of a revaluation of the exchange rate. The stock of foreign exchange reserves held by China, at $401 billion in October 2003, represented a sizeable increase of $114.6 billion from the start of the year.

Hong Kong, China, is experiencing a net FDI outflow

With the recovery of economic activities, net FDI in Hong Kong, China, was estimated at $0.9 billion in 2003, a sharp reversal of a decline of $4.0 billion in 2002. In particular, FDI inflows reached $11.2 billion in 2003, or $1.5 billion lower than in 2002, while outward FDI was equal to $10.3 billion, or $7.4 billion less than in the previous year. Generally, FDI flows into Hong Kong, China, have declined substantially since China's entry into WTO with the ratio of inward FDI to GDP falling to 6.9 per cent in 2003 from 8.5 per cent in 2002 and 14.6 per cent in 2001. The percentage of inward FDI in gross fixed investment dropped from a peak of 55.7 per cent in 2001 to just under 31 per cent in 2003, reflecting the sluggishness of both the domestic and global economies. On a global basis, the territory's share of inward direct investment flows, however, has remained largely around 6 per cent over the past few years.

External debt increased to $53.6 billion in 2003 (or 33.1 per cent of GDP) from $48.3 billion (or 29.9 per cent) in 2002. The higher level of such debt is not considered to be a significant threat to the economy in view of the reserves position of $112.1 billion at the end of the third quarter of 2003 and the debt-service ratio of less than 2 per cent of export earnings in 2003.

FDI inflows into Mongolia on an upward trend since 1992

FDI flows into Mongolia equalled $78 million in 2002, an 81 per cent rise from the previous year's level. Developing countries emerged as the principal source of FDI in the country, accounting for 73 per cent of all approved investment projects between 1997 and 2002. China was the largest investor in terms of the FDI stock, followed by the Republic of Korea; Japan was a large investor among the developed countries. Inward FDI has been concentrated in the tertiary sector, which received 41 per cent of approved FDI between 1990 and 2003, while the 28 per cent share of the primary sector was dominated by mining and petroleum activities. About 52 per cent of all foreign investment projects were in trade and construction. Since the transition to a market-based economy in 1990, the Government has sought to attract FDI so as to accelerate economic development. In addition to maintaining macroeconomic stability, specific measures have also been put in place in the last two years to create an environment favourable to FDI, including the exemption from import and custom duties of high-tech equipment and machinery imported by foreign investors for export-oriented production.

As at the end of 2002, Mongolia's outstanding external debt amounted to $984.9 million, or some 89 per cent of GDP. A commitment to open economic policies during the transition period has led to a continual increase in ODA, which was worth $2.1 billion for the period 1991-2002; of this amount, 48 per cent was in the form of concessional loans. By the end of 2002, Mongolia's foreign exchange reserves had reached $350 million, although the level was down to $293 million by the second quarter of 2003.

Higher external borrowing and foreign exchange reserves in the Republic of Korea

FDI flows to the Republic of Korea fell by almost 25 per cent, to $1.5 billion in 2003 from $2 billion a year earlier. In net terms, FDI in the Republic of Korea was down from $5.1 billion in 1999 to $1.1 billion in 2001, and this downward trend was due mainly to deteriorating business sentiments, which, in turn, were caused by increased political uncertainties on the Korean Peninsula, domestic labour unrest, the sluggish global economy, the war in Iraq and the increased economic importance of China. Meanwhile, outward FDI from the Republic of Korea appeared to have declined to $2.5 billion in 2003, some 8 per cent less than in 2002; the net FDI outflow of $0.7 billion in 2002 is projected to widen to $1.1 billion in 2003.

Meanwhile, there was a rebound in portfolio investment inflows in 2003, reaching $10.4 billion during the first three quarters of 2003, from $0.2 billion in 2002. The surge was attributable to the improving outlook of the gradual economic recovery and corporate profitability. The renewed foreign purchases of common stock were sufficient to offset FDI outflows by Republic of Korea companies. At the end of June 2003, the Republic of Korea's external debt went up to $159 billion, the highest level since the latter part of 1998 and the ninth consecutive month of debt increase.

Much of the upswing was in private, long-term liabilities, mainly in the form of bond issuance, while the lower short-term debt partly reflected a decrease in trade financing. The overall level of external debt remained manageable. However, the yen's recent appreciation against the won is a matter of some concern; many borrowers in the Republic of Korea had been taking advantage of the low interest rates in Japan in recent years, thus pushing up the value of yen-denominated loans from just about $600 million at the end of 2001 to around $9 billion by October 2003. Meanwhile, foreign exchange reserves in the Republic of Korea had risen to $150.3 billion by November 2003, from $121.4 billion at the end of 2002.

Key policy issues and responses

Fiscal deficits widened in the subregion

The East and North-East Asian subregion pursued an expansionary fiscal policy in 2003 to stimulate domestic economic activities, with the consequent enlargement of the fiscal deficits as a percentage of GDP across all economies in the subregion. The increase in the deficit was particularly sizeable in the Republic of Korea, from a surplus equivalent to 3.8 per cent of GDP to a deficit of almost 1 per cent of its GDP between 2002 and 2003. The fiscal shortfall also remained relatively high at around 6 per cent of GDP in both Hong Kong, China, and Mongolia (table II.7).

Table II.7. Selected East and North-East Asian economies: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Budget balance as a percentage of GDP				
China	–2.8	–2.6	–3.0	–3.3
Hong Kong, China	–0.6	–5.0	–5.5	–6.6
Mongolia[a]	–6.8	–4.1	–5.7	–6.0
Republic of Korea	1.3	1.3	3.8	–0.8
Current account balance as a percentage of GDP				
China	1.9	1.5	2.9	1.1
Hong Kong, China	5.5	7.5	10.7	10.2
Mongolia[b]	–16.2	–16.6	–16.1	–15.0
Republic of Korea	2.7	1.9	1.3	2.3

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Including grants.
[b] Excluding official transfers.

China needs to continue its reforms and strengthen the social safety net

China's budget deficit, equal to 3.3 per cent of GDP in 2003, is expected to continue in 2004 and 2005. In recent years the Government has been successful in raising revenues, from a low of just over 11 per cent of GDP in 1995 to an annual average 18 per cent in 2001-2002. In the first 9 months of 2003, for example, revenue collections went up by 23 per cent compared with the rate a year earlier; strong growth in revenues is expected to continue in 2004 partly as a result of reforms, including the unification of the standard 33 per cent corporate tax paid by many local firms and the rate of 15 per cent levied on most foreign companies. Meanwhile, government spending is expected to remain on an upward trend as the implementation of structural reforms also carries the need to finance additional welfare provisions, possibly at a faster rate than revenue growth. The Government plans to guarantee allowances and pensions for those employees laid off by, or retired from, State-owned enterprises as well as to improve the implementation of unemployment insurance and guarantees on minimum subsistence in urban areas. The number of workers and unemployed requiring assistance is likely to be considerable along with the ongoing restructuring of more such enterprises.

The significant surge in investment in China over the past few years is one of the issues of concern to the Government, because it might exacerbate problems of overcapacity in many industries. Production was already running ahead of consumption, even in those sectors recording the strongest growth in sales. For example, although sales of passenger cars went up by nearly 67 per cent year on year in the first 10 months of 2003, production in the same period increased by more than 80 per cent. From a broader perspective, retail sales expanded by 8.8 per cent year on year during the same period, far below the 30 per cent increase in investment.

According to official sources, NPLs at the four largest State-owned commercial banks fell from 23.1 to 21.4 per cent of all loans between the end of 2002 and the first 9 months of 2003, in part owing to rapid growth in lending. The loan portfolio of banks has also partly shifted away from inefficient State enterprises to consumers and the non-State sector, but the robust credit expansion over the past year might impact on the quality and adequacy of internal controls and credit analysis. An upturn in NPLs will undermine the progress that banks have made over the past several years in strengthening their balance sheets, thus further complicating the restructuring efforts, which could include public share offerings. A banking system under stress embodies an enormous potential fiscal burden and a source of financial instability. Additionally, intensifying competition can be expected to follow China's accession to WTO and the pending opening of the domestic banking market to foreign banks in 2006. The banks have made concerted efforts to reduce their NPL ratios, including by writing off bad assets as well as by raising the overall loan volumes. They had been given a major incentive to write off NPLs with the government pledge that banks with an NPL ratio below 15 per cent would be allowed to apply for a stock market listing. Such listing would be a significant breakthrough for the major banks in China, generating funds that could help them to lower further their NPL ratios, strengthen their capital base and recruit strategic partners able to offer better and innovative financial expertise and technology.

China also needs to deal with the various structural deficiencies related to the inadequate development of market institutions. While structural reforms have unleashed a powerful development process, the establishment of market institutions that would help to guide the economy has been a slow process. Administrative control over interest, the newly developed capital markets and the underdeveloped state of the foreign exchange markets all exemplify the many-sided demands for policy attention and resources in the financial system with wider implications on macroeconomic management and hence the domestic economy as well.

Sustaining strong growth over the medium term will require the sustained broadening of the role of the private sector in economic activities, banking sector overhaul and financial sector reform more generally. In particular, job growth in the private sector could be stimulated by improved access to financing and reduced barriers to entry into new lines of business. Meanwhile, however, caution is needed in the implementation and sequencing of market opening and liberalization measures although such measures will both unleash and enhance further the considerable economic potential of the country. Recent efforts to contain the emerging pressures from excess demand bode well for near-term growth prospects, maintaining China's position as a magnet for global manufacturers seeking to enter its domestic market and/or to develop an export base.

Following the outbreak of SARS, China spent about Y20 billion on combating the disease and put equal emphasis on disease control and economic development. The Government took a series of firm measures against the spread of SARS in early 2003 and succeeded in greatly improving internal reporting and prevention systems for the control of epidemics. Steps are also being taken to further improve the public health system as the country becomes increasingly integrated with the outside world.

Hong Kong, China, needs to improve its fiscal position

Hong Kong, China, is still in the midst of a structural transformation process, with consequent dislocations, unemployment and persistent deflation. The fiscal position continues to deteriorate and this is a potential source of macroeconomic vulnerability. Traditional sources of government revenue, especially from land sales, are projected to remain volatile and come under increasing pressure. The introduction of a low-rate, broad-based goods and services tax could help to broaden the revenue base and reduce its volatility. At the same time, ancillary reductions in expenditure will be also required for successful and sustained fiscal consolidation, a process which would be consistent with the objective of maintaining a small government.

Currently, the territory's financial system remains resilient and fundamentally sound and operates in a strong financial stability framework. However, vigilance might be needed to ensure that higher-risk credit does not undermine the banks' resilience to shocks, as profit opportunities are shrinking in traditional lending. Greater coordination is also required among regulators of the banking, insurance and securities industries for better financial surveillance. Moreover, the regulatory framework in the area of corporate governance may benefit from some tightening up, and accounting and auditing standards need to be enhanced to further strengthen the infrastructure of the financial sector.

Mongolia also needs to control the fiscal balance, while continuing reforms

Mongolia has made progress in many areas in its transition to a market-based economy, including liberalization and deregulation as regards administered prices, exchange rates and interest rates and the establishment of a modern, two-tier banking system. However, the lack of a diversified economic base and the heavy dependence on mineral resources and animal husbandry has contributed to the persistence of fiscal deficits; typically, revenue collections have fallen short of the high costs of economic reform and government expenditure needs. The overall fiscal deficit rose steadily from 4.1 to 6 per cent of GDP between 2001 and 2003. The stock of public debt (although declining slightly over the same period) remained relatively high at 92 per cent of GDP at the end of 2002. Strong upward pressure on public expenditure can be expected to continue and this poses a continuing problem for fiscal sustainability. In order to rein in public expenditure without impinging on pro-poor outlays, it may be necessary to improve screening procedures for investment projects and reduce quasi-fiscal activities as well as enhance their fiscal transparency and accountability.

Mongolia's external debt also remained at 89 per cent of GDP in 2002. In addition to further efforts at external resource mobilization, it would be desirable to ensure that the debt service ratio not exceed 10 per cent of GDP. Meanwhile, the utilization of foreign aid could be improved by further enhancing the database on external debt, creating a legal framework for boosting credit regulation and improving the effective identification of sectors that should be the beneficiaries of credit and aid on the basis of current policy priorities. Other issues meriting Government attention include banking sector reform (entailing, among others, the need to ensure better bank supervision), restructuring of State-owned banks, reform of non-financial public enterprises, strengthening of an open trade and investment system, reinforcement of a market-oriented regulatory framework, a progressive reduction of public sector arrears, the gradual removal of indirect subsidies and improved economic governance.

The Republic of Korea needs to restore business confidence and improve youth employment

Business and consumer confidence and the pace of economic activities have been adversely affected by a variety of unfavourable factors in the Republic of Korea. These include economic and political uncertainties from increased labour strife, the broadening investigations into illegal corporate campaign financing, lingering concerns about the health of the credit card industry and the recent postponement of the six-party talks on the nuclear programme of the Democratic People's Republic of Korea. The recent problems faced by a major corporation demonstrated the need for further improvements in corporate governance, including strengthening of shareholder rights, clearer responsibilities of external directors, better disclosure procedures, upgrading of accounting and auditing standards to meet international best practices and strengthening of bankruptcy laws. Meanwhile, the liquidity crisis facing a leading credit card company highlights the need to resolve the related problems of consumer debt and the non-payment of credit card debt.

The Republic of Korea's labour market has deteriorated with the number of unemployed workers and the unemployment rate both on a rising trend. In particular, the unemployment rate of 8 per cent in November 2003 for those aged between 15 and 29 is of considerable concern; lack of relevant skills was one of the reasons cited most often by Republic of Korea companies for preferring to hire experienced workers rather than their younger counterparts. According to a survey of 415 listed companies published in December 2003, the number of companies planning to hire new employees in 2004 is expected to fall by 2.2 per cent compared with the results from the 2002 survey. More worrying was the finding that 38 per cent of companies surveyed indicated that they would not hire more staff even if the economy would improve in 2004, while some other companies are seeking to make further cuts in their workforces.

Under the first bilateral FTA concluded with Chile in February 2003, Chile will reduce tariffs on more than 2,000 products from the Republic of Korea, including such export mainstays as IT equipment and motor vehicles. According to the Korea International Trade Association, such tariff reduction would affect around two thirds of the country's exports to Chile. However, vested interest groups, particularly farmers, are concerned about a possible influx of competitively priced Chilean agricultural and marine products and thus have fiercely opposed the agreement. Negotiations for a potentially more important and more contentious FTA with neighbouring Japan also began at the end of 2003, with the aim of concluding the talks in 2005. If successfully concluded, this bilateral FTA would create one of the world's largest trading zones; it would also offer a useful counterbalance for both countries to the rising competitive strength of China.

North and Central Asia

Subregional overview

Strong economic performance continued in 2003

Over the past several years countries of North and Central Asia enjoyed the longest period of sustained, strong growth for decades, with annual GDP growth averaging 9-10 per cent in Armenia, Azerbaijan, Kazakhstan and Tajikistan, and 6.6 per cent in the Russian Federation in 2000-2002. Despite some adverse external circumstances, most of the countries in the subregion managed to display a strong economic performance in 2003 with GDP expansion in the range of 10-20 per cent in Armenia, Azerbaijan, Tajikistan and Turkmenistan. While growth in the largest economy of the subregion, the Russian Federation, exceeded 7 per cent, GDP growth continued to be modestly strong in other economies of the subregion during the year (figure II.6).

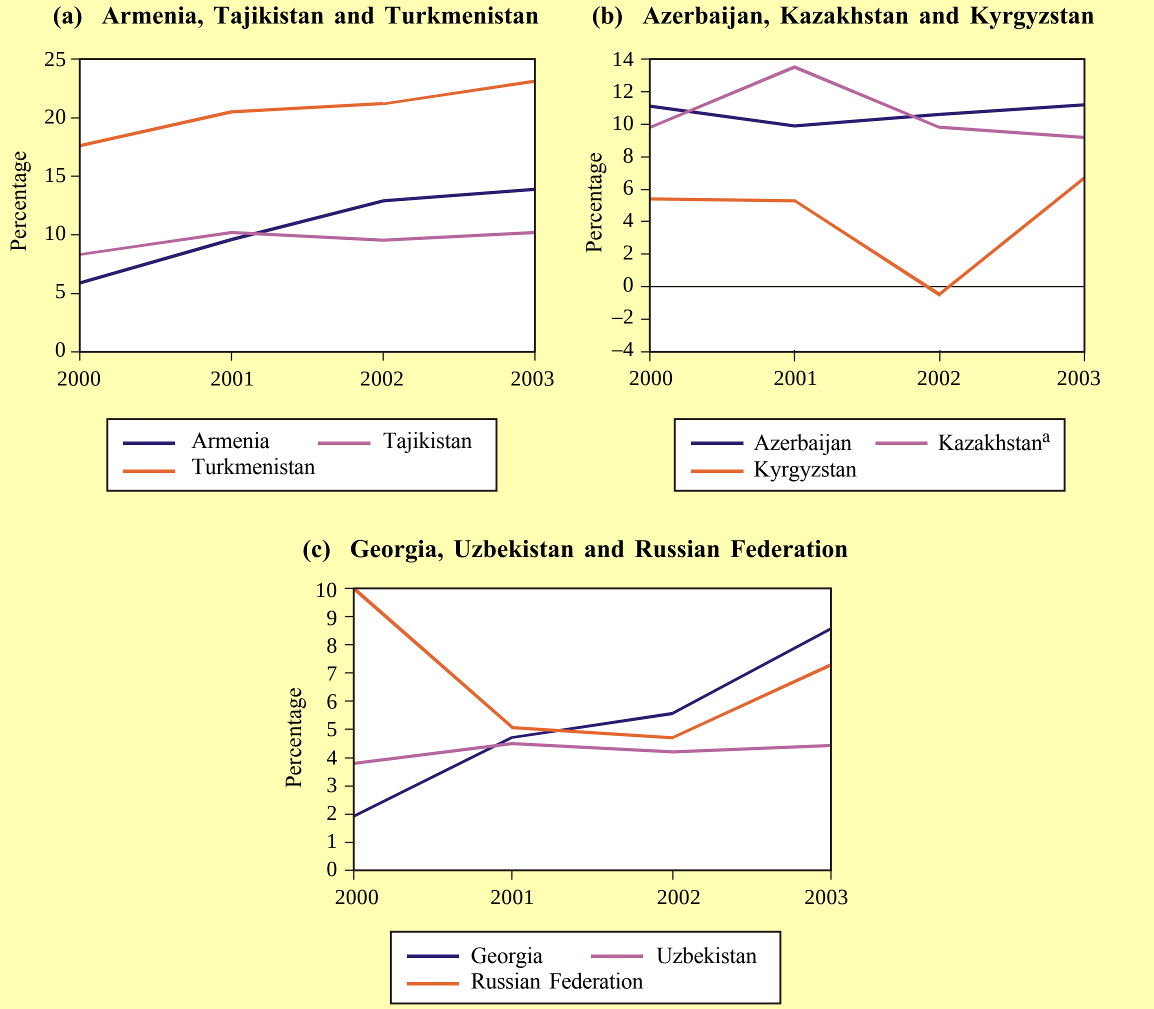
A new investment-grade status in the subregion

In 2003, the Russian Federation became the second country in the subregion (after Kazakhstan) to be accorded investment-grade status, the result of a solid economic performance and commitment to macroeconomic and structural reforms. There was a dramatic improvement in public finances, which facilitated the pre-payment of government debt, and in the external reserve position. The tax system was also enhanced with, among other measures to raise efficiency and flexibility, the introduction of a 13 per cent flat income tax rate and the simplification of corporate taxes. At the same time, the corporate sector also matched the reform efforts by paying more taxes and improving financial transparency through the introduction of international accounting standards. As a result, the government budget remained in surplus, a favourable development which was also observable in other countries in the subregion richly endowed with natural resources such as Kazakhstan, Azerbaijan and Turkmenistan. The improved fiscal situation contributed in turn to greater public investment in infrastructure and in job-creation programmes in both agriculture and industry.

However, greater diversification was needed

Generally, however, countries in North and Central Asia continued to face and manage daunting challenges in their ongoing transition to a market-based economic system and the associated policy reforms, particularly those relating to the creation of a favourable climate for the generation of greater and more diversified investment, employment opportunities, banking and financial sector development and strengthening, and poverty reduction. Four subregional economies remained heavily dependent on the oil and gas sectors, which have been the source of most of their export earnings and government revenues, hence the ongoing and pressing need to ensure greater diversification of output and employment.

Figure II.6. Rates of GDP growth in North and Central Asian economies, 2000-2003



Sources: ESCAP, based on national sources; Economic Commission for Europe, *Economic Survey of Europe 2003,* No. 2 (United Nations publication, Sales No. E.03.II.E.27); web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 31 October 2003 and 4 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003 and 2004), various issues.

Note: Data for 2003 are estimates.

[a] Figure for 2003 is for January-November.

More moderate growth prospects and economic performance in the near term

Economic growth in the most of North and Central Asian countries, by and large, was expected to moderate somewhat in 2004-2005 mainly due to a weakening of external stimuli, including less buoyancy in the export prices for natural resources and GDP growth in the Russian Federation. In particular, the federal budget of the Russian Federation for 2004 predicted a 5 per cent growth of GDP and a 10 per cent increase in consumer prices. Meanwhile, the economy in Armenia, Georgia, Kyrgyzstan and Tajikistan in 2004 is expected to be affected by limited investment and sluggish domestic demand so that GDP growth could decelerate to 8 per cent in Armenia, to 4.4 per cent in Kyrgyzstan, and to 6 per cent in Tajikistan. Falling oil and gas prices and some appreciation in real terms of the national currency could lead to a deceleration of GDP growth to 8.7 per cent in Azerbaijan and to 8.3 per cent in Kazakstan in 2004. However, the former economy was expected to realize an increase in aggregate production to 12 per cent in 2005 after the completion of the new oil pipeline from the country to Turkey. Rising exports of oil from a new hydrocarbon-bearing area and continued high investment could also push up GDP growth to 9.5 per cent in Kazakhstan in 2005.

A new initiative within CIS

As regards economic cooperation, Kazakhstan and the Russian Federation took the initiative in establishing an economic union with two other members of CIS, Belarus and Ukraine. An agreement was signed in September 2003 for the creation of an organization for regional integration with a single economic space, entailing the harmonization of customs, currency, legislative and budgetary spheres. These four CIS countries agreed to establish free-trade zones and create a supranational commission on trade and tariffs. Concerning global integration efforts, Armenia, Georgia and Kyrgyzstan became WTO members while other countries in the subregion continued to negotiate WTO accession in 2003.

Poverty remained a common concern

Poverty remained a common concern in all countries of North and Central Asia in 2003. First, as a result of higher unemployment and underemployment, the number of people living in poverty was estimated to range from more than 10 per cent in Kazakhstan, to 20 per cent in the Russian Federation, to 25 per cent in Uzbekistan, and to more than 50 per cent in Armenia, Georgia and Tajikistan. The anti-poverty programmes adopted in the subregion in 2003 included a series of measures to boost economic growth, create new jobs, especially through fostering the growth and competitiveness of SMEs, and ensure greater equity in the distribution of income and services.

GDP performance

Economic growth was driven by industry and domestic demand ...

Higher levels of output, especially from industry and domestic demand, together with sustained macroeconomic stability were behind the robust economic performance of many North and Central Asian economies. In 2003, for example, the value of retail turnover rose by more than 10 per cent virtually across the subregion; the expansion in demand reached almost 25 per cent in Tajikistan. Retail sales were strongest in foodstuffs, consumer durables and other household items. Strong consumer demand combined with higher exports, especially of energy-based products, to stimulate local production, with industrial output growing in

2003 by 15-17 per cent in Armenia and Kyrgyzstan and around 6-10 per cent in Azerbaijan, Georgia, Kazakhstan, the Russian Federation and Tajikistan (table II.8). The most dynamic industrial activities were in construction, processing and energy, with the latter sector continuing to drive economic growth in the main oil- and gas-producing countries of the subregion (namely, Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan).

... plus external stimuli

Indeed, the sustained and generally strong growth in oil and gas exports was the major contributor to the recovery in those economies from the 1998 crisis. In the Russian Federation, in particular, rising revenues from such exports improved significantly the foreign exchange and fiscal positions, thus facilitating the timely repayment of foreign and domestic debt. In 2003, however, domestic stimuli were also important in sustaining GDP growth of more than 7 per cent in the Russian Federation. There was an increase of about 8 per cent in retail trade and 12.5 per cent in investment in fixed capital. Largely as a result, industrial production rose by 7 per cent but inflation was kept within the Government's projections of around 12 per cent. Agricultural output grew by only 1.5 per cent due to flooding and adverse weather conditions in the main grain-producing areas. In order to assist agricultural producers and increase rural investment, the Government wrote off some 57 billion roubles (about $1.88 billion) owed to the State by agricultural producers in 2003.

Prudent macroeconomic policies in Armenia

Armenia headed for a second consecutive year of double-digit growth in GDP, by almost 13 per cent in 2002 and about 14 per cent in 2003. Such a robust performance was attributable to prudent macroeconomic policies and supported by ongoing structural reforms. In particular, industrial production and construction activities continued to register high growth rates along with the development of the private sector activities. Despite the unusually severe winter of 2002/03, agricultural output went up by 4 per cent in 2003. Generally, tax collections in Armenia would need to improve so as to underpin increased social spending while the business climate could be further enhanced through greater policy transparency and improved incentives.

A robust performance in Azerbaijan

Massive FDI inflows to Azerbaijan for the development of oil and gas resources were the main stimulus to economic growth, with GDP going up by more than 11 per cent in 2003. There was a healthy expansion in industrial output of 6.1 per cent during the same period although that was confined mainly to the oil and gas sectors. Higher production of oil, gas, energy and water, in turn, helped to lower energy imports in 2003. Agricultural output in 2003 was constrained by the persistent lack of credit for farmers and investment in agricultural infrastructure. Domestic production of agricultural machinery and the promotion of agricultural exports are among the focal areas of government policy in the country.

Table II.8. North and Central Asian economies: growth rates, 2000-2003

(Percentage)

		Rates of growth		
		Gross domestic product	*Gross agricultural output*	*Gross industrial output*
Armenia	2000	5.9	–2.5	6.0
	2001	9.6	12.0	5.0
	2002	12.9	4.0	14.2
	2003	13.9	4.0	14.9
Azerbaijan	2000	11.1	12.0	6.9
	2001	9.9	11.0	5.1
	2002	10.6	6.0	4.0
	2003	11.2	6.0	6.1
Georgia	2000	1.9	–15.0	11.0
	2001	4.7	6.2	–5.0
	2002	5.6	7.0	7.0
	2003	8.6	11.0	10.6
Kazakhstan	2000	9.8	–4.0	16.0
	2001	13.5	16.9	14.0
	2002	9.8	3.0	10.0
	2003	9.2[a]	1.0	8.8
Kyrgyzstan	2000	5.4	3.0	6.0
	2001	5.3	6.8	5.0
	2002	–0.5	3.0	–13.0
	2003	6.7	4.0	17.0
Russian Federation	2000	10.0	7.7	11.9
	2001	5.1	7.5	4.9
	2002	4.7	1.5	3.7
	2003	7.3	1.5	7.0
Tajikistan	2000	8.3	13.0	10.0
	2001	10.2	11.0	14.8
	2002	9.5	..	8.0
	2003	10.2	..	10.2
Turkmenistan	2000	17.6	..	14.0
	2001	20.5	..	11.0
	2002	21.2	17.0[b]	10.0
	2003	23.1	..	..
Uzbekistan	2000	3.8	3.1	6.0
	2001	4.5	4.2	8.1
	2002	4.2	6.1	8.5
	2003	4.4	4.3	6.2

Sources: ESCAP, based on national sources; Economic Commission for Europe, *Economic Survey of Europe 2003,* No. 2 (United Nations publication, Sales No. E.03.II.E.27); web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 31 October 2003 and 4 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003 and 2004), various issues.

Note: Data for 2003 are estimates.

[a] January-November.
[b] January-June.

The internal and external balances of Georgia deteriorated

GDP in Georgia grew by 8.6 per cent in 2003 because of strong growth in industry (by over 10 per cent) and construction, and in gross agricultural output (by 11 per cent) owing mainly to more favourable weather conditions. However, credit shortage restricted the ability of farmers to purchase modern agricultural machinery and high-quality fertilizers. The internal and external balances of Georgia appeared to have deteriorated in the later part of 2003, in part because a considerable fall in export earnings and State budget revenues resulted in large current accounts and budget deficits, the latter amounting to 125 million laris (about $60 million) for the first 10 months of 2003. The export base of the country remained very narrow, consisting mostly of low value added production, while external debt exceeded $1.7 billion in 2003. In October-November 2003, the exchange rate of the lari fell from 2.1044 to 2.1750 to the dollar while food prices, including those for bread, rose in the same months.

Sustained, strong growth in Kazakhstan

In Kazakhstan, GDP growth of 9.2 per cent in the first 11 months of 2003 was driven largely by higher industrial production (which expanded by almost 9 per cent in 2003) and foreign trade earnings, the latter consisting largely of oil and gas products. For example, oil production was expected to increase from 47 million tons in 2002 to 52 million tons in 2003 and further to 61 million tons in 2005, and this upward trend was mirrored by a sharp rise in export value, by 32.9 per cent in 2003. The agricultural sector, which provided employment for around 35 per cent of the labour force, thus remained the second-largest employer. Agricultural output grew by 1 per cent in 2003. The grain harvest, at 15 million tons, was expected to be lower than in 2002 because of adverse weather conditions. Agricultural development was one of the main priority areas in Kazakhstan, where a new Land Code, introduced in 2003, provided for the institution of private ownership of agricultural land.

Economic recovery took place in Kyrgyzstan

Kyrgyzstan's economy recovered strongly from a decline in output recorded in 2002. The expansion in GDP, by 6.7 per cent in 2003, was due largely to higher industrial production (by 17 per cent), with the most dynamic sectors being manufacturing activities and electricity generation. The manufacturing upturn, in turn, was driven by significant growth in food processing and light industrial output. Gold mining was also recovering from the crisis of 2002. By contrast, there was a marginal growth in agricultural output (by 4 per cent) due to the bad weather conditions and other constraints associated with inadequate agricultural reform. In particular, the expected decrease in grain harvests could adversely affect the food situation in the country during 2003.

Higher consumption contributed to the production and growth in Tajikistan

GDP growth in Tajikistan was sustained at a high rate, 10.2 per cent in 2003 compared with 9.5 per cent growth in the previous year. This strong performance was underpinned by industrial production, which went up by more than 10 per cent, relative to the 8.0 per cent growth registered in 2002. In particular, there was a considerable increase in the production of consumer goods, which resulted in double-digit growth of retail trade turnover (by 24.5 per cent in 2003). Rising real wages in Tajikistan boosted consumer demand and contributed to the recovery of domestic production, while better irrigation and the improved availability of inputs were behind the record harvest of cotton and a good wheat crop in 2003; the cotton output, for example, was up by 14 per cent.

Fourth consecutive year of double-digit growth in GDP in Turkmenistan

Meanwhile, in Turkmenistan, GDP growth was expected to speed up further from 21.2 per cent in 2002 to 23.1 per cent in 2003 owing mainly to raising output in the leading sectors, namely, hydrocarbons and cotton; in particular, cotton output in 2003 was expected to be significantly higher than that in 2002. Construction activities were another important source of production growth, however, while a harvest of 2.5 million tons of grain in 2003 contributed to food self-sufficiency.

Marginal expansion of GDP in Uzbekistan

GDP in Uzbekistan was expected to expand marginally, to 4.4 per cent in 2003, compared with 4.2 per cent in the previous year. A slight decline in the growth rate of industrial production, from 8.5 to 6.2 per cent, was recorded between 2002 and 2003. In response, all light industrial enterprises with foreign investment were exempted from all taxes, except VAT until the beginning of 2005, so as to enable them to upgrade and modernize their technologies and expand consumer goods production. There was a moderate growth in agricultural output between 2002 and 2003 although the grain harvest, at 5.1 million tons in 2003, still exceeded domestic demand. However, the main export earner and the largest source of employment in the country, the cotton sector, faced considerable difficulties such as a shortage of credit and adverse weather conditions in the spring of 2003. A new agricultural contract system was expected to be introduced in Uzbekistan in 2004 to improve market-based management and incentive structures, among other objectives. The new system also envisaged the transformation of all collective farms and other agricultural units into a system of leases.

Inflation

Inflation remained within the projected levels for 2003

With few exceptions, inflation was on a downward trend in North and Central Asia in the past few years (figure II.7). The increase in consumer prices in Kyrgyzstan and the Russian Federation remained within the projected levels for 2003. The budget of Kyrgyzstan for 2003, for example, was based on an annual inflation target of 5 per cent, but consumer prices rose by only 3.1 per cent in 2003 (table II.9). This price increase was due mainly to higher food prices, which, in turn, were attributable to the cancellation of VAT exemptions previously granted to large agricultural producers. In addition, there was a modest rise in the prices and costs of services while a reduction in the excise tax on fuel in 2003 contributed to a decline in non-food prices. Meanwhile, inflation in the Russian Federation, at just 12 per cent in 2003, reflected wage

Figure II.7. Inflation[a] in North and Central Asian economies, 2000-2003

Sources: ESCAP, based on Economic Commission for Europe, *Economic Survey of Europe 2003,* No. 2 (United Nations publication, Sales No. E.03.II.E.27); web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 31 October 2003 and 4 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003 and 2004), various issues.

Note: Data for 2003 are estimates.

[a] Percentage changes in the consumer price index.
[b] Data refer to year-end rates.

Table II.9. North and Central Asian economies: inflation,[a] 2000-2003

(Percentage)

	2000	2001	2002	2003
Armenia	−0.8	3.1	1.0	4.7
Azerbaijan	1.8	1.6	2.8	2.2
Georgia	4.1	4.6	5.7	4.8
Kazakhstan	13.5	8.5	6.0	6.4
Kyrgyzstan	18.7	7.0	2.1	3.1
Russian Federation[b]	20.2	18.6	15.1	12.0
Tajikistan	24.0	36.5	10.2	17.1
Turkmenistan	8.3	11.6	10.6	10.5
Uzbekistan	24.9	27.2	24.2	13.9

Sources: ESCAP, based on Economic Commission for Europe, *Economic Survey of Europe 2003,* No. 2 (United Nations publication, Sales No. E.03.II.E.27); web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 31 October 2003 and 4 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003 and 2004), various issues.

Note: Data for 2003 are estimates.

[a] Percentage changes in the consumer price index.
[b] Data refer to year-end rates.

increases in large industries such as energy and minerals and higher prices for essential foodstuffs, gasoline and tobacco products. For example, prices of meat went up by 15-20 per cent, those of gasoline by 45 per cent and of tobacco products by 80 per cent in the first half of 2003.

Tight monetary policy and stability of the national currencies reduced inflationary pressures in Azerbaijan and Georgia

In Azerbaijan and Georgia, inflationary pressures were both lower and moderate in absolute terms, the net outcome from a combination of tight monetary policy and the stability of the national currencies in 2003. Consumer prices went up by just over 2 per cent in Azerbaijan and 4.8 per cent in Georgia in 2003, compared with 2.8 and 5.7 per cent respectively registered in 2002. A relatively good harvest resulted in lower food prices in Georgia although the higher wages of workers involved in pipeline construction and the rising costs of energy, together with an increase of 30 per cent in railway tariffs and some depreciation of the local currency, was expected to push up inflation towards the end of 2003. The overall inflation could be marginally higher in Azerbaijan in 2004 due to government commitments to increase employment and wages in the hydrocarbons sector and to liberalize energy prices.

Moderate inflation in Armenia and Kazakhstan and higher price increases in Tajikistan

In 2003, increases in consumer prices were likewise moderate, by 4.7 per cent in Armenia and 6.4 per cent in Kazakhstan, where the prices for food and services had gone up by 4-5 per cent and the cost of imported consumer goods by 5.4 per cent by October of the year. Comparatively, however, there was much higher inflation in Tajikistan (more than 17 per cent) because of higher utility tariffs and energy prices, as well as a rise in salaries and minimum wages in the public sector and pensions.

Foreign trade and other external transactions

External trade

Significant trade growth in the subregion

Most countries in North and Central Asia recorded a significant expansion in both export earnings and import spending in 2003, with the former being attributable largely to favourable prices for energy products. The Russian Federation, by far the largest economy and the biggest trader in North and Central Asia, recorded a substantial increase in export earnings, by more than 25 per cent, to $133.3 billion in 2003. In particular, the value of oil and oil-related products increased by one third over the same period as a result of buoyant market conditions for energy exports. Spending on imports also went up strongly, by more than one fifth, to total $57.3 billion over the same period owing to strong growth in domestic demand as well as appreciation of the rouble. All of these contributed positively to the balance on external accounts, which showed a substantial surplus of $76 billion in 2003, compared with $60 billion in the previous year. Largely as a result, the current account balance was expected to be equivalent to 9.2 per cent of GDP in 2003 (table II.10).

Table II.10. North and Central Asian economies: current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Armenia	−14.5	−9.1	−6.3	−7.6
Azerbaijan	−3.2	−0.9	−12.4	−24.0
Georgia	−8.8	−6.8	−7.3	−11.4
Kazakhstan	3.7	−4.9	−2.8	1.5
Kyrgyzstan	−9.2	−3.4	−3.9	−3.3
Russian Federation	18.0	10.8	8.6	9.2
Tajikistan	−6.3	−7.0	−1.4	−3.4
Turkmenistan	13.0	4.2	5.3	1.8
Uzbekistan	0.9	−0.9	3.0	4.4

Sources: ESCAP, based on IMF, *World Economic Outlook Database, September 2003: Public Debt in Emerging Markets* (Washington, IMF, 2003); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003 and 2004), various issues.

Note: Data for 2003 are estimates.

Among other major traders in the subregion, Kazakhstan increased its trade surplus from $3 billion in 2002 to $4.6 billion in 2003, owing to a significant gain in export receipts, which reached $12.9 billion, compared with $9.7 billion in 2003 and 2002 respectively. Oil and gas accounted for more than one half of the country's export earnings. Spending on imports rose by more than 28 per cent to reach $8.3 billion in 2003 (tables II.11 and II.12). The CIS economies supplied almost 50 per cent of Kazakhstan's total imports, while they accounted for only 22 per cent of export earnings by Kazakhstan in 2003.

Table II.11. North and Central Asian economies: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Exports (f.o.b.) Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003*
Armenia	507	30.0	13.4	48.7	33.7
Azerbaijan	2 168	87.4	33.0	–6.4	19.6
Georgia	325	38.4	–3.0	1.7	37.5
Kazakhstan	9 709	62.7	–5.3	11.8	32.9
Kyrgyzstan	486	11.2	–5.5	2.0	19.7
Russian Federation	106 154	41.8	–2.8	6.1	25.6
Tajikistan	737	14.1	–16.7	13.3	8.3
Turkmenistan[a]	2 856	104.7	6.0	13.1	37.6
Uzbekistan[b]	2 510	5.2	–6.1	–8.9	6.8

Sources: Web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 23 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

[a] Figure for 2003 is the EIU estimate.
[b] Figures for 2000-2002 are EIU estimates; figure for 2003 is the EIU forecast.

Table II.12. North and Central Asian economies: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Imports (c.i.f.) Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003*
Armenia	991	9.2	–0.5	13.0	28.1
Azerbaijan	1 666	12.9	22.4	16.4	57.6
Georgia	720	7.9	4.2	6.0	47.4
Kazakhstan	6 491	36.8	25.9	2.1	28.3
Kyrgyzstan	587	–7.7	–15.8	26.0	22.1
Russian Federation	46 153	12.2	24.0	10.0	24.0
Tajikistan	721	2.1	1.8	5.0	22.2
Turkmenistan[a]	2 119	26.6	26.6	–3.7	23.5
Uzbekistan[b]	2 187	–5.6	1.6	–11.8	3.3

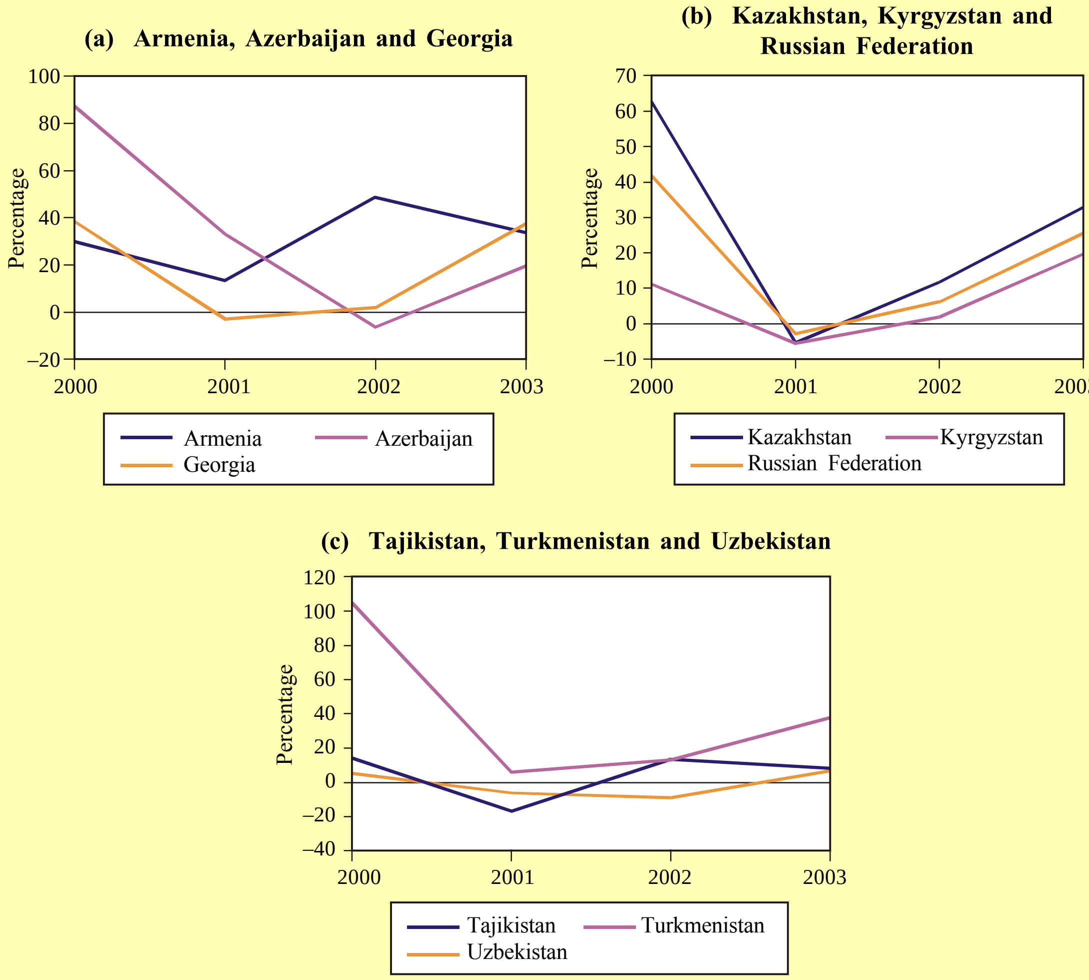
Sources: Web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 23 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

[a] Figure for 2003 in f.o.b. value is the EIU estimate.
[b] Figures for 2000-2002 in f.o.b. values are EIU estimates; figure for 2003 is the EIU forecast.

Rising trade surplus for Uzbekistan

Trade liberalization (including through the reduction of customs duties and the promotion of cross-border trade) continued to be one of the main areas of focus of trade policy in Uzbekistan in 2003. As a whole, the trade surplus was expected to increase by about 30 per cent to reach $422 million in 2003, with exported goods and services (estimated at $2.68 billion) thus rising by just under 7 per cent in 2003 (figure II.8). The depreciation of the local currency contributed to an expanded external market for the country's products, about two fifths of which (in terms of

Figure II.8. Growth rates in merchandise export earnings of North and Central Asian economies, 2000-2003

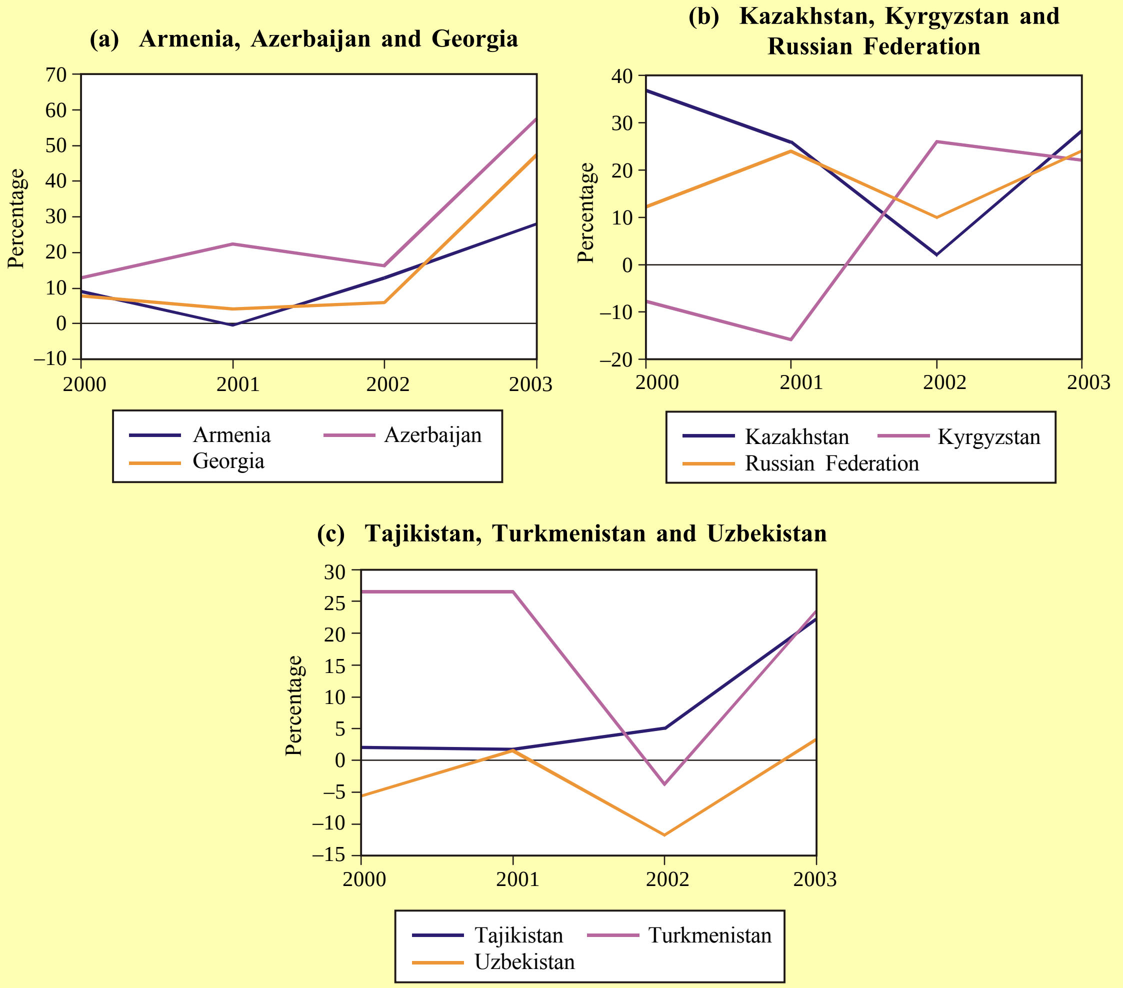


Sources: Web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 23 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Notes: Data for 2003 are estimates for Turkmenistan and Uzbekistan. All growth rates in these figures are annual.

value) consisted of manufactures and finished goods from the import-substituting industries. Meanwhile, there was only a modest rise in imports of goods and services, from $2.19 billion in 2002 to $2.26 billion in the following year, reflecting in part policy measures to conserve the stock of foreign exchange reserves (figure II.9). The Russian Federation remained the largest trading partner of Uzbekistan although there was a shift in the country's foreign trade away from CIS countries over 2002-2003.

Figure II.9. Growth rates in merchandise import spending of North and Central Asian economies, 2000-2003



Sources: Web site of the CIS, Inter-State Statistical Committee, <www.cisstat.com>, 23 February 2004; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Notes: Data for 2003 are estimates for Turkmenistan and Uzbekistan. All growth rates in these figures are annual.

Strong expansion of gas exports from Turkmenistan to the CIS countries

Turkmenistan also realized a relatively sizeable and higher trade surplus (from $0.74 billion to an estimated $1.3 billion between 2002 and 2003) through the strong expansion of gas exports to the CIS countries. Both export earnings and import spending went up considerably in 2003, with the former registering an increase of more than 37 per cent (to $3.9 billion) for the year. By contrast, however, several countries in North and Central Asia were registering a trade deficit of varying proportions. Armenia recorded a sizeable trade deficit despite higher export earnings. A substantial increase in the export of precious stones and metals raised merchandise earnings by more than one third, to $678 million, in 2003. Import spending, which went up by 28.1 per cent (to $1.3 billion) in the same period, was dominated mainly by mineral products, machinery and equipment. Generally, Armenia's trade patterns showed a shift away from the CIS markets, which accounted for 18 per cent of the export receipts and 25 per cent of the import outlays of the country.

Deterioration of the trade balance in Azerbaijan ...

The accelerating investment in and expansion of the hydrocarbons sector of Azerbaijan also contributed to a deterioration in the trade balance. The trade surplus of some $500 million in 2002 became a deficit of $34 million in 2003 despite an increase of about 20 per cent in export revenue (to $2.6 billion) owing to higher demand for oil and continued high oil prices. Oil exports accounted for nearly three fifths of total export receipts although earnings from chemicals and metals also grew rapidly as a result of the strong expansion in the industrial sector. Azerbaijan's exports were mainly destined for non-CIS countries, which accounted for 88 per cent of all receipts from merchandise exports in the first 11 months of 2003. The most significant import items were machinery and base metals for the construction of new oil pipelines.

... as well as in other economies in the subregion

The construction of the oil pipeline from Azerbaijan to Turkey via Georgia contributed to an increase in the import expenditure of Georgia by more than 47 per cent (to more than $1 billion) in 2003. This led to a deterioration of the trade balance, with the deficit of $395 million recorded in 2002 rising to $614 million in the following year, despite a pickup of 37.5 per cent in export receipts in 2003. Oil, electricity and related products remained the largest import category, accounting for over 20 per cent of total import spending, and CIS countries were the source of an increase of 49 and 33 per cent respectively in Georgia's export earnings and import outlays in the first 11 months of 2003.

In 2003, the import expenditure of Kyrgyzstan continued to exceed export receipts, a reflection of rising investment in the capital goods and gold sectors. Exports rose by 19.7 per cent (to $582 million) although sales to the traditional CIS markets, particularly neighbouring Kazakhstan and Uzbekistan, rose by 7 per cent and gold exports were largely destined for non-CIS economies. Imports expanded by more than 22 per cent (to $717 million) in 2003, resulting in a widening trade deficit from the $101 million recorded in 2002 to $135 million in the following year.

The trade surplus of $16 million in Tajikistan during 2002 became a deficit of $83 million in the following year because of a steep rise of more than 22 per cent in import outlays compared with an expansion of 8.3 per cent in export revenue (to $798 million) in 2003. Aluminium remained the main export item, providing more than half of merchandise earnings, while cotton brought in another one fifth in the same period. Tajikistan remained heavily depended on fuel imports from the Russian Federation and Uzbekistan and, to boost trade, the country simplified border-crossing and customs procedures with its Central Asian neighbours.

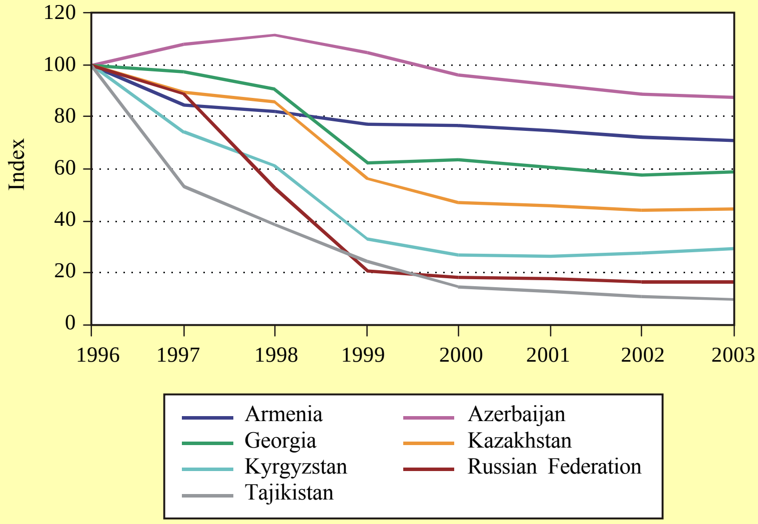
Exchange rate developments

Official exchange rates remained generally stable in 2003

A sound mix of fiscal and monetary policy measures helped to sustain macroeconomic stability and enable economies of North and Central Asia to keep their official exchange rates against the United States dollar generally stable in 2003 (figure II.10). The national currency of

Figure II.10. Index of exchange rates against the United States dollar of selected North and Central Asian economies, 1996-2003

(1996 = 100)



Source: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003).

Note: Data for 2003 are for January to October; in the case of Tajikistan, the figures are for January to September.

Armenia appreciated marginally (by almost 2 per cent) against the dollar in the first 9 months of 2003. New legislation requiring all transactions worth more than $100,000 to be conducted through the banking sector enabled the country to keep the currency exchange rate within a narrow corridor of fluctuations. Tight monetary policy, among other measures, ensured that the exchange rate of the Georgian lari against the dollar remained relatively stable in 2002 although the currency strengthened against the dollar by over 3 per cent in the first half of 2003. However, weak export revenues and rising import spending resulted in a fall in international reserves in the latter part of 2003, causing a depreciation of the local currency by almost 4 per cent in October-November 2003.

Meanwhile, in the first half of 2003, the national currency of Kyrgyzstan appreciated by about 10 per cent and interventions by central banking authorities in the foreign exchange market were designed to smooth out sharp daily fluctuations and strengthen the international reserve position. In 2003, the Government of Uzbekistan undertook wide-ranging measures for currency liberalization, including the unification of exchange rates, the creation of a free market in foreign exchange and the elimination of restrictions on access to hard currency for enterprises; previously three different kinds of exchange rates (namely, the exchange bureau rate, the official rate and the commercial rate) had existed in the country. As a result of these policy changes, the official exchange rate was generally stable in 2003 and the spread between the official exchange rate and the black-market rate was minimal, below 5 per cent in mid-2003. The national currency was expected to be fully convertible in 2004.

Upward pressures on the local exchange rates in oil-producing countries

High oil and gas prices led to large inflows of hard currency to Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan in 2003, thus contributing to upward pressure on the local exchange rates. Azerbaijan established the State Oil Fund to help to mitigate the undesirable effects of a massive inflow of foreign exchange, including the avoidance of a substantial real appreciation of the national currency and a surge in consumer goods imports in 2003. Mainly as a result, the nominal exchange rate was by and large stable in the first half of 2003. Also in the first half of 2003, the national currency appreciated in nominal terms for the first time in Kazakhstan since 1995. However, the Government adjusted its monetary policy to prevent excessive currency volatility and keep the exchange rate on a steady trend in real terms. The official exchange rate of the manat and the money supply in Turkmenistan were kept largely stable in 2003, despite the sustained inflow of hard currency. In comparison, however, the exchange rate of the Russian Federation's rouble appreciated by 7 per cent in the first 9 months of 2003, compared with an appreciation of only 2 per cent during the previous year. A stabilization fund was also set up to moderate the effects of excessive exchange rate fluctuations arising from external trade and financial transactions.

Capital inflows

Strong capital inflows in some economies and low ones in others

Despite a global decline in FDI, several economies in North and Central Asia continued to see strong capital inflows, with FDI rising from $4.8 billion to $7.5 billion between 2000 and 2002. The resource inflows were uneven, however, with the oil and gas sectors in Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan remaining the most attractive areas for FDI; export-oriented gold mining was another attraction for FDI in the subregion. Generally, FDI flows to Armenia, Georgia, Tajikistan and Uzbekistan remained the lowest among those channelled to North and Central Asia. In 2002, for example, they totalled some $36 million in Tajikistan, $65 million in Uzbekistan, $111 million in Armenia and $165 million in Georgia.

Oil and gas sectors remained the most attractive areas for FDI

In comparison, Azerbaijan was the destination during the first quarter of 2003 for $435 million of FDI, used mainly for the construction of new oilfields and pipelines. This, in turn, provided a stimulus to domestic investment, which rose by more than 70 per cent in the first 9 months of 2003, with nine tenths of capital investment going to the oil and gas sectors. FDI accounted for about 85 per cent of the total fixed capital formation in Azerbaijan and it was expected to reach $10 billion over the next 3 years, an amount which about doubled the FDI received by the country during 1996-2002.

The Kazakhstan economy was also driven by higher FDI in oil-related production and export capacities. In 2001-2002, for example, the country received the largest annual inflows since independence (more than $2.5 billion), with the stock of FDI estimated at $13.7 billion for the decade 1992-2002. The Law on Investment approved in January 2003 was important in improving the investment climate in Kazakhstan. The legislation included the best clauses of the previous investment law together with additional provisions based on international experience relating to foreign investment. Turkmenistan continued to receive FDI in its main economic sectors: hydrocarbons, construction and textiles. To some extent, however, such inflows were hampered by exchange rate restrictions and a business environment not as yet fully conducive to foreign investors.

The economic recovery, macroeconomic stability and fiscal prudence sustained in the Russian Federation helped to restore international confidence in the country. Annual FDI inflows, for example, increased from $100 million in 1992 to more than $3 billion in 2002, with the cumulative stock of foreign investment exceeding $27 billion between 1992 and 2002. In the first nine months of 2003, FDI went up by a further 77 per cent (to $4.7 billion) compared with the corresponding period of 2002, with the bulk of such resources being channelled to the energy sector. Foreign investment was considered vital for the development of the economy and export activities in Kyrgyzstan. Over the past decade, the country was the destination for more than $430 million of FDI, with the large bulk of this external resource used for the development of gold mining in Kumor. In 2003, a new assistance programme for Kyrgyzstan, amounting to $171 million in credit, was approved by the World Bank to foster the development of private sector activities, including small businesses in the energy, agricultural and agro-processing sectors, among other focal areas.

Foreign debt

Strengthened financial position of the Russian Federation ...

The financial position of the Russian Federation has been significantly strengthened since the 1998 financial crisis, and this facilitated, among other things, the faster repayment of debt to international financial agencies. Total government debt was about $145 billion and more than $17 billion of this amount was likely to be discharged in 2003; debt repayment was expected to rise to $18.9 billion in 2004. Additionally, the Government approved a plan to transform parts of its foreign debt into local debt and plans were under way to borrow $20 billion domestically over the next 3 years by issuing short-term bonds at 6 per cent interest. In the process, the foreign debt of the Russian Federation was expected to fall to $113 billion by 2006.

... and other economies in the subregion

The substantial FDI inflows also enabled Azerbaijan and Kazakhstan to reduce their foreign debt burden. In net terms, the latter country did not have external debt as most of the external obligations consisted of intra-company loans in the energy sector. The net foreign debt of Azerbaijan was about $650 million from a gross external debt position of $1.4 billion in the first quarter of 2003. Tajikistan succeeded in reducing its foreign debt in 2003, from $1.16 billion (or 98 per cent of GDP in 2002) to $985 million (or 88 per cent) at the beginning of 2003. Moreover, the Government had also reached an agreement with the Russian Federation on restructuring its $300 million debt over a 3-year period. The foreign debt of Kyrgyzstan, which amounted to more than 100 per cent of GDP in 2001-2003, was expected to reach $1.7 billion in 2003. Improvements in fiscal policy and revenue generation would help to reduce public borrowing from the present level of 8 per cent of GDP per year to 3 per cent in the medium term.

Georgia struggled to service its external debt

Much of the external debt stock of Georgia, about $1.78 billion in 2003, came from the World Bank and IMF to finance economic reform programmes. However, the financial assistance from those institutions was frozen in 2003 owing to problems in programme implementation. To alleviate its debt-servicing burden, a difficulty compounded further by weak tax collection, the Government was expected to conclude debt-restructuring agreements with the Paris Club of official creditors and its main CIS creditors such as the Russian Federation, Kazakhstan, Azerbaijan and Turkmenistan. Meanwhile, Armenia succeeded in restructuring its external debt payment to the Russian Federation and Turkmenistan in 2003. However, the country's main creditors remained the World Bank and IMF, and resources from those institutions helped to bridge the budget deficit and support domestic poverty reduction programmes. The total external debt of the country exceeded $1 billion in the middle of 2003.

Key policy issues

Fiscal policy

Considerable fiscal performance improvements in most economies

Most economies in North and Central Asia improved their fiscal performance, particularly in terms of reduced budget deficits; the Russian Federation remained the only economy in the subregion with a positive budget balance of 1.6 per cent of GDP in 2003 (table II.13). This remarkable transformation from an average fiscal deficit of 7.5 per cent of GDP in 1995-1997 to a surplus of 2.4 per cent of GDP by 2000 was attributable to the sharp fall in government expenditure and higher revenue collections, the latter being a favourable outcome of a series of tax reforms. The level of tax collection in the Russian Federation, for example, was 96 per cent of the target in 2003, compared with about three fifths in 1996. A tax-reform package approved in 2003 included a reduction of VAT from 20 to 18 per cent and the speeding up of VAT refunds in order to boost manufacturing activities. The tax burden on the

Table II.13. North and Central Asian economies: budget balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Armenia	−4.6	−4.0	−2.4	−2.5[a]
Azerbaijan	−1.9	−2.0	−1.2	−1.0
Georgia	..	−4.0	−2.0	..
Kazakhstan	−1.8	−0.2	−2.5	−1.9
Kyrgyzstan	−1.9	0.4	−1.1	−0.5
Russian Federation	2.4	3.0	1.6	1.6
Tajikistan	−0.6	−0.6	−1.0	−0.9
Turkmenistan	0.4	0.9	−0.7	−0.1
Uzbekistan	−3.9	−3.6	−0.8	−0.8

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LVI, No. 10 (Washington, IMF, October 2003); and Economist Intelligence Unit, *Country Reports* (London, 2003 and 2004), various issues.

Note: Data for 2003 are estimates.

[a] January-June.

energy sector was to be raised through amendments to the Tax Code which would at the same time cancel the excise tax on natural gas, increase taxes on the extraction of oil and natural gas and introduce higher export duties on natural gas from 5 to 20 per cent.

New laws and policy measures in Armenia and Kazakhstan ...

In 2003, Armenia adopted a set of laws aimed at strengthening tax enforcement and raising tax collections, in particular, from import duties, VAT and profit and income taxes. Fiscal revenue was expected to be 20 per cent higher so that the budget deficit could be reduced to a more manageable 2.5 per cent of GDP. The targeted budget deficit of Kazakhstan for 2003 was 1.9 per cent of GDP, compared with 2.5 per cent in 2002. It was to be funded largely via the local capital markets and private pension funds. Although the energy industry was the main contributor to budget revenue, sizeable fiscal receipts were also obtained from other sectors such as transport, telecommunications, agriculture and SMEs. Further tax adjustments and reforms were expected to include a reduction in payroll taxes (from 21 to 15 per cent) and the introduction of preferential rates on high value added exports.

... and better fiscal outcomes in other economies

Azerbaijan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan continued to maintain sound fiscal positions with better fiscal outcomes in 2003 than in 2002. In particular, the extension of VAT to agricultural goods and the introduction of a property tax in Kyrgyzstan contributed in turn to higher revenue and a lower budget deficit, which was expected to be 0.5 per cent of GDP in 2003, compared with 1.1 per cent in the previous year. Uzbekistan had targeted a budget deficit of 2 per cent of GDP for 2003. However, the budget recorded a surplus of 0.5 per cent of GDP in the first half of 2003 owing to a reduction in current spending and improved tax receipts; the latter came about through the enforcement of a tax on the gross earnings of enterprises in the trade and public catering sectors. The fiscal shortfall for 2003 as a whole was expected to be 0.8 per cent of GDP.

Higher fiscal receipts from the oil and gas sectors, and strong GDP growth helped to narrow the budget deficit in Azerbaijan, Tajikistan, Turkmenistan and Uzbekistan. The improvement was comparatively sharper in Turkmenistan, where the budget was, by and large, expected to be in balance in 2003, compared with a shortfall of 0.7 per cent of GDP in 2002. In Georgia, however, the Government was not expected to meet its targeted budget deficit in 2003; weak tax collection and revenue planning contributed to lower tax collections (by 16 per cent) in the first half of 2003. IMF and the World Bank requested that steps be taken to balance the budget through reducing expenditure by $45 million and increasing revenues by about $20 million, including through the imposition of higher taxes on mobile telephone communications and the construction of apartment buildings.

Structural and other reforms

Further reforms to provide well-balanced and sustainable growth in the Russian Federation

Economies in North and Central Asia continued to carry out a series of mutually reinforcing reforms in policies and institutions, and the following discussion provides selectively some broad indications of these efforts at reform. The banking sector of the Russian Federation was on a sounder footing five years after the financial crisis of 1998, with increased bank deposits, assets, loans, capital and profits. Important regulatory steps were taken to abolish the tough security rules of the Central Bank and intensify banking supervision. A deposit insurance scheme for banks was established in 2003 to boost confidence and promote competition in the banking sector, among other objectives. There were 1,335 bank licences in 2003 and strengthened supervision continued to be a priority issue.

The Russian Federation intended to double its GDP in the next decade, and further reforms were carried out to foster private sector participation in the economy and reduce the role of government monopolies. An important step taken in this direction was the approval in 2003 of the basic law on electricity, which provided for the creation of two open joint-stock companies: one to manage the national electricity grid and the other to operate the unified energy system with the federal Government holding a charter stake. A national strategy for the development of the energy sector (including the oil, gas and nuclear power sectors) through to 2020 was also adopted.

Phenomenal growth in financial services in Kazakhstan

The financial system of Kazakhstan was less damaged by the 1998 financial crisis than those in other countries of the subregion. The Government continued to maintain tight fiscal and monetary policies and financial standards and regulations were brought into accord with international practices in most areas, including introduction of consolidated financial supervision and an electronic payment system. Although the number of banks was reduced from the 230 that existed in 1993 to 38 in 2003 (with 17 of them foreign-owned), the banking sector quadrupled its assets to nearly $9 billion between 1999 and 2003. Meanwhile, the country experienced phenomenal growth in financial services over the past three years with the amount of outstanding credits more than doubling from $2.1 billion to $4.7 billion, while the money supply increased from $2.7 billion to $5 billion during 2000-2002. A new tax code, a new law on investment and amendments to the joint-stock company law were also adopted in 2003 along with measures to enhance public and private sector governance in order to attract more foreign investment, ensure more efficient use of the available resources and promote diversification of economic activities.

The core principles of international finance were strengthened in Armenia, Azerbaijan and Tajikistan

The monetary policy stance pursued in other economies in North and Central Asia was similarly aimed at keeping inflation at a low level, reducing pressures on exchange rates and fostering greater confidence and a healthier climate for business and employment generation, including SMEs. Among other things, deposit insurance schemes were introduced and compliance with the core principles of international finance was strengthened in Armenia, Azerbaijan and Tajikistan. The Central Bank of Uzbekistan did not finance the fiscal deficit and curtailed the provision of cheaper loans to State enterprises in 2003. Other measures in administrative reform to improve economic management and further the liberalization process were among the main areas of policy attention. In 2003, the Ministry for Macroeconomics and Statistics was replaced by the Ministry of Economics and the State Statistics Committee to improve institutional efficiency, with the new Ministry mandated to coordinate public sector bodies dealing with macroeconomics in order to implement balanced social and economic policies, while the main objective of the State Statistics Committee was to streamline statistical methods and management to meet international standards.

The Government of Armenia undertook measures to improve the business environment in the country and transparency in the operations of State-owned companies in the energy sector, control their large debts and improve their efficiency and accountability. The private sector, meanwhile, generated more than four fifths of GDP in 2003 in part owing to the privatization in the last decade of some 2,000 large and medium-sized firms and more than 7,000 small business. The privatization of State enterprises and assets was in its final stages and the process was expected to be completed in Armenia by the end of 2004.

Poverty reduction efforts

Human development index declined in the subregion

The UNDP *Human Development Report 2003* showed a declining human development index for all the countries of North and Central Asia, an unfavourable outcome attributed to lower life expectancy, lower literacy rates, reduced incomes and poorer education. While all the economies of the region continued to be classified as having a medium human development index, the North and Central Asian countries were currently ranked much lower than the ranks assigned to them in the 2001 *Report*, with the Russian Federation currently occupying the 63rd position, and Kyrgyzstan and Tajikistan being in the 102nd and 113th positions respectively out of 175 countries.

Average monthly wage and incomes increased in the Russian Federation ...

The rate of unemployment was estimated at 7.6 per cent of the labour force in the Russian Federation in August 2003 although the rate of officially registered unemployment was low at 2.1 per cent in the first 8 months of 2003. During the same period, the average monthly wage increased by about 24 per cent to 5.560 roubles ($185) compared with the corresponding period of 2002. The monthly incomes of the population were expected to increase by just over 11 per cent in 2003. Comparatively, the average income of the richest portion of the population exceeded that of the poorest portion by a factor of 14. About one fifth of the population of the Russian Federation lived below the poverty line in 2003.

... as well as in Kyrgyzstan

In 2003, Kyrgyzstan continued to implement its national poverty reduction strategy, which had yielded some tangible results. In particular, people living under the poverty level declined by 10 per cent in the last 3 years although some 44 per cent of the country's population remained poor and 14 per cent of the population were considered "extremely poor" in 2003. In 2003, the Government revised its plans to provide for an acceleration in poverty reduction from an annual rate of 3 to 5 per cent and to expand other welfare measures such as the introduction of a system of small loans at the local level. The average monthly wage in Kyrgyzstan grew by 18 per cent in the first quarter of 2003 in comparison with the level in the first quarter of 2002 and stood at 1,683 som (about $41). In the first half of 2003, the number of unemployed persons was reduced by 3 per cent compared with the level prevailing during the first 6 months of 2002. The official unemployment rate remained at a relatively low volume of 3.1 per cent in 2000-2002, however.

Unemployment remained a chronic problem in Tajikistan

Unemployment, which continued to be a chronic problem in Tajikistan, was estimated to be high owing, in part, to the slow speed of privatization and creation of SMEs, as well as to the lack of reform and greater dynamism in the agricultural sector. More than 600,000 citizens of Tajikistan worked outside the country in 2000-2003, about four fifths in the Russian Federation. The problems of unemployment were compounded by low unemployment benefits and inadequate employment and training services. Despite the substantial progress achieved in macroeconomic stabilization, more than one half of the population of Tajikistan lived below the poverty line in 2003. Additionally, the average monthly salary of around $10 in Tajikistan at the beginning of 2003 remained one of the lowest among the economies in the subregion.

New strategies and programmes to reduce poverty in Armenia, Georgia, Kazakhstan and Turkmenistan

In Armenia, the poverty reduction strategy for 2003-2015 was designed to lower the number of people living in poverty from 50 to 19 per cent by 2015 through a variety of measures such as the creation of new jobs, improved tax collection and higher public spending. At the same time, social benefits were expected to be increased by fourfold over the next 12 years to reach the official threshold for the poverty level. In 2003, the Government also raised monthly pensions for the 530,000 retirees (from 7,200 to 7,900 drams or from about $13 to $14) and payments for parents of newborn children and relatives of the deceased. In particular, the one-time payment for the birth of a child was increased from 5,900 to 35,000 drams (or $10 to $62). The minimum monthly wage was expected to rise from 5,000 to 13,000 drams ($9 to more than $23) in 2003.

