2014

Asian Development Outlook 2014: Fiscal Policy for Inclusive Growth

Asian Development Bank

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Abstract

Developing Asia achieved steady economic growth in 2013 as the region adapted to a changing global landscape. Demand from the advanced economies picked up as recovery gathered momentum. Yet this improvement was tempered somewhat by moderated growth in the People's Republic of China (PRC) as it continued its shift toward more balanced growth. These two trends help shape the regional forecast. The *Asian Development Outlook 2014* estimates that regional growth will edge up from 6.1% in 2013 to 6.2% in 2014 and 6.4% in 2015.

As the United States (US) continues to phase out its unconventional monetary policy, combined GDP growth in the US, the euro area, and Japan is expected to almost double to 1.9% in 2014 from 1.0% in 2013. Growth in these economies will strengthen more to 2.2% in 2015. While the US policy shift may bring further volatility in financial markets, the tightening of global liquidity can be mitigated by accommodative monetary policy in the euro area and Japan.

Reform is key to the outlooks for the region's two largest economies: the PRC and India. Growth in the PRC slowed to 7.7% in 2013 as credit growth tightened, wages rose, the currency appreciated, and the authorities continued implementing policies to promote economic expansion that is more equitable, sustainable, and balanced. As reform gathers pace, growth in the PRC is forecast to slow to 7.5% in 2014 and 7.4% in 2015. In contrast, India's outlook depends on its ability to successfully implement structural reforms and spark stronger growth. If successful, reform in India may accelerate economic growth from 4.9% in 2013 to 5.5% and 6.0% in the next 2 years.

Risks to the outlook have eased compared to the recent past, and policy makers in the region can manage them. Yet three areas continue to warrant close monitoring. First, another shock to global financial markets from changes in US monetary policy cannot be ruled out. Second, data on the recovery in advanced economies have been mixed, leaving the possibility that demand for developing Asia's exports may be softer than forecast. And finally, if efforts in the PRC to curb credit expansion are too abrupt or excessive, a deeper slowdown could drag down prospects for its trading partners.

As Asian governments manage these risks, they must also act to ensure that steady growth can continue in the decades ahead. The region's past economic growth lifted hundreds of millions of Asians out of poverty, but now widening inequality is undermining this success. During the 1990s and 2000s, more than 80% of the region's population lived in countries with worsening Gini coefficients, a common measure of inequality. The same market forces that enhanced growth—globalization, technological progress, and market reform—now exacerbate inequality.

International experience shows that public spending can reduce income inequality. Government spending on education and health care, for example, broadens access for the poor to these vital services and levels the playing field.

Pragmatic fiscal policy has endowed many economies in the region with scope to direct more public resources toward enhanced inclusion. But this opportunity may not last. Fiscal space will be squeezed in the coming decades by rising costs for health care and other needs common to rapidly aging societies. To ensure the ability to invest in inclusive growth, regional authorities must explore a wide range of options to raise revenue. These include broadening the base for personal income tax and value-added tax, enlarging corrective taxes and nontax revenues, and introducing naturally progressive taxes on property, capital gains, and inheritance. Improving tax collection is also important.

Fiscal policy can and should play a bigger role in promoting inclusive growth in the region. Asian governments need to actively target inclusion when formulating fiscal plans and thereby build economic growth on broadly shared benefits. Achieving inclusive growth is a long-term challenge. As regional growth stabilizes, now is the time to plan and act for a more inclusive future.

Keywords

economic growth, Asia, development, finance, Asian Development Bank

Comments

Suggested Citation

Asian Development Bank. (2014). *Asian development outlook 2014: Fiscal policy for inclusive growth*. Mandaluyong City, Phillippines: Author.

Required Publisher's Statement

This article was first published by the Asian Development Bank (www.adb.org).

ASIAN DEVELOPMENT OUTLOOK 2014

FISCAL POLICY FOR INCLUSIVE GROWTH

ASIAN DEVELOPMENT BANK

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ASIAN DEVELOPMENT BANK

ISBN 978-92-9254-453-9 (PDF)
ISSN 0117-0481
Publication Stock No. FLS146360-3

Cataloging-in-Publication Data

Asian Development Bank.
Asian development outlook 2014. Fiscal policy for inclusive growth.
Mandaluyong City, Philippines: Asian Development Bank, 2014.

1. Economics. 2. Finance. 3. Asia. I. Asian Development Bank.

The annual *Asian Development Outlook* provides a comprehensive economic analysis of 45 economies in developing Asia and the Pacific.

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Foreword

Developing Asia achieved steady economic growth in 2013 as the region adapted to a changing global landscape. Demand from the advanced economies picked up as recovery gathered momentum. Yet this improvement was tempered somewhat by moderated growth in the People's Republic of China (PRC) as it continued its shift toward more balanced growth. These two trends help shape the regional forecast. The *Asian Development Outlook 2014* estimates that regional growth will edge up from 6.1% in 2013 to 6.2% in 2014 and 6.4% in 2015.

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Reform is key to the outlooks for the region's two largest economies: the PRC and India. Growth in the PRC slowed to 7.7% in 2013 as credit growth tightened, wages rose, the currency appreciated, and the authorities continued implementing policies to promote economic expansion that is more equitable, sustainable, and balanced. As reform gathers pace, growth in the PRC is forecast to slow to 7.5% in 2014 and 7.4% in 2015. In contrast, India's outlook depends on its ability to successfully implement structural reforms and spark stronger growth. If successful, reform in India may accelerate economic growth from 4.9% in 2013 to 5.5% and 6.0% in the next 2 years.

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Pragmatic fiscal policy has endowed many economies in the region with scope to direct more public resources toward enhanced inclusion. But this opportunity may not last. Fiscal space will be squeezed in the coming decades by rising costs for health care and other needs common to rapidly aging societies. To ensure the ability to invest in inclusive growth, regional authorities must explore a wide range of options to raise revenue. These include broadening the base for personal income tax and value-added tax, enlarging corrective taxes and nontax revenues, and introducing naturally progressive taxes on property, capital gains, and inheritance. Improving tax collection is also important.

Fiscal policy can and should play a bigger role in promoting inclusive growth in the region. Asian governments need to actively target inclusion when formulating fiscal plans and thereby build economic growth on broadly shared benefits. Achieving inclusive growth is a long-term challenge. As regional growth stabilizes, now is the time to plan and act for a more inclusive future.

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Acknowledgments

The *Asian Development Outlook 2014* was prepared by the staff of the Asian Development Bank (ADB) from the Central and West Asia Department, East Asia Department, Pacific Department, South Asia Department, Southeast Asia Department, Economics and Research Department, as well as the resident missions. Representatives from these departments and the Office of Regional Economic Integration constituted a Regional Economic Outlook Task Force, which met regularly and coordinated closely to develop consistent forecasts for the region.

The authors who contributed the sections are bylined in each chapter. The subregional coordinators were Christopher Hnanguie for Central and West Asia; Yolanda Fernandez Lommen for East Asia; Sabyasachi Mitra and Sarah Carrington for South Asia; Samiuela Tukuafu for Southeast Asia; and Christopher Edmonds for the Pacific.

A team of economists from the Economics and Research Department, led by Joseph E. Zveglich, Jr., Assistant Chief Economist, Macroeconomics and Finance Research Division, assisted by Edith Laviña, coordinated the overall production of the publication. Technical and research support was provided by Arnelyn May Abdon, Shiela Camingue, Cindy Castillejos-Petalcorin, Gemma Esther Estrada, Nedelyn Magtibay-Ramos, Pilipinas Quising, Aleli Rosario, and Lea Sumulong. The economic editorial advisors Robert Boumphrey, Joshua Greene, Richard Niebuhr, Anthony Patrick, and Reza Vaez-Zadeh made substantive contributions to the country chapters and regional outlook.

The theme chapter benefited from the substantive inputs and advice from Gemma Esther Estrada, and Joshua Greene. Josef Teofisto Yap provided editorial advice on the theme chapter.

Peter Fredenburg did the style and manuscript editing. Alvin Tubio was responsible for typesetting, as well as graphics generation in which he was assisted by Maria Susan Torres. Art direction of the cover design was by Anthony Victoria, with artwork from Design Muscle. Critical support for the printing and publishing of the report was provided by the Printing Services Unit of the Office of Administrative Services, and the Publishing and Dissemination Unit of the Department of External Relations. Fermirelyn Cruz, Elenita Pura, and Rhia Bautista-Piamonte provided administrative and secretarial support.

The Department of External Relations, led by Satinder Bindra, Omana Nair, and David Kruger, planned and coordinated the dissemination of the *ADO 2014*.

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Definitions

The economies discussed in the *Asian Development Outlook 2014* (*ADO 2014*) are classified by major analytic or geographic group. For purposes of this publication, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** refers to the 45 developing member countries of the Asian Development Bank.
- **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **East Asia** comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China.
- **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka.
- **Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.
- **The Pacific** comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars.

ADO 2014 is generally based on data available up to **14 March 2014**.

Abbreviations

ADB	Asian Development Bank
ADO	Asian Development Outlook
ASEAN	Association of Southeast Asian Nations
CCT	conditional cash transfer
CEQ	Commitment to Equity Assessment
CPI	consumer price index
EU	European Union
FDI	foreign direct investment
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
ICT	information and communication technology
IMF	International Monetary Fund
Lao PDR	Lao People's Democratic Republic
LNG	liquefied natural gas
NGO	nongovernment organization
NTA	national transfer account
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PIT	personal income tax
PNG	Papua New Guinea
PPP	public–private partnership
PRC	People's Republic of China
QE	quantitative easing
RMI	Republic of the Marshall Islands
saar	seasonally adjusted annualized rate
SOE	state-owned enterprise
US	United States of America
VAT	value-added tax

ADO 2014—Highlights

Developing Asia is expected to extend its steady growth. The region's growth is projected to edge up from 6.1% in 2013 to 6.2% in 2014 and 6.4% in 2015. Moderating growth in the People's Republic of China as its economy adjusts to more balanced growth will offset to some extent the stronger demand expected from the industrial countries as their economies recover.

Risks to the outlook have eased and are manageable. The monetary policy shift in the United States may invite some volatility ahead in financial markets, albeit mitigated by accommodative monetary policy in Japan and the euro area. The regional growth outlook depends on continued recovery in the major industrial economies and on the People's Republic of China managing to contain internal credit growth smoothly.

Widening income gaps in developing Asia strengthen the case for greater use of fiscal policy to foster equality of opportunity. While the region has benefited from fiscal prudence in the past, demographic and environmental challenges are expected to compete for public resources in the coming years. To boost public spending on equity-enhancing programs such as education and health without undermining fiscal sustainability, the authorities will need to explore a wide range of options for mobilizing revenue and to build equity objectives into their fiscal plans.

Key messages

- Developing Asia's gross domestic product (GDP) expanded steadily by 6.1% in 2013, the same pace as in the previous year. Higher demand from recovering advanced economies will be dampened somewhat by moderating growth in the People's Republic of China (PRC), such that growth in the region is forecast to edge up to 6.2% in 2014 and 6.4% in 2015.

- The major industrial economies—the United States (US), euro area members, and Japan—grew by a collective 1.0% in 2013. The momentum is expected to quicken to 1.9% in 2014 and 2.2% in 2015. US monetary authorities began phasing out their direct asset purchases as the US economy strengthened, but the consequent tightening of global liquidity can be mitigated by accommodative monetary policy in the euro area and Japan.

- Output in the PRC grew by 7.7% in 2013, matching the performance of the previous year. However, growth is set to slow somewhat in the years ahead as policy promotes growth that is more equitable, sustainable, and balanced. A downtick in growth to 7.5% is forecast for 2014 with additional easing to 7.4% in 2015.

- Growth in India is picking up to 4.9% in FY2013 (ending 31 March 2014), but the economy is still operating below its potential. Reform to resolve impediments to investment could allow growth to accelerate to 5.5% in this fiscal year and further to 6.0% FY2015.

- Soft global commodity prices continue to lighten pressure on consumer prices, allowing inflation to ease to 3.4% in developing Asia. Although further declines in food and fuel prices are envisaged, inflation is forecast to rise to 3.6% in 2014 and 3.7% in 2015 as the authorities in some countries adjust subsidized fuel and power rates.

- The region's current account surplus has flattened, after falling continuously since its peak in 2007. The narrowing surplus recorded by the PRC as it rebalances toward domestic demand will be offset somewhat by the pickup in exports from other export-oriented manufacturing economies and from some natural resource producers.

- Risks to the outlook have eased, and developing Asia can manage them. A shock to PRC growth, or recovery faltering in the major industrial economies, could undermine demand for the region's exports. Another risk that cannot be ruled out is a shock to global financial markets from changes in US monetary policy.

- During the recent period of US quantitative easing, countries that allowed capital inflows to fuel real exchange rate appreciation and undermine their current account balances are most vulnerable to the risk of destabilizing capital outflows. Fortunately, most regional economies have strengthened their economic fundamentals. Looking ahead, strengthening macroprudential measures before the boom can help avert sudden capital reversals that accompany the bust.

- For resource-dependent economies, commodity price swings matter more than volatile capital flows. However, they share equally with other economies the need to strengthen underlying macroeconomic fundamentals and institutions, which can insulate their economies from the destabilizing impacts of commodity price shocks. Better fiscal management and capital budget planning and implementation can convert the benefits of commodity booms into permanent social and physical assets.

- Fiscal policy can help the region tackle rising inequality by fostering equality of opportunity. In the past, Asia used fiscal policy more to support growth than to affect income distribution. The challenge ahead for Asian policy makers is to expand well-designed investments in inclusive growth without jeopardizing the fiscal prudence that has served the region well.

- Public spending on education, health care, and direct transfers can contribute to equity, but Asia underspends not only the advanced economies in these areas but also its peers in Latin America. Though many countries have headroom to increase public spending on equity-promoting programs, sizable future fiscal demands such as those from an aging population will compete for scarce resources. Generating sufficient resources to reverse rising inequality and maintain fiscal sustainability will require exploring all revenue categories.

- Strategic planning and innovative policies can contribute to more inclusive fiscal policy in Asia. A medium-term fiscal framework for inclusive growth should systematize plans for incorporating equity objectives into fiscal policy. Support for such a framework comes from fiscal data able to inform evidence-based policy and from strong political commitment. Innovative measures, such as leveraging information and communication technology for more efficient tax administration, can amplify how effectively fiscal policy supports inclusive growth in the region.

Charting a course for steady growth

Developing Asia's growth prospects

- **Developing Asia adapts to the shifting global landscape.** The US is winding down its crisis-response stimulus as tentative recovery takes hold there. The prospect of tighter global liquidity, mitigated by accommodative monetary policy in Japan and the euro area, has investors pulling back from emerging financial markets. However, developing Asia has managed to stay on top of this transition. Even with reversals of foreign capital flows knocking the region's equity markets and currencies at midyear, GDP expanded by 6.1% in 2013, the same pace as in 2012. With moderating growth in the PRC somewhat balancing improved demand from the advanced economies, developing Asia should expect steady growth extending to the forecast horizon, edging up to 6.2% in 2014 and to 6.4% in 2015.

  - » **Growth momentum is building in the major industrial economies.** Combined GDP growth in the US, the euro area, and Japan is expected to pick up to 1.9% in 2014 from 1.0% in 2013 before strengthening further to 2.2% in 2015. Prompted by the strengthening economy, the US Federal Reserve started phasing out its unconventional monetary policies—policies that helped keep the US from sinking back into recession but also spilled over into international capital markets. While the policy shift may mean further volatility ahead in financial markets, developing Asia can manage the risk with appropriate policy responses.

  - » **PRC growth is moderating as authorities engineer a more balanced model.** GDP growth in the PRC slowed to 7.7% in 2013 for several reasons: tightened credit growth, pared industrial overcapacity, deepening local government debt, rising wages, currency appreciation, and the continuing shift in the government's development priorities away from quantity toward quality. These underlying factors remain largely relevant. PRC economic expansion is forecast to slow to 7.5% in 2014 and 7.4% in 2015, which will drag somewhat on regional growth.

» **Despite a forecast pickup in growth, India still underperforms its potential.** India's 4.9% GDP expansion in FY2013 remained well below the estimated long-term pace of 6.0%. Despite this cyclical slowdown, India's capacity for more rapid growth over the long term is high, with a promising outlook for labor, worker skills, capital, infrastructure, and productivity. But reforms are needed before the economy can achieve and sustain this faster pace. Although growth is envisaged accelerating—to 5.5% in FY2014 and then to 6.0% in FY2015—this forecast rests on the elimination of structural bottlenecks that impede investment.

» **Country-specific factors are temporarily softening growth in the ASEAN-5.** After expanding by 5.2% in 2013, growth in the five largest economies in the Association of Southeast Asian Nations—Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam—will be steady into 2014. Domestic factors and moderating growth in the PRC will largely offset the benefits of higher demand expected from the major industrialized economies. The growth outlook improves to 5.6% in 2015, driven by better performances in the two largest ASEAN economies as inflation cools in Indonesia and political disruption recedes in Thailand.

- **Declining international commodity prices will keep regional inflation low.** Developing Asia experienced relatively mild inflation in 2013, with consumer prices rising by 3.4% on average. Commodity price movements are expected to continue to keep inflation low in the years ahead. The price of crude oil is forecast to soften as higher output from producers outside of the Organization of the Petroleum Exporting Countries offsets rising demand. International food prices, which declined by 7.1% in 2013, will fall further as supplies pick up. Inflation in developing Asia is projected to rise gradually to 3.6% in 2014 and 3.7% in 2015, partly because some authorities are taking advantage of soft oil prices to adjust subsidized fuel and power rates.

- **After 5 consecutive years of decline, the trend for the region's current account surplus has flattened out.** In 2007, before the global financial crisis, developing Asia's current account surplus peaked at 6.5% of its GDP. After narrowing to 1.8% of GDP in 2012, the surplus widened slightly to 2.1% in 2013. However, it is forecast to narrow again to 1.9% through the forecast period. A declining surplus in the PRC, from that economy's shift toward more reliance on domestic demand, is expected to be offset by the widening surpluses (or narrowing current account deficits) of some export-oriented East and Southeast Asian economies and several natural resource exporters.

- **Risks to the outlook have diminished, and regional policy makers can manage them.** The outlook already envisages some slowing of growth in the PRC. However, if efforts there to curb credit expansion are too abrupt and excessively undermine growth, the PRC's deeper slowdown could drag down prospects for its trade partners. Similarly, data on the recovery in the major industrial economies have been mixed, pointing to the possibility that demand for the region's goods from these countries may be softer than envisaged. Finally, most markets have so far taken the ending of US quantitative easing in their stride, but a shock to global financial markets from changes in US monetary policy cannot be ruled out.

Navigating unpredictable financial flows

- **Price stability and prudent fiscal policy are key defenses against external financial shocks.** All countries that received large foreign capital inflows during the episodes of US quantitative easing took on the risk that eventual tapering would trigger sudden outflows. The most vulnerable were those that allowed the influx of capital to induce rapid appreciation in their real exchange rates, undermining their current account balances. Other factors determining the extent of the impact were past inflation and the size of the fiscal deficit. In this respect, emerging Asia economies were no different than other emerging markets across the globe.

- **Macroprudential policies should be preemptive to capital flow reversals, not remedial.** Policies that restrain domestic credit expansion and stabilize real exchange rates soften the impact that external shocks have on domestic financial systems. Evidence suggests that economies with such measures in place before US authorities hinted at tapering their quantitative easing were largely spared the subsequent market turmoil. Macroprudential measures should therefore be implemented during boom times, as they can later help preempt the busts that would otherwise follow capital outflow.

- **Most regional economies have strengthened their economic fundamentals, but more is needed.** The countries that were most buffeted by turnarounds in capital flows in mid-2013 showed symptoms of vulnerability in at least four areas: very high domestic credit growth, escalating inflation, widening current account deficits, and worsening fiscal deficits during the capital-influx stage. Economies in developing Asia have generally improved these indicators but still need to do more to further safeguard their financial sectors. Now may be the time to tighten macroprudential policies, as capital is currently flowing back into the region.

Coping with volatile export prices

- **For resource-dependent economies, commodity price swings matter more than capital flow reversals.** Unexpected commodity price movements account for 10%–30% of real GDP fluctuation in resource-dependent economies. Market-based instruments like forward contracts to hedge against price volatility remain underdeveloped. While precautionary saving is often suggested as a form of insurance, simply setting up a wealth fund is insufficient to guard against commodity market instability. Moreover, resource-dependent countries need to develop diverse economic sectors apart from resources to make themselves less vulnerable to external shocks.

- **Strengthening absorptive capacity can buffer commodity price shocks to foster stability in resource-dependent economies.** As with financial flows, how vulnerable an economy is to swings in export commodity prices often depends on domestic factors. A country's absorptive capacity—that is, the skills mastered by its bureaucracy, the state of its infrastructure, and the quality of its institutions—affects its ability to use a sudden influx of funds effectively. Economies with the skills, capital, and institutions to put a windfall to good use can apply these strengths to manage a price swing.

- **Better capital budget planning and implementation is needed to prolong the benefits of commodity booms.** How efficiently a government uses revenues from natural resources often determines whether windfalls help make growth sustainable. Developing Asia has room to improve its absorptive capacity. Papua New Guinea and Timor-Leste, for example, struggle to meet planned public investment spending despite currently having sufficient funds. These economies need to strengthen their budget planning and implementation and enhance the skills of their civil servants.

- **To translate natural resource wealth into inclusive growth, build institutional and human capacity.** Fiscal policy can play a vital role in narrowing inequality if it is well designed and implemented. As explored in the theme chapter of this publication, public spending on education and health can directly improve the well-being of the poor and augment their productive capacity.

Outlook by subregion

- **Global and regional headwinds will have disparate impacts on subregions in developing Asia.** Just as the financial shock in mid-2013 from the prospective end of US quantitative easing had divergent impacts on emerging financial markets in the region, the gradual US exit is likely to be felt more in financially open economies. Similarly, the extent that growth moderation in the PRC stymies the growth pickup in the major industrial economies depends on patterns of trade. In the absence of major external shocks, though, domestic factors are playing primary roles in individual country outlooks.

- **East Asia sees its growth trend flatten as growth moderates in the PRC.** The subregion grew by 6.7% in 2013, a slight uptick from 2012, and is expected to maintain that rate into 2014 and 2015. GDP expansion in the PRC that is forecast to moderate from 7.7% in 2013 to 7.5% in 2014 and 7.4% in 2015 is offsetting upswings in the newly industrialized economies of the Republic of Korea; Hong Kong, China; and Taipei,China. As policies tighten to curb inflation, growth in Mongolia will moderate in 2014 and remain broadly stable in 2015. Inflation in East Asia hit a 4-year low of 2.4% in 2013 and will remain manageable at 2.5% in 2014 and 2.9% in 2015. Other than Mongolia, where concerted efforts are needed to end double-digit inflation, consumer price increases will be mild across the East Asian economies. Inflation in the PRC will remain at 2.6% in 2014 but rise to 3.0% in 2015 following energy price reforms.

- **South Asia needs successful reform in India to accelerate growth.** Although growth is inching up, South Asia remained one of the slowest growing subregions, with GDP expanding by 4.8% in 2013. Moderation in India—marked by stalled infrastructure and corporate investment, persistent inflation, and fiscal and external imbalances—had an outsized impact on the subregional average. Growth is forecast to improve to 5.3% in 2014 and 5.8% in 2015, with projected recovery in India to 5.5% and 6.0%, assuming the implementation of long-delayed structural remedies. Wide-ranging adjustments in Bangladesh and Pakistan to strengthen economic fundamentals are expected to bear fruit with higher growth in 2015. Inflation in South Asia eased to 6.2% in 2013 as global commodity and oil prices were broadly stable. Inflation is expected to edge up to 6.4% in 2014 before subsiding to 6.2% in 2015 on country-specific factors such as currency depreciation, pressures on food prices, and energy price adjustments as subsidies are withdrawn.

- **Southeast Asia displays growth patterns dominated by country factors.** Subregional GDP decelerated to 5.0% in 2013 as soft export markets and slowdowns affected Indonesia, Thailand, and Malaysia. Growth in Indonesia, the biggest of these economies, was dampened by policies the government adopted to subdue inflation after it sharply raised fuel prices. Against this trend, GDP in the Philippines quickened to 7.2%, driven by stronger private consumption and fixed investment. Subregional growth is forecast to be similar in 2014, as gains from better export markets are offset by moderating domestic demand. However, labor tensions in Cambodia and political unrest in Thailand are restraining growth in these neighbors. The outlook improves in 2015, with growth picking up in Indonesia after inflation ebbs, and Thailand's economy rebounding if political disruption recedes. Southeast Asia's inflation rate accelerated to 4.2% in 2013, driven by hikes in administered fuel prices in Indonesia and Malaysia. It is forecast to inch up further to 4.3% in 2014 but to ease again to 4.0% in 2015 on lower global commodity prices.

- **Central Asia should maintain its growth pace as its largest economy boosts public spending.** Unexpectedly strong performance in Kazakhstan, which accounts for nearly half of subregional GDP, and sharp gains in Azerbaijan and the Kyrgyz Republic raised Central Asia's growth rate by nearly a percentage point to 6.5% in 2013. The subregion is forecast to maintain this rate through 2015, though tensions arising from events in Ukraine pose downside risk. Increased public spending in Kazakhstan to mitigate the effects of the sharp currency devaluation will help support growth there, while high government outlays and rising private consumption should maintain growth in Uzbekistan. However, plateauing oil production in Azerbaijan and slackening investment in the Kyrgyz Republic will dampen growth in these economies, while additional gas exports will give only a temporary fillip to Turkmenistan's 2014 output. Inflation in Central Asia is projected to accelerate sharply to 9.0% in 2014, reflecting currency depreciation in Kazakhstan, the Kyrgyz Republic, and Tajikistan and higher growth in Georgia and Turkmenistan. Inflation should slow to 7.4% in 2015 as the impact of depreciation wanes and as growth decelerates in Azerbaijan, Turkmenistan, and Uzbekistan.

- **The Pacific will rebound as natural gas production in its largest economy drives growth.** GDP growth slowed in the Pacific for the second consecutive year, falling to 4.8% in 2013 as construction on the liquefied natural gas project in Papua New Guinea (PNG)—the subregion's predominant economy—wrapped up. The commencement of gas exports in late 2014 and the first full year of production in 2015 will boost growth in PNG and the subregion in aggregate through the forecast period. Meanwhile, growth in most other Pacific economies is expected to pick up in 2014, contributing to subregional GDP growth that is projected to reach 5.4% in 2014 before skyrocketing on PNG gas exports to 13.3% in 2015. Inflation rose to 4.5% in 2013 and is projected to rise further to 5.9% in 2014 before ebbing to 5.1% in 2015. Currency depreciation in late 2013 and surging government investment will stoke PNG inflation to 6.5% in 2014. Increased government spending in Timor-Leste is expected to keep inflation close to double-digit, at 9.5% in 2014 and 9.0% in 2015.

Fiscal policy for inclusive growth

The emerging case for inclusive fiscal policy

- **Widening income gaps in developing Asia strengthen the case for government response.** The region's past economic growth boosted living standards and lifted millions out of poverty, but now widening inequality is undermining this success. Asian Development Outlook 2012 notes that, during the 1990s and 2000s, more than 80% of the region's population lived in countries with worsening Gini coefficients, a common measure of inequality. The same market forces that have enhanced growth—globalization, technological progress, and market reform—now exacerbate inequality.

- **Fiscal policy that fosters equality of opportunity can help tackle the region's rising inequality.** International experience shows that public spending can reduce income inequality. For example, government spending on education and health care broadens access for the poor to these vital services and thus levels the playing field. But policy makers in developing Asia have generally used fiscal policy more to support growth than to affect income distribution. Authorities in advanced economies, by contrast, have extensively used fiscal tools to improve social equity.

- **The region has benefited from a legacy of fiscal prudence.** Sound fiscal positions have served the region well in the past, promoting macroeconomic stability and ensuring the ability to respond in times of economic crisis. Pragmatic fiscal policy has given many regional economies scope today to direct more public resources toward enhanced inclusion. Future scope may narrow, though, as long-term demographic and environmental trends encroach on fiscal space and the spending flexibility it provides.

- **The dilemma facing developing Asia is how to use fiscal policy to promote inclusion while maintaining fiscal sustainability.** Making the growth process more inclusive is likely to require some expansion of public spending. But expanding public expenditure without adequate revenue mobilization can be unsustainable. Governments thus need to calibrate spending programs to better meet the needs of the poor as they strengthen the revenue base through improved mobilization.

Public spending to foster inclusive growth

- **Among fiscal policy tools, government expenditure, more than taxation, has a tangible effect on inequality.** Policies on both spending and revenue can promote inclusive growth through, for example, antipoverty programs and progressive taxation. The evidence from advanced and developing economies alike suggests that government expenditures have somewhat stronger impact on income distribution than do revenues because spending can easily target low-income groups. However, revenue provides the resources required for such programs, in addition to redistributing income.

- **Public expenditures can mitigate inequality if well designed and implemented.** Public spending on education and health care, targeted subsidies and transfers, and physical infrastructure can all contribute.

  - **Education and health services directly improve the well-being of the poor and augment their productive capacity.** Policy simulations suggest that permanently raising public spending on education by the equivalent of 1 percentage point of GDP lowers the Gini coefficient by 1.1 percentage points within a decade; doing the same for health care buys a gain of 0.3 percentage points.

» **Targeted subsidies and transfers protect the most vulnerable and deprived segments of society.** Moreover, replacing distortionary general subsidies with targeted assistance to the poor can contribute to growth, as shown by analysis of fuel subsidy reform in India, Indonesia, and Thailand.

» **Extending public infrastructure can magnify the inclusive impact of public spending on education and health.** Spending 1 percentage point of GDP more on infrastructure can boost growth by an estimated 1.3 percentage points. Further, making infrastructure affordable and accessible allows the poor to take better advantage of the economic opportunities that come with improved education and health.

- **Developing Asia lags other regions in fiscal spending to promote equity.** Public spending on education averages 5.3% of GDP in the advanced economies, 5.5% in Latin America, but only 2.9% in Asia. The difference is starker for health care (8.1% in advanced economies, 3.9% in Latin America, but only 2.4% in developing Asia) and doubly so for social protection (20.0% in advanced economies, 12.0% in Latin America, but only 6.2% in developing Asia).

- **While the amount of fiscal spending is important, so is its composition.** Education policy can amplify how public spending promotes inclusion by prioritizing basic education or expanding technical and vocational training to give students the practical skills and knowledge they need for work. Public health policy can do the same by dedicating the last dollar to a new rural clinic rather than to the latest medical marvel for the urban rich.

Public revenues to safeguard fiscal sustainability

- **The region currently has the fiscal space to finance government programs that mitigate poverty and inequality.** Policy makers in developing Asia generally have a strong record of fiscal prudence, granting the region some scope today to expand inclusive expenditures. There are, however, some exceptions in South and Central Asia.

- **Yet medium-term demographic and environmental challenges will pose their own fiscal demands.** Structural changes will compete for public finances with efforts to make growth more inclusive. Aging populations in the region will raise the share of public spending on health care from 2.4% of GDP in 2010 to 7.3% by 2050. For fast-aging East Asia, the increase is particularly dramatic, from 3.0% to 9.7% in the same period. As policy makers should not assume that current fiscal space guarantees future fiscal space, the region needs stronger revenue systems that can efficiently mobilize fiscal resources.

- **Developing Asia needs to expand and strengthen its comparatively limited fiscal resource base.** During the 2000s, the ratio of tax revenue to GDP averaged 17.8% in developing Asia, below the 21.8% recorded in Latin America, 31.9% in the OECD, and 28.6% worldwide. This clearly shows that the region must improve its mobilization of fiscal resources across all categories. A stronger and broader fiscal resource base will secure the fiscal space needed to accommodate inclusive fiscal policies.

- **Greater mobilization of fiscal revenues requires exploring all possible sources.** Options include broadening the base for personal income tax and value-added tax (VAT), enlarging corrective taxes and nontax revenues, and introducing naturally progressive taxes on property, capital gains, and inheritance.

  - **Broadening the base for personal income tax and VAT offers scope for raising far more revenues.** This can be done by reducing various exemptions, deductions, and tax incentives. For some Asian countries, lowering income thresholds for the higher tax rates can net more personal income tax revenues. Expanding VAT—or introducing one where it does not exist—generates revenue efficiently. Earmarking new VAT revenues to increase public social spending can make this regressive tax progressive on balance.

  - **Corrective taxes and nontax revenues can promote efficiency and equity while raising revenue.** Evidence from the Philippines suggests that a sin tax on cigarettes—a form of corrective tax—yields a triple dividend of equity, efficiency, and fiscal revenues. Nontax revenues are lower in Asia than in the rest of the world and could be new contributors.

  - **Taxing property, capital gains, and inheritance can make the tax structure more progressive and equitable.** These taxes are inherently progressive because the poor own less capital and usually less valuable property. Further, property tax is a good revenue source for local governments.

Planning and innovation for a more inclusive Asia

- **A medium-term fiscal framework for inclusive growth should systematize plans for incorporating equity objectives into fiscal policy.** Such frameworks require careful annual review of inclusive government programs. They must align concrete medium-term targets with the means to finance them. Importantly, the inclusive elements must be integral to the overall medium-term fiscal framework to preserve fiscal sustainability.

- **Support for a framework comes from fiscal data able to inform evidence-based policy and from strong political commitment.** Improved fiscal data will enable Asian policy makers to better track public programs and assess their effectiveness toward improving their design and implementation. Political commitment will safeguard fiscal sustainability and ensure a more equitable allocation of scarce fiscal resources.

- **Innovative measures can amplify how fiscal policy contributes to inclusive growth.** Examples include leveraging information and communication technology to enhance tax administration efficiency, and forging public–private partnerships in social infrastructure to extend the reach of education and health care services. Such measures can provide additional financing for public services and improve their delivery, thus promoting equity.

- **Fiscal policy can and should play a bigger role in promoting inclusive growth in Asia.** To put the region on a growth path of broadly shared benefits, Asian governments need to actively target inclusion in their fiscal plans. Because achieving inclusive growth is necessarily a long-term challenge, policy makers must plan and act now.

Growth rate of GDP (% per year)

Subregion/Economy	2011	2012	2013	2014	2015
Central Asia	**6.8**	**5.6**	**6.5**	**6.5**	**6.5**
Azerbaijan	0.1	2.2	5.8	5.0	4.8
Kazakhstan	7.5	5.0	6.0	6.0	6.4
East Asia	**8.2**	**6.6**	**6.7**	**6.7**	**6.7**
China, People's Rep. of	9.3	7.7	7.7	7.5	7.4
Hong Kong, China	4.8	1.5	2.9	3.5	3.6
Korea, Rep. of	3.7	2.0	2.8	3.7	3.8
Taipei,China	4.2	1.5	2.1	2.7	3.2
South Asia	**6.4**	**4.7**	**4.8**	**5.3**	**5.8**
Bangladesh	6.7	6.2	6.0	5.6	6.2
India	6.7	4.5	4.9	5.5	6.0
Pakistan	3.7	4.4	3.6	3.4	3.9
Sri Lanka	8.3	6.3	7.3	7.5	7.5
Southeast Asia	**4.8**	**5.7**	**5.0**	**5.0**	**5.4**
Indonesia	6.5	6.3	5.8	5.7	6.0
Malaysia	5.1	5.6	4.7	5.1	5.0
Philippines	3.6	6.8	7.2	6.4	6.7
Singapore	6.0	1.9	4.1	3.9	4.1
Thailand	0.1	6.5	2.9	2.9	4.5
Viet Nam	5.9	5.2	5.4	5.6	5.8
The Pacific	**8.9**	**6.1**	**4.8**	**5.4**	**13.3**
Fiji	2.7	1.7	3.6	2.8	3.0
Papua New Guinea	11.3	7.7	5.1	6.0	21.0
Developing Asia	**7.4**	**6.1**	**6.1**	**6.2**	**6.4**
Major industrial economies	**1.3**	**1.3**	**1.0**	**1.9**	**2.2**

Notes: **Developing Asia** refers to the 45 members of the Asian Development Bank. **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. **East Asia** comprises the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei,China. **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. **Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam. **The Pacific** comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Papua New Guinea, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

(*continued on the next page*)

Inflation (% per year)

Subregion/Economy	2011	2012	2013	2014	2015
Central Asia	**8.9**	**5.1**	**5.9**	**9.0**	**7.4**
Azerbaijan	7.9	1.1	2.4	4.0	3.5
Kazakhstan	8.3	5.1	5.8	11.5	8.8
East Asia	**5.0**	**2.6**	**2.4**	**2.5**	**2.9**
China, People's Rep. of	5.4	2.6	2.6	2.6	3.0
Hong Kong, China	5.3	4.1	4.3	3.8	3.7
Korea, Rep. of	4.0	2.2	1.3	2.1	2.5
Taipei,China	1.4	1.9	0.8	1.1	1.3
South Asia	**9.5**	**7.8**	**6.2**	**6.4**	**6.2**
Bangladesh	10.9	8.7	6.8	7.5	6.5
India	8.9	7.4	5.9	6.0	5.8
Pakistan	13.7	11.0	7.4	9.0	9.2
Sri Lanka	6.7	7.9	6.9	5.0	6.0
Southeast Asia	**5.5**	**3.8**	**4.2**	**4.3**	**4.0**
Indonesia	5.3	4.0	6.4	5.7	4.8
Malaysia	3.2	1.7	2.1	3.2	3.5
Philippines	4.6	3.2	3.0	4.3	4.0
Singapore	5.2	4.6	2.4	3.0	2.9
Thailand	3.8	3.0	2.2	2.4	2.6
Viet Nam	18.7	9.1	6.6	6.2	6.6
The Pacific	**8.5**	**4.2**	**4.5**	**5.9**	**5.1**
Fiji	7.3	3.4	2.9	3.0	3.5
Papua New Guinea	8.4	2.2	4.0	6.5	5.0
Developing Asia	**5.9**	**3.7**	**3.4**	**3.6**	**3.7**
Major industrial economies	**1.7**	**1.8**	**1.3**	**1.6**	**1.6**

(*continued from the previous page*)

Major industrial economies comprise the United States, the euro area, and Japan.

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

1

Charting a course for steady growth

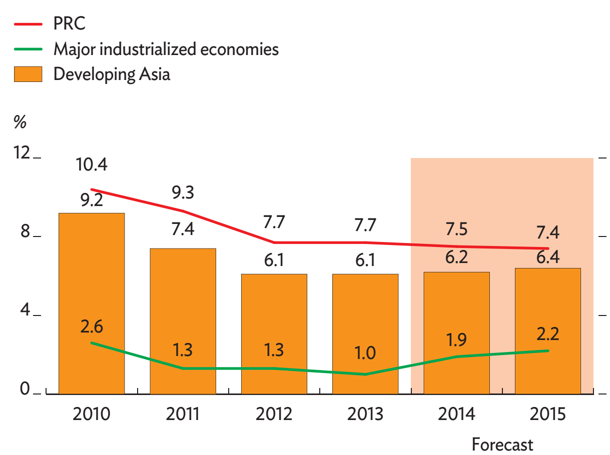
Charting a course for steady growth

The global environment is changing as the fear of a return to recession has diminished in most industrial economies. Most notably, with recovery strengthening in the United States (US), the Federal Reserve has scaled back each month in 2014 its direct asset purchases. Developing Asia has taken the US monetary policy shift in stride, and the region is set to grow steadily through 2015 (Figure 1.0.1). While moderating growth in the People's Republic of China (PRC) is a positive sign of policy makers' intent to achieve more balanced growth, the slower pace is acting as a drag on the other economies in the region.

Although unlikely to materialize, some severe risks to the regional outlook cannot be ruled out. The outlook already envisages some slowing of growth in the PRC. If efforts there to rein in credit expansion, for example, are too abrupt, a deeper slowdown in the PRC could drag down prospects for its regional trade partners. Similarly, the expected recovery in the major industrial economies could falter, as recent mixed indicators have hinted. Demand from these countries for the region's exports may be softer than envisaged. Finally, financial volatility could return. Although most markets anticipate a smooth ending of US quantitative easing within 2014, any unexpected changes in US monetary policy can trigger abrupt shifts of financial flows.

In any case, developing Asia should be able to manage the shocks through the policy tools at hand—whether monetary, macroprudential, or fiscal. Sound macroeconomic fundamentals and institutions are essential to weather shocks. During the recent period of US quantitative easing, countries that allowed capital inflows to undermine their competitiveness and current account balances suffered the worst capital flow reversals. While the global environment is relatively calm, and the significant shocks that could roil it look unlikely, the authorities need to strengthen macroeconomic fundamentals and to address bottlenecks that hinder effective policy execution such as weak institutions.

1.0.1 GDP growth outlook, developing Asia



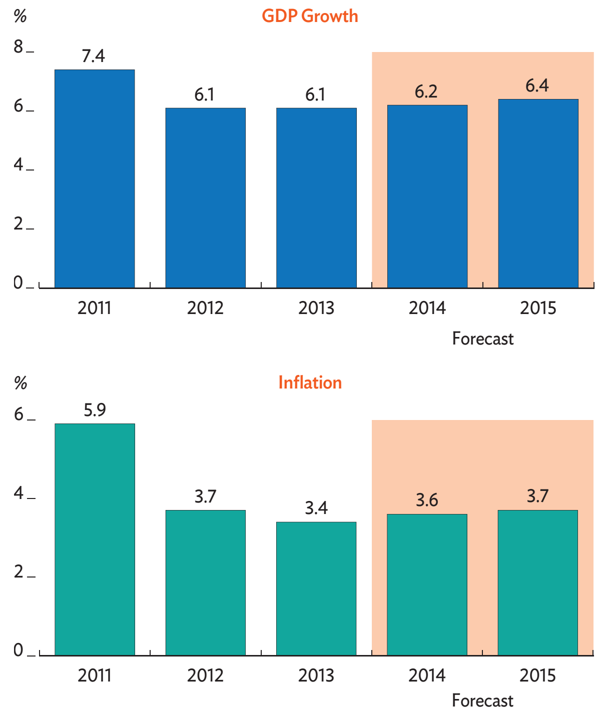
Source: Asian Development Outlook database.

This chapter was written by Akiko Terada-Hagiwara, Arief Ramayandi, Madhavi Pundit, Shiela Camingue-Romance, and Pilipinas Quising of the Economics and Research Department, Asian Development Bank, Manila. Background materials from Aaron Batten, Christopher Edmonds, and Kristian Rosbach are gratefully acknowledged.

Developing Asia endures amid modest global recovery

Developing Asia ended 2013 with growth of 6.1%, matching its 2012 pace. Growth is expected to accelerate marginally during the coming 2 years, to 6.2% in 2014 and 6.4% in 2015, reflecting ongoing adjustments in some of the region's larger economies and a pickup in global activity (Box 1.1.1). Average inflation in the region slowed to 3.4% in 2013 and is forecast to remain below 4.0% through 2015, absent a surge in global commodity prices (Figure 1.1.1). The region's current account surplus expanded to 2.1% of gross domestic product (GDP) last year but is expected to narrow to 1.9% in 2014 and 2015.

1.1.1 GDP growth and inflation, developing Asia



Source: *Asian Development Outlook* database.

Domestic and external factors underlying growth

Slowing growth in the PRC and India dragged heavily on growth in developing Asia in 2013. The PRC expanded by only 7.7%, the same growth rate as in 2012. The slowdown came as the government steered the economy away from export- and investment-led growth toward a more balanced and sustainable growth path. Likewise, India's growth is estimated to have been only 4.9% during FY2013 (ended 31 March 2014), 0.4 percentage points above the revised figure for FY2012, as structural bottlenecks that constrained investment, consumption, and industrial activity retarded expansion.

Developing Asia sustained growth of 6.1% in 2013 despite tepid demand from the PRC and India, as improving economic conditions in the advanced economies helped some economies expand more quickly. More than half of the economies in the region saw their growth rates sink below the rates recorded in 2012; of these, some 13 economies saw growth moderate for the second year in a row. But stronger growth in the more open and export-oriented newly industrialized economies of Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China—comprising more than 15% of developing Asia's GDP—helped cushion the impact of deceleration in other economies.

That improvements in external demand were only tentative combined with various domestic issues to exert downward pressure in some economies. In South Asia, power shortages, other structural bottlenecks in infrastructure, and political uncertainty in Afghanistan, Bangladesh, India, Nepal, and Pakistan kept growth virtually unchanged at 4.8%. In Southeast Asia, the average growth rate slowed to 5.0% in 2013 from 5.7% in 2012. Growth accelerated in only four economies, as Myanmar, the Philippines, Singapore, and Viet Nam enjoyed strong expansion in private consumption and investment, and Myanmar and

1.1.1 Industrial economies gradually strengthening

Growth continues to gain traction in the major industrial economies. GDP expansion in the US will be stronger than in the euro area or Japan. GDP growth for these economies together is seen strengthening from an estimated 1.0% in 2013 to 1.9% in 2014 and 2.2% in 2015 (box table). Inflation will remain low in the forecast horizon, as the combined output gap will close only gradually and weak prospects linger for international commodity prices.

GDP growth in major industrial economies (%)

	2012	2013	2014	2015
Area	Actual		ADO projection	
Major industrial economies	1.3	1.0	1.9	2.2
United States	2.8	1.9	2.8	3.0
Euro area	–0.7	–0.4	1.0	1.4
Japan	1.4	1.5	1.3	1.3

Notes: Average growth rates are weighted by gross national income, Atlas method. More details in Annex table A1.1.

Sources: US Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov; Eurostat, http://epp.eurostat.ec.europa.eu; Economic and Social Research Institute of Japan, http://www.esri.cao.go.jp (all accessed 20 March 2014); ADB estimates.

The US GDP expanded by 1.9% in 2013 after growth accelerated in the second half. Consumption grew steadily throughout the year, but investment picked up only in the second and third quarters. After boosting investment growth in the third quarter, private inventory fell significantly in the fourth. The US net foreign trade and services position improved, but government spending dragged. GDP growth decelerated to a seasonally adjusted annualized rate (saar) of 2.6% in the fourth quarter from 4.1% in the previous quarter, but this is seen as a temporary effect of extreme winter cold.

The unemployment rate declined steadily from 7.9% in January 2013 to 6.7% in December, but the average duration stayed elevated. Inflation remains under control, with negligible risk of taking off. As such, the Federal Reserve is anticipated to keep interest rates low, but the degree of monetary policy accommodation will be gradually curtailed. Fiscal risks have receded, and the low interest rate environment is expected to catalyze lending by commercial banks.

Industrial indicators are mixed but point to expansion continuing in 2014 and 2015. Recurring positive signs for investment, consumption, housing, employment, and credit suggest that the economy is on track for continued gradual strengthening. Growth in the US is forecast to accelerate to 2.8% in 2014 and further to 3.0% in 2015.

The euro area GDP contracted by 0.4% in 2013 but grew in the second, third, and fourth quarters of 2013, after 6 consecutive quarters of continuous shrinkage. It grew at a saar of 1.1% in the fourth quarter of 2013, improving on a 0.6% increase in the previous quarter. Recovery in the euro area is projected to gather strength, as consumer confidence and business conditions improve, financial markets recover slightly, and fiscal pressures ease. However, indicators sketch a recovery that is still fragile, with persistent growth differentials between member countries. For example, the Netherlands grew by 2.8% in the last quarter and Germany by 1.5%. Yet France grew by only 1.2%, Italy by 0.3%, and Spain by 0.7%. Credit remains constrained in euro area economies, and problematic financial fragmentation persists, with bank lending rates to households and businesses higher in the periphery than in the core countries.

As a whole, the outlook for the euro area is for mildly recovering growth and subdued inflation. A nagging concern in most of the euro area continues to be unemployment, which can have a detrimental effect on consumption and growth. Investment must recover as well to boost real GDP growth. The euro area is expected to see modest 1.0% acceleration in growth in 2014, picking up to 1.4% in 2015.

Japan posted annual growth of 1.5% in 2013. Although domestic demand held up well throughout 2013 as consumers bought ahead of the April 2014 hike in the value-added tax (VAT) from 5% to 8%, growth turned sluggish in the second half of 2013, rising by a saar of less than 1% as exports to developing Asia weakened. Private consumption and public demand were the main drivers of growth. Public demand (combining public investment and government consumption) contributed about 1 percentage point to growth in every quarter of 2013. Private investment also strengthened in the second half, driven by new investments in construction and services. Imports of goods and services continued to pick up along with strong domestic demand. Exports remained subdued despite the cheaper yen. Currency depreciation did, however, contribute to consumer price index (CPI) inflation by pushing up prices for imported products.

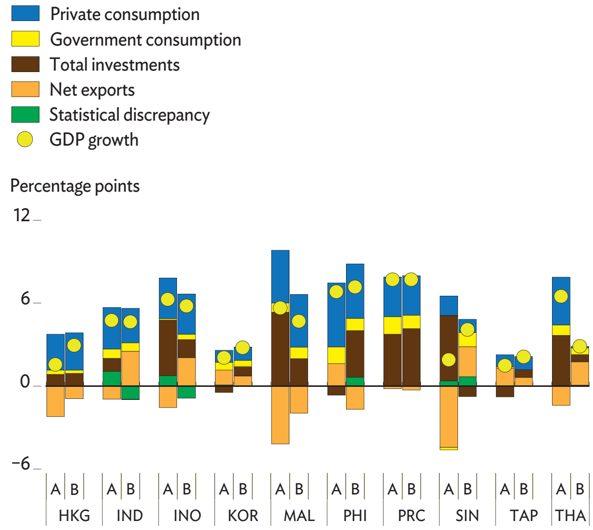
Japan's announced fiscal stimulus will likely mitigate concern over the planned VAT hikes, allowing private consumption to remain resilient. External demand, particularly in the US and euro area, is forecast to gain strength, and Japanese monetary policy will remain accommodative. Considering these factors, GDP growth in Japan is forecast to be constant at 1.3% in 2014 and 2015. Short- and long-term interest rates alike are assumed to remain low to support economic activity, and headline CPI inflation is forecast to continue increasing gradually. The yen may depreciate further, but impacts on the real exchange rate are expected to be limited as domestic prices surge in Japan.

Viet Nam also saw exports revive. However, growth in the rest of the subregion slowed, with Indonesia, Malaysia, and Thailand suffering economic setbacks as investment and exports weakened and consumption stalled.

While showing little overall change, growth in developing Asia was broad-based during 2013, driven by domestic and external factors alike. Domestic demand remained the major contributor to growth, contributing more than half in 2013 in almost all economies. External demand—which dragged on growth in 2012, particularly in the more open, trade-oriented economies in East and Southeast Asia—improved to become a major contributor to growth in 2013 (Figure 1.1.2).

The nascent recovery in the major industrial economies and improved income prospects raised consumer confidence and thus consumption, particularly in East Asia (Figure 1.1.3). This is particularly evident in the Republic of Korea and Taipei,China, where consumer confidence indices surged for most of the year as the outlook for global demand improved. Consumer confidence was fairly steady in Hong Kong, China as income and employment were stable. In Southeast Asia, the index remained generally low compared with a year earlier, as consumer confidence was dented by renewed weakness in local currencies, rising inflation, sluggish employment prospects, strikes, and prolonged political strife. Consumer confidence weakened the most in Malaysia and Thailand, declining for at least 11 consecutive months during 2013 in response to rising inflation and poorer job prospects in Malaysia and the deteriorating political situation in Thailand. In the Philippines, devastation from a major earthquake and severe typhoons eroded consumer confidence in the last quarter of the year.

1.1.2 Demand-side contributions to growth, selected developing Asia



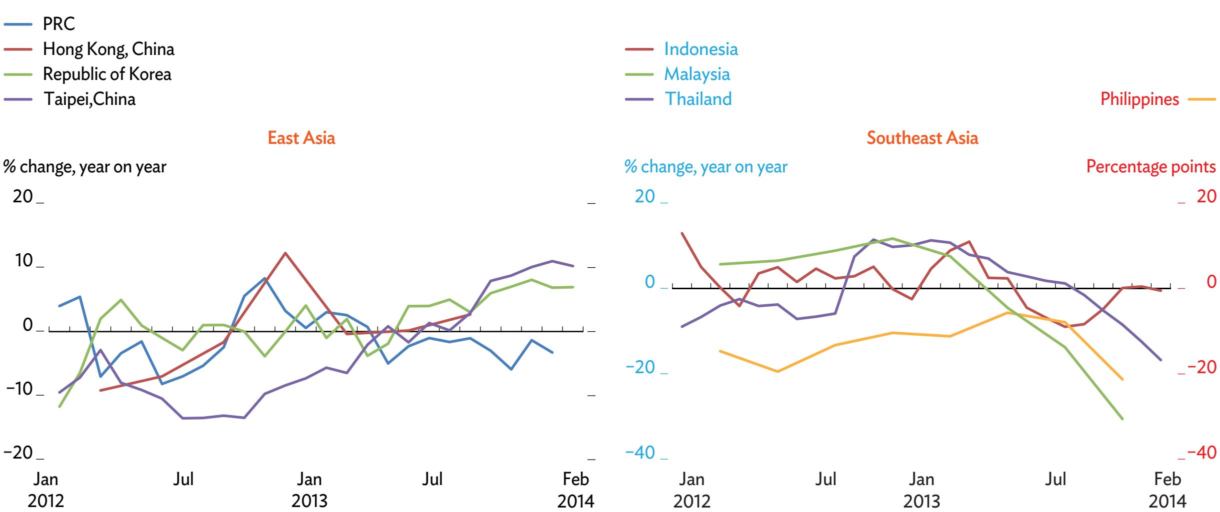
A = 2012, B = 2013.

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

Note: The GDP growth data used for India is GDP at constant market prices.

Source: Haver Analytics (accessed 20 March 2014).

1.1.3 Consumer confidence and expectations, selected developing Asia



PRC = People's Republic of China.

Notes: Data for Hong Kong, China; Malaysia; and Philippines are on a quarterly basis.

Data for the Philippines refer to consumer expectations, computed as the percentage of households that answered in the affirmative less the percentage of households that answered in the negative. A positive (negative) consumer expectations index indicates a favorable (unfavorable) view.

Sources: CEIC Data Company; Central Bank of the Philippines. http://www.bsp.gov.ph (accessed 20 March 2014).

Despite continuing weakness in the global outlook and a general slowdown from 2012 rates of expansion, retail sales remained resilient in six of nine major economies in East and Southeast Asia (Figure 1.1.4). Retails sales in Indonesia and Hong Kong, China slowed in most of the second half of last year but quickly recovered in December. In Singapore and Thailand, retail sales fell below their 2012 levels, the decline particularly steep in the latter as political turmoil intensified.

Investment was uneven across developing Asia in 2013 but remained resilient in some of the major economies (Figure 1.1.5). Expansion was particularly robust in the Philippines, underpinned by higher demand for housing buoyed by urbanization, an increase in the number of people entering the workforce, and robust remittances from overseas workers. Investment in the PRC remained resilient for the year as a whole despite a slowdown toward the end. It was supported by a pickup in agriculture and by gains in infrastructure, manufacturing, and particularly real estate, where strong demand contributed to continued rapid expansion. In Taipei,China and the Republic of Korea, private investment rebounded from the decline in 2012 as private companies moved to enhance manufacturing capacity in anticipation of stronger external demand.

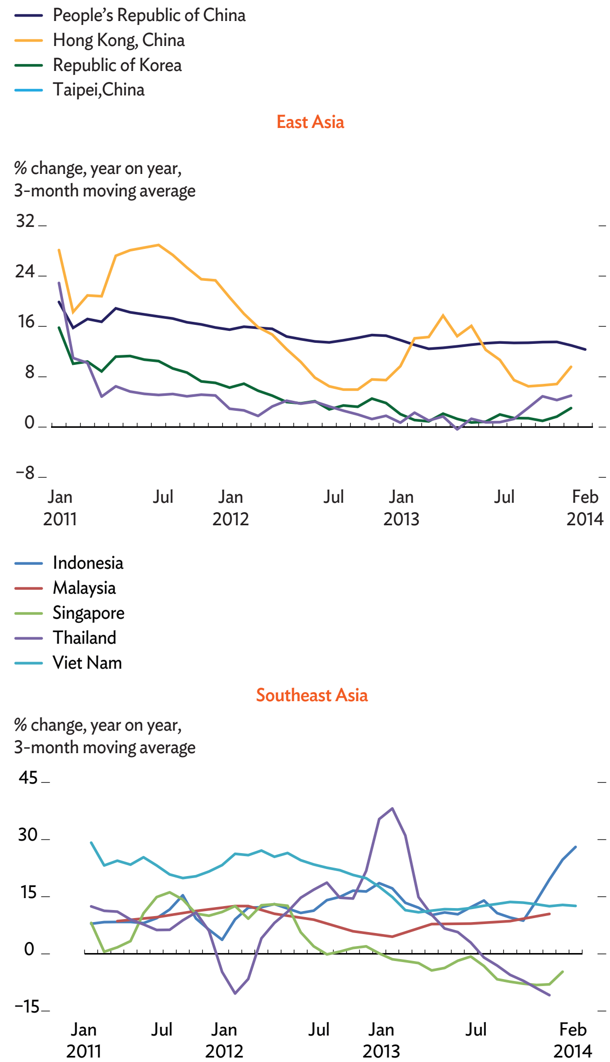
In other large economies in Southeast Asia, investment growth slowed in 2013 in tandem with consumption. In Malaysia, investment growth remained high despite slowing significantly from massive expansion in 2012 as public enterprises moderated their capital spending, government expenditure declined, and the private sector spent less as real estate investment slowed. In Thailand, prolonged political disruption dented business confidence and delayed the implementation of some government infrastructure projects, particularly big-ticket investments in flood and water management. Investment contracted sharply in Singapore following robust growth in 2012, largely reflecting a 28% drop in private sector transportation investment after rules for financing vehicle purchases were tightened.

Diverging outlooks for the two giants

Developing Asia's two large economies, the PRC and India, face significant challenges. Though both have achieved some advances in industrial and electricity production since the last quarter of 2013, the outlook diverges for the two countries over the next 2 years, with growth expected to slow in the PRC and quicken in India.

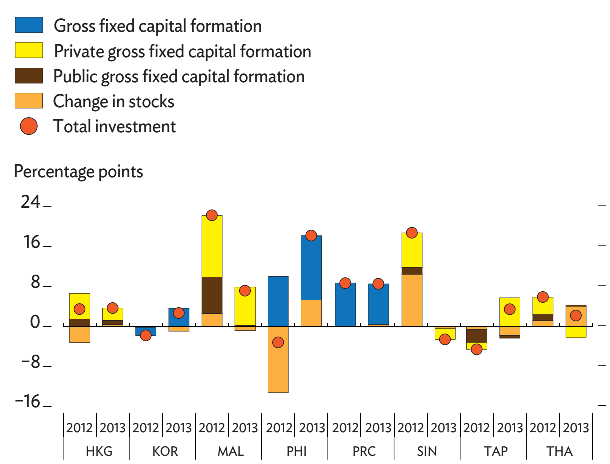
In India, manufacturing ended 2013 on an encouraging footing as the purchasing managers' index (PMI) rose above 50.0 for 2 consecutive months beginning in October 2013. Although weaker than its long-run trend, the PMI average in the third quarter of 2013 was, at 50.5, higher than

1.1.4 Retail sales, selected developing Asia



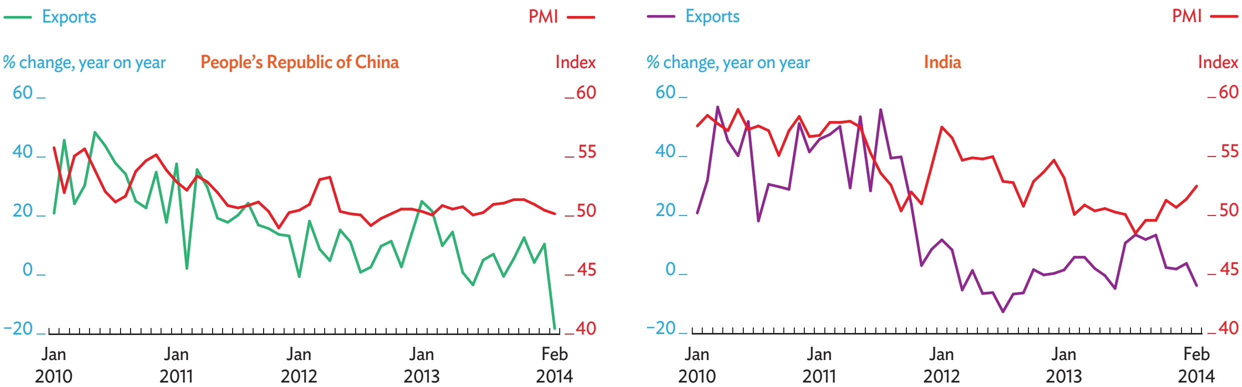
PRC = People's Republic of China.
Source: Haver Analytics (accessed 20 March 2014).

1.1.5 Contributions to investment growth, selected developing Asia



Source: CEIC Data Company (accessed 11 March 2014).

1.1.6 Purchasing manager's index and exports, PRC versus India



PMI = Purchasing manager's index.

Note: A reading of over 50 on this survey-based index shows expansion while below that signals contraction.

Sources: Bloomberg; Haver Analytics (both accessed 11 March 2014).

the 49.4 recorded in the previous quarter, indicating higher output. The February 2014 reading also signaled increased production capacity in the first quarter of the year. The gradual resolution of India's lingering structural concerns should strengthen growth momentum in the coming quarters, though growth will remain below its potential (Box 1.1.2).

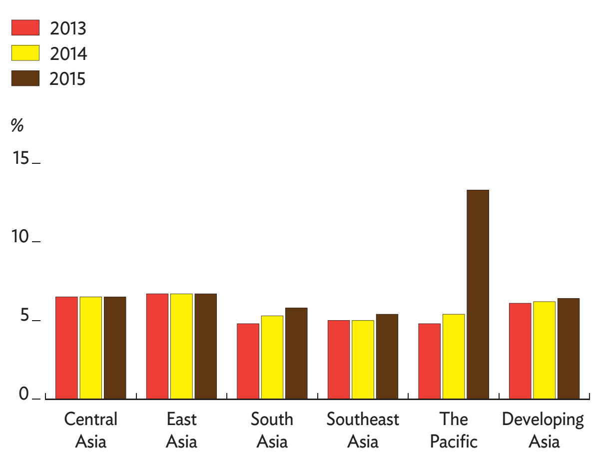
By comparison, the PMI in the PRC has been flat, signaling a weak start for the economy in 2014, but it remained slightly above 50, indicating stable expansion in manufacturing (Figure 1.1.6). Moreover, growth in manufacturing is expected to accelerate in the months ahead as the advanced economies recover. The PRC will likely end the year on a lower growth trajectory, however, dragged down by various constraints on market demand and the government's efforts to reduce industrial overcapacity, curb local government debt, and rein in credit growth by limiting financial innovation (Box 1.1.3).

Subregional trends in growth and inflation

While the external environment remains sluggish, South Asia and the Pacific are the only two subregions in developing Asia that are projected to grow more quickly this year and next than in 2013. In 2015, Southeast Asia is expected to become the third subregion with accelerated growth (Figure 1.1.7). Inflation, by contrast, is forecast to rise in 2014 as many countries adjust their administered prices, taking advantage of the absence of global price pressure, and as currency adjustments boost inflation in some Central Asian countries (Figure 1.1.8).

In East Asia, economic growth will stall over the next 2 years at 6.7%, the same rate as in 2013. Despite this stagnation, East Asia will remain the fastest-growing subregion in 2014. Growth in the PRC is projected to moderate to 7.4% in 2015 from 7.5% in 2014, reflecting the

1.1.7 GDP growth, by subregion



Source: Asian Development Outlook database.

1.1.2 Is India's trend growth slowing?

GDP growth in India decelerated from 8.5% in FY2011 (ended 31 March 2012) to 6.5% in FY2012 and further to 4.9% in FY2013, raising concerns that growth may be slowing permanently. As the trend growth rate for real GDP in the last 3 decades since 1981 has been an impressive 6.0%, the reasons for this strong trend must be understood before any attempt is made to assess the possibility of its continuing in the future.

Patnaik and Pundit (forthcoming) examined the main drivers of India's growth over the past 3 decades, in particular labor and human capital, and physical capital (including infrastructure capital) and productivity. By projecting the input variables over the next few decades, the study asks whether long-term trend GDP growth is rising or declining.

Labor supply has two components: the size of the workforce and its human capital. India has a young demographic, with 65% of its population in the working-age group aged 15–64. That percentage figure comes from 2010, but population projections suggest that, despite an aging population, the working-age proportion will remain high for the next 30 years. Moreover, human capital has improved significantly in the past 30 years, and further improvement is expected. By 2010, the literacy rate had reached 70% , and it is expected to reach 100% in the next 3 decades. All indicators of education—such as years of schooling and the proportion of the population to attain primary, secondary, and tertiary education—have improved, and further improvement over the coming decades is anticipated.

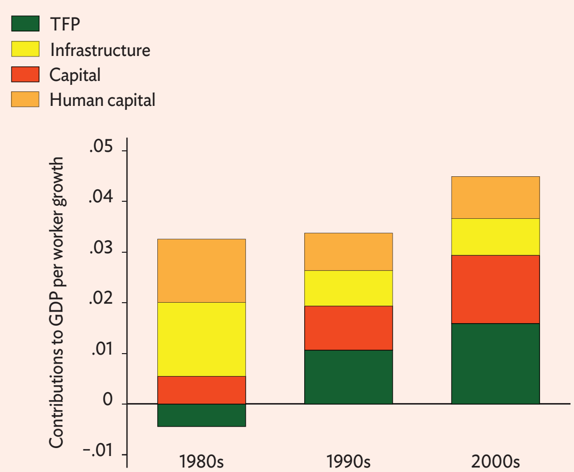
Physical capital, measured as net capital stock, has also risen. Data from nonfinancial firms show that, except during the global financial crisis, the number of projects under implementation and projects completed has been growing rapidly. The case is similar for infrastructure capital. Since the crisis, the pace of new projects has slowed, but this may be a correction from past over-exuberance. If current institutional reforms continue, investment can be expected to return to its long-run average over the next few years. Aside from stalled projects, actual additions to highways and metro lines signal potential for further growth in urban infrastructure.

The globalization of domestic firms has brought new technologies and management practices along with substantial inflows of skills, labor, and capital. The scope for total factor productivity growth built on learning from advanced countries is immense. The rapid growth of services in India—in particular information technology, communication, and internet use—should accelerate future growth in productivity.

Using an estimated production function, box figure 1 shows how much each factor of production contributes to growth in GDP per worker. The contribution of capital has always been important through the decades; infrastructure and human capital also contributed to growth, almost in equal measure. Total factor productivity dragged down growth in the 1980s, but since liberalization its share has increased to make it the main driver of growth in recent years.

As fluctuations around the trend will remain, the recent slowdown in GDP growth below 5% is likely cyclical. The forecast for 2014 and 2015 shows slight acceleration in GDP growth, reflecting an improving global environment and higher exports attributable mainly to currency depreciation. However, higher growth requires more investment. This may take time to achieve, as reforms are needed to eliminate bottlenecks in infrastructure, taxes, and business and financial regulations.

Estimated potential GDP per worker growth



Source: ADB estimates.

Over the long run, productivity will be the main driver of economic growth. Accelerating growth in productivity will require the timely and consistent implementation of reforms to improve institutional quality and capacity.

Reference

Patnaik I. and M. Pundit. 2014. Is India's trend growth declining? forthcoming ADB Working Paper.

1.1.3 Reform efforts under the third plenum in the PRC

The Third Plenum of the 18th Central Committee of the Communist Party of the PRC issued two documents in November 2013 that articulated a major reform plan for the PRC in the coming years. The program ranges over much of national life. Building on this blueprint, conferences took place to flesh out the objectives presented in the government work report of March 2014. Reform now seems focused on further economic opening (especially to trade in services), relaxing administrative constraints and boosting reliance on markets to allocate factors of production, improving transparency and reducing waste and corruption, rationalizing state-owned enterprises (SOEs), and strengthening the role of the private sector.

The PRC kept its economic growth target unchanged at 7.5% in 2014, accepting that growth may be slightly lower to accommodate structural reform. Growth below the target would provide greater space for more ambitious structural reforms that are likely to have adverse implications for growth in the short term. Moreover, attaining the growth target will be hard without allowing the kind of investments in infrastructure and real estate that have in the past swollen local government debt and encouraged shadow banking. In terms of macro management, the PRC will continue to implement a proactive fiscal policy and prudent monetary policy. The 2014 inflation target has been set at 3.5%, unchanged from last year.

High on the government's agenda for 2014 is containing local government debt. Reform involves initiating credit ratings for local governments and early warning systems while allowing local governments to issue debt for revenue-earning and other projects through standard mechanisms. This is part of the broader objective of establishing an effective and efficient fiscal system with improved budget management, reformed taxation, budget transparency, and responsibility to match expenditure to revenue. The government has clamped down on wasteful expenditure for government construction projects, reduced the number of government employees, and curbed spending on official visits overseas. It also aims to fight corruption in the public sector.

Efforts are under way to modernize SOE governance. Reforms include separating ownership from management, breaking down all forms of administrative monopoly, strengthening the accountability of SOE investments through better information disclosure, increasing the proportion of market-oriented recruitment, strictly regulating SOE executives' wages and benefits, and improving the management of state-owned capital. SOEs are being encouraged to go global, possibly with a view to exposing them to foreign competition that may improve their performance and market orientation.

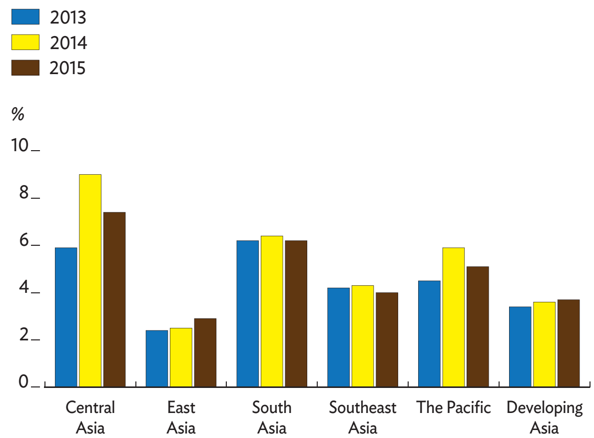
The government's overarching goal is to develop an economy with mixed ownership and a continuing dominant role for the public sector but also support for a larger and more significant private sector. The plenum discussed ways to support the healthy development of the private sector to enable it to play an important role in fostering growth, promoting innovation, expanding employment, and increasing tax revenues. Reform includes adherence to equal rights, opportunity, and rules; abolishing all unreasonable regulations on the private sector and eliminating hidden barriers to its development; encouraging private enterprises to participate in SOE reform; and promoting private firms' adoption of modern enterprise systems, or software packages to manage complexity. The recent government work report emphasized allowing private capital into more state projects connected to banking, oil, electricity, railways, telecommunications, resource development, and public utilities, among other areas.

Regarding the financial sector, the authorities committed to establishing a deposit insurance scheme and banking resolution mechanism, as well as to widening the exchange rate band this year. They also expect full interest rate liberalization during the next few years. The government report discussed promoting the healthy development of internet finance, taking into account its possible risks. Other reforms include reining in environmental pollution, improving energy conservation, and developing plans for urbanization that address the migration of labor and how to develop modern urban services and infrastructure.

authorities' intention to rein in credit growth and implement reforms that may hinder investment. Tighter policies will similarly slow growth in Mongolia in 2014, though faster expansion should resume in 2015 as restrictive policies are eased. Growth will accelerate in the rest of the subregion on rising domestic demand and an improving global economy. Inflation in East Asia will rise to 2.5% in 2014 and 2.9% in 2015 but remain below inflation in other subregions, except in Mongolia, where double-digit inflation is expected this year followed by some moderation in 2015. Inflation in the PRC will remain at 2.6% in 2014 but rise to 3.0% next year, following energy price reform.

Southeast Asia should see steady growth this year before improving in 2015. Growth in the subregion decelerated to 5.0% in 2013, mainly because of soft export markets and slowdowns in three large economies: Indonesia, Malaysia, and Thailand. Growth in Indonesia, the biggest of these economies, was dampened by government policies to subdue inflation after fuel prices were raised sharply. Against this trend, GDP in the Philippines sped to 7.2%, driven by stronger private consumption and fixed investment. In 2014, subregional growth looks set to remain flat, as moderating domestic demand offsets gains from higher exports. Growth should improve in 2015, with Indonesia expanding more quickly once inflation ebbs and Thailand rebounding if political disruptions recede. Southeast Asia's inflation rate accelerated to 4.2% in 2013, driven by hikes in administered fuel prices in Indonesia and Malaysia. It will likely slow to 4.0% in 2015, helped by soft global food and fuel prices.

1.1.8 Inflation, by subregion



Source: *Asian Development Outlook* database.

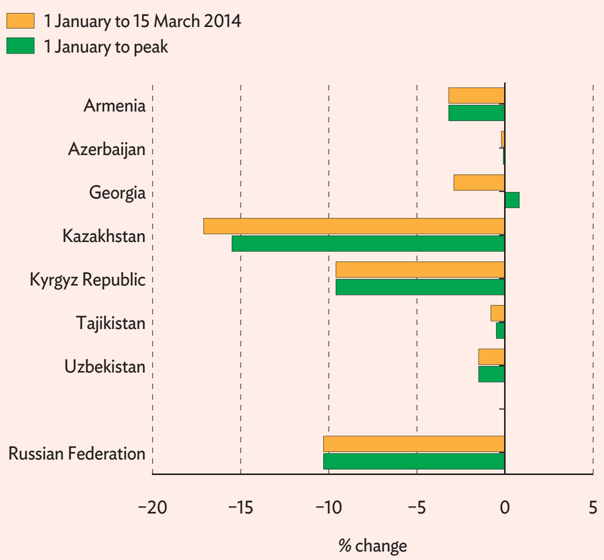
Unlike in East and Southeast Asia, growth in South Asia is forecast to rise in 2014 following 3 limp years of slow growth in India. Growth in the subregion inched up to 4.8% from 4.7% in 2012 but remained well below potential. The recent performance reflects mainly a continued slowdown in India marked by stalled infrastructure and corporate investment, persistent food and general inflation, and fiscal and external imbalances. South Asia's GDP growth is forecast to improve modestly to 5.3% in 2014 and 5.8% in 2015 as growth in India reaches 5.5% in 2014 and 6.0% in 2015, assuming long-delayed structural reform starts being implemented. Both Bangladesh and Pakistan are engaged in wide-ranging adjustment programs to strengthen economic fundamentals, and both should see growth improve in 2015 after dipping slightly in 2014. In Nepal, successful national elections in late 2013 have boosted economic prospects, while in Afghanistan presidential elections in April 2014 and an agreement on security arrangements after the withdrawal of international troops by the end of this year are crucial to a favorable outlook. Inflation in South Asia eased to 6.2% in 2013 as global commodity and oil prices were broadly stable. Inflation is expected to bump to 6.4% in 2014 before easing back to 6.2% in 2015 as global commodity prices remain soft.

Heightened geopolitical tension clouds Central Asia's outlook. Despite possible repercussions from recent currency depreciations (Box 1.1.4), however, Central Asia is forecast to maintain its growth rate, as Kazakhstan boosts public spending. GDP growth jumped by nearly 1 percentage point to 6.5% in 2013, reflecting unexpectedly strong performance in Kazakhstan and sharp gains in Azerbaijan and the Kyrgyz Republic. Barring a marked slowdown in the Russian Federation, growth in the subregion is forecast to remain at this rate

1.1.4 Impacts of ruble depreciation on Central Asia's currencies

Recent political developments in Ukraine are compounding pressure on the already weakening ruble, such that the currency of the Russian Federation lost 10.3% of its market value against the US dollar from 1 January to 15 March 2014 (box figure 1). While most countries in Central Asia remain closely linked with the Russian Federation economically and politically, their responses to this development have differed markedly. Their responses to ruble depreciation have also varied, depending on how close the trade relationship is, whether national exports compete with those of the Russian Federation, and the state of the economy's macroeconomic fundamentals.

Exchange rates in Central Asia and the Russian Federation



Note: Turkmenistan maintains a fixed exchange rate to the dollar.
Source: Bloomberg (accessed 20 March 2014).

Among the four petroleum-rich Central Asian countries, Kazakhstan reacted quickly to ruble depreciation, while the other three—Azerbaijan, Turkmenistan, and Uzbekistan—had still not acted as of late March. Kazakhstan receives more than a third of its imports from the Russian Federation and exports competing goods, such as oil, to Europe, with which the Russian Federation is also a major trading partner. To maintain the competitiveness of Kazakh exports, Kazakhstan devalued its currency, the tenge, by 16.2% on 11 February 2014. This has stoked inflation, which will likely rise into double digits this year. However, Kazakhstan's ample foreign reserves, equivalent to 6 months of imports at the end of 2013, and strong fiscal stimulus should help cushion the impact and support the economy's forecast growth at 6.0% this year.

The ruble's depreciation has also put stress on the currencies of the other states in Central Asia. The impact may be particularly strong in countries with limited foreign exchange reserves and tighter links with the Russian Federation, namely Armenia, the Kyrgyz Republic, and Tajikistan. As of 2013, remittances largely from the Russian Federation accounted for a substantial 18.0% of GDP in Armenia, 26.3% in the Kyrgyz Republic, and 44.5% in Tajikistan—but only 8.0% in Georgia. Ruble-denominated remittances will be squeezed in the short run when converted into home currencies. These economies without commodity exports are therefore highly susceptible to economic developments in source countries.

Among the currencies of the four Central Asian states without petroleum exports, the Kyrgyz som has been under pressure despite efforts to defend it. The central bank there has intervened using foreign currency reserves to contain exchange rate fluctuations. It also raised the policy interest rate from 4% to 6%, but the som nevertheless lost 9.6% of its value against the US dollar from 1 January and 15 March. The Armenian dram depreciated against the US dollar by 3.2%, as Armenia's reserves were more ample, equivalent to 7.9 months of imports at the end of 2013. As of late March, Tajikistan had managed to maintain the value of its currency, the somoni, but may find itself in difficulties as its foreign exchange reserves equal less than 2 months of imports and global prices are falling for aluminum, its main export commodity. Georgia is expected to feel little pressure because its trade links with the Russian Federation and Kazakhstan are limited, though it exports to Ukraine.

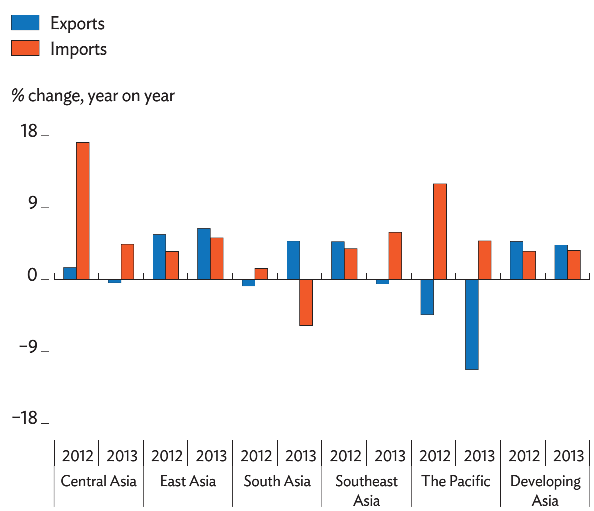
during 2014 and 2015. In Kazakhstan, a large currency devaluation and increased public spending to mitigate its effect on the population are projected to maintain growth during 2014 and boost it in 2015, while in Turkmenistan additional gas exports should temporarily boost growth during 2014. Faster growth in Armenia and Georgia in 2014 and 2015 will help offset slowdowns in Azerbaijan, where oil production is starting to plateau, and the Kyrgyz Republic, where investment is slackening. High government outlays and rising private consumption should maintain growth in Uzbekistan during 2014 and limit any slowdown in 2015. Inflation in Central Asia is projected to accelerate sharply to 9.0% in 2014, reflecting currency depreciation in Kazakhstan, the Kyrgyz Republic, and Tajikistan and higher growth in Georgia and Turkmenistan. Inflation should slow to 7.4% in 2015 as the impact of depreciation wanes in Kazakhstan and the Kyrgyz Republic, and as growth decelerates in Azerbaijan, Turkmenistan, and Uzbekistan.

Growth across the Pacific economies is seen higher in 2014, except for the Cook Islands, Fiji, and the Federated States of Micronesia. The Pacific will become the fastest-growing subregion in 2015. The growth rate in the Pacific fell for the second consecutive year in 2013 as construction ended on the liquefied natural gas (LNG) project in Papua New Guinea, the subregion's largest economy. Growth in the subregion as a whole in 2014 is forecast at 5.4% with the start of LNG exports from Papua New Guinea late in the year, rising to 13.3% in 2015, the first full year of LNG production. Inflation rose to 4.5% in 2013 and is projected to rise further to 5.9% in 2014 before ebbing to 5.1% in 2015. The subregional inflation figure is, like GDP, heavily influenced by developments in Papua New Guinea, where government investments and currency depreciation in late 2013 are expected to fuel inflation to 6.5% in 2014. Inflation in Timor-Leste is forecast to remain at 9.5% in 2014 as the government boosts spending.

Trade resilient and set to rise

On the external front, the recovery in the industrial economies has not yet fully lifted exports from developing Asia, though export orders placed with the more open, trade-oriented economies slowly increased in the second half of 2013. Nevertheless, merchandise export growth in developing Asia remained fairly resilient, increasing by 4.3% in 2013, down a bit from 4.7% the year before. Unlike in 2012, growth in exports outpaced that of imports in 2013 in most economies (Figure 1.1.9). PRC exports rose only marginally from 2012, supporting the view that stronger growth in the US, the euro area, and Japan has not yet translated into higher export demand for developing Asia. In India, merchandise exports were generally lower during the first half of 2013 but improved in the second half following a double-digit rise in shipments. Export growth was moderate in Hong Kong, China but recovered in the Republic of Korea and Taipei,China after weakening in 2012. In Southeast Asia, merchandise exports decreased generally in line with marked declines in four large economies in the Association of Southeast Asian Nations: Indonesia, Malaysia, the Philippines, and Thailand (Figure 1.1.10).

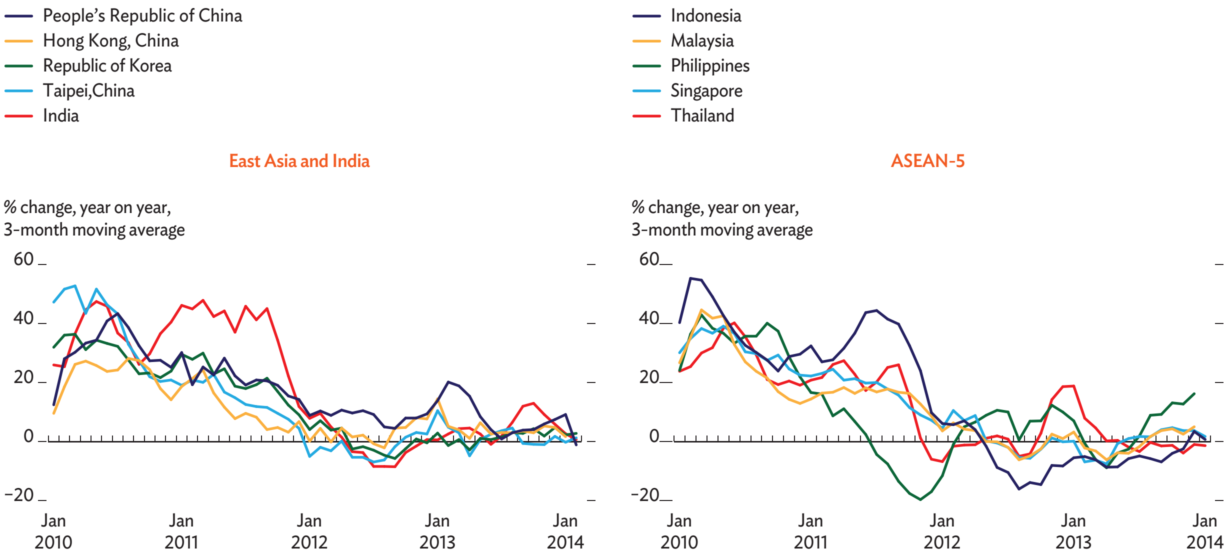
1.1.9 Exports and imports growth, developing Asia



Source: Asian Development Outlook database.

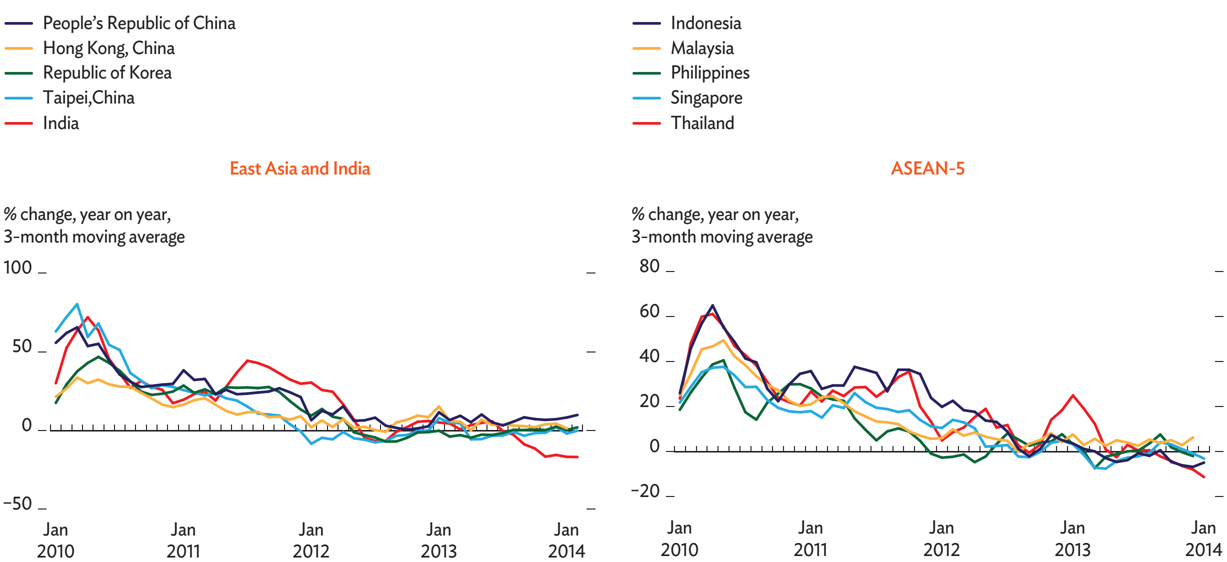
Merchandise imports rose by 3.6%, up only slightly from 3.5% growth in 2012 because growth was sluggish in some economies (Figure 1.1.11). Import growth slowed much more quickly than export growth except in Central Asia, where import growth continued to

1.1.10 Exports growth, selected Asian economies



Source: CEIC Data Company (accessed 20 March 2014).

1.1.11 Imports growth, selected Asian economies



Source: CEIC Data Company (accessed 20 March 2014).

outpace that of exports. Imports declined the furthest in South Asia, reflecting weaker imports to India, and shrank in half of Southeast Asia's economies.

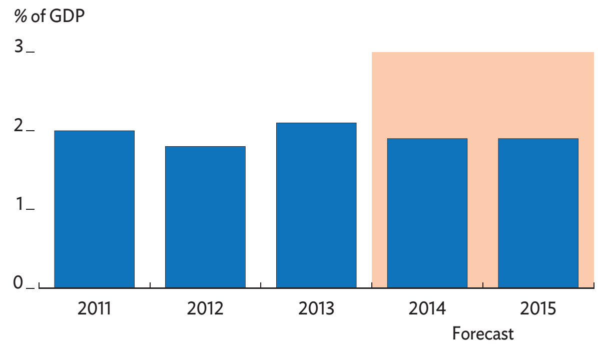
Including services, net exports of goods and services recovered in 4 of 10 large economies of developing Asia, while the rate of expansion in the remaining 6, particularly those with strong trade ties with the advanced economies and the PRC, moderated in 2013. In the PRC, net exports of goods and services deducted 1.7 percentage points from growth. In Southeast Asia, net exports of goods and services declined in Malaysia and the Philippines, subtracting on average 1.7 percentage points from growth, while net exports recovered in Indonesia, Singapore, and Thailand after dipping in 2012. Net exports in economies that trade heavily with India may have slowed, in view of India's economic slowdown in 2013.

Growth in exports from developing Asia is expected to accelerate to 8.1% in 2014 from 4.3% last year, rising further to 9.2% in 2015. Meanwhile, import growth should strengthen to 8.4% in 2014 and 9.3% in 2015 on resilient domestic consumption and rising investment. Better prospects in the major industrial economies, domestic rebalancing, and good weather should raise domestic demand in many developing Asian economies this year. In the last quarter of 2013, consumer confidence began to improve in most regional economies, except Malaysia, the Philippines, and Thailand. However, rising incomes, including higher remittances, and a hoped-for quick resolution to political problems should boost consumption in these economies in 2014.

Despite weak demand from the major industrial economies, developing Asia's current account surplus rose last year to 2.1% from 1.8% in 2012. Faster growth in imports than in exports, to support domestic demand, and the slowdown in the PRC will likely tamp the regional current account surplus back down to 1.9% of GDP in 2014 and 2015 (Figure 1.1.12). Smaller current account surpluses are anticipated in all subregions except Central Asia, where the current account surplus is expected to widen in 2014 and 2015 in view of higher demand from the euro area and local currency depreciation. In 2014, Southeast Asia's current account surplus looks set to rise slightly to 2.5% of GDP as global demand improves. Meanwhile the 2014 current account surplus for the Pacific is forecast to plunge to a fifth of its 2013 amount because of continuing decline in petroleum output from Timor-Leste, then rocket back up in 2015 on new LNG production in Papua New Guinea.

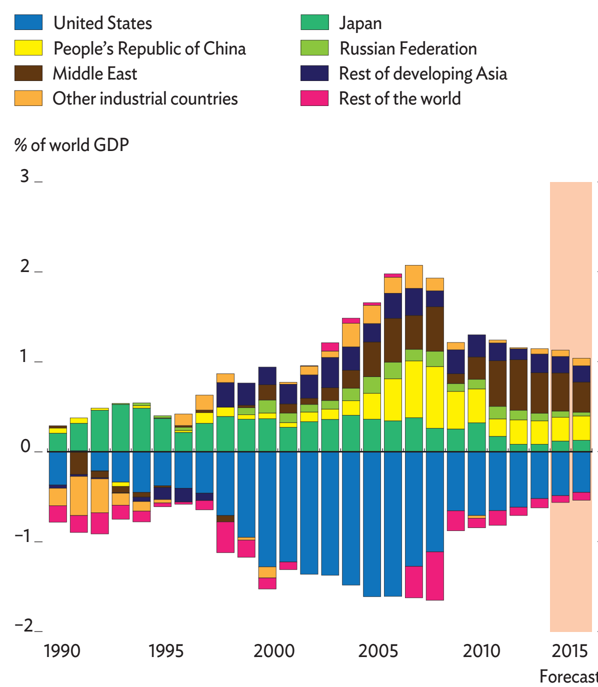
The declining trend in developing Asia's current account surplus is consistent with the narrowing trend in the global current account, measured as a share of global GDP (Figure 1.1.13). The global current account balance is estimated to have declined slightly to 1.1% of world GDP in 2013 from 1.2% in 2012. Despite its narrowing, developing Asia's surplus grew as a share of world GDP from 0.38% in 2012 to 0.47% in 2013, signifying the region's growing economic importance. The PRC holds the bulk of developing Asia's current account surplus, but its surplus as a share of world GDP declined slightly from 0.27% in 2012 to 0.26% in 2013, while current account surpluses (or narrowing in deficits) in some export-oriented East and Southeast Asian economies and several natural resource exporters widened.

1.1.12 Current account balance, developing Asia



Source: *Asian Development Outlook* database.

1.1.13 World current account balance



Sources: *Asian Development Outlook* database; International Monetary Fund. 2013. *World Economic Outlook* database. October. www.imf.org (both accessed 20 March 2014).

Risks to the outlook

The risk of a major global shock upending the regional outlook has receded significantly. However, if the assumptions underlying the forecasts turn out to be wrong, policy makers in the region will need to be ready to act to safeguard the steady growth envisaged. Three factors underlying developing Asia's outlook warrant particularly close monitoring: the pace of recovery in the major industrial economies, the effect of reform on growth in the PRC, and possible financial turbulence from changes in US monetary policy.

While the gradual strengthening of the recovery in the major industrial economies is boosting external demand for regional exports, data on their recovery have been mixed, pointing to the possibility that demand may be softer than envisaged. Fiscal risks in the US appear to have receded, but mixed data on labor markets and producer outlooks point to possible weaknesses in the recovery. In the euro area, depressed demand, credit contraction, and a strong currency could conspire to push the economy into deflation, which would further suppress growth. For Japan, weak demand in Asia and VAT hikes scheduled for April 2014 and October 2015 are the primary concerns. In sum, further recovery in the advanced countries cannot be taken for granted.

Regarding the PRC, the outlook envisages some slowing of growth there. However, the authorities are pursuing an ambitious reform agenda, and financial reform in particular could have an outsized impact on PRC output if unforeseen difficulties crop up. If efforts to rein in domestic credit expansion are too abrupt, for example, interest rates could spike, as they did in June 2013. In such a scenario, the PRC GDP could slow much more dramatically, significantly weakening prospects for its regional trading partners.

Finally, the outlook assumes that accommodative monetary policies in the major industrial economies will gradually return to normal as economies strengthen, beginning with the tapering of US quantitative easing. So far, markets have taken in stride the stepped reductions in the US Federal Reserve's monthly asset purchases. However, market sentiment is difficult to predict. Monetary policy changes could still trigger hasty shifts in capital flows if they are not well communicated. If that happens, the economies of developing Asia, particularly the vulnerable ones, will need to respond with timely policy responses.

Despite the continued risks, developing Asia's policy makers should be able to cope with the shocks with the tools and policy space they possess. Governments can manage the shocks by adopting appropriate policies—whether monetary, macroprudential, or fiscal—to smooth the impacts of any unanticipated developments.

Navigating unpredictable financial flows

The United States Federal Reserve responded to the global financial crisis of 2008–2009 by adopting unconventional monetary stimulus after lowering the policy interest rate nearly to zero proved to be insufficient. So-called quantitative easing (QE) entailed large asset purchases intended to boost the US economy, but the policy appeared to have the side effect of accelerating capital flows to emerging markets. When the US signaled in mid-2013 that it was contemplating an exit from QE, the news shook financial markets in emerging economies as they worried about the possible negative impact of such unwinding. As US monetary policy has moved from talk of tapering to implementing a phased reduction, the question remains whether developing Asia will face further shocks.

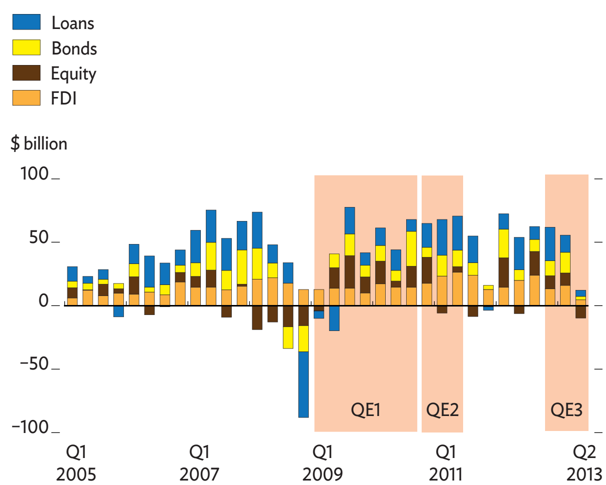
Quantitative easing and financial flows

The US Federal Reserve initiated three rounds of quantitative easing. QE1, from the first quarter of 2009 to the third quarter of 2010, occurred after the US Fed had made major purchases of mortgage-backed securities and other "toxic assets" in the early stages of the crisis in late 2008. In March 2009, the Fed announced its intention to purchase $1.7 trillion worth of financial assets. QE2, from the fourth quarter of 2010 to the second quarter of 2011, saw the Fed purchase $600 billion in US Treasury securities. QE3 renewed Fed asset purchases from the fourth quarter of 2012, starting with the monthly purchase of $40 billion in mortgage-backed securities and, from December 2012, $45 billion in Treasury securities. QE3 continues today, albeit following monthly cuts in purchase amounts since January 2014.

Figure 1.2.1 shows quarterly flows of foreign capital since 2005 into and out of six Asian economies: India, Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand. The figure also indicates sequential episodes of QE. At the onset of the global financial crisis in 2008, foreign capital flowed quickly out of the six Asian economies.