In Georgia the poverty reduction and economic development programme for the period 2003-2015 envisaged a reduction in the percentage of the population living below the poverty line from an estimated 55 per cent in 2003 to 20-25 per cent in 2015. It was also intended to raise GDP by a factor of two- or threefold during the same period to generate more job opportunities; the unemployment rate was over 12 per cent in 2002. Meanwhile, the minimum salary was increased from 20 to 35 laris (or about $10 to $17.50) in 2001-2002 while the nominal monthly wage also continued to grow and reached around 105 laris ($48) in 2002, compared with 91 laris ($42) in 2001. In comparison, however, the cost of the minimum consumption basket was estimated at just over 110 laris ($50) in 2002.

In 2003, Kazakhstan adopted a national anti-poverty programme aimed at reducing poverty by promoting economic growth, lowering unemployment and improving the provision of social security services. In 2002, more than 10 per cent of the population in Kazakhstan lived below the poverty line and the programme envisaged a 25 per cent reduction in poverty between 2002 and 2005. Towards this goal, the Government increased the minimum wage, pensions and the wages of civil servants while the VAT rate was lowered from 16 to 15 per cent and the maximum tax rate on individual incomes from 30 to 20 per cent. Declining birth rates and an ageing population were the main concerns in the social sphere, and the Government made efforts to improve conditions for repatriating ethnic Kazakhs and to implement more pro-family policies to increase the population in the country. Unemployment in Kazakhstan was estimated at 8.8 per cent of the workforce and underemployment remained widespread, particularly in the agricultural sector.

A new strategy of economic, political and cultural development of Turkmenistan for the period until 2020 was adopted in 2003 to ensure, among other objectives, that the basic wage becomes a reliable source of income for workers and their families. The average wage was to be increased by 50 per cent by 2005 and to double every 5 years afterwards. The Government continued to provide the population with electricity, gas, water and salt free of charge, as well as to subsidize housing, communal services, public transport and telecommunications in 2003. More than 25 per cent of the population of Uzbekistan were considered as poor in 2003 and one third of those persons lived in extreme poverty. The average wages in real terms dropped from $57 per month in 1998 to $29 in 2002. A compounding problem related to the tight fiscal and monetary policies implemented by the Government, which contributed to considerable arrears in the payment of wages, benefits and pensions in 2003.

Pacific island economies

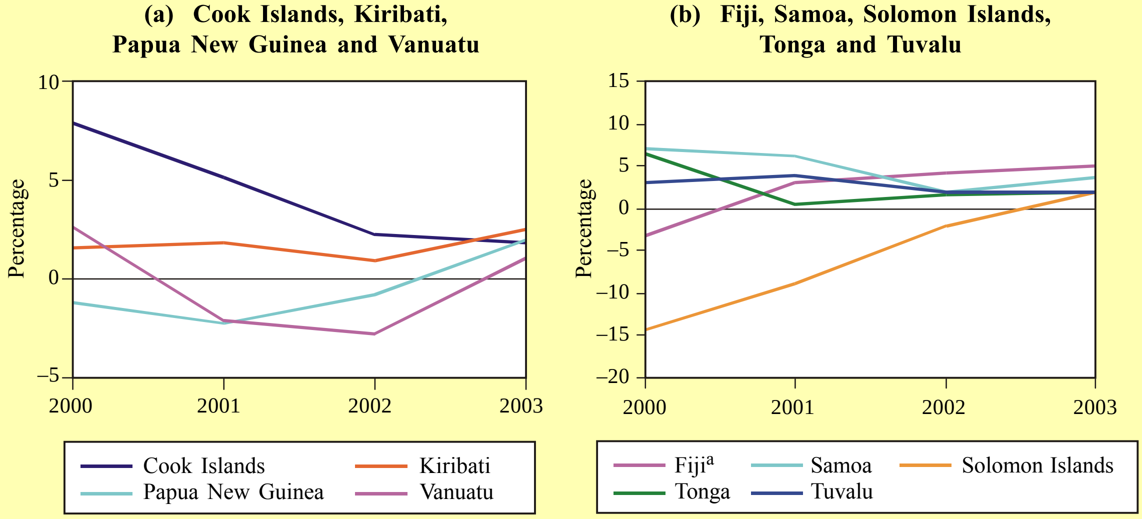
Subregional overview and prospects

Mixed economic performance in 2003

Lack of up-to-date data is a major constraint to economic analysis of Pacific island countries. Nevertheless, the available information suggests that in 2003 all of the Pacific island economies included in this *Survey* recorded positive rates of GDP growth, which in the majority of cases were at least as good as, or higher than, those in 2002 (figure II.11). Cook Islands is the only country with slower GDP growth. Fiji, the best-performing country, had a growth rate of 5 per cent, while the rates in other Pacific island countries were 3 per cent or lower. Nevertheless, the positive outcome was still a welcome development in Papua New Guinea, Solomon Islands and Vanuatu, which had experienced an economic contraction in the previous two or three years, along with the inevitable and significant decline in the standard of living, given their high population growth rates close to 3 per cent.

Increases in the prices for minerals and cash crops, such as cocoa, vanilla and palm oil, were of considerable help to Papua New Guinea, Tonga and Vanuatu although the continuing high crude oil prices raised production and transport costs in petroleum-importing countries. Regional

Figure II.11. Rates of GDP growth in selected Pacific island economies, 2000-2003



Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003).

Note: Data for 2003 are estimates.

[a] Real GDP at factor cost.

Export earnings benefiting from higher prices for agricultural commodities in 2003

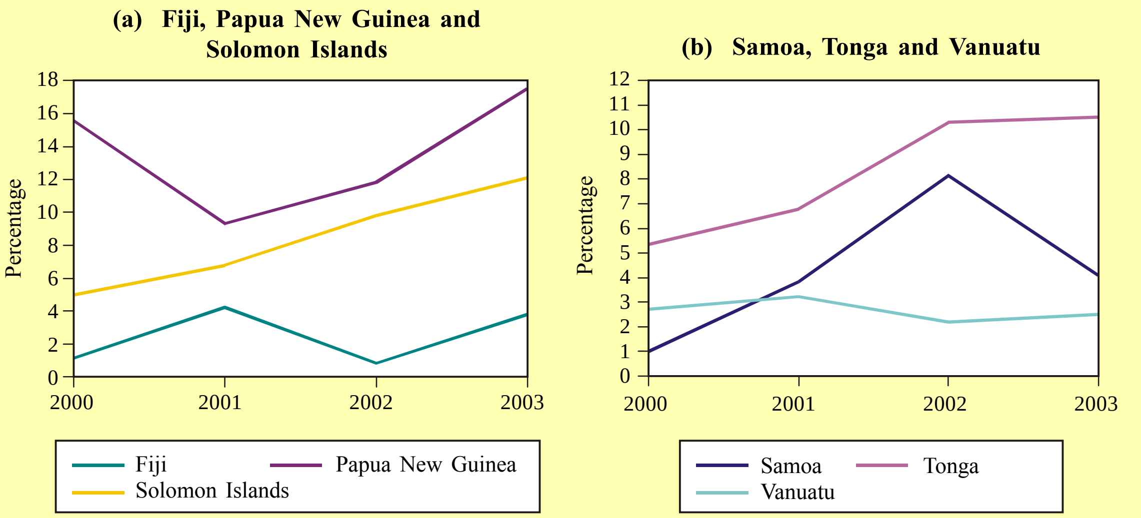
tourism, which had suffered in the wake of the terrorist attacks in the United States, was still in the doldrums, although it recovered well in Fiji. The depreciation of the United States dollar in recent months served to contain imported inflation but also reduced somewhat the value of higher commodity prices for exporters. Nevertheless, higher export earnings were experienced by most Pacific island countries in 2003.

Fiscal deficits persisted in many Pacific island countries

High levels of fiscal deficit have been a widespread problem in the Pacific island subregion, with the ensuing large government borrowings raising interest rates, crowding out private investment, increasing public debt, putting downward pressure on exchange rates and generating upward pressure on prices. High fiscal deficits were in part the result of continuing government support for inefficient, loss-making State-owned enterprises (SOEs) and other public sector commercial activities but another causal factor was the inability to control recurrent spending, principally wages and salaries. While value added tax collections have improved in several countries where the tax was introduced, the relief that it has provided to public finances is likely to be only temporary without successful and concerted efforts to contain recurrent expenditure.

Inflation was comparatively high in Papua New Guinea, Solomon Islands and Tonga in 2003 (figure II.12). In Solomon Islands, civil strife led to supply shortages and prices could be difficult to control in times of

Figure II.12. Inflation[a] in selected Pacific island economies, 2000-2003



Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003).

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.

Consumer prices rising at double-digit rate in some countries

reconstruction with high levels of capital inflows. Consumer prices in Papua New Guinea were pushed up significantly by large fiscal deficits financed with public borrowings, with predictable effects on the currency and interest rates. Tonga recorded inflation rates above 10 per cent in 2002 and 2003 and the prospects of financing future budget deficits have been clouded by the loss of its trust fund under suspicious circumstances, as well as the insolvency of the State-owned airline. Meanwhile, Fiji has been financing large budget deficits from the national provident fund while private sector activity has been relatively subdued since the coup in 2000; thus, upward pressures on prices remained moderate. Inflation in Samoa, which was on an upward trend in 1999-2002, fell sharply to 4.1 per cent in 2003, reflecting the ongoing, gradual decline in fiscal deficits in recent years. Price stability in Vanuatu owed much to the relatively small budget deficits, which were funded mostly from the national provident fund.

GDP performance

Fiji's improved economic performance was driven by a pickup in tourism in 2003 ...

As had been the case in 2002, Fiji was the only strong performer in the Pacific subregion in 2003, recording real GDP growth of 5.0 per cent, up from 3.6 per cent on average in 2001-2002 (table II.14). The Government has projected a slower rate of growth of 4.1 per cent in 2004 with strong performance anticipated in all sectors except the sugar cane industry. The SARS scare did not have much of an impact on tourism in the Pacific and in all probability tourists could be switching to Fiji from destinations in Indonesia following the Bali bombing. Hotels were heavily booked throughout the tourist season and it appears that the shortage of hotel rooms has been the main constraint on tourist arrivals in Fiji. Visitor arrivals totalled 397,859 in 2002, an increase of 14 per cent from the previous year, and in 2003 they were expected to surpass the 1999 level of 410,000 visitors owing to increased frequency of flights and seat capacity on existing routes serviced by local and international airlines. Largely as a result, the service sector expanded by 5.3 per cent in 2003 compared with growth of 6.5 per cent in 2002.

Despite poor performance in the sugar industry, the industrial sector as a whole bounced back to grow 6.8 per cent in 2003 but the agricultural sector stagnated generally. Much of the growth in the industrial sector, meanwhile, was attributable to construction activity, largely driven by major private and public capital projects, as well as the manufacturing sector, following improved performance in the garment industry. The South Pacific Games also provided an additional stimulus to economic activity in 2003.

... but the sugar industry remained in a troubled state

With a relative share of some 7 per cent of GDP, the sugar industry was still bogged down over the land tenure issue as more and more land leases were expiring and there has been no long-term solution to the renewal of the lease system. Rationalization of the industry is necessary, including a reduction in the number of sugar mills from the current four,

Table II.14. Selected Pacific island economies: growth rates, 2000-2003

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Cook Islands	2000	7.9	32.4	6.8	6.5
	2001	5.1	−24.0	−0.8	0.6
	2002	2.2	..	..	..
	2003	1.8	..	..	..
Fiji[a]	2000	−3.2	−0.9	−7.4	−1.8
	2001	3.0	−4.9	7.7	3.3
	2002	4.1	2.2	0.0	6.5
	2003	5.0	0.4	6.8	5.3
Kiribati	2000	1.6	−8.5	4.3	5.1
	2001	1.8	0.2	21.6	−0.5
	2002	0.9	−4.5	−7.8	3.2
	2003	2.5	..	..	..
Papua New Guinea	2000	−1.2	9.1	−4.8	−7.0
	2001	−2.3	−5.3	−0.3	1.9
	2002	−0.8	7.3	−10.8	1.2
	2003	2.0	1.6	3.8	2.3
Samoa	2000	6.9	0.3	11.3	7.5
	2001	6.2	−4.6	10.3	8.1
	2002	1.8	−7.2	−5.5	7.7
	2003	3.5	..	..	..
Solomon Islands	2000	−14.3	−25.1	−25.0	−6.7
	2001	−9.0	−11.0	−24.1	−5.6
	2002	−2.0	..	..	..
	2003	1.9	..	..	..
Tonga	2000	6.5	10.6	3.7	5.2
	2001	0.5	−6.3	2.3	3.4
	2002	1.6	0.5	5.5	0.6
	2003	1.9	..	..	..
Tuvalu	2000	3.0	..	..	..
	2001	4.0	..	..	..
	2002	2.0	..	..	..
	2003	2.0			
Vanuatu	2000	2.7	7.4	2.1	1.8
	2001	−2.1	0.5	−4.6	−2.4
	2002	−2.8	1.7	−5.9	−3.6
	2003	1.0	0.8	−0.9	1.0

Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003).

Notes: Data for 2003 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Real GDP at factor cost.

which have been in a poor state of repair and are badly in need of upgrading. At the same time, the industry also faces the threat of a reduction in the price of sugar exported to its quota markets in the EU and the United States as a result of the WTO Doha Round. Sugar cane harvest levels fell again (by 3 per cent) in 2003 largely as a result of the prevailing uncertainties, with farmers having little incentive to make productivity-enhancing investments. Much of the land suitable for sugar cane, which was returned to Fijian landowners when leases held by Indo-Fijian farmers expired, has not been fully utilized although indigenous landowners are forming cooperative-type arrangements to farm the land in some cases. However, the success of these efforts remains to be demonstrated. In 2004, sugar cane production is expected to decline 0.6 per cent and sugar production to increase 3.5 per cent because of better-quality sugar canes.

The garment industry, which along with tourism had been the main source of growth in the Fijian economy, has stagnated since the 2000 coup. However, the most important long-term threat to the industry is the withdrawal of preferential access to Australia and New Zealand as a result of global trade liberalization. Fiji will have to come to terms with the fact that preferential access to export markets, together with preferential domestic taxation arrangements for investors, may not provide a durable basis for sustainable development. The clothing and footwear sector declined 21 per cent in 2002, but growth was expected to be 8 per cent in 2003, slowing to 5 per cent in the following year.

The key to robust, sustainable GDP growth in Fiji is the recovery of investment, particularly private investment, as the ratio of investment to GDP had fallen as low as 9 per cent in recent years. The investment ratio went up to around 14 per cent in 2003, still a long way from the Government's target of 25 per cent. Among the improvements to the business environment are political stability, policy credibility and security of property rights, particularly with regard to land.

Strong growth in minerals helped to drive economic recovery in Papua New Guinea in 2003

After three years in recession, the economy of Papua New Guinea grew modestly (by an estimated 2.0 per cent) in 2003 although this rebound was far from adequate to reverse a further decline in average per capita GDP with the population increasing at close to 3 per cent annually. The strong growth in tax collections in 2003 suggested that the final GDP growth rate for 2003 could be higher than currently estimated. Sustained high prices for petroleum and gold were largely responsible for the expansion of 6.7 per cent in the minerals sector, which was primarily responsible for the turnaround in national output. Falling production from the Kutubu and Gobe oilfields has been offset by higher output from the new Moran field.

Agricultural production was up by 1.6 per cent, an outcome driven largely by the robust growth in production and exports, plus the higher prices, of palm oil. The strong interest in investing in the palm oil industry is generally justified by good, long-term market prospects in

China. However, unless greater security for individual land tenure can be achieved, there are likely to be many disappointed investors. Coffee-growing also has great potential in Papua New Guinea and the fall in international coffee prices may now have bottomed out, but again land tenure is also a big problem in this industry, as are difficulties facing growers in getting beans to the market because of law and order problems and the very bad state of feeder roads as well as the main highways. The construction sector benefited in 2003 from the building of the Napa Napa oil refinery, due to begin production in 2004, as well as from several aid-funded and otherwise assisted infrastructure projects.

Growth was positive in Solomon Islands in 2003 but log production may be unsustainable

There was a sharp economic improvement in Solomon Islands in 2003 following GDP declines of over a quarter during 2000-2002. Aggregate production went up by 1.9 per cent in 2003 in the wake of the re-establishment of law and order through the military and police intervention led by Australia. Log production reached nearly 800,000 tonnes in 2003, or an increase of 50 per cent over the previous year, a level even higher than during the logging boom of the 1990s. An annual harvest of 400,000 cubic metres is thought to be the maximum sustainable threshold in the medium term. Fisheries output rose by 70 per cent as a result of favourable weather, higher tuna prices and more fishing operations. In 2003, the catch is estimated to have been about 20,000 tonnes, higher than in 2002 but still well below the level of production before the coup in 2000. Meanwhile, there was also an increase in copra and cocoa production during 2003, with cocoa production doubling to 4,500 tonnes. The main task now facing the Government and the international community is to put in place a basis for sustainable future economic growth in Solomon Islands.

Future growth prospects depend on maintaining law and order and providing security of tenure over land

The Australian-led Regional Assistance Mission to Solomon Islands has contributed positively to the maintenance of law and order in the country (box II.1). Nevertheless, economic recovery is at a delicate stage and could easily be derailed by any setback to the improved security situation or by poor policy decisions. Promoting further growth and diversification in economic activities and services will also depend to a very large extent on efforts to ensure security of tenure over land for both domestic and international investors. As part of its assistance to the economic recovery in Solomon Islands, Australia is providing substantial help in the form of personnel working in key government departments, hoping thus to enhance work skills and ethical attitudes towards public service and hence improved economic management and good governance more generally. However, such capacity-building is a very long-term process while it is also necessary to ensure that a substantial number of people receive high-level training in public policy fields.

Macroeconomic stabilization is likely to be established fairly quickly in Solomon Islands, with external technical assistance being conducive to regaining control over fiscal policy and the budgetary processes.

Box II.1. Regional Assistance Mission to Solomon Islands: a regional initiative in conflict resolution

The Australian-led Regional Assistance Mission to Solomon Islands (RAMSI) brought some normalcy to that country after commencing its work on 24 July 2003. At an estimated cost of A$ 300 million a year, RAMSI is made up of police and army personnel, some 2,225 in all, from Australia, Fiji, New Zealand, Papua New Guinea and Tonga; however, Australia contributes the largest number of personnel and meets most of the operating costs.

Following a meeting of foreign ministers from 16 Pacific island countries in Sydney in June 2003 to discuss the concept of a so-called "cooperation intervention", the Government of Solomon Islands formally requested the Australian Government to intervene militarily and put an end to the acts of violence that had gripped the country since the outbreak of ethnic conflict in 1998. Subsequently, a series of legislative measures were adopted by the parliament of Solomon Islands to provide the legal framework for the intervention.

The principal objective of RAMSI is to restore law and order, particularly in Weather Coast, the southern region of the main island of Guadalcanal, where the rebel leader and rebel forces controlled part of the island. Pacific peace monitoring forces had been deployed before, in Bougainville, Papua New Guinea, and in Solomon Islands itself. However, RAMSI is the first military intervention conducted under the framework of the Biketawa Declaration, which was endorsed by the Pacific Islands Forum leaders meeting in Kiribati in 2000. In that Declaration, the leaders urged the international community, and particularly countries of the region, to give the peace process in Solomon Islands every encouragement, including by contributing generously to Solomon Islands' urgent security, rehabilitation and development needs.

RAMSI achieved several key successes in little more than a week after it began operations. The streets of Honiara became relatively free of disorder and police patrols were regularly seen throughout the city. Further significant progress was made by RAMSI when the rebel leader, among others, was arrested in August 2003. The first batch of many surrendered guns was also handed to the commander of the participating police force at a meeting with the National Peace Council (NPC) less than 24 hours after RAMSI began operations; these weapons were publicly destroyed outside NPC headquarters. The gun amnesty, which came to an end on 21 August 2003, yielded almost 3,700 weapons, including 660 military weapons.

The substantial progress in restoring law and order in Solomon Islands had enabled a reduction in the military forces needed to support police work by the end of October 2003. However, a core group of military, police and finance personnel from Australia, Fiji and New Zealand will remain in Solomons Islands for the foreseeable future. Much of the success of RAMSI has been attributed to the involvement of Pacific island countries along with Australia and New Zealand in the mission, on the one hand, and the atmosphere of friendship and goodwill shown by the Government and people of Solomon Islands towards the mission, on the other.

Despite its achievements, RAMSI still has a lot of work to do. For example, people caught breaking the law will also have to be tried in court and, to date, more than 350 people have been arrested on 600 charges. The participating police force was bolstered by the arrival of two new groups from Australia and New Zealand in August 2003. Among them was a team of forensic science police from Australia, with expertise in fingerprint examination, crime scene investigation and photography and ballistic examinations. Such expertise and skills will assist considerably in providing the scientific evidence required to prosecute cases in the courts of Solomon Islands.

While the military presence is being reduced, the Australian Government will continue to support RAMSI by providing specialists to advance reforms in several key areas, including health care, policing, justice and economic and financial management. Financial experts with RAMSI, for example, were instrumental in formulating a balanced budget for Solomon Islands for 2004. Although initial efforts to restore peace, stable government and, eventually, sustainable growth in Solomon Islands have produced some encouraging results, rebuilding the country's shattered economy, which is heavily dependent on agriculture, forestry and fishing, may take years. The rebuilding process will nevertheless be eased by substantial financial and technical assistance from the Governments of Australia and New Zealand, while the World Bank and ADB have also signalled their willingness to re-engage with Solomon Islands.

However, economic activity is likely to be depressed for some time as existing firms and smallholders will not be willing to increase production until the restoration of law and order and fiscal discipline is seen as being sustainable. Creating an investor-friendly environment is the only way that the economy will move onto a rapid, stable and equitable growth path; this is an essential requirement if ethnic conflicts and tensions are to be reduced and resolved in the long run.

Vanuatu experienced an economic rebound in 2003 but the kava industry was hurt by import bans in several countries

The economic contraction in the previous two years, totalling some 5 per cent of GDP, was reversed in 2003 with growth of 1 per cent in 2003. However, there was a slowdown in the agricultural sector, which had expanded 1.7 per cent in 2002, to 0.8 per cent in 2003 despite positive contributions from the beef and cocoa industries in response to higher international prices. In particular, cocoa output was estimated to have increased 142 per cent in 2003 compared with 9 per cent in the previous year. Kava exports are still suffering from the ban on the sale of kava-based medicinal products in several European countries, and their voluntary withdrawal from sale requested by the United Kingdom and the United States. Earnings on kava exports had grown rapidly (by 27.9 per cent in 2002) but a decline of 42.6 per cent was expected in 2003. Considerable efforts are being made by Pacific kava producers to convince external authorities of the safety of kava-based medicinal products. Fiji and New Caledonia accounted for about two thirds of Vanuatu's kava exports and demand in those markets, as well as from domestic sources, has remained strong. Copra production is the main income source for the majority of the rural population in Vanuatu and this industry continues to be in decline throughout the world, with copra output falling by a cumulative 25 per cent over 2001-2003.

The service sector also rebounded to grow modestly in Vanuatu, by 1 per cent in 2003, reflecting better earnings on tourism, finance and insurance and real estate transactions, following a sizeable contraction of 3.6 per cent in 2002. Tourist arrivals in 2002 were 7.4 per cent lower than in 2001 owing to a combination of greater competition from other destinations in the Pacific and, to a lesser extent, a relatively high real exchange rate. However, the industry recovered from a decline in both 2001 and 2002 to expand by an estimated 6 per cent in the following year. Prospects for the tourism industry are improving with the adoption of an "open skies" policy for air travel by the Government, a proposed new air route from Australia and a new shipping service if port facilities are available at Port Vila.

Tonga's economy recorded a modest expansion in 2003

GDP growth in Tonga, estimated at 1.9 per cent for 2003, represented a modest improvement from the relatively subdued performance of the previous two years; growth is projected at 2.6 per cent in 2004. Because of the high level of emigration, the country's population growth rate is very low; hence, GDP per capita was likely on a rising trend despite a modest gain in GDP. Agricultural GDP was up by around 2 per cent in 2003, helped by good weather conditions, higher prices for squash and vanilla and an increased output of squash and kava. However, fisheries output fell sharply in 2003 and tourism has recovered only modestly since 2000, growing at just 2 per cent in 2003.

Economic activities in Samoa were adversely affected by poor performance in agriculture and fisheries in 2003

Samoa had been the star performer among the Pacific island countries in recent years, with GDP growth of over 6 per cent in 2000-2001. Economic expansion in 2002 was projected at 5 per cent, underpinned by manufacturing, construction and tourism. However, the target could not be achieved, with GDP growth slumping to 1.8 per cent in 2002 and estimated at 3.5 per cent for the following year. A strong stimulus in recent years had come from tuna-fishing, largely a small-scale operation supplying the high-priced sushi market. However, tuna-fishing has been poor since mid-2002 partly owing to bad weather and overfishing. Agriculture has also done poorly because of an extended period of dry weather while tourism has also not recovered from the 2000 slump. Another contributing factor to the subdued economic performance appeared to be the slowing pace of programmed economic reform, accompanied by a loosening of expenditure controls, including increased support for SOEs and departmental overspending. Samoa has been designated as the site for the 2007 South Pacific Games, and this will mean the construction of extensive infrastructure and a short-term increase in national output. However, there will also be more budgetary pressures, which will be further compounded by the relief promised by the Government for the fishing industry.

Growth in the smaller Pacific island countries has remained uneven

Growth in Cook Islands has been on a downward trend, from 7.9 per cent in 2000 to 1.8 per cent in 2003. Tourism-related subsectors such as hotels and restaurants experienced weaker sales after the terrorist attacks in the United States. At the same time, the agricultural sector also suffered from bad weather conditions and many farmers faced difficulties in marketing their produce. In Kiribati, GDP expansion of 2.5 per cent in 2003 was more than double the previous year's level and a significant improvement from the rates achieved in earlier years. This improved outcome was driven largely by higher consumer spending, which, in turn, resulted from recent increases in the public sector wage bill, expenditures connected with national elections in late 2002 and employment from the construction of a copra mill, a junior secondary school and a national sports complex. Tuvalu recorded stable GDP growth of around 2 per cent during 2002-2003, compared with 4 per cent in 2001. The slowdown was caused largely by a sharp reduction in public expenditure, which had risen substantially in 2000 on the back of a huge revenue windfall gained from leasing arrangements with the manager of Tuvalu's Internet domain address. Higher public spending continued in 2001 but the expected further windfall gain for that year did not materialize, giving rise to the country's first overall fiscal deficit, equivalent to about 43 per cent of GDP. Public expenditure was consequently curtailed in 2002, contributing thus to an economic slowdown, despite higher revenues from the sale of the Internet domain address and a very large budget surplus of around 85 per cent of GDP.

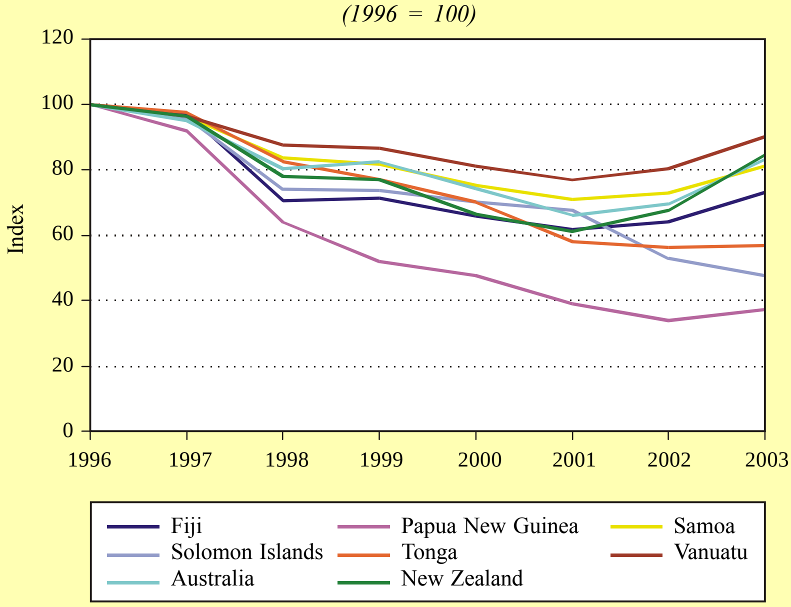
Inflation

Relatively high rates of inflation in Papua New Guinea, Solomon Islands and Tonga

The persistence of large budget deficits and their monetization, leading to downward pressure on exchange rates and higher import prices, were among the main factors behind the price situation in many Pacific island economies. Indeed, imported inflation from currency depreciation would have been even greater than it has been if the United States dollar had not been weakening against most currencies over recent months (figure II.13). In Papua New Guinea, headline inflation peaked at almost 21 per cent over the year to March 2003, but declined thereafter. The Bank of Papua New Guinea, which had raised its intervention rate five times between July 2002 and June 2003, cut the rate in August and October 2003, signalling its belief that the worst was over as regards inflationary pressures; commercial banks' cash reserve requirements were also lowered in October. However, inflation pressures were still not under control, particularly as the underlying rate of inflation was rising in June 2003. The message of the September 2003 mini-budget was that government overspending remained a problem and the risk of continued monetization of the fiscal deficits could not be discounted. Tax revenues

Figure II.13. Index of exchange rates against the United States dollar of selected Pacific island economies and Australia and New Zealand, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Notes: Data for 2003 are estimates. In the case of Fiji, Samoa and Vanuatu, the figures are for January-October and in the case of Solomon Islands and Tonga, the figures are for January-July and January-September, respectively.

and royalties were more than expected and this provided the Government with the resources, augmented by public asset sales, to reduce treasury bills, along with a temporary advance from the central bank.

Inflation accelerated in Samoa to exceed 8 per cent in 2002 (table II.15), although it was expected to fall to just over 4 per cent in the following year. Increases in consumer prices still averaged over 6 per cent at midyear, albeit inclusive of the effects of a rise of 2.5 percentage points in the value added tax. The persistence of a price updrift was due to the unfavourable conditions for agriculture over the previous year and the poor fishing harvest, which reduced domestic food supplies, and higher petroleum prices. While the Government has not resorted to much domestic borrowing, expansionary fiscal policy and increases in the money supply have been an important underlying contributor to inflation; the money supply, for example, has been expanding at 10.6 per cent on average each year since 2000, accompanied at the same time by a relatively high rate of domestic credit growth.

Table II.15. Selected Pacific island economies: inflation and money supply growth (M2), 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Inflation[a]				
Fiji	1.1	4.2	0.8	3.8
Papua New Guinea	15.6	9.3	11.8	17.5
Samoa	1.0	3.8	8.1	4.1
Solomon Islands	5.0	6.8	9.8	12.1
Tonga	5.3	6.8	10.3	10.5
Vanuatu	2.7	3.2	2.2	2.5
Money supply growth (M2)				
Fiji	–2.1	–3.1	7.9	14.7[b]
Papua New Guinea	5.0	1.6	4.0	1.0[c]
Samoa	16.3	6.1	10.2	9.7[b]
Solomon Islands	0.6	–13.6	6.0	19.3[d]
Tonga	18.8	14.9	7.8	12.9[b]
Vanuatu	5.5	5.7	–1.7	–3.6[e]

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003); and IMF, *International Financial Statistics,* vol. LVI, No. 10 (Washington, IMF, October 2003).

Notes: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] January-August.
[c] January-February.
[d] January-June.
[e] January-September.

Consumer prices in Tonga went up by 10.3 per cent in 2002 from 6.8 per cent in the previous year, and inflation was expected at 10.5 per cent in 2003 after exceeding 10 per cent at midyear. The causal factors included shortages in local food supplies, higher wages and a depreciation of 20 per cent in the nominal exchange rate against a basket of currencies since mid-2000. In particular, the currency depreciated by 16 per cent against the Australian dollar between January and October 2003, Australia being the main (import) supplier for Tonga.

Inflation in Solomon Islands has been on an upward trend since the beginning of the civil unrest, jumping from 5 per cent in 2000 to over 12 per cent in 2003 as a result of shortages of supplies, business disruptions and poor government control of expenditure. Efforts made to resist pressures to allow the Government to borrow above the statutory limit and the placing of expatriates in core departments during the recovery period are expected to help to improve economic management and this should, in turn, be reflected favourably in the behaviour of consumer prices and other economic fundamentals in the short to medium terms. Nevertheless, given the planned injection of large amounts of development assistance for reconstruction and development over the next few years, holding inflation at the projected annual level of around 12 per cent for 2003-2004 would be a significant achievement.

Price stability maintained in Vanuatu

Vanuatu has experienced a sustained record of comparative price stability and consumer prices were expected to rise by only 2.5 per cent in 2003. The Reserve Bank of Vanuatu has targeted inflation within a band of 2-3 per cent through disciplined control of the money supply, which contracted 3.6 per cent in the first 9 months of 2003 on top of a contraction of 1.7 per cent in the previous year. Meanwhile, the vatu appreciated against the United States dollar by 4 per cent in 2002 and by another 11.6 per cent in January-October 2003. However, it depreciated against the Australian dollar by 0.7 per cent in 2002 and by a further 4 per cent in the first 10 months of 2003. The Vanuatu National Provident Fund has been tapped for government bond financing while an increase in the Government’s overdraft limit to provide finance for the budget deficit has been requested from the Reserve Bank of Vanuatu.

Fiji has also enjoyed considerable price stability, with consumer prices rising by 3.8 per cent in 2003 largely as a result of the increase in the value added tax from 10 to 12.5 per cent in 2003. This one-off effect was expected to be short-lived with inflation projected to return to around 3 per cent in 2004. The low level of private investment and the resulting lack of demand for credit meant that there was little necessity to raise interest rates but this could change with the materialization of the hoped-for, sustained rise in private investment.

Foreign trade and other external transactions

Firmer commodity prices boosted the export earnings of several Pacific island countries

Higher world prices for primary commodities in 2003 made life easier for some Pacific island countries and more difficult for others. Crude oil prices were at a higher level in 2003 than in 2002, particularly in the build-up to the war in Iraq early in the year. Firmer oil prices were good news for Papua New Guinea, an oil exporter, which (together with Fiji, a small gold exporter) also benefited at the same time from the surprising strength of gold prices during 2003, moving from around $350 per ounce at the beginning of the year to close at $400 per ounce at the end of the year. Palm oil prices were also rising strongly, bringing another windfall to Papua New Guinea and facilitating the rebuilding of the palm oil industry in Solomon Islands. The export outlook for this commodity is bright with demand for palm oil rising strongly in China, the most populous country and one of the fastest-growing economies in the world. Cocoa prices increased strongly in the latter half of 2002 and in the early months of 2003, but were on a downward trend in the second half of the year; Papua New Guinea and, to a lesser extent, Solomon Islands and Vanuatu are important exporters of cocoa.

The available data up to the first half of 2003 showed various improvements in merchandise export earnings in most Pacific island countries (table II.16). Notably, Vanuatu's exports went up by 77 per cent

Table II.16. Selected Pacific island economies: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Exports (f.o.b.) Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003 (two quarters)*
Fiji	579	−6.8	−6.8	9.2	32.9
Papua New Guinea	1 643	7.3	−13.7	−9.5	29.1
Samoa[a]	13	−24.2	9.8	−16.0	11.1
Solomon Islands[b]	58	−53.1	−32.0	22.6	44.3
Tonga[a, c]	18	−9.5	9.5	49.0	−3.4
Vanuatu[b]	22	6.0	−27.0	9.3	77.5

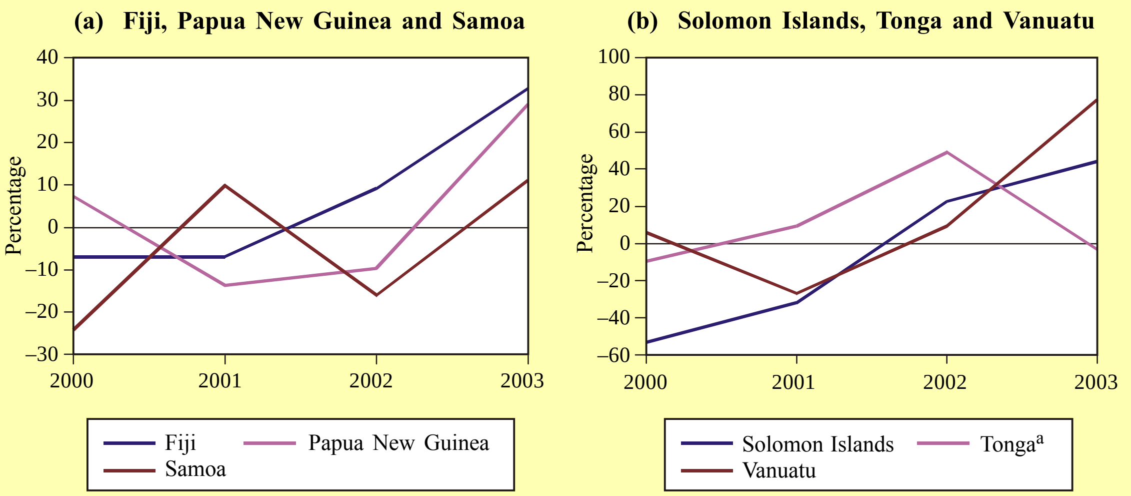
Sources: Central Bank of Samoa web site <http://www.cbs.gov.ws/default.htm>, 27 November 2003; National Reserve Bank of Tonga web site <http://www.reservebank.to/pub.htm>, 27 November 2003; Central Bank of Solomon Islands web site <http://www.cbsi.com.sb/About_CBSI/eco/reports/quarterly_reports.htm>, 27 November 2003; Reserve Bank of Vanuatu web site <http://www.rbv.gov.vu/QtrEconomic.htm>, 27 November 2003; Reserve Bank of Fiji web site <http://www.reservebank.gov.fj/pub.html>, 27 November 2003; and Bank of Papua New Guinea web site <http://www.bankpng. gov.pg/publications/index.htm>, 27 November 2003.

[a] Figure for 2003 refers to three quarters.
[b] Figure for 2003 refers to first quarter only.
[c] Fiscal year.

in the first quarter of 2003 compared with 9 per cent for 2002 as a whole. Fiji, Papua New Guinea and Solomon Islands recorded export growth in excess of 29 per cent during the first half of 2003 (figure II.14). There was at the same time a similarly strong expansion in merchandise import spending ranging from 20 to 33 per cent in Fiji, Papua New Guinea, Tonga and Vanuatu (table II.17). By contrast, import value went down by 3.5 per cent in Samoa during the first three quarters of 2003 (figure II.15) while the sharp contraction in imports in Solomon Islands, at 22.6 per cent in the first quarter of 2003, was indicative of the depressed state of that economy.

Fiji's merchandise exports grew 9.2 per cent to $579 million in 2002, after falling by 7 per cent in both 2000 and 2001; they were 33 per cent higher in the first half of 2003 largely as a result of higher gold exports. Imports were also on an upward trend, rising by nearly 21 per cent in 2002, and by a further 33 per cent in the first half of 2003 because of higher spending on mineral fuels, machinery and transport equipment. The country's merchandise trade deficit worsened and,

Figure II.14. Growth rates in merchandise export earnings of selected Pacific island economies, 2000-2003



Sources: Central Bank of Samoa web site <http://www.cbs.gov.ws/default.htm>, 27 November 2003; National Reserve Bank of Tonga web site <http://www.reservebank.to/pub.htm>, 27 November 2003; Central Bank of Solomon Islands web site <http://www.cbsi.com.sb/About_CBSI/eco/reports/quarterly_reports.htm>, 27 November 2003; Reserve Bank of Vanuatu web site <http://www.rbv.gov.vu/QtrEconomic.htm>, 27 November 2003; Reserve Bank of Fiji web site <http://www.reservebank.gov.fj/pub.html>, 27 November 2003; and Bank of Papua New Guinea web site <http://www.bankpng.gov.pg/publications/index.htm>, 27 November 2003.

Notes: Figures for 2003 are for two quarters only except for Samoa and Tonga (three quarters) and Solomon Islands and Vanuatu (first quarter only).

[a] Fiscal year.

Table II.17. Selected Pacific island economies: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Imports (c.i.f.)*			
		Annual rate of growth (percentage)			
	2002	*2000*	*2001*	*2002*	*2003 (two quarters)*
Fiji	946	−11.2	−2.6	20.8	33.2
Papua New Guinea	962	−7.0	−6.4	2.1	20.9
Samoa[a]	124	−7.9	9.0	6.7	−3.5
Solomon Islands[b]	47	−14.8	−11.5	−41.8	−22.6
Tonga[a, c, d]	61	12.8	−1.6	−0.3	19.7
Vanuatu[b, c]	78	−7.3	0.5	0.3	31.1

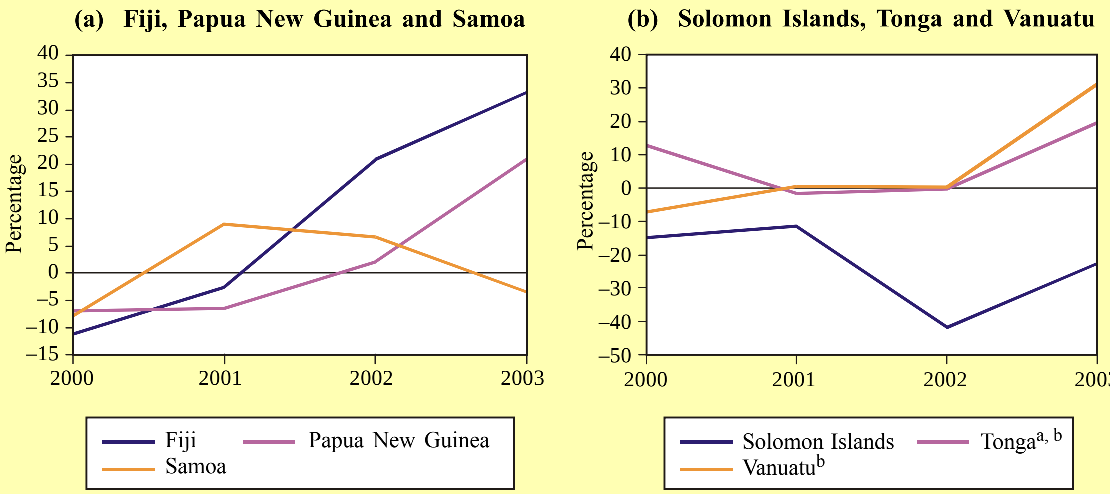
Sources: Central Bank of Samoa web site <http://www.cbs.gov.ws/default.htm>, 27 November 2003; National Reserve Bank of Tonga web site <http://www.reservebank.to/pub.htm>, 27 November 2003; Central Bank of Solomon Islands web site <http://www.cbsi.com.sb/About_CBSI/eco/reports/quarterly_reports.htm>, 27 November 2003; Reserve Bank of Vanuatu web site <http://www.rbv.gov.vu/QtrEconomic.htm>, 27 November 2003; Reserve Bank of Fiji web site <http://www.reservebank.gov.fj/pub.html>, 27 November 2003; and Bank of Papua New Guinea web site <http://www.bankpng. gov.pg/publications/index.htm>, 27 November 2003.

[a] Figure for 2003 refers to three quarters.
[b] Figure for 2003 refers to first quarter only.
[c] Import value f.o.b.
[d] Fiscal year.

compounded by higher outflows of private services and investment income, contributed to a widened current account deficit expected to be 3.7 per cent of GDP in 2003, from 3.5 and 3 per cent in 2002 and 2001 respectively (table II.18).

Reflecting high commodities prices, the total value of Papua New Guinea's merchandise exports was up sharply, by 29 per cent during the first half of 2003, compared with an export contraction of 9.5 per cent in 2002 (caused mainly by a fall of 24.3 per cent in oil exports as output fell from the declining Kutubu field). Despite production problems at two mines, higher world prices pushed up the value of gold exports by 8.5 per cent in 2002. Agricultural exports were up by over 35 per cent also in response to higher international prices for major agricultural commodities, while log exports were up 42.9 per cent in 2002. There was a marginal increase in merchandise imports of 2 per cent in 2002, owing in part to a kina depreciation of 21 and 15 per cent against the Australian and United States dollars respectively. The trade surplus was down to $681 million in 2002, from $717 million in the previous year. Combined with higher service payments, the current account surplus narrowed from 9.7 to 4.4 per cent of GDP between 2001 and 2002. In the first half of 2003,

Figure II.15. Growth rates in merchandise import spending of selected Pacific island economies, 2000-2003



Sources: Central Bank of Samoa web site <http://www.cbs.gov.ws/default.htm>, 27 November 2003; National Reserve Bank of Tonga web site <http://www.reservebank.to/pub.htm>, 27 November 2003; Central Bank of Solomon Islands web site <http://www.cbsi.com.sb/About_CBSI/eco/reports/quarterly_reports.htm>, 27 November 2003; Reserve Bank of Vanuatu web site <http://www.rbv.gov.vu/QtrEconomic.htm>, 27 November 2003; Reserve Bank of Fiji web site <http://www.reservebank.gov.fj/pub.html>, 27 November 2003; and Bank of Papua New Guinea web site <http://www.bankpng.gov.pg/publications/index.htm>, 27 November 2003.

Notes: Figures for 2003 are for two quarters only except for Samoa and Tonga (three quarters) and Solomon Islands and Vanuatu (first quarter only).

[a] Fiscal year.
[b] Values f.o.b.

there were higher exports of gold, crude oil, logs and almost all agricultural commodities, with the exception of copra. Import spending also expanded by about 21 per cent in the same period, and the current account surplus is projected to rise to 5 per cent of GDP. Foreign reserves at the end of June 2003, at $360.7 million, were sufficient for 3.7 months of import cover.

Samoa's exports in 2002, valued at $13 million, were 16 per cent lower than in 2001 but they rose 11 per cent year on year in the first 9 months of 2003. Earnings from fresh fish, accounting for 64 per cent of total export receipts in 2002, went down by 5 per cent during the first 9 months of 2003 compared with the same period in 2002. Exported garments overtook fish as the main foreign exchange earner in 2003, contributing 37 per cent of total export value; proceeds from garment exports increased by a remarkable 195 per cent during the same period in 2003. Meanwhile, Samoa's import bill amounted to $124 million in 2002, or 6.7 per cent higher than the previous year's level, but spending on

Table II.18. Selected Pacific island economies: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	2001	2002	2003
Budget balance as a percentage of GDP				
Fiji[a]	−4.9	−7.2	−6.1	−4.0
Papua New Guinea	−2.0	−3.7	−3.3	−2.0
Samoa	−0.7	−2.3	−2.0	−1.9
Solomon Islands	−4.1	−11.5	−12.2	−0.3
Tonga	0.8	−0.9	0.9	−2.9
Vanuatu	−7.1	−3.7	−1.5	−0.8
Current account balance as a percentage of GDP				
Fiji	−5.5	−3.0	−3.5	−3.7
Papua New Guinea	10.0	9.7	4.4	5.0
Samoa	4.5	−2.7	1.8	−1.5
Solomon Islands	−15.8	−15.2	−3.5	6.5
Tonga	−14.8	−19.9	14.8	..
Vanuatu	2.1	0.8	−6.1	..

Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003).

Notes: Data for 2003 are estimates.

[a] Excluding grants.

imports was reduced by 3.5 per cent in the first three quarters of 2003. Overall, imports continued to outweigh export receipts, and the resulting trade deficit reached $111 million in 2002. However, the trade deficit was 15 per cent lower in the first 9 months of 2003 compared with the same period in 2002. Receipts from tourism and remittances, as well as aid inflows, helped to underpin Samoa’s large import bills. The Iraq war and the SARS scare affected tourism in Samoa to some extent, with earnings on tourism increasing only 4 per cent during the first 9 months of 2003 while private remittances actually declined 2 per cent in the same period. The current account deficit was transformed from a surplus of 1.8 per cent of GDP in 2002 to a deficit of 1.5 per cent in 2003. Nevertheless, Samoa’s foreign reserves in September 2003 were sufficient to cover 5.2 months of imports, compared with 4.6 months in 2002.

Solomon Islands’ exports recovered in 2002 and 2003

The value of Solomon Islands’ merchandise exports (including timber, fish, copra and cocoa) increased 22.6 per cent to $58 million in 2002 after very large contractions in the previous two years, when the country’s production base was severely damaged by internal conflicts. Exports grew strongly (by 44 per cent) in the first quarter of 2003 owing to increased production of logs and copra, and indications are that export growth for the full year would likely be even stronger. Meanwhile, the decline in import spending, which was around 13 per cent annually in 2000-2001, accelerated to 42 per cent in 2002, reflecting the general weakness in the economy. In the first quarter of 2003, however, the value of merchandise imports contracted by just under 23 per cent year on year. The country recorded a trade surplus of $11 million in 2002 but had a small current account deficit equal to 3.5 per cent of GDP in the same year, very substantially down from deficits in excess of 15 per cent of GDP in the two preceding years. Foreign reserves at the end of June 2003, equivalent to just 2.4 months of import cover, would have been far lower if the Government had met external debt-service obligations for the second quarter and if all foreign exchange applications had been approved.

Remittances and receipts from tourism make up for Tonga's large trade deficit

Tonga's exports registered an increase of 49 per cent in 2002, largely as a result of the exceptional growth in exported squash and fish, while imports were marginally down. The country's trade deficit narrowed slightly to around 33 per cent of GDP in 2002. Inward remittances were the principal source of foreign exchange receipts, leading to a current account surplus of about 14.8 per cent of GDP in 2002 after two years of significant deficits. The country's foreign reserves were under some pressure from capital outflows for most of 2002 but improved significantly in the last quarter as a result of large inflows from the Economic and Public Sector Reform Programme loan from ADB. However, foreign reserves represented less than 2 months of import cover by the end of 2002. In 2003, imports were on a rising trend while exports became largely stagnant in value. A compensating factor was the sustained, large remittances from Tongans living overseas, which, together with tourism receipts, helped to cover the import bill. The country was anticipating a near-record squash crop of about 20,000 tonnes at a price of around $0.23 per kilo in 2003. However, squash prices slumped along with a glut in the Japanese market caused by higher supplies from Japanese and Russian producers and this had an adverse impact on the production and export of squash from Tonga. Tuna harvests have also fallen because of unfavourable fishing conditions and possible overfishing, as a large number of foreign fishing boats operate in the region.

A surplus on the services account plus official inflows financed the large import bill in Vanuatu

Vanuatu's merchandise exports, totalled $22 million in 2002, representing an increase of 9 per cent following a decline of 27 per cent in the previous year. Export earnings, however, went up substantially, by 77 per cent during the first quarter of 2003. Meanwhile, merchandise imports were much higher at $78 million in 2002, thus contributing to a trade deficit of $56 million for the year. The large import bill has usually been financed by a surplus on the services account, including receipts from tourism, and aid and investment inflows, which had been much higher in 2001, thus leading to a huge current account deficit equal to 6.1 per cent of GDP in 2002, compared with a surplus of 0.8 per cent in the previous year. The current account balance was likely to turn around in 2003, as the import bill would likely be lower and official capital inflows higher. The country's foreign reserves in the first quarter of 2003 were equivalent to 4.4 months of imports, down from 4.7 months in 2002.

Key policy issues

Fiscal deficits

Higher recurrent expenditure often behind fiscal deficits in Pacific island countries

Several of the Pacific island countries have been running large fiscal deficits in recent years (table II.18) while the previously low levels of fiscal deficit appeared to have trended upwards in other island countries. As a percentage of GDP, the budget shortfall in Fiji has declined considerably from its peak in 2001 but remained relatively high at 4 per cent in 2003; it was projected to fall to 3.5 per cent in the 2004 budget mainly through increased revenues rather than reduced expenditure; indeed, there was a budgeted rise in recurrent outlays at the expense of some reduction in capital spending. The large budget deficits of recent years have led to large domestic borrowing so that public debt is expected to equal 50 per cent of GDP in 2004.

In Papua New Guinea, the budget deficit has narrowed somewhat since 2001, falling to around 2 per cent of GDP in 2003. The fiscal shortfall has largely been funded by domestic borrowing, thus contributing to higher domestic interest rates, squeezing out private investment and reducing opportunities for job creation. As in Fiji, however, higher recurrent expenditures have been behind the budget deficits, implying a tax on future incomes to pay for increased current consumption. Cognizant of these concerns, the Government introduced a mini-budget in September 2003 that projected substantial reductions in departmental expenditure and improved revenue flows from value added and mineral taxes. The budget deficit was expected to decline but the outcome will depend greatly on the Government's ability to rein in departmental expenditures.

Meanwhile, the 2004 budget demonstrated in stark relief the difficulties that Papua New Guinea faces. Recurrent expenditure and debt servicing accounted for 80 per cent of the projected expenditure with approximately one half of the former absorbed by wages and salaries. On the other side of the ledger, the revenue base is eroding as most large-scale mines and oil fields are reaching the end of their productive lives in the next 10 years, so that government revenues could fall by 25 per cent in that time. External borrowing equal to $60 million would be needed in the 2004 budget but relations between Papua New Guinea and the international financial agencies are at a low ebb and sourcing for funds thus remains a challenge. If domestic borrowing became substantial, some adverse consequences for macroeconomic fundamentals appear unavoidable. In June 2003, Papua New Guinea secured a short-term reprieve in postponing for one year the repayments to IMF on the 2000/01 Standby Facility. With the budgeted additional external borrowing, a major issue facing the Government is establishing good working relationships with the international financial agencies, implying genuine efforts at economic reform. This will be a difficult challenge given the budgeted support for selected domestic manufacturing industries, among other things.

Australia is to provide personnel to assist Papua New Guinea in key areas

The poor economic performance of Papua New Guinea, after many years of substantial grant aid from Australia, led to the recent agreement between the two countries whereby Australia is to provide a significant number of police officers for field duty and personnel for key government departments. This agreement will result in a large increase in Australian aid but the form of the aid reflects the view that Papua New Guinea's problems stem largely from the deteriorating law and order situation and poor control over public expenditure.

Solomon Islands' fiscal position deteriorated in 2001 and 2002, when budget deficits rose to 11.5 and 12.2 per cent of GDP respectively from 4.1 per cent of GDP in 2000. The budget for 2002 had provided for a sharp reduction in the overall fiscal deficit to 3 per cent of GDP. However, the recurrent budget, especially for public sector employment, increased substantially during the year owing to the recruitment of special constables, as well as higher salaries and allowances, so that the recurrent budget target for wages and salaries was exceeded by 42 per cent in 2002. As a result, total expenditure amounted to 37.2 per cent of GDP while total revenue and grants reached only 25 per cent of GDP for the year, compared with 44 per cent in 1999 (prior to the ethnic conflict). Central government debt surged to about 110 per cent of GDP in 2002 and the external debt outstanding to 79 per cent of GDP. By and large, the Government has been unable to meet its external or domestic debt-service commitments for the past two years.

The budget stabilization team that is part of the Australian-led Regional Assistance Mission to Solomon Islands assisted in balancing the budget for 2003

The 2003 budget aimed to balance outlays and receipts through a large reduction in public sector wages and salaries owing to the anticipated redundancies of over 1,000 civil service staff. With help from the budget stabilization team of the Australian-led Regional Assistance Mission to Solomon Islands, the Inland Revenue Department launched a drive to improve tax collections that resulted in a marked rise in tax revenue from all sources, except stamp duty. Despite these positive developments, the ballooning public expenditure before the assumption of control by the intervention force led to expenditure reaching almost 90 per cent of the total for the year by September 2003. In October, the Australian Government signed an agreement for the provision of supplementary budget assistance while additional indirect budgetary support will come from Australia and New Zealand; Australia is to continue paying Solomon Islands' external debt arrears until mid-2004. Another balanced budget was prepared for 2004 with a quarter of total revenue to come from grants from Australia and New Zealand and no additional borrowing by the Government.

Rapid growth in recurrent expenditure was also behind the fiscal deterioration in Tonga

Rising fiscal deficits in Tonga reflect the provision of increased support for SOEs as well as the rapid growth in recurrent expenditure associated with a 20 per cent increase in public sector wages in 2001. Borrowing in support of the budget and currency depreciation raised the level of public debt, largely denominated in foreign currencies, from 50 to 62.5 per cent of GDP during 1999-2003. Tonga recorded a budget deficit of 2.9 per cent of GDP in 2003, compared with a small surplus in 2002, and the budget deficit is expected to increase further in 2004 given the difficult financial position of the State-owned airline. Meanwhile, the financial cushion that had been provided by the Tonga Trust Fund has been lost through poor management.

Budget deficits were generally smaller as a percentage of GDP in Samoa, hovering around 2 per cent during 2001-2003. The drawing down of government deposits in the banking system helped to fund the deficits and there has been no large-scale resort to borrowing from the financial markets as yet. Vanuatu had a budget deficit of 1.5 per cent of GDP in 2002 and the midyear estimate of the deficit for 2003 was low at 0.8 per cent of GDP. This represented a marked improvement from the deficits in 2000 and 2001, which were equivalent to 7.1 and 3.7 per cent of GDP respectively.

Management of national provident funds

The use of provident funds to finance budget deficits is a matter of concern

Government "capture" of national provident funds is widespread in Pacific island countries. Generally, the funds are limited in their ability to invest offshore, which effectively restricts them to the few opportunities available for investment in mostly small, low-growth economies, where returns tend to be low; there is also limited scope for risk diversification. In Fiji and Vanuatu, the national provident funds are used directly to fund fiscal deficits. In the wake of the 2000 coup, moreover, the national provident fund in Fiji was required to repatriate its offshore investments in order to support the Fijian currency. In Samoa, the national provident fund, along with the Development Bank, is being used to provide loan guarantees for the development of a tourist resort, which is a high-risk venture. National provident funds are the main retirement savings vehicles and many retirees may not be in a position to return to their own villages; the trusteeship of these funds should therefore ensure the maximum return on investment consistent with an acceptable risk profile.

Physical infrastructure development

Poor state of physical infrastructure and high charges for users are a hindrance to private sector activities in the Pacific

In several Pacific island countries, the parlous state of the transport system, including roads and bridges, has had a negative effect on economic development, especially in rural areas, where the majority of the population live. In addition to poor maintenance, destruction of physical infrastructure from natural disasters such as cyclones is also a frequent occurrence in Pacific island countries. However, in their attempts to control budget deficits, some countries have reduced capital expenditure, further reducing incentives for FDI. Most Pacific island countries also have very high costs for telecommunications and cheaper charges would be one of the best ways for these geographically isolated countries and communities to break out of their isolation. Low telecommunication costs have been the driving force in the global fragmentation of industries and the creation of multinational production networks. Many Pacific island countries have also fostered monopolistic public-private joint ventures to manage their telecommunication businesses. The Governments appear to be more focused on short-term monopoly profits from their involvement in the management of telecommunication businesses than on the much greater tax base that could be available from the emergence of more competitive industries and the resulting expansion of business activities and opportunities arising from lower telecommunication costs and more reliable services.

Poverty in the Pacific

Rising incidence of poverty in several Pacific island countries

The idea that absolute poverty exists in the Pacific has been difficult for many in the region to accept, given the countries' traditional systems of mutual support. It seems clear, however, that absolute poverty does exist, is substantial and is increasing in some countries. Up-to-date, in-depth information about the extent of poverty in the Pacific island countries is limited. Some information on poverty is available from household income and expenditure surveys but these surveys are available only on a sporadic basis and there is little information about trends. However, the fact that real GDP has been growing more slowly than the rate of population growth in several countries in the Pacific islands subregion suggests that the trend has not been a favourable one.

ADB carried out an analysis of poverty in Pacific island countries in 2000-2003. Poverty lines based on basic needs calculated from the survey data show that in 1996 an estimated 37.5 per cent of Papua New Guinea's population was living in poverty; the corresponding figures were 20.3 per cent in Samoa in 2002, 23.8 per cent in Tonga in 2001 and 40 per cent in Vanuatu in 1998. The last reported household income and expenditure survey for Fiji was in 1990-1991, when 25.5 per cent of the population were found to be living below the poverty line.

In Papua New Guinea, the 1996 survey (excluding Bougainville) showed that between 94 and 97 per cent of people in poverty were living in remote areas with low-fertility soils and difficulty terrain. Most of these people had a subsistence lifestyle, with only a small proportion of their consumption coming from income earned from hunting, fishing and cash crops. Access to education, health and markets was extremely poor, moreover. Since 1996, however, Papua New Guinea has experienced several years of negative GDP growth and thus the poverty situation has worsened, with the population increasing by close to 3 per cent per year. The provision of services in such areas as education and health has deteriorated, with many aid posts closed and medicines in short supply, and many schools failing to operate because of the non-payment of teachers' salaries. The system of main roads and feeder roads has also been in a bad state of repair and maintenance, thus contributing to the worsening law and order situation in rural areas and severely constraining transport and other access to markets. Because of the stress from increasing population pressures on the communal system, the movement of people from rural to urban areas has been substantial and squatter settlements in peri-urban areas have become large, insecure places.

Most of the conditions prevailing in Papua New Guinea are observable to a lesser degree in Fiji, Solomon Islands and Vanuatu; Samoa and Tonga are also experiencing some of the dimensions and manifestations of higher levels of absolute poverty. The recent ADB surveys of people living in poverty reported concerns about lack of safe drinking water, unusable roads, insufficient job opportunities, as well as deteriorating transport and other public services. Even in countries such as Samoa and Tonga, where the resident population is not increasing rapidly because of emigration, the lack of investment and subdued economic growth is making life very difficult for many people. At the other end of the spectrum, the civil unrest in Solomon Islands contributed to a decline of around 25 per cent in GDP during 2000-2003, with a much sharper fall in per capita income given the high population growth rate of some 3 per cent annually.

Despite the comparatively robust GDP growth experienced by Fiji in recent years, the growth in squatter settlements around major cities is worrying, the latest estimate indicating that some 80,000 people are living in these settlements in Suva. This phenomenon is probably the result of two factors: first, it is a sign that the communal village system is not able to support the increasing population and is not providing the kinds of goods and services available in the urban areas; and, second, the low level of investment and job growth is leaving many urban migrants without work and income.

The poverty situation in Pacific island countries gives clear pointers to the kinds of outcomes that government policies and actions have to produce. For the poor to participate fully in economic activities, they need to be provided with improved access to education and health services, as well as to markets and jobs. This means that Governments have to do more to provide needed infrastructure and services and put in place a policy and regulatory environment conducive to investment and job creation by the private sector.

Governance and related issues

Poor governance has contributed to poor economic growth in Pacific island countries

Poor governance is now widely seen as a major reason for the poor economic development experience of the Pacific island countries. Poor governance is manifest in different ways, such as inadequate macro-economic management and administration of public services, poor policies, discriminatory behaviour by politicians and public servants in favour of select individuals and groups, corrupt behaviour in the public and private sectors and even the breakdown of law and order. Development assistance agencies have devoted much effort and attention to capacity-building in the public sector through training and enhanced work experience. More emphasis is also being given to improving public understanding of what to expect from Governments and to increasing public awareness of what Governments are actually doing. Improving the capacity of non-governmental organizations to monitor government activities can also be a useful means to ensure greater transparency and accountability of government actions.

Basic social institutions in the Pacific may need to be examined to determine their suitability for changing societies

Along with the intensifying focus on governance has come a closer examination in recent years of the reasons for poor governance. There is a developing view that governance is the outcome of the operation of basic institutions in such areas as constitutions and electoral systems, parliamentary, governmental and administrative systems, law and justice systems, and property rights. These institutions effectively establish the "rules" for individual responses in various areas of society and social interaction. It is therefore the incentive framework, established by these institutions, which determines whether or not a country has good governance institutions and practices. A key question now being explored within the Pacific is whether the existing institutions, which were largely introduced under colonial rule, are appropriate for the current and future social organization of the Pacific island countries, which are still primarily made up of traditional, communal communities. The institutions introduced were from societies in which individual rights, particularly property rights, are pre-eminent. The basic social institutions of Pacific island countries need to be examined to see whether they should be modified to fit the hybrid nature of the societies in those countries better. In this way, an incentive framework that leads to improved governance can be developed.

South and South-West Asia

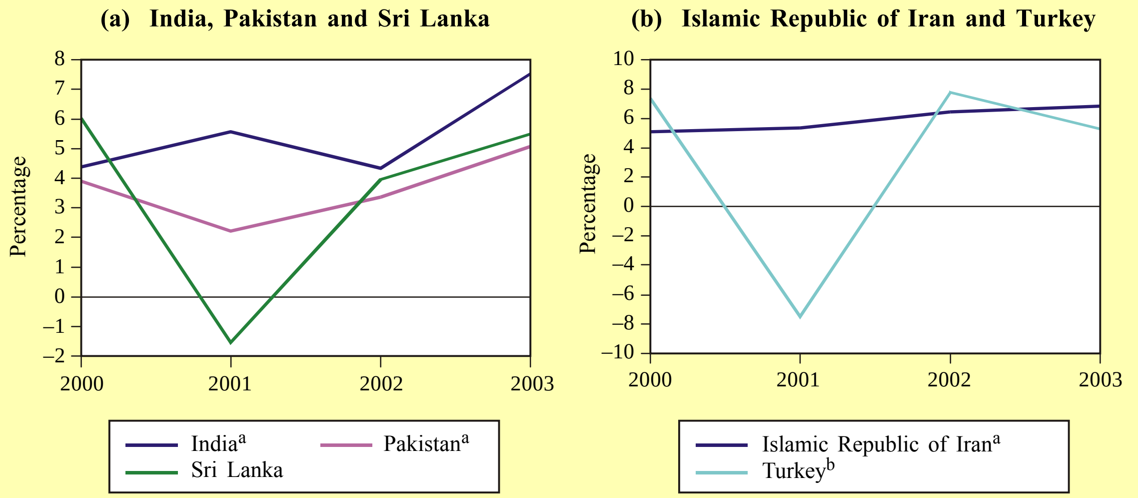
A. Developing economies of the subregion

Subregional overview and prospects

Growth momentum was trending upwards

Output accelerated in most countries in the subregion in 2003 as compared with the previous year (figure II.16). GDP growth in India, for example, rose from 4.3 to 7.5 per cent between 2002 and 2003, driven by a rebound of agricultural production, which, in turn, served to sustain high industrial sector expansion and improve the performance of the service sector. In Pakistan, meanwhile, economic growth picked up from 3.4 per cent in 2002 to just over 5 per cent in 2003. Strong agricultural recovery (due to good weather), improved value added in both industrial and service activities, and a sustained current account surplus contributed to a broad-based expansion in aggregate demand. Benefiting from the ceasefire agreement between the Government and the Liberation Tigers of Tamil Eelam (LTTE), the economy of Sri Lanka grew at 5.5 per cent in 2003, as compared with 4 per cent in the previous year. Despite floods in some parts of the country, agricultural production expanded as peace prevailed while both domestic and foreign investment were up

Figure II.16. Rates of GDP growth in selected South and South-West Asian economies, 2000-2003



Source: ESCAP, based on national sources.

Note: Data for 2003 are estimates.

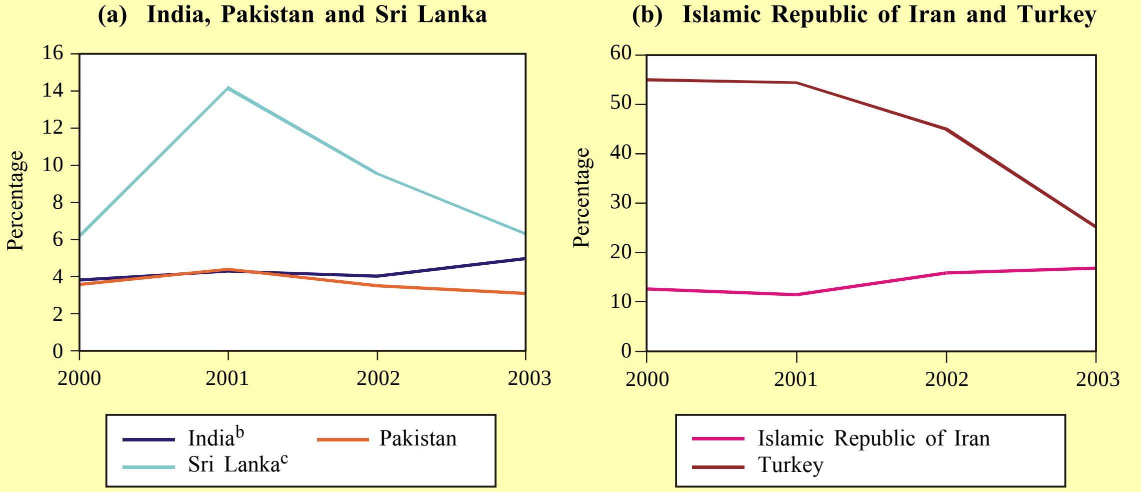
[a] Real GDP at factor cost.
[b] Real GDP at producer prices.

considerably; the tourism sector got a major boost as well. In the Islamic Republic of Iran, the growth momentum was sustained with increased domestic demand and oil production; it was estimated that GDP would grow at almost 7 per cent in 2003, or slightly higher than the previous year's rate of 6.5 per cent. Turkey, however, experienced an economic slowdown, from 7.8 to 5.3 per cent between 2002 and 2003. The precarious security situation in neighbouring Iraq following the war and terrorist attacks in Istanbul in November 2003 adversely affected tourism revenues and domestic economic activities.

Inflation rates were moderate and generally on the decline

Both India and Pakistan were able to keep increases in consumer prices within a modest range in 2003 (figure II.17). While inflation picked up marginally in India, from 4 to 4.8 per cent between 2002 and 2003, it fell slightly in Pakistan from 3.5 to 3.1 per cent during the same years. These outcomes were largely due to stable food prices, which, in turn, were attributable to bumper agricultural crops. In Sri Lanka, tighter monetary policy, improved domestic supply conditions and stability in the exchange rate helped to moderate considerably consumer prices, which rose by 9.6 per cent in 2002 but by only 6.3 per cent in the following year. However, the Islamic Republic of Iran continued to experience a high rate of inflation, which, owing to strong domestic demand (fuelled in part by an expansion in government spending), remained at 16-17 per cent

Figure II.17. Inflation[a] in selected South and South-West Asian economies, 2000-2003



Source: ESCAP, based on national sources.

Note: Data for 2003 are estimates.

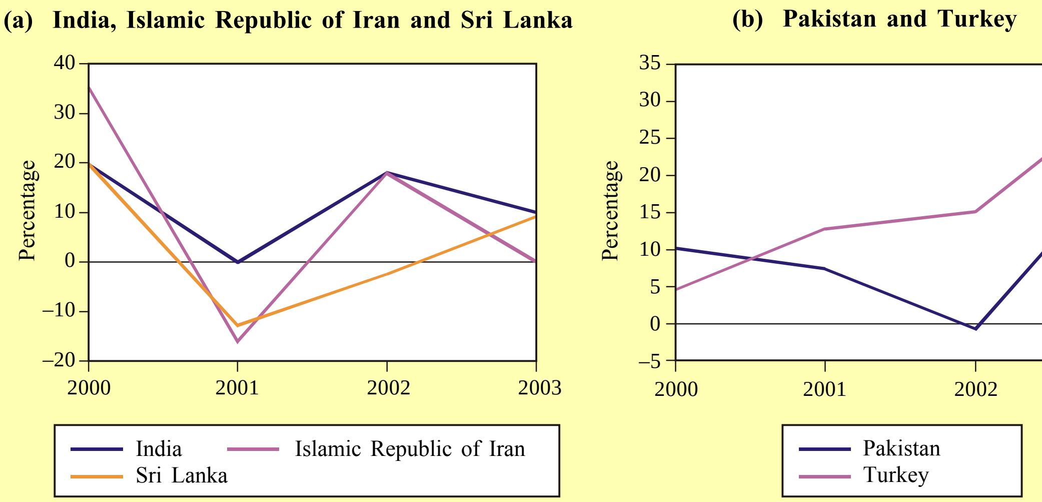
[a] Changes in the consumer price index.
[b] Consumer price index for industrial workers.
[c] Colombo only.

during 2002-2003. Turkey, meanwhile, recorded very high but declining inflation, which reached over 54 per cent in 2001 and 45 per cent in 2002. Increases in consumer prices were relatively more modest at just over 25 per cent in 2003, a downward trend helped by macroeconomic policies and structural reforms carried out under the new economic programme, which began in 2001.