Once QE began, inflows largely returned to trend. As Figure 1.2.1 shows, the first round of US QE coincided closely with the revival of capital inflows to Asia. The composition of the flows changed, however, as funds previously sent through banks (many of which now having to deleverage) flowed during QE directly through capital markets into bonds and equities. Capital inflows to the region remained much the same during QE2 and the first few quarters of QE3 but then braked suddenly in the second quarter of 2013, as talk of a possible end to QE3 soured investor sentiment and caused some flows to reverse.

1.2.1 Capital inflows, selected Asian economies



FDI = Foreign direct investment, Q = quarter, QE = quantitative easing.

Note: Selected Asian economies comprise India, Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.

Source: International Monetary Fund. 2013. *International Financial Statistics.* December. CD-ROM.

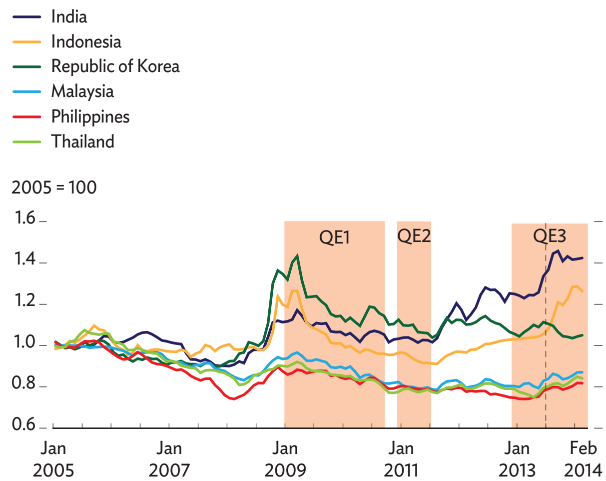
Exchange rates in the six Asian economies are closely related to foreign capital flows. A sharp drop in capital inflows during the second half of 2008 coincided with sharp currency depreciation, most notably in India, Indonesia, and the Republic of Korea (Figure 1.2.2). Following QE1 and QE2, the recovery of foreign capital flows into these economies coincided with currency appreciation. Exchange rates generally remained stable after QE2, except in India and Indonesia, which experienced new waves of currency depreciation probably at least partly linked to their own economic problems. The Indian rupee and the Indonesian rupiah began to stabilize when the US Fed started its QE3 program and resumed pouring liquidity into the US economy.

In May 2013, the Fed chair began to mention the possibility of gradually tapering the $85 billion in monthly purchases of securities to a lower amount. This taper talk jolted financial markets in emerging economies and caused sharp currency depreciation in many of them. The reversal of foreign capital flows, now out of Asia, dragged down exchange rates across the region, steeply in India and Indonesia and less so in Malaysia, the Philippines, and Thailand (but not in the Republic of Korea). The Fed's announcement at last in mid-September 2013 that it would extend its asset purchase program after all stabilized Asian exchange rates.

How much exchange rates moved in different countries may have reflected not only specific country characteristics but also differences in how central banks intervened to defend their currencies. Different countries spent foreign reserve holdings to different extents, with the Philippines and Thailand apparently intervening less than other countries (Figure 1.2.3). Under QE1, all six countries built up their foreign reserves despite currency appreciation, with the Philippines, Thailand, and Indonesia showing the largest gains. This suggests that rising exchange rates did not bear all the impact of capital inflows during that period. Reserve accumulation diminished when QE2 ended and did not seem to resume under QE3. Since the Fed began taper talk in May 2013, affecting the currencies of India and Indonesia in particular, these two countries appear to be the only ones in Asia to have intervened to defend their currencies.

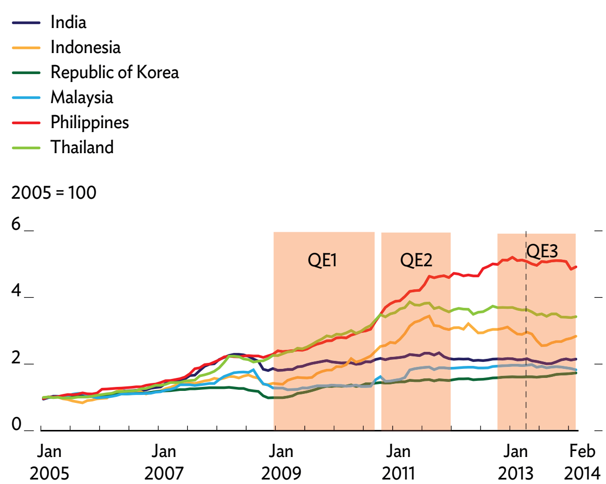
These observations suggest that currency intervention since the global financial crisis has not been a key factor in explaining differences in exchange rate movements across Asia. Other factors, such as countries' underlying economic fundamentals, may have determined capital flows and exchange rate movements.

1.2.2 Exchange rate index, selected Asian economies



Source: Haver Analytics (accessed 20 March 2014).

1.2.3 Foreign reserves index, selected Asian economies



Source: Haver Analytics (accessed 20 March 2014).

Impact of quantitative easing tapering

Since QE3 tapering started only in January of this year, assessing its impact on capital flows to emerging markets is still difficult. However, studies that examined how the talk of QE taper in May 2013 affected financial markets in emerging economies suggest that countries with weaker macroeconomic fundamentals have experienced more severe effects on capital flows and exchange rates. For example, Nechio (2014) argues that countries with more external or internal imbalances tend to be more vulnerable to capital flow reversals associated with currency depreciations. The research showed in a sample of emerging market countries a significant negative correlation between rates of currency depreciation from May to December 2013 and average fiscal and current account positions—indicators for a country's internal and external balance, respectively—during 2010–2012.

Eichengreen and Gupta (2014) more carefully examined currency depreciation from the end of April to the end of August 2013 using a broader set of country-specific factors. These included (i) past deterioration in the current account deficit and real exchange rate appreciation as measures of local market impacts and lost competitiveness; (ii) past cumulative private capital inflows or stocks of portfolio liabilities as measures of the size of the financial market; (iii) past GDP growth, inflation, budget deficits, and foreign reserves as measures of economic fundamentals; and (iv) the exchange rate regime, capital market openness, public debt, and institutional quality (measured by rule of law as rated by the World Bank's Worldwide Governance Indicators) as structural variables. The authors used for each variable either the value in 2012 or its average during 2010–2012.

Eichengreen and Gupta obtained several striking results. First, the economies that allowed the largest rise in real exchange rates and widening of current account deficits in the period before QE3 suffered the largest drop in currency value after the onset of taper talk. Second, stronger economic fundamentals—measured by such policy and economic performance measures as foreign reserves, GDP growth, and budget deficits and public debt as percentages of GDP—did not seem to insulate countries from the worst effects of taper talk, but countries with larger financial markets did experience more downward pressure on currencies. Third, there is little evidence that capital controls instituted before taper talk began relieved the exchange rate depreciation pressure.

Park, Ramayandi, and Shin (forthcoming) extended the analysis of Eichengreen and Gupta in several ways. The study included additional variables, such as rising domestic credit as a measure of financial instability. It treated the size of the financial market separately from the amount of capital flows during the QE episodes and used a recent database constructed by Forbes, Fratzscher, and Straub (2013) to incorporate macroprudential measures and capital controls as additional explanatory variables. In addition, it introduced a dummy variable for Asia to test for other region-specific influences.

Park, Ramayandi, and Shin (forthcoming) find a country's past current account deficits and real exchange rate rises greatly affected how much its currency depreciated after the taper talk. Economic fundamentals other than past inflation rates did not significantly affect the depth of depreciation, but capital flows from 2010 to 2012 did, with countries that received larger inflows of bank loans and equity investments tending to suffer more. Past expansion of domestic credit also mattered, as the size of capital inflows was strongly associated with subsequent deep depreciation. Pursuing macroprudential policies and capital controls in response to intensified market pressures did not significantly ease depreciation pressure. Finally, after controlling for other factors, no evidence exists that taper talk affected Asia more than any other developing region.

In summary, last year's discussion of QE tapering did not affect Asian countries any more than others. Countries with lower and more stable inflation, and better fiscal balances, experienced less financial instability. Those that had restrained domestic credit growth faced less downward pressure on their exchange rates. On the other hand, countries that had allowed their real exchange rates to appreciate rapidly under large capital inflows generally experienced worse current account and exchange rate damage as capital inflows reversed. Thus, macroprudential measures implemented during boom times to restrain domestic credit expansion and stabilize real exchange rates have a good chance of preempting the busts that subsequent capital outflows may otherwise cause.

Progress in Asia's financial indicators

India and Indonesia were the two Asian countries worst affected by taper talk in May 2013. In fact, these two countries were grouped among the so called "five vulnerable emerging market economies", along with Brazil, South Africa, and Turkey, mentioned as especially at risk from tapering. The *Asian Development Outlook 2013 Update*, published in October, noted that India and Indonesia stood out in developing Asia as vulnerable as they are experiencing very high domestic credit growth, worsening inflation, widening current account deficits, and worsening fiscal deficits during the capital-influx stage (ADB 2013). How have developing Asian economies fared now that tapering is under way?

Tables 1.2.1 and 1.2.2 update the external and financial vulnerability indicators for developing Asia previously published in ADB (2013). The new data suggest that most countries in the region have made progress against vulnerability indicators and toward strengthening their macroeconomic fundamentals. The measures taken have varied across countries, but most have aimed to narrow fiscal and current account deficits and keep domestic financial markets attractive to foreign investors.

Although Asian countries have achieved considerable progress on many indicators, some vulnerable areas persist. Inflation and domestic credit expansion are under control in Thailand and the Republic of Korea but less so in Malaysia and the Philippines. Thailand, meanwhile, struggles with domestic political problems that could hamper its ability to deal with external shocks despite its benign vulnerability indicators.

1.2.1 Assessment of external vulnerabilities

	Current account balance/GDP (%) (latest available)		Short-term external debt/reserves (2Q 2013)(%)[a]	Broad money[b]/ Foreign reserves (%) (latest available)		Import cover (months) (latest available)[c]		Foreign liabilities/ Foreign assets[d] (%) (latest available)	
Cambodia	–8.4	(2012)	19.2	1.8	(Dec13)	2.9	(Oct13)	87.1	(Dec13)
China, People's Rep. of	1.8	(Q32013)	16.7	4.7	(Dec13)	23.6	(Dec13)	62.4	(Dec13)
Hong Kong, China	5.8	(Q32013)	85.2	4.2	(Dec13)	7.1	(Nov13)	74.7	(Nov13)
India	–1.3	(Q32013)	53.6	5.4	(Dec13)	7.1	(Dec13)	2.1	(Dec13)
Indonesia	–2.0	(Q42013)	59.8	3.2	(Dec13)	6.2	(Dec13)	196.8	(Dec13)
Kazakhstan	–3.6	(Q32013)	17.7	3.9	(Dec13)	4.8	(Dec13)	33.3	(Dec13)
Korea, Republic of	6.3	(Q32013)	48.2	5.3	(Nov13)	8.0	(Dec13)	103.7	(Oct13)
Malaysia	6.1	(Q42013)	26.6	3.4	(Dec13)	7.8	(Dec13)	115.9	(Nov13)
Pakistan	–0.9	(2012)	79.1	21.1	(Dec13)	1.4	(Dec13)	45.2	(Dec13)
Philippines	5.0	(Q32013)	21.4	2.1	(Dec13)	14.8	(Dec13)	103.2	(Nov13)
Singapore	18.3	(Q42013)	81.8	1.5	(Dec13)	8.8	(Dec13)	117.3	(Dec13)
Sri Lanka	–3.7	(Q32013)	51.5	3.8	(Nov13)	4.1	(Oct13)	350.2	(May13)
Taipei,China	13.3	(Q42013)	19.1	2.9	(Dec13)	18.3	(Dec13)	54.6	(Jan14)
Thailand	–1.0	(Q32013)	12.9	3.1	(Dec13)	7.6	(Dec13)	142.5	(Dec13)
Viet Nam	3.5	(Q42012)	51.1	6.6	(May13)	2.7	(May13)	73.1	(Jul13)

GDP = gross domestic product, Q = quarter.

[a] Short-term external debt includes loans and credits due and debt securities due within a year as defined in the Joint External Debt Hub. Data start 2004 for all countries. Q1 2013 for Viet Nam.

[b] Data refers to M3 for Hong Kong, China; India; Kazakhstan; Rep. of Korea; Malaysia; Pakistan; the Philippines; and Singapore. M2 for other countries.

[c] Refers to number of months of import that can be covered by official reserves; computed as reserves (excluding gold) divided by 12-month moving average of imports (cost of insurance, freight). Latest month when reserves data is available. Import data may be earlier, the same, or later than period indicated.

[d] Foreign liabilities and assets of banking institutions, deposit money banks, and other depository corporations.

Note: Green font implies improvement; red means worsening in vulnerability; black means no change in vulnerability status relative to data mostly around the second quarter of 2013 as published in *ADO 2013 Update*.

Sources: ADB calculations using data from CEIC; national sources; *Asian Development Outlook 2013 Update*, Asian Development Bank; Joint External Debt Hub, BIS-IMF-OECD-WB; International Financial Statistics online database, Direction of Trade Statistics, World Economic Outlook and Article IV Consultations, International Monetary Fund.

India and Indonesia in particular have made progress in addressing high credit growth, inflation, and budget and current account deficits. Both countries' current account deficits have improved, and their inflation rates have slowed. India has also significantly improved its fiscal balance and has somewhat lowered its domestic credit growth. Inflation and domestic credit growth in both India and Indonesia, however, remain elevated. In sum, Indonesia and India must still do more to strengthen their financial sectors. Interest rates in both economies are much higher than elsewhere in the region, giving the Indian and Indonesian authorities less room to maneuver against any future financial turbulence. Besides strengthening their economic fundamentals, both countries may need to tighten their macroprudential policies.

On the brighter side, most economies in developing Asia have substantial foreign reserves with which to counter any future external financial shock. This makes a repeat of the Asian financial crisis of 1997–1998 unlikely, as developing Asia is now in a much stronger position than it was then to weather a crisis.

1.2.2 Assessment of financial vulnerabilities (%)

	Inflation rate (latest available)		Fiscal balance/GDP[a] (2013)	Loans/Deposits of banks[b] (latest available)		Bank lending growth[c] (% year on year, latest available)	
Cambodia	4.6	(Jan14)	–5.2	99.5	(Nov13)	–	
China, People's Rep. of	2.0	(Feb14)	–1.9	78.4	(Dec13)	14.3	(Jan14)
Hong Kong, China	3.9	(Feb14)	3.2	60.9	(Nov13)	17.8	(Jan14)
India	8.1	(Feb14)	–6.4	78.7	(Sep13)	14.7	(Dec13)
Indonesia	7.7	(Feb14)	–2.3	99.4	(Dec13)	21.6	(Dec13)
Kazakhstan	4.3	(Jan14)	–3.0	133.3	(Dec13)	–9.5	(Dec13)
Korea, Republic of	1.0	(Feb14)	–1.8	120.7	(Oct13)	5.0	(Dec13)
Malaysia	3.4	(Jan14)	–3.9	95.9	(Nov13)	11.2	(Jan14)
Pakistan	7.9	(Feb14)	–8.5	52.1	(Dec13)	18.9	(Dec13)
Philippines	4.1	(Feb14)	–1.4	61.1	(Nov13)	17.1	(Jan14)
Singapore	1.4	(Jan14)	1.1	103.0	(Dec13)	13.7	(Jan14)
Sri Lanka	4.2	(Feb14)	–6.2	83.3	(May13)	12.5	(Aug13)
Taipei,China	0.3	(Feb14)	–1.6	63.4	(Jan14)	3.1	(Dec13)
Thailand	2.0	(Feb14)	–2.0	103.0	(Dec13)	7.3	(Jan14)
Viet Nam	4.7	(Feb14)	–7.1	92.9	(Jul13)	13.4	(Jul13)

GDP = gross domestic product, Q = quarter.

[a] Estimate.

[b] Loans to private sector and nonfinancial institutions; and deposits (demand, time, savings, foreign currency, bond, and money market instruments—where available) of banking institutions, deposit money banks, and other depository corporations of each economy.

[c] Data for the People's Republic of China refer to financial institution loans; Hong Kong, China to domestic credit; Indonesia to commercial bank loans; Kazakhstan to loans of other depository corporations; the Republic of Korea to loans of commercial and specialized banks; Malaysia to commercial bank loans and advances; the Philippines to commercial and universal bank loans net of reverse repurchase arrangements; Singapore to loans and advances of domestic banking units; Taipei,China to domestic banks' loans and advances; Thailand to commercial bank loans; and Viet Nam to claims on private sector of banking institutions.

Note: Green font implies improvement; red means worsening in vulnerability; black means no change in vulnerability status relative to data mostly around the second quarter of 2013 as published in *ADO 2013 Update*.

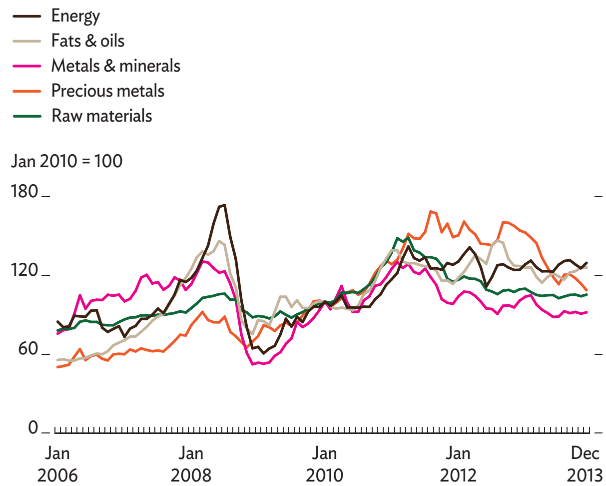
Sources: ARIC website http://aric.adb.org/publications/rci-infopack (accessed 19 March 2014); *Asian Development Outlook* database.

Coping with volatile export prices

Volatile capital flows caused by changes in US monetary policy have received a lot of attention recently, but economies with underdeveloped capital markets have been little affected. For economies that rely heavily on commodity exports, financial flows have much less profound effects than do gyrations in international prices for food, fuel, or metals. Commodity prices remain elevated recently, but improved supply conditions have kept them more stable than they were in 2007–2008, when they experienced wide swings (Figure 1.3.1). Moreover, global commodity prices are expected to decline in the next 2 years.

While most countries in the region welcome lower commodity prices, as low prices would help contain inflation, commodity exporters naturally have a different perspective. Countries that depend on commodity exports for foreign exchange and government revenues can suffer significant macroeconomic shocks from volatile or excessively low prices. This is particularly true for countries that rely on extracted natural resources such as petroleum, metals, and minerals. Looking more closely at these economies can reveal the factors that help some resource-dependent economies cope with these shocks better than others.

1.3.1 Price developments of extractable commodity products (Jan 2010=100)



Source: World Bank, Commodity Price Data (Pink Sheet). http://www.worldbank.org (accessed 4 March 2014).

Instability from commodity prices

Empirical studies have established the link between commodity price fluctuations and macroeconomic instability. Broda (2004) and Kose (2002) find that price fluctuations account for 10%–30% of real GDP variation in resource-dependent economies. Where countries are along that considerable range depends on their exchange rate regimes and institutional capacity. Historically, income volatility in countries dependent on exhaustible resources has been more than twice as large as income volatility in other economies. Such volatility has been especially large in countries that export commodities other than petroleum (Bems and Filho 2011).

Resource windfalls are often outsized factors in otherwise small domestic economies. As the government is typically the main recipient of resource revenues, fiscal policy is the main medium through which windfalls impinge on domestic economic activity. Such countries need appropriate mechanisms to smooth out the effects of volatility and ensure a sustainable flow of fiscal resources over the long term.

However, the application of transparent rule-based fiscal policy is still limited in regional countries dependent on natural resource exports. In theory, a country can ensure against resource revenue volatility through either market-based hedging or contracting future deliveries of goods at a price set in advance. But such approaches are uncommon globally (Borensztein et al. 2009). Instead, precautionary savings in the form of foreign exchange reserves or sovereign wealth funds have been the usual approach to insulating an economy from price shocks.

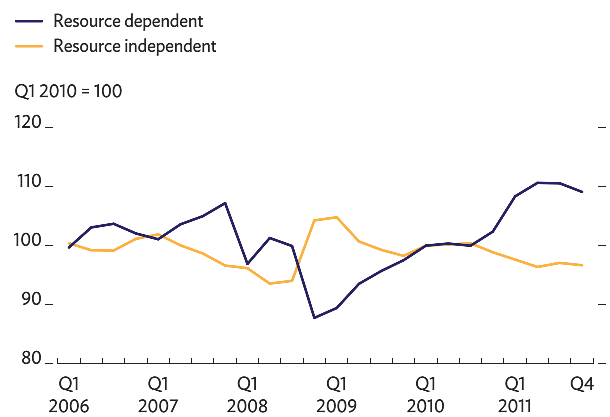
The objectives of sovereign wealth funds vary around the world. Some finance public investments to expand productive capacity, and others aim to cushion future price declines. This is true of commodity-based wealth funds in Asia, including those in Azerbaijan, Kazakhstan, Kiribati, Mongolia, Papua New Guinea, Timor-Leste, and Turkmenistan. Mongolia's Fiscal Stability Fund, for example, is designed to promote stability in the face of price fluctuations. By contrast, Azerbaijan's State Oil Fund makes medium- to long-term investments.

Beyond managing windfall revenues, resource-dependent countries need to develop diverse economic sectors to reduce their vulnerability to external shocks. Countries richly endowed with natural resources need to manage them well to avoid undue currency appreciation as they export natural resources. And they need to invest in the physical and human capital necessary to build the manufacturing and other industries that will add up to diverse economies that are resilient over the long term.

An analysis covering 45 countries, including 23 economies in developing Asia, sheds light on the issues facing natural resource exporters, particularly those with low incomes. A country is considered commodity dependent if natural resource exports account for at least 20% of all exports and if exports were at least 15% of GDP in 2006–2011. Among the Asian economies in this analysis, Azerbaijan, Bhutan, Kazakhstan, the Kyrgyz Republic, Malaysia, and Solomon Islands are identified as heavily dependent on natural resource exports to finance public expenses.

Commodity terms of trade—defined as the ratio of export prices to import prices for 22 agricultural, energy, and metal commodities—are computed to capture the pure impacts arising from price fluctuations in global commodity prices (Figure 1.3.2). For natural resource-dependent economies, these terms have been quite volatile on average in recent years. Prices improved sharply by 5% in 2007, deteriorated by more than 10% toward the end of 2008, and then surged by 7% by the end of 2011. For countries with more diversified exports, on the other hand, commodity terms of trade have been relatively stable, deteriorating somewhat through 2008 before picking up in early 2009. Because the fluctuation was twice as large for resource-dependent economies, it is crucial for them to prepare for the large swings that will almost certainly follow the current period of price stability.

1.3.2 Average commodity terms of trade, resource dependent versus resource-independent economies



Note: Commodity terms of trade refers to the ratio of export prices to import prices of commodities that include wheat, rice, maize, oilseed and soybean, palm oil, sugar, coffee, cotton, total energy, petroleum, natural gas, coal, electricity, biofuel, aluminum, copper, lead, nickel, tin, zinc, iron, and steel.

The country groupings are as listed in the table in Box 1.3.1.

Sources: ADB estimates using data from World Bank, World Development Indicators online database; United Nations COMTRADE database. http://comtrade.un.org/data

Absorptive capacity and resilience to shocks

Empirical evidence shows that how much commodity price fluctuations cause output to fluctuate depends on the quality of macroeconomic management. A country's absorptive capacity—the skills of its bureaucracy, the state of its infrastructure, and the quality of its institutions—affects its ability to effectively use a sudden influx of funds. The idea of gauging absorptive capacity has its roots in the literature on aid effectiveness and how small economies cope with the large inflows of aid, but it can be applied as well to analyze policy makers' ability to put other large inflows to good use without destabilizing the economy.

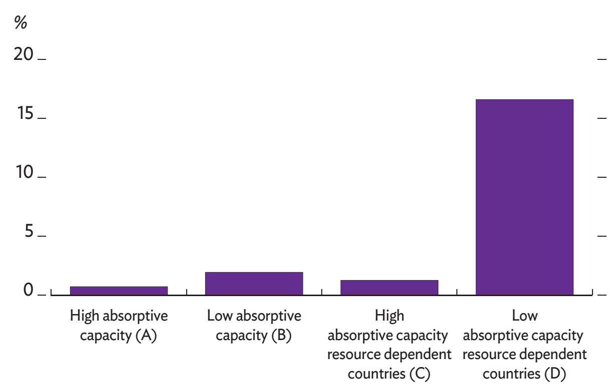
Developing Asia's absorptive capacity is comparable to that of other developing regions on average, but some countries lag. Feeny and de Silva (2012) rank economies according to an index comprised of proxies for human capital (health and education), physical infrastructure, governance quality, and the administrative burden of international aid. Investment in a low-ranking economy may not catalyze higher growth, as weak absorptive capacity hinders capital accumulation and its productive use.

How important absorptive capacity is in this context is an empirical question. Using an economic model based on Kose (2002), the effect on growth of a commodity terms-of-trade shock is estimated for country groups segregated by natural-resource dependence and degree of absorptive capacity. The data and approach are described in Box 1.3.1. Estimates suggest that these shocks can explain 10%–30% of real output fluctuations, which is twice as great as those explained by external shocks from other sources such as global interest rates. This finding is consistent with existing empirical studies.

The estimates find that resource dependence combined with low absorptive capacity increases a country's vulnerability to commodity terms-of-trade shocks. Looking at the full sample of countries in Figure 1.3.3, absorptive capacity alone does not make a significant difference, as a commodity price shock has similar output effects in countries with high and low capacity. But absorptive capacity clearly matters when comparing resource-dependent countries, indicated by bars C and D. In this case, commodity terms-of-trade shocks explain more than 16% of output variation if the country is both resource dependent and has limited absorptive capacity—significantly more than for resource-dependent countries with high absorptive capacity. In other words, those that are less able to use windfall proceeds productively are also less able to shield real output from global commodity price shocks.

Countries with limited absorptive capacity are therefore challenged when they face uncertainties surrounding commodity price swings and exhaustibility, which complicate resource and macroeconomic management. Additional costs can arise whenever the speed of investment adversely affects project selection, implementation, or management because the country cannot use capital productively. In this case, even high public investments contribute little to growth. The cases of Papua New Guinea (PNG) and Timor-Leste highlight the problem.

1.3.3 Variance decomposition by absorptive capacity index and resource dependency



Note: The data refers to the average variance decomposition over 24 quarters. The country groupings are as listed in the table in Box 1.3.1.

Source: ADB estimates.

1.3.1 Estimating the role of absorptive capacity

How much does absorptive capacity matter for resource-dependent economies in developing Asia that face commodity price shocks? A variation on the panel vector autoregression econometric model used by Kose (2002) is estimated to simulate the extent that such capacity helps to cushion the blow.

The model includes quarterly data on the following four variables: the cyclical component of real GDP, commodity terms of trade, real effective exchange rate, and real interest rate. Quarterly GDP was computed following Litterman (1983) and commodity terms of trade following Spatafora and Tytell (2009) when published data is not available. The model used published country data on real effective exchange rates augmented with data from Terada-Hagiwara and Villaruel (2013) as needed. The real interest rate is calculated as the 6-month US dollar London interbank offered rate (LIBOR) deflated using the US consumer price index. The four variables are standardized to have a standard deviation of 1 for comparability across countries and, except for the real interest rate, are log transformed.

The dataset spans from the first quarter of 2006 to the fourth quarter of 2011 for 27 countries, 21 of them in developing Asia. The countries are categorized according to resource dependence and absorptive capacity, as shown in the box table. The four-variable system is estimated separately for country groups classified according to their degree of resource dependency and absorptive capacity.

The variance decomposition method—which determines how much of the forecast error variance of each of the variables can be explained by random shocks to the other variables—was used to quantify the impact of global commodity price shocks. While model estimates are generally consistent with Kose (2002) and similar studies in that the growth impacts of commodity price shocks depend on country institutions and macroeconomic frameworks, explicitly modeling absorptive capacity differences provides a fresh perspective.

Country classification by resource dependence and absorptive capacity

	Low absorptive capacity	High absorptive capacity
Resource dependent	Bhutan and Solomon Islands	Azerbaijan, Chile, Croatia, Kazakhstan, Kyrgyz Republic, and Malaysia
Resource independent	Cambodia, Georgia, India, Indonesia, the Maldives, Pakistan, Peru, the Philippines, Sri Lanka, Thailand, Vanuatu, and Viet Nam	Argentina, Armenia, Fiji, Mexico, Samoa, Tonga, and Turkey

Source: Kose (2012).

The challenge of turning windfalls into productive capital

PNG and Timor-Leste continue to be the fastest-growing economies in the Pacific, propelled by natural resource exploitation and associated foreign direct investment. PNG has now recorded 12 consecutive years of economic growth averaging around 6%, while Timor-Leste's economy outside the offshore energy export sector has grown at an average rate of 11% since 2007. The rapidly expanding fiscal space generated by resource extraction has raised expectations in both countries that government can play a more active role in overcoming persistent development constraints.

Since 2009, government expenditure in PNG has grown at an annual average of 12%, and in Timor-Leste at 19%, as both countries fund ambitious national transport and energy infrastructure projects and boost investments in health care, education, and social services. Expanded public investment has been broadly aligned with those sectors that support inclusive growth, but achievements have been hampered in both countries by implementation challenges. Government agencies have struggled to stay on top of rapidly rising workloads and effectively translate growing budgetary resources into improved service delivery.

A number of factors contribute to implementation difficulties. First, the number of qualified personnel to administer government infrastructure projects is insufficient. Spending on public personnel responsible for executing budgets has not kept pace with rising project expenditure, such that public employee workloads have soared, adversely affecting their implementation capacity. Government agencies have also struggled to keep skilled and experienced technical staff from leaving for the private sector, which offers higher salaries. Second, unpredictable budgetary processes often delay plan approval and the availability of fiscal resources early in each fiscal year. In PNG, this has been particularly true as political leaders have funded infrastructure projects before detailed feasibility and preparatory design studies have been completed. This complicates and impedes subsequent implementation of budgeted capital projects (Figure 1.3.4). In both PNG and Timor-Leste, barely half of the budget allocated for public investment projects is actually spent.

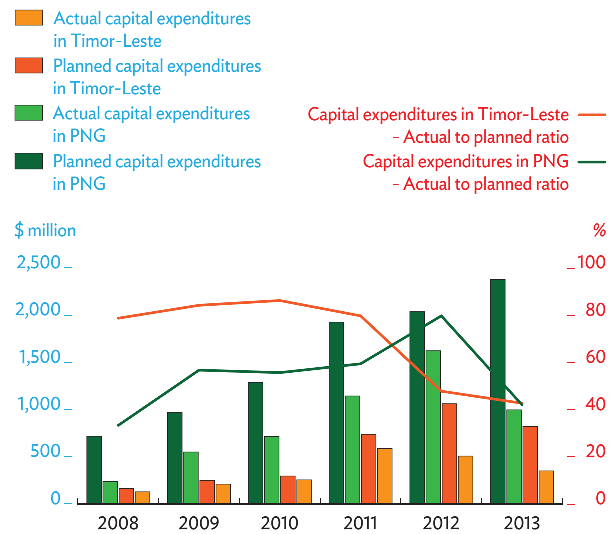
The rapid expansion of public expenditure challenges both countries to obtain value for money from disbursed funds. Figure 1.3.5 shows both countries continue to spend a disproportionate amount in the final quarter of the fiscal year.

While it is normal for capital project disbursement to increase as projects progress, the extreme distribution of budget disbursements toward the end of the fiscal year signals a tendency in both countries to push money out the door before annual fiscal accounts close. This practice risks unproductive expenditure and fund leakage.

The tendency to favor investment in new capital projects—rather than investing in the underlying institutions and agencies tasked with planning, delivering, and maintaining new assets and services—has further undermined value for money spent. Deficient maintenance funding in particular has engendered an expensive build-neglect-rebuild cycle for many national infrastructure assets. The PNG Department of Works received, as a key agency executing government infrastructure plans, a 60% funding increase in 2014 on top of a 35% increase in 2013. Yet more than 97% of this increase in funding is for additional capital projects, leaving almost nothing new to allocate for operation and maintenance.

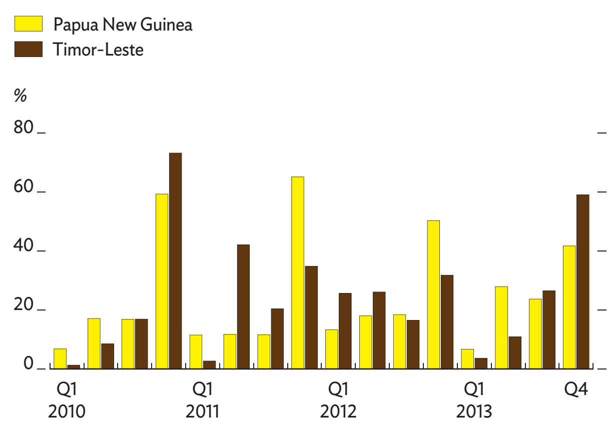
Fiscal policy plays a vital role in translating economic growth into improved human development outcomes for the population. Yet fiscal policy that truly promotes inclusive growth must do more than just expand budget allocations to priority sectors. Time and resources are needed to strengthen the underlying systems and institutions charged with executing budgetary plans and to build the human-resources needed to effectively implement government programs and investments. In the cases of PNG and Timor-Leste, translating the windfall from

1.3.4 Planned and actual capital expenditures: PNG versus Timor-Leste



Sources: ADB estimate using data from Papua New Guinea Department of Treasury; Democratic Republic of Timor-Leste, Ministry of Finance. https://www.mof.gov.tl (accessed 10 March 2014).

1.3.5 Quarterly spending as a share of total annual expenditure



Sources: ADB estimate using data from Papua New Guinea Department of Treasury; Democratic Republic of Timor-Leste, Ministry of Finance. https://www.mof.gov.tl (accessed 10 March 2014).

natural resource extraction into inclusive fiscal policy requires a broader focus on building the capacity of the civil service, strengthening coherence and coordination in the budget process, and ensuring adequate funding to maintain and operate assets once they are built.

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Annex: Slow recovery continues

The major industrial economies are slowly regaining their growth momentum, and this trend is likely to continue. Gross domestic product (GDP) growth will be stronger in the United States (US) than in the euro area or Japan. Combined GDP growth in these economies is expected to reach 1.9% in 2014 before strengthening further to 2.2% in 2015. Low inflation is envisaged through the forecast period as international commodity prices remain weak (Table A1.1).

Recent developments in major industrial economies

United States

GDP expanded by 1.9% in 2013 as growth accelerated in the second half. Consumption had been growing steadily throughout the year, but a pickup in investment in the second and third quarters gave a boost to growth momentum (Figure A1.1). The contribution to growth from net foreign trade and services improved, but government spending acted as a drag following the scaling back of the US fiscal position.

A1.1 Baseline assumptions on the international economy

	2012	2013	2014	2015
	Actual		*ADO 2014 projection*	
		Estimate		
GDP growth (%)				
Major industrial economies[a]	1.3	1.0	1.9	2.2
United States	2.8	1.9	2.8	3.0
Euro area	−0.7	−0.4	1.0	1.4
Japan	1.4	1.5	1.3	1.3
Prices and inflation				
Brent crude spot prices (average, $ per barrel)	112.0	109.0	106.0	102.0
Food index (% change)	1.6	−7.1	−3.5	−1.0
Consumer price index inflation (major industrial economies' average, %)	1.8	1.3	1.6	1.6
Interest rates				
United States Federal funds rate (average, %)	0.1	0.1	0.1	0.6
European Central Bank refinancing rate (average, %)	0.9	0.6	0.3	0.3
Bank of Japan overnight call rate (average, %)	0.1	0.1	0.1	0.1
$ Libor[b] (%)	0.2	0.2	0.2	0.4

[a] Average growth rates are weighted by gross national income, Atlas method.

[b] Average interbank quotations on 1-month loans.

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

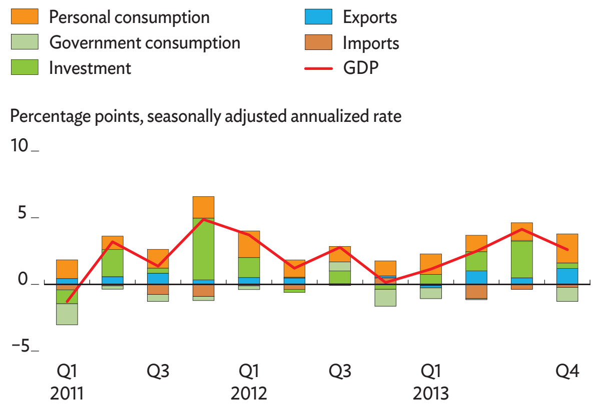
GDP grew at an annual rate of 2.6% in the fourth quarter of 2013, a sharp reduction from the 4.1% pace in the previous quarter. Growth in the last quarter had positive contributions from private consumption, exports, and investments but was dragged down by lower government spending and increased imports. Private consumption, growing at an annualized rate of 3.3%, accounted for most of growth in the fourth quarter. Tentative recovery in consumer confidence after a drop in September 2013 is somewhat consistent with a pickup in consumption. Growth in retail sales was weak, however, through the last quarter and carrying over into January 2014. The figure improved slightly in February, suggesting a possible pickup in private consumption.

After boosting investment growth in the third quarter, the contribution of private inventory was significantly smaller in the fourth quarter. Fixed investment expanded further, however, as real nonresidential fixed investment increased by 5.7% in the fourth quarter on the back of high growth in equipment, outpacing the 4.8% increase recorded in the third quarter.

Purchasing managers' index values, compiled by the Institute for Supply Management, fell from 57.0 in November 2013 to 56.5 in December and 51.3 in January, recovering somewhat to 53.2 in February (Figure A1.2). The positive take is that the values remained above 50 and therefore indicate that manufacturing was still expanding. In addition, the industrial production index rose consistently in the second half of 2013, regaining in September its 2007 average (before the global financial crisis) and, despite a small decline in January 2014, remaining high. The trend in manufacturing and industrial production reaffirms the role of investment in promoting growth momentum and the need for more private investment.

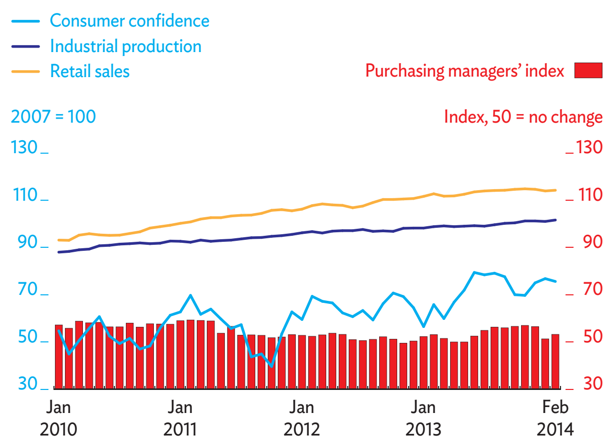
Positive signs in the labor and housing markets in 2013 continued to underline progress in the US economic recovery. The unemployment rate improved steadily throughout 2013, dropping from 7.9% in January to 6.7% in December. Although this is close to the 6.5% unemployment threshold that may trigger upward revisions to the Federal Reserve policy rate, the situation does not yet seem to warrant such action. The rate of workforce participation has declined continuously since 2008 and is not yet showing any strong sign of recovery. On a positive side, however, growth in nonfarm employment has been supported by the steady addition of jobs in industry (Figure A1.3). This suggests that further gradual strengthening in the labor market is likely. The housing price index increased throughout 2013, but affordability, measured by the housing affordability index median price, has declined since the second quarter of 2013. In terms of housing quantity, the number of housing units under construction and of housing starts both rose in 2013.

A1.1 Demand-side contributions to growth, United States



Source: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov; CEIC Data Company (both accessed 15 March 2014).

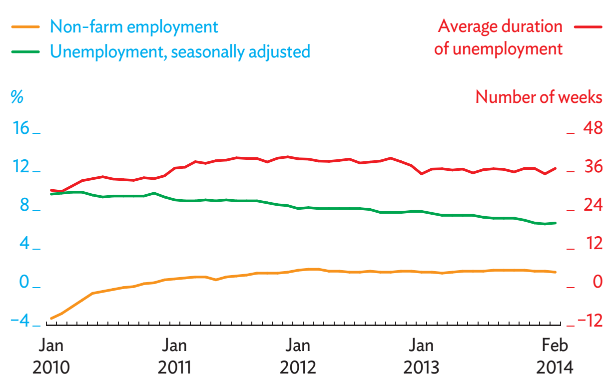
A1.2 Business activities and consumer confidence indicators, United States



Note: For purchasing managers' index, a reading <50 signals deterioration of activity; >50 means improvement.

Source: CEIC Data Company (accessed 17 March 2014).

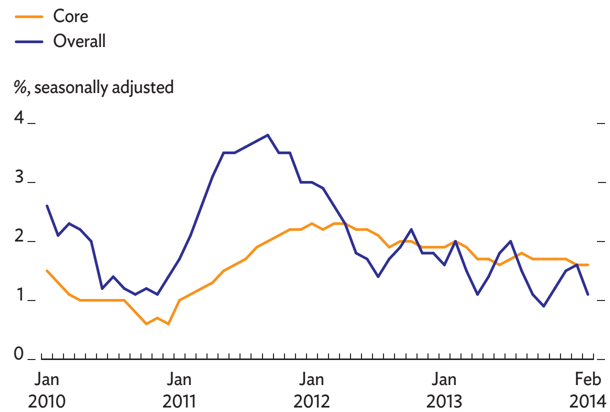
A1.3 Unemployment rate and growth in nonfarm employment, United States



Source: CEIC Data Company (accessed 9 March 2014).

Inflation, both overall and core, remained under control, partly because food and energy prices were low and stable throughout the year (Figure A1.4). The risk of inflation taking off before the forecast horizon is negligible given the weak prospects for higher international commodity prices. The Federal Reserve projects that inflation will start to bump against its 2% objective no sooner than 2016. As the Federal Reserve plans to link policy rate changes to the labor market and the inflation rate, an accommodative monetary policy is likely to continue. The low interest rate environment persisted in 2013, promoting a steady increase of credit from commercial banks. Credit growth moderated in the last quarter of the year but remained in positive territory as commercial banks continued to boost their lending.

A1.4 Inflation, United States



Source: CEIC Data Company (accessed 17 March 2014).

Fiscal risks have ebbed as the US administration and Congress reached a compromise deal that would mitigate the impact of automatic spending cuts in FY2014 (ending 30 September 2014) and FY2015, and then suspended the debt ceiling until 15 March 2015. The unemployment rate fell further to 6.6% in January 2014 but inched back to 6.7% in February as the labor force participation rate increased slightly. Noting improvement in the US economic performance, the Federal Reserve decided to continue phasing down its asset purchase program, through which it pumps money into the US economy. This third reduction in so-called quantitative easing in April 2014, from $65 billion per month to $55 billion, followed similar $10 billion cuts in January and February 2014. Monetary policy will remain highly accommodative, however, maintaining the low policy interest rate to the forecast horizon.

This tapering of stimulus spending suggests that the Fed is confident about the strength of the US recovery. It views the January–February soft patch as temporary and linked to cold weather. The new chair of the Federal Reserve has said “significant change” to the economy’s prospects would be required for the central bank to suspend its policy of winding down its bond-buying program. While the tapering of monthly asset purchases is likely to bring an end to quantitative easing within 2014, the Federal Reserve is expected to keep its low interest rate policy through 2015, as inflation is projected to remain muted to the forecast horizon. Despite that, long-term US interest rates—e.g., yields on 5- and 10-year US government bonds—have already shown some signs of rising, likely heralding higher global interest rates in the short term.

Looking ahead, relatively strong industrial indicators point to growth momentum continuing in 2014 and picking up further in 2015, as the economy further closes the output gap. Lower public spending has been more than compensated by growing private sector activity. Continued positive signs in investment, consumption, housing, employment, and credit suggest that the economy is on track for continued gradual strengthening. The US GDP is forecast to grow by 2.8% in 2014 and accelerate further to 3.0% in 2015.

Euro area

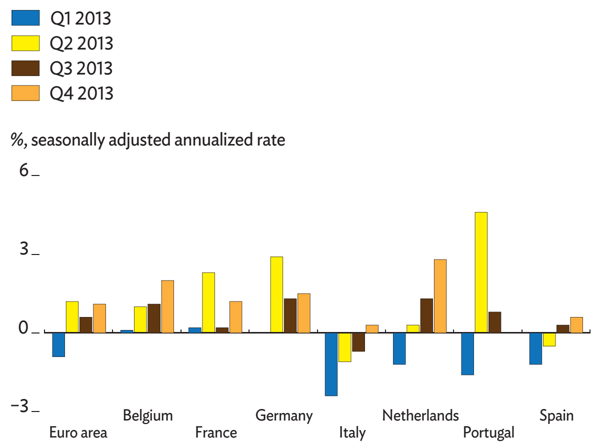
Recovery in the euro area has continued since the second quarter of 2013. It is projected to gather strength in the next couple of years as consumer confidence and business conditions improve, financial markets recover slightly, and fiscal pressures ease. However, indicators show that the recovery is still fragile, with persistent growth differentials between member countries. High unemployment and low inflation remain the chief concerns in the region, and both have implications for consumption and growth.

GDP growth in the euro area was positive for the third consecutive quarter following 6 quarters of shrinkage. An estimate released by Eurostat showed seasonally and working day adjusted annualized GDP growth at 1.1% quarter on quarter in the fourth quarter of 2013, improving on the 0.6% increase recorded in the previous quarter. The economy expanded by 0.5% year on year in the fourth quarter, following 7 quarters of negative numbers by this measure. Among the major countries, the Netherlands showed strong expansion by 1.3% quarter on quarter in the third quarter and 2.8% in the fourth quarter, followed by Belgium (1.1% and 2.0%) and Germany (1.3% and 1.5%). Spain entered positive territory with quarter-on-quarter growth of 0.3% in the third quarter and 0.7% in the fourth. In the fourth quarter, France grew by 1.2% and Italy by 0.3% (Figure A1.5).

As seen in Figure A1.6, in the fourth quarter, the contribution of net exports to GDP growth was highest at 1.6 percentage points. Net exports have usually added to growth, the exception being in the third quarter of 2013, when it dragged down growth by 1.5 percentage points. Exports increased by 1.2% quarter on quarter in the fourth quarter, up from no expansion in the previous quarter, and imports increased by 0.4%, slowing from 1.2% in the third quarter. Inventory adjustment dragged on growth in the fourth quarter by 1.3 percentage points, after having contributed 1.2 points to growth in the third quarter. Government consumption also detracted by 0.2 points in the fourth quarter after contributing 0.3 points in the third quarter. A rebound came for private consumption and investment in the second quarter of 2013, after they dragged on growth in every quarter of 2012 and the first quarter of 2013.

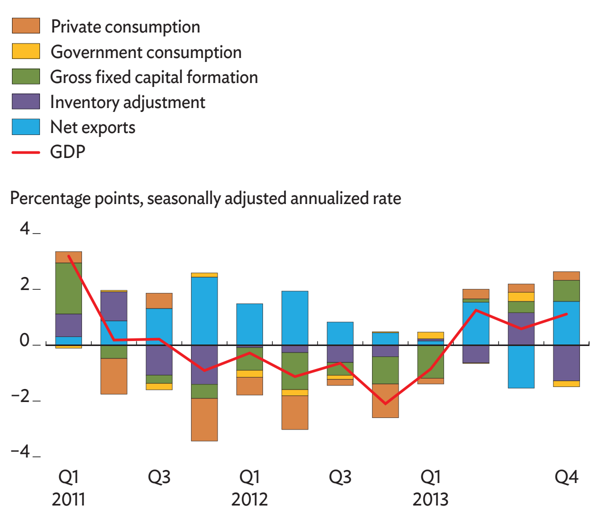
Consumption was dampened in the past mostly by low wage growth and high unemployment, and private wealth was diminished by the weak housing market, which also imposed borrowing constraints. Private consumption, the largest component of GDP, may be expected to lead the recovery in the coming quarters, as shown by the consumer confidence indicator improving throughout 2013 and further by 1.8% in January 2014 (though it fell back by 1.0% in February). In the fourth quarter, consumption contributed 0.3 percentage points to GDP growth. However, it registered only a very small rise in the fourth quarter over the previous quarter, signaling continued weakness in demand.

A1.5 GDP growth, selected euro area countries



Source: CEIC Data Company (accessed 19 March 2014).

A1.6 Demand-side contributions to growth, euro area



Source: CEIC Data Company (accessed 11 March 2014).

Gross fixed capital formation showed a healthier increase of 1.1% in the fourth quarter, up from 0.2% and 0.6% in the two previous quarters. It added 0.8 percentage points to GDP growth in the last quarter of 2013. Signaling improving business conditions, the euro area composite purchasing managers' index has been above the threshold of 50 since July 2013, climbing from 52.9 in December 2013 to 53.3 in February 2014, its highest reading since July 2011. Investment volume still needs to pick up from its current low as financing conditions start to improve, while the European Commission projects an increase in gross fixed capital formation overall, supported by rebounding investment in equipment.

Other indicators, however, show weaknesses in the euro area. Industrial production contracted by a seasonally adjusted 0.4% month on month in December 2013, following a 1.6% increase in November. Eurostat estimates that production fell further by 0.1% in January 2014. By country, the biggest declines were in Latvia by 10.7%, the Netherlands by 6.4%, and Finland by 3.5%.

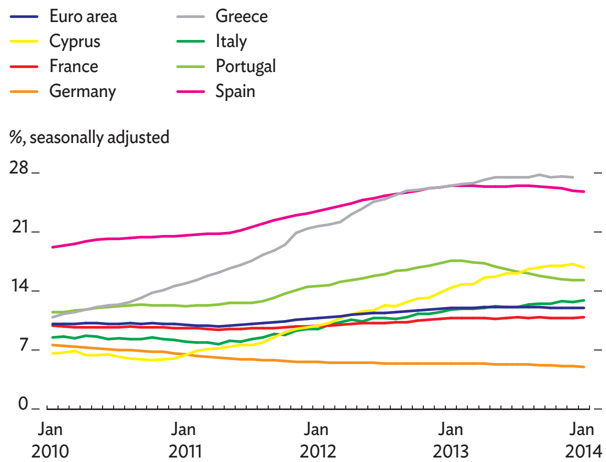
Retail trade volume in the euro area dipped by 1.3% month on month in December 2013 after rising by 1.0% in November and before rising again by 1.6% in January. The rise came mainly from higher sales of nonfood items, followed by automotive fuel.

The unemployment rate stayed at a high 12.0% in January 2014, stable since October 2013. Data from Eurostat show that 19.1 million people were unemployed in January 2014, slightly more than in December. Labor market conditions are diverse in the region, with December's highest unemployment rates in Greece at 28.0%, Spain at 25.8%, Cyprus at 16.8%, and Portugal at 15.3%. Also suffering double-digit rates are Italy at 12.9% and France at 10.9%. Germany's unemployment rate was a low 5.0% (Figure A1.7). Youth unemployment improved slightly to 23.8% in December 2013 from 24.0% in the previous 3 months.

Inflation slowed throughout 2013, staying from February below the European Central Bank target of 2.0%. The harmonized index of consumer prices slipped further from an annual 0.9% in December 2013 to 0.8% in January 2014, reflecting falling energy prices (Figure A1.8). The month-on-month inflation rate dropped by 1.1 percentage points in January 2014, reversing a 0.4 percentage point increase in December 2013. Though inflation remains subdued, the European Central Bank decided at its March meeting to keep the main refinancing interest rate unchanged at 0.25%, where it has been since a rate cut in November 2013. The central bank expects the recovery indicated in recent data to continue, albeit at a slow pace.

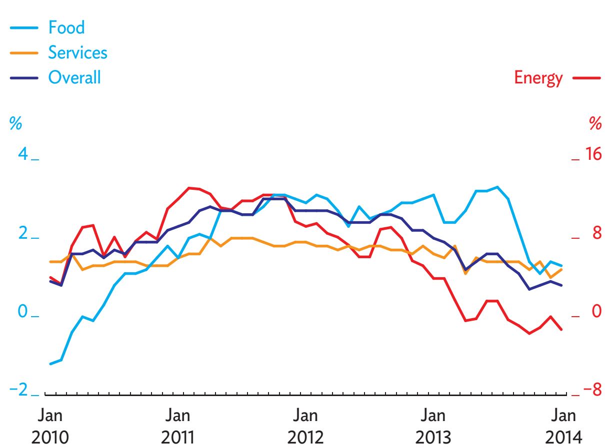
Credit conditions remain weak in euro area economies because banks' balance sheet problems are unresolved and confidence in the financial sector is low. Loans to nonfinancial corporations continued to fall, by 3.1% year on year in February 2014, adjusted for sales and

A1.7 Unemployment rate, selected euro area countries



Source: CEIC Data Company (accessed 19 March 2014).

A1.8 Inflation, euro area



Source: Eurostat. http://epp.eurostat.ec.europa.eu (accessed 11 March 2014).

securitization. Loans to households increased only slightly, by 0.2%. Financial fragmentation remains a problem, with bank rates for lending to households and businesses higher in the periphery than in the core countries.

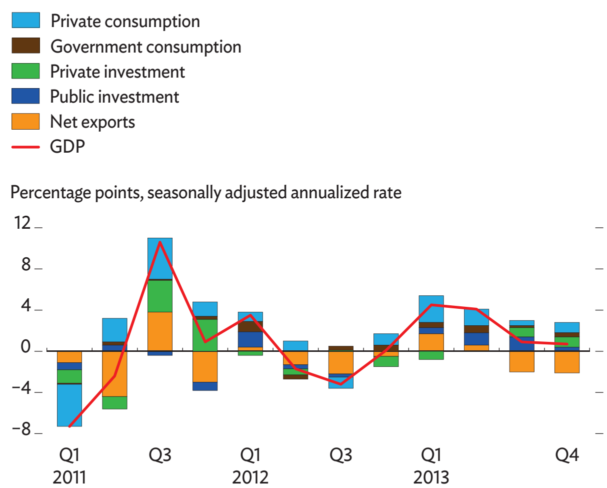
For the euro area as a whole, the outlook is for mildly recovering growth and subdued inflation. A key concern in most of the euro area continues to be unemployment, which can have a detrimental effect on consumption and growth. Investment must also pick up to boost real GDP growth. In sum, the euro area is expected to see 1.0% growth in 2014 picking up to 1.4% in 2015. However, depressed demand, credit contraction, and a strong currency could conspire to keep inflation low for a protracted period, which would further suppress growth.

Japan

Japan posted annual growth at 1.5% last year. Although domestic demand held up well throughout 2013 as consumers bought ahead of the April 2014 hike in the value-added tax (VAT) from 5% to 8%, growth turned sluggish in the second half of 2013, rising at a seasonally adjusted annual average rate (saar) of less than 1% as exports to developing Asia weakened. Still, actual growth was faster than the potential rate estimated by the Cabinet Office. The gap between the economy's current output and its potential output has narrowed from the 8.1% of GDP reached during the trough of the global financial crisis to 1.5% of GDP in 2013.

Throughout 2013, private consumption and public demand were the main drivers of growth in Japan. Public investment in particular grew substantially in the second and third quarters, by more than 30% year on year in each quarter. This is because public works contracted earlier in 2103 were executed during this period. Public demand (public investment combined with resilient government consumption, which provided 20% of GDP) contributed nearly 1 percentage point or more to growth in every quarter of 2013. Private investment also strengthened in the second half, driven by the new investment in construction and services (Figure A1.9).

A1.9 Demand-side contributions to growth, Japan



Source: Economics and Social Research Institute, Cabinet Office, Government of Japan. http://www.esri.cao.go.jp (accessed 12 March 2014).

Imports of goods and services continued to pick up in tandem with strong domestic demand, growing by a saar of 2.1% in the first half of 2013 and 10.5% in the second half. In particular, imports of capital equipment surged to 5% real growth, and consumer nondurable goods to 3%. These results come even after accounting for the strong import price increase of 12% in local currency terms caused by the 21% depreciation of the yen in the first 9 months of 2013. Given continued strong demand for energy imports since nuclear plants shut down in the aftermath of the Tohoku earthquake and tsunami in 2011, growth in imports of mineral fuels, such as liquefied natural gas from the Russian Federation, became particularly significant.

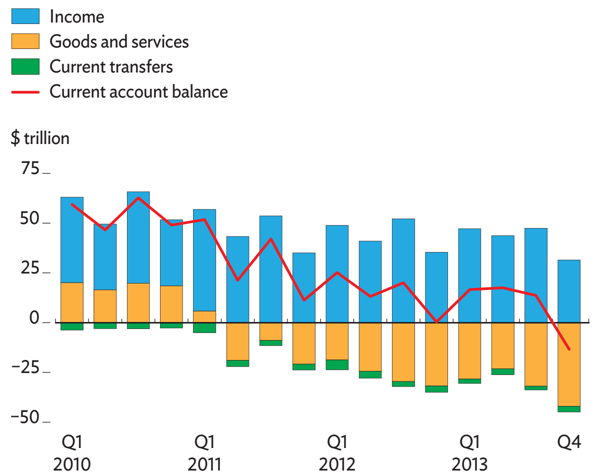
While yen depreciation has inflated import bills in the local currency, it has not markedly boosted exports. Despite yen depreciation, exports dropped sharply in the second half of 2013 to post growth at a saar of only 1.9%, down from 8.5% in the first half. Growth in exports to Japan's major export destination—Asia, which receives nearly half of all exports—decelerated significantly. Exports to member economies in the Association of Southeast Asian Nations dropped particularly sharply by 8% year on year as economies weakened, notably in Thailand, where Japanese automobile companies ship intermediate inputs from Japan for assembly. Moreover, because Japan has shifted its production abroad over recent decades, it has less to gain from a competitive currency. As investment income declined somewhat toward the end of 2013, Japan's current account fell into a deficit of $13.4 trillion in the fourth quarter of 2013. This is Japan's first quarterly current account deficit recorded since the compilation of comparable data began in 1985, and the $34.3 trillion surplus for the year as a whole is the smallest recorded in the same period (Figure A1.10).

Japan's long-awaited exit from deflation seems to be on track, though the main driver so far seems to be the depreciated yen pushing up prices for imported products. Headline consumer price index (CPI) inflation started to rise in June, driven largely by higher prices for energy and imports generally. The CPI excluding food and energy also started to post positive inflation by October. The rise has been broad-based but most significant in surges in fuel prices, electricity and water utility rates, and transportation and communications costs.

Japan's growth trajectory is uncertain and subject to various risks both external and domestic. On the domestic front is concern over VAT hikes scheduled for April 2014 and October 2015. As much of private consumption for this year has been frontloaded into the first quarter, prior to the introduction on 1 April of the higher 8% VAT rate, the rest of the year is expected to experience muted private consumption (particularly of durable goods) and residential investment. The supplementary budget, equal to 1% of GDP and approved in February 2014, may mitigate the impact of the VAT hike somewhat, but the bulk of domestic demand this year looks set to come from nonresidential investment and public works. Although nominal wages look set to gradually pick up this year, consumption growth may be dented if the rise is slower than CPI inflation (Figure A1.11).

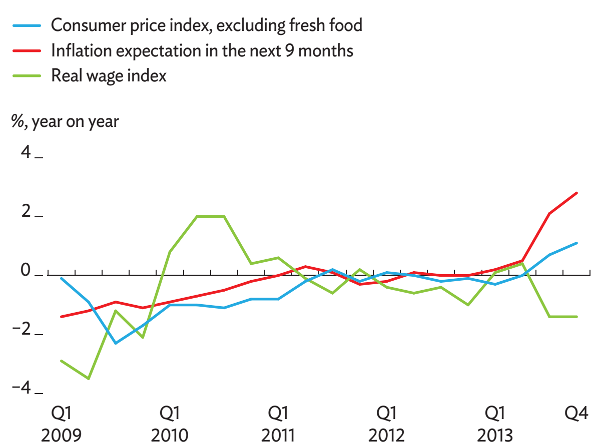
Meanwhile, fiscal consolidation is likely to crimp public consumption and investment in 2015. Growth in 2015 will have to come from private demand, specifically private investment and consumption. New investments, new hiring, and wage increases are currently concentrated in construction, the sector benefitting from public works, but recent data show upticks in new investment in agriculture and services. The Tankan survey of business conditions suggests that firms across sectors see an improving outlook. Machinery orders, a leading indicator of private capital expenditure, have been growing, and new temporary jobs are swelling the workforce.

A1.10 Current account components, Japan



Source: Haver Analytics (accessed 17 February 2014).

A1.11 Consumer and wage inflation, Japan



Sources: Haver Analytics; CEIC Data Company (both accessed 17 February 2014).

Externally, weak demand in Asia is a concern. Although the global economy is expected to recover gradually over the next 2 years, sluggishness persists in Japan's major trading partners in the region. On the other hand, import demand, particularly for energy imports, is expected to stay robust this year, though it may gradually moderate in 2015 as some nuclear plants and oil refineries resume operations this year. All in all, the trade deficit will likely widen further this year before narrowing somewhat next year.

Japan's announced fiscal stimulus will mitigate the impact of VAT hike, probably allowing private consumption to remain resilient as it grows only a bit more slowly at about 1%. Meanwhile, external demand, particularly in the US and euro area, will gain strength in the second half of 2014. This analysis assumes the VAT to be hiked further, as planned, from 8% to 10% on 1 October 2015, and monetary policy to remain accommodative. A modest fiscal stimulus equal to about 1% of GDP may accompany the 2015 VAT hike to smooth its impact, but the government is expected to continue striving for fiscal consolidation. Considering all factors, GDP growth in Japan is forecast to be flat at 1.3% in 2014 and 2015. Short- and long-term interest rates alike are assumed to remain low to support economic activity (Box A1.1).

Headline CPI inflation, excluding the impact of VAT hikes, is likely to exceed 1.0% this year and 1.5% in 2015. The yen may depreciate further, driven down by the widening interest rate gap as the US recovers and continues tapering its quantitative easing, but impacts on the real exchange rate are expected to be limited as domestic prices surge in Japan.

Commodity prices

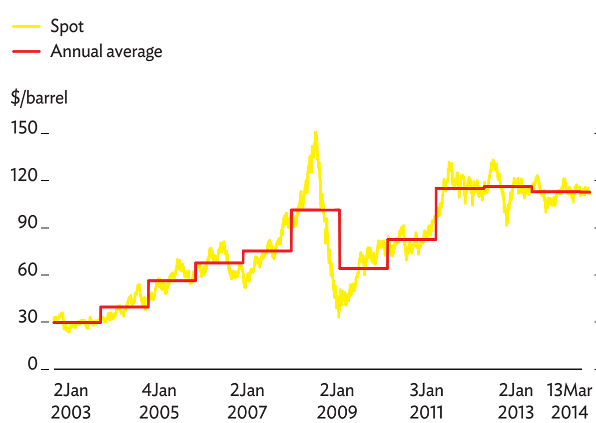
Average commodity prices declined in 2013. Oil prices, though lower than last year as supply conditions improved and demand remained low, have stayed elevated because of geopolitical concerns and output disruptions. Most agricultural commodity prices continued to be weak, but tight stocks will keep prices sensitive to the weather.

Oil prices

The international benchmark Brent crude averaged $108.9 per barrel in 2013, 2.8% lower than the average of $112 in 2012 (Figure A1.12). Brent crude has averaged above $100 every year since 2011, having more than tripled in the decade since 2003, when it was less than $30/barrel. Although the price has greatly increased, volatility has calmed. In the 3 years that the price has averaged above $100, volatility has faded to record lows and the price trend has flattened from its historical upward trend.

Despite strengthened supply and still-restrained demand, oil prices have remained elevated because of continuing supply risks. Unplanned supply disruptions have removed oil from the market, and fears of further disruptions make the market nervous, adding a risk premium that keeps oil

A1.12 Price of Brent crude



Sources: Bloomberg; CEIC Data Company (both accessed 14 March 2014).

A1.1 Why hasn't Japan's massive government debt wreaked havoc (yet)?

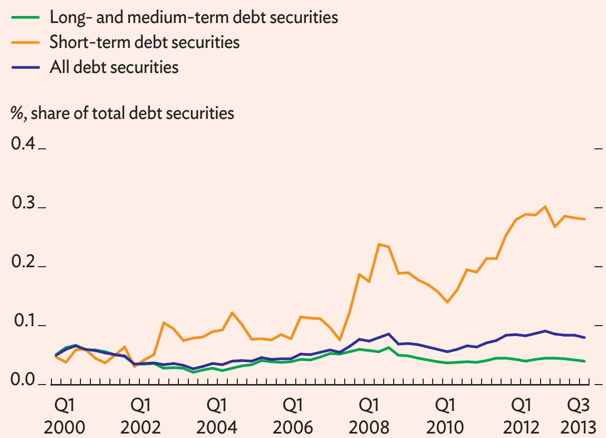
The most common answer to the question posed in the title above is that Japan has not had to borrow from abroad and bear those risks. Japan has been able to finance a high proportion of its massive government debt domestically because domestic savings are very high relative to domestic investment, and the home bias of Japanese investors is strong. Household savings deposited in bank and postal accounts, insurance policies, and pension funds have been funneled into government securities through government financial institutions, private banks, and insurance companies. As a result, the share of Japanese government securities held by foreigners was never more than 11% until 2006 (Horioka et al. 2013).

Starting in 2007, however, foreign holdings of short-term Japanese government securities skyrocketed to as high as 30%, though foreign holdings of medium- and long-term government securities remained below 7% (box figure). This transformation can be largely explained by two developments. First, the yields of these securities became relatively attractive as yields elsewhere, in the US and the euro area in particular, fell sharply in 2008–2009 as a result of monetary easing in response to the Lehman crisis. Second, the risk gap between Japanese government securities and alternative government securities widened dramatically from late 2008 to early 2010 as risk spiked for the latter with the advent of the debt crisis in the euro area. Both factors forced risk-adjusted hedged returns on government securities in the US and the euro area down toward convergence with Japanese returns in 2008–2009 and, in some cases, below Japanese returns thereafter. Relatively high return and low risk induced foreign investors to shift their portfolios into Japanese government securities, sharply increasing foreign holdings of short-term Japanese government securities (Horioka et al. 2014).

However, the surge in foreign holdings of Japanese government securities will not continue indefinitely because risks in the rest of the world will eventually subside—by early 2010, risk had already declined sharply for US and euro area government securities—and investors' appetite for risk will eventually return as the euro area crisis recedes. In addition, as bond markets develop in emerging Asia, they become increasingly competitive with Japanese bonds, especially as they offer higher yields and the possibility of currency appreciation as their economies grow. In fact, foreign holdings of short-term Japanese government securities slipped somewhat to 28% in September 2013 after peaking at 30% a year earlier.

The current situation is even more tenuous than it appears at first blush because higher foreign holdings and shortening maturities, especially for foreign holdings, make rolling over Japanese government securities more difficult and heighten the risk of trends suddenly reversing, as is now observed. Also, household and individual saving rates in Japan can be expected to decline even further as the population continues to age, depriving domestic banks and insurance companies of sufficient bank and postal deposits, insurance policies, and pension funds to invest in Japanese government securities.

Foreign holdings of debt securities



Source: Bank of Japan flow of fund accounts statistics. https://www.boj.or.jp/en/statistics/sj/index.htm/ (accessed 17 March 2014).

The Japanese government has managed to buy time by inducing foreign investors to invest temporarily in Japanese government securities, but pressure is building to rein in Japan's uniquely high ratio of government debt to GDP. One way is to reduce government debt itself by raising tax revenues, as the Japanese government is doing. Another is to cut government expenditure by, for example, reforming the public pension system and other social safety nets. The other way is to stimulate economic growth, which the current government is trying to do using the "three arrows of Abenomics": massive fiscal stimulus, aggressive monetary easing, and structural reform to boost competitiveness.

Japan's huge government debt has not wreaked havoc in the past because it was covered by robust domestic savings, especially household savings and, more recently, corporate savings, and by a temporary inflow of foreign capital provided by the global financial crisis. However, it may wreak havoc in the future as these factors fade, unless the government debt-to-GDP ratio is quickly brought under control.

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prices firm. The Energy Information Agency estimates that disruptions in 2013 removed an average of 2.6 million barrels per day from global markets (Figure A1.13).

Thus, after ending 2013 at $110/barrel, oil is currently trading in the narrow band of $107–$112. Factors supporting the price are cold weather in the US that boosted demand for heating fuel and a rebound in demand in the Organisation for Economic Co-operation and Development (OECD) as it slowly regains its growth momentum. As noted by the latest International Energy Agency (IEA) report, commercial inventories in the OECD have been depleted to their lowest since 2008 by unexpectedly strong demand, which has tightened the market and challenged predictions of oversupply. In the short-run, with futures below the current price, there is no incentive to build stocks, making the market tight and keeping prices firm (Figure A1.14).

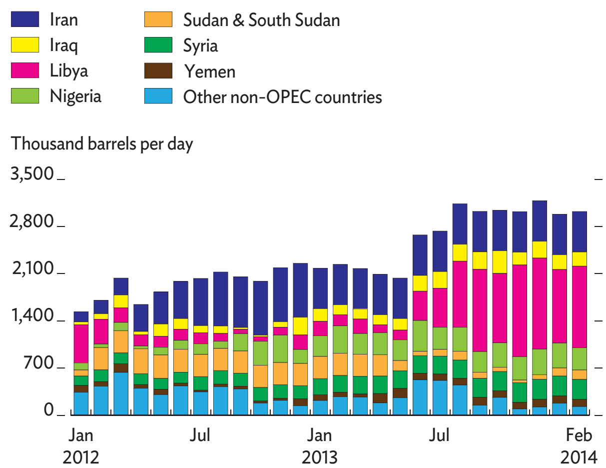
Another factor keeping oil prices stubbornly fixed is the willingness of swing producers in the Organization of the Petroleum Exporting Countries (OPEC) to cut supply and support prices. Saudi Arabia has gone from producing some 10.1 million barrels per day (mb/d) in August 2013 to 9.6 mb/d in January 2014. In its December 2013 conference, OPEC decided to maintain its notional target of 30 mb/d "in the interest of maintaining market equilibrium." According to the organization, the projected increase in world oil demand can easily be matched by production increases outside of OPEC, but OPEC members will be ready to respond to any developments that threaten to adversely affect the oil market.

The IEA forecasts global oil demand to grow in 2014 by 1.4 mb/d to reach 92.7 mb/d as the world economy strengthens. Although oil demand in the OECD has shown signs of recovery, the IEA observes, the main engine for growth in global demand for oil will still be elsewhere. So will some downside risks. Recent currency volatility in some large emerging market economies—notably Brazil, India, Indonesia, South Africa, and Turkey—has raised the local price of imported commodities such as crude oil, tempering demand for them. Consequently, central banks in some emerging markets have raised interest rates to contain inflation, but this can slow economic growth and, like currency depreciation, undermine demand for crude oil.

Oil supply from outside OPEC is forecast to increase by 1.7 mb/d in 2014, led by production increases in the US and Canada. The supply of crude oil from the US grew by 15% in 2013, the fastest growth in production to be achieved by any country in the past 2 decades. Output from Canada is forecast to remain healthy on continued growth in production from oil sands and conventional oilfields. Production increases are also forecast from Brazil and Kazakhstan. The recently completed pipeline for crude oil exports from Iraq to Turkey is another potential source of supply.

Supply disruptions will remain a key feature of the oil market. The Energy Information Administration estimates that 3.0 mb/d of oil was removed from oil markets in February 2014. As an example, concerns about Libyan supply had been calmed after production in January more than doubled monthly output at the end of 2013.

A1.13 Estimated historical unplanned production outages

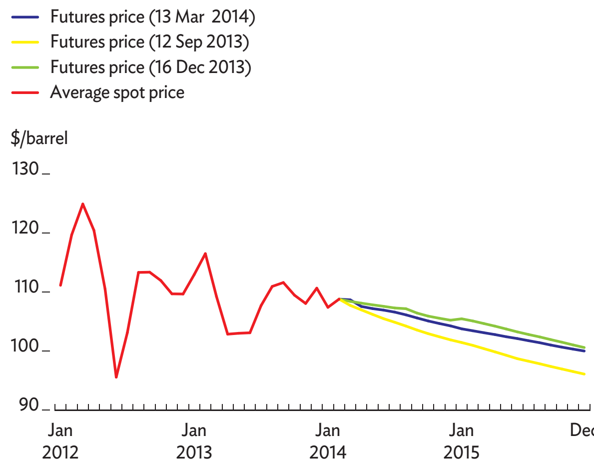


Sources: US Energy Information Administration. http://www.eia.gov/forecasts/steo/data.cfm?type=figures (accessed 14 March 2014).

However, in February 2014, the partial shutdown of a pipeline in Libya following protests drove oil production down again to below 341,000 barrels per day. The ban on Iran's crude exports remains, though some insurance provisions have been relaxed after an interim nuclear accord between Iran and the UN. The relaxation of sanctions may lead to small increases in crude oil exports, but it will be some time before Iran is able to fully rejoin the market. The recent escalation of hostilities and conflicts in Syria, Yemen, Sudan, and South Sudan also pose downside supply risks.

On the whole, better supply conditions will continue but will likely be countered by an increase in world demand as global economic conditions improve, albeit uncertainly. The price of crude oil is forecast to soften but remain above \$100, settling at \$106 in 2014 and \$103 in 2015.

A1.14 Brent crude futures and spot price



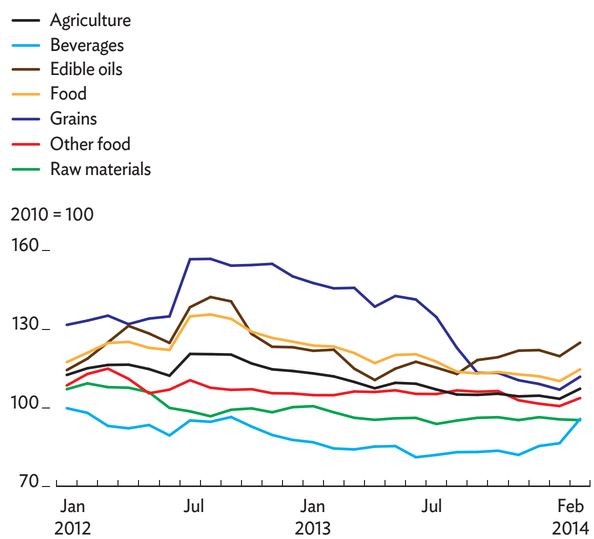
Sources: Bloomberg; CEIC Data Company (both accessed 14 March 2014).

Food prices

Prices for food and other agricultural commodities continued to be weak in 2013 (Figure A1.15). The agricultural commodity index was down by 7% in 2013. Its sub-indexes—beverages, food, and raw materials—all dropped. Beverages led the decline, down by more than 10.0% from the previous year, followed by food with a 7.1% decline year on year and then raw materials down by 5.9%. Similarly, all sub-indexes of food fell in 2013: grains by 9.3%, edible oils by 8.1%, and other food by 3.0%. Grain prices have been declining steadily since July 2013 on account of continuously improving supply conditions. Year-on-year changes to the prices of wheat and maize have been negative since July, and of rice since May.

The food price index averaged 113 points in February 2014, 3.9% above the January average but still 6.9% lower than a year before. February's rebound, the sharpest month-on-month increase since July 2012, resulted from strengthening in all its sub-indexes. The commodities that exhibited high rises were sugar at 6.3%, wheat at 6.1%, maize at 5.7%, and edible oils at 4.2%. Weather-related uncertainty triggered upward price movements for sugar, soybeans, maize, wheat, and palm oil. Prices for sugar and soybeans rose on concern over unfavorable weather in Brazil. Wheat and maize prices reacted positively to prolonged cold weather in the US, while palm oil prices found support in concern over dry weather in some major production areas in Southeast Asia. Political uncertainty around the Black Sea, notably in Ukraine, also supported wheat and maize prices, while export prices for Thai rice increased as irregularities surrounding the government's paddy pledging scheme remained unresolved. Aside from these supply-side risks, buoyant demand supported maize and palm oil prices.

A1.15 Agricultural commodity price indexes



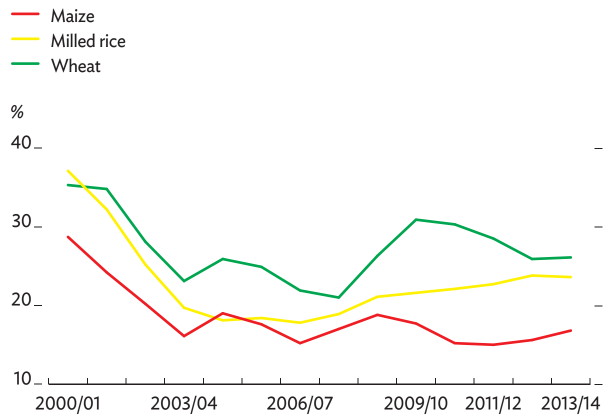
Source: World Bank. Commodity Price Data (Pink Sheet). http://econ.worldbank.org (accessed 14 March 2014).

The outlook for the supply of food commodities remains favorable. The Agriculture Market Information System Market Monitor noted uncertainty arising from geopolitical tensions in the Black Sea region but expects bumper crops from multiple producers in 2014 to run up world stocks of maize, wheat, rice, and—despite adverse weather in South America—soybeans. The same favorable outlook can be gleaned from the US Department of Agriculture (USDA) March 2014 report, which projects slightly higher grain output in the crop year 2013/14. The USDA now forecasts 2013/14 grain production to reach 2.45 billion tons from an estimated 2.26 billion tons the year before. It also forecasts the production of wheat to rise by 8.6% year on year, maize by 12.1%, and rice by 0.7%.

The drag on rice prices will continue this year, absent any major production setback, as millions of tons of Thai rice are poised to enter the market following the expiration in February 2014 of the rice subsidy scheme. The scheme, which was launched in 2011, cost the Thai government billions of dollars as it paid rice farmers nearly double market rates. Market analysts have been quick to point out that rice prices will not go into free fall, as exporters will be unwilling to sell below cost. Rice prices are therefore expected to hover within the range of \$400–\$450 per ton. Maize and wheat prices are also expected to stay low, as initial yield estimates remain favorable for the current crop and the following year.

The increase in grain production has bolstered stock-to-use ratios. Latest estimates for 2013/14 using USDA forecasts yield stock-to-use ratios of 16.8% for maize, 26.1% for wheat, and 23.6% for rice. Although well within their range in recent years, the ratios are lower than in the early 2000s (Figure A1.16). As such, tight stocks will keep prices sensitive to the weather. Prices could rise substantially if a major production shortfall were to occur. Absent adverse weather, a surge in energy prices, or a revival of protectionist trade policies, food prices are forecast to decline by 3.5% in 2014 and 1.0% in 2015.

A1.16 Stock-to-use ratios of major grains



Source: US Department of Agriculture. http://www.fas.usda.gov/psdonline/psdQuery.aspx (accessed 14 March 2014).

External environment in sum

Demand for imports from the major industrial economies may improve gradually as growth there continues to gain traction, and developing Asia could see their exports pick up. Despite continuing accommodative monetary policy in the US, Europe, and Japan, volatility remains a risk for emerging financial markets as the unwinding of the US bond-buying program continues to unsettle global investors. Although sensitive to potential disruptions, international prices for oil and food are otherwise largely immune to inflation to the forecast horizon, which is putting downward pressure on inflation globally, including in Asia.

2

Fiscal policy for inclusive growth

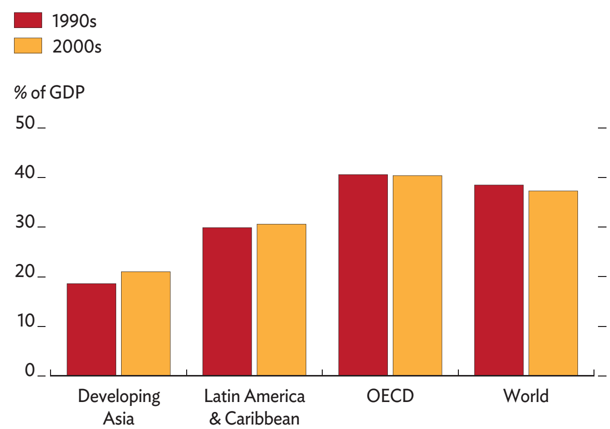
Fiscal policy for inclusive growth

As it transforms itself from a low-income region into a middle-income region, developing Asia faces the critical strategic challenge of making its growth process more inclusive. The sustained and rapid economic growth that transformed the region was fueled by globalization, technological progress, and market reform. Yet those same market forces that enormously benefited the region are now worsening the income gulf between the rich and the poor across Asia. Widening inequality is not only a matter of equity. If left unchecked, it may undermine the social and political stability that has underpinned the region's exceptional growth performance in the past few decades. Therefore, governments may need to take action to level the playing field and to expand access to opportunity so that the broadest swathe of society, including the poor, enjoys the fruits of growth.

Government expenditures in developing Asia are small by international standards. They are much less than in the advanced countries, Latin America (which is comparable with developing Asia in terms of income and development), or the world at large (Figure 2.0.1). To some extent, this generalization reflects the region's strong tradition of fiscal prudence, as Asian governments have, by and large, lived within their means and avoided unsustainable expansion. The role of fiscal policy in Asia has been to foster economic growth by providing macroeconomic stability and growth-conducive investments in physical infrastructure and education. Growth rather than equity has been the ultimate objective of this approach to fiscal policy, even though it may incidentally have promoted equity in the process.

Yet, if governments are to play an active role in fostering inclusive growth, fiscal policy will have to come to the fore. At the same time, Asia's policy makers are well aware of the value of fiscal prudence that creates fiscal space, or spending flexibility, to ensure macroeconomic stability. They are also aware that structural changes like aging populations may encroach on this fiscal space. Therefore, the central dilemma facing Asia is how to use fiscal policy for inclusive growth without compromising fiscal sustainability. Is it possible for the region to pursue inclusive yet prudent fiscal policy?

2.0.1 Ratio of government expenditures to GDP



OECD = Organisation for Economic Co-operation and Development.
Source: Asian Development Bank estimates based on data from International Monetary Fund, *World Economic Outlook* Database, October 2013.

This chapter was written by Donghyun Park of the Economics and Research Department. It draws on the background papers listed at the end of the chapter. Background materials from Satoru Araki, Almas Heshmati, Shikha Jha, Niny Khor, Jungsuk Kim, Nora Lustig, Patricia Moser, Hyeon Park, and Rathin Roy are gratefully acknowledged. Juzhong Zhuang, deputy chief economist, provided guidance at various stages.

The emerging case for inclusive fiscal policy

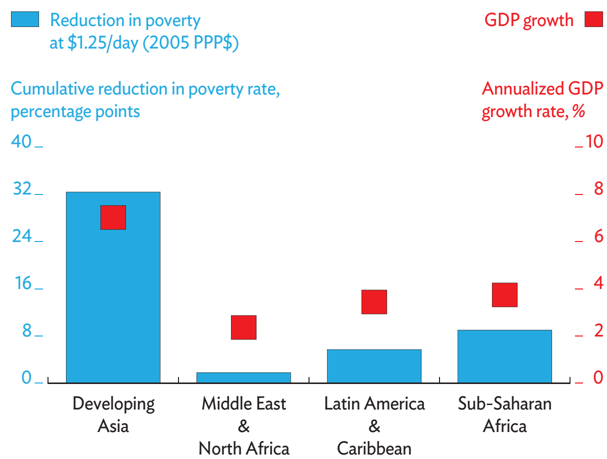
Sustained and rapid growth during the past few decades sharply lifted general living standards across developing Asia and enabled hundreds of millions in the region to lead more dignified and productive lives. According to *Asian Development Outlook 2012*, Asia's GDP grew in purchasing power parity terms by an average of 7.0% from 1990 to 2010 (Figure 2.1.1). This rapid expansion helped more than 700 million people escape poverty, slashing the percentage of people living at or below the $1.25/day poverty line from 52% in 1990 to 21% in 2010.

But *Asian Development Outlook 2012* warned that widening inequality was undermining efforts to eliminate poverty. The Gini coefficient, a widely used measure of inequality in per capita income or expenditure, rose from the early 1990s to the late 2000s in 11 of 28 Asian countries that provide comparable data, the higher Gini coefficients indicating worsening inequality (Box 2.1.1). The 11 countries—which include the People's Republic of China (PRC), India, and Indonesia—hold 82% of Asia's population (Figure 2.1.2). Widening inequality dampens the poverty-reducing effect of economic growth. If inequality had remained constant in these 11 countries, the same rate of growth would have lifted out of poverty an additional 240 million people, or 6.5% of their total population.

In response to worsening inequality, the authorities in developing Asia are exploring ways to make growth more inclusive. According to one definition (Zhuang and Ali 2010), inclusive growth is "growth that is based on equality of opportunity." In other words, growth is inclusive when it allows all members of society to participate in it, contribute to it, and benefit from it on an equal basis, regardless of individual circumstances. This concept of inclusive growth is based on creating economic opportunity and making opportunity accessible to all. While equality of opportunity is perhaps the defining characteristic of inclusive growth, the concept encompasses the need to protect the destitute and most vulnerable.

As incomes rise, the quality of economic development—that is, how the public experiences the environmental and social consequences of growth—becomes increasingly important. In Asia, the demand to make growth more inclusive follows on the region's development success as it becomes increasingly middle income. The demand also mirrors growing recognition that the same market forces that accelerate

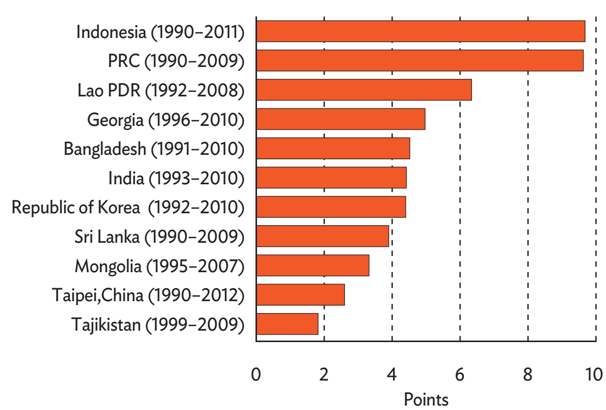
2.1.1 GDP growth and poverty reduction, 1990–2010



Note: Cumulative reduction in the poverty rate is estimated as the difference in the percentage of poor people between the latest year in the 2000s and the earliest year in the 1990s for which data are available, weighted by 2010 and 1990 population. In Asia and the Pacific, the countries covered are Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan in Central Asia; the People's Republic of China in East Asia; Fiji and Timor-Leste in the Pacific; Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka in South Asia; and Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Thailand, and Viet Nam in Southeast Asia.

Source: Asian Development Bank 2012 (data updated in 2014).

2.1.2 Gini coefficient change in developing Asia, 1990s and 2000s



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.

Note: A rising Gini coefficient indicates worsening inequality.

Source: Asian Development Bank 2012.

growth can exacerbate inequality. For example, technological progress will disproportionately benefit richer and better-educated population groups, who are more comfortable with new technologies. Likewise, the expansion of trade, which served as the springboard for Asia's rapid growth, benefits some firms and households while it hurts others. The solution is not to block pro-growth market forces but to create a level playing field on which everybody has an opportunity to take advantage of those forces. This failure of market forces to ensure equal opportunity suggests a need for government intervention to make growth inclusive.

One important instrument available to the government for bringing about a more inclusive society is fiscal policy. Governments can design spending programs and tap revenue sources in ways that reduce inequality. For example, means-tested government grant programs, which provide cash or in-kind assistance to households below a specified income threshold, are geared to reduce inequality and poverty directly. Public health and education spending can, like government transfers, be potent tools to reduce inequality. On the revenue side, progressive personal income tax, which imposes a higher tax burden according to ability to pay, is a classic example of equality-enhancing revenue policy.

Historically in Asia, the role of fiscal policy has been to facilitate economic growth by providing basic infrastructure while safeguarding macroeconomic stability. A tradition of fiscal prudence was instrumental in Asia's past success, along with public investments in growth-conducive physical and human capital. While some public spending such as on public education contributes to both higher growth and equality, the primary objective of fiscal policy and broader government policy lay in fostering economic growth—an understandable priority when Asia's economies were largely low income. This is not to say that Asia refrained altogether from using fiscal policy to share the economic pie more equally, but rather that the main focus was to foster rapid growth and thus provide a bigger pie.

As a result, the authorities in Asia possess, by and large, only limited experience in using fiscal policy to promote equity, in contrast with their counterparts in advanced economies. But the difference does not simply come down to lower income. Developing Asia also lags Latin America in using fiscal policy to promote inclusion.

While Latin America still suffers stark inequality, the region has made some progress toward equality over the past 2 decades, even as equality in other regions, notably developing Asia, has slipped.

Evidence indicates that Asia falls short relative to the advanced economies and Latin America in three equity-promoting fiscal expenditures: education, health care, and social protection. Education and health care directly improve the welfare of the poor even as these services augment their human capital and productive capacity. Social protection helps to protect individuals from the risks and uncertainties of life. Public spending on education averages 5.3% of GDP in the advanced economies and 5.5% in Latin America but only 2.9% in Asia (Figure 2.1.3). The difference is starker

2.2.1 The Gini coefficient defined

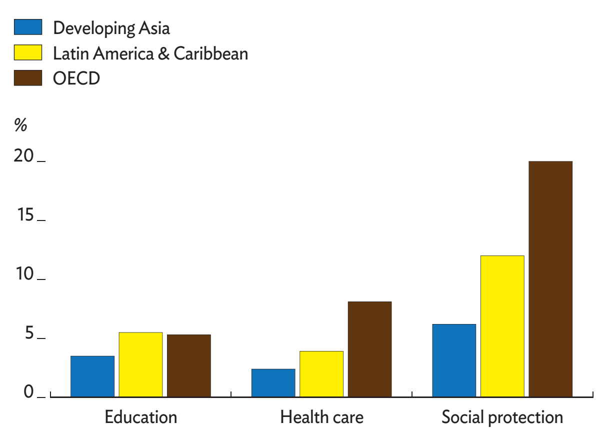
The Gini coefficient measures how income or consumption expenditures are distributed across households. In the theoretical situation of perfect inequality where only one person has all of the income, the Gini coefficient will be 1. If, at the other extreme, the economy has achieved perfect equality with all incomes exactly the same, the Gini coefficient will be 0.

Mathematically, consider income data on an economy of n households that have been sorted according to household income, such that the first observation is the poorest household and nth observation is the richest. If the income of observation i is denoted as x_i and the average income of all households as μ_x, then the Gini coefficient is calculated as

$$Gini = \frac{-(n+1)}{n} + \frac{2}{n^2 \mu_x} \sum_{i=1}^{n} i x_i$$

The theme chapter follows the convention of multiplying the Gini coefficient by 100 so that it ranges from 0 to 100.

2.1.3 Share of education, health care, and social protection in GDP in 2010, weighted average

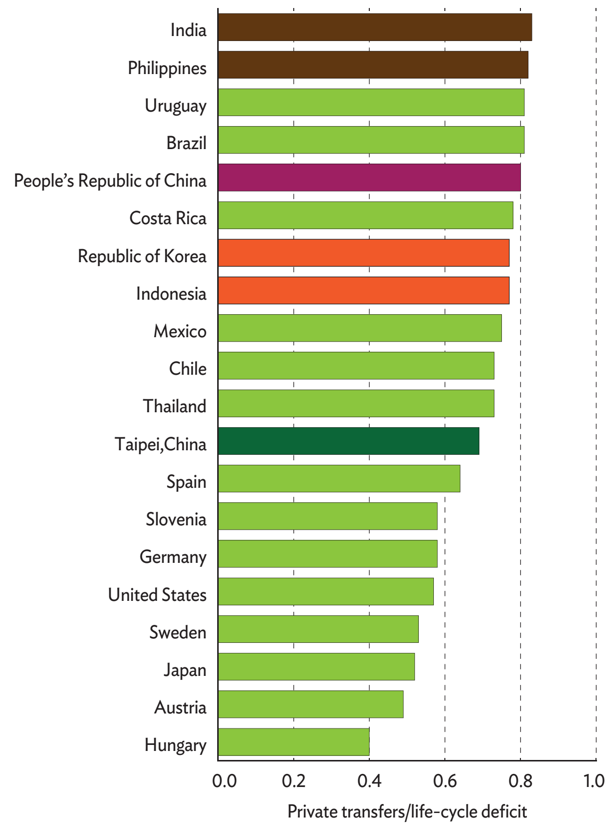


OECD = Organisation for Economic Co-operation and Development.
Source: ADB estimates based on data from World Bank, World Development Indicators online database (accessed 27 February 2014), ADB Key Indicators.

for public spending on health care, which equals 8.1% of GDP on average in the developed world and 3.9% in Latin America but a paltry 2.4% in developing Asia. Finally, Asian governments devote 6.2% of GDP to social protection, essentially half of Latin America's 12.0% and less than a third of the advanced economies' 20.0%.

Seen from the perspective of the human economic life cycle, Asia uses public transfers for old age support less than do other regions (Lee and Mason 2012). During this cycle, individuals consume more than they produce when they are young and again when they are elderly. They do the opposite when they are of working age. A combination of private transfers within the family and public transfers through government programs finances the gap between consumption and production in childhood and old age. The relative role of private versus public transfers in financing the deficit differs markedly across Asia, Europe, and Latin America. For children, private transfers play a bigger role in Asia and Latin America than in Europe (Figure 2.1.4). The percentage of a child's total material needs covered by the family, such as education and nutrition, stands at 70% in Taipei,China, 82% in the Philippines, and 83% in India. Meanwhile, for the elderly, public transfers to cover health care and long-term care are smaller in Asia than elsewhere (Figure 2.1.5).

2.1.4 Private transfers as a proportion of the life cycle deficit for ages 0–19 in selected economies in Asia and elsewhere



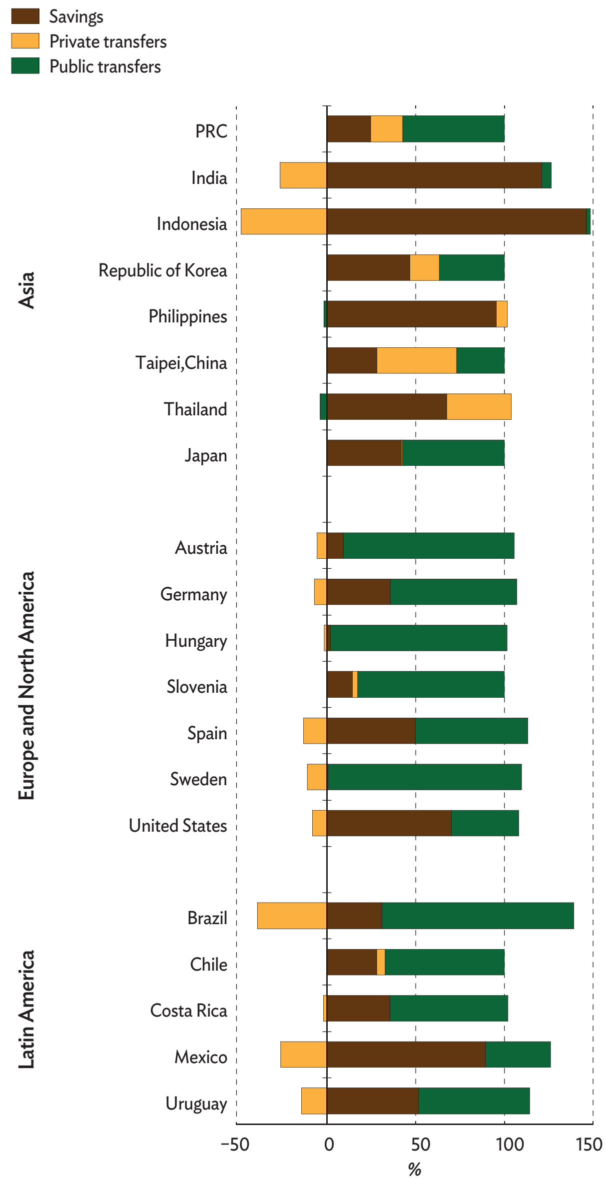
Source: Lee and Mason 2012.

Nevertheless, governments around the region are rising to the challenge of rendering growth more inclusive by making it a higher priority on their policy agendas. This is evident in countries at all stages of development and income. In the Republic of Korea, both of the two main political parties promised sharp increases in social welfare spending in the 2012 presidential elections. In the PRC, the government has since 2006 embraced as a broader development objective the concept of a "harmonious society," which resonates with inclusive growth. In November 2013, the Third Plenary Session of the 18th Central Committee of the Communist Party of the PRC adopted its Decision on Major Issues Concerning Comprehensively Deepening Reforms, which accords a high priority to improving income distribution. Since then, several concrete policy measures have been announced, including the plan to unify the social security schemes for urban and rural populations. The Government of India has adopted a development strategy with two goals: lifting economic growth and making growth as inclusive as possible. In Southeast Asia, many governments have set promoting inclusive growth as the goal of their medium-term development plans, some with explicit targets (Kanbur et al. 2014).

If Asia is to use fiscal policy more actively for inclusive growth, it must do so without compromising two key strategic priorities: economic growth itself and fiscal sustainability. For all its success, Asia still needs sustained, rapid growth to raise per capita income. The region is still home to two-thirds of the world's poor, so sustained economic growth remains critical to eliminate poverty. Yet inclusive growth will ultimately suffer if, for example, burdensome taxes distort decisions to invest or hire workers. Moreover, the benefits of fiscal prudence should not be discounted. Pragmatic fiscal policy in many Asian economies has supported macroeconomic stability and opened adequate fiscal space, which is a highly valuable resource for fending off such severe shocks as the recent global financial crisis and for addressing medium-term fiscal demands such as those made by aging populations.

Expanding the role of fiscal policy to fight inequality should not undermine fiscal sustainability. Yet tensions are surfacing between these competing ends. In the Republic of Korea, a new social pension scheme to provide basic income support to the elderly, scheduled to be introduced in July 2014, had to be scaled back in response to fiscal concerns. In India, legislation was passed in September 2013 that guarantees nearly 70% of the country's 1.2 billion citizens access to subsidized food. The estimated cost of $20 billion per year is contributing to concerns about India's already chronic fiscal deficits. Likewise, Thailand's ongoing rice subsidy scheme, under which the government buys rice from Thai farmers at 50% above market prices, is estimated to have cost the government over $12 billion in 2012. A key challenge is how to leverage fiscal policy for more inclusive growth while maintaining fiscal sustainability.

2.1.5 Support system for people aged 65 and above, selected economies in Asia and elsewhere



PRC = People's Republic of China.

Note: The data year for each economy is Austria 2000, Brazil 1996, Chile 1997, the People's Republic of China 2002, Costa Rica 2004, India 2004, Indonesia 2005, the Republic of Korea 2000, Germany 2003, Hungary 2005, Japan 2004, Mexico 2004, the Philippines 1999, Spain 2000, Slovenia 2004, Sweden 2003, Taipei,China 1998, Thailand 2004, the United States 2003, and Uruguay 2006. Negative values represent net outflows, with the elderly providing more support to their families than they receive. A positive value exceeds 100% by the extent of any negative value.

Source: Asian Development Bank 2011.

Public spending to foster inclusive growth

Fiscal policy comprises public spending programs and how revenue is secured to finance them. Government expenditures cover a broad range of activities. Current expenditures pay for such recurring costs as salaries for teachers, police, and other civil servants, and capital investments finance the construction of new roads or ports. The revenue side is similarly diverse, consisting of conventional tax revenues, such as value-added taxes and income taxes, and such nontax revenues as proceeds from the sale of state assets.

In principle, governments can calibrate either their spending programs or their revenue sources to promote inclusion—or both. Cash transfers are expenditures that can directly boost the incomes of poorer households, and the poor often benefit more than the rich from free or subsidized public education and health-care services because they cannot afford private substitutes. On the revenue side, progressive personal income tax, under which tax rates increase with income, is a classic example of an equity-enhancing policy. Better-off households may also pay more property tax than poorer ones because their property is worth more. Given the diversity of government programs, it is likely that some fiscal tools will have bigger impacts on inequality than others. But which spending and revenue levers most effectively promote inclusive growth?

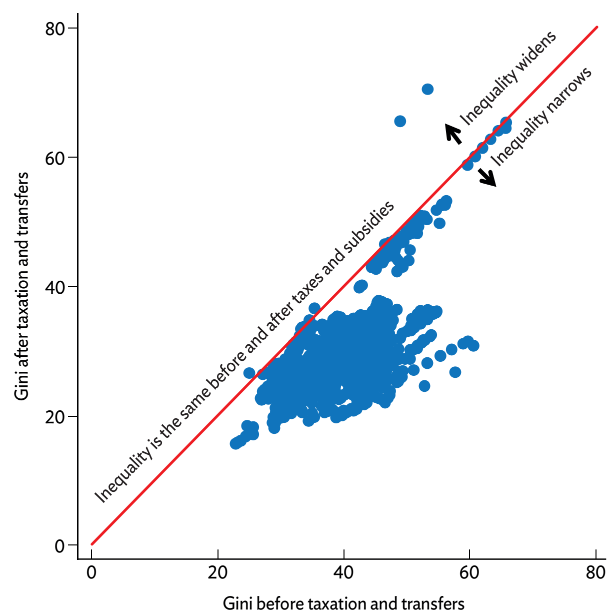
Empirical evidence on public spending for inclusive growth

Whether fiscal policy can promote inclusive growth—and, if so, which fiscal tools are more effective—are ultimately empirical questions. The evidence, presented below, suggests that while fiscal policy can reduce inequality from either the spending or the revenue side, the impact from public spending is significantly greater. The evidence also finds public spending on health, education, and direct transfers to be particularly effective ways to reduce inequality in developing Asia.

A review of published findings

In the advanced economies, fiscal policy contributes significantly to reducing inequality, according to a comprehensive review by Bastagli et al. (2012). The effect was more pronounced in economies initially beset by high inequality. After factoring in high taxes, subsidies, and direct transfers, the Gini coefficient in these economies

2.2.1 Effect of taxation and transfers on Gini coefficients, OECD member countries



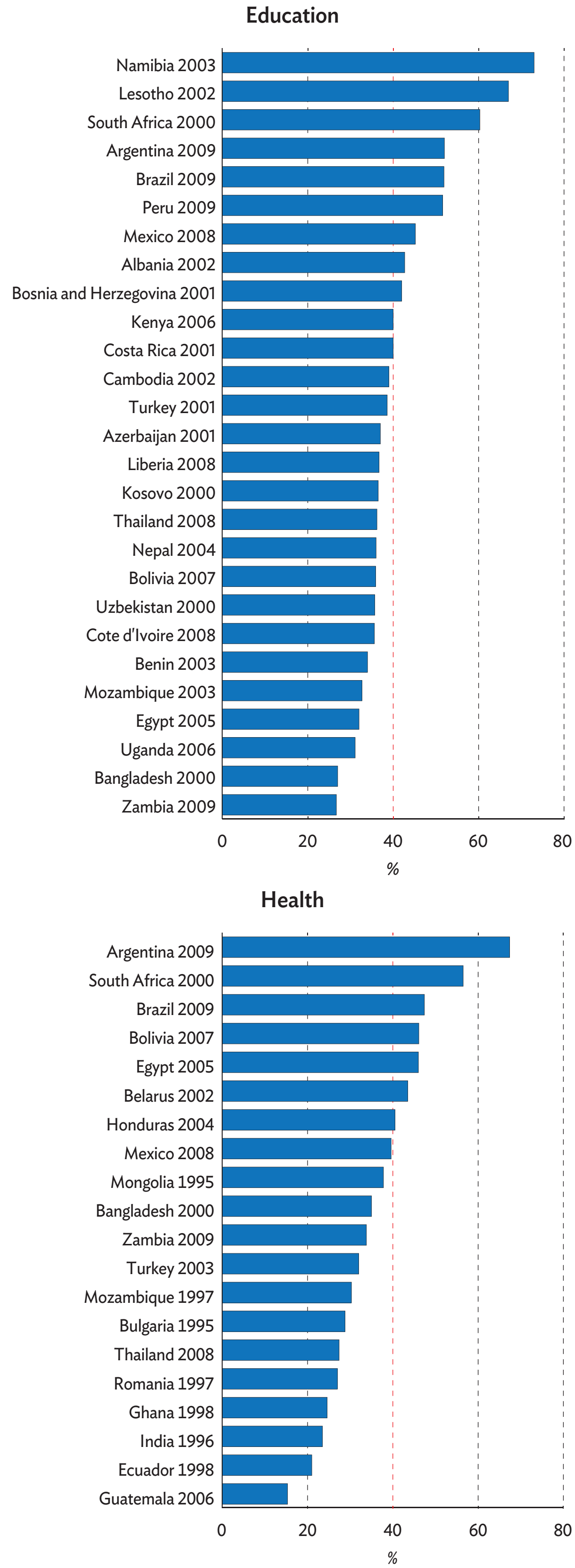
Source: Hur, forthcoming.

is lower than the pretax Gini (that is, calculated without regard to corrective spending or taxes), as illustrated by the observations being clustered below the 45 degree line in Figure 2.2.1. For each year between 1985 and 2005, fiscal policy reduced the Gini coefficient in 25 member economies of the Organisation for Economic Co-operation and Development (OECD) by an average of around 15 percentage points (OECD 2011). The results were uneven from country to country. For 2005, fiscal policy reduced inequality by at least 20 points in 7 economies and by less than 10 points in 5 economies, with the other 13 economies recording Gini coefficient declines in the range of 10–20 points. Cash transfers that were not means tested, such as public pensions and universal child benefits, accounted for the bulk of equity-promoting expenditures in the advanced economies (Paulus et al. 2009, Immervoll et al. 2005).

In contrast to the advanced economies, fiscal policy in developing countries has only a limited effect on inequality. According to Bastagli et al. (2012), low taxes and transfers greatly limit the redistributive impact of fiscal policy in developing economies. While average tax ratios in advanced economies exceed 30% of GDP, developing economies' tax ratios generally fall much lower, in the range of 15%–20% of GDP. Partly as a consequence of this tighter resource envelope, public spending—especially on transfers—is lower in developing economies, especially in Asia and in sub-Saharan Africa. Transfer programs' meager coverage and benefits, along with the widespread use of regressive tax instruments, compound the effects of low tax and spending levels (Cubero and Hollar 2010). Further, evidence indicates that aggregate spending on education and health care has been regressive in developing countries, with the lowest 40% of the population generally receiving less than 40% of the benefits (Figure 2.2.2). This is because some components are regressive. While primary education can be progressive, for example, the benefit from total education spending is dominated by the regressive nature of secondary and tertiary education.

One result that emerges consistently from the literature, applicable to both advanced and developing economies, is that public spending has a bigger impact on reducing inequality than does taxation. According to Bastagli et al. (2012), expenditures, especially transfers without means tests, contributed more to income redistribution than did taxes. On average, redistribution via cash transfers is twice as large as redistribution via taxes, with the United States as the only exception to this pattern. In developing countries, taxes have been found to exert at best only a limited effect on income inequality, pushing the average Gini for disposable income only slightly below the pretax income Gini, to 34 from 38 (Chu et al. 2004).

2.2.2 Percentage of public spending going to poorest 40% of households



Sources: Davoodi et al. 2010, Lustig et al. 2011, World Bank.

Public spending on education and health in particular seem to offer a lot of scope for reducing inequality. Using a data set covering both advanced and developing economies, Martinez-Vasquez et al. (2012) find that aggregate government expenditures on social welfare, education, health, and housing significantly reduce income inequality over time. Journard et al. (2012) and Cubero and Hollar (2010) find similar results for public spending on education and health. Notwithstanding some counterevidence—for example, the Clements (1997) finding in Brazil that government social expenditures worsen income inequality—the weight of the evidence supports an equity-enhancing effect. Significantly, this effect is larger for expenditures such as on primary education and basic health care that are heavily used by the poor (Bastagli et al. 2012).

By requiring low-income households to make education or health investments to qualify for income support, conditional cash transfers can create synergy between direct income transfers and public education and health services, compounding their reduction of inequality. Conditional cash transfers have become especially well established in Latin America, where they have significantly reduced inequality in many countries. In Brazil and Mexico, home to the two largest conditional cash transfer programs, the programs account for about 20% of the decline in inequality from the mid-1990s to the mid-2000s (Soares et al. 2007).

Significantly, Claus et al. (2014) confirm that the two main lessons from the broader literature for developing Asia are that fiscal expenditures, not taxation, offer the most effective means of lowering inequality and that the public spending best able to reduce inequality is on education and health care. Their analysis of data from 150 countries spanning 1970–2009 shows that, despite tax systems tending to be progressive, government expenditures are more effective at redistributing income. Government expenditures on health care and education are found to reduce income inequality in Asia and the rest of the world, as Table 2.2.1 shows (minus signs indicating improved equality). However, the study suggests that government expenditures on social protection and housing in Asia do not reduce inequality, as they do in the rest of the world, but actually worsen it. One possible explanation is that social protection and public housing in developing countries tend to benefit people living in cities, who are generally better off than rural populations. The lesson here is the importance of extending social protection and public housing benefits to the rural poor.

2.2.1 Estimated marginal impact of government spending on income inequality (percentage points)

Spending type	Asia	Rest of the world
Social protection	0.490	−0.276
Education	−0.486	−0.034
Health	−0.241	−0.330
Housing	2.162	−0.614

Note: Minus sign indicates improved equality.
Source: Claus et al. 2014.

With respect to government spending policies, Asia has made substantial progress toward achieving Millennium Development Goals for education and health. However, social protection policies generally remain limited in Asia; where they exist at all, benefit coverage tends to be narrow and not well-targeted to the poor. Unemployment benefits are typically restricted to those who lost formal employment, excluding the large proportion of people in informal work. Pensions are another example. In Asian countries outside of the OECD, pension systems are often quite generous in terms of early retirement eligibility and high pension amounts, but they are typically available only to a privileged minority.

Although more effective redistributive policies can be achieved with government expenditure than with taxation, some government spending has not been well targeted and mainly benefited higher income groups. General subsidies on fuel or electricity, for example, tend to be regressive because energy use rises with income.

Spending and inequality in Asia—a simulation

Deploying inclusive growth to eliminate poverty depends on maintaining growth itself. Policy interventions should broaden the opportunities for individuals to benefit from the growth process without derailing growth. Emerging empirical literature suggests that income inequality and growth may be intimately linked (Berg and Ostry 2011). Gauging the effect of fiscal spending on inclusive growth is therefore best done in a framework that explicitly models the linkages between the three variables: fiscal spending, income inequality, and economic growth (Box 2.2.1).

The empirical analysis yielded the following key results. First, gross fixed capital formation, public health spending, and education spending have significant positive effects on economic growth. However, the positive effects of health care and education spending on growth tend to be more persistent than those of gross fixed capital formation. Second, public health spending on both health and education seems to alleviate income inequality significantly in developing Asia, potentially furthering inclusive growth in the region. It is important to emphasize that the income-equalizing effect of fiscal expenditures is more evident in the long run. All fiscal items—except public gross capital formation and military spending—significantly improve the Gini coefficient with 10-year lags. Examination of contemporaneous relationships also reveals a tangible effect of fiscal items on inequality.

The estimation results can be used to simulate the magnitude of the income-equalizing effect of an increase in a given fiscal expenditure category. Summing the impulse responses over 7 years, based on the analysis of developing Asia, can answer the following question: If spending on a specific fiscal program is permanently raised by 1 percentage point of GDP, how much will the Gini coefficient change over 7 years? Fiscal spending on education seems to reduce inequality the most, lowering the Gini coefficient by a cumulative 1.1 percentage points. However, health and transfers also have substantial impacts, with Gini coefficient improvements of 0.3 percentage points and 0.6 percentage points, respectively. The simulation results demonstrate that policy makers in developing Asia can deploy their spending programs on public education, health, and direct transfers to help reverse the rise in income inequality.

Public spending on health, education, transfers, and infrastructure

The preceding simulation illustrates the potential macro impact that government spending on education, health, and direct transfers can have on inclusive growth in developing Asia. However, it is necessary

2.2.1 Empirical framework to simulate the effects of public spending on inclusive growth

To simulate the impact of fiscal policy on inclusive growth, an empirical framework is used that can allow for the feedback effects between growth, inequality, and fiscal policy. In a recent study, Hur (forthcoming) uses panel vector autoregression to explicitly model these interdependencies.

The model includes four variables: real gross domestic product (GDP) growth, the Gini coefficient, total public spending as a percentage of GDP, and a selected component of government spending (such as education) as a percentage of GDP. By jointly including both total government expenditures and a single expenditure component, the model can distinguish between the effect of a change in a particular type of expenditure and the effect of a change in the scale of spending overall. Estimating the model with public education spending, for example, allows a more direct assessment of the impact of public education on growth and equity while controlling for the overall size of government.

The study uses annual data on 63 economies, 30 in developing Asia and 33 in the Organisation for Economic Co-operation and Development (OECD), spanning 1960–2012. For the purposes of the study, the Republic of Korea—the one developing Asian economy that is also an OECD member—is classified only as developing Asia.

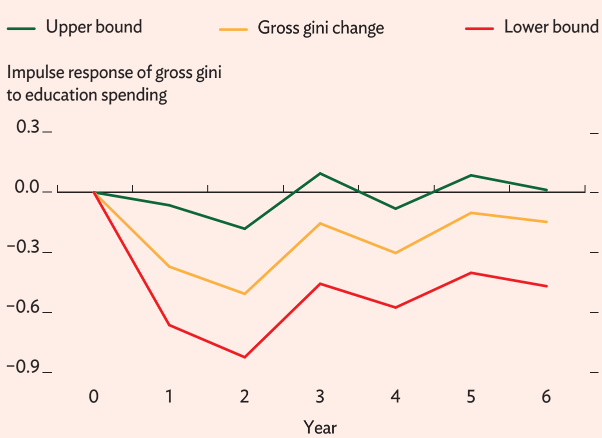
Gini coefficients are drawn from the Standardized World Income Inequality Database and are based on incomes before taxes and transfers. Real GDP growth rates, total public spending, and the individual spending items are derived from data drawn from the World Development Indicators. The model is estimated separately for each individual expenditure item. The six categories of government spending analyzed are as follows (according to their World Development Indicator series names): (i) government final consumption expenditure (including for some goods and services it supplies directly to the populace), (ii) gross public capital formation, (iii) public health expenditure, (iv) military expenditure, (v) social transfer and subsidy expenditure, and (vi) public spending on education.

The main output of the model, the impulse response function, shows how the variable of interest responds over time to a shock to another variable over time. Box figure 1 shows the range of possible impacts on the Gini coefficient (within a 90% confidence interval) of a one-time positive shock to public spending on education. Box figure 2 shows the same for public spending on health care. The impulse response functions suggest that both types of expenditures show a negative impact on the Gini—that is, they tend to reduce income inequality—and that the effect persists for several years.

References

Hur, S.-K. Forthcoming. Government Spending and Inclusive Growth in Developing Asia. ADB Economics Working Paper Series. Manila: ADB.

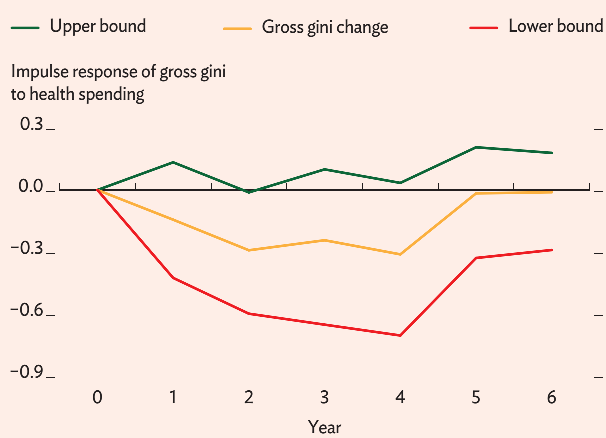
1 Inequality effects of public education spending, developing Asia



Note: Estimates are derived from panel vector autoregressions using four variables: real GDP growth, the Gini coefficient, total public spending as a percentage of GDP, and education as the selected component of government spending as a percentage of GDP. The area between the upper and lower bounds is the 90% confidence interval for the impulse response function.

Source: Hur, forthcoming.

2 Inequality effects of public health spending, developing Asia



Note: Estimates are derived from panel vector autoregressions using four variables: real GDP growth, the Gini coefficient, total public spending as a percentage of GDP, and public health as the selected component of government spending as a percentage of GDP. The area between the upper and lower bounds is the 90% confidence interval for the impulse response function.

Source: Hur, forthcoming.

to delve deeper into the relationship between these public expenditures and inequality to derive clearer policy guidance. In addition, the foregoing analysis indicates that public investment in infrastructure supports growth in the region even though it does not appear to budge income inequality. This raises the question whether such investments can be used to ensure the poor greater economic opportunity. A closer look at different kinds of fiscal spending will offer a more concrete understanding of how fiscal spending can promote equity in Asia.

Public spending on education and health in Asia

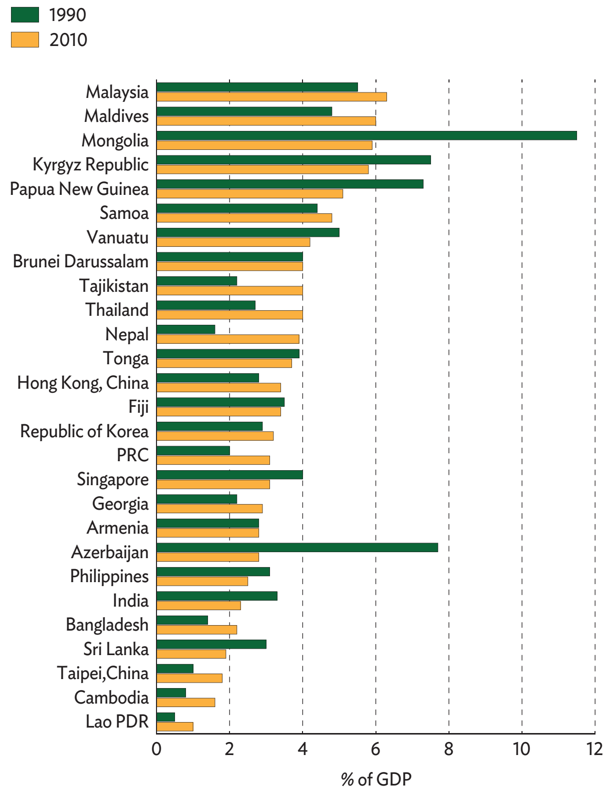
Education and health care directly improve human welfare. This is why they form part of the broad definition of poverty under the Millennium Development Goals. Further, education and health are significant determinants of an individual's earning potential. This is especially true for the poor, who have limited physical capital or unearned income. Better educated and healthier workers are more likely to find a job and command higher wages. Educational attainment and health status can be major sources of income inequality when there is unequal access to the two social services. High-income groups can better afford private education and health care than can low-income groups. As public spending often renders the two services more affordable to the poor, free or subsidized education and health care broadens access to them.

Public spending on education

Government spending on education is rising as a percentage of GDP in many economies in developing Asia (Figure 2.2.3). Even where the share has fallen, sustained rapid growth implies a large expansion of outlays. Asia's rising educational investment is part of a broader trend among developing countries, which have embarked on huge reforms to expand the supply of education, achieve equity in access, and significantly raise the quality of education (Tiongson 2005).

However, access to schooling is unequal in a number of Asian countries. This holds true especially in South Asia (Porta et al. 2011). In Pakistan, over half of the children of primary school age from the poorest families were out of school in 2006, compared with just 7% of those from the richest families (Figure 2.2.4). In India, children in the lowest income group were 5 times more likely to be out of school in 2005 than those in the highest income group. Similarly, there are wide gaps in access to secondary schooling. As expected, the percentage of those out of school tends to be higher at the secondary level (Figure 2.2.5). The percentage of out-of-school youths of secondary school age from families

2.2.3 Government spending on education

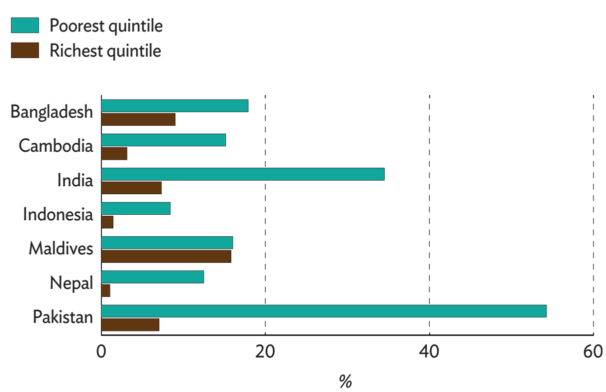


Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.

Note: Initial data for the PRC, the Maldives, Samoa, and Tajikistan are from 1995 and for Armenia, India, and Georgia 2000.

Source: ADB Key Indicators; ADB estimates.

2.2.4 Percentage of children not in elementary school



Note: Data for Bangladesh and Cambodia are from 2010, India 2005, Indonesia 2010, Maldives 2009, Nepal 2011, and Pakistan 2006. Countries are ranked by the discrepancy in percentage between the poorest and richest quintiles, with the Maldives enjoying the narrowest gap.

Source: Estimated by Porta et al. (2011).

in the lowest income group in Bangladesh was a staggering 53% in 2010, compared with only 18% of primary school age. These youths were nearly twice as likely as youths from the richest group to be out of school.

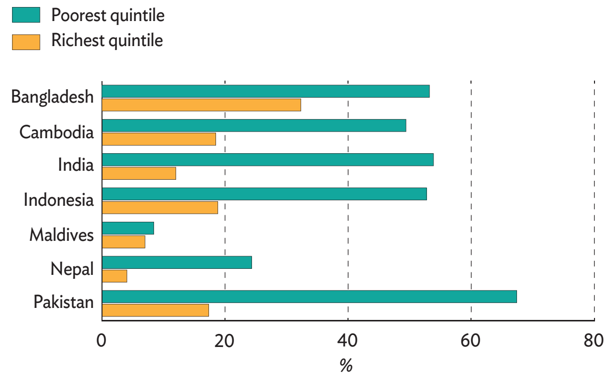
A number of factors cause these unequal outcomes. The poor may be unable to afford out-of-pocket costs, the curriculum may seem irrelevant to their circumstances, or they may even face discrimination from their better-off peers (Porta et al. 2011). As children grow older, the opportunity cost of keeping them out of the workforce may be greater than the perceived benefits of further education, explaining poor children's falling enrolment rates in higher grades. For poor households more than others, the monetary and opportunity costs of sending children to school are high relative to income, and this accounts for much of the difference in enrolment rates between the poor and other classes (Roberts 2003).

Evidence from Asia confirms that how governments spend on education affects whether it is progressive or regressive. Lanjouw et al. (2002) report from Indonesia that an increase in public spending on primary education tends to benefit the poorest two income quintiles the most. However, spending on secondary schooling mainly benefits the richest two quintiles. Warr et al. (2013) finds quantitatively similar results in the Lao People's Democratic Republic (Lao PDR). The poor thus benefit the most from an increase in public spending on primary education. One important caveat is that many jobs, especially in the formal economy, require at least a secondary education. Technical and vocational education that teaches students the practical skills and knowledge that employers demand is therefore especially valuable (Adams 2011).

Public spending on health care

Like education, health-care services enhance welfare in their own right, and public spending on health care has an outsized positive effect on the poor. Gupta et al. (2001) find that public spending on health care has a larger impact on the health status of the poor than on other classes. A 1% increase in public spending on health care reduces the child mortality rate in society as a whole but doubles the benefit for the poor. The relationship between public health spending and the health status of the poor tends to be stronger in low-income countries. This effect is compounded in terms of the absolute number of lives saved when taking into account low-income countries' higher child mortality rates. The data show government spending on health care services on the rise across developing Asia (Figure 2.2.6). If implemented well, this increase could be quite beneficial to the poor.

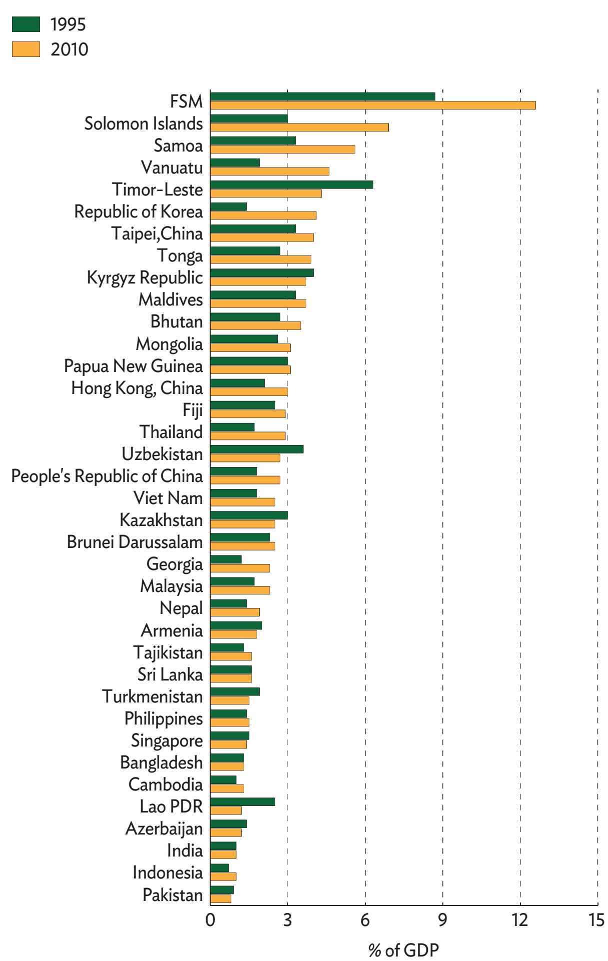
2.2.5 Percentage of children not in secondary school



Note: Data for Bangladesh and Cambodia are from 2010, India 2005, Indonesia 2010, Maldives 2009, Nepal 2011, and Pakistan 2006. Countries are ranked by the discrepancy in percentage between the poorest and richest quintiles, with the Maldives enjoying the narrowest gap.

Source: Estimated by Porta et al. (2011).

2.2.6 Government spending on health



FSM = Federated States of Micronesia, Lao PDR = Lao People's Democratic Republic

Note: Latest data for Georgia and Timor-Leste are from 2000.

Source: World Health Organization, World Health Statistics 2013.

For now, though, the poor in developing Asia suffer health conditions that are starkly inferior to those enjoyed by people with higher incomes. In Cambodia, Indonesia, Nepal, and the Philippines, mortality rates for children under the age of 5 in the poorest 20% of the population are more than twice those for the wealthiest 20% (Figure 2.2.7). While more than 60% of women in the highest income groups in the Lao PDR, Nepal, Pakistan, and Timor-Leste give birth attended by skilled health personnel, the corresponding share in the lowest quintile is less than 20% (Figure 2.2.8). This gap in health outcome by income is a strong argument for greater public spending on health services.

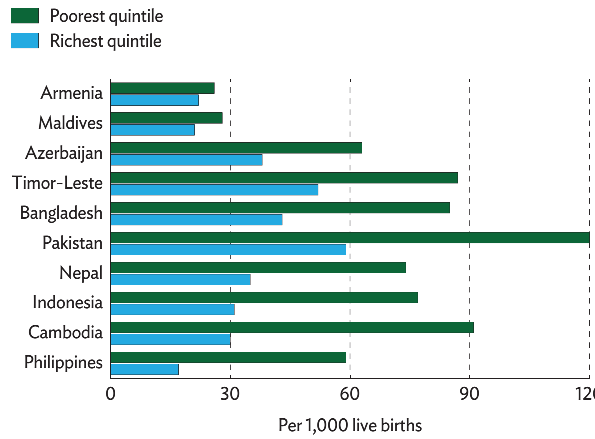
Public spending on health care also raises the income of the poor and protects them from financial risks. As Bidani and Ravallion (1997) highlight, public spending on health care tends to matter more to the poor for broader reasons. Improved health can enable them to lead more productive lives in school or work. By the same token, health deficiencies can make the poor more vulnerable, generating a vicious cycle of poor health and poor incomes. Household spending on a member's health crisis can drive poor households deeper into poverty or tip the near poor into poverty. In 1998, medical expenses were estimated to have pushed about 3 million Vietnamese into poverty. Seldom are the poor enrolled in voluntary insurance schemes or compulsory public programs that provide protection against health expenditure shocks (World Bank 2004).

Public health expenditures in Asia need to be made more inclusive in three ways.

First, expanded health insurance for the poor and middle class would alleviate the stress out-of-pocket expenditures for health place on household income and assets. As out-of-pocket payment for both publicly and privately provided health services is the norm in many Asian countries, health expenditures can devastate the finances of families below or near the poverty line (Brearley et al. 2012). Financial risk protection is needed in the form of well-targeted government subsidies to render insurance premiums affordable. However, such programs must be designed with careful attention to the fiscal impacts of more generous health service entitlements, as well as to improving the incentives for cost-effective and high-quality health care delivery. In the Philippines and Thailand, health insurance coverage for the poor has been expanded by allocating revenues raised through so-called "sin taxes," or excise taxes on tobacco and alcohol. This extends access to health care and financial risk protection while discouraging the consumption of substances that pose health risks.

Second, Asian countries must further develop primary health care with subsidies and incentives to encourage the poor to adopt highly cost-effective approaches, especially health promotion, disease prevention,

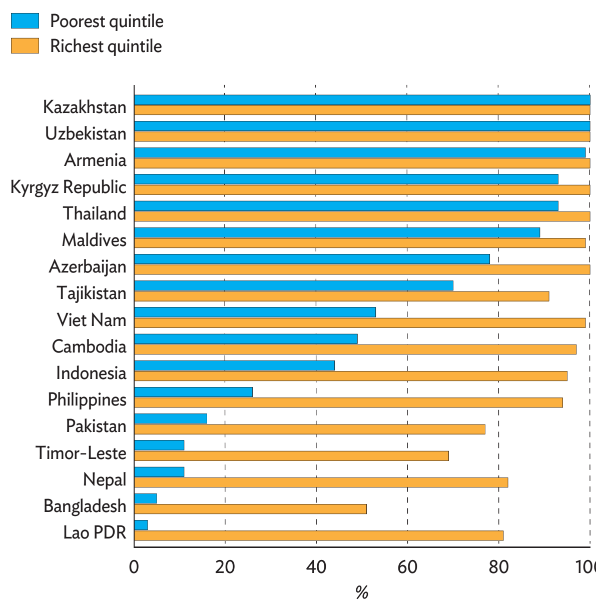
2.2.7 Under-5 mortality rate per 1,000 live births



Note: Countries are ranked by the discrepancy in percentage between the poorest and richest quintiles, with Armenia enjoying the narrowest gap.

Source: World Health Organization, World Health Statistics 2013.

2.2.8 Births attended by skilled health personnel



Lao PDR = Lao People's Democratic Republic.

Note: Countries are ranked by the discrepancy in percentage between the poorest and richest quintiles, with Kazakhstan and Uzbekistan enjoying the narrowest gap.

Source: World Health Organization, World Health Statistics 2013.

and early diagnosis. The utilization of cost-effective primary health-care services reduces long-term health-care costs and improves health and productivity. There is evidence that the marginal benefits of increased expenditure for primary health care are pro-poor (Warr et al. 2013).

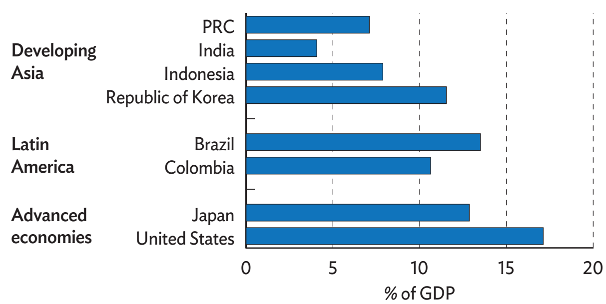
Third, Asian countries need to improve health system governance, accountability, and procurement practices to improve health outcomes from available budgets. This would enable them to magnify the inclusive benefits of public spending on health care without any additional spending. The World Health Organization estimates that 20%–40% of health expenditure is wasted through inefficiency. This estimate points to the very large potential gains to be had from improved efficiency in health care expenditure. Options include greater use of generic drugs and more rational use of medical equipment and diagnostic tests.

Fiscal sustainability is a key concern when expanding public spending on health care. However, the International Monetary Fund (IMF 2010) reported that emerging economies have the fiscal ability to increase health expenditure if it is done in a fiscally sustainable manner and avoids inefficiencies and high costs that even much wealthier advanced economies struggle to manage in recent years. Thailand and Chile have successfully expanded their basic coverage at relatively low fiscal cost, providing models for other countries to emulate.

Direct transfers in developing countries

Across all developing countries, ineffective targeting limits the redistributive capacity of direct transfer programs. Such programs tend to be smaller in developing Asia than elsewhere (Figure 2.2.9). According to Bastagli et al. (2012), they are hard to establish effectively in Asia because a large portion of the economy is informal. Expenditure on social assistance programs for the poor is low and poorly targeted. Heavy government spending on regressive general price subsidies such as for fuel and electricity constrain the fiscal space available for equity-promoting social transfers. Access to social insurance programs such as pensions is often limited to high-income workers in urban areas who enjoyed formal employment and to employees in the public sector. In many developing countries, in-kind public spending on key services such as education is regressive in aggregate, even though individual components, such as primary education, are progressive (Davoodi et al. 2010, Lustig et al. 2011).

2.2.9 Social protection spending in selected economies, 2010



PRC = People's Republic of China.

Source: ADB estimates based on data from World Bank, World Development Indicators online database (accessed 3 February 2014).

In recent years, conditional cash transfers (CCTs) have emerged as a promising option for magnifying the equity impact of public spending in developing countries. In essence, such programs provide monetary transfers to low-income households in exchange for their investing in the education and health of family members. In developing Asia, CCT programs are found in Bangladesh, Cambodia, India, Indonesia, Nepal, and the Philippines. Through the Pantawid Pamilya CCT program in the Philippines, for example, poor households with children receive education and health grants in exchange for education and health investments. Evidence on the effectiveness of CCT programs in Asia is still limited and mixed (Lee and Park, forthcoming). To cite one shortcoming, many people in Bangladesh fail to participate in CCT programs because the benefits are very meager (Fiszbein et al. 2009).

Compared with Asia, Latin America has much larger and better established CCT programs. In fact, CCTs have become a distinctive and relatively successful form of equity-promoting public spending in Latin America, where 17 countries currently operate them. The two largest and best-known Latin American programs—Brazil's Bolsa Familia ("family allowance") and Mexico's Oportunidades (formerly Progresa)—account for about 20% of the reduction in the Gini coefficient between the mid-1990s and the mid-2000s (Soares et al. 2007). Latin American CCTs tend to be cost-effective, with budgets typically equal to less than 1% of GDP—equal to only 0.4% of GDP in the case of Bolsa Familia. In general, research has found that CCT is a relatively effective form of social assistance for reaching the poor (Fiszbein et al. 2009).

Ultimately, the effectiveness of CCTs depends on exactly how they are put into effect. Program design, implementation, targeting, timing, and benefit amount are what matter (Bazzi et al. 2012). CCT programs in Bangladesh and Cambodia, for example, have several elements in common. Both countries are poor and have only weak administrative capacity. For both programs, the only condition for receiving cash transfers is education—specifically secondary education for girls. Yet their outcomes sharply diverge. Cambodia has deployed careful geographic and proxy means targeting, which is a method for identifying beneficiaries through various proxies such as the type of roof on their home (thatch or corrugated iron) or its floor (dirt or concrete). In this way, Cambodia succeeded in concentrating transfers among the poor. In Bangladesh, the program operates nationally, except in the four largest cities, and is targeted only by gender. That program had only a limited effect on equity and has turned out to be regressive, as the poor enroll at lower rates than other classes.

CCT programs tend to be most effective when they target the poorest households, which otherwise typically lack access to education and health care. Well-designed and implemented CCT programs deliver a double dividend to their beneficiaries: greater access to education and health combined with cash transfers that augment families' purchasing power. The relative effectiveness of CCT further underlines the importance of education and health care toward reducing inequality and promoting inclusive growth.

Finally, however, there is no guarantee that programs that worked well in Latin America will also work well in Asia. Many Asian countries lack a complex administrative structure to monitor a large program. On the other hand, social cohesion is often stronger in Asia than in Latin America, so a simple pilot program that emphasizes the role of the community in implemention could demonstrate an effective approach for Asia.

Spending on physical infrastructure in Asia

Governments tend to be smaller in developing countries, including those in Asia, than in advanced economies. As with government size, most fiscal items' ratio to GDP is lower in developing economies.

An important exception is public gross fixed capital formation, which can be viewed as a rough proxy for physical infrastructure: communications, electricity supply, water supply and sanitation, and transportation. Since 2000, the average ratio to GDP of public gross fixed capital formation in ADB member countries has been 7.7%, which is much higher than the 4.3% average for OECD members (Hur, forthcoming). Developing countries tend to allocate their limited fiscal resources to building up infrastructure that supports economic activity and growth.

Good infrastructure supports economic growth for several reasons. A good road network and a reliable electricity supply raises productivity across industries and firms and, hence, for the economy as a whole. In addition, as Winters (forthcoming) points out, infrastructure-dependent trade offers large potential gains both within an economy and across borders. The empirical literature broadly supports the view that infrastructure investment boosts growth, especially in developing countries with modest infrastructure (e.g., Easterly and Rebelo 1993, Arslanalp et al. 2010). On the other hand, the relationship between infrastructure and inequality is more ambiguous. Empirically, a significant study of the infrastructure–inequality nexus is Calderon and Serven (2010). Using data from 1960 to 2005 on more than 100 countries, the authors find that both the quantity and quality of roads, telecommunications, and electricity supply have significant beneficial effects on both growth and inequality. For inequality, a highly relevant additional finding is a significant relationship between inequality and access for the poor to infrastructure.

The analysis in Hur (forthcoming) does not find a significant link between public gross capital formation and changes in the Gini coefficient, but it does find a strong growth impact. Simulation results indicate that a one-time increase by 1 percentage point of GDP in public investment spending raises GDP growth by a cumulative 1.3 percentage points over 7 years. Growth is needed to successfully reduce poverty. For example, Kraay (2006) finds that cross-country differences in the growth of average incomes explain 60%–90% of their differing pace of poverty reduction during 1970–2005, making per capita income growth the single biggest determinant of success in eliminating poverty.

Winters (forthcoming) provides some possible explanations for the failure of studies to find a positive direct effect from physical infrastructure on inequality. In particular, he points out that infrastructure can exacerbate inequality, partly from its unfair

2.2.2 Access to infrastructure by income quintile (% of population receiving services)

	Electricity		Water		Sanitation		Telephone	
Country group	Poorest quintile	Richest quintile	Poorest quintile	Richest quintile	Poorest quintile	Richest quintile	Poorest quintile	Richest quintile
Low	9.7	68.7	41.1	78.5	27.2	68.8	3.2	24.5
Lower-middle	79.5	99.3	64.5	86.6	48.2	78.7	21.2	66.1
Upper-middle	81.4	99.5	76.7	95.0	73.4	96.4	32.0	73.1

Source: Estache and Fay 2007.

allocation but also because the better off are better positioned to take advantage of the economic opportunity it creates. Similarly, Estache and Fay (2007) show that access to infrastructure is highly skewed against the poorest, as is evident in Table 2.2.2. This reflects lack of physical access as well as limited affordability. Therefore, maximizing the inclusive impact of infrastructure requires extending access to the poor and making it affordable to them.

The location of infrastructure development is determined by political influence. Even if it is nearby, service charges may be too costly for the poor. As a result, as Winters notes, the poor are often unable to reap much benefit from infrastructure unless its development is accompanied by complementary policies that require policy makers to identify why the poor fail to benefit in the first place. Finally, sound regulation is key to successful infrastructure programs.

Benefit incidence and the need for better targeting

The evidence presented to this point suggests that spending on education, health care, and direct transfers can combat income inequality in broad terms. Yet the impact for individual poor households depends on benefit incidence, or how public expenditure is distributed across different demographic groups. How much of the spending reaches the poor? Targeting to better channel a larger share of the benefits to the poor can amplify the impact that spending has on inequality. The evidence from Asia underscores the need for more effective targeting.

Benefit incidence from public spending in the PRC

Public spending programs have the power to level the playing field by broadening access to basic services for disadvantaged groups. But the extent to which programs succeed depends crucially on the distribution of benefits across income groups. A fiscal program can be said to be progressive if the benefits accrue disproportionately to poorer households; it is regressive if the benefits accrue disproportionately to the rich. Shifting the composition of spending can magnify the inclusive impact of total spending at no additional cost by simply raising the share of benefits enjoyed by the poor.

The national transfer account framework measures consumption and labor income for each age group, providing a detailed view of who benefits from certain government expenditures (Box 2.2.2). Using this data from the PRC in 2012, Shen and Lee (forthcoming) analyze the benefit incidence of three fiscal programs: education, health care, and pensions. The study looks at the distribution of these benefits across income quartiles—from the poorest 25% of households in the PRC to the richest. The case of the PRC is particularly insightful as the government has made great strides in instituting and improving public programs to provide education, health care, and pensions to the populace.

2.2.2 National transfer accounts

National transfer accounts (NTA) are rooted in the life-cycle hypothesis, wherein individuals plan their consumption and savings over their lifespans, relying on transfers when young, saving money during working years, and drawing down savings in old age. Using household surveys, administrative data from government agencies, and data from the United Nations System of National Accounts, NTAs estimate how much individuals earn and consume at each age and how they finance the difference.

Broadly, financing comes from transfers within the family or from public transfers. Public transfer inflows include benefits in-kind such as education services and cash benefits such as direct income transfers to households. Public transfer outflows consist of taxes and other public revenues. The values of the various public transfer flows are calculated for each age group and adjusted to match actual values of aggregate public spending on education, health care, and direct income transfers available in a reference year (2010 or, in some instances, earlier).

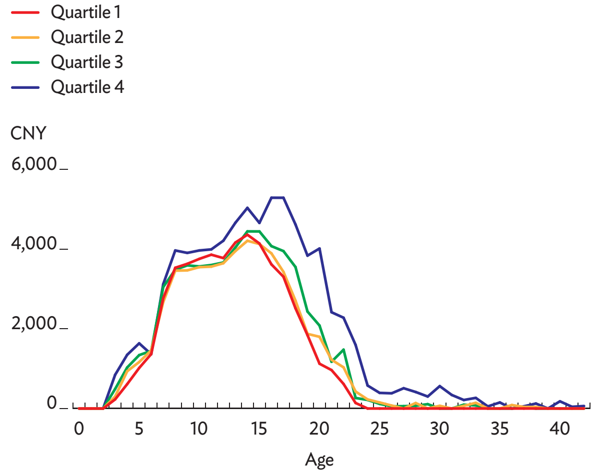
For the PRC, the NTA data combine micro-level household data from the 2010 wave of [People's Republic of] China Family Panel Studies, an annual survey of nationally representative households, and macrolevel data from the System of National Accounts. The 2010 survey covered 25 of 31 provinces and recorded information on adults and children in 16,000 households. The questions covered the detailed data on household structure, income, and expenditures needed to construct the NTA.

With regard to the benefit incidence of education, a number of patterns emerge (Figure 2.2.10). First of all, the top quartile gains more public education resources for children under age 5. This indicates that children from better-off families are more likely to be enrolled in kindergarten. Pre-primary education is not yet compulsory in the PRC, so tuition fees are relatively high. Second, children from families in the top quartile are much more likely than others to go to college. Under earlier central planning, higher education was heavily subsidized (Li et al. 2013). With the scaling up of higher education, the government gradually lowered its subsidies. From 1995 to 2004, college tuition fees increased sharply from an average of CNY800 per student per year to CNY5,000 (Yang 2006). Third, the richest quartile receives the most public education funding for students aged over 25, indicating that this is the group most likely to pursue post-graduate and adult education.

Publicly funded health care is consumed fairly equally across income groups until the age of 60 (Figure 2.2.11). Though higher-income groups may be covered by generous public health insurance, they may also be healthier and thus use less publicly funded health care than the poor. In any case, public health spending per capita is highly skewed in favor of the top quartile for recipients who are age 60 and older. This is largely because the elderly poor are held back from availing themselves of these benefits by three principal factors: health insurance, income, and access. First, an elderly person's health insurance is linked to previous employment in urban China. Those in the top quartile typically serve in the formal sector prior to retirement and are covered by generous health insurance, making them more inclined to seek public health care. Second, health care is a normal good, so the use of public health services will likely increase with income. For instance, in rural areas of the PRC, enrollment in New Rural Cooperative Medical Insurance is found to significantly increase inpatient service utilization only among high-income groups. Third, poor households often live far from high-quality public health institutions, so obtaining health care entails long journeys and high opportunity cost (Castro-Leal et al. 1999).

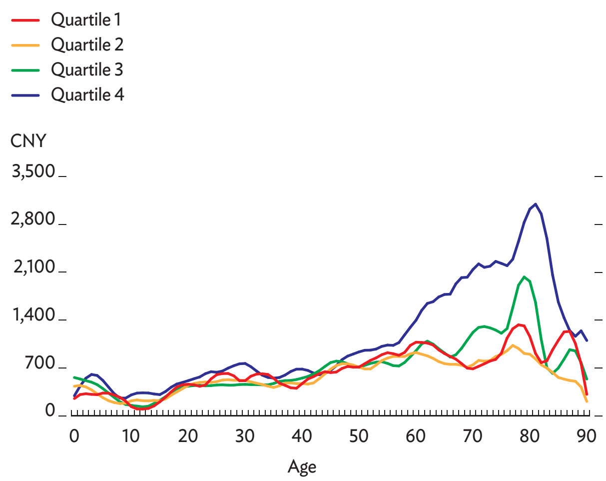
In contrast to public spending on education and health care, public pensions are strongly regressive, with older people at the top of the income distribution enjoying much higher pension benefits (Figure 2.2.12). On average, those aged 75 and in the top quartile receive a pension of CNY11,793, those in the second quartile CNY4,000, and those in the bottom quartile less than CNY250. This is partly because the PRC pension system combines public funding with personal contributions; as employees in the richest group paid higher contributions during their working life, they are entitled as retirees to higher pensions. Another factor is that the vast majority of pension benefits go to urban residents, whose average per capita income was

2.2.10 Per capita public education spending by income quartile, 2010



Source: Shen and Lee, forthcoming.

2.2.11 Per capita public health care consumption by income quartile, 2010



Source: Shen and Lee, forthcoming.

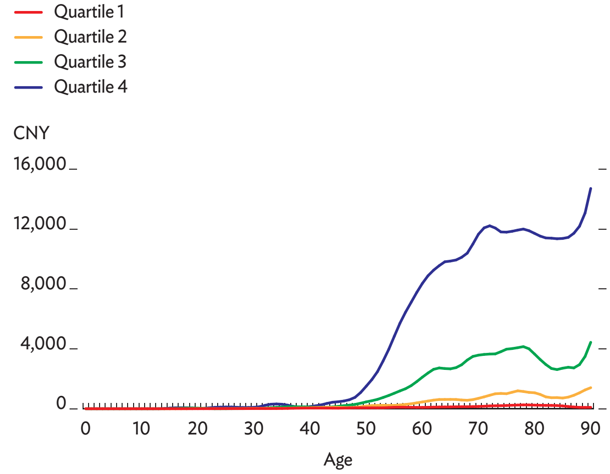
3 times that of rural residents in 2009: CNY17,174.7 versus CNY5,153.2. The top income quartile lives predominately in urban areas and therefore enjoys higher pension benefits.

Public spending on these social services varies markedly by age across income groups (Figure 2.2.13). Public spending per child accounts for 45.5% of public social spending on the bottom quartile, almost twice the share of the elderly. By contrast, for the top quartile, the share of public spending going to the elderly is more than twice the share going to children. This suggests that, among higher-income groups, the public sector is responsible for the sustenance of the elderly, and that families remain largely responsible for childrearing.

Equitable incidence can be examined not only by income group but also by gender and place of residence, urban or rural. For example, if fiscal spending favors men and urban areas, it exacerbates the male–female and urban–rural income gap. Shen and Lee (forthcoming) find that public spending on primary and secondary education are equally distributed by residence, gender, and income group, but that spending on tertiary education favors city dwellers, women, and the rich. Public health-care programs tend to target the young and middle aged equally in different socioeconomic groups but tilt toward urban residents, men, and higher-income groups for senior recipients. Public pensions show similar bias, with rural residents, women, and lower-income groups benefiting less.

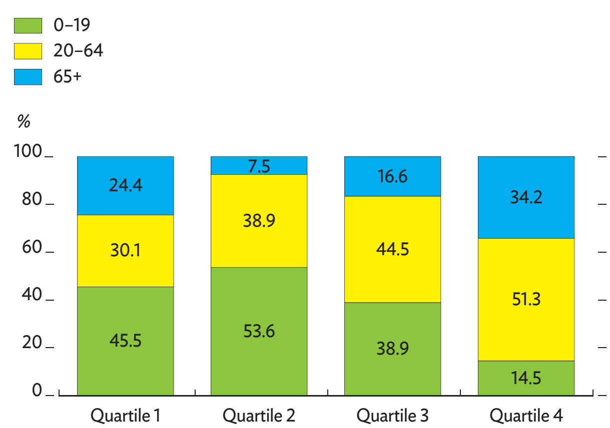
Benefit incidence analysis uncovers significant disparities in the distribution of public transfers across different population groups in the PRC. In particular, the elderly poor and elderly rural residents rely heavily on transfers from their children to cover their living and medical expenses. With declining fertility and burgeoning migration, the erstwhile strong family network is ebbing, along with the private transfer system it supported. If the disadvantaged elderly are not well targeted by government programs, inequality worsens. More generally, analysis suggests that benefit incidence is a central determinant of a government program's equity-promoting effect. Benefit incidence must therefore be a major consideration in the design and implementation of any government program that aims to tackle inequality.

2.2.12 Per capita public pension spending by income quartile, 2010



Source: Shen and Lee, forthcoming.

2.2.13 Age distribution of public social spending by income quartile, 2010



Source: Shen and Lee, forthcoming.

Reforming energy subsidies in Asia

Fuel and electricity subsidies provide further evidence of the centrality of benefit incidence in determining how inclusive fiscal spending is. The governments of many developing countries, including those in Asia, provide significant energy subsidies for consumers. The underlying rationale is that fuel and electricity are basic necessities to which everybody is entitled. Despite such benign intentions, the subsidies often end up offering very little if any positive effect on equity, as a large share of the benefits accrue to the better off. Further, such subsidies are often costly and undermine fiscal health and sustainability.

A number of studies indicate that fuel subsidies primarily benefit upper-income groups. In Indonesia, more than 90% of fuel subsidies benefit the richest urban households (Agustina et al. 2008). In India, the richest 10% of households receive 7 times more benefit than the poorest 10% (Anand et al. 2013). This is because fuel consumption tends to rise substantially in tandem with income, so general subsidies will benefit poor households the least (Hope and Singh 1995). In low- and middle-income countries, the richest 20% of households capture, on average, 6 times more in fuel product subsidies than the poorest 20% (IMF 2013). In short, there is significant evidence that fuel subsidies fail to promote equity.

In addition, providing energy subsidies imposes significant fiscal costs on Asian governments. In 2008, subsidies for coal, refined petroleum products, natural gas, and electricity were equivalent to about 3%–8% of GDP in India, Indonesia, Malaysia, Pakistan, Thailand, and Viet Nam (Burniaux and Chateau 2011). Many countries have since embarked on fuel and electricity subsidy reform—notably Indonesia and Malaysia last year—or are seriously considering doing so. However, such reform will be politically challenging in light of its large immediate welfare costs (Table 2.2.3).

2.2.3 Direct and indirect welfare losses from fuel price increases (% of household consumption)

Region/Country	Direct impact	Indirect impact
Africa	2.0	3.8
South & Central America	1.4	2.4
South & Southeast Asia	3.9	2.1
Bangladesh	1.7	1.5
Sri Lanka	2.7	2.6
Cambodia	2.2	na
India	3.6	na
Indonesia	8.8	na
Middle East & Central Asia	5.8	4.2
All regions	2.8	3.3

na = not available.

Note: Examples of direct impact are higher prices for fuels used for cooking or lighting. Indirect impact occurs as prices for other goods and services rise because of higher production costs associated with more costly fuel.

Source: del Granado et al. 2010.

The impact of fossil fuel subsidy reform depends on a country's circumstances regarding the extent and type of subsidies being reformed, the size of the economy, and the proportion of income spent by different income groups on subsidized energy. Yet governments generally do not estimate subsidies systematically, nor do they make the data available. To get a clear view of the impact, a bottom-up approach is needed, methodically identifying and quantifying many subsidies that are often hidden (Box 2.2.3).

The findings underline how reallocating subsidy expenditure to shield the poor from higher energy prices can use public resources more efficiently and have significantly more progressive social and economic outcomes. Even greater benefits can be achieved by targeting subsidy spending on areas that best safeguard household welfare and stimulate business, economic growth, and job creation. On the other hand, fully compensating the bottom 40% is easier modeled than done. Problems with targeting and program administration mean that many existing safety nets may not be able to protect the poor. It is thus important to examine safety net policies in each country and international best practices to protect the poor during subsidy reform.

Overall, the results show that policy makers can use public spending to reverse widening inequality. Yet inclusive spending is not just about spending more, but spending wisely. Eliminating costly general subsidies in favor of targeted subsidies can make current spending levels more inclusive. Prioritizing programs that benefit the poor, such as primary education and basic health care, can maximize the equity-promoting impact of additional spending. But spending is only half of the fiscal story. How can governments use their revenue policies to promote inclusive growth?

2.2.3 The costs of energy subsidies and their reform

ADB (forthcoming) inventoried fossil fuel and electricity studies in India, Indonesia, and Thailand. These three economies have quite different underlying circumstances, and each has taken a unique approach to subsidies and attempts to reform them. These full inventories provide the most comprehensive, accurate, and up-to-date estimates of fossil fuel subsidies in the three countries (Box table). While the estimates are higher than official government estimates, total subsidy values are likely to be even higher, as some subsidies could not be quantified, and producer subsidies were calculated for only one energy type.

The subsidy estimates were used to analyze the economic impacts of hypothetical subsidy reform using economic models. For each country, a social accounting matrix—a representation of all transactions and transfers in an economy—was first used to analyze the direct impacts of increased prices for fossil fuels and electricity on macroeconomic indicators, economic sectors, and households. Changes made in one part of the model, such as higher energy prices, flow through to other parts of the model, affecting sectors according to how they are assumed to be interrelated.

The analysis showed that a 20% reduction in subsidies with no other changes to government spending or revenue would cause GDP contraction, compared with a baseline business-as-usual scenario, ranging from 0.4% in Thailand to 1.5% for Indonesia. Sectoral price impacts, such as on transport, had the biggest effect on households that spent the most on those sectors.

However, the impact of subsidy reform on the economy is muted if some of the savings are used to fully reimburse households in the bottom 40% for the higher energy prices. These scenarios projected that the reallocation of subsidy savings would be enough to offset losses and create significant social and economic benefits. Despite only the bottom 40% being compensated, all households are projected to benefit from stimulated demand and more efficient allocation of resources.

References

ADB. Policy Report: Forthcoming. Fossil Fuel Fubsidies in Asia–Trends, Impacts and Reforms. Manila: Asian Development Bank.

Summary of consumer and producer subsidies identified for each country (latest year)

		India		Indonesia		Thailand	
Subsidy type	Energy type	2011[a] ($ million)	% of total subsidies	2012 ($ million)	% of total subsidies	2012 ($ million)	% of total subsidies
Consumer	Petroleum	27,923	57	24,595	68	6,077	87
	Natural gas	85	0.2	374	1	714	10
	Coal	7,288	15	0	0	0	0
	Electricity	13,486	27	11,034	30	184	2.6
	Consumer subsidy total	48,782	99	36,002	99	6,975	99
Producer	Natural Gas for Vehicles	nq	nq	46	0.70		
	Coal	208	0.4	nq	nq	21.2	66.1
	Electricity	nq	208	0.6%	nq	32.0	73.1
Total fossil fuel subsidies ($ million)		48,990		36,210		7,021	
% of GDP		2.66		4.12		1.92	

[a] Fiscal year ending 31 March 2013.

0 = no subsidies identified, nq = not quantified.

Notes: All policies that favor fossil fuels were captured, including direct transfers of funds, foregone revenue, the provision of goods or services, and income or price support. Externalities and optimal taxation rates were not assessed. Subsidy data were drawn from government budgets and financial statements or, where necessary, estimated. Producer subsidies were calculated for only one fuel in one area of the upstream energy supply chain in each country, for lack of resources to identify and quantify more such subsidies.

Source: ADB, forthcoming.

Public revenues to safeguard fiscal sustainability

While the evidence presented above shows that public spending can promote more inclusive growth, increased spending could jeopardize fisc al sustainability and macroeconomic stability if not balanced by increased revenues. A history of fiscal prudence has endowed much of the region with seemingly adequate fiscal space at present. However, the current availability of fiscal space does not guarantee its availability in the years ahead. Aging populations in many Asian countries are likely to have greater needs for public health services, to cite probably the biggest challenge.

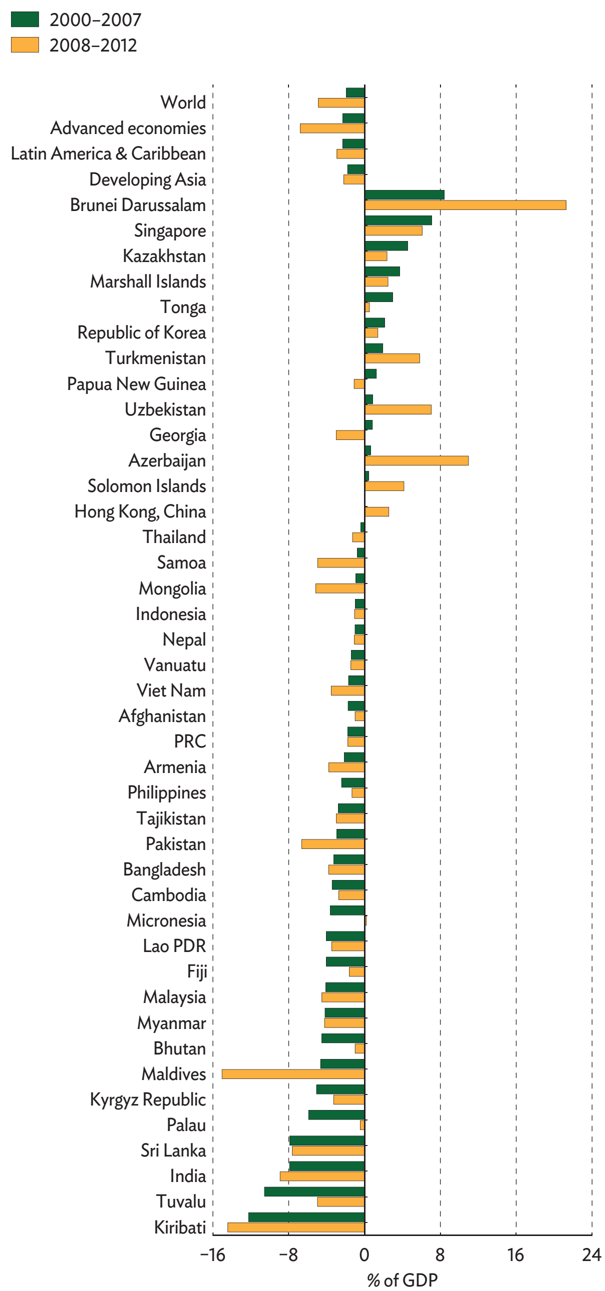
Meeting such future challenges will entail fiscal demands that compete for the same public resources needed to reduce inequality. Unfortunately, fiscal revenue intake has been more limited in Asia than in other parts of the world. The region needs to explore the full array of revenue options to secure the robust resource base needed to fund equity-promoting spending, meet future challenges like population aging, and maintain the prudent fiscal policy that has helped promote macroeconomic stability.

Developing Asia's current and future fiscal space

Fiscal space refers to the government's capacity to deploy fiscal resources for short-term purposes (such as to counteract macroeconomic shocks) and to satisfy long-term needs (such as maintaining public infrastructure) without jeopardizing fiscal sustainability. A country's current fiscal position is a consequence of past patterns of public expenditures and revenues.

With some exceptions, the examination of developing Asia's past fiscal behavior confirms a generally conservative stance. As in other parts of the world, the region's fiscal position has weakened since the global crisis forced governments to implement fiscal stimulus to prop up demand and encourage growth during the crisis (ADB 2010). There is considerable diversity in countries' fiscal balance in the region, with some countries running sizable deficits. The deficit countries include some large economies such as India and Pakistan. Generally speaking, though, the fiscal position of many countries in the region, and of the region as a whole, is healthier than elsewhere in the world.

2.3.1 Average fiscal balance of selected economies (% of GDP)

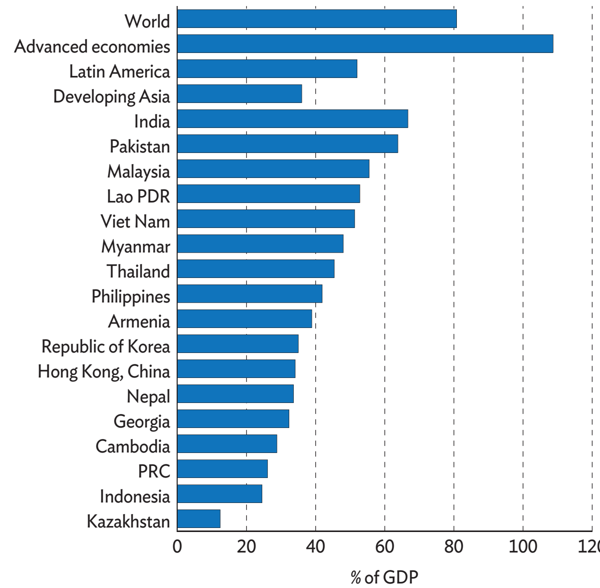


Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Source: IMF World Economic Outlook database, October 2013.

Interestingly, the fiscal health gap between the region and the rest of the world seems to have widened since the global crisis (Figure 2.3.1).

Prudent fiscal behavior in the past means that government debt is low in much of developing Asia relative to the rest of the world (Ferrarini et al. 2012). This is a predictable and natural consequence of the fiscal prudence that characterized many Asian countries in the past. The region's ratio of debt to GDP compares favorably with that of other regions and the world as a whole (Figure 2.3.2). Even taking into account that a debt ratio considered sustainable for a developing country is lower than for an advanced economy, developing Asia's low ratio bodes well for its fiscal sustainability and fiscal space. However, the large economies of India and Pakistan are among those that stand out as exceptions, needing to make concerted efforts to improve their fiscal health and secure the finances required to invest in inclusive growth.

2.3.2 Gross government debt in selected economies, 2012 (% of GDP)



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Source: IMF Fiscal Monitor, October 2013.

While it may seem that many countries in developing Asia have sufficient fiscal space to expand government expenditure for inclusive growth, current fiscal space is no guarantee of future fiscal space. The size and mix of fiscal expenditures reflects income levels and economic structures that necessarily evolve over time. Developing Asia faces potentially significant fiscal demands from a wide range of structural challenges. For one, as income rises, public spending and government size tend to rise too. This helps to explain why governments are larger in advanced economies than in developing countries: demand for many public goods rises with income. Demand for a cleaner environment, for example, tends to intensify with higher average incomes, so a better-off populace may expect its government to invest more public resources to protect the environment.

But perhaps the single biggest social and economic shift facing developing Asia is population aging. Despite considerable demographic diversity, the region as a whole is in the midst of a shift toward older populations. Demographic structures affect public spending because the beneficiaries are often children and the elderly, as shown in *Benefit incidence and the need for better targeting*. National transfer account data (described in Box 2.2.2 above) lends itself to studying the effect aging has on the fiscal position as it estimates flows between households and the government by age group. Using this data for seven low- to middle-income Asian economies (Cambodia, the PRC, India, Indonesia, the Philippines, Thailand, and Viet Nam) and four higher-income regional economies (Australia, Japan, the Republic of Korea, and Taipei,China), UN population projections by age group (United Nations Population Division 2013), and GDP forecasts, Lee and Mason (forthcoming) project government spending for education, health care, and social protection in developing Asia until 2050. The projections use the recent spending in higher income countries as a guide to how spending is likely to change in the lower-income group as their incomes rise.

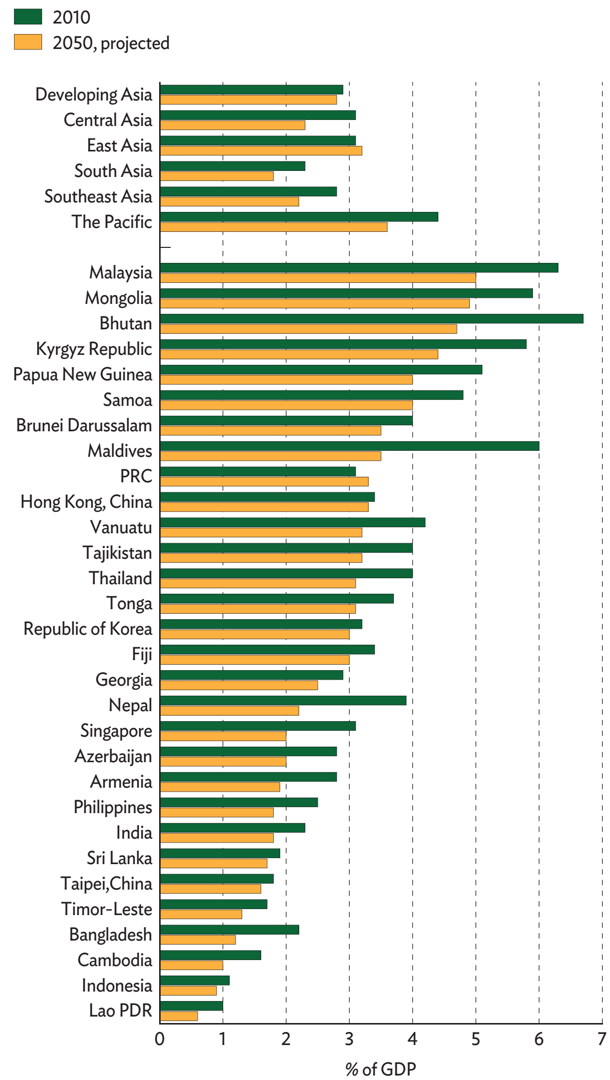
As Asian populations age from 2010 to 2050, public spending on education is expected to decline (Figure 2.3.3). In 2010, public education spending averaged 3.5% of GDP, ranging from 1.6% to 6.7%. By 2050, the average is projected to fall to 2.7% of GDP, ranging from 0.6% to 5.0%. This is calculated using a simple average of country values. A regional calculation weighted by GDP shows the share of education falling from 2.9% of GDP to 2.8%. The projected decline in education spending is driven by fertility decline and the consequent decline in the school-age share of population. The rate of spending decline varies across subregions, with the greatest declines projected for South Asia and Southeast Asia. Note that this is public spending only; in some Asian economies—such as the PRC, the Republic of Korea, and Taipei,China—private spending on education is quite substantial.

Projected health spending contrasts dramatically with projected education spending (Figure 2.3.4). Unlike for education, demographic change and economic growth both push health-care spending higher. As populations age, the share of older age groups increases, and they require higher health-care spending. At the same time, higher per capita income should push per capita spending on health care higher, particularly for older age groups. In no country is the share of GDP devoted to health care projected to decline. The simple average increases from 2.9% of GDP in 2010 to 4.7% in 2050. The GDP-weighted share rises even more sharply, from 2.4% of GDP in 2010 to 7.3% in 2050.

The rise in publicly funded health-care spending in East Asian economies is particularly dramatic, with the average share of GDP rising from 3.0% in 2010 to 9.7% in 2050. In the PRC, the projected rise is from 2.7% to 9.8%. These increases reflect the particularly rapid aging anticipated in East Asia, combined with high rates of economic growth anticipated for the PRC. And, outside of East Asia, a number of other countries in the larger region—Azerbaijan, Bhutan, Brunei Darussalam, Kazakhstan, Malaysia, and the Maldives—are expected to more than double the percentage of GDP devoted to health care.

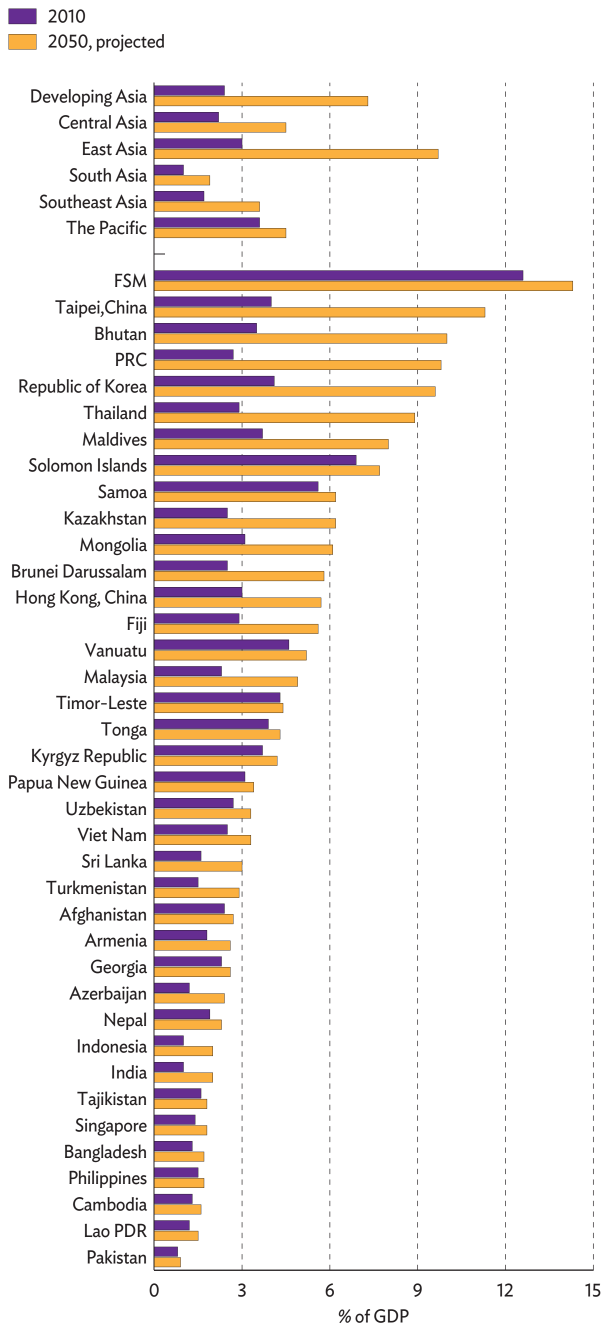
Among the public expenditure items studied, aging wields the biggest fiscal impact on social security and welfare (Figure 2.3.5). For developing Asia as a whole, using simple averages, the percentage of GDP devoted to social security and welfare is projected to rise from 2.8% in 2010 to 4.9% in 2050. The GDP-weighted figure rises from 2.5% to 6.7%. However, the importance of social security and welfare spending varies considerably from country to country, currently and in the future. Spending is relatively high in the region's higher-income developing economies. Spending in the Republic of Korea is expected to reach 12.0% by 2050, and in Taipei,China 10.5%. These values represent significant growth in spending in these countries, but they still fall well short of values for Japan: 17.0% in 2010 and 21.0% in 2050. These

2.3.3 Current and projected public spending on education, developing Asia



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Note: The figures for developing Asia and subregions are weighted for GDP.
Sources: ADB Key Indicators; ADB estimates.

2.3.4 Current and projected public spending on health, developing Asia

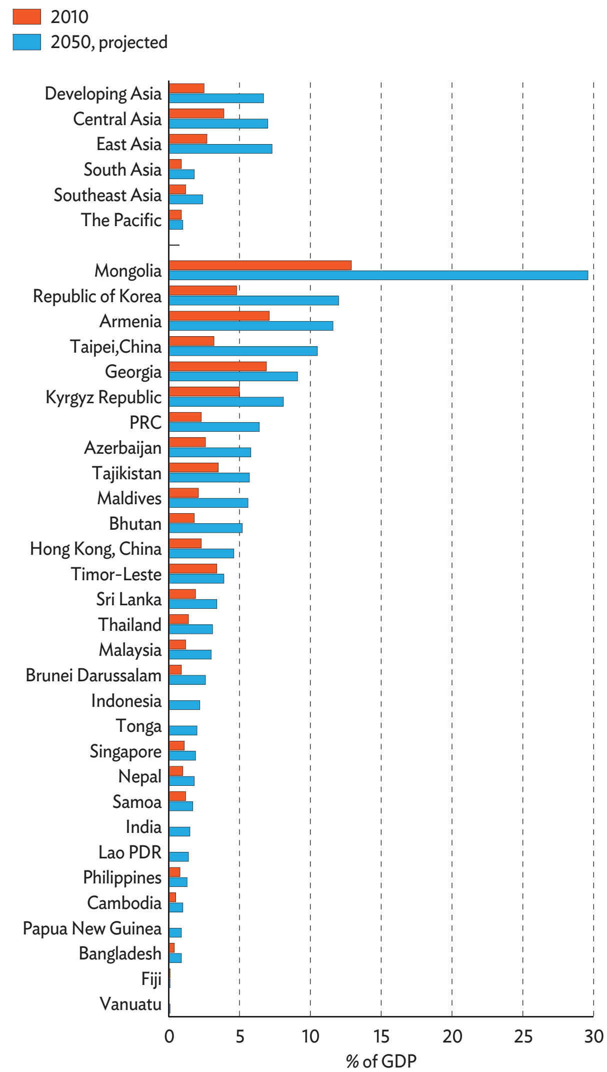


FSM = Federated States of Micronesia, Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.

Note: The figures for developing Asia and subregions are weighted for GDP.

Sources: ADB Key Indicators; ADB estimates.

2.3.5 Current and projected public spending on social security and welfare, developing Asia



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.

Note: The figures for developing Asia and subregions are weighted for GDP.

Sources: ADB Key Indicators; ADB estimates.

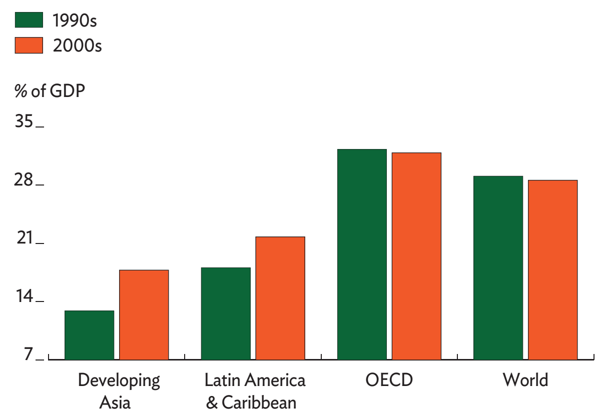
projections may be conservative, as many countries have relatively underdeveloped public pension systems. Should they choose to introduce these schemes in the future, public spending could rise much more rapidly than projected here.

The demands that rising age structures and incomes alone will place on public spending programs will encroach considerably on Asia's fiscal space. Yet the analysis in Lee and Mason (forthcoming) is only part of the story and may understate future demands. The estimates use Asia as a benchmark, but as discussed in *The emerging case for inclusive fiscal policy*, the region underspends on public education, health care, and direct transfers when compared with the rest of the world. This is yet another reason why Asian countries should not take for granted that fiscal space will be available tomorrow just as it is today. Governments need to find ways to make their revenue systems more productive if they are to take a more active role in combating widening inequality.

Overview of Asia's revenue systems

To maintain fiscal space as spending needs expand, developing Asia needs to raise more public revenues. As with spending, Asia lags other world regions on the revenue front (Figure 2.3.6). Revenue from taxes in developing Asia remains, despite improvement, at barely half the average in members of the Organisation for Economic Co-operation and Development (OECD). The tendency of government to expand in tandem with per capita income explains some of the gap with the OECD, but fiscal revenue mobilization in Asia also lags Latin America. This gap with peers in Latin America suggests considerable scope for developing Asia to improve revenue mobilization. Understanding key features of the region's current revenue systems will help clarify policy direction.

2.3.6 Tax revenues in developing Asia, Latin America, and the OECD



Note: Data are weighted averages.

Source: ADB estimates based on data from the International Monetary Fund Government Financial Statistics Database.

Growth and the equity effects of fiscal revenues

Government revenues can help reduce inequality through four channels. First is the indirect effect that fiscal revenues have by funding expenditures that promote equity. The main issue related to this role is the economic cost associated with raising different types of resources. Second is the direct effect on inequality when a revenue source is itself an instrument of redistribution. Progressive income tax, under which tax rates rise with income, is the prime example, but such taxes can entail a trade-off sacrificing growth for equity. Third, some revenue instruments are deployed to curb activities with harmful social consequences. Taxes such as environmental levies have a double dividend in that they raise revenue while curtailing socially undesirable activities.

The fourth channel pertains to revenue administration. Whatever the intrinsic potential of a particular revenue instrument to promote equity, how efficiently it is administered will have its own effect. For example, tax administration that demands onerous bookkeeping or filing procedures imposes burdens on firms that are particularly heavy for small businesses. Such ill-conceived administration raises the tax agency's collection cost as well as the taxpayer's compliance cost. Complex tax laws subject to frequent, arbitrary changes similarly add to taxpayer costs and may incite tax disputes and litigation, which generate additional legal costs. By contrast, streamlining procedures and making them more transparent, such as through the greater use of information and communication technology, can reduce costs for tax authorities and taxpayers alike.

The two main fiscal resources are tax and nontax revenues. As Das-Gupta (forthcoming) points out, governments have other resource-generating options—such as issuing debt or receiving foreign aid—but the analysis presented here will focus on these two sources. In general, taxes on domestic and international goods and services are the most widespread, followed by individual and corporate income taxes, though there is some variance from this norm. The governments of some countries rich in publicly owned resources, for example, rely mainly on income from the sale of resources or their use rights. Nontax revenues arise mainly from the sale of government goods or resources and income from publicly owned assets.

Growth and distribution effects vary across tax types, as detailed in the Annex at the end of the chapter. Among broad-based taxes, property tax is the least harmful to economic growth, followed by consumption tax and personal income tax, with corporate income tax dampening growth the most (McBride 2012). Since property tax is also likely to be progressive, because the rich tend to have greater property holdings than the poor, raising revenue through this source can reduce inequality without undermining growth.

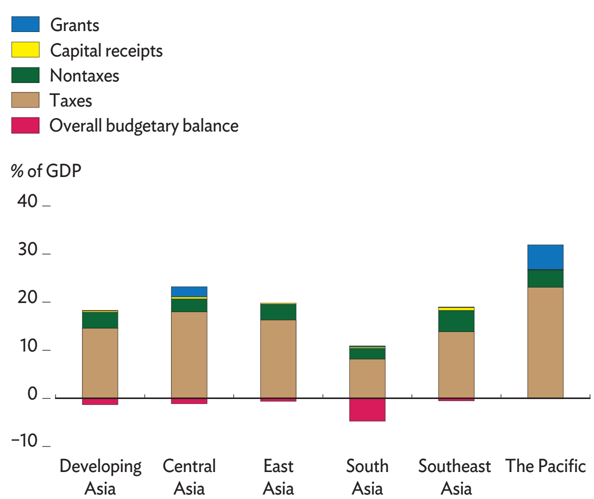
Empirical analysis of Asian countries confirms that the composition of tax structure matters for growth. Abdon et al. (forthcoming) simulate the impact of tax composition changes on growth in developing Asia and find that reducing reliance on income tax while raising reliance on consumption and other taxes can raise GDP growth over the long run. The IMF (2014) points out that different taxes have different effects on equity, so how the tax structure mixes resources matters for equity. For example, as taxes on wealth, especially property, are progressive, expanding them can make the tax system more progressive.

Developing Asia's fiscal revenues

For developing Asia as a whole and across all of its subregions, taxes are the primary sources of fiscal revenues (Figure 2.3.7). Current revenues provide the vast majority of the region's fiscal revenues, and taxes dominate them. The share of taxes is higher in some subregions than others, but in no subregion of Asia and the Pacific does the share of taxes fall below 75%.

Within this broader region-wide picture of the primacy of current revenues and taxes, some interesting differences distinguish subregions and countries, as detailed by Das-Gupta (forthcoming). For example, grants contribute

2.3.7 Average resource positions in developing Asia, 2005–2011



Note: The average for any country without data for part of 2005–2011 is for available years. No data are available for Nauru, Palau, Tonga, or Turkmenistan.

Source: ADB estimates based on data from the Asian Development Bank's Statistical Database System (accessed 14 August 2013) except GDP for Malaysia, from World Bank World Development Indicators (accessed 14 August, 2013).

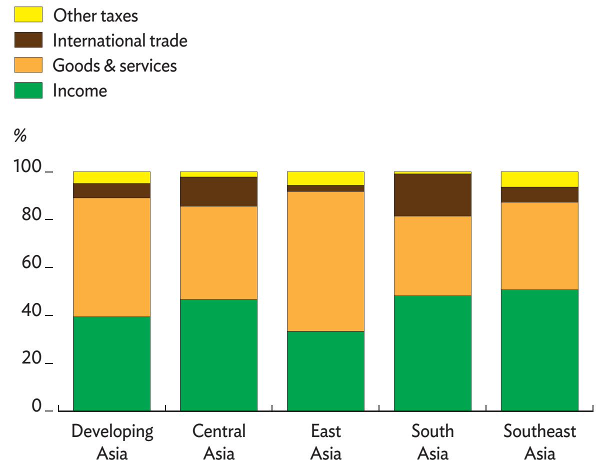
relatively strongly to fiscal revenue in the Pacific and Central Asia (Figure 2.3.7). Countries that use grants as a major revenue source include Afghanistan, Bhutan, Papua New Guinea, and many Pacific island states. The share of grants in revenue is 14.9% in Papua New Guinea, 38.5% in Bhutan, 53.2% in Afghanistan, and even higher in some Pacific island economies. While tax revenues are the primary current revenues, nontax revenues are a significant revenue source across the whole region—but for different reasons. Resource dependence is clearly the reason for the high nontax revenue share in oil-rich Brunei Darussalam (providing 54.2% of total revenue) and some Pacific economies. On the other hand, corrective and other deliberate policy is likely the reason for the relatively high nontax revenue share in Singapore.

Taxes on goods and services and tax on income are the two main sources of tax revenue in developing Asia. Figure 2.3.8 shows the composition of tax revenue for the region as a whole and its subregions in 2005–2011.

The relative contribution of the major tax groups follows the expected pattern in developing countries. Taxes on goods and services contribute the largest share region-wide, closely followed by tax on income. Taxes on goods and services are especially preponderant in the large and heavily weighted East Asia subregion but, in Central Asia, Southeast Asia, and South Asia, somewhat less important than tax on income. International trade taxes have declined in importance in developing countries following trade liberalization and tariff reduction through the World Trade Organization (Bahl and Bird 2008). Among country-specific differences, India and Indonesia stand out for their high dependence on income tax (Das-Gupta, forthcoming). Taken together, taxes on goods and services and tax on income dominate developing Asia's tax revenue landscape.

Comparing developing Asia's fiscal revenue base with that of Latin America and the world, three noteworthy patterns emerge (Table 2.3.1). First, as noted above, developing Asia's fiscal resource base is relatively limited. Second, in developing Asia the share of taxes in total fiscal

2.3.8 Contribution of major tax groups to revenue, 2005–2011



Source: ADB estimates based on data from World Bank, World Development Indicators online database (accessed 27 February 2014).

2.3.1 Revenue sources in developing Asia, Latin America, and the world, 2005–2011 (% of GDP)

Type of revenue	Developing Asia	Latin America & Caribbean	World
Revenue, excluding grants	14.5	23.9	19.5
Tax revenue	11.3	15.6	12.7
Taxes on income, profits, and capital gains	4.5	6.4	7.1
Taxes on goods and services	5.6	7.2	4.4
Taxes on international trade	0.7	0.7	0.7
Other taxes	0.6	1.3	0.5
Nontax revenue	2.5	5.4	4.5
Grants and other revenue	3.1	4.5	3.0

Note: Some nontax revenue sources such as fines and penalties are included as "other revenue" in the World Development Indicators classification system.
Source: ADB estimates based on data from World Bank. World Development Indicators online database (accessed 27 February 2014).

revenues is higher, and the share of nontax revenues lower, than in Latin America and the world as a whole. Finally, the share of income taxes in total tax revenues is lower in developing Asia than in other parts of the world, and the share of taxes on goods and services is correspondingly higher.

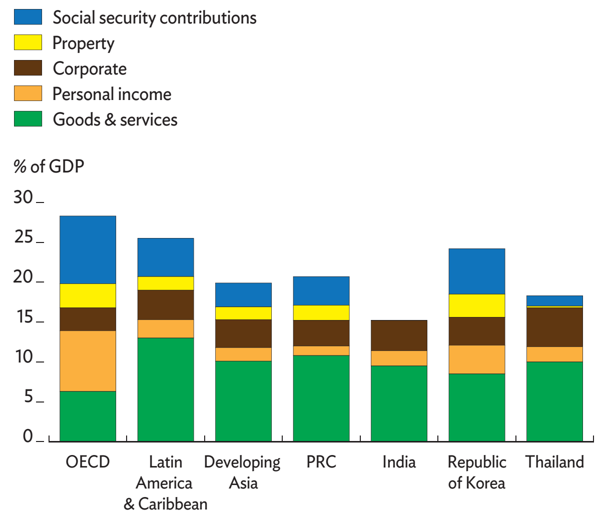
The highly aggregated presentation of fiscal resource categories presented so far has precluded a look at the relative importance of tax subcategories such as on property, corporate income, and personal income. This matters because different taxes affect growth and equity differently, as detailed in the Annex. Although narrower in country coverage—covering only 8 developing Asian economies among the 41 countries included in the analysis above—the IMF's *Government Financial Statistics* database contains data with finer disaggregation of tax revenue categories.

Figure 2.3.9 shows the GDP share of corporate income tax, personal income tax, indirect tax, property tax, and social security contributions in the OECD, developing Asia, and Latin America and the Caribbean. Predictably, the sum of the five taxes is lower for Asia than for the OECD or Latin America. The regional figures are weighted by GDP of member economies. The share of property tax in Asia is only a shade below the share in Latin America but barely half the share in the OECD. Asia's corporate income tax rate stands at a tad below the share in Latin America but above the OECD's share. Social security contributions are lower in Asia than in the other two groups. Personal income tax in Asia is somewhat lower than in Latin America and much less than in the OECD. Finally, indirect taxes are lower in Asia than in Latin America but higher than in the OECD. All in all, the figure confirms that indirect taxes are more important than income taxes in developing countries, but the opposite holds for the OECD. It also confirms that social security systems are most developed in the OECD and least developed in Asia.

The four major developing Asian economies in the IMF data display common elements and differences. Indirect tax is the single most important fiscal revenue instrument in the PRC, India, the Republic of Korea, and Thailand. Corporate income tax is also a major instrument in all four countries. Property tax is less important, to the point of being negligible in India and Thailand, but significant in the Republic of Korea, which is consistent with property tax requiring strong tax administration. Personal income tax is much less important than corporate income tax in the PRC, India, and Thailand, but in the high-income Republic of Korea it brings in slightly more than corporate income tax. Social security contributions are notably larger in the PRC and the Republic of Korea than in India and Thailand, reflecting more developed social security systems in the two East Asian countries.

The overview of developing Asia's fiscal revenue systems suggests some broad policy directions for achieving a more secure fiscal revenue base. The dominant role of taxes in the region's fiscal revenues suggests that the key to revenue mobilization lies in strengthening and reforming the region's tax systems. However, the composition of revenue sources

2.3.9 Tax composition in developing Asia, Latin America, and the OECD, 2010



OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

Note: Developing Asia includes Afghanistan; Armenia; the PRC; Hong Kong, China; India; the Republic of Korea; Mongolia; and Thailand. Latin America & Caribbean comprises Barbados, Brazil, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Jamaica, Paraguay, Peru, Trinidad and Tobago, and Uruguay. The OECD consists of Australia, Belgium, Canada, France, Greece, Iceland, Israel, Japan, Luxembourg, Norway, Poland, Portugal, Slovenia, Spain, Switzerland, and the United States.

Source: ADB estimates based on IMF *Government Financial Statistics* Database.

affects growth and income inequality. Given the current revenue structure in the region, how can policy makers generate the additional resources needed to maintain prudent fiscal policy while also fostering inclusive growth?

Options to expand developing Asia's fiscal revenues

In light of the region's huge economic and fiscal diversity, there can be no one-size-fits-all sustainable path to resource expansion, so policy priorities will necessarily differ across countries. However, policy makers will choose from the same menu of options to find a mix of revenue sources that generates sufficient resources, does not unduly hamper growth, and promotes equity or is at least equity-neutral. Greater mobilization of fiscal revenues requires exploring all possible sources. Options include broadening the base for personal income tax (PIT) and value-added tax (VAT), enlarging corrective taxes and nontax revenues, and introducing naturally progressive taxes on property, capital gains, and inheritance.

Broadening income and value-added tax collection

The evidence in *Overview of Asia's revenue systems* indicates that income taxes and taxes on goods and services provide the bulk of tax revenues in developing Asia. This makes doing a better job of collecting these two types of taxes the best point of departure for improving revenue mobilization in the region. Among income taxes, PIT is found preferable to corporate income tax because it is more efficient. Also, PIT offers more room for development because its share in the regional tax mix lags that of corporate income tax. Among goods and services taxes, VAT, which is a form of consumption tax, is especially appealing for development in Asia because it is already fairly widespread in the region (Martinez-Vasquez and Bird 2011). Further, VAT entails relatively low economic costs (Banks and Diamond 2010). There is substantial evidence, though, that VAT is regressive (IMF 2014). This suggests that its design should be improved to make it more progressive.

PIT is often said to discourage work and thus have a negative growth effect. On the other hand, the tax is generally progressive and thus promotes equity. As noted above, in terms of growth effects, PIT compares favorably with corporate income tax but unfavorably with VAT and other consumption taxes.

Claus et al. (2014) estimate how progressive income tax is in Asia and its impact on inequality. They find that a 1 percentage point increase in PIT reduces income inequality by 0.573 percentage points in Asia, more than the 0.041 percentage points estimated for the rest of the world (Table 2.3.2). The greater redistributive effect of PIT may reflect a larger percentage of people not paying income tax in Asia because their income is below the tax-free threshold. Indeed the ratio of tax-free threshold income to gross national income per capita is generally

2.3.2 Estimated marginal impact of taxation on income inequality (percentage points)

	Asia	Rest of the world
Personal income tax	−0.573	−0.041
Personal income tax-progressivity interaction	-0.002	-0.005
Corporate income tax	0.598	−0.338
Corporate income tax-globalization interaction	−0.017	0.005
Social security and payroll taxes	1.324	0.165
General taxes on goods and services	0.666	0.768
Excises	0.609	−0.059
Customs duties	0.174	0.651

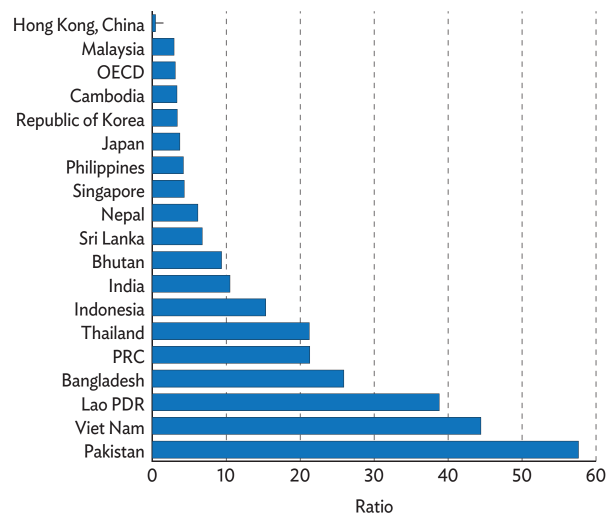
Source: Claus et al. 2014.

higher in most Asian countries than in OECD members (Claus et al. 2014). Further, the top income tax rate applies to few taxpayers, as the ratio of the top PIT threshold to per capita income is relatively high in Asia (Figure 2.3.10). Narrow PIT bases keep PIT revenues low in some Asian countries that exempt certain types of income or tax them at lower rates. For example, in the PRC, only 11 types of personal income are subject to tax. The direction of reform is to broaden PIT, including at the top tax rates.

Of particular importance in Asia is VAT, which is a major revenue source in many countries. VAT is among the least-distortionary taxes (Banks and Diamond 2010). The distortionary economic costs of taxation rise along with tax rates and as tax bases narrow, but VAT is typically charged at a uniform, relatively low rate applied to a broad base. Table 2.3.2 indicates, on the other hand, that general taxes on goods and services, which may be viewed as a proxy for VAT, worsen inequality in Asia and rest of the world. The IMF (2014) agrees that VAT itself is regressive but points out that it can be made progressive if its proceeds are used to fund inclusive spending. The discussion in *Overview of Asia's revenue systems* found goods and services taxes to be the single biggest revenue source for the region. The primary policy implication is not to reduce the share of such taxes but to make them more progressive through better design.