Robust trade performance along with some appreciation of domestic currencies in most parts of the subregion

There was a relatively strong expansion of external trade with most countries in the region recording double-digit growth (figures II.18 and II.19). In Pakistan, in particular, exports grew by over 22 per cent in 2003 to a record $11.1 billion level. The export earnings of the Islamic Republic of Iran went up sharply by 18 per cent in 2002 although the value of exports in United States dollar terms remained virtually unchanged in 2003. Meanwhile, the domestic currencies of most countries in the subregion appreciated against a weakening United States dollar in 2003, but exchange rate movements were far from uniform. The Indian rupee, for example, depreciated by 3.5 per cent in 2002 but appreciated by 3 per cent in 2003 while the rupee in Pakistan went up by almost 4 per cent against the dollar in fiscal year 2003, on top of another appreciation of 6.7 per cent in the previous year. Current account surpluses and

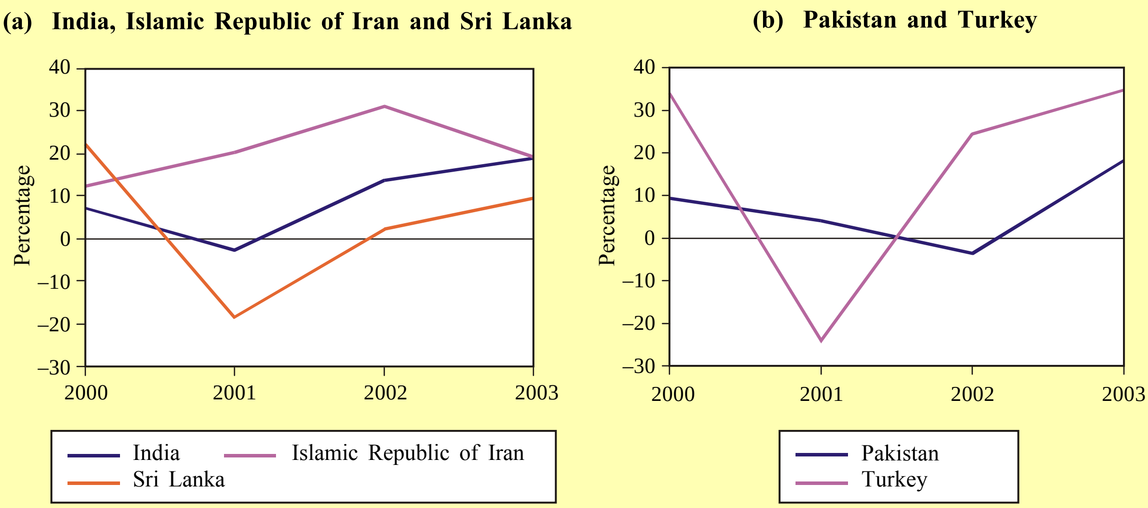
Figure II.18. Growth rates in merchandise export earnings of selected South and South-West Asian economies, 2000-2003



Sources: Reserve Bank of India, *Annual Report 2002-03;* State Bank of Pakistan web site <http://www.sbp.org.pk>, 7 November 2003; Central Bank of Sri Lanka web site <www.lanka.net/centralbank>, 27 February 2004; Central Bank of the Islamic Republic of Iran web site <http://www.cbi.ir/>, 14 November 2003; Republic of Turkey State Institute of Statistics web site <http://www.die.gov.tr/english/>, 12 January 2004; and other national sources.

Notes: Fiscal year for India, the Islamic Republic of Iran and Pakistan. Data for 2003 refer to January-November for Turkey, estimates for India and provisional data for Sri Lanka.

Figure II.19. Growth rates in merchandise import spending of selected South and South-West Asian economies, 2000-2003



Sources: Reserve Bank of India, *Annual Report 2002-03;* State Bank of Pakistan web site <http://www.sbp.org.pk>, 7 November 2003; Central Bank of Sri Lanka web site <www.lanka.net/centralbank>, 27 February 2004; Central Bank of the Islamic Republic of Iran web site <http://www.cbi.ir/>, 14 November 2003; Republic of Turkey State Institute of Statistics web site <http://www.die.gov.tr/english/>, 12 January 2004; and other national sources.

Notes: Fiscal year for India, the Islamic Republic of Iran and Pakistan. Data for 2003 refer to January-November for Turkey, estimates for India and provisional data for Sri Lanka. Import value f.o.b. for the Islamic Republic of Iran.

growing foreign exchange reserves in both India and Pakistan contributed to the strength of their currencies. However, the value of the rupee against the dollar remained virtually unchanged in Sri Lanka during 2003. Elsewhere in the subregion, the exchange rate remained relatively stable in the Islamic Republic of Iran and Turkey.

Existing growth trend likely to be maintained in 2004

Assuming no major internal or external shocks, India should be able to sustain real GDP growth rates in the range of 6-7 per cent in 2004-2006, while Pakistan could expect a slight improvement of economic growth to 5.3 per cent in 2004 (the Government's strategy is to expand aggregate output further to 6 per cent in a couple of years). The continuation of the ceasefire agreement and the ongoing efforts to bring about lasting peace remain critical for consolidating past achievements as a foundation for further social and economic progress in Sri Lanka. The economy is projected to grow at 6 per cent in 2004, higher than the rate achieved in 2003. The outlook for the Islamic Republic of Iran for fiscal year 2004 is also favourable; the investment and growth momentum under the impetus of the economic reforms of the past few years is expected to sustain the expansion in both oil-related and non-oil activities and hence in domestic demand to underpin projected GDP growth at around 7 per cent in 2004. In Turkey, output expansion is expected to stabilize at around 5 per cent in 2004, with the agricultural sector making some gains over the previous year.

GDP performance

India achieved the highest growth rate among the economies in the subregion in 2003

In India, the decline by 3.2 per cent of agricultural value added in 2002, owing to a severe drought, contributed to a deceleration of GDP growth to 4.3 per cent (table II.19). The economy then experienced a significant recovery in 2003, with aggregate production going up by 7.5 per cent. Among the causal factors was the rebound of agricultural

Table II.19. Selected South and South-West Asian economies: growth rates, 2000-2003

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
India[a]	2000	4.4	−0.4	6.6	5.6
	2001	5.6	5.7	3.3	6.8
	2002	4.3	−3.2	6.0	7.1
	2003	7.5	9.5	6.0	7.5
Iran (Islamic Republic of)[a, b]	2000	5.1	2.9	8.7	4.0
	2001	5.4	4.2	7.1	4.8
	2002	6.5	10.1	6.8	5.1
	2003	6.9	5.1	7.7	7.0
Pakistan[a]	2000	3.9	6.1	1.3	4.2
	2001	2.2	−2.7	2.5	4.7
	2002	3.4	−0.1	5.4	4.1
	2003	5.1	4.1	5.4	5.3
Sri Lanka	2000	6.0	1.8	7.5	7.0
	2001	−1.5	−3.4	−2.1	−0.5
	2002	4.0	2.5	1.0	6.0
	2003	5.5	1.7	5.8	6.8
Turkey[c]	2000	7.4	3.9	5.8	7.5
	2001	−7.5	−6.5	−7.2	−5.9
	2002	7.8	7.1	7.2	7.0
	2003	5.3	0.5	6.2	6.0

Source: ESCAP, based on national sources.

Notes: Data for 2003 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Real GDP at factor cost.
[b] Industry comprises oil; mining and manufacturing; water, power and gas; and construction.
[c] Real GDP at producer prices.

output, growing by 9.5 per cent on the back of bumper foodgrain harvests. The industry sector also sustained its strong performance, expanding by 6 per cent in 2003. Another positive influence came from several monetary and fiscal incentives in the central government budget for 2003 to boost industrial production and infrastructure development. These incentives included simplification and rationalization of both direct and indirect taxes on industrial products, a reduction of peak customs duty to 25 per cent (and subsequently to 20 per cent in January 2004) and a further decrease in prime lending rates by the commercial banks and financial institutions. The service sector improved its growth to 7.5 per cent owing to the revival in agricultural growth and sustained industrial growth.

GDP growth also accelerated in Pakistan

There was a noticeable pickup in economic activities in Pakistan so that GDP rose by over 5 per cent in fiscal year 2003, compared with 3.4 per cent in the previous year. Indeed, the actual growth rate in 2003 was even higher than the targeted level of 4.5 per cent set by the Government. A strong surge in aggregate demand, including private investment, and a sustained external account surplus, among other improvements in macroeconomic fundamentals, combined with good weather conditions, contributed to a broad-based acceleration in economic activities (table II.20). In particular, helped by good water availability, the agricultural sector posted an impressive recovery; production went up by over 4 per cent in 2003 compared with stagnant output growth in the previous year.

Table II.20. Selected South and South-West Asian economies: ratios of gross domestic savings and investment to GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Savings as a percentage of GDP				
India	23.4	24.0	25.1	27.0
Iran (Islamic Republic of)	26.8	29.8	34.3	33.7
Pakistan	15.6	15.9	15.2	15.2
Sri Lanka	17.4	15.8	14.5	14.6
Turkey	18.4	17.2	16.3	15.6
Investment as a percentage of GDP				
India	24.0	23.7	24.5	26.6
Iran (Islamic Republic of)	27.1	25.6	26.6	27.5
Pakistan	16.0	15.9	13.9	14.4
Sri Lanka	28.0	22.0	21.3	22.2
Turkey	25.0	15.9	19.7	20.4

Source: ESCAP, based on national sources.

Note: Data for 2003 are estimates.

The agricultural resurgence was particularly important because of its strong impact on rural poverty reduction and on employment, especially in downstream activities. Another contributor to strong growth was the exceptional performance of the large-scale manufacturing sector, which expanded by 8.7 per cent in 2003 against the previous year's 4.9 per cent. Export-led demand for manufactures continued to increase as a result of better access to key foreign markets as well as the supportive stance of the central bank in holding down the appreciation of the rupee while simultaneously pushing down interest rates to historically low levels. Additionally, the service sector had been growing at a faster pace than that of the commodity-producing sectors for quite some time; this trend remained unchanged in 2003 as the service sector grew by 5.3 per cent, compared with 4.1 per cent in 2002. The transport and communication subsector, with strong linkages to the commodity-producing sectors, made impressive gains in value added.

Economic growth picked up in Sri Lanka

Sri Lanka registered a healthy rate of GDP growth of 5.5 per cent in 2003, compared with 4.0 per cent in 2002, despite an uncertain global economic and geopolitical situation and the adverse impact of floods in some parts of the country in the middle of the year. Domestic economic activities benefited considerably from the ceasefire agreement between the Government and LTTE as investment (both domestic and foreign) improved; in particular, there were sharp improvements in tourism, international trade and financial services. The service sector, which contributed around 54 per cent to total output, provided an important stimulus, growing by almost 7 per cent as the tourism sector rebounded with a rise of 27 per cent in tourist arrivals while the volume of financial and telecommunication services went up in tandem with a higher tempo of economic activities. Industrial value added rose by 5.8 per cent; an improved supply of utility services such as electricity, water and gas also contributed positively to economic production as frequent supply shortages had adversely affected industrial output in 2002. The manufacturing sector, in particular the textile and apparel subsector, continued to expand despite a slow recovery in major industrial countries. Despite some flood damage, agricultural production rose by 1.7 per cent, with the resumption of farming activities in war-affected areas in the North and East.

Growth momentum was maintained in the Islamic Republic of Iran

In the Islamic Republic of Iran, GDP grew by 5.8 per cent a year on average over the first three years of the country's third five-year development plan (2000/01-2005/06). A higher expansion in total output, by 6.5 per cent in fiscal year 2002, was largely underpinned by a significant increase of around 7.5 per cent in non-oil production activities. Domestic demand (including private and public investment) grew reasonably quickly as a result of enhanced business confidence as well as monetary and fiscal stimuli. Good weather conditions helped to bolster agricultural performance, so that output grew from 4.2 per cent to over 10 per cent between 2001 and 2002, while the industrial sector sustained a high growth rate of around 7 per cent. The continued expansion of value added in service activities, amounting to 4.8 per cent in 2001 and 5.1 per cent in 2002, helped to widen employment opportunities further with unemployment falling to 15.7 per cent in 2002 from 16.3 per cent a year earlier. The economy of the Islamic Republic of Iran was expected to maintain its growth momentum in fiscal year 2003, with estimated GDP growth of 6.9 per cent.

Economic growth decelerated somewhat in Turkey

Turkey has been experiencing relatively sharp swings in economic production in the recent past. The economy contracted by 7.5 per cent in 2001 as a result of the massive earthquakes and financial crisis of 2000-2001. However, GDP expanded by 7.8 per cent in 2002, an upturn driven by robust export performance, strong agricultural production and large inventory rebuilding during the first half of the year. There was, in addition, a sharp rise in public consumption and investment during the second half of the year reflecting accelerated government spending ahead of early elections held in November 2002. The upturn was also a positive response to a variety of policy measures aimed at (a) reducing uncertainties in the financial markets through the implementation of urgent measures to enhance the stability of interest and exchange rates, (b) completing structural reforms to promote economic efficiency and (c) focusing macroeconomic policies on economic stabilization to ensure a rapid economic turnaround and a more sustainable growth path. The economic recovery tapered off slightly in 2003 with GDP growth estimated at 5.3 per cent. Although the war in Iraq was short, the precarious security situation there and the terrorist attacks in Istanbul in November 2003 have adversely affected tourism revenues and economic activities.

Inflation

Inflation in India rose slightly in 2003

In India, the price situation was well under control in 2002 as a result of huge food stocks within the public distribution system; food items accounted generally for a 57 per cent weighting in the consumer price index. Other moderating factors included greater competition from liberalized imports, which, in turn, was due to the complete removal of quantitative restrictions and other non-tariff barriers on imports, the continued reduction of import duties to fulfil WTO requirements and weak domestic demand along with the existence of excess capacity in various industries. Inflation, which had gone down from 4.3 to 4 per cent between fiscal years 2001 and 2002, rose slightly to 4.8 per cent in the following year (table II.21). Non-food commodities and several manufactured products (including edible oils and items made of iron and steel) accounted for most of the upward drift in prices during the year; some of the increases were also due to higher petroleum prices (which were adjusted upward in December 2003 and January 2004) and greater spending associated with elections in a number of states in India.

Table II.21. Selected South and South-West Asian economies: inflation and money supply growth (M2), 2000-2003

(Percentage)

	2000	2001	2002	2003
Inflation[a]				
India[b, c]	3.8	4.3	4.0	4.8
Iran (Islamic Republic of)[c]	12.6	11.4	15.8	16.8
Pakistan[c]	3.6	4.4	3.5	3.1
Sri Lanka[d]	6.2	14.2	9.6	6.3
Turkey	54.9	54.4	45.0	25.3
Money supply growth (M2)				
India	15.2	14.3	16.8	11.9[e]
Iran (Islamic Republic of)	22.4	27.6	27.5	23.5[f]
Pakistan	12.1	11.7	16.8	18.5[e]
Sri Lanka	13.0	11.4	13.2	13.8
Turkey	40.5	86.2	29.1	8.9[g]

Sources: ESCAP, based on national sorces; and IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003).

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] Consumer price index for industrial workers.
[c] Fiscal year.
[d] Colombo.
[e] January-August.
[f] January-July.
[g] January-June.

Pakistan witnessed a further reduction in the inflation rate from its already low level

The downward trend in inflation continued in Pakistan with price increases amounting to just over 3 per cent in fiscal year 2003, from 3.5 per cent in the previous year. Among the stabilizing factors were the improved availability of food items, imported deflation due to both the appreciating rupee and lower international commodity prices, the greater availability of credit at low interest rates for production purposes, prudent fiscal management and effective sterilization of the monetary impact of massive capital inflows.

Inflation in Sri Lanka also continued to decline

In line with global trends, inflation in Sri Lanka continued to decline from 9.6 per cent in 2002 to 6.3 per cent in the following year. Upward movements in consumer prices were, by and large, constrained by a somewhat tighter monetary policy to arrest demand-pull inflation, the improved domestic supply condition, stability in the exchange rate (which in fact tended to appreciate during the latter part of 2003) and declining inflationary expectations as reflected in the decreasing forward premium in the foreign exchange market and interest rates at government bond auctions.

Inflation in the Islamic Republic of Iran continues to rise

In comparison, however, inflation in the Islamic Republic of Iran remains high and consumer prices rose further by 15.8 per cent in fiscal year 2002, as compared with 11.4 per cent in the previous year. Food prices rose by 19.4 per cent in 2002, as against 7.3 per cent in 2001. This was considerably faster than the increases in non-food prices, despite the government subsidy for basic foodstuffs, such as wheat, rice, vegetable oil and sugar. Strong domestic demand, partly fuelled by higher public spending, along with a relatively accommodating monetary policy led to the acceleration of monetary growth, to 27.5 per cent in 2002, and higher prices. Inflation was estimated to rise to 16.8 per cent in 2003, and concerted efforts at greater price stabilization at a lower level have been among the highest priorities of monetary policy in the country.

Inflation in Turkey continued its downward path

Inflation in Turkey, though still high in absolute terms, has been on the decline in recent years, for example, from over 54 per cent in 2001 to 45 per cent in 2002. The increase in food prices was at the lowest rate in the last 15 years, thus moderating somewhat domestic inflation. The macroeconomic policies and structural reforms carried out under the new economic programme became the determining factors in the struggle against inflation, leading in the process to a decrease in future inflationary expectations. Other stabilizing factors included weak domestic demand, a marginal increase in consumption and investment expenditure and the stability of the lira. Helped by stable and low world prices, consumer prices in Turkey continued to rise but at a more modest rate, with inflation estimated at 25.3 per cent for 2003.

Foreign trade and other external transactions

External trade

Export growth in India decelerated but remained double-digit in 2003

Indian exports remained buoyant with a gain of 18 per cent in fiscal year 2002 owing to increased earnings on both primary and manufactured products (table II.22). Export performance in fiscal year 2003 was encouraging with earnings growth of 10 per cent during April-September 2003 and this rate of export expansion was expected to be sustained for fiscal year 2003 as a whole, given the resurgence in world trade, improved world commodity prices, various export facilitating measures and a good performance in agricultural products and key manufacturing sectors (such as engineering goods, chemicals, automobiles, ores and minerals, basic metals and petroleum products).

Import spending rose by 13.6 per cent in 2002, driven by a pickup of industrial activities and investment demand (table II.23). However, imports were estimated to go up at a faster rate – 19 per cent in 2003 – mainly owing to higher outlays on imported edible oils, export-related raw

Table II.22. Selected South and South-West Asian economies: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	Exports (f.o.b.) Annual rate of growth (percentage)			
	2002	2000	2001	2002	2003
India[a, b]	53 000	19.6	0.0	18.0	10.0
Iran (Islamic Republic of)[a]	28 186	35.3	–16.0	17.9	0.1
Pakistan[a]	9 135	10.1	7.4	–0.7	22.2
Sri Lanka[c]	4 699	19.8	–12.8	–2.4	9.2
Turkey[d]	36 059	4.5	12.8	15.1	29.2

Sources: Reserve Bank of India, *Annual Report 2002-03*; State Bank of Pakistan web site <http://www.sbp.org.pk>, 7 November 2003; Central Bank of Sri Lanka web site <www.lanka.net/centralbank>, 27 February 2004; Central Bank of the Islamic Republic of Iran web site <http://www.cbi.ir/>, 14 November 2003; Republic of Turkey State Institute of Statistics web site <http://www.die.gov.tr/english/>, 12 January 2004; and other national sources.

[a] Fiscal year.
[b] Data for 2003 are estimates.
[c] Data for 2003 are provisional.
[d] Data for 2003 refer to January-November.

Table II.23. Selected South and South-West Asian economies: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	Imports (c.i.f.) Annual rate of growth (percentage)			
	2002	2000	2001	2002	2003
India[a, b]	65 474	7.0	–2.8	13.6	19.0
Iran (Islamic Republic of)[a, c]	23 786	12.3	20.2	31.2	19.4
Pakistan[a]	10 340	9.3	4.1	–3.6	18.2
Sri Lanka[d]	6 105	22.4	–18.4	2.2	9.3
Turkey[e]	51 554	34.0	–24.0	24.5	31.4

Sources: Reserve Bank of India, *Annual Report 2002-03*; State Bank of Pakistan web site <http://www.sbp.org.pk>, 7 November 2003; Central Bank of Sri Lanka web site <www.lanka.net/centralbank>, 27 February 2004; Central Bank of the Islamic Republic of Iran web site <http://www.cbi.ir/>, 14 November 2003; Republic of Turkey State Institute of Statistics web site <http://www.die.gov.tr/english/>, 12 January 2004; and other national sources.

[a] Fiscal year.
[b] Data for 2003 are estimates.
[c] Imports value is f.o.b.
[d] Data for 2003 are provisional.
[e] Data for 2003 refer to January-November.

materials and other inputs, and capital goods imports. Meanwhile, the current account recorded a surplus amounting to 0.7 per cent of GDP in 2002 and was expected to remain in surplus in 2003 also despite higher import leakages and a slower rate of export earnings growth. Inward transfers from Indians working abroad remained generally buoyant.

Exports of Pakistan surged and reached record levels

Pakistan experienced, by and large, favourable outcomes in external trade and exchange transactions in 2003. Both exports and imports registered impressive growth, the current account posted a large surplus, workers' remittances continued to surge, the accumulation of foreign exchange reserves remained strong, the rupee strengthened further against the dollar and FDI inflows rose substantially. Earnings on exports increased to a record $11.1 billion in fiscal year 2003; this represented an expansion of over 22 per cent, compared with negative growth of 0.7 per cent in fiscal year 2002. Textile manufactures, which constituted about two thirds of total exports, registered an increase of 25 per cent in 2003. Receipts from other manufactured exports grew by almost 11 per cent, with engineering goods, chemicals and pharmaceutical products, petroleum products and sports goods showing high growth rates. Earnings on primary commodity exports, meanwhile, went up also by 25 per cent.

Import expenditure, at $12.2 billion in 2003, represented an increase of 18.2 per cent as compared with negative growth of 3.6 per cent in the previous year. Almost one fourth of imports consisted of oil-related products, which grew by 9 per cent in value owing to higher oil prices. Higher spending on non-food and non-oil imports, by almost 22 per cent in 2003, was instrumental in improving local production and manufacturing activities; notably, in this context, imports of machinery were up by one third in 2003. Meanwhile, a stronger expansion of export earnings in 2003 further lowered the trade deficit to a 10-year low of $1.1 billion and the current account surplus improved to 5.9 per cent of GDP in 2003, from 4.8 per cent in the previous year, on account of a lower service account deficit plus a sharp rise in current transfers inwards. In particular, the inflow of overseas workers' remittances went up to an all-time high, from $2.4 billion to $4.2 billion between 2002 and 2003.

Exports of Sri Lanka staged a strong recovery

In Sri Lanka, the external sector recovered from a subdued performance in 2002 with exports increasing by 9.2 per cent in 2003, as against a drop of 2.4 per cent in 2002. Export earnings were strengthened largely through a rise of 12 per cent in industrial exports, which, in turn, reflected higher demand by industrial countries. Apparel and garments exports account for half of total exports, and despite its reputation for quality consistency and timely delivery of goods, the persistent overreliance on textiles could constrain Sri Lanka's ability to take off to a high-growth path. Moreover, the phasing out of textile quotas by 2005 could adversely affect the smaller industries, which are not geared to cater for up-market demands or link up to large industries, which can better cope with a highly competitive market environment. Diversification of the production base towards services to exploit the country's strategic location and the high standards of its labour force could be most opportune under the circumstances.

Total imports, up by just over 2 per cent in 2002, expanded by 9.3 per cent in the following year. Improved consumer confidence, the current economic recovery and positive prospects of higher growth were largely behind a rise in import spending of 13 per cent on investment goods imports, 12 per cent on consumer goods imports and 9 per cent on intermediate goods. Improvements in the external services account reflected a higher number of tourist arrivals and better performance in port services. Private transfers were equivalent to nearly three quarters of the deficit in the goods, services and income accounts; the inflow rose by 8 per cent in 2003 probably because tensions in West Asia might have induced workers to remit their savings homewards as a precautionary measure. All in all, there was a modest increase in the current account deficit, from 1.6 to 2.3 per cent of GDP between 2002 and 2003 (table II.24).

Table II.24. Selected South and South-West Asian economies: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Budget balance as a percentage of GDP				
India	−5.6	−6.1	−5.9	−4.8
Iran (Islamic Republic of)[a]	−0.2	−0.1	−1.9	−1.1
Pakistan[a]	−6.6	−5.2	−5.2	−4.4
Sri Lanka[a]	−9.9	−10.8	−8.9	−7.8
Turkey	−10.3	−16.0	−14.2	−12.2
Current account balance as a percentage of GDP				
India	−0.8	0.2	0.7	0.4
Iran (Islamic Republic of)	17.5	7.0	3.3	−0.6
Pakistan	−0.4	0.6	4.8	5.9
Sri Lanka	−6.3	−1.6	−1.6	−2.3
Turkey	−4.9	2.3	−0.8	−3.3

Sources: ESCAP, based on national sources; and Economist Intelligence Unit, *Country Reports and Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Excluding grants.

Value of exports of the Islamic Republic of Iran remained stable in 2003 following a sharp increase in the previous year

The Islamic Republic of Iran had recorded a substantial rise in export earnings of almost 18 per cent in fiscal year 2002, as against a contraction of 16 per cent for the previous year, because of better oil prices despite a lower export volume in 2002. Oil and gas accounted for around 80 per cent of total merchandise exports while non-oil exports also registered higher growth in 2002. In dollar terms, the value of exports in 2003 was estimated as remaining virtually at the level attained in the previous year. A significant rise in earnings on non-oil exports helped to offset the somewhat smaller exports of oil owing to lower prices.

Imports had grown at a high rate, over 30 per cent in 2002 on top of an increase of over one fifth in the earlier year, as a result of buoyant domestic demand, recent trade liberalization measures and a build-up of inventories in the period leading up to the Iraq war. In particular, some of the recent liberalization in the trade regime included the consolidation of customs duty rates and other import charges and fees into a single customs duty rate set at 4 per cent; the elimination of various exemptions from the customs duty; and the ongoing replacement of non-tariff barriers with tariffs plus a significant reduction in non-tariff barriers. Import spending on capital and intermediate goods constituted more than 80 per cent of the total, and total imports continued to grow by an estimated 19.4 per cent in 2003. Largely as a result, the current account surplus of 3.3 per cent of GDP in 2002 turned into a small deficit in 2003.

Turkey witnessed a sharp increase in exports

There was also a sharp rise of about 15 per cent in the export earnings of Turkey, reaching $36 billion in 2002. Manufactured exports, accounting for 93 per cent of the total export value, consisted largely of textiles and garments, construction materials, household appliances and electrical goods, and motor vehicles and parts. The EU accounted for just over a half of Turkey’s exports while some 10 per cent of exports went to the United States. Despite a significant appreciation of the lira in real terms, the momentum of export growth continued into 2003 with earnings rising by over 29 per cent during the first 11 months of the year.

Imports increased even more rapidly at 24.5 per cent to exceed $50 billion in 2002, following a sharp contraction of 24 per cent in the previous year. The main categories of imported goods were intermediate goods, including steel and plastics, electronic components, and oil and gas. Investment goods (mostly industrial machinery) accounted for around 17 per cent of total imports, and consumer goods another 10 per cent. The main sources of imports apart from the EU were the United States, Switzerland, Japan, the Russian Federation and Saudi Arabia. Iraq has the potential to become a major trading partner of Turkey once the security situation improves in Iraq and its economy starts functioning normally. Expenditure on imports continued to be on a rising trend in 2003 owing to a recovery in domestic demand and higher oil prices, surging by 31.4 per cent in the first 11 months of 2003. Supported by tourism and inward remittances from overseas workers, the external services account registered a substantial surplus. As a result of a large trade deficit, however, the usual deficit in the current accounts was projected to rise to around 3 per cent of GDP in 2003.

Capital flows and exchange rates

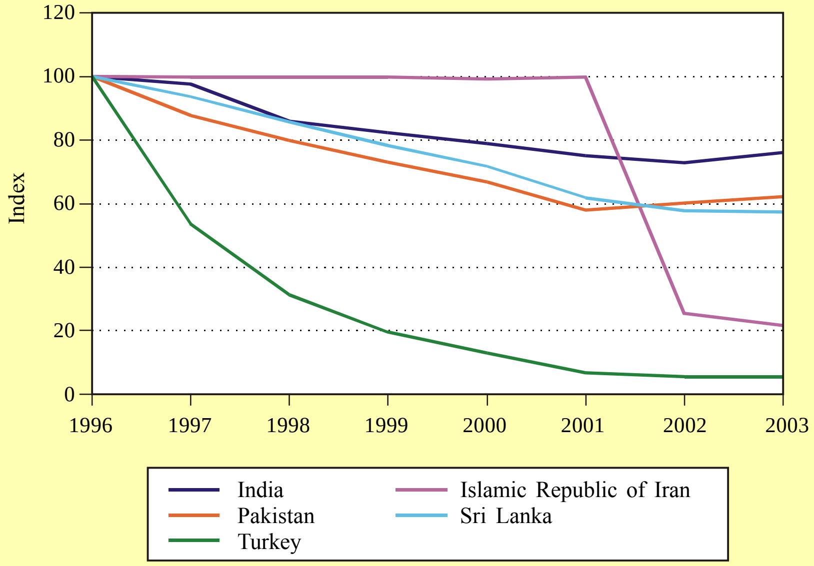
Improved balance of payments position led to a significant increase in the foreign exchange reserves of India and Pakistan

Inward investment went up strongly in India in 2003 along with a pickup in commercial borrowings by the corporate sector in response to lower interest rates in the international markets. Foreign investment inflows (including both FDI and portfolio investment) more than doubled from $4.5 to $11.5 billion between 2002 and 2003, a favourable development trend attributable to the sound macroeconomic environment, continuation of reforms in infrastructure, further liberalization of foreign investment policies and relatively high rates of return on investment. India's foreign exchange reserves, which rose by $29 billion in 2003 on top of an increase of $17 billion in the previous year, stood at more than $100 billion in December 2003, a level equivalent to as many as 15 months of imports.

The depreciation of 3.5 per cent in the rupee exchange rate relative to the dollar in 2002 was largely reversed by an appreciation of 3 per cent in 2003 (figure II.20). This reversal was due chiefly to substantial foreign

Figure II.20. Index of exchange rates against the United States dollar in selected South and South-West Asian economies, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Notes: Data for 2003 are estimates. In the case of the Islamic Republic of Iran, the data are for January-October.

exchange reserves and the persistent weakness of the dollar vis-à-vis other major international currencies. However, the real effective exchange rate of the rupee also appreciated in 2003 owing to the widening price differentials between India and those in its major trading partners.

The capital account of Pakistan registered a small surplus in fiscal year 2003, a significant improvement over the previous year, when there had been a large deficit. Driven by current account and capital account surpluses, the surplus in the overall balance of payments amounted to $4.6 billion or 6.7 per cent of GDP in 2003, boosting the accumulation of foreign exchange reserves to a record $11.7 billion by the end of fiscal year 2003. Notably in this connection, the major portion of the increase in foreign exchange reserves came from non-debt-creating inflows. The Pakistani rupee continued to appreciate against the dollar, by 3.9 per cent during fiscal year 2003 on top of an appreciation of 6.7 per cent in the previous year. The central bank moderated the ascent of the rupee during 2003 through its interventions in the foreign exchange market so as to preserve export competitiveness.

Capital inflows showed significant improvement in Sri Lanka

Financial flows showed a significant improvement in Sri Lanka during 2003 mainly because of a sharp rise in long-term concessional borrowings by the Government. With the ongoing peace initiative in place, the country has commenced with donor support rehabilitation and reconstruction work in the war-torn areas. In addition, there was a medium-term Poverty Reduction and Growth Facility (PRGF) arrangement with IMF as well as support from the World Bank and ADB for the implementation of structural reform. FDI stood at $326 million in 2003, as against $235 million in 2002, a reflection of the positive influence of the ceasefire agreement and the policy framework under PRGF. As a result, the surplus on the overall balance of the balance of payments improved slightly to $390 million in 2003, from $338 million in 2002.

Meanwhile, the exchange rate by and large was stable during most of 2003 against the backdrop of a weaker dollar. There was, however, some appreciation against the dollar after September 2003 relative to the level prevailing at the end of 2002, in part owing to the continuing weakening of the dollar, higher capital flows and a declining domestic inflation rate. Overall, the rupee appreciated marginally by just 0.3 per cent against the United States dollar during 2003.

Islamic Republic of Iran approved a new law for the promotion of foreign investment

The capital account of the Islamic Republic of Iran registered a sizeable surplus with the continuation of sizeable FDI mainly in the oil sector. Portfolio investment in the Tehran Stock Exchange also added its weight to capital inflows, however. The new law for the attraction and promotion of foreign investment, approved in June 2003, introduced significant measures to liberalize investments in the non-oil sector, thus attracting considerable interest from foreign investors; FDI in the non-oil sector had been very limited in the past. The country also returned to the international capital markets in 2002, with the issue of two five-year euro bonds (worth 625 million and 375 million euros), in part to serve as a benchmark for the corporate sector of the country. Large capital inflows coupled with a current account surplus led to an increase of $4.8 billion in foreign exchange reserves in fiscal year 2002 with the total amount of foreign exchange reserves reaching $21.8 billion (equivalent to about 7 months of imports) as at March 2003.

The multi-tier exchange rate regime was abolished in March 2002 and the unified exchange rate was relatively stable against the dollar, as indicated by the low market premium. The central bank has been pursuing a managed floating regime, with limited intervention to smooth out rate fluctuations. In addition, the Government allowed foreign branches of domestic banks to operate in the offshore foreign exchange market for current, and some capital, account transactions. This broadened access to foreign exchange contributed to a convergence of the exchange rates in the domestic and offshore markets.

Turkey also undertook measures to promote foreign investment, including the introduction of a new foreign direct investment law

FDI flows to Turkey in 2002 were low at just under $600 million. Among the major steps carried out to promote external investment were constitutional amendments to allow international arbitration, the approval of a new FDI law in June 2003 to improve conditions for foreign investments (replacing the earlier legislation which had been in place since 1954) and the establishment of an investment promotion agency. The Turkish lira depreciated against the euro in 2003 but its value remained relatively stable against the dollar.

Foreign debt

Foreign debt indicators show improvement for India, Pakistan and Sri Lanka

India’s external debt (consisting of both short- and long-term liabilities) increased from $98.8 to $104.2 billion between end-March 2002 and end-March 2003. It was expected to reach $109.8 billion at the end of March 2004. The share of short-term debt has been declining continuously in recent years and stood at less than 4 per cent of total external debt in 2002. The changing composition of capital account transactions in favour of non-debt financial flows led to an impressive improvement in debt indicators. The external debt-to-GDP ratio declined continuously by over one half, from 38 per cent in 1991 to 20.6 per cent in 2002 and further to 18.3 per cent in 2003. The debt-service ratio (i.e., the ratio of total debt service to gross receipts on the current account of the external sector) also fell from 35 per cent in 1990 to 14.7 per cent in 2002 and further to 13.8 per cent in 2003.

An increase in non-debt-creating external flows, the Paris Club debt restructuring and a debt write-off of $1 billion significantly improved the debt profile of Pakistan in 2003. External debt as a percentage of GDP decreased from 46 to 42 per cent between 2002 and 2003. Retirement of some external debts and the replacement of expensive debt by soft loans from international financial institutions have helped in reducing debt-servicing costs. As a percentage of export earnings, external debt servicing fell from 21.3 per cent in 2001 to 13.1 per cent in 2002; this ratio was expected to remain around the same level in 2003.

In Sri Lanka, the level of total public debt dropped from over 105 per cent of GDP at the end of 2002 to around 100 per cent at the end of 2003 with the external debt component declining marginally from 59.6 to 58.7 per cent of GDP respectively in the two periods. Despite some improvement during the year as a result of fiscal consolidation and efforts directed at better debt management, the country's overall debt still remained at a relatively high level. Compounded by the continuing high level of fiscal deficits and low growth, the consequent interest payments on government debt have become the single-largest expenditure item while the total debt-service payments have exceeded total revenue in recent years.

External debt of the Islamic Republic of Iran remains low

The amount of external debt of the Islamic Republic of Iran has been low, totalling about $9.2 billion or just 8 per cent of GDP in fiscal year 2002. Of the outstanding debt, $2.1 billion (or about 23 per cent) was short-term. External debt was expected to rise marginally in 2003 along with the projected current account deficit in the balance of payments.

Steady increase in Turkey's external debt

By contrast, Turkey's external debt has risen steadily, reaching $131.6 billion or 72 per cent of GDP in 2002. Medium- and long-term foreign debt (contracted largely by the public sector), was put at $116.4 billion or about 88 per cent of the total, and short-term debt at $15.2 billion; the latter was held almost entirely by the private sector.

Policy issues

Poverty reduction remains a major challenge

Despite varying progress over time, poverty reduction and social progress remain a major challenge for most countries in the subregion. The incidence of income poverty is high.[1] Moreover, poverty should not be viewed in terms of low income alone because other dimensions of poverty include lack of access to education, health, clean drinking water and proper

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[1] For more details on the poverty situation in the countries and national efforts aimed at poverty reduction, see the next chapter of this *Survey*.

sanitation. It is widely accepted that sustained economic growth at a high rate is necessary to reduce poverty. However, while growth is a necessary condition, it is by no means sufficient without an enabling environment for the poor to participate in, and benefit from, gainful economic activities and the growth process. As such, pro-poor public policies include the creation of employment opportunities and the implementation of measures to enhance both access to and the availability of health care, education and training facilities for the poor. While sustaining the hard-earned growth momentum and at the same time maintaining macroeconomic stability, Governments should also continue to spend more on social development and poverty reduction. While the level, efficiency and equity of social expenditure matter, there is also a need to ensure more effective utilization of existing resources. Expenditure levels cannot be increased without greater absorptive capacity and, in this respect, the involvement of community groups appears to be important to improve absorptive capacity, transparency and appropriate monitoring of expenditures.

SAARC Summit held at Islamabad in January 2004 declared poverty alleviation the overarching goal

The 12th SAARC[2] Summit, held at Islamabad from 4 to 6 January 2004, recognized poverty alleviation as the greatest challenge facing the peoples of South Asia and declared poverty alleviation the overarching goal of all SAARC activities. Provision of basic needs, promotion of literacy and better health care were described as regional priorities. The Summit once again emphasized the importance of undertaking effective and sustained poverty reduction programmes through the implementation of pro-poor growth strategies and other policy interventions with specific sectoral targets. In order to finance economic and social development in member States, it was agreed to examine the prospects for setting up a South Asian development bank. The Summit also signed the SAARC Social Charter. The issues covered under the Charter include poverty alleviation, population stabilization, empowerment of women, youth mobilization, human resources development, promotion of health and nutrition and protection of children. To foster trade among member States and strengthen their economic ties, the agreement on South Asia Free Trade Area was also signed (box II.2).

Large public debts as a result of large and persistent fiscal deficits

The high levels of public (including both external and domestic) debt are a major problem facing most countries in the subregion. The central Government of India, for example, has accumulated substantial, deficit-driven obligations as indicated by a rising public debt-to-GDP ratio (64 per cent at the end of March 2001 and 71 per cent at the end of March 2003). The debt ratio was estimated to remain at more or less the

[2] The members of SAARC are Bangladesh, Bhutan, India, Nepal, Maldives, Pakistan and Sri Lanka.

Box II.2. Agreement on the South Asian Free Trade Area

At the Twelfth SAARC Summit, held at Islamabad from 4 to 6 January 2004, member States (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka) signed the Agreement on the South Asian Free Trade Area (SAFTA) to promote and enhance mutual trade and economic cooperation. The Agreement will come into force on 1 January 2006 upon completion of formalities, including ratification by all member States. The main provisions of the Agreement are explained briefly below.

The Agreement will be implemented through a number of instruments, including a trade liberalization programme, institutional arrangements, consultation and dispute settlement procedures, safeguard measures and any other instruments that may be agreed by member States.

Under the trade liberalization programme, tariffs are to be brought down to 0-5 per cent in two stages. Member States agreed that India, Pakistan and Sri Lanka would reduce their tariffs from the existing levels to 20 per cent within a two-year time frame from the date on which the Agreement comes into force. States are encouraged to adopt the reductions in equal annual instalments. It was also agreed that the least developed countries (LDCs), Bangladesh, Bhutan, Nepal and Maldives, would reduce their existing tariffs to 30 per cent within two years of the coming into force of the Agreement. The subsequent tariff reductions by India and Pakistan from 20 per cent or below to 0-5 per cent are to be completed within a second five-year time frame, beginning from the third year from the date on which the Agreement takes effect. However, the period for subsequent tariff reductions by Sri Lanka will be six years. States are encouraged to adopt the reductions in equal annual instalments, but not less than 15 per cent annually. The subsequent tariff reductions by LDCs from 30 per cent or below to 0-5 per cent are to be done within a second eight-year time frame beginning from the third year from the date of the coming into force of the Agreement. LDCs are encouraged to adopt the reductions in equal annual instalments, but not less than 10 per cent annually.

The tariff reduction schedules will not prevent member States from immediately reducing their tariffs to 0-5 per cent or from following an accelerated schedule of tariff reduction. It was agreed that India, Pakistan and Sri Lanka would reduce their tariffs to 0-5 per cent for the products of LDCs within a three-year time frame beginning from the date of the coming into force of the Agreement.

The rules of origin will be negotiated by member States and incorporated as an integral part of the Agreement. Under the rules of origin a product is considered to be of a particular country only if it has a certain pre-specified level of value added content by that country.

Each member State would be allowed to maintain a sensitive list of products on which tariffs would not be reduced. These sensitive lists are to be negotiated by member States and incorporated as an integral part of the Agreement. The number of products in the sensitive lists will be subject to a maximum ceiling, to be mutually agreed among the States, with flexibility given to LDCs. The lists will be reviewed every four years or earlier, as may be decided by the SAFTA Ministerial Council, with a view to reducing the number of items in them.

It was also agreed that member States would eliminate all quantitative restrictions, except as otherwise permitted under GATT 1994, in respect of products included in the trade liberalization programme. Moreover, member States agreed to consider the adoption of trade facilitation and other measures to support and complement SAFTA for their mutual benefit.

The Agreement provides details on the dispute settlement mechanism. All disputes among member States are preferably to be solved through bilateral consultations. If consultations fail to settle a dispute, the Committee of Experts can become involved and make recommendations. Any member State party to a dispute may appeal the recommendations of the Committee to the SAFTA Ministerial Council, which may uphold, modify or reverse the Committee's recommendations. If a member State fails to implement the recommendations within 90 days, the Committee may authorize other interested member States to withdraw concessions having trade effects equivalent to those of the measure in dispute.

The full implementation of the Agreement will significantly enhance trade among member States. Moreover, low tariffs will reduce the incentive for smuggling. The actual impact on trade expansion will depend on how extensive the sensitive lists turn out to be in terms of the range of products without tariff reductions.

same level at the end of March 2004. In Pakistan, the public debt-to-GDP ratio stood at 92 per cent in 2003, although there has been some improvement in recent years as a result of writing off some external debt and better debt management by the Government. A major part of the public debt in both India and Pakistan consists of domestic debt obligations payable in national currencies.

Several countries in the subregion have managed to improve their fiscal performance and reduce excess spending. In Pakistan, for example, higher general sales tax revenue and better tax administration culminated in an increase in tax revenue of over 16.2 per cent in 2003. Together with disciplined spending, the fiscal deficit was reduced to 4.4 per cent of GDP, a notable achievement since for the first time in 25 years the deficit has fallen below 5 per cent of GDP. Meanwhile, the fiscal deficit of the central Government of India was expected to come down to 4.8 per cent of GDP in 2003, compared with around 6 per cent of GDP in both 2001 and 2002. However, the budget deficit remained high at 7.8 per cent of GDP in Sri Lanka during 2003, although this represented a considerable drop from 8.9 per cent in 2002 (table II.24).

Need for further fiscal reforms

Governments are aware of the pressing need to contain the budget deficit and the public debt-service burden so that additional resources can be redirected towards poverty reduction and social development. Tax reforms are being carried out to increase tax revenues through a broadening and deepening of the tax base, a further rationalization of rate structures, the introduction of a value added tax, an additional widening of the service tax base and ongoing improvements in tax administration. Tax administration plays a vital role in the success or failure of any attempt at fiscal reform and there is, indeed, a growing conviction among tax policy specialists that policy change without commensurate administrative reforms cannot help much in achieving the desired results. However, it is also critical to ensure that changes in tax policy are compatible with administrative capacity. On the expenditure side, fiscal reforms are embodied in efforts to reduce subsidies and the wage bill. Disinvestment of government equity in public sector commercial enterprises can be expedited and some of the privatization receipts can be earmarked for the advance payment of more expensive public debt, the restructuring of weak public enterprises and high-priority social expenditures.

Investment levels to be raised to accelerate economic growth

It is widely accepted that investment is one of the most important determinants of long-term economic growth. Despite an improving macroeconomic environment, the levels of investment in Pakistan during the past few years have averaged in the range of 15-16 per cent of GDP. Private investment did not expand sufficiently to compensate for the relatively low levels of public investment, which were, in turn, due to the constraints associated with a large budget deficit. In addition to a conducive macroeconomic environment, other critical elements of a good investment climate include improved governance and better infrastructure.

Financial sector reforms gained momentum in the Islamic Republic of Iran and Turkey

To enhance competition and private participation in the banking sector, four privately owned banks were established in the Islamic Republic of Iran. These banks have been expanding rapidly, putting pressure on State-owned banks (which were recapitalized) to improve their services. The formation of private insurance companies was also authorized. At the same time, the central bank eased direct controls over the banks as regards retail lending rates and the sectoral allocation of credit. To facilitate international trade and investment, banks have been permitted since March 2003 to deal in foreign exchange in the offshore market. A comprehensive programme to develop and implement a risk-based regulatory and supervisory framework for the banking sector is being implemented. The establishment of a securities and exchange commission to improve capital markets regulation and supervision is also planned. Ongoing banking reforms in Turkey have been driven and built on the momentum gained over the last two years. Prudential regulations have been strengthened along with the recapitalization of the banking system, and non-performing loans of banks have been on the decline.

Further diversification of exports needed to reduce vulnerability to external shocks

The export base of the Islamic Republic of Iran, Pakistan and Sri Lanka is relatively narrow, with textile manufactures, for example, accounting for almost two thirds of the total export earnings of Pakistan. This relative share rises further if exports of raw cotton are added. Sri Lanka’s exports are also dominated by textiles and garments, which account for around one half of total exports. Around 80 per cent of the total exports of the Islamic Republic of Iran consist of oil and gas. Such a heavy degree of export product concentration not only exposes these countries to the vulnerabilities of external shocks, it also constrains their ability to achieve a faster growth path. Therefore, a long-term strategy is needed to encourage investment in non-traditional areas of production in each country, complemented by the ancillary development of the required human skills.

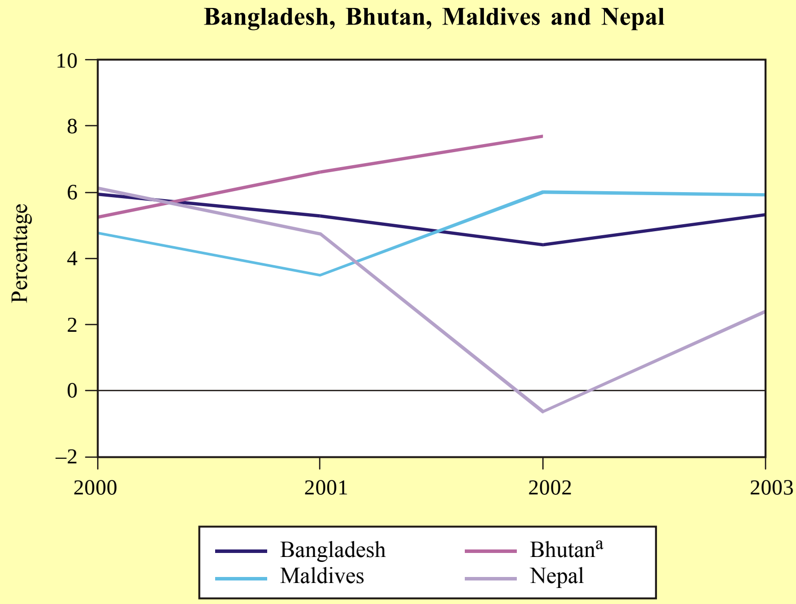
B. Least developed countries in the subregion

Overview

Overall trends in least developed countries in South Asia are positive, with relatively strong economic growth, low inflation and robust expansion of the trade sector

Least developed countries in South Asia generally recorded a reasonably robust economic performance in 2003 (figure II.21). Afghanistan continued to experience strong growth of 20 per cent in the year owing to the stimuli from reconstruction efforts, the resumption of agricultural growth and the implementation of sound economic policies. The economy of Nepal recovered from a marginal contraction in 2002, and hopes for peace and renewed confidence in the manufacturing and tourism sectors contributed to positive but relatively modest GDP growth during 2003. Aggregate production continued to be buoyant, rising by more than 5 per cent in Bangladesh, Bhutan and Maldives. However, ongoing efforts to diversify their relatively narrow economic base, especially in the latter two economies, will be essential in order to stimulate and sustain solid growth over the medium term.

Figure II.21. Rates of GDP growth in selected least developed countries in South and South-West Asia, 2000-2003



Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003).

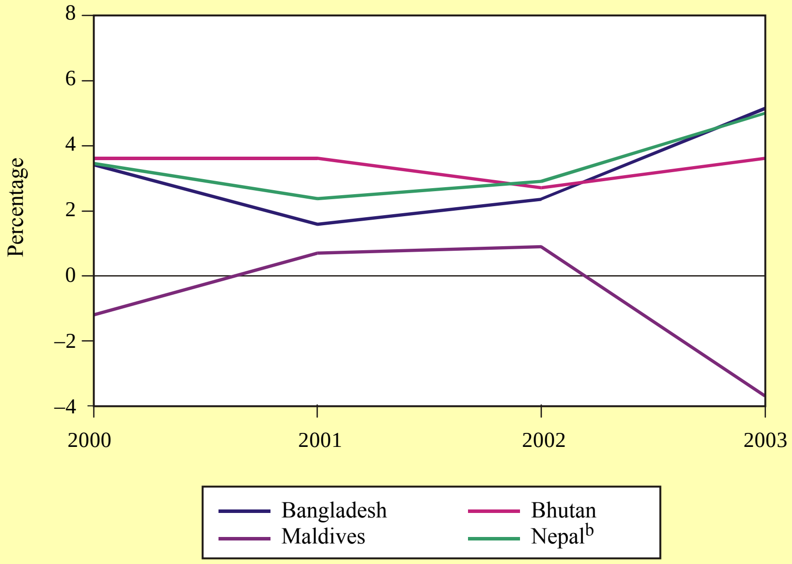
Note: Data for 2003 are estimates.

[a] GDP at factor cost.

As in many other countries in Asia, inflation was generally at a moderate level in most of the least developed countries of South Asia in 2003, except Afghanistan (figure II.22). In order to insulate domestic prices from external forces, small and open economies such as Bhutan and Nepal continued to maintain an exchange rate peg against the Indian rupee while Maldives maintained a peg against the United States dollar. Bangladesh, the largest economy among the least developed countries, introduced a market-based floating exchange rate regime for the taka in 2003. Afghanistan recorded a relatively high rate of inflation following the introduction of its new currency in 2002.

Figure II.22. Inflation[a] in selected least developed countries in South and South-West Asia, 2000-2003

Bangladesh, Bhutan, Maldives and Nepal



Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003).

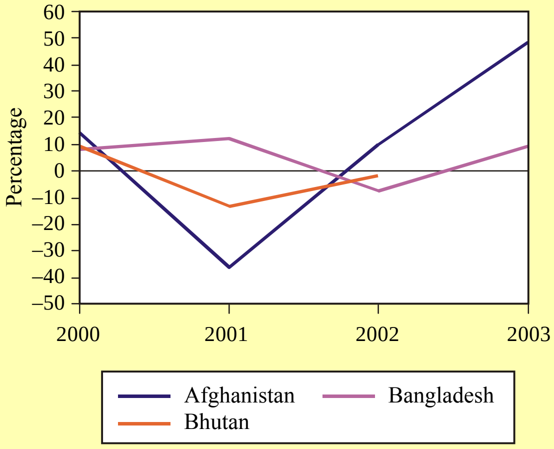
Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] National urban consumer price index.

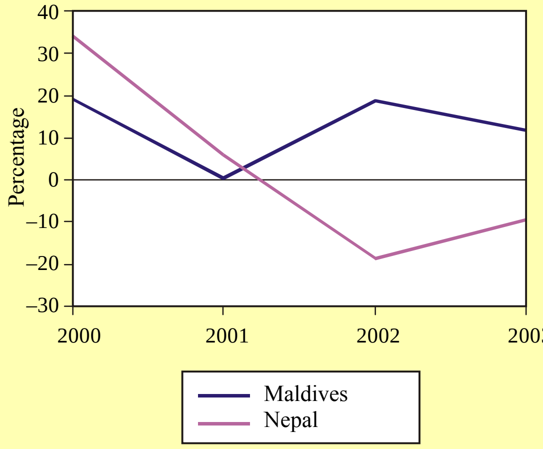
The trade sector expanded in most of the least developed countries in South Asia although a considerable volume of trade flows, including those in Afghanistan and Nepal, are not always fully reported (figures II.23 and II.24). Owing to broad-based reforms in the real and financial sectors as well as a recovery in garment exports, both export earnings and

Figure II.23. Growth rates in merchandise export earnings of selected least developed countries in South and South-West Asia, 2000-2003

(a) Afghanistan, Bangladesh and Bhutan



(b) Maldives and Nepal

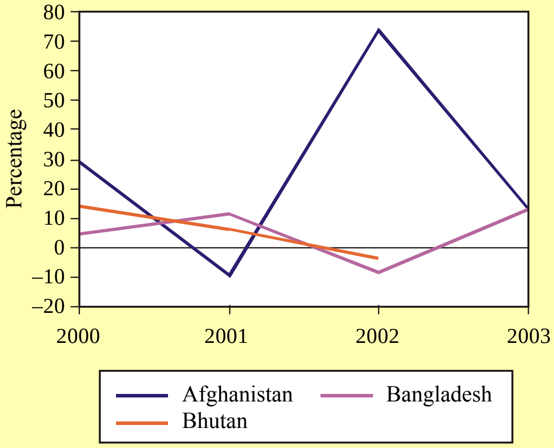


Sources: IMF, *Country Reports,* various issues, and *Direction of Trade Statistics* (CD-ROM), November 2003; and national sources.

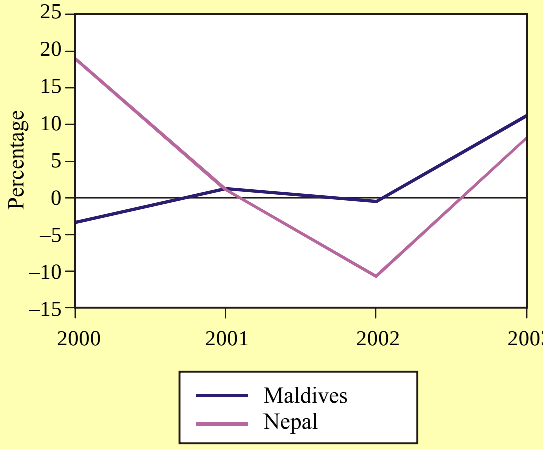
Notes: Figures for 2003 refer to two quarters, except for Bangladesh (the whole year) and Maldives (projection for the whole year). Bangladesh, Bhutan and Nepal figures are for the fiscal year. Exports from Maldives exclude re-exports.

Figure II.24. Growth rates in merchandise import spending of selected least developed countries in South and South-West Asia, 2000-2003

(a) Afghanistan, Bangladesh and Bhutan



(b) Maldives and Nepal



Sources: IMF, *Country Reports,* various issues, and *Direction of Trade Statistics* (CD-ROM), November 2003; and national sources.

Notes: Figures for 2003 refer to two quarters, except for Bangladesh (the whole year) and Maldives (projection for the whole year). Bangladesh, Bhutan and Nepal figures are for the fiscal year.

import spending rose in Bangladesh during 2003. India accounted for more than 90 per cent of the external trade of Bhutan, and to further diversify its economic base, Bhutan liberalized its FDI policy, thus allowing the private sector to seek joint-venture investment partners, and renewed bilateral trade agreements with Bangladesh and India. In Maldives, the possible graduation from least developed country status raised concerns for future export growth. In addition to WTO accession, Nepal also implemented a series of legal reforms and streamlined a number of administrative procedures to facilitate trade.

Growth performance

International assistance and a rebound in agricultural output underpinned strong economic growth in Afghanistan

In Afghanistan, GDP growth was estimated to have reached almost 30 per cent (or about $4 billion in real terms) in fiscal year 2002, as a result of international assistance and spending and a robust expansion of agricultural production (excluding the illicit cultivation and production of opium and its derivatives). Total output was expected to rise by a further 20 per cent in the following fiscal year. Agriculture, with a relative share of about 52 per cent of GDP and a source of employment of three quarters of the population in fiscal year 2002, grew by 28 per cent owing to higher rainfall as well as the increased availability and better quality of seeds, fertilizer and other inputs. Total cereal production (consisting of wheat, barley, maize and rice) went up by over four fifths, to 3.6 million tonnes. Output of premium export crops such as raisins, fruits and walnuts recovered strongly, although that of several agro-products (including livestock and orchard and plantation items) would take longer to reach pre-conflict levels. Agricultural production remained on a strong upward trend in fiscal year 2003, with cereal production rising by 50 per cent to 5.4 million tonnes, although further increases in output will require considerable investment in repairing and rehabilitating irrigation facilities.

Industry accounted for 26 per cent of GDP and grew by an estimated 21 per cent, while the service sector, which contributed less than a quarter of GDP, expanded by 40 per cent in fiscal year 2002. The impact of international assistance has been most visible in the construction and service sectors in the wake of an improving security situation and the return of numerous refugees to reclaim their former homes. There was also a rapid rise in the manufacturing of cement, beverages and bottled water and in retail trade, while the carpet-weaving industry is being restored and nurtured. Large-scale private investment has been limited to telecommunication and the rehabilitation and new construction of hotels. In this context, a significant and sustained increase in private investment would require a market-oriented regulatory framework, as well as a functioning legal and banking system.

Improved economic performance with strong growth in all major sectors in Bangladesh

Owing to increasing investment following domestic macroeconomic stabilization and a recovery in global demand, real GDP for Bangladesh rose 4.4 and 5.3 per cent in fiscal years 2002 and 2003 (table II.25). The agricultural sector, whose relative share in GDP has tended to decline in recent years, expanded by 3.3 per cent in fiscal year 2003 (from stagnancy in 2002 as a result of the shortfall in the aman rice crop harvest). Favourable weather conditions and a larger area under cultivation led to a 3.6 per cent increase in the aman rice crop and resulted in foodgrain output of 27.0 million tonnes in fiscal 2003. Industrial sector value added gained by 7.3 per cent in fiscal year 2003, compared with 6.5 per cent in the previous year, despite a marginal slowdown in construction

Table II.25. Selected least developed countries in South and South-West Asia: growth rates, 2000-2003

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Afghanistan	2002	28.6	27.7	21.1	39.5
	2003	20.0	..	..	..
Bangladesh	2000	5.9	7.4	6.2	5.2
	2001	5.3	3.1	7.4	5.5
	2002	4.4	0.0	6.5	5.4
	2003	5.3	3.3	7.3	5.8
Bhutan[a]	2000	5.3	4.5	2.2	9.5
	2001	6.6	3.2	13.4	6.6
	2002	7.7	2.5	12.1	8.0
Maldives	2000	4.8	-0.2	1.2	6.1
	2001	3.5	5.1	8.1	2.4
	2002	6.0	15.9	9.0	4.3
	2003	5.9	2.5	6.2	6.3
Nepal	2000	6.1	4.9	8.8	5.7
	2001	4.7	5.5	2.7	5.3
	2002	–0.6	2.2	–3.3	–1.8
	2003	2.4	2.1	2.5[b]	

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues; and IMF, *Country Report No. 03/299* (Washington, IMF, September 2003).

Notes: Data for 2003 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction. Fiscal year data are for Afghanistan, Bangladesh, Bhutan and Nepal.

[a] GDP at factor cost.
[b] Rate of growth of non-agriculture.

(from 8.6 to 8.3 per cent) because of an oversupply of commercial buildings and apartments. A strong turnaround in both exports and imports helped to raise manufacturing output from 5.5 to 6.6 per cent over the fiscal years 2002 and 2003.

Increased manufacturing production, led by jute products, apparel, chemicals, food items and non-metallic products, in turn supported growth in the power, gas, water, mining and quarrying subsectors as well as a wide range of services, including transport, storage, communications, wholesale and retail trade, and financial service activities. In consequence, service sector output went up from 5.4 per cent in fiscal year 2002 to 5.8 per cent the following year. Meanwhile, the priority accorded to social sector spending in the fiscal 2003 budget also contributed to growth in education, health, social services and public administration. To achieve a significant reduction in poverty, Bangladesh projects an expansion of real GDP growth of 5.5, 6.0 and 6.5 per cent in fiscal years 2004, 2005 and 2006 respectively. However, the current outlook on crops and the increased pace of activities in export and domestic markets suggest that actual growth in fiscal year 2004 may be even higher. Nevertheless inadequate supplies of power, gas, telecommunication facilities, roads and ports could be a hindrance to future expansion.

Gross domestic savings remained, by and large, stable at around 18 per cent of GDP during 2000-2003, although compositionally private sector savings tended to increase while public sector savings were generally unchanged (table II.26). At the same time, investment also

Table II.26. Selected least developed countries in South and South-West Asia: ratios of gross domestic savings and investment to GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Savings as a percentage of GDP				
Bangladesh	17.9	18.0	18.1	18.2
Bhutan	17.2	21.0	16.0	..
Nepal	15.2	14.9	11.8	11.3
Investment as a percentage of GDP				
Bangladesh	23.0	23.1	23.2	23.2
Bhutan	43.8	50.0	44.0	..
Nepal	24.3	24.0	24.6	26.1

Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003).

Notes: Data for 2003 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

remained stable at 23 per cent of GDP over the same period, although private sector investment went down marginally (from 16.8 to 16.5 per cent of GDP between 2002 and 2003), owing in part to greater utilization of existing capacity, while the marginal rise in public sector investment arose from the countercyclical investment policy. The savings-investment gap was financed with net factor income from abroad and foreign savings. Additional revenue mobilization, increased concessional financing from donors and modest external borrowing on commercial terms for infrastructure projects would culminate in an increase in public investment by one percentage point (to 8 per cent) between fiscal years 2004 and 2006.

Public sector investments continued to drive real GDP growth in Bhutan

Stimulated primarily by public investment, aggregate production in Bhutan was estimated to have risen from 6.6 to 7.7 per cent between 2001 and 2002. Agriculture contributed a third of GDP and grew by an estimated 2.5 per cent in 2002 while the industrial sector, comprising electricity (9 per cent of GDP), manufacturing (10 per cent of GDP) and construction (17 per cent of GDP) expanded by 12.1 per cent in 2002. With the operation of the Chukha, Kurichu and Basochu hydropower projects and the completion in 2005 of the Tala project, power generation has not only emerged as an important economic activity but has also created opportunities for various linkages with other production and service activities (see box II.3). As to manufacturing, the Bhutan Beverages Company Limited was established in 2002 with 40 per cent of the shares issued as paid-up capital allotted to the general public. Reflecting the growing appetite for equity investments as well as the absence of other investment opportunities, equity shares for the fifteenth company to be listed on the Royal Securities Exchange of Bhutan were oversubscribed by 150 per cent. Among the existing industries, Penden Cement Authority recorded the highest total sales in 2002, followed by Bhutan Carbide and Chemicals Ltd. and Bhutan Ferro Alloys Ltd.

The service sector, which provided slightly more than 30 per cent of GDP, grew by 8.0 per cent in 2002. However, the contribution of tourism (the most important service sector in terms of generating foreign exchange revenue and employment) to GDP declined from the peak of 2.2 per cent reached in 2000 to 1.3 per cent in 2002 as a result of global instability, with only 5,249 tourists arrivals. Several steps have been taken to boost the tourism industry, including opening up the sector to FDI, and two joint-venture luxury hotels are currently under construction. Tour operators are also turning their attention to tourists from India and other neighbouring countries. Savings as a percentage of GDP were estimated to have declined from 21 to 16 per cent between 2001 and 2002 while investment as a percentage of GDP declined from 50 to 44 per cent over the same period. Real GDP is expected to grow at between 7 and 9 per cent during the period from 2003 to 2007 under the ninth five-year development plan.

Box II.3. Energy policies in selected least developed countries in South Asia

Energy is an essential input for development. However, the level of per capita energy consumption in selected least developed countries of South Asia is considerably lower than in other developing countries in Asia. For example, per capita energy consumption in Bangladesh is approximately 76 kilogrammes of oil equivalent (kgoe) per year, while in Bhutan, Maldives and Nepal it is 121, 23 and 49 kgoe respectively. By contrast, per capita energy consumption in China is approximately 574 kgoe, while the comparable figure for India is 302 kgoe and for Thailand 938 kgoe. The low level in some least developed countries of South Asia occurs despite the fact that many of those countries are endowed with natural resources of energy that contribute significantly to total exports and government revenue. There is a need for strategic policy shifts in the energy sector so that urgent attention is paid to improving access to reliable and affordable supplies of energy in the least developed countries in support of actions to achieve the Millennium Development Goals, as well as the sustainable development objectives contained in the Johannesburg Plan of Implementation.

In the mountainous countries of South Asia, such as Bhutan and Nepal, hydropower is an important domestic as well as regional source of energy. Sales of electricity accounted for 9 per cent of Bhutan's nominal GDP in 2002, 46 per cent of its total exports to India and more than 40 per cent of government revenue. In addition to the three existing hydropower projects, Chukha, Basochu and Kurichu, the 1,020 megawatt Tala hydroelectric power project is expected to be commissioned in 2005. Bhutan and India also signed a memorandum of understanding in September 2003 for the preparation of a report on the 870 megawatt Punatsangchu hydroelectric power project. Expansion of the electricity and construction sectors is expected to encourage the development of allied industries and drive economic growth during the ninth five-year plan period.

Since the revenue generated from energy exports is used primarily to finance the long-term debt resulting from the construction of power projects, developments in the natural resources sector also have significant implications for the fiscal position and macroeconomic stability of energy-exporting least developed countries. In Bhutan, total debt as a percentage of GDP increased from 58.4 to 70.2 per cent in 2002-2003, while the stock of external debt rose 38 per cent to $403.3 million in that period. Fifty-six per cent of the stock of external debt was in Indian rupees and owed to the Government of India for the construction of the Tala and Kurichu power projects. In Nepal, the Government planned to reduce its direct investment in large and medium-sized power projects and encourage private sector investment in new projects. To facilitate private sector involvement, the Power Development Fund was expected to channel private sector loans for the construction of medium-sized power projects.

In least developed countries where fiscal revenue is largely derived from the export of hydropower, gas and petroleum, such revenues are also needed to promote growth and alleviate poverty. In formulating the fiscal strategy in those countries, the appropriate size of the drawdown of natural resource reserves needs to be considered and the investment programmes tailored to the country's absorptive capacity. Domestic energy policies in those countries must complement other policies to promote economic development. Recognizing that energy policies are essential components of rural development and poverty alleviation policies, Bhutan's budget for 2003 included rural electrification and the establishment of an integrated national power transmission grid by linking Basochu with the Kurichu power supply. Further, the establishment of such infrastructure was expected to improve conditions for the delivery of educational and health services.

Careful analysis in identifying the demand for energy necessary for people's livelihoods, in particular those of the poor, and for economic and social development requires a differentiated approach. As the provision of energy alone cannot induce development, a more comprehensive approach is needed that integrates energy issues with other social and economic development issues to meet overall national development goals. There are good examples in the region of policies and programmes that could serve as models for possible replication or adaptation in other countries. The involvement of stakeholders will, however, be critical in ensuring their successful formulation and management. An illustration is provided by the VOICE[a] programme being implemented by the Bangladesh Rural Development Board to meet the objectives of the Village Development Plan (VDP).[b] While energy is one of the essential inputs in rural development, through this programme it has been successfully integrated into the process of overall development.

[a] V stands for visit and village; O for opportunities and organization; I for information and initiatives; C for cooperation and commitment; and E for environment, employment and empowerment.

[b] V stands for visible and viable; D for diagnostic, dialogue, democratic and decision; and P for peoples' participation.

Economic growth underpinned by the recovery in tourism and fisheries in Maldives

As a small and open economy, Maldives is highly vulnerable to external shocks, including those emanating from the trade sector. After a significant decline in economic growth to 3.4 per cent in 2001, the country managed through an improved performance in fisheries and a recovery in the tourism sector to sustain 6 per cent economic growth in both 2002 and 2003. Primary production expanded by an estimated 16 per cent in 2002. Liberalization of the tuna industry in 2001 enabled the private sector to process and export tuna bought from local fishermen and, as a result, the fisheries sector grew by almost 23 per cent in 2002 as the fish catch went up by nearly 30 per cent from the level reached the previous year. Growth in the primary sector was expected to fall to 2.5 per cent in 2003, however, as the provisional estimates for January to October 2003 showed a decline of 9.4 per cent in the fish catch from the level reached during the same period of the previous year. Agricultural production gained 4 per cent in 2002 and 2003 but the coral and sand-mining subsectors remained largely stagnant.

Meanwhile, growth of the secondary sector declined from an estimated 9 to 6.2 per cent between 2002 and 2003. Although only a few new resorts have been constructed since 2000, the construction industry continues to flourish, especially in Male, the capital city. The tertiary sector continued to expand, by an estimated 4.3 per cent in 2002 and 6.3 per cent in 2003. Tourism accounts for nearly a third of GDP and provides nearly 70 per cent of Maldives' total foreign exchange earnings. Tourism-related activities were largely stagnant in 2001, recovered to grow by 3.3 per cent in the following year and expanded strongly (by 8.4 per cent) in 2003. In particular, tourist arrivals increased by 17 per cent to reach more than half a million visitors during the period January to September 2003 compared with the same period in 2002. Financial and business services as well as transport and communications also remained on an upward growth trend in 2003 although the expansion of utilities was slowing down as a result of completed access to telecommunications and electricity in the atolls and to piped water in Male. Gradual moves away from government intervention in economic activities, a greater role for the private sector and broadened production activities were expected to help make Maldives more resilient in withstanding external shocks and in sustaining income growth.

Nepal experienced an economic upturn in 2003

GDP had registered a marginal contraction of 0.6 per cent in Nepal during fiscal year 2002 as a result of the domestic insurgency, irregular monsoon and weak external demand. The economy recovered to grow by 2.4 per cent in fiscal year 2003, an outcome reflecting the ceasefire and the return of some degree of normalcy in the agricultural, transport and service sectors. In particular, agricultural production was estimated to have risen by 2.1 per cent in fiscal year 2003 despite a slight reduction in the production of paddy. Broad-based growth and poverty reduction require strong agricultural growth, projected at 3.5 per cent during fiscal years 2004-2006. In this context, the implementation of the Agriculture Perspective Plan was envisaged to result in higher utilization of fertilizers, an expansion of year-round irrigation, an extension of the rural road network, diversification into other cash crops and livestock production in hill areas and increased credit availability; all these would in turn contribute to higher productivity.