One way to improve VAT is to raise the threshold for payment. In Asia, few VATs are levied at a single rate above a threshold that excludes small business (Figure 2.3.11). Das-Gupta (forthcoming) points out that the relatively low VAT threshold in some Asian countries reduces VAT efficiency because the administrative cost of taxing small taxpayers is much higher per unit of revenue. There is also evidence that tax compliance costs are regressively distributed, adversely affecting small businesses more than larger firms (Barbone et al. 2012). Another option for making VAT less regressive is to use the proceeds for equity-promoting expenditures such as education and health care (Munoz and Cho 2004). Finally, while the number of Asian countries levying VAT has been rising rapidly (Martinez-Vazquez and Bird 2011), several

2.3.10 Ratio of top personal income tax threshold to gross national income per capita, 2012



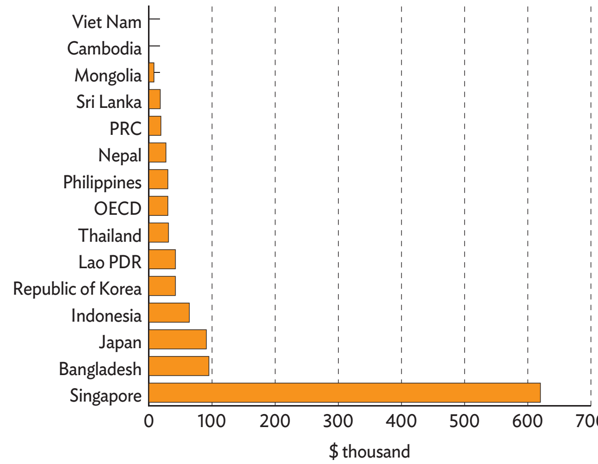
Lao PDR = Lao People's Democratic Republic, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

Note: Data for OECD are unweighted average for 2011.

Source: Claus et al. 2014

exceptions remain. They include Bhutan; Hong Kong, China; Macau, China; Malaysia; and Myanmar. These countries should also explore adopting a well-designed VAT in light of its relatively low economic cost. There is also scope for further improving the efficiency of the VAT in the region by, for example, broadening its coverage to as many goods as possible (Das-Gupta, forthcoming). Exemptions cause distortions and inefficiencies.

2.3.11 Value-added tax registration threshold, 2012



Lao PDR = Lao People's Democratic Republic, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.
Note: Data for OECD are unweighted average for 2011.
Source: Claus et al. 2014.

Enlarging corrective taxes and nontax revenues

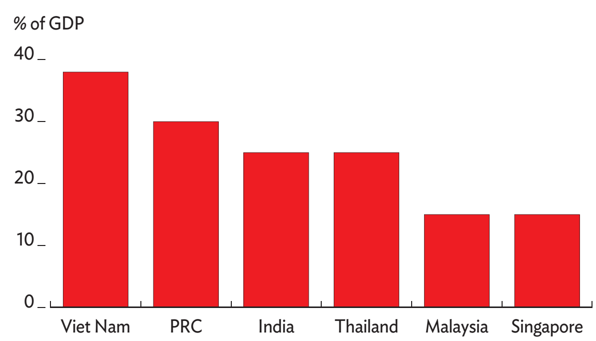
The evidence indicates that countries in developing Asia rely more heavily on broad-based taxes than on other taxes. There is thus plenty of scope for the region to expand the fiscal resource base by moving beyond broad-based taxes to alternative revenue sources. Individually, these alternative sources may be small, but collectively they can make a significant contribution to a larger, more sustainable fiscal resource base. One promising option is corrective taxes because they can promote efficiency while raising revenues. Another option is nontax revenues, an area in which the region lags other parts of the world.

Corrective taxes, or "sin taxes," are levied on goods and services deemed to be bad for the individual or society at large. Classical examples are taxes on alcohol and cigarettes, more recently extended to products and activities with adverse environmental consequences, such as driving a personal car. If well-designed, such taxes can curtail economically or socially undesirable activity while raising fiscal resources, thus providing a double dividend (Annex Table). Interestingly, experience in the Philippines shows that alcohol and cigarette taxes can yield a triple dividend by promoting efficiency and equity while raising fiscal revenues (Box 2.3.1).

Nontax revenues are payments made to the government for a range of goods, services, special rights, and recompense. The most important sources of nontax revenue are asset exploitation fees, charges, royalties, dividends, tolls, interest, and auction proceeds; fees and user charges for goods and services; and license, permit, and registration fees for regulated activities. Among other widely used sources of nontax revenue are fines and penalties. The effects of nontax revenue instruments on growth and equity are not uniform. However, broadly speaking, they are either neutral or positive for growth and can have positive distribution impacts if properly designed (Das-Gupta, forthcoming). Sources of nontax revenues vary widely across Asian countries. In Singapore, land leases and certificates of entitlement to own a car are important; in Kiribati, the sale of tuna fishing licenses is a major source.

Another source of nontax revenues is profit from state-owned enterprises (SOEs), which occupy a major part of the economy in a number of countries in developing Asia (Figure 2.3.12). SOEs are often less efficient than their

2.3.12 State-owned enterprise share of GDP, 2010



PRC = People's Republic of China.
Source: OECD 2010.

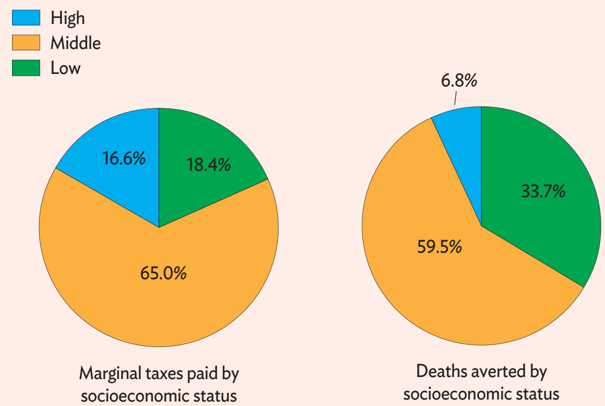
2.3.1 Tobacco and alcohol excise taxes: a win-win solution for inclusion, public finance, and health

Increasing the price of tobacco and alcohol products by raising the excise taxes levied on them reduces smoking and drunkenness and so improves public health as it raises tax revenues. A comprehensive review of evidence from over 100 studies, including some in middle- and low-income countries, clearly shows that tobacco taxes reduce tobacco use while providing a reliable source of fiscal revenues (Chaloupka et al. 2012). The review suggests that taxes are the single most cost-effective intervention to keep young people from starting to smoke and to encourage current smokers to quit. When the tax revenues thus raised are allocated to health care or other social services for the poor, they further promote positive health and equity outcomes.

The Philippines increased excise taxes specifically for cigarettes and alcohol in 2013. The tax increase greatly hiked cigarette prices and more than doubled the tobacco tax revenue collected in 2013 over 2012. Higher taxes on tobacco and alcohol together netted revenue estimated at $1.4 billion. Tobacco and alcohol tax revenues are allocated to tobacco-growing provinces and tobacco farmers (who receive 15%), health infrastructure (5%), and health services and health promotion (80%), largely through subsidies for poor families under the Philippine Health Insurance Corporation. As a result, the Department of Health budget for 2014 has been expanded by 58%. Resources will be used largely to extend insurance coverage to an additional 9.5 million families that are poor and near poor.

While the example of the Philippines reflects good revenue results, it will take some time to measure the impact on smoking rates, health, and poverty. One model found in 2012 that, while the poor would likely shoulder a disproportionate burden from the new taxes, they would also receive a larger share of the health benefits

Distribution of marginal taxes and health benefits by socioeconomic group, Philippines



Source: Jha et al. 2012.

(Jha et al. 2012). This is because the poor may be more price sensitive in light of the opportunity costs that buying cigarettes imposes on them, making them more likely to quit, and because they are more vulnerable to tobacco-related diseases. The box figure shows that the low socioeconomic group pays 18.4% of the tax increase and receives 33.7% of the health benefits, for a favorable health/tax ratio of 183%.

References

Jha, P., R. Joseph, D. Li, C. Gauvreau, I. Anderson, P. Moser, S. Bonu, I. Bhushan, and F.J. Chaloupka. 2012. Tobacco Taxes: A Win-Win Measure for Fiscal Space and Health. Manila: Asian Development Bank.

Chaloupka, F.J, A. Yurekli, and G.T. Fong. 2012. Tobacco Taxes as a Tobacco Control Strategy. *Tobacco Control*. 21. pp. 172–180.

counterparts in the private sector for a number of reasons, and some enjoy monopoly power in industries where government restrictions keep out competitors (OECD 2010). There is often plenty of scope for reforming SOEs to improve their productivity, after which they can deliver larger dividends to the governments that own them and help lift productivity across the economy. In the case of the PRC, increasing the share of SOE profits delivered to the government to 50%, which is the percentage prevailing in the advanced economies, would increase PRC fiscal revenues by as much as 3 percentage points of GDP (World Bank 2012). Countering such large potential gains, SOE reform can cause job losses and regional dislocation in the short term, so policy makers should act to mitigate such costs when embarking on reform.

Introducing naturally progressive taxes

There are a number of inherently progressive fiscal revenue options that can enhance the progressive orientation of fiscal revenue systems across Asia. Most of them promise more equitable resource mobilization at relatively low economic cost. These include property tax, inheritance tax, and capital gains tax.

Taxes levied on immoveable property are widely viewed as a fiscal source tailored for local government. Because they are underused in most parts of the world, including developing Asia, they offer scope for strengthening fiscal resources, particularly for local governments. For example, the PRC is currently exploring property tax options toward solving the high indebtedness of local governments (Box 2.3.2). Taxes on property include annual taxes on land and property, stamp duties or property transfer taxes, development fees, betterment levies, estate duties or inheritance taxes, and capital gains taxes on property transfers. As noted above, one attractive feature of property tax is that, among broad-based taxes, it has the least adverse effect on growth effects. In addition, property tax is progressive because it is proportional to property value.

Another inherently progressive tax is inheritance tax, which currently exists in only four countries in Asia and the Pacific (Table 2.3.3). This levy taxes the transmission of wealth (and hence inequality) across generations but has little effect on work incentive. The capital gains tax similarly targets the rich, who tend to own more capital, and does not adversely affect incentives, as the tax is usually levied on gains realized from investments. Finally, tax expenditures—also known as tax relief, tax subsidies, or tax aid—reduce or postpone the tax liabilities of a narrow selection of taxpayers. Tax expenditures are often costly, unproductive, and regressive. One example is preferential tax rates on capital gains and qualified dividends. Reducing tax expenditures thus benefits both efficiency and equity.

Developing Asia as a whole lags other parts of the world in the relative size of its fiscal revenues, pointing to the need to improve revenue mobilization across all categories. PIT and VAT, corrective taxes and nontax revenues, and inherently progressive taxes can all contribute. Innovative policies, such as using ICT in tax administration, can help, if accompanied by institutional reforms that enhance governance, enforcement, and incentives (Das-Gupta, forthcoming).

2.3.3 Inheritance tax in major Asian economies

Economy	Name of tax	Taxation on property left or acquired	Lowest–highest rate (%)	Percentage of national tax revenues
Japan	Inheritance	Property acquired	10–50	1.6 (FY2013 budget)
Republic of Korea	Inheritance	Property acquired	10–50	2.0% (inheritance and gift taxes in 2012)
Philippines	Estate	Property left	5–20	0.1% (2010)
Taipei,China	Estate	Property left	10	1.1% (2012)

Source: Araki 2014.

2.3.2 Property tax in the People's Republic of China

Property tax generates only modest revenue in the PRC, despite its long history and rising yield in recent years. In 2012, the five types of property tax combined contributed 21.4% of local tax revenue (box table). This compared very unfavorably with 73% in the United States and almost 100% in Australia, Ireland, and the United Kingdom (Norregaard 2013). As a result, local governments in the PRC must rely on other sources for income, such as land-lease fees.

The low yield of property tax in the PRC is explained by diverse factors. First, the tax structure levies taxes on property transactions rather than on possession. Second, owner-occupied residential properties are excluded. Third, the tax base is narrow and has widened only insignificantly over the years, with tax rates based on the purchase price instead of current market value. Fourth, there are no standards established nationally for assessment and assessors.

Pilot schemes have taxed home ownership in Chongqing and Shanghai since 2011 toward introducing residential property tax more widely. They have had only limited impact so far. Both cities opted for low rates and many exemptions, taxing luxury units in Chongqing and new purchases in Shanghai. In Chongqing, property tax was levied on 8,800 housing units in 2011 and 11,000 units in 2012. Despite this slight increase, property tax continued to provide less than 1% of local government revenue because it still covered less than 1% of all properties. Results are similar in Shanghai, where property tax revenue is larger, at CNY9.3 billion, but still amounted to less than 1% of local government revenue in 2012 because of similarly low coverage. Nonetheless, the pilots were extremely important for introducing residential property taxation in the PRC and paving the way for the nationwide rollout, which was announced in November 2013 after the Third Plenary Session of the 18th Central Committee of the Communist Party of the PRC.

Other issues deserve attention: the poor quality of property and land registration data; separate authorities for land and building registration; the difficulty of assessing the market value of land, rural housing, and subsidized housing for government and state-owned enterprise employees; the lack of independent property appraisal firms, which remain dominated by subsidiary companies of local governments; and resistance from vested interests to the adoption of residential property tax.

Reference

Norregard, J. 2013. Taxing Immovable Property: Revenue Potential and Implementation Challenges. IMF Working Paper WP/13/129. Washington, DC: IMF. http://www.imf.org/external/pubs/ft/wp/2013/wp13129.pdf (accessed December 2013).

Property tax and local government revenue in the PRC

Year	Total revenue	Total tax revenue	Real-estate tax	Urban land-use tax	Land value-added tax	Cultivated land occupancy tax	Deed title tax	Direct Subtotal
in CNY billion								
1999	559.49	493.49	18.34	5.91	0.68	3.30	9.60	37.83
2006	1,830.36	1,522.82	51.48	17.68	23.15	17.11	86.77	196.19
2012	6,107.83	4731.91	137.25	154.17	271.91	162.07	287.40	1,012.80
As % of total local revenue:								
1999	100.0	88.2	3.3	1.1	0.1	0.6	1.7	6.8
2006	100.0	83.2	2.8	1.0	1.3	0.9	4.7	10.7
2012	100.0	77.5	2.2	2.5	4.5	2.7	4.7	16.6

Source: National Bureau of Statistics yearbooks, various years.

Planning and innovation for a more inclusive Asia

The preceding analysis demonstrates considerable scope for leveraging fiscal policy to combat rising inequality in developing Asia. The evidence points to a role for increased public spending—especially on education, health care, and targeted direct transfers—to make growth more inclusive. Moreover, augmenting public spending on infrastructure can boost growth and magnify the inclusive impact of public spending on education, health care, and direct transfers.

Critically, inclusive fiscal policy requires not just more fiscal spending, but better spending. Simply spending more without careful planning—such as on costly general fuel subsidies that disproportionately benefit the rich—erodes valuable fiscal space without generating any equity benefits in return. Further, some programs such as primary education and basic health care are especially beneficial for the poor. Therefore, an urgent priority throughout the region should be to improve the design and implementation of public programs so that they reach those who need them most.

Revenue policy is critical to easing inequality in developing Asia, partly through a direct effect on equity but primarily by raising resources to fund inclusive public spending. Past fiscal prudence has earned many countries in the region sufficient fiscal space to invest more in inclusive growth. However, sizable future fiscal demands loom on the horizon as consequences of major structural shifts, such as population aging. Asia lags other parts of the world in the relative size of its fiscal revenues, pointing to scope for better fiscal resource mobilization. All possible sources need to be explored. Options include broadening the base for personal income tax and VAT, enlarging corrective taxes and nontax revenues, and introducing naturally progressive taxes on property, capital gains, and inheritance.

The use of fiscal policy for inclusive growth will benefit from a more conducive fiscal environment. Such an environment would include, among other things, an inclusive medium-term fiscal policy framework, more and better fiscal data, and innovative policies.

Fiscal framework for inclusive growth

Governments need to look beyond annual budgeting cycles to balance competing demands on public resources while guarding fiscal sustainability. Effectively using fiscal policy to reverse widening inequality requires a planning tool with explicit equity objectives—call it the medium-term fiscal framework for inclusive growth.

The framework begins with a careful review of existing and planned public spending and revenue programs to identify the share of spending benefits and revenue burdens that are expected to accrue to low-income households (those below the national poverty line, for example, or a certain income decile) over the coming 5–10 years. An initial step in the planning process is to diagnose the equity impacts of current fiscal policy. Box 2.4.1 illustrates a possible diagnostic toolkit for this purpose, which can set the baseline to operationalize the framework. The framework includes a plan to increase the share of public spending benefiting target households while explicitly detailing revenue increases and accompanying cuts in other spending that allow the plan to be achieved within the envelope defined by fiscal sustainability (e.g., the targeted ratio of government debt to GDP).

The medium-term fiscal framework for inclusive growth provides a procedure to help direct more government activity to benefit low-income households over time, and to review progress toward this end. The framework involves careful annual reviews of inclusive government programs and sets concrete medium-term targets and the means for financing them. As Bangladesh, for example, has explicit poverty-reduction goals, the framework could show the government's plans to boost services and assistance for low-income households over a multiyear period. However, the framework also shows how changes to spending fit within the government's fiscal targets, thereby demonstrating their feasibility.

Commitment to evidence-based planning

Effective fiscal policy for inclusive growth requires more and better fiscal data to inform evidence-based policy. It also requires strong political commitment. Improved fiscal data will enable Asian policy makers to better track public programs and assess their effectiveness. Such data, which should ideally include at least some micro-level data on individual projects, will help policy makers improve the design and implementation of inclusive public spending. The medium-term fiscal framework for inclusive growth would benefit from, for example, data on expenditures on primary, secondary, and vocational education flowing to low-income regions and neighborhoods, and on the percentage of low-income students in such schools and programs. Another example is data on spending within the health budget for basic health care, nutrition, and public health services, ideally limited to expenditures for low-income households or regions. Political commitment protects public spending from pressure for populist overspending, thus safeguarding fiscal sustainability. It also keeps politically powerful groups from capturing the benefits for themselves, thus ensuring a more equitable allocation of scarce fiscal resources.

Innovations for inclusive fiscal policy

A number of innovative policies can support and amplify the role of fiscal policy in inclusive growth. For example, it may be possible to expand social infrastructure such as education and health care by harnessing public–private partnership (PPP), which has been a valuable tool for building physical infrastructure such as roads and power plants. While social PPP is still in its infancy in developing Asia, there are some promising developments. The Republic of Korea has

2.4.1 Commitment to equity: a diagnostic framework for fiscal policy

The Commitment to Equity Assessment (CEQ) is a diagnostic framework used to measure and evaluate how well government expenditures and taxes align with supporting a minimum living standard and reducing inequality in ways that are broadly consistent with macroeconomic stability, microeconomic efficiency, and growth.

The CEQ evaluates government efforts in terms of the following criteria: Do governments collect and allocate enough resources to support a minimum living standard and human capital accumulation for all? Is the collection and distribution of fiscal resources consistent with eradicating extreme poverty gaps in income and human capital? Do governments collect and distribute resources equitably? To understand the diagnostic framework, it is best to visualize it as a diagnostic tree as in box figure 1.

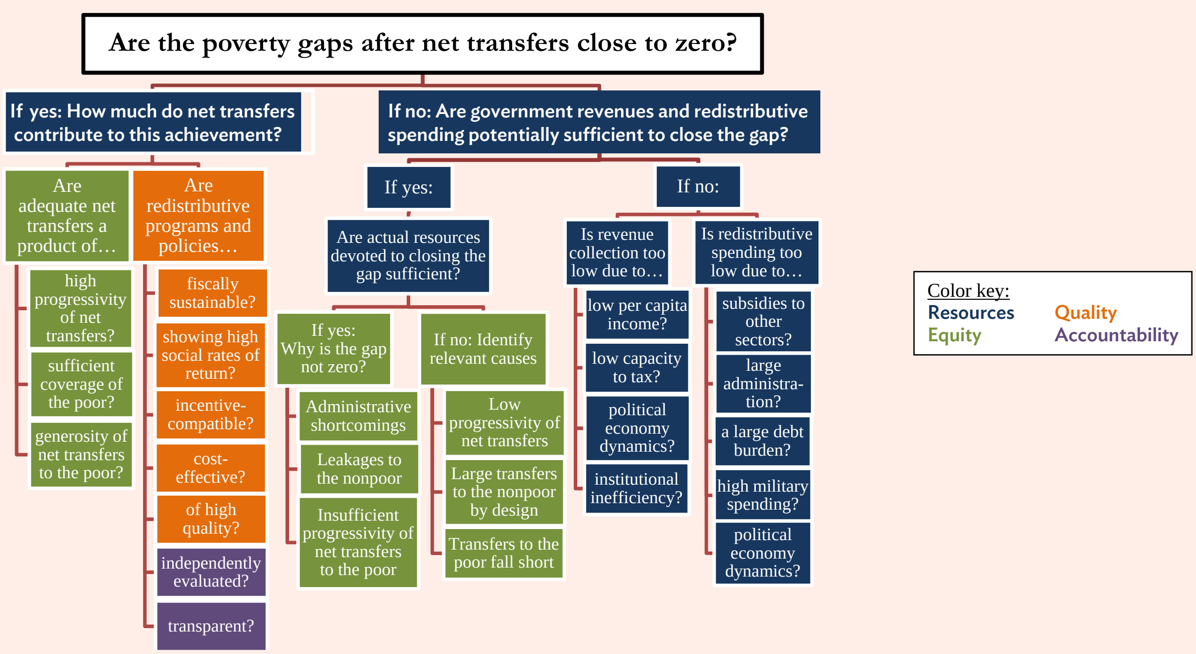
The CEQ uses a standard analysis of tax and benefit incidence and a specially designed diagnostic questionnaire. Each criterion has quantitative and qualitative indicators derived from poverty and inequality analysis; tax and benefit incidence analysis; and best practices in macroeconomic management, program and policy design and evaluation, and accountability indicators.

Applying the CEQ framework to Brazil as an illustration, using data for 2009, yields the following policy-relevant findings: Revenue collection and redistributive spending are sufficient to close the poverty gaps and are consistent with Brazil's GDP per capita when compared with international benchmarks. However, poverty is not eradicated.

The diagnostic framework helps determine the reasons. First, transfers to the nonpoor are too large, as the share of direct transfers the poor receive is approximately equal to their population share. For direct transfers to reduce poverty and inequality, the poor should receive proportionally more. Benefits are directed—or misdirected—to the nonpoor both by design and through errors of inclusion. Second, the poor are not universally covered, as 15% of them are not covered by any direct transfer program. In fact, some families that are moderately poor by Latin American and national standards are not eligible for any targeted antipoverty program, even if the family has children or elderly members, because programs have low eligibility cutoffs. Third, the average transfer per poor beneficiary is less than the average poverty gap. This means that many poor families receive direct transfers but remain in poverty nevertheless because the transfers are too low to lift them out. Even if all poor were thus covered, poverty would still not be eradicated.

Reference

Lustig, N. and S Higgins. 2014. Commitment to Equity: A Diagnostic Framework to Assess Governments' Fiscal Policy. In: Kanbur, R., R.C. Rhee, and J. Zhuang, eds. *Inequity in Asia and the Pacific: Trends, Drivers, and Policy Implications.* Manila: Asian Development Bank and New York: Routledge.



Source: Lustig and Higgins (2014).

2.4.2 Social public–private partnership for inclusive growth

Social PPP extends a development modality usually associated with physical infrastructure such as roads and power plants to such social infrastructure as education and health care. There are many types of PPP, but the PPP arrangements for social infrastructure can be broadly classified into two types. In one, the private sector is responsible only for providing physical facilities such as schools or hospitals. In the other, private participation extends to providing core services in addition to facilities.

Education is the one social sector that has seen private participation increase rapidly over the past 2 decades across the world. India, for example, introduced various forms of PPP that provide school services by contracting out school management functions: finance and staff management, professional services such as teacher training and curriculum design, or support services such as providing school meals. The private education providers include a wide range of entities: faith-based organizations, local communities, nongovernment organizations, and private for-profit and nonprofit organizations.

The Republic of Korea introduced PPP to increase the funding available for constructing and upgrading school buildings. With rapid economic growth in the 1990s, there was rising demand for improved school facilities. The government estimated that it would take 20 years or more to rehabilitate all inadequate schools. It turned to PPP as the solution in 2005. The existing PPP Act was revised to add schools and other social infrastructure such as hospitals and public housing. As of December 2012, PPPs had constructed 191 elementary, middle, and high schools at an aggregate cost of $7.6 billion.

PPP can better tailor the delivery of social services to the needs of end users than can traditional government arrangements, which favor uniform delivery. The Urban Primary Health Care Project in Bangladesh is an example of how PPP can improve the delivery of primary health care to the urban poor by engaging NGOs to provide services. The project aims to improve the health of the urban population, especially the poor. It focuses in particular on women and children, providing essential health and reproductive health services. The government entered into 16 PPPs with competitively selected NGOs to deliver health care services tailored to local community needs at 180 health care centers. A performance evaluation found that partnership arrangements with NGOs outperformed government-run services in facility management, service quality, and cost per health care recipient.

Despite the dearth of rigorous empirical evidence, PPP clearly offers potential advantages for social infrastructure. Besides expanding governments' fiscal space, PPP provides better-quality services more efficiently. By generating competition in the market, PPP allows the government to choose private providers through open bidding. In addition, PPP allows contract flexibility that enables service providers to respond to the expressed demands of end users.

Reference

Park, H. 2013. *An Analysis of Public Investment Decision Patterns Applying the Analytical Hierarchy Process.* Public and Private Investment Management Center, Korea Development Institute: Seoul.

successfully leveraged PPP to fund the construction and upgrading of school buildings. In Bangladesh, the government has partnered with nongovernment organizations to effectively deliver primary health care to poor urban children and women (Box 2.4.2).

Another option is to leverage information and communication technology (ICT) to make tax administration more efficient. ICT can improve and strengthen every aspect of tax administration, which tends to be weak in many developing Asian countries. Tax administration bodies in developing Asia generally have the basic infrastructure they need to apply ICT to tax administration. The potential benefits are enormous. A shift to ICT spares many taxpayers the time and trouble of traveling to the tax office to pay their taxes in person by offering electronic payment through internet banking or electronic direct debit from bank accounts. Further, this shift reduces operating costs for tax offices and opportunities for corruption. Tax administration bodies should extend their ICT systems to streamline their own internal operations, including enforcement, as well as promote taxpayer convenience (Box 2.4.3).

2.4.3 Leveraging tech to enhance tax administration in Asia

Information and communication technology (ICT) improves every aspect of tax administration: taxpayer services, tax audit, tax collection, and other internal management processes. ICT benefits tax administration by improving the performance of tax administration bodies, reducing tax administration costs, reducing taxpayers' compliance costs, and enhancing interaction between taxpayers and tax administration bodies. These four benefits are interrelated. From the perspective of tax administration bodies, a well-established ICT system supported by good ICT-based media expedites the collection of information from taxpayers and other government institutions. Once within the tax administration body, the collected information can be used efficiently for the various tax administration functions such as taxpayer management, audit, and arrears collection.

Electronic tax-filing systems are the most visible of ICT-based taxpayer services. For most taxpayers, contact with the tax office consists of submitting annual income tax returns, nothing more or less. A system enabling taxpayers to submit tax returns electronically benefits them as well as the tax administration bodies because it can greatly reduce the time and effort required of a taxpayer compared with visiting a tax office or even sending a tax return by post. At the same time, it saves time and labor for tax officials compared with receiving and processing stacks of paper tax returns. Further, inputting data electronically improves the quality of tax returns. Automatic calculation functions prevent miscalculation, and the help functions available onscreen enhance taxpayers' understanding of tax regulations and requirements. As a benefit for tax administration bodies, data filed electronically can be inputted directly into a tax information management system. This is vastly more efficient and error-free than having tax officers input the data manually or through an optical character recognition system.

The box table shows the penetration rates of electronic tax filing for personal income tax, corporate income tax, and value-added tax (or goods and services tax). Australia, India, the Republic of Korea, Mongolia, and Taipei,China record more than 90% use for some of the tax items. In Singapore, electronic filing for goods and services tax is mandatory. In India, electronic filing has been mandatory since FY2009 for corporations and individuals whose income exceeds a certain amount. In Indonesia, the Kyrgyz Republic, and the Philippines, electronic tax filing is available to at least some filers, but its use is still limited. Possible reasons include patchy internet access, particularly for individuals, and the high cost of obtaining a digital signature, which is necessary to authenticate a taxpayer's identity.

Tax administration bodies in Asia and the Pacific, including those in developing economies, are generally equipped with basic foundations for ICT-based tax administration. Most economies have an inhouse ICT system for tax administration, and all economies surveyed now provide at least some tax information to taxpayers through their websites. With respect to electronic tax-filing systems, the picture varies from one economy to another. While penetration rates are quite high in developed economies, they are still low in some developing economies, even where electronic tax filing is available. On the other hand, the trend in tax payment appears to have shifted from in-person payment at tax offices to electronic tax payment such as through internet banking or direct debit from bank accounts, reducing operating costs and opportunities for corruption. Despite their current unfamiliarity to most tax administration bodies,

Other policies can strengthen the role of fiscal policy in promoting inclusive growth. For example, the reform of state-owned enterprises (SOEs) can expand fiscal space and foster productivity growth (*Options to expand developing Asia's fiscal revenues*). Although SOE reform can cause labor retrenchment and regional dislocation in the short run, it is likely to promote efficiency and growth over the longer term. Further, if reform paves the way for higher SOE profits, the government can use the resulting larger dividends to fund investments in inclusive growth. Reducing subsidies to inefficient SOEs can similarly expand fiscal space. Fiscal decentralization can render fiscal policy more responsive, as local governments understand much better than the faraway central government the most pressing needs of their poor communities. An essential feature of fiscal decentralization is that is enables local governments to secure enough resources—by, for example, levying the various social media offer tremendous potential for effective communication, making their deployment only a matter of time.

The implications for tax administration bodies in developing economies are as follows. First, an ICT tax administration system should be developed to serve a dual purpose: expediting tax administration including enforcement, and serving the convenience of taxpayers. Second, electronic taxpayer services should be combined with good policies that enhance taxpayers' use of these services. Japan offers a tax deduction for electronic filers. Third, where most taxpayers have only limited access to ICT and financial services, measures such as tax payment by mobile phone can facilitate access to tax administration services.

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Use of electronic tax filing in 2011 by tax item

Economy	Personal income tax	Corporate income tax	Value-added tax
Australia	92	92	54
Hong Kong, China	14	<1	NA
India	26	100	NA
Japan	44	58	53 (corporations)
Korea, Republic of	87	97	79
Kyrgyz Republic	0.6	3	37
Malaysia	69	49	NA
Mongolia	...	76	96
New Zealand	71	80	28
Philippines	0.3	6	7
Singapore	96	63	100
Taipei,China	82	98	94
Thailand	45	10	14

... = data not available, NA = not applicable because the economy has no value-added tax.

Note: The table includes only those countries whose tax authorities responded to the survey.

Sources: OECD 2013; Asian Development Bank tax administration survey.

property taxes (Options to expand developing Asia's fiscal revenues)—to deliver more and better public services. In addition, introducing greater competition into public services can improve their efficiency.

Fiscal policy can and should play a bigger role in promoting inclusive growth in Asia. In light of the wide range of development stages and income levels across developing Asia, solutions need to be tailored to the individual country's circumstances. Nevertheless, the broad contours of an inclusive fiscal policy emerge from the analysis: higher public spending on better-quality education, health care, and direct transfer programs; the expansion of underused revenues sources such as property taxes; and the improvement of existing sources such as VAT and personal income tax. To put the region on a growth path of broadly shared benefits, Asian governments need to actively target inclusion in their fiscal plans. Achieving inclusive growth is necessarily a long-term challenge, so policy makers must plan and act now.

Annex: Properties of major tax and nontax fiscal revenues

Fiscal resource	Growth impact	Distribution impact	Advantages & disadvantages	Key risk areas	Other observations
Taxes	Negative, but the negative impact of corrective taxes may be outweighed by corrective benefits	No uniform impact	Promote accountable government, but economic cost tends to be higher than for other revenue sources	Tax evasion, corruption, informal and underground economic activity	Groups that are hard to tax pay proportionately less tax than do other groups.
Taxes on income	Negative	No uniform impact	Compliance costs regressive for business, as they weigh more heavily on small businesses	Correlation	The quality of state bureaucracies is positively associated with GDP growth.
Individual income tax	Negative, especially if economic activity is driven into the informal sector, for which economies of scale are limited	Generally progressive but not uniformly so	Usually imposes high and possibly regressive compliance costs on business and self-employment income	Most prone to tax evasion and official corruption except possibly where tax is withheld by employers	Evidence suggests that individual income tax has less impact on growth than does corporate tax but more impact than does commodity tax (McBride 2012).
Social security tax	Negative	Generally regressive, especially if tax on individuals is deductible	Reduces private savings and investment in pay-as-you-go systems if workers covered by social security save less of their income		
Corporate tax	Negative	Possibly progressive, as the poor own few corporate shares, but international competition to lower corporate taxes and companies' efforts to shift tax liability to labor and other less mobile factors may reduce progressivity	As taxpayers are few, low cost of collection and compliance relative to the revenue collected, and the cost of collection lower still if administered through large, efficient taxpayer units	Can push economic activity into the informal sector and leave a country vulnerable to others that attract foreign investment with tax breaks	Evidence suggests that corporate tax has a larger impact on growth than do income, property, or commodity taxes (McBride 2012). How much it induces corporate migration to low-tax venues is disputed, as is the impact on domestic and foreign labor (Clausing 2011).
Capital gains tax	Negative but limited if levied when gains are realized	Similar to corporate tax except that capital gains tax on immobile capital such as real estate may be more progressive	Easily avoided or evaded but can discourage investment	Subject to competitive pressure from countries seeking foreign investment	

Fiscal resource	Growth impact	Distribution impact	Advantages & disadvantages	Key risk areas	Other observations
Taxes on goods and services	Negative	No uniform impact			Usually the most important revenue source in developing countries
Value-added tax (VAT)	Possibly negative	Generally regressive but, depending on the VAT threshold, possibly neutral (Keen 2012, Bird and Zolt 2012)	Costly to administer and comply with, and compliance costs tending toward regressive, depending on how high the tax threshold is; if properly administered, can reduce avenues of evasion and the informal sector	Administration in developing countries tending to be weak, which can allow revenue leakage but usually less leakage than from the taxes it typically replaces	VAT usually has less impact on growth than the commodity taxes or international trade taxes it replaces. Evidence suggests that it has less impact on growth than income or corporate taxes (McBride 2012).
Selective excises	Negative	Regressive if passed on to final consumers	Can control economically and socially undesirable activity, yielding a double dividend		Fuel taxes can have large costs to growth in the short run. In the long run, if they stem the overuse of nonrenewable resources, the growth impact may be positive. Their impact on distribution is unclear.
Domestic commodity taxes other than VAT and selective excises including sales taxes	Negative	Regressive	Relative prices distorted through tax cascading	More prone to evasion than VAT	
Taxes on international trade	Negative	No uniform impact	Harmful to international trade, but a revenue source that is easy to administer for countries with easily controlled boundaries such as island states (Keen 2012)		Such taxes are subject to World Trade Organization (WTO) agreements. They are of limited value for raising revenue except for poorer countries with controllable boundaries.
Import duty	Negative	No uniform impact	If protectionist, can induce excessive import substitution	Prone to evasion and can give rise to smuggling	Such taxes are subject to WTO agreements. They may help growth by improving the current account and preventing adverse macroeconomic impacts from currency depreciation.

Fiscal resource	Growth impact	Distribution impact	Advantages & disadvantages	Key risk areas	Other observations
Export duty	Negative	No uniform impact	Allows countries to exploit international monopoly power		Such taxes are subject to WTO agreements.
Asset taxes					
Individual wealth tax	Limited but negative	Generally progressive	Limited source of revenue	Possible hardship for individuals with little income but rich assets	.
Land tax	Limited but negative	Generally progressive	Limited source of revenue	Possible hardship for individuals with little income but rich assets	
Taxes on assets other than property and including resource taxes	Negative unless taxing pure rents	Generally progressive		Maybe encouraging illegal resource extraction and incurring environmental costs	
Stamp duty and transaction tax	Negative	No uniform impact	Price distortion hindering market efficiency and perhaps transaction volume if levied on, for example, financial transactions	May encourage property sale prices to be under-declared	
Other taxes					
Property Taxes	Negative	Progressive if rates are proportional to property values		Prone to evasion unless levied using presumptive valuation norms	Evidence suggests that property taxes have less impact on growth than do income, corporate, or commodity taxes.
Betting and gambling taxes	Not clear	No uniform impact			
Corrective taxes	Gross effect negative but may be positive with corrective impact	No uniform impact	Maybe yielding a double dividend		
Nontax revenue	Positive or neutral if rates are not excessive	No uniform impact		Generally more volatile than tax revenue	Nontax revenue may be underexploited in most countries.
Resource rents	Positive if not overexploited but can be negative if overexploited	No direct impact	Permit the allocation of resources in line with development objectives; foster growth and inclusion	So-called "natural resource curse" if governance is poor, as funds may be misused	
User charges	Positive if set at economically efficient rates, typically at marginal cost	May be positive (Balestrino 1999)	Can help reduce undesirable consumption or production and give rise to a double dividend	May be costly to administer and so impractical for goods and services for the poor	User charges are generally underexploited in most countries.

Fiscal resource	Growth impact	Distribution impact	Advantages & disadvantages	Key risk areas	Other observations
Fines and penalties	Positive if they reduce economically undesirable activity	No uniform impact	If well designed, can help reduce activities causing harm and give rise to a double dividend, but proper penalty design not very common; their importance to revenue limited if very effective in deterring harmful activity	May be costly to administer.	Fines and penalties are generally underexploited in most countries.
Nontax revenue other than resource rents, user charges, and penalties	No direct impact	No direct impact	By using prices to ration the availability of goods, can improve resource allocation; some sources open to tailoring to have a positive distribution impact through price discrimination	Corruption in the supply of priced goods or allocation of resources; revenue leakage in the decentralized administration of payment for some goods such as public school fees and hospital charges	Sources such as spectrum auction fees can exploit public monopoly power.

Note: Refer to Das-Gupta (forthcoming) for a discussion of fiscal resources other than taxes and nontax revenues.

Source: Das-Gupta, forthcoming.

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3

Economic trends and prospects in developing Asia

CENTRAL ASIA

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

Economic performance was mixed in 2013, as slower growth and higher inflation accompanied the marked narrowing of fiscal and current account deficits. The outlook is for higher growth, lower inflation, and further improvements in fiscal and external positions. Despite progress in structural reforms and an improved business environment, high unemployment remains a challenge.

Economic performance

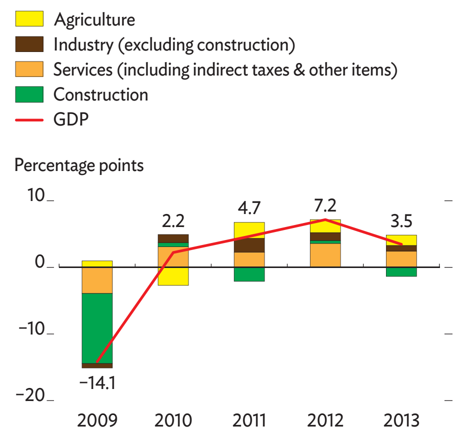
Economic growth slowed to 3.5% in 2013 from 7.2% in 2012. On the supply side, industrial growth decelerated to 4.9% in 2013 from 7.0% in 2012, reflecting the adverse effects of steep price increases for electricity and imported gas in July 2013, partly offset by government efforts to stimulate export-oriented industries. Industrial growth came mainly from higher output in mining, quarrying, and the production of pharmaceuticals, food, and beverages (Figure 3.1.1).

Growth in agriculture moderated to 8.1% in 2013 from 9.5% in 2012, mainly because a severe hailstorm hit several regions of the country in May–June 2013 and slowed growth over the rest of the year. Agricultural growth was driven by state assistance programs, including free seed distribution and subsidies to farmers for fuel and fertilizer. Construction fell by 11.2%, reversing 3.3% growth in 2012. The decline came from lower demand and investment in construction and delays in large public infrastructure projects. Despite some moderation in the second and third quarters, services (accounting for about 45% of GDP) expanded by 5.9% as compared with 7.0% in 2012. Growth was driven mainly by increases in trade, information and communication, finance, insurance, food service, and recreation.

On the demand side, consumption was the main driver of economic growth in 2013, as in the previous year. Growth in private consumption slowed to an estimated 2.8% in 2013 from 9.1% in 2012, as higher inflation reduced real income, despite continuing increases in workers' remittances and bank credit. But public consumption jumped by an estimated 12.7%, versus a 0.2% decline in 2012, reflecting higher government spending. Gross fixed capital formation dropped by 4.9%, compounding the 1.8% decline in 2012 and reflecting sluggish public and private investment. The negative impact of net foreign trade and services eased somewhat in 2013, as a relatively favorable external environment helped exports grow more quickly than imports.

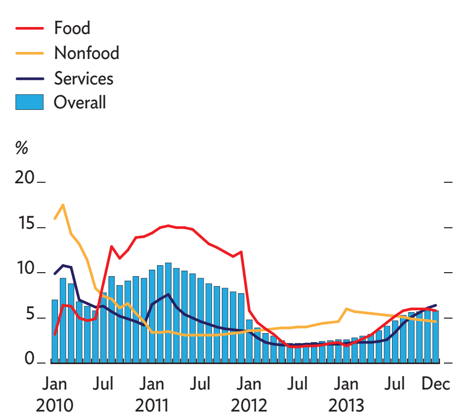
Average annual inflation more than doubled to 5.8% in 2013 from 2.6% in 2012, largely reflecting rising energy prices and lagged effects from severe storms in the second quarter (Figure 3.1.2). However, the 12-month inflation rate, which peaked at 9.2% in August, declined

3.1.1 Supply-side contributions to growth



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 7 March 2014).

3.1.2 Inflation



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 7 March 2014).

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gradually to 5.6% in December, slightly above the Central Bank of Armenia (CBA) target band of 4% ±1.5 percentage points.

Rising inflation prompted the CBA to raise its refinancing rate to 8.5% in August 2013 from the 8.0% set in September 2011. With inflation slowed, the CBA then bolstered economic activity by lowering the rate to 7.5% in three steps from November 2013 to February 2014. Broad money supply rose by 14.8% during 2013, reflecting a significant buildup in CBA net foreign assets and continued credit growth. Credit to the private sector rose by 11.9% in 2013, versus 26.5% in 2012, mainly for personal loans and lending to retailers and wholesalers.

The government continued its policy of fiscal consolidation, aiming to stabilize the ratio of public debt to GDP. The fiscal deficit declined to 0.4% of GDP in 2013, well below the target of 2.6% (Figure 3.1.3).

Higher tax collection and some improvement in revenue administration lifted government revenues including grants by nearly 13% in 2013, to 25.0% of GDP from 23.7% in 2012. Government expenditure, while rising by 7.6%, remained 6% below the budget (equal to 25.4% of GDP), mainly because of delays in public investment projects. Total public debt declined to 43.6% of GDP at the end of 2013 from 44.1% a year earlier (Figure 3.1.4). External public debt dropped to 37.1% of GDP in 2013 from 37.7% in 2012, while domestic public debt increased by 0.1 percentage points to 6.5% of GDP.

The successful placement in September 2013 of Armenia's first eurobonds ($700 million in 7-year bonds with a yield of 6.25%) enabled the government to repay early a $500 million loan to support its 2009 anti-crisis program, which the Russian Federation had granted with 15-year maturity and an interest rate 3% above the London interbank offered rate (LIBOR).

Continuing large inflows of transfers and income from abroad helped narrow the current account deficit to an estimated 9.5% of GDP in 2013 (Figure 3.1.5). In volume terms, the trade deficit narrowed in 2013, as exports expanded more quickly than imports. Export growth accelerated to an estimated 8.5% in 2013 from 2.5% in 2012, largely driven by higher mineral and processed food exports. Merchandise imports grew by 2.5% in 2013, versus 2.2% in 2012, mainly reflecting slack domestic demand. Remittance inflows from workers abroad, primarily in the Russian Federation, rose by 10.8% to $1.5 billion in 2013 (Figure 3.1.6).

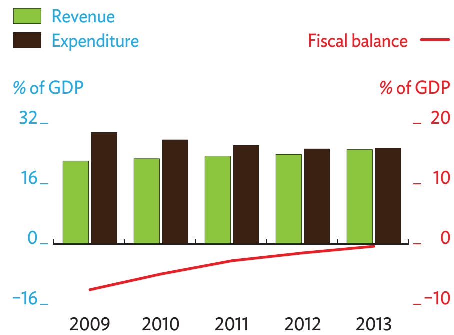
Inflows of foreign direct investment (FDI), concentrated in mining and energy, fell by 9.2% to an estimated $430 million during 2013. Gross international reserves jumped by 25.2% in the year to the end of 2013, to $2.3 billion, reflecting the eurobond issue and CBA purchases of US dollars (Figure 3.1.7). During 2013, the Armenian dram depreciated by 0.7% in nominal effective terms and appreciated by 5.7% in real effective terms, as inflation exceeded that of its main trading partners.

Economic prospects

Growth is expected to accelerate to 4.6% in 2014 and 5.0% in 2015, with both projections subject to upside and downside risks (Figure 3.1.8).

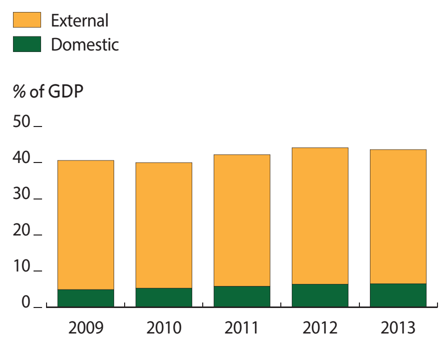
The pace of growth depends on Armenia's accession to the customs union and common economic space of the Russian Federation,

3.1.3 Fiscal indicators



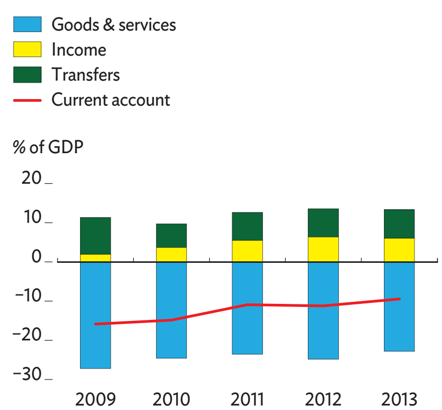
Sources: Ministry of Finance. http://www.minfin.am; National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 7 March 2014).

3.1.4 Public debt



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 7 March 2014).

3.1.5 Current account components



Sources: Central Bank of Armenia. http://www.cba.am; National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 7 March 2014).

Kazakhstan, and Belarus in 2015; accession was announced in September 2013, but the full implications will depend on the final agreements to be signed in mid-2014. While Armenia may benefit in the long run from higher trade in the enlarged market, lower nontariff trade barriers, more efficient flows of labor and capital, and potentially greater FDI, it remains to be seen how terms-of-trade changes will affect trade with countries outside the union.

Also likely to promote growth are domestic factors such as continued reforms in taxation, customs duties, and the business environment, along with air space liberalization introduced in 2013.

Agriculture is expected to continue expanding, reflecting the implementation of state assistance programs designed to improve productivity and efficiency. Industrial expansion is expected to accelerate, benefitting from the government's export-led industrial development strategy approved in 2012, which targets 11 subsectors with export potential. Intergovernmental agreements between Armenia and the Russian Federation signed in December 2013 to exempt imported gas, raw oil, and diamonds from customs fees could provide additional support to industrial growth. Services should also expand, driven largely by increases in civil service salaries in January and July 2014 and remittance-based consumption spending. Construction is expected to rise, primarily on investments associated with the North–South Road Corridor project.

On the demand side, the main contributor to growth will be consumption, fueled by rising salaries, remittances, and public spending.

Significant increases in public sector salaries and pensions in 2014, and continuing impacts from energy price increases in July 2013, will likely keep average annual inflation high at 4.5% in 2014 before it eases to 4.0% in 2015. However, the 12-month inflation rate (December over December) is expected to remain within the CBA's target band of 4% ±1.5 percentage points. Slower demand growth and lower food inflation, from better harvests, are seen as offsetting other price increases. Monetary policy is expected to be broadly accommodative to support growth.

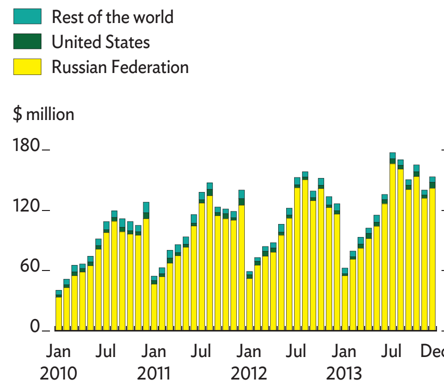
Fiscal policy is likely to remain relatively tight during 2014 and 2015, given the vulnerability of public debt to shocks. The 2014 budget aims for a deficit that is just over 2.3% of GDP, with higher capital spending and wage and pension increases. The government's medium-term fiscal objective is to narrow this deficit to 2.3% of GDP in 2015 and 2.0% in 2016.

The current account deficit is projected to narrow slightly to 8.7% in 2014 and 8.0% in 2015, reflecting further shrinkage in the trade deficit and increases in workers' remittances (Figure 3.1.9). Exports are projected to grow by 6.2% in 2014 and 6.5% in 2015, benefitting from the government's export-led industrial strategy, assuming no downward pressure on prices for nonferrous metals. Imports are projected to rise by 3.5% in 2014 and 4.3% in 2015 as domestic demand expands.

The policy of air space liberalization may well become important for expanding service exports. Further declines in the current account deficit will also require follow-through on reforms to the business environment, which would improve competitiveness and attract more FDI.

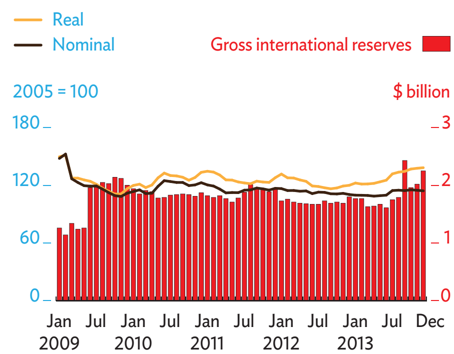
The stock of public debt will continue rising, albeit at a slower pace and in line with the government's strategy to reduce the external

3.1.6 Sources of remittance



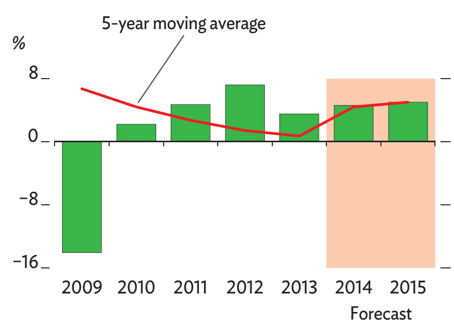
Source: Central Bank of Armenia. http://www.cba.am (accessed 7 March 2014).

3.1.7 Effective exchange rates and reserves



Sources: Central Bank of Armenia. http://www.cba.am; International Monetary Fund; International Financial Statistics online database (accessed 7 March 2014).

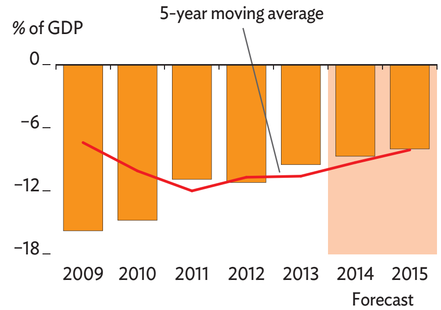
3.1.8 GDP growth



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 7 March 2014); ADB estimates.

share of public debt. While Armenia's graduation from eligibility for concessional financing from the International Monetary Fund in April 2013 and the World Bank in July 2014 will raise the cost of external borrowing, the eurobond issuance in September 2013 helped the government lengthen its debt profile and lower the average rate on government securities. Higher economic growth should put the ratio of public debt to GDP on a steady downward path, at least through 2015.

3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 7 March 2014); ADB estimates.

Policy challenge—high unemployment

Economic growth has had limited impact thus far on Armenia's high unemployment. Despite some reduction during the past 4 years, the persistently high unemployment rate, estimated at 16.8% in 2013, hinders poverty reduction. A shrinking workforce (caused by outward migration), outmoded worker skills, and market distortions created by a large informal sector continue to undermine Armenia's growth potential. Addressing these weaknesses would reduce unemployment, narrow income disparities, reduce poverty, and promote more inclusive growth.

The government recognizes the need to foster private sector development in order to create more jobs. Expanding employment by creating high-quality and highly productive jobs is an objective of the government's Armenia Development Strategy 2025. Achieving this is seen to depend mainly on employment growth, human capital development, an improved social protection system, and better public administration and governance.

Employment is still concentrated in sectors with low productivity, as measured by the value added per employee. As a few export-oriented industries—such as mining, diamond processing, and sectors with some foreign ownership, notably financial intermediation and information technology—generate higher GDP per worker, the government's export-oriented industrial development strategy is seen as a way to boost employment and productivity over the medium term.

Improving the business climate to attract more FDI is also critical for boosting employment. Weak foreign investment has hindered the economy's structural transformation. The government has begun extensive reforms to improve the efficiency of public services, streamline operating procedures, and reform tax and customs administration.

Because much unemployment is rooted in outmoded skills and therefore structural in nature, more active labor market policies and better-targeted education and training would complement these programs.

Wide-ranging reforms have been implemented throughout the education system since the 2000s. Advancing these reforms and ensuring that academic and training courses match labor market needs would help alleviate unemployment, create better-paying jobs, and promote further economic growth. The government has adopted a new approach for 2014 that aims to reform labor market policies by eliminating unemployment benefits and less effective programs and focusing resources on better services for job seekers. These policies will receive support from new social programs to be introduced in 2014, such as educational support for the young from vulnerable families and mortgage assistance for civil servants.

3.1.1 Selected economic indicators (%)

	2014	2015
GDP growth	4.6	5.0
Inflation	4.5	4.0
Current account balance (share of GDP)	−8.7	−8.0

Source: ADB estimates.

Azerbaijan

Growth accelerated to 5.8% in 2013 from 2.2% a year earlier, reflecting recovery in the oil sector and continued growth in the rest of the economy. Declining oil prices squeezed export earnings and narrowed the current account surplus to 16.7% of GDP. Growth is projected to moderate to 4%–5% in 2014 and 2015 as industry grows more slowly.

Economic performance

Growth accelerated to 5.8% from 2.2% in 2012, driven mainly by a 10% expansion in the 52% of the economy not directly connected with oil.

On the supply side, rapid growth in non-oil activity and a resumption of growth in petroleum enabled industry (excluding construction) to expand by 1.2% after the 3.3% decline in 2012 (Figure 3.2.1). Food processing, construction materials, and machinery all expanded, benefitting from significant public investment, bank lending, and support from the Entrepreneurship Support Fund. Petroleum output rose by 1.0%.

Construction expanded by 23.0%, supported by large public infrastructure projects and private investment. Agriculture grew by 4.9%, largely by tapping concessional government lending and improved access to finance in rural areas. To stimulate local entrepreneurship in agriculture, the government continued to provide exemptions from taxation and customs duties. Services, representing about 30% of GDP, grew by 7.2%, reflecting gains particularly in trade, tourism, and catering. Retail trade grew by 9.6%, reflecting higher consumption demand.

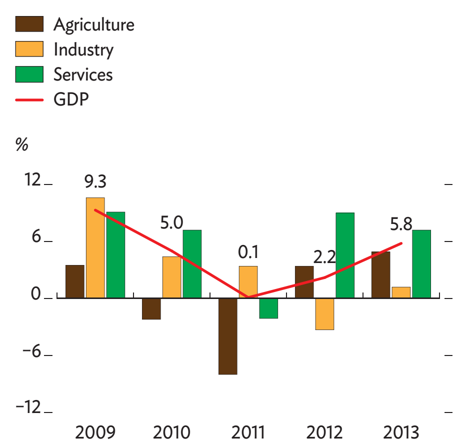
On the demand side, private consumption, public investment, and net exports all expanded. Rising incomes attributable to higher salaries and pensions and increased consumer lending fueled private consumption. Gross fixed capital formation rose by 11%, mainly reflecting higher investment in the non-oil economy, much of which was supported by government development programs.

Average annual inflation rose to 2.4% in 2013 from 1.1% in 2012 as prices for services increased, reflecting higher civil service wages and expanding credit (Figure 3.2.2). Markets for agricultural goods organized by the government and moderating global food prices helped contain inflation. An unexpected increase in fuel tariffs during December raised inflationary pressure at year-end.

Fiscal policy in Azerbaijan is driven largely by oil income, which accumulates in the State Oil Fund of Azerbaijan (SOFAZ), from which transfers are made to finance budget expenditures. Transfers from SOFAZ provide about 58% of total revenues. Improved tax administration contributed to tax revenues exceeding expectations.

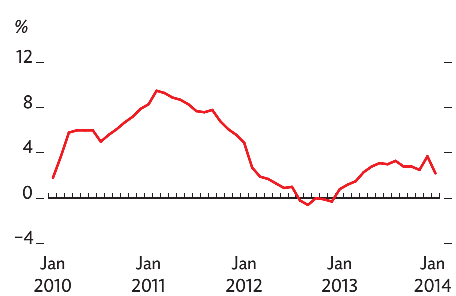
This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, Asian Development Bank, Baku.

3.2.1 GDP growth by sector



Source: State Statistical Committee of the Republic of Azerbaijan.

3.2.2 Monthly inflation



Sources: Central Bank of the Republic of Azerbaijan; International Monetary Fund. International Financial Statistics online database (accessed 17 March 2014).

Total revenues increased by 12.8% from 2012 and constituted 33.8% of GDP, up from 31.6% in 2012.

Expenditure rose by 9.7%, which was 3.7% less than projected. Large salary increases, greater support to social services including health and education, and aggressive regional development activities raised total outlays to an estimated 33.1% of GDP from 31.8% in 2012. The budget surplus was estimated at 0.7% of GDP, reversing a deficit of 0.2% in 2012.

The objective of Central Bank of Azerbaijan monetary policy has been to limit inflation to 5% while stabilizing the exchange rate. In February 2013, the central bank further relaxed monetary policy by reducing its policy rate from 5.00% to 4.75%, to strengthen activity and support firms in the non-oil economy. Average interest rates declined in response. Broad money grew by almost 15.4%, reflecting a 20.0% rise in credit to the economy.

Exchange rate policy targets the US dollar/Azerbaijan manat rate. During 2013, the central bank intervened in the market and sterilized $2.5 billion to maintain exchange rate stability. This helped limit the appreciation of the manat to less than 0.1% (Figure 3.2.3). The authorities accepted the recommendation from the International Monetary Fund to move over time to a more flexible exchange rate regime, which should provide additional tools to weather potential shocks as the economy diversifies.

After the bankruptcy of a local bank, the central bank acted to protect the country's banking sector from risks and raised capital requirements fivefold, from AZN10 million to AZN50 million. This measure envisaged banking sector consolidation and recapitalization. However, most of the banks managed to meet the new requirement, and the deadline for compliance was extended a year, until the end of 2014.

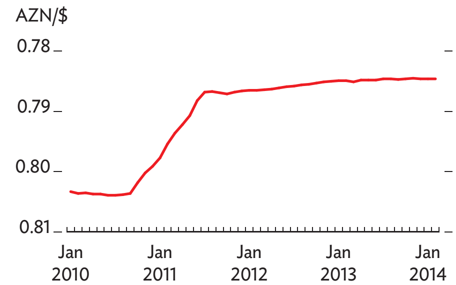
Hydrocarbons contribute 94.4% of export revenues. Exports declined by 1.8% in 2013, as lower global prices reduced oil export earnings, while imports, mainly of food and other consumption goods, rose by 9.4%. Accordingly, the trade surplus narrowed to $20.6 billion in 2013 from $22.2 billion in 2012. The smaller trade surplus contributed to a 17.4% contraction, to $12.3 billion, in the current account surplus, which fell to 16.7% of GDP in 2013, from 21.4% in 2012.

Foreign direct investment amounted to $6.3 billion, 82.4% of which went to the oil and gas sector. Gross international reserves grew to an estimated $14.4 billion at the end of 2013, equivalent to 15.5 months of imports, from $12.0 billion a year earlier (Figure 3.2.4). Strategic reserves—the sum of gross reserves in the central bank and SOFAZ assets—amounted to nearly $50 billion at the end of 2013. External public debt at the end of 2013 was estimated at $6.1 billion, or 8.2% of GDP.

Economic prospects

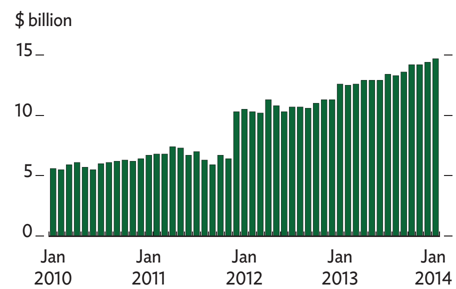
Growth is forecast to slow to 5.0% in 2014 and decelerate further to 4.8% in 2015, mainly because of an anticipated moderation in public expenditure and slowing expansion in the oil industry (Figure 3.2.5). Large public sector programs, including public investments in infrastructure, will continue to propel growth, though declining oil prices and limited increases in production will constrain how much

3.2.3 Nominal exchange rate



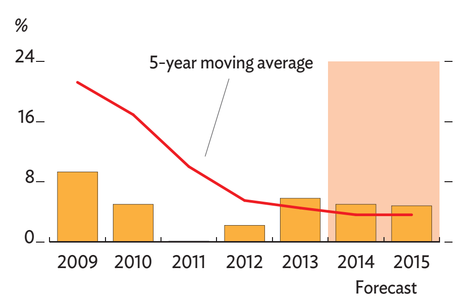
Source: Central Bank of the Republic of Azerbaijan.

3.2.4 International reserves



Source: International Monetary Fund. International Financial Statistics online database (accessed 17 March 2014).

3.2.5 GDP growth



Sources: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 18 March 2014); ADB estimates.

petroleum income can finance the promotion of other activities. Recently approved state programs for the development of Baku, the capital, and of the regions will identify new opportunities for public investments to diversify the economy. Attempts to make the budget less dependent on oil revenues may further cut public investments in coming years, possibly slowing growth more than currently projected.

On the supply side, industry is forecast to expand by 0.9% in 2014 and then slow to 0.5% growth in 2015. Oil and gas will contribute modestly to growth, while construction, benefiting from public investment, will remain an important driver, though less so than in 2013 because of an expected plateauing of budget expenditure. The government will continue its support to agriculture and will extend subsidies and concessional lending to farmers through its company Agroleasing. The authorities are expected to prepare a plan to reclaim unused land for agriculture as two big irrigation projects reach completion. Hence, agriculture is expected to grow by 5.5% in 2014 and 5.7% in 2015, reflecting higher crop production. Services are projected to grow by 8.0% in 2014 and 8.5% in 2015 because of tourism and trade.

Inflation is projected to accelerate to 4.0% in 2014, reflecting higher incomes and a rise in fuel tariffs, then moderate to 3.5% in 2015 (Figure 3.2.6). Higher transportation costs may impose additional inflationary pressure on food prices, which will nevertheless remain low. Strict processing rules introduced in 2013 for consumer loans should reduce overheating in consumer markets, helping contain inflation and widen the trade surplus.

The government budget is expected to return to deficit in 2014 and 2015, with the deficit reaching 2.6% of GDP in 2014 before diminishing to 2.0% in 2015 (Figure 3.2.7). Despite improved tax administration, revenues are expected to decline by 6% in 2014, mainly because of smaller transfers from the SOFAZ sovereign wealth fund, as oil earnings approach a peak and the authorities work to reduce the budget's dependence on oil revenues. Total expenditure is forecast to decline to 32.1% of GDP in 2014 and possibly less in 2015, notwithstanding continued investment in infrastructure and spending for social projects that support education, health, and social protection. The decline in the ratio of expenditure to GDP will limit domestic demand and retard growth.

Monetary policy during 2014–2015 is expected to target inflation even more narrowly than before. With stronger controls over consumer loans, banks are expected to promote lending to micro, small, and medium-sized enterprises. At the same time, the central bank announced in February 2014 a significant relaxation of provisioning requirements. Both developments may accelerate growth in private sector credit.

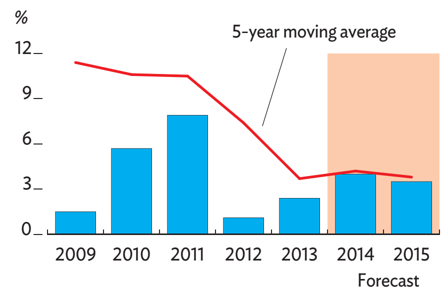
The current account balance is forecast to record a surplus of 16.0% of GDP in 2014 and 15.0% in 2015, reflecting continued sizable oil and gas exports (Figure 3.2.8). Imports are expected to grow by 3.4% in 2014 and 4.0% in 2015. New rules on consumer lending will reduce imports of electric appliances and other household goods, though imports required to build the Shah Deniz gas pipeline will keep total imports rising. Service earnings should expand in 2014 and 2015, buoyed by the transportation of goods and two big international events Azerbaijan will host.

3.2.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.0	4.8
Inflation	4.0	3.5
Current account balance (share of GDP)	16.0	15.0

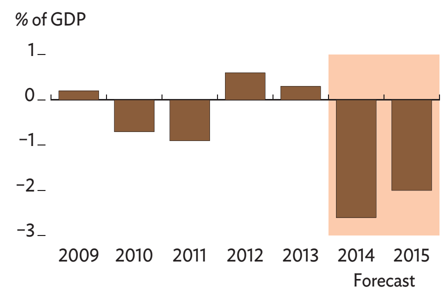
Source: ADB estimates.

3.2.6 Inflation



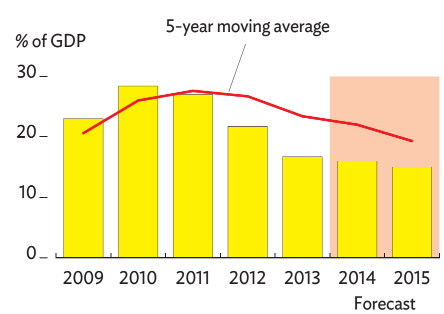
Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 17 March 2014).

3.2.7 Fiscal balance



Source: Ministry of Finance of the Republic of Azerbaijan.

3.2.8 Current account balance



Source: Central Bank of the Republic of Azerbaijan. http://www.cbar.az (accessed 17 March 2014).

Policy challenge—fiscal consolidation and reducing dependence on oil

Much of Azerbaijan's recent growth has come from using oil earnings to finance public investment, as transfers from SOFAZ have provided nearly 60% of budget revenues. Oil revenues are unlikely to rise much over the medium term, however, as production levels off and global prices decline. Thus, the budget may fall under pressure, requiring the government to consolidate its budget and spend its money more productively.

The resulting cuts in public spending will likely reduce public investment in various sectors of the economy. Unless managed carefully, these cuts could undermine growth in the broader economy, especially in construction, and slow its necessary diversification.

The government needs to make its budget planning and implementation more effective by introducing best practices, including the use of effective public–private partnerships, while also creating deeper and more efficient financial markets. Effective public–private partnerships can help the authorities to address infrastructure needs at lower cost to the budget, though such arrangements must be well organized and managed to attain good results. The careful use of such partnerships would allow the budget to devote more spending to programs in health, education, and training, which offer the best hope of addressing the needs of the most vulnerable populations. Developing more effective financial markets would promote private sector development.

The central bank's decision to curb consumer lending in favor of loans to small and medium-sized enterprises should promote growth. Additional lending to small and medium-sized enterprises should assist a wide variety of firms, particularly those in the broader economy apart from oil, and narrow disparities between the capital and the regions. However, more is needed to promote lending in rural areas.

Around 40% of the population of Azerbaijan lives in rural areas, where agriculture is the main pursuit and firms are usually small. At present, agriculture is heavily subsidized by the government, which shields activities in the sector from taxes and exempts several agricultural inputs, such as seeds, livestock, and fertilizer, from customs duties. These exemptions reduce revenues and help keep the budget dependent on oil income.

Agriculture has the potential to employ around 30% of total labor force, and generate additional income to reduce poverty and promote growth in rural areas. Making finance available in these areas, and using microfinance to reach underserved farmers and other poor households, is important for boosting rural income. Promoting microfinance will require that a sound regulatory framework be established. A new strategic approach for financial inclusion that includes new services, such as micro insurance and micro leasing, would support this effort.

Besides improving microfinance, the authorities need to promote a wider regional network of bank branches, enforce financial consumer protection, and create conditions that will enable financial institutions to reduce real lending rates for rural enterprises. These steps should boost rural income and, eventually, revenue from rural areas, thereby reducing the budget's current dependence on oil earnings.

Georgia

A reduction in budget spending, and low private investment attributable to political uncertainty, slowed growth to an estimated 3.2% in 2013, while the current account deficit narrowed substantially to about 6% of GDP. Greater political stability, better trade links, reforms to boost competitiveness, and improved investor sentiment are expected to raise growth to 5.5% in 2014 and 6.0% in 2015, though the current account deficit will likely widen.

Economic developments

Growth slowed to an estimated 3.2% in 2013 from 6.2% in 2012. On the demand side, a 16.7% decline in public investment offset improvement in net foreign trade and services. Public investment declined because of audits of ongoing projects, while private investment fell because of political uncertainty. The drop in investment reduced construction by 10.6% (versus 13.6% growth in 2012), slowed manufacturing growth to 8.4% from 13.6% in 2012, and cut growth in industry overall to 1.9% from 9.5% (Figure 3.3.1). Partly offsetting these steep slowdowns were 9.8% growth in agriculture, reversing a 3.7% decline in 2012, and 3.1% growth in services, down from 6.2% in 2012, as domestic trade, financial intermediation, and tourism all expanded by less than in the previous year. Growth accelerated toward the end of 2013, reflecting greater political certainty and increased public investment.

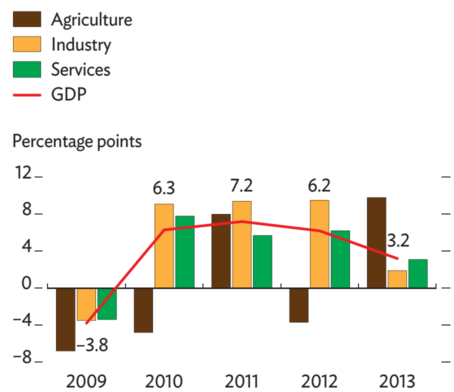
Deflation persisted in 2013. Consumer prices fell by 0.5%, about half the 0.9% decline in 2012, reflecting both supply and demand factors (Figure 3.3.2). Lower international food and fuel prices, together with cuts in electric and gas utility charges, contributed to deflation from the supply side, while slower growth helped lower prices from the demand side. Inflation accelerated to 2.9% in January 2014 with higher food and utility prices.

The fiscal deficit narrowed slightly to 2.7% of GDP in 2013 from 2.8% in 2012 (Figure 3.3.3). With slower growth, revenues fell by 2.1% to the equivalent of 27.6% of GDP, from 28.9% in 2012. Tax revenues declined slightly (against a 4.3% projected increase), and nontax revenues fell by 13.3%. Total expenditure decreased by 3.1% to the equivalent of 30.3% of GDP from 31.7% in 2012. Increases of 23.5% in social spending and 16.0% in salaries were offset by two large declines: 20.8% in capital expenditure and 22.1% in spending on goods and services. At the end of 2013, total government debt rose to 32.9% of GDP from 32.3% a year earlier.

In response to the slowdown, the National Bank of Georgia, the central bank, progressively cut the policy rate from 5.25% to 3.75% during 2013 before restoring it to 4.00% in February 2014 (Figure 3.3.4).

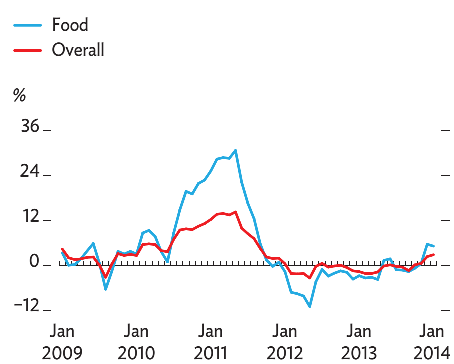
This chapter was written by George Luarsabishvili of the Georgia Resident Mission, Asian Development Bank, Tbilisi.

3.3.1 GDP growth by sector



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 14 March 2014).

3.3.2 Inflation



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 14 March 2014).

Growth in broad money (M3) rose to 24.5% in 2013 from 11.4% in 2012. Bank credit to the economy grew by 18.7% during 2013 (compared with 20.6% in 2011 and 13.3% in 2012), reflecting revived economic activity, increasing demand for bank loans, and less risk aversion among banks (Figure 3.3.5).

The average lending rate dropped to 15.6% from 18.6% in 2012, and the average deposit rate to 6.2% from 8.5%, as constrained credit growth and excess liquidity persisted in the banking sector. Dollarization remained high, although the share of foreign exchange deposits in total deposits declined to 55.7% from 60.4% in 2012. Nonperforming loans eased to 7.5% of total loans at the end of 2013 from 9.3% a year earlier, as overdue loans and provisions for loan losses decreased.

The current account deficit nearly halved to 6.0% of GDP in 2013 from 11.4% in 2012 (Figure 3.3.6). The trade balance improved substantially with a strong, 27.6% recovery in exports and a 0.5% decrease in imports. Improved trade relations prompted a fourfold rise in exports to the Russian Federation. Exports to other markets in the Commonwealth of Independent States rose by 19.2%, and those to the European Union by 72.2%. The reduction in imports largely reflected the economic slowdown and lower imports of investment items.

Gains in tourism generated a surplus in the services account, as the number of tourists including those in transit rose by 21.1% in 2013 and earnings related to tourism increased by 6.0%. Total remittances rose by 7.8% to $1.3 billion (8.0% of GDP), including a 5.0% increase in remittances from the Russian Federation.

The current account deficit was largely financed by inflows of foreign direct investment, which slightly increased to $914 million from $912 million in 2012. The Georgian lari weakened by about 5% vis-à-vis the US dollar in 2013, reflecting rising imports and faster economic growth at year-end, along with market sentiment that the lari was overvalued. Over the year, it depreciated by 1.5% in real effective terms.

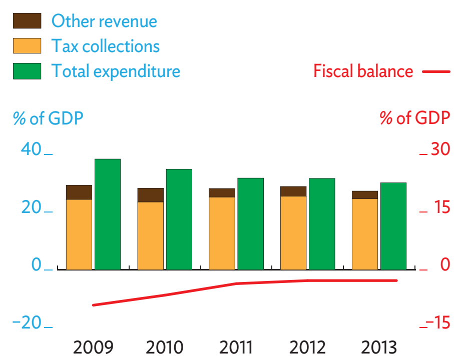
In response to outflows of short-term capital, the central bank sold $240 million in foreign exchange near the end of 2013 to stabilize the exchange rate, following purchases of $575 million during the first three quarters. Official reserves decreased by $50 million to $2.8 billion in 2013, equivalent to 4.4 months of merchandise imports. Gross external debt declined to 62.8% of GDP at the end of 2013 from 63.5% a year earlier, in part reflecting Georgia's repayment of $377 million in loans from the International Monetary Fund.

Economic prospects

Growth is expected to accelerate to 5.5% in 2014 and 6.0% in 2015, reflecting higher public investment and improved investor sentiment (Figure 3.3.7). Anticipated improvements in the external environment, coupled with rising consumer confidence, should also support growth. Reduced political uncertainty will help revitalize the banking sector and credit activity, aiding growth.

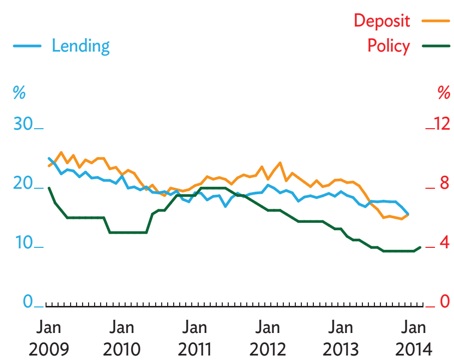
Industry is projected to expand by 5.8% in 2014 and 6.5% in 2015, reflecting improved investor sentiment, while rising income is forecast to boost services by 5.1% in 2014 and 5.5% in 2015. Barring adverse

3.3.3 Fiscal indicators



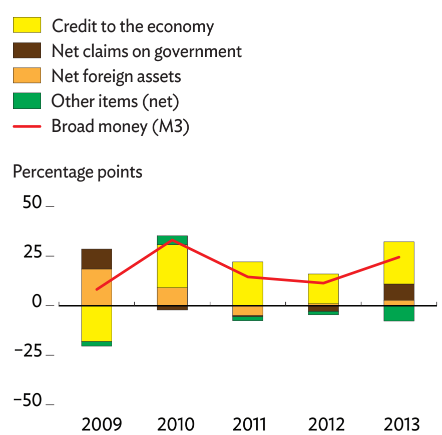
Sources: International Monetary Fund. 2010. *Country Report* No. 10/219. July; 2011. *Country Report* No. 11/146. June. www.imf.org; Ministry of Finance of Georgia. www.mof.ge (accessed 14 March 2014).

3.3.4 Interest rates



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 14 March 2014).

3.3.5 Contributions to money supply (M3) growth



Source: International Monetary Fund. International Financial Statistics online database (accessed 14 March 2014).

weather, agriculture is expected to expand further by at least 7.0% in 2014 and in 2015 as the government continues to promote higher productivity and technological advancement.

Inflation is projected to remain below the central bank's 6.0% target but rise to 4.0% in 2014 and 5.0% in 2015, reflecting accommodative monetary policy, the pass-through effect of a weakening lari, and the diminishing impact of earlier utility price cuts. Demand-side inflationary pressures should intensify as economic activity picks up. However, delayed recovery in business activity and investment may keep inflation below current projections.

Higher expenditures are expected to widen the fiscal deficit to 3.6% of GDP in 2014, but increased revenues and a leveling off of spending should narrow it again to 3.0% in 2015. Revenues are expected to decrease to 27.2% of GDP in 2014 before rising to 27.5% in 2015. Expenditures are expected to reach 30.8% of GDP in 2014 and then decline to 30.5% in 2015. The ratio of government debt to GDP is forecast to rise to 33.6% of GDP in 2014 before declining to 33.0% in 2015, with the share of external debt expected to fall (Figure 3.3.8).

Monetary policy will pursue the twin objectives of low and stable inflation and higher employment as it remains accommodative to support growth. Broad money is projected to expand by 26% annually during 2014–2015 as credit growth accelerates, reflecting the central bank's efforts to expand borrowers' access to long-term loans in local currency.

Faster growth in consumption should, along with higher investment, boost imports and widen the current account deficit in 2014. The deficit is forecast to reach 8.0% of GDP in 2014, with exports projected to grow by 19.0% and imports by 21.5%. The deficit should narrow slightly in 2015 to 7.5%, as export growth accelerates to 22.0% and import growth eases to 17.4%. Exports will expand as additional productive public investment boosts output and productivity generally, while higher growth will further attract imports. The services balance should improve as service earnings expand with increased tourism. However, the income account deficit should widen, with higher profit transfers and lower portfolio investment income. Foreign direct investment is expected to remain strong at just under $1 billion in 2014 and 2015, as increased integration with the European market and improved infrastructure boost investor sentiment and project opportunities. Gross international reserves are forecast to dip to $2.7 billion in 2014 before increasing to $2.8 billion in 2015 (Figure 3.3.9). Total external debt is expected to decline to 60.4% of GDP in 2014 and further to 60.0% in 2015. In 2013, Georgia initialed an association agreement with the European Union that is expected to lead to a deep and comprehensive free trade agreement.

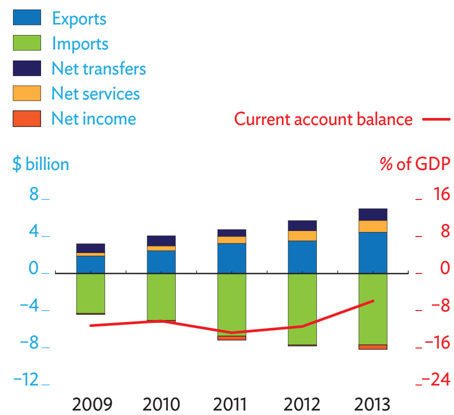
Downside risks to economic growth relate to fiscal and financial challenges and unexpectedly slow growth in major trading partners from such possible causes as regional tensions that diminish trade and investor confidence. Inflation could also be higher. A protracted recovery in the euro area and continued economic weakness in the Russian Federation may undermine growth prospects if exports, remittances, and capital inflows disappoint expectations.

3.3.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.5	6.0
Inflation	4.0	5.0
Current account balance (share of GDP)	−8.0	−7.5

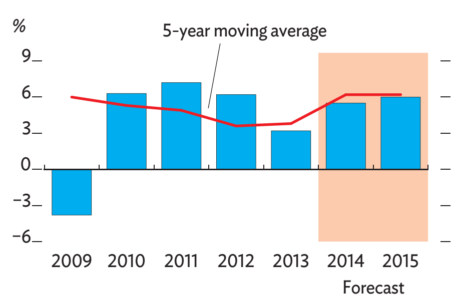
Source: ADB estimates.

3.3.6 Current account components



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 14 March 2014).

3.3.7 Annual GDP growth



Source: ADB estimates.

Policy challenge—fiscal policy for inclusive growth

The government is pursuing fiscal policies that support inclusive growth while maintaining a sustainable fiscal position. Measures aim to improve the tax system, the business environment, and the quality and composition of public spending.

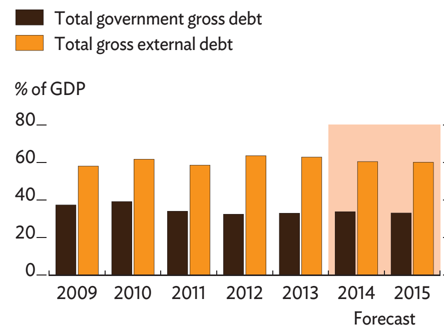
The tax environment is to be made more conducive for business through policy reform and better tax administration. Reform and easier tax compliance should encourage business activity, generating higher revenues that could fund additional benefits to the poor, particularly in health care, education, and social security. On the expenditure side, health care and social protection are rising priorities, reflecting a strong commitment to improving the health status of the most vulnerable. Plans are under way to reshuffle spending to focus on the poor, expanding jobs to replace aid provision and offering reserve social assistance for the poorest groups, while cutting other expenditure to provide sufficient fiscal space to ensure sustainability.

To facilitate inclusion and social cohesion, the government has expanded social expenditure and upgraded the country's social protection system with targeted social assistance and a basic pension. Spending on targeted social assistance has doubled, at a cost of 0.5% of GDP, while the basic pension was raised almost to the subsistence minimum, costing an additional 0.8% of GDP. Universal medical insurance, which extends coverage for basic care to every citizen, has also been introduced at a cost of about 1% of GDP, nearly doubling health care spending in 2013 to 2.7% of GDP. The new insurance system is expected to stay cost-effective and sustainable by using a common procurement mechanism for basic medical services. Further social reforms yet to be elaborated are expected to add about 1% of GDP annually to existing costs.

The government intends to index the basic pension to inflation, to protect the purchasing power of pension benefits and offer recipients an acceptable percentage of prior earnings. To lessen financial pressures arising from future pension increases for an aging population, the government is planning to supplement the current basic pension, funded solely from payroll taxes, with a private pension savings scheme under a defined contribution plan. This reform will support retirement needs while extending basic income security to those working outside the formal sector.

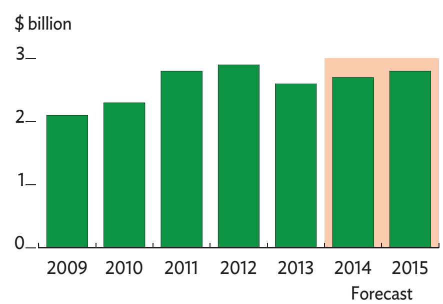
Better targeting of social benefits should promote social inclusion while making social spending more sustainable. Coverage of the poorest decile under the Targeted Social Assistance program is expected to increase to 60% by 2017 up from a baseline of 40% in 2013. At the same time, as the elderly use their pensions to supplement income for their extended families, higher pensions should benefit children living in such families and reduce the number of children living below the poverty line.

3.3.8 Government debt indicators



Sources: International Monetary Fund. 2013. *Regional Economic Outlook: Middle East and Central Asia.* November. http://www.imf.org; National Bank of Georgia; ADB estimates.

3.3.9 Gross international reserves



Sources: National Bank of Georgia. http://www.nbg.gov.ge (accessed 14 March 2014); ADB estimates.

Kazakhstan

Growth rose to 6.0% from 5.0% in 2012, reflecting accelerated private consumption and investment, though the current account surplus shrank further to 0.1% of GDP from 0.3% a year earlier. The pace is projected to remain at 6.0% in 2014 and improve to 6.4% in 2015, as the February 2014 devaluation of the Kazakh tenge and new flows from the Kashagan oilfield should boost exports and the current account surplus.

Economic developments

GDP growth accelerated to 6.0% from 5.0% in 2012, driven mainly by robust private consumption and investment. On the supply side, industry expanded by 2.3%, up from 0.4% in 2012, as mining output rose by 3.1% from 0.4% in 2012. Agriculture rebounded strongly, rising by 10.8% after the 18.5% decline in 2012, as harvests expanded by nearly 20%. Preliminary data for 2013 show growth in services slowing to an estimated 7.4% from the 10.4% recorded in 2012, despite large gains of 12.7% in trade and 14.0% in communications (Figure 3.4.1).

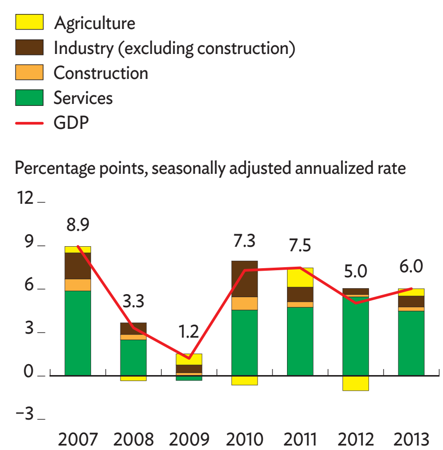
On the demand side, based on 9 months' data, consumption is estimated to have expanded by over 12.0%, up from 11.4% in 2012. Private consumption rose by 16.1%, versus 11.0% in 2012, fueled by rapid growth in consumer credit, though fiscal tightening slowed growth in public consumption to 1.6% from 13.2% in 2012. Net exports fell by about 30% during the same period, on top of an estimated 40% decline in 2012, as export volumes declined by 7.2% while import volumes rose by 23%. Investment in 2013 expanded by 6.5%, up from 3.8% in 2012, as public investment fell by more than 10% but private investment rose by about 12% (Figure 3.4.2).

The average inflation rate rose to 5.8% from 5.1% in 2012 as service tariffs jumped by 10.6%, up from 6.8% in 2012. Food prices increased by 4.3%, slightly less than the 4.5% recorded in 2012, and other prices by 3.1%, down from 4.3% a year earlier. However, the December-to-December inflation rate fell to 4.8% from 6.0% in 2012 (Figure 3.4.3).

Fiscal policy tightened slightly during 2013, as the republican budget deficit narrowed to 2.1% of GDP from 3.0% in 2012. Revenues contracted slightly to 15.5% of GDP from 15.8%, but expenditure fell to 17.6% of GDP from 18.8% as the government consolidated spending. Total public and publicly guaranteed debt rose to 13.4% of GDP from 13.0% at the end of 2012, while external debt declined to 2.7% of GDP from 2.9% a year earlier. The foreign debt of state-owned enterprises declined to 10.9% of GDP from 12.9% at the end of 2012. However, the International Monetary Fund has warned against the risk of contingent liability from foreign debt incurred by the Samruk-Kazyna sovereign wealth fund equivalent to 30% of GDP.

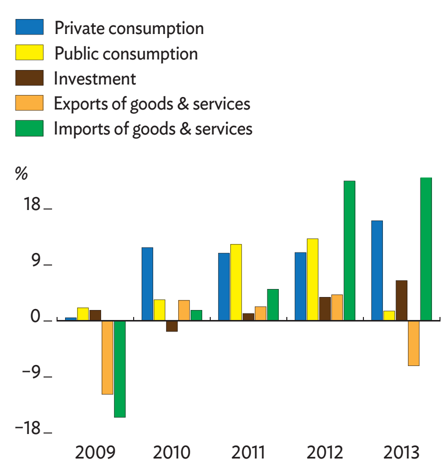
This chapter was written by Manshuk Nurseitova of the Kazakhstan Resident Mission, Asian Development Bank, Astana.

3.4.1 Supply-side contributions to growth



Source: Agency of Statistics of the Republic of Kazakhstan.

3.4.2 Growth of GDP demand components



Source: Agency of Statistics of the Republic of Kazakhstan.

Monetary policy aimed in 2013 to contain inflation while supporting growth. Broad money (M3) grew by 10.2% (versus 7.9% in 2012), reflecting 13.4% growth in credit to the economy (as in 2012) and 12.2% growth in deposits (versus 7.3% in 2012) (Figure 3.4.4). Credit to legal entities rose by 8.0%, and to individuals by 27.0%, though credit to small and medium-sized enterprises fell by 9.1%, despite subsidized interest rates and guarantees. Restrictions on consumer lending introduced in October responded to concerns over a possible bubble.

In September 2013, the National Bank of Kazakhstan (NBK) moved from pegging the exchange rate solely to the US dollar to a multicurrency basket peg comprising the ruble at 10%, euro at 20%, and the US dollar at 70%. The NBK was a net seller of currency during the year. While the real effective exchange rate against a basket of 33 currencies did not change, the Kazakh tenge depreciated against the US dollar, as the nominal average exchange rate fell from T149.1 per US dollar to T152.1 and, in January 2014, further to T155.0. On February 11, shortly after the Russian Federation announced its move to a floating exchange rate and the ruble depreciated, the NBK reset the exchange rate band at T185 ±T3 per US dollar, a devaluation of 16.2% against the US dollar, or a 19.4% rise in tenge per dollar (Figure 3.4.5).

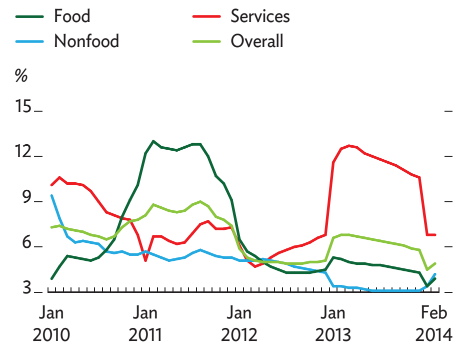
The current account surplus fell to 0.1% of GDP from 0.3% at the end of 2012 and 5.4% a year earlier. Export earnings declined by 4.0%, reversing a 2.3% rise in 2012 and reflecting weaker demand and lower prices, with ferrous metals and grain suffering the most. Growth in imports dropped sharply to 1.0% after a 21.6% rise in 2012, as prices for most goods declined but volumes increased. Deficits in the services and income accounts narrowed as the Kashagan oilfield neared completion. Net inflows of foreign direct investment fell by 31.1% to $8.1 billion, while gross reserves fell to $24.7 billion from $28.3 billion at the end of 2012. Assets in the National Fund of the Republic of Kazakhstan rose to $70.5 billion from $57.9 billion a year earlier.

External debt rose from $137.0 billion at the end of 2012 to $148.0 billion by the end of September 2013 (Figure 3.4.6). This was unchanged as a share of GDP at 67.4%, but the ratio of debt service to exports of goods and services rose from 33.7% to 39.5%. Almost half of the external debt, or $72.5 billion, is intra-company debt of multinational corporate subsidiaries operating in Kazakhstan.

Economic prospects

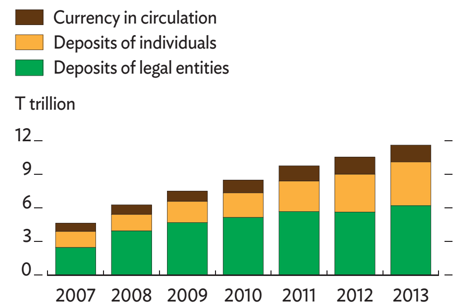
Following the tenge devaluation in February 2014, growth is forecast to remain unchanged at 6.0% in 2014 and accelerate to 6.4% in 2015, mainly supported by higher investment and net exports (Figure 3.4.7). On the supply side, industry is forecast to expand by 2.9% in 2014 and a further 4.0% in 2015, as mining revives and the first results of the industrialization program materialize. Production at the Kashagan oilfield, originally forecast to begin in 2014, may be delayed until 2015. Infrastructure development and preparation for the global Expo 2017 (themed "future energy") will boost construction and related services. Agriculture growth is expected at about 4.0% in 2014, accelerating to 4.4% in 2015 thanks to ongoing support and huge investments under

3.4.3 Inflation



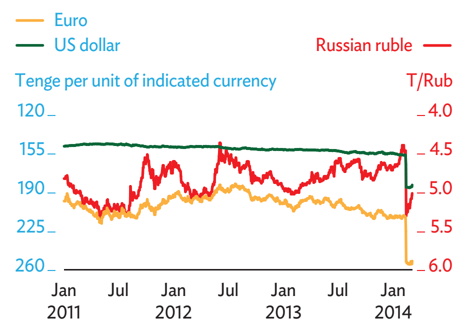
Source: Agency of Statistics of the Republic of Kazakhstan.

3.4.4 Broad money (M3)



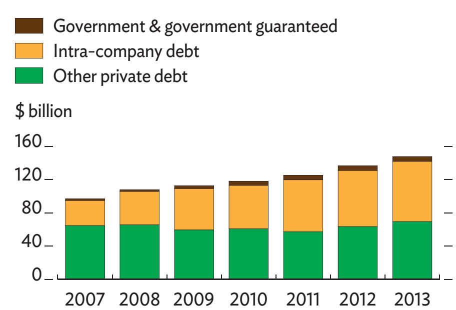
Source: National Bank of Kazakhstan.

3.4.5 Exchange rate



Source: National Bank of Kazakhstan.

3.4.6 External debt



Source: National Bank of Kazakhstan.

the state program Agribusiness 2020 to modernize and diversify output beyond grain production. Services should grow by about 8% each year, driven by fast expansion of trade, transport, communications, and business services.

On the demand side, consumption is forecast to grow by 6.2% in 2014 and 6.8% in 2015. The expansion in private consumption is expected to slow to 6.8% in 2014 because of new restrictions on consumer credit, higher taxes on property and transport, and the impact of tenge devaluation on prices, recovering to 7.5% in 2015. Meanwhile, growth in public consumption is projected to accelerate to 4.0% in 2014 and then subside to 3.8% in 2015. An anticipated rise in total investment (equipment plus structures) of 6.8% in both 2014 and 2015 should boost construction by 3%–4%. Net exports are forecast to rise by 4.0% in 2014 and 4.5% in 2015, as devaluation boosts mineral exports and slows import growth.

Inflation is projected to rise to 11.5% in 2014 and then slow to 8.8% in 2015 as the effect of the devaluation ebbs over time. Prices are projected to rise in 2014 by 8.1% for food and 18.6% for other items, which are mainly imported, and by an estimated 6.6% for food and 11.8% for other items in 2015. Prices for services should rise by 8.4% each year.

The augmented republican budget deficit is expected to expand to 2.8% of GDP in 2014. Revenues are projected to reach 15.7% of GDP, reflecting mainly higher revenues from corporations, including a 33.0% increase in the crude oil excise from $60 to $80 per ton. Expenditure is forecast to expand to 18.5% of GDP on increases in social benefits, pensions, and public wages granted to mitigate hardship caused by devaluation. For 2015, revenues are forecast at 13.8% of GDP, expenditures at 16.2%, and the deficit at 2.4% (Figure 3.4.8).

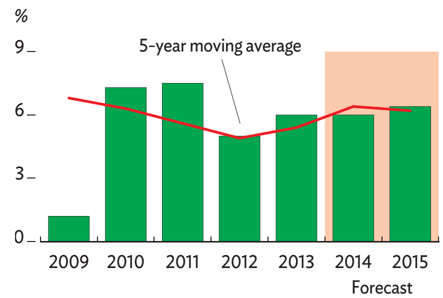
A unified state pension fund with assets estimated at $22 billion is to emerge by the middle of 2014 from the merger of 10 private pension funds. The government is considering another sovereign eurobond issue to provide a benchmark for the corporate sector and refinance debt due in 2014 and 2015.

The government remains committed to limiting its debt to 13.7% of GDP, public and publicly guaranteed debt to 13.9% of GDP (22% if state-owned enterprise debt is included), and debt service to 15% of republican budget revenue. Projections show public and publicly guaranteed debt remaining below its limit in 2014 and 2015.

Monetary policy over the next 2 years will face the challenge of limiting inflation while supporting growth and maintaining the exchange rate. Broad money is projected to rise by about 10% in 2014 and 12% in 2014, as the resolution of the nonperforming loan (NPL) problem helps expand credit to the private sector. Exchange rate policy will focus on the competitiveness of Kazakh exports and depend on the policy of the Russian Federation, Kazakhstan's major trade and economic partner. However, given the intention to move to a floating exchange rate, the rate's long-term trend will depend on macroeconomic developments, with the recent tensions in Ukraine introducing downside risk.

Loan quality will remain a concern of bank regulators. A range of tools will be used to remove NPLs from the books of commercial banks,

3.4.7 GDP growth



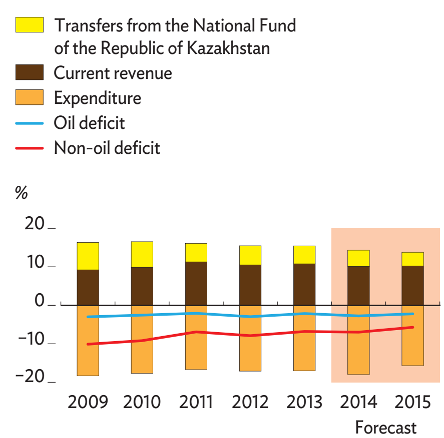
Source: *Asian Development Outlook* database.

3.4.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.0	6.4
Inflation	11.5	8.8
Current account balance (share of GDP)	0.6	2.3

Source: ADB estimates.

3.4.8 Fiscal indicators



Source: The Ministry of Finance of the Republic of Kazakhstan.

3.4.1 Spotlight on tenge devaluation and its consequences

On 11 February 2014, shortly after the Central Bank of the Russian Federation announced a transition to a floating exchange rate, and the consequent depreciation of the ruble, the National Bank of Kazakhstan reset its exchange rate band for the tenge at T185 ±T3 per US dollar, from about T155 the previous day. This was equivalent to a 16.2% devaluation, or a 19.4% rise in tenge per dollar. To contain volatility, the bank announced it would intervene in the exchange market, though it eventually planned to establish a floating exchange regime consistent with targeting inflation. On 14 February 2014, T1 trillion was allocated from the assets of the National Fund of the Republic of Kazakhstan to use in 2014 and 2015 to support economic growth and provide credit to small and medium-sized enterprises. The government and the national central bank were tasked to propose policies and ensure the efficient and transparent distribution of these funds.

The devaluation is expected to have significant repercussions on the economies of Kazakhstan and its neighbors. It should boost the competitiveness of Kazakh exporters and encourage import substitution. Import prices will rise, adding to inflation, while the expected higher exports should boost growth and budget revenues. Budget outlays may rise as social programs for the vulnerable are expanded, but revenues are expected to rise by more than expenditures. Devaluation will hit banks' profitability and capital adequacy and weaken the finances of the many other firms with foreign debt.

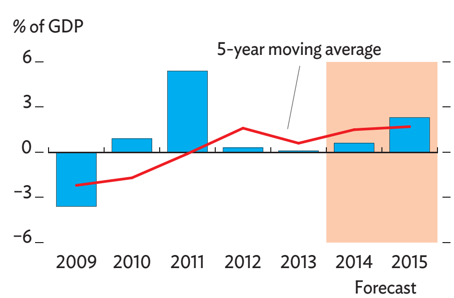
The devaluation has affected Kazakhstan's macroeconomic outlook. Growth is forecast to be about 0.3% higher in 2014 than originally expected, thanks in part to the additional spending financed by the National Fund of the Republic of Kazakhstan, and about 0.2% higher in 2015, as the impact of the devaluation weakens. Inflation is projected to exceed earlier forecasts by at least 5% in 2014 and 2.5% in 2015. The devaluation is projected to improve the current account balance by nearly 5% of GDP in 2014 and more than 7% in 2015.

Following the devaluation, the government announced measures to mitigate its impact on the populace. Prices will be regulated for socially important goods and tariffs, as catch-up wage increases are instituted. By 1 April 2014, employee salaries in the public sector and state-owned companies were to be raised by 10%, pensions and social allowances by 9%–14% (versus previously scheduled increases of 7%–9%), and student stipends by 10%. Major industrial companies have been advised to do the same, and many leading employers have agreed. Kazakhmys, a large copper producer with over 55,000 employees, announced a 10% pay increase for its operational staff. Tengizchevroil, the country's largest oil producer, announced an additional 9% increase for employees from 1 April.

in some cases by writing off assets; the bankruptcy law was amended to facilitate the process. The goal is to reduce NPLs to less than 20% of loan portfolios by the end of 2014 and below 10% by the end of 2015, though new NPLs arising from currency devaluation may complicate achieving these objectives.

The current account balance is forecast to improve to a surplus of 0.6% of GDP in 2014, because of tenge devaluation, and to 2.3% in 2015 if production begins in the new oilfield (Figure 3.4.9). Import growth is expected to stabilize at 2%–4% in 2014 and 2015, as the devaluation and industrialization slow demand for imported investment goods. The services deficit should remain at about $7 billion in 2014 and 2015 as the development of the Kashagan oilfield winds down but preparations for Expo 2017 begin—though production at Kashagan may widen the deficit in the income account. Reverse remittances are forecast to fall to about $1.5 billion in 2014 and 2015. Gross reserves are projected to reach $28.0 billion in 2014 and $31.0 billion in 2015, reflecting the improved current account. Assets in the National Fund of the Republic of Kazakhstan are projected to reach $73.2 billion at the end of 2014 and $77.7 billion a year later (Figure 3.4.10), with accumulation limited by the use of funds for budget support and mitigating the impact of the devaluation (see Box 3.4.1).

3.4.9 Current account



Source: Asian Development Outlook database.

Policy challenge—strengthening the financial sector

The health of the banking industry reflects Kazakhstan's economic situation. Massive loan losses have made banks averse to risk despite having considerable liquidity. Lending has lagged, hindering investment. Since the onset of the global financial crisis in 2009, more than a third of all bank loans have fallen seriously into arrears despite efforts by the government and the NBK to clean bank balance sheets and improve access to finance for priority economic sectors. Unlike in some other countries, banks have to set aside very large provisions against NPLs. In January 2014, provisions equaled 32.5% of all loans outstanding, while 31.4% of loans were 90 days or more past due.

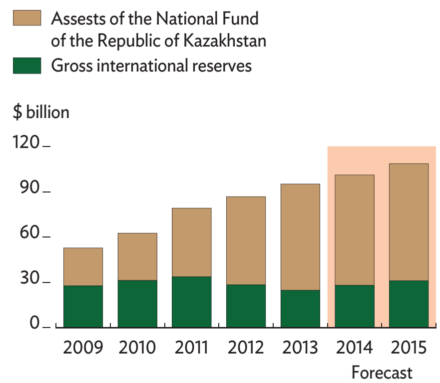
From 2010 to 2013, the authorities introduced a variety of measures to reduce the share of NPLs. These included tax waivers, creating special purpose vehicles as subsidiaries of commercial banks, and establishing collection agencies. In addition, two vehicles to handle distressed assets were established nationally: dynamic provisions to anticipate losses and new restrictions on NPLs were intended to be introduced from 2013 but were poorly designed, inconsistent, and ultimately unsuccessful.

Further regulatory tightening was originally scheduled to take effect in 2014. However, new NBK management, installed in October 2013, agreed with the government to ease regulatory pressures by extending the favorable tax treatment of loan write-offs and by postponing by 6–12 months various steps to tighten the regulatory regime—a move highly praised by the financial community. Changes to bankruptcy procedures are also being considered. At the same time, the NBK has reached agreements with major banks holding sizable NPLs on how to reduce the number of such loans. The NBK expects to see NPLs declining to about 10% of all loans by the end of 2015. Regulatory response to noncompliant banks may go as far as withdrawing bank licenses. Compliant banks, on the other hand, will be eligible to participate in the distribution of T1 trillion mobilized from assets of the National Fund of the Republic of Kazakhstan to mitigate the effect of devaluation, support economic growth, and provide credit to small and medium-sized enterprises. Some of the funds may be used to enable NPL purchases by a fund for problem loans that is a subsidiary of the NBK.

Toward the end of 2013, negotiations intensified with private investors on the most troubled banks nationalized in 2009, and agreements were reached with three—BTA (the largest lender before the financial crisis), Alliance, and Temir—albeit causing substantial loss to the Samruk-Kazyna sovereign wealth fund.

The new, more relaxed regulatory policies may expand lending, thereby supporting the government's efforts to accelerate industrialization. However, the currency devaluation in February could undermine these efforts to the extent that higher inflation and the revaluation of foreign liabilities raise costs and impair borrowers' capacity to service their debt. The weaker tenge is already hampering borrowers' repayment of foreign currency loans and causing NPLs to proliferate. Avoiding further deterioration of bank profitability and capital adequacy may require additional support, including capital injections.

3.4.10 Foreign exchange reserves and fund assets



Source: National Bank of Kazakhstan.

Kyrgyz Republic

Economic growth jumped to 10.5% in 2013, and the current account deficit narrowed to 10.4% of GDP, reflecting a rebound in gold production. Meanwhile, inflation accelerated to 6.6%. Growth is expected to return to 6.5% in 2014 and 5.5% in 2015, while inflation should average 6.0%–7.0%. The major challenge remains enacting governance reforms to improve the investment climate and boost investor confidence.

Economic performance

GDP rebounded by 10.5% during 2013, driven mostly by a recovery in gold production that outpaced expectations (Figure 3.5.1). All sectors except agriculture showed robust growth as the private sector expanded.

On the supply side, industrial output grew by 28.0%, reflecting 45.4% growth in manufacturing driven by a near doubling of gold output from the low base in 2012. Growth in other manufacturing subsectors slowed to 3.5% from 6.1% in 2012, dragged down by declines in textiles, utilities, and the production of minerals other than gold, as well as by somewhat slower growth in construction.

Services, which provide about half of GDP, grew strongly for the third consecutive year, at 5.1%. The strongest gains were in transportation (5.8%), trade (7.0%), and hotels and restaurants (11.1%), in view of higher consumer demand and improved cross-border trade. Agriculture outperformed the meager 1.2% rise in 2012, expanding by 2.9% as gains in grain and vegetable output outweighed a small decline in livestock production.

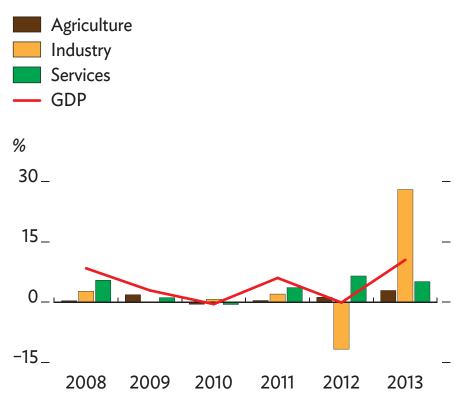
On the demand side, private consumption is estimated to have grown by 9.9%, as higher employment, wage increases, and a rise in remittances boosted retail sales by 7.5%. Investment growth plummeted to 2.3% from the 42.1% recorded in 2012, as higher private investment was offset by a 14% decline in government investment due to cuts in lower-priority spending.

Annual average inflation rose to 6.6% from 2.8% in 2012, mainly because nonfood prices climbed by 6.3%, and utility charges by 6.8%, while food prices rose by only 1.8%. Inflation decelerated during the second half of the year, led by lower prices for wheat, which reduced the 12-month (December over December) inflation rate to 4.0% from 7.5% during 2012 (Figure 3.5.2).

The fiscal deficit narrowed to 4.0% of GDP in 2013 from 5.4% in 2012, reflecting expenditure cuts. Total revenue fell to 29.0% of GDP from 34.5% in 2012, despite better tax administration. Expenditure declined to 32.8% of GDP from 39.8% in 2012, as current and capital spending both shrank (Figure 3.5.3).

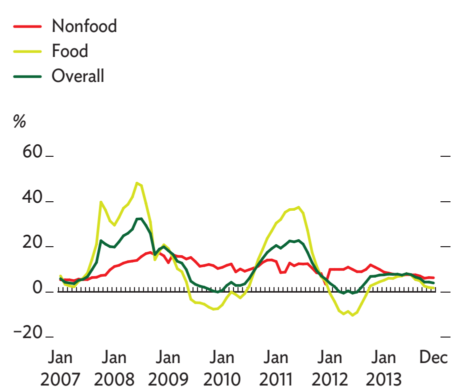
This chapter was written by Gulkayr Tentieva of the Kyrgyz Resident Mission, Asian Development Bank, Bishkek.

3.5.1 GDP growth by sector



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 14 March 2014).

3.5.2 Monthly inflation



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 14 March 2014).

Despite the large government deficit, public debt (almost all external) declined to 43.7% of GDP from 46.9% at the end of 2012, reflecting a debt write-off agreement reached with the Russian Federation and higher economic growth (Figure 3.5.4).

Extensive dollarization limits the impact of monetary policy in the Kyrgyz Republic. The central bank raised the policy interest rate from 2.64% at the beginning of the year to 4.17% at year-end, in line with inflationary pressures during the year. The average deposit rate rose slightly, to 4.26% from 4.11% in 2012, while the lending rate fell to 18.40%, from 19.90% in 2012.

Confidence in banks has strengthened. During January–December 2013, the deposit base grew by 32.9% and credit to the economy by 34.5%. The nonperforming loan ratio improved further, falling to 5.5% in December 2013 from 7.2% a year earlier. The local currency depreciated by 4% against the US dollar, with $1 equaling Som47.4 in January and Som49.3 in December. The central bank intervened in the foreign exchange market only to smooth excess volatility (Figure 3.5.5).

The current account deficit is estimated to have narrowed considerably, to 10.4% of GDP from 15.3% in 2012, helped by the recovery in gold output and lower prices for imported food and fuel. Remittances rose by 7.4% to $1.9 billion, reflecting positive developments in the Russian Federation and Kazakhstan (Figure 3.5.6). Gross international reserves remained stable at $2.2 billion.

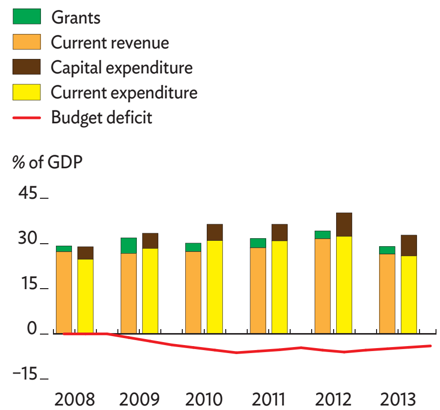
Economic prospects

GDP is expected to grow by 6.5% in 2014 and 5.5% in 2015 (Figure 3.5.7). This estimate assumes that gold production remains stable and that investments in energy and transport infrastructure projects, mainly from the Russian Federation and the People's Republic of China, materialize as expected. The projected growth slowdown in 2015 anticipates some slackening in the pace of investment projects during 2015. Government expenditures will remain a driver of economic activity amid gradual recovery in the private sector. Higher domestic demand, encouraged by greater political stability and an improved investment climate, should spur growth in the private sector unconnected to gold. Growth is expected to stabilize at about 5% in the medium term, supported by infrastructure investments and continued increases in credit.

On the supply side, services will remain the major source of growth, expanding by more than 5% annually. Transportation and communications should perform well as major road networks and energy infrastructure are rehabilitated and communication networks are expanded. Industry is expected to grow by about 10% annually, with metals and metallurgy being the main drivers and gold remaining the principal output.

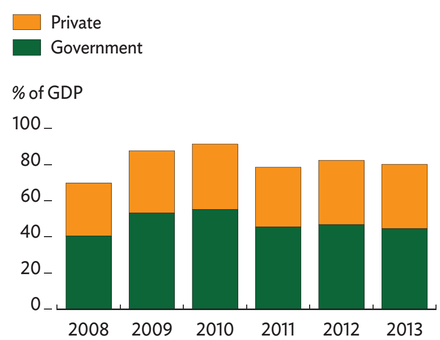
The ongoing dispute with the Centerra Gold company over the government's share of the Kumtor gold mine may cause risks to the outlook. In September 2013, the government signed a memorandum of understanding whereby it would exchange 33% of its shares in Centerra Gold for a 50% stake in the Kumtor goldmine. Parliament initially

3.5.3 Budget indicators



Sources: International Monetary Fund. 2011. *Country Report* No. 11/354. December; 2012. *Country Report* No. 12/329. December; 2013. *Country Report* No. 13/376. December; http://www.imf.org; Ministry of Finance.

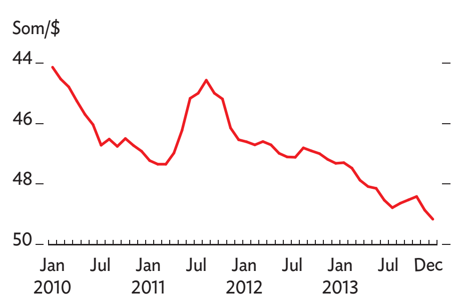
3.5.4 External debt



Note: Government debt refers to both government and government-guaranteed debt.

Sources: Ministry of Finance; National Statistics Committee. http://www.stat.kg; National Bank of the Kyrgyz Republic. http://www.nbkr.kg (both accessed 14 March 2014).

3.5.5 Exchange rate



Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 14 March 2014).

opposed the deal but, in February 2014, approved the memorandum with the proviso that the details of the new agreement be negotiated within 3 months.

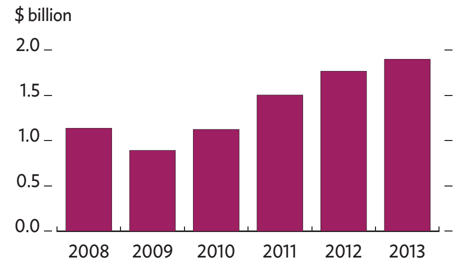
Average annual inflation is expected to stay within 6%–7% during 2014–2015. Substantial price hikes are not expected for food, which accounts for around half of the consumer price index, given current forecasts for declining global food and fuel prices. The recent depreciation of the Kyrgyz som by about 10% and its fluctuations, following the decline in the Russian ruble and Kazakh tenge, may cause higher inflation in 2014, as well as higher dollarization.

The fiscal deficit is forecast at 4.0% of GDP in 2014 and 3.0% in 2015. This is despite the closure of the military transit center at Manas Airport in July 2014, as operations wind down in Afghanistan, and the consequent loss of rental revenue worth $60 million in 2014 and an annual $120 million thereafter. The government is committed to fiscal consolidation in the medium term and will be guided by conservative revenue forecasts as it restrains expenditure on low-priority items and weighs social needs. The loss of nontax revenues in 2014 is expected to be offset partly by grants and expenditure restraint. Revenue is expected to reach 30% of GDP in 2014 and 31% in 2015, as improving tax administration remains high on the government's agenda. Expenditure is projected at 35% of GDP in 2014 and 34% in 2015, reflecting higher capital spending and somewhat lower current outlays.

Monetary policy is expected to remain restrictive, as the central bank aims to restrain inflation by absorbing excess liquidity arising from government spending. The central bank will likely increase the policy interest rate if inflation rises, as expected in 2014. Nominal interest rates are expected to stay in the 13.0%–15.0% range if the Kyrgyz Som does not depreciate further.

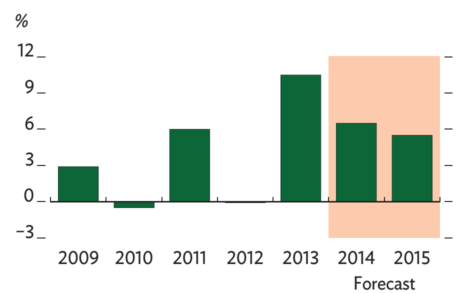
The current account deficit is forecast to widen to 15.7% in 2014 because of substantial import-intensive foreign direct investment and new infrastructure projects, and then decline gradually in subsequent years (Figure 3.5.8). Exports are forecast to grow by about 8% in 2014 and 2015, mainly from higher gold exports by volume. However, falling gold prices and expected weaker demand, mainly for textiles, food, and machinery in the Russian Federation and other markets in the Commonwealth of Independent States, may worsen the trade outlook. Imports are expected to grow steadily, by about 10% in both 2014 and 2015, because of new infrastructure projects. Inflows of foreign direct investment will depend largely on the government implementing its proposed structural reforms and improvements to the investment climate. External reserves are forecast to climb to $2.3 billion in 2014 and $2.4 billion in 2015. Currency depreciation in the Russian Federation and Kazakhstan, where most Kyrgyz migrants work, may reduce remittances. Accession into the customs union with Belarus, Kazakhstan, and the Russian Federation—expected within the next few years—adds uncertainty, as trade may initially falter with countries outside the union, including the People's Republic of China.

3.5.6 Remittances



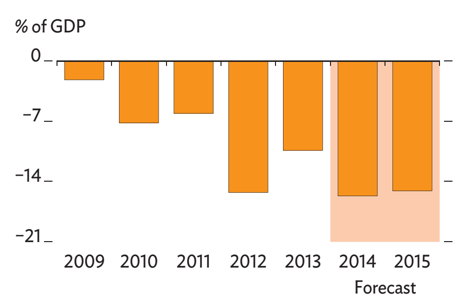
Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 14 March 2014).

3.5.7 GDP growth



Sources: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 14 March 2014); ADB estimates.

3.5.8 Current account balance



Sources: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 14 March 2014); ADB estimates.

Policy challenge—promoting inclusive growth

The rising poverty rate in the Kyrgyz Republic, which climbed from 31.7% in 2009 to 38.0% in 2012, has shown how easily the poverty reduction achieved from 2005 to 2008 can be reversed. Moreover, poverty rates vary significantly across the regions. They are relatively low in Bishkek city (at 21.4%), the surrounding oblast of Chui (16.6%), and Issyk-Kul oblast (28.1%), but the other five oblasts have always been poorer, with poverty rates in some exceeding 50%. Poverty rates are also volatile, and studies are examining why. The National Statistics Committee's report on poverty for 2012 found that inflation strongly affects the poverty rate because it drives incomes of many near-poor people below the national poverty line. Inclusive growth, benefitting all regions and people, is thus an urgent priority and necessary for political and social stability and security.

In January 2013, the Kyrgyz President approved the National Sustainable Development Strategy (NSDS) for 2013–2017, which aims to achieve political stability and stable growth in GDP and household incomes. The NSDS recognizes persistent poverty and regional disparities as key challenges.

A 2012 diagnostic study identified political instability, weak rule of law, and corruption as binding constraints on inclusive economic growth. Other constraints include the failure of low-quality education and training programs to meet the demand for skilled labor, the high cost of finance, and unreliable electricity supply. The first two constraints are especially acute in remote oblasts.

Addressing these constraints and supporting private sector development will likely accelerate growth, but making growth inclusive requires giving people more equitable access to economic opportunities. Young people in remote oblasts and the poor and vulnerable in particular need greater access to the high-quality training and education that can make them employable. Improving access to affordable finance will help distribute economic opportunity more evenly across geographic areas.

The main economic priority of the NSDS is to create an enabling environment for the private sector, thereby attracting investment and promoting growth. The strategy aims to reduce poverty mainly by creating new jobs, upgrading education and training to promote employability, and improving social assistance to pensioners and low-income groups. The government intends to address regional disparity by attracting investment to areas outside of the traditional growth centers of Bishkek, Issyk-Kul, and Chui oblasts, largely by improving the business climate. The government program for 2013–2017 intends to facilitate inclusive regional development by decentralizing administration, strengthening local self-governance, and developing road maps for economic and social development in each region.

3.5.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.5	5.5
Inflation	7.0	6.0
Current account balance (share of GDP)	–15.7	–15.1

Sources: National Statistics Committee, National Bank of the Kyrgyz Republic, International Monetary Fund, and ADB staff estimates.

Tajikistan

Growth remained robust at 7.4% in 2013, supported mainly by remittances. It is expected to slow to 6.0% in 2014 and 5.8% in 2015 because of anticipated declines in the production of aluminum and cotton, Tajikistan's primary exports. The main policy challenge is to boost private investment by improving governance and the investment climate.

Economic performance

Growth remained robust at 7.4%, though slightly lower than the 7.5% recorded in 2012. It was driven by strong domestic demand attributable to higher remittances, booming construction, and increased public investment. Private investment expanded but remained barely half the size of public investment.

On the supply side, growth in industry slowed to 3.9% from 10.4% in 2012, reflecting an 18.9% contraction in aluminum production caused by aging technology, disruptions in the supply of raw materials, and the lowest global prices since 2009. Industry nevertheless expanded because of higher output from mining, food processing, and electricity generation and distribution. Growth in agriculture also slowed, to 7.6% from 10.4% in 2012, as a 6.0% decline in cotton production linked to lower international prices offset major gains in newer crops. Growth in services accelerated to 19.3% from 14.5% in 2012, fueled by high remittances, while a recovery in public investment helped boost construction by 18.2%, sharply reversing an 18.9% contraction in 2012 (Figure 3.6.1).

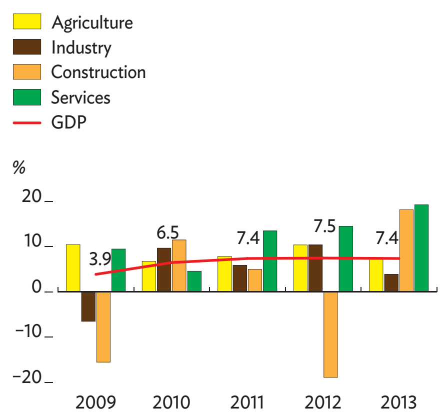
On the demand side, consumption remained the main driver of growth, supported by strong remittances and increased public consumption as spending on social services rose. Public investment expanded by 2.2%, reversing the 3.5% contraction in 2012 with renewed government spending in infrastructure projects, mainly for transport and energy. Private investment expanded by 1.2%, up from 1.0% in 2012. Recent reforms to improve the investment climate, particularly in tax policy and administration, are gradually paying off. However, excessive regulation, problems with governance, and limited property rights hinder the expansion of private investment and wages.

Average annual inflation slowed to 5.1% from 5.8% in 2012, although food prices rose slightly faster based on monthly data (Figure 3.6.2). Prices for services increased by only 6.1%, less than half the 12.9% recorded in 2012 as the price of imported liquefied gas used in transport fell by 5.5% and the Russian Federation eliminated its export duty on oil and oil products.

Monetary policy remained largely accommodative as inflation moderated. The refinancing rate was reduced to 5.5% in October from the

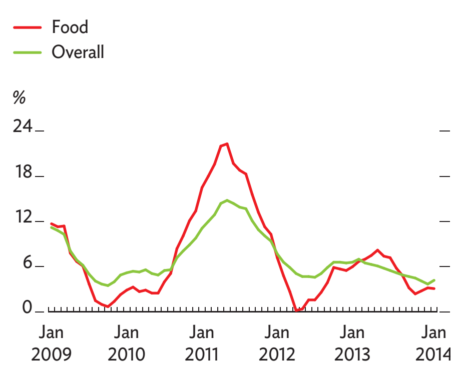
This chapter was written by Kakhorjon Aminov of the Tajikistan Resident Mission, Asian Development Bank, Dushanbe.

3.6.1 GDP growth by sector



Source: Tajikistan State Statistics Agency.

3.6.2 Monthly inflation



Source: Tajikistan State Statistics Agency.

6.5% set in September 2012. Broad money grew by 20.1%, the same rate as in 2012. Credit to the private sector grew by 53.6%, following the 17.2% rise in 2012. Total credit to the economy soared by 38.9%, on top of the 13.0% rise in 2012. Depositors' confidence in banks is gradually strengthening, as indicated by growth in the share of individual deposits to 8.7% of GDP at the end of 2013 from 7.9% a year earlier. However, the banking system remains prone to risks from low profitability, and the percentage of nonperforming loans rose to 22.0% from 18.2% in 2012. The average exchange rate for the Tajik somoni remained stable at TJS4.77 = $1, which helped moderate import prices and inflationary expectations (Figure 3.6.3).

Fiscal policy became more expansionary during 2013. The budget recorded a deficit equal to 0.8% of GDP, following the surplus of 0.4% in 2012. Excluding investment outlays, the budget surplus narrowed to 0.2% of GDP from 1.7% in 2012 (Figure 3.6.4). Revenues rose to 26.9% of GDP from 25.1% in 2012, reflecting continued improvements in tax administration attributable to a comprehensive reform program. Expenditure grew to 27.7% of GDP from 24.7% in 2012, as social spending expanded further and public spending on infrastructure recovered after a decline in 2012. However, rapid economic growth meant that total public and publicly guaranteed debt decreased as a percentage of GDP to 29.2%, from 32.3% in 2012.

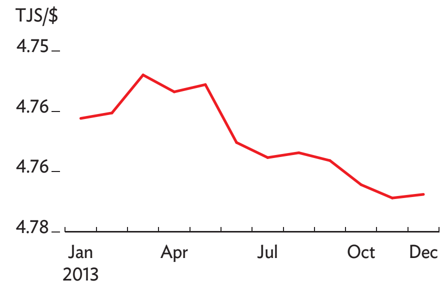
Despite a worsening trade balance, higher remittances narrowed the current account deficit to 1.9% of GDP from the 2.0% recorded in 2012. Exports fell by 0.8%, following 41.0% expansion in 2012, as aluminum and cotton exports fell sharply. At the same time, imports grew by 9.8%, following the 16.8% rise in 2012, as increased remittances helped finance imports of consumer goods. Remittances grew by 8.3% to an estimated $3.9 billion, from $3.6 billion in 2012, with 95% of inward remittances coming from the Russian Federation. Foreign direct investment fell sharply, from $198 million in 2012 to an annualized $81 million based on data for the first 9 months of 2013. Gross reserves rose from $650 million in 2012 to $694 million, equivalent to about 1.4 months of import cover. Total public and publicly guaranteed external debt fell to 25.3% of GDP at end-year from 28.3% at the end of 2012 (Figure 3.6.5).

Economic prospects

Growth is forecast to slow to 6.0% in 2014 and 5.8% in 2015, as aluminum and cotton output both decline (Figure 3.6.6). Nevertheless, the overall outlook remains cautiously optimistic. Barring a sharp slowdown in the Russian Federation, remittance inflows should remain sufficiently healthy for growth to continue in 2014 and 2015, stimulating private consumption, imports, and budget revenues. On the supply side, greater diversification into the production of new industrial products and agricultural crops will contribute to more sustainable growth. However, the economy remains vulnerable because income, consumption, and the balance of payments depend heavily on remittances, and because the outlook is weak for the economy's two main exports: aluminum and cotton.

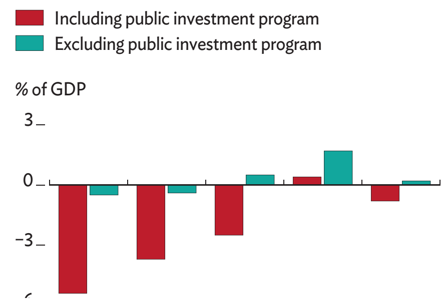
Aluminum output is expected to decline substantially in response to low international prices for the metal and consequent financial problems facing the Tajikistan Aluminum Company. The continued depreciation

3.6.3 Nominal exchange rate



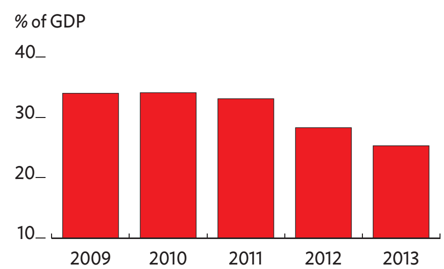
Source: National Bank of Tajikistan.

3.6.4 Fiscal balance



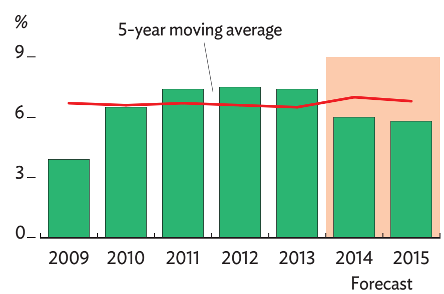
Source: Tajikistan State Statistics Agency.

3.6.5 External public and publicly guaranteed debt



Source: Tajikistan State Statistics Agency.

3.6.6 GDP growth



Sources: International Monetary Fund. 2013. *World Economic Outlook*. October; Tajikistan State Statistics Agency. http://www.stat.tj (accessed 15 March 2014); ADB estimates.

of production facilities, ongoing problems with power supply, and limited supplies of other inputs will exacerbate the situation. Cotton production is also projected to decrease, reflecting lower international prices, the poor investment climate, and a weak financial sector. Despite recent marginal improvements, Tajikistan's standing in the comparative rating on ease of doing business published in the World Bank's Doing Business 2014 report remains the second lowest in Europe and Central Asia and very low globally, at 143rd of 185 countries. Thus, structural reform will be essential to boost private investment.

Inflation is projected to accelerate slightly, to 5.5% in 2014 and 6.0% in 2015, mainly because of higher utility prices, particularly for electricity (Figure 3.6.7). Stable global and regional food prices are foreseen, as is only modest depreciation of the somoni, which should help keep inflation moderate, although sharper depreciation, perhaps triggered by the depreciation of the Russian ruble and the Kazakh tenge early in 2014, would accelerate inflation in 2014.

Fiscal policy is expected to tighten somewhat. The budget deficit will likely narrow to 0.7% of GDP in 2014 and further to 0.5% in 2015, while the budget balance excluding investment is projected to record surpluses of 0.5% of GDP in 2014 and 0.7% in 2015. While public debt should decline as a percentage of GDP, external borrowing for large infrastructure projects, mainly in energy and transport, should continue. Higher imports, fueled by remittances, and the effects of the tax code approved in January 2013 and the implementation of tax administration reforms are expected to raise revenues to 19.0% of GDP in 2014 and 19.5% in 2015. Expenditures are projected to moderate to 27.3% of GDP in 2014 but rebound to 27.7% in 2015. The announced public debt management strategy aims to keep public plus publicly guaranteed debt below 40% of GDP, ensure that new loans have a grant element of at least 35%, and undertake cost–benefit analyses of large investments. The strategy is expected to further reduce public plus publicly guaranteed debt to 28.2% of GDP in 2014 and 28.0% in 2015.

Over the next 2 years, monetary policy will need to balance support for growth with ensuring price stability. The refinancing rate is expected to remain between 4.5% and 5.5% in 2014 and 2015. Broad money growth is projected to fall to 18.3% in 2014 and further to 17.8% in 2015, envisaging slower growth in credit to the private sector. Some depreciation of the somoni is expected in 2014, in view of the depreciation of the ruble, though remittances should limit the downward pressure on the somoni exerted by weak export performance. Continued exchange rate flexibility and closely coordinated monetary and fiscal policies will be important to maintain competitiveness and avoid shocks.

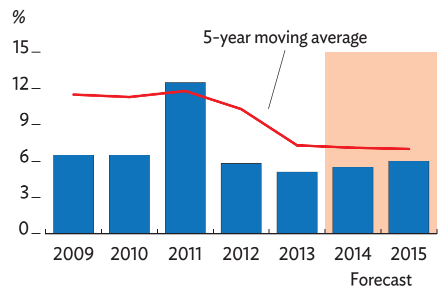
The current account deficit is forecast to widen to 2.1% in 2014 and 2.3% in 2015 (Figure 3.6.8). Exports are projected to expand moderately, reflecting growth in nontraditional goods. On the other hand, shipments of traditional goods such as aluminum and cotton will shrink in line with declining international commodity prices. Imports are projected to expand by 7.9% in 2014 and 9.3% in 2015 because of higher remittances (Figure 3.6.9). Foreign direct investment should continue to rise gradually, to 2.1% of GDP in 2014 and 2.5% in 2015, in line with ongoing

3.6.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.0	5.8
Inflation	5.5	6.0
Current account balance (share of GDP)	–2.1	–2.3

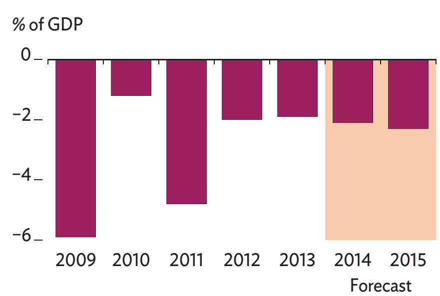
Source: ADB estimates.

3.6.7 Inflation



Sources: International Monetary Fund. 2013. *World Economic Outlook*. October; Tajikistan State Statistics Agency. http://www.stat.tj (accessed 15 March 2014); ADB estimates.

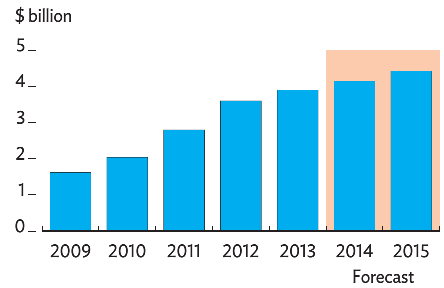
3.6.8 Current account balance



Sources: International Monetary Fund. 2011. *Country Report* No. 11/130. June; 2012. *Country Report* No. 12/110; ADB estimates.

reform initiatives and major infrastructure projects. External debt is forecast to stabilize at around 27.5% of GDP in 2014 and 2015. Reserves are expected to rise to $930 million at the end of 2014 and $1.1 billion a year later, equivalent to less than 3 months of imports.

3.6.9 Net remittances



Source: International Monetary Fund.

Policy challenge—promoting good governance and investment climate reform

One of the most serious challenges in Tajikistan is to sustain a high rate of economic growth and generate employment through higher private investment. The government undertook a number of broad legal and regulatory measures to improve the business environment, such as signing the New York Arbitration Convention and joining the World Trade Organization (WTO) in 2013. These moves were matched by some progress in lightening the burden of regulation on businesses and curtailing government intervention in several sectors of the economy. Nonetheless, private sector participation in the economy remains limited. Private investment stands at only about 5% of GDP, and the private sector still runs less than half of the formal economy. These statistics reflect an unfavorable business environment and lack of investor confidence. More is needed to boost investor confidence and promote private investment. This will require improvements in governance, property rights, and the rule of law.

While some progress has been achieved in preparing and issuing laws, regulations, and general policies, their enforcement and implementation remain problematic. The legal system does not support effective enforcement, and systemically poor governance continues to undermine the impact of reform, imposing risk on any potential private investment. There is limited momentum toward serious structural reform that would cut red tape and improve governance and public management. The quality of governance suffers a lack of capacity within the government and of accountability and transparency in service delivery. The consequences are visible problems with the regulatory and investment climate: subsidies for large state-owned enterprises, patchy rule of law and enforcement, and a high perception of corruption. Bank loans to related parties are also problematic. Good governance requires more decisive action to enforce laws that protect property rights and counter corruption. Mechanisms and structures to impose accountability are urgently needed.

Tajikistan has several sectors that can compete domestically, regionally, and even globally, but developing them depends upon attracting greater private investment. Immediate action is therefore needed to eliminate constraints on private investment and accelerate structural reform. Continued improvements to the business and investment climate are important, especially to make policy more predictable, reduce excessive regulation, secure property rights, and further improve tax policy and administration. More broadly, improving security and maintaining political and economic stability are key to encouraging private investment inflows and improving the business environment.

Turkmenistan

Growth remained strong at 10.2% in 2013, reflecting high public investment and strong performance in all production sectors, and the current account surplus widened to about 0.5% of GDP. Growth is projected to accelerate to 11.0% in 2014, as gas exports increase, and register 10.0% in 2015, while the current account surplus should average 2.0% of GDP during 2014–2015.

Economic performance

GDP growth in 2013 remained high at 10.2%, based on government reports, slightly below the 11.1% attained in 2012. Expansion was supported by strong performances in both the hydrocarbon economy and its non-hydrocarbon counterpart (Figure 3.7.1).

On the supply side, the government reported that all sectors expanded, with industry—accounting for about half of GDP—growing by 7.3% in 2013, versus 8.6% in 2012. Services rose by 13.9%, versus 14.7% in 2012, and agriculture expanded by 10%, versus 8%. Growth in industry reflected moderate expansion in hydrocarbons, electrical power, and chemicals, paired with a strong pickup in construction materials, textiles, food, and agro-industrial products. Growth in services reflected government construction projects that fueled the domestic production of construction materials, which expanded by 17.3%; a 7.8% rise in transportation and telecommunications; and growth in wholesale and retail trade, catering, and other services. Rapid agricultural growth reflected the production of wheat, cotton, and rice above targets.

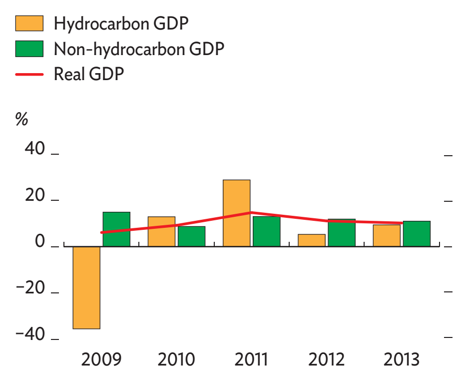
On the demand side, economic growth was boosted by public investment and consumption. Capital investment in industrial and social infrastructure under the state-led Program of Socio-Economic Development, 2012–2016 grew by 7.1%, compared with 38% in 2012, and comprised 46.7% of GDP. Higher public outlays and rising real incomes spurred consumption growth.

Rising domestic demand helped fuel inflation, especially for nonfood items and services. The consumer price index is estimated to have risen by 6.0% on an annual average basis, versus 5.3% in 2012 (Figure 3.7.2). Nevertheless, price controls, extensive subsidies, a fixed exchange rate, and government import-substitution policies helped keep inflation within the implicit target of the Central Bank of Turkmenistan (CBT).

Monetary policy strove to maintain macroeconomic stability and limit inflation. Tighter monetary policy helped slow broad money growth to an estimated 29.5% from 35.6% in 2012, as growth in private sector credit was estimated to have declined to 40% from 47% in 2012. The CBT maintained its exchange rate peg, bolstered by comfortable foreign exchange reserves.

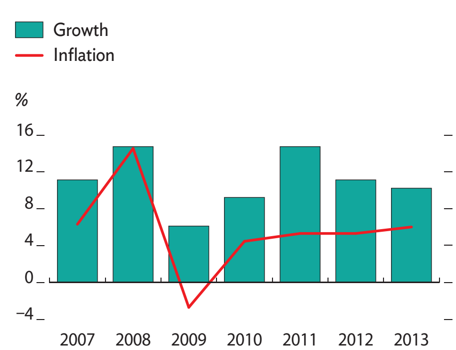
This chapter was written by Jennet Hojanazarova of the Turkmenistan Resident Mission, Asian Development Bank, Ashgabat.

3.7.1 GDP growth



Sources: International Monetary Fund. 2013. *Regional Economic Outlook, Middle East and Central Asia*. November; ADB estimates.

3.7.2 GDP growth and inflation



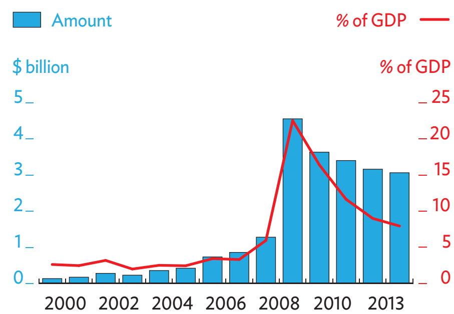
Sources: International Monetary Fund. 2013. *World Economic Outlook*. October; ADB estimates.

Fiscal policy continued to support growth in 2013. Revenue exceeded the budget forecast by 31%, estimated at 17.9% of GDP. Budget expenditure was slightly below the planned amount, equaling 16.4% of GDP. The budget surplus is estimated to have fallen to 1.5% of GDP from 6.4% in 2012 as spending on social programs rose. Public sector wages, pensions, and students' stipends were raised by 10% in January 2013, and teachers' salaries were raised by another 10% in September 2013. Spending from extra-budgetary funds for large-scale public investment is believed to remain significant. Total government debt, all of it external, is estimated to have risen to 20.6% of GDP in 2013 from 18.1% at the end of 2012, as foreign loans financed substantial hydrocarbon infrastructure investments.

The current account surplus, estimated at 0.5% of GDP in 2013, was smaller than earlier projected because technical delays in completing gas processing facilities at the large Galkynysh gas field kept gas exports below expectations. In addition, heavy imports of industrial and technological goods for investment projects and large service imports for hydrocarbons and construction caused imports to grow more quickly than exports.

Turkmenistan continues to receive sizable foreign direct investment, mainly in oil and gas (Figure 3.7.3). Turkmenistan's foreign exchange reserves are estimated by the International Monetary Fund to total $29.3 billion, equivalent to 19 months of imports.

3.7.3 Foreign direct investment



Note: Data for 2013 are estimates.

Sources: United Nations Conference on Trade and Development. 2013. *World Investment Report.* New York and Geneva: United Nations; ADB estimates.

Economic prospects

Growth is forecast to reach 11.0% in 2014 and register 10.0% in 2015, further buoying GDP per capita (Figure 3.7.4). This reflects continued public investment and growing hydrocarbon exports, particularly exports of gas to the People's Republic of China (PRC), which receives over half of Turkmenistan's gas exports. Recent agreements with the PRC call for doubling Turkmen gas exports by 2020, using an expanded pipeline.

On the supply side, continued double-digit growth in services, along with acceleration in industry growth to 10.0%, is projected to raise GDP growth to 11.0% in 2014, while in 2015 a return to 7%–8% growth in industry will likely limit GDP growth to 10.0%.

Higher earnings from hydrocarbon exports are expected to spur growth in the non-hydrocarbon economy.

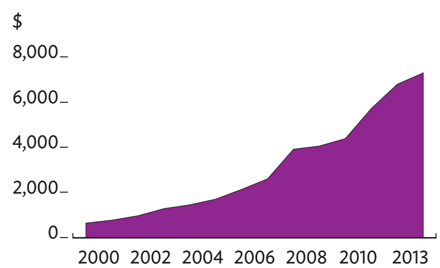
Growing domestic demand is expected to raise inflation to 6.7% in 2014 and 6.2% in 2015. The government will continue to subsidize public utility, food, and fuel prices, though some utility charges will rise in 2014.

The CBT will likely further tighten monetary policy to keep inflation under control. Money growth is expected to slow further to 20.6% in 2014.

Fiscal policy will remain expansionary in 2014 and 2015 to meet government plans under the Program of Socio-Economic Development, 2012–2016. The state budget for 2014 calls for spending to rise by 15%, and revenues by 17%. Government debt is projected to decline to about 15% of GDP at the end of 2014 and below 14% at the end of 2015.

Exports are estimated to rise by 12.6% in 2014 and 7.0% in 2015, taking into account the expected rise in gas exports to the PRC. Import growth is expected to be slower at 7.0% in 2014 and 6.0% in 2015, enabling the current account surplus to widen to 2.0% in 2014 and 2015. The improved current

3.7.4 GDP per capita



Note: Data for 2013 are estimates.

Sources: United Nations Conference on Trade and Development. 2013. *World Investment Report.* New York and Geneva: United Nations; ADB estimates.

3.7.1 Selected economic indicators (%)

	2014	2015
GDP growth	11.0	10.0
Inflation	6.7	6.2
Current account balance (share of GDP)	2.0	2.0

Source: ADB estimates.

account position should further strengthen international reserves, which are estimated to reach the equivalent of 20 months of imports in 2014.

Policy challenge—strengthening public financial management

Since independence Turkmenistan's oil and gas exports have provided a large revenue base to support the country's socioeconomic development (Box 3.7.1).

Rapid growth in the non-hydrocarbon economy is driven by public spending financed by hydrocarbons (Figure 3.7.5). To reduce overreliance on earnings from exhaustible hydrocarbon resources and develop alternative sources of revenue, the government plans to diversify the economy beyond hydrocarbons and increase the private sector's share of the non-hydrocarbon economy to 70% by 2020. Public investment can help develop the human capital and infrastructure needed to support growth in the non-hydrocarbon sector.

As the government is the main beneficiary of hydrocarbon receipts, strengthening public financial management is crucial to ensure efficient fiscal policies. Such strengthening currently faces two major challenges.

A significant amount of government revenue and expenditure remains outside the main state budget, moving through extra-budgetary funds, which leaves the total fiscal position opaque. A strong fiscal framework to ensure spending through the budget rather than through extra-budgetary or quasi-fiscal channels would improve budget transparency, accountability, and effective resource use.

The current magnitude of public investment spending accentuates the need for better control over the efficiency of spending. In addition, the large outlays risk spurring inflation and real appreciation of the Turkmen manat, which may weaken prospects for creating a more broadly competitive and diverse economy. A strong fiscal framework could help rationalize spending decisions in line with the country's absorption capacity. Further, fiscal management would improve with better selection and monitoring of public investment projects, giving priority to more productive projects while allocating sufficient resources to social infrastructure.

The government's recent move to introduce a new budget code is a welcome step toward a stronger fiscal framework. The new budget code, expected to be finalized in 2014 with assistance from the European Union, aims to improve budget coverage by consolidating extra-budgetary funds under the budget and streamlining the budget process. Concurrent with introducing the new budget code, the government plans to modernize its treasury and introduce a new budget classification system.

Introducing a medium-term budgetary framework and measures to improve the quality and transparency of public sector statistics would support government reforms. Moreover, establishing stronger fiscal rules consistent with international best practices would facilitate countercyclical fiscal policy and ensure that government fiscal targets promote intergenerational equity.

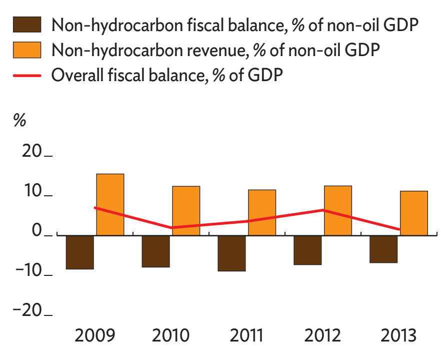
3.7.1 Oil and gas translated into growth

Turkmenistan's resource endowments make it the 4th largest holder of gas reserves in the world. The country also ranks among the top 10 oil producers in Asia and the Pacific.

Oil and gas revenues have boosted prosperity and allowed Turkmenistan to accumulate substantial savings while raising incomes. GDP growth averaged 13.4% annually from 2000 to 2013, while income per capita has increased more than tenfold since independence, to $7,300 in 2013 (Figure 3.7.4). In 2012 Turkmenistan graduated to upper-middle-income status.

The country's financial position has strengthened thanks to favorable oil and gas prices, technological advances and foreign expertise in the oil and gas sector, the development of new transportation routes for energy exports, and improved regional energy cooperation. The country accumulated gross reserves equivalent to 19 months of imports at end 2013. Over the years Turkmenistan has run substantial fiscal surpluses that averaged 5.2% of GDP during 2008–2013 and helped build up large fiscal reserves. Public debt, all of it external, remains close to 20% of GDP, while inflation has remained in single digits since 2009.

3.7.5 Government fiscal balances



Note: Fiscal data refer to general government.

Sources: International Monetary Fund. 2013. *Regional Economic Outlook, Middle East and Central Asia.* November; ADB estimates.

Uzbekistan

Growth remained robust at 8.0% in 2013, led by wage and pension increases, high public investment spending, and large remittances. Recovery in external demand raised the current account surplus to 3.7% of GDP. Continued high public spending, strong private consumption, and an improving external environment are projected to keep growth near 8.0% in 2014 and 2015.

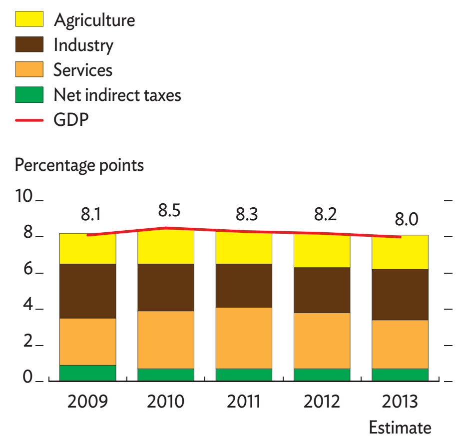
Economic performance

GDP grew by 8.0%, down slightly from 8.2% in 2012 but making 2013 the seventh consecutive year of growth at 8.0% or better. On the supply side, the main contributors to growth were industry including construction, which expanded by 9.0% (up from 8.0% in 2012) and services at 8.8% (down from 10.4%). In industry, the ongoing modernization program, backed by substantial public investment and recovering external demand, boosted the production of machinery, textiles, construction materials, and foodstuffs. Services posted healthy growth as retail trade, telecommunications, finance, and catering all recorded double-digit increases. The continuing housing boom raised construction growth to 16.6% from 11.5% in 2012. Agriculture grew by 6.8% (versus 7.0% in 2012), supported by favorable weather and record harvests of the key cereal and vegetable crops (Figure 3.8.1).

On the demand side, wage and pension increases and substantial remittance inflows boosted private consumption, while net exports also increased. The government raised public sector wages and pensions by 21% in 2013 and maintained large-scale public investment in industry and housing. State investment spending grew by 11.0% to $11.3 billion, enabling gross fixed capital formation to rise by 19.8%, following 11.1% growth in 2012. An increasing share of investment is financed by the Fund for Reconstruction and Development (FRD), a sovereign wealth fund with assets exceeding $15 billion.

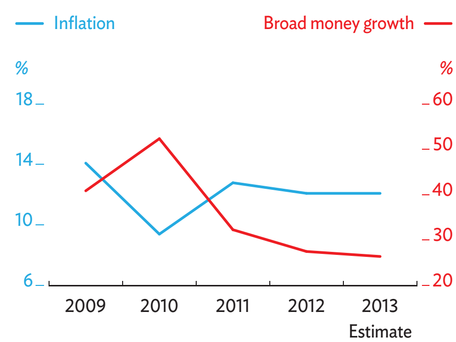
The government reported that inflation in 2013 was 6.8% (Figure 3.8.2), below the 7%–9% target range set by the Central Bank of Uzbekistan. (The International Monetary Fund, using the same data but different methods, estimated inflation to be unchanged from 2012 at 12.1%.) Despite public wage and pension increases, tariff hikes, and greater exchange rate depreciation, inflation was held in check by ongoing global food price deflation, lower import costs, and the central bank's sterilization of excess liquidity. On 1 January 2014, the central bank reduced its main policy rate from 12% to 10%, signaling lower inflation expectations for 2014.

3.8.1 Supply-side contributions to growth



Sources: State Statistics Committee; ADB estimates.

3.8.2 Inflation and broad money



Sources: International Monetary Fund; ADB estimates.

This chapter was written by Iskandar Gulamov of the Uzbekistan Resident Mission, Asian Development Bank, Tashkent.

The continuing if slower accumulation of net foreign assets put upward pressure on reserve money. In response, the central bank increased its issuance of certificates of deposits, mainly to commercial banks; the volume of sterilization operations, including sales of certificates of deposits on the open market, rose by 20% in 2013. These activities helped slow broad money growth to around 26% from 27% in 2012.

Uzbekistan's state-dominated banking sector has promoted industrial development by channeling public investment to strategic industries and increasing total bank lending, while keeping banks sound. At the end of 2013, the sector's capital adequacy ratio reached 24.3%. Aggregate capital in the banking sector rose by 25%, helping expand total credit by 31%. In August 2013, Moody's Investors Service issued a stable outlook for the country's banking sector, citing healthy bank profits, improvements in asset quality, stable liquidity, limited reliance on wholesale funding, and few problem loans, averaging less than 10% of total lending.

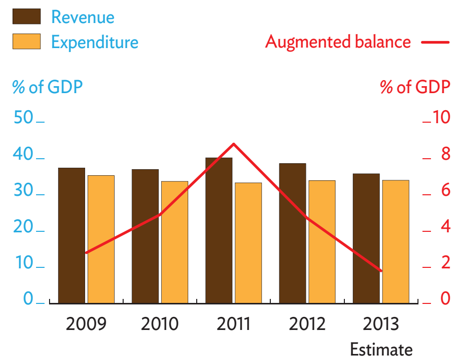
The government reported a budget surplus of 0.3% of GDP in 2013, though the surplus in the augmented budget, which includes the FRD, is estimated to have narrowed to 1.8% of GDP from the 4.7% recorded in 2012 (Figure 3.8.3). Budget revenues (including the FRD's estimated revenues) are estimated to have declined slightly, from 38.6% of GDP in 2012 to 35.8% in 2013, in line with declining international prices for key export commodities. Rising government spending, particularly for health and education, helped slightly raise budget expenditures (including the FRD's estimated expenditures) from 33.9% of GDP in 2012 to 34.0% in 2013. The government adopted a new budget code in 2013, streamlining legislation on public finance management and strengthening the enforcement framework.

The current account surplus rose to 3.7% of GDP, reflecting a larger trade surplus, as external demand started to recover and destinations for key exports diversified (Figure 3.8.4). Despite lower international prices, export earnings grew by 14.7%, mainly on higher gas exports. Declining prices for natural gas exports to the Russian Federation led Uzbekistan to begin shifting exports to other markets, starting in April 2013 to export gas to the People's Republic of China (PRC). Data through September 2013 showed a substantial 80% jump year on year in energy exports, likely reflecting natural gas exports to the PRC.

Imports of goods and services rose by 9%, as continued infrastructure development and industrial modernization required more imports of capital goods and services. Remittances and compensation from abroad grew sharply. Remittances and income from the Russian Federation are estimated to have risen by 20.7% in the first 9 months of 2013 to $4.9 billion (Figure 3.8.5).

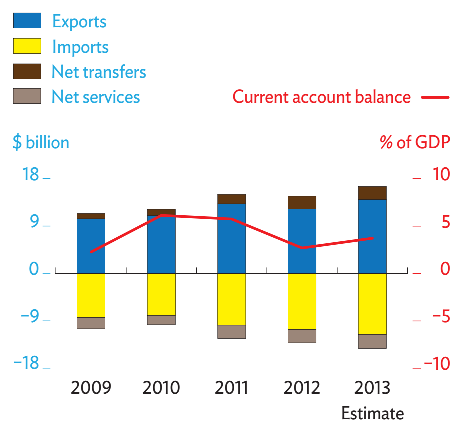
The government reported foreign investment inflows of $3.0 billion, up from $2.5 billion in 2012, mainly into oil and gas, petrochemicals, and automobile manufacturing. External debt is estimated at 13% of GDP. Gross official reserves are believed to have increased to $19.4 billion from $18.4 billion at the end of 2012.

3.8.3 Fiscal indicators and augmented budget



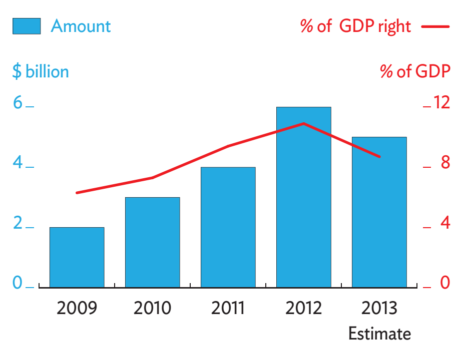
Note: Augmented budget includes the Fund for Reconstruction and Development.
Sources: International Monetary Fund; ADB estimates.

3.8.4 Current account components



Sources: International Monetary Fund; ADB estimates.

3.8.5 Remittances and compensation from the Russian Federation



Sources: Central Bank of the Russian Federation; ADB estimates.

Economic prospects

Higher government spending and private consumption are projected to support growth at 8.0% in 2014 and 7.8% in 2015 (Figure 3.8.6). Improvement in the external environment should raise demand for exports. On the supply side, investment-led industry and consumption-led services will remain the key drivers of growth. Planned wage and pension increases exceeding the inflation rate should, combined with remittances, boost private consumption and promote services. Agriculture is projected to grow by 6.5% each year, reflecting stable production in cotton and wheat.

The government will continue its large-scale investment program, which is set to conclude by 2015. Its aim is to increase industry's share of GDP to 28% in 2015 from 24% in 2013. The state investment program for 2014 envisages an investment package of $14.3 billion (equal to 23% of GDP), of which $3.9 billion is to be financed externally. A growing share of investment is coming from the Russian Federation and the PRC, Uzbekistan's main trading partners. Gross fixed capital formation is forecast to rise by 10% in 2014 and 13% in 2015.

As in 2012 and 2013, the government will stimulate domestic consumption in 2014 and 2015, most likely by raising public sector wages, welfare payments, and pensions. If external risks materialize, the government is expected to implement additional measures, including consumer lending, to sustain household spending. These developments are forecast to raise private consumption by 4.5% in 2014 and 6.0% in 2015.

Inflation is forecast at 11.0% in 2014 and 10.0% in 2015, reflecting higher government spending, greater accumulation of net foreign assets, and continued depreciation of the local currency (Figure 3.8.7). Anticipated declines in global food prices and lower import costs could partly offset these pressures. Nevertheless, inflation will remain a key challenge, requiring close coordination of monetary and fiscal policies.

The government projects a consolidated budget deficit of 1.0% of GDP in 2014, to support economic expansion. Including expected FRD surpluses, the augmented budget is projected to post surpluses of 2.9% of GDP in 2014 and 2.5% in 2015. Augmented budget expenditures are forecast to dip slightly, to 33.5% of GDP in 2014 and 33.7% of GDP in 2015, as the government offsets wage and pension increases by trimming less critical spending. Despite the announced cuts in the profits tax from 9.0% to 8.0% and the personal income tax from 8.0% to 7.5% for the lowest taxable income bracket, higher revenue collection, reflecting the external environment and continued tax reforms, is forecast to yield augmented budget revenues equal to 36.4% of GDP in 2014 and 36.2% in 2015.

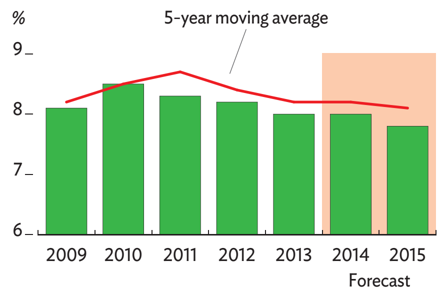
The current account surplus is forecast at 4.7% of GDP in 2014 and 3.6% in 2015, as recovering global trade should boost the trade surplus and transfers. Merchandise exports are projected to rise by 11.9% in 2014 and 6.0% in 2015, while imports are forecast to increase by 10.3% in 2014 and 10.9% in 2015, reflecting continued public spending for infrastructure and industrial modernization. Remittances are likely to reflect the economic situation in the Russian Federation. Gross official reserves are expected to reach $21 billion by the end of 2014, covering

3.8.1 Selected economic indicators (%)

	2014	2015
GDP growth	8.0	7.8
Inflation	11.0	10.0
Current account balance (share of GDP)	4.7	3.6

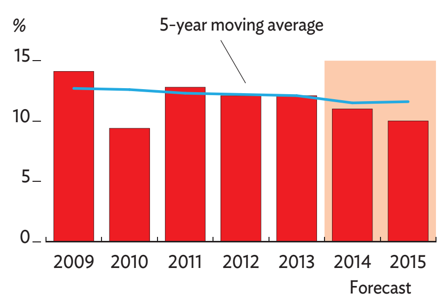
Source: ADB estimates.

3.8.6 GDP growth



Source: Asian Development Outlook database.

3.8.7 Inflation

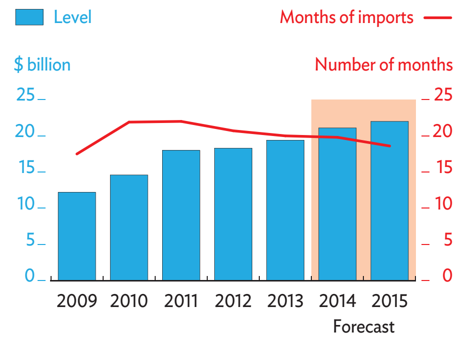


Source: Asian Development Outlook database.

about 20 months of imports, and $22 billion by the end of 2015 (covering 19 months) (Figure 3.8.8).

The key downside risks are continuing economic slowdown in the European Union and uncertainties regarding the Russian Federation; how US tapering of quantitative easing may affect the Russian Federation through lower oil prices, tighter access to international capital markets, and higher capital outflows; and decelerating import demand from the PRC as its economy slows.

3.8.8 Offical reserves



Sources: International Monetary Fund; ADB estimates.

Policy challenge—improving financial services

Uzbekistan's banking sector—which represents 95% of the finance system—is stable but remains at an early stage of development and faces many challenges. Financial intermediation is underdeveloped and unable to meet growing need in the private sector. Independent business surveys identify lack of access to finance (including credit, cash, and foreign exchange) as a major challenge facing Uzbekistan's private sector. Underlying this problem are three key factors:

- At 25% of GDP, financial intermediation is barely half the average in developing countries in Europe and Asia.
- The banking sector accounts for only 37% of the GDP in terms of assets, while total loans at 21% and total deposits at 24% are among the lowest in the region.
- A third of private sector demand for external financing remains unmet.

The sector is highly concentrated, with state-controlled banks holding 76% of total assets in 2012. While supporting the government's industrial modernization policies, banks have not done much to promote private sector development, and credit to the private sector is substantially lower than in other transitional economies (Table 3.8.2). The need to maintain noncore functions, such as monitoring and registering import contracts, hinders banks' ability to meet private sector demand.

3.8.2 Monetization and credit to the private sector (%)

Country/region	M2 money supply to GDP (%)	Domestic credit to the private sector (% of GDP)
Uzbekistan	25.0	19.6
Lower-middle-income country average	61.3	42.3
Developing Europe and Central Asia average	49.9	49.8

Sources: International Monetary Fund. 2012. *Article IV Staff Report No. 13/278*; World Bank. *World Development Indicators* (accessed 24 February 2014).

The government recognizes the importance of financial sector reform and supports financial activities through a variety of legal and regulatory frameworks, the most important being Presidential Resolution No. 1438 of November 2010: *On Priority Areas for Further Reforms and Sustainability Improvement of Country's Finance and Banking System in 2011–2015 and Achieving High International Ratings*. This resolution elaborates priorities for further reform, including comprehensive programs for banks, nonbank institutions, and microfinance, and covering the extension of nonbank credit networks and their range of services.

The government's reform agenda is to maintain the sector using state support, credit infrastructure, risk management, and banking supervision. Additional reforms are needed to prioritize private sector access to finance through competition, diversification, and market-driven allocation and distribution of resources. These additional reforms would strengthen the ability of banks to provide efficient intermediation, thereby supporting government targets for growth and improved well-being.

EAST ASIA

People's Republic of China

Hong Kong, China

Republic of Korea

Mongolia

Taipei,China

People's Republic of China

Last year saw high and stable economic growth, subdued inflation, and a smaller current account surplus. Slightly lower growth, higher inflation, and a still smaller current account surplus are forecast for 2014 and 2015. Containing credit growth while maintaining growth momentum is one policy challenge, and another to improve income distribution.

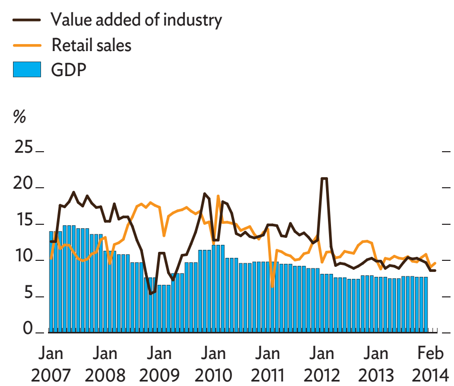
Economic performance

After decelerating to 7.6% year on year in the first half of 2013 as domestic demand weakened, GDP growth in the People's Republic of China (PRC) rose to 7.8% in the third quarter following a limited fiscal and monetary stimulus, then moderated slightly to 7.7% in the fourth quarter (Figure 3.9.1). Over the full year, GDP grew by 7.7%, the same rate as in 2012 and above the government target of 7.5%.

On the supply side, the service sector expanded by 8.3%, contributing 3.6 percentage points to GDP growth. Providing the impetus to growth in the sector were urbanization, rising household incomes, and the rollout since August 2013 of reforms to taxes on services, which effectively lowered them. Industry (including manufacturing, mining, and construction) grew by 7.8%, driven mainly by infrastructure projects and real estate development. The share of services in GDP rose to 46.1% in 2013 current prices, while that of industry fell to 43.9% (Figure 3.9.2). Domestic rebalancing from industry to services has thus continued to gain traction, as planned by the government. As in previous years, the private sector registered higher growth than the public sector. Similarly, growth in the western and central regions, the main beneficiaries of development programs, was higher than in eastern provinces. Monthly data indicate that the growth momentum has weakened in both industry and services since December 2013, most likely owing to monetary tightening and stronger controls on local governments' off-budget spending.

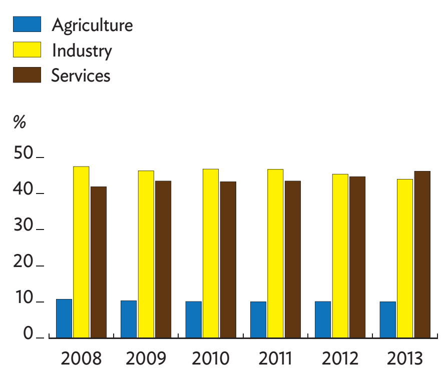
A good harvest brought agricultural growth up to 4.0% in 2013, after a weaker performance in the first 9 months. The grain harvest reached a new peak above 600 million tons, or 442 kilograms of raw grain per capita. This is well above the 400-kilogram benchmark considered sufficient to meet the aspirations of an increasingly affluent population for a more protein-rich diet. However, agricultural growth remained below its 5-year average of 4.5%, and the share of agriculture in GDP slipped to 10.0%.

3.9.1 Economic growth



Source: National Bureau of Statistics.

3.9.2 Share of sectors in nominal GDP



Source: National Bureau of Statistics.

This chapter was written by Jurgen Conrad, Niny Khor, and Jian Zhuang of the People's Republic of China Resident Mission, Asian Development Bank, Beijing.

3.9.1 Income inequality now and in the future

One outcome of rapid economic growth in the PRC over the past 30 years is high income growth. In 2013, urban households' average disposable income per capita grew by 9.7% to CNY26,955. Rural households' average net income per capita grew by 12.4% to CNY8,896. The main long-term driver of income growth is exceptionally robust growth in real wages for urban and rural households alike. As rural households work more off the farm, their wage income growth has outstripped that of their urban counterparts every year since 2005. In 2013, rural households' wage income grew by 16.8%, almost double the 9.6% recorded by urban households. However, because rural incomes started much lower, the gap between urban and rural incomes is still wide, with urban households' earning and consuming 3 times as much. The gap between coastal and western regions also persists.

High income growth, particularly for migrants, suggests that labor demand is still generally healthy, especially for blue collar jobs, and that income distribution is improving as growth in the rural migrant worker population slows. According to the National Bureau of Statistics, 6.3 million new migrants entered the workforce in 2013, fewer than the average of 8.2 million per year from 2000 to 2010. In contrast, university graduates face an increasingly crowded labor market because their numbers rise considerably each year. More than 6 million undergraduate degrees were awarded in 2011 and again in 2012, compared with fewer than 1 million in 2000. The tightening supply of new blue-collar workers, mostly rural migrants, is combining with the rapidly expanding supply of new white-collar workers to narrow the rural–urban income gap.

Current trends in urban and rural income and wage growth present a hopeful contrast to the rapidly rising income inequality that the PRC experienced until recently. In 1990, income inequality as measured by the Gini coefficient was 0.320, comparable to Western Europe but low for Asia. The coefficient has risen by more than 50% since then, tracking one of the most rapid increases in inequality in history. Despite moderating to 0.473 in 2013 from 0.491 in 2008 (box figure), the coefficient still exceeds figures for the developed world and the average for Asia.

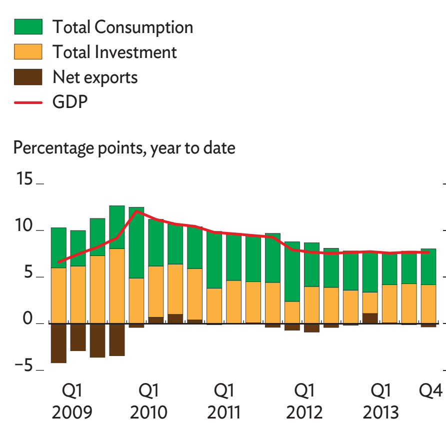
Three important developments mark recent trends in income inequality. First, the ratio of urban incomes over rural has stopped rising as rural households record strong wage income growth. Second, education-related income inequality has increased along with returns on education. Third, the privatization of housing and the emergence of an entrepreneurial private sector have sharply spurred wealth inequality. Thus, despite recently higher rural income growth, the rise in wealth and education inequality could undermine the moderation of the urban–rural income gap.

The government issued guidelines in 2013 to narrow the range of primary income distribution, mainly by mandating wage caps and thresholds. Measures include promoting equal employment opportunity, increasing investments in vocational training, improving the management of revenue from public natural resources, and establishing regulations to narrow the distribution of labor incomes. Minimum wage targets aim to ensure low-income workers about 40% of average urban wages by 2015. Executive compensation will be capped, especially at state-owned enterprises. Financial reform is expected to increase unearned income by liberalizing deposit rates.

The guidelines call for improving secondary redistribution through taxes, social insurance, and transfers. Taxation will be made more progressive by reforming individual income and property taxes and cutting taxes on small enterprise. Social safety nets, including health care and pensions, would be extended to rural residents. Education will be improved, especially

On the demand side, investment contributed 4.2 percentage points to GDP growth in 2013, up from 3.8 in 2012, and consumption contributed 3.8 percentage points, down from 4.1 (Figure 3.9.3). Thus no further progress was made toward replacing investment-driven growth with growth driven by consumption. Investment growth was strongest in agriculture, underlining the government's perception of agriculture as the "foundation" of the economy, followed by services and industry. Within industry, investment growth was strongest in infrastructure, followed by manufacturing, utilities, and mining. Real estate investment continued to grow at a very high rate on the back of strong demand. The floor space sold in residential buildings increased by 17.5% year on year, and in commercial buildings by 17.3%. Weaker net exports dragged GDP growth down by 0.3 percentage points.

3.9.3 Demand-side contributions to growth



Source: National Bureau of Statistics.

3.9.1 (*continued*)

in rural and poverty-stricken areas, and more affordable housing and need-based subsidies provided. These reforms will be financed by an increase from 35% to 37% in the social security and employment share of fiscal expenditure by 2015. The PRC will still lag the 52% average in other middle-income countries, limiting how much social safety net improvement can reduce precautionary savings and unleashes rural consumption.

The PRC also needs to improve education and strengthen skills and labor productivity. As unskilled wages rise in urban areas, so does the incentive to drop out of high school. Yet rising returns on education worsen wage inequality. Means-tested schooling subsidies, higher than those set in 2006, and conditional cash transfers for upper secondary education may be necessary to increase enrollment and graduation rates.

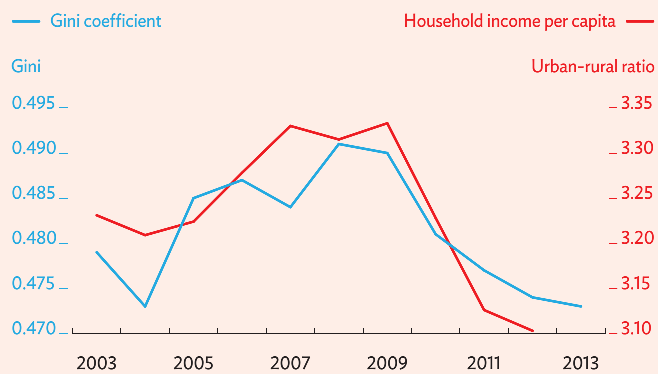
Improved health care boosts labor productivity and thus narrows wage inequality. In developing economies, health-related financial shocks are the major cause of households sliding into poverty. Despite recent reforms to extend health care into rural areas, the urban–rural health care gap remains worse even than labor income inequality. Fiscal spending on health should be raised gradually from the current 1.4% of GDP closer to the 6.5% average in the advanced economies.

Also important is to improve mobility, lending urgency to the announced reform of the household registration system, as graduates need to be able to move to where the jobs are. In 2011, the PRC's urban population finally surpassed its rural population. The 12th Five-Year Plan calls for accelerating urbanization, and the urban share of the population is expected to reach 60% by 2020 and 70% by 2030.

Can inequality be reversed? International experience suggests that large fiscal transfers for health, education, and pensions effectively reduce inequality. So do reforms that broaden the tax base and make taxes more progressive. In the advanced countries, progressive fiscal policies helped lower the average Gini coefficient by about a third from 1985 to 2005. Brazil and Argentina are among the emerging economies that have narrowed inequality by improving social protection, health care, and education.

The PRC currently spends less than 9% of GDP on these services, significantly less than the 20% average in advanced countries or the 15% spent by Brazil and the Russian Federation. It can afford to spend more.

Recent inequality trends



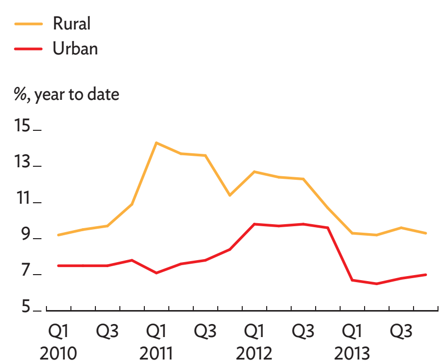
Sources: CEIC Data Company (assessed 10 February 2014); National Bureau of Statistics; ADB estimates.

Source: ADB. 2013. Reducing Inequality in the People's Republic of China through Fiscal Reform. Observations and Suggestions No. 2013-3. Beijing.

Monthly figures suggest that investment growth has decelerated sharply since October 2013 while that of retail sales, a proxy for consumption, has been robust. This is good news for domestic rebalancing. Within investment, the picture was mixed, with infrastructure plummeting while manufacturing and real estate performed better. Housing starts posted a rebound in November 2013, as did housing sales.

Consumption was supported by strong income growth in 2013. For the sixth successive year, real per capita income growth for rural households, at 9.3% year on year, exceeded that for urban households, at 7.0% (Figure 3.9.4). The income of migrant workers increased even more quickly as demand for their services rose in labor-intensive services and construction. Income distribution improved marginally as the official Gini-coefficient edged down to 0.473 from 0.474 in 2012 (Box 3.9.1).

3.9.4 Growth of per capita urban and rural incomes



Source: National Bureau of Statistics.

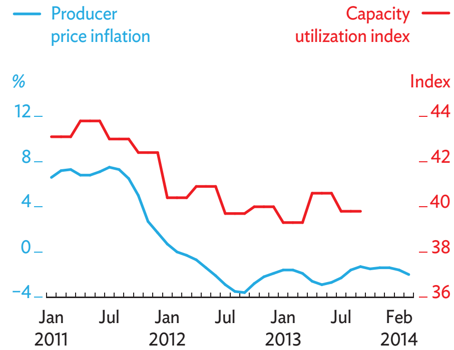
Annual consumer price inflation averaged 2.6% in 2013, the same as in 2012, with fluctuations over the year caused mainly by food price volatility. Nonfood inflation and core inflation (which omits energy as well as food) remained relatively low and stable within a range of 1.6%–1.7%. Average producer price deflation accelerated to 1.9% in 2013 from 1.7% in 2012, reflecting lower commodity prices and overcapacity in domestic industries. This suggests that inflationary pressures within the economy remain modest. Although producer price deflation moderated to 1.4% year on year in December 2013, it reverted to 2.0% in February 2014, casting doubt on the possibility that demand is strengthening or capacity utilization improving (Figure 3.9.5).

The official budget deficit for 2013 stood at 1.9% of GDP, slightly higher than in 2012 but within the government target of 2.0%. Revenue growth slowed to 10.1% in 2013, the lowest annual rate since 1991 and only marginally above nominal GDP growth, while expenditure growth moderated to 10.9% in 2013 from 15.3% in 2012 (Figure 3.9.6). The decline in revenue reflected mainly overdependence on indirect taxes. Value-added, business, and consumption taxes currently bring in over 60% of total tax revenues. Reflecting the higher sensitivity of these taxes to economic up- and downswings compared with direct taxes, falling import growth suppressed import-related duties and taxes.

A recent audit suggests that the augmented budget deficit, which includes off-budget spending, was higher than officially reported, and the fiscal stance more expansionary. The audit showed local government debt increasing from 26.7% of GDP in 2010 to about 36.0% at the end of June 2013. Most of this debt was borrowed off budget through special financing vehicles because local governments are prohibited from borrowing on budget, despite their expenditure needs substantially exceeding their revenues. The augmented local government debt was partly invested in nonearning infrastructure assets, making it difficult for these governments to meet their debt service burden, which is high for some, particularly in light of maturity mismatches. Deeply indebted governments are now allowed to borrow only to refinance existing liabilities with longer-term loans. As central government debt is still low at 13.6% of GDP, however, consolidated central and local government debt does not appear excessive from an international perspective.

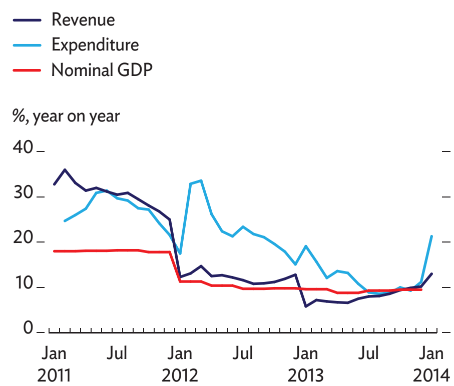
The M2 money supply was growing at 13.6% year on year at the end of 2013 (Figure 3.9.7). This exceeded the 13.0% target set by the People's Bank of China (PBOC), the central bank, for 2013, as in the previous years. The ratio of M2 to GDP rose to nearly 200%, which is high for a developing country. Despite efforts to pursue a firmer monetary stance to rein in credit growth and financial risks, which have driven up interbank interest rates since May 2013, credit growth outpaced nominal GDP growth. The root cause of high credit growth in 2013 was an increase in the PBOC's net foreign assets resulting from strong capital inflows, which put upward pressure on the currency. The PBOC had to purchase foreign currency to stem renminbi appreciation, thereby inflating the monetary base and the money supply. The government and banks increased their deposits at the central bank, but this sterilized only about a third of the expansion.

3.9.5 Producer prices and capacity utilization



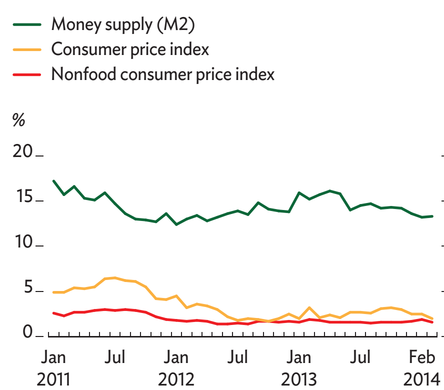
Sources: National Bureau of Statistics; People's Bank of China.

3.9.6 Fiscal indicators and nominal GDP



Sources: Ministry of Finance; National Bureau of Statistics.

3.9.7 Money and prices



Sources: National Bureau of Statistics; People's Bank of China.

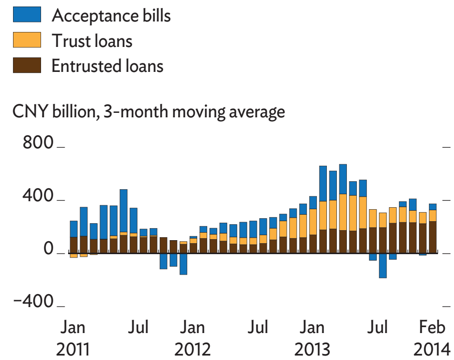
Another factor behind strong money supply growth in 2013 was the difficulty of controling lending, particularly lending associated with shadow banking. However, some progress was made in the second half of 2013, when tighter interbank market conditions and stricter regulations forced a sharp decline in the issuance of trust loans and bankers' acceptances (Figure 3.9.8). This trend continued into 2014, helping to further reduce broad money growth to 13.2% year on year in January 2014.

The trend appreciation of the renminbi vis-à-vis the US dollar continued as capital inflows remained strong except for short interruptions in mid-2013 and early 2014. By December 2013, the renminbi had appreciated by 3.1% year on year against the US dollar (Figure 3.9.9). In nominal effective terms, the appreciation was higher at 7.2% because the Japanese yen depreciated early in 2013. In real effective terms, the renminbi appreciated by 7.9% year on year. Real effective appreciation peaked in September 2013 at 9.3% year on year—a magnitude that, if sustained, might be difficult to compensate for through productivity gains. The downward trend since then, resulting mainly from yen stabilization and higher inflation in Japan, is thus good news for the PRC's external competitiveness.

As its foreign trade continued to grow, the PRC replaced the United States in 2013 as the largest goods-trading nation. Merchandise export growth was volatile throughout the year but reached 7.8% year on year based on customs statistics, only marginally below the export growth rate in 2012 (Figure 3.9.10). Export figures since late 2013 do not yet clearly support the view that stronger growth in developed economies translates into higher export demand for the PRC, as export growth was strong in November 2013 and January 2014 but weak in October and December 2013, and even negative in February 2014. Import growth was lower than export growth but more stable. It reached 7.3% for the year as a whole. Therefore, the trade surplus rose to $261 billion, 12.3% higher than in 2012, but remained unchanged as a percentage of GDP at 2.8%.

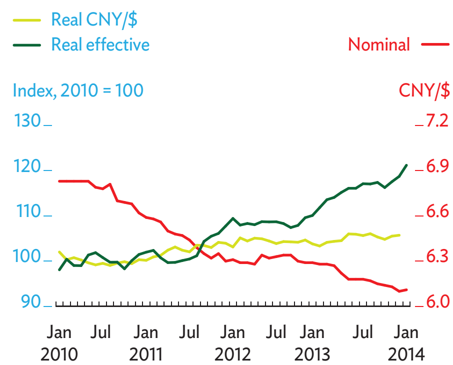
The improved trade balance and lower deficit in the income account were offset by an expanding deficit in the service account and a small deficit in net transfers. The current account surplus thus narrowed to $188.7 billion or 2.1% of GDP from $193.1 billion or 2.3% of GDP in 2012. In contrast, the financial and capital accounts closed with a large surplus of $262.7 billion in 2013, following a deficit of $16.8 billion in 2012. This impressive turnaround came mainly from strong net inflows of portfolio investment in 2013, particularly in the first and fourth quarters, following strong net outflows in 2012. Gross inflows of foreign direct investment also increased in 2013, by 5.3% to $117.6 billion according to the Ministry of Commerce, but the PRC's direct investment abroad rose more quickly, recording 17.3% expansion to reach $87.8 billion. This means that net foreign direct investment inflows may well have declined, but the balance of payment figures to confirm this have yet to be disclosed. The overall balance of payments surplus increased fourfold over 2012, boosting official reserves by $510 billion to nearly $4 trillion.

3.9.8 New loans from "shadow banks"



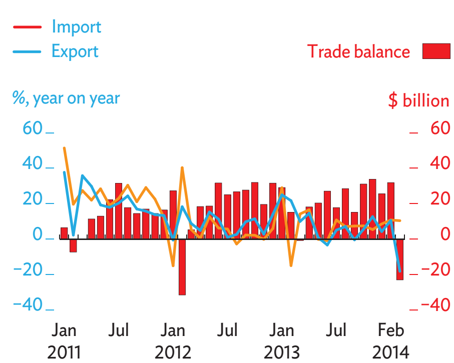
Sources: People's Bank of China; ADB estimates.

3.9.9 Exchange rates



Source: General Administration of Customs.

3.9.10 Trade indicators



Source: General Administration of Customs.

Economic prospects

GDP growth is projected to decelerate somewhat to 7.5% in 2014, which is the official target, and 7.4% in 2015 (Figure 3.9.11). Slightly weaker growth momentum from the fourth quarter of 2013 is carrying over into 2014. Support for growth over the forecast period should come from more equitable income growth and higher social spending in line with government objectives, which will sustain growth in consumption. GDP growth should also benefit from the upturn in developed countries, which should sooner or later generate stronger demand for PRC exports despite continuing real renminbi appreciation and higher unit labor costs.

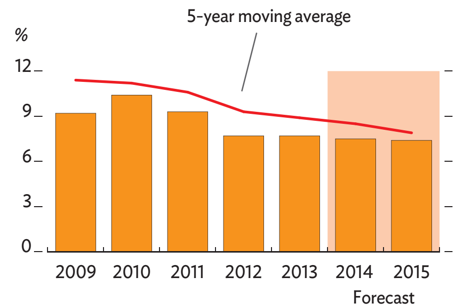
Investment growth, on the other hand, will likely decelerate as the government tries to rein in high credit growth, reduce industrial overcapacity, and bring local government debt under control. These efforts are already forcing many local governments to adjust their investment targets for 2014. Other structural reforms outlined at the Third Plenary Session of the 18th Central Committee of the Communist Party of the PRC in November 2013 might also weigh on headline growth: state-owned enterprise reform, higher prices and/or taxes for primary resources, and a change in how senior local government officials are evaluated that depends less on economic growth. However, such reforms have the potential to improve the quality of growth and ensure its long-term sustainability. The government has announced that it will try to prevent a sharp downturn to avoid social problems, implying that reforms will be rolled out over longer periods. Therefore, GDP growth is forecast to decelerate slowly over several years before it stabilizes or rises again.

Inflation is forecast to remain subdued at 2.6% on average in 2014, below the government target of 3.5%, as moderating GDP and credit growth keeps price pressure in check (Figure 3.9.12). Low capacity utilization in manufacturing should help contain domestic price pressures for some time to come. However, increases in administered prices, in line with government's plans to reform the pricing of energy, water, and other commodities, may push annual average inflation to around 3.0% in 2015. Volatile food prices harbor risks to this inflation forecast.

As the government has announced that fiscal policies will stay broadly unchanged, the consolidated budget deficit is forecast to remain at about 2.1% of GDP in 2014 and 2015. The government will likely try to broaden its fiscal space and options by gradually increasing budget revenues through tax system reforms. Efforts to reduce local governments' off-budget spending may, however, have the effect of fiscal tightening. Government current expenditure should rise more than in 2013 as fiscal spending related to social security, public housing, education, and health care will continue to increase in line with announced government policies. In contrast, administrative spending will be cut further.

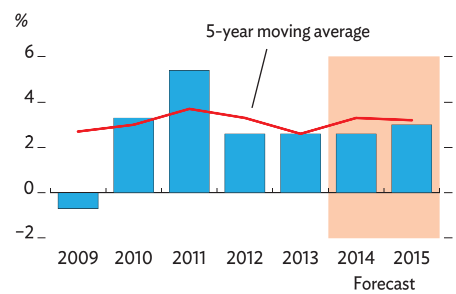
Monetary policy needs to strike a balance between mitigating risks in the financial and property sectors that stem from high past credit growth and supporting sustainable economic growth. As current growth momentum seems sufficiently high to provide enough jobs, monetary policy is expected to lean further toward tightening over the forecast period. This should bring the growth rate of money supply closer to that of nominal GDP and possibly even below the official target of 13% (Figure 3.9.13).

3.9.11 GDP growth



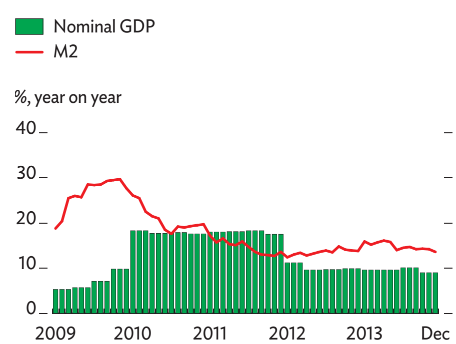
Source: *Asian Development Outlook* database.

3.9.12 Inflation



Source: *Asian Development Outlook* database.

3.9.13 M2 and nominal GDP



Sources: National Bureau of Statistics; People's Bank of China.

As global commodity prices are forecast to fall, the PRC's foreign trade will likely benefit from improved terms of trade. The merchandise trade surplus should thus widen further in 2014 and 2015. As the deficit in the service account will also likely widen, the current account surpluses are forecast to narrow marginally to 2% of GDP.

If strong net capital inflows continue, which seems likely, the PBOC will find it difficult to widen the exchange rate band for the renminbi, which was already extended from ±1 percent to ±2 percent in mid-March this year as an intermediate step toward the declared policy objective of full exchange rate liberalization. It will also be more difficult to rein in money supply growth. The authorities are therefore likely to facilitate capital outflows to ease upward pressure on the renminbi, followed in later years by steps toward further exchange rate liberalization. A more balanced capital and financial account would help slow the accumulation of reserves, which boosted money supply in 2013, given the limited scope for sterilization owing to the shallow financial market. Unexpectedly high trade surpluses and net capital inflows harbor risks for these exchange rate and monetary forecasts.

Among the international risks to the forecast is unexpectedly severe financial volatility in developing economies as the US Federal Reserve gradually tapers quantitative easing. If some countries suffer excessive capital outflows, the PRC may be affected indirectly through weaker demand for its exports. Another global risk is recovery in developed economies remaining sluggish. While there seems to be evidence of improved performance in these markets, a setback to recovery in the PRC's main trading partners would translate into lackluster demand for its exports, which would slow growth during the forecast period. On the other hand, an unexpectedly strong external environment would improve the upside potential for the PRC economy and create room for bolder structural reforms.

The principal domestic risks to the forecast stem from uncertainties regarding the effectiveness of monetary management and the concern over credit quality. A number of trust funds are already facing difficulties, and a few have reportedly defaulted on bonds in recent months for lack of repayment from their own borrowers. Many of these borrowers, which include real estate developers and companies in industries with excess capacity, are subprime and struggle in an environment of decelerating economic growth. The factors mitigating these risks are that debts are mainly domestic and, at least in the case of local government debt, largely backed by long-term assets. Further, given relatively low central government debt and a well-capitalized banking system, the PRC is in a strong position to forestall domestic risks.

Policy challenge—maintaining GDP growth while taming credit expansion

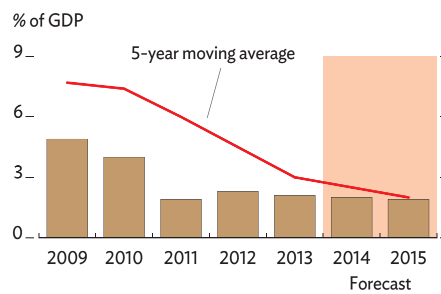
The key challenge for policy makers during the forecast period is to implement policies that help to decelerate investment growth in a controlled manner, thereby ensuring orderly debt accumulation by local governments and state-owned enterprises and the safety and soundness

3.9.1 Selected economic indicators (%)

	2014	2015
GDP growth	7.5	7.4
Inflation	2.6	3.0
Current account balance (share of GDP)	2.0	1.9

Source: ADB estimates.

3.9.14 Current account balance



Source: Asian Development Outlook database.

of the banking system, without derailing the growth momentum of the economy. After launching the key structural reforms outlined at the November 2013 party plenum, the government will pursue, as in the past, a gradual reform strategy and regularly fine-tune the speed of reform and which specific measures to apply.

While this strategy will help to contain instability, achieving results will take time. In the short term, the PBOC needs to find the right balance between subduing credit growth and supporting economic growth. Attempts to slow credit growth too rapidly may impose additional stress on enterprises and financial institutions, eroding investor confidence. However, if continued, the current pace of credit growth and the associated increase in debt, including the debt of local governments and state-owned enterprises, may aggravate existing asset quality problems, which also risks undermining investor confidence. Responding to this bind requires strengthening monetary, fiscal, and exchange rate policies in a coordinated way. To this end, the PBOC can be expected to target a monetary growth rate in 2014 that exceeds nominal GDP growth but by less than in 2013, invigorate competition in the financial sector to help allocate credit more efficiently, and strengthen sector oversight to prevent excessive risk taking. Other needs are further interest rate liberalization, financial market deepening, and more flexibility in exchange rate policy to reduce the need to sterilize eventual large capital inflows.