The output of the non-agricultural sector declined along with the deterioration of security in fiscal year 2002, with the manufacturing and tourism sectors registering a fall of 3 and 4.5 per cent respectively. However, an expansion of 2.5 per cent was recorded by non-agricultural activities in fiscal year 2003. In particular, the construction, water, electricity and gas sectors were expected to show positive growth in fiscal year 2004 as a result of higher donor aid and infrastructure spending. To ensure that more than 70 per cent of the investment would be channelled through the private sector, Nepal planned to enact legislation on the build-own-operate-transfer process for infrastructure projects in transport, trade, housing and power generation and transmission. This process will require the adoption of a transparent privatization plan, the selling of some land in industrial estates to enterprises and the promotion of investments by non-resident Nepalese. With a one-third increase in tourist arrivals from India in the period January-August 2003, the Government planned to foster regional tourism and waive visa duties for tourists from SAARC countries as well as China. GDP was projected to grow by 3.5 per cent in fiscal year 2004 and 4.5 per cent in fiscal year 2005, given progress in peace talks, higher agricultural productivity, a rebound in export and manufacturing production and strong inward tourism.

Inflation

Inflation stabilized but at a relatively high level in Afghanistan

The exchange rate, which fluctuated widely in late 2001 and early 2002 as a result of political and economic uncertainties, strongly affected consumer prices in Afghanistan. Subsequently, with the increasing availability of goods, inflation declined to 3.5 per cent in the first 8 months of 2002. However, uncertainties over the introduction of a new currency in the last quarter of 2002 contributed to a sharp depreciation of the exchange rate, while consumer prices rose by a cumulative 60 per cent during September-November 2002. With the completion of the currency conversion in January 2003, tight monetary policy as well as increased supplies of staple foodstuffs, the average monthly inflation remained close to zero and the 12-month inflation rate fell to 51 per cent by August 2003. The consumer price index (CPI) covered 50 items, mainly food in Kabul; it was expanded to include 200 items and the collection of price data was expected to cover all major provincial cities in the near future.

Modestly rising inflation in the last three years was expected to peak in 2003

Although the national CPI in Bangladesh trended upward from September 2001 (from 1.6 to 2.4 per cent in fiscal years 2001-2002), inflation was expected to peak by the end of 2003 (table II.27). Higher consumer prices in fiscal year 2003 (by over 5 per cent) reflected increases in both the food and non-food components of the consumption basket. Among the major causal factors were higher prices of imported petroleum products, rice, sugar and edible oil, plus upward revisions of the administered domestic prices of petroleum products, gas and electricity. Rural consumers appeared to have faced higher inflation in fiscal year 2003, for both the food and non-food components, than their urban counterparts. Consumer prices were projected to rise by 4.5 per cent in fiscal 2004 and by 4 per cent in both of fiscal years 2005 and 2006.

Table II.27. Selected least developed countries in South and South-West Asia: inflation and money supply growth (M2), 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Inflation[a]				
Bangladesh[b]	3.4	1.6	2.4	5.1
Bhutan[b]	3.6	3.6	2.7	3.6
Maldives	–1.2	0.7	0.9	–3.7
Nepal[b, c]	3.5	2.4	2.9	5.0
Money supply growth (M2)				
Bangladesh	18.6	16.6	13.1	15.6
Bhutan	17.4	7.9	27.9	30.0[d]
Maldives	4.1	9.0	19.3	12.1[e]
Nepal	21.8	15.3	4.4	9.0

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and IMF, *International Financial Statistics,* vol. LVI, No. 10 (Washington, IMF, October 2003).

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] Fiscal year.
[c] National urban consumer price index.
[d] January-June.
[e] January-September.

Revision of the basket of goods for the consumer price index in Bhutan

Inflation in Bhutan is linked to that in India owing to the close trading relationships between the two countries and the pegging of the ngultrum at par with the Indian rupee. Generally, consumer prices were stable at a low level, for example, rising by just 3.6 per cent in 2003, or about one percentage point higher than the inflation rate in the previous fiscal year. This was largely due to the favourable monsoon and good performance in the agricultural sector. The CPI basket of goods, which had been in operation since 1979, was thus obsolete, and the Central Statistical Organization changed the base year to 2000 and increased the number of items in the basket to 343 in 2003. Additionally, to better reflect the changed consumption patterns, the weight of the food items has been lowered from 72.3 to 46.4 per cent while the relative weight of the non-food items has been increased with the introduction of housing and repairs. Moreover, the revised CPI will be computed every quarter for three separate regions in addition to the consolidated CPI.

The falling price of fish offset higher import prices in Maldives

Inflation in Maldives has been very low in recent years, being less than 1 per cent in both 2001 and 2002; excluding fish, it was moderately higher at 3.1 (largely owing to the exchange rate depreciation in July 2001) and 1.5 per cent, respectively, in those two years. However, there was deflation of almost 3.7 per cent between October 2002 and September 2003 as the price of fish fell by 12.9 per cent. Maldives is currently updating the CPI weights in use since 1993 on the basis of expenditure information gathered from the 2002/03 representative survey of the whole country covering a 12-month period to account for seasonality in consumption.

Higher inflation in Nepal in fiscal year 2003

Consumer prices rose from 2.9 to about 5 per cent between fiscal years 2002 and 2003 as a result of increased wholesale prices, upward adjustments in such administrative prices as educational fees and petroleum prices, and supply shortfalls, especially of agricultural items. In particular, the price index of food and beverages went up from 2.6 per cent in fiscal year 2002 to 8.3 per cent in fiscal year 2003 as higher prices of oil and ghee, grains and cereals, and vegetables and fruits more than offset the decline in the prices of sugar and spices. Prices in the Terai rose more quickly than those in the Hills or the Kathmandu Valley. Inflation was estimated to moderate to 4.8 per cent in fiscal year 2004 along with the diminishing follow-on effects of the earlier price increases and the expected falls in international and domestic fuel prices.

Trade and exchange rates

Estimates of Afghanistan's balance of payments suggest that exports of goods totalled $1.6 billion in fiscal year 2001 and $2.3 billion in fiscal year 2002, with domestic exports, mainly agricultural products and carpets, accounting for about $68 million and less than $100 million, respectively, over those two years (table II.28). Most of the re-exports, mainly from the Islamic Republic of Iran to Pakistan to minimize import tariffs and domestic sales taxes, were unofficial, with an estimated value of $1.5 billion in fiscal year 2001 and $2.1 billion in fiscal year 2002. Re-establishment of an effective customs administration may slow future growth in unofficial re-exports. According to official records, India and Pakistan each accounted for about a quarter of Afghanistan's exports in fiscal year 2002, followed by Finland, Germany and the United Arab Emirates. Imports of goods were estimated at $2.5 billion in fiscal year 2001 and $3.6 billion the following year, with recorded imports reaching nearly $1 billion in 2002 (table II.29). Higher import spending on machinery and equipment, automobiles and consumer goods reflects the revival of private sector activity. Japan accounted for more than two fifths of the official import value, including re-exports, in fiscal year 2002, followed by the Republic of Korea and Pakistan.

Notwithstanding some restrictive rules and regulations, Afghanistan is now following a liberal trade regime

Although commodity food aid went up from $71 million to $94 million in fiscal years 2001 and 2002, it was expected to fall in fiscal year 2003 with higher production of domestic cereals. Unrecorded imports, mainly duty-exempt donor imports, transit trade and smuggled goods, were estimated to be around $764 million in fiscal year 2001 and $1.2 billion the following year. Since customs data cover only two thirds

Table II.28. Selected least developed countries in South and South-West Asia: merchandise exports and their rates of growth, 2000-2003

	Exports (f.o.b.)				
	Value (millions of US dollars)	*Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003 (two quarters)*
Afghanistan	98	14.2	−36.3	10.1	48.2
Bangladesh[a, b]	5 986	8.0	12.4	−7.4	9.4
Bhutan[a]	98	9.2	−12.9	−1.8	..
Maldives[c]	90	19.1	0.4	18.6	11.6
Nepal[a]	603	34.0	6.0	−18.8	−9.7

Sources: IMF, *Country Reports*, various issues, and *Direction of Trade Statistics* (CD-ROM), November 2003; and national sources.

[a] Fiscal year.
[b] Figure for 2003 refers to the whole fiscal year.
[c] Figure for 2003 is a projection for the whole year, excluding re-exports.

Table II.29. Selected least developed countries in South and South-West Asia: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	Imports (c.i.f.)			
		Annual rate of growth (percentage)			
	2002	2000	2001	2002	2003 (two quarters)
Afghanistan	999	29.4	−9.3	73.7	13.2
Bangladesh[a, b]	8 540	4.6	11.5	−8.5	13.0
Bhutan[a]	188	14.0	6.1	−4.0	..
Maldives[c]	345	−3.4	1.3	−0.5	11.2
Nepal[a]	1 379	19.0	1.1	−10.7	8.2

Sources: IMF, *Country Reports*, various issues, and *Direction of Trade Statistics* (CD-ROM), November 2003; and national sources.

[a] Fiscal year.
[b] Figure for 2003 refers to the whole fiscal year.
[c] Figure for 2003 is a projection for the whole year.

of total imports and only a fraction of total exports, it is very difficult to arrive at any reasonable estimates of the actual balance of external trade and current payments.

Although a number of restrictive rules and regulations still remain in place, Afghanistan now follows a very liberal trade regime with a simplified tariff regime to be in place by the end of 2003 and reform of the customs administration under implementation. There is virtually no control on imports, exports, payments on invisibles and capital transactions in Afghanistan, and only a commercial licence, required for all businesses, was necessary for engaging in external trading activities. While Afghanistan is a landlocked country dependent on its neighbouring countries for access to the sea, it is also an important transit location for trade between the Islamic Republic of Iran and Pakistan as well as between Central Asia and the Indian Ocean. A feasibility study to run a natural gas pipeline from Turkmenistan to Pakistan was being undertaken, and its construction could yield substantial transit and easement fees. The quality of the transport infrastructure, security and border administration, however, still needs to be improved. Normalization of trade relations and discussion of new transit and trade agreements with India, the Islamic Republic of Iran and Pakistan in 2003 together with other regional initiatives was expected to lead to more transit trade.

Since the introduction of the new currency in late 2002, the exchange rate has been established at 48 afghanis per United States dollar. Stability is maintained through a managed float regime and this was expected to instil confidence in the currency and support price stability, given the rapid transmission of exchange rate fluctuations to domestic prices.

Despite expansion of the trade sector in Bangladesh, overall terms of trade worsened

Improved conditions in external markets and the domestic economy were behind the rise of 9.4 per cent in the merchandise exports of Bangladesh and an increase of 13 per cent in import spending during fiscal year 2003. Higher export earnings were experienced by all major commodity groups, except tea and leather, although export prices for raw jute and ready-made garments made of woven fabrics continued to fall, while unit prices of knitwear and hosiery, leather, frozen shrimp and fish remained below levels reached in fiscal year 2001. Exports of ready-made garments registered a modest recovery to reach $3.3 billion in fiscal year 2003 while knitwear and hosiery exports rose to nearly $1.7 billion. The overall share of apparel exports in total exports, however, declined slightly from 76.6 to 75 per cent between fiscal years 2002 and 2003. Recent export patterns show signs of progress in diversification with the export of vegetables, tobacco and other non-jute agricultural items, engineering products, bicycles and ceramics in the “others” category expanded by more than a fifth to comprise about 10 per cent of total exports in fiscal year 2003. The adoption of a floating exchange rate regime was expected to further strengthen the export diversification process.

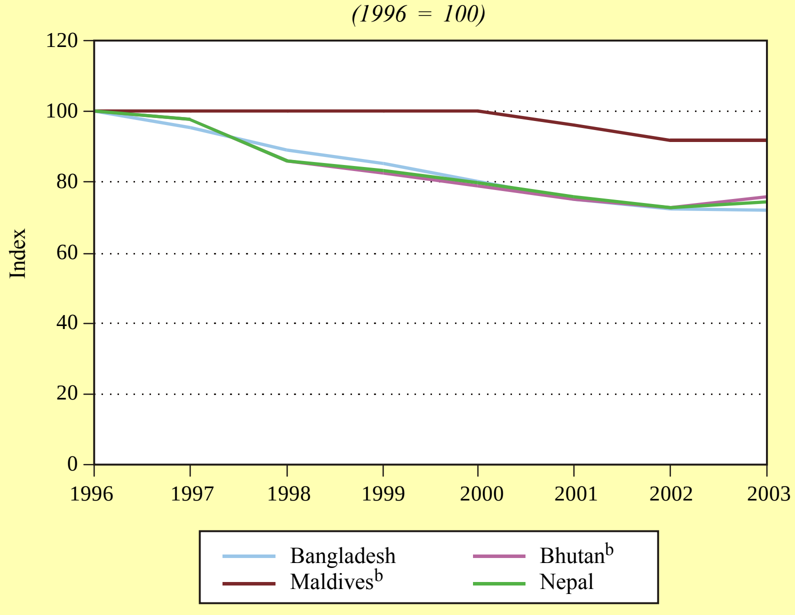
Intermediate inputs and capital goods accounted for dominant shares of total imports in fiscal year 2003. However, foodgrain imports more than doubled, as a result of a 13-fold increase in rice imports; similar increases were also recorded for wheat and sugar imports in fiscal year 2003. The higher volume of inputs needed for the growing apparel export industry was met by an increase of 4 per cent in textile imports and 26 per cent in cotton imports. This trade pattern also suggested some deepening of backward linkages and higher value addition in the apparel export sector. Cement imports continued to decline as a result of increased domestic production while the increase in imports of crude petroleum and petroleum products reflected higher consumer and industrial needs as well as a rise in import prices.

The overall terms of trade worsened somewhat in fiscal year 2003 but the widening trade deficit in goods and services was covered by the lower deficit on the income account and increased current transfers inward. The current account surplus rose from $240 million to $330 million in fiscal years 2002 and 2003. For fiscal years 2004-2006, Bangladesh projects export growth rates of 8-9 per cent while spending on merchandise imports was estimated to grow by 13 in 2004, but by less than half that rate during the following two fiscal years. In order to liberalize trade, the country has eliminated import licensing and plans to phase out surrender requirements on export receipts as well as export subsidies. Despite the relative importance of trade taxes, Bangladesh will reduce the average import tariff rate and rationalize the tariff structure to a four-tier tariff rate with a top rate of 30 per cent in the fiscal year 2004 budget. The country has already reduced the list of goods subject to export and import controls by half.

The exchange rate of the taka against United States dollar remained stable throughout fiscal year 2003 despite the introduction of a floating exchange rate regime on 31 May 2003 (figure II.25). Such stability reflects the current account surplus and the weaker United States dollar with the competitiveness of the taka based on a trade-weighted basket of trade partner currencies improving by the end of fiscal year 2003. However, the exchange rate has been under some pressure from the end of the second quarter of fiscal year 2004, as a strong expansion of imports outpaced the growth of receipts from exports and workers' inward remittances.

Figure II.25. Index of exchange rates[a] against the United States dollar in selected least developed countries in South and South-West Asia, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Note: Data for 2003 are estimates.

[a] Period average.
[b] Data for 2003 are for January-October.

Inflows of current transfers to Bhutan, mainly in the form of foreign grants, offset the trade deficit

Trade is important to Bhutan and preliminary balance of payments estimates for fiscal year 2003 showed a rise of 8.9 per cent in export earnings and less than 1 per cent in import expenditure. Nevertheless, the lower trade deficit still amounted to 13 per cent of GDP (or $75.1 million). India accounted for 94 per cent of Bhutan's exports and 91 per cent of its imports. In particular, the sale of electricity alone was equivalent to 46 per cent of the total merchandise exports to India, and the commissioning of the Kurichu hydropower project added another $8 million to annual exports. Other export items included mineral products (such as calcium carbide), ferro-alloys, cement, coal and gypsum. Raw materials and construction materials, machinery and mechanical appliances, and base metals dominated the import basket. Such imports were expected to remain high until the completion of the Tala power project and other physical infrastructure projects during the ninth five-year plan period. Vehicle imports have also increased significantly.

Although invisible service and income payments were in excess of receipts on these categories, current inward transfers (mainly in the form of grants) rose by 85 per cent to reach a net of $195 million in fiscal year 2003, thus more than offsetting the trade deficit of $75 million. The current account deficit, however, stood at $86.3 million (or 15 per cent of GDP) for fiscal year 2003. Bhutan is a small, landlocked country and to ease custom formalities and reduce transport costs, a dry port is to be established at Phuentsholing and the development of industrial estates is being considered. The country has expressed its strong commitment to pursuing a more liberalized trade regime at the bilateral, regional and international levels. For example, significant tariff reductions were embodied in the 2003 Bhutan-Bangladesh bilateral trade agreement while the free trade agreement between Bhutan and India was renewed up to 2005. Bhutan expects to complete similar agreements with Nepal and Thailand and to accede to WTO by 2007.

Confidence in the ngultrum has been maintained partly owing to pegging to the Indian rupee. The exchange rate averaged 45.9 ngultrum per United States dollar in August 2003 along with a rise in foreign exchange reserves in India and a decline in interest rates. Since trade was largely denominated in Indian rupees, the appreciation of the ngultrum has not been a serious concern. With the planned convertibility of the Indian rupee in the near future, Bhutan's external trade policy was expected to form a critical part of its overall macroeconomic policy and planning.

In Maldives, merchandise exports totalled $90 million in 2002. They rose further by 11.6 per cent during 2003 owing to a sharp increase of two fifths in export earnings on fish and fish products. Frozen, fresh or chilled marine products and canned and dried tuna accounted for 68 per cent of all merchandise exports from Maldives in 2003, followed by apparel and clothing with the remaining 32 per cent. More than a third of

Despite a significant uplift in exports, the narrow export base rendered Maldives highly vulnerable to changes in external prices and market preferences

all exports, mainly apparel and clothing, were destined for the United States, while Sri Lanka was the main market for exported fish products. Owing to the lack of a broad resource base, Maldives has had to import almost all the products necessary for domestic consumption and investment. Import spending remained relatively high at $383.6 million in 2003 with the large bulk of imports originating in Singapore, Sri Lanka, India, the United Arab Emirates and the EU in 2002. The merchandise trade balance showed a deficit of $211.1 million in 2002 and $236.0 million in 2003.

Considerable volatility exists in the trade performance of Maldives as result of its narrow export base, which makes the country very vulnerable to changes in external prices and market preferences. In particular, the merchandise export sector is largely concentrated not only in the marine products industry, which is vulnerable to environmental conditions, but also on one product, namely, tuna. The merchandise trade deficit and volatility are mediated, however, by the strength of the service sector, particularly the tourism industry. Tourism, however, is also vulnerable to shocks in the international market, such as the economic conditions at the origin tourist markets and international political instability. Additionally, the United Nations considered Maldives' possible graduation from its status as a least developed country in 2003. Graduation will affect trade performance since current merchandise exports are heavily reliant on the preferential treatment for least developed countries allowed in the European and United States markets. Upon graduation, for example, tuna exports will be subject to a 24 per cent import tax by the EU while garment exports to the United States are possible only as a result of the quota system for least developed countries. Export projections suggest a 10 per cent loss in export revenue by 2005 as a result of graduation.

Maldives has operated a de facto fixed exchange rate system since 1994, with the peg currently set at a mid rate of 12.8 rufiyaa per United States dollar. The devaluation of the rufiyaa by 9 per cent to restore international reserves and eliminate the parallel foreign exchange market in July 2001 led to higher prices of imports in 2001.

The deficit in Nepal's trade balance increases

Exports from Nepal were reported to have decreased by 9.7 per cent in the first two auarters of fiscal year 2003, after another decline of 18.8 per cent the previous year. Exports to India declined, following quantitative restrictions in the renewed trade treaty in 2002, but there was a rise in earnings on garment and jewellery exports. Sustained import demand for both capital and consumer goods resulted in a 8.2 per cent increase in import expenditure in the first half of fiscal year 2003 against a decline of 10.7 per cent the preceding year; imports from India, in particular, increased very substantially. Major commodity imports included yarn and cloth, rice, agricultural products, electrical equipment, and medicines from India and petroleum products, wool and cotton, and telecommunication equipment from third countries.

The deficit in Nepal's trade balance widened in fiscal year 2003, as against a decline the previous year. In particular, the trade deficit with India more than doubled in fiscal year 2003, while the trade deficit with third countries increased marginally. The available balance of payment statistics for the first eight months of fiscal year 2003 show a net decline in the service balance of just over 2 per cent, compared with a 63 per cent decline during the corresponding period in the previous fiscal year. The current account deficit, excluding official transfers, was projected to increase from less than 0.7 to 1.8 per cent of GDP between fiscal years 2003 and 2004 as import spending would rise to fuel economic recovery. As a result of its open trade regime, Nepal (together with Cambodia) successfully concluded its negotiations for WTO accession on 12 September 2003. To facilitate trade, Nepal eliminated reinspection at customs points for goods consigned in sealed containers, abolished both the export service charge system and double taxation on dividends and created a bonded warehouse facility.

As a result of the peg to the Indian rupee, which appreciated against the weakening United States dollar, the nominal and real effective exchange rates for the Nepalese rupee depreciated by 12.5 per cent and 6 per cent, respectively, between January 2002 and April 2003. The Nepalese rupee has appreciated less than the Indian rupee since mid-2002 despite an official exchange rate of 1.6 Nepalese rupees to the Indian rupee. To moderate the 2 per cent cross differential, the central bank has raised the service fee for United States dollar purchases. The current exchange rate peg is subject to review in view of the potential impact on competitiveness due to accession to WTO and the phasing out of the Multi-Fibre Arrangement.

Capital inflows and outflows

Although financial inflows into Afghanistan were largely in the form of bilateral grants and highly concessional loans, the amount pledged to cover reconstruction in Afghanistan was relatively low, compared with the amount pledged to other post-conflict countries in recent years. Concessional loans, mainly from India, for the construction of power projects continued to dominate receipts in Bhutan. Unlike other least developed countries, however, private capital channelled to the tourism and financial sectors comprised nearly half of financial inflows to Maldives. Remittances from workers abroad formed a significant share of capital inflows to Bangladesh and Nepal but appeared as a net outflow in the balance of payments for Maldives, which depended heavily on foreign labour.

Although pledges of aid to Afghanistan remain low, disbursement for humanitarian purposes is high

A high level of donor support, predominantly in the form of grants, needs to be maintained in order to sustain economic growth and reconstruction. Preliminary needs assessment for the donor conference for Afghanistan held at Tokyo in January 2002 estimated a total of $14.6 billion would be required to underpin economic and social recovery, excluding humanitarian assistance, over 10 years with $4.9 billion for the first two and a half years. At the conference, pledges were made for $4.5 billion over the first five years and $2.1 billion in grants during the first 15 months. Of these amounts, over $1.8 billion in grants and $100 million in loans were disbursed, but two thirds of the disbursed amount was dedicated to humanitarian assistance. Very little of the amount disbursed in fiscal year 2002 went to the government budget in view of its limited administrative capacity at the level of the line ministries. The national development budget for fiscal 2003 includes $1.8 billion of humanitarian and reconstruction projects to be financed by donor grants but commitments were $500 million short of that amount. International assistance over the next several years needs to be in the form of grants in order to avoid future debt-servicing difficulties; relief of existing claims and regularization of relations with all creditors were essential to ensure the sustainability of debt-service payments.

Pledges of aid to Afghanistan have been relatively low compared with those of other post-conflict countries, even though the costs of staffing as well as providing transport and security were expected to be as high. In terms of aid per capita per year, Afghanistan received $67 during 2002-2003, as against $256 in the case of Timor-Leste during 1999-2001. During those periods, aid approached only 40 per cent of Afghanistan's estimated GDP but exceeded 60 per cent of Timor-Leste's. Donor interest often declines sharply after a few years, just when post-conflict countries are able to better absorb aid, as other cases compete for donor funds.

Gross foreign exchange reserves increase in Bangladesh

Net capital inflows to Bangladesh rose by over 37 per cent in fiscal year 2003 to reach $754 million, with ODA continuing to form a major share of such resources. At $958 million, ODA inflow (net of amortization) thus rose by 21 per cent in fiscal year 2003. The grant element in ODA, however, decreased by 5.6 per cent to $452 million, while the loan element increased by 27.8 per cent to $937 million. Although modest in absolute terms at $92 million, private FDI went up by 41.5 per cent in fiscal year 2003. Commercial bank and trade credit continued to be negative in the same fiscal year. Meanwhile, gross foreign exchange reserves were 56 per cent higher in fiscal year 2003, at nearly $2.5 billion or about three months of import cover as at 30 June 2003. The reserves level increased further in the first half of fiscal year 2004 as a result of the current account surplus, which, in turn, was attributable to higher exports, workers' inward remittances and ODA receipts.

There was a slight rise in official external debt from $16.2 billion to $16.9 billion between 30 June 2002 and 30 June 2003. Although such debt was equivalent to 32.6 per cent of GDP, the debt-service burden remained modest since the bulk of external obligations were on concessional terms from multilateral and bilateral donors. Total repayments of principal and interest, including repurchases from IMF, amounted to $642 million in fiscal year 2003 and the debt-service ratio stood at 8.9 per cent of exports. The outstanding stock of medium- and long-term external borrowings of the private sector was estimated at $1 billion. Since the overall external debt-service burden has been relatively modest, Bangladesh has not been included in the debt reduction initiatives for heavily indebted poor countries. There are, however, a number of debt relief arrangements with some bilateral donors, most notably Japan.

The inflow of current transfers offsets the trade deficit in Bhutan

In Bhutan, concessional loans for the construction of power projects continued to dominate ODA receipts, which were estimated to have increased during fiscal 2003 by 64 per cent (to $94.5 million) while FDI was up by 36 per cent (to $2.5 million) as a result of two tourism-related joint-venture projects. The current FDI policy allows international investors to hold up to 70 per cent equity in joint projects, sets a minimum project size of $1 million in the manufacturing sector and $500,000 in the service sector and opens 14 sectors for foreign participation (including manufacturing, financial services and tourism). As a result of these capital inflows, international reserves went up from $316 million in fiscal 2002 to $374 million, equivalent to 23 months of import cover, in the following year.

Meanwhile, the stock of external debt rose by 38 per cent in fiscal year 2003 to $403.3 million, of which 56 per cent was in Indian rupees. As a result of the loans for the construction of the Tala and Kurichu power projects, the total Indian rupee debt was higher by 40 per cent, to reach the equivalent of 39 per cent of GDP. The debt-service ratio for Indian rupee debt stood at 2 per cent of export earnings. Some 43 per cent of the convertible currency loans are due to ADB the largest provider of loans to Bhutan. Total debt-service payments of convertible currency loans amounted to $4.7 million in fiscal 2003, of which 34 per cent were for interest payments. The convertible currency debt-service ratio increased from 19 per cent of export earnings on goods and non-factor services as at 30 June 2002 to 27 per cent in the following year.

The official flows of medium- and long-term finance to Maldives jumped almost fourfold to an estimated $37 million in 2002 and were projected to increase to $40.4 million in the following year. The amount of ODA from bilateral and multilateral sources fell gradually in the 1990s, as resources were channelled to countries perceived to be less developed;

The amount of ODA to Maldives from both bilateral and multilateral sources has gradually decreased

at the same time, the conditions attached to available loans were also increased. However, the amount of private capital inflows also declined from just under $43 million in 1999 to $24.3 million two years later as the construction of additional tourist resorts, initiated as part of government policy to expand tourism capacity, was completed. The flows recovered to $33.8 million in 2002 owing to financial sector investments.

After deteriorating by almost $30 million in 2001, the level of international reserves went up by $40.2 million during 2002 to reach $134.5 million by the end of the year. Improvements in the external current accounts as well as in net capital inflows resulted in a surplus of $39.8 million in the overall balance of payments in 2002, as opposed to a net outflow of $21.4 million in the previous year. The international reserves of Maldives were estimated to have grown by $22.4 million while the overall balance of payments was estimated to record a surplus of $22.4 million in 2003. As a result, the amount of external reserves was equivalent to 2.9 months of merchandise imports (or $94.3 million) at the end of 2001 and to 4.1 months (or $134.5 million) by the end of 2002.

Maldives has a relatively moderate level of debt, with total debt stock standing at $257.1 million or 40 per cent of GDP in 2002; of this amount, some 88 per cent is medium- and long-term public or publicly guaranteed debt. Short-term liabilities of commercial banks expanded from $28.3 million to almost $36 million between the end of 2001 and the end of 2002. Government borrowings have largely been for capital investment, development of the social infrastructure and human resources development. The current external debt stock of the public sector comprises loans received from bilateral and multilateral sources, largely on concessional terms, loans from financial markets and suppliers' credits. In particular, multilateral loans accounted for 63 per cent of the total medium- and long-term external debt stock at the end of 2002, with bilateral loans accounting for 11 per cent and suppliers' credits another 21 per cent. Amortization of loans totalled $15.6 million in 2001 and was estimated at $19 million in 2002 while interest payments were $4.5 million in 2002. The debt-service ratio stood at 4 per cent of export earnings on goods and non-factor services in recent years.

Higher remittances, aid and unrecorded inflows led to a balance of payments surplus in Nepal

The overall balance of payments in Nepal was expected to be in surplus in fiscal year 2003. Inward remittances from the 3 million expatriate workers, estimated at 125 per cent of merchandise exports, exceeded the amount of external aid in 2003; they were expected to climb even further in the coming years. External aid, meanwhile, fell short of the budget targets for fiscal year 2003, leading to downward revisions in total government expenditure, with significant cuts in capital expenditure during the second half of the year. Gross international reserves were estimated at over $1 billion, equivalent to over 6 months of goods and services imports. External debt, mostly in concessional terms, was in excess of 48 per cent of GDP by the end of fiscal year 2002 with the combined service burden of domestic and external debt service absorbing a quarter of government revenues. Net foreign assets were expected to rise from $60 million to $1.3 billion by the end of fiscal year 2004 as a result of higher foreign aid, remittances and other inflows. The Poverty Reduction Support Credit and the Poverty Reduction and Growth Facility of the World Bank and IMF, respectively, were expected to bridge the financing gap estimated at $90 million for fiscal year 2004.

Fiscal developments

Concerted efforts have been made by the least developed countries to widen and deepen their tax base. Non-tax revenues still accounted for nearly three fifths of total government revenue in Maldives in 2001. In Bangladesh, Bhutan and Maldives, expenditure on the social sectors absorbed the largest share of the government budget but in Afghanistan and Nepal, expenditure on security still remained sizeable. Practically all of the least developed countries in the subregion undertook measures to gradually close down or privatize State-owned enterprises, including loss-making commercial operations. Privatization was expected to lead not only to an increase in non-tax revenues, but to improved public finance owing to the elimination of financing of losses.

Higher revenue collection and additional pledges of donor assistance are necessary in Afghanistan

The commitment to fiscal discipline and restraint from monetary financing was embodied in the "no overdraft" rule in the operating and development budgets in Afghanistan during fiscal years 2002 and 2003. Government expenditure, mostly on salaries, security and social sectors, amounted to an estimated $349 million in 2002, while domestic resources reached $132 million. Since only a limited amount of locally collected revenues were transferred to the centre, the budgetary financing gap had to be covered with donor support. The operating budget for fiscal year 2003 envisaged a rise in government expenditure to $550 million and a sharp jump in domestic revenues to $200 million. The development budget of $1.8 billion for reconstruction and humanitarian projects depended crucially on the availability of donor support and the implementation capabilities of the Government.

The integration of donor projects into the development budget has greatly facilitated the comprehensive monitoring of project implementation and ensured consistency with the overall strategy outlined in the national development framework. Concerted domestic efforts to increase domestic revenues through the implementation of customs and tax reforms, the centralization of domestic revenues from the provinces and additional pledges of donor assistance are necessary in order to ensure a sustainable balance in the operating and development budgets. Meanwhile, steps have also been taken in Afghanistan to improve expenditure management and provide basic public services. The country has also sought to establish and enhance transparency in its economic operations and management. In addition to the customs and tax reform under progress, civil service reform and restructuring of the State-owned enterprise sector are important tasks to be addressed.

Significantly heavier service burden on domestic public debt compared with external debt in Bangladesh

Fiscal revenue as well as both current and development outlays, although higher in Bangladesh in fiscal year 2003, were still below initial projections. The former increased marginally from 10.2 to 10.4 per cent of GDP between fiscal years 2002 and 2003, with tax receipts going up by 17 per cent in fiscal year 2003. Indirect taxes comprised VAT, import duties and supplementary duties and contributed nearly three quarters to total tax revenues with another one fifth coming from direct taxes on income and profits. Meanwhile, non-tax receipts, including profits and dividends from State-owned enterprises, administrative fees and charges, and telephone and telegraph revenue declined by almost 6 per cent in fiscal year 2003. The budget for fiscal year 2004 projects a 16.5 per cent increase in tax revenues and a 15.1 per cent increase in non-tax revenues. Bangladesh aims to widen the revenue base through the extension of direct taxes on income and profits as well as VAT coverage over the medium term and to establish a domestic debt market for raising domestic resources for non-inflationary deficit financing.

Total expenditure, meanwhile, declined slightly from 14.9 to 14.6 per cent of GDP in fiscal year 2003. The social sector, led by health and population, and education absorbed nearly a quarter of total current expenditure and interest payments on domestic and foreign debt another 18 per cent. Although modest as a share of total expenditure, current expenditure on transport, communication and housing continued to rise in successive budgets. The annual development programme allocated 41 per cent of the total outlays in fiscal year 2003 to energy, transport and communication and over 30 per cent to rural development, education and technology, and health and population-sectors having a direct impact on growth and poverty reduction. The fiscal year 2004 budget provides for a rise of 18.7 per cent in development expenditure with available funding from multilateral and bilateral donors following the loan arrangement under the Poverty Reduction and Growth Facility with IMF in late (fiscal year) 2003.

The fiscal deficit as a percentage of Bangladesh's GDP declined significantly from 4.7 per cent of GDP in fiscal year 2002 to 4.2 per cent of GDP in the following year (table II.30). Domestic financing of the deficit was lower in fiscal year 2003, both in absolute terms and as a percentage of GDP, because a greater part of the deficit was covered by foreign financing. The stock of domestic public debt declined marginally

Table II.30. Selected least developed countries in South and South-West Asia: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	2001	2002	2003
Budget balance as a percentage of GDP				
Bangladesh[a]	−6.1	−5.1	−4.7	−4.2
Bhutan	−4.1	−11.8	−5.1	−10.4
Maldives	−4.4	−4.7	−7.3	−8.3
Nepal	−4.7	−5.9	−5.7	−5.5
Current account balance as a percentage of GDP				
Afghanistan	..	..	−3.3	..
Bangladesh	−0.7	−2.2	0.5	0.7
Bhutan	5.3	0.2	−0.1	15.0
Maldives	−8.6	−9.2	−6.9	−7.4
Nepal	−2.4	−2.7	−4.6	..

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and IMF, *Country Report No. 03/299* (Washington, IMF, September 2003).

Note: Data for 2003 are estimates.

[a] Excluding grants.

to 16.3 per cent of GDP in fiscal year 2003. However, the interest payments on the smaller stock of domestic public debt at market rates was nearly five times greater than those made on the much larger volume of external debt on concessional terms. The budget for fiscal year 2004 projects an increase of 16.2 per cent in revenue collection (to 10.9 per cent of GDP), a rise of 18.4 per cent in expenditure (to 15.7 per cent of GDP) and a deficit equivalent to 4.8 per cent of GDP. The deficit gap was to be covered by higher domestic borrowing as well as external loans and grants.

Bhutan maintained a surplus in the fiscal balance on current account

In Bhutan, domestic revenue, equivalent to just over three fifths of total resources and grants, declined from 37 to 31.4 per cent of GDP between fiscal years 2002 and 2003. Tax receipts (mostly enterprise profit taxes and taxes on goods and services) were up by a quarter in fiscal year 2003, thus contributing to almost 54 per cent of the total domestic revenue. In particular, higher revenue through the introduction of a personal income tax in 2002 offset the revenue losses associated with the granting of tax holidays for new investments and an exemption for earnings in convertible currency. The remaining domestic revenue came from non-tax sources, including surplus transfers from government-owned enterprises.

Meanwhile, total expenditure rose by an estimated 11.4 per cent in fiscal year 2003 owing to additional current expenditure incurred in the form of transfers to local governments under the ongoing decentralization policy. Current expenditure, comprising 43 per cent of total expenditure, was allocated mainly to the health and education sectors, followed by general public services and the roads and agricultural sectors. Capital outlays were channelled primarily to infrastructure development in the power, road, urban development and housing sectors.

The decline in grant receipts, mainly from India, was responsible for the lower budgetary resources in fiscal year 2003 with the financing gap mainly covered by internal sources. Domestic revenue was in excess of recurrent spending, leading to a surplus, but the shortfall in grants to meet capital expenditure contributed to a higher overall budget deficit of 10.4 per cent of GDP, as against the original estimate of 6.5 per cent. Although the deficit was largely met through advances from the banking sector and the issuance of ad hoc government debt instruments, concerns have been raised regarding the sustainability of such borrowings. Pre-delivery payment for the purchase of two aircraft was expected to increase the deficit further in fiscal year 2003.

Economic diversification in Maldives essential to reduce the heavy reliance on tourism-related receipts in government revenue

In Maldives, total government revenue was estimated to have increased by nearly 12 per cent in both 2002 and 2003. Although tax revenue (mainly import duties and tourism tax receipts) was up by an estimated 2.4 per cent in 2002 and 5.6 per cent the following year, the tax base was quite narrow with, for example, no direct income taxation. Non-tax revenue, including rent from government property and returns from public enterprises, went up from 54 to 59 per cent of total government revenue during 2001-2003. The Government of Maldives is highly reliant on the tourism sector for its revenues; in particular, the tourism tax and rentals from resort leases accounted respectively for 35 and 32 per cent of the total current revenue estimate in 2002 and 2003. Inclusion of tariff revenue generated from tourism-related imports, estimated at three fifths of all of tariff revenue, raised the tourism sector's contribution to government revenue to around 50 per cent.

Broadening of the tax base through the introduction of a business profits tax and a property tax on land, as well as through increased fees and administrative charges, has been under consideration. Indeed, the sixth national development plan places special emphasis on economic diversification as a means to reduce such dependence on tourism and to raise both the level and consistency of government revenue and hence spending. Meanwhile, total government expenditure rose by an estimated 15 per cent in 2002 and 2003, with public outlays on social services up from an estimated 41 per cent in 2001 to 46 per cent in 2003 a nd those on public services down from 37 to 33 per cent over the same period. As a result of the country's geography, the high level of expenditure on social services reflects the cost of providing education and health services in the outer atolls.

The overall fiscal deficit, excluding grants, increased by an estimated 29 per cent in 2002 and was expected to increase by another 12 per cent in 2003. External grants (excluding those for direct expenditure by donors) were on a downward trend, falling by an estimated 30 per cent in 2002 and by another 23 per cent in 2003. As a result, the overall deficit (including grants) rose from 4.7 per cent of GDP in 2001 to a projected 8.3 per cent in 2003. Lower resort to the Government's overdraft facility at the central bank was important as bank financing of the budgetary deficits on a continuing basis threatens the fixed exchange rate regime and weakens fiscal discipline. To address the issue of the fiscal deficit, the sixth national development plan recognizes the need for the private sector to play an increasing role in the socio-economic development of Maldives. It also calls for an evaluation to strengthen the accountability and operational efficiency of State-owned enterprises.

Revenue shortfalls and lower levels of external finance contributing to downward revisions of Nepal's budgetary targets

Nepal's tax revenue and external financing targets in the budget for fiscal year 2003 were adjusted downward at the mid-term review, including lower total expenditure and a net domestic financing target set at 2 per cent of GDP. The ceasefire was followed by a pickup in economic activities and revenue collections, but capital spending remained below the revised budget because of implementation constraints. Among the options under consideration for raising revenue in Nepal over the medium term were cuts in tax exemptions, improvements in tax and customs administration, and higher VAT rates. Additionally, the prioritization of development spending to better achieve poverty reduction goals would need to be made within a medium-term expenditure framework. At the same time, lower domestic borrowing was expected to help to maintain fiscal sustainability, in view of the potentially large contingent liabilities from financial sector and public enterprise reforms. Moreover, progress in the peace talks was expected to relieve the pressures for security spending while privatization and the restructuring of viable enterprises (and liquidation of unviable ones) would help to strengthen the public sector financial position.

Money and finance

A new central bank law and banking legislation were enacted in Afghanistan

The primary objective of monetary policy in Afghanistan is to achieve and maintain stability in the national currency, introduced in the fall of 2002, while the monetary policy framework is based on indicative money supply targets in an otherwise highly dollarized economy. A foreign exchange auction system serves as the main instrument of monetary control. As a result of the "no overdraft" rule prohibiting government borrowings from the central bank, expansion of the monetary supply is closely matched by foreign reserve accumulation. The existing commercial banks had lost public confidence and had virtually ceased to function, leaving money traders as the only providers of banking services.

Since late 2001, however, the central bank has been restoring key functions in the areas of monetary policy, payment and supervision; and plans are being developed to bring the central bank's organization, capacities and functions more in line with modern-day practices. The enactment of a new central bank law and banking law in 2003 were expected to ensure the transformation of the central bank and facilitate the entry of new commercial banks. The problems associated with the existing State-owned banks were to be addressed on a case-by-case basis through restructuring, privatization or closure to minimize budgetary costs and systemic risks to the banking system. New legislation was to be passed in fiscal year 2003 and the *hawala* money transfer system was expected to be placed under greater regulation to counter money laundering and the financing of terrorism.

High levels of bank liquidity reflecting weakness of capital markets and the reluctance to lend to small borrowers in Bangladesh

Monetary policies in Bangladesh in fiscal year 2003 were aimed at rebuilding net foreign assets and containing monetary expansion to a level consistent with projected rates of GDP growth and inflation. The lower budget deficits and public sector borrowings allowed an expansion of almost 15 per cent in private sector credit. Since the domestic interest rates were significantly higher than those of neighbouring countries with comparable inflation levels, Bangladesh reduced the repo rate of commercial bank transactions with the central bank, lowered the discount rate from 6 to 5 per cent and cut the statutory liquidity ratio for banks from 16 to 12 per cent in fiscal year 2003. To ease the cost for banks in competing long-term deposits, the interest rates on national savings scheme instruments were also slated for a reduction in 2004.

However, owing to weaknesses in the capital markets and the reluctance of banks to lend to borrowers of small means, bank liquid assets (consisting of cash balances and government securities holdings) remained well over the statutory requirement in fiscal year 2003 and in the first half of fiscal year 2004. Other things being equal, deployment through lending of this excess liquidity could have raised private sector credit by an estimated 10 per cent, with attendant gains in output, income and employment. Meanwhile, the central bank tightened financial sector regulation and supervision considerably, through the imposition on banks of higher capital requirements, lower single-borrower exposure ceilings and higher corporate governance and financial disclosure standards. Additionally, under a comprehensive reform programme, one of the four nationalized commercial banks (with high non-performing loans) was to be privatized, another was to have a new management team and management support teams would be placed in the other two. In the interim, ceilings have been imposed on net new lending by these four banks to stem new non-performing loans.

Strategy formed to strengthen the financial sector in Bhutan

Given its close relationship with India, Bhutan's monetary policy was aimed at maintaining price stability, including through the maintenance of the exchange rate peg. This required convertibility of the ngultrum against the Indian rupee through reserve backing of the currency issued and ensuring some parity of interest rates in Bhutan with those in India. In fiscal year 2003, however, domestic liquidity continued to grow despite the cash reserve ratio of 20 per cent on deposits, the sale of Royal Monetary Authority bills and the holding of sizeable foreign exchange balances abroad. Although interest rates on housing construction, industries and personal loans declined together with the lowering of the discount rate to an annual 3.5 per cent, interest rates in India remained lower than in Bhutan. In addition, the total assets and liabilities of the two commercial banks rose by 31 per cent through a strong expansion of the deposit base.

Limited investment opportunities in the domestic market meant that most of the assets were in the form of foreign currency investments and liquid funds parked with the central bank. The combined assets and liabilities of the two non-bank financial institutions, which compete with the two commercial banks in lending, also rose strongly, by almost 35 per cent in fiscal year 2003 and credit to the private sector accounted for 93 per cent of their total assets. Investment by the four financial institutions was up 52 per cent during the year. The service and tourism sector and building and construction sector each accounted for about a quarter of total credit extension, followed by the manufacturing sector and the trade and commerce sector.

Along with amendments to the existing acts and regulations governing financial institutions to strengthen the operative, regulatory and supervisory framework of the financial system, a financial sector study completed in 2002 also recommended a series of measures. Among those were: first, establishing a sound market infrastructure through the adoption of standardized accounting systems, a strengthened legal system and improved corporate governance to reduce risk to financial institutions; second, enhancing the capabilities of existing financial institutions in management, establishing an asset-liability policy and credit assessment systems; third, developing the capital market by strengthening the Royal Securities Exchange of Bhutan and its legal framework; fourth, encouraging participation by international institutions in the banking, insurance, leasing and housing sectors; and fifth, improving the supervisory role of the Royal Monetary Authority as the single regulatory body for all financial services, including insurance, stock exchange, pension and provident funds.

Ongoing modernization of the legislative framework, and the legal system governing the financial sector in Maldives

There has been a gradual relaxation of direct controls by the monetary authority on private sector credit extended by commercial banks, which are now able to determine the allocation of credit to the private sector. Interest rates have remained stable in recent years, with posted rates for transactions denominated in United States dollars remaining higher than those denominated in rufiyaa, and the 7 per cent maximum spread between lending and deposit rates on rufiyaa transactions was also abolished. As a result, policy instruments currently in use are the minimum reserve requirement (set at 30 per cent), certificates of deposit issued by the monetary authority in Maldives, the ceiling of 20 per cent on rufiyaa-denominated lending rates and a Lombard window available to commercial banks. In addition, a lender of last-resort facility was established to accommodate unexpected short-term liquidity needs of commercial banks.

To create a more competitive environment in the financial sector, a licence was given to an international banking corporation to operate a branch in Maldives and operations started in March 2002. A facility for the trading of securities was also established within the premises of the monetary authority. The insurance industry has also expanded in recent years, with several regional insurance companies, brokers and agents introducing new and more diversified services. By and large, there are a number of measures which could be introduced for the further development of the financial sector. In particular, ways and means to promote the provision of long-term finance for private sector investment are needed since the existing banks are unable to meet long-term financing needs. Ongoing improvement and modernization of the legislative framework and the legal system governing the financial sector would also be essential. Finally, greater transparency and better corporate governance, including through strengthened reporting requirements of companies, would ensure more timely and reliable information on corporate operations.

Financial sector reform covering both the central bank and the largest commercial banks in Nepal

As in Bhutan, a key monetary policy objective of Nepal is to support the exchange rate peg to the Indian rupee and an element of this policy stance was to limit the expansion of reserve money, money supply and private sector credit to around 10 per cent. Reserve requirements for commercial bank deposits were unified and differential cash requirements were eliminated. Limits on commercial bank interest rates and foreign exchange spreads would be eliminated in early 2004 while priority sector lending requirements would also be phased out. Other notable progress in the implementation of financial sector reform includes the enactment in early 2002 of legislation to increase central bank autonomy and strengthen the central bank's supervisory and regulatory functions over the entire financial system. In addition, there was the establishment of a debt recovery framework to provide time-bound decisions for debt recovery along with the strengthening of the blacklisting directive. The central bank also took steps to reduce staffing through a voluntary retirement scheme while the instalment of external management teams in the two largest insolvent commercial banks has improved loan recovery; branch rationalization has also been undertaken in Nepal.

Policy issues and responses

Improved access to social services as well as higher economic growth are the key to sustained poverty reduction in the least developed countries

Poverty reduction, through durable economic growth and equitable access to government services, needs to be addressed over the medium term through, among other options, the implementation of structural reforms in the financial and public sectors and more effective targeting of policies towards the poor. The incidence of poverty is strongly correlated with the availability of and access to social services. In Afghanistan, for example, the Government's limited control over many areas complicates both macroeconomic management and reconstruction efforts outside Kabul. Adequate security and respect for the rule of law are required to permit the implementation of far-reaching reforms, the resumption of private economic activities and the efficient provision of basic public services in all rural areas.

In landlocked Bhutan, the emphasis is placed on strengthening the infrastructure, particularly the road network, as a means to overcome the constraints arising from the country's mountainous terrain. Although many development indicators reveal significant progress in improving the quality of life in Maldives, the incidence of poverty in the outer atolls remains high, partly owing to the uneven distribution of economic infrastructure and social services. The issue of poverty is therefore being addressed through a reduction in regional disparities in living conditions caused by the remoteness of some islands, thus rendering costly the provision of social and economic services. To enhance service delivery, both Bhutan and Nepal have placed greater emphasis on decentralization, a process to be accompanied by improved public sector governance and greater capacity-building at the local level.

Decentralization of government to enhance the voice of the poor

Several least developed countries are adopting a more decentralized form of government. Participatory governance in Bangladesh serves to enhance the voice of the poor, thus helping to improve the quality of public health, education and social services delivery. Political and economic reforms have also been initiated in Bhutan since the devolvement of executive powers to the Cabinet of Ministers in 1998. For example, the ninth five-year plan outlined the devolution of responsibilities to local government authorities in the implementation of development programmes and projects in rural areas. A new constitution currently being drafted in Bhutan was expected to facilitate further devolution of the decision-making process in the country.

In Maldives, strengthened democratic governance, more equitable development and greater participation by the people (including women) in public life are to be addressed in the coming years. Some of the key parameters in the process include improved enforcement of contracts and property rights, a more effective and timely decision-making process and equal protection under the law. In Bangladesh, the issue of governance was also being addressed through the draft legislation on the establishment of an independent anti-corruption commission. The legislation was expected to raise the level of accountability of public officials and elected public representatives. More demanding disclosure requirements and corporate governance standards were also expected to strengthen the accountability of corporate entities in the private sector.

Greater employment through private sector growth is essential in the light of the changing demographic patterns

A durable expansion of the private sector is essential in order to create adequate employment opportunities for the growing young workforce in least developed countries. In Maldives, for example, the labour force grew more quickly than the population during the period 1985-2000 and the number of persons in the 15-19 year age group was expected to peak in 2006. Bhutan adopted a new FDI policy, engaged in trade liberalization and provided tax incentives to foster and nurture the development of small and medium-sized enterprises; the establishment of industrial estates and a dry port facility are under consideration. The private sector was also viewed in Bangladesh as the engine driving broad-based activities in manufacturing, agriculture and rural off-farm pursuits. However, only a fifth of Bangladesh's total labour force was formally employed in the organized sector.

Given the limited opportunities for employment at home, there are a very large number of people from least developed countries working abroad. Estimates suggest that 3 to 3.5 million Nepalese migrant workers (or over 10 per cent of the population of Nepal) are in India, the Middle East, and South-East and East Asia. As a result, remittances to Nepal were expected to be greater than merchandise exports or external aid in coming years. Migration abroad of skilled and unskilled labour also appears to have eased unemployment pressures in Bangladesh. However, expatriate labour, which accounted for over a quarter of the labour force in Maldives, increased by 5 per cent annually in 2002 and 2003.

South-East Asia

A. Developing countries in the subregion

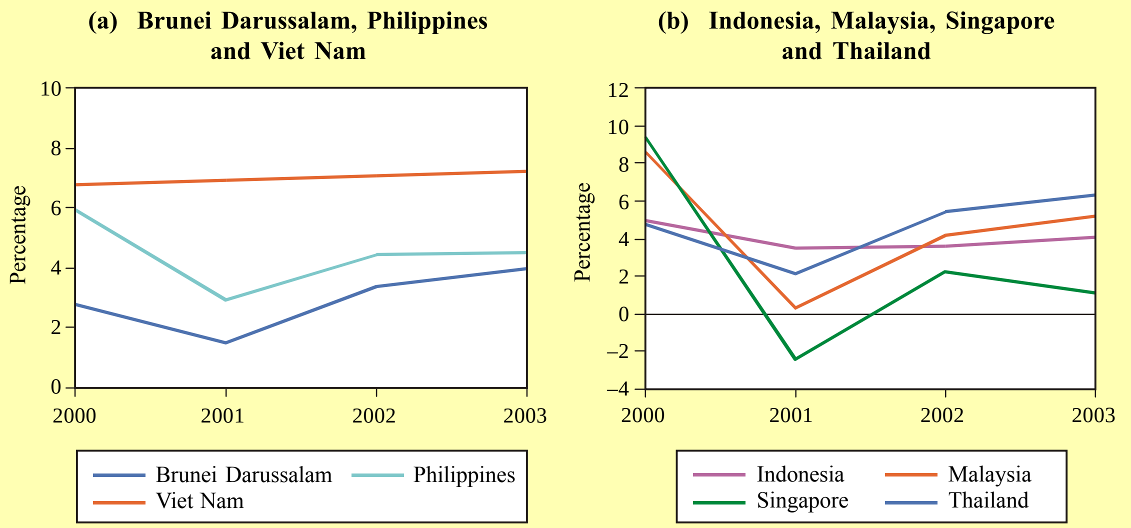
Subregional overview and prospects

Despite an uncertain external environment, most developing countries in South-East Asia grew faster in 2003

Despite the uncertain global economic recovery, the SARS crisis and the build-up to the war in Iraq, developing countries in South-East Asia generally managed to increase GDP growth rates in 2003 (figure II.26). The only exception was Singapore, which was badly affected by the SARS crisis and did not fully benefit as in the past from the upturn in the electronics cycle. Some sectors of the electronics and electrical goods industry were also weak in parts of the subregion, while a number of low-cost, labour-intensive and export-oriented manufactured goods (such as garments and footwear) also faced some difficulties, partly owing to internal reasons, intensifying competition in third-country markets from China and the relocation of production facilities to lower-cost countries.

Exporters of agricultural commodities, such as Indonesia, Malaysia and Thailand, and of oil and gas, such as Brunei Darussalam, Indonesia and Viet Nam, received a considerable boost from higher commodity

Figure II.26. Rates of GDP growth in selected South-East Asian economies, 2000-2003



Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003).

Note: Data for 2003 are estimates.

prices, which were in part sustained by significantly increased demand from China. The service sector, which now accounts for a large share of GDP in many developing countries of South-East Asia, was hit by the SARS epidemic, not only in Singapore as noted above but also in Thailand and Viet Nam. However, other services related to business (such as transport and communications), financial services and vehicle distribution expanded in all countries and retail trade also recovered.

One of the principal pillars sustaining growth in most parts of the subregion was higher private consumption expenditure, which, in turn, was underpinned by historically low interest rates and increased access to credit, and in some cases, rising farm incomes. In particular, spending on motor vehicles was up in many countries. While private investment expenditure recovered or expanded strongly in a number of countries (such as Thailand and Viet Nam), the investment ratio in most countries in the subregion, except notably Viet Nam, was still below the pre-1997 crisis levels. Fiscal restraint was significant in 2003, although Malaysia and Viet Nam continued to register robust expenditure on development projects. External demand provided an added boost to several countries, although less so to Indonesia, the Philippines and Singapore, and many countries saw trade with China surge.

The outlook for subregional growth in 2004 has improved

The strengthening global economic recovery, the continued prevalence of low levels of interest rates and firm commodity prices should boost growth in South-East Asia in 2004, particularly in Singapore and Thailand. The former country should also benefit from a solidifying recovery in electronics. However, lagging investment could be a constraint on medium-term growth in many countries, although business confidence has generally been on the rise throughout the subregion. Private consumption expenditure is likely to slow, in part reflecting higher levels of debt, while the need for fiscal consolidation may have a restrictive impact on public expenditure in many countries. However, trade, particularly intraregional trade, is likely to increase and the benefits of the various FTAs and RTAs will be reflected in lower consumer prices.

The National Economic and Social Development Board of Thailand has forecast a further acceleration of growth to 7-8 per cent, given a favourable external environment. The negative impact of the avian influenza epidemic, which began at the end of 2003, could shave 0.1-0.5 percentage points off this forecast in 2004, depending on the duration of the loss in exports, the (still-unknown) risks of human-to-human transmission and its effects on tourism and travel. However, lower earnings on chicken exports could be more than offset by the expected strong growth in other exports while government support for selected industries, together with the ambitious infrastructure development plan, could offset any fall-off in aggregate demand.

The avian influenza epidemic is the first shock of 2004

Avian influenza will also affect growth in several other South-East Asian countries, including Viet Nam, where continued strong growth, expected at 7.5 per cent in 2004, will be helped by a strengthening world economy and increased FDI from Japan following the signing of an agreement with that country. To sustain medium-term growth, the Government is pushing strongly to join WTO by 2005, a process requiring greater trade liberalization in Viet Nam, the abolition of quantitative restrictions and the conversion of non-tariff into tariff barriers. Other things being equal, Indonesia expects aggregate production to accelerate to 4.8 per cent in 2004. An increase in investment is critical and will necessitate attracting both domestic and foreign savings, but increased debt-service pressures and rising global interest rates could reduce the available financial resources.

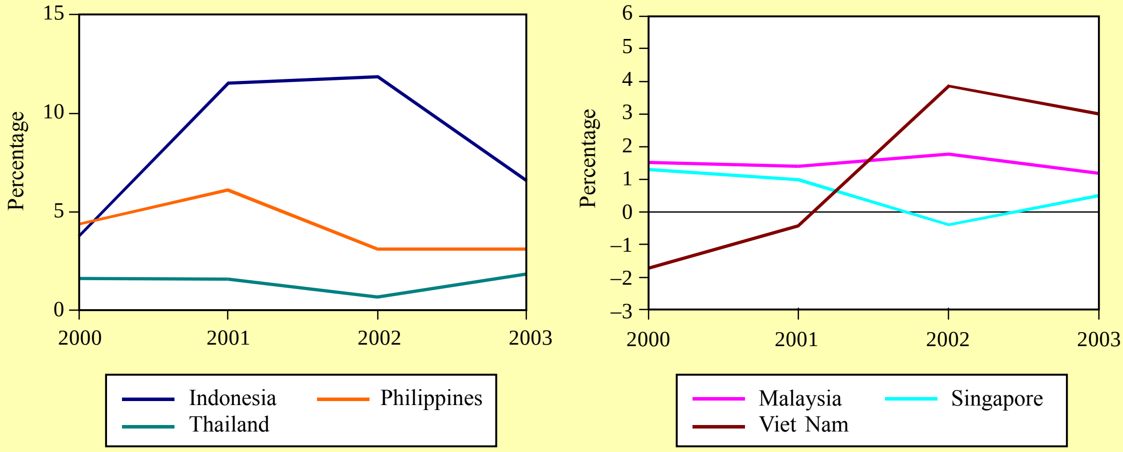
Although government policy remains strongly supportive of growth, the budget for 2004 indicates that fiscal consolidation is being given priority in Malaysia. GDP growth, targeted at 5.5-6.0 per cent in 2004-2005, will depend on a revival in investment and strong external demand. Much the same is true of Singapore, where the broad-based recovery in business confidence augurs well for future growth. The Government is forecasting GDP growth to be in the 3.5-5.5 per cent range in 2004. In the Philippines, the current expansion is likely to be sustained in 2004 if inflation and interest rates remain low and the external environment strengthens. However, continuing political uncertainty and the recent downgrade in ratings will tend to increase interest costs, making the task of fiscal consolidation harder. The Government is targeting GDP growth at 4.9-5.8 per cent in 2004 and this may also require a strong reversal of the falling business confidence in the Philippines.

Inflation was subdued in the subregion in 2003

Consumer prices continued to be generally muted owing to the persistence of various margins of spare capacity and demand that was not excessive (figure II.27). At the same time, cost pressures were contained in part by currency appreciation in many cases as well as by competition from imports. The remarkable fall of 5.3 percentage points in the rate of inflation in Indonesia reflected monetary restraint and low food prices. Adequate stocks also helped the Philippines and Viet Nam to keep food prices and hence inflation in check, despite currency depreciation. Increased food and energy prices were, however, responsible for an increase in consumer prices in Thailand, although inflation remains low in absolute terms. Singapore managed to reverse the deflation of 2002 and the positive, but small, rate of inflation in 2003 partly reflected higher sales tax and electricity charges; the latter attributable to more expensive oil prices. Monetary policy was accommodative in most parts of South-East Asia and low inflation together with currency stability enabled central banks to sustain record low interest rate levels.

Figure II.27. Inflation[a] in selected South-East Asian economies, 2000-2003

(a) Indonesia, Philippines and Thailand **(b) Malaysia, Singapore and Viet Nam**



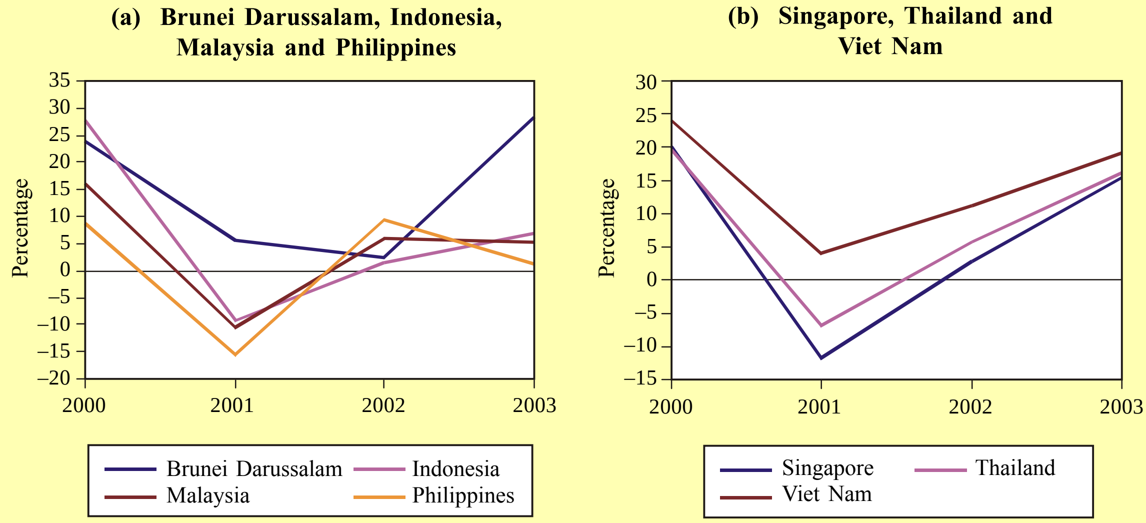
Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.

Merchandise exports generally expanded in 2003 in South-East Asia (figure II.28) with the sharpest increase registered in the first 6 months of the year by Brunei Darussalam, an oil and gas exporter, while the slowest growth occurred in the Philippines, where electronics exports fell. In Singapore, the strong performance of pharmaceutical products could not fully compensate for weak electronics exports. However, Malaysia was able to rely on agricultural products, as well as other manufactured goods such as chemicals to offset declining export earnings on electronics and electrical goods. In contrast, Thailand and Viet Nam saw exports of electronic products surge, along with commodities exports. Strong growth in the export of automotive products was also achieved by Thailand, and in garments, textiles and footwear by Viet Nam. However, exports of garments and footwear from the Philippines and Indonesia declined somewhat and Indonesia relied on primary commodities, including hydrocarbons, for export growth. Intraregional trade within East and South-East Asia has been an important factor sustaining export growth, as noted above.

Figure II.28. Growth rates in merchandise export earnings of selected South-East Asian economies, 2000-2003



Sources: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003; Statistics Indonesia web site <http://www.bps.go.id>, 19 February 2004; Malaysia Economic Planning Unit web site <http://www.epu.jpm.my/bi/Stat/Kei/Ext2001.pdf>, 12 January 2004; Philippines National Statistics Office web site <http://www.census.gov.ph/data/sectordata/tsft.htm>, 13 January 2004; Bank of Thailand web site <http://www.bot.or.th/bothomepage/databank/EconData/Thai_Key/Thai_Key E.asp>, 8 December 2003; Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues; and other national sources.

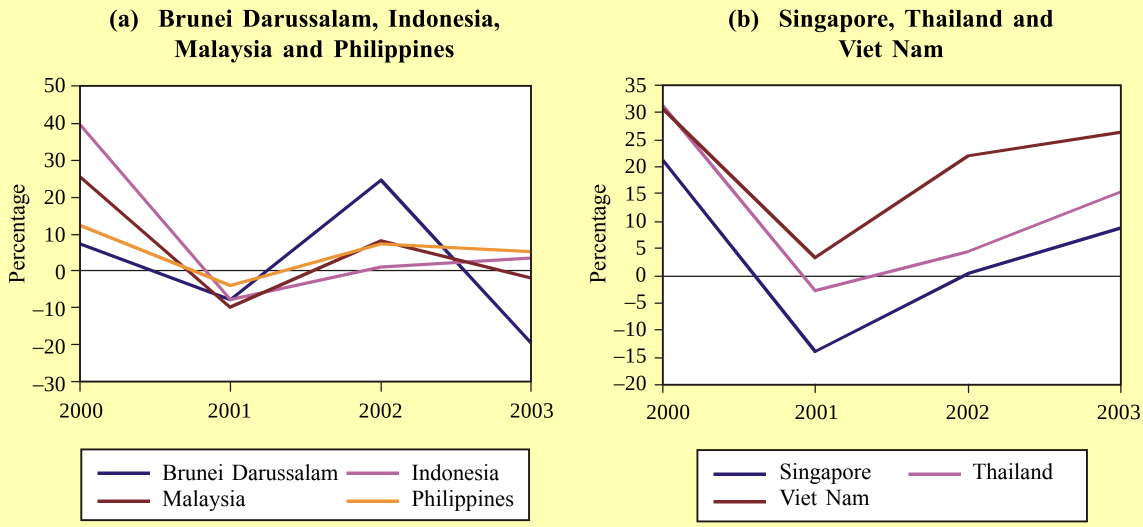
Note: Data for 2003 refer to January-June, except for Indonesia (preliminary data for the whole year), the Philippines and Thailand (January-October), Malaysia (January-November) and Viet Nam (estimates for the whole year).

Spending on merchandise exports was at a faster rate than in 2002 but import growth was often weak

Merchandise imports declined in Brunei Darussalam (figure II.29), as demand for vehicles tapered off, and in Malaysia, as investment and export demand remained relatively subdued. Lower demand for machinery and capital goods imports as well as intermediate inputs was seen in Indonesia, the Philippines and Singapore. However, broad-based growth in merchandise imports occurred in Thailand and Viet Nam, with imports of consumer and capital goods, as well as intermediate inputs, expanding with vigour.

On the capital account, net inflows of FDI were generally weak, even though they increased somewhat in Brunei Darussalam, Thailand and Viet Nam. Singapore was an exception, with a sharp jump in FDI towards the end of 2003. Much of the increase reflected reduced outflows and reinvestment of earnings. Meanwhile, the generally strong performance of stock markets in the subregion was behind inflows of portfolio investment in a number of countries. Exchange rates appreciated against the United States dollar, except for the Malaysian ringgit, which is pegged to that currency, and the Philippine peso and Vietnamese dong, which

Figure II.29. Growth rates in merchandise import spending of selected South-East Asian economies, 2000-2003



Sources: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003; Statistics Indonesia web site <http://www.bps.go.id>, 19 February 2004; Malaysia Economic Planning Unit web site <http://www.epu.jpm.my/bi/Stat/Kei/Ext2001.pdf>, 12 January 2004; Philippines National Statistics Office web site <http://www.census.gov.ph/data/sectordata/tsft.htm>, 13 January 2004; Bank of Thailand web site <http://www.bot.or.th/bothomepage/databank/EconData/Thai_Key/Thai_Key E.asp>, 8 December 2003; Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues; and other national sources.

Note: Data for 2003 refer to January-June, except for Indonesia (preliminary data for the whole year), the Philippines and Thailand (January-October), Malaysia (January-November) and Viet Nam (estimates for the whole year).

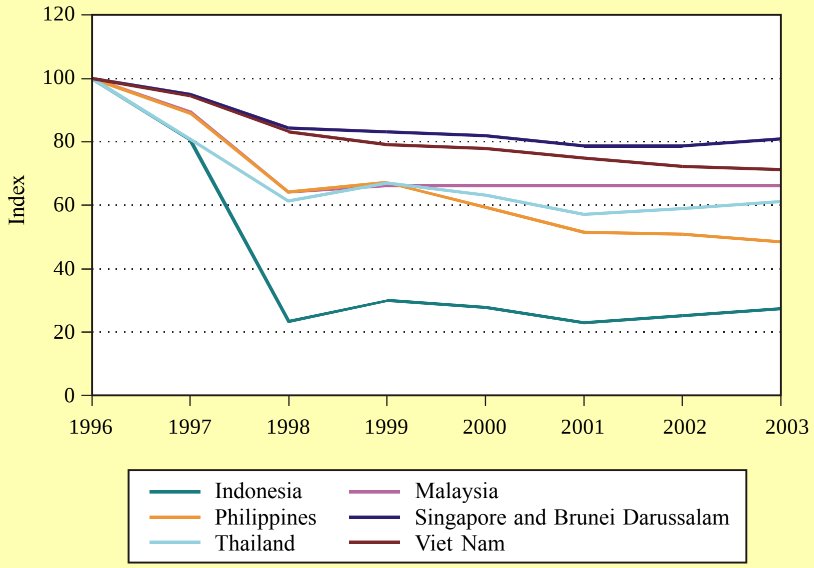
depreciated (figure II.30). Gross international reserves increased in all the developing countries in South-East Asia. Additionally, increased market confidence in most of those countries was indicated by ratings upgrades or affirmations for their long-term sovereign debt denominated in foreign currency in the course of 2003, except for Viet Nam, where the ratings were unchanged but the outlook was lowered, and the Philippines, which suffered a ratings downgrade early in 2004.

There was substantial continuity in the policy agenda in 2003

Poverty and unemployment continued to be important concerns, although many countries have made good progress on the Millennium Development Goals, meeting the first target of halving income poverty from 1990 levels well ahead of time. Restructuring and strengthening of the financial sector, including through bank consolidation, received particular attention in 2003. Fiscal consolidation, after six years of post-crisis expansionary policies, was a matter that would require continuing attention. Finally, sustaining growth in the medium and long terms in an increasingly competitive world is an issue to be managed by all countries, not only those in the subregion.

Figure II.30. Index of exchange rates against the United States dollar of selected South-East Asian economies, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Notes: Data for 2003 are estimates. The currency of Brunei Darussalam is set at par with the Singapore dollar.

GDP growth performance

Viet Nam was the first country to contain the SARS outbreak in April 2003, and notwithstanding the considerable disruption to tourism and other exports, GDP growth for the full year was expected at 7.2 per cent, marginally higher than the rate in 2002 but slightly below the target level of 7.5 per cent (table II.31). The high growth experienced by Viet Nam in recent years has been driven by strong domestic demand, particularly investment, as well as exports. Household consumption expenditure, which had been on an upward trend owing to higher prices for agricultural commodities as well as higher wages, eased somewhat in 2003. Increased household savings were reflected in the higher savings ratio between 2002 and 2003, from 28.8 to 30 per cent of GDP (table II.32). Despite lower FDI, total investment expanded rapidly in recent years. In particular, the investment ratio went up to 34.2 per cent of GDP in 2003, from 32.1 per cent the previous year, as a result of the ongoing expansion of the domestic non-State sector and the creation of new private enterprises; the non-State sector increased its share of

Table II.31. Selected South-East Asian economies: growth rates, 2000-2003

(Percentage)

		Rates of growth			
		Gross domestic product	Agriculture	Industry	Services
Brunei Darussalam	2000	2.8	..	..	..
	2001	1.5	..	..	..
	2002	3.4	..	..	..
	2003	4.0	..	..	..
Indonesia	2000	4.9	1.9	5.9	5.2
	2001	3.4	1.0	3.3	4.6
	2002	3.7	1.7	3.7	4.4
	2003	4.1	2.4	4.5	4.4
Malaysia	2000	8.5	2.6	13.6	6.0
	2001	0.3	−0.9	−3.8	6.1
	2002	4.1	3.0	3.9	4.2
	2003	5.2	5.5	7.1	4.1
Philippines	2000	6.0	4.3	9.0	4.4
	2001	3.0	3.7	0.9	4.2
	2002	4.4	3.3	3.8	5.4
	2003	4.5	3.9	3.0	5.9
Singapore[a]	2000	9.4	−4.9	10.9	8.7
	2001	−2.4	−5.9	−9.2	1.1
	2002	2.2	−6.0	4.0	1.4
	2003	1.1	−2.4	1.5	1.0
Thailand	2000	4.8	7.2	5.3	3.7
	2001	2.1	3.5	1.7	2.3
	2002	5.4	3.0	6.9	4.5
	2003	6.3	3.4	9.0	4.4
Viet Nam	2000	6.8	4.6	10.1	5.3
	2001	6.9	2.8	10.4	6.1
	2002	7.0	4.1	9.4	6.5
	2003	7.2	3.2	10.3	6.6

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003), and Economist Intelligence Unit, *Country Forecasts* and *Country Reports* (London, EIU, 2003 and 2004), various issues.

Notes: Data for 2003 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Agriculture also includes fishing and quarrying.

total investment from 25.3 to 26.7 per cent between 2002 and 2003. Nevertheless, the State sector continued to account for over 56 per cent of total investment while the relative share of total investment accounted for by firms with foreign capital was down from an average of 18.5 per cent in 2000-2002 to 16.8 per cent in 2003.

Table II.32. Selected South-East Asian economies: ratios of gross domestic savings and investment to GDP, 2000-2003

(Percentage)

	2000	2001	2002	2003
Savings as a percentage of GDP				
Indonesia	26.2	26.0	23.6	20.4
Malaysia	47.1	42.2	41.8	41.9
Philippines	17.5	18.1	19.5	20.1
Singapore	47.9	44.0	43.9	46.7
Thailand	33.1	32.0	32.6	31.4
Viet Nam	27.1	28.8	28.8	30.0
Investment as a percentage of GDP				
Indonesia	21.0	21.2	19.5	17.9
Malaysia	27.1	23.8	24.4	24.3
Philippines	21.5	20.6	19.3	18.7
Singapore	32.0	24.9	21.2	13.4
Thailand	22.7	23.9	23.8	24.6
Viet Nam	29.6	31.2	32.1	34.2

Sources: ESCAP, based on national sources; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003).

Note: Data for 2003 are estimates.

Industrial production was the main driver of growth in Viet Nam

On the supply side, industrial production (contributing over 53 per cent to GDP growth) expanded at 10.3 per cent with such manufacturing subsectors as food and beverages, apparel and electrical machinery and apparatus growing in excess of 15 per cent. There was also rapid expansion in the energy sector although agricultural growth slowed somewhat in 2003 because of weather-related shocks, despite a recovery in the fisheries industry following the removal of sanitary restrictions in the EU and the United States. Notwithstanding the temporary SARS-induced setback to the tourism and travel industries, the service sector (contributing over 37 per cent to GDP growth) continued to expand in 2003; the sector gained 6.6 per cent in value added owing to a strong performance in trade, banking and insurance, and public services.

In 2003, the Thai economy continued the strong performance of 2002 that saw GDP surpassing its 1997 level for the first time. Aggregate production decelerated somewhat in the second quarter of 2003 but a sharp rebound afterwards lifted growth for the year to 6.3 per cent, up from 5.4 per cent in 2002. Much of the impetus for growth in 2002 and 2003 came from private consumption expenditure (with a share of nearly 55 per cent of GDP in 2002), reflecting in turn a robust increase in farm incomes, as a result of higher commodity prices, low interest rates, increased access to credit and strong consumer confidence. However, consumption growth slowed during the year, in contrast to the continued strong recovery of private investment from the second half of 2002, up 17.7 per cent in the first three quarters of 2003, as against 12 per cent in the same period in 2002. Although much of the recovery was driven by construction-related activities, investment in machinery and equipment was also up significantly along with the sustained revival of business confidence. Capacity utilization in manufacturing averaged 66.2 per cent in 2003 compared with 59.3 per cent in the previous year. However, government consumption fell in the first 9 months of 2003, reversing the expansion recorded in the same period in 2002, while the fall-off in public investment that began in 2002 accelerated in 2003. The support provided by net exports to growth also declined during the year, pulled down principally by a weak performance in services.

Growth was broadly based in Thailand

Growth in the service sector was only marginally lowered by the SARS-related decline in tourism, which affected the hotels and restaurants sector particularly severely in the second quarter of 2003. Transport and communications were also affected by the fall in inbound and outbound travel but a compensating development was the continued expansion in financial services, with growth accelerating to 9.9 per cent in January-September 2003, from 7.7 per cent in the same period in 2002. Agricultural production also improved between 2002 and 2003, as both the crops and livestock sectors benefited from strong demand and higher prices along with the recovery of fisheries. Manufacturing activities were particularly robust in 2003 compared with 2002. Among the fastest-growing sectors were electrical and electronic parts, food production and vehicles and equipment. In contrast, public construction remained weak. However, the strong expansion in private construction that had begun in late-2001 continued into 2003 and the momentum was sufficient to pull overall growth in the industrial sector up to 9.0 per cent in 2003.

In Malaysia, GDP growth of 5.2 per cent during 2003 was considerably faster than in 2002 and above the official forecast of 4.5 per cent. Domestic demand made a significant contribution to growth, stimulated by robust public spending on development projects. However, private investment remained relatively weak, with the ratio of investment to GDP remaining at around 24.3 per cent in 2002-2003. Capacity utilization averaged 78 per cent during 2001-2003.

On the supply side, Malaysia was able to offset demand volatility in the market for electronics with strong growth in commodity-related sectors and agricultural output rose by 5.5 per cent in 2003 (nearly double the previous year's 3 per cent growth) as high commodity prices provided a stimulus to palm oil and rubber production. Despite somewhat slower growth in construction, industrial value added expanded at the considerably faster rate of 7.1 per cent in 2003, compared with 3.9 per cent the preceding year, on the back of a strong performance from export-oriented

Export-oriented manufacturing recovered in Malaysia

manufacturing in response to the recovery of global demand, particularly for electronics, chemicals and processed rubber products. However, there were signs that some sectors of the electronics and electrical goods industry, which accounted for around 53 per cent of manufacturing output and 70 per cent of manufactured exports, faced some difficulties competing in third markets, particularly for electrical goods. Growth in services was steady at around 4.1 per cent in 2002-2003 but slower than the 6 per cent on average in 2000-2001. The sector was hit by a contraction in tourism-related activities and other final services although intermediate services grew strongly in response to the rising need for business-related services such as transport, finance and insurance.

Output slowed in the Philippines in the first half of 2003 but with an upturn in the second half, estimated full-year growth of 4.5 per cent was slightly higher than in 2002. Stimulated by low inflation and interest rates as well as steady growth in inward remittances, consumer spending was the principal support for growth. Export demand remained weak and government expenditure was cut back, including in capital construction, in order to control the budget deficit, impacting on fixed investment; the investment ratio declined further to 18.7 per cent of GDP in 2003, compared with an average of about 21 per cent during 2000-2001.

Buoyant services sustained GDP growth in the Philippines

Despite the SARS scare, service sector output growth in the Philippines increased to 5.9 per cent in 2003, compared with 5.4 per cent the previous year, owing to a strong performance in transport and communications, and other services. The sector accounts for nearly 53 per cent of GDP in the Philippines. Industrial production was initially sustained by a moderate recovery in manufacturing, which petered out subsequently as electronics exports remained weak. Manufacturing capacity utilization, which had risen to nearly 79 per cent by June 2003, was down to 77.5 per cent in September. Construction also declined with public expenditure cut back, while drought related to an El Niño weather event in the first quarter and typhoons in the second dragged agricultural production down. The sector staged a strong recovery in the second half of the year, however, as a result of a rebound in the rice crop that more than offset a further decline in maize.

In Indonesia, GDP growth of 4.1 per cent in 2003 was somewhat higher than the Government's forecast of 4 per cent as well as the 3.7 per cent rate of 2002. The return of macroeconomic stability has enabled the country to withstand the various shocks mentioned earlier as well as domestic problems related to terrorism and regional unrest. Again, induced by low deposit rates and easy access to credit, consumer spending was the main driver of growth although the savings ratio continued the decline that had started in 2001, falling to 20.4 per cent of GDP in 2003. Exports appear to have contributed less to growth in Indonesia than in some other countries of the subregion while tourism revived briefly after the SARS scare only to slump again after the bombing of a leading hotel. Investment also grew slowly and, as a percentage of GDP, declined to 17.9 per cent in 2003, well below the 30 per cent on average in the years before 1997. Around four fifths of investment was estimated to have accrued in property and only 18 per cent in plant and machinery in the first 9 months of 2003.

GDP growth benefited somewhat from commodity exports in Indonesia

Agricultural output went up by 2.4 per cent in 2003, from 1.7 per cent in 2002, despite floods in the third quarter of the year. There was a significant rise in the production of crude palm oil and cocoa in response to higher commodity prices while growth in industrial production was sustained in 2003 by faster growth in mining and quarrying, utilities and construction. However, manufacturing production slowed in the first 9 months of the year despite a sharp increase in automotive sales, especially passenger vehicles, stimulated by low interest rates and easier consumer credit. Growth in services remained steady at 4.4 per cent on average in 2001-2003.

The main determinant of economic performance in Brunei Darussalam continued to be the oil and gas sector, with a relative share of 37 per cent of GDP in 2002. Higher oil prices were behind faster annual growth in 2002-2003 despite the lingering weakness in the private sector. GDP growth in 2003 was expected to be around 4 per cent, below the 5-6 per cent estimated in the eighth plan. Although most private sector industries were expected to grow slowly or contract during 2003-2004, a recovery in tourism and a better outlook for exports should help to stimulate activities in the non-oil and gas sector, particularly if development projects are implemented as planned.

The private sector has not yet taken off in Brunei Darussalam

Manufacturing contributed to around 4 per cent of GDP and major industries are related to construction and garments. The latter industry has benefited from United States quotas, due to expire in 2005; high labour costs could render the industry uncompetitive afterwards. Construction activities recovered strongly from a contraction of 2.4 per cent in 2001 to expand 7.5 per cent in the following year but a real estate glut in the capital added to the sector’s difficulties in 2003. The food industry has been targeted for expansion as four fifths of domestic food consumption is imported. However, the development of small-scale domestic food processing has been hampered by higher costs. As to services, the expansion in the hotels and restaurants subsectors slowed in the first half of 2003 on SARS-related concerns; domestic retail activities benefited from the reduced outward travel of nationals in early 2003 but slumped later in the year possibly as a result of increased consumer indebtedness. The reduction in motor vehicle import taxes in November 2001 lifted the number of car owners from 170,000 in 2002 to 200,000 in 2003. The banking sector remained robust, lending principally to households.

Singapore's economy recovered from a sharp contraction in GDP in the second quarter of 2003, equal to 3.9 per cent year on year, as a result of the SARS outbreak and soft external demand for electronics; it expanded by 1.7 and 4.9 per cent year on year in the third and fourth quarters respectively along with the recovery of both external demand and private domestic consumption. For the year as a whole, GDP growth is expected to be around 1.1 per cent, half the 2.2 per cent achieved in 2002. Strong demand for motor vehicles boosted private consumption, but the savings rate increased further to 46.7 per cent in 2003. Gross capital formation continued to contract, with investment falling sharply to 13.4 per cent of GDP in 2003, 7.8 percentage points below its level in the previous year and less than half the level achieved by Viet Nam. The decline reflected weakness in the property market, where vacancy rates were high and prices have been falling. Public investment in housing has also declined but expenditure on durable equipment has revived to some extent.

Sectors affected by the SARS epidemic accounted for 30 per cent of Singapore's GDP

According to the Monetary Authority of Singapore (MAS), the sectors most severely affected by the SARS outbreak were hotels and restaurants, whose output contracted 29 per cent in the second quarter with smaller declines of around 8 and 6 per cent in the third and fourth quarters as tourism slowly revived; retail trade and air and land transport were similarly affected. The upturn in external trade and increased motor vehicles sales as well as continued strength in financial services strengthened growth in the service sector in the fourth quarter. For 2003 as a whole, however, the service sector is estimated to have grown 1.0 per cent, down from 1.4 per cent in 2002. Growth in manufacturing faltered in the second quarter as demand for electronics remained weak but a strong performance by the biomedical sector and improved export demand for electronics led to a revival in manufacturing activities in the second half of 2003. Indeed, healthy external demand was behind the higher production of semiconductors and disk drives, as well as pharmaceuticals. However, the construction industry is estimated to have declined 10.7 per cent in 2003, following another drop of 10.8 per cent in 2002. Overall, growth in industrial production slowed markedly to an estimated 1.5 per cent in 2003 from 4 per cent the previous year.

Inflation

The slowdown in inflation in Indonesia was remarkable

A stable exchange rate, effective control over the money supply and lower food prices were responsible for the sharp drop in inflation in Indonesia during 2003 (table II.33). The annual increase in the consumer price index was 6.6 per cent in 2003, compared with an average of 11.7 per cent per year in 2001-2002. Broad money growth (M2) slowed to 4.7 per cent in 2002 but appeared to have grown somewhat faster in the first 9 months of 2003. Lower inflation and currency stability permitted Bank Indonesia to let short-term interest rates fall to record

Table II.33. Selected South-East Asian economies: inflation and money supply growth (M2), 2000-2003

(Percentage)

	2000	2001	2002	2003
Inflation[a]				
Indonesia	3.7	11.5	11.9	6.6
Malaysia	1.5	1.4	1.8	1.2
Philippines	4.4	6.1	3.1	3.1
Singapore	1.3	1.0	−0.4	0.5
Thailand	1.6	1.6	0.7	1.8
Viet Nam	−1.7	−0.4	3.9	3.0
Money supply growth (M2)				
Indonesia	15.6	13.0	4.7	5.7[b]
Malaysia	5.2	2.2	5.8	7.8[b]
Philippines	8.1	3.6	9.7	5.7[c]
Singapore	−2.0	5.9	−0.3	8.1
Thailand	3.4	2.4	1.4	1.6[c]
Viet Nam	35.4	27.3	13.3	21.7[d]

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Notes: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] January-September.
[c] January-August.
[d] January-July.

lows; the rate on 1-month Bank Indonesia certificates was at 8.31 per cent in December or nearly 5 percentage points below the end-2002 level. Bank lending rates have not fallen to the same extent with working capital rates down to 16.4 per cent in the third quarter as against 18.3 per cent at the end of 2002. However, commercial bank credit to consumers has expanded rapidly. Inflation is expected to fall somewhat over 2004-2005 as a result of a stronger and more stable rupiah, and lower minimum wage rises; the latter reflecting a greater awareness among stakeholders of the negative impact on competitiveness.

Inflation also declined in Malaysia from 1.8 per cent in 2002 to an estimated 1.2 per cent in 2003. Excess capacity, weak consumer demand and competition from imports helped to offset higher food prices in the second half of 2003, owing in part to currency weakness and to a greater willingness by businesses to pass on price increases to consumers. However, inflation is forecast to pick up modestly in 2004 as government-controlled prices and charges will likely increase later in the year.

The central bank's intervention rate is at its lowest level in 10 years in Malaysia

Monetary policy remained accommodative in Malaysia, with broad money growth accelerating between 2002 and 2003; Bank Negara Malaysia also lowered its 3-month intervention rate by 50 basis points to 4.5 per cent in May, the lowest level for 10 years, at the same time as the announcement of the Government's additional stimulus package. Lending and deposit rates were also lower and there has been a significant expansion in bank credit. The central bank has said that the current intervention rate will be maintained as long as there is excess capacity in the domestic economy and inflation remains weak. However, it is also seeking to keep the intervention rate above international rates to deter capital outflows and accumulate international reserves.

After falling in 2000-2001, consumer prices increased 3.9 per cent in Viet Nam during 2002; higher food prices were due to low inventories of rice and the flood-damaged rice crop. Inflation slowed in 2003 as food prices declined for much of the year. However, the prices of pharmaceuticals went up by nearly 21 per cent year on year in November and the prices of housing and construction materials also rose rapidly. Compounded by a pickup in food prices towards the end of the year, inflation reached 3 per cent in 2003. Inflationary pressures are expected to pick up in 2004 in line with stronger domestic demand, higher food prices and higher wage and other production costs. Currency weakness will add to these pressures. Monetary policy was expansionary in 2003, with the broad money supply increasing by about 22 per cent in the first 7 months of the year, well above the 13.3 per cent year on year growth at the end of 2002. Credit expanded rapidly for both consumption and investment purposes, by an estimated 29 per cent year on year in July 2003. The pace of open market operations, which commenced in January 2001, has increased over time but the State Bank of Viet Nam has continued to rely on indirect instruments and changes in regulations to support credit expansion.

Inflation in the Philippines was contained by slow growth in food prices despite disruptions in rice production

Consumer prices drifted upward through 2003 in the Philippines because of higher oil prices and the depreciation of the peso. For the full year, however, inflation was expected to be around 3.1 per cent, unchanged from 2002. This reflected an even slower pace of growth in the prices of food, beverages and tobacco; the disruptions in rice production in the first half of the year were offset by adequate stocks. The inflation targeted by the Bangko Sentral ng Pilipinas (BSP) for 2004 is in the 4-5 per cent range, as inflationary pressures are expected to be stronger this year.

BSP tightened monetary policy in March to pre-empt inflationary risks arising from the budget deficit, the weakening peso and concerns about the Iraq war. Bank liquidity reserves were increased and the rate-tiering system was removed, effectively lowering yields on placements with BSP. Monetary policy was eased at mid-year, however, when rates were lowered 25 basis points, but increased political uncertainty and the resulting slide in the peso led to a tightening in the third quarter. Broad money growth, which had accelerated towards the end of 2002 to an annual growth rate of 9.7 per cent, slowed to 5.7 per cent in January-August 2003.

The weak economy and rising NPLs hampered bank lending and credit growth slowed despite relatively low interest rates. The subdued inflation has enabled BSP to hold interest rates steady since July 2003, at the comparatively low levels of 6.75 per cent in the case of the overnight borrowing rate and 9 per cent for the overnight lending rate. However, interest rates on 91-day treasury bills, which fell from 8.9 per cent in December 2001 to 5.2 per cent in December 2002, drifted up to reach 6.5 per cent in November 2003 as political uncertainty persisted and fiscal slippage opened up the prospect of greater dependence on domestic capital markets for funding by the Government.

Higher taxes and charges contributed to a reversal of Singapore's 2002 deflation

Consumer prices in Singapore fell 0.4 per cent in 2002 but this deflation was turned around to modest inflation of 0.5 per cent in 2003. The increase in the goods and services tax to 4 per cent and higher electricity charges (owing to rising oil prices) put some upward pressure on prices but inflation remained relatively muted because of soft demand conditions. The outlook is for a marginally faster rise in consumer prices, by 1.1 per cent for 2004, as consumer demand strengthens and the second increase in the goods and services tax to 5 per cent occurs. However, an offsetting factor is that Singapore should also benefit from lower imported inflation as a result of its FTAs.

From the beginning of 2003, MAS has maintained a neutral policy stance, targeting zero appreciation in the trade-weighted nominal effective exchange rate. MAS lowered the midpoint of the band within which the exchange rate is permitted to fluctuate in July, however, effectively easing monetary policy. Combined with reduced demand for credit, this has permitted interest rates to remain below 1 per cent; the 3-month interbank rate declined from 0.81 per cent at the end of 2002 to reach a low of 0.63 per cent in June 2003, before rising somewhat to end the year at 0.75 per cent. The prime lending rate was stable at 5.30 per cent during 2003, slightly lower than the 5.35 per cent level in the previous year.

Inflation also remained low in Thailand in 2003, although it was up from the 0.7 per cent recorded in 2002. Headline consumer price inflation averaged 1.8 per cent, largely as a result of higher food and energy prices, but the upward pressures on prices were contained by a strong currency, increased domestic and foreign competitive pressures and a continuing margin of spare capacity. Core inflation, excluding food and energy prices, averaged 0.2 per cent in 2003 but was close to zero in the last four months of the year as housing rents declined on increased home ownership. Inflation was expected to pick up somewhat in 2004 as a result of strong economic growth and continued high food prices, but currency strength and lower import prices as a result of the country's FTAs are expected to moderate upward price pressures.

Consumers have benefited from lower interest rates and increased access to credit in Thailand

Monetary policy remained accommodative in 2003 as the Bank of Thailand (BOT) maintained the 14-day repurchase rate steady at 1.25 per cent in the second half of the year, after having reduced it to that level in June 2003 with a 50 basis point cut. The cut was motivated by a need to reduce interest rate differentials and head off upward pressure on the currency as global interest rates declined, as well as to support domestic consumption. Bank minimum lending rates in the second half of 2003 were in the 5.50-5.75 per cent range, down from 6.50-7.00 per cent at the end of 2002. Although corporate lending was reviving towards the end of the year, it remained subdued for much of 2003, with bank lending being directed mainly at consumers. Many businesses are choosing to rely on internally generated funds, as well as equity and bond financing, as a result of the lessons learned from the 1997 financial crisis.

Fiscal policy and public debt

In Malaysia, fiscal policy continued to be the main tool for economic stabilization. In particular, an additional stimulus package, amounting to M$ 7.3 billion and equivalent to 2 per cent of GDP, was introduced in May to counter the adverse effects of SARS and a weakening external environment. Partly as a result, the budget deficit was expected to widen to around 5.4 per cent of GDP, compared with an earlier target of 3.9 per cent and an actual deficit of 5.6 per cent in 2002 (table II.34). The federal Government's debt as a percentage of GDP has been on a rising trend, from 32 per cent in 1997 to 46 per cent in 2002 and 48 per cent in the third quarter of 2003. However, interest costs have remained low as liquidity in the banking system has been ample, partly because of the persistent sluggishness of private investment.

Fiscal policy has also been expansionary in Viet Nam, with the budget deficit widening from 3.5 to 4.8 per cent of GDP between 2002 and 2003, but the shortfall remained below the 5 per cent limit set by the Government. Public spending increased substantially in 2003, by 14.1 per cent, owing to higher wages and pensions for civil servants, the costs of recapitalization of State-owned banks and spending on infrastructure development. However, there has also been rapid growth in tax revenues, which in 2003 expanded by 11.3 per cent as a result of faster economic growth and improved tax administration and collection. The tax ratio is now around 22 per cent of GDP.

Despite some slippage during 2003, the fiscal deficit was contained in the Philippines

In the Philippines, the budget deficit was contained within the Government's revised target of 4.7 per cent of GDP for much of 2003; tax collections exceeded goals for the first time in seven years following sustained efforts to improve tax administration, while concerted and effective efforts were made to restrain expenditure. Despite some slippage

Table II.34. Selected South-East Asian economies: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Budget balance as a percentage of GDP				
Indonesia	–1.2	–2.8	–1.7	–1.9
Malaysia	–5.8	–5.5	–5.6	–5.4
Philippines[a]	–4.1	–4.0	–5.2	–4.6
Singapore	2.5	–1.8	–0.1	–0.6
Thailand	–2.2	–2.4	–1.4	1.2
Viet Nam[b]	–4.8	–3.8	–3.5	–4.8
Current account balance as a percentage of GDP				
Indonesia	5.3	4.9	4.2	3.7
Malaysia	9.4	8.3	7.6	6.2
Philippines	7.8	1.8	5.4	3.6
Singapore	14.5	19.0	21.5	30.8
Thailand	7.6	5.4	6.0	6.1
Viet Nam	2.1	2.1	–1.7	–5.1

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues; and web site of the Ministry of Finance of Singapore <www.mof.gov.sg/budget_2003/fiscal_overview/>, 21 November 2003.

Note: Data for 2003 are estimates.

[a] Including grants.
[b] Including on-lending.

in public spending towards the end of the year, the budget deficit for the full year was 4.6 per cent of GDP, still above what is considered to be sustainable. Central Government debt (mainly medium- and long-term in nature) has been rising in order to meet the deficit requirements and is now around 71 per cent of GDP.

The Indonesian budget deficit targeted for 2003 was revised upward somewhat, from 1.8 to 1.9 per cent of GDP. Revenues from the oil and gas industry rose as a result of higher oil prices; there was a slower increase in non-oil and gas revenues. Expenditure, including that on development projects, has lagged, owing in part to delays in the release of spending authority to project management units. Meanwhile, lower interest payments also helped to reduce public outlays. Fiscal consolidation will be given priority in 2004, with a planned budget deficit of only 1.2 per cent of GDP. Reforms in tax and customs administration should lead to greater revenue collections in the non-oil and gas sector and, on the expenditure side, expenditure on fuel subsidies should decline as a result of lower oil prices and the reductions in subsidies. As a percentage of GDP, public debt (almost half is of domestic origin) is projected to reach 67 per cent by the end of 2003, well below the post-crisis peak of 100 per cent. However, external financing requirements are projected to increase in 2004 as Indonesia's exit from the IMF loan progamme means that it will no longer be eligible for Paris Club debt relief. The Government intends to rely more heavily on domestic and foreign bond markets to meet its financing needs, as well as to draw down its deposits with the central bank.

Expansionary fiscal policies in Singapore and lower revenues, owing to the subdued economy, are expected to widen the government deficit in the fiscal year ending March 2004 to a projected 0.6 per cent of GDP, after recording a small budget deficit equal to 0.1 per cent of GDP the preceding year. In addition, two off-budget packages for SARS relief and to revive the construction industry in 2003, amounting to S$ 830 million, will likely increase the final deficit figure. The decline in revenues occurred despite an increase in the goods and services tax to 4 per cent in 2003; a further increase to 5 per cent is scheduled for early 2004.

Sustained, strong economic performance boosted government revenues in Thailand

A high level of economic production in 2002-2003 helped Thailand to record a budget surplus equivalent to 1.2 per cent of GDP in fiscal 2003, as against an originally targeted deficit of 3.3 per cent of GDP, the first surplus since the 1997 financial crisis. Among the contributing factors were strong revenue growth (as a result of higher incomes and expenditure), improved tax collections and falling debt-service costs. Government expenditure was only 90 per cent of the budgeted amount, in part reflecting savings from civil service reorganization. The Government announced a supplementary budget of 135.5 billion baht in November 2003 to eliminate a possible fiscal drag as tax revenues continued to increase sharply. The Government is working on a five-year plan to increase substantially investment in infrastructure, particularly on railways and roads, and on the construction of a new satellite city north of Bangkok. Total public debt amounted to 50 per cent of GDP in mid-2003, well below the Government's 60 per cent limit and down from 54 per cent of GDP at the end of 2002.

Foreign trade and other external transactions

External trade

Merchandise exports from Brunei Darussalam, about 28 per cent higher year on year in the first 6 months of 2003 (table II.35), rebounded sharply from the low rates of growth in 2001-2002. Oil and gas exports, mainly to Japan, accounted for nearly 88 per cent of the total, while garments, the other principal export, did not perform well in the face of intensifying competition from China and Viet Nam. Spending on imports was down by nearly 20 per cent year on year in January-June 2003

Table II.35. Selected South-East Asian economies: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	Exports (f.o.b.) Annual rate of growth (percentage)			
	2002	*2000*	*2001*	*2002*	*2003 (Jan.-Jun.)*
Brunei Darussalam	3 416	23.8	5.5	2.5	28.3
Indonesia[a]	57 159	27.7	−9.3	1.5	6.8
Malaysia[b]	93 281	16.1	−10.4	6.0	5.4
Philippines[c]	35 208	8.7	−15.6	9.5	1.0
Singapore	125 087	20.2	−11.8	2.8	15.4
Thailand[c]	66 800	19.5	−6.9	5.7	16.1
Viet Nam[d]	16 706	24.0	4.0	11.2	19.2

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003; Statistics Indonesia web site <http://www.bps.go.id>, 19 February 2004; Malaysia Economic Planning Unit web site <http://www.epu.jpm.my/bi/Stat/Kei/Ext2001.pdf>, 12 January 2004; Philippines National Statistics Office web site <http://www.census.gov.ph/data/sectordata/tsft.htm>, 13 January 2004; Bank of Thailand web site <http://www.bot.or.th/bothomepage/databank/EconData/Thai_Key/Thai_KeyE.asp>, 8 December 2003; Economist Intelligence Unit, *Country Reports* (London, EIU, 2004), various issues; and other national sources.

[a] Figures for 2003 are preliminary (the full year).
[b] Figures for 2003 refer to January-November.
[c] Figures for 2003 refer to January-October.
[d] Figures for 2003 are estimates for the whole year.

(table II.36), reflecting a levelling off in the demand for passenger cars. The deficit on the services account has been increasing although Brunei Darussalam's trade surplus remained substantial and there was also a surplus on the income account from investment income. Overall, the surplus on the external current account was estimated at $3.7 billion in 2002; it would likely be substantially higher in 2003. The country is actively pursuing FTAs with the United States and Japan.

Exports of garments and textiles from Viet Nam to the United States surged

After a fall of nearly 6 per cent year on year in the first half of 2002 was sharply reversed in the second, earnings on merchandise exports by Viet Nam were driven largely by an increase of 38 per cent in the value of exported garments and textiles in the first 11 months of 2003 to grow by 19.2 per cent for the full year. Garment and textile exports, 60 per cent of which go to the United States, accounted for approximately 18 per cent of total exports. Other manufactured exports also performed strongly, particularly computers and electronics products and footwear, which expanded 39 and 21 per cent respectively in January-November 2003 on an annualized basis. Commodity exports such as crude oil and rubber soared along with the strong growth in exports of coffee, cashews, wood products and seafood.

Table II.36. Selected South-East Asian economies: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Imports (c.i.f.) Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003 (Jan.-Jun.)*
Brunei Darussalam	1 635	7.4	−7.8	24.4	−19.7
Indonesia[a]	31 289	39.6	−7.6	1.1	3.5
Malaysia[b]	79 869	25.3	−9.9	8.1	−1.7
Philippines[c]	35 427	12.2	−4.2	7.2	5.0
Singapore	116 482	21.2	−13.8	0.4	8.8
Thailand[c]	63 400	31.3	−2.8	4.4	15.3
Viet Nam[d]	17 760	30.8	3.4	22.1	26.4

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003; Statistics Indonesia web site <http://www.bps.go.id>, 19 February 2004; Malaysia Economic Planning Unit web site <http://www.epu.jpm.my/bi/Stat/Kei/Ext2001.pdf>, 12 January 2004; Philippines National Statistics Office web site <http://www.census.gov.ph/data/sectordata/tsft.htm>, 13 January 2004; Bank of Thailand web site <http://www.bot.or.th/bothomepage/databank/EconData/Thai_Key/Thai_KeyE.asp>, 8 December 2003; Economist Intelligence Unit, *Country Reports* (London, EIU, 2004), various issues; and other national sources.

[a] Figures for 2003 are preliminary (the full year).
[b] Figures for 2003 refer to January-November.
[c] Figures for 2003 refer to January-October.
[d] Figures for 2003 are estimates for the whole year.

Spending on merchandise imports by Viet Nam was up by just over 22 per cent in 2002 and the estimated growth rate in 2003 was largely the same at 26.4 per cent. A strong expansion was recorded for all major categories of imports, including machinery, equipment and spare parts, which were up 48 per cent in value, and electronics, computers and parts, which soared 45 per cent. Imports of petroleum products went up by 19.4 per cent, in part reflecting higher oil prices, while the strong demand for vehicles was behind the 36 per cent expansion in imports of automotive kits and parts in January-November 2003. The merchandise trade deficit widened considerably to an estimated $4.3 billion in the same period, or 80 per cent greater than the deficit in the same period in 2002. As a result, the estimated current account deficit rose from 1.7 to 5.1 per cent of GDP between 2002 and 2003.

Booming exports of high-technology products and automotive vehicles and parts in Thailand

A significant increase in merchandise exports was recorded in the first 10 months of 2003 in Thailand; on an annualized basis, the value of exports jumped 16.1 per cent, up from 5.7 per cent for all of 2002. Of this growth, 6.6 per cent was attributable to an increase in export prices and 9 per cent to an increase in export volumes. High-technology exports, such as integrated circuits, and computers and parts, accounted for approximately 70 per cent of exports and grew particularly strongly; in particular, exports of integrated circuits increased nearly 30 per cent year on year in dollar terms in January-October 2003. Meanwhile, earnings on exported passenger cars and parts went up by over 56 per cent in the same period and other sectors that performed well in exporting were chemical products and rubber and rubber products. More traditional labour-intensive exports (such as garments, footwear and jewellery) also increased steadily in 2003 and earnings on them were somewhat higher than in the previous year. A robust expansion across the board was also registered by merchandise imports, totalling 15.3 per cent year on year in January-October 2003. Imports of intermediate goods and raw materials, particularly those used in the manufacture of capital goods, were up 17 per cent in the first 10 months of 2003 from the previous year, while consumer and capital goods imports increased 12.2 and 11.4 per cent respectively in the same period. Oil imports were higher by nearly 20 per cent, reflecting rising oil prices as well increased demand for oil.

The trade balance in the first 9 months of 2003 amounted to $3.4 billion in Thailand, or 57 per cent higher than in the same period in 2002. However, the services balance was badly affected by the SARS epidemic, falling from a surplus of $1.4 billion in the first quarter of 2003 to a deficit of $0.2 billion in the second, although it rebounded in the third quarter to a surplus of $1 billion, just under the $1.1 billion recorded in the third quarter of 2002. The current account balance was nevertheless healthy with a surplus of $5.6 billion in January-September 2003, or 19 per cent higher than the comparable figure in 2002. The surplus is estimated to reach 6.1 per cent of GDP in 2003, slightly above the 6 per cent figure of 2002.

Exports of high value added pharmaceuticals helped to compensate for weak earnings on electronics exports in Singapore

Although demand for electronics exports from Singapore remained weak in the first three quarters of 2003, this was offset to some extent by stronger demand for high value added pharmaceutical products and by an increase in the value of exported oil products. Overall, merchandise exports grew 15.4 per cent year on year in the first 6 months of 2003. Meanwhile, there was a pickup in import expenditure (by 8.8 per cent in the same period) although domestic and external demand, which affected intermediate goods imports, remained subdued. The trade surplus rose and, despite the problems that affected the travel industry, the service sector was also able to increase its surplus, helped by a recovery in entrepôt trade, transport and communications, travel and financial services. The current account balance as a percentage of GDP is estimated to improve to 30.8 per cent in 2003, compared with 21.5 per cent of GDP in 2002.

Indonesia’s export performance in 2003 was mixed. High commodity prices and increased demand from non-traditional markets, such as China, stimulated energy and agricultural exports but competition from China and Viet Nam in third-country markets for low-skill, labour-intensive manufactured products had a negative effect. The value of merchandise exports, up by 6.8 per cent in 2003, expanded faster than the annual growth of 1.5 per cent in 2002, mainly because of increased oil and gas exports. Earnings on non-oil and gas exports have remained weak. Notably, exports to China were estimated to have grown 32 per cent in 2002 and by as much as 60 per cent in the first half of 2003.

The current account surplus narrowed in Indonesia partly because service exports were hit by SARS and terrorism

Merchandise imports also rose at a faster rate in 2003, 3.5 per cent as against 1.1 per cent in 2002, as the rupiah and private consumption remained strong. However, machinery imports slumped. The merchandise trade surplus for the first 9 months of the year, estimated at $21.6 billion or 7 per cent higher than in 2002, helped to offset some of the decline in services exports as tourism fell. In particular, the Bali bombing and global fears about SARS caused tourist arrivals to fall to their lowest level in six years in April 2003. The subsequent revival was short-lived as the Marriott Hotel bombing saw arrivals falling again in the third quarter before picking up in the fourth. The current account surplus as a percentage of GDP has been on a declining trend since 2000, narrowing to 3.7 per cent in 2003.

In Malaysia, the decline in electronics exports during 2003 was partly offset by higher export earnings on chemical products, manufactured metals, agricultural commodities and mineral fuels. Electronic and electrical goods accounted for approximately 70 per cent of total exports and the electronics equipment and parts subsector was most affected by the intensified competition from China and soft global demand. Overall, merchandise export value grew 5.4 per cent in the first 11 months of 2003 while spending on merchandise imports was down by 1.7 per cent, reflecting weaknesses in domestic investment as well as in external export demand, as a large proportion of imports consisted of parts and components for export-oriented manufacture.[3] As a result, the trade surplus increased substantially to offset the deficit on the income and services accounts, the latter being affected by weak travel receipts. The current account surplus as a percentage of GDP has been narrowing in recent years, but was still large at an estimated 6.2 per cent in 2003.

Export earnings were lower than expected in the Philippines in 2003 despite signs of a revival in the third quarter. Weakness in the global electronics industry depressed demand for electronics exports, which make up around 60 per cent of the country's exports, while merchandise

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[3] There is, however, a caveat to be attached to recent trade data from Malaysia as export statistics have exhibited movements that do not correspond to production data or to data from export destinations. Part of the problem may be underreporting owing to a switch from manual to electronic recording and the matter is being investigated further by the authorities.

Weak export performance in the Philippines

exports were up by only 1 per cent year on year in the first 10 months of the year. Electronics exports fell 4.5 per cent year on year in January-September 2003 from a year earlier, and exports of apparel and clothing accessories were practically stagnant. By contrast, export earnings on machinery and transport equipment and on coconut products surged by 34-35 per cent in the same period. The stockpiling of raw materials, inputs and crude oil ahead of the anticipated war in Iraq contributed to higher import outlays in the first quarter, which then fell back subsequently as inventories were run down and the demand for imported inputs declined in line with weaker export performance. All in all, merchandise imports expanded 5 per cent year on year in the first 10 months of 2003. In order to increase revenues as well as protect domestic firms, import duties were raised on 464 manufactured goods, including pharmaceuticals, cosmetics, clothing accessories, shoes and wooden furniture. This represents a slippage on the import liberalization programme, under which tariffs were due to fall to 0-5 per cent at the beginning of 2004.

There was a substantial increase in the Philippine trade deficit, to $1.4 billion in the first three quarters of 2003 from $62 million in the same period in 2002. The net outflow on the services account also widened from $933 million to $1.1 billion in January-September of 2002 and 2003, reflecting lower travel receipts as well as higher imports of transport services. However, the continued growth in inward remittances from overseas workers, albeit at a slower rate than in 2002, boosted the income account and kept the current account in surplus by $1.9 billion in the first three quarters of 2003, less than the $2.6 billion in the same period in 2002. For the full year, the current account as a percentage of GDP is estimated to have slumped to 3.6 per cent in 2003, from 5.4 per cent in 2002.

Capital flows and exchange rates

FDI inflows have increased slowly and steadily in Viet Nam in recent years, amounting to just under $1.5 billion in 2003, slightly more than the $1.4 billion in 2002. Cumbersome administrative procedures and often non-transparent practices, a weak legal environment and the high costs of business services have been cited as factors preventing faster growth in foreign investment. Private remittances through formal financial channels have also remained relatively stable. Viet Nam has seen a high level of ODA commitments in 2000-2003, averaging around $2.5 billion each year, although the level of disbursements has been much lower because of delays in project implementation. In 2002, for example, only $1.6 billion in ODA was disbursed and this figure is expected to rise moderately to $1.7 billion in 2003. The dong averaged 15,516 per United States dollar in 2003, a depreciation of 1.5 per cent from the average value in 2002.

Higher FDI inflows in Thailand and slowing outflows of net portfolio investment as the stock market became South-East Asia's star performer

Thailand witnessed a rise in FDI inflows in 2003 largely as a result of reduced outflows; in the first three quarters of the year, for example, net FDI equalled $1.5 billion, well above the $1 billion recorded for the whole of 2002. Meanwhile, the net outflow of portfolio investment slowed down, becoming strongly positive in the fourth quarter as the stock market gained 130 per cent in 2003. However, there was a sharp widening of the deficit on the capital and financial account in the first 10 months of 2003 (to $6.8 billion), reflecting early repayments to IMF and other creditors as well as outflows associated with non-resident baht accounts. The cumulative balance of payments was still in surplus during the same period, albeit by only $34 million. The exchange rate appreciated during 2003, averaging 41.50 baht to the United States dollar, compared with 43 baht in the previous year and 44.48 baht in 2001. BOT acted to prevent a rapid appreciation of the baht by cutting its policy rate in June 2003 and subsequently permitting domestic institutional investors to purchase foreign-currency debt securities. However, concerns rose during the second half of the year about excessive speculation in the baht and borrowing by domestic financial institutions in baht from non-residents was limited in September. Further restrictions were introduced in October, when non-residents were prohibited from holding more than 300 million baht in onshore accounts while domestic financial institutions were also barred from paying interest on such accounts with a maturity of less than 6 months.

In Singapore, there was a very sharp increase in the net outflow in the capital and financial account in 2003 to S$ 44 billion from S$ 24-25 billion in 2001-2002. This was partly owing to an increase in the placement of funds overseas by non-financial institutions and individuals. Net portfolio outflows slowed, however, as the stock market gained 30 per cent in the course of the year. Notably, FDI inflows of S$ 10.2 billion in 2003 were well above the S$ 3.6 billion in 2002. There was a steady improvement in the overall balance-of-payments surplus during 2003 to S$ 11.8 billion, approximately 7.4 per cent of GDP, well above a surplus of 1.5 per cent of GDP in 2002.

A return of confidence reversed the depreciation of the Singapore dollar in the first half of 2003

MAS maintained its neutral stance towards the Singapore dollar during 2003, although it lowered the mid-point of the band within which the trade-weighted nominal effective exchange rate fluctuated. There was a marginal depreciation of the Singapore dollar against the United States dollar in the first half of the year. However, the restored local confidence following the ending of the SARS threat and the improving economic outlook contributed to some upward pressures on the exchange rate, with the Singapore dollar ending the year at S$ 1.70 to the United States dollar, as against S$ 1.74 at the end of 2002. The performance of the

Singapore dollar against regional currencies was mixed; it weakened against the Thai baht and the Indonesian rupiah but strengthened against the Philippine peso and the Malaysian ringgit, which was pegged to the United States dollar.

Inflows of FDI to Brunei Darussalam, at around $1 billion in 2002, almost doubled over the 2001 level, a sign of returning confidence in the country, which, meanwhile, has also been successful in attracting funds from the Middle East to its Islamic financial institutions, part of the new Brunei International Financial Centre. Total foreign assets, which in most years generate substantial investment income, were currently estimated at around $30 billion, down from $80 billion in the early 1990s, while official international reserves were estimated to be $423 million in 2002. The Brunei dollar is fully convertible at par with the Singapore dollar and moved in line with the latter during 2003.

Mixed performance of the ringgit against other currencies of the subregion

There was a net outflow on the capital account in Malaysia in the first half of 2003, with inward FDI decreasing in the first quarter but rebounding strongly in the second, while there was a rise in outward FDI and other investment from Malaysia. Net FDI, which had fallen from 4 to less than 0.5 per cent of GDP between 1997 and 2001, recovered somewhat to 1 per cent of GDP in 2002 and was expected to reach 1.2 per cent in 2003. Meanwhile, portfolio investment outflows slowed down along with a pickup of 38 per cent in the stock market over the year. The overall balance-of-payments surplus in the first half, at M$ 9.5 billion, was down from M$ 10.5 billion a year previously. The ringgit, which is pegged to the United States dollar, depreciated against other major currencies as well as against most currencies in the region particularly the Thai baht; however, it appreciated somewhat against the Philippine peso and the Singapore dollar.

There was also a slowdown in net private capital outflows from Indonesia during 2003, reflecting debt restructuring and increased inflows of portfolio investment as the stock market soared, gaining nearly 75 per cent over the year. In spite of large asset sales, net direct investment was in deficit in the first quarter by $2.7 billion, indicative of the still-unfavourable investment climate. Although FDI approvals were 3.7 per cent higher in the first 9 months of 2003 as compared with the same period in 2002, much of this modest rise was attributable to asset sales by the restructuring agency and approvals of new projects were still below levels of a year previously. The rupiah appreciated during much of 2003, driven by increased macroeconomic stability; there was an adverse but short-lived impact from the hotel bombing but the rupiah had stabilized to around Rp 8,500 to the United States dollar by the end of the year.

FDI and portfolio investment inflows were sharply down in the Philippines

FDI approvals by various official agencies in the Philippines fell 45 per cent in the first half of 2003 but were up by 38 per cent in the third quarter. However, the total FDI inflow reached only $68 million in the first 9 months of 2003, as against just over $1 billion in the same period a year earlier, as foreign companies delayed expansion plans owing to the slack economy. Even though the stock exchange was about 30 per cent up by the end of 2003 from the start of the year, portfolio investment flows were substantially down. Including large debt repayments by the Government and banks, the net outflow on the capital and financial accounts was $3.5 billion in the first 9 months of 2003, compared with an outflow of $3.7 billion in the same period in 2002. There was a reversal in the overall balance of payments, which was in deficit to the extent of $783 million in the January-September period, compared with a surplus of $751 million in the same period in 2002. Partly as a result, the peso touched a record low of P 55.85 to the United States dollar in November 2003 but firmed slightly to P 55.53 by the end of the year. Generally sound macroeconomic fundamentals in line with Government targets, support from BSP and an increase in foreign reserves have enabled the peso to withstand considerable political pressures and uncertainty.

External debt

In Singapore, total external debt (none of which was government debt) increased somewhat from 16.3 per cent of GDP in 2002 to 16.6 per cent in 2003. Total official foreign reserves have expanded rapidly, by 8 per cent in 2002 and a remarkable 17 per cent in 2003 to reach $96.3 billion. Singapore's long-term foreign-currency sovereign debt has the top rating of AAA/Aaa with a stable outlook and this was affirmed in 2003.

Lower external debt in several developing countries in South-East Asia

Thailand's total external debt declined from $67.5 billion to $59.5 billion between 2001 and 2002 and by October 2003 it was down to $52.3 billion, or approximately 40 per cent of GDP. Just under 80 per cent of the debt was long-term and around one third was public sector debt, which also dropped substantially at the end of July after BOT repaid outstanding credits incurred in the aftermath of the 1997 crisis to IMF and other central banks ahead of schedule. In addition, the Government announced that public sector entities would no longer be permitted to borrow externally from 2005. Meanwhile, total international reserves have continued to increase, reaching $42.1 billion in December 2003 (from $38.9 billion at the end of 2002), sufficient for around 7 months of imports and nearly four times outstanding short-term debt. Thailand's strong macroeconomic fundamentals and rising international reserves led to an upgrade by credit ratings agencies of its long-term foreign-currency sovereign debt to BBB/Baa1 with a stable or positive outlook.

External debt, most of it concessional, was 41.6 per cent of GDP in Viet Nam in 2002 and was projected to fall to 38.3 per cent in 2003. International reserves have been increasing steadily in recent years and amounted to $6.3 billion at the end of the third quarter of 2003, compared with $4.1 billion at the end of the previous year. Major ratings agencies left Viet Nam's long-term foreign-currency sovereign debt ratings unchanged at BB-/B1, although Fitch revised its outlook from positive to stable in November 2003 on concerns regarding the widening trade deficit and rapid domestic credit growth.

Total external debt in Malaysia was equivalent to 51 per cent of GDP at mid-year, thus slightly lower than the 51.4 per cent level at the end of 2002. The federal Government and non-financial public enterprises accounted for around 65 per cent of total medium- and long-term external debt. Gross international reserves, at $44.9 billion by the end of 2003 (compared with $34.6 billion at the end of 2002), were equivalent to 7.1 months of imports and 4.8 times short-term external debt. The long-term foreign-currency sovereign debt of Malaysia was upgraded in 2003 to A-/Baa1 with a stable outlook.

The Philippines was the only country in South-East Asia to suffer a ratings downgrade

In the Philippines, the total external debt amounted to $53.9 billion at the end of 2002 and expanded during 2003 to an estimated $57.9 billion by the end of the year, equal to around 71 per cent of GDP, following additional borrowing by the Government and BSP at the end of October. Both the Government and the central bank raised funds externally in advance of requirements to take advantage of lower interest rates. The increased gross international reserves, at $16.8 billion at the end of December 2003 compared with $16.2 billion at the start of the year, were equivalent to 4.7 months of imports and 2.8 times the level of short-term external debt. However, political uncertainties and delays in the date by which the budget is to be balanced were among the factors behind the downgrade to BB/Ba2, with a stable or negative outlook, in the long-term foreign-currency sovereign rating of the Philippines.

External financing requirements are set to rise following Indonesia's exit from the IMF programme

Indonesia's total public and private external debt outstanding was reduced to 70 per cent of GDP in September 2003, from a high of nearly 158 per cent in 1998. While the public sector component has tended to expand gradually, external debt of the private sector has fallen further and overall the Government aims to reduce foreign debt to below 60 per cent of GDP by 2005. However, external financing requirements are expected to rise by $3 billion in 2004 following Indonesia's exit from the IMF programme. Meanwhile, gross international reserves rose to $34.7 billion in 2003, from $31.6 billion in 2002, equivalent to 6 months of imports and over twice the level of short-term external debt. Market sentiment has remained broadly favourable despite several shocks over the past year, and the long-term foreign-currency sovereign rating for Indonesia was upgraded in the latter part of the year to B/B2 with a stable outlook. This will lower interest costs as the Government planned to issue a global bond to finance its budget deficit in 2004.

Key policy issues

Poverty and unemployment

Developing countries in South-East Asia have made good progress on poverty reduction, many of them having already met the first Millennium Development Goal of halving the level of extreme poverty between 1990 and 2015. On present trends, the percentage of the population expected to fall below the poverty line of one dollar (in terms of purchasing power parity) a day in 2015 is expected to be close to 0 in Malaysia and well below 1 per cent in Thailand and Viet Nam; it is projected to be relatively higher in Indonesia and the Philippines at 2.5 and 7.5 per cent respectively.

A decline in the incidence of poverty in Indonesia coexisted with high vulnerability and rising unemployment

Macroeconomic stability has helped to lower poverty to pre-crisis levels in Indonesia along with the falling prices of key goods in the consumption basket of the poor. The national poverty headcount index based on the poverty line of $1 a day was relatively low at 7.4 per cent in 2002 but vulnerability was high as 53.4 per cent of households fell below the $2 a day level. The national headcount index also did not reveal fully the wide disparities in poverty incidence across the country. The Government is working on the draft of a national Poverty Reduction Strategy Paper, in consultation with local governments, donor agencies, the private sector and civil society organizations in Indonesia. However, the relatively modest economic performance in recent years has had a limited effect on unemployment, which reached 8.5 per cent by February 2003, a percentage point higher than in 2002. Despite the high unemployment rate, minimum wages have been on the rise in real terms although the main beneficiaries appeared to have been industrial workers in formal employment in urban areas.

Unemployment has also been drifting upward in the Philippines as growth in manufacturing remained sluggish. The unemployment rate reached 12.7 per cent in the third quarter of 2003, up from 11.2 per cent in the same quarter a year earlier, before declining to 10.1 per cent in October as the pace of growth quickened and seasonal factors came into play. At the same time, underemployment is estimated to have declined from 20.7 per cent at mid-year to 15.7 per cent in October 2003. The national incidence of income poverty, using new methodology introduced in January 2003, was estimated at 34 per cent in 2000 but the incidence of poverty in rural areas was much higher, at 48.8 per cent, than in urban areas, at 18.6 per cent.

As a result of faster economic growth, both unemployment and underemployment have been falling in Thailand, with the former rate, which had peaked at 4.4 per cent in 1998, down to about 1.1 per cent in 2003, half its level in 2002. The latest socio-economic survey also indicated that the poverty headcount ratio fell to 9.8 per cent in 2002,

Unemployment fell sharply in Thailand and the incidence of poverty has fallen to below the pre-crisis levels

below the 1996 ratio of 11.4 per cent and finally reversing the increase in poverty in the wake of the 1997 financial and economic crisis. Much of the progress in poverty reduction has occurred in rural areas, particularly in the north-eastern region, the poorest in the country, where higher agricultural prices and increased off-farm employment have raised household incomes considerably. Recently introduced public programmes aimed at the grass roots, such as the One-Tambon-One-Product scheme, the Village Fund and debt relief for farmers, are likely to have contributed to poverty reduction, although their impact is not quantifiable as yet. The Government has also declared that it intends to eliminate poverty by 2009 and, in the process, a programme of self-registration of the poor was initiated in 2003, in which the poor were requested to identify the main causes of their poverty so that appropriate action could be taken at a later stage. Regional poverty reduction strategies are also being formulated. In addition, an asset capitalization scheme has been launched to enable financial institutions to recognize assets without title deeds, such as cultivation rights, for use as collateral against loans for the poor.

In Viet Nam, the number of people defined as being poor on the basis of a level of expenditure insufficient to ensure adequate food intake and a minimum standard of living had halved to 29 per cent from 58 per cent in 1993, according to the most recent survey of living standards undertaken in 2002. Food poverty fell even more sharply, from 25 to 11 per cent in the same period. Poverty reduction was broad-based but was particularly rapid in the Mekong and Red River deltas. Increased prices for agricultural commodities in 2002 and 2003 also helped to restore the real purchasing power of the people living in the rural areas of the country, estimated at 76 per cent of the total population, who had experienced a decline in real income in previous years.

The higher unemployment rate in Malaysia may reflect lower female mobility

Progress in poverty reduction has been steady in Malaysia despite the 1997 crisis with the proportion of people living on less than $2 a day falling from 11.6 per cent in 1996 to 4 per cent in 2002, after a small increase in 2001. Unemployment has been drifting upwards, however, and the official unemployment rate reached 4 per cent in the second quarter of 2003, up from 3.5 per cent at the end of 2002. One reason for this updrift could be that the majority of unemployed graduates in Malaysia are women who are less willing to move to other cities in search of work.

Although the employment situation in Singapore showed signs of improvement in 2003, the growth in job opportunities, mainly as a result of the post-SARS recovery in the service sector, was insufficient to offset the higher number of job seekers as new entrants to the labour force were joined by workers returning to the labour market. The average unemployment rate rose to 4.7 per cent in 2003, from 4.4 per cent in 2002. The subdued economy and the relatively high rate of unemployment have resulted in slow growth in wages and incomes in the private sector. In the public sector, meanwhile, the Government announced 20 per cent cuts in civil service rates of pay in November and a halving of year-end bonuses. Further cuts would be likely if civil service pay were to exceed private sector benchmarks.

Recent estimates put the unemployment rate at around 5.6 per cent in Brunei Darussalam and disguised unemployment may also be a problem. An estimated 5,000 youths enter the labour force each year but problems of skills mismatch as well as private sector weaknesses, public sector fiscal stringency and the inability of the energy sector to absorb more than 3 per cent of the workforce suggests that the solution to the problems of unemployment and underemployment will be complex and challenging.

Restructuring and strengthening the financial sector

The fall in NPLs in Indonesia may not be sustainable

The Indonesian Bank Restructuring Authority (IBRA) is optimistic that it will be able to dispose of 95 per cent of the assets on its books by the end of the year, with a recovery rate of 28 per cent, and will set up holding companies to manage the remaining assets after its dissolution in February 2004 so that the Ministry of Finance can complete the sale of these assets. In future, resolution of problem loans will rely more on market mechanisms, where the Government's programmes of legal reforms will be significant. NPLs in the banking system, not including those acquired by IBRA, declined to 8.3 per cent of total loans in September from their peak of 49.2 per cent in January 1998, partly as a result of the rapid growth of bank lending. However, some of the reduction in NPLs was the result of banks converting them into shares in unlisted and often financially distressed companies. The capital adequacy ratio for the banking system as a whole was 23 per cent in June 2003 but credit assessment is still weak and banks remain reluctant to lend. Bank Indonesia's regulations have been upgraded in recent years and are now in line with international norms but enforcement and supervision issues remain, especially with regard to State-owned banks. In September, the law on money laundering (adopted in 2002) was amended in a step towards meeting Indonesia's international commitments in this area, and the Financial Action Task Force of OECD was to review the country's current blacklisted status in February 2004. Established in October 2003, the Financial Transaction and Report Analysis Center, or Financial Intelligence Unit, is to be the watchdog in this area.

Indonesia's banking industry will be further consolidated by 2014 under a national banking structure programme, launched by the central bank in January 2004, seeking to incorporate higher standards of capital adequacy, good governance and effective banking supervision in line with the Basel principles, among other things. Although the financial crisis sharply reduced the number of banks from 220 to 138, this number is considered to be still too many and the aim is to create a structure with two or three international banks, with capital exceeding Rp 50 trillion, and three to five national banks, with capital between Rp 10 and 50 trillion. The phasing out of the blanket guarantee on bank deposits and claims introduced in the aftermath of the financial crisis, which is due to commence in 2005, will provide an additional impetus to consolidation.

Consolidation in the banking industry in Malaysia improved capital adequacy

The risk-weighted capital adequacy ratio of the Malaysian banking system was 13.4 per cent in December 2003, a slight increase from the end of 2002. Progress has been largely a consequence of consolidation into 10 financial groups, with the number of banks being halved from 60 before the crisis to 30 at present. Reforms have also been initiated to consolidate the insurance and stock-brokerage industries to create larger and more diversified firms. The net NPL ratio (3-month basis) of the banking system declined to 8.9 per cent at the end of 2003, from 10.2 per cent at the end of 2002, mainly owing to new lending. Danaharta, whose mandate ends in 2005, has plans to recover or restructure all outstanding loans on its portfolio and is targeting a recovery rate of 58 per cent.

Although liquidity has been ample in the banking system in the Philippines, credit growth is being hampered by the NPL problem, with the NPL ratio at 14.5 per cent in September 2003, slightly better than the 15 per cent ratio at the end of 2002. BSP is planning to introduce several measures to limit risky lending. One Special Purpose Vehicle (SPV) has been set up so far, following the enactment in January 2003 of the law permitting banks to transfer NPLs to specially designed private sector asset management corporations or SPVs. Commencing in April 2003, banks have a two-year period in which to transfer NPLs to privately funded and independent SPVs, and banks have indicated that they may transfer as much as 50 per cent of such assets. The banking system overall had a risk-weighted capital adequacy ratio of 16.6 per cent at the end of 2002. Following the threat of sanctions by the OECD Financial Action Task Force, the anti-money laundering legislation was amended to correct perceived deficiencies.

The number of NPLs remains high in Thailand and new and re-entry NPLs have been rising

Thailand has made considerable progress in restructuring the financial sector but the volume of NPLs remains high and the number of new and re-entry NPLs has been on a rising trend. Resolution of the NPL problem is of considerable importance as the problem is thought to have played a role in the slow recovery of investment and of bank credit to businesses. At the end of the second quarter of 2003, NPLs of commercial banks amounted to 15.9 per cent of total loans. Much of the reduction in NPLs has been achieved by transferring non-performing assets to the Thai Asset Management Corporation (TAMC), which had restructured around 610 billion baht of the 761 billion baht of assets transferred to it by August 2003 at a recovery rate of 45 per cent. Most of the remaining NPLs concerned SMEs and were due to be cleared by the end of 2003. However, of 795 debt-restructuring cases before TAMC, only 294 had been signed by the debtors and, of this total, two thirds were still some way from a final settlement. Recently, the Government launched a 10-year mutual fund, known as Vayupak, that will pay a guaranteed 3 per cent return and the proceeds of which will be invested in companies in which the Ministry of Finance is a shareholder, thereby assisting in financial and corporate restructuring. However, the launch of the fund did not meet with the hoped-for success.

In January 2004, the Government approved a financial sector master plan that is to guide the development of the financial sector in the next 5-10 years. The plan has three aims: first, to broaden general access to financial services, particularly at the grass-root levels so as to benefit low-income households; second, to increase the efficiency of the financial sector, principally through bank consolidation to create a few large, full-service banks and smaller banks with more restricted services; and lastly, to increase consumer protection. Compliance with the revised Basel Capital Accord is likely to be achieved by 2006 and this could necessitate an increase in the risk-weighted capital adequacy ratio of commercial banks to 12.5 per cent from the current 8.5 per cent required by BOT. Also in January 2004, trading in corporate bonds of listed companies began on the Bond Market Exchange, enhancing liquidity for those companies which can tap the bond market and greatly improving pricing transparency. The exchange's electronic trading system and the efficiency of its clearing and settlement mechanisms will encourage participation by retail investors and facilitate the development of bond markets in the region.

The pace of restructuring has been slow in Viet Nam and the banking sector remains fragile

The pace of reforms of State-owned enterprises (SOEs) and the banking sector has been relatively slow in Viet Nam. During 2003-2005, some 3,000 SOEs are scheduled for restructuring, with 1,640 in 2003 alone, but only 286 SOEs had been restructured in the first half of the year, with 163 being equitized. Meanwhile, the fragile banking sector remained a major concern but important reforms are under way to improve the legal framework and strengthen supervision and to ensure that State-owned and private banks compete on an equal footing. The four largest State-owned banks have become the focus of efforts to resolve the NPLs on their books and bring management techniques up to international standards as part and parcel of the recapitalization process. New regulations are also being drafted to govern activities related to the stock market.

Fiscal consolidation

The additional fiscal stimulus measures announced in Malaysia in May 2003 have pushed the Government's target date for a balanced budget to 2006; the fiscal deficit is to be limited to 3.3 per cent of GDP in 2004 to avoid crowding out private investment, however. The 2004 budget aims to transform the economy from being FDI-driven to one where private sector expenditure, including on capital formation, provides the principal impetus for growth along with the gradual downsizing of the Government's role in sustaining domestic economic activities. Development expenditure, particularly on educational facilities, will be sharply cut together with the postponement of a railway project. Higher revenue collections are expected with faster growth, and there will also be a heavier reliance on indirect taxation. The Government's investment arm has commenced disposing of its shares in Malaysian companies to take advantage of the return of stock market strength.

Greater revenue generation is crucial for fiscal sustainability in the Philippines

Structural reforms are needed for fiscal sustainability in the Philippines, particularly in the tax system, as the current strategy of reducing the deficit by cutting expenditure on public services may be counterproductive in the long run if capital spending becomes insufficient to maintain and improve infrastructure. The Government postponed its target date for a balanced budget from 2006 to 2009 following the deterioration in public finances in 2002. Revenue generation was at the heart of the problem, caused by the confluence of weak governance in the bureaucracy, corporate tax evasion, complex tax regulations, poor tax assessment and collection systems and a narrow tax base that was excessively reliant on manufacturing. The ratio of tax revenue to GDP is still more than 4 percentage points below the 1997 level and, in response, the Government has initiated several measures to strengthen tax administration, assessment and collection. Additionally, efforts will be made to index excise taxes, improve value added tax and rationalize fiscal incentives for investment.

Fiscal consolidation received a strong boost from the 2002-2003 recovery in the Thai economy; the projected budget surplus in fiscal 2003 has led to a forecast balanced budget in fiscal 2004, well ahead of the original target date of 2008. However, the costs associated with assisting and compensating farmers affected by the cull of diseased birds following the outbreak of avian influenza in early 2004 are expected to amount to around 3 billion baht. Another matter of concern is that many of the Government's recent stimulus measures have been of a quasi-fiscal nature and based on credit from State-owned banks and specialized financial institutions, with possible implications for the medium-term strength of the fiscal position. IMF estimates in mid-2003 indicated that the total cost of initiatives implemented between fiscal 2002 and fiscal 2004 was 5.5 per cent of GDP; some of these initiatives, such as the Village Fund and debt relief for farmers, have now been incorporated into the budget.

Sustaining future growth

Enhancing skills, improving competitiveness and attracting FDI are key to growth in the medium and long terms

Several of the developing economies in South-East Asia are grappling with the problem of sustaining growth in the medium and long terms in an environment of increasing competitive pressures, fast-changing and more sophisticated market demands and rapid advances in ICT. Achieving greater integration within ASEAN (box II.4) is one way forward. Persistent weaknesses in domestic private sector investment and slower FDI inflows have added urgency to the issue. Economic and structural diversification has been a perennial concern in Brunei

Box II.4. The proposed ASEAN Economic Community

ASEAN leaders issued the Declaration of ASEAN Concord II (also known as Bali Concord II) at the Ninth ASEAN Summit held in Bali, Indonesia in October 2003. The Bali Concord foreshadows the establishment of an ASEAN community comprising three mutually reinforcing pillars: political and security cooperation, economic cooperation, and socio-cultural cooperation. Among the three, the ASEAN Economic Community (AEC) has attracted the most attention, with interest focused on the reasons for its establishment and the feasibility of its realization by the target date of 2020.

In the years since the 1997-1998 financial crisis, ASEAN has had to face intensifying competitive pressure from increased globalization and advances in ICT. Its position on the world and regional stages has, to some extent, been overshadowed by the emergence of China and, more recently, India as alternative growth poles with large, integrated markets. According to UNCTAD, ASEAN was able to attract only $14 billion in FDI in 2002, less than 2 per cent of the world's total and well below the 7 per cent channelled to it before the crisis. In comparison, FDI flows to China have been on a rising trend and reached 8.1 per cent of the total in 2002.

AEC, which is to be an economic region with a free flow of goods, services, investment and skilled labour and a freer flow of capital, is viewed as being the end goal of economic integration as outlined in the ASEAN Vision 2020. It will enable ASEAN to become not only a unified market, with a population of over 500 million, a combined GDP of approximately $737 billion and total trade of over $720 billion in 2002, but also a unified production base that will increase efficiency and lower costs. A study by McKinsey and Company, commissioned by ASEAN, on the subregion's competitiveness forecast that a fully integrated economy could raise its GDP by 10 per cent, while reducing its operational costs by 10 to 20 per cent.

Although ASEAN has many of the building blocks for closer union in place, such as the ASEAN Free Trade Area (AFTA), the ASEAN Framework Agreement on Services (AFS) and the ASEAN Investment Area (AIA), it is still far from being an integrated market. The share of intra-ASEAN trade in the total trade of the grouping rose from 21.1 per cent in 1993 to peak at 25 per cent in 1996 but fell back to just under 23 per cent in 2001. It has also been estimated that only around 1 per cent of total ASEAN trade, or less than 5 per cent of intra-ASEAN trade, falls under the Common Effective Preferential Tariff of AFTA. This rather limited ratio is attributable to the high costs of compliance with rules of origin and the fact that most members of ASEAN have reduced most-favoured-nation (MFN) tariff rates along with the AFTA rates. As pointed out by Singapore Prime Minister Goh Chok Tong, the original proponent of AEC, only 18 per cent of personal care products and 5 per cent of food are currently sourced within ASEAN, whereas the corresponding figures for the EU are 50 and 25 per cent. As an additional example, he indicated that to bring a new pharmaceutical drug to market in ASEAN, a manufacturer needs the approval of 10 health authorities and a bewildering array of non-tariff barriers and product standards impede the freer flow of trade.

To achieve the goal of closer integration, ASEAN intends to strengthen the implementation of measures under existing agreements. Under AFTA, the six founding members of ASEAN are committed to implementing zero tariffs by 2010 and the newer ASEAN members have advanced their deadline for doing so from 2018 to 2015 for most products. ASEAN members of Asia-Pacific Economic Cooperation (APEC) will also implement zero MFN tariffs by 2020, and under AIA there will be a free flow of investments within ASEAN as well as globally by that date. Thus, full implementation of the existing arrangements will lead to a free flow of goods and investment by 2020, not only within the grouping but also multilaterally. The next logical step would be to move towards a common external tariff, liberalization of trade in services and a free flow of labour and capital.

The High-Level Task Force on ASEAN Economic Integration issued its recommendations at the same time as Bali Concord II, setting out numerous, time-bound initiatives, many of which are to be completed within the next two years. These include improvements in the rules of origin to be completed by 2004 and the removal of non-tariff measures judged to be barriers to trade by 2005. Customs procedures are to be unified and mutual recognition arrangements completed by 2004-2005 in five priority sectors, electrical and electronic equipment, cosmetics, pharmaceuticals, telecommunications equipment and prepared foodstuffs, with more general harmonization of product standards at a later date. Mutual recognition arrangements in major professional services are to be completed by 2008, and the implementation of AFS and AIA speeded up and given greater priority. Cooperation on, and enforcement of, intellectual property rights will be extended by 2004 and capital mobility facilitated by the implementation of the Road map for the Integration of ASEAN in Finance. Eleven priority sectors, wood-based

(Continued overleaf)

(Continued from preceding page)

products, automotives, rubber-based products, textiles and apparel, agro-based products, fisheries, electronics, e-ASEAN, health care, air travel and tourism, are to be fast-tracked for vertical integration and a network of free-trade zones is to be established. Visa requirements will also be liberalized and harmonized.

It seems clear that the proposed economic community will be more of an “FTA+” arrangement by the target date, with a zero-tariff AFTA combined with some elements of a common market such as the free movement of capital and skilled labour. Such arrangements are a reflection of the different levels of development, economic structures and degrees of openness of ASEAN member States that make the formation of a customs union, with a common external tariff, very difficult to achieve by 2020. Similarly, complete freedom of movement of natural persons and of capital, necessary for a common market, and the harmonization of monetary, fiscal and other economic policies and the creation of a common currency, as required for a full economic union, are still some way in the future. A “two-tier” process of integration is considered to be inevitable, but care will be taken to ensure that the newer members of ASEAN are not left too far behind as that could damage the cohesiveness of the grouping. The work plan for implementation of the Initiative for ASEAN Integration (IAI), launched in 2000 and designed to narrow the gap between older and newer members, is to be given renewed attention. In addition, to permit greater flexibility so that member countries ready to do so can implement the deadlines by an earlier date, a “2+X” arrangement, rather than the more demanding “ASEAN-X”, has been put in place. Singapore and Thailand have already initiated moves to take advantage of this provision.

Finally, the High-Level Task Force has recognized the need for institutional strengthening within ASEAN and in this regard the experience of Europe is instructive; the European Commission and the European Court of Justice were formed at a comparatively early stage in the process of European integration. To this end, a legal unit will be established within the ASEAN secretariat for advisory purposes; the ASEAN Consultation to Solve Trade and Investment Issues will be set up for the quick resolution of operational problems and an ASEAN Compliance Monitoring Body will also be formed, in addition to an enhanced ASEAN Dispute Settlement Mechanism for more effective adjudication of disputes. Given the dense agenda before it, the need for strong political will and sustained effort by ASEAN to achieve concrete results in subregional integration cannot be underestimated.

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Darussalam, where the oil and gas sector accounted for approximately 89 per cent of total exports and 87 per cent of government revenues in 2002. The projected decline in energy reserves, together with higher unemployment, persuaded the Government to commission the Monitor Group in February 2003 to evaluate the country's competitiveness and its ability to attract FDI. Among the problems identified were a slow process in government decision-making, an underdeveloped private sector and the absence of an entrepreneurial culture. Meanwhile, the comparative strengths in the country were identified as political stability, a high-quality education system and ample Government revenues from the oil and gas sector. The reforms suggested thus included an expansion in private sector participation in public enterprises and clearer rules and regulations governing FDI. It was also suggested that the country focus on key private sector activities, rather than on extensive diversification as such, with the possible candidates being "niche" tourism (for ecological, sport and health and medical reasons), financial and business development services (including ICT) and transport, including aircraft maintenance.

Indonesia's White Paper sets out a time-bound programme of reforms

Indonesia's decision in August 2003 not to renew the IMF-supported programme was broadly welcomed by the markets as it was based on strong improvements in the domestic macroeconomic situation and the consequent reduction in external vulnerability. The Indonesian authorities now face the challenge of maintaining investor confidence through the continuation of sound policies, strengthening of the investment climate and collaboration with IMF through post-programme monitoring. The Government issued its "Economic Policy Package Pre and Post-IMF Program", known as the White Paper, as a presidential instruction in September 2003, in which it committed itself to a time-bound action plan for policy implementation after its exit from the IMF programme. A separate instruction of the Governor of the central bank regarding monetary policy was also issued at the same time. The White Paper envisages reforms in the macroeconomic, financial and real sectors aimed at raising and sustaining high levels of investment, exports and employment. It addresses the main impediments to investment, including legal and governance reforms, rationalization of labour laws, issues related to decentralization and security against terrorism and crime. Initial progress has been encouraging, with the timely (and, in some cases, earlier) completion of a substantial majority of the actions scheduled to be carried out in 2003. The World Bank has decided to resume lending to Indonesia following the publication of the White Paper and the country will in return establish an anti-corruption commission and strengthen government procurement methods. The Bank intends to integrate governance and corruption issues throughout its programme.