In the fiscal area, the government intends to further improve tax collection and cut preferencial tax treatments, introduce property taxes, and start adjusting the distribution of fiscal responsibilities and resources between the central and local governments by recentralizing social expenditure responsibilities and enlarging the block transfers that the central government pays to local governments. Both measures will, over time, ease the need for local governments to accumulate more debt.

Reform of personal income tax may also be launched during the forecast period, as a broader income tax base would go a long way toward mobilizing the resources needed to better provision social and infrastructure services without accumulating more debt. Equally important, progressive income taxes would help to shift the tax burden from low-income to high-income households. This would improve income distribution and equity, which are declared policy objectives.

Hong Kong, China

Spurred by domestic demand and tourism, GDP grew steadily. Growth is expected to accelerate moderately to 3.5% in 2014 and 3.6% in 2015 as inflation hovers just below 4%. Being an international financial center poses risks from volatility, but a healthy financial sector and substantial financial resources can cushion the economy. A policy challenge is to address long-term fiscal sustainability in view of an ageing population and the government's financial commitments.

Economic performance

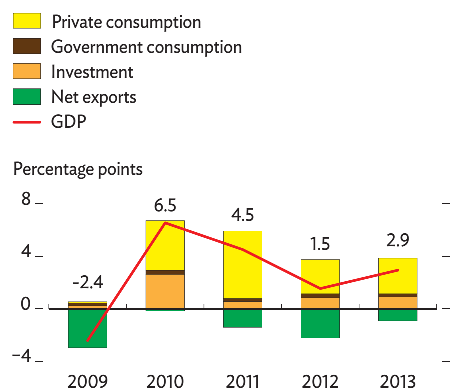
The economy grew by 2.9% in 2013, more quickly than in 2012. Domestic demand and healthy tourism supported economic expansion. Consumption was the backbone of growth, contributing about 3 percentage points, with private consumption accounting for 92% of that contribution (Figure 3.10.1). Investment also picked up in 2013 with increased purchases of machinery and equipment, contributing 1 percentage point to growth. Sluggish external demand reduced net exports, subtracting nearly 1 percentage point from growth.

Private consumption was buoyed by rising real incomes. Reflecting a low unemployment rate of 3.3% and an upward adjustment to the statutory minimum wage in May 2013, real wages have risen. The continuing influx of tourists also played a major role in boosting private incomes. In 2013, Hong Kong, China attracted 54.3 million tourists, 75% of them from the People's Republic of China (PRC). While tourists arrivals from other markets have remained stable, those from the PRC have increased by 80% since 2010 (Figure 3.10.2).

Gaining from high tourist arrivals in 2013, the service sector, which accounts for more than 90% of GDP, grew by 3%. Most services grew at a robust pace, with the exception of real estate, which contracted by 4%. The contribution of industry and construction was small, and that of agriculture negligible.

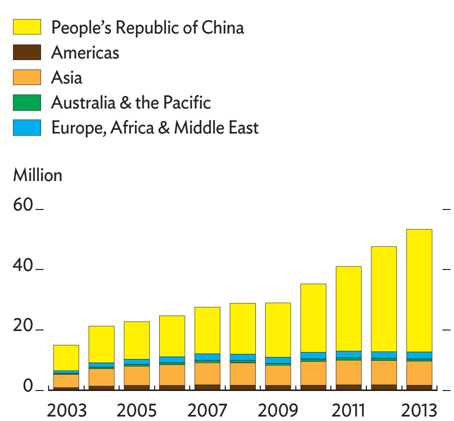
Export and import growth both accelerated slightly in 2013, reflecting economic recovery in the advance economies in the latter half of 2013. Net services exports grew by 33%. The combined goods and services balance produced a modest surplus of $2.9 billion, and the current account surplus widened to 2.1% of GDP from 1.6% in 2012. This outcome, together with a net capital inflow of $2.2 billion, generated a balance of payments surplus of 2.7% of GDP. Official foreign reserves increased to $311.2 billion by the end of 2013 from $305.8 billion a year earlier. Tracking movements of the US dollar to which it is pegged, the local currency appreciated in nominal effective terms by 3.7% against the currencies of the economy's major trading partners in 2013 (Figure 3.10.3).

3.10.1 Demand-side contributions to growth



Source: CEIC Data Company (accessed 15 March 2014).

3.10.2 Tourist arrivals



Source: CEIC Data Company (accessed 15 March 2014).

This chapter was written by Arief Ramayandi and Aleli Rosario of the Economics and Research Department, Asian Development Bank, Manila.

Under the currency board system, interest rates generally align with the policies of the US Federal Reserve. The low interest rate environment pushed domestic credit to 170% of GDP in 2013, for a growth rate of 8.2%, and the total loan-to-deposit ratio to 72.9% in January 2014 (Figure 3.10.4). The total loan portfolio of authorized institutions, including their lending abroad, expanded by 16%, up from 10% in 2012. Tighter macroprudential policies and fiscal measures imposed in February 2013 to contain soaring property prices lowered the ratio of property loans to total loans to 30% from about 33% in 2012. The money supply grew by 12.3% in 2013, substantially outpacing nominal GDP growth and somewhat more quickly than the 11.1% rate posted in 2012.

Consumer price index inflation increased to 4.3% year on year in 2013 from 4.1% in 2012 as costs rose for rent and food, which together accounted for 79% of the index rise. Despite the sharp cooling of the property market, residential rents increased by 6.7%, albeit stabilizing in the fourth quarter (Figure 3.10.5). The number of new rental leases edged down in line with cooling in the property market, which will take time to feed through to other rental indicators. Food prices rose by 4.4%, but prices for durable goods declined on weak import prices. Headline inflation was calculated with no corrections for one-off relief measures such as tax concessions, an electricity subsidy, and 2 months' free rent for public housing tenants.

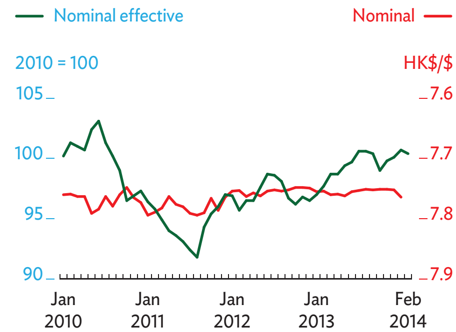
Since 2004, the budget has recorded surpluses cumulatively amounting to $60.3 billion, providing substantial fiscal reserves at a time when higher social expenditure seems inevitable. The budget for FY2013 (ended 31 March 2014) was no exception, recording a surplus of 0.6% of GDP. Revenues rose to HK$447.8 billion, 3% more than projected, as additional land was sold for housing. Expenditure of HK$435.8 billion was lower than budgeted by HK$4.2 billion, though recurrent expenditure growth has averaged 8.5% in the past 3 years, with a huge chunk of that allotted to education, health care, and social welfare.

Economic prospects

The economy is forecast to grow by 3.5% in 2014 and 3.6% in 2015 (Figure 3.10.6). This is within the range of 3.0%–4.0% that the government forecast for 2014. In the next 2 years, as the economies of the US and the euro area strengthen, the external trade of Hong Kong, China is expected to pick up. Exports are expected to grow over the next 2 years by an average of 8.2%, and imports by 7.0%. Close links to the PRC economy are expected to open up more business opportunities in that market, and facilitate access to more provinces, for service companies based in Hong Kong, China. This should mitigate any adverse impact from slower growth in the PRC. Inflation is expected to moderate to 3.8% in 2014, as the slower pace of rent hikes in the last quarter of 2013 feeds through and as international food and oil prices decline with expected better supply. As these developments feed through in turn to 2015, inflation is envisaged declining slightly to 3.7%.

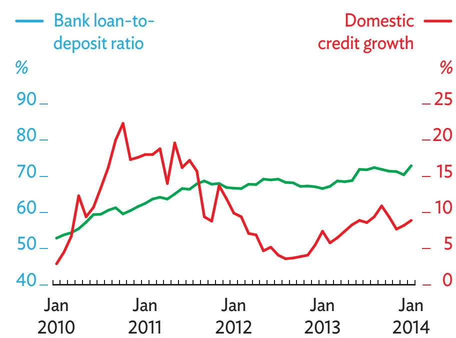
Domestic demand is expected to be robust in the forecast period. Private consumption will continue to be an important source of growth in 2014 and 2015. Private investment is expected to pick up from its low

3.10.3 Exchange rate



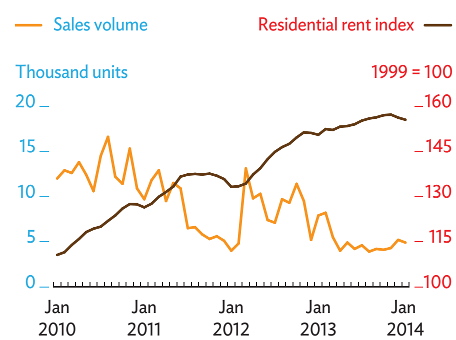
Source: CEIC Data Company (accessed 15 March 2014).

3.10.4 Credit indicators



Source: CEIC Data Company (accessed 15 March 2014).

3.10.5 Property indicators



Source: CEIC Data Company (accessed 14 March 2014).

base in 2013. Public spending will likely continue growing from its high base, as projects initiated over recent years keep public construction buoyant. More generally, low and stable interest rates in 2014, reflecting US monetary policy, will fuel domestic demand in 2014, but this effect may wane in 2015 if US monetary policy tightens.

Both imports and exports will grow, with the trade balance remaining in deficit. However, the current account surplus is expected to widen to 3.5% of GDP in both 2014 and 2015 on growing net service receipts and income from PRC tourists. This is despite the Government of the PRC agreeing to temporarily tighten restrictions on travel to Hong Kong, China in response to mounting concerns about the burden tourist numbers place on public infrastructure. The position of Hong Kong, China as an international financial center could strengthen as the PRC continues to open its capital account and to foster the renminbi's expanded use internationally.

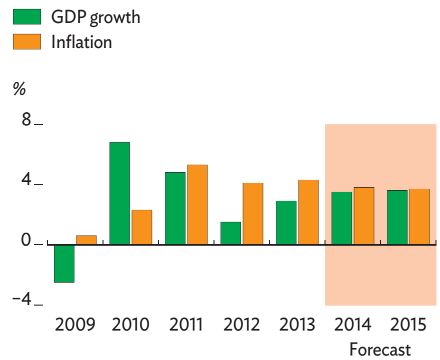
A surplus of about 0.4% of GDP is planned under the FY2014 budget, with revenue and expenditure both amounting to about 19% of GDP. This represents a 4% reduction in revenue and a 6% reduction in expenditure from the FY2013 budgetary outturn. Lower expenditure reflects reduced relief measures and transfers to various funds. The FY2014 budget cuts the amount budgeted to finance relief to HK$20 billion. The budget is in line with the recommendations of the Working Group on Long-Term Fiscal Planning, which was set up in June 2013 to contain public expenditure to 20% of GDP, close to the ratio in the past year.

Growth prospects hinge on continued expansion in the PRC, economic recovery in the advanced economies, and accommodative monetary policy in the US. As an international financial center, Hong Kong, China would feel the impact of global financial shocks, particularly those emanating from the US or the PRC. If the US tightens monetary policy in 2014, capital outflows, higher interest rates, and financial market volatility will likely ensue, curtailing domestic demand and economic growth. However, a strong fiscal position, robust and proactive oversight of the financial system, and a flexible labor market would allow the timely adjustment of the real exchange rate, if needed. Another domestic risk is a sharp rise in property prices followed by an abrupt correction, which would undercut the value of collateral securing loans and leave some mortgaged homeowners owing more than their homes are worth. This would stifle economic activity.

Policy challenge—fiscal sustainability

Fiscal prudence has been the hallmark of government policy in Hong Kong, China. The budget has not been in deficit since the global financial crisis, and the government has amassed reserves sufficient to finance more than 20 months of government expenditure. In the past 5 years, actual budget surpluses have substantially exceeded the budgeted amounts. This small, open economy is particularly susceptible to fluctuations in the global economy and other external factors. Its major sources of revenue, such as profit tax, land premiums, and stamp duty, have been highly volatile and susceptible to fluctuation.

3.10.6 GDP growth and inflation



Source: Asian Development Outlook database.

3.10.1 Selected economic indicators (%)

	2014	2015
GDP growth	3.5	3.6
Inflation	3.8	3.7
Current account balance (share of GDP)	3.5	3.5

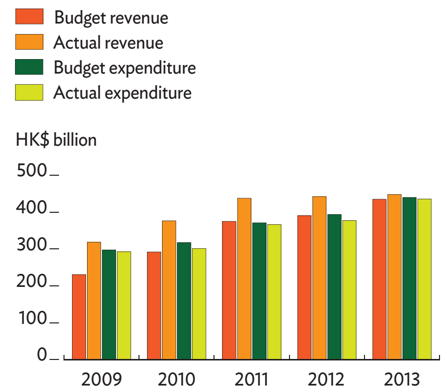
Source: ADB estimates.

Realized revenues are thus not always the same as budgeted, and have often exceeded the budget, with unanticipated surpluses coming largely from land sale receipts. Unlike revenues, actual spending has rarely been allowed to exceed budgeted amounts (Figure 3.10.7).

The share of education, health care, and social welfare in recurrent spending in the FY2014 budgeted is similar to actual expenditure in FY2013. These expenditures have been on the rise since 1997 and account for about 60% of the recurrent government expenditure. The aging population has heightened the need for substantial increases in health care and welfare spending. Managing this inevitable increase while preserving fiscal sustainability presents a fiscal challenge in the years ahead. The Working Group on Long-Term Fiscal Planning has noted that, while the government's fiscal position will remain healthy in the medium term, the prospects of an aging population and a shrinking workforce pose a future fiscal challenge. With revenues assumed to grow by 4.5% annually, the fiscal position is projected to begin deteriorating in about 15 years under no service enhancement for social services—that is, with spending adjusted only to take into account demographic and price factors. With service enhancement requiring government expenditure to grow at an average of 7.5% per year, a structural deficit would result in 7 years. The working group recommended that the government implement coordinated measures to contain expenditure growth, preserve the revenue base, and save for future generations to cope with the fiscal challenges ahead.

The government of Hong Kong, China cites the continued increase in recurrent expenditure on education, health care, and social welfare as reflecting its long-term commitment to providing public services. This policy aligns with the working group's recommendations and its analysis, which points to the need to enhance both social services and the availability of resources to fund them over the medium term. A further need, as also highlighted by the working group, is to ensure the sustainability of public finances by aligning government expenditure growth with the growth in the economy and government revenue.

3.10.7 Fiscal indicators



Sources: The Government of the Hong Kong Special Administrative Region. *The 2014–2015 Budget*, and other years. http://www.budget.gov.hk; Hong Kong Monetary Authority; *Asian Development Outlook* database.

Republic of Korea

Growth picked up moderately in 2013 as inflation slowed and the current account surplus expanded. Growth will accelerate this year and the next, unaffected by moderation in the People's Republic of China, with inflation higher but still low and with shrinking current account surpluses. Inducing more women to join the workforce remains a high-priority policy challenge.

Economic performance

Growth accelerated gently from 2.0% in 2012 to an estimated 2.8% in 2013, somewhat less than expected at the beginning of the year because exports remained soft. Budding recovery in the advanced economies, especially the US, did not translate into an increase in exports. Nevertheless, exports made a tangible contribution to growth, reflecting the improving global outlook. Mirroring the world economy, GDP growth accelerated from below 2.0% in the first half to above 3.5% in the second half, exhibiting a clear strengthening trend since the fourth quarter of 2012 (Figure 3.11.1).

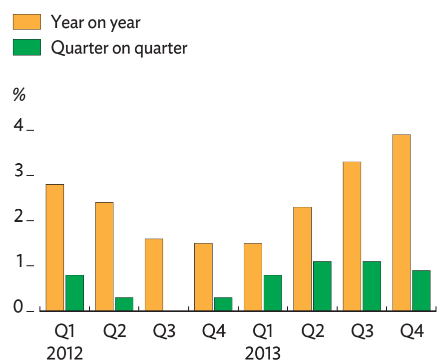
The main driver of growth in 2013 was healthy domestic demand, spurred by a solid employment gain of 386,000 jobs and accommodative government policies. Private consumption was the most dynamic component of demand, expanding by 1.7% on a consistently rising trend throughout the year (Figure 3.11.2) and adding 1.0 percentage point to GDP growth. Government consumption also remained robust, contributing another 0.5 percentage points (Figure 3.11.3). Investment registered a large turnaround, adding 0.7 percentage points to growth after subtracting 0.5 percentage points in 2012. Net exports made a similar contribution of 0.6 percentage points.

The pickup in investment was spurred by a big improvement in construction, which more than offset falling investment in plant and equipment. Construction investment grew by 6.9% after 3 straight years of contraction and remained buoyant throughout the year. An unexpectedly weak export performance took its toll on plant and equipment investment, which fell by 1.5% following a 1.9% contraction in 2012. The high-tech manufacturing sector, geared toward exports to the advanced economies, was especially hard hit, and investment in machinery continued to shrink.

On the supply side, robust construction did not translate into faster growth of value added in the service sector, which expanded by 2.4% in 2013, slightly down from 2.5% in 2012. Manufacturing growth accelerated to 3.0% from 2.2%, while exceptionally favorable weather fostered robust 5.6% growth of agriculture in 2013, on the heels of a 0.6% slide in 2012.

This chapter was written by Donghyun Park of the Economics and Research Department, Asian Development Bank, Manila.

3.11.1 Quarterly GDP growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 3 February 2014).

3.11.2 Growth in private consumption

Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 3 February 2014).

The inflationary impact of rising domestic demand was more than compensated by the improved agricultural outcome and soft global commodity prices, which brought lower inflation. The consumer price index averaged 1.3%, down from 2.2% of 2012, its lowest level since 2000 and well below the Bank of Korea's inflation target band of 3.0% ±0.5% (Figure 3.11.4).

Monetary and fiscal policies were both expansionary during 2013. Low inflation did not raise the specter of deflation but enabled the Bank of Korea to cut its benchmark policy rate from 2.75% to 2.50% in May, facilitating an expansion of domestic liquidity. Fiscal policy provided by far the bigger impetus to growth. Including the $16 billion supplementary budget, the fiscal deficit rose to 1.8% of GDP from 1.4% in 2012, and the ratio of sovereign debt to GDP climbed to 36.2% from 34.8%.

Trends in external trade and services balances brought the current account surplus to a record $71 billion, or 5.8% of GDP, up from $48 billion in 2012. Merchandise exports grew by 3.0%, up from 0.4% in 2012, while merchandise imports shrank by 0.8%, following a 1.1% contraction in 2012 (Figure 3.11.5). Lower global commodity prices underlay the softness of imports, while export growth strengthened in tandem with the global outlook. Notably, exports to the People's Republic of China remained resilient in the face of that country's growth moderation. The services trade surplus soared from $270 million in 2012 to $6 billion as business service imports fell sharply. The surplus in the overall balance boosted official foreign exchange reserves to $335.6 billion at the end of 2013.

The won averaged 1,094 to the dollar in 2013, somewhat stronger than the 1,126 of 2012, and the real exchange rate also strengthened during the second half of the year (Figure 3.11.6). These developments did not appear to have tamped down export demand or raised import demand.

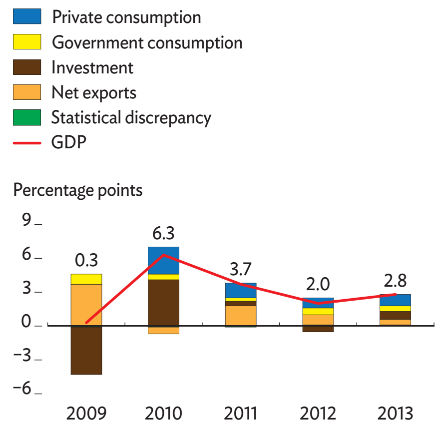
The economic outcome in 2013 marks a moderate improvement from the disappointing performance of 2012. Growth still underperformed market expectations because exports were lackluster, but the stronger second half bodes well for 2014.

Economic prospects

GDP growth is forecast to accelerate to 3.7% in 2014, fueled by strong exports and private consumption (Figure 3.11.7). The improvement of the global outlook, which became evident in the second half of 2013, is expected to strengthen in 2014, benefiting this highly export-oriented economy. The expected robust recovery of consumption in the US and other advanced economies will especially boost durable and information technology exports, while exports to the People's Republic of China and other developing countries will continue to grow at a healthy pace. Merchandise export growth is therefore forecast to rise above 6.0% in 2014, as the trend in the second half of 2013 is expected to persist.

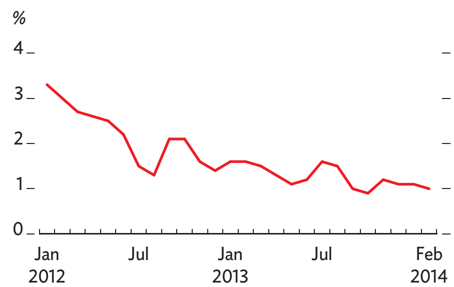
Private consumption will supplement exports as a driver of growth in 2014 and 2015, as a higher export volume combines with improving terms of trade to boost household disposable income. Consumer confidence is on the mend, as uncertainties associated with restrictions on chaebols

3.11.3 Demand-side contributions to growth



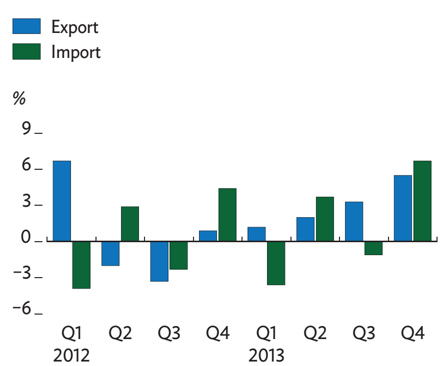
Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 3 February 2014).

3.11.4 Monthly inflation



Source: CEIC Data Company (accessed 3 February 2014).

3.11.5 Quarterly merchandise export and import growth



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 3 February 2014).

(large conglomerates) and the tapering of US quantitative easing are expected to recede (Figure 3.11.8).

Growth in private consumption is projected to strengthen to 3.0% in 2014 as it closely tracks gross national disposable income, which is expected to grow at a solid pace. The job market will be another bright spot, with an employment gain of over 400,000 jobs expected. The combination of robust employment, the reversal of the recent downward slide in asset prices, and a stronger currency also augurs well for household spending. These factors will likely dampen the impact of any increase in interest rates, which could restrict consumption by raising the debt service burden.

After 2 years of contraction, investment in plant and equipment is expected to increase by over 5% on the back of rising exports, substantially outpacing projected GDP growth. The rebound will not extend, however, to sectors plagued by excess capacity, such as steel and petrochemicals. Construction investment growth will remain positive but slow to below 2%, well short of the 2013 outcome, which was a one-off driven by temporary public works, rather than the beginning of a trend. Investment in residential construction will remain subdued despite some pickup in private sector activity (Figure 3.11.9).

Imports will outpace exports as they grow by more than 8% on the back of stronger domestic demand. As a result, the current account surplus will shrink to $42 billion, or 4.1% of GDP. In short, 2014 will mark the consolidation and firming of recovery in the Republic of Korea, which will persist into 2015.

Consumer price index inflation will pick up to 2.1% in 2014, as growth momentum firms and the rise in agricultural output diminishes. Stable global commodity prices and the strong won will persist, holding down import prices, but demand-side pressures will gain strength. In light of the energy sector's growing debt, electricity charges may escalate significantly.

Despite the improving outlook, fiscal and monetary policy will remain mildly expansionary in 2014. The relatively tame recovery rules out a quick and decisive change of policy direction. The Bank of Korea is thus expected to keep its policy interest rate unchanged in the absence of any big shock. The projected fiscal deficit for 2014 is 1.8%, identical to that of 2013, such that the ratio of public debt to GDP will likely rise to 36.5% from 36.2%. The Republic of Korea has run fiscal deficits every year since 2008, and the public debt ratio has grown consistently. Keeping fiscal deficits from becoming entrenched will require medium-term fiscal consolidation achieved by strengthening the tax base, including exemption reduction, and expenditure prioritization.

The brightening global outlook will continue to exert a positive effect in 2015. Growth is forecast to pick up marginally to 3.8% from 3.7% in 2014. Consumer inflation will likely rise to 2.5% from 2.1%, and the current account surplus is projected to continue shrinking marginally, from 4.1% to 4.0%.

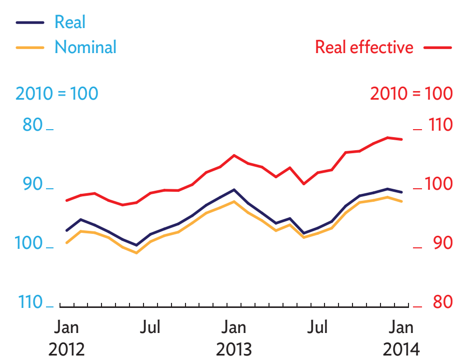
Overall, risk and uncertainty in the economy are likely to recede in 2014, as the global recovery gains traction and global financial markets become accustomed to the tapering of US quantitative easing. Upside risks to this assessment outweigh downside risks, so growth

3.11.1 Selected economic indicators (%)

	2014	2015
GDP growth	3.7	3.8
Inflation	2.1	2.5
Current account balance (share of GDP)	4.1	4.0

Source: ADB estimates.

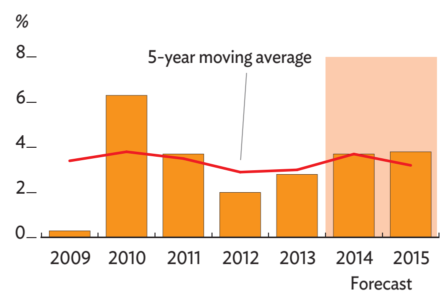
3.11.6 Exchange rates



Note: Rising trend means appreciation.

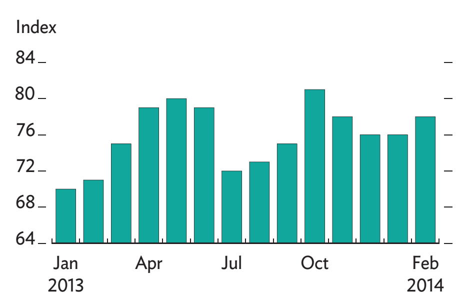
Source: ADB estimates using data from CEIC Data Company (accessed 7 March 2014).

3.11.7 GDP growth



Sources: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 3 February 2014); ADB estimates.

3.11.8 Consumer confidence



Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 3 February 2014).

may pleasantly surprise. The Republic of Korea's financial stability is evident from its low and declining credit default spread (Figure 3.11.10) and will be shielded by its strong fundamentals such as a solid current account surplus and formidable foreign exchange reserves. Nevertheless, US tapering can exert a sizable indirect impact if it rekindles significant financial stress in the euro area and emerging markets, which collectively form a substantial export market for the Republic of Korea. Domestically, the growth of household debt is slowing, but the structure of mortgages, which account for half of household debt, remains a source of concern. A large part of mortgage debt is short term, variable interest, and single repayment, rendering it vulnerable to interest rate shocks and housing price decline.

The single biggest risk affecting the generally benign economic outlook for 2014 is the steady appreciation of the won relative to the yen (Figure 3.11.11). This will adversely affect export competitiveness vis-à-vis Japan, as exporters in the two countries compete in many markets. According to 2013 estimates by Hyundai Research Institute, yen depreciation to 100 per US dollar would reduce the Republic of Korea's exports by 2.6% and shave up to 0.2% off its GDP growth; further yen depreciation to 120 per US dollar would almost triple this export reduction to 7.3%. Won appreciation against the yen would also reduce net tourism and corporate market value as external competitiveness suffers.

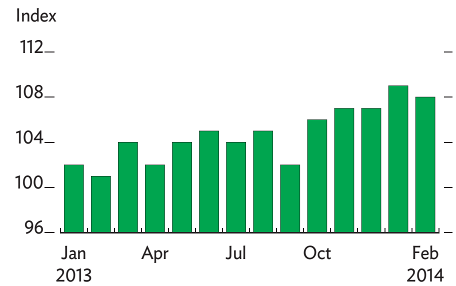
While growth momentum is expected to firm up in 2014 and 2015, widespread concerns about the visible loss of dynamism since the global crisis are likely to linger. To some extent, the growth slowdown reflects the maturing of the Republic of Korea as a high-income economy. Nevertheless, its policy makers are exploring policy options to lift long-term growth. On 25 February 2014, the government announced a three-pronged growth strategy: fostering the creative economy, reforming state-owned enterprises, and strengthening domestic demand. Another emphasis is deregulation, especially in the service sector, toward revitalizing private investment. Yet another option is to increase the workforce participation of women, which remains below the average for member economies of the Organisation for Economic Co-operation and Development (OECD) despite recent gains (see below). However, the impact of these policies is unlikely to be felt during the forecast period.

Policy challenge—lifting the employment of women

The Republic of Korea may soon face labor shortages as its population rapidly ages. One obvious solution is to encourage more women to work. The country's female workforce participation rate stood at 55.2% in 2012, the lowest figure among the 34 OECD member countries, which averaged 62.3%. The gap is most pronounced among university graduates. By contrast, the Republic of Korea's high school graduation rate is the highest in the OECD. As 74.3% of Korean female high school graduates continue to university—a rate even higher than the 68.6% for males—the underutilization of female labor masks the underutilization of a highly educated portion of the potential workforce.

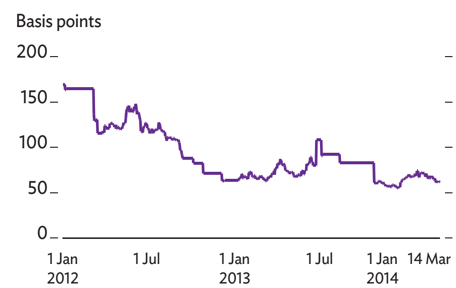
The fundamental reason behind the underemployment of Korean women is that many of them drop out of the workforce in their 30s

3.11.9 Business confidence



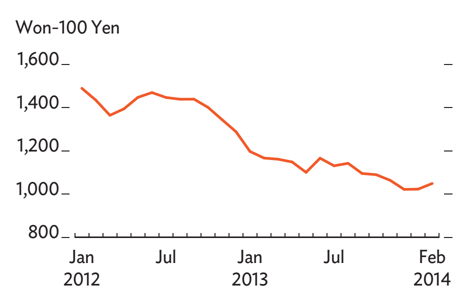
Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 14 March 2014).

3.11.10 Credit default spread, senior 5-year



Source: Bloomberg (accessed 14 March 2014).

3.11.11 Won-yen exchange rate



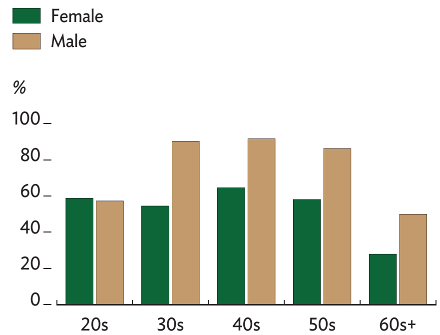
Source: Bank of Korea. Economics Statistics System. http://ecos.bok.or.kr/EIndex_en.jsp (accessed 14 March 2014).

(Figure 3.11.12). Pregnancy, childbirth, and child-raising are the immediate causes for leaving the workplace. Only 56.0% of all women in their 30s are economically active. The female employment rate fails to recover strongly in later years, peaking at 64.6% in the 40s. By contrast, the male employment rate surges to 90.3% in the 30s and rises further to 91.7% in the 40s, creating a large gender gap.

According to a 2013 Hyundai Research Institute report, the experiences of Germany, the Netherlands, and the United Kingdom can provide good benchmarks for the Republic of Korea. Those countries have higher female workforce participation, which in the case of female university graduates exceeds 80.0%, far above the Republic of Korea's 62.4%. The three benchmark countries are also seen as leaders in providing employment compensated by the hour, which allows for more flexible work arrangements (Figure 3.11.13). Women in those countries are able to work during their childbearing years mainly because many shift from full time to hourly. Another noticeable difference is the widespread availability of other flexible work arrangements, including work from home. Korean women are shifting to hourly work in their 30s, but less than in peer countries, and they have less access to other flexible work arrangements.

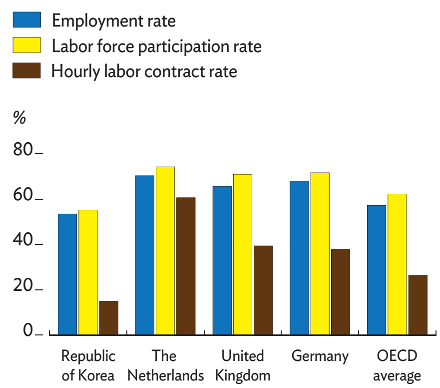
The experiences of these countries point to the importance of developing a labor market model that caters to the needs of highly educated women whose careers are interrupted by motherhood. Hourly work may be a flexible arrangement that enables women to work while raising children, but it offers only limited career prospects. The model should therefore allow women to transition back to full time. The number and quality of hourly jobs, especially for highly educated women, should be augmented. In the Republic of Korea, hourly employment is dominated by temporary or daily work, and pay per hour is only 45.4% that of full-time workers. A broader prerequisite is to establish woman-friendly work environments with flexible hours, other arrangements such as work from home, and more and better childcare facilities. Such arrangements would encourage highly educated Korean women to combine office work with homemaking.

3.11.12 Employment of Korean men versus women, by age group



Source: Hyundai Research Institute (2013).

3.11.13 Women's employment rate, workforce participation, and hourly labor contract rate, various countries



OECD = Organisation for Economic Co-operation and Development.
Source: Hyundai Research Institute (2013).

Mongolia

Mongolia is challenged by significant external imbalances because foreign direct investment has declined rapidly and some mineral exports remain weak. Growth is forecast to moderate in 2014 and remain broadly stable in 2015, inflation to decline, and the current account balance to improve over the next 2 years, assuming appropriate policies. The major policy priority is to address pressures on the balance of payments and foreign exchange reserves.

Economic performance

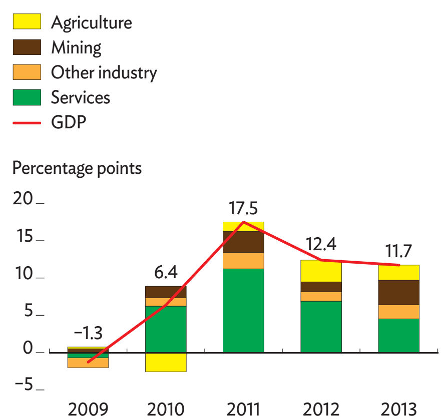
The Mongolian economy grew by 11.7% in 2013, down from 12.4% in 2012. Growth was boosted by highly expansionary fiscal and monetary policies to compensate for the marked slowdown in coal exports and mine development financed through foreign direct investment (FDI), which have been the drivers of growth in recent years. Strong economic growth has helped reduce the poverty rate by more than 11 percentage points in the past 2 years, to 27% in 2012.

Industrial production increased by 20.1% in 2013, contributing 5.1 percentage points to economic growth, driven by construction, which expanded by 66%, boosted by monetary and fiscal stimulus. Mining output expanded by 20.7%, thanks to the ramp-up of copper production at the vast Oyu Tolgoi mine, which started in June 2013. Services expanded by 10.0%, contributing 4.3 percentage points to economic growth. Favorable weather allowed agriculture to expand by 13.5%, contributing 2.0 percentage points (Figure 3.12.1).

Domestic consumption was the main driver of economic growth from the expenditure side, increasing by 16.3% in constant prices and contributing 13.7 percentage points to growth. Gross capital formation increased by 2.1%, contributing 1.5 percentage points, while net foreign trade and services subtracted 3.6 percentage points (Figure 3.12.2). The completion of the first phase of Oyu Tolgoi and a dramatic fall in FDI reduced imports of capital goods, which led a 5.7% drop in imports of goods. Exports of goods declined by 2.6% as coal exports to the People's Republic of China (PRC) plummeted by 40.7% owing to abundant coal supplies in the PRC and growing competition from other major coal-exporting countries.

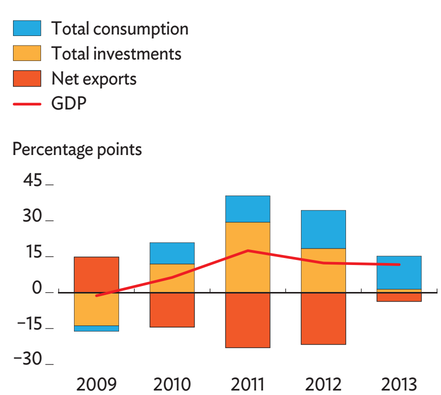
The consumer price index rose by 10.4% in 2013. It had fallen in the first half with the phase-out of the cash handout scheme and the temporary impact of the price stabilization program of the Bank of Mongolia (BOM), the central bank. Inflation rose subsequently, driven by currency depreciation and expansionary fiscal and monetary policies (Figure 3.12.3).

3.12.1 Supply-side contributions to growth



Source: National Statistics Office of Mongolia. 2014. *Monthly Statistical Bulletin*. December. http://www.nso.mn

3.12.2 Demand-side contributions to growth



Source: National Statistics Office of Mongolia. 2014. *Monthly Statistical Bulletin*. December. http://www.nso.mn

This chapter was written by Jan Hansen and Amar Lkhagvasuren of the Mongolia Resident Mission, Asian Development Bank, Ulaanbaatar.

Fiscal policy became more expansionary in 2013 as the consolidated, on- and off-budget fiscal deficit widened to 11.1% of GDP from 10.9% in 2012. Excluding off budget spending, the cash deficit amounted to 1.4% of GDP, lower than the 7.4% recorded in 2012, and the structural deficit reached 1.7%, within the 2% ceiling of the Fiscal Stability Law (FSL). Actual government revenue increased by 19.6%, less than the budgeted (and highly optimistic) amount. Revenue shortages and implementation challenges reduced public investment expenditure by 5.1%, holding the increase in government expenditure to a mere 3.1% (Figure 3.12.4).

The Development Bank of Mongolia (DBM) has become the main source of financing for off-budget spending, providing an amount equal to 9.6% of GDP in 2013 mainly for projects such as roads that do not generate revenue. The main source of DBM financing is proceeds from the Chinggis bond and a 5-year, $580 million euro bond issued in 2012, and the $290 million Samurai bond issued in December 2013. DBM debt is guaranteed by the government and so a contingent liability for the budget.

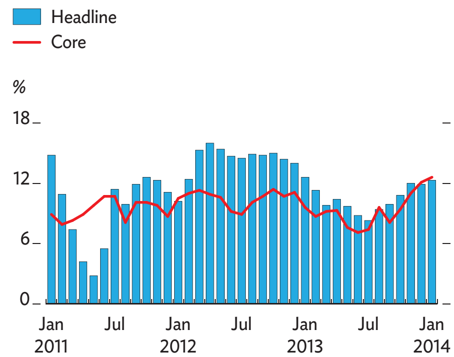
The ratio of public debt to GDP rose from 35.9% in 2010 to 63.0% in 2012, and likely remained broadly unchanged in 2013, though no official data are yet available. The external debt component equaled 48.3% of GDP in 2012. A debt sustainability analysis conducted in 2013 by the International Monetary Fund found Mongolia at moderate risk of debt distress, assuming a strong policy scenario—no longer at low risk, as found by previous analyses. Public debt sustainability has been impaired by the rising share of borrowing at commercial rates since 2012.

To cushion the impact of declining FDI and boost credit growth, the BOM cut the policy rate three times in 2013 by a total of 275 basis points to 10.5%. It injected liquidity equal to 17.1% of GDP, including for onlending to selected sectors through price stabilization and mortgage programs at subsidized interest rates. Bank credit increased as a result by 41.0% year on year in 2013 and by 54.3% year on year to January 2014. Broad money (M2) increased by 19.3% and 36.6% year on year during the same periods (Figure 3.12.5). These policies are widely seen as important factors behind balance-of-payment (BOP) pressures starting last year.

Capitalization and liquidity in the banking system have improved, but vulnerabilities remain. Weakness in bank supervision, inadequate provisioning, high loan concentration (especially in construction), dollarization, and a high and rising ratio of credit to deposits (at 103% in February 2014) have heightened the risk of bank distress. Corporate governance needs to be strengthened in the banking sector.

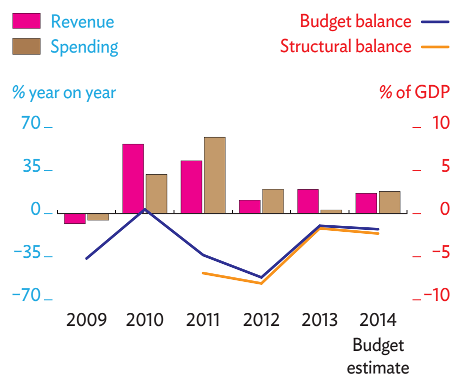
The current account deficit narrowed in 2013 to $3.2 billion, or 27.4% of GDP, from 32.6% in 2012 (Figure 3.12.6). The trade deficit improved to 18.1% of GDP from 22.8% in 2012 as the decline in imports outpaced that of exports, but the services and transfers balance worsened. Since mid-2013, the trade and current account deficits have both narrowed as currency depreciation strengthened export competitiveness and constrained imports—and as exports were boosted by the start of production at the Oyu Tolgoi mine. FDI plunged by about 55% in 2013 because of uncertainties arising from changes in the investment law, slower growth in the PRC, the completion of the first phase of Oyu

3.12.3 Monthly inflation



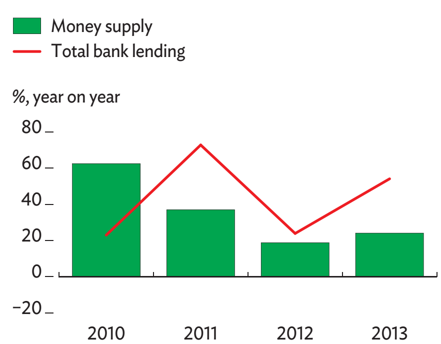
Source: Bank of Mongolia. 2014. *Statistical Bulletin*. January. http://www.mongolbank.mn

3.12.4 Fiscal indicators



Source: National Statistical Office. 2014. *Monthly Statistical Bulletin*. http://www.nso.mn

3.12.5 Money supply and total bank lending



Source: Bank of Mongolia. http://www.mongolbank.mn

Tolgoi, and delays in the expected commencement of the mine's second phase. Foreign exchange reserves almost halved in 2013, falling by $1.9 billion to $2.2 billion, or 4 months of imports. They increased to $2.4 billion in January after the DBM issued a $290 million samurai bond 90% guaranteed by the Japan Bank for International Cooperation.

The Mongolian togrog has depreciated by 27% against the US dollar since early 2013 as capital inflows ebbed and market sentiment weakened over prolonged debate surrounding Oyu Tolgoi issues and over uncertainty regarding the regulatory framework for foreign investment. The nominal effective exchange rate of the togrog fell by 15.5%, but the real effective exchange rate fell by only 7.2% as inflation in Mongolia exceeded that of its trading partners (Figure 3.12.7).

In October 2013, the parliament enacted a new comprehensive investment law, which aims to encourage FDI over the medium-term by leveling the playing field for foreign and domestic investors and ensuring a stable legal environment for investment. Under the law, the category of "strategic investor" no longer applies, and private foreign investors need only register with a state agency, rather than seek government approval.

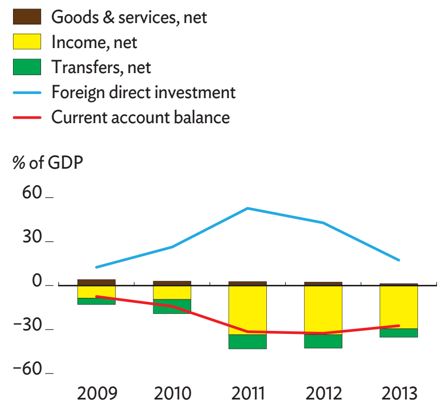
Economic prospects

Medium-term prospects remain promising, with growth expected in the double digits after a dip in 2014, given Mongolia's potential to develop its natural resources. Economic growth is forecast at 9.5% in 2014, driven in particular by the start of copper production at the Oyu Tolgoi open pit in June of last year. Growth in non-mineral output is expected to be held back by the tighter economic policy, which will be needed to reduce high domestic demand and so relieve BOP pressures. In particular, the overall budgetary deficit including off-budget outlays is expected to be lower than in 2013, as the DBM curtails investment expenditure and as BOM liquidity injections are expected to begin their phaseout this year.

Economic growth is expected to pick up slightly to 10% in 2015, spurred by further development in mining, including the possible development of the Oyu Tolgoi underground mine and an expansion of coal production from the Tavan Tolgoi mine (Figure 3.12.8). Non-mining growth is expected to accelerate as restrictive economic policies are eased and FDI flows are assumed to partly recover. Inflation in 2014 is expected to increase to 11%, driven by the lagged effect of expansionary monetary policy in 2013 and the recent depreciation of the togrog. Inflationary pressure in 2015 is expected to ease, assuming a tightening of economic policy in 2014 and a more stable exchange rate, with inflation falling to 8% consistent with BOM monetary policy (Figure 3.12.9).

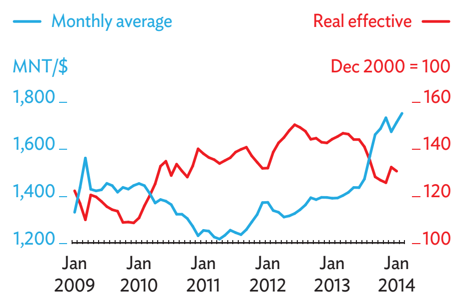
The current account deficit is forecast to fall to 20% of GDP in 2014 and 15% in 2015 as the trade balance improves. Exports are expected to grow following the start of Oyu Tolgoi production last year, and as new mining projects come onstream. The recent exchange rate depreciation and the expected tightening of economic policy will further constrain domestic absorption and dampen imports. The new investment law and

3.12.6 External balance indicators



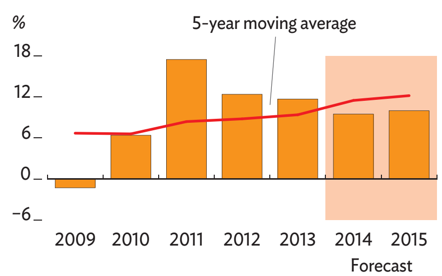
Sources: National Statistical Office. http://www.nso.mn; Bank of Mongolia. http://www.mongolbank.mn

3.12.7 Exchange rate



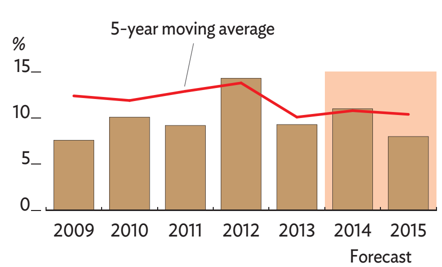
Source: Bank of Mongolia. http://www.mongolbank.mn (accessed 17 March 2014).

3.12.8 GDP growth



Source: Asian Development Outlook database.

3.12.9 Inflation



Source: Asian Development Outlook database.

the planned second phase of Oyu Tolgoi development are expected to support a recovery in FDI inflows, further stabilizing the BOP.

Mongolia's economic prospects are subject to downside risks from an uncertain external environment and the continuation of expansionary economic policies at a time when the BOP is under pressure. The PRC is the main destination for Mongolia's exports, accepting about 87% of them in 2013. Mongolia is thus highly vulnerable as the PRC rebalances from investment-led growth toward greater reliance of consumption, which may initially dampen demand for Mongolia's exports. Environmental concerns in the PRC may also reduce coal consumption. Further, substantial increase in global supplies and growing competition are putting Mongolia's mineral exports on an uncertain growth trajectory. Future trends in Mongolia's major export prices are also uncertain (Figure 3.12.10). On the domestic front, the continuation of current monetary and fiscal policies will inevitably perpetuate BOP and inflationary pressures, requiring significant real economic adjustments that may curtail growth.

Policy challenge—safeguarding macroeconomic and financial stability

The main policy challenge is to adjust unsustainable macroeconomic policies to relieve BOP pressure, contain inflation, and reduce the risk of severe distress in the financial sector. Negative shocks to FDI and coal exports have intensified BOP pressures since mid-2012. These pressures have been compounded by highly expansionary fiscal and monetary policies that have spurred substantial credit expansion and debt accumulation, as well as boosted demand for imports.

While current foreign exchange reserves are broadly adequate, the declining trend is not sustainable. The resumption of significant foreign capital inflows may take some time despite the adoption of the new investment law. Current policy offers little room to strengthen financial buffers to cope with possible external shocks. Mongolia needs to change course to mitigate its vulnerability to external shocks.

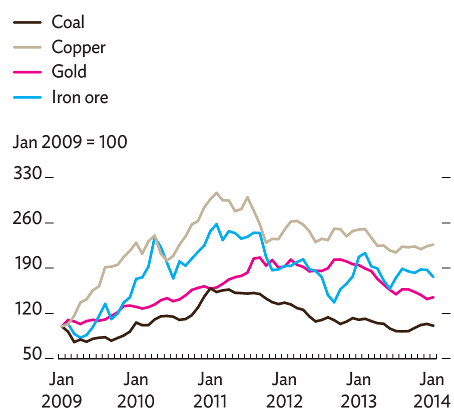
Addressing these challenges requires a comprehensive package of economic policy reforms, but improvements to monetary management and fiscal policy are the most urgent. Monetary policy should focus on macroeconomic and financial stability. The priority should be to gradually phase out the BOM's quasi-fiscal lending programs—or, if they are considered high priority, include them in the budget. Procyclical fiscal policy is a major concern, although the discipline of the FSL, if adhered to in practice and in spirit, would reduce the scope for such a policy. Needed fiscal reforms include reprioritizing and reducing public expenditure, incorporating DBM off-budget expenditure into the budget (thereby subjecting it to the FSL), and developing a medium-term fiscal framework to reduce the consolidated, on- and off-budget deficit to the law's 2% ceiling. Expenditure reform should include improving the quality of public investment expenditure, which has come under strain in view of the rapid increase in public investment.

3.12.1 Selected economic indicators (%)

	2014	2015
GDP growth	9.5	10.0
Inflation	11.0	8.0
Current account balance (share of GDP)	–20.0	–15.0

Source: ADB estimates.

3.12.10 Global prices of main exports



Source: World Bank. Commodity Price Data (Pink Sheet). http://econ.worldbank.org (accessed 17 March 2014).

Taipei,China

Higher growth is forecast for 2014 and 2015, but inflation will remain low. The current account surplus will expand. As export competition stiffens, this export-dependent economy needs a new engine of growth and strengthened cross-strait relations. Also crucial is to further deregulate the economy and shift resources toward more productive sectors.

Economic performance

GDP expanded by 2.1% in 2013. This outpaced the 1.5% growth recorded in 2012 but was less than expected as exports and private investment both grew more slowly than projected. Exports of goods and services, which account for nearly 75% of the economy's GDP, were the main engine of growth in 2013, expanding by 3.8% and adding 2.8 percentage points to growth, up from essentially nil in the previous year. Imports of goods and services also rose on higher demand for capital goods and consumer goods alike, climbing by 4.0% and reversing a 2.2% decline in 2012. Net exports expanded by 3.2%, lifting economic growth in 2013 by 0.6 percentage points.

Private investment grew by 7.4% in anticipation of stronger external demand, especially for machinery, but budgetary consolidation reduced government investment (Figure 3.13.1). As a result, total investment rose by 3.5%, reversing the slump of the past 2 years and contributing 0.6 percentage points to growth.

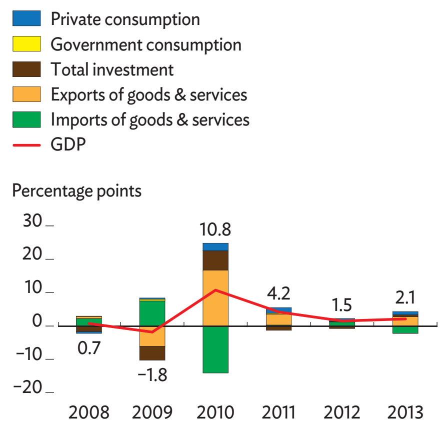
The same trend was apparent with consumption expenditure. Private consumption grew by 1.8%, aided mainly by lower unemployment, healthy increases in earnings across sectors, and rising consumer confidence. This more than offset a 0.3% decline in government consumption to lift total consumption by 1.4%, contributing 0.9 percentage points to growth (Figure 3.13.2).

On the supply side, growth was driven by the service sector, which expanded by 1.5% and contributed 0.9 percentage points to GDP growth. Expansion in all services remained strong, boosted by the doubling of tourist arrivals from the People's Republic of China (PRC), which have cumulatively exceeded 8 million since Taipei,China opened to PRC tourists in 2009 (Figure 3.13.3). Industrial output rose by 1.8% on a modest rise of 2.0% in manufacturing and contributed 0.6 percentage points to growth. Construction expanded by 0.8% in line with the rise in investment, but mining and quarrying weakened by 5.7%. Growth in agriculture was almost flat at 0.2% as typhoons hit crop production.

Average inflation slowed to 0.8% from 1.9% in 2012 in line with lower global energy prices, education fees, and clothing prices, which offset the lifting of electricity subsidies and a series of fuel price hikes.

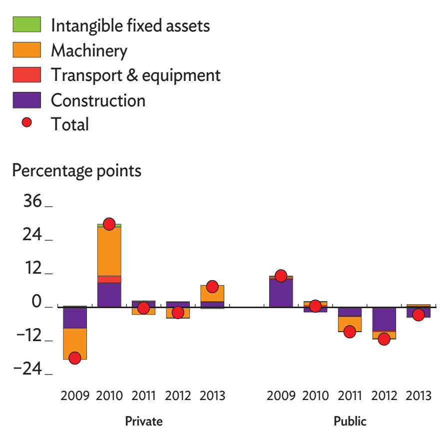
This chapter was written by Akiko Terada-Hagiwara and Shiela Camingue of the Economics and Research Department, Asian Development Bank, Manila.

3.13.1 Demand-side contributions to growth



Source: Directorate-General of Budget, Accounting and Statistics (DGBAS). http://eng.stat.gov.tw (accessed 11 March 2014).

3.13.2 Contributions to growth in gross fixed capital formation



Sources: Directorate-General of Budget, Accounting and Statistics (DGBAS). http://eng.stat.gov.tw; Haver Analytics (both accessed 11 March 2014).

Excluding fruits, vegetables, and energy prices, core inflation slowed to an average of 0.7% from 1.0% a year earlier (Figure 3.13.4).

The budget deficit stood at 1.0% of GDP in 2013, down from 1.6% in 2012 and 1.8% in 2011. Continued fiscal consolidation limited the increase in expenditure to 1.3%. Revenues increased by 3.9% as the government issued new licenses to telecommunications companies, and as receipts from customs duties and business and commodity taxes grew. Meanwhile, income taxes, which comprise 54.9% of total tax revenues, declined by 2.3%, as receipts from both corporate and individual income taxes were lower. They were dragged down by the uncertain global environment, which affected the profitability of firms operating locally and in the PRC.

In view of inflation being tamed, the central bank kept the rediscount rate unchanged at 1.875%. The accommodative monetary policy, positive business sentiment, and steadily improving consumer confidence pushed up credit to the private sector by 4.1%. The rise in credit last year, especially to the real estate sector, led the central bank to tighten rules on issuing collateralized loans, despite the ratio of nonperforming loans remaining very low. Real estate lending by banks rose by 4.1% to account for 44.0% of all loans at the end of 2013, up from 43.5% a year earlier. The rise in domestic credit and a sizeable increase in net foreign assets lifted the money supply (M2) by 5.8% in 2013, which outpaced the 3.5% recorded in 2012 but remained well within the central bank's target range of 2.5%–6.5% (Figure 3.13.5).

The current account improved in 2013 to $57.4 billion, or 11.7% of nominal GDP, as the increase in both the trade surplus and net service receipts more than compensated for a narrower income account surplus. The balance of trade recorded a surplus of $37.0 billion, up 17.1% from $31.6 billion a year earlier. The services surplus widened to $9.3 billion (equal to 1.9% of GDP) from $6.3 billion in 2012 (1.3%), buoyed by higher travel receipts and lower royalty and license fee payments.

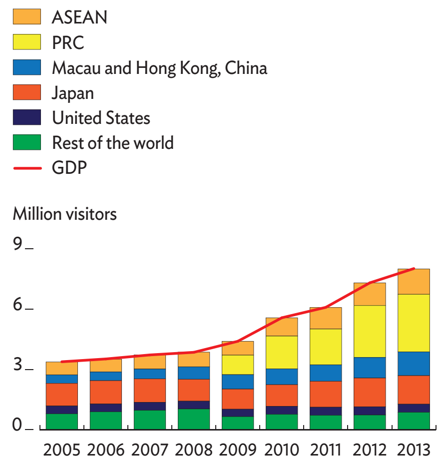
The improved trade balance reflected a 1.4% rebound in exports, which reversed a 2.3% slump in 2012, as well as a decline in imports. Exports to all destinations improved, especially to the US and Japan, two of the economy's biggest markets. Exports to the PRC and to Hong Kong, China also remained high, but their combined share of the export total slipped to 39.7% from 41.1% in 2009 as a growing share of exports went to the five largest economies in the Association of Southeast Asian Nations: Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam.

Reflecting these developments, the overall balance of payments recorded a surplus of 2.3% of GDP, despite net capital outflows of $41.2 billion (Figure 3.13.6). Foreign exchange reserves increased by 3.4% and amounted to $416.81 billion at the end of December 2013. The NT dollar depreciated against the US dollar by 0.5% in nominal terms in 2013 but appreciated by 1.4% in real effective terms.

Economic prospects

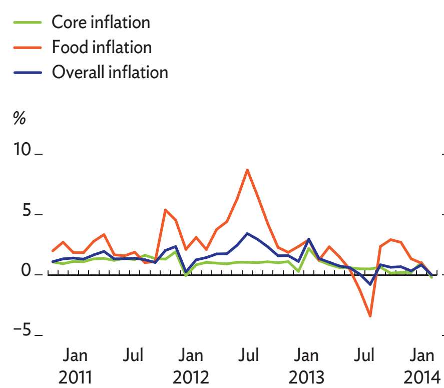
Economic prospects for the next 2 years are positive, with GDP growth accelerating to 2.7% in 2014 and 3.2% in 2015, inflation accelerating slightly but remaining low, and the current account balance improving. Domestic demand will likely grow as consumer confidence is trending up,

3.13.3 Tourist arrivals by country or region



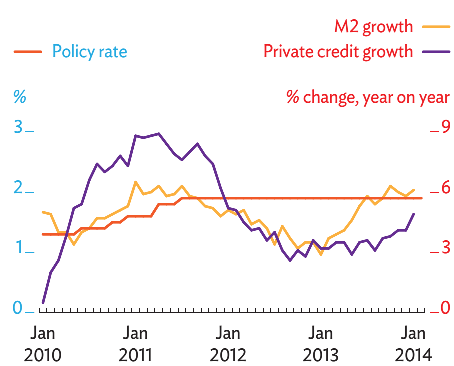
ASEAN = Association of Southeast Asian Nations, PRC = People's Republic of China.
Source: Haver Analytics (accessed 11 March 2014).

3.13.4 Inflation



Sources: Directorate-General of Budget, Accounting and Statistics (DGBAS). http://eng.stat.gov.tw; Haver Analytics (both accessed 11 March 2014).

3.13.5 Credit indicators



Source: CEIC Data Company (accessed 12 March 2014).

supported by government efforts to boost the service sector and the continued rise in tourist arrivals from the PRC. Investment is expected to rise in line with the improving outlook for exports. The economy should also benefit from free economic pilot zones and new infrastructure for tourism including hotels.

As global economic recovery gains momentum in 2014, external demand is expected firm. Exports are expected to be the key driver of economic growth in the next 2 years. Recent data on export orders show an increase of 5.7% year on year in February 2014 (Figure 3.13.7), suggesting a likely pickup in exports, especially for electronics. Imports are also expected to climb during the forecast period in line with the expected rise in private consumption and strengthening trade ties with the PRC. The trends in external trade and services, together with a large surplus in the income account as earnings from overseas investments are repatriated, will likely lift the current account balance to 12.3% of GDP in 2014 and 12.5% in 2015. The balance of payments surplus is expected to increase to around 3% as capital inflows expand.

Inflation is expected to remain low but trend marginally higher to 1.1%–1.3% in 2014–2015 as production costs rise with higher wages and stronger demand for inputs, and as electricity rates and transportation fares increase. The likely rises in global commodity prices are expected to be too modest to significantly affect domestic prices.

Monetary policy is expected to remain accommodating in 2014, but perhaps less so in 2015. The central bank is likely to keep the policy rate unchanged, given expectations for low inflation. Fiscal policy is expected to remain prudent, but a slightly bigger fiscal deficit is expected for 2014 as budgetary revenue is forecast to be lower than in 2013, when a one-time issuance of wireless communications licenses boosted nontax receipts.

The economic outlook for Taipei,China depends largely on developments in its major trading partners. A highly open economy, it is vulnerable to fluctuations in external demand because of its heavy reliance on electronics exports. While the major industrialized economies have shown signs of improvement, the slowdown in the PRC would have significant downside risks for the economy. The likely appreciation of the NT dollar could also tamp down export growth (Figure 3.13.8), while delays in establishing the free economic zones could curb business expansion.

Policy challenge—boosting investments and exports

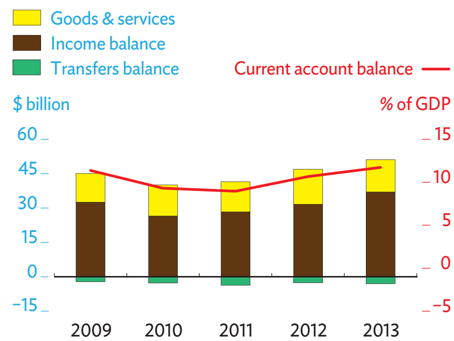
The growing localization of productive capacity in the PRC, under which local manufacturers move to produce or source some inputs domestically, is putting pressure on the Taipei,China economic model. For the past 3 decades, Taipei,China has occupied a central position in Asian supply chains, manufacturing semiconductors and other electronic parts and components to be incorporated into products that are assembled in the PRC for export to the major industrialized economies. Taipei,China has invested heavily in the PRC for this

3.13.1 Selected economic indicators (%)

	2014	2015
GDP growth	2.7	3.2
Inflation	1.1	1.3
Current account balance (share of GDP)	12.3	12.5

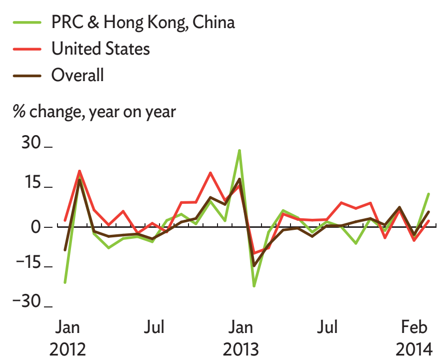
Source: ADB estimates.

3.13.6 Current account components



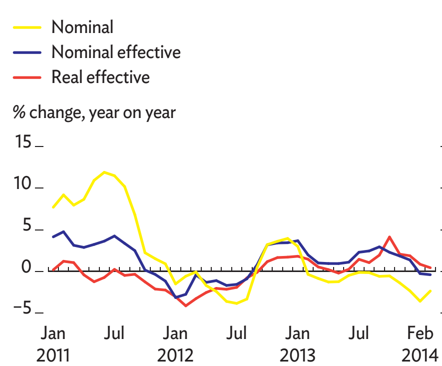
Sources: http://www.cbc.gov.tw; Haver Analytics (both accessed 11 March 2014).

3.13.7 Export orders



PRC = People's Republic of China.
Sources: http://www.cbc.gov.tw; Haver Analytics (both accessed 11 March 2014).

3.13.8 Exchange rate movements



Sources: http://www.cbc.gov.tw; Haver Analytics (both accessed 11 March 2014).

purpose and transferred some of its manufacturing plants there. This economic model is now strained by growing localization and from rising PRC production costs, especially for wages and property.

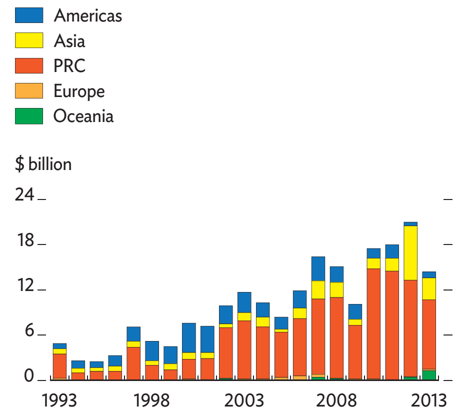
These factors helped depress Taipei,China's investments in the PRC since 2010 (Figure 3.13.9). Although these investments remain large, their downward trend indicates eroding profit margins and stiffening competition from domestic PRC production facilities, which have gradually shifted parts orders away from Taipei,China suppliers (Figure 3.13.10). Recent data confirm this trend. Some leading technology companies, particularly those involved in manufacturing notebook computers (in which Taipei,China is a leader), report shrinking profit margins and market shares in 2013. PRC imports of intermediate goods from Taipei,China have steadily declined, though the decline can be attributed to competition from the US, the Republic of Korea, and other Asian countries as well as to production localization in the PRC. Recent data indicate that Taipei,China's production base for tech products has started to shift to other countries such as Viet Nam, reflecting both PRC localization and manufacturers' search for cheaper production venues.

These trends indicate that Taipei,China may not be able to benefit to the same extent as before from investing in and exporting to the PRC. However, as the PRC grows, the scale effect easily compensates for the declining share of the PRC import market occupied by Taipei,China. Meanwhile, an analysis of spillover effects shows that, taking into account income elasticity and scale effects, changes in PRC economic activity have the largest impact on Taipei,China exports and GDP growth. Changes in other neighboring Asian economies have somewhat less effect, and changes in the major industrialized economies have much less effect (Figure 3.13.11). Moreover, the analysis indicates that the spillover effect from the PRC relative to that of other trade partners of Taipei,China has been on a rising trend, with a pronounced increase in 2012.

Against this background, the strategies by which Taipei,China can minimize its vulnerability to developments in the PRC are twofold. It can diversify its industrial base, and it can continue its efforts to tap neighboring markets for more export and investment opportunities. To improve competitiveness, the government has established free economic pilot zones where customs, investment regulations, and tax incentives are more competitive. It has signed two free-trade agreements, with New Zealand and Singapore. It aims to expand the service sector with a focus on tourism, medical services, and cultural and creative industries by further easing restrictions on tourists from the PRC, upgrading tourism infrastructure, opening new service-oriented manufacturing industries, and bolstering research and development investments and innovations.

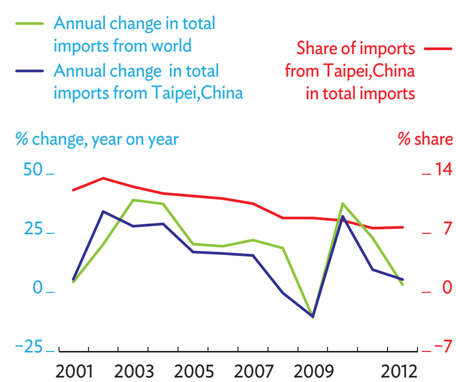
While these initiatives are expected to boost competitiveness, other factors such as widespread restrictions on foreign direct investment and excessive regulation should also be addressed. Success depends on when and how quickly the much-needed reforms are implemented, and on reform overcoming such obstacles as the medium-term priority on fiscal consolidation and domestic lobbies for protectionism. Spillover effects mean economic conditions in major trading partners and developments in the PRC will also play major roles.

3.13.9 Approved outward investments by region



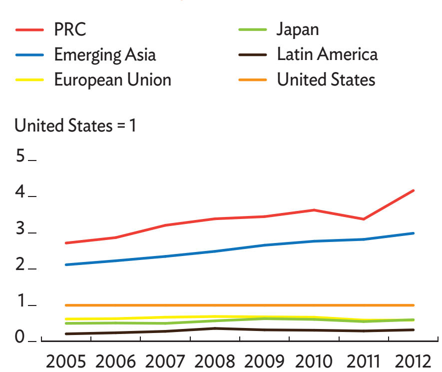
PRC = People's Republic of China.
Source: CEIC Data Company (accessed 12 March 2014).

3.13.10 PRC's imports of intermediate goods from Taipei,China



Source: Staff calculations using data from United Nations Commodity Trade Statistics database. http://comtrade.un.org/db/default.aspx (accessed 25 February 2014).

3.13.11 Relative spillover effects



PRC = People's Republic of China.
Source: ADB estimates using GPM7, following Carabenciov et al. (2011) and Koopman et al. (2007).

SOUTH ASIA

Afghanistan

Bangladesh

Bhutan

India

Maldives

Nepal

Pakistan

Sri Lanka

Afghanistan

Growth decelerated to 3.3% following stellar agriculture and growth performances in 2012. Afghan forces have assumed responsibility for security, and the withdrawal of international troops will be complete by the end of 2014. The decision on retaining a small number of international troops, largely for mentoring and logistical support, has been delayed until after the April presidential election. The outlook is for modest growth until uncertainties are resolved.

Economic performance

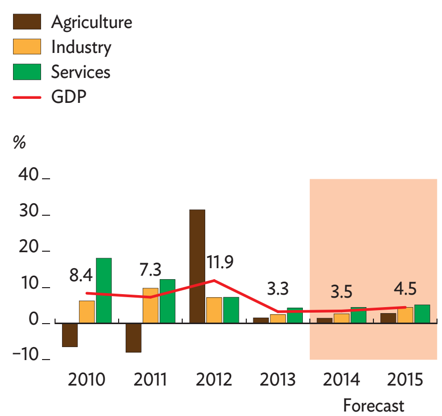
Evolving political and security uncertainties substantially affected nonagricultural economic activity in 2013. Growth in GDP excluding opium production is estimated to have declined to 3.3% in 2013, consistent with ADO 2013 projections, and was much lower than the 11.9% gain in 2012 (Figure 3.14.1). The weaker performance reflects slow expansions in agriculture, industry and services on the supply side, and in private consumption and investment on the demand side.

On the supply side, agriculture production was slightly higher than the record output achieved in 2012, as the country enjoyed favorable weather for another excellent harvest. However, because 31.5% growth in 2012 established a high base, agriculture growth recorded in 2013 was only 1.6%. The retrenchment in spending by international security forces, the winding down of a large number of projects funded and implemented by development partners, and Afghans' heightened caution greatly curtailed activity in industry and services. Growth in industry decelerated to 2.5% from 7.2% in 2012, while that in services slipped to 4.3% from 7.3%.

On the demand side, private consumption continued to drive growth but at a slower pace, reflecting increased domestic savings but also the impact of slowing growth in incomes reflecting the drawdown of military and civilian personnel and declining aid since 2010. The deadlock over signing the Bilateral Security Agreement, which is necessary to retain a small number of international troops in Afghanistan for training and logistical support, added to uncertainties created by the exit of international forces by the end of 2014 and the prospect of further reductions in assistance. With consumer and investor confidence down, private investment is estimated to have dropped to 3.6% of GDP in 2013 from 4.9% in 2012.

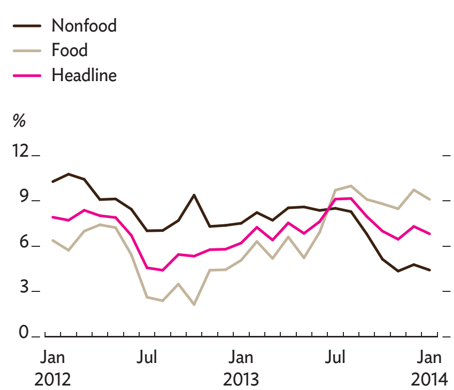
Headline inflation accelerated to 7.3% in the year to December 2013 from 5.8% a year earlier, mainly because of food price hikes (Figure 3.14.2). Food inflation reached 9.7% in December on account of sharp rises in the prices of vegetables, fresh fruit, and dried nuts.

3.14.1 GDP growth



Note: Years are fiscal years, ending on 21 December of the same calendar year.
Sources: Ministry of Finance; ADB estimates

3.14.2 Inflation



Sources: Central Statistical Office; ADB estimates.

This chapter was written by Rehman Gul of the Afghanistan Resident Mission, Asian Development Bank, Kabul.

Nonfood inflation notably slowed to 4.8% in December from 7.4% in December 2012, reflecting a sharp drop in prices for real estate and rental houses and in restaurant and hotel services as demand softened from foreigners and Afghans alike. Inflation averaged 7.4% in 2013.

The budget came under enormous pressure in 2013 as revenues fell short of their targets and public expenditures rose, especially those related to security and the election. Customs revenues notably disappointed because of the economic slowdown and the weak administration of customs and tax collections. The government managed to collect AF109.0 billion ($2.0 billion) toward its AF114.0 billion ($2.1 billion) target. This deepened the shortfall in domestic financing of the recurrent budget to a deficit of 7.7% of GDP from 6.8% in 2012 (Figure 3.14.3). In 2013, international development partners financed 60% of the national budget, 45% of recurrent expenditure, and 77% of the development budget. Including support from development partners, the budget surplus increased to 2.1% of GDP, from 1.1% in 2012.

Monetary policy aims for price stability and was relatively tight in 2013. Broad money (M2) growth edged up to 9.3% from 8.9% in 2012. However, it remained well below the 20%–30% rate of expansion in the fast-growth era before 2012. The slow growth in money supply since 2012 is attributed to significantly slowing demand for local currency in anticipation of the transition, as dollarization further increased. The value of the afghani has trended downward since 2011, and the currency depreciated by 9.1% against the dollar in 2013 to AF57.2 (Figure 3.14.4). The nascent financial sector has yet to shake negative spillover from the Kabul Bank crisis in 2010, and subsequent growth in banks' net credit to the private sector has been slight.

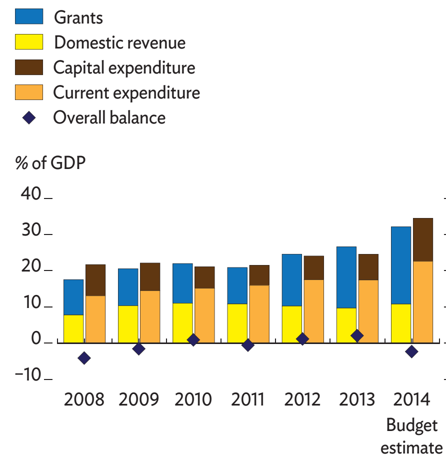
The current account deficit excluding grants narrowed slightly to 41.6% of GDP in 2013 from 41.9% a year earlier (Figure 3.14.5). Import growth slowed in 2013, and deficits in the income and services accounts increased modestly. The current account surplus including grants declined to 2.5% of GDP from 3.9% in FY2012 on lower net foreign earnings.

Economic prospects

GDP is forecast to grow by 3.5% in 2014. This assumes subsiding political and security uncertainties, a smooth transfer of power to a new government following broadly accepted presidential and provincial council elections on 5 April 2014, and a signed Bilateral Security Agreement. Growth in agriculture is expected to be modest because current production is close to capacity. Expansion in industry and services should edge higher in the second half of the year as the policy direction of the new government becomes apparent and public confidence strengthens.

For 2015, GDP growth is estimated to accelerate to 4.5%, driven by higher consumer spending, private investment, and trend performance in agriculture. This post-transition outlook for growth rests on stable political and security conditions and high investor and consumer confidence.

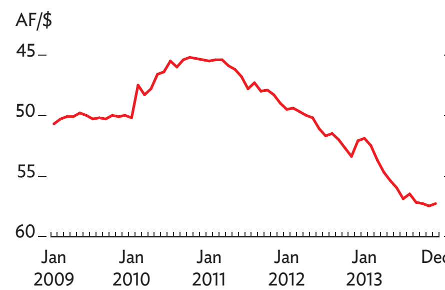
3.14.3 Fiscal indicators



Note: Years are fiscal years, ending on 21 December of the same calendar year.

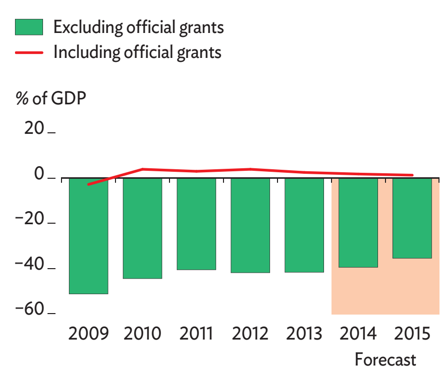
Sources: World Bank. *Afghanistan Economic Update*; International Monetary Fund. *County Report* No. 12/245; ADB estimates.

3.14.4 Nominal exchange rate



Source: Da Afghanistan Bank (Central Bank of Afghanistan). http://www.centralbank.gov.af/ (accessed 14 March 2014).

3.14.5 Current account balance



Note: Years are fiscal years, ending on 21 December of the same calendar year.

Sources: World Bank. 2011. *Afghanistan Economic Update*. October; International Monetary Fund. 2011. *Country Report* No. 11/330. November; ADB estimates.

A large 27.6% increase in national budget spending is planned for 2014, mostly for security—the item that will consume 65% of budgeted recurrent expenditures and 44% of the total budget. Rising security expenditure will create huge pressure to find new funding resources in 2014 and 2015. The new government will need to boost domestic revenues credibly to ensure strong support from development partners.

Inflation is projected at 7.0%, assuming good harvests, stable international commodity prices, and the pursuance of tight monetary policy. The government will keep the existing managed float regime for the exchange rate.

Including grants, the current account balance is forecast to ease to 1.7% of GDP in 2014 and 1.2% in 2015 as foreign aid inflows diminish. Excluding grants, the current account deficit is expected to narrow to 35.5% of GDP in 2015, reflecting reduced expenditures owing to the departure of international security forces in 2014.

3.14.1 Selected economic indicators (%)

	2014	2015
GDP growth	3.5	4.5
Inflation	6.8	7.1
Current account balance (share of GDP)	1.7	1.2

Source: ADB estimates.

Policy challenge—domestic revenue mobilization

A major policy challenge for the government is to improve its domestic revenue performance. Domestic revenue as a share of GDP is lower in Afghanistan that almost anywhere else in the world. Moreover, it dropped to 9.6% of GDP in 2013 from 11.0% in 2010, falling short of an important reform benchmark in the current International Monetary Fund (IMF) economic program. The government has been struggling to improve revenue performance for the past 2 years. The revenue shortfalls partly reflect the slowdown in economic activity, in particular the shortfall in foreign trade that weakened customs revenues. However, the bulk of revenue is lost to leakage under weak tax administration that allows corruption. The gap between domestic revenues and the government's recurrent expenditures has consequently widened, with revenue coverage down to 55.0% in 2013 from 72.8% in 2010.

In the forecast period, fiscal policy will be under huge pressure from rising security expenditures, the cost of operating and maintaining assets built by development partners, and the expense of expanding civil service reform, including reform to pensions. As a result, public expenditures will reach 34.5% of GDP in 2014 as domestic revenues are estimated to languish at 10.8%, leaving a financing gap of 23.7% that will need to be filled by development partners.

The weak revenue outlook necessitates concerted efforts on the part of government to improve revenue collection through reform to tax policy, tax administration, and governance, as well as through other structural reforms in customs taxation under the program. The bills on tax administration and value-added tax pending in the parliament must be approved quickly to ensure that the value-added tax is implemented toward the end of 2014. Governance has to be strengthened and leakage significantly reduced through policy and structural reform to the revenue and customs departments. The approval of the mining bill now before the parliament has to be expedited to secure in the medium term new contributions to revenue from the development of mineral resources.

Bangladesh

Growth moderated last year, inflation declined, and the current account returned a larger surplus. This year, growth will slip again, reflecting slower expansion in exports, falling worker remittances, and political unrest before parliamentary elections. Higher inflation and a modest current account deficit are expected. The garment industry faces challenges in adopting tough compliance and safety standards. Growth should improve in the following year, but a major boost will come only with ramped up investment in infrastructure.

Economic performance

As officially estimated, GDP in FY2013 (ended 30 June 2013) grew by 6.0%, less than the 6.2% recorded in FY2012 (Figure 3.15.1). Agriculture growth slipped to 2.2% from 3.1% in FY2012 as crop output was held down by higher input costs, lower output prices, and unfavorable weather. Services growth slowed to 5.7% from the previous year's 6.0% owing to stagnant imports and frequent *hartals* (political demonstrations) that disrupted supply chains and affected retail and wholesale trade. Industry growth rose slightly to 9.0% from 8.9% in FY2012, with contributions from construction and small-scale manufacturing.

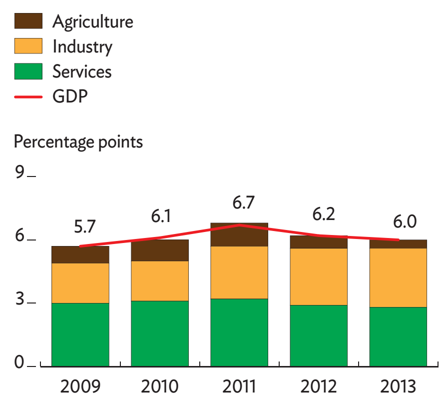
On the demand side, net foreign trade and services added to growth as garment sales grew briskly. Growth in private consumption accelerated, fueled by healthy remittance inflows, though expansion in private credit slowed. Investment rose only slightly to 26.8% of GDP from the previous year's 26.5%. Private investment declined to 19.0% of GDP from 20.0% in FY2012, while public investment rose to 7.9% of GDP from 6.5% in FY2012. Private investment was constrained by electricity and gas shortages and a weaker investment climate. Foreign direct investment inflows rose only slightly.

Year-on-year inflation rose to 8.1% in June 2013, reflecting escalating food prices as the demonstrations disrupted supplies. The rise in government-administered power and fuel prices also contributed (Figure 3.15.2). Nonfood prices fell, responding to slower credit growth and the appreciation of the Bangladesh taka. Average inflation slowed to 6.8% from 8.7% in FY2012.

In September 2012 the government raised power tariffs for bulk consumers by 17.0% and for retail consumers by 8.0%. It also raised diesel, kerosene, and gasoline prices by 5.3%–11.5% in January 2013, but the price of furnace oil, used mostly to generate electricity, was not increased.

Although the central bank's monetary policy was accommodative, money and credit growth slowed in FY2013. Broad money growth eased to 16.7% in June 2013 from 17.4% a year earlier (Figure 3.15.3).

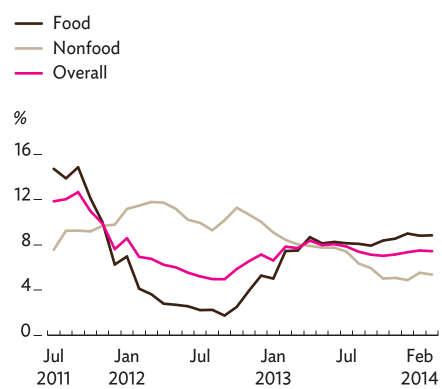
3.15.1 Supply-side contributions to growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Bangladesh Bureau of Statistics. 2013. *National Accounts Statistics.* June.

3.15.2 Monthly inflation



Sources: Bangladesh Bank. 2014. *Monthly Economic Trends.* February. http://www.bangladesh-bank.org; Bangladesh Bureau of Statistics. http://www.bbs.gov.bd/

This chapter was written by Mohammad Zahid Hossain, Shamsur Rahman, Md. Golam Mortaza, and Barun K. Dey of the Bangladesh Resident Mission, Asian Development Bank, Dhaka.

Private credit growth slowed markedly to 10.9% from 19.7% in June 2012, as net credit to the government grew by 20.1% in June 2013, down from 24.9% a year earlier and well below its peak expansion in the middle of FY2012. As imports remained unchanged, net foreign assets shot up, accounting for nearly half of monetary expansion.

In easing monetary policy, the central bank in March 2013, cut repo and reverse repo rates by 50 basis points. The weighted average yield on the 91-day Treasury bill fell to 8.3% by June 2013 from 11.4% a year earlier. Banks' weighted average lending rate, however, declined only marginally to 13.7% from 13.9% in June 2012, but the weighted average deposit rate rose to 8.5% from 8.1%, narrowing banks' interest rate spread by 0.6 percentage points to 5.2%.

Revenue growth was less than the FY2013 budget target of 21.6% as import-based taxes yielded less than expected. Growth in domestic indirect taxes also slowed, although income taxes were buoyant. At 12.4% of GDP, revenue collection in FY2013 remained essentially at the previous year's level, but public spending rose to 16.9% from 16.6% in FY2012 (Figure 3.15.4). The fiscal deficit widened to 4.5% of GDP from 4.1% in FY2012 but remained within the budgeted 5.0% of GDP. Domestic sources financed about two-thirds of the deficit.

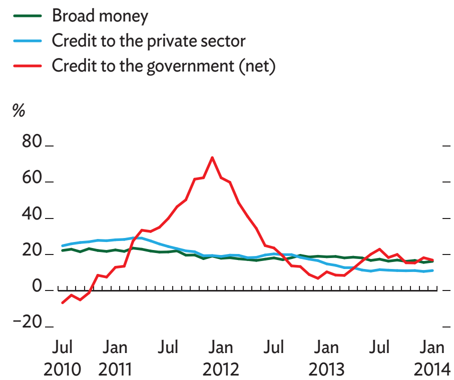
Exports expanded by 10.7% in FY2013, up from the previous year's 6.2%, with higher demand from both traditional and newly developed markets for the country's low-end garments. Earnings from readymade garments rose by 12.7%, doubling the figure a year earlier. Growth in import payments fell to 0.8% from 2.4% in FY2012, as imports of rice, sugar, edible oil, fertilizer, petroleum products, and capital goods declined. Remittance inflows rose to 12.6%, up from 10.2% in FY2012 because of improved banking services and the lagged impact of large placements of Bangladeshi workers a year earlier.

With higher remittances and a narrower trade deficit, the current account sharply improved to a surplus of $2.5 billion (1.9% of GDP) in FY2013 from a deficit of $447.0 million in FY2012 (Figure 3.15.5). The combined capital and financial accounts showed a surplus of $3.4 billion, strengthening from $1.9 billion in FY2012, as net disbursements of medium- and long-term loans were higher, as were net inflows on account of trade credit. The overall balance grew tenfold to a surplus of $5.1 billion in FY2013 from $494.0 million in FY2012. Gross foreign exchange reserves, adjusted for valuation changes, rose sharply to $15.3 billion at the end of June 2013 from $10.4 billion a year earlier, providing cover for 4.6 months of imports.

The taka appreciated by 5.2% against the dollar in FY2013, reflecting weak import demand and strong growth in both exports and remittances (Figure 3.15.6). The taka had appreciated in real effective terms by 11.1% year on year by the end of June 2013 because of its nominal appreciation and higher domestic inflation relative to trading partners, indicating some loss of export competitiveness.

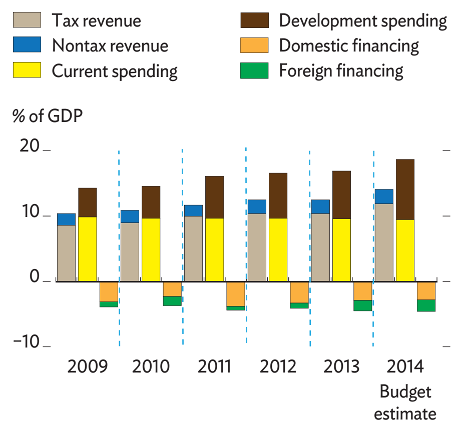
The stock market continued to be volatile in FY2013, with abrupt price movements. The Dhaka Stock Exchange general index fell by 4.1%, though market capitalization grew marginally by 1.6% (Figure 3.15.7). The price–earnings ratio rose from 12.5 in June 2012 to 14.6 in June 2013. Net foreign portfolio investment in FY2013 rose

3.15.3 Growth of monetary indicators



Source: Bangladesh Bank. 2014. *Monthly Economic Trends.* February. http://www.bangladesh-bank.org

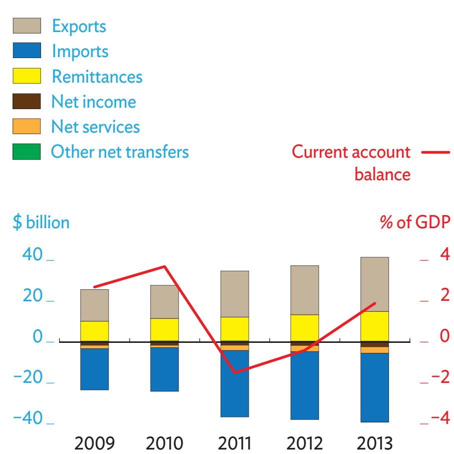
3.15.4 Fiscal indicators



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Asian Development Outlook database.

3.15.5 Current account components



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Bangladesh Bank. *Annual Report 2012–2013.* http://www.bangladesh-bank.org to $287 million from $240 million in FY2012. Parliament passed the Demutualization Act in April 2013 with a view to separating ownership from management and converting both of the country's stock exchanges into shareholder-owned corporate entities, as the authorities sought to boost investor confidence in stock dealing and to stabilize the market.

Economic prospects

The forecasts for FY2014 and FY2015 rest on several assumptions: Political stability will be restored following the January 2014 national elections, improving consumer and investor confidence. The central bank will be watchful, in line with the January 2014 monetary policy statement, to keep inflation in check while helping direct steady credit flows to the private sector. Electricity and fuel prices will be raised to lower subsidy costs. It will be possible to mobilize more foreign financing, thus limiting government bank borrowing. Food grain and oil prices will remain stable on the international market. And the weather is normal.

GDP growth is expected to slow to 5.6% in FY2014, owing to a decline in remittances (which have been equivalent to about 15% of private consumption spending) and as export growth tapers off in the coming months (Figure 3.15.8). Domestic demand was depressed in the first half of the year because the prolonged political unrest ahead of parliamentary elections in January 2014 dented consumer and investor confidence. This is reflected in lower private credit growth, a decline in imports of consumer goods and capital machinery, and modest growth in imports of raw materials. Growth is expected to rebound to 6.2% in FY2015, aided by higher remittance and export growth, as well as by prospects for continued economic recovery in the US and the euro area. A likely rise in consumer and investor confidence as the political situation stabilizes is also expected to stimulate demand and strengthen growth momentum.

Industry growth is expected to slow to 8.0% in FY2014 because of the output lost to political unrest in the first half of the year, and as weaker domestic demand depresses production. Production by the readymade garment industry may also be affected if foreign buyers postpone orders in response to delays in implementing agreed fire and building safety standards to prevent further industrial accidents. Industry growth is expected to increase to 9.0% in FY2015 with a pickup in domestic and external demand, better safety standards and compliance in garment factories, and gains in power generation.

Agriculture growth is projected to rebound to 3.0% in FY2014, aided by favorable weather conditions in the early months of the year and reflecting the previous year's low base. Growth in FY2015 is expected to strengthen to 3.5%, about on trend.

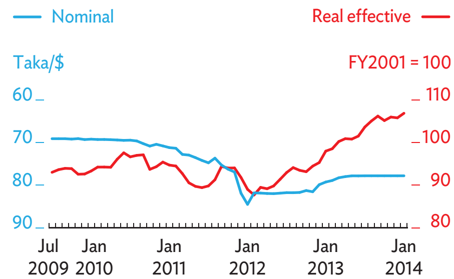
Services growth in FY2014 is projected to slip to 5.4% due to lost sales during the pre-election unrest and slower industry activity. Sluggish demand in retail and wholesale trade, hotels and restaurants, transport, and tourism—and the fall in commercial banks' operating profits on weak credit flows—evidence a slow expansion. With the expected rebound in industry and agriculture, services growth is expected to recover to 5.7% in FY2015.

3.15.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.6	6.2
Inflation	7.5	6.5
Current account balance (share of GDP)	–0.5	–1.5

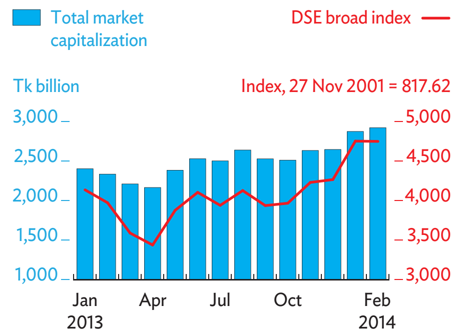
Source: ADB estimates.

3.15.6 Exchange rates



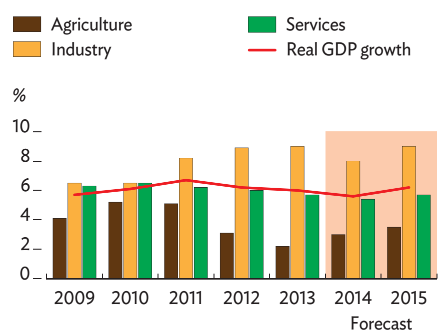
Source: Bangladesh Bank. 2014. *Monthly Economic Trends.* February. http://www.bangladesh-bank.org

3.15.7 Dhaka stock exchange indicators



Sources: Bangladesh Bank. 2014. *Major Economic Indicators: Monthly Update.* February. http://www.bangladesh-bank.org; Dhaka Stock Exchange. http//:www.dsebd.org

3.15.8 GDP growth by sector



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Sources: Bangladesh Bureau of Statistics. 2013. *National Accounts Statistics.* June; ADB estimates.

Inflation is expected to rise to average 7.5% in FY2014 because of the effects of supply disruptions, rising wages in both the public and the private sector, and expected increases in electricity and fuel prices. With the easing of supply constraints, continued prudent monetary policy, and better crop outlook, inflation is expected to moderate to 6.5% in FY2015.

Exports grew by 21.2% in the first quarter of FY2014 and then slowed to 14.0% in the first 8 months of the year (Figure 3.15.9). Garment exports grew by 16.7%. Other exports (about 20% of total) were up by only 3.4%, with performance little improved from a year earlier. Earnings from frozen food and leather rose strongly, but exports of jute goods, petroleum products, raw jute, and engineering products declined. In the first 7 months, earnings on exports to the European Union grew by 19.6%, to the US by 9.1%, and to newly developed markets by 14.2%. With momentum declining during the middle months, growth in exports is expected to moderate to 9.0% in FY2014. Then, with stronger external demand in FY2015, export growth is projected to recover to 12.0%.

Import payments grew by 13.9% in the first half of FY2014, mainly to pay for higher imports of rice and wheat, while imports of sugar, edible oil, machinery, fertilizer, and petroleum products declined. With moderation in the second half, imports are expected to increase by 10.0% in FY2014 and pickup to 14.0% in FY2015 on projected higher demand.

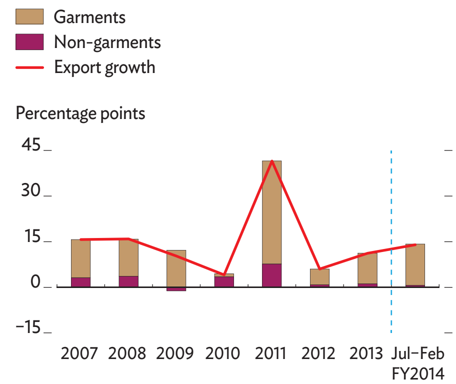
Worker remittance inflows declined by 6.9% in the first 8 months of FY2014, reflecting reduced employment overseas, especially in the Middle East. Action against illegal workers in Saudi Arabia and taka appreciation contributed to the lower remittance inflows. Overseas jobs for Bangladeshi workers fell by 13.1% in the first 8 months of FY2014 (Figure 3.15.10). Remittances are expected to decline by 3.0% for all of FY2014 but then grow by 7.0% in FY2015, as more jobs are created by the government's efforts to engage with recruiting countries.

With a somewhat larger trade deficit and falling remittances, the current account is expected to reverse to a small deficit of 0.5% of GDP in FY2014. The current account is projected to slide further to a deficit of 1.5% of GDP in FY2015, as remittance growth is inadequate to offset the projected wider trade gap.

Growth in revenue collection slowed to 10.0% during the first 7 months of FY2014, underperforming the 19.9% budget target because economic activity was disrupted and growth in dutiable imports was low. Income tax collection, boosted by automation in tax administration, grew strongly by 18.2%, but the gains were offset by lower growth in import duties, and value-added tax at both the import and the domestic production stage. The ratio of revenue to GDP is expected to rise slightly to 12.6% in FY2014.

Budget spending is expected to remain unchanged at 16.9% of GDP. Current spending will be contained by cuts to low-priority items and expected adjustments to electricity and fuel prices to lower subsidy costs to 2.2% of GDP from 3.1% in FY2013. Annual development program spending will increase as the government steps up project implementation to fulfill election pledges. The expected fiscal deficit of 4.3% of GDP in FY2014 will be within the budget target. Domestic sources, mostly banks, are expected to cover two-thirds of financing.

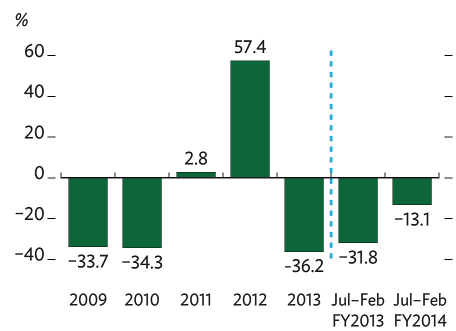
3.15.9 Contributions to export growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Sources: Export Promotion Bureau; ADB estimates.

3.15.10 Overseas employment growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Bangladesh Bank. 2014. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org

Policy challenge—reviving and upgrading economic growth

Bangladesh needs to boost investment in infrastructure and skills development to raise the economy's productive capacity if it hopes to upgrade economic growth to a 7%–8% trajectory. Investment has remained virtually stagnant at around 25%–26% of GDP over the past several years and needs to be raised to the 32%–33% range, as envisaged in the Sixth Five-Year Plan, FY2011–FY2015 (Figure 3.15.11). Actual output closely follows the track of potential output (Figure 3.15.12). This suggests that little scope exists for raising GDP growth without stoking inflation, unless potential GDP is bolstered through higher investment.

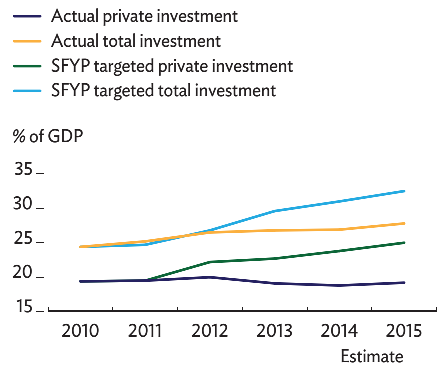
Clearly, more public resources should be mobilized to finance large infrastructure investment requirements in electric power, gas, ports, railways, roads, and urban services, and to enhance the skills base to strengthen the garment industry (Box 3.15.1), help diversify the economy and raise global competitiveness and growth. Bangladesh's tax effort is, at 10.4% of GDP in FY2013, low compared with other South Asian countries. It needs to be raised through tax measures that include axing exemptions and exclusions, and through improved tax administration achieved by simplifying laws and procedures, improving logistics and automation, and reducing scope for evasion with the introduction of advanced auditing and enforcement techniques. Moreover, fiscal space needs to be expanded by cutting subsidies, which requires raising electricity prices to reflect the cost of production vis-à-vis other options, and by aligning fuel prices with international oil prices. Gas prices need to be set keeping in view gas prices on the international market and the cost of alternative fuels. The resources freed up could be allocated for infrastructure and human resource development.

Public sector capacity for project design and administration, procurement, audit, and financial management must be enhanced to make project implementation more efficient. In addition, projects under public–private partnerships need to be advanced by developing the capacity in line agencies to design, bid, and award such contracts.

Banks are the main financing source for private investment. However, weak governance in state-owned commercial banks has undermined their strength and efficiency. In line with the latest memorandum of understanding between these banks and the central bank, performance is to be improved by adopting stronger risk management and controls, and by placing ceilings on credit growth for each bank based on its performance and financial soundness. Ongoing capital market reforms to enhance market stability and governance need to be deepened, including through the development of a liquid bond market, to expand sources for private sector financing.

To improve the business climate, the trade regime needs to be liberalized through tariff and nontariff reform. Import duties need to be cut, and the dispersion in rates and average level of protection lowered to boost competitiveness and reduce biases against exports. Trade infrastructure and logistics, including port services and automation, need to be improved to lower transaction costs and facilitate faster clearance of goods.

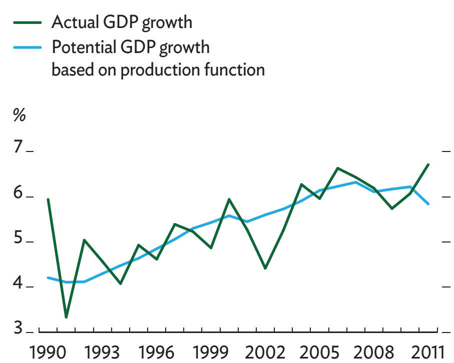
3.15.11 Actual vs. Sixth Five Year Plan (SFYP) targeted investment



Notes: Years are fiscal years, ending on 30 June of the same calendar year. Actual investments for FY2014 and FY2015 have been estimated.

Sources: Bangladesh Bureau of Statistics. *National Accounts Statistics*. June 2013; *Planning Commission. 6th Five Year Plan FY2011–FY2015;* ADB estimates.

3.15.12 Actual vs. potential GDP growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: ADB estimates.

3.15.1 Toward a better garment industry in Bangladesh

Bangladesh's garment industry is in transition. With 5,400 factories employing 4.0 million workers, mostly women, and with export earnings at $20 billion, or 16.6% of GDP in FY2013, the industry is the backbone of the economy and a major force for inclusive growth. However, it has a mixed safety history. Following major industrial accidents in 2012 and 2013, the industry in collaboration with the government, foreign buyers, and development partners have agreed to and is in the process of adopting internationally accepted safety and compliance standards. Success in this endeavor will be difficult, as it will require major changes and substantial financing. To comply with international standards, about half of the country's garment factories, mostly small and medium-sized ones that depend on subcontracting from large factories, will be hard pressed to adapt. Operating on small profit margins and lacking financial resources, many of these factories will likely need to close or be absorbed by larger companies.

An operating manual was developed with the assistance of the International Labour Organization (ILO) for assessing structural integrity and fire and electrical safety. Factory inspections have begun under the Accord on Fire and Building Safety in Bangladesh, the signatories of which are European buyers and trade unions, and the Alliance for Bangladesh Worker Safety, an initiative of US buyers. In March, the first batch of detailed inspection results under the accord was made public. The two groups have pledged to provide loans to qualifying companies for safety upgrades. In January 2014, the Rana Plaza Donors Trust Fund was established and began to receive contributions from buyers and private donors to assist victims of that 2013 building collapse and their families.

Under the National Action Plan, development partners—Canada, the European Union, Japan, the United Kingdom, and the US—have started providing funds as part of their long-term initiatives to ensure labor safety and factory standards while involving local and international nongovernment organizations and trade unions in their efforts. Low-cost loans are made available through support from the Japan International Cooperation Agency and the International Finance Corporation (IFC). In addition, the government has decided to cover 3 percentage points of commercial bank lending rates for export loans, to enable garment factories affected by political unrest to cut their losses.

The ILO and the IFC have announced, in partnership with the government, the Better Work Program as a component of the program Improving Working Conditions in the Ready-Made Garment Sector. In addition to providing financial support to the victims and their families, and to ensuring treatment for injured workers, the government took initiatives to reemploy affected workers and implement suggestions for ensuring workplace safety.

The minimum wage was raised to Tk5,300 per month from Tk3,000 in November 2013. Even with this increase, Bangladesh will continue to be the most wage-competitive of major garment producers in Asia, having maintained the least-cost pattern from 2001 to 2011, according to recent research (box figure 1). Moreover, estimates place Bangladesh labor productivity at 80% of that in the People's Republic of China (PRC). This suggests that unit labor costs are about half that of India and Cambodia, two main Asian competitors for production moving from the PRC to lower-cost venues.

The continued dynamism of Bangladesh's garment industry will depend on its ability to raise productivity, boost value addition, and move upmarket. Major challenges include upgrading safety standards to maintain strong buyer market access, improving inadequate electricity and transport-related infrastructure and logistics (box figure 2), and developing skilled candidates for middle and senior management needed both to improve labor relations and to raise production efficiency through better quality control, labeling, and shipment.

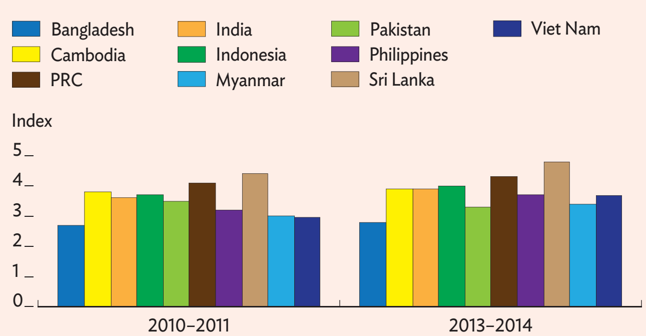
1 Comparison of labor productivity and unit labor costs

PRC = People's Republic of China.

Note: Data refer to calendar years.

Source: Staff estimates based on (i) McKinsey & Company's *'Bangladesh's ready-made garments landscape: The challenge of growth'*, November 2011; and (ii) wage data for 2011 published in *'Global Wage Trends for Apparel Workers, 2001–2011'*, Workers Rights Consortium, July 2013, Center for American Progress. http://www.americanprogress.org

2 Quality of overall infrastructure in selected Asian developing countries



PRC = People's Republic of China.

Note: Data refer to calendar years. Index scale varies from 0 to 7, the best.

Sources: World Economic Forum. *Global Competitiveness Report 2010–2011 and 2013–2014.*

Bhutan

Growth slowed for a second year as the authorities continued administrative measures to rein in consumption spending that was creating pressures on the balance of payments and Indian rupee reserves. These measures are giving way to adaption in fiscal and monetary mechanisms to strengthen demand management. Growth is expected to pick up on construction of a series of large hydropower projects that will substantially expand this mainstay industry and exports of power to India.

Economic performance

Economic growth continued to moderate from 6.5% to an estimated 5.2% in FY2013 (ended 30 June 2013), rates well below the average growth of 8.4% over the past decade (Figure 3.16.1). The slowdown largely reflects policy measures adopted in 2012 to alleviate growing shortages of Indian rupee reserves. The measures entailed credit and import restrictions, particularly in import-heavy activities such as construction and transport that required large rupee payments.

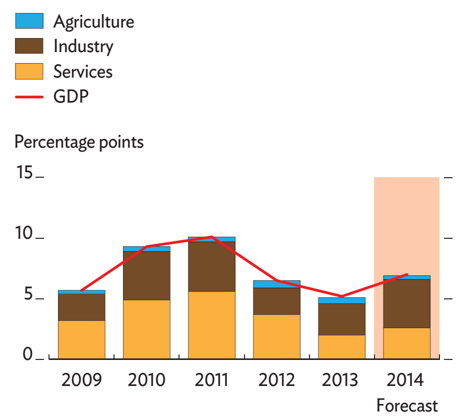
The brunt of the downdraft in FY2013 was felt in services. Expansion in transport and communications halved to 5.2% from 10.3%, while growth in retail trade, hotels and restaurants and other services moderated mainly owing to slower domestic spending, especially on vehicles. In addition, finance output fell as lending plummeted. Growth in industry provided a partial offset; the 6.4% expansion in manufacturing and 7.7% in construction remained relatively high, the latter related to hydropower projects rather than to house building.

Inflation decelerated to 5.5% in the fourth quarter of FY2013 from its peak at 13.6% a year earlier as food prices significantly eased (Figure 3.16.2). Local food prices had gone up in the last quarter of FY2012 as supplies tightened and demand rose for consumption goods not subject to the restrictions. Inflation after this slowed as the high base effect dissipated and inflation moderated in India, Bhutan's major trading partner that supplies over 90% of food imports. Since June 2013, inflation has rebounded, tracking currency depreciation and price developments in India. Over all of FY2013, inflation averaged 8.6%, down from 10.1% a year earlier.

Monetary tightening rolled out in March 2012 to fight the rupee liquidity shortage included credit constraints for various imported goods. As the measures took hold, growth in credit to the private sector plunged from high rates averaging about 35% over the past 5 years, to 6.8% in FY2013 (Figure 3.16.3). Credit for transport and construction was hardest hit. While growth in the broad money supply recovered to

This chapter was written by Sarah Carrington and Yoko Niimi of the South Asia Department, Asian Development Bank, Manila; and Elbe Aguba, consultant, South Asia Department, Asian Development Bank, Manila.

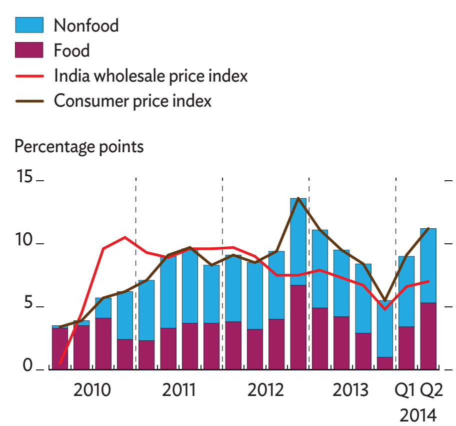
3.16.1 Supply-side contributions to growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: National Statistics Bureau. *National Accounts Statistics 2013.* http://www.nsb.gov.bt

3.16.2 Contributions to inflation



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: National Statistics Bureau. http://www.nsb.gov.bt

18.6%, the expansion reflected marked improvement in banking system net foreign assets as the balance of payments turned around.

Following on earlier measures to implement use of policy rates for more effective monetary management and a base-rate system for financial institutions to strengthen competition, the Royal Monetary Authority in 2013 reviewed in depth its reserve management operations and issued revised policy and operational guidelines.

On the fiscal front, the budget deficit narrowed to 0.9% of GDP in FY2013 from 1.1% the year earlier, and was below the target of 1.6% (Figure 3.16.4). Substantial grants alongside some increase in tax revenue largely funded spending and helped to rein in the deficit. Preliminary estimates indicate that total expenditure and net lending grew by 14.6%, slightly more quickly than in the previous year.

The trade balance improved as the country's large import bill fell by 6.5%, reflecting the administrative restrictions that curtailed imports of vehicles and construction materials. Hydropower exports continued to be a major source of earnings, accounting for nearly one-third of exports in FY2013, though earnings, which vary with river flow, slipped slightly. Accordingly, the trade deficit narrowed to an estimated $354 million, or 18% of GDP, even as the current account deficit widened from 21.3% to 23.6% of GDP on sharply lower current transfers and increased interest payments (Figure 3.16.5).

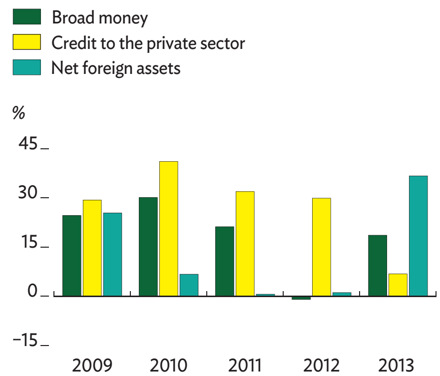
The deficit was funded by ample capital and financial flows, more than three-quarters of which were earmarked for hydropower construction. The overall balance of payments moved to a surplus of $167.9 million, or 8.7% of GDP, which marked a sharp turnaround from a deficit of 9.8% of GDP a year earlier. Reserves increased sharply to $916.9 million, equivalent to 12.6 months of imports (Figure 3.16.6). The $200 million purchase of Indian rupees in June 2013 substantially boosted rupee reserves to about 3 months of imports from India, which should provide a more comfortable cushion for managing cross-border payments.

Economic prospects

GDP growth is expected to rebound to 6.0% in FY2014 as hydropower construction projects under the Eleventh Five-Year Plan get underway and improving economic conditions in major tourist source countries boost tourism. Growth is forecast to strengthen further to 6.8% in FY2015 as hydropower construction expands and exports increase with the start of operations at the Dagachhu power plant. Notably, the sale of carbon credits is potential source revenue for the project, as it was approved under the United Nations Framework Convention on Climate Change.

Total budget spending is planned to moderate in FY2014 in line with the government's policy to rationalize expenditure, but the deficit is nevertheless expected to widen to 3.6% of GDP on lower projected grants. The reduction in spending reflects spending cuts on vehicle purchases, staff quarters construction, and other nonessential operating expenses, as part of austerity measures to address the rupee liquidity problem. Moreover, medium-term macro-fiscal projections envisage annual expenditure ceilings to maintain a sustainable fiscal path.

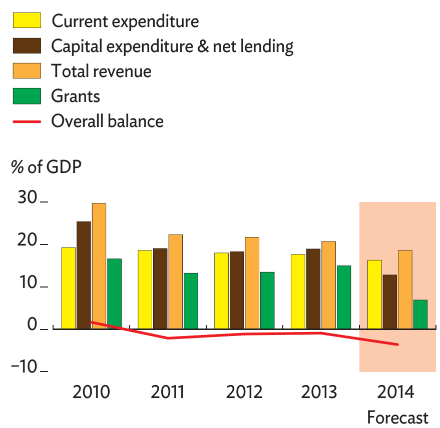
3.16.3 Monetary indicators growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Royal Monetary Authority of Bhutan. 2014. *Monthly Statistical Bulletin February 2014.* http://www.rma.org.bt

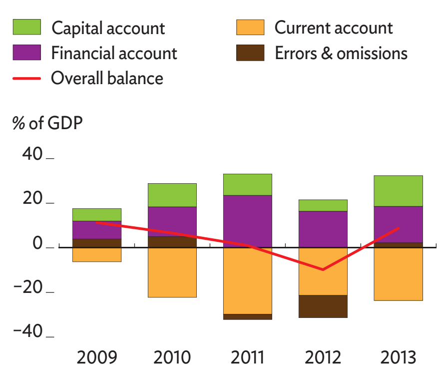
3.16.4 Fiscal indicators



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Royal Monetary Authority of Bhutan. 2013. *Annual Report FY2012/13.* http://www.rma.org.bt

3.16.5 Balance of payments



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Royal Monetary Authority of Bhutan. 2013. *Annual Report FY2012/13.* http://www.rma.org.bt

The current account deficit is projected to widen to 28.6% of GDP in FY2014, mainly owing to large imports for power projects, but to narrow again to 26.4% in FY2015 with the mobilization of more development grants.

Inflation is anticipated to rise to average 10.2% in FY2014 as the economy expands and currency depreciation keeps import prices high. Inflation will ease slightly in FY2015 as global price pressures subside and inflation moderates in India.

3.16.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.0	6.8
Inflation	10.2	8.5
Current account balance (share of GDP)	–28.6	–26.4

Source: ADB estimates.

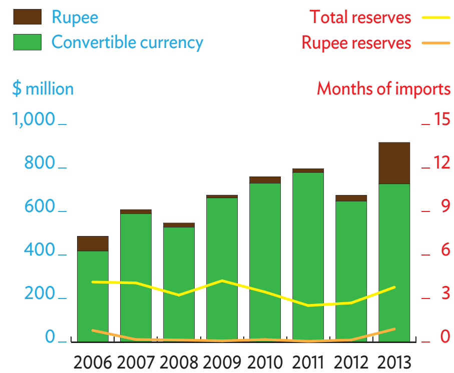
Policy challenge—credit availability for inclusive growth

Bhutan's economy has grown remarkably in recent years, with GDP tripling over the past decade mostly on the back of capital-intensive hydropower development, which has contributed 20.9% to GDP growth on average over the past 14 years. While government has harnessed hydropower proceeds to substantially raise the standard of living for many Bhutanese, economic expansion in other sectors has been limited. Productivity gains have been largely confined to industry, which has improved productivity by over threefold in the past 13 years but uses little labor. Productivity increases in the key employment generating sectors have, by contrast, been negligible. As 62% of the Bhutanese work in agriculture, mainly for subsistence, encouraging private-sector development to create more jobs outside of agriculture remains an important macroeconomic priority toward achieving self-sufficient and inclusive growth.

In terms of business development, the greatest constraint identified by small and medium-sized firms is their lack of access to finance, cited by over 30% of all firms (Figure 3.16.7). Accordingly, constraints on domestic credit to the private sector need to be addressed. While deficiency in domestic savings for investment restrains the overall availability of credit, the distribution of existing credit is hampered by risk-averse selection of clients in response to limited loan-recovery capacity, little variety in loan products, financial infrastructure shortfalls, and client dispersion across difficultly accessed rugged terrain. Further, external borrowing by the private sector remains severely restricted by law in terms of the borrower type as well as regarding the use of funds, effectively eliminating this as a source of funds for potential borrowers who face credit constraints in the domestic market.

Enhancing access to finance should thus be a pillar of government policy to foster private sector development, employment growth, and diversification. The stimulus package that the government will soon start to disburse aims to ease access to credit in priority development sectors such as cottage industries and the informal sector. It is an important measure to address issues of credit distribution. Further development of a credit information system and a better variety of financial products may also help bolster the provision of credit to entrepreneurs.

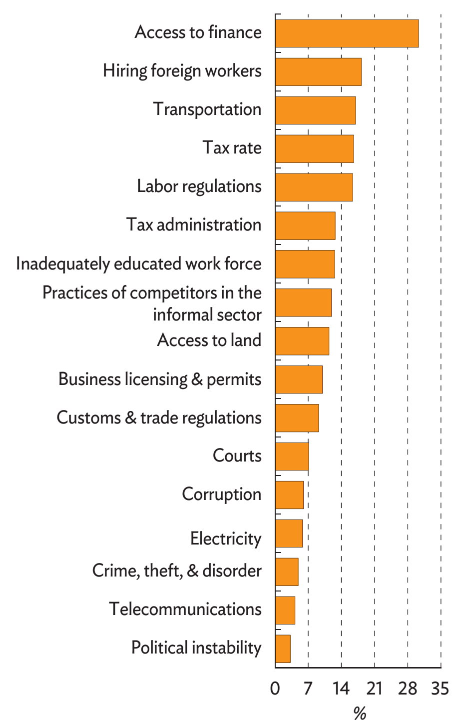
3.16.6 Gross international reserves



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Royal Monetary Authority of Bhutan. 2013. *Annual Report FY2012/13.* http://www.rma.org.bt

3.16.7 Constraints on doing business



Source: International Finance Corporation. 2009. Enterprise Survey. http://www.enterprisesurveys.org/

India

The economic slowdown bottomed out last year. A spell of global financial turbulence caused capital outflows and pressure on the exchange rate, but strong policy measures stabilized the currency, rebuilt reserves, and narrowed the excessive current account deficit. Weaknesses remain, however, and include persistent inflation, fiscal imbalances, bottlenecks to investment, and inefficiencies that require structural reforms. Without a systemic resolution to these, growth is forecast to pick up modestly.

Economic performance

The government's initial estimates peg GDP growth at 4.9% in FY2013 (ended 31 March 2014), slightly higher than the ADO Update 2013 forecast of 4.7%. The estimate could be a tad optimistic, as achieving it would require growth to be boosted to 5.5% in the fourth quarter of FY2013 (Figure 3.17.1). The marginal pickup in headline GDP growth masks underlying weakness in the economy as it was due to stronger agriculture. Excluding agriculture, GDP growth slipped from 5.0% in FY2012 to 4.9% in FY2013.

The recovery of the monsoon in the season's second half in 2012 and a good monsoon in 2013 helped agriculture to grow by 4.6% in FY2013, though growth moderated somewhat in the second half of the year. Food grain production is estimated to have increased by 2.4% in FY2013, reaching a record of 263.2 million tons.

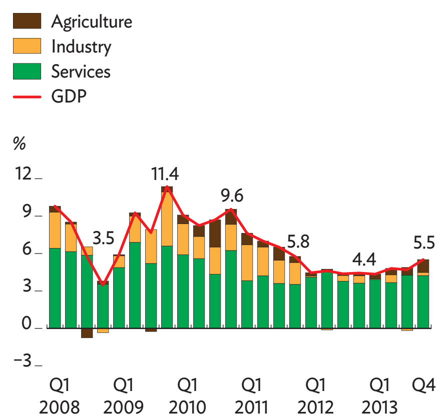
After growing by a tepid 1.0% in FY2012, industry decelerated further to 0.7% in FY2013. While mining has been in the red for nearly 2 years because policy bottlenecks plaguing coal and natural gas have seen little resolution, the contraction in manufacturing output was a new low. Continuing contraction in the output of capital goods and consumer durables reflects very weak investment and consumer demand (Figure 3.17.2). Bottlenecks restricting fuel supplies have hampered electricity generation.

The industrial slowdown and weak recovery in advanced economies caused growth in services to drop below 7%. Trade, hotels, transport, and communication services, which together account for more than a quarter of GDP, saw growth slump to 3.5% in FY2013 as industry weakened and consumption dried up. Growth in the large financial services industry is estimated at a healthy 11.2%. However, much of this expansion is attributed to strong deposit mobilization as large inflows came from Indian nonresidents under a temporary foreign exchange swap window. This appears to be largely a one-off event.

Growth in private consumption slowed sharply to 4.1% in FY2013. A weak currency, persistent food inflation, rising fuel prices, and dim

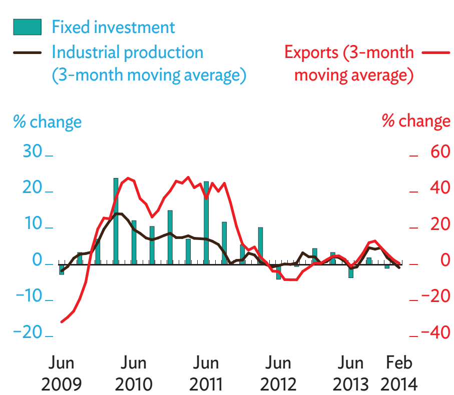
This chapter was written by Abhijit Sen Gupta and Nidhi Kapoor of the India Resident Mission, Asian Development Bank, New Delhi.

3.17.1 Supply-side contributions to growth



Note: Years are fiscal years. Q1 refers to data for April–June.
Source: CEIC Data Company (accessed 14 March 2014).

3.17.2 Investment, industrial production, and exports



Source: CEIC Data Company (accessed 14 March 2014).

employment prospects severely dented consumer confidence. Rural consumption is likely to have been affected by some moderation in rural wage growth since January 2013. Growth in government consumption, which sharply picked up in the first quarter, remained subdued for the rest of the year as fiscal pressures intensified. Investment flattened during the year, registering no growth. While structural and procedural delays continued to hamper investment, new headwinds appeared in the form of monetary tightening and the heightened challenge of repayment in foreign currency as the currency weakened. Domestic demand contributed less than half of growth.

Consumer price inflation averaged 9.8% in FY2013, while wholesale price inflation averaged 5.9%. Inflation picked up for both from May with higher food prices and periodic increments in fuel prices (Figure 3.17.3). However, from December 2013, inflation decelerated sharply due to a drop in food prices, especially for vegetables. Marked currency depreciation during the year affected import prices, though the pass-through to final prices has been limited by weak demand, which has curtailed firms' pricing power and forced them to tighten margins.

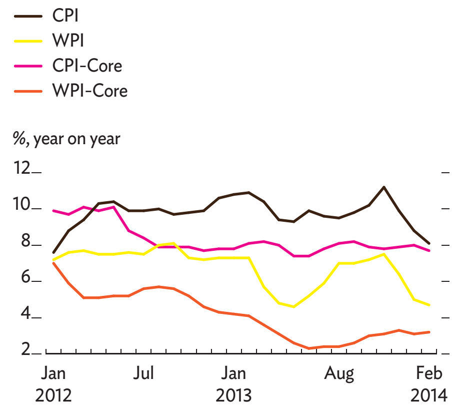
The Reserve Bank of India, the central bank, had to calibrate monetary policy to balance weak growth with concerns over external and price pressures. After reducing the policy repurchase rate by 25 basis points to 7.25% in the first quarter of FY2013 to foster growth, it had to force market rates much higher in July, using its marginal standing facility rate, which it increased to 10.25% (Figure 3.17.4). This was to counter intense pressures on the exchange rate and reserves from turmoil in global capital markets stemming from fears that the US Federal Reserve was about to abruptly end quantitative easing. This action and others in September to buttress capital flows effectively dealt with external pressures. Subsequently, the central bank underlined its firm commitment to bring down inflation (while mindful of slack in the economy) by pushing up the repurchase rate to 8.0%.

A committee that the central bank set up in December 2013 proposed using the consumer price index as the nominal anchor for monetary policy and the adoption of an inflation target of 4%±2%, to be achieved over 2 years. While the advantage of having a clear nominal anchor to influence expectations is widely acknowledged, a debate continues on inflation targeting, as it would depend critically on better coordinated monetary and fiscal policy, more accurate forecasting, and an improved transmission mechanism.

The quality of commercial bank assets continues to be a major concern. The ratio of nonperforming loans to all loans worsened to 4.2% in September 2013 from 3.4% in March 2013. Over the same period, the ratio of restructured loans to all loans also increased, to 6.0% from 5.8%, taking the ratio of stressed loans to over 10% (Figure 3.17.5). The publicly owned banks that dominate the banking system hold a disproportionate share of stressed loans.

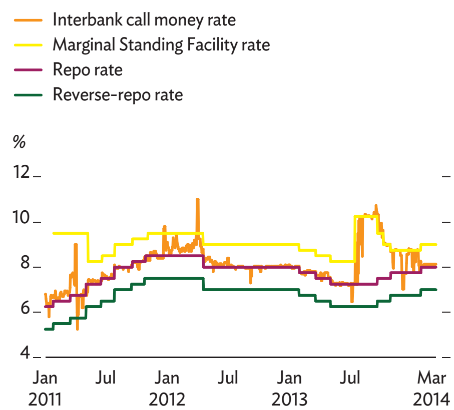
The federal budget deficit in FY2013 is estimated at 4.6% of GDP, slightly less than the 4.8% recorded in FY2012. However, the quality of fiscal consolidation is a concern. Revenue growth was, at 15.9%, well below the target. Collections of corporate tax and customs and excise duties were weakened by tepid economic activity, and receipts from

3.17.3 Inflation



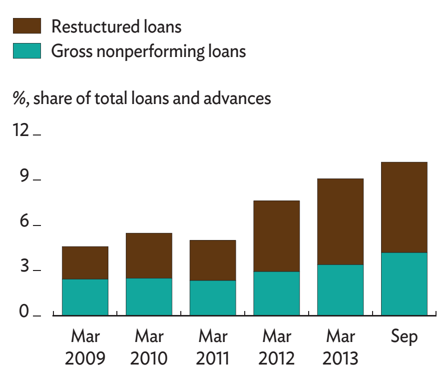
CPI = Consumer price index, WPI = Wholesale price index.
Sources: CEIC Data Company (accessed 14 March 2014); ADB estimates.

3.17.4 Policy interest rates



Source: Bloomberg (accessed 14 March 2014).

3.17.5 Nonperforming and restructured loans



Source: Reserve Bank of India. http://www.rbi.org.in asset sales were less than half of the target despite the government benefitting from a strong response to the auction of the telecom spectrum. To meet the deficit target, expenditure was compressed, with the burden falling disproportionately on growth-enhancing capital expenditure, which came in at 15% below target, while current expenditure was maintained as planned. Subsidy payments, though capped at 2% of GDP, were 10.6% higher than targeted, as a weak currency pushed the cost of fertilizer and petroleum higher than originally budgeted. In a bid to narrow the fiscal deficit, petroleum subsidies equal to about 0.3% of GDP have been deferred to FY2014.

The current account deficit is estimated to have narrowed sharply to 2.2% of GDP in FY2013 from 4.7% a year earlier. The improvement reflected a large compression of the trade deficit from 10.4% of GDP in FY2012 to 7.9%, mainly owing to a 7.0% drop in imports. Imports of oil, the largest item, were stagnant, while those of gold, the second largest, fell by 45.2% from a year earlier as higher taxes and quantitative restrictions took hold. However, the decline in imports was broad based, with the economic slowdown hitting imports of capital goods such as machinery and transport equipment. Competitiveness gains from a weaker currency and the pickup in demand in some of the advanced economies helped exports to grow by 4.7% in FY2013 (Figure 3.17.6). Exports of petroleum products, fabrics, garments, and plastics grew at a robust pace. Improved services receipts and a modest advance in transfers narrowed the current account deficit by an amount equal to 0.1% of GDP.

A favorable swap scheme for domestic banks initiated by the central bank as one of the September 2013 stabilization measures garnered $46 billion before its expiration in November, mainly from 3-year deposits from nonresident Indians. This facility was a major contributor to rebuilding international reserves after they dipped to $275 billion in early September, helping to restore them to $297 billion in mid-March, a couple weeks before the end of the FY2013 (Figure 3.17.7). While there were substantial net outflows of portfolio investment from June through August during the global market turmoil, subsequently there have been sizeable net inflows, especially to purchase local currency bonds (Figure 3.17.8). With the strengthening and stabilizing of the rupee and marked narrowing of the current account deficit in the second half of the year, global investors moved back into bonds, which allowed them to lock in profit in a covered transaction. However, net foreign direct investment, estimated at $20 billion, improved little on the FY2012 figure.

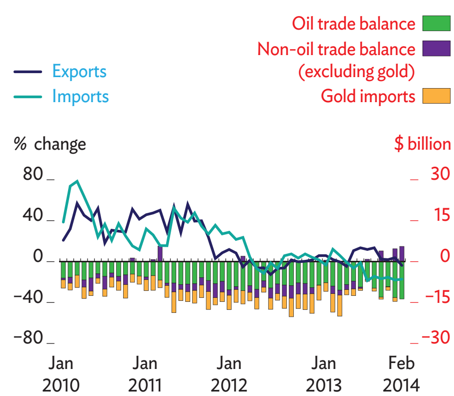
Policies that have improved reserves and substantially strengthened the external position are reflected in exchange rate developments. The Indian rupee depreciated by about 20% against the US dollar from May to its low at the end of August but has subsequently appreciated to trade in March 2014 at about 10% below its rate a year earlier (Figure 3.17.9). The average real effective rate has depreciated about 6%, aiding competiveness. Stock prices declined by 7% from March to August 2013 but recovered sharply for a gain of around 19% in FY2013 (Figure 3.17.10). Despite difficulties, markets in India were more positive over the year than emerging markets averages either in Asia or globally.

3.21.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.5	6.0
Inflation	6.0	5.8
Current account balance (share of GDP)	–2.5	–2.8

Source: ADB estimates.

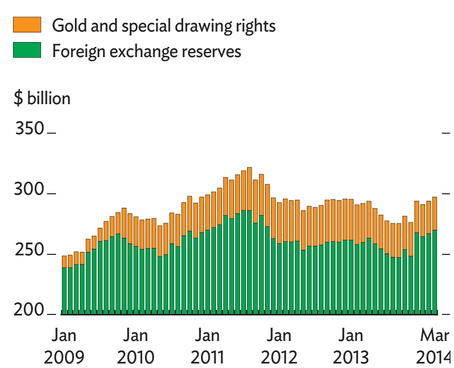
3.17.6 Trade indicators



Note: Separate data for gold imports available up to January 2014 only. Non-oil trade balance for February 2014 includes gold.

Source: CEIC Data Company (accessed 25 March 2014).

3.17.7 International reserves



Source: CEIC Data Company (accessed 25 March 2014).

Economic prospects

Economic recovery would have to be led by improved investment and consumption, but the prospects do not appear promising at this stage. Elevated inflation, a tight monetary stance, and a weak currency will continue to constrain spending. Further, fiscal austerity is likely to be an additional drag on growth.

While the quarter ending in December 2013 witnessed a healthy increase in the number of new projects announced, most were government projects (Figure 3.17.11). At the same time, the number of stalled projects continued to increase with the withdrawal of coal block allocations placed earlier with private sector operators and problems related to acquiring land.

The Cabinet Committee on Investment has cleared projects with a combined worth of $89 billion or 4.8% of GDP. This is likely to provide some traction toward resolving issues with some of the stalled projects. The government is likely to initiate actions that would bolster capital expenditure, as companies are looking for macroeconomic stability and forward movement on some structural issues before commencing operations. Better growth prospects in the US and the euro area will likely bolster external demand, as will competitiveness gains from currency depreciation.

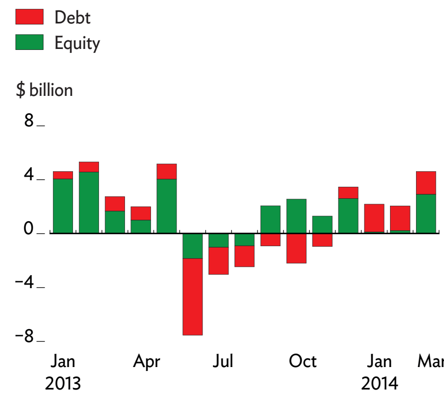
A favorable monsoon is assumed to help agriculture grow at close to its trend rate of 3%. However, some global weather agencies have reported the increased chance of a weak El Niño in 2014, which could reduce rainfall in India and suppress agriculture growth.

Industry is likely to achieve a marginal uptick in growth with mining clearances and improved electricity generation. The HSBC India Manufacturing Purchasing Managers' Index rose in February 2014 to its highest level in a year (Figure 3.17.12). The increase was driven by improvement in current indicators such as output and in forward indicators such as new orders and export orders. Improved global prospects are likely to boost tradeable services such as finance, communication, and information technology and business services, but the HSBC Services Sector Activity Index for February remained below par despite some improvement. The central bank's Business Expectation Index continued to strengthen in the fourth quarter of FY2013 on improved sentiment regarding production, order books, capacity utilization, and exports (Figure 3.17.13).

The economic downdraft of recent years appears to have calmed, and GDP growth in FY2014 is expected to inch upward by 5.5% on improved performance in industry and services. In FY2015, economic growth is expected to pick up to 6.0%, as a speeding up in advanced economies bolsters external demand and government action opens some structural bottlenecks that have impeded industry and investment.

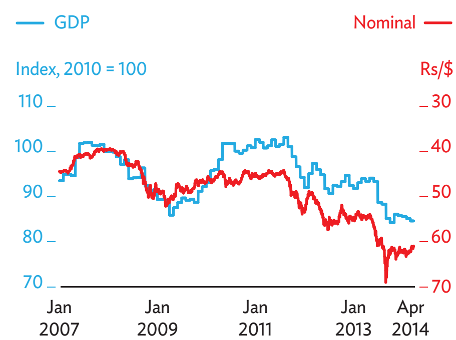
Consumer price inflation is expected to ease below the double digit rates witnessed in recent years but will continue to be high. Record production of food grains in FY2013 will help to soften food prices. Government policies on support prices for procuring food grains under the National Food Security Act will bear heavily on food inflation. A monsoon disrupted by El Niño could fuel food inflation. Improvements in agricultural productivity and the marketing and distribution of

3.17.8 Capital flows



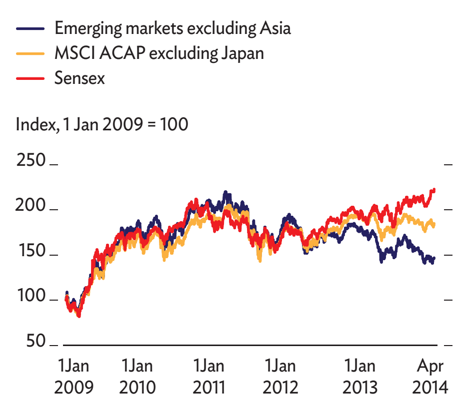
Source: Securities and Exchange Board of India. http://www.sebi.gov.in

3.17.9 Exchange rate



Source: Bloomberg (accessed 25 March 2014).

3.17.10 Stock price indexes



Source: Bloomberg (accessed 25 March 2014).

perishables are needed. Monthly diesel price hikes will need to continue for more than a year if the government is to eliminate this subsidy. On balance, consumer inflation will likely average 8.1% in FY2014 and moderate further to 7.8%, assuming no adverse shocks to agriculture. Wholesale price inflation, which has a smaller food component and excludes services, is expected to average 6.0% in FY2014 and 5.8% in FY2015. These projections assume that monetary policy will remain tight, as consumer price inflation, which has persistently trended higher than wholesale price inflation, is increasingly viewed as the nominal anchor, making the inflation target of 4% ±2% within the next 2 years a bigger reach.

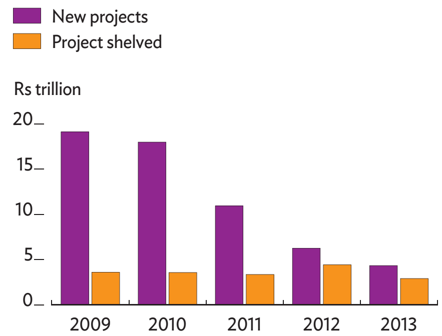
This being an election year, an interim budget was presented in February 2014. The fiscal deficit is seen dropping to 4.1% of GDP in FY2014, which appears optimistic. With no major increase in tax rates, tax revenue collection is expected to increase by 19% in FY2014 on account of higher projected tax buoyancy. Meanwhile, excise duty for capital and consumer goods has been reduced from 12% to 10% to stimulate growth. Personal income tax and excise and customs duties are projected to grow at rates higher than the average over the past decade, indicating assumptions of a manufacturing rebound, expanded tax coverage, and a dynamic global environment in FY2014. At 0.4% of GDP, projected revenue earnings from asset sales are also on the ambitious side, up from an average of less than 0.3% over the past 5 years.

While current expenditure is estimated to grow by 10.8%, capital expenditure growth is pegged at 11.7%. With nominal GDP growth at 13.4%, this implies a further reduction in the ratio of capital expenditure to GDP. Subsidies have been maintained in FY2014 at FY2013 levels in absolute terms, as lower fuel subsidies offset a higher food subsidy with the introduction of the National Food Security Act, 2013. Fuel subsidies are likely to overshoot their budgets in FY2014 as arrears of around 0.3% of GDP from FY2013 were rolled into FY2014. Further, the cap on the number of cooking gas cylinders eligible for subsidies was recently raised, and the losses incurred by oil marketing companies rose because of the weaker rupee.

Improved global growth momentum in 2014 and the recent weakening of the rupee should spur exports, which are expected to increase by 8.0% in FY2014. Imports are also likely to grow, at 9.0%, as imports of items other than oil and gold respond to a modest upturn in growth. Softer international oil prices are likely to keep oil imports in check. Gold imports will likely witness an uptick as some of restrictions are gradually eased to accommodate the large jewelry and gem-setting industry. Better growth prospects in the advanced economies and high domestic interest rates should bolster remittance inflows. The FY2014 current account deficit is expected to be 2.5% of GDP, slightly higher than FY2013.

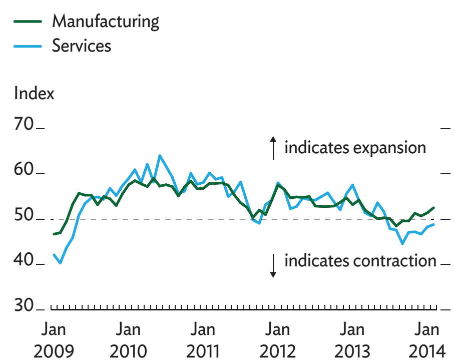
In FY2015, the current account deficit is expected to widen further to 2.8% of GDP as import demand grows by 12% with improvements in investment and industry. Export growth is also expected to pick up to 10.5% as the advanced economies consolidate their growth momentum. While the current account deficit is expected to be comfortable in

3.17.11 New projects and projects shelved



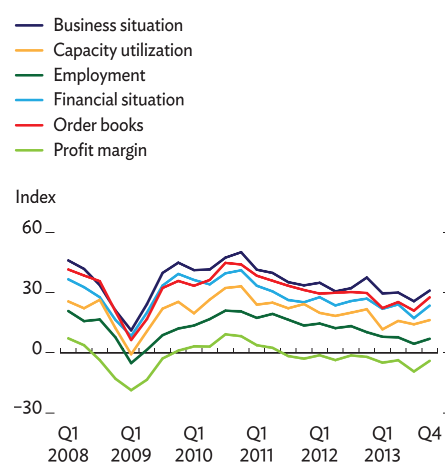
Note: Years are calendar years.
Source: Centre for Monitoring Indian Economy.

3.17.12 HSBC Markit India purchasing managers indexes



Source: Bloomberg (accessed 17 March 2014).

3.17.13 Industrial outlook survey



Note: Years are fiscal years. Q1 refers to data for April–June.
Source: Reserve Bank of India. http://www.rbi.org.in

FY2014 and FY2015, and financed by capital inflows, the economy remains susceptible to external shocks. A large part of the moderation in the current account deficit has been achieved through discretionary curbs on gold, which cannot be sustained over the long run. Similarly, export competitiveness, restored by a sharp depreciation in mid-2013, will slowly erode under high inflation and stagnant productivity. Moreover, the economy continues to import large volumes of essential commodities such as crude oil, coal, and fertilizer because domestic production is constrained. As demand for them is inelastic, a hike in international prices or a marked weakening of the rupee would damage external stability.

Policy challenge—expanding manufacturing to create jobs

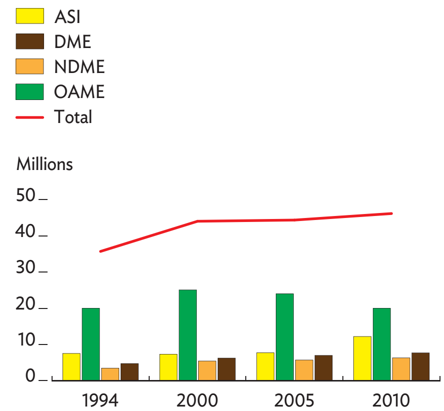
One of India's most pressing policy challenges is to create significantly more productive and well-paying jobs. Such jobs are vital to sustain high growth and ensure that it is inclusive. As the proportion of the workforce that depends on agriculture declines, and given the 12 million people enter the workforce each year, manufacturing will have to play a key role in generating productive and well-paying jobs.

In many ways, manufacturing is well placed to play this role. First, India's factor endowments provide an abundance of semiskilled labor, which is essential for a comparative advantage in labor-intensive manufacturing. Second, India has developed the capabilities required for a diversified and dynamic manufacturing industry in terms of the range of manufactured products produced and of India's manufactured export basket, which includes relatively sophisticated chemical and pharmaceutical products, as well as auto components. Moreover, India's information technology and engineering services have increasingly been deployed by multinational corporations for designing industrial products for global markets, including sophisticated memory chips used in a range of electronic devices.

Unfortunately, manufacturers in India do not perform close to their tremendous potential. For many years now, the sector has contributed around 15% of GDP and 12% of employment. By comparison, manufacturing in the People's Republic of China, Malaysia, Thailand, and Viet Nam accounts for close to 25% or more of GDP.

While employment shares in some of these countries are similar to India's—for example, a little above 15% in Thailand—the large majority of Indian manufacturing employment is concentrated in small, informal enterprises. As Figure 3.17.14 shows, the largest share of manufacturing employment in India is in the informal sector "own account manufacturing enterprises," which employ no wage-workers. Though the most recent data suggest a welcome decline in this segment of manufacturing employment from 2005 to 2010, Indian manufacturers by and large continue to be small and informal, which translates into low productivity and wages. Figure 3.17.15 shows low average wages generated by the informal sector and low average wages paid by small firms in the formal sector relative to their larger counterparts.

3.17.14 Manufacturing employment



Notes: Years are fiscal years, ending on 31 March of the next calendar year.

ASI – Annual Survey of Industries: represents formal enterprises—those registered under the Factories Act, and employing at least 10 workers if using power or 20 workers if not using power.

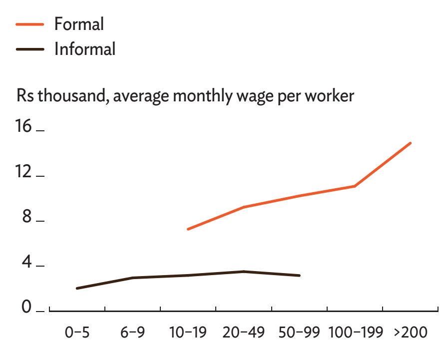
DME – Directory Manufacturing Etablishement: represents informal establishments with 6 or more workers (household and hired workers taken together).

NDME – Non-directory Manufacturing Establishments: represents informal establishments with less than 6 workers (household and hired workers taken together).

OAME – Own Account Manufacturing Enterprises: represents informal enterprises that are run without any hired workers employed on a regular basis.

Source: Annual Survey of Industries and National Sample Survey Organization.

3.17.15 Wage gap between formal and informal manufacturing in India



Source: Annual Survey of Industries and National Sample Survey Organization.

Infrastructure deficiencies, especially for power and transport, and a difficult regulatory environment for manufacturing loom large in discussions and analyses of the factors holding back manufacturing. Rigorous empirical work has begun documenting how insufficient and irregular power supply affects firms' product choices, output, and scale of operations. Also, for products such as apparel that have geographically dispersed domestic supply chains, poor connectivity and logistics raise transaction costs and damage global competitiveness. Similarly, the World Bank's 2014 *Doing Business* study on regulations ranks India 134th of 189 countries for ease of doing business. Particularly problematic are regulations on starting a business, obtaining permits, and closing unprofitable units. Further, elements of India's labor laws, especially those pertaining to layoffs in manufacturing plants, seem to have discouraged larger and more productive firms from entering labor-intensive product lines.

Recognizing the importance of a more dynamic manufacturing industry, the government unveiled in 2011 its new National Manufacturing Policy, which calls for boosting the share of manufacturing to 25% of GDP and adding 100 million workers by 2022.

To achieve these targets, the policy proposes rationalizing and simplifying business regulations, including the use of single-window clearance mechanisms; an exit policy that aims to balance firms' need to adjust employment in response to market conditions with labor's need for income security; financial and institutional mechanisms to develop technology, especially for small and medium-sized enterprises; large-scale infrastructure development; and clustering manufacturers in new national investment and manufacturing zones.

These zones will be developed as industrial townships, benchmarked with the best manufacturing hubs in the world. They will also help meet growing demand in India for world-class urban centers. Further, they will address infrastructure bottlenecks. These zones will be equipped with necessary infrastructure, particularly power, either through grid connection or by power plants in the zone. They will also seek to minimize supply chain fragmentation and its associated costs.

The government is transforming major transport corridors into economic corridors and promoting greater industrial activity along them. In addition, the Cabinet Committee on Investment has been set up to speed clearance for stalled infrastructure projects throughout the country.

The successful implementation of these recent initiatives will be necessary to ensure that India's manufacturers perform at or close to potential.

Maldives

Growth picked up in 2013 owing to a strong recovery in tourism, mainly a further large influx of visitors from Asia. The country still has to grapple with hefty fiscal and external imbalances despite some improvement. With strengthening in global economic conditions, the outlook is for higher growth. Policy nevertheless needs to focus on durable reductions to the fiscal deficit.

Economic performance

After a deep downdraft in 2012, GDP growth picked up to an estimated 3.7% in 2013, buoyed by a strong rebound in tourism and associated sectors such as transport and communication (Figure 3.18.1). Tourism, the mainstay of this island economy, expanded by an estimated 5.5% and accounted for about 40% of growth. Transport performed robustly, expanding by 5.1%, as did communication at 7.6%. Together, the three sectors provided three-quarters of GDP growth. Industry, which is dominated by construction, has stalled in the past 2 years on weak investment, as hotel occupancy has not recovered to rates enjoyed before the financial crisis.

Tourist arrivals grew by 17.4%, nearly reaching the government's target of 1.2 million, led by a strong influx of visitors from Asia, particularly the People's Republic of China (PRC), which now provides nearly 30% of total arrivals (Figure 3.18.2). Asia has been a rapidly growing source of visitors, increasing its share to 45.0% of arrivals from barely a third only 4 years ago. Visitors from Europe, which made up just less than half of total arrivals, grew by a mere 1.8%, reflecting the prolonged economic slump in Europe.

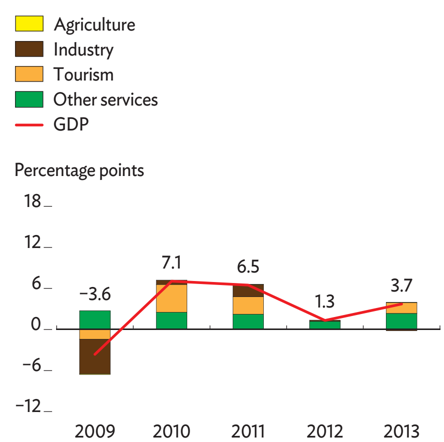
Other sectors such as wholesale and retail trade, social services, and real estate posted good growth. Agriculture and fisheries also grew but contributed barely 2% to GDP growth. Agriculture remains constrained by the lack of cultivable land, while fisheries, the main employer in the atolls, struggles with depleted fish stocks. That said, after 6 years of steady decline, the catch rebounded substantially by 16.8%.

Inflation in Malé, the capital, eased markedly from averaging 10.9% in 2012 to 4.0% in 2013, the lowest since 2006 (Figure 3.18.3). Price increases for fish were much lower in 2013 as the catch improved. Prices for furnishings, household equipment, miscellaneous goods and communications services, fell sharply after double-digit growth in 2012. Controlled prices of certain food items, electricity and fuel were largely unchanged.

The government estimates the budget deficit to have narrowed to 4.7% of GDP in 2013 on higher revenues and lower spending (Figure 3.18.4). Revenue grew by 15.8% on large increases in tax

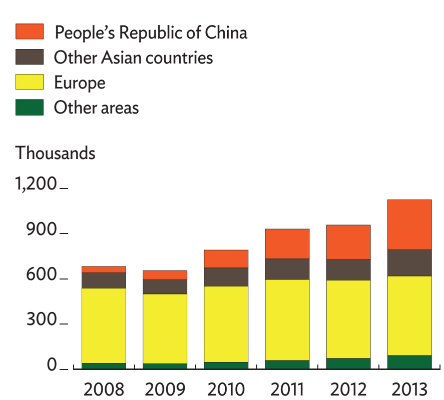
This chapter was written by Sarah Carrington and Huiping Huang of the South Asia Department, Asian Development Bank, Manila; and Elbe Aguba, consultant, South Asia Department, Asian Development Bank, Manila.

3.18.1 Supply-side contributions to growth



Source: Maldives Monetary Authority. 2014. *Monthly Statistics*. February. http://www.mma.gov.mv

3.18.2 Tourist arrivals



Source: Maldives Monetary Authority. 2014. *Monthly Statistics*. February. http://www.mma.gov.mv revenue from the goods and services tax on tourism and the business profit tax. Total expenditure is reported up by only 2.2%, with current expenditure advancing by 10.3% and capital expenditure falling by 26.1%, holding total spending to just 37.9% of GDP, well below the 40.8% average over the past 5 years. Although the estimated deficit is a marked improvement from 9.2% of GDP in 2012 and double-digit deficits in previous years, the actual deficit will likely be higher, as financial data suggested a cash deficit of 13.4% of GDP.

Because of chronic fiscal deficits, government domestic debt has soared to reach 47.8% of GDP in 2013 (Figure 3.18.5). Moreover, rising demand for financing is pushing interest rates significantly higher, as Treasury bill rates of all maturities were over 10% by December 2013. Meanwhile, bank-lending rates to the country's large nonfinancial public corporations have also sharply escalated (Figure 3.18.6). Worsening financing difficulties have driven the government to rely heavily on the Maldives Monetary Authority, with claims, mostly holdings of government securities, mounting to 18% of GDP in 2013. Moreover, the government appears to have accumulated payment arrears that are estimated to be nearly 4% of GDP in 2012. Government data show domestic and external public debt together estimated at 72% of GDP at the end of 2013; the International Monetary Fund, meanwhile, estimates a much higher total equal to 96% of GDP.

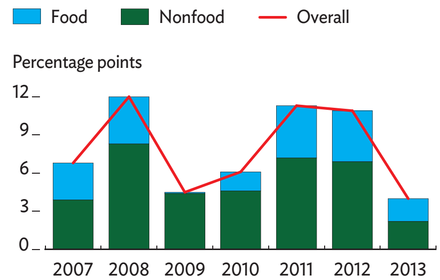
The current account deficit is estimated to have narrowed to 20.5% of GDP in 2013 from 23.0% a year earlier, on higher tourism receipts, improved exports (mainly re-exports of jet fuel), and sizably reduced net income outflows to pay interest (Figure 3.18.7). Though the deficit narrowed, it remains high, reflecting the country's heavy reliance on imports (82.8% of GDP), particularly for food and petroleum products. Financial inflows, errors and omissions, and the overall balance remain unrecorded, reflecting weak data. Nevertheless, financing was sufficient to increase gross international reserves by $35.8 million to $340.3 million, which is still low, equivalent to only 1.7 months of projected imports of goods and services.

Economic prospects

Tourism remains the major driver of the economy. Favorable global economic prospects—particularly in the euro area and the PRC—are expected to increase tourist arrivals and have a positive spillover into the rest of the economy. Following the election of the new President in November 2013, after nearly 2 years of political turmoil, greater stability is expected to prevail, bolstering a favorable outlook. The new government is expected to take steps to advance economic activity, including implementing plans to ensure that the Maldives maintains its high-end position in the world tourism market. Economic growth is projected to pick up moderately to 4.5% in 2014 and further to 5.4% in 2015.

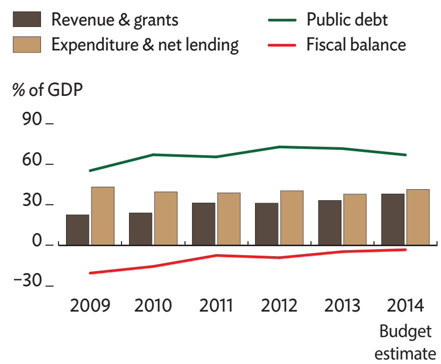
The budget deficit is likely to expand. Although some measures were introduced to improve fundamentals, such as increasing the tourism goods and services tax from 8% to 12% effective July 2013 and broadening the base for the general goods and services tax,

3.18.3 Contributions to inflation in Male'



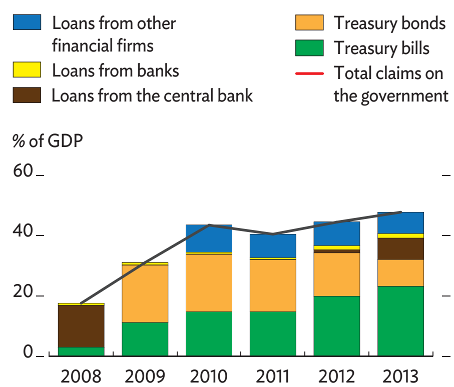
Source: Maldives Monetary Authority. 2014. *Monthly Statistics.* February. http://www.mma.gov.mv

3.18.4 Fiscal indicators



Source: Maldives Monetary Authority. 2014. *Monthly Statistics.* February. http://www.mma.gov.mv

3.18.5 Domestic debt



Source: Maldives Monetary Authority. 2014. *Monthly Statistics.* February. http://www.mma.gov.mv

3.18.1 Selected economic indicators (%)

	2014	2015
GDP growth	4.5	5.4
Inflation	5.0	4.8
Current account balance (share of GDP)	−21.8	−22.1

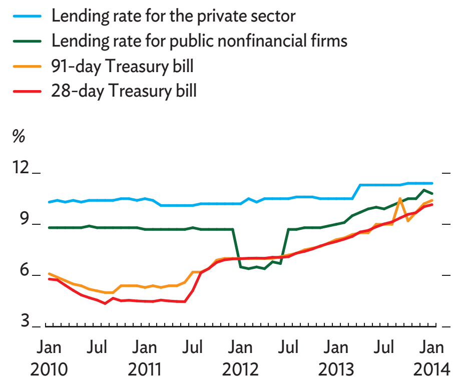
Source: ADB estimates.

actions fell short of identifying specific policies to effect needed cuts in expenditure. The budget for 2014 envisions a 22.6% expansion in spending and a reduction in the deficit to 3.2% of GDP. Budget revenues are seen increasing by 30%, or by a full 5% of GDP, which would be an extraordinary accomplishment.

In an expanding economy that must continue to rely heavily on imports, inflation is expected to increase slightly to 5.0% in 2014 but may ease a bit in 2015 as global prices subside. The current account deficit is projected to widen over the next 2 years to 22.1% of GDP, as increased tourism pushes imports and other payments higher.

Risks to the outlook center on large, simultaneous current account and fiscal deficits, high government debt and an exchange rate that is fixed in practice—circumstances that are increasingly difficult to sustain. Adverse shocks to income in tourist source countries or spikes in global oil prices continue as downside risks.

3.18.6 Interest rates



Source: Maldives Monetary Authority. 2014. *Monthly Statistics*. February. http://www.mma.gov.mv

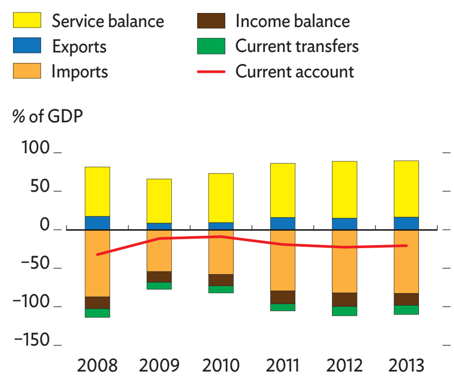
Policy challenge—reining in fiscal and external imbalances

The most pressing macroeconomic priority for the Maldives is containing its substantial fiscal and external imbalances. The government has very high expenditures, averaging 40.6% of GDP over the past 5 years and reflecting mainly expansion in current expenditure (Figure 3.18.8). Current expenditures comprise over two-thirds of total expenditure, with around one-third of it for salaries, wages, and allowances. Another 22% of expenditures fund subsidies, transfers, and social welfare. Heavy subsidies for food and fuel, two of the country's main imports, contribute increasingly to the widening of current account and fiscal deficits alike.

High fiscal deficits and rising public debt increasingly challenge financing the budget. The government relies mainly on domestic sources, even at escalating interest rates, to finance its deficit. The principal sources of finance are bank loans and the issuance of Treasury bills to banks, state-owned enterprises, and the private sector. Most recently, the government has resorted to heavy debt monetization at the Maldives Monetary Authority and further accumulation of payment arrears.

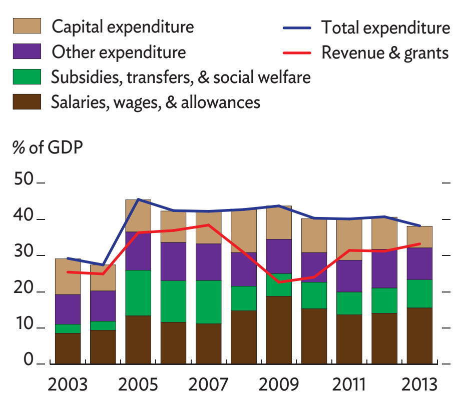
Fiscal consolidation is therefore an urgent priority. Slimming a civil service that employs 11% of the population and costs about 14% of GDP is an important task, though past efforts have had little impact. A redesign of subsidy and transfer mechanisms to improve targeting and minimize leakage would help ease the burden. Better targeting of health insurance and pension systems in particular would advance government efforts to rein in excessive expenditure. A review of forecasting methods, particularly for allocating expenditures among ministries or agencies, would be key to taming large variations in these accounts. Looking more to the midterm, developing a stronger and more diverse economic base beyond tourism will be important to address the country's heavy reliance on imports and persistently large current account deficits.

3.18.7 Current account components



Source: Maldives Monetary Authority. 2014. *Monthly Statistics*. February. http://www.mma.gov.mv

3.18.8 Cenral government revenue and expenditure



Source: Maldives Monetary Authority. 2014. *Monthly Statistics*. February. http://www.mma.gov.mv

Nepal

A significant drop in agriculture and delay in introducing a full budget dragged down GDP growth. Inflation remained high, and the current account surplus contracted as remittance inflows decelerated. Growth is expected to pick up with a favorable monsoon, the timely adoption of a full budget, and political stability following the successful Constituent Assembly election in November 2013.

Economic performance

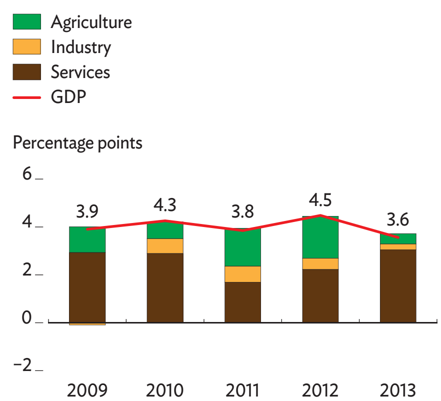
GDP growth decelerated to 3.6% in FY2013 (ended 15 July 2013) because of an unfavorable monsoon, a shortage of chemical fertilizers, and the delay in introducing a full FY2013 budget (Figure 3.19.1). Agricultural output growth slowed sharply to 1.3%, the lowest rate in the past 5 years, while services grew by 6% on improvements in wholesale and retail trade and in hotels and restaurants. Industry continued to languish, growing by a mere 1.6% as persistent electricity shortages, labor disputes, and political uncertainty soured the investment climate.

Inflation crept up to average 9.9% in FY2013, even as prices for food and for other goods and services moderated from highs at the beginning of the year, to bring overall inflation to 7.7% in the 12 months to the end of the fiscal year (Figure 3.19.2). Subsequently, the low agricultural harvest and high prices for agricultural imports from India pushed up food inflation sharply to bring overall inflation to 9.7% in the month of February 2014.

The delayed presentation of a full budget, which was introduced only in the 9th month of FY2013, combined with weak implementation capacity in the government, sharply curtailed total expenditure growth to 3.6%. Importantly, only 81% of the budget allocation for capital expenditure was actually spent, coming to a mere 3.1% of GDP (Figure 3.19.3). Strengthened revenue administration, a broadened tax base, and a boost in imports propelled tax revenue 22.6% higher, to bring total revenue including grants up to 19.8% of GDP, exceeding 18.6% a year earlier. As a result, the overall budget balance turned from deficits in recent years to a surplus equal to 0.4% of GDP.

Reflecting the central bank's push to increase credit to productive sectors, lending to agriculture, industry, and energy picked up, and credit to the private sector grew by 20.2%, accelerating from 11.3% in the previous year (Figure 3.19.4). Construction, wholesale and retail trade, services, and mines saw the largest increases in lending. The increases in lending to construction, at 16.4%, and to retail and wholesale trade, at 22.9%, indicate recovery in these sectors from a

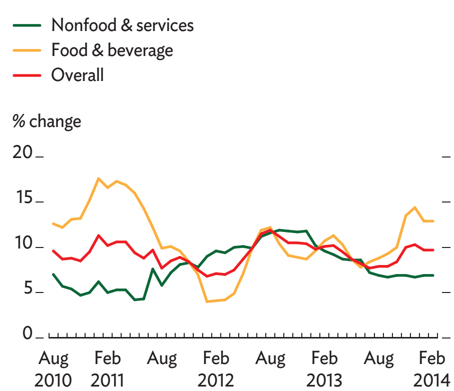
3.19.1 Supply-side contributions to growth



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Source: Central Bureau of Statistics. 2013. *National Accounts of Nepal 2012/13.* http://cbs.gov.np/

3.19.2 Monthly inflation



Source: Nepal Rastra Bank. 2014. *Recent Macroeconomic Situation.* http://www.nrb.org.np

This chapter was written by Chandan Sapkota of the Nepal Resident Mission, Asian Development Bank, Kathmandu.

slowdown in the previous year. The annual average weighted lending rate remained stable at around 12%.

The current account surplus narrowed to 3.4% of GDP, mainly on deceleration of remittance inflows and a surge in the trade deficit (Figure 3.19.5). Exports declined by 2.9% as demand slowed and supply-side constraints hurt competitiveness. Merchandise imports grew by 10.9%—largely because reliance on imports to meet domestic demand continued to intensify despite the weakening of Nepalese rupee, and demand for petroleum products rose—pushing the trade deficit up to 27.1% of GDP. Growth of remittance inflows eased to 11.3% after the large 26.6% expansion in the previous year, yet remittances still amounted to 25.6% of GDP. The overall balance of payments surplus moderated to $786.5 million, and foreign exchange reserves increased to $5.6 billion, equivalent to 9.3 months of imports of goods and services (Figure 3.19.6).

Economic prospects

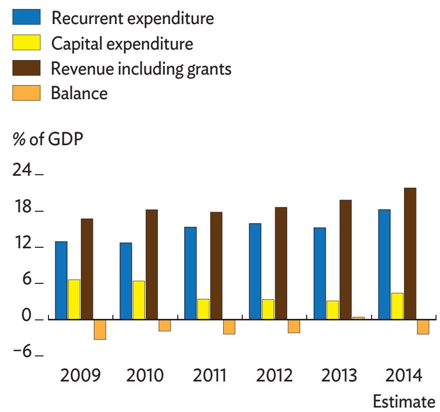
The economic outlook is more optimistic than in FY2013, considering the successful second Constituent Assembly election in November 2013 (following an 18-month hiatus from the end of the first assembly), the favorable monsoon, and expected strengthening in remittance inflows. The successful political transition to a new government has boosted business and investor confidence. The Constituent Assembly is expected to pass legislation that will promote investment in key sectors and mandate structural reforms. However, there is a downside risk of political instability arising from continued disagreement among the major political parties over unsettled constitutional and governance issues, especially those of federalism and the nature of parliament and the executive. These issues have the potential to create hurdles to drafting a new constitution like those that stymied the earlier Constituent Assembly.

Taking into account the favorable monsoon, more rapid growth of remittance inflows, and the timely introduction of a full budget—and assuming political stability—GDP is projected to grow by 4.5% in FY2014, somewhat less than the government's target of 5.5%. Normal monsoon rains and adequate supplies of chemical fertilizers have allowed full paddy planting in most of the country. The budget—with a sharp 41.1% boost planned for expenditure and underpinned by positive political developments and clearer government direction—has strengthened business and investor confidence, and so prospects for a boost to industrial activity and exports. Higher remittance-backed consumer demand and an uptick in tourism will support services growth at around 5%. More than half of growth will come from services, and the balance largely from agriculture.

GDP growth is expected to pick up to 4.7% in FY2015, assuming a normal monsoon, a timely budget, continued strong remittance inflows, a revival in real estate and housing, and the better growth outlook in India.

Despite the improved agricultural harvest, numerous factors—wage pressures, upward adjustment of administered fuel prices, the continued weakening of the currency and high inflation in India, and persistent power shortages and other supply-side constraints—are expected to

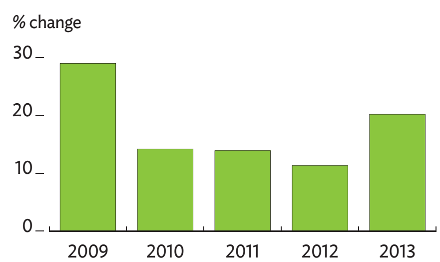
3.19.3 Fiscal indicators



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Source: Ministry of Finance. *Budget Speech 2014.*

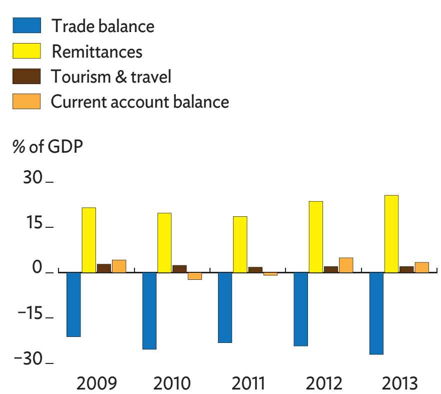
3.19.4 Credit to the private sector



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Source: Nepal Rastra Bank. 2014. *Recent Macroeconomic Situation.* http://www.nrb.org.np

3.19.5 Current account indicators



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Source: Nepal Rastra Bank. 2014. *Recent Macroeconomic Situation.* http://www.nrb.org.np drive inflation up to 10% in FY2014, well above the central bank's targeted improvement to 8.5%. Notably, the FY2014 budget increased the civil service salary scale by 18% and provided an additional NRs1,000/month allowance for all government employees. Moreover, the minimum wage for workers outside of agriculture was raised by 29% in June 2013. Inflation is projected to ease only slightly to 9.5% in FY2015, even assuming a good harvest, an appreciable reduction of inflation in India, cautious monetary and fiscal policies, and subsiding domestic wage pressures.

The balance of payments is expected to remain strong in FY2014. Exports are projected to increase by 3.0%, reflecting improving external demand and the gain in cost competitiveness owing to currency depreciation. Imports are projected to grow by 15% on the back of an upturn in domestic demand. Despite the widening trade deficit, higher growth in remittance inflows and increased tourism will sustain a current account surplus at 3.6% of GDP, slightly improved from a year earlier. The increase in the number of migrant workers going abroad, higher pay packages, and stronger incentives to remit money as the home currency depreciates underpin a favorable outlook for remittance inflows. Assuming a further pickup in export growth, some moderation in import demand, and a sustained advance in remittances, the current account surplus is expected to increase marginally in FY2015 to 3.7% of GDP.

Even with a timely full budget for FY2014, capital expenditure may not be fully spent because of delays (some of them election related) affecting procurement, budget release, and the implementation of approved projects. No major tax changes have been made, and gains from ongoing revenue administration reform may not be sufficient to meet the revenue target of 19.9% set in the budget, especially if imports underperform budget forecasts. Nevertheless, with some shortfall in expenditure, the budget deficit is expected to be around 2.4% of GDP, as envisioned in the budget.

The financial sector is stabilizing after the earlier excessive credit expansion and the subsequent break in the real estate boom in FY2011. FY2013 saw banks and other financial institutions consolidate further. The average capital adequacy ratio stands at 13.2%, well above the 10% threshold (plus 1% capital buffer), and real estate exposure continued to abate and is now well below the cap of 25% of loan portfolio that had been imposed by the central bank. Moreover, nonperforming loans declined to 3.8% of all loans. Nevertheless, banks and other financial institutions need to enhance their operational efficiency and explore further opportunities for consolidation. Credit and savings cooperatives, which fall outside of the purview of the central bank, need to be closely monitored, regulated, and supervised to ensure the soundness of the financial sector.

Policy challenge—taming high inflation

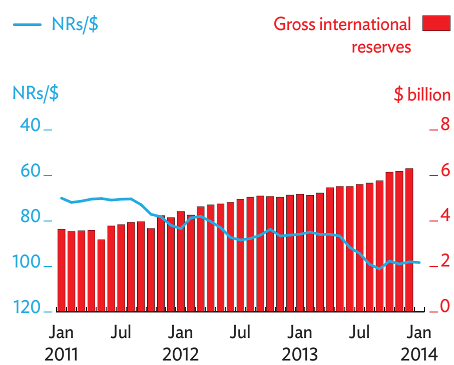
Average inflation has surpassed 9% in each of the past 5 years except for FY2012, when it was only slightly less. Inflation at 12.6% in FY2009 was the highest in the past 2 decades, largely driven by 17.4% rise in the price of food, which occupies a 46.8% share of the consumer price

3.19.1 Selected economic indicators (%)

	2014	2015
GDP growth	4.5	4.7
Inflation	10.0	9.5
Current account balance (share of GDP)	3.6	3.7

Source: ADB estimates.

3.19.6 Gross international reserves and exchange rate



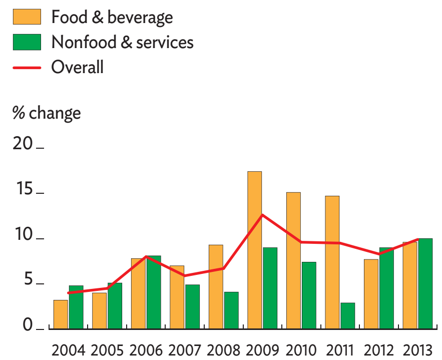
Source: Nepal Rastra Bank. 2014. *Recent Macroeconomic Situation.* http://www.nrb.org.np index basket. Since then, food inflation has slowed but remains high, averaging 11.8% in the past 4 years. Similarly, inflation for other items and services has surpassed 9% in the past 2 years (Figure 3.19.7). Taming high inflation, which erodes consumers' purchasing power and makes producers less competitive, is one of the country's major macroeconomic challenges.

Inflation in Nepal tends to move in tandem with inflation in India, which is Nepal's largest trading partner and with whose currency Nepal has pegged its rupee. According to a study by the International Monetary Fund, inflation in India and international oil price movements account for about one-third of the variability in Nepal's inflation. Moreover, after FY2007 inflation became more responsive to changes in international oil prices and the nominal effective exchange rate. Food price inflation, which has contributed about three-fourths of all consumer price index inflation in recent years, is more responsive to spillover from oil price movement and India's food inflation (Figure 3.19.8). The impact of international oil price movements seems more pernicious because a rise in petroleum product prices is quickly felt in the price of chemical fertilizers and transportation. Monetary factors affect both food and nonfood inflation, but their effect tends to fade away quickly.

Other factors that have driven inflation in recent years are weak currency, wage pressures, and supply-side constraints. The depreciation of the Nepalese rupee against the currencies of its trade partners has inflated costs not only for final goods but also for imported raw materials and intermediate goods. Furthermore, 161 products, mostly industrial raw materials, are imported from India in exchange for US dollars. Supply-side constraints such as power outages, transportation bottlenecks, and market price distortions imposed by middlemen and syndicates have also played major roles in keeping inflation high. These factors appear to have intensified since FY2007, when inflation in Nepal started to diverge from its usual path in tandem with inflation in India (Figure 3.19.9). Syndicates' arbitrary hikes in transportation costs and the widening gap between farm gate prices and retail prices—estimated to be at least 40% in the case of fresh vegetables—have propped up high inflation.

Though the government has banned syndicates and anticompetitive practices, enforcement remains weak. Effective market supervision and monitoring are needed to rectify market distortions. Another need is to check inflationary expectations by ensuring prudent fiscal and monetary policies. A way to diminish inflationary expectations would be to remove uncertainty over supplies of motor fuel and cooking gas. Appropriate steps to boost agricultural production would also help meet market demand and limit the impact of imported inflation. Taming inflation requires that financial policies and structural bottlenecks alike be effectively addressed.

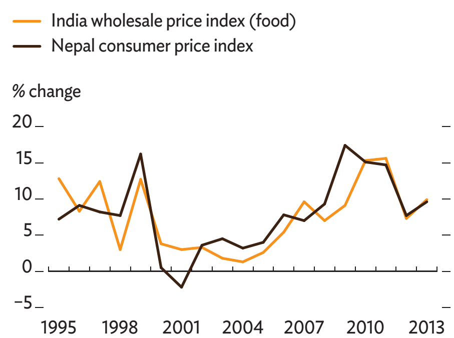
3.19.7 Inflation



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Source: Nepal Rastra Bank. 2014. *Recent Macroeconomic Situation.* http://www.nrb.org.np

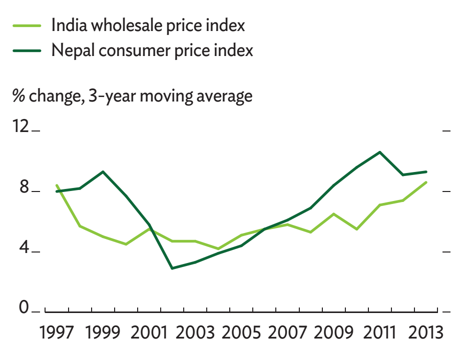
3.19.8 Food inflation in Nepal and India



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Sources: Nepal Rastra Bank; Reserve Bank of India.

3.19.9 Inflation in Nepal and India



Note: Years are fiscal years, ending on 15 July of the same calendar year.

Sources: Nepal Rastra Bank; Reserve Bank of India.

Pakistan

Macroeconomic and security challenges continue to weigh on the economy. Growth is expected to remain modest in FY2014, largely reflecting fiscal consolidation to deal with high deficits that have caused macroeconomic imbalances. The government has embarked upon a program of fiscal and structural reform, supported by an Extended Fund Facility Arrangement with the International Monetary Fund, to restore macroeconomic balance, relieve energy shortages, and guide the economy toward faster and more sustainable growth.

Economic performance

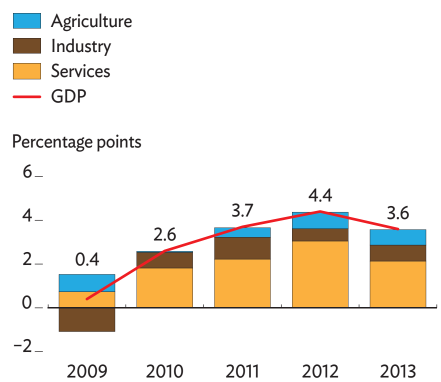
Moderate GDP growth in FY2013 reflected weak macroeconomic fundamentals in recent years. Investment remained low as energy shortages and security concerns continued to undermine investor confidence. Fiscal pressures kept the budget deficit very high for the second consecutive year. At the same time, however, inflation fell into single digits. Stable global commodity prices, Coalition Support Fund (CSF) inflows, and continued growth in worker remittances reined in the current account deficit.

GDP growth slowed to 3.6% in FY2013 (ended 30 June 2013) as weak expansion in the large service sector more than offset improved growth in manufacturing (Figure 3.20.1). Growth in agricultural production slowed slightly on weaker output of major crops, especially cotton and rice. Manufacturing expanded by 3.5%, reflecting a 4.4% pickup in large-scale manufacturing, though the sector remained hobbled by a continued power crisis and weak internal security. Textiles, food processing, and construction materials showed faster growth. Improved performance in construction was supported by flood rehabilitation, other public sector development projects, and their positive spillover effects to rest of the economy. Low growth in services was caused mainly by a slowdown in telecommunications. This countered improvement in finance and insurance that, however, reflected little more than commercial banks' profits from their high investment in government securities.

Investment continued its downward trend, with fixed investment falling from 13.3% of GDP in FY2012 to 12.6%. Private investment fell to 8.7% of GDP in large part because investment in manufacturing weakened, likely reflecting power shortages and low confidence in the country's prospects, while investment in services also slipped (Figure 3.20.2). Consumption growth slowed to 4.6% in FY2013 from 6.0% in the previous year but still outpaced GDP growth. Private consumption eased as growth in remittance inflows slowed.

This chapter was written by Sharad Bhandari and Farzana Noshab of the Pakistan Resident Mission, Asian Development Bank, Islamabad.

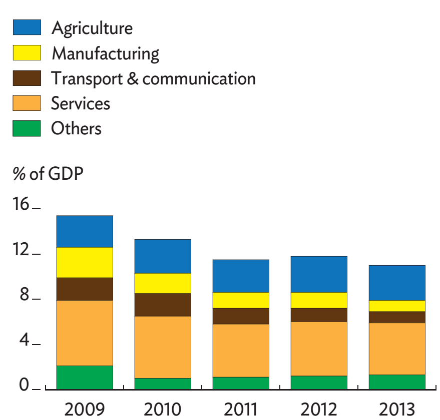
3.20.1 Supply-side contributions to growth



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Ministry of Finance. *Pakistan Economic Survey 2012–13.* http://www.finance.gov.pk

3.20.2 Gross fixed capital formation



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Ministry of Finance. *Pakistan Economic Survey 2012–13.* http://www.finance.gov.pk

Government spending, on the other hand, continued to exhibit strong growth. Positive net exports reflected improved export volume and a decline in imports as investment fell.

Headline inflation slowed from 11.0% in FY2012 to average 7.4% in FY2013, as food shortages eased (Figure 3.20.3). Gas tariff cuts and easing global commodity prices during the year moderated the rise of food and other prices. Greater exchange rate stability in FY2013—as compared with significant depreciation against the US dollar in the year before—also helped contain inflationary expectations. Inflation averaged 7.1% for food and 7.5% for non-food items.

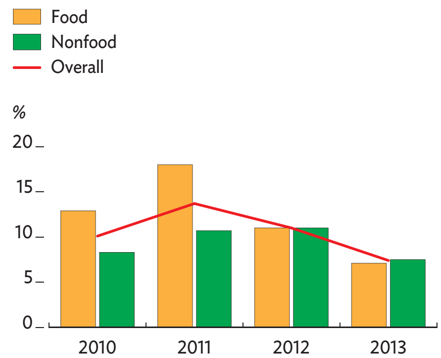
The fiscal deficit stood at 8.0% of GDP in FY2013, lower than the 8.8% recorded in FY2012. It reflected low tax revenues and higher current expenditures on power subsidies, pensions, and interest on short-term domestic borrowing. The unbudgeted clearance of power sector debt amounted to 1.4% of GDP. Consolidated development expenditures in FY2013 were 6.3% lower than the target, on account of smaller provincial development outlays.

Federal tax revenues grew a meager 3.2%, undermined by lower income tax and general sales tax collection and falling short of the FY2013 annual target. Federal Board of Revenue (FBR) tax revenues grew by only 2.9% and, at PRs1.94 trillion, were below the revised target of PRs2.01 trillion. As such, they cover only about half of current budget expenditure (consolidated), which is a pattern that has prevailed over the past 5 years (Figure 3.20.4). The shortfall in tax collection in FY2013 was partly compensated by higher nontax revenues, including the receipt of $1.8 billion under the CSF.

Monetary policy was accommodating. As inflation began to decelerate, the State Bank of Pakistan (SBP), the central bank, began in August 2012 to cut its policy rate gradually by a cumulative 300 basis points to 9.0% at the end of June 2013 (Figure 3.20.5). Government borrowing from the SBP and commercial banks remained high, as foreign financing was negligible. Budgetary borrowing from banks increased by 28%, or PRs1.5 trillion, in FY2013, including net borrowing of PRs536 billion from the SBP. To maintain market liquidity, the SBP injected, through open market operations, double the amount of funds injected in FY2012. However, credit to the private sector showed a slight net contraction in FY2013, as banks preferred to invest in government securities and economic activity remained weak. The heavy reliance on short-term borrowing has increased the government's exposure to interest rate and rollover risks.

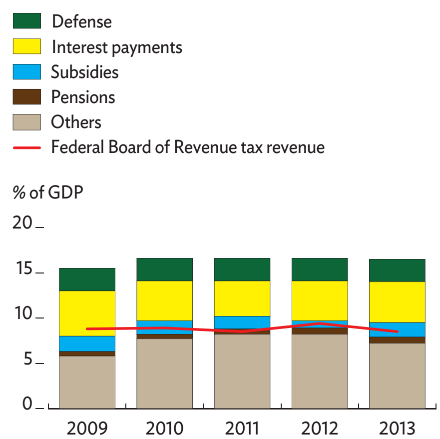
The current account deficit narrowed to $2.3 billion, or 1% of GDP, in FY2013 with improvement in the trade deficit, a lower service account deficit following receipts under the CSF, and continued inflows of worker remittances. Imports declined by 0.6% while export growth remained positive at 0.4%. A fall in external loan and nondebt financing, larger external debt repayment, and SBP interventions in the foreign exchange market to limit local currency depreciation drained foreign exchange reserves to a critically low $6.0 billion, enough to cover only 1.3 months of imports of goods and services by the end of June 2013. The Pakistani rupee depreciated against the dollar to Rs98.5, a decline of 4.5% over the year.

3.20.3 Annual inflation



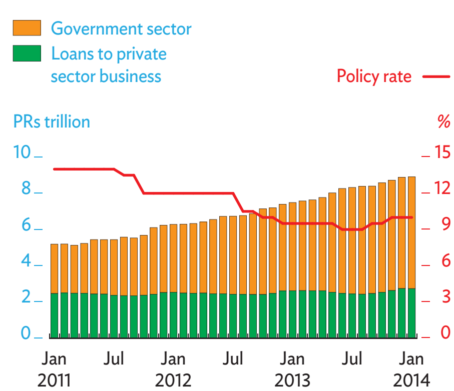
Note: Years are fiscal years, ending on 30 June of the same calendar year.
Source: CEIC Data Company (accessed 6 March 2014).

3.20.4 Current revenue and expenditure



Note: Years are fiscal years, ending on 30 June of the same calendar year.
Source: Pakistan Economic Survey 2012–13; Pakistan Fiscal operations 2011–12 www.finance.gov.pk

3.20.5 Banking sector credit



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 14 February 2014).

Economic prospects

GDP growth is projected at 3.4% for FY2014, marginally slower than in FY2013. Agriculture is expected to be weaker due to a drop in cotton output, which partly offset the improvement in sugarcane and rice crops. Ongoing rains, however, may benefit the upcoming wheat crop, despite a reduction in the sowing area this year.

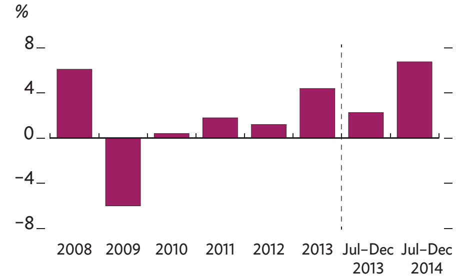
Weak agriculture will be partly compensated by the pickup in large-scale manufacturing, which grew by 6.7% during the first 6 months of FY2014, three times the rate during the same period a year earlier (Figure 3.20.6). Larger and more reliable power supply, partly reflecting better controls on unscheduled load shedding, as well as increasing use of alternative fuels is helping to revive the production of food, fertilizers, chemicals, electronics, and leather products, while petroleum refinery output continued its robust growth. Textiles are expected to recover from existing weak growth as they benefit from Generalized Scheme of Preferences Plus status granted by the European Union from January 2014. Improved manufacturing performance will spur retail and trade activity. Performance in transport and communication will, however, continue to be affected by financial losses incurred by Pakistan Railways and Pakistan International Airlines.

On the demand side, private consumption will remain the main driver of economic growth, supported by the sustained inflow of remittances, low real interest rates, and better credit availability at banks. Government spending will be contained by fiscal consolidation to bring down the budget deficit, but accelerated credit flows to the private sector during the first 7 months of FY2014 indicate an uptick in private investment. Net exports are expected to be modestly negative as import growth quickens to support improved capacity utilization in manufacturing. GDP growth is expected to be higher in FY2015, at 3.9%, as the impact of fiscal consolidation eases somewhat, energy supplies improve, and the global economy strengthens.

In the first 8 months of FY2014, inflation averaged 8.6%, reflecting the increase in the general sales tax rate by 1 percentage point to 17%, increases in power tariffs in August and October 2013 for commercial and bulk residential and industrial users, and significant currency depreciation against the major currencies. Reflecting short supply of perishable items and higher wheat prices, food inflation rose to 13.0% in November 2013 before receding to 7.2% in January 2014 for an average of 9.3% over the 8 months (Figure 3.20.7). Core inflation was relatively stable and averaged 8.4% during the period. Further adjustments to electric and gas tariffs, as well as a levy to support gas infrastructure development, are expected to keep inflation elevated over the forecast period. Average consumer price inflation is projected at 9.0% in FY2014 and 9.2% in FY2015.

Monetary policy was tightened in response to a depreciating currency and rising inflation during the first half of the FY2014. The SBP raised the policy interest rate by 50 basis points in September 2013 and again in November, bringing it up to 10% from 9% in FY2013 (Figure 3.20.8). While inflation eased in January 2014, the SBP kept the policy rate unchanged in its monetary policy meeting that month.

3.20.6 Large-scale manufacturing



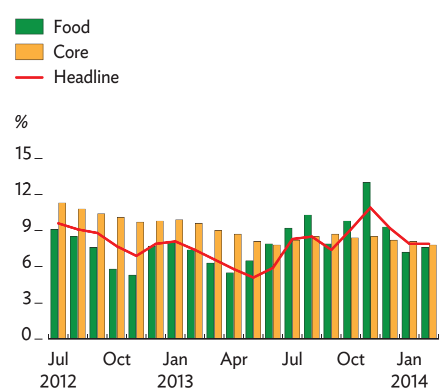
Note: Years are fiscal years, ending on 30 June of the same calendar year.
Source: State Bank of Pakistan.

3.20.1 Selected economic indicators (%)

	2014	2015
GDP growth	3.4	3.9
Inflation	9.0	9.2
Current account balance (share of GDP)	–1.4	–1.3

Source: ADB estimates.

3.20.7 Inflation



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 12 March 2014).

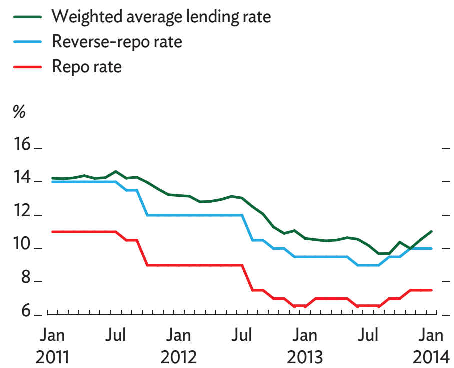
Monetary management continues to be challenged by high government borrowing from the banking system in FY2014. As a result, the end-December International Monetary Fund (IMF) ceiling for government borrowing from SBP was breached. As foreign inflows remained negligible, and commercial banks lacked interest in government securities because short-term money market rates had risen more quickly than the policy rate, the burden of borrowing once again shifted from commercial banks to the SBP. During 1 July 2013 to 21 February 2014, government borrowing from the SBP increased to PRs890 billion, against net retirement of PRs184 billion to commercial banks. Credit to the private sector picked up to PRs280 billion during this period from PRs107 billion a year earlier, largely reflecting credit to private businesses for fixed investment and working capital as business activity in textiles, power, and trade improved, as well as for consumer credit. Weighted average bank lending rates have been relatively stable at just over 10%. Broad money growth slowed to 4.9% during this period from 7.5% in the previous year, as the marked contraction in the banking system's net foreign assets reflected a deteriorating overall balance of payments.

The fiscal framework under the 3-year extended fund facility agreed in September 2013 with the IMF focuses on strengthening the revenue base, limiting power subsidies, ending the drain on the budget from loss-making state-owned enterprises, and compressing non-salary expenditure. With the framework, the budget deficit is expected to be held to 5.8% of GDP (excluding grants) in FY2014, which is somewhat lower than the original budget target of 6.3% (Figure 3.20.9). The fiscal deficit was contained at 2.1% of GDP during the first half of the FY2014 mainly by higher sales tax and nontax revenues from CSF receipts ($322 million), as well as by containing expenditure. The increase in tax revenues partly reflects measures already taken under the federal budget for FY2014, including raising the general sales tax rate and eliminating some tax exemptions. Tax collection of PRs1.031 trillion during first 6 months is broadly consistent with the fiscal framework target of PRs2.3 trillion for FY2014.

Consolidated expenditure for the first half of FY2014 was contained partly by reduced interest payments following the earlier clearance of accumulated power sector arrears—the circular debt. Interest payments are likely to be high in second half of FY2014 as domestic borrowing finances the deficit. In addition, the risk of a rebuild of circular debt in FY2014 remains high. Public sector development spending was subdued (PRs243 billion) in the first 6 months of FY2014 and is likely to remain so to contain the budget deficit due to high current expenditures. This will have negative implications for long-term investment and growth.

While the government's commitment to severely limit energy subsidies is underscored by various initial measures, such efforts need to be more comprehensive. Apart from further price adjustments, substantial governance reforms to reduce theft and losses in transmission and distribution are needed. Similarly, it will be necessary over the medium term to change the energy mix through very large investments in new generation capacity. While the energy sector measures will help contain the expenditure overruns, efforts on widening the revenue base need to be accelerated.

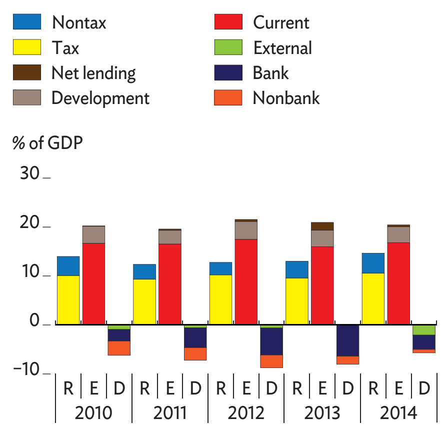
3.20.8 Interest rates



[a] On gross disbursements, the amounts disbursed by banks either in pak rupees or in foreign currency against loans during the month. It also includes loans repriced, renewed or rolled over during the month. In case of running finance the disbursed amount however means the maximum amount availed by the borrower at any point of time during the month.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 14 February 2014).

3.20.9 Fiscal performance



R = Revenue, E = Expenditure, D = Deficit financing

Notes: Years are fiscal years, ending on 30 June of the same calendar year.

Data refer to consolidated federal and provincial governments.

Net lending includes statistical discrepancy.

Nonbank includes privatization proceeds.

Sources: Ministry of Finance. *Pakistan Economic Survey 2012–13*; Pakistan Fiscal Operations July–June 2011–12; *Federal Budget 2013–14, Budget in Brief*; ADB estimates.