On 30 October 2003, the Government of Malaysia presented its mid-term review of the eighth Malaysia plan of 2001-2005. Despite the downward revision of the original growth targets, which had not been met in part as a result of regional and global economic shocks, the mid-term review reaffirmed the Government's current policy and aims, principally to reach developed country status by 2020. A crucial assumption is the future strength of investment, as the investment rate has not returned to pre-crisis levels in Malaysia despite the growth in public investment in the six years since the crisis; fiscal prudence necessitated a gradual fall in public investment set at 4.2 per cent annually in 2004-2005. Under the circumstances, the target for private investment growth envisaged in the mid-term review is relatively high at 11.8 per cent per year; private investment had fallen by 10.8 per cent annually on average during 2001-2003, as against a projected rise of 19 per cent per year. A recent study by the World Bank indicated that private investment has been constrained by a significant regulatory burden, inadequate development of key business-support services, severe and persistent skills shortages, as reflected, for example, in the high wage premium for tertiary-education graduates, and insufficient technological capability, which hinders innovation.

Malaysia's "brain gain" programme aims to improve science and technology skills

The Government is aware of all these concerns and, in attempting to transform Malaysia into a knowledge-based economy, aims at attracting "quality" FDI, among other things. In order to revive investment, following the mid-term review, the regulatory burden is to be eased, with rules governing company and property ownership by foreigners to be relaxed, and the central bank is lifting capital controls which directly limit the operations of foreign banks and multinationals. Malaysia also plans to boost the skilled labour force by increasing the ratio of researchers and engineers fivefold by 2010, from the current ratio of 15 to 75 per 10,000 workers. Research infrastructure and tax and other incentives will be provided under Malaysia's "brain-gain" programme to attract qualified and talented Malaysians overseas to return home as well as to ensure a balanced mix of science and technology workers. At the same time, the financial sector is to focus on providing support for domestic investment in productive economic sectors, with particular attention being given to SMEs, which are viewed as the principal catalyst for domestic investment. The privatization programme will continue with a focus on projects with strong spillover and multiplier effects while aiming to increase the total equity holding of the *bumiputera* in the economy to 30 per cent.

The manufacturing sector in Singapore has not received the same boost from the recovery in global IT industries as in previous cycles, partly because of the relocation of lower-end electronics production to China and other lower-cost producers in the region. Hence, responsive steps are being taken to move up the value chain and remain integrated in regional production networks, of which China and India seem to be the new centres. The process is being effected by strengthening trade linkages, including through FTAs and RTAs, with those countries and other markets with considerable growth potential.

The Economic Review Committee, set up at the end of 2001 to rethink development strategies, reported in February 2003 with detailed recommendations on actions to be taken on several fronts to make

Singapore aims to move up the value chain and become a key node in the global economic networks

Singapore a truly globalized, entrepreneurial and diversified economy. These recommendations will form the basis for economic policies in the medium and long terms as Singapore seeks to position itself as a key node in the global economic networks. In the process, the financial sector is to be developed further so as to facilitate the supply of risk capital to entrepreneurs. At the same time, a balance will be maintained between manufacturing and services although more growth engines as well as the formation of new companies will be encouraged. Training and retraining will be offered to produce qualified workers for jobs which are knowledge-intensive or require high levels of technical and inter-personal skills. Of immediate concern, however, is the need to maintain Singapore's competitiveness and lower business costs in order to attract more investment from both domestic and external sources and reduce unemployment. To this end, action is being taken on taxation, pension contributions, land and other business costs, while offsetting any consequent decline in consumption, and on policies towards foreign workers

Thailand's success in achieving rates of growth not seen since the 1997 financial crisis has attracted a great deal of attention, and not just in the region. The dual-track approach, relying on both domestic and external demand stimuli, was considered to be something of a novelty. However, signs of asset-price inflation and the re-emergence of speculative behaviour in the markets for luxury condominiums and stocks have generated concerns that another bubble may be in the making; in consequence, measures have been taken to restrain mortgage lending and day trading. Concerns have also been voiced about rising debt levels among households not just because the incidence is particularly apparent at the lower end of the income scale; much of the increased borrowing has gone to finance purchases of consumer durables, mobile phones and motorcycles, as well as property. The ratio of debt to disposable household income, approximately 51 per cent in 2002, is likely to have increased further in 2003 although this is considered to be manageable and low in comparison with neighbouring countries. However, a rise in interest rates in the future could increase the risk of default.

A strategic framework under way for implementation in Thailand

The National Competitiveness Committee has started promoting industries such as fashion, agriculture, ICT, automotives and high value added services; it intends as well to strengthen the SME sector and build institutions charged with promoting national competitiveness. Additionally, Thailand is to become the tourism capital of Asia and Bangkok is to be developed into a fashion capital. The Automotive Institute has received funds to improve productivity in the vehicles and parts sector through the development of skills and testing systems, again with particular attention to SMEs. A venture capital fund has also been set up to strengthen SMEs both financially and managerially while a national competitiveness institute is being set up to focus on formulating future strategies to improve the competitiveness of Thailand.

B. Least developed countries in the subregion

Overview

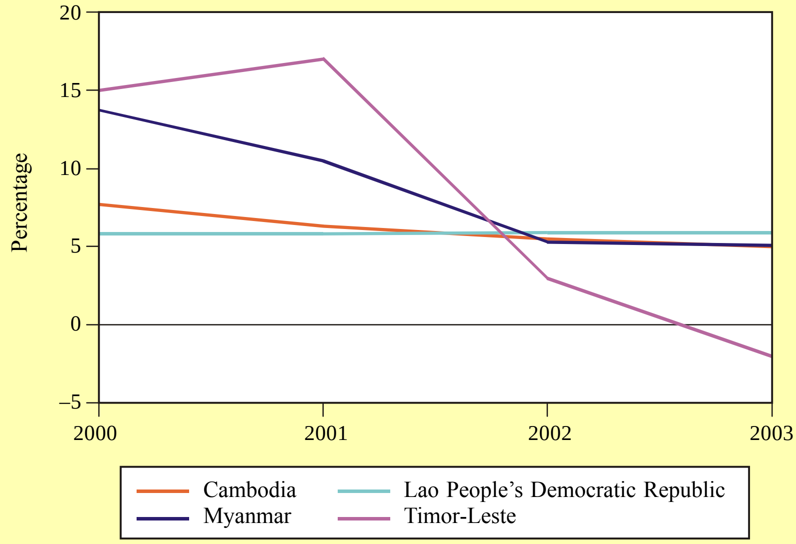
Poverty in the four least developed countries coexisted with the relative prosperity in the rest of South-East Asia

Cambodia, the Lao People's Democratic Republic, Myanmar and Timor-Leste are much less developed than the rest of the South-East Asian subregion, especially in terms of human resources, institutional development, the science and technology base and overall economic development (box II.5). While the three countries in the Greater Mekong Subregion are members of ASEAN, they have yet to complete a full transition to market-based economic systems. Meanwhile, in Timor-Leste, the fiftieth least developed country, reconstruction efforts over the past three years have focused on the development of basic institutions for economic management and recovery; the initial steps have been taken in addressing the economic and social development challenges facing the country.

Economic growth in 2003 was generally at a slower pace in the least developed countries of South-East Asia, although the pace of economic expansion in Cambodia and the Lao People's Democratic Republic was only marginally more subdued than in 2002 (figure II.31).

Figure II.31. Rates of GDP growth in the least developed countries in South-East Asia, 2000-2003

Cambodia, Lao People's Democratic Republic, Myanmar and Timor-Leste



Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

Box II.5. Least developed countries in Asia and the Pacific

The triennial review was conducted in 2003 to determine countries to be added to or graduated from the list of least developed countries. In this exercise, the Committee for Development Policy based its identification of these countries on the three dimensions of a country's state of development, namely, income level, stock of human assets and economic vulnerability. Gross national income (GNI) per capita was used as the indicator of income, the Human Assets Index (HAI) as the indicator of the stock of human assets and the economic vulnerability index (EVI) as the indicator of economic susceptibility.[a] In addition, no country with a population exceeding 75 million was considered for addition to the list. The results based on the eligibility indicators for 14 least developed countries in the Asian and Pacific region are summarized in the table below.

Criteria used in determining eligibility for least developed country status

	Population 2002 (millions)	*Per capita GNI (US dollars)*	*HAI*	*EVI*	*EVI (modified)*		*Population 2002 (millions)*	*Per capita GNI (US dollars)*	*HAI*	*EVI*	*EVI (modified)*
Afghanistan	23.3	523	11.6	50.1	49.0	Maldives	0.3	1 983	65.2	33.6	37.5
Bangladesh	143.4	363	45.3	22.9	29.5	Myanmar	49.0	282	60.0	45.4	45.6
Bhutan	2.2	600	40.4	40.6	41.0	Nepal	24.2	240	47.1	29.5	31.0
Cambodia	13.8	263	44.5	49.7	48.1	Samoa	0.2	1 447	88.8	40.9	50.8
Kiribati	0.1	923	67.5	64.8	60.4	Solomon Islands	0.5	657	47.3	46.7	49.1
Lao People's						Timor-Leste	0.8	478	36.4	n.a.	n.a.
Democratic						Tuvalu	0.01	1 383	63.7	70.3	67.3
Republic	5.5	297	46.4	43.9	43.4	Vanuatu	0.2	1 083	57.4	44.5	46.4

Sources: *Official Records of the Economic and Social Council, 2003, Supplement No. 13.* (E/2003/33).

Notes: Thresholds for inclusion in the list of least developed countries are population less than 75 million; a three-year average (1999-2001) per capita GNI less than $750; HAI less than 55; and EVI greater than 37. A country must meet all three criteria for inclusion. Thresholds for graduation from the list of least developed countries are a three-year average (1999-2001) per capita GNI greater than $900; HAI greater than 61; and EVI of less than 33. A country must achieve at least two of the criteria for graduation. The modified EVI includes the percentage of population displaced by natural disasters as a supplement to the data on the instability of agricultural production and has a threshold of greater than 38 for inclusion and less than 34 for graduation.

Since the establishment of the list of least developed countries in 1971, Bangladesh, Cambodia, Kiribati, Myanmar, Solomon Islands, Tuvalu and Vanuatu have joined the original six least developed countries in the Asian and Pacific region. In addition, the Committee for Development Policy recommended the inclusion of Timor-Leste in the list in 2003. Clustered in South Asia, South-East Asia and the Pacific, the 14 least developed countries in the region vary widely, with four landlocked countries and seven island developing countries among them.[b]

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[a] HAI reflects (a) nutrition, measured by the average caloric consumption per capita as a percentage of the minimum requirement; (b) health, as measured by the under-five child mortality rate; and (c) education, measured by (i) the adult literacy rate and (ii) the gross secondary school enrolment rate. EVI reflects structural economic vulnerability through an average of five indicators: (a) merchandise export concentration; (b) instability of export earnings; (c) instability of agricultural production; (d) share of manufacturing and modern services in GDP; and (e) population size.

[b] The least developed countries on the original list are Afghanistan, Bhutan, the Lao People's Democratic Republic, Maldives, Nepal and Samoa. Afghanistan, Bhutan, the Lao People's Democratic Republic and Nepal are landlocked, while Kiribati, Maldives, Samoa, Solomon Islands, Timor-Leste, Tuvalu and Vanuatu are island developing countries.

(Continued overleaf)

(Continued from preceding page)

Among the 50 least developed countries in the world, Bangladesh is the largest in terms of population while Tuvalu is the smallest. Bangladesh and Myanmar account for nearly three quarters of the total population of the least developed countries in the region, resulting in a larger population, on average, in the least developed countries in Asia than those in other regions. During the period 1990-2000, the per capita GDP of the least developed countries in Asia and the Pacific increased, on average, by one and a half times while exports more than tripled. The average adult literacy rate increased from 60 per cent in 1990 to 71 per cent in 2000, life expectancy rose from 58 to 62 years while the infant mortality rate declined from 77 to 55 (per 1,000 live births).

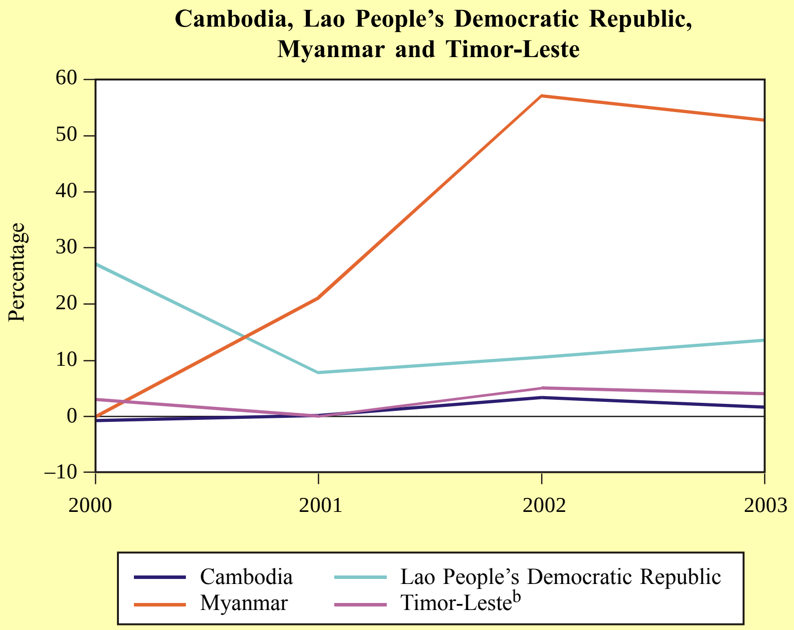
The per capita GNI and HAI of a number of island least developed countries surpass the income and HAI threshold for graduation. Yet these island least developed countries still need special consideration owing to their small population base and, more important, their high economic vulnerability. These island economies have small, dispersed populations, are located away from the major growth centres and are extremely vulnerable to external shocks and natural disasters. As a result of their limitations in terms of human capital, economic diversification and infrastructure, coupled with their external debt burden and the decrease in ODA, these countries are among the weakest economically.

Despite the recovery in agriculture and a rise in garment exports, civil unrest and a decline in investment in early 2003 were expected to temper growth in Cambodia in the year. Additionally, there was a fall in tourist arrivals with adverse ripple effects in the tourism sector and related activities in both Cambodia and the Lao People's Democratic Republic. Exports of hydropower from the latter country and of natural gas from Myanmar and Timor-Leste continued to be important, while the Government's emphasis on fostering agricultural production contributed to growth in Myanmar. In Timor-Leste, the contraction in business activities was attributable to a winding down of the international presence; it underscored the importance of strengthening local production activities and employment opportunities while maintaining a stable macroeconomic environment.

The least developed countries in South-East Asia have relatively small and open economies and are heavily dependent on agriculture, including for subsistence. Indeed, because of the large share held by food in the consumption basket, poor agricultural production in Cambodia and Timor-Leste contributed to a rise in consumer prices in 2003 (figure II.32). Inflation was trending upward in the Lao People's Democratic Republic, reflecting, in part, a relatively strong rise in the broad money supply in the year. Consumer prices in Myanmar continued to rise although inflation was stabilized at a high level in 2003.

Trade performance improved in 2003, with higher export earnings in Cambodia and the Lao People's Democratic Republic over the previous year (figures II.33). There was also a strong expansion of spending on imports in these two countries import expenditure fell sharply in Myanmar and Timor-Leste between 2002 and 2003 (figures II.34). As in Bangladesh,

Figure II.32. Inflation[a] in the least developed countries in South-East Asia, 2000-2003



Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues; and IMF, *Country Report No. 03/227* (Washington, IMF, July 2003).

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.

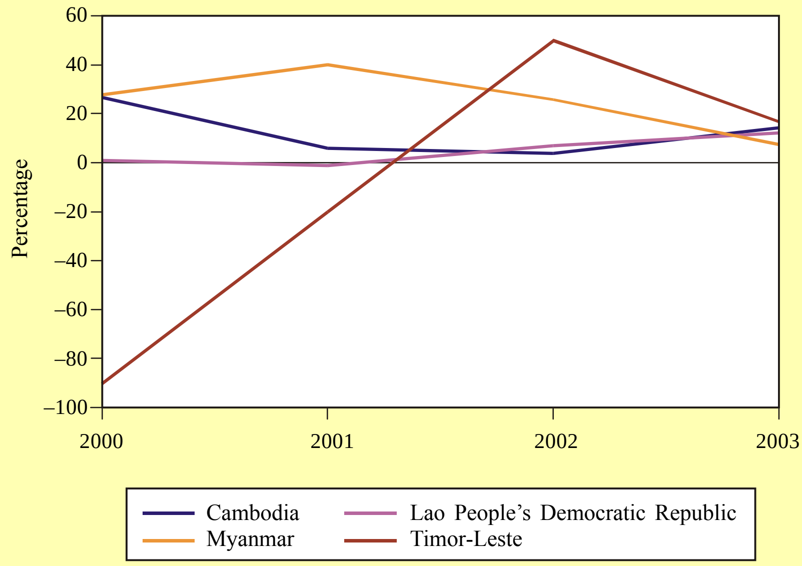
[b] Rupiah-based CPI for Dili through 2000 and thereafter dollar-based CPI for Dili; all are percentage changes at end-period.

Maldives and Nepal, there has been considerable uncertainty in Cambodia, the Lao People's Democratic Republic and Myanmar regarding the future of garment exports because of the expiration of the Multi-Fibre Arrangement at the beginning of 2005. Meanwhile, the number of garment manufacturing firms declined in Myanmar as it lost access to the United States market in 2003, Cambodia's accession to WTO has been helpful in addressing issues related to market access and exports of oil and gas from Timor-Leste are expected to contribute greatly to its fiscal revenues in the near future.

Growth performance

Despite adverse weather conditions and subsequent contraction in the agricultural sector in Cambodia, robust construction activities, strong growth in garment exports and tourism-related activities were behind the economic expansion of 5.5 per cent in 2002 (table II.37). The agricultural

Figure II.33. Growth rates in merchandise export earnings of the least developed countries in South-East Asia, 2000-2003



Sources: IMF, *Country Reports,* various issues; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

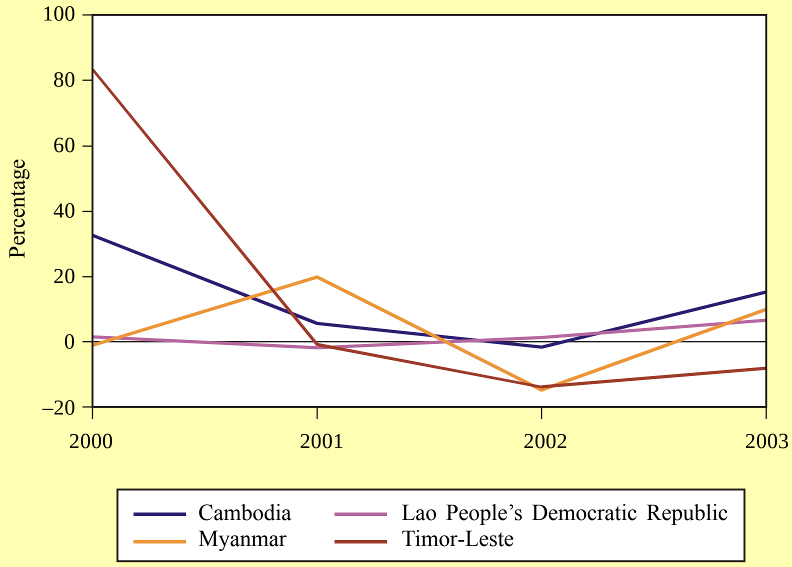
Notes: Figures for 2002 and 2003 are projections for Cambodia. Figures for 2001 and 2002 are estimates and 2003 figures are projections for the Lao People's Democratic Republic. Figures for 2002 and 2003 are estimates for Myanmar. All Timor-Leste export values are estimates except that for 2003, which is a projection.

Poor performance of the tourism sector impacted on overall growth in Cambodia in the first half of 2003

sector in 2003 was expected to recover from a contraction of 2.7 per cent in the previous year, and earnings on garment exports were strong in the first 6 months of 2003. However, GDP growth in that year was expected to be marginally lower at about 5.0 per cent, in part as a result of unrest in Phnom Penh and the outbreak of SARS. The latter contributed to a decline of 17 per cent in tourist arrivals in the first 6 months of 2003, compared with the same period in 2002. Although tourism-related activities were concentrated in a few geographic areas, they contributed 8 per cent of GDP (or $294 million) in 2002.

Agricultural production in Cambodia accounted for 40 per cent of GDP but it has not been growing fast, partly because the underdeveloped irrigation system. Irrigated areas in Cambodia, around 19 per cent of the total area under food crop production, were the source of 54 per cent of agricultural output and over 30 per cent of rice production because of the feasibility of cultivating an additional annual crop. Large areas of land still remained unused and the utilization of new rice varieties could

Figure II.34. Growth rates in merchandise import spendings of the least developed countries in South-East Asia, 2000-2003



Sources: IMF, *Country Reports,* various issues; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Notes: Import values f.o.b. for Myanmar. Figures for 2002 and 2003 are projections for Cambodia. Figures for 2001 and 2002 are estimates and 2003 figures are projections for the Lao People's Democratic Republic. Figures for 2002 and 2003 are estimates for Myanmar. All Timor-Leste import values are estimates except that for 2003, which is a projection.

also contribute to higher yields. Agro-processing and aquaculture were other possible sources of employment and income generation, and hence domestic economic growth. Despite a reduction in illegal logging and the cancellation of several forestry concessions, an effective system for monitoring logging activity and planning sustainable logging remained to be established in Cambodia. Although the share of garments and tourism in overall economic output was increasing, the garment sector employed only a small fraction of Cambodia's population of 13 million. Slippages in structural reform, together with weak administrative capacity, have continued to hamper the creation of an environment conducive to robust private sector activities.

Domestic investment in Cambodia increased from 17.3 to 22.8 per cent of GDP between 2000 and 2003, while national savings (of which more than 90 per cent come from non-government sources) were up from 6.8 to 11.7 per cent of GDP in the same period (table II.38). Investment decisions by the private sector were delayed in the run-up to the July

Table II.37. Least developed countries in South-East Asia: growth rates, 2000-2003

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Cambodia	2000	7.7	−1.5	30.7	5.7
	2001	6.3	2.2	12.9	4.2
	2002	5.5	−2.7	17.7	4.5
	2003	5.0	..	..	..
Lao People's Democratic Republic	2000	5.8	4.9	8.5	4.9
	2001	5.8	3.8	10.1	5.7
	2002	5.9	4.0	10.3	5.7
	2003	5.9	4.0	..	..
Myanmar	2000	13.7	12.4	18.0	13.4
	2001	10.5	7.2	17.2	14.0
	2002	5.3	1.2	..	..
	2003	5.1	..	..	..
Timor-Leste	2000	15.0	..	..	..
	2001	17.0	..	..	..
	2002	3.0	..	..	..
	2003	−2.0	..	..	..

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Notes: Data for 2003 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

2003 election and the current system of investment incentives, which provides for large exemptions and is relatively difficult to administer, may be replaced by a simple and transparent investment regime with low tax rates.

Weaker external environment and marginal change in GDP growth in the Lao People's Democratic Republic

Aggregate output in the Lao People's Democratic Republic was marginally higher by an estimated 5.9 per cent in fiscal year 2002 owing to a slight rise in agricultural, industrial and service activities. The weaker external environment, a slowdown in tourism, reduced credit growth and lower investment, due to a fall in FDI as well as cautious bank lending policies, were expected to maintain overall economic growth at an estimated 5.9 per cent in fiscal 2003. Agriculture and forestry comprised slightly more than one half of GDP in 2002 while industry accounted for 23.5 per cent and services 26.4 per cent. Although total

Table II.38. Selected least developed countries in South-East Asia: ratios of gross domestic savings and investment to GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Savings as a percentage of GDP				
Cambodia	6.8	9.5	12.1	11.7
Lao People's Democratic Republic	15.1	15.4	16.1	17.3
Myanmar	12.3	11.3	..	..
Investment as a percentage of GDP				
Cambodia	17.3	21.2	22.2	22.8
Lao People's Democratic Republic	20.5	21.0	21.2	22.0
Myanmar	12.4	11.3	..	..

Source: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003* (Manila, ADB, 2003).

Notes: Data for 2003 are estimates. Savings/GDP refers to gross domestic savings/GDP; investment/GDP refers to gross domestic investment/GDP.

rice production was higher by 9 per cent, to 2.4 million tonnes in fiscal year 2004, coffee exports were down by 9 per cent in the first 6 months of 2003 as a result of frost. Processing activities accounted for 70 per cent of the total industrial and handicraft sector and grew by nearly 8 per cent per annum during fiscal year 2003. However, the additional economic stimulus from the power sector has been delayed with the postponement of the Nam Theun 2 hydroelectric project. Concerted efforts have been made in the Lao People's Democratic Republic to attract regional tourists in response to the sharp decline in tourist arrivals in the first half of 2003 as a result of the SARS outbreak.

The geographic patterns of growth were uneven in Myanmar

Although Myanmar had earlier forecast annual GDP growth of 6 per cent on average between fiscal years 2001 and 2005, the revised estimates were expected to show a slightly lower economic expansion of 5.1 per cent in 2003 and 4.3 per cent in 2004. Agricultural output, estimated to be up by 1.2 per cent in 2002, was led by higher production of rice, pulses, cotton and sugarcane. Because of the uneven geographical distribution of income and economic activities, subsidies and incentives to reclaim unused agricultural land were provided to promote production and employment. Rice exports increased dramatically in 2001 with the resumption of large-scale rice sales and good growing seasons but they declined in 2002 owing to flooding. In 2003, Myanmar abolished its paddy procurement policy whereby 10 per cent of the overall output was to be purchased by the Government at officially fixed prices. At the same time, rice farmers were permitted to trade all of their output at market prices, leading to a higher production of 21 million tonnes in fiscal year 2003; subsequently, however, a 6-month ban on rice exports was apparently reimposed in 2004. Despite strong exports, output and yields remain below the potential because of the lack of fertilizer and quality seeds, as well as inadequate storage and transport facilities. The fishing industry has benefited from strong regional demand for exports of prawns and fish, as well as greater private investment in freezing and processing facilities. However, exports of raw rubber declined in fiscal year 2002 as a result of the ageing stock of rubber trees.

Although mining activity has grown significantly in recent years, the industrial sector has faced a sustained period of contraction. In particular, gas exports to Thailand, a country which had accounted for much of the recent expansion in overall exports, dropped by 38 per cent year on year during the first half of fiscal year 2003. The manufacturing sector, which contributed 10 per cent to GDP, continued to struggle because of a shortage of power and other essential inputs, and of problems with market access, owing to poor infrastructure and the withdrawal of trade privileges. The construction sector was expected to revive; domestic cement production went up by 10 per cent year on year in fiscal year 2002. Although tourist arrivals showed a strong increase of almost 12 per cent, expensive accommodation and poor infrastructure continued to limit the number of arrivals to fewer than 290,000 in fiscal year 2002.

Drought and the winding down of the international presence adversely impacted economic activities in Timor-Leste

The economy of Timor-Leste recovered strongly following the turmoil of 1999, with real GDP in 2001 reaching close to the pre-crisis level. This turnaround owed much to the large international presence, which in turn spurred business activity in the service and construction sectors and a rebound in agricultural production. GDP growth, however, peaked at 17 per cent in 2001 and fell significantly to 3 per cent in the following year; aggregate output then contracted by about 2 per cent in 2003. The downturn was largely attributable to a drought and the winding down of the international presence. Subsistence agriculture accounted for one fourth of GDP and three fourths of employment in Timor-Leste. Such heavy dependence emphasized the importance of better access to and availability of infrastructure and extension services, fertilizers and new varieties of seeds. Work has begun on the Bayu-Udan liquefied natural gas project and the country is expected to benefit significantly from the commercial exploitation of oil and gas resources in the Timor Sea. The national development plan covering fiscal years 2003-2007 aims at attaining 5 per cent growth over the medium term and the alleviation of poverty.

Inflation

Low and falling inflation in Cambodia

Consumer prices in Cambodia rose by an average of just over 1 per cent a year during 2000-2003 (table II.39). Poor agricultural production served to lift inflation from 0.2 per cent in 2001 to 3.4 per cent in the following year. Consumer prices were subsequently on a declining trend, increasing by only 1.7 per cent in 2003 owing to a stable exchange rate, lower growth in the money supply and a drop in real estate prices.

Consumer prices on an upward trend in the Lao People's Democratic Republic

In the Lao People's Democratic Republic, inflation was up from 7.8 per cent in 2001 to 13.5 per cent two years later. This trend was a result of a depreciation of 14 per cent in the nominal exchange rate between May and September 2002, higher prices for food, utilities and petroleum in early 2003 and continued strong growth in the broad money supply. The adoption of tighter fiscal policies in October 2002 has stabilized the

Table II.39. Least developed countries in South-East Asia: inflation and money supply growth (M2), 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Inflation[a]				
Cambodia	−0.8	0.2	3.4	1.7
Lao People's Democratic Republic	27.1	7.8	10.6	13.5
Myanmar	−0.1	21.1	57.1	52.8
Timor-Leste[b]	3.0	0.0	5.0	4.0
Money supply growth (M2)				
Cambodia	26.9	20.4	31.1	11.5[c]
Lao People's Democratic Republic	46.0	13.7	37.6	26.2[d]
Myanmar	42.4	43.9	34.6	14.2[e]
Timor-Leste	..	155.5	8.6	0.0[f]

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003); IMF, *International Financial Statistics,* vol. LVI, No. 10 (Washington, IMF, October 2003) and *Country Report No. 03/227* (Washington, IMF, July 2003); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Changes in the consumer price index.
[b] Rupiah-based CPI for Dili through 2000 and thereafter dollar-based CPI for Dili; all are percentage changes at end-period.
[c] January-June.
[d] January-July.
[e] January-April.
[f] January-March.

exchange rate and was expected to keep price increases to a single-digit level in 2004. The various relative weights in the consumption basket and the sample of outlets and products have been reviewed on the basis of the expenditure and consumption survey conducted in 2002.

Myanmar experiencing relatively high inflation

Consumer prices were rising at a relatively high rate of over 50 per cent in Myanmar in 2002 and 2003. This was attributable to the monetization of the fiscal deficits and supply-side factors such as higher food prices. Prices of essential goods also went up sharply in February 2003 partly as a result of restrictions imposed on cash withdrawals.

Drought as well as weakening of the United States dollar leads to price fluctuations in Timor-Leste

The increased availability of basic goods, as well as the adoption of the United States dollar as the official currency, caused inflation in Timor-Leste to fall from 140 per cent at the end of 1999 to near zero in 2001. However, consumer prices rose around 4-5 per cent in the following two years as a result of a drought-related hike in food prices. Wage pressures in the construction and service sectors had moderated after an earlier increase in public sector wages, but remained a third higher than in neighbouring countries. The relatively sharp weakening of the United States dollar against the Australian dollar as well as against other Asian currencies also contributed cost-push pressures, especially on imported alcohol and tobacco, clothing and footwear in 2003.

Trade and exchange rates

The expected phasing out of garment quotas could have a negative impact on Cambodia's most important exchange earner

Merchandise exports from Cambodia, which had expanded less than 4 per cent to reach $1.5 billion (equivalent to over two fifths of GDP) in 2002, were projected to rise sharply by about 14 per cent in 2003 (table II.40). The garment sector accounted for the bulk of the increase and the United States accounted for nearly two thirds of merchandise exports from Cambodia through the provision of a higher quota allowance. However, exports outside that quota category slowed in 2002 because of increased competition; there were high cost pressures in Cambodia as a result of relatively high wages and generous labour benefits, and higher operating costs due to limitations in the physical infrastructure and informal facilitation fees. The expected phasing out of garment quotas with the expiry of the Multi-Fibre Arrangement at the beginning of 2005 could also have a negative impact on Cambodia's garment exports.

Intermediate goods for the garments industry and petroleum products were among the major imports in Cambodia (table II.41). Spending on imports contracted by almost 2 per cent in 2002 (to $1.9 billion), reflecting the poor export performance during the year. Along with the upturn in export earnings in the following year, import expenditure was projected to rise by over 15 per cent in 2003. Excluding official transfers, there was a current account deficit of nearly 10 per cent of GDP in

Table II.40. Least developed countries in South-East Asia: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	Exports (f.o.b.) Annual rate of growth (percentage)			
	2002	2000	2001	2002	2003
Cambodia[a]	1 529	26.7	5.8	3.7	14.1
Lao People's Democratic Republic[b]	365	0.9	–1.2	7.0	12.1
Myanmar[c]	2 886	27.9	40.1	25.8	7.4
Timor-Leste[d]	6	–90.4	–20.0	50.0	16.7

Sources: IMF, *Country Reports*, various issues; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

[a] Figures for 2002 and 2003 are projections.
[b] Figures for 2001, 2002 and 2003 are estimates and projections.
[c] Figures for 2002 and 2003 are estimates.
[d] All figures are estimates except those for 2003, which are projections.

2001-2002 and was expected to be 11 per cent in 2003. Thailand and Singapore together provided about one half of Cambodia's total imports, followed by China and Viet Nam. Since its accession to WTO in September 2003, Cambodia has drafted several commercial laws to facilitate the creation of a transparent trading environment. Trade liberalization has proceeded smoothly within the context of the ASEAN Free Trade Area, while the country also pledged to reduce import tariffs on agricultural and non-agricultural products and to liberalize its service sector in its bilateral trade agreements with Australia, the EU and Japan in 2003.

The riel remained stable against the United States dollar in 2002 and 2003, depreciating by less than 2 per cent annually on average (figure II.35). In view of the limited scope to improve competitiveness through the use of exchange rate policy in a heavily dollarized economy, ongoing efforts are needed to raise productivity in the real sector. Currency devaluation would be offset by an immediate increase in prices, thus adversely affecting the rural poor and civil servants. Meanwhile, measures are being pursued to encourage the greater use of the riel in economic transactions, with de-dollarization being the ultimate, long-term objective.

Export earnings in the Lao People's Democratic Republic recovered strongly from a contraction of just over 1 per cent in 2001 to rise by 7 per cent (totalling $365 million) in 2002 and by another 12 per cent

Table II.41. Least developed countries in South-East Asia: merchandise imports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Imports (c.i.f.) Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003*
Cambodia[a]	1 918	32.6	5.7	–1.7	15.2
Lao People's Democratic Republic[b]	559	1.4	–1.8	1.3	6.6
Myanmar[c]	2 185	–1.0	19.9	–14.8	9.9
Timor-Leste[d]	186	83.2	–0.9	–13.9	–8.1

Sources: IMF, *Country Reports*, various issues; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

[a] Figures for 2002 and 2003 are projections.
[b] Figures for 2001, 2002 and 2003 are estimates and projections.
[c] Import value f.o.b.; figures for 2002 and 2003 are estimates.
[d] All figures are estimates except those for 2003, which are projections.

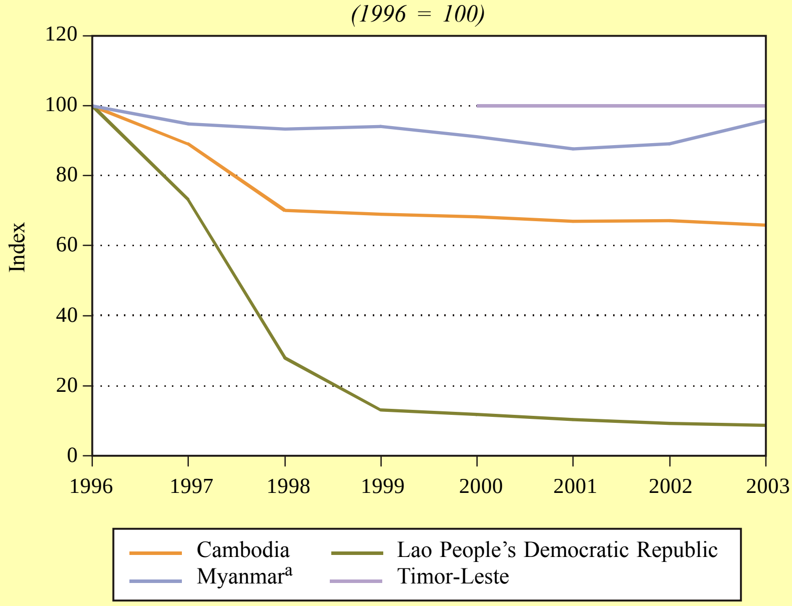
The Lao People's Democratic Republic's exports are benefiting from lower external tariffs, buoyant commodity prices and the implementation of normal trade status

in 2003. Such a robust performance reflected reduced tariffs in Australia, China and Viet Nam, strengthened world prices for a number of commodities and the implementation of normal trade status by the United States. The export base remained narrow, however, consisting of electricity, garments, agricultural and timber products, and inward tourism. Additionally, low world prices for coffee compounded by time-consuming and costly export procedures have deterred somewhat the growth in coffee exports. Viet Nam accounted for one third of exports from the Lao People's Democratic Republic, followed by Thailand, France and Germany.

Import spending, which had gone up marginally (by just over 1 per cent) to reach $559 million in 2002, was expected to expand strongly, by about 6.6 per cent, in the following year in line with the robust recovery in export earnings, a significant share of imports being inputs for export production. Consumer goods accounted for one half of total import outlays, followed by investment goods and textiles. Thailand accounted for more than three fifths of imports to the Lao People's Democratic Republic, followed by Viet Nam, China and Singapore. The trade balance was expected to narrow slightly in 2003 while the current account deficit, including official transfers, was projected to remain on a declining trend, being less than 4 per cent of GDP in 2003.

Figure II.35. Index of exchange rates against the United States dollar in selected least developed countries in South-East Asia, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Note: Data for 2003 are estimates.

[a] Data for 2003 are for January-October.

The Lao People's Democratic Republic maintains a flexible exchange rate regime with the margin between the official and parallel rates being limited to under 2 per cent. Since excessive capital spending in fiscal year 2002 contributed to the kip depreciation in mid-2002, controls were imposed on public expenditure and bank credit and interest rates were raised in October 2002. All these stabilization measures helped to maintain the exchange rate at around 10,600 kips to the United States dollar. As in the case of neighbouring Cambodia, heavy dollarization in the Lao People's Democratic Republic greatly narrowed the scope for the use of exchange rate adjustments for price stabilization purposes. A Foreign Exchange Decree has been promulgated and regulations for its implementation are expected to be issued by June 2004.

Exports of gas from Myanmar reaching a plateau

Myanmar was experiencing a significant expansion of export earnings in the early 2000s. This trend, coupled with a decline in imports of capital and intermediate consumer goods, led to a sizeable trade surplus and was expected to have also contributed to a current account surplus in fiscal year 2002. Major export items included gas, teak and other hardwoods, pulses, prawns and fish as well as garments. In particular, gas exports to Thailand, which accounted for much of the recent expansion in overall exports, were expected to peak in fiscal year 2003. Rice exports went up in line with a succession of good harvests while exports of pulses, hardwoods and marine products also performed well. Garment exports (and Myanmar's domestic cotton industry) were expected to contract with the enforcement of the import ban by the United States in August 2003 (the United States had accounted for almost two thirds of Myanmar's total garment and textile exports). Overall, Thailand was the market for about 36 per cent of Myanmar's total exports in fiscal year 2002, followed by China (16 per cent) and the United States and India (11 per cent each).

Spending on imports in Myanmar has been erratic, with a marginal contraction in 2000 and a sharper decline (by almost 15 per cent) in 2002. This reflected, among other things, various restrictions on import trading activities and on access to foreign exchange as well as weak domestic demand and the frequent closure of the border with Thailand. Although Myanmar is committed to a schedule of tariff cuts in the context of the ASEAN Free Trade Area, there appeared to remain some reliance on non-tariff barriers and the import licences of foreign trading firms were suspended in 2002. Meanwhile, the official exchange rate has been fixed against the Special Drawing Right since 1977 and it has remained by and large stable at around 6.2-6.8 kyats to the dollar. Since the liberalization of exchange rates in 1988, the majority of transactions have taken place at the free-market rate, which stabilized at around 990 kyats to the dollar in October 2003.

Reconstruction-related imports leading to a large trade deficit in Timor-Leste

In Timor-Leste, the value of exports excluding unrecorded merchandise exports and oil and gas revenues, was projected to rise from $6 million in 2002 to over $7 million in 2003.[4] Coffee exports (mainly to Indonesia, the United States, Australia and Portugal) comprised nearly three quarters of total earnings on merchandise exports in 2001. Spending on merchandise imports continued to contract from its peak in 2000 to total $186 million in 2002; it was projected to decline further by another 8 per cent in the following year. A substantial amount of imports (mainly from Australia, Japan and India) was associated with donor-assisted reconstruction. The trade deficit of $180 million in 2002 was estimated to fall to $163 million in 2003, while the current account balance, excluding official transfers, showed a deficit of $230 million (or 61 per cent of GDP) and $212 million (or 63 per cent), respectively, during those years. However, the substantial amount of inward ODA helped to bring about a surplus in the external current account, at $37 million in 2002 and a projected $19 million in 2003.

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[4] Oil and gas revenues are recorded under the income account as royalties and transfers as tax revenues.

The United States dollar was adopted as legal tender in Timor-Leste in January 2000 and to assist small transactions, coins were introduced in fiscal year 2004. Given the limited institutional capacity, and inadequate financial and market development, Timor-Leste planned to maintain the current monetary and exchange rate regime since it has contributed to financial stability.

Capital inflows and outflows

Aid from official sources is generally the largest source of inward capital for the least developed countries in South-East Asia. The establishment of government institutions and reconstruction of infrastructure in Timor-Leste, for example, would have been extremely difficult without financial assistance from bilateral donors and international organizations. While Timor-Leste has shied away from the use of loans, given its limited absorptive capacity and institutional depth, a substantial amount of external debt has accumulated in Cambodia, the Lao People's Democratic Republic and Myanmar. Rescheduling of debt owed to the Russian Federation was recently discussed in the first two of those countries. Although Japan began to waive obligations on loan repayments, Myanmar has not been able to obtain debt relief from the Paris Club and has consequently turned to finance from short-term commercial sources. The inflow of remittances continues to be a significant source of capital for Myanmar, however.

The burden of debt service expected to rise significantly in Cambodia after 2004

The overall balance of payments in Cambodia was expected to fall from $51 million in 2002 to $14 million in 2003, despite a surplus in the capital account in both years. FDI inflows remained at around $100 million as the high cost of production and the limited infrastructure in Cambodia make it difficult to attract such investment. Between the end of 1998 and 2002, international reserves went up from $390 million to $665 million (equivalent to 3.5 months of imports); they were expected to rise further in 2003. The public debt-service ratio was projected at 2.6 per cent of domestic exports of goods and services. Subject to the resolution of outstanding debt with the Russian Federation and the United States, debt-service payments were expected to increase by 1 per cent of GDP, thus implying that 70 per cent of the expected rise in fiscal revenue will be used to meet additional debt-service obligations and maintain the planned reduction of the primary debt.

The inflow of grants and loans from official creditors, totalling $187 million, and FDI of $40 million were expected to cover the projected gross financing needs of $207 million in the Lao People's Democratic Republic in 2003. However, a net financial outflow of $36 million led to a projected financing gap of $16 million in 2003. With the increase in

Agreement on rescheduling of debt between the Lao People's Democratic Republic and the Russian Federation

foreign financing and the build-up of government deposits at the central bank, gross international reserves had grown to $207 million (equivalent to 3.7 months of imports) by June 2003 and were projected to rise to 3.8 months of imports in 2004. The net present value of public external debt is 113 per cent of exports, excluding debt to the Russian Federation, and the public debt-service ratio was projected to absorb about 10 per cent of exports of goods and services in 2003. The Lao People's Democratic Republic has refrained from contracting and guaranteeing non-concessional external debt for public sector entities, and external debt previously contracted by State-owned enterprises with government guarantees and external debt without government guarantees will be included in the monitoring and reporting of public sector external debt; a comprehensive report on this matter was expected to be prepared soon. Meanwhile, the country reached an agreement in principle with the Russian Federation in June 2003 whereby the external debt to the Russian Federation will be rescheduled with a 70 per cent upfront discount; the remaining debt stock of $387 million will be repaid over 33 years on preferential terms.

Myanmar's debt profile shifts away from long-term concessional obligations towards shorter-term commercial debt

With the improvement in the merchandise trade balance, international reserves were estimated to have risen from $223 million to $470 million (equivalent to 2 months of imports) between 2000 and the end of 2002; reserves were reported as being equivalent to 3.6 months of import cover by the end of September 2003. However, current inward transfers, primarily remittances, were expected to decline, even though at $298.5 million in 2001 these were one of Myanmar's largest sources of foreign exchange, exceeding the amount of FDI inflows totalling some $210.3 million. Investment has shifted away from oil and gas to manufacturing, property, tourism, mining, construction, agriculture and fisheries. Outside the agri-processing sector, most of the economic diversification that has occurred has been driven by foreign investment although difficulties in profit repatriation (owing to tight controls on foreign exchange transactions) have acted as a constraint on FDI.

Myanmar's external debt stock dropped to $5.7 billion at the end of 2001. The country has not been able to obtain debt relief from the Paris Club although Japan switched from providing Myanmar with grants for the purpose of debt repayment, which totalled $2.2 billion in 2001, to waiving obligations on loan repayments in 2003. China agreed to provide $200 million in preferential loans for economic development and an undisclosed amount of debt relief in 2003. With a shortage of foreign exchange reserves, Myanmar is financing its overall balance-of-payments deficit through an accumulation of arrears on its external debt. By the end of 2001, interest arrears totalled $500 million, equivalent to 75 per cent of the short-term debt stock, while principal arrears were estimated at $1.8 billion. Long-term debt accounted for nearly nine tenths of Myanmar's external debt in 2001, but with no new lending from the major multilateral institutions the debt profile is shifting away from long-term concessional debt towards shorter-term commercial debt such as exporters' credits. Myanmar is furthermore concentrating on repaying commercial creditors before bilateral creditors.

A liberal foreign investment regime expected in Timor-Leste

External financial support in the form of grants from the Trust Fund for East Timor, bilateral donor assistance and financial contributions from international organizations have underpinned reconstruction and development efforts in Timor-Leste. The levelling off of projects funded by the Trust Fund and bilateral donors is a matter of considerable concern in fiscal year 2004. The country is expected to pursue a liberal foreign investment regime, and the legislation on investment was expected to provide equal tax incentives to both domestic and foreign investors, to adopt a one-stop shop for approval procedures and to avoid a reserve list for domestic production.

Fiscal developments

Improved revenue mobilization is critical in the least developed countries because their currently narrow tax bases, limited capacity in tax administration and overall low compliance rate meant that indirect taxes would remain the principal source of domestic revenue in most of these countries. Additionally, revenue collections have typically been less than public expenditure so that a financing gap has to be covered from other domestic or international sources of finance. The establishment of a petroleum fund in Timor-Leste was expected to ensure a stable source of domestic revenue in the medium term. Nevertheless, the fiscal situations in the least developed countries of South-East Asia are far from robust in the foreseeable future.

Improved tax and customs administration, reduction of tax exemptions and greater transfer of fees from service providers to the Treasury are needed to improve Cambodia's fiscal revenue

Fiscal revenue increased from 11.7 to a projected 12.1 per cent of GDP in Cambodia between 2001 and 2002 while public expenditure rose from 17.7 per cent to an estimated 18.9 per cent of GDP over the same period. The demobilization programme has contributed to a decline by 1 per cent of GDP in defence and security spending in recent years, thus permitting a commensurate rise in social outlays. Lower trade taxes, an erosion of the tax base due to widespread tax exemptions and reduced transfers from private service providers to the Treasury led to a reduction of non-wage expenditure and a greater reliance on foreign financing in 2002 than originally expected. The current fiscal balance showed a surplus of 0.9 per cent of GDP in 2002 but an overall fiscal deficit, excluding grants, of 6.5 per cent (table II.42).

The government revenue target of 13.2 per cent of GDP in 2003 was unlikely to be achieved owing to weak revenue collections in the first 7 months of 2003. As a result, current expenditure was also expected to fall and improved tax and customs administration plus a higher transfer of fees from service providers to the Treasury would be necessary to sustain

Table II.42. Least developed countries in South-East Asia: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*
Budget balance as a percentage of GDP				
Cambodia	−4.9	−6.4	−6.5	−5.3
Lao People's Democratic Republic	−6.0	−7.6	−4.8	−7.8
Myanmar[a]	−3.4	..	−3.8	−3.9
Timor-Leste	−6.8	−5.5	−7.4	−5.8
Current account balance as a percentage of GDP				
Cambodia	−12.3	−9.7	−9.8	−11.0
Lao People's Democratic Republic[b]	−8.3	−7.0	−5.6	−4.0
Myanmar[c]	−0.1	−0.1	0.01	−0.02
Timor-Leste[d]	21.0	12.0	10.0	6.0

Sources: ESCAP, based on national sources; ADB, *Key Indicators of Developing Asian and Pacific Countries 2003* (Manila, ADB, 2003) and *Asian Development Outlook 2003 Update* (Manila, ADB, 2003); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Including grants.
[b] Excluding transfers.
[c] At official exchange rates.
[d] Including official transfers.

spending in the social sectors, infrastructure development as well as civil service reform. To strengthen budget management, government accounts were being centralized at the National Treasury and the adoption of standardized accounting procedures for government account transactions was being planned. Additionally, an integrated fiduciary assessment and public expenditure review carried out in 2003 aimed at strengthening resource mobilization, reducing the fiduciary risk to public funds, rationalizing public expenditure policy and management and accelerating civil service reform.

Concerted measures introduced to raise revenue and contain bank financing in the Lao People's Democratic Republic

Budget revenue was expected to decline from 13 to 11.5 per cent of GDP between fiscal years 2002 and 2003. Since tax collections during the first 6 months of 2003 remained below target, the Lao People's Democratic Republic reimposed excise and turnover taxes on imported petroleum products, introduced an inflation-based excise tax on luxury goods and added other administrative fees and charges, including stamp duties. Other restraining measures included the reduction and postponement of wage increases and lower allocations for domestically financed capital expenditure. As a result, bank financing of the fiscal deficit was expected to be just 0.2 per cent of GDP in fiscal year 2003. At the same time, the

Lao People's Democratic Republic has also been clearing domestic arrears (equivalent to 3 per cent of GDP) that have eroded the health of the banking system through the issuance of government bonds, while tight expenditure controls have helped to limit new arrears.

To reverse the sliding ratio of revenue to GDP and reduce recourse to bank financing, the budget for fiscal year 2004 projected revenue collections equivalent to 12.2 per cent of GDP by maintaining the taxes that had been introduced, providing tax incentives while safeguarding budget revenues and introducing a nationwide structure for the treasury and customs departments under the Ministry of Finance. Current expenditure in fiscal year 2004 was expected to rise by 0.9 percent of GDP because of a 30 per cent wage increase granted to civil servants to offset higher utility prices. Capital expenditure, meanwhile, was expected to fall significantly because of cuts in new expenditure to be financed domestically. Bank financing of the budget deficit was not expected on the basis of the projected increase in programme loans from external sources. To improve the management of public expenditure, a new accounting system was introduced to enable compilation of expenditure data by administrative units at the central government level in the fiscal year 2004 budget while a census of arrears was to be completed by March 2004.

Central government tax revenue remains low in Myanmar

Myanmar's budget deficit has been around 4 per cent of GDP in recent years. Although central government revenue, including customs duties, rose by nearly 50 per cent in the first 11 months of fiscal year 2002, efforts to increase overall receipts remained hampered by poor tax compliance and a large informal economy. Central government tax revenue remains low at around 2 per cent of GDP. Continuing losses from State-owned enterprises were expected to place a severe strain on limited public resources and prevent the reduction of the public sector deficit.

Two thirds of Timor-Leste's oil and gas wealth expected to be saved in a petroleum fund

The dollarized economy in Timor-Leste necessitates the adjustment of overall expenditure in accordance with available fiscal resources. Government fiscal operations under the Consolidated Fund for East Timor have been marked by large deficits, reflecting the pressing needs for reconstruction expenditure in the face of limited revenues. Fiscal revenue was projected to rise along with the increase in oil and gas revenues from 7.7 per cent of GDP in fiscal year 2001 to 12.4 per cent in fiscal year 2003. As a result of its narrow tax base, limited tax administration capacity and low compliance rate, however, indirect taxes, (mainly import duties, excise taxes, sales tax and service tax) accounted for nearly two thirds of domestic revenues.

Public expenditure, however, was also projected to rise from 13.8 to 23.9 per cent of GDP over the period 2001-2003, with the increase almost exclusively associated with recurrent expenditure. The budget deficit widened from 5.5 to 7.4 per cent of GDP during 2001-2002 before falling off to 5.8 per cent of GDP in 2003. Unanticipated changes in production schedules and projected operating costs, and the weak position of the power sector could adversely affect the revenue front and budgeted outcomes, however. The fiscal deficits so far have been financed mostly through cash grants from donors, owing to the lack of access to domestic borrowings and the authorities' cautious approach to external borrowings. Donor budgetary support of $81 million in 2002 could cover 90 per cent of the financing gap until 2004. Under an ad hoc savings policy for oil and gas revenues adopted under the United Nations Transitional Administration in East Timor, all royalties are automatically saved and only tax revenues are available for the financing of budgetary operations. As such, two thirds of the oil and gas wealth would be saved in a petroleum fund to be established by the end of fiscal year 2004. A small proportion of the wealth will be used to meet infrastructure and human capital investment needs.

Money and finance

Ongoing financial sector strengthening and tighter bank supervision in Cambodia ...

The process of relicensing commercial banks in Cambodia helped to restore banking sector soundness by ensuring the availability of an adequate capital base and ample liquidity. The ongoing strengthening of bank supervision capabilities of the central bank, including through on-site inspections, and of the regulatory framework, including the enactment of laws relating to the provision of collateral and the protection of creditors' rights, would be helpful in reducing lending risks. In addition, the privatization of the Foreign Trade Bank was expected to reduce policy-based lending. In Cambodia, the existing banks and their branch networks were heavily concentrated in urban areas while the provision of small-scale loans to farmers and SMEs are other issues for attention in fostering financial sector development.

... and in the Lao People's Democratic Republic

Excessive credit growth led to an increase in non-performing loans while the high rates of money supply expansion contributed to inflationary pressures in the Lao People's Democratic Republic in the past few years. Since a large proportion of credit repayments were in foreign currency, repayments generated demand for foreign exchange and downward pressure on the kip exchange rate. Implementation of measures for banking sector reform helped to raise loan recoveries in State commercial banks, and improved banking supervision was carried out through on-site inspections of asset quality and the monitoring of adherence to central bank regulations on large borrower limits, foreign exchange exposure and off-balance-sheet operations of two State commercial banks. Off-site supervision was also being developed to direct on-site inspectors to those areas needing special attention. To enhance competition in the banking system, the minimum capital requirements for banks with domestic and foreign shareholders were expected to be equalized, and foreign bank branches allowed to operate nationwide in 2004.

Sudden withdrawals by depositors leading to an erosion of the deposit base in Myanmar

Money supply growth and inflation have been at high levels owing to large fiscal deficits being financed through central bank credit in Myanmar. Five State-owned commercial banks and the central bank, which were estimated to provide three fifths of all credit, comprised the State banking sector. There were sudden withdrawals of bank deposits in early 2003, owing to rumours of losses at private sector banks and non-bank financial institutions; in the first quarter of 2003, for example, quasi-money (comprising time, savings and foreign-currency deposits) dropped by 23 per cent quarter on quarter. These developments led the central bank to intervene with assurances of its support for the banking sector and the printing of money to cover part of the bank bail-out. Restrictions on withdrawals imposed by private banks, coupled with a blanket ban on money transfers by the central bank, were also introduced in response. Interest rates remain significantly negative in real terms, with the 6-month deposit rate at 9.5 per cent, making it difficult for private banks to attract depositors.

Legal framework for bank lending under preparation in Timor-Leste

The broad money supply, excluding currency holding by the public, for which no data are available, was estimated to be on an upward trend in Timor-Leste, increasing from 13 per cent of GDP in 2001 to 15 per cent and then 16 per cent of GDP in the following two years. The banking system now comprises the monetary authority, three foreign-owned commercial banks and a microfinance institution. The monetary authority is not empowered to extend credits to either the Government or commercial banks. Deposits have increased substantially since 2000, but the banking system is still at an early stage of development, with inter-bank transactions virtually non-existent and financial intermediation limited by the lack of viable domestic lending opportunities and an underdeveloped legal framework. With total loans equivalent to just 10 per cent of bank deposits as at March 2003, the bulk of bank deposits were invested abroad. Timor-Leste has been developing a prudential legislation and bank supervision framework, and so far there has been a low level of non-performing loans within the financial system. In particular, the legal framework for bank lending, including the enactment of a bankruptcy law, and legislation to combat money laundering and terrorism financing are under preparation.

Policy issues and responses

The promotion of broad-based economic growth, including through foreign investment and greater private sector enterprise, was widely recognized as a key to sustained social and economic progress, including poverty reduction. Cambodia and the Lao People's Democratic Republic have carried out an ongoing, comprehensive economic reform programme with support from significant inflows of external aid. The strategic focus in Cambodia was to provide a conducive environment for private sector development through the maintenance of macroeconomic stability, rebuilding institutions and addressing governance problems while the strategic aim in the short term in the Lao People's Democratic Republic was to reduce inflation to single digits and maintain stable exchange rates. Among the main policy challenges in both of these least developed countries were rationalizing public sector expenditure, increasing domestic resource mobilization, broadening of the production base and ensuring further progress on key structural issues, particularly governance, fiscal reform and sustainable forestry. The national development plan of Timor-Leste similarly recognizes that the development of a dynamic private sector and the building up of local institutions and capabilities, together with the maintenance of a stable macroeconomic environment, are critical for the realization of future growth targets and development aspirations. Towards these aims, the fiscal and monetary authorities were re-established and initial steps taken to develop a statistics office; the United States dollar was also adopted as the official currency in January 2000. However, these institutions are still in their infancy, relying heavily on the services of international human resources, and the further building up of local capabilities and expertise for a variety of development-related functions will be a major challenge in the foreseeable future.

A transparent legal framework and good governance are vital to private sector development

An environment conducive to private sector development is predicated on the existence of a transparent legal and regulatory framework, including an independent judiciary, as well as a liberal trade and investment regime. Excessive administrative interference and persistent uncertainties in the implementation of regulations can be counterproductive to the proper development and functioning of markets and enterprises, while efforts to foster agricultural productivity and diversification would yield significant externalities, given the fact that agriculture continues to be a principal source of livelihood and employment and most of the poor live in rural areas. Efforts to rationalize the role of public sector enterprises continue to be important. In the Lao People's Democratic Republic, for example, the Government was expected to review the restructuring plans of the five large State-owned enterprises, including Electricité du Laos, while international experts assist with the development of enterprise-specific restructuring plans. Sales of non-core assets will also help to resolve the non-performing loans of State-owned banks. Price adjustments of key utilities will continue with a view to reaching cost-recovery levels. In Myanmar, a privatization programme for State-owned enterprises which began in 1995, has stalled owing to lack of investor interest. As a result, State commercial activities still account for a fifth of GDP and dominate the mining and power sectors; they are also important in transport, domestic trade, manufacturing and exports of many key commodities.

DEVELOPED COUNTRIES OF THE REGION

Australia, Japan and New Zealand

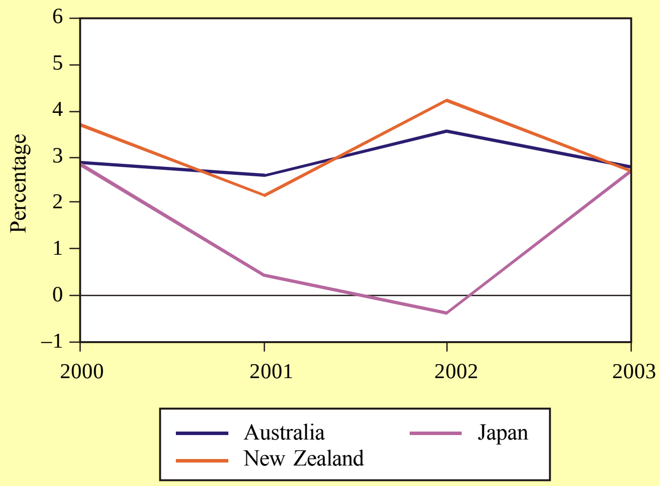
Overview and prospects

Strong recovery in Japan; growth eases in Australia and New Zealand

Preliminary estimates showed a strong economic recovery in Japan during 2003 after two years of barely perceptible growth. The upturn was primarily due to higher net exports stimulated by a rapidly improving external environment. But, more encouragingly, domestic factors such as an upturn in corporate investment and some renewed signs of life in household spending also contributed to the recovery. In Australia and New Zealand, as expected, the strong pace of growth achieved in 2002 proved unsustainable in 2003. These two economies slowed down considerably in 2003 although their output was still expanding at well above the average for the developed economies of the world (figure II.36). Export growth was largely unaffected in volume terms up to the middle of 2003 by the sizeable appreciations of both the Australian and New Zealand dollars against the United States dollar, but growth in domestic demand moderated in both countries despite falling unemployment. This was on account of a combination of external and internal factors, for instance, the war in Iraq and its associated uncertainties, moderation of the property boom and, more particularly in Australia, the lingering effects of the 2002 drought.

Figure II.36. Rates of GDP growth in developed countries in the ESCAP region, 2000-2003

Australia, Japan and New Zealand



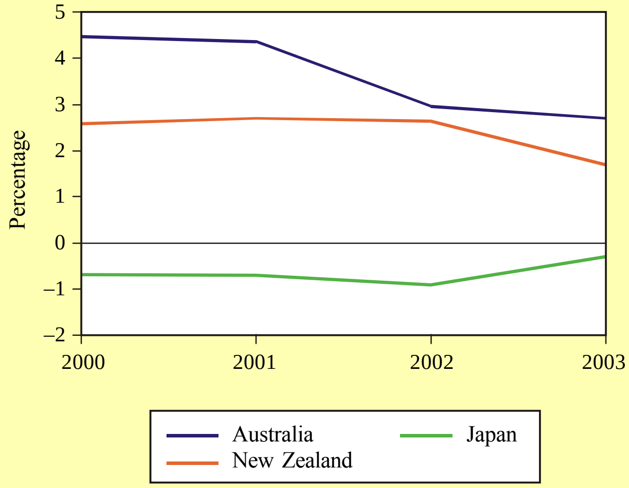
Sources: ESCAP, based on national sources; IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, IMF, 2003), and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

Relatively strong output growth was accompanied by a slower pace of price increases in Australia and New Zealand and by continuing deflation in Japan, where the GDP deflator fell for a fifth year in a row (figure II.37). In Australia, consumer prices rose in the early part of 2003 in response to higher energy prices in the run-up to the war in Iraq,

Figure II.37. Inflation[a] in developed countries in the ESCAP region, 2000-2003

Australia, Japan and New Zealand



Sources: ESCAP, based on national sources; IMF, *International Financial Statistics,* vol. LVI, No. 10 (Washington, IMF, October 2003), and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

Note: Data for 2003 are estimates.

[a] Percentage changes in the consumer price index.

but price pressures eased back to an annual rate of 2.7 per cent by the third quarter of the year, substantially below the rates experienced in the previous three years. In New Zealand, prices tended to fluctuate at an annual rate of 1.7 per cent over much of 2003, lower than in the previous three years. The benign inflationary environment allowed interest rates to remain low. In both Australia and New Zealand a stronger exchange rate more than offset the effects of domestic capacity constraints; price pressures thus remaining muted.

Externally, the Japanese current account surplus tended to widen slightly during 2003 while the current account deficits in Australia and New Zealand became larger, the stronger exchange rates in the two countries sucking in imports. In the case of New Zealand, for example, the current account deficit increased from 3.3 to 5.0 per cent of GDP between 2002 and 2003. Meanwhile, imports outpaced exports in Japan as recovery led to higher imports of raw materials in 2003, after two years of declines in import spending. Japan continued to run a balance of trade surplus and earnings from Japan's growing foreign assets contributed in part to the widening overall current account surplus.

Prospects for 2004 are positive

All three countries enjoy positive economic prospects, although the Japanese economy is unlikely to maintain its present pace of output growth in 2004, notwithstanding an improving external environment. A modest easing of the rate of GDP growth closer to what is now considered to be its long-term trend rate of around 2.0 per cent per annum is expected, mainly on account of the persisting weakness in domestic household demand and entrenched deflationary pressures. The worst may be over but the consensus view is that dramatic changes are unlikely in 2004. In contrast, in both Australia and New Zealand GDP expansion is expected to pick up in response to stronger growth in trading partner countries and improved commodity prices, but it is unlikely to exceed the currently estimated potential growth of around 3.0 to 3.5 per cent per annum over the next two or three years in both countries. The strong exchange rates are expected to keep inflation and nominal interest rates at around their currently prevailing levels with a possibility of a modest policy tightening to dampen import growth if the current account deficits continue to widen.

GDP performance

Although economic growth was revised downwards for the third quarter of 2003, Japan had by then experienced seven consecutive quarters of growth since the 2001 recession (table II.43). It appears that the Japanese economy has now turned the corner after almost a decade of near-stagnation and a massive build-up of domestic public debt, the result of a vain quest to enhance economic performance during the 1990s. The positive signs are increasing in number, including rising industrial production, more visible progress with corporate restructuring, gently declining unemployment and relatively upbeat business surveys. Indeed, the improved GDP growth in 2003 is perhaps best exemplified in the strength shown by the stock market, which rose by more than a fifth in the year on the back of improved corporate earnings.

Table II.43. Developed countries of the ESCAP region: rates of economic growth and inflation, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*[a]
GDP growth rates				
Australia	2.9	2.6	3.6	2.8
Japan	2.8	0.4	–0.4	2.7
New Zealand	3.7	2.2	4.2	2.7
Inflation[b]				
Australia	4.5	4.4	3.0	2.7
Japan	–0.7	–0.7	–0.9	–0.3
New Zealand	2.6	2.7	2.6	1.7

Sources: ESCAP, based on national sources; IMF, *World Economic Outlook, September 2003: Public Debt in Emerging Markets* (Washington, IMF, 2003) and *International Financial Statistics,* vol. LVI, No. 11 (Washington, IMF, November 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

[a] Estimates.
[b] Percentage changes in the consumer price index.

How durable is the Japanese recovery?

As in the past, net exports (helped by a more favourable external environment, primarily strong growth within the region) have been the main driver of the recovery in Japan; in addition, domestic sources of growth, such as business investment and private consumption, have contributed as well to the overall stimulus provided by higher government spending in the last few years (see table II.44). This suggests that the current recovery could well prove more durable than the one in 2000. There is a growing feeling, too, that the worst of Japan's economic slump is now over and households should feel encouraged to spend more in response to declining unemployment, thus reversing the persisting weakness of private consumption in the last few years. Confirming the more positive outlook, Japanese corporations also appear to have raised investment levels primarily through internal cash generation, following the sharp decline in 2002. However, the low nominal interest rates that have prevailed in Japan for almost four years have not succeeded, thus far at any rate, in stimulating credit growth in the economy. They have, however, attenuated the burden of debt service on the massive public debt, which now amounts to over 150 per cent of GDP and is likely to grow for the foreseeable future.

The main threat to a sustained recovery in Japan, insofar as it rests upon the contribution of net exports, is the yen exchange rate over the next 12 months. The yen was broadly stable in trade-weighted terms over 2003; it appreciated by no more than 5 per cent in the second half of 2003 and almost entirely against the United States dollar.

Table II.44. Developed countries of the ESCAP region: consumption and investment as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*[a]
Consumption as a percentage of GDP				
Australia	78.0	78.0	78.3	78.4
Japan	72.4	73.8	75.1	74.5
New Zealand	78.1	76.5	78.2	78.0
Investment as a percentage of GDP				
Australia	22.7	21.6	23.3	23.8
Japan	26.2	25.6	24.1	23.9
New Zealand	18.9	18.9	19.7	20.7

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LVI, No. 11 (Washington, IMF, November 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

[a] Estimates.

As such, the yen has depreciated significantly against the euro and has by and large remained stable against most Asian currencies with the exception of the Chinese yuan renminbi, against which it has appreciated in tandem with the United States dollar. It should be stressed that yen strength against the dollar is more a reflection of dollar weakness than strength of the former currency and the Japanese authorities have intervened in a major way in the currency markets to slow down the rise of the yen. The uncertainty in 2004 lies in whether dollar weakness will persist and whether the yen exchange rate will remain at a level where Japanese exporters can continue to sell profitably to the United States or to other economies with dollar-based exchange parities, such as China and Hong Kong, China.

Domestically, the main threat lies in continuing deflation, which can seriously undermine household spending. Up to November 2003, consumer prices had fallen 0.2 per cent on a year-on-year basis and 2003 would thus be the sixth year of falling prices in Japan. Although the rate of price declines appears to have bottomed out, most forecasters predict that deflation is likely to persist well into 2004 given the output gap in the Japanese economy and the inability of Japanese corporations to increase prices. The problem with deflation is that it raises the real burden of debt and debt servicing for both corporations and households and acts as a strong disincentive to consume, particularly in the purchase of durable goods. It is thus a negative influence on both consumption and investment and possibly one of the principal causes of the decade-long stagnation in the Japanese economy. While there is no early end in sight to the problem of deflation, the recent improvement in business and household confidence should lead to higher domestic output and consumption in 2004 in any case.

Strong growth in Australia and the impact of an appreciating exchange rate

Growth in the Australian economy has been driven in the recent past primarily by domestic factors, i.e., strong household consumption based on rising property prices, and the relatively low interest rate environment. Services have contributed the bulk of Australia's growth in the last five years, with industry following a more erratic course. The manufacturing component of industry has been adversely affected by the appreciating exchange rate, losing ground in the face of cheaper imports. Agriculture, traditionally one of the mainstays of the Australian economy contributing around 4.5 per cent of GDP, suffered a precipitous decline of over 10 per cent in 2002 (as a result of severe and extensive drought); it now accounts for just 3.7 per cent of GDP. Unemployment declined from 6.1 to 5.6 per cent between November 2002 and November 2003. The continuing dynamism of the Australian economy saw its stock market rise by more than 10 per cent in 2003 and by over 45 per cent in terms of United States dollars. Investment levels also rose appreciably, in mining ventures especially.

The growing shortfall in the external current accounts suggests that the contribution of net exports to growth was minimal in both 2002 and 2003. The former was a year of drought while GDP growth slowed perceptibly in 2003 as a stronger exchange rate served to dampen earnings on tradables; this applies especially to commodities priced in United States dollars. In other words, while export growth has been largely stable in volume terms, it has translated into lower incomes with the strengthened exchange rate. As a result, growth in private consumption and residential construction has moderated from its rapid pace in 2002. Business investment continues to remain strong, but the cooling of the property boom and the appreciating dollar are likely to have brought the investment rate down in 2003 as a whole. In addition, the lingering effects of the 2002 drought have left a legacy of problems of lower agricultural incomes, higher debt and increased uncertainty in the farming community that could take a considerable time to be fully resolved.

Although domestically driven GDP growth should continue to remain relatively strong, albeit at a more moderate pace compared with the recent past, the appreciation of the dollar could exacerbate the contribution of net exports and so widen the current account deficit. Its present size might require some additional corrective measures before too long, essentially some firming of interest rates to slow down the growth rate of imports (see table II.45). Paradoxically, however, such a policy option would also generate upward pressure on the exchange rate. Furthermore, given the importance of property investment in GDP growth in Australia

Table II.45. Developed countries of the ESCAP region: short-term interest rates and money supply growth (M2), 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*[a]
Short-term interest rates				
Australia	6.2	4.9	4.7	4.8
Japan	0.2	0.1	0.1	0.0
New Zealand	6.5	5.7	5.7	5.4
Money supply growth (M2)				
Australia	6.3	11.4	5.6	11.9[b]
Japan	1.1	2.2	3.4	3.0[c]
New Zealand	0.9	14.7	8.0	6.9[d]

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and OECD, *OECD Economic Outlook,* No. 74 at <http://www.oecd.org>, 2 November 2003.

[a] Estimates.
[b] January-August.
[c] January-May.
[d] January-September.

since 1999, the winding down of the real estate boom could dampen new investment in property with knock-on effects on the consumption of property-related consumer goods, and possibly lead to a wider slowdown in GDP growth. Unemployment is stable, however, so that a broader slowdown in the future is still only a theoretical outcome. It should be stressed here that in overall macroeconomic terms, Australia is in a comfortable situation with regard to its fiscal surplus (see table II.46).

Table II.46. Developed countries of the ESCAP region: budget and current account balance as a percentage of GDP, 2000-2003

(Percentage)

	2000	*2001*	*2002*	*2003*[a]
Budget balance[b] as a percentage of GDP				
Australia[c]	0.9	0.2	0.1	0.4
Japan	−7.4	−6.1	−7.5	−7.4
New Zealand[d]	1.3	1.6	1.5	2.0
Current account balance as a percentage of GDP				
Australia	−4.0	−2.4	−4.5	−5.2
Japan	2.5	2.1	2.8	2.9
New Zealand	−5.3	−2.8	−3.3	−5.0

Sources: ESCAP, based on IMF, *International Financial Statistics,* vol. LVI, No. 11 (Washington, IMF, November 2003) and *World Economic Outlook: Public Debt in Emerging Markets* (Washington, IMF, September 2003); and Economist Intelligence Unit, *Country Forecasts* (London, EIU, 2003), various issues.

[a] Estimates.
[b] General government fiscal balance.
[c] Data exclude net advances (primarily privatization receipts and net policy-related lending).
[d] Government balance is revenue minus expenditure plus balance of State-owned enterprises, excluding privatization receipts.

New Zealand's economic performance also driven by strong domestic demand; faster output growth forecast for 2004

As in Australia, the New Zealand economy has also enjoyed several years of buoyant growth driven essentially by strong domestic demand. The expansion in total output, however, slowed by 1.5 percentage points in 2003 compared with 2002, owing to a marked slowdown in export growth, while higher imports rendered negative the contribution of net exports to GDP growth. Drought in 2001 also played a part in lowering agricultural output and exports in the following two years, and in reducing the generation of hydroelectric energy.

Agriculture in New Zealand now accounts for just under 5 per cent of GDP, whose growth is thus driven, as in Australia, mainly by services. The strength of domestic demand has been significantly buoyed recently by strong inward migration and the ensuing higher domestic investment, which has been successfully converted into a strong rise in job opportunities. Unemployment in New Zealand is currently at around 4.6 per cent, a rate at which certain skill shortages are becoming more evident and could generate upward wage drift in due course. Strong job growth has, in turn, stimulated higher investment in housing and real estate generally. However, an appreciating exchange rate is likely to reduce the competitiveness of New Zealand's tradables, thus dampening somewhat new investment expenditures and in the process also slowing down job growth slightly. Indeed, current forecasts suggest that unemployment could go up a notch in 2004 despite faster output growth in the next 12 months. Like Australia, New Zealand's macroeconomic situation is marked by strong public finances with the fiscal surplus, for example, standing at 2.0 per cent of GDP and public debt, although higher than that of Australia when measured as a ratio of GDP, being at about 25 per cent, a level well below the average for the OECD countries. As a result of the low inflation, interest rates have also drifted downwards in the last three years but the widening current account deficit could reverse this trend.

Foreign trade and other international transactions

Strong momentum of export growth in Japan, Australia and New Zealand but current accounts widen in both Australia and New Zealand

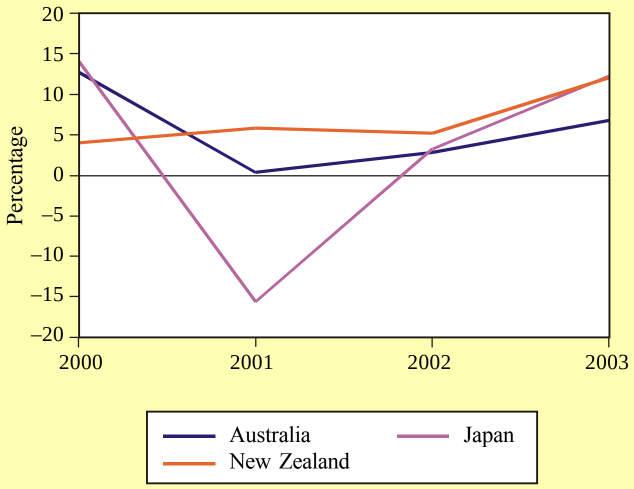
Japan's exports grew by 3.3 per cent to reach $416.6 billion in 2002, after experiencing a decline of more than 15 per cent (in dollar value) during the global slowdown in 2001 (see table II.47 and figure II.38). Export momentum strengthened further in 2003 as intraregional trade began to play a more significant role with China now becoming Japan's second biggest trading partner after the United States. It is noteworthy that the Asian region as a whole now accounts for 45 per cent of Japan's foreign trade compared with 40 per cent only five years ago.

Table II.47. Developed countries of the ESCAP region: merchandise exports and their rates of growth, 2000-2003

	Value (millions of US dollars)	*Exports (f.o.b.)*			
		Annual rate of growth (percentage)			
	2002	*2000*	*2001*	*2002*	*2003 (Jan.-Jun.)*
Australia	65 159	12.7	0.4	2.8	6.8
Japan	416 632	14.1	–15.6	3.3	12.3
New Zealand	14 159	4.0	5.8	5.2	12.1

Source: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003.

Figure II.38. Growth rates in merchandise export earnings of developed countries in the ESCAP region, 2000-2003



Source: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003.

Note: Data for 2003 refer to January-June.

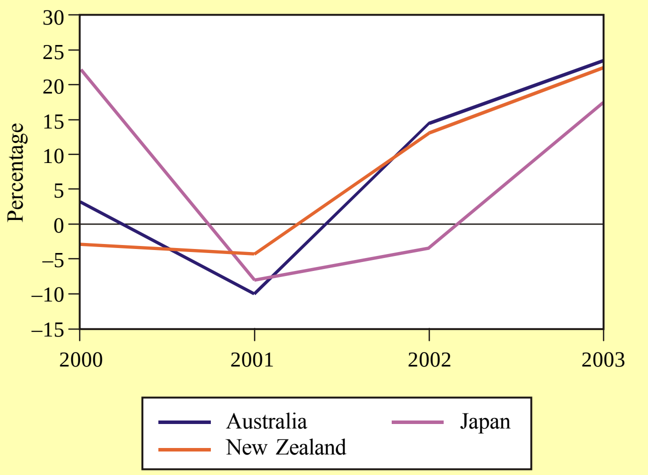
Imports also increased in 2003 after two years of decline (see table II.48 and figure II.39) but the current account surplus widened slightly from 2.8 to 2.9 per cent of GDP. As in the past, the main components of the current account surplus were outward FDI, portfolio flows and accumulation of foreign exchange reserves. As at the end of 2002, Japan's net foreign assets were $1.4 trillion, of which foreign reserves

Table II.48. Developed countries of the ESCAP region: merchandise imports and their rates of growth, 2000-2003

	Imports (c.i.f.)				
	Value (millions of US dollars)	*Annual rate of growth (percentage)*			
	2002	*2000*	*2001*	*2002*	*2003 (Jan.-Jun.)*
Australia	76 506	3.3	–10.0	14.4	23.5
Japan	337 149	22.1	–8.0	–3.4	17.4
New Zealand	15 097	–2.9	–4.3	13.1	22.5

Source: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003.

Figure II.39. Growth rates in merchandise import spending of developed countries in the ESCAP region, 2000-2003



Source: IMF, *Direction of Trade Statistics* (CD-ROM), November 2003.

Note: Data for 2003 refer to January-June.

amounted to $461 billion; these had risen to $1.7 trillion by October 2003, of which reserves reached $617 billion.

In Australia, exports increased slowly in both 2001 and 2002 but they expanded in 2003 (first half) at a faster pace in United States dollars terms but a somewhat slower pace in volume terms. Imports declined by 10 per cent in 2001 but they picked up well in 2002 (more than reversing the fall-off in 2001) and then increased by more than a fifth in 2003 (first half). Australia's recent trading performance reflects the after-effects of the severe drought of 2002 and the appreciation of its currency in 2003. Exports of agricultural commodities have been affected by the need to rebuild stocks at the expense of increases in output while the stronger exchange rate has sucked in imports, especially of capital goods (most of which have to be imported in any case) but also consumer goods. However, the static share of Asia in Australia's external trade is surprising; Asia's share has barely grown since 1996, effectively preventing Australia from participating fully in the external trade of the dynamic economies of East and South-East Asia. Australia is currently pursuing a free trade agreement with the United States.

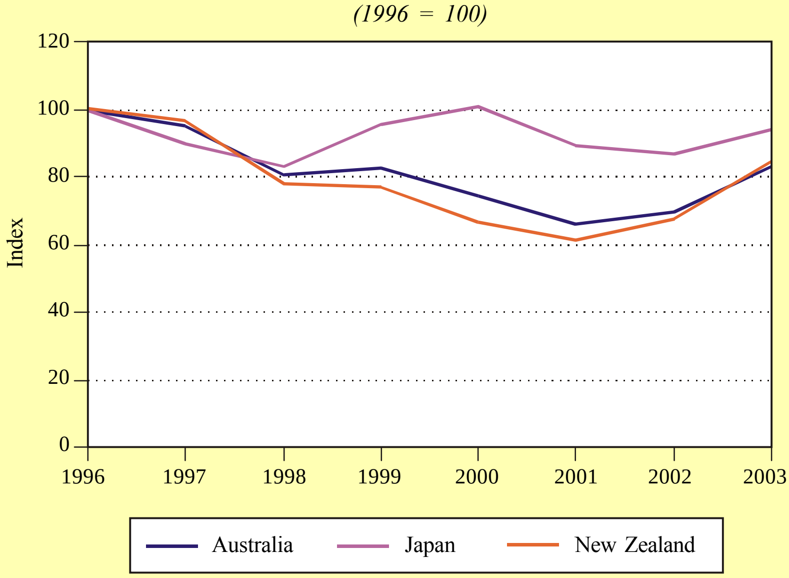
A rather moderate export performance and rapidly rising imports in 2003, plus a smaller surplus in external services, contributed to the widened current accounts deficit of over 5 per cent of Australia's GDP. This is historically on the high side but the deficit is expected to decline as tourism receipts recover in 2004. Australia's strong GDP growth and favourable interest rate differential vis-à-vis those in the United States and several other countries have helped to finance the deficit. Nevertheless, the growing deficit means a higher volume of external debt, which has worsened from an average of around 53 per cent of GDP in the 1990s to over 59 per cent in 2003. This will increase the cost of debt servicing and render more intractable the reduction of the external debt to the level of the 1990s. However, the debt is concentrated in private corporations and despite a higher foreign currency portion in such debt, the associated currency risk is well managed through extensive hedging. Moreover, it is generally accepted that corporate balance sheets are strong and should be able to cope with any likely swings in exchange and interest rates.

The deterioration of the current accounts deficit has been caused primarily by the sharp appreciation of the Australian dollar (of roughly 20 per cent in 2003 on a trade-weighted basis and by almost a third against the United States dollar on a bilateral basis). To some extent, the recent strengthening of the currency reverses the significant weakening it experienced in 2000-2001 and, compared to 1990, the Australian dollar remains undervalued in trade-weighted terms (figure II.40). Its strengthening nonetheless serves to underline Australia's low domestic savings rate, which cannot finance the investment needs of the economy. Further strengthening of the Australian dollar could thus materially affect the sustainability of investment and productivity and output growth in the economy.

In New Zealand, trade is an important component of the overall economy, with exports of goods and services amounting to over a third of GDP. Over the last three years, the country's external trade has followed a pattern similar to that of Australia. Imports declined in 2001 but grew in both 2002 and 2003. Exports have, again like Australia's, tended to accelerate in 2003 after two years of relatively modest growth. And, once more paralleling Australia's experience, New Zealand's current account deficit widened in 2003 on the back of an appreciating exchange rate, mainly through the rapid increase in imports.

Figure II.40. Index of exchange rates against the United States dollar of developed countries in the ESCAP region, 1996-2003

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LVI, No. 12 (Washington, IMF, December 2003); and *Far Eastern Economic Review,* various issues.

Note: Data for 2003 are estimates.

The consensus view is that the appreciation of the New Zealand dollar will have its main impact on non-commodity exports with a time lag of around 18 months. Hence, if imports continue to rise, the current account is likely to deteriorate further in the later part of 2004. A particular complication in this context is the bilateral exchange rate between New Zealand and Australia as the latter accounts for around 50 per cent of New Zealand's exports of manufactured goods and is also an important source of tourist arrivals. The New Zealand dollar has appreciated by less than the Australian dollar and this should give New Zealand a modest competitive boost in 2004. In addition, a return to more normal conditions in agriculture should help overall exports, thus lessening somewhat the deterioration in the current account in 2004. Indeed, New Zealand's own forecasts are for the current accounts deficit to fall sharply from its present peak of 5.0 per cent of GDP to a more sustainable 3.0 per cent in 2005.

Key policy issues

The major policy issues confronting the three developed countries in the region are ultimately not very different from the challenges facing the developing economies, where Governments have to constantly juggle with the social and economic tradeoffs involved in pursuing alternative options. The uncertainties prevailing in the global environment affect all economies, depending upon the levels of their international integration, and the need to maintain macroeconomic stability is now considered equally valid for all economies. However, developed countries have the advantage of more ample resources, both human and material, and greater institutional depth and flexibility to implement their policy agendas. Even so, success in confronting the policy challenges often eludes even well-endowed economies. Economic management thus raises complex and multidimensional issues regardless of the initial setting; as such, it involves a difficult mix of incentives, persuasion and, as necessary, discipline. In the following paragraphs the key policy issues facing the three developed economies of the region are discussed, highlighting their similarities and differences. Many of the policy issues have been discussed previously in past issues of the *Survey;* what is attempted here is a re-examination of how these issues have evolved over time.

Sustaining the momentum of recovery in Japan

The key policy objective in Japan in 2004 is to sustain the current process of economic recovery so that the momentum of output growth can return closer to what it was prior to the ending of the bubble economy in the early 1990s. In the 1980s, for example, the Japanese economy was growing at an average, and admirable, rate of around 4 per cent per annum. Many observers would, however, consider such a pace of economic activity unrealistic given the demographic changes within Japanese society, the evolution of the Japanese economy itself over the last decade or more and such global developments as the rise of China and other economies in the region as platforms for manufacturing and exports. At the same time, Japan is faced with several other impediments to sustaining a strong recovery, with many of these impediments being part of the legacy of the bubble economy, such as a largely insolvent financial sector, a huge decline in personal wealth and the subsequent build-up of chronic deflationary pressures and of public sector debt, the largest of any developed country. Most observers agree that a realistic and sustainable rate of growth for the Japanese economy is perhaps around 2 per cent per annum, at least in the near future.

Faster pace of reforms needed in Japan

Against this daunting background, there is now encouraging evidence not only of a recovery in output and the stabilization of unemployment but also of progress in tackling the problems of the financial sector and restructuring the impaired balance sheets of corporations. In addition, the Government has begun to pursue fiscal consolidation in order to achieve a stable ratio of public debt to GDP over a defined time-span (see box II.6). The question now is whether these positive developments will be long-lasting and whether the progress in their implementation can be speeded up. The general consensus is that a more durable solution to the problems outlined above and, by implication, the achievement of sustained growth over the medium term would seem to require a faster pace of reform. For instance, further strengthening of the banking system is critical to corporate restructuring, especially in the case of small and medium-sized enterprises, as banks must now be able to absorb losses arising from restructuring without recourse to public funds. In this regard, it is important that non-viable firms not be kept alive and that transparent, arms-length criteria be used to sift viable from non-viable enterprises. While economic recovery is increasing the resources available to banks to write off non-performing loans, it is important that such resources not be dissipated in efforts to salvage insolvent firms.

The Bank of Japan has been attempting to overcome domestic deflationary pressures by quantitative monetary easing and by buying asset-backed securities from the private sector to strengthen the monetary transmission mechanism. While deflation appears to have stabilized, it still appears that prices will likely continue falling in 2004 and perhaps beyond as well. Thus, the continuing incidence of deflation is likely to impede both bank and corporate restructuring and perhaps call into question the sustainability of the present recovery. In this regard, establishing an inflation target, say, for 2005, may be worth considering as another option in the arsenal of concerted policy attempts to reverse the strongly entrenched deflationary expectations in the economy of Japan.

The question of fiscal consolidation poses particularly complex policy issues. In particular, the rising public debt, if unchecked, will almost certainly lead to a rise in long-term interest rates, thus choking off

Box II.6. The public debt of Japan

The end of the stock market and real estate bubble in the late 1980s led to a massive loss of personal and institutional wealth that plunged the Japanese economy into more than a decade of near-stagnation. Successive public spending packages by the Government to boost growth – 13 in all between August 1992 and January 2003 – have been accompanied by three recessions and the average growth in output of the Japanese economy has barely exceeded 1 per cent per annum since 1992. Public debt now stands at 155 per cent of GDP,[a] the highest ratio in the developed countries. Fiscal consolidation is thus clearly an urgent issue. However, uncertainty in the strength of the current economic recovery limits the range of options available to the Government to take any drastic measures to tackle the problem. An additional concern is the risk of a surge in the cost of servicing the massive public debt once economic recovery becomes more firmly established, inflationary expectations kick in and interest rates start to rise. Thus far, deflationary pressures have helped to maintain the exceptionally low interest rate environment and hence the cost of servicing the debt.

There was an initial attempt at fiscal consolidation in 1997, in retrospect at the cost of economic recovery. Shifting the priority of economic policies towards fiscal sustainability, the Government discontinued a temporary tax cut while at the same time raising the consumption tax. It also enacted the Fiscal Structural Reform Act in the same year, setting a target for reducing the deficit (excluding social security) to below 3 per cent of GDP from around 6 per cent at the time.[b] Deterioration of the economy following the fiscal tightening led the Government to launch two large economic stimulus packages and suspend the Act in 1998. This experience is now seen as a major factor contributing to the reluctance of the Government to take more decisive action towards fiscal consolidation and to its decision to wait until economic recovery takes hold in a more sustainable fashion.

While the present Government has announced targets for fiscal consolidation, these have been revised several times because of sluggish economic recovery. The policy guidelines for tackling the problem are enshrined in a policy document on structural reform of the Japanese economy: basic policies for macroeconomic management, released in 2001, in which the Government had indicated the policy objective of limiting bond issuance to 30 trillion yen in fiscal year 2002 and had estimated achieving the primary balance in the national budget two years thereafter. However, the shortage of tax revenues in fiscal year 2002 led to an additional 5 trillion yen of bond issuance. The issuance of bonds has been close to this level in subsequent years: 36.4 trillion yen in fiscal year 2003 and 36.5 trillion yen in fiscal year 2004 (equivalent to around 7 per cent of GDP). This has damaged the credibility of the fiscal consolidation targets announced in 2001. Thus, there is growing scepticism about how realistic the Government's targets are, including the revised targets to achieve primary budget balance (excluding debt servicing) by 2010.

The prolonged economic stagnation has justified the accumulation of the huge public debt under the guise of stimulating output growth. There is a view that the Government's slow and somewhat weak response to fiscal consolidation is partly due to the fact that the debt is supported by the huge domestic household savings in Japan and has no foreign component and the accumulation of public debt has not caused any visible problems in the economy, thus far at any rate. In addition to deflationary pressure, the troubled financial sector's preference to avoid risk has contributed to low long-term interest rates. As a result, despite the increase in total government debt from 300 to nearly 700 trillion yen (for both the national and local governments) between 1991 and 2001, the nominal costs of debt service have actually declined. Thus, the Government has had little incentive to pursue fiscal consolidation in a more robust fashion.

With a greater sense of urgency for fiscal consolidation now taking hold, the Government is having to face the challenge of balancing immediate and mid-term policy goals. On the one hand, even with the current economic recovery being sustained in the next few years, dramatic tax increases would be inevitable to achieve a fiscal balance within a reasonable time frame; on the other, the adverse impact of tax hikes on the economy is likely to be

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[a] Estimate is for a calendar year, referred to in "Highlights of the budget for FY2004", Ministry of Finance, Japan, December 2003.

[b] Hideaki Tanaka, "Fiscal consolidation and medium-term fiscal planning in Japan", *OECD Journal on Budgeting,* vol. 3, No. 2, pp. 105-137.

significant. Some estimates suggest that the primary balance may not be achieved before 2014 even with a 10 per cent consumption tax. There is little doubt, therefore, that painful cuts in expenditure may be necessary as interest payments on the public debt are increasingly crowding out other government expenditure. In fact, for the initial budget for 2004, the general expenditure increase is a mere 0.1 per cent (39.8 billion yen), compared with an increase in debt servicing of 4.5 per cent (to 770.4 billion yen).[c] On the expenditure side, the ageing population and the need for pension scheme reform have been a central concern in the Government's structural reform programme. The budget for fiscal year 2004 outlines a pension scheme reform plan, which includes an increase in premiums and a reduction in benefits. However, concern remains that the reform will simply lead to increasing the burden on employers while reducing the reliability of the pension scheme, which will further increase the endemic uncertainty that has characterized the Japanese economy for a decade or more.

[c] "Highlights of the budget for FY2004", Ministry of Finance, Japan, December 2003.

long-term economic recovery. The official goal is to achieve primary fiscal balance in the early part of the next decade, but this would still require substantial increases in taxes in the intervening period. Where the burden of additional taxation should fall is going to pose a huge political challenge. It is important, therefore, that the public be fully involved in the process of deciding burden-sharing, especially as regards which taxes are to go up and which components of the welfare system are going to require higher contributions from the public. Without such involvement by the public, the credibility and sustainability of the consolidation strategy could be impaired.

Notwithstanding short-term risks, Australia's medium-term outlook remains positive

The Australian economy, in contrast, continues to grow strongly with relatively low inflation. The country's ability to generate and maintain robust economic growth over the last decade or more at well above the OECD average is attributed to the steady commitment of the Government to macroeconomic prudence and the simultaneous management of extensive structural change and reform in the economy in a transparent political process. However, the immediate outlook is slightly clouded by a number of potential risks, both internal and external.

Internally, the property price boom of the past few years could presage a real estate bubble with its attendant downside risks for the financial sector. The high and rising property prices pose difficult issues for the conduct of monetary policies in view of the appreciation of the Australian dollar. An increase in interest rates to cool the housing market would, in the current situation, further strengthen the exchange rate and this might adversely affect exports. At the same time, intervening in asset markets when the underlying inflation is low poses a host of essentially unresolved monetary policy trade-offs. The overall situation thus is one where the Government and the monetary authorities have to weigh the risks between taking action pre-emptively and following a policy approach of "benign neglect" for the time being.

Externally, the sharp appreciation of the Australian dollar (over 29 per cent against the United States dollar in 2003) is likely to affect the country's competitiveness both in the United States and in the Asian region. Many of the biggest markets for Australia, such as China, Hong Kong, China, the Republic of Korea and Taiwan Province of China, have exchange rates that have either remained tied to the United States dollar or have seen much less appreciation than the Australian currency. As such, Australian exports, those of manufactured goods particularly, are almost certainly likely to lose some ground in these markets, possibly causing a worsening current accounts deficit in the process. This deficit poses a problem only if it leads to financing difficulties; reassuringly, these are not considered likely given Australia's successful history in the management of its external debt.

Apart from these relatively minor short-term risks, Australia's medium-term outlook remains positive. Growth is expected to continue at around the present pace driven by strong domestic demand, sound macroeconomic fundamentals and a sophisticated financial system. Unemployment is low and declining, and the strong growth in services has generated a variety of new jobs, providing Australia's job seekers with an enviable range of employment opportunities. Strong output growth should also enable the Government to carry out further reforms to align taxes and welfare spending in a more sustainable way.

New Zealand must boost productivity and both the Government and society must play a part

New Zealand's economy is in many ways very similar to that of Australia. Growth has been fairly strong for a number of years (over 3 per cent per annum since 1992) driven, as in Australia, by domestic demand, in which rising housing prices have recently played a major role. Output expansion has also been the result of a wide-ranging programme of structural reforms that was initiated more than 20 years ago. Nevertheless, the country suffers from a chronic current account deficit, which is currently being exacerbated by an appreciating exchange rate. Other macroeconomic fundamentals, such as inflation and the budget balance, remain sound.

However, New Zealand cannot overcome the disadvantages of its physical remoteness and its small population, which makes economies of scale difficult to achieve, and its economy has significantly underperformed that of Australia, notwithstanding the recent improvement. As a result, New Zealand's per capita GDP in 2003 (in United States dollars on the basis of purchasing power parity) was more than $5,000 less than that of Australia. Although there has been high immigration into New Zealand, which has boosted the working-age population by around 1 per cent per annum over the last two years, over time New Zealand has tended to lose working-age and relatively skilled people through emigration to Australia. The key challenge is thus to boost overall productivity in the economy, which increases incomes and reduces the need to emigrate.

Through its Growth and Innovation Framework, the New Zealand Government is seeking to address these issues by pursuing the following four development objectives: increasing global connectedness, fostering innovation, promoting skills and talent and catalysing development in certain "focus" sectors of the economy. While these objectives are undoubtedly vital for New Zealand's future growth and prosperity, it is unlikely that they will be able to deliver results in the short term. The country thus has to make a renewed effort to reduce emigration, encourage immigration, especially of younger people, and, through a sustained programme of investment in ICT, seek to overcome the problems posed by its physical remoteness. Such an effort is not primarily related to the investment of financial resources but more to the Government and society joining together in the pursuit of a common long-term national interest, to preserve and enhance the prosperity and welfare of the country.

III POVERTY REDUCTION STRATEGIES: TACKLING THE MULTIDIMENSIONAL NATURE OF POVERTY

INTRODUCTION

Despite significant progress over time, poverty reduction continues to be a major challenge for many countries in Asia and the Pacific. Moreover, progress in reducing poverty has been uneven across and within countries. Poverty is a complex phenomenon whose dimensions extend far beyond income. This clearly calls for a holistic approach to deal with the problem comprehensively.

Poverty reduction strategies have to deal with many difficult and complex challenges

Most countries in the region have already developed their own national poverty reduction strategies and programmes. A number of them have also prepared or are in the process of preparing poverty reduction strategy papers (PRSPs) as a framework for poverty reduction, with the help and support of multilateral organizations. Translating PRSPs and other national poverty reduction strategies into effective policies and programmes to tackle the various dimensions of poverty simultaneously with limited resources has become a challenging task for many countries.

Economic growth is essential for sustained poverty reduction. The challenge for countries is how to accelerate it and at the same time make it broad-based for the greater benefit of the poor. Policy packages that promote economic stability and growth and at the same time lead to a rapid reduction in poverty are required. It is a very challenging task to design a balanced policy package that incorporates and deals with various trade-offs and promotes growth with equity.

The achievement of the Millennium Development Goals (MDGs) necessitates progress in all major areas related to the well-being of the people, including poverty reduction and improvements in education, health, gender equality and the environment. Eradication of extreme poverty and hunger is at the forefront of the MDGs. Since PRSPs and targets to be achieved under the MDGs have different time horizons, the countries face the challenge of linking the targets under PRSPs and national poverty reduction measures with those required under the MDGs.

The objective of this chapter is to critically review national poverty reduction strategies in order to draw policy lessons

This chapter examines trends in selected dimensions of poverty to ascertain the nature and extent of poverty in countries of the region. A critical review of national poverty reduction strategies and programmes including those dealt with within the framework of PRSPs is provided to bring out commonalities, share experiences and draw lessons for designing more effective policies and programmes. Based on the analysis in the previous sections, the concluding section of the chapter contains policy recommendations.

DIMENSIONS AND MAGNITUDES OF POVERTY

Poverty is a multidimensional concept and is not easy to define

Being a multidimensional concept, poverty is not easy to define. It can mean different things to different people. Conceptual and methodological differences in defining poverty can lead to the identification of different individuals and groups as being poor. As a result, policy prescriptions for tackling the problem can vary according to how poverty is defined. A brief discussion on the concept and definition of poverty should help in understanding the discussion on policy-oriented issues later in the chapter.

Four approaches to understanding and defining poverty

Four approaches to defining poverty are highlighted here.[1] These include the monetary approach, the capabilities approach, the social exclusion approach and the participatory approach.

Monetary approach

The monetary approach is most commonly used to define and measure poverty. A poverty line is defined in terms of the monetary income sufficient to attain a minimal standard of living. While estimating the poverty line, allowance is usually made for both food and non-food expenditure. A person whose income (expenditure) falls below the poverty line is considered poor. Since income provides access to goods and services, it is considered a good proxy for covering many aspects of poverty. However, a limitation of the approach is that it does not capture access to social services, which clearly enhances a person's well-being.

Capabilities approach

The capabilities approach pioneered by Amartya Sen emphasizes that income is only valuable in so far as it increases the capabilities of individuals and thereby permits functioning in a society. The ultimate objective is capabilities such as the ability to lead a long life, to function

[1] For details on these, see C.R. Laderchi, R. Saith and F. Stewart, "Everyone agrees we need poverty reduction, but not what this means: does this matter?", paper for the WIDER Conference on Inequality, Poverty and Human Well-being, Helsinki, 30-31 May 2003, available at <http://www.wider.unu.edu/conference/conference-2003-2/conference2003-2.htm/>, 5 January 2004.

without chronic morbidity, to be capable of reading, writing and performing numerical tasks and to be able to move from place to place. In accordance with this approach, a person whose capabilities or functioning falls below a minimum acceptable standard is poor. The resources or income required to achieve the same capabilities can vary from person to person. Therefore, a capability-poor person may not be income-poor. Because of difficulties in measuring capabilities, in practice there has been a marked tendency to measure functioning in such terms as literacy and life expectancy. The capabilities approach is much broader and addresses the neglect of social goods in the monetary approach.

Social exclusion approach

The social exclusion approach emphasizes relations among individuals. Social exclusion occurs when individuals or groups are unable to participate fully in the society in which they live. As a result of exclusion, the incomes, capabilities or other characteristics of the poor become unacceptably distant from the norms of their community or reference group. In accordance with the exclusion approach, poverty is a social construct and has little to do with the fulfilment of an individual's minimum needs. As a result, social exclusion is often a characteristic of groups – women, the aged, handicapped, racial or ethnic categories – rather than of individuals. An important aspect of this approach is that it not only focuses on the outcome of social exclusion but also on the processes that lead to it.

Participatory approach

The participatory approach takes into account the views of poor people themselves. The people themselves decide what it means to be poor, and that determines the magnitude of poverty. Here the perspective is that of the poor; it is not imposed from outside. The approach relies on the contextual method of analysis and this helps in understanding the poverty dimensions within the social, cultural, economic and political environment of a locality. Hence, poverty outcomes may not be quantified and standardized.

The poor identified under different approaches may not overlap …

In case all the approaches identify broadly the same people as poor, any single approach can be used to measure poverty. However, the empirical evidence shows that poverty rates in countries differ significantly according to the approach adopted. As a result, policy options can differ depending on the approach selected. For example, increasing the money income of the poor is the solution under the monetary approach. Capabilities development can be recommended under the same approach but only as a means of increasing money incomes among the poor. The use of the capabilities approach in general suggests the social provision of goods to achieve health, nutrition and education targets. Money income is important but only as a means to promote some capabilities.

... and as a result, policy prescriptions can differ for different groups of poor

Since both the monetary and capabilities approaches are basically concerned with absolute poverty, growth can help in solving the problem, and distributional issues are less relevant. However, the relative element in poverty is at the forefront in the social exclusion approach and growth alone may never eliminate social exclusion. Therefore, priority is given to redistributive policies to remove imbalances. A distinguishing feature of the social exclusion approach is its focus on groups as compared with individuals under the monetary and capabilities approaches. For social exclusion, therefore, policies are targeted at groups, such as eliminating discrimination and various forms of affirmative actions. To deal with the problem of poverty under the participatory approach, solutions have to respond to the expressed concerns of the poor, which can be of a localized nature also. The poor should be involved not only in identifying the problems but in solving them also. Moreover, they should be involved in implementing poverty reduction programmes so that they develop a true sense of ownership, much needed for the greater success of such programmes.

Trends in income poverty

More than two thirds of the world's poor live in Asia and the Pacific

Income poverty is the most serious problem faced by many developing countries of the region. Based on the dollar a day poverty line, more than two thirds of the world's poor live in Asia and the Pacific.[2] The incidence of poverty in the region decreased from 37 per cent in 1990 to 25 per cent in 1999.[3] As a result, around 225 million people were taken out of poverty over that period. However, some 767 million were still living on less than one dollar a day in 1999. The performance of East Asia (including South-East Asia) and the Pacific in reducing poverty was much better than that of South Asia. The incidence of poverty in East Asia and the Pacific, at 31 per cent in 1990, was nearly halved in 1999. In South Asia, the number of people living below the poverty line fell from 44 per cent in 1990 to 37 per cent in 1999.

If the poverty line is raised to two dollars a day, Asia and the Pacific becomes home to around three fourths of the world's poor. More than 2 billion people were living on less than two dollars a day in the

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[2] The poverty line is actually $1.08 per capita a day at 1993 purchasing power parity. The poverty line in terms of purchasing power parity and estimates based on this have many limitations. For details, see Angus Deaton, "Counting the world's poor: problems and possible solutions", *World Bank Research Observer*, vol. 16, No. 2 (Fall 2001); see also the comments on the paper by Martin Ravallion and T.N. Srinivasan in the same issue.

[3] These poverty estimates have been derived from World Bank, *Global Economic Prospects and the Developing Countries 2003*, available at <http://www.worldbank.org/prospects/gep2003/full.htm>, 15 October 2003.

region. The comparison of this figure with that based on one dollar a day shows that far more than 1 billion people have incomes of between one and two dollars a day. The increase in the poverty line more than doubles the number of the poor and reveals the extent and seriousness of the poverty situation in the region. Moreover, while the incidence of poverty under the two dollar a day poverty line fell from 78 per cent in 1990 to 65 per cent in 1999, the absolute number of the poor declined by around 100 million over the same period.

Most countries have been able to reduce poverty over time but the extent of success varies across countries

The regional data mask diverse performances by the countries. Using the one dollar poverty line, poverty has been virtually eliminated in Malaysia and the Republic of Korea (table III.1). Between 1990 and 2002, poverty has been more than halved in China, Indonesia, Thailand and Viet Nam. Therefore, these countries have already achieved the Millennium Development Goal of reducing poverty by half between 1990 and 2015. The Lao People's Democratic Republic and the Philippines

Table III.1. Percentage of the population below the one dollar poverty line in selected countries, 1990-2002

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Bangladesh	..	..	35.9	..	..	..	29.1	..	..	..	36.0	..	..
Cambodia	48.3	..	..	..	..	..	36.7	38.4	37.7	41.7	44.6	45.0	44.2
China	31.5	..	..	29.0	..	..	16.4	..	16.1	17.8	15.4	14.3	12.7
India	46.6	..	51.1	..	45.1	47.1	46.2	44.2	..	34.7	..	..	..
Indonesia	20.6	..	..	14.8	..	..	7.8	..	..	12.0	9.9	9.2	7.2
Kazakhstan	..	..	..	1.1	..	..	1.5	..	..	..	..	..	..
Kyrgyzstan	..	..	..	23.0	..	..	..	1.6	..	..	2.0	..	..
Lao People's Democratic Republic	53.0	..	48.8	..	..	..	41.3	38.4	36.6	36.7	35.1	31.3	30.0
Malaysia	2.0		1.5	..	..	1.0	0.8	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5
Mongolia	..	..	..	..	..	13.9	..	..	..	..	..	..	..
Nepal	..	..	..	..	..	37.7	..	..	..	..	..	..	..
Pakistan	47.8	..	..	33.9	..	..	31.0	..	..	..	..	..	..
Papua New Guinea	35.4	..	..	..	..	..	24.6	25.6	27.8	30.7	35.3	38.2	42.8
Philippines	19.1	19.8	..	..	18.4	..	14.8	12.1	13.7	13.5	13.5	11.9	11.5
Republic of Korea	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5
Russian Federation	..	..	..	6.2	..	..	7.2	..	7.1	..	6.1	..	..
Sri Lanka	3.8	..	..	..	..	6.6	..	..	..	..	..	..	..
Thailand	12.5	..	6.0	..	..	..	2.2	..	3.3	3.1	5.2	3.6	2.4
Turkmenistan	..	..	..	20.1	..	..	..	..	12.1	..	..	..	..
Viet Nam	50.8	..	..	39.9	..	..	23.6	..	16.4	16.9	15.2	14.6	13.6

Sources: World Bank, *East Asia Update: Regional Overview*, October 2003, <http://www.worldbank.org.cn/English/Content/EAP10-03.pdf>, 20 November 2003 and global poverty monitoring web site, <http://www.worldbank.org/research/povmonitor/>, 17 June 2003.

also witnessed rapid reduction in poverty over the period 1990-2002 and are close to achieving the Millennium Development Goal. Both Cambodia and Papua New Guinea recorded a significant decrease in poverty during the first half of the 1990s but witnessed an upward trend after that. Data for most other countries are patchy and somewhat old. In India, the incidence of poverty fell markedly between 1990 and 1999. There was a major decrease in poverty in Pakistan between 1990 and 1996. While poverty remained virtually unchanged in Bangladesh between 1992 and 2000, in Sri Lanka it trended upward between 1990 and 1995. Relatively lower poverty rates in Kazakhstan and the Russian Federation remained somewhat stable during the 1990s. There was a marked decline in poverty in Kyrgyzstan and Turkmenistan. Based on the two dollar per capita poverty line, the rates of poverty are understandably much higher and progress in reducing poverty has been much slower in most countries (table III.2).

Table III.2. Percentage of the population below the two dollar poverty line in selected countries, 1990-2002

	1990	*1995*	*2000*	*2001*	*2002*
Bangladesh	86.4[a]	77.8[b]	82.8	..	..
Cambodia	83.7	76.9[b]	80.0	80.1	78.7
China	69.9	51.6[b]	44.8	41.5	37.3
India	88.2	87.9	79.9[c]	..	..
Indonesia	71.1	50.5[b]	59.5	58.7	53.5
Kazakhstan	41.7[d]	15.3[b]	..	..	..
Kyrgyzstan	44.5[d]	..	34.1	..	..
Lao People's Democratic Republic	89.6	83.1[b]	79.8	77.4	76.6
Malaysia	18.5	14.0	9.8	9.8	9.6
Nepal	88.0[e]	82.5	..	..	..
Pakistan	87.9	84.7[b]	..	..	..
Papua New Guinea	64.3	54.4[b]	65.0	69.7	71.5
Philippines	53.5	46.5[b]	47.1	45.3	44.7
Republic of Korea	<0.5	<0.5	<0.5	<0.5	<0.5
Russian Federation	19.7[d]	24.4[b]	23.8	..	..
Sri Lanka	40.6	45.4	..	..	..
Thailand	47.0	28.2[b]	35.6	32.0	27.7
Viet Nam	87.0	69.4[b]	63.5	61.8	58.2

Sources: World Bank, *East Asia Update: Regional Overview*, October 2003, <http:www.worldbank.org.cn/English/Content/EAP10-03.pdf>, 20 November 2003 and global poverty monitoring web site, <http://www.worldbank.org/research/povmonitor/>, 17 June 2003.

[a] 1992.
[b] 1996.
[c] 1999.
[d] 1993.
[e] 1985.

Many countries have their own national poverty lines defined in domestic currencies. Poverty estimates based on these poverty lines are not strictly comparable between countries owing to differences in poverty lines and methodologies. However, the country poverty estimates can be used to study trends in poverty within countries. The countries may prefer poverty estimates based on these poverty lines for evaluating the impact of national poverty reduction strategies. Some available data based on national poverty lines are reported in table III.3. The incidence of poverty

Table III.3. Percentage of the population below the national poverty line in selected countries, 1990-2002

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Armenia	18.0[a]	..	..	..	..	..	..	..	55.0	..	..	..	..
Azerbaijan	33.0[a]	..	..	..	..	62.0	..	..	..	..	..	..	..
Bangladesh	47.8[b]	..	42.7	..	..	..	36.0	..	..	..	33.7	..	..
Cambodia	..	..	..	..	39.0	..	..	36.1	..	..	..	..	..
China	9.4	..	..	..	..	7.1	6.7	5.4	4.6	3.7	3.4	3.2	3.0
Fiji	..	..	..	..	..	..	..	25.5	..	..	..	..	..
Georgia	16.0[a]	..	..	..	..	..	..	11.1	..	..	..	..	..
India	38.9[a]	..	..	..	36.0	..	..	..	..	26.1	..	..	..
Indonesia	15.1	..	..	13.7	..	..	11.3	..	..	18.2	..	..	..
Kazakhstan	..	..	..	..	..	..	34.6	43.0	43.4	34.5	31.8	..	..
Kyrgyzstan	37.0[a]	..	..	40.0	..	..	..	51.0	..	64.1	..	..	..
Malaysia	17.1[b]	..	..	13.4	..	9.6	..	6.8	..	8.1	..	..	..
Mongolia	..	..	17.0	24.0	..	36.3	..	..	35.6	..	..	..	..
Nepal	41.4[c]	..	..	..	..	..	42.0	..	..	..	..	..	..
Pakistan	..	26.1	..	26.8	28.7	..	..	29.8	..	30.6	32.1	..	31.8[d]
Papua New Guinea	..	..	..	..	..	..	21.7	..	..	..	..	..	..
Philippines	..	45.3	..	..	40.6	..	..	33.0	..	..	34.0	..	..
Republic of Korea	8.4[a]	..	..	8.2	..	..	7.0	..	..	..	..	..	..
Sri Lanka	..	20.0	..	..	..	..	25.0	..	..	..	..	..	..
Tajikistan	59.0[a]	..	..	..	..	..	..	..	..	83.0	..	..	..
Thailand	27.2	..	23.2	..	16.3	..	11.4	..	13.0	..	14.2	..	9.8
Viet Nam	..	..	..	58.2	..	..	..	..	37.4	..	32.0	..	28.9

Sources: ESCAP, *Growth with Equity: Policy Lessons from the Experiences of Selected Asian Countries* (United Nations publication, Sales No. E.00.II.F.14); ADB, country papers prepared for the Inception Workshop on Building a Poverty Database, held at Manila in July-August 2001; World Bank, *World Development Report 2000/2001: Attacking Poverty* (New York, Oxford University Press, 2001) and *World Development Indicators 2003* (Washington, World Bank, 2003); IMF and World Bank, "Poverty reduction, growth and debt sustainability in low-income CIS countries" (Washington, IMF and World Bank, 2002); and national sources.

Notes: Poverty estimates are based on country-specific poverty lines, expressed in national currencies. Many countries have more than one such poverty line, and efforts have been made to include consistent time series data on the incidence of poverty. For China, poverty estimates are for rural areas only.

[a] 1988.
[b] 1989.
[c] 1985.
[d] 2003.

fell between the early and late 1990s in several countries including Bangladesh, China, India, Indonesia, Malaysia, the Philippines, the Republic of Korea, Thailand and Viet Nam. As a result of the economic crisis in 1997, the poverty rates increased in Indonesia, Malaysia, the Philippines and Thailand. The available data indicate an upward trend in poverty in Pakistan and Sri Lanka, whereas poverty remained unchanged in Nepal. Most transitional economies including Armenia, Azerbaijan, Kyrgyzstan and Tajikistan saw an upsurge in poverty during the 1990s as compared with the pre-transitional poverty levels.

The incidence of poverty in rural areas generally continues to be higher than in urban areas

Within countries, particularly large ones, different patterns of poverty can emerge, reflecting diverse regional developments. This is clearly visible in rural and urban poverty levels in a limited number of countries for which data based on national poverty lines are available. Poverty is still considered mainly a rural problem for two reasons. First, the overwhelming majority of the population in Asia live in rural areas. For example, more than two thirds of the population in Bangladesh, Cambodia, China, India, the Lao People's Democratic Republic, Myanmar, Nepal, Thailand and Viet Nam lived in rural areas in 2003. The incidence of poverty tends to be much higher in rural than urban areas. Of the 13 countries referred to in table III.4, the incidence of rural

Table III.4. Incidence of poverty in rural and urban areas in selected countries based on national poverty lines

	Period	*Rural poverty*		*Urban poverty*	
		First year	*Final year*	*First year*	*Final year*
Bangladesh	(1992, 2000)	46.0	37.4	23.3	19.1
Cambodia	(1994, 1997)	43.1	40.1	24.8	21.1
India	(1988, 1999)	39.1	27.1	38.2	23.6
Indonesia	(1990, 1999)	14.3	20.2	16.8	15.1
Kazakhstan	(1996, 2000)	39.0	34.2	30.0	30.0
Kyrgyzstan	(1993, 1999)	48.1	69.7	28.7	49.7
Malaysia	(1989, 1999)	21.8	13.2	7.5	3.8
Mongolia	(1995, 1998)	33.1	32.6	38.5	39.4
Pakistan	(1991, 2003)	25.2	38.6	26.6	22.4
Philippines	(1991, 2000)	55.1	48.8	35.6	18.6
Republic of Korea	(1988, 1996)	7.2	9.4	8.9	6.1
Sri Lanka	(1991, 1996)	22.0	27.0	15.0	15.0
Viet Nam	(1993, 1998)	66.0	45.0	25.0	9.0

Sources: ESCAP, *Growth with Equity: Policy Lessons from the Experiences of Selected Asian Countries* (United Nations publication, Sales No. E.00.II.F.14); ADB, country papers prepared for the Inception Workshop on Building a Poverty Database, held at Manila in July-August 2001; World Bank, *World Development Report 2000/2001: Attacking Poverty* (New York, Oxford University Press, 2001) and *World Development Indicators 2003* (Washington, World Bank, 2003); and national sources.

poverty was higher in all but one country. With rapid urbanization and migration of poor people from rural to urban areas in search of job opportunities, urban poverty may emerge as a serious problem in the future.[4] In addition to rural-urban differences, remote areas and regions of countries can have a higher incidence of poverty. For example, in Thailand the North-East has historically been the poorest region, followed by the South, North and Central regions, whereas Bangkok has the lowest incidence of poverty. Similarly, many other countries, including China, India, Indonesia and Pakistan, have regions developing at different rates.

Trends in indicators of capabilities

Adult literacy rates remain relatively low in some countries

As discussed earlier, because of difficulties in measuring capabilities, the literacy and life expectancy indicators are usually used to measure them. The relevant indicators show the prevailing disparities among countries. A significant group of countries in the region enjoys near-universal adult literacy. Out of the 31 countries/areas referred to in table III.5, 11 had adult literacy rates of 95 per cent or higher. The adult literacy rate was less than 75 per cent in 8 countries. All the countries are making efforts to improve their literacy rates. The impact of the efforts is better reflected in youth literacy rates (15-24 age group). Youth literacy is nearly universal in a much larger group of countries (22 out of 31 countries/areas). A small group of countries with low literacy rates need to intensify their efforts to enhance enrolment ratios at the primary level of education, particularly in the case of female students. It is also important that students not drop out of school and complete their primary education.

Despite closing gaps over time, large differences in life expectancy persist among countries

Most countries in the region have made considerable progress in raising life expectancy at birth over the past two decades (table III.6). In several countries, the increase in life expectancy was around 10 years. For example, a child born in Bangladesh today can expect to live 62 years, 13 years longer than one born in 1980. Life expectancy in Indonesia improved from 55 years in 1980 to 66 in 2001. The increase in life expectancy was more pronounced in countries with low rates to begin with. Although gaps among countries have been closing over time, there are still large differences among developing countries in the region. For instance, life expectancy in Singapore is nearly double (78 years) that in Afghanistan (43 years). The increase in life expectancy can be attributed to many factors, including improved nutrition, health facilities and education. Infant mortality rates have come down significantly over

[4] It is useful to note that one in four people in developing countries of the ESCAP region lived in urban areas in 1980. This situation changed to one in three in 2000 and by 2025 roughly half of the population will be living in urban areas.

Table III.5. Adult and youth literacy rates in selected economies of the ESCAP region

	Adult literacy (percentage of people aged 15 and above)		*Youth literacy (percentage of people aged 15-24)*	
	1980	*2001*	*1980*	*2001*
Developing economies				
South and South-West Asia				
Afghanistan	18	..	30	..
Bangladesh	29	41	36	49
India	41	58	55	73
Iran (Islamic Republic of)	50	77	73	94
Maldives	92	97	97	99
Nepal	22	43	33	62
Pakistan	28	44	37	58
Sri Lanka	85	92	93	97
Turkey	68	86	88	97
South-East Asia				
Brunei Darussalam	77	92	94	99
Cambodia	55	69	67	80
Indonesia	69	87	89	98
Lao People's Democratic Republic	48	66	63	79
Malaysia	71	88	90	98
Myanmar	76	85	85	91
Philippines	88	95	95	99
Singapore	83	93	97	100
Thailand	88	96	97	99
Viet Nam	87	93	95	95
East and North-East Asia				
China	67	86	91	98
Hong Kong, China	85	94	96	99
Mongolia	97	99	99	99
Republic of Korea	93	98	100	100
Pacific island economies				
Fiji	82	93	95	99
Papua New Guinea	48	65	61	76
Samoa	97	99	99	99
North and Central Asia				
Armenia	96	99	99	100
Kazakhstan	98	99	100	100
Russian Federation	99	100	100	100
Tajikistan	96	99	100	100
Uzbekistan	98	99	100	100

Sources: World Bank, *World Development Indicators 2001* (CD-ROM); UNESCO, Institute for Statistics, Estimates and Projections, July 2002 assessment, <http://www.uis.unesco.org>, 17 September 2003; UNDP, *Human Development Report 2003* (New York, Oxford University Press, 2003); and United Nations Common Database, <http://millenniumindicators.un.org/unsd/cdb>, 8 September 2003.

Table III.6. Life expectancy and infant mortality rates in selected economies of the ESCAP region

	Life expectancy at birth (years)		*Infant mortality rate (per 1,000 live births)*	
	1980	*2001*	*1980*	*2001*
South and South-West Asia				
Afghanistan	40	43	183	165
Bangladesh	49	62	129	51
Bhutan	..	63	135	74
India	54	63	113	67
Iran (Islamic Republic of)	58	69	92	35
Maldives	56	69	115	58
Nepal	48	59	133	66
Pakistan	55	63	105	84
Sri Lanka	68	73	35	17
Turkey	61	70	103	36
South-East Asia				
Brunei Darussalam	71	76	19	6
Cambodia	40	54	110	97
Indonesia	55	66	79	33
Lao People's Democratic Republic	45	54	135	87
Malaysia	67	73	31	8
Myanmar	51	57	94	77
Philippines	61	70	55	29
Singapore	71	78	11	3
Thailand	64	69	45	24
Viet Nam	60	69	50	30
East and North-East Asia				
China	67	70	49	31
Democratic People's Republic of Korea	67	61	32	42
Hong Kong, China	74	80	..	..
Mongolia	58	65	97	61
Republic of Korea	67	74	16	5
Pacific island economies				
Fiji	64	69	34	18
Kiribati	..	62	..	51
New Caledonia	67	73	..	..
Papua New Guinea	51	57	79	70
Samoa	63	69	70	20
Solomon Islands	60	69	43	20
Vanuatu	..	68	77	34
North and Central Asia				
Armenia	73	74	22	31
Azerbaijan	69	65	76	74
Georgia	71	73	34	24
Kazakhstan	67	63	50	61
Kyrgyzstan	65	66	90	52
Russian Federation	67	66	28	18
Tajikistan	66	67	67	53
Turkmenistan	64	65	67	76
Uzbekistan	67	67	47	52

Sources: World Bank, *World Development Indicators 2002* and *2003* (CD-ROM); and UNICEF, statistics web site, <http://www.childinfo.org/cmr/revis/db1.htm> and *The State of the World's Children 2003* (New York, UNICEF, 2002).

time, which helped life expectancy to rise. For example, the infant mortality rate in Bhutan fell from 135 in 1980 to 74 in 2001, whereas the comparable figures for Indonesia are 79 and 33.[5] Some transitional economies in North and Central Asia, however, witnessed a decrease in life expectancy as compared with their pre-transitional levels.

Some empirical evidence based on the social exclusion and participatory approaches

Some groups of individuals tend to be excluded in certain societies

Social exclusion is a complex and multidimensional concept that defies clear definition and measurement. It is the result of certain processes that prevent some individuals (or groups or communities) from participating equally and effectively in the social, economic, cultural and political life of societies. The social exclusion approach tries to identify and learn about who is excluded, by whom (i.e., the agents whose actions result in the exclusion) and from which institutions and through which processes exclusion occurs. Answers to these questions are society-specific and can vary over time. Knowledge of these various aspects of social exclusion is important for designing effective policy responses to tackle exclusion. Certain groups of individuals tend to be excluded in several countries. These include women, children, the elderly, HIV/AIDS sufferers, people with physical disabilities, people belonging to a particular ethnic, religious or social group or people living in a particular geographic area.

Women suffer social exclusion in many societies

It is a well-known fact that women suffer social exclusion in many societies; its form and intensity can vary from place to place. Social and cultural factors inhibit the full participation of women in various walks of life. As a result, gender inequalities continue to persist in several countries in the region. These are visible in enrolment ratios at different levels of education. At the primary level, gross enrolment ratios are approaching 100 per cent, which means that differences between male and female enrolment ratios are disappearing.[6] However, male-female gaps are still quite pronounced in some countries in South Asia. Male-female gaps in enrolment ratios at the secondary level are much more pronounced, particularly for most countries in South Asia and the least developed countries in general. At the tertiary levels, overall enrolment ratios are generally low. Male-female gaps exist, but interestingly some countries have higher enrolment ratios for females than males.

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[5] The infant mortality rate is the number of babies out of every 1,000 live births who die before reaching one year of age.

[6] ESCAP, *Economic and Social Survey of Asia and the Pacific 2003* (United Nations publication, Sales No.E.03.II.F.11), chapter III, "The role of public expenditure in the provision of education and health", pp. 225-265.

Adult literacy rates are generally lower for females than for males in many countries in the region.[7] The differences are very pronounced in some countries. In Nepal, for example, the adult literacy rate for females in 2000 was only 24 per cent, as compared with 60 per cent for males. Major differences also existed for some other countries in South Asia. Gender differences in adult literacy were also quite significant in Cambodia, the Lao People's Democratic Republic and Papua New Guinea.

Women's representation in top decision-making bodies is lacking in many countries in the region. This is evident in the proportion of seats held by women in national parliaments. In many developing countries, the proportion of seats held by women is still less than 10 per cent.[8] These gender disparities have been acknowledged in the Millennium Development Goals, and one of the eight Goals specifically calls for the promotion of gender equality and the empowerment of women.

The participatory approach shows how the poor themselves view poverty

The participatory approach requires intensive dialogue with groups of poor to ascertain their views on poverty. The views of the poor bring out their own specific concerns and needs. They describe the processes, causes and outcome of poverty as they perceive them. Sample views of the poor are given in box III.1. Since poverty is multidimensional, the poor talk about various dimensions of poverty and express frustration over their powerlessness and voicelessness. It is important that the poor be consulted to find out which dimension of poverty is affecting them most adversely and how they want it to be tackled. Their involvement in designing and implementing policies and programmes will empower the poor and improve the chances that the efforts will be successful.

The previous discussion clearly shows that poverty is a multidimensional phenomenon. Various approaches to defining and understanding poverty need to be combined to get a comprehensive picture of poverty. This is important for designing effective policies and programmes to deal with poverty. The next section of this chapter analyses poverty reduction strategies being pursued by the countries in the region. It will become clear that these strategies have several elements to respond to various dimensions of poverty.

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[7] Ibid.

[8] ESCAP and UNDP, *Promoting the Millennium Development Goals in Asia and the Pacific* (United Nations publication, Sales No. E.03.II.F.29).

Box III.1. Participatory poverty assessment: voices of the poor

The participatory approach brings out how poor people themselves define poverty and describe their realities and well-being.[a] Some illustrative descriptions of poverty by the poor are reproduced below:

Poverty is pain; it feels like a disease. It attacks a person not only materially but also morally. It eats away one's dignity and drives one into total despair.

– A poor woman, Moldova, 1997

The rich have one permanent job; the poor are rich in many jobs.

– A poor man, Pakistan, 1996

It's the cost of living, low salaries and lack of jobs. And it's also not having medicine, food and clothes.

– A poor person, Brazil, 1995

Poverty means working for more than 18 hours a day, but still not earning enough to feed myself, my husband and two children.

– A poor woman, Cambodia, 1998

Poverty [is] inherited. If you were born to a poor father, he cannot educate you and cannot give you any land, or very little land of poor quality; every generation gets poorer.

– A poor person, Uganda, 1998

In my family if anyone becomes seriously ill, we know that we will lose him because we do not even have enough money for food so we cannot buy medicine.

– A poor person, Viet Nam, 1999

After one poor crop we need three good harvests to return to normal.

– A poor person, Viet Nam, 1999

Poverty is humiliation, the sense of being dependent and of being forced to accept rudeness, insults and indifference when we seek help.

– A poor person, Latvia, 1998

Some of the main themes emerging from the views of the poor regarding poverty include hunger, deprivation, powerlessness, violation of dignity, social exclusion, rudeness of service providers and gender inequity. This clearly demonstrates that poverty is a complex and multidimensional phenomenon.

At least six interlocked dimensions feature prominently in poor people's definitions of poverty. First, hunger and lack of food remain core concerns of the poor. Second, poverty has important psychological dimensions also. In explaining poverty, the poor often express a sense of hopelessness, powerlessness, voicelessness, dependency, shame and humiliation. Third, poor people often lack access to basic infrastructure such as roads, transport, clean water, electricity and marketplaces. Fourth, while literacy is clearly valued, schooling receives little mention or mixed reviews. This might be due to the poor quality of education or lack of job opportunities for educated people. Fifth, the poor dread serious illness within the family more than anything else. Poor health can lead to job loss and entail large health-care expenses, pushing the family into further poverty. Finally, the poor tend to mention income only infrequently. They focus on managing assets including human, social, physical and environmental assets as a way to cope with their vulnerability.

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[a] The material presented in this box is taken from Deepa Narayan and others, *Voices of the Poor: Can Anyone Hear Us?* (New York, World Bank and Oxford University Press, 2000).

NATIONAL POVERTY REDUCTION STRATEGIES[9]

The analysis in the previous section highlighted an important issue, namely, that countries in the Asia-Pacific region have divergent poverty levels, despite the fact that development policy in almost all countries focuses on reducing poverty. While some countries have been successful in reducing poverty within a relatively short period of time, poverty continues to be a persistent problem in many others.

Growth is a necessary but not sufficient condition for poverty reduction

The success of East Asian economies up until the 1990s and China's achievements in making major inroads in poverty reduction in the 1990s confirm how high levels of growth can induce broad-based development and reduce poverty within a relatively short period. Macroeconomic stability, openness to international trade, human resources development and the rule of law underpinned high economic growth in these economies. Meanwhile, the East Asian crisis in 1997 highlighted the necessity for institution-building to consolidate the above gains and avoid the pitfalls of liberalization. Would economic growth itself lead to a trickle-down effect and reduce inequality and poverty? Cross-country evidence suggests that macroeconomic reforms on average have had little effect on income distribution.[10] Contrary to the wisdom several decades ago, it is now argued that economic growth is only a necessary but not sufficient condition for poverty reduction.

Poverty continues to exist owing to inequitable distribution of the benefits of growth

In a number of countries, even when the economies are growing there has not been a commensurate improvement in the quality of life of the poor sections of society. Poverty persists owing to inequitable distribution of the benefits of growth. Moreover, poor governance conditions diminish the potential impact of growth on poverty. The rising debt burden of developing countries has impaired development efforts, exacerbating the poverty situation in many countries. The traditional approaches to development through national planning and structural adjustment have had little impact on poverty reduction in many developing countries, as the central theme of such policies had been growth and stability and not poverty reduction. Country experiences suggest that, in addition to sustained growth, measures designed specifically to increase access to economic opportunities for the poor are necessary if the benefits of growth are to be distributed evenly and poverty is to be eliminated on a sustainable basis.

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[9] The analysis in this section is based on Interim Poverty Reduction Strategy Papers (Armenia, Georgia, Indonesia, Lao People's Democratic Republic, Mongolia and Pakistan), Poverty Reduction Strategy Papers (Azerbaijan, Bangladesh, Cambodia, Kyrgyzstan, Sri Lanka, Tajikistan and Viet Nam) and national development plans (China, India, Islamic Republic of Iran, Malaysia, Maldives, Nepal, Philippines, Thailand and Turkey).

[10] World Bank, *World Development Report 2000/2001: Attacking Poverty* (New York, Oxford University Press, 2001).

In this context, the objective of this section is to review poverty reduction strategies in the Asia-Pacific region, analyse policy strategies with a particular emphasis on their effectiveness in meeting the Millennium Development Goals related to poverty reduction and make suggestions for further improvement.

The evolution of PRSPs

The evolution of PRSPs marked a major shift in the approach to development financing

The increasing concern over the stalemate in the fight against poverty and the continued deterioration of poverty and inequality prompted an intense re-examination of development and debt strategies in the 1990s. The 1999 Koln Debt Initiative, which broadened the scope of the Heavily Indebted Poor Countries (HIPC) Initiative to provide a greater focus on poverty reduction by releasing resources for investment in health, education and social needs, marked a major shift in the approach to development financing, in particular by multilateral lending agencies. These changes were reflected in the agreement in 1999 by the World Bank and IMF to link debt relief to the establishment of a poverty reduction strategy based on a new policy instrument, the PRSP, for all countries receiving concessional assistance from these institutions. The poverty reduction strategies are expected to guide the use of resources freed up by debt relief under the enhanced HIPC Initiative. Since 1 July 2002, PRSPs have also served as the framework for concessional development assistance by the World Bank and IMF.

The relationship between PRSPs and national development plans

Poverty reduction strategies under PRSPs embody an inclusive development framework mainstreaming the poor into the development process through capacity-building

The PRSP approach and several recent national poverty reduction strategies under national development plans (NDPs) embody an inclusive development framework with a focus on, in addition to macroeconomic stability in an open economic setting, mainstreaming the poor into the development process through capacity-building. However, PRSPs differ from most NDPs for several reasons:

(a) Policy strategies under most NDPs do not specifically target poverty reduction but at best growth and development. Poverty reduction is only a by-product of trickle-down effects;

(b) Policy strategies in NDPs are formulated by specialists and experts without proper consultation of civil society;

(c) Often NDPs are mere policy statements which are rarely linked to the budgetary or decision-making process.

The PRSP approach is based on five core principles: it is country-driven with broad-based participation by civil society and the private sector, results-oriented with a focus on targeted poverty outcomes, comprehensive recognizing the multidimensional nature of poverty and partnership-oriented with coordinated participation of development partners, and it takes a long-term poverty reduction perspective (see table III.7).

PRSPs are country-driven, results-oriented, comprehensive and partnership-oriented, and have a long-term perspective for poverty reduction

Table III.7. Core principles underlying the development and implementation of poverty reduction strategies

	Core principles of PRSPs	*Comparison with NDPs*
Country-driven:	Country-owned. Involve broad-based participation by civil society and the private sector	Fully country-owned but participation by civil society very limited at most
Results-oriented:	Focus on outcomes. Performance targets are set particularly when supported by multilateral lending	Except for recently developed NDPs, which are influenced by PRSPs, NDPs usually do not target specific outcomes. Focus mainly on broadly defined goals
Comprehensive:	Recognize the multidimensional nature of poverty	Do not recognize the multidimensional nature of poverty except in those influenced by the PRSP approach
Partnership-oriented:	Involve coordinated participation of development partners. Development partners involved in the design, and joint assessment of various stages of the PRSP process and financing resource gaps	Do not directly involve coordinated participation of development partners
Long-term poverty reduction perspective:	Policy framework involves a 3-year medium-term framework, which in most cases is linked to long-term goals	Mostly involve a 5-year long-term framework, in some cases linking to 10- to 20-year long-term goals

While NDPs reflect a country's policy agenda with a general focus on broad-based economic growth, the PRSP approach goes a step further by bringing together national policies, civil society and donor support to help low-income countries to achieve their development goals. Unlike NDPs, which operate on their own, the policy framework under the PRSP process operates, under country ownership, in a coordinated structure involving the World Bank, IMF and other stakeholders, including the United Nations system, and links the outcomes to MDGs.

PRSPs bring together national policies, civil society and donor support to help low-income countries to achieve their development goals

The operational framework under PRSPs

The core objectives of PRSPs are broad-based growth and poverty reduction. As such, the operational framework under the PRSP approach focuses on maintaining macroeconomic stability; structural, regulatory and institutional reforms; mainstreaming of the poor including women into the development process through capacity-building, in particular through empowerment, provision of opportunities and enhancing security; provision of social safety nets for vulnerable groups; improving governance; and protecting the environment.

Meanwhile, NDPs adopt a somewhat similar approach with varying degrees of focus on poverty reduction. For example, the tenth plan of Nepal (2002-2008), which singled out poverty alleviation as its principal objective, places priority on developing the agricultural sector. Thailand adopts the philosophy of a sufficiency economy, which emphasizes the empowerment of people through equal access to education and social services. The provision of social insurance for all age groups and the extension of health insurance to all of the population on an equitable basis are embodied in its ninth national economic and social development plan (2002-2006). However, more advanced developing countries in the region such as Malaysia (see box III.2) and Turkey place more emphasis on strengthening research and development and use of ICT to reap the maximum benefits of globalization.

Box III.2. From inputs to knowledge: Malaysia's new growth strategy

The Eighth Malaysia Plan reflects a marked shift in Malaysia's growth strategy from an input-driven to a knowledge-driven one in order to enhance potential output growth, accelerate structural transformation within the manufacturing and service sectors, revitalize the agricultural sector and strengthen socio-economic stability.

The new approach would enable Malaysia to embark on a new growth path and take the country towards its goal of becoming a fully developed nation by 2020. The thrust of the new approach is on productivity improvement, institutional capacity-building, financing new ventures and environmental protection.

The Plan's main features are:

Increasing productivity and efficiency through human resources development with an emphasis on enhancing the education, skills and expertise of the labour force, improving management and organizational techniques, upgrading research and development (R&D) and science and technology (S&T), strengthening innovative capacity and protecting intellectual property rights as well as expanding the use of ICT. Efforts to strengthen R&D and S&T will include the upgrading of domestic capability to undertake R&D and streamlining the public sector financing mechanism for R&D.

Improving institutional and support services to further encourage organized farming and active private sector participation in agricultural activities. Commercialization of agricultural products will be promoted through greater concentration on applied R&D activities and closer interaction with potential investors.

Accelerating the development of the venture capital industry and the capital market to serve as important sources of financing for innovative and high-technology ventures.

Attaining sustainable development through an integrated and holistic approach to environmental and resource issues.

Introducing more income-generating activities to increase the household income of poor and low-income groups.

Source: Eighth Malaysia Plan (2003).

The operational mechanism of PRSPs involves five major steps as detailed in table III.8.

Table III.8. Steps for the preparation of a PRSP

Step I	IPRSP (Interim PRSP)	Outlines a country's existing poverty situation and poverty reduction strategy	Country has the option to prepare a full PRSP straight away
		Presents a road map for the development of a full PRSP	If more than one year is taken to develop the full PRSP, a progress report is required
			Could build upon existing national strategies and plans. Such plans could be considered to be the PRSP if they are consistent with the guiding principles of the PRSP approach
	Joint staff assessment (JSA)	Evaluates the soundness of the IPRSP	Highlights World Bank/IMF staff perspectives of the strengths and weaknesses
Step II	PRSP preparation status report	Deals with cases in which countries take longer than a year to develop a full PRSP, and where there is an operational need for an update in the context of an IMF programme	
	JSA	Evaluates the soundness of the document	
Step III	PRSP	Description of the participatory process	Involves civil society and non-governmental organizations
		Comprehensive poverty diagnosis	
		Clearly presented and costed priorities for macroeconomic, structural and social policies	The three-year policy matrix and macroeconomic framework links to the national budget
		Appropriate targets, indicators and system for monitoring and evaluation	
	JSA	Evaluates the soundness of the PRSP	
Step IV	Submission to IMF/ World Bank Executive Board	Will consider the overall strategy and endorse policies for adoption under concessional assistance programmes	
Step V	Annual PRSP progress report	Gives information on the implementation of the country's poverty reduction strategies	
	JSA	Evaluates the soundness of the report	

Eight countries had completed PRSPs by the end of 2003, while four had completed IPRSPs

As shown in table III.9, eight countries had completed PRSPs by the end of 2003, while four had completed IPRSPs. Although Indonesia has prepared an IPRSP, it has yet to be assessed by IMF and the World Bank. The table also reflects two important issues relating to the PRSP process:

(a) It takes around two years for the completion of a PRSP;

(b) Almost all PRSPs are relatively new, making it difficult to assess the impact of PRSPs in poverty reduction. Therefore, the present analysis is based on the proposed policy strategies contained in the PRSPs rather than their outcomes.

Table III.9. Progress in PRSP preparation in the Asia-Pacific region

	IPRSP completion date	*JSA of IPRSP*	*PRSP completion date*	*JSA of PRSP*
Armenia	30 March 2001	27 April 2001		
Azerbaijan	30 May 2001	5 June 2001	14 May 2003	29 May 2003
Bangladesh	23 June 2003	26 June 2003		
Cambodia	20 October 2000	26 December 2000	20 December 2002	23 January 2003
Georgia	30 November 2000	4 December 2000	27 August 2003	7 November 2003
Kyrgyzstan	13 June 2001		9 December 2002	26 February 2003
Lao People's Democratic Republic	20 March 2001	6 April 2001		
Mongolia	30 June 2001	2 October 2001	3 September 2003	29 September 2003
Pakistan	30 November 2001	14 December 2001		
Sri Lanka			5 December 2002	22 April 2003
Tajikistan	24 March 2000		30 June 2002	16 December 2002
Viet Nam	14 March 2001	21 March 2001	31 May 2002	9 July 2002

Burning issues as reflected in PRSPs

Lack of access to assets and basic needs such as education, health care and safe drinking water seen as the most critical issues concerning poverty and development

An overwhelming majority of PRSPs identify the lack of access to assets and basic needs such as education, health care and safe drinking water as the most critical issues concerning poverty and development. Several other country-specific issues have also been highlighted (table III.10) as causes of poverty.

The relationship between PRSPs and previous SAF/ESAF-related programmes

PRSPs recognize the importance of high-quality growth and pro-poor policies in reducing poverty on a sustainable basis. Reflecting this, the policy approach under PRSPs focuses on a combination of

Table III.10. Burning issues on poverty and development in PRSP countries

	Issue (ranked based on the number of countries facing the issue)	*Policy strategy to address the issue*
1	Lack of access to assets, in particular land and finance	Implementation of land reforms, improved land administration and management policy and provision of microfinance
2	Lack of access to education (human capital development), health care and other basic needs	Improved access, in particular to primary education, training and retraining, educational reforms and provision of resources
3	High level of unemployment	Creation of a favourable environment for private sector-led growth and employment generation
4	Lack of utilities and rural infrastructure	Improved provision of utilities through investment and infrastructure development
5	High population growth	Implementation of family planning programmes
	Difficulties in economic integration	Implementation of economic reforms
	Gender inequality	Promotion of gender equality and introduction of legislative provisions
	Issues arising from internally displaced persons	Implementation of support programmes and rehabilitation
	Natural disasters	Disaster management and environmental protection
6	Slow economic growth	Maintaining macroeconomic stability and promoting private sector-led growth
	High level of debt	Debt management and restructuring of debt
	Exposure to land mines	Mine clearance activities

macroeconomic policies and structural reforms aimed at growth and stability as under previous Structural Adjustment Facility (SAF)- and Enhanced Structural Adjustment Facility (ESAF)-related programmes (the structural adjustment programme (SAP) component) and pro-poor policies, particularly those aimed at capacity-building for the poor (the new component). The latter is in fact an attempt to bring all social policies previously dealt with under separate programmes under one policy agenda.

Policies on growth and stability: the SAP component

Macroeconomic stability

Maintaining macroeconomic stability is still a key factor

Maintaining macroeconomic stability is an essential feature of development policy in both PRSPs and NDPs, as it is a precondition for building investor confidence and sustainability of growth. High and variable inflation can affect the poor through a decline in real wages, as nominal wages are usually rigid in the short run, and a possible loss of employment opportunities if investors respond to high inflation by production cuts. Unsustainable fiscal conditions could lead to high inflation and cuts in public capital and social expenditure which could affect future growth and social welfare. However, maintaining a competitive exchange rate is a key factor for promoting export-led growth and changing the structure of production in favour of labour-intensive agriculture. Achieving a sustainable level of debt that does not affect expenditure on social development needs is essential for the efficient use of available resources. A heavy debt burden reduces the incentives for policy reform and could affect a country's growth performance and its ability to spend on social priorities. Recognizing these issues, the poverty reduction strategies focus on four main fronts:

(a) Monetary policy aimed at maintaining price stability at a low rate of inflation. The focus is mainly on implementation of a prudent monetary policy, enhancing the market orientation of monetary management and improving transparency in policy decisions;

(b) Fiscal policy aimed at fiscal sustainability to achieve a low budget deficit. The main policy areas are broadening the tax base, improvement in the efficiency of tax administration and increased administrative simplicity, improving the efficiency and effectiveness of public expenditure and reducing semi-quasi fiscal losses of public enterprises through restructuring and market-based pricing;

(c) Exchange rate policy aimed at external competitiveness by increasing the flexibility of exchange rate determination, preferably through an independent float, increasing the transparency of the foreign exchange market and developing the inter-bank foreign exchange market;

(d) Debt management aimed at debt sustainability by limiting contracting of foreign non-concessional loans, limiting the provision of government guarantees, establishing a yield curve for government debt instruments and improving infrastructure.

Countries need to be flexible in adjusting to changing circumstances in business cycles

While macroeconomic stability is vital for sustainability of growth, countries need to be flexible in adjusting to changing circumstances in business cycles. This flexibility is lacking in PRSP approaches when they are linked to external financing, in particular under Poverty Reduction and Growth Facility (PRGF) arrangements with IMF. Countries attempting to meet performance criteria under PRGF arrangements may adopt policies that might be counterproductive to sustainable growth. Targeting a low inflation rate of around 4 per cent in the medium term and continued fiscal deficits imply that policy prescriptions for developing countries involve a continued tightening of monetary and fiscal policies without due consideration for their adverse implications for growth and development, particularly during economic slowdowns.

Structural reforms

Financial sector reforms

A healthy financial system is vital for capital accumulation, productivity improvement and economic growth

The benefits of integrating domestic capital markets into global capital markets are best captured when domestic financial markets are well developed, strong enough to withstand temporary shocks, complemented by smoothly functioning credible regulatory mechanisms and free from frequent State intervention. A healthy financial system is vital for capital accumulation, productivity improvement and economic growth. However, the financial sectors in many developing countries in the Asia-Pacific region are plagued by lack of infrastructure, lack of competition due to State dominance and frequent public intervention leading to inefficient mobilization and allocation of financial resources.

Reflecting these concerns, financial sector reforms under PRSPs and NDPs are aimed at making financial markets in developing countries healthy and efficient through improved competition, in particular by restructuring State-owned banks and opening market access to foreign banks, complying with internationally accepted standards and codes and facilitating the development of bond and equity markets. Adequate regulatory and supervisory institutions to minimize sudden financial collapses accompany financial reforms. For example, Azerbaijan, Bangladesh, Pakistan and Sri Lanka have proposed restructuring of State-owned commercial banks while appropriate prudential regulations are in place. However, not all countries have adopted a balanced approach to financial sector reform. Restructuring of State banks in countries such as Mongolia and Viet Nam is not accompanied by a strong and supportive regulatory environment. Pension reforms such as the establishment of private pension funds proposed in Kyrgyzstan and Tajikistan do not go hand in hand with a credible financial sector reform agenda.

The divestiture of State banks proposed in several PRSPs, in an attempt to increase the efficiency of the banking system, could leave a vacuum in financial services delivery in rural areas if private sector operation in such areas is prohibitively costly. Private sector involvement in rural financing needs to be facilitated through rules and regulations that encourage competition and debt recovery.

A cautious approach to capital account liberalization reflects the changing mindset

The PRSP applies a cautious approach to capital account liberalization, reflecting the lessons learned after the East Asian financial crisis, with an emphasis on the liberalization of inward FDI rather than full foreign exchange convertibility in the short to medium term. Due consideration has been given to proper sequencing of the liberalization of the capital account, even under an IMF programme, reflecting a marked shift in policy towards capital account convertibility.

Fiscal reforms

Too much fiscal tightening could have a negative impact on broader development objectives

Fiscal reforms constitute a central element of broader reform programmes as unsustainable government expenditure could derail any development programme, with adverse consequences, in particular for the poor. As in other reform programmes, fiscal consolidation aimed at sustainable low budget deficits has become the main target of fiscal reforms. The level of fiscal tightening embodied in most PRSPs, in particular under the influence of multilateral lending agencies, could negate the developmental objective of fiscal policy if such tightening leads to cuts in public investments or social expenditure, especially on health and education.[11] While public expenditure management should receive its due priority in fiscal consolidation efforts, countries need to focus on raising revenue through, among other things, efficient tax administration, a weak area in many developing countries in the Asia-Pacific region.

Fiscal reforms need to look beyond stability

In many instances privatization of public enterprises has resulted in the conversion of public sector monopolies into private ones, negating the benefits of competition and efficiency. However, privatization of public enterprises to build up foreign reserves, particularly when the country is under an IMF programme, restricts the sale of assets to local entrepreneurs even if they have the capacity and are quite capable of bringing in foreign technology through joint partnerships. Fiscal policies under PRSPs could have been geared to building up a competitive local entrepreneurial class, which would have paid off heavily in the long run.

It is also important that the fiscal policy be consistent with other sectoral reforms to ensure the effectiveness of the overall reform agenda. However, several PRSPs reflect a missing link between fiscal policy and sectoral reforms. Countries such as Georgia and the Lao People's Democratic Republic, for example, propose a downsizing of the civil service without a parallel transformation in the labour markets to make them more flexible and able to absorb such shocks and minimize their impact on the poor sections of the society.

Trade reforms

International trade offers a primary means of realizing the benefits of globalization and growth. Open trade policies support growth and development through increased access to markets, incentives for

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[11] The bias against cuts in public investments stems from the fact that some recurrent expenditures, in particular public service salaries and wages, are rigid downward and politically very sensitive, and prospects of raising revenue without addressing structural rigidities is limited.

investment, transfer of technology, innovation and efficient allocation of resources. In particular, the creation of markets where the poor participate can have a direct effect on poverty reduction. Trade liberalization could also help to reduce an economy's vulnerability to negative external shocks that could affect the poor. In most PRSPs and NDPs, the approach to trade reforms is aimed at integrating domestic markets with the rest of the world, increasing competitiveness and export diversification. However, only Bangladesh has focused on improving trade negotiation capabilities (with WTO and others), including handling of international trade rules, one of the most important aspects of international trade in the present context, while none of the landlocked countries under review has an agenda under PRSPs to remove stumbling blocks and facilitate transit trade with neighbouring countries.[12]

International trade offers a primary means of realizing the benefits of globalization and growth

Agricultural reform

Agriculture has the highest potential for growth and poverty alleviation in the short and medium terms in many developing countries in the region as the majority of the poor live in rural areas and draw their livelihood from agriculture. Providing access to real assets, in particular land, plays an important role in poverty reduction efforts. Hence, policy towards land has an important bearing on poverty reduction. Land-market reform, together with the provision of credit, in particular microfinance, and rural infrastructure development, could bring large benefits to the poor as it not only raises the productivity of land but also that of labour.[13] Improving access to land through land-market reform and enforcement of land property rights could reduce transaction costs and improve access to bank credit as land could be used as collateral. China benefited from agricultural reforms and is a good example from the region. For example, family farming through the "household responsibility system", introduced in 1979, led to a rapid increase in effective demand for high-value products, which had been repressed by the earlier State-directed policies. These policies enabled China to reduce the incidence of rural poverty significantly.

Agriculture has the highest potential for growth and poverty alleviation in the short and medium terms

[12] Members of the Economic Cooperation Organization (ECO), Afghanistan, Azerbaijan, the Islamic Republic of Iran, Kazakhstan, Kyrgyzstan, Pakistan, Tajikistan, Turkey, Turkmenistan and Uzbekistan signed the ECO Transit Trade Agreement in 1995 with the objective of improving transit trade among member countries. However, such arrangements and future directions are not reflected in the PRSP policy matrices.

[13] Some proposed land reforms may in fact be counterproductive to poverty reduction efforts. For example, Nepal proposes to restrict the division of land plots smaller than a certain size with a view to stopping land fragmentation. The logic of such a policy is questionable, particularly in a mountainous country such as Nepal, where poverty is mainly a rural phenomenon and land plays a major role in the income-earning capacity of the poor. The efficiency arguments also do not hold in a mountainous region.

Labour-market reforms

Rigid labour-market conditions could become a binding constraint on growth and employment during structural transformation

A well-functioning labour market plays an important role in a market economy. However, in many developing countries in the Asia-Pacific region, the potential for private sector-led growth has been hampered by rigid labour markets, which is reflected in low labour productivity. Such rigid labour market conditions could become a binding constraint on growth and employment during structural transformation by interfering with enterprises' ability to adjust to changing market conditions. Expanding populations, employee lay-offs and dislocations through the privatization of public enterprises, public service reforms and private sector responses to market behaviour, the increasing share of the ageing population and budgetary constraints add further pressure to the need for labour-market reforms in developing countries.

However, several PRSPs do not adequately focus on labour-market reforms to minimize the adverse effects of certain reform measures or to make the private sector more efficient (Bangladesh, Georgia, Kyrgyzstan, Lao People's Democratic Republic and Pakistan). Sri Lanka recognizes labour-market reform as a complex exercise as some policy measures are politically sensitive and highlights the need for constructive social dialogue to identify ways of making the labour market more flexible, while protecting the workers' rights. Social considerations that underlie labour-market regulation would need to be addressed through effective social safety nets for those affected by such reforms.

Institutional reforms

Efficient institutions are essential to support policy reforms

The PRSP approach reflects a significant deviation from the previous adjustment processes. While the previous approaches, particularly those linked to multilateral lending, focused more on structural adjustments and maintaining macroeconomic stability, little attention was paid to institutional developments that would be required for the effective implementation of such policies. In the absence of efficient institutions to support them, structural policies would fail sooner or later.[14] Institutional failures could weigh heavily on the efficient functioning of the private sector, the engine of growth in a market economy. To the extent that such constraints impair competition and encourage rent-seeking rather than

[14] The experience of transition economies, in particular countries in the former Soviet Union illustrates how market reforms can fail in the absence of domestic institutional reforms. Viet Nam, which recognizes in its PRSP the difficulties and challenges in opening up its economy and integrating it into the global economy, could draw lessons from these experiences. Building domestic institutions along with market reforms could facilitate the transformation with minimum social cost.

entrepreneurship, they hurt competitiveness and dampen growth. Many PRSPs acknowledge the key role played by institutions in growth and development, and focus on institutional reforms, including good governance. Such policies include adopting modern and credible legal and regulatory frameworks, property rights and internationally accepted standards and codes, establishing independent judiciary systems and eliminating bureaucratic red tape, intrusiveness and corruption.

Decentralization could help to maintain political stability, a prerequisite for sustainable development

A large number of countries in the Asia-Pacific region have undergone or are undergoing some sort of decentralization involving a transfer of powers from the central Government to subnational units of government (see box III.3). Several countries have attempted to link the decentralization process to poverty reduction under PRSPs. While the Lao People's Democratic Republic embarked on a re-decentralization process by transferring micromanagement at the local level to facilitate the pursuit of the national poverty eradication objectives, Sri Lanka embarked on decentralization as a tool for harmonizing tensions between different ethnic

Box III.3. Decentralization: a trade-off between efficiency and political stability?

Decentralization entails the transfer of political, fiscal and administrative powers to subnational units of government.[a] The primary objective of decentralization is to maintain political stability, a prerequisite for sustainable development. This is particularly relevant in countries with social and ethnic divisions. In such countries decentralization provides an institutional mechanism for harmonizing and accommodating diverse forces among different layers of the society. In Sri Lanka, for example, decentralization offers a potential political solution to the civil war, which has cost the economy about 1.5-2 per cent of GDP per annum during the past two decades. Society could also benefit from decentralization as the efficiency and responsiveness of government to local needs and accountability are expected to improve with local representation in governance.[b] Thailand views its decentralization as an efficient strategy for improving local service delivery in reaction to the financial crisis in 1997.

An increasing number of countries have experimented with some form of decentralization or local government reform during the past 50 years; the objectives and outcomes, however, vary among countries. Out of 75 developing and transitional countries with populations greater than 5 million, all but 12 claim to have embarked on some form of transfer of political power to local units of government.[c] However, that does not imply that decentralization itself is good or that the outcomes have always been successful. The Lao People's Democratic Republic, which

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[a] World Bank, *World Development Report 1999/2000: Entering the 21st Century* (New York, Oxford University Press, 1999).

[b] According to Charles Tiebout, ("A pure theory of local expenditure", *Journal of Political Economy*, vol. 64, No. 2, April 1956, pp. 416-424), decentralization leads to greater variety in the provision of public goods, which are tailored to better suit local populations.

[c] W. Dillinger, (1994) as reported in A.N. Parker, "Decentralization: the way forward for rural development?", World Bank, Policy Research Working Paper No. 1475, 1995.

(Continued overleaf)

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strengthened the autonomy of subnational governments in the mid-1980s to make them economically and financially self-sufficient in an attempt to eradicate poverty, reverted back to a more centralized model of government after losing control over the spending of local administrations and then embarked on a re-decentralization process in 2000. The evidence from empirical analyses remains far from conclusive. However, in most cases the failure to achieve the desired outcomes appears to be due to incomplete decentralization and lack of institutional arrangements to support efficient functioning of decentralized systems.

In certain cases, the trade-off between economic efficiency and political instability would make decentralization an economically inefficient but socially optimal approach to governance.[d] Duplication of work at the central and local levels not only makes transaction costs high but also results in a high level of complexity and fragmentation. Some assert that decentralization is justified by political economy considerations but not on economic grounds.[e] There is also strong evidence for a negative relationship between decentralization and corruption.[f] By contrast, a centralized bureaucracy could create incentives to divert resources to the non-poor owing to their willingness to pay bribes.[g]

The success of a socially optimal decentralization depends on several key factors:

(a) Political decentralization should be accompanied by fiscal decentralization to make the former work and be felt by the communities. Decentralization initiatives that focus exclusively on electoral and administrative processes without considering the fiscal and institutional dimensions would be hard to sustain;[h]

(b) A balance should be struck between accountability that prevents severe fiscal imbalances at both the local and central levels and fiscal decision-making at the local level. This would not only resolve the issues relating to overspending by local authorities but also minimize the potential deterioration in inequalities among states or provinces;

(c) A proper system of accountability and transparency at both the local and central levels has to be in place to minimize corruption and maintain public confidence in the decentralized system;

(d) Broad-based participation should be ensured at the local level to eliminate opportunities for collusion between the local elite and the centre, which could nullify the very objectives of decentralization;

(e) Building social and technical capacity at the local level to reap the benefits of decentralization by the poor and marginalized sections in particular;

(f) Poverty and gender issues should be given priority in the development process at the local level to make decentralization truly a local-level approach to governance.[i]

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[d] Tanzi (1996) (as reported in R. Fisman and R. Gatti, "Decentralization and corruption: evidence across countries", World Bank Policy Research Working Paper No. 2290, 2000), argues that there exist many imperfections in the local provision of services that may prevent the realization of benefits from decentralization.

[e] T. Besley and S. Coate (1999), "Centralized versus decentralized provision of local public goods: a political economy analysis", National Bureau of Economic Research, Working Paper No. 7084.

[f] R. Fisman. and R. Gatti., op. cit.

[g] P. Bardhan and D. Mookherjee (1998), as reported in Fisman and Gatti, op. cit.

[h] Lack of adequate funding for lower-level institutions was the single most important factor that undermined many of the decentralization attempts in the 1990s (G.S. Cheema and D.A. Rondirelli, eds. (1983) as reported in Parker, op. cit.

[i] R. Crook and J. Manor (1994) (as reported in Parker, op. cit.) find no evidence for poverty and gender issues receiving a higher priority in the development process although poor people and women participated more under decentralized systems in South Asia.

groups who felt marginalized in governance. Meanwhile, Pakistan aims at strengthening good governance by increasing transparency and accountability through a devolution of power.

Corruption is becoming a major problem in the region

Governance issues have been emphasized in several PRSPs. This is in contrast to previous development strategies, which did not pay attention to them. Among the policy strategies proposed in this respect are strengthening anti-corruption laws and authorities (Bangladesh, Cambodia and Pakistan) and development of checks and balances (Cambodia) for improved transparency and accountability, strengthening the law and order situation and ensuring the fundamental rights of people. Many countries in the Asia-Pacific region continue to suffer from poor governance, which is reflected in the corruption perception index.[15] Almost all countries under review rank very low on the index, with several of them being at extremely low levels. In respect of several countries, the corruption perception deteriorated further during 2003. Effective implementation of institutional reforms is therefore essential to build up public and investor confidence and ensure equitable distribution of the benefits of growth.

Infrastructure development

The development of infrastructure, both urban and rural, is essential for enhancing a country's capacity for socio-economic development. In particular, good infrastructure, including a network of roads, telecommunications, ports and airports that facilitate access to markets, and utility services such as electricity, gas and water is necessary to encourage foreign investors. Meanwhile, rural infrastructure development constitutes an important element of poverty reduction efforts in almost all PRSPs and NDPs (see table III.11). The main focus areas are developing and maintaining rural roads, connecting to markets, facilitating and establishing rural markets, improving access to basic utilities and improving rural irrigation.

Improving linkages to markets could help the poor to sell their products

Countries such as Viet Nam pay special attention to remote and isolated regions, which tend to have a higher incidence of poverty. Infrastructure development in these regions, which are characterized by geographical isolation, limited access to productive resources and services, harsh natural conditions and frequent natural disasters, and linking them to markets could have a large impact on poverty reduction. Countries having similar conditions, such as Nepal, could also benefit from such an approach.

[15] For details see <http://www.transparency.org>.

Table III.11. Individual country approaches to rural infrastructure and urban development

Areas	*Policy approaches*	*Countries*
Rural infrastructure:		
Rural roads	Develop and maintain rural road network	Bangladesh, Cambodia, China, Georgia, Kyrgyzstan, Lao People's Democratic Republic, Pakistan, Philippines, Sri Lanka, Tajikistan
	Construct and maintain farm-to-market road network	Philippines
Rural markets	Ensure marketing facilities by developing/establishing rural markets and improving linkages to markets	Bangladesh, Cambodia, Georgia, India, Nepal, Philippines, Sri Lanka
Basic utilities	Improve access to basic utilities such as electricity, drinking water and telecommunications	Cambodia, China, India, Islamic Republic of Iran, Kyrgyzstan, Nepal, Pakistan, Philippines, Sri Lanka, Tajikistan, Viet Nam
School infrastructure	Provide improved school infrastructure and facilities for basic education in difficult areas	Armenia, Mongolia, Viet Nam
Irrigation	Improve irrigation systems	Armenia, Azerbaijan, Cambodia, India, Nepal, Philippines, Tajikistan, Viet Nam
	Facilitate and promote private investment in irrigation	Cambodia
Urban development:		
Housing construction	Provide access to affordable housing	Cambodia, India
Slum development	Relocate the urban poor and provide access to land and housing	Bangladesh, Cambodia, India, Sri Lanka
Infrastructure development	Upgrade communities by improving water and sanitation and economic infrastructure	Armenia, Bangladesh, Cambodia

Pro-poor policies: going beyond SAF/ESAF policies

PRSPs go beyond SAF/ESAF policies

The inclusion of pro-poor policies, in particular policies to build the capacity of the poor and targeted social safety nets for the vulnerable, indicates a major shift in development policy advocated by multilateral lending agencies.

Building the capacity of the poor

Building the capacity of the poor is a key component of any sustainable poverty reduction strategy, as it would allow mainstreaming of the poor into the development process. The PRSPs identify three major components of capacity-building: (a) empowerment, (b) providing opportunities and (c) enhancing security.

Access to land is a critical issue for poor people in many countries in the region

Strategies to facilitate empowerment of the poor include provision of basic education and skills and increased access to land through reforms. While some countries have focused on the provision of basic education to vulnerable groups (Bangladesh, India, Lao People's Democratic Republic, Pakistan, Philippines and Viet Nam), rural youth (India) and children from herders' families (Mongolia), others have targeted educating peasants and farmers in processing and marketing of agricultural products (Kyrgyzstan) (see table III.12 for details). However, strengthening the participation of the poor in decision-making and political processes as a strategy to empower the poor has not received adequate attention in any of the PRSPs.

Table III.12. Individual country approaches to capacity-building: empowerment

Areas	*Policy approaches*	*Countries*
Empowerment	Increased access of the poor to land through reforms in land tenancy markets, effective distribution and management of land and registration	Azerbaijan, Bangladesh, Cambodia, China, Georgia, India, Lao People's Democratic Republic, Pakistan, Philippines, Sri Lanka, Tajikistan, Viet Nam
	Building capacity by providing basic education and skills to vulnerable groups	Bangladesh, India, Lao People's Democratic Republic, Pakistan, Philippines, Viet Nam
	Targeted capacity-building of farmers through training in the areas of management practices, agro inputs and provision of technical support for agricultural production and agribusiness	Azerbaijan, Cambodia, Tajikistan
	Inclusion of the poor in free educational schemes	Armenia
	Supply of textbooks to elementary-level students free of charge	Armenia, Azerbaijan, Kyrgyzstan, Mongolia, Tajikistan
	Organization of community-based kindergarten classes with local government support	Philippines
	Education of peasants and farmers in processing and marketing of agricultural products	Kyrgyzstan
	Short-term centralized training for children from herders' families to prepare them for school enrolment	Mongolia
	Provision of targeted education programmes in rural areas	India

The provision of opportunities is a central theme in capacity-building of the poor. Such opportunities place the poor on an equal footing to exploit the advantages of globalization and market-based domestic economic structures. The PRSPs give the poor opportunities through measures such as facilitation of microfinancing, promotion of SMEs and self-employment, rural infrastructure development, facilitation of urban rural linkages, provision of scholarships to students in remote areas and training of school dropouts (see table III.13). However, PRSPs are silent on the issue of equal access to employment in both the public and private sectors. Youth from urban areas and well-to-do families are at an advantage owing to access to information, bureaucrats and politicians. Provision of employment through competitive examinations could avoid these issues and put both the urban well-to-do and rural youth on an equal footing in competing for employment.

The provision of security for the poor provides partial insurance against socio-economic shocks

The provision of security for the poor provides partial insurance against socio-economic shocks, enabling them to re-enter the development process after shocks of a temporary nature are over. Several PRSPs focus on enhancing the security of the poor in respect of their vulnerability to ill-health, conflict-or policy-induced dislocations and natural disasters. For example, several countries (Armenia, Mongolia, Philippines and Viet Nam) attempt to provide targeted health-care programmes for

Table III.13. Individual country approaches to capacity-building: provision of opportunities

Areas	*Policy approaches*	*Countries*
Provision of opportunities	Strengthening microcredit programmes	Bangladesh
	Prioritizing microcredit and credit to small enterprises and providing support to SMEs	Armenia, Bangladesh, Cambodia, China, Indonesia, Kyrgyzstan, Pakistan, Philippines, Sri Lanka, Viet Nam
	Introducing self-employment programmes	India
	Promoting business-farm linkages	Philippines
	Developing rural industrial zones and urban-rural linkages	Viet Nam
	Providing school infrastructure in rural areas	Philippines
	Providing scholarships to students from remote provinces	Cambodia, Tajikistan
	Training dropout children and youngsters	Mongolia
	Providing academic support to primary teachers	India
	Establishing regional and district consulting centres for farmers to increase awareness of micro- and SMEs	Georgia
	Commencing projects in poor regions aimed at generating community-based employment	Sri Lanka, Viet Nam

the poor, while India and Nepal focus on providing adequate access to health and nutritional care services for tribal populations (table III.14). Implementation of support programmes for opium cultivators is a central issue in the Lao People's Democratic Republic, while rehabilitation and resettlement of internally displaced persons have become important development challenges in Azerbaijan and Sri Lanka, countries affected by conflicts. Meanwhile, several countries have improved their preparedness for disaster management to minimize the socio-economic implications of natural calamities for vulnerable groups (Sri Lanka, Viet Nam).

Table III.14. Individual country approaches to capacity-building: enhancing security

Areas	*Policy approaches*	*Countries*
Enhancing security	Providing meals for students at elementary schools	India, Mongolia, Tajikistan
	Assisting poor families with clothing for children attending school	Azerbaijan, Kyrgyzstan, Mongolia
	Providing targeted health-care programmes for the poor	Armenia, Mongolia, Viet Nam
	Greater and effective coverage of local public health programmes	Philippines
	Providing adequate access to health and nutritional care services for tribal populations	India, Nepal
	Implementing programmes aimed at reducing nutritional deficiencies among the poor	Cambodia, India, Lao People's Democratic Republic, Nepal, Pakistan, Philippines
	Implementing support programmes to replace opium cultivation by alternative cash crops providing alternative sources of income to farmers	Lao People's Democratic Republic
	Providing affordable quality housing for the poor	Sri Lanka

Gender equality: empowering women

In most developing countries gender gaps are widespread and the costs of ignoring such disparities are very high

A majority of PRSPs have focused on empowering women as a development strategy, particularly in reducing broader aspects of poverty. The underlying reasoning is that in most developing countries gender gaps are widespread and the costs of ignoring such disparities are very high. Improving access to resources, economic opportunities and decision-making processes reduces such costs by strengthening countries' abilities to grow, escape from poverty and improve standards of living. Moreover, increasing gender equity can have a positive effect on productivity and the human capital of the next generation. The PRSPs recognize that growth alone will not result in a more equitable society and that institutional arrangements and policy measures are necessary to provide equal rights and opportunities for both men and women. In many PRSPs under review, the emphasis has mainly been on improving access to education, employment and financial assets and decision-making processes.

Educated mothers are more likely to adopt appropriate health care for themselves and family members, in particular children

Improved access to education translates into a higher quality of health care and education for children, which in turn translates into lower infant and child mortality and malnutrition (see box III.4 for achievements in Bangladesh and table III.15 for policy actions proposed in PRSPs). Educated mothers are more likely to adopt appropriate health care for themselves and family members, in particular children, and to participate in decision-making in family matters. However, PRSPs have placed little emphasis on addressing gender inequity in the provision of health care and access to real assets such as land.

Rigid social norms make it harder for women to have access to employment and assets, limiting the productive use of women in the development process

In many developing countries rigid social norms make it harder for women to have access to employment and assets, limiting the productive use of women in the development process. The PRSPs attempt to address these issues by addressing gender-specific issues that prevent girls and women from having access to education, improving access to assets, in particular financial assets through microfinance and agricultural education programmes, and improving women's participation in decision-making processes. While countries such as Cambodia and Pakistan have taken initiatives to introduce new legislation and amend existing laws to eliminate gender bias, Pakistan and Viet Nam aim at introducing policies to reduce the vulnerability of women to domestic violence.

The success of any policy aimed at eliminating gender inequality and mainstreaming women in the development process depends greatly on the speed of corrections in deep-rooted, rigid traditional social norms and beliefs that negate the principle of equality between the sexes, in which the public can play a larger role.

Direct poverty reduction strategies: targeted social safety nets

Provision of social safety nets to vulnerable groups is essential

Provision of social safety nets to vulnerable groups is an essential part of poverty reduction strategies, but it is not a substitute for policies to deal with social exclusion or building up of capabilities. Fallouts from market-based policies, inequality in the distribution of assets and lack of opportunities could drive certain sections of society into poverty. Countries that usually fall into this category are those without proper

Box III.4. Closing the gender gap and reducing poverty in Bangladesh: progressing towards a success story

Empowering women and thereby closing the gender gap has become one of the central elements of the poverty reduction strategy in Bangladesh. The underlying reasoning for this is the fact that the burden of poverty continues to fall disproportionately on women owing to their low literacy rate, low nutrition, low income as a result of discriminatory wage differentials compared with men, low life expectancy and high morbidity. The close link between women's empowerment and human development of present and future generations through declining fertility rates, improvement in child and maternal nutrition, children's education and the welfare of both children and women makes efforts to reduce poverty through women's empowerment not only challenging but also a more effective strategy.

Bangladesh has made considerable progress in mainstreaming women into the development process with significant strides in social and economic development. Women in Bangladesh have played an important role in the success of microcredit, apparel exports, increasing child nutrition, increasing primary education and population growth. Bangladesh has achieved gender parity in life expectancy at birth and primary education and recently eliminated the gender gap in secondary education, a significant achievement for a country dominated by religious culture and traditions.[a]

Closing the gender gap – Bangladesh

	1990		*2000*	
	Male	*Female*	*Male*	*Female*
Primary education (percentage)	77	66	100	101
Secondary education (percentage)	25	13	45	47
Life expectancy at birth (years)	55	55	61	62

Sources: UNESCO, Institute for Statistics, <http://portal.unesco.org/uis/>, 17 September 2003; and World Bank, *World Development Indicators 2002* (CD-ROM).

Note: Gross enrolment ratios can be over 100 per cent owing to the inclusion of overaged and underaged pupils/students because of early or late entrants and grade repetition. Interpretation of the ratios requires additional information to assess the extent of repetition, late entrants, etc.

Achievements and goals in social indicators

	1990	*2000*	*2015*		*1990*	*2000*	*2015*
Primary education enrolment	56	75	100	Female illiteracy (percentage, among 15- to 24-year olds)	67.69	60.17	..
Percentage of children under weight	67	52	26	Fertility rate (births per woman)	4.12	3.13	..
Infant mortality	94	66	31	Female life expectancy (years)	54.68	61.7	..
Under-five mortality	108	94	..				
Poverty	59	50	30				

Sources: PRSP, Bangladesh; and World Bank, *World Development Indicators 2002* (CD-ROM).

While the progress in closing the gender gap in certain respects is commendable, Bangladesh still requires radical efforts to reap the full benefits of mainstreaming women into the development process. Skills development, improved marketing and quality of products to make a significant dent on national-level aggregate poverty may supplement the success of microfinance, in which Bangladesh has made a niche. Improvements in decision-making and the political voice of women, which were emphasized in the PRSP, violence against women, literacy rates, maternal mortality and access to assets and employment are areas where Bangladesh can make a significant contribution in further closing the gender gap and faster progress in the well-being of children and women.

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[a] See Novartis Foundation, "Women in development", <http://www.foundation.novartis.com/social_development/women_development.htm>.

Table III.15. Individual country approaches to resolving gender issues

Areas	*Policy approaches*	*Countries*
Access to education	Reserved quota for recruitment in government service	Bangladesh
	Capacity-building for women and girls	India, Lao People's Democratic Republic
	Addressing gender-specific issues that prevent girls and women from having access to education	India
	Introducing appropriate and gender-responsive human resources development programmes	Philippines
Access to resources	Increasing women's access to labour and capital markets	Bangladesh, Kyrgyzstan, Pakistan, Sri Lanka, Viet Nam
	Promoting gender-specific agricultural extension programmes/ equal access to agricultural extension programmes	Cambodia, Nepal, Sri Lanka
Access to economic opportunities	Ensuring women's participation in government elected bodies	Bangladesh, Pakistan, Viet Nam
	Improving women's participation in decision-making processes	Cambodia, Kyrgyzstan, Lao People's Democratic Republic, Sri Lanka
Action against violence	Introducing policies to reduce the vulnerability of women to family violence	Viet Nam
	Setting up crisis centres for victims of domestic violence with provision for medical and legal help	Pakistan
Change in laws, policies and beliefs	Introducing gender-specific programmes in backward areas and legislative measures to eliminate gender discrimination in relation to wages in the informal sector	India
	Correcting traditions and beliefs that negate the principle of equality between the sexes and adopting the gender and development mainstreaming programme	Philippines
	Prioritizing gender considerations in policy formulation	Bangladesh
	Developing new laws and amending existing gender-biased laws	Cambodia, Pakistan
	Incorporating gender issues into school curricula	Azerbaijan

macroeconomic frameworks, political structures and commitments, small island economies and landlocked countries (see table III.16). Almost all countries adopting the PRSP approach to poverty reduction emphasize targeting such vulnerable groups for the provision of social safety nets, while drastically restricting across-the-board benefits such as price subsidies owing to budgetary constraints. By contrast, more advanced developing countries in the region adopt a somewhat different approach.

Table III.16. Targeted social safety nets: individual country approaches

Countries	*Policy approaches*
Armenia, Azerbaijan, Bangladesh, China, Georgia, India, Islamic Republic of Iran, Kyrgyzstan, Pakistan, Philippines, Sri Lanka, Tajikistan, Viet Nam	Improving efficiency in targeting
Bangladesh, China	Prioritizing (increasing funds for) targeted programmes in budgetary allocations
Philippines	Providing vulnerable groups with preferential access to social services and safety nets. Providing safety net programmes for displaced workers through employment facilitation assistance, training or retraining and skills upgrading, unemployment assistance and access to credit facilities and markets
China, Georgia, India	Implementing food for work programmes
India	Wage employment programmes during lean seasons Providing free housing to poor families
Bangladesh	Increased allocations for the distressed, widowed women and old-aged people
India, Nepal	Empowering the disadvantaged by improving access to education, increased employment opportunities and rehabilitation
Viet Nam	Reducing negative effects of reforms on the poor by ensuring job security, unemployment insurance and training
Nepal	Social security in the form of family support for the elderly Providing free medical services to senior citizens
Mongolia, Nepal	Providing access to education for invalids and poor children

For example, countries such as Malaysia, Maldives and Turkey focus more on empowerment and provision of opportunities (for low-income groups) in their national development plans.

In addition to the above factor, the analysis of PRSPs suggests that people in developing countries in the Asia-Pacific region are driven into poverty by three other specific factors. First, countries experiencing an increasing prevalence of diseases, in particular HIV/AIDS, tend to have an increasing incidence of poverty. Addressing such emerging health issues and providing support for affected persons have been given priority in countries having a high HIV/AIDS prevalence rate. For example, Cambodia, India and the Lao People's Democratic Republic focus on strengthening HIV/AIDS prevention programmes and support programmes for families affected by the disease (table III.17).

Table III.17. Targeted social safety nets: selected policy approaches

Countries	*Policy approaches*
Cambodia, Lao People's Democratic Republic	Strengthening and supporting programmes for families affected by HIV/AIDS
India	Strengthening HIV/AIDS prevention programmes
Cambodia, Viet Nam	Providing financial support to health services for the poor
Cambodia	Improving community-based health care
Kyrgyzstan, Tajikistan	Rehabilitating institutions for invalids, the elderly and mentally retarded children
Azerbaijan	Reimbursing expenditure on children's food for low-income families
Tajikistan	Creating day-care centres for poor pensioners

Secondly, countries with economies in transition have experienced sharp increases in poverty and inequality owing to their inability to adjust to market economic systems. Market reforms in the absence of effective domestic institutions have failed to deliver growth outcomes expected in market economies and thereby reduce poverty. Countries such as Kyrgyzstan and Tajikistan have incorporated specific social safety net programmes targeting the elderly, invalids and pensioners as their purchasing power has dropped significantly and they have increasingly become marginalized in a market-based economic structure.

Social divisions and internal conflicts have become a major reason for high levels of poverty in certain countries

Thirdly, social divisions and internal conflicts have become a major reason for high levels of poverty in certain countries in the Asia-Pacific region. Providing social safety nets for internally displaced persons is a major element of poverty reduction strategies in those countries. For example, rehabilitation of such persons and the provision of support to invalids and families affected by civil wars are major tasks in the poverty reduction strategies in Azerbaijan, Sri Lanka and Tajikistan, while strengthening unexploded ordnance (UXO) clearance and demining activities have become critical issues in Cambodia, the Lao People's Democratic Republic and Sri Lanka (see table III.18).

Table III.18. Targeted social safety nets: handling special issues

Countries	*Policy approaches*
Cambodia, Sri Lanka	Strengthening UXO clearance and demining activities, enhancing mine risk reduction through awareness programmes and providing assistance to victims
Tajikistan	Rehabilitating sanatoriums, preventive clinics and boarding houses for war and labour veterans. Providing services and prosthetic-orthopaedic goods to invalids
Azerbaijan	Providing land, housing and financial grants for refugee families
Azerbaijan, Sri Lanka	Constructing new settlements for internally displaced persons
Georgia	Targeting poor refugee families and prioritizing them in special employment programmes, increasing pensions and other allowances and financing medical services
Nepal	Prioritizing admission of aboriginal and ethnic students to higher education and technical training and providing scholarship programmes
Cambodia	Employment guarantee scheme for the poor, orphans and persons with disabilities

Sustainable development: environmental protection

Environmental effects have a disproportionate negative impact on the poor as their livelihood greatly depends on natural resources

Environmental degradation has adverse implications for sustainable development. Such environmental effects have a disproportionate negative impact on the poor as their livelihood greatly depends on natural resources.[16] The benefits of addressing issues related to global commons such as the environment are often high and the costs of doing so are relatively low. It is also an accepted fact that over the long term, economic growth is unlikely to be sustained unless issues relating to environmental degradation are addressed. As a consequence, environmental protection has become an important element of policies aimed at sustainable development, which would make it possible to meet the needs of present generation without compromising the ability of future generations to meet their own needs. The integration of environmental and economic considerations is a fundamental underpinning of the concept of sustainable development.

[16] It is estimated that about 11 per cent of illnesses and premature deaths in developing countries are due to environmental health risks from water and poor sanitation and from urban and indoor air pollution. See World Bank, *World Development Report 2003: Sustainable Development in a Dynamic World* (Washington, World Bank and Oxford University Press, 2003).

PRSPs attempt to strike a balance between the existing livelihood requirements of the people and sound environmental resource management

In recognition of the environment-poverty nexus, several of the PRSPs and NDPs have attempted to strike a balance between the existing livelihood requirements of the people and sound environmental resource management that can ensure sustainability by integrating environmental conservation into national poverty alleviation strategies.

National strategies on environmental protection include strengthening legal frameworks and enforcement, building capacity for environmental management, conducting awareness programmes, strengthening waste disposal and emission standards for vehicle exhausts and improving environmental impact assessments. However, the PRSPs in some countries (Lao People's Democratic Republic, Mongolia, Pakistan and Sri Lanka) do not sufficiently address environmental issues, while several others (e.g., Indonesia) have omitted integrating environmental aspects into their policy approaches.

Making the PRSPs MDG-friendly

PRSPs constitute the primary strategic and implementation vehicle to achieve the MDGs

The PRSPs constitute the primary strategic and implementation vehicle to achieve the MDGs. They provide a national-level operational framework setting out a country-oriented cross-cutting agenda aimed at sustained shared growth and public action directed towards achieving the MDGs. As such, achieving the MDGs would depend greatly on success in implementing poverty reduction strategies built on a broader development framework. Effective implementation of policy strategies, institutional changes and the availability and effective use of resources would be critical in this respect.

Since the introduction of country-owned poverty reduction strategies in December 1999 as a new approach to the challenge of reducing poverty in low-income countries, PRSPs have received widespread acceptance by both the respective Governments and development partners. The PRSP approach, which is built on the two pillars of country self-help and support from external development partners, is considered a more effective approach to reducing poverty as it is based on an inclusive, broad-based consultative process backed by political will.

However, for many low-income countries, the development and implementation of broad-based national poverty reduction strategies is a process of "learning by doing".[17] Moreover, lack of capacity at the national level, the difficulty in incorporating socio-economic and external

[17] IDA and IMF "Review of the Poverty Reduction Strategy Paper (PRSP) approach: main findings", 15 March 2002.

uncertainties into forecasting, the political sensitivity of certain policies and pressure from lobby groups, the lack of a coherent relationship between certain policies and poverty reduction and the tendency to be biased towards achieving macro-level performance criteria at any cost could derail efforts to achieve certain MDGs.

Analyses of PRSPs and NDPs point to several weaknesses in them, which could potentially negate attempts to achieve certain MDGs by 2015. Improvements in these areas would enable countries to achieve their poverty reduction targets set for 2015 under the Millennium Development Goals.

Making poverty reduction strategies country-owned

Improvements in the ownership of PRSPs is vital to make them truly country-owned

Despite the fact that PRSPs are claimed to be owned by countries themselves, the policy strategies hardly reflect national ownership. The purpose of having a PRSP is basically to qualify for debt relief and financing under IDA and PRGF. The PRSPs need to be cleared by the Boards of the World Bank and IMF.[18] As such, it is felt that national Governments are indirectly compelled to prepare policy agendas that satisfy the requirements of the World Bank and IMF rather than focusing on strategic issues which are relevant to their national economies. This in itself has made the structures of all PRSPs across the globe more or less the same.

The bureaucratic and political ownership of PRSPs is weak as representation of political parties and different branches of government in the preparation and consultative process is often lacking. In many instances, the link between the lead ministry in the PRSP process (often the Ministry of Finance) and the Ministry of Planning, which is usually responsible for NDPs, or other line ministries is weak or does not exist.[19] Consultations with civil society are aimed merely at satisfying the requirements of the consultative process and are usually done at the last moment, which provides little room for the incorporation of their concerns into policy formulation. In many instances, PRSPs have not been translated into local languages, making the consultative process a futile effort. Addressing these issues is essential to make PRSPs truly country-owned.

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[18] See also *Evaluation of UNDP's Role in the PRSP Process* (New York, UNDP, 2003).

[19] In Cambodia, the Ministry of Finance tends not to include the Ministry of Planning in its work, while weak linkages and tensions between the Finance Division and Planning Commission in Bangladesh are problematic for the future of the poverty reduction strategy. See PRSP Synthesis Note 8, <http://www.prspsynthesis.org/synthesis8.pdf>.

Greater focus on poverty reduction

As the overarching objective of PRSPs is poverty reduction, more emphasis should be given to policies aimed at poverty reduction

Although policy proposals in PRSPs include direct poverty reduction strategies, the focus is not on poverty reduction but stabilization and growth. This is particularly the case when PRSPs are linked to external financing, especially under PRGF arrangements with IMF. The prior actions and performance criteria under PRGF arrangements only focus on growth-related policy actions. They do not usually include any direct poverty reduction policy strategy.[20] This implies that the multilateral lending agencies still believe in an automatic trickle-down effect, a theory discredited long ago. Under such external financial arrangements, national Governments are also under pressure to be biased in achieving the performance criteria, which may distract their focus from poverty reduction to stabilization. As the overarching objective of PRSPs is poverty reduction, more emphasis should be given to policies aimed at poverty reduction through broad-based growth.

Strengthening the link between the medium-term framework of PRSPs and the MDGs

Need to strengthen the link between PRSPs and the MDGs as only a few PRSPs have benefited from any kind of analysis of the MDGs in the preparation of poverty reduction strategies at present

The relationship between PRSPs and the MDGs is weak, as only a few PRSPs have benefited from any kind of analysis of the MDGs in the preparation of poverty reduction strategies. The poverty reduction strategies in PRSPs or NDPs usually focus on a medium-term span of 3-5 years, while the MDGs are set for 2015, a long-term target. Although several low-income countries have spelled out their own long-term visions even beyond 2015 (Lao People’s Democratic Republic) and in certain cases linked them to the MDGs (Bangladesh, Mongolia, Tajikistan), such long-term projections are mere goals they wish to achieve without any strong underlying commitment or policy approach. The link between such long-term goals and policy actions taken at present is very weak and there is often a vacuum in between. Despite the fact that PRSPs are subject to annual review, the tendency is to make adjustments downward in most cases, making the achievement of certain MDGs even more difficult. The PRSP targets could be directly linked to the MDGs through intermediary targets set in PRSPs.

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[20] Performance criteria usually relate to net domestic financing of the central government deficit, net domestic assets, international reserves, new government non-concessional loans, stock of short-term external debt and external payment arrears. Meanwhile, indicative targets relate to central government revenue, primary fiscal balance, bank’s net claims on government credit to public corporations by the banking system and reserve money of the Central Bank. See performance criteria and indicative targets for Sri Lanka for the period December 2002-December 2003 under its PRGF arrangement with IMF at <http://www.imf.org/external/pubs/ft/scr/2003/cr03107.pdf>.

Focus on priority issues

Policy proposals should not be a mere wish list

Several PRSPs reflected the lack of a proper poverty assessment, while some others did not focus their policy strategies in addressing the priority issues. The lack of technical and financial capacity appears to have constrained countries in developing an effective and comprehensive poverty reduction strategy. For instance, Azerbaijan does not provide an in-depth analysis of the root causes of poverty. Several countries do not focus their policy on critical areas identified in the PRSPs. For example, landlessness, unemployment and the gender gap, which have been identified as major causes of poverty, among other things, have not received adequate focus in the policy agenda for poverty reduction in Armenia and Tajikistan. Similar disconnections between the root causes of poverty and proposed policy strategies are reflected in the PRSPs of the Lao People's Democratic Republic and Pakistan.

Pacing and prioritization of policy strategies need to be strengthened to ensure that policy strategies are effectively implemented

The lack of a proper assessment of poverty makes poverty reduction strategies ineffective and the socio-economic outcomes of policy actions could deviate heavily from the desired goals. The medium-term policy matrices under PRSPs usually contain a long list of policy actions to be undertaken by Governments, reflecting the ambitiousness of the exercise (Sri Lanka). However, the pacing and prioritization of policy strategies need to be strengthened to ensure that policy strategies are effectively implemented taking account of financial resource constraints as well as limitations in absorptive capacity (Azerbaijan, Cambodia, Georgia and Lao People's Democratic Republic). Policy strategies under PRSPs could be made effective if burning issues are addressed immediately.

Making realistic medium-term projections

Realistic targets are needed to keep the policy agenda on track and ensure that the ultimate objectives are met

The medium-term macroeconomic projections in PRSPs are often incomplete, overly optimistic (Bangladesh) and inadequately substantiated,[21] and the analysis of the underlying economic and structural policies required to achieve such targets is weak, making policy outcomes less appealing.[22] The reason for having overly optimistic macroeconomic projections, in particular economic growth projections, could be their political sensitivity. Governments are usually reluctant to incorporate

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[21] For example, a study by the Independent Evaluation Office of IMF in 2002, *Evaluation of Prolonged Use of Fund Resources,* finds that projections of growth, savings and investment rates were consistently higher than actual outcomes. Michael Artis finds a significant positive bias in current-year and year-ahead forecasts for growth and a large negative bias for inflation forecasts for developing countries "How accurate are the IMF's short-term forecasts? another examination of the world economic outlook", IMF Working Paper 96/89, Auqust 1996.

[22] See IMF, "Aligning the Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Paper (PRSP) Approach: issues and options" (2003) and UNDP, "UNDP review of the Poverty Reduction Strategy Paper (PRSP)" (2001).

uncertainties into their economic forecasts until events materialize. Realistic targets are needed to keep the policy agenda on track and ensure that the ultimate objectives are met.

Harmonizing PRSPs and NDPs

Harmonization of PRSPs and NDPs is essential to ensure that policy implementation by various agencies is consistent with country strategies for poverty reduction

In several countries little effort has been made to harmonize PRSPs and NDPs owing to the lack of coordination between different branches of government and the lack of clarity in their roles, the preparation of PRSPs and NDPs by separate agencies without close coordination and lack of political acceptance (Bangladesh, Cambodia, Lao People's Democratic Republic, Mongolia and Viet Nam).[23] Such disparities could also emerge when multilateral lending agencies influence the PRSP preparatory process without taking into account national priorities and socio-economic conditions. This could lead to divergent policies and strategic directions, in particular when the country's performance is not tied to donor funding as in the case of financing under IDA or PRGF. Harmonization of PRSPs and NDPs is essential to ensure that policy implementation by various agencies is consistent with country strategies for poverty reduction.

Incorporating downside risks into economic forecasts

The lack of an evaluation of downside risks of external and internal shocks is a major weakness in PRSPs

One of the major weaknesses of PRSPs is the lack of evaluation of the downside risks of external and internal shocks such as deterioration in the terms of trade, recessionary conditions in industrial countries, the phasing out of the Multi-Fibre Arrangement and China's accession to WTO on achieving the targets set for each year.[24] Alternative contingency policy scenarios reconciling macroeconomic projections with these concerns and the trade-offs underpinning these choices are necessary for Governments to minimize the deviation of actual performance from the original target.

Linking PRSPs and the budgetary process

Policy strategies must be followed by actions

In many instances, macroeconomic frameworks emerging from PRSPs and those used for national budgeting processes are not closely linked, even when the countries concerned are receiving programme support from multilateral lending agencies such as IMF and the World

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[23] Although the PRS of Pakistan draws on both the former Social Action Plan and the Planning Commission's Poverty Reduction Programme 2001-2004, the draft PRSP does not appear to refer to the 10-year plan. In Sri Lanka, the link between the key national strategies, the RRR (Relief, Rehabilitation and Reconstruction) Framework and RSL (Regaining Sri Lanka), which also contains the PRS, is weak. See PRSP Synthesis Note 8, loc. cit.

[24] Sri Lanka notes the possible downside risks to poverty reduction strategies but has refrained from incorporating them into an alternative policy scenario.

Bank. In some PRSPs the medium-term expenditure framework is not well linked to the PRSP or the budget. Except for a few cases, the parliaments in the respective countries do not appear to have played a significant role in the PRSP process.[25] This disconnect between policy frameworks under PRSPs and NDPs and the national budgets could nullify efforts to meet the MDGs as policy actions could deviate from the proposed policy agenda. Policy strategies alone are not sufficient to achieve goals; they must be followed by actions. Integrating the PRSP as an important input into the government decision-making and budgetary process is vital for the effective implementation of policies aimed at broad-based poverty reduction as it enables policy design and costing of policy strategies to be matched with government priorities.

Integrating the PRSP as an important input into the government decision-making and budgetary process is vital for the effective implementation of policies

Institution-building for monitoring and evaluation

Effective monitoring and evaluation of the progress of poverty reduction strategies is essential for ensuring that the development targets are met. Such mechanisms also facilitate the identification and rectification of major institutional and resource constraints. The PRSP process being new, monitoring and evaluation will necessarily be an evolving process. Although some countries have proposed the establishment of separate units or teams for monitoring and evaluation, proper monitoring systems are yet to be developed.

Proper monitoring and evaluation systems are yet to be developed

Capacity constraints will constitute a major problem in effective monitoring and evaluation of poverty reduction strategies in many PRSP countries. This is one area where donor support could make a difference in scaling up capacity-building in monitoring and evaluation at the country level.

Strengthening the role of the international community

The international community, as a major stakeholder in global efforts to reduce poverty, can play a critical role in facilitating country efforts. The international community's direct involvement in the PRSP process would, in addition to providing financial and technical support, help to ensure Governments' commitments to undertake policy strategies needed to reduce poverty on a sustainable basis. Addressing broad-based poverty issues at the global level would benefit not only the low-income countries but also industrialized countries directly and indirectly as emphasized in various global instruments such as the Monterrey Consensus and the Johannesburg Plan of Implementation.

The international community can play a critical role in facilitating country efforts

[25] For example, parliamentary involvement in the PRSP was lacking in Bangladesh, Cambodia and Pakistan. See PRSP Synthesis Note 8, loc. cit.

Developing a global partnership for development, MDG 8, could complement efforts by low-income countries to reduce poverty

While poverty reduction in low-income countries could create a larger market for industrial country goods and services, provide a source of inputs for their products, including knowledge and skills, and expand opportunities for advanced country investments, it also addresses emerging social issues such as global terrorism and the spread of diseases, which would benefit all. The industrial countries and multilateral lending agencies could complement efforts by low-income countries to reduce poverty, in particular by:

(a) Providing technical assistance for capacity-building for the design of poverty reduction strategies under the PRSP process and monitoring;

(b) Providing support for countries to undertake poverty and social impact analysis;

(c) Opening industrial country markets to developing country exports and phasing out of trade-distorting subsidies;

(d) Helping to bridge the financial gap in the resources needed to undertake poverty-related development policies.

Such initiatives would facilitate achieving the goals of eradicating poverty and sustainable development as expressed in the Monterrey Consensus and also in developing a global partnership for development, MDG 8.

The United Nations and the PRSP process

The fact that the PRSP is the primary strategic and implementation vehicle to achieve the MDGs would essentially require the United Nations involvement in the PRSP process

At present, the United Nations involvement in the PRSP process (in addition to the direct involvement of the World Bank and IMF) is mainly confined to participation in the consultative process, evaluation of PRSPs and donor coordination by UNDP as the custodian of the United Nations resident coordinator system. The level of participation varies across countries and often runs in parallel with the preparation of the United Nations Development Assistance Framework. Hence the interventions by the United Nations can only be considered to be evolving in the dynamic path of the PRSP process.

The fact that the PRSP is the primary strategic and implementation vehicle to achieve the MDGs would essentially require the United Nations involvement in the PRSP process. This is particularly important owing to the multidimensional nature of poverty, in which the United Nations system has a niche, in particular in those areas which are not usually taken care of by stabilization policies alone. Fostering national ownership, capacity-building for the preparation of PRSPs, monitoring and evaluation, implementation of pro-poor policies and donor coordination (including the private sector) to fill the financing gap are some of the areas where the United Nations can get directly involved to make PRSPs more MDG-friendly and achieve the poverty reduction targets set for 2015.

The United Nations, through its funds, programmes and specialized agencies, and with its long presence in developing countries, has accumulated vast sectoral and non-sectoral experience. The guidance note issued by the United Nations Development Group states that United Nations country teams should ensure that the policy framework and interventions proposed in PRSPs contribute to achieving the MDGs and other aspects of the Millennium Declaration. Since consecutive PRSPs are progressive steps along the path towards the MDGs, the note emphasizes a more holistic human development approach linked to human rights.

Although not directly involved in the PRSPs, ESCAP, which is not a funding agency, undertakes a blend of multidisciplinary research and technical cooperation activities on pro-poor policies and strategies. It identifies, analyses, documents, tests and disseminates good practices on poverty reduction (see boxes III.5 and III.6 for a sample of ESCAP's activities in this area). In addition, its policy advocacy work centres on promoting policy dialogues on global and regional commitments, especially the MDGs. In this way, ESCAP alerts Governments to policy choices in poverty reduction strategies to tackle the multidimensional nature of poverty.

PRSPs: summary of strengths, weaknesses and suggestions

The PRSP approach has been widely regarded by all development partners as a primary tool for reducing poverty in developing countries. The introduction of PRSPs led to structural changes in several recent NDPs. Despite its broad acceptance, the PRSP approach has been a "learning-by-doing" exercise for all stakeholders. Just as it has its own merits, there are several weaknesses as outlined before and summarized below together with some suggestions for further improvement.

Strengths, weaknesses and suggestions

Strengths

- Widely accepted by all stakeholders as the primary vehicle for reducing poverty and meeting MDGs
- Serves as a framework for external development assistance, thereby ensuring its continuity
- Specifically targets poverty reduction
- Consultation of civil society in designing policy makes the PRSP an effective tool for poverty reduction
- Links to the budgetary process ensure that policy strategies receive State patronage

(Continued overleaf)

(Continued from preceding page)

Weaknesses	***Suggestions***
• *Ownership:* Although PRSPs are country-owned, multilateral lending agencies continue to have a significant influence in policy formulation, effectively nullifying the country ownership. Country strategies would be biased towards the liking of multilateral lending agencies	• Lending agencies should minimize pressure on member countries to adopt certain policies in order to achieve performance criteria. Countries should be encouraged to engage in consultations with civil society organizations throughout the PRSP process so that their concerns are taken into account in the formulation of the policy framework
• *Pro-poor?:* PRSPs which are linked to external financing, in particular PRGF arrangements with IMF, would tend to be biased toward macroeconomic stability and growth rather than pro-poor policy strategies aimed at poverty reduction	• Need to have a proper assessment of the impact of macroeconomic stabilization policies on growth and poverty reduction. Macroeconomic stabilization should go hand in hand with pro-poor policies
• *Time horizon*: There is a disconnection between time horizons in PRSPs and MDGs. While PRSPs usually focus on a medium-term framework spanning three years, MDGs target outcomes in 2015. In most PRSPs macroeconomic targets are built on a baseline scenario and a feasible policy framework, which may not necessarily be compatible with the path for achieving MDGs	• Set country Millennium Development Goals and then intermediate targets (say 2005, 2010) taking the MDGs as a base. Develop a policy framework that reflects both the intermediate and final targets taking into account country capacities and resource constraints. Make appropriate adjustments to the policy framework if the set goals will not be met by the initial set of policies
• *A learning process*: The "learning-by-doing" exercise and the lack of financial and technical capacity have constrained countries in developing a comprehensive and effective poverty reduction strategy. As such, what is reflected in the PRSP may not necessarily be what is needed for the country	• Provide financial and technical support for the preparation of poverty reduction strategies. However, it should not influence the policies to be adopted
• *Overly optimistic:* The tendency to overestimate macroeconomic projections may take the focus away from real issues, making poverty reduction a difficult task	• Assist countries in capacity-building for macroeconomic forecasts
• *Down-side risks:* Risk assessment of possible shocks and alternative policy approaches are lacking in PRSPs	• Need to analyse downside risks and incorporate in the forecasting process. May be desirable to have alternative policy options to counter shocks
• *Linked to budgetary process?:* Not all PRSPs are linked to the budgetary process	• Budgetary proposals need to be based on the policy framework outlined in the PRSP or the NDP
• *Prioritization:* Lack prioritization of policy strategies	• Should focus on the most desirable policies for broad-based growth and poverty reduction on a priority basis rather than trying to touch all known policies

Box III.5. Human Dignity Initiative[a]

In the process of globalization, it has become increasingly clear that various government policies to develop cushions and safety nets to protect the poor need to be complemented by initiatives driven by the poor themselves, to ensure that poverty reduction initiatives take into account the specific needs, priorities and conditions of the poor and are adjusted to rapidly changing socio-economic conditions. Furthermore, in assisting poverty reduction efforts, it is essential that these vulnerable groups be helped to restore a sense of identity, self-confidence and mutual assistance within the community, which used to act as an informal safety net, as they have been lost in the rapid globalization process.

Experience has shown that community-based decision-making and encouraging a sense of ownership in poverty reduction programmes constitute a very effective approach for poverty reduction. One initiative by ESCAP in this respect is the Human Dignity Initiative,[b] which focuses on replicating good practices through the implementation of pilot projects, analysis, documentation, testing and dissemination of good practices on poverty reduction. By demonstrating the successful adaptation of good practices under different conditions, the project attempts to illustrate a path to extend the benefit of those small-scale good practices to the policy level as well as to illustrate how the small-scale projects complement large-scale programmes while providing direct benefits to the low-income communities involved in the projects. In particular, the good practices referred to here are decision-making modalities that lead to the provision of social safety nets within low-income communities. In other words, the aim is to determine (a) what communities can do to develop social safety nets for their weaker members and (b) what kind of policy environment and external inputs (e.g., financial resources, training, advice) are required.

One unique feature of the Initiative is that its intervention focuses on the process of participation and the provision of technical and financial support only, while the communities have total control over the design and implementation of the individual pilot projects. Another unique feature of the Initiative is that, in addition to geographically targeted communities, it deals with non-geographic communities, i.e., groups with specific vulnerabilities such as people with disabilities or HIV/AIDS.

Implementation is done through two rounds of pilot projects. In the first round, five pilot projects were implemented in Thailand to demonstrate the capacities of communities to develop social safety nets within the communities when appropriate resources and opportunities are provided. With the full involvement of the communities, the pilot projects were undertaken through various steps, such as (a) evaluation of priorities, (b) assessment of needs and resources, (c) formulation of action plans, (d) distribution of tasks and responsibilities and (e) implementation of the action plans. Depending on the priorities of the communities, the action plans varied from building pedestrian bridges and cleaning canals to undertaking programmes of cultural activities for children and youth. Through observation and analysis of the process and outcome during implementation, the projects identified the key factors for the promotion, support and implementation of successful community-based initiatives. Follow-up reports indicate the sustainability of the approach as the pilot communities seem to have adopted the project modalities and are successfully undertaking further activities through their own initiatives and resources even after the end of the pilot projects.

The current round involves 25 pilot projects in five countries, Cambodia, Indonesia, the Lao People's Democratic Republic, Thailand and Viet Nam. In the current phase, good practices of community-based initiatives from the earlier phase are being tested under a variety of conditions. The implementation of the current set of pilot projects follows a path similar to the earlier phase, but in a more structured manner as stakeholders are equipped with lessons learned from the past phase, which are reflected in training materials and guidelines on the implementation of community-based development projects.

Similar to the earlier phase, communities have identified their own priorities and decided on the activities through a participatory approach. The same approach was applied to non-geographic communities. For example, a community of people with disabilities identified a barrier-free environment as a priority and decided to put rails around the community. Another community with similar problems identified income opportunities as a key issue and developed a microcredit scheme for people with disabilities. In another example, a community of people with HIV identified mainstreaming with the rest of society as a priority issue and developed a school lunch programme for children whose parents are affected by HIV and cannot afford to provide lunch money.

The analysis, documentation and dissemination of the whole process of such projects will assist countries in building their capacity to adapt the modalities of community-based decision-making in their efforts to reduce poverty.

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[a] See ESCAP web page <http://www.unescap.org/projects/index.asp> for a full list of projects undertaken by ESCAP.

[b] Funded by the Government of Japan.

Box III.6. Provision of basic services to the poor through public-private partnerships: ESCAP follow-up to the World Summit on Sustainable Development

There has been growing recognition that limited access to basic services is a key characteristic of poverty in the ESCAP region and that public-private partnerships (PPPs) could provide a remedy for government budgetary constraints in supplying basic services. Nevertheless, the concept of PPPs in the provision of public services is still new in the region. Thus, ESCAP has taken the initiative of designing and implementing the project "Provision of basic services to the poor through public-private partnerships: ESCAP follow-up to the World Summit on Sustainable Development"[a] to demonstrate the effectiveness of the approach through initiating and implementing pilot projects on the one hand and identifying existing good practices on the other. By demonstrating that PPPs represent a flexible modality for delivering services to the poor and could effectively overcome some of a Government's budgetary constraints in funding poverty reduction programmes, the project presents policy options for developing countries in delivering basic services, namely, water, energy, health and biodiversity conservation, to the poor. Thus, its ultimate goal is to strengthen the capacity of countries in the region to develop PPPs for delivering these basic services for the poor.

The project follows a three-track approach: (a) identification and documentation of replicable and adaptable good practices with the prime focus on water, health, energy and biodiversity, (b) implementation of pilot projects initiated by ESCAP that bring about actual pro-poor public-private partnerships at the ground level and (c) strengthening of pro-poor facilities in countries of the ESCAP region.

The first track of the project develops guidelines for PPP good practice documentation and adapted replication, as well as a storage and retrieval system for the good practices. Along with the guidelines, the project identifies good practices on provision of basic services to the poor, especially access to water, energy and health care, and conservation of biodiversity.[b] Innovative models and lessons learned from demonstration projects are documented and disseminated by various means, including electronic media through easy access to the storage and retrieval system. Moreover, to ensure the effective dissemination of the good practices and operationalization of PPPs in the region, the project assists in the establishment and/or strengthening of pro-poor facilities in the countries of the region.

The second track of the project implements demonstration projects to show that PPPs actually work in different countries. Each demonstration project focuses on different aspects of poverty reduction through the provision of basic services in rural areas. These are (a) development of renewable energy and provision of income to poor households through PPP-funded minihydro plants so as to contribute to increased access to energy in rural areas of Indonesia, (b) a model PPP for expanding access to water-related services by the poor in Colombo and in a semi-urban area in Sri Lanka, (c) a demonstration PPP for ex-situ conservation and preservation of biodiversity through shared management and development of alternative resources and sources of income and livelihoods for the poor in Pakistan and (d) demonstration of a PPP for promoting affordability and accessibility of antiretroviral drugs through the development of alternative resources and sources of income and livelihoods for poor people living with HIV/AIDS.

The third track establishes institutional mechanisms and undertakes technical backstopping of PPP projects in the region eventually aiming to act as resource centres for future PPP ventures in the countries.

All the tracks of the project are at advanced stages of implementation at present. Positive responses from the beneficiaries indicate that the project is demonstrating the benefits of the PPP approach to the stakeholders as intended. For instance, the community participating in the minihydro plant project in Indonesia requested ESCAP to replicate it in neighbouring communities to extend the benefits, while the Government is in the process of instituting a mechanism to support such initiatives.

The completion of the project will assist central and local governments and the private sector in cooperating with each other to derive mutual benefits from initiatives that incorporate the provision of basic services to the poor. This is achieved by providing a package of demonstrated models of PPPs, analysing the pros and cons of the different experiences, preparing guidelines on the documentation, adaptation and dissemination of good practices, setting up/strengthening networks and facilitating further dissemination and development of pro-poor PPPs.

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[a] Funded by the Government of the Netherlands.

[b] It also analyses the demonstration projects conducted under the second track of the project.

CONCLUSIONS

A holistic approach is needed to deal with the many dimensions of poverty

Poverty is a complex and multidimensional phenomenon. The poor are not a homogeneous group. Various approaches to defining poverty can lead to identification of different groups of poor. Therefore, a holistic approach is needed to deal with the problem of poverty. However, countries with widespread poverty face financial and other resource constraints. This may require setting priorities in terms of dealing with various dimensions of poverty, which may not be easy given the fact that various dimensions of poverty are closely linked with each other. Therefore, it is a daunting challenge for each country to formulate an effective poverty reduction strategy according to its own needs and circumstances.

Based on the above analysis, some policy-oriented conclusions are summarized. Broad-based economic growth is integral for sustained poverty reduction. The multidimensional nature of poverty makes it essential to address cross-cutting development issues along with growth. In addition to sustained growth, measures designed specifically to increase access to economic opportunities for the poor are necessary if the benefits of growth are to be distributed equally and poverty is to be eliminated on a sustainable basis.

PRSPs reflect a significant change in the approach to financing for development by external development partners by linking external financing with poverty reduction efforts

The PRSP process, where implemented, has been widely accepted by all stakeholders as the primary vehicle for reducing poverty as it specifically targets poverty reduction, involves a consultative process involving civil society in designing policy which would make the PRSP an effective tool for poverty reduction with links to the budgetary process ensuring that policy strategies receive State patronage and serves as a framework for external development assistance, thereby ensuring its continuity. It also reflects a significant change in the approach to financing for development by external development partners by linking external financing with poverty reduction efforts.

The PRSP constitutes the primary strategic and implementation vehicle to achieve the MDGs. It provides a national-level operational framework setting out a country-oriented cross-cutting agenda aimed at sustained shared growth and public action directed towards achieving the MDGs. As such, achieving the MDGs would depend greatly on the success achieved in implementing of poverty reduction strategies built on a broader development framework.

Since the PRSPs are new and a learning process for many, there is a great deal of room for improvement in country approaches to addressing cross-cutting issues aimed at reducing poverty on a broader scale. This is particularly important as PRSPs are to be used as the primary tool for achieving MDGs.

PRSPs could be made nationally owned and acceptable to all by broadening the consultative process

Although it is claimed that PRSPs are country-owned, external development partners continue to have a significant influence on policy formulation, effectively nullifying the country ownership. The pressure from external development partners would make country strategies biased towards the liking of multilateral lending agencies. In many instances, both bureaucratic and political ownership is lacking while consultations with civil society have been limited. The PRSPs could be made to reflect the country-driven approach by minimizing the pressure on member countries to adopt certain policies in order to achieve performance criteria. The PRSPs could be made nationally owned and acceptable to the communities at large by broadening the consultative process to get civil society effectively involved and reflect the views of civil society in the policy agenda.

PRSPs, which are linked to external financing, in particular PRGF arrangements with IMF, tend to be biased towards macroeconomic stability and growth rather than pro-poor policy strategies aimed at poverty reduction. The impact of macroeconomic stabilization policies on growth and poverty reduction needs to be properly assessed to ensure that the policies adopted are the most effective for reducing poverty on a sustainable basis. As the overarching objective of PRSPs is poverty reduction, more emphasis needs to be given to policies aimed at poverty reduction while paying due attention to macroeconomic stabilization to ensure sustainability.

The learning-by-doing exercise and the lack of financial and technical capacity have constrained countries in developing a comprehensive and effective poverty reduction strategy. The pacing and prioritization of policies need to be strengthened to ensure that policy strategies are implemented and are within the resource and institutional constraints. The provision of financial and technical support for the preparation of poverty reduction strategies without influencing the policies to be adopted would help to overcome capacity and resource constraints.

The tendency to overestimate macroeconomic projections may take the focus away from real issues, making poverty reduction a difficult task. Incorporating an analysis of the downside risks of possible external and internal shocks and alternative policy approaches into the forecasting process could strengthen PRSPs. The incorporation of alternative policy options would help to minimize the negative impact of such potential shocks on development goals. Assisting countries in capacity-building could raise the efficiency of macroeconomic projections and poverty assessment.

Policies alone are not sufficient; they must be supported by actions

An important message arising from the above analysis is the fact that policy strategies alone are not sufficient to achieve development goals; they must be followed by actions. Integrating the PRSP process as an important input to government decision-making and budgetary processes is vital for the effective implementation of policies aimed at broad-based poverty reduction.

The international community could play an important role in making PRSPs an effective policy tool for eradicating poverty and addressing cross-cutting issues

The international community, including the United Nations, could play an important role in making PRSPs an effective policy tool for eradicating poverty and addressing cross-cutting issues in developing countries. Provision of technical assistance for capacity-building for the design of poverty reduction strategies under PRSPs, in particular to make them more MDG-friendly, and monitoring and evaluation, strengthening the support for countries to undertake poverty and social impact analysis and bridging the financial gap for meeting medium-term policy agendas of developing countries are some of the critical areas where the international community could get directly involved to complement the efforts of low-income countries to reduce poverty.

More resources are needed to produce quality poverty data

Timely availability of quality poverty data is important for designing effective poverty reduction programmes as well as for evaluating their impact. Therefore, more resources should be invested by countries and multilateral organizations to improve the quality of poverty data.

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- **The economic performance of developing countries in the ESCAP region in 2003, at 6 per cent, was higher than in the previous year by half a percentage point, despite the war in Iraq and the SARS crisis. At the same time, inflation was kept in check at low levels in most parts of the region. Thus, the ESCAP developing countries have enjoyed two years of economic growth which also proved to be more buoyant than that experienced by both the global economy and other groups of developing countries in 2003.**

- **Other things being equal, the collective growth rate in the ESCAP developing countries should largely be at the same high rate while consumer price inflation should generally remain subdued in most parts of the region in 2004. Nevertheless, the possible emergence of asset bubbles in stock markets and in real estate has to be given due attention for preventive purposes. There is also a need for fiscal consolidation to stabilize the rising levels of public debt and ensure a more equitable and efficient fiscal system. Collaborative initiatives and efforts involving cross-border stakeholders would be helpful in promoting and speeding up the development of capital markets in the region.**

- **Despite the robust economic growth in the region, poverty remains a challenge for many countries. The multidimensional nature of poverty would require addressing both the income and non-income attributes of poverty. Country experiences suggest that, in addition to sustained growth, measures designed specifically to provide economic opportunities targeted at the poor are necessary if the benefits of growth are to be distributed evenly. The *Survey* examines the poverty reduction strategies of some 20 countries in Asia and the Pacific and concludes that more needs to be done to align them more explicitly with the Millennium Development Goals.**