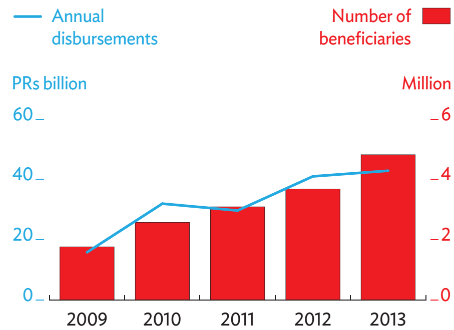
Fiscal devolution under the 18th constitutional amendment in 2011 has made consolidated budget outcomes more dependent on provincial fiscal performance. Expenditure containment envisaged under the federal budget for FY2014 called for a combined provincial budgetary cash surplus of PRs23.1 billion. Provincial fiscal operations for the first half of FY2014 indicate a consolidated cash surplus for the period, which needs to be sustained during the second half in order to meet the overall fiscal deficit target for FY2014. A slower-than-expected progress towards the issuance of 3G spectrum licenses and issues around pending proceeds from telecom privatization, raise concerns over whether these receipts will be realized during FY2014. The delays in expected CSF receipts ($878 million) could also be a challenge for the fiscal target.

To protect the poor from adverse effects of fiscal adjustments and other negative shocks, the federal government is providing cash transfers through the Benazir Income Support Program to families identified through a poverty scorecard system. The number of program beneficiaries increased to 4.8 million in FY2013 (Figure 3.20.10). The federal government budget for FY2014 plans to nearly double the allocation for the program to PRs75 billion. The program has started piloting a number of additional initiatives for beneficiaries, including health insurance, skills training, loans to develop small businesses, and primary education co-responsibility cash transfers for children.

Deficits in trade and services accounts worsened with revived imports and delays in CSF receipts, widening the current account deficit during the first 7 months of FY2014 to $2.1 billion (Figure 3.20.11). Imports grew by 4.2%, compared with negligible growth in the corresponding period a year earlier, as the textile and power industries bought machinery. Export growth also picked up to 3.3% in the first 7 months of the fiscal year, stimulated by 8% growth in textile exports, which offset the decline in exports of other manufactures and slow growth in food exports. Exports overall are expected to grow further in the remainder of the fiscal year, as benefits from the Generalized Scheme of Preferences Plus are realized. With worker remittances showing a 10.1% increase in the first 7 months of FY2014, the current account deficit is projected at 1.4% of GDP. The current account deficit for FY2015 is forecast to be marginally lower at 1.3% of GDP, as lower global commodity prices partly compensate for higher imports needed to support the modest pickup in GDP growth.

Key risks emanate from low official foreign exchange reserves as weak official inflows and high debt repayments outweighed IMF disbursement during the first half of FY2014. Net foreign direct investment inflows, at $523 million during first 7 months of FY2014, were essentially unchanged from a year earlier, and net financial account inflows totaled only $251 million, though improved from a slight deficit in the earlier period (Figure 3.20.12). Gross official reserves having plunged from $6.0 billion at the end of June 2013 to $3.1 billion in January 2014, equal to less than 1 month of imports, resurged to $3.9 billion at end February reflecting foreign inflows during this month (Figure 3.20.13). The Pakistani rupee, as a result appreciated to PRs100.3/$, following a 6.5% depreciation during the first 7 months of FY2014.

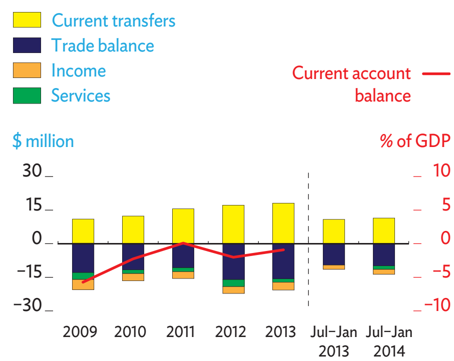
3.20.10 Social safety net



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: Ministry of Finance.

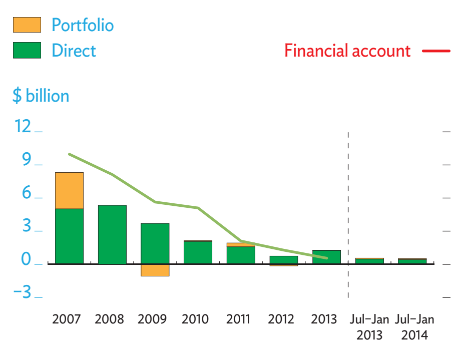
3.20.11 Current account components



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 3 March 2014).

3.20.12 FDI, portfolio, and financial account (net flows)



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 17 February 2014).

Policy challenge—achieving fiscal sustainability

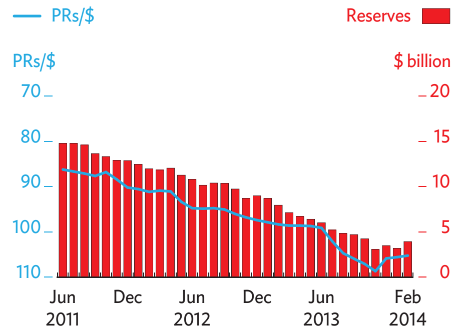
Achieving fiscal sustainability is a major recurring challenge for policy makers in Pakistan. Fiscal discipline has eroded in recent years with the persistent need to finance expanding energy sector subsidies, growing losses incurred by state-owned enterprises, and high expenditures for security.

Pakistan's (FBR collected) tax-to-GDP ratio stood at 8.5% in FY2013, which is one of the lowest in the region and reflects structural and administrative issues. As a result, spending for badly needed infrastructure has relied largely on foreign inflows. Additional spending requirements have emanated from consecutive natural disasters in the past few years, as well from the need to establish social safety nets. Higher fiscal deficits and very limited foreign inflows during the past 2 years have significantly increased short-term domestic borrowing, causing interest payments to balloon. Moreover, high government borrowing from commercial banks also contributes to low private sector credit.

The domestic portion of public debt increased sharply for the second year in a row, from 38.0% of GDP at the end of FY2012 to 41.5% in FY2013, to finance high fiscal deficits (Figure 3.20.14). Foreign debt fell by 4.6% of GDP in FY2013, mainly as IMF debt was repaid. Total public debt (including external liabilities) at the end of FY2013 amounted to 63.3% of GDP, exceeding the legal limit of 60% set under the Fiscal Responsibility Debt Limitation Act, 2005. Although a generally favorable negative differential between real interest rates and GDP growth has eroded the real value of government debt, growth in the primary deficit would endanger debt sustainability.

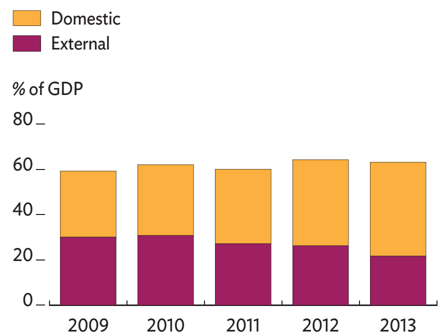
The federal government is implementing its fiscal framework under the IMF's 3-year program. Immediate measures affecting the federal budget for FY2014 pertain to raising the general sales tax rate and certain power tariffs to contain subsidies. Structural reforms to widen the revenue base are, however, critical for restoring fiscal sustainability. These include improving tax administration, eliminating exemptions to certain sectors, and bringing all sectors including agriculture under the tax net. Efforts would be required from federal and provincial governments alike, as some taxes (notably on agriculture) fall under provincial administration and reforms would help enhance their own revenues. Currently, over 90% of provincial revenues are transfers of federal shared taxes. As provinces have assumed a greater share of federal resources and spending responsibilities through devolution, their fiscal performance has become even more important in relation to the national fiscal outcomes. For instance, collecting sales tax on services is now a provincial government responsibility, and most social sector responsibilities have been transferred to provinces. Clearly, the allocation of 57.7% of the national shared tax base to provinces determined under the 2010 National Finance Commission award requires greater fiscal prudence and discipline on the part of the provinces. A mechanism to ensure provincial fiscal discipline is likely to be a crucial consideration in upcoming discussions for the 2015 award.

3.20.13 Foreign reserves and exchange rate



Sources: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 2 September 2013); CEIC Data Company (accessed 6 March 2014).

3.20.14 Domestic and external debt



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 17 February 2014).

Sri Lanka

Growth rebounded last year from a slowdown in 2012, and the current account deficit narrowed substantially. As inflation eased, the central bank relaxed monetary policy. The outlook is for sustained rapid growth leveraging easy private access to credit and the government's continued drive to expand infrastructure. An improving external environment will lift trade, but the current account deficit will expand on higher imports. Fiscal consolidation will focus on revenue enhancement.

Economic performance

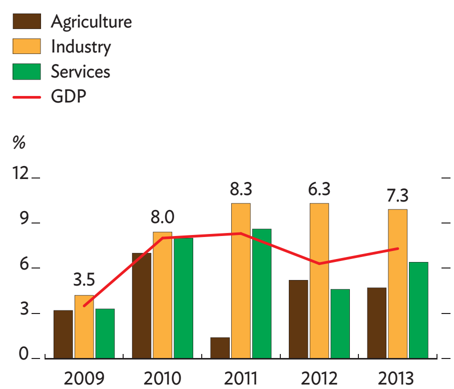
GDP growth rebounded to 7.3% in 2013 (Figure 3.21.1). The recovery reflected domestic demand strengthening and a pickup in exports and tourism. Faster growth in wholesale and retail trade, hotels and restaurants, transport, banking, insurance and real estate lifted performance in the large service sector to 6.4% from 4.6% a year earlier, providing the impetus for the rebound. Industry grew by 9.9%, slightly less than a year earlier, as slower growth in mining and quarrying and in construction offset a pickup in manufacturing and utilities. Favorable weather helped maintain agriculture growth at a relatively favorable 4.7%.

Inflation trended downward in 2013, averaging 6.9% for the year. Food inflation was at about 12% during the first quarter, as drought late in 2012 had disrupted domestic food supplies, but then dropped markedly to 0.9% in February 2014 (Figure 3.21.2). Nonfood inflation also moved lower over the year but picked up to 7.1% in January 2014 on large increases in communications and transport prices that month.

The 2013 fiscal deficit is estimated at 5.8% of GDP, in line with the target (Figure 3.21.3). The target was hit, despite unexpectedly weak revenues, by compressing current expenditure. Capital expenditure was largely maintained but was again slightly below the target of 6% of GDP. Revenue including grants is estimated at 13.8% of GDP, lower than both the budget and the 2012 performance. The shortfall in revenue partly reflected measures that curbed certain imports such as automobiles, which suppressed value-added tax (VAT) collections and import-related taxes.

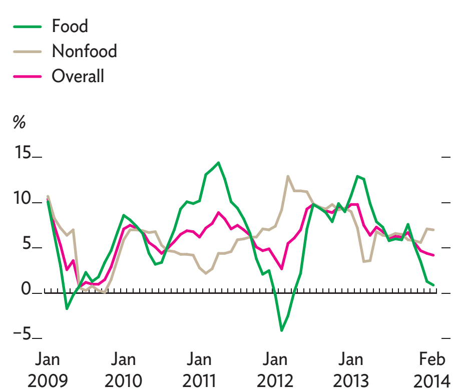
The ratio of government debt to GDP fell to 78.4% in September 2013 from 79.1% in 2012 (Figure 3.21.4). Debt composition is changing with the gradual move toward marketable and non-concessional instruments and foreign investment in government securities with the rise in income levels as a middle income country.

3.21.1 GDP growth by sector



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk/ (accessed 18 March 2014).

3.21.2 Inflation



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk (accessed 10 March 2014).

This chapter was written by Tadateru Hayashi, Nimali Hasitha Wickremasinghe, and Savindi Jayakody of the Sri Lanka Resident Mission, Asian Development Bank, Colombo.

To address weak growth evident in 2012, the Central Bank of Sri Lanka relaxed its monetary stance for 2013, which was facilitated by a declining trend in inflation during the year. The bank began its relaxation in mid-December 2012 by cutting policy rates by 25 basis points and continued in May and October 2013 with rate reductions of 50 points in each adjustment (Figure 3.21.5). Commercial bank lending interest rates declined markedly during the year from 14.3% in January 2013 to 9.9% in December. However, credit to the private sector continued to decelerate with year-on-year growth slowing to 7.5% in December 2013 from 17.6% at the end of 2012.

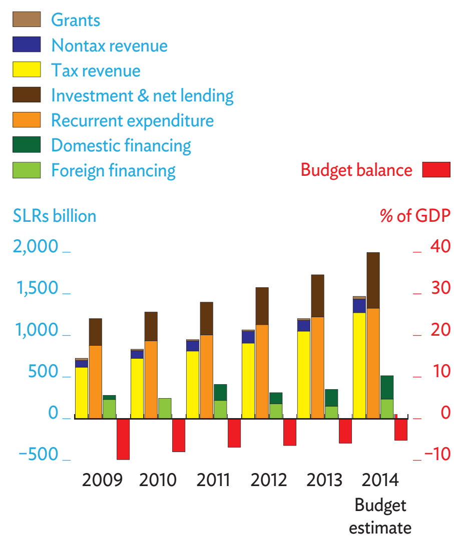
After the sharp depreciation of the Sri Lanka rupee in the early months of 2012, when the exchange rate was allowed to float, the currency has been broadly stable against the US dollar (Figure 3.21.6). Foreign investors' exit from emerging markets in mid-2013 had only a modest and temporary effect on the exchange rate. The rupee depreciated against the dollar by only 1.9% over 2013. The real effective exchange rate has risen markedly since April 2012, essentially moving back to the rate prevailing prior to the decision to let the currency float.

Exports and imports both posted positive growth only in the second half of 2013, following weakness a year earlier. Export earnings increased by 6.3% for the year to $10.4 billion, reflecting gradual recovery of demand in partner countries, with garment exports increasing by 13.0% and agricultural exports, mostly tea, advancing by 10.7%. Imports, on the other hand, declined by 6.2% during 2013 to $18.0 billion, as a result of less demand for oil, policy measures adopted in 2012 to rationalize imports, and subdued commodity prices in international markets. Most of the fall was due to reduced imports of transport equipment by 32.7% and fuel by 14.7%. The trade deficit fell to 11.4% of GDP, a marked decline of 4.4 percentage points from 2012.

The tourism boom continued in 2013 with the number of visitors growing by 27% to reach 1.2 million and earnings expanding by 35% to $1.4 billion. Tourist arrivals from the People's Republic of China and the Russian Federation increased significantly, but Western Europe continued to be a large source of visitors. Workers' remittances expanded by 13% to $6.8 billion in 2013. The main factors boosting remittance inflows were increased labor migration under the professional and skilled category, the expansion of formal channels for remitting money, and the introduction of a swift web-based money-transfer system. These earnings held the current account deficit to an estimated $1.4 billion, which is an estimated 2.0% of GDP and a marked improvement on the 6.6% deficit seen a year earlier (Figure 3.21.7).

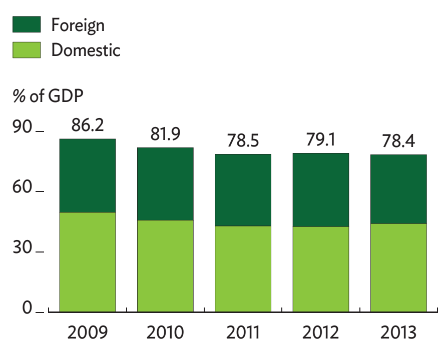
Portfolio investments recorded a net inflow of $269.9 million for the year, of which about half went into the Colombo Stock Exchange in the form of secondary market transactions. Foreigners' monthly net purchases on the exchange were broadly stable throughout the year. Foreign direct investment increased by 42% to $870.1 million in the first 9 months of 2013 from the corresponding period in 2012. Financial account net inflows brought the balance of payments surplus to an estimated $700 million. Consequently, Sri Lanka's gross official reserves increased to $7.2 billion in December 2013, equal to 4.5 months of imports (Figure 3.21.8).

3.21.3 Fiscal indicators



Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. 2013. *Budget Speech 2014.* http://www.treasury.gov.lk

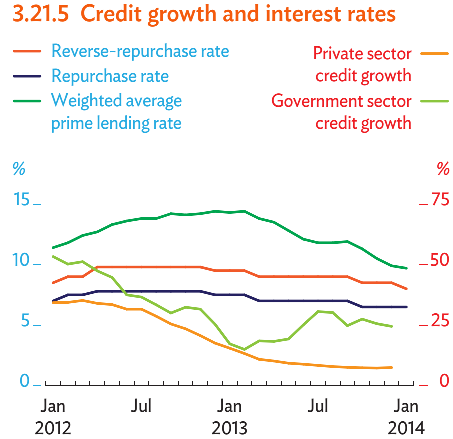
3.21.4 Government debt



Note: Data for 2013 is up to end of September.

Source: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* http://www.cbsl.lk

3.21.5 Credit growth and interest rates



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators.* http://www.cbsl.lk (accessed 18 March 2014).

Economic prospects

An improving external environment, higher investments, and a recovery in domestic consumption will sustain a rapid pace of GDP growth in the next 2 years. The recent relaxation in monetary policy will allow more lending to the private sector and provide an impetus for expansion. Sri Lanka's post-conflict growth has been buoyed by construction, which has increased its share of GDP from 6.6% in 2009 to 8.1% in 2012, and by transport and telecommunications, its share up from 12.8% to 14.3% in the same period. The government's focus on infrastructure and post-conflict reconstruction and development has supported this expansion and will continue to drive growth in the medium term. The expansion in tourism and related construction has been noteworthy and is reflected in hotel and restaurant expansion, though modest scale limits the contribution to growth. As tourist numbers continue to rise rapidly and large hotel projects in the pipeline open their doors, economic growth and foreign exchange earnings from tourism will continue to be buoyant over the next several years.

On the demand side, the investment ratio improved from 28% in 2010 to 31% in 2013. This gradual gain reflects the government's infrastructure drive and the expansion in construction. Monetary policy relaxation will start to take effect on private sector credit around mid-2014 and continue in 2015, facilitating private investment. Moreover, foreign direct investment is expected to continue to expand as the economy strengthens and the investment climate improves. Exports, having recovered since mid-2013, will continue to expand. With these factors pushing up income, private consumption will pick up after slowing in 2013 and contribute significantly to higher growth. Growth is thus expected to accelerate to 7.5% in 2014 and maintain that rate in 2015.

While high inflation has been a problem in the past, it has been contained below 10% since 2009. Inflation is expected to remain in the middle single digits in 2014 and 2015. Broadly stable international fuel and food prices will help to keep inflation in check over the next 2 years, assuming normal weather. While high inflation in the past has been attributed to government's borrowing from banks, among other things, improved fiscal discipline and a falling fiscal deficit have eased such inflationary pressures in recent years.

As the pace of economic growth picks up, the central bank will use monetary policy to keep inflation acceptable. In January 2014 the bank compressed the policy rate corridor, now renamed the standing rate corridor, to reduce variability in the transmission of its policy intentions, and then continued with monetary easing. The standing lending facility rate (the upper band) was cut by 50 basis points to 8.0%, narrowing the corridor to 150 basis points from 200. Credit to the private sector, which decelerated throughout 2013, will expand in 2014 by 16%, according to central bank projections. However, broad money is expected to grow at a slower pace as credit demand from the public sector will decline. Average inflation in 2014 is expected to fall to 5.0% from 6.9% in 2013, then accelerates slightly to 6.0% in 2015.

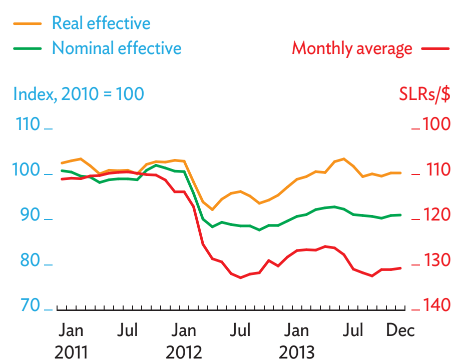
The fiscal deficit steadily shrank to 5.8% of GDP in 2013 from a peak of 9.9% in 2009. The government has deployed both revenue measures

3.21.1 Selected economic indicators (%)

	2014	2015
GDP growth	7.5	7.5
Inflation	5.0	6.0
Current account balance (share of GDP)	–2.6	–3.5

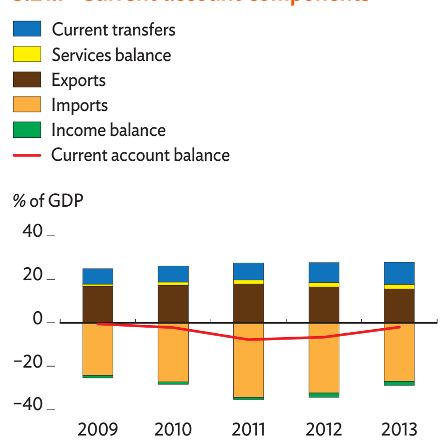
Source: ADB estimates.

3.21.6 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 18 March 2014).

3.21.7 Current account components



Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012*; Central Bank Press Release. http://www.cbsl.lk; ADB estimates.

and expenditure reduction to narrow the deficit. However, the revenue ratio—tax collections as a percentage of GDP—has not picked up as expected, so deficit reduction has been achieved mainly by rationalizing expenditure. The government expects the deficit to narrow further over the medium term. The 2014 budget estimates the deficit at 5.2%, with a higher revenue ratio and expansive 16% growth in expenditure. Better economic performance and more imports will catalyze higher revenue collection in 2014 and 2015, but continued policy action is also needed, together with improved revenue administration, to achieve a higher revenue ratio. Some measures are being introduced through the 2014 budget to broaden the revenue base, such as expanding the nation building tax (NBT) to the financial sector and lowering the VAT threshold for retail and wholesale trade. The NBT is an indirect tax that has been levied since 2009 to help finance rehabilitation of conflict damage; it is passed on in the sales price of goods or services sold.

One risk to achieving the targeted revenue ratio is that the measures to expand the revenue base may take effect more slowly than anticipated. If revenue collection is lower than anticipated, the capital budget will be hard pressed to meet its target of 6%–7% of GDP, as expenditure rationalization is already substantial in the 2014 budget and 2015 projections.

Exports are expected to strengthen with better economic performance in the EU and the US, Sri Lanka's main export destinations. After declining in 2013, imports will pick up in 2014 as domestic demand normalizes. However, policy measures taken to limit food imports to support local production will affect imports in the medium term. Measures that helped improve remittances will continue to bolster such inflows in 2014 and 2015. The current account deficit is projected to widen from an estimated 2.0% in 2013 to 2.6% in 2014 and 3.5% in the following year (Figure 3.21.9).

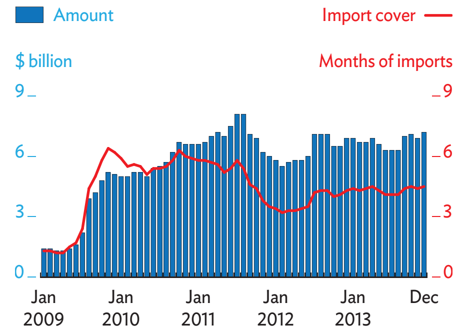
Policy challenge—boosting fiscal revenues

Sri Lanka has been focusing on fiscal consolidation and taking many steps in recent years to improve revenue collection. However, the revenue ratio (excluding grants) remains low, at 13.6% of GDP in 2013 (Figure 3.21.10). In fact, it has fallen over the past few years, underperforming its target each year. As the government continues its fiscal consolidation, reversing the revenue ratio's declining trend is critical.

The main cause for the erosion of the revenue ratio has been the VAT, which accounts for 25% of tax revenue. VAT revenue has declined from 5.8% of GDP in 2004 to 2.7% of GDP in 2012 (Figure 3.21.11).

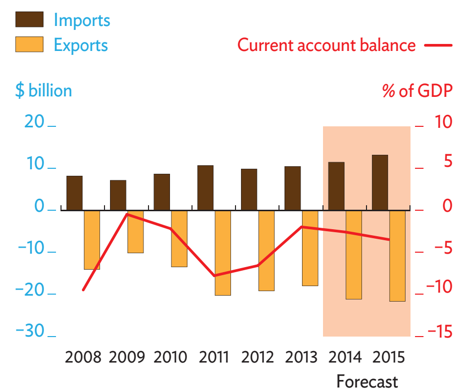
The VAT was introduced in 2002, replacing the goods and services tax with rates of 0%, 10%, and 20%. There are many exemptions: food such as rice, wheat, tea, and domestically produced sugar; machinery, including that for agriculture and construction; and other items such as crude oil, diesel, kerosene, liquefied petroleum gas, electricity, and public transportation. Many amendments to the VAT Act have taken place since 2002, mainly to improve collection. However, VAT collection has relentlessly declined, affected by exemptions, the unification of the rate at 12% in 2011, and the poor performance of imports since 2009.

3.21.8 Gross official reserves



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators.* http://www.cbsl.gov.lk (accessed 18 March 2014).

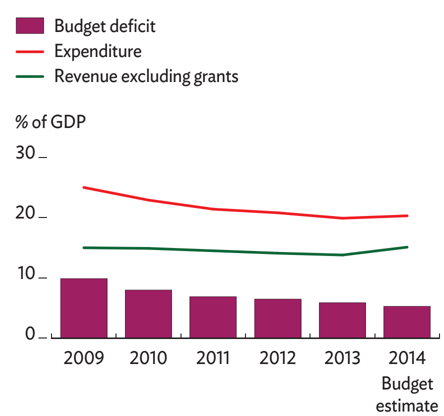
3.21.9 Current account indicators



Note: 2013 values are estimates.

Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* Central Bank Press Release. http://www.cbsl.lk; ADB estimates.

3.21.10 Government finance



Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. 2013. *Budget Speech 2014.* http://www.treasury.gov.lk

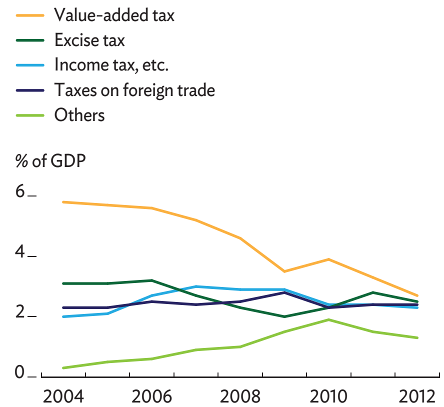
In the context of faster growth reached in the post-conflict years and increased income per capita, the low revenue ratio implies that revenue generation has not kept pace with the rising capacity of the population to pay. Average tax buoyancy—how well revenue mobilization tracks GDP growth—has hovered for the past 5 years at 0.78, which is significantly below unity. This indicates that tax collection has been unresponsive to the pace of economic expansion.

A study released in 2013 by the International Monetary Fund entitled Understanding Countries' Tax Effort estimates Sri Lanka's tax capacity at 21.9% of GDP, one of the lowest in South Asia. This suggests that strengthening institutions and improving administration can increase tax capacity. With regard to efforts at fiscal consolidation, so far the reduction in the deficit has come about mainly by rationalizing expenditure. However, improving the revenue ratio is key to reining in the fiscal deficit to a sustainable level and ensuring that public investment is not curtailed. As interest payments are a large drain on Sri Lanka's budget, higher revenue collection will contribute to lowering the borrowing requirement and future borrowing costs to the government.

The government recognizes the importance of improving the revenue ratio and has set up a tax reform committee. The committee submitted reform recommendations in 2009 that began to be introduced through the 2010 budget. The major tax reform in 2011 reduced rates as it sought to broaden the tax base. Many rationalization measures were introduced, including simplifying the economic service charge (a tax withholding system) and lowering the tax slabs of the personal income tax. In 2013, the government expanded the VAT base by bringing in the retail trade, which had been exempt. The 2014 budget introduced further measures to expand coverage and lower the threshold for certain taxes, such as expanding the nation building tax to the financial sector and lowering the VAT threshold for the retail and wholesale trades.

The government has brought the Board of Investment under the Inland Revenue Act in an effort to limit exemptions and tax holidays provided to new companies that apply for incentives. Many existing concessions are ending in the near future, which will broaden the tax base. The government expects the reforms introduced in recent years to contribute to a higher revenue ratio in 2014. It is currently implementing in the Inland Revenue Department the new Revenue Administration Information System to make revenue collection more efficient.

3.21.11 GDP share of tax revenue



Source: Central Bank of Sri Lanka. *Economic Statistics 2013.* http://www.cbsl.lk

SOUTHEAST ASIA

Brunei Darussalam

Cambodia

Indonesia

Lao People's Democratic Republic

Malaysia

Myanmar

Philippines

Singapore

Thailand

Viet Nam

Brunei Darussalam

Weakness in the oil and gas sector continued to weigh on economic growth in 2013. Services, construction, and manufacturing expanded, helping to broaden the base of this hydrocarbon-dependent economy. Inflation remained low, and the current account surplus high. Modest economic growth and low inflation are forecast for this year and next.

Economic performance

The latest official data, covering January–September 2013, show GDP declining by 0.4% from the same period in 2012. GDP for the full year declined by an estimated 1.4% due to contraction in the oil and gas sector (Figure 3.22.1).

The oil and gas sector contracted by 3.7% in January–September from the year-earlier period (Figure 3.22.2). The production of crude oil and condensate fell to 134,460 barrels a day in the second quarter from 154,240 in 2012. Since 2006, daily oil output has declined by nearly 40% due to managed production, maintenance of production facilities, and depletion of oil fields (Figure 3.22.3). The production of liquefied natural gas (LNG) fell to 992 billion British thermal units a day in the second quarter from 1,254 billion in 2012.

The rest of the economy, comprising mainly services, construction, and manufacturing, expanded by 2.5% in January–September and by an estimated 3.6% for the year. Services drove most of this growth last year, with construction and manufacturing also contributing. Output from the small agriculture, forestry, and fisheries sector declined.

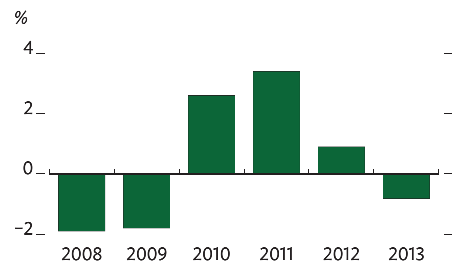
In a positive sign for private sector development, the privately owned part of the economy outside the oil and gas sector expanded by slightly over 3% in January–September, compared with growth of less than 1% for the public sector.

From the demand side, private consumption grew in January–September last year, but at a slower pace than a year earlier. Government consumption spending was flat, and the weakness in oil and gas production eroded net exports. However, growth in fixed investment accelerated from 2012.

Merchandise exports, mainly crude oil, LNG, and methanol, fell by 11.9% to $11.4 billion in 2013 (Figure 3.22.4). Imports, which provide most of the country's food, consumer goods, and capital goods, rose by 1.2% to $3.6 billion. A still-substantial trade surplus of $7.8 billion generated a current account surplus estimated at 43% of GDP. International reserves rose to $3.4 billion, cover for 9.9 months of imports of goods.

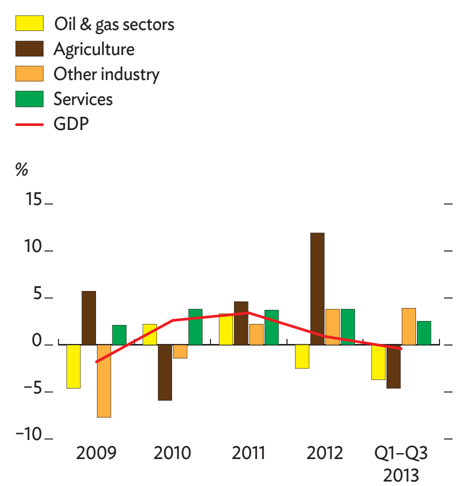
A reweighting of the consumer price index last year to take into account changes in spending patterns, based on a household expenditure

3.22.1 GDP growth



Sources: *Asian Development Outlook* database; ADB estimates.

3.22.2 GDP growth by sector



Sources: Department of Economic Planning and Development; CEIC Data Company (accessed 14 March 2014).

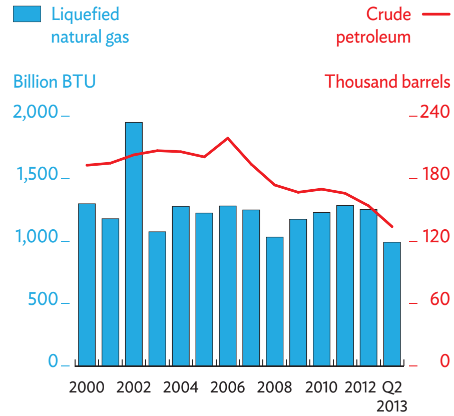
This chapter was written by Mohammed Parvez Imdad of the Southeast Asia Department, Asian Development Bank, Manila.

survey in 2010–2011, put average inflation at 0.4% in 2013, compared with revised inflation of 0.1% in the 2 previous years. Higher costs for automobiles and their maintenance largely accounted the increase last year. Price controls and government subsidies on many goods and services keep inflation low.

Income from hydrocarbons through taxes, dividends, and royalties provides the government with revenue to fund a relatively large public sector and to invest in infrastructure and subsidize consumer goods and services. In FY2012 (ended 31 March 2013 and applicable only to government finances), revenue fell by 9.0%. Government spending rose by 4.2%, which still left a large fiscal surplus equal to 20.2% of GDP. Reflecting the weakness in oil production, revenue fell a further 10.4% in the first half of FY2013 and the fiscal surplus for that period fell by 43.4%.

The Brunei dollar, which is pegged at par to the Singapore dollar through a currency board arrangement, depreciated by 3.6% against the US dollar during 2013. In March 2013, the monetary authority introduced interest rate controls on lending and Brunei dollar deposits, which may hamper financial intermediation.

3.22.3 Average daily production



BTU = British thermal unit.

Sources: CEIC Data Company (accessed 14 March 2014); Department of Economic Planning and Development. 2013. *Brunei Economic Bulletin 2Q 2013.* http://www.depd.gov.bn/download/BEB_Q22013.pdf

Economic prospects

Modest GDP growth at 1.1%–1.2% is forecast for this year and next, based on gradual expansion in sectors outside of oil and gas and assuming some recovery in hydrocarbon production. Forecasting is hampered by uncertainty over the timing of oil and gas production from new fields and of stoppages for maintenance of wells and pipelines. The limitations of economic data and delays in their release are further constraints.

The pace of growth depends in part on the expeditious implementation of public projects under the national development plan for 2012–2017. The implementation of public projects in the past has sometimes lagged behind schedule, but additional efforts to expedite projects under the plan in the fiscal year ended 31 March 2013 meant that 96.3% of the B$1.55 billion allocated for that period was spent.

Economic growth this year and next will be supported by infrastructure construction. Projects under way or planned to start in the forecast period include the construction of a port and industrial zone at Pulau Muara Besar, development of a technology park and high-speed broadband network, construction of three major bridges, and expansion of the international airport to double its handling capacity by the end of 2014.

Site preparations are scheduled for the first phase of an oil refinery and aromatics cracker planned for Pulau Muara Besar, which is expected to involve the investment of $2.5 billion over several years from a company in the People's Republic of China. Brunei Darussalam's first petrochemical project, a $450 million methanol plant at Sungai Liang Industrial Park, has been operating since 2010. A third petrochemical project has been proposed by a Japanese company, but its timing is unclear.

In addition to petrochemicals, the government is encouraging the development of halal products, including food, cosmetics, and pharmaceuticals for export. A halal-certified pharmaceuticals

3.22.1 Selected economic indicators (%)

	2014	2015
GDP growth	1.1	1.2
Inflation	0.5	0.6
Current account balance (share of GDP)	44.0	46.0

Source: ADB estimates.

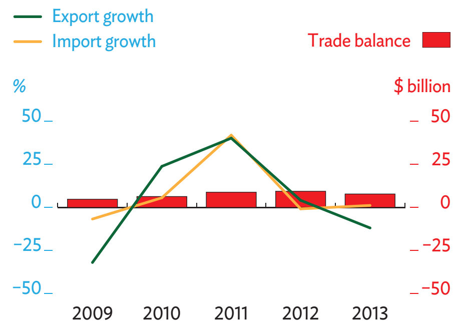
manufacturing plant—a joint venture with a Canadian company—plans to increase production. The Halal Science Center for food analysis is scheduled to open this year.

To improve financial services, the monetary authority is developing a national payment and settlement system, a credit bureau to improve lenders' asset quality, and a strategy to expand the Islamic insurance industry. The government approved last year an upgraded securities market law to support the development of capital markets.

Inflation is expected to stay below 1% through the forecast period, owing to subdued global food and fuel prices and domestic price controls and subsidies. In February 2014, the consumer price index rose by just 0.05% year on year.

Soft global oil prices will dampen merchandise exports, while construction projects will put upward pressure on imports. Still, exports of oil, LNG, and methanol will, together with income from the country's overseas investments, sustain substantial current account surpluses forecast at 44%–46% of GDP. External and fiscal surpluses provide significant buffers for the economy.

3.22.4 Merchandise trade



Source: CEIC Data Company (accessed 18 March 2014).

Policy challenge—diversifying the economy

Brunei Darussalam benefits from substantial reserves of oil and natural gas that generate one of the highest GDPs per capita in developing Asia, at $41,127 in 2012 for a population of 412,000. However, heavy reliance on this sector makes the economy vulnerable to swings in global energy demand and to the gradual depletion of hydrocarbon reserves.

Aiming to diversify the economy, the government has identified certain industries and provides incentives to attract foreign investment to develop export-oriented businesses. The industries include petrochemicals, halal products, information and communications, Islamic financial services, and aviation and oilfield support services. Incentives include the public provision of infrastructure, liberal trade and labor policies, competitively priced utilities, and tax breaks.

In this regard, the investments made and planned by foreign companies, plus gradual expansion of the domestic private sector, indicate that the strategy is enjoying some success.

Steps are being taken to redress some of the weaknesses in the investment environment. The government strengthened its patent system and stepped up efforts to enforce intellectual property rights. As a result, the US trade representative last year removed Brunei Darussalam from the US watch list of countries with inadequate protection for intellectual property rights.

Brunei Darussalam jumped 20 places to 59th of 189 economies in the World Bank's *Doing Business 2014* ranking, owing mainly to improved access to credit. However, the country's rankings in the categories of starting a business, registering property, and trading across borders fell slightly from 2013.

Cambodia

Agriculture slowed but industry and services expanded in 2013, maintaining economic growth at just above 7% for the third consecutive year. Political tensions and labor unrest suggest growth will ease in 2014 before picking up next year. Inflation, at modest rates last year, is seen edging higher in 2014. Spurring the development of small and medium-sized firms would help to sustain and diversify economic growth.

Economic performance

Robust growth in services and expanding export industries drove economic growth of 7.2% in 2013 (Figure 3.23.1).

Services remained the largest source of growth from the supply side, expanding by an estimated 8.4% in 2013. This stemmed largely from growth in wholesale and retail trading, real estate services, and tourism-related services. Bank credit to wholesale and retail trading increased by 24.5% to $2.5 billion and to real estate by 36.5% to $250.5 million. Tourist arrivals rose by 17.5% to 4.2 million (Figure 3.23.2).

Industry grew by an estimated 10.5% on strong demand for Cambodian garments and footwear in the European Union. Exports of garments and footwear to that market surged by 26% to $2.0 billion in 2013 and those to the US rose by 6.0% to $2.1 billion, according to customs data.

Construction and rice milling also contributed to industry growth. Bank credit to construction rose by 29% to $577 million, and exports of milled rice almost doubled to 366,000 tons, valued at $262 million.

Floods in September and October 2013 damaged crops and reduced growth in agriculture to 1.8% last year.

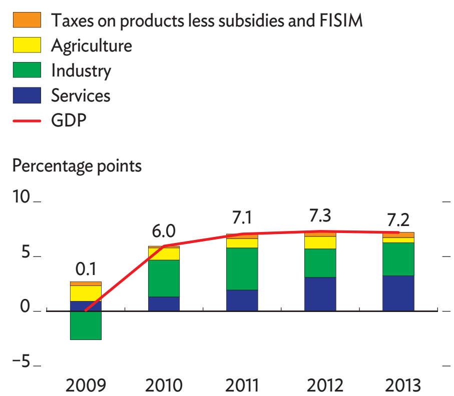
Increased private consumption, fueled by higher household incomes, contributed much of the GDP growth from the demand side. Investment also made a substantial contribution. Domestic investment remained solid, especially in small and medium-sized businesses. Inflows of net foreign direct investment (FDI) were buoyant at $1.3 billion, though that figure represented a decline from the previous year, partly a result of political tensions after Cambodia's national elections in July 2013.

Inflation picked up to 4.7% at the end of 2013, mainly because customs duty collection was tightened, which raised some import prices (Figure 3.23.3). The floods had only a modest impact on food prices. For the year, inflation averaged 2.9%, the same as 2012.

The government continued to rein in the fiscal deficit last year, to an estimated 5.0% of GDP, excluding grants. Solid domestic demand and the stronger tax collection efforts raised revenue to an estimated 14.9% of GDP, while expenditure was an estimated 19.9% of GDP. Foreign loans and grants funded the fiscal deficit.

This chapter was written by Peter Brimble of the Myanmar Resident Mission , Asian Development Bank, Yangon; and Poullang Doung of the Cambodia Resident Mission, Asian Development Bank, Phnom Penh.

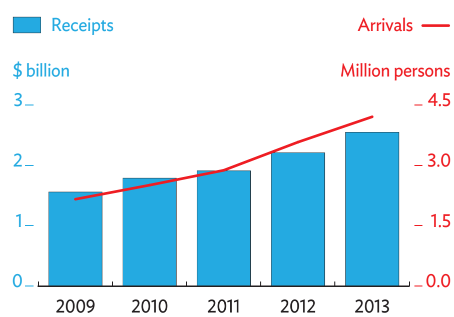
3.23.1 Supply-side contributions to growth



FISIM = financial intermediation services indirectly measured.

Sources: National Institute of Statistics; ADB estimates.

3.23.2 Tourism indicators



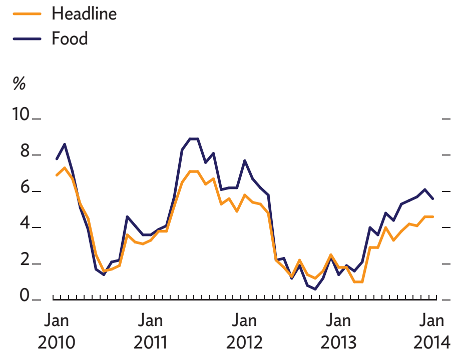
Source: Ministry of Tourism.

Credit to the private sector expanded by a rapid 26.7% (Figure 3.23.4). Total liquidity (M2), excluding foreign currency outside the banking system, rose by 14.6%. Dollarization remained high, with foreign currency deposits accounting for 82% of total liquidity. The Khmer riel was stable against the US dollar.

Buoyant demand for Cambodia's garments, footwear, and milled rice pushed up merchandise exports by an estimated 15.9% to $6.5 billion in 2013. Merchandise imports rose by an estimated 13.8% to $8.9 billion, largely imports of fabrics for the garment export industry, and imports of petroleum products. A trade deficit of $2.4 billion contributed to widening the current account deficit, excluding official transfers, to an estimated 10.8% of GDP. Some official data on past years' trade, FDI, and the current account were revised in 2013.

The current account gap was fully financed by FDI and official loans and grants. Gross official reserves edged up to $3.6 billion, covering 4.1 months of imports of goods and services.

3.23.3 Monthly inflation



Source: National Institute of Statistics. http://www.nis.gov.kh (accessed 14 March 2014).

Economic prospects

Political tensions since national elections last July, together with strikes for higher wages by garment workers, dented investor confidence and disrupted some production of garments and footwear in late 2013 and early 2014. Political uncertainty and the risk of further labor unrest suggest some dampening of investment this year. The uncertainties could weigh as well on tourism and real estate activity. Consequently, economic growth is forecast to ease to 7.0% this year before picking up to 7.3% in 2015 (Figure 3.23.5).

Garments and footwear will benefit during the next 2 years from economic recovery projected for the European Union, which grants Cambodia's exports duty-free access, and the US. These markets together buy 76% of the country's exports of garments and footwear. Industry as a whole is forecast to grow this year by 8.7% and services by 7.1%, both decelerating from 2013.

Agriculture is seen recovering from last year's floods to grow by 4.7% in 2014, assuming better weather. Crops and livestock are benefiting from an increase in the area under cultivation and by investment in irrigation.

Fiscal consolidation efforts should narrow the fiscal deficit further in 2014. Government revenue is budgeted at 15.0% of GDP, helped by measures taken to improve the efficiency of customs and tax collection. Spending is budgeted at 19.8% of GDP. The effective implementation of the revenue-raising efforts is critical to rebuild fiscal space and close monitoring of contingent liabilities will be important to safeguard fiscal space.

The tightening of customs duty collection will maintain some upward pressure on import prices into 2014. Inflation was 4.6% year on year in January 2014 but is expected to average 3.5% for the year as a whole, up from 2013. It will likely remain around 3.5% in 2015 (Figure 3.23.6).

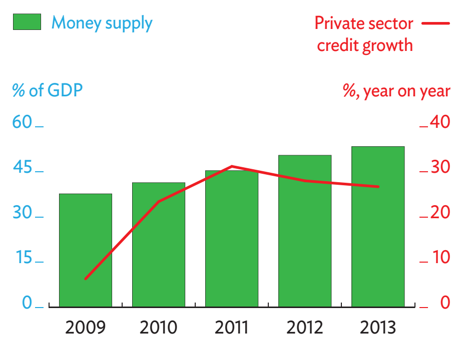
Growth in merchandise exports could be dampened by the disruptions to garment and footwear production and by downward pressure on global rice prices. Robust domestic demand will sustain growth in imports, so that the current account deficit, excluding official

3.23.1 Selected economic indicators (%)

	2014	2015
GDP growth	7.0	7.3
Inflation	3.5	3.5
Current account balance (share of GDP)	–11.3	–10.9

Source: ADB estimates.

3.23.4 Money supply and private sector credit



Source: National Bank of Cambodia.

transfers, is forecast to widen to 11.3% of GDP in 2014 before narrowing to 10.9% next year (Figure 3.23.7).

The government's development policy for 2013–2018 targets average annual economic growth at 7% and a reduction in the poverty rate by at least 1 percentage point a year. This latest policy framework heightens the emphasis on commercializing agriculture, building urban infrastructure, supporting the development of the private sector, expanding vocational training, and strengthening social protection including health and nutrition. Importantly, the government's commitment to economic reform appears to have intensified.

Policy challenge—strengthening the private sector

Cambodia's private sector has a few large, modern businesses but is dominated by informal and very small enterprises and farms. Micro enterprises, mostly wholesale and retail trading and vehicle-repair services, accounted for 97.7% of the roughly 500,000 enterprises covered by a recent economic census. Large enterprises—primarily in garments, light manufacturing, construction, tourism, and agribusiness—represented a fraction of a percent.

A weakness in the structure of the private sector is the "missing middle," as only 2.1% of enterprises fall into the category of small and medium-sized enterprises. The absence of this segment hinders development and diversification in the economy.

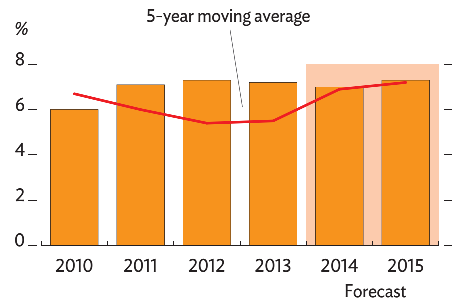
The Investment Climate Survey conducted in 2012 by international development banks showed that Cambodian enterprises ranked electricity supply as the major constraint on their growth, citing insufficient access and high price. Since then, new hydropower plants have come on line, and more will join the grid in the next few years, helping to address the shortage of power.

Other constraints, ranked in the order respondents cited them in the survey, were macroeconomic uncertainty, corruption, difficult transportation, anticompetitive practices, the high cost of finance, and deficient skills and education.

The government is addressing some of these issues, including through reforms unveiled in March 2014 to facilitate domestic and international trade and to simplify business registration procedures. More broadly, the government's development policy identifies private sector development as a core objective. It is pressing ahead with a program to support public–private partnership that will encourages the private sector to invest in infrastructure.

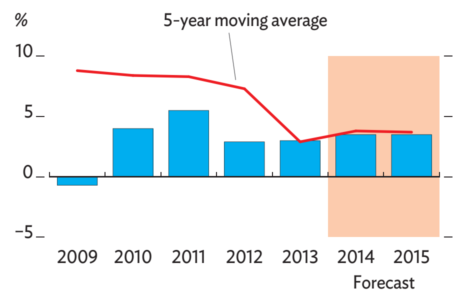
Other steps that would strengthen the private sector include developing sustainable business associations, promoting inclusive businesses and social enterprises to serve the interests of farmers and small enterprises, and supporting the incubation of new businesses. It would be helpful for the government and private sector to work together to improve competitiveness and assist integration into regional supply chains in preparation for the Association of Southeast Asian Nations Economic Community in 2015.

3.23.5 GDP growth



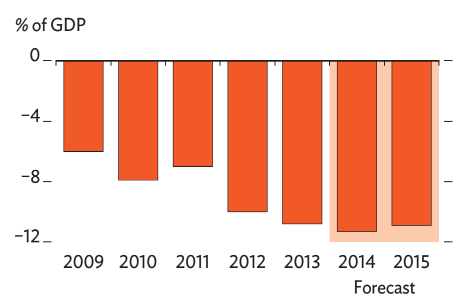
Source: *Asian Development Outlook* database.

3.23.6 Inflation



Source: *Asian Development Outlook* database.

3.23.7 Current account balance



Source: *Asian Development Outlook* database.

Indonesia

Moderating investment and sluggish external demand curtailed growth in Southeast Asia's biggest economy in 2013. The authorities took steps to dampen domestic demand after inflation spiked, the rupiah weakened, and the current account deficit widened. Growth is forecast to dip slightly in 2014 before recovering next year. Inflation is seen easing and the external position improving through the forecast period.

Economic performance

GDP growth moderated to 5.8% in 2013 from an average of 6.3% over the previous 3 years, as investment decelerated sharply (Figure 3.24.1). Bank Indonesia, the central bank, raised interest rates to restrain domestic demand at a time of rising inflation and a widening current account deficit.

Growth in fixed investment slowed to 4.7% in 2013 after strong increases of about 9% annually in 2010–2012. This largely reflected the impact higher interest rates and rupiah depreciation had on investment in machinery and equipment. Investment in buildings held up relatively well. The central government's capital spending moderated, though it still expanded by 18.4%. Gross fixed investment as a share of GDP edged down to 31.7% (Figure 3.24.2).

Private consumption remained robust in 2013, expanding by 5.3% and contributing half of the growth in GDP on the expenditure side. Consumption spending was supported by tax reductions for lower-income earners and government cash transfers to poor households in the second half of the year, which helped to counter the impact of rising inflation and tighter consumer credit.

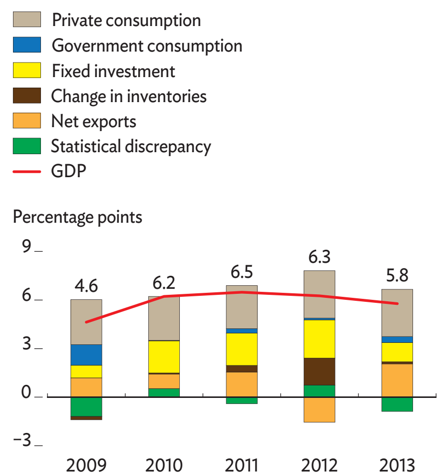
Government consumption grew by 4.9%, which signaled some improvement in budget execution. Higher net exports of goods and services made a significant contribution to GDP growth last year, despite weakness in major export markets. This improvement resulted from import restraint caused by the rupiah depreciation and slower investment, together with modest growth in export volumes.

From the production side, growth in services ebbed to 7.1%, but this sector still contributed 3.3 percentage points of total growth. Robust growth of at least 7.0% was recorded in transport, communications, finance, and hotels. Manufacturing expanded by 5.6%, little changed from the previous year, and it added 1.4 percentage points to GDP growth.

Bad weather and sagging global prices for palm oil and rubber slowed growth in agriculture to 3.5%. Mining output grew by just 1.3%, reflecting growth in coal and metals but contraction in oil and natural gas. Crude oil production fell to 826,000 barrels a day last year,

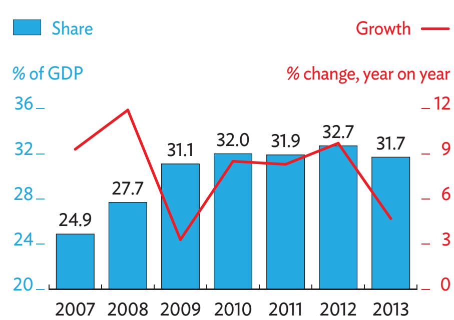
This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, Asian Development Bank, Jakarta.

3.24.1 Demand-side contributions to growth



Sources: Asian Development Outlook database; CEIC Data Company (accessed 15 March 2014).

3.24.2 Fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 15 March 2014).

about half the amount produced in 1995 because oilfields had aged and received little investment.

Inflation accelerated sharply from 3.8% at the start of 2013 to a peak of 8.2% in August, propelled by increases of 44% in the price of gasoline and 22% for diesel in June when the government cut fuel subsidies (Figure 3.24.3). Inflation was also spurred by disruptions to supplies of some foodstuffs because of bad weather and import restrictions. For the year, inflation averaged 6.4%. The statistics office rebased the consumer price index and changed the regional weightings in 2014, which lowered historical inflation. The government made cash transfers to the poor for 4 months to compensate for the rise in fuel prices.

Higher inflation and a weakening rupiah prompted the central bank to raise its policy interest rate by 175 basis points to 7.5% between June and November. The monetary authorities lifted the overnight deposit rate, also called the Fasbi rate, by 175 basis points to 5.75%.

Bank Indonesia also introduced macroprudential measures to curb credit growth, including more stringent loan-to-valuation ratios for certain mortgages and a reduction in the upper band of the loan-to-deposit ratio for banks. By December 2013, growth in credit eased to a still-robust 21.6%. Commercial banks raised lending interest rates but by much less than the policy rate hike.

Fiscal policy provided some support as the economy slowed. The fiscal deficit widened to equal 2.3% of GDP from 1.9% in 2012 (Figure 3.24.4). Government spending on social policies rose while tax revenue was eroded by declines in prices for export commodities and weaker imports.

The government secured all its funding of $27.2 billion for the budget, though it needed to raise yields on government debt and increase its issuance of securities with maturities of 1 year or less. Rupiah depreciation contributed to an increase in the ratio of national government debt to GDP to an estimated 26.1% in 2013. The average time to maturity for government debt shortened only marginally to 9.6 years from 9.7 years. However, a high 44.6% of government debt is in foreign currency.

Slower economic growth weakened the labor market. The unemployment rate rose to 6.3% in August 2013, the first such increase since 2005 (Figure 3.24.5). The economy lost 10,000 jobs in the 12 months through August, compared with employment generation of 1.2 million in the year-earlier period.

A weaker labor market and higher inflation nudged up the poverty rate to 11.5% in September 2013 from 11.4% in March 2013, an increase of 480,000 people.

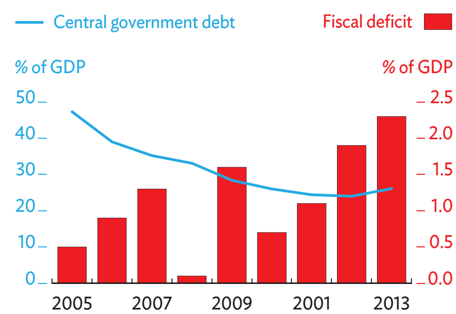
External accounts deteriorated sharply last year. Lower global prices for export commodities such as coal, copper, and palm oil reduced the value of merchandise exports by 2.6% from 2012, to $183 billion. Merchandise imports fell by 1.4% to $177.4 billion, reflecting the softening in machinery and equipment imports and the rupiah's depreciation.

Consequently, the trade surplus fell to $6.1 billion, the smallest in a decade. The smaller trade surplus, coupled with deficits in income and services, widened the current account deficit to 3.3% of GDP.

3.24.3 Inflation and policy rate

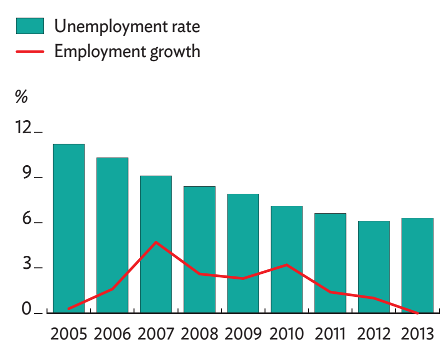
Note: Inflation is based on consumer price index (2012 = 100).
Source: CEIC Data Company (accessed 15 March 2014).

3.24.4 Fiscal indicators



Sources: Asian Development Outlook database; Indonesia Debt Management Office. http://www.dmo.or.id (accessed 15 March 2014).

3.24.5 Labor indicators



Note: Data refer to August unemployment rates.
Source: CEIC Data Company (accessed 14 March 2014).

Inflows of foreign direct investment in the balance of payments fell slightly, but at $18.4 billion they remained substantial. Despite financial market turbulence in the second half of 2013, portfolio investment recorded a net inflow of $9.8 billion for the year. A surplus in the capital and financial account was more than offset by the current account deficit, pushing the balance of payments into a deficit of $7.3 billion, the first such deficit since 2008 (Figure 3.24.6).

Gross international reserves declined by $13.4 billion to $99.4 billion over 2013, a result of the widening current account deficit and central bank actions to support the rupiah in May and June (Figure 3.24.7). Reserves at year-end represented 5.4 months of imports and government debt payments. Since late July 2013, Bank Indonesia has allowed greater flexibility in the rupiah's exchange rate to help correct the external imbalance.

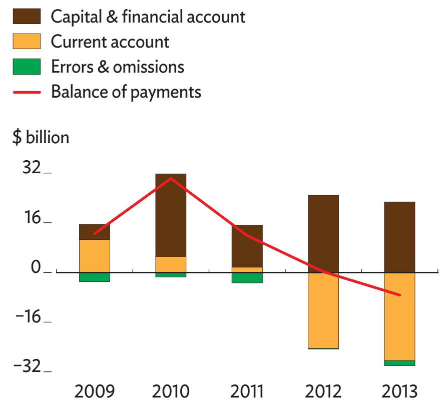
High inflation, a widening current account deficit, and declining foreign reserves shook financial markets. The Jakarta Stock Exchange index of share prices dropped by 15.5% from May to December, though the index closed for the year with a loss of only 1%. Yields on 5-year government bonds rose by 327 basis points, and the rupiah depreciated by 20.7% against the US dollar in 2013.

In addition to the steps to stabilize the economy, the authorities introduced a package to strengthen the supply side. To support exports, the government provided tax breaks to labor-intensive industries that export at least 30% of their production, relaxed quotas on mineral exports, and removed value-added and other taxes on imports of raw materials used in exporting industries. To reduce fuel imports, the government increased the mandatory minimum percentage of diesel that must be derived from biofuel made using domestic palm oil. To rein in other imports, it raised taxes on luxury goods from overseas.

Recognizing the need to attract investment to finance the current account deficit and support economic growth, the authorities provided tax holidays and tax allowances to investors in selected industries and simplified the application process for investment permits.

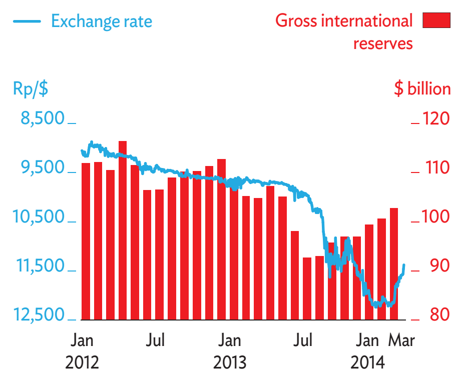
Quotas on some food imports were eliminated to ease upward pressure on food prices. To support the stock market, the Financial Sector Supervisory Authority made a temporary change that allowed companies to buy back shares without having to hold a stockholders meeting.

3.24.6 Balance of payments components



Source: CEIC Data Company (accessed 14 March 2014).

3.24.7 Gross international reserves and exchange rate



Sources: *Asian Development Outlook* database; CEIC Data Company; Bloomberg (both accessed 14 March 2014).

Economic prospects

Forecasts assume that the government follows through with the stabilization policies rolled out in the second half of 2013 and that parliamentary elections in April and presidential elections in July go smoothly. Projections also assume that steps are taken to improve the investment environment.

On this basis, GDP growth is forecast at 5.7% in 2014 picking up to 6.0% in 2015 (Figure 3.24.8).

The fiscal stance is expected to be similar to the one taken last year. The 2014 budget targets a fiscal deficit of 1.7% of GDP, but a revised budget is expected in May that could widen the deficit to 2.5% in view of

3.24.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.7	6.0
Inflation	5.7	4.8
Current account balance (share of GDP)	−2.9	−2.0

Source: ADB estimates.

unexpectedly weak tax revenue and declining oil production. Reductions in electricity subsidies are scheduled to come into effect in May.

As for monetary policy, further increases in interest rates are possible in 2014, if financial market sentiment weakens or the external position does not improve as anticipated. As the year progresses, though, a projected deceleration in inflation should stem pressure to raise interest rates.

Private consumption is expected to remain reasonably robust, assisted by election-related spending in the first half of 2014 and by easing inflation over the forecast period. While global commodity prices are anticipated to remain soft, the depreciation of the rupiah will support the incomes of commodity exporters. The cash transfers to cushion the impact of the fuel price increase in 2013 expired in December. Nevertheless, a Bank Indonesia consumer survey in January showed consumer confidence improving (Figure 3.24.9).

Growth in fixed investment in 2014 is projected to be similar to last year's pace. Uncertainties over domestic election outcomes and over the impact of the US tapering its monetary stimulus will dampen investment in the first half. Against this, continued solid growth in lending and improved international investment rankings support the outlook. Indonesia's ranking in the World Economic Forum's 2013 Global Competitiveness Index rose by 12 places to 38th out of 148 economies, reflecting in part improvements in infrastructure over recent years. In a survey of Japanese manufacturing companies conducted in 2013, Indonesia was ranked the favored investment destination.

Investment is forecast to pick up in 2015 as the newly elected government clarifies its policies and likely accelerates investment in infrastructure. Investment prospects will improve on considerably lower inflation and current account deficits projected for 2015, as well as on strengthening world trade.

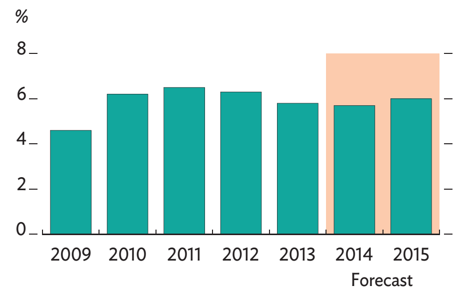
Net foreign trade is expected to contribute to GDP growth this year and next, though not as strongly as in 2013.

As a sign of how the year started for industry, the Manufacturing Purchasing Managers' Index for February 2014 indicated that conditions had improved for a sixth consecutive month but that the pace of improvement had slowed (Figure 3.24.10).

In external accounts, the stabilization policies in the second half of 2013 helped to rein in the current account deficit to 2.0% of GDP in the fourth quarter from 4.4% in the second quarter. In part this reflected the bringing forward of exports of unprocessed ores such as copper and nickel in anticipation of a scheduled ban on their export that came into effect in January 2014. This ban, aimed at impelling mining companies to add value to mineral exports, cut exports of unprocessed ores early this year. Exports of mineral ores usually account for 3.5% of total exports.

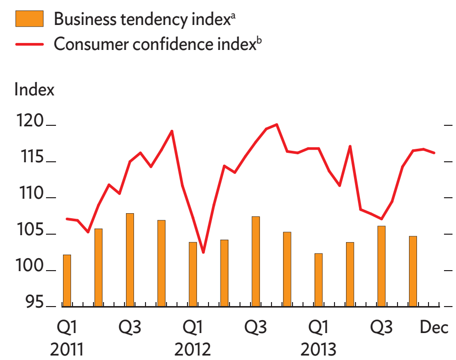
Manufactured exports improved in the fourth quarter of 2013 and are expected to benefit during 2014 from the rupiah depreciation. Total exports are forecast to rise by 4.5% in US dollar terms this year and by 6.0% in 2015, underpinned by gradual economic recovery in the US, euro area, and India. The rupiah's depreciation will restrain imports, but they are nevertheless projected to rise by 3.4% this year and 4.2% in 2015.

3.24.8 GDP growth



Source: Asian Development Outlook database.

3.24.9 Consumer and business confidence indexes



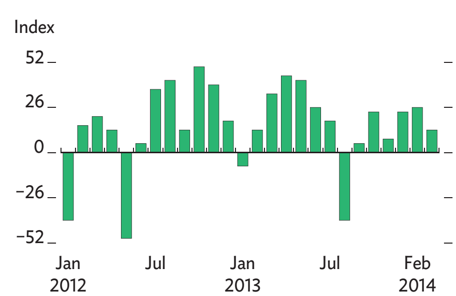
[a] From a quarterly Statistics Indonesia survey of business executives.

[b] From a monthly Bank Indonesia survey of households.

Note: A score above 100 means that respondents are optimistic and vice versa.

Source: CEIC Data Company (accessed 14 March 2014).

3.24.10 HSBC Manufacturing Purchasing Managers' Index



Source: Bloomberg (accessed 15 March 2014).

The impact of these factors, and of the other measures taken since last year to dampen imports and support exports, are expected to narrow the current account deficit to 2.9% of GDP in 2014 and 2.0% in 2015 (Figure 3.24.11). Portfolio investment inflows, which bounced back since the fourth quarter of 2013, and inward foreign direct investment also will contribute to strengthening the balance of payments.

Inflation has eased since August 2013 and is expected to moderate further as the effect of the fuel price hike subsides. In February 2014, month-on-month inflation was down to 0.3%, though the year-on-year rate was still elevated at 7.7%. The base effect of the June 2013 fuel price increase is projected to drive inflation down to average 4.2% in the second half of 2014.

The pass-through to consumer prices of last year's rupiah depreciation is expected to have a modest impact on the consumer price index. Moreover, the rupiah appreciated by 6.9% against the US dollar from the end of 2013 to mid-March 2014. Inflation this year is expected to average 5.7%. Next year, inflation is seen decelerating to an average of 4.8%, near the top of Bank Indonesia's 3.0%–5.0% target range for 2015. However, inflation would be higher if fuel prices were raised again or food supplies disrupted by bad weather.

Downside risks to this outlook center on further deterioration of export performance and changes in market sentiment that cause capital outflows. Deficits in the current account and the budget reinforce the importance of maintaining capital inflows. Gross funding to cover the fiscal gap remains sizeable at 3.8% of GDP in 2014. To manage risks the government has maintained a $5 billion contingent funding facility with development partners and increased currency swap agreements to more than $40 billion.

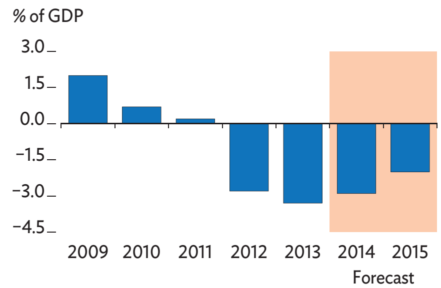
Policy challenge—the current account deficit

Financial markets were rattled by last year's sharp deterioration in the current account deficit, to the equivalent of 4.4% of GDP in the second quarter, the widest gap since the 1997 Asian financial crisis.

A major immediate cause was the slump in export earnings stemming from a downturn in prices for agricultural and mineral export commodities, as well as soft demand from major trading partners. Imports have also played a role. Over several years, robust domestic demand pushed up imports of the capital goods demanded by stronger investment, and of consumer goods for a burgeoning middle class. Imports of capital and consumer goods together climbed by an average of about 18% annually during the years from 2008 to 2012.

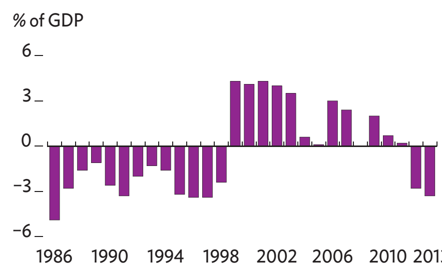
Structural factors have contributed to the problem. The current account fell into deficit in 2012, but the deterioration had started in 2003 (Figure 3.24.12). This suggests that Indonesia's export competitiveness, particularly in manufacturing, has eroded. The rupiah has appreciated in real effective terms, and labor productivity in manufacturing has fallen below rates achieved in neighboring countries (Figure 3.24.13). Further, the share of commodities in Indonesia's exports has increased, making its external accounts more vulnerable to cyclical swings in global commodity prices (Figure 3.24.14).

3.24.11 Current account balance



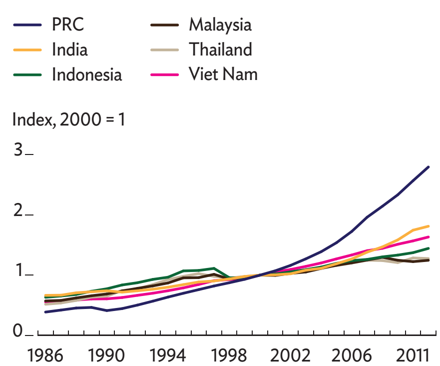
Source: Asian Development Outlook database.

3.24.12 Current account balance



Sources: ADB Statistical Database System online; *Asian Development Outlook* database.

3.24.13 Labor productivity (based on employment)



PRC = People's Republic of China.

Source: APO Productivity online database. http://www.apo-tokyo.org/about/measurement.html#apo_database (accessed 14 March 2014).

Another structural factor—a doubling in the cost of oil imports since 2005—stems from declining domestic oil production and government subsidies on fuel. The subsidies stimulate fuel consumption and discourage the development of alternative energy sources. Imports of oil products cost $40 billion in 2013.

As noted, steps taken last year to slow domestic demand, spur exports, and dampen imports started, together with the rupiah's depreciation, to rein in the current account deficit. Nevertheless, the impact may be relatively short-lived. For instance, the depreciation of the rupiah in 2008 boosted manufacturing exports for only a couple of years.

Longer-term strengthening of the current account requires structural reforms to achieve sustained gains in productivity and competitiveness. One such reform is phasing out fuel subsidies by raising fuel prices. The government took a step in this direction in 2013 and is committed to market-based pricing in the years ahead.

Further reduction in subsidies would help to curtail fuel imports and free up substantial budget funding for infrastructure and education, which would improve the country's competitiveness.

Government investment in infrastructure, including that from state enterprises, has returned to the level of 3% of GDP, last seen before the 1997 Asian financial crisis. However, private investment in infrastructure is largely missing. Faster development of infrastructure requires that the private sector participate more to complement the government's limited resources.

Continued efforts to enhance the investment climate are key to attracting a substantial and steady inflow of foreign direct investment, which not only provides financing to cover current account deficits but, over the longer term, can spur technological innovation to improve productivity and competitiveness. In this regard, proposals to open more sectors to foreign direct investment are welcome.

Indonesia needs to boost labor productivity, which in turn requires better education outcomes, stronger incentives for firms to develop the skills of their employees, and a more flexible labor market.

Overall, progress on structural reform has been uneven, as difficult policy changes are often delayed when the economy is performing well. Much could be gained if the government improved its process of formulating structural reforms and then implemented reforms in a more predictable manner.

3.24.14 Primary commodity exports

Source: United Nations COMTRADE online database (accessed 15 March 2014).

Lao People's Democratic Republic

Expansionary fiscal and monetary policies supported economic growth in 2013. They also put stability at risk as inflation accelerated, fiscal and external deficits widened, and international reserves shrank. The government responded by cancelling some fiscal expenditure, which will take a toll on GDP growth in 2014. The key to maintaining economic stability and robust economic growth is to restore a sustainable fiscal position.

Economic performance

GDP grew by 7.6% in 2013, slightly below the pace of the previous 2 years (Figure 3.25.1). Growth in services gathered momentum, but industry and agriculture slowed.

Services expanded by 9.0% last year. Robust consumer spending, backed by a very large rise in incomes for the civil service, drove increases in wholesale and retail trade, while strong growth in credit boosted financial services. A 12% increase in tourist arrivals to 3.7 million in 2013 benefited hotels, restaurants, and transportation. Double-digit growth in telecommunications stemmed from the extension of mobile phone and internet services.

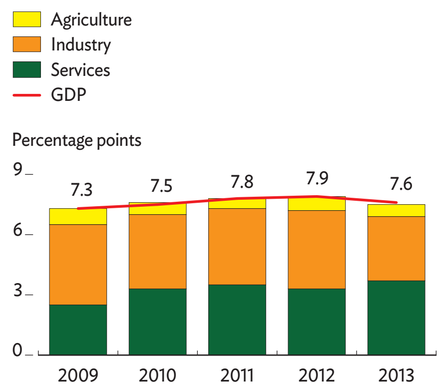
As for industry, copper production from the two main mines increased by 3.5% to 154,920 tons, slowing from the expansion rates of previous years. Growth in gold production also decelerated, with output rising by 6.6% to 219,880 ounces. Silver production jumped by 54.9% to 955,360 ounces. After 3 years of sharply rising electricity generation, the rate of increase slowed to 3.6% in 2013 (Figure 3.25.2). Several new hydropower plants were under construction. About 70% of hydropower is exported.

Construction slowed, with the completion in the previous year of public projects in the capital city and delays in 2013 on some foreign-invested property developments owing to economic slowdowns in the past 2 years in the People's Republic of China (PRC), Thailand, and Viet Nam, which provide much of the country's foreign investment. Growth in industry as a whole slowed to 7.2% in 2013.

Agriculture was hit by floods in the third quarter, but production still grew by 2.7% for the year.

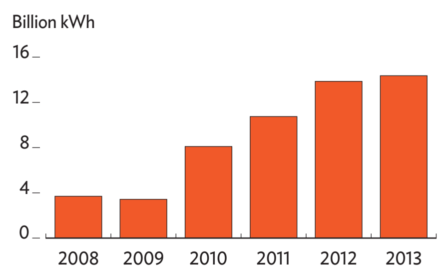
Economic growth was supported by expansionary fiscal and monetary policies. The government raised base wages for the civil service by 37% and approved large cost-of-living allowances for its employees, decisions that were estimated to double the government's wage bill in FY2013 (ended 30 September 2013). At the same time, revenue fell short of the target.

3.25.1 Supply-side contributions to growth



Sources: Lao Statistics Bureau; *Asian Development Outlook* database.

3.25.2 Electricity output



kWh = kilowatt-hour.
Source: Ministry of Energy and Mines.

This chapter was written by A. Barend Frielink and Soulinthone Leuangkhamsing of the Lao Resident Mission, Asian Development Bank, Vientiane.

These developments sharply widened the fiscal deficit (including grants but excluding off-budget spending) to an estimated 5.8% of GDP in FY2013 (Figure 3.25.3). The strain on the government's cash position became evident when it fell into arrears in payments for wages and utilities that were estimated at 2.5% of GDP.

Moving to stanch the deteriorating fiscal position, the government in October 2013 cancelled the cost-of-living allowance for the public sector and postponed a large number of public investment projects, including roads and government buildings.

On the monetary side, growth in the M2 money supply expanded by 22.7% and growth in credit was a rapid 36.1% (Figure 3.25.4). Concerned about the expansion of credit and about dwindling international reserves, the central bank in June 2013 directed commercial banks to curb lending in foreign currencies and in August it restricted sales of foreign currencies to the public.

The Lao kip started to soften against the US dollar after the central bank restricted sales of foreign currencies. However, reflecting relatively high domestic inflation, the kip has appreciated in real effective terms over recent years, hurting export competitiveness and contributing to the current account deficit.

Robust domestic demand drove up imports of both consumer goods and capital equipment last year, while weakening global commodity prices curbed growth in export earnings. A larger trade deficit contributed to a wider current account deficit, estimated at 29.5% of GDP. A deficit in the balance of payments reduced gross international reserves to $666 million, providing limited cover estimated at 1.2 months of imports of goods and services.

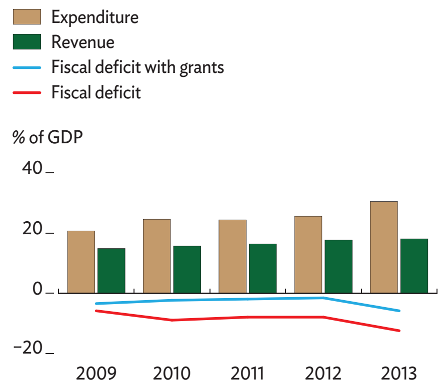
Strong consumer spending also added inflationary pressure. Higher food prices, particularly for meat and vegetables, drove inflation up to a 2013 peak of 7.4% in July (Figure 3.25.5). Year-average inflation accelerated to 6.4% in 2013 from 4.3% in 2012.

Economic prospects

Domestic demand is expected to moderate in 2014, trimming GDP growth to 7.3%. Government investment will slow as it postpones 254 public projects and cuts off-budget spending. Reduced government investment and delayed government payments to suppliers and employees will hurt business activity and confidence. Slowdowns in large and influential neighbors, the PRC and Thailand, also cloud the outlook, particularly for investment.

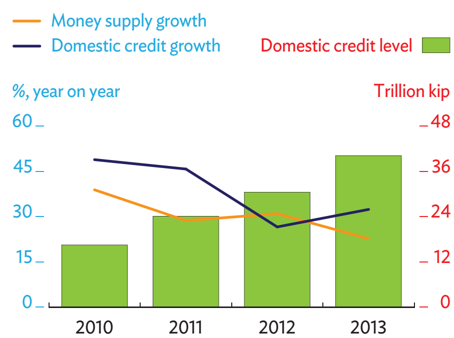
The government aims to gradually rein in its fiscal deficit through tighter controls on spending and by strengthening revenue administration. That said, the authorities have again raised wages for the civil service in FY2014 by nearly 40% and hired additional public employees. Moreover, civil service wages are scheduled to rise for a third year in FY2015. Deficit reduction is complicated as well by arrears carried forward from last year and uncertain prospects for mining revenue in light of soft global commodity prices.

3.25.3 Fiscal indicators



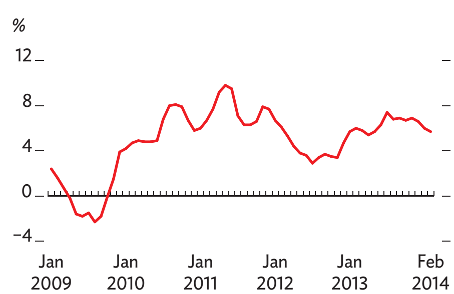
Notes: Revenue excludes grants. Years are fiscal years, ending on 30 September of the same calendar year.
Source: Ministry of Finance.

3.25.4 Monetary indicators



Note: Available data for 2013 is from January to November.
Source: Bank of Lao People's Democratic Republic.

3.25.5 Monthly inflation



Source: CEIC Data Company (accessed 17 March 2014).

Monetary policy aims to slow growth in credit and maintain restrictions on lending in foreign currencies in 2014. But the extent of fiscal and monetary tightening this year is uncertain.

Nevertheless, private consumption will remain buoyant, and foreign direct investment approvals are strong. Construction is continuing on eight new hydropower projects, including the $3.5 billion Xayaburi project, and four more plants are expected to start construction in 2014. Work is well advanced on the large Hongsa lignite coal power project, due to be finished in 2016. Several new mines are under construction.

Against this, the Sepon mine stopped gold production in December 2013 in response to lower global gold prices.

Services are likely to maintain solid growth, particularly tourism-related services, telecommunications, and wholesale and retail trade. Agriculture is projected to expand at about the same rate as last year.

Next year, GDP growth is forecast to pick up to 7.5% as more export-oriented projects come into production, Thailand recovers, and exports gain momentum with the brightening global outlook (Figure 3.25.6).

Inflation averaged 5.8% in the first 2 months of 2014 and is forecast at 5.5% for the year, down slightly from 2013. Improved supplies of meat and moderation in domestic demand are expected to ease upward pressure on prices. The kip is projected to depreciate slightly against the US dollar, which will support exports and help rebuild foreign reserves. In 2015, inflation is seen escalating as the economy picks up.

The government has started to scrutinize the import valuation of vehicles and fuel to close loopholes that have caused revenue losses. That tighter control, together with restrictions on access to foreign currencies and reduced government capital outlays, should dampen growth in imports. The large current account deficit is seen narrowing only slightly over the forecast period (Figure 3.25.7).

Policy challenge—a sustainable fiscal position

The sharp widening of the fiscal deficit last year raised serious concerns for the government, which is wrestling with persistent arrears in its payment of wages and resorting to postponing public projects and cancelling cost-of-living allowances for the civil service. Addressing the fiscal deficit in a sustainable manner is key to maintaining economic stability and future growth, even if it means accepting lower growth in the short to medium term.

The three major reasons for the large fiscal deficit have been overly optimistic revenue projections, large wage increases and allowances awarded without due regard for their impact on the country's fiscal and external positions, and development projects financed off budget. In response to the emerging fiscal crisis, the government doubled its efforts to collect revenue and cancelled or postponed some expenditure. It is also preparing a new fiscal strategy.

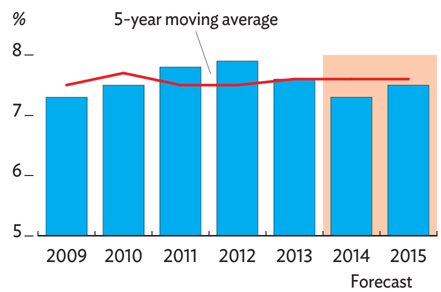
The main challenge is to reduce expenditure to drive the fiscal deficit down to a sustainable 3% of GDP. Assuming real economic growth of 7.5% and nominal growth of 13.0%, slowing expenditure growth in real terms to 2%–3% over the next 3 years would bring the budget deficit down to a sustainable level. Also, off-budget spending needs to be reined in.

3.25.1 Selected economic indicators (%)

	2014	2015
GDP growth	7.3	7.5
Inflation	5.5	6.0
Current account balance (share of GDP)	–27.4	–26.0

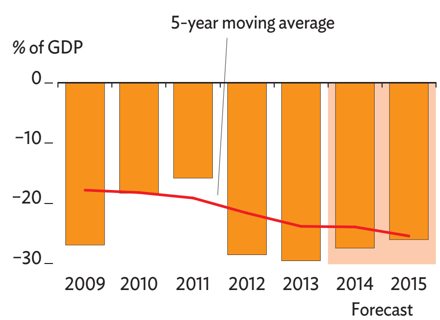
Source: ADB estimates.

3.25.6 GDP growth



Source: Asian Development Outlook database.

3.25.7 Current account balance



Source: Asian Development Outlook database.

Malaysia

Domestic demand remained buoyant in 2013, but external demand weakened. This year, stronger exports are projected to lift economic growth, even as higher inflation and fiscal tightening act to moderate domestic demand. Current account surpluses will likely rise after narrowing last year. Sharply rising household debt and housing prices pose risks for banks and for growth.

Economic performance

Buoyant domestic demand drove the economy in 2013, but weak external demand and subdued public investment constrained GDP growth to 4.7%, below the average of just over 5.0% since 2010 (Figure 3.26.1).

Private consumption rose by a vigorous 7.6%, similar to the pace in 2012, and it contributed most of GDP growth in 2013. The expansion in consumption spending was underpinned by 4.8% growth in employment, a low 3.1% unemployment rate, and average real wages that rose by an estimated 0.9% in 2013. Also, a national minimum wage came into effect in January 2013. Additional factors were widespread cash transfers from the government and increases in public sector wages, bonuses, and pensions.

Fixed capital investment grew by 8.2% in 2013, but this was less than half the rapid 19.9% pace recorded in 2012. From its high base, fixed investment made a smaller but still significant contribution to GDP growth. The ratio of fixed investment to GDP increased to 26.9%, maintaining a gradual improvement over recent years.

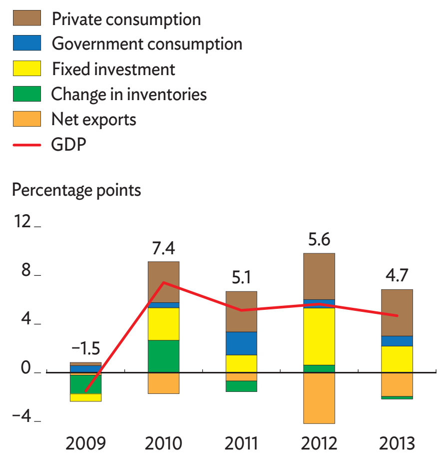
Private fixed investment decelerated to a still-strong 13.6%, focused on mining, services, and manufacturing. Meanwhile, the government cut growth in public fixed investment to just 0.7% from 17.1% a year earlier (Figure 3.26.2). This largely reflected government reductions in development outlays.

Government consumption spending rose by 6.3% in 2013, an election year, and made a small contribution to GDP growth. By contrast, net exports contracted, which dragged on growth. Import volumes of goods and services rose slightly, spurred by the robust domestic demand, while export volumes fell, reflecting slack external demand.

From the production perspective, services grew by 5.9% and contributed nearly 70% of the increase in GDP on strong expansion in communications, real estate and business services, government services, and wholesale and retail trade. Growth in finance and insurance slowed sharply, however.

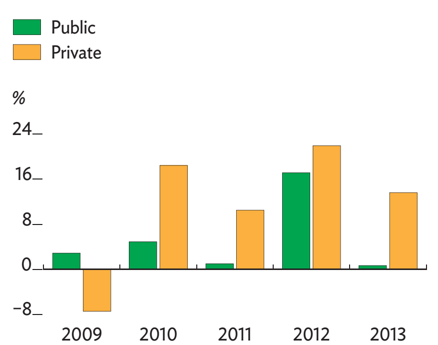
This chapter was written by Gary Krishnan of the Southeast Asia Department, Asian Development Bank, Manila.

3.26.1 Demand-side contributions to growth



Sources: Department of Statistics Malaysia. http://statistics.gov.my; CEIC Data Company (both accessed 2 March 2014).

3.26.2 Fixed investment growth



Source: CEIC Data Company (accessed 21 March 2014).

Manufacturing grew by 3.4%, the slowest pace in 4 years, in large part reflecting lackluster demand for exports of goods such as electronics and electrical products. Construction expanded by a buoyant 10.9%, though this too represented an easing of growth from 2012. Civil engineering in particular moderated as major projects were completed, including the Second Penang Bridge, Sabah–Sarawak gas pipeline, and Sabah oil and gas terminal.

Crude oil production fell last year as maintenance idled production facilities, but natural gas output rose. Growth in agriculture picked up to 2.1% with palm oil recovering and growth in food production strengthening. Producers of natural rubber reduced tapping, though, when global rubber prices fell.

Fiscal policy was less stimulatory in 2013 as the government started to address its fiscal deficit, which exceeded 4% of GDP every year from 2008 to 2012. Fitch lowered its credit rating outlook on Malaysia from stable to negative in July 2013, citing its budget deficit, declining current account surplus, and rising household debt.

The task of curbing the fiscal deficit was complicated by the decline in prices for export commodities and oil, which held growth in government revenue to 2.6%. The government cut development expenditure by 8.2%, slowed growth in operating expenditure to 2.8%, and trimmed some subsidies. Further, it decided to stretch the construction of certain public projects out to relieve the strain on fiscal and external accounts alike. By year-end, the fiscal deficit had narrowed to 3.9% of GDP from 4.5% in 2012 (Figure 3.26.3).

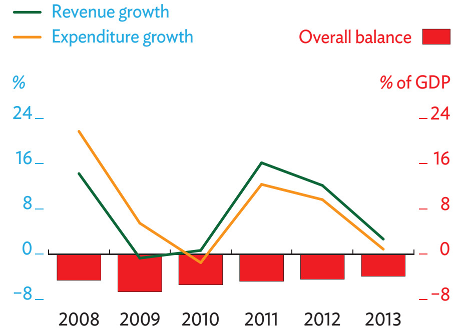
Bank Negara Malaysia, the central bank, kept its policy interest rate steady at 3.0%, as it has done since May 2011. The average base lending rate of commercial banks was unchanged at 6.5% in 2013. Lending to consumers maintained robust growth, increasing by 12.0% year on year in December 2013. Lending to businesses rose by a more sedate 8.3%.

Inflation edged higher to 3.2% in December 2013, nudged up by the impact of bad weather on food prices and government decisions in September to reduce subsidies for fuel and sugar and to increase the excise duty on tobacco (Figure 3.26.4). Another factor was a weaker Malaysian ringgit, which depreciated by 6.6% against the US dollar over 2013. For the year, inflation averaged 2.1%.

Slack external demand had a deep impact on Malaysia's trade accounts. Merchandise exports fell by 3.6% to $219.4 billion in 2013, reflecting reduced volumes and prices for the country's commodities, such as palm oil and rubber, as well as a soft global market for the country's manufactures, including electronics. Robust domestic demand contained to 0.1% the decline in merchandise imports, valued at $186.8 billion. The trade surplus fell by 19.8% to $32.6 billion, the smallest in 9 years. After accounting for deficits in services trade, income, and transfers, the current account surplus narrowed to $11.8 billion, equivalent to 3.8% of GDP.

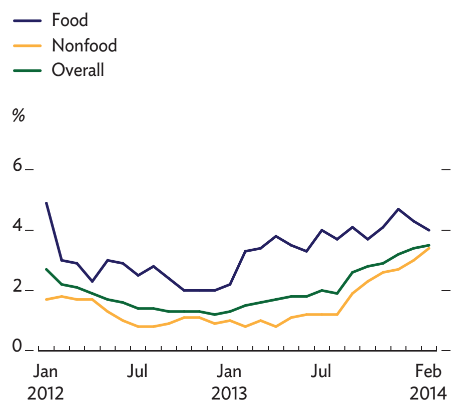
The financial account posted net outflows. Malaysians' direct investment abroad totaled $12.9 billion, less than in the previous 3 years. Portfolio investment recorded a smaller net inflow while inward foreign direct investment rose to $11.6 billion. The balance of payments remained in surplus, and international reserves totaled $134.6 billion at year-end, cover for 7.0 months of goods and services imports.

3.26.3 Fiscal performance



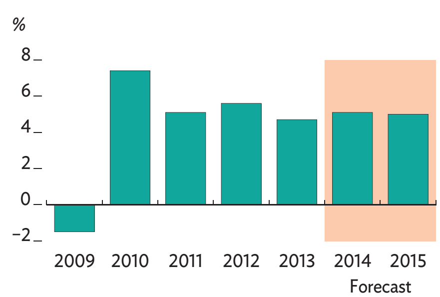
Source: CEIC Data Company (accessed 21 March 2014).

3.26.4 Monthly inflation



Source: CEIC Data Company (accessed 21 March 2014).

3.26.5 GDP growth



Source: Asian Development Outlook database.

Economic prospects

Malaysia has high exposure to global trade, with exports of goods and services equivalent to 83% of GDP. Thus, projected improvement in the economies of major industrial countries and in world trade bode well for its growth in 2014 and 2015. At the same time, rising inflation and fiscal tightening will moderate domestic demand.

Taking these factors into account, GDP is forecast to grow by 5.1% this year, quickening from 2013, and by 5.0% in 2015 (Figure 3.26.5).

Merchandise exports were trending up late in 2013, and that trajectory was maintained in early 2014 (Figure 3.26.6). For the year, exports are forecast to rise by 6.3% in US dollar terms, spurred by ringgit depreciation and stronger demand, in particular from the US and the euro area as their economies gather momentum. Prospects for growth in exports to the PRC are clouded by softer economic growth there. Still, in January 2014, exports rose by 12.2% year on year, with significant increases in shipments of electrical and electronic products.

Private consumption and fixed investment are projected to expand in 2014, but both at more moderate paces than in 2013. Private consumption will benefit from the firm labor market and rising wages. Cash transfers from the government's 1Malaysia People's Aid program (known as BR1M) have been increased and extended to as many as 7.9 million Malaysians in 2014. However, rising inflation and other concerns have dented consumer confidence, which will temper growth in consumption spending. The index of consumer sentiment declined last year (Figure 3.26.7). The business conditions index compiled from a survey of manufacturers also declined.

Fixed investment is expected to be slightly dampened by the government's fiscal consolidation, the ringgit's depreciation, and possibly by higher borrowing costs. Nevertheless, the government's Economic Transformation Programme, which aims to lift Malaysia into the ranks of high-income nations by 2020 by upgrading industry and infrastructure, is generating a pipeline of investment projects. Also, recovery in exports will spur investment in export-oriented manufacturing.

Government consumption spending is seen decelerating. The government has narrowed its fiscal deficit target to 3.5% of GDP. Among other measures, the budget for 2014 raised electricity tariffs by 15.0% from January.

A 6.0% goods and services tax (GST) is scheduled to come into effect from April 2015. This is a broad-based tax that will replace existing sales and service taxes. It should be an important revenue source that reduces current heavy reliance on revenue from oil production.

One likely effect of the GST schedule is that consumers bring forward into 2014 and early 2015 planned spending on costly items such as automobiles and household appliances and furniture. Personal income tax rates will likely be trimmed in 2015 and cash transfers expanded to mitigate the impact of the GST on households.

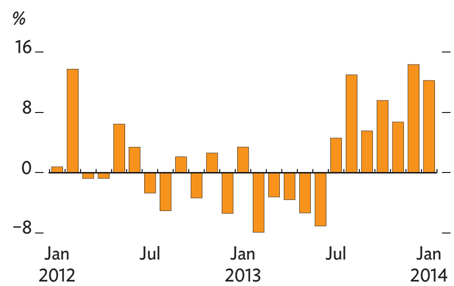
As the government plans to narrow the fiscal deficit to 3.0% in 2015, fiscal tightening could weigh on GDP growth next year, as could higher inflation. But the export recovery is projected to continue in 2015.

3.26.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.1	5.0
Inflation	3.2	3.5
Current account balance (share of GDP)	4.1	4.6

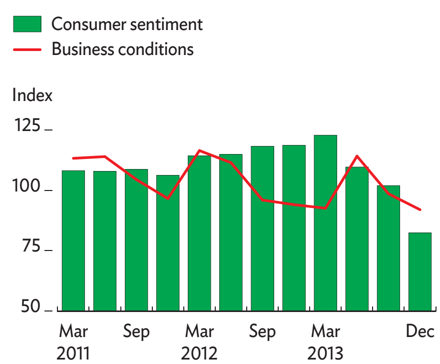
Source: ADB estimates.

3.26.6 Merchandise exports growth



Source: CEIC Data Company (accessed 24 March 2014).

3.26.7 Business and consumer confidence indexes



Source: CEIC Data Company (accessed 21 March 2014).

Monetary policy may become less accommodating during the forecast period, particularly if inflationary expectations build and second-round effects emerge after reductions in subsidies and the implementation of the GST. Rising inflation has made the policy interest rate negative in real terms.

Inflation is forecast to trend up to average 3.2% in 2014 (Figure 3.26.8). Reductions in subsidies and the spillover effects on other goods and services has put upward pressure on prices. Last year's depreciation of the ringgit has contributed to inflation. In the first 2 months of this year, inflation rose to 3.4%, the highest since July 2011.

Next year, inflation is seen rising to 3.5% and perhaps higher if inflationary expectations and second-round effects are not contained as the GST is introduced. The government plans further reductions in subsidies, which means higher prices for consumers, to help address its fiscal pressures, as the cost of subsidies has grown to 4.7% of GDP. However, it is unclear when subsidies will be reduced further.

Imports are seen growing at a similar pace to exports this year. The expansion of export-oriented manufacturing will draw in greater volumes of intermediate goods, but moderating domestic demand will dampen some other categories of imports. The trade surplus is forecast to turn up in both 2014 and 2015, contributing to larger current account surpluses (Figure 3.36.9).

Policy challenge—high household debt

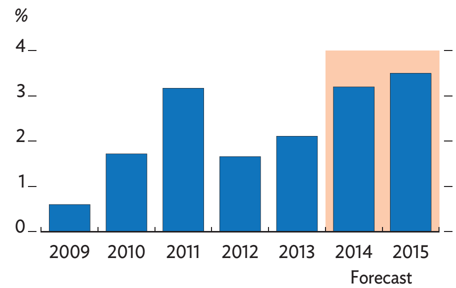
Malaysian households are among the most highly indebted in Asia. Household borrowing for houses, automobiles, and other home and personal expenditures increased at an average annual rate of 12.1% over 2003–2013 to reach the equivalent of 86.8% of GDP in 2013 (Figure 3.26.10). Furthermore, increased borrowing has contributed to sharply higher housing prices. These trends heighten risks to the banking system and the sustainability of household spending.

The central bank has addressed this issue with a range of macroprudential regulations aimed at slowing property price inflation and credit growth. They include moves last year to set the maximum tenor for personal loans at 10 years and for property loans at 35 years, and to prohibit banks from offering to households preapproved personal financing such as unrequested credit cards.

For its part, the government has raised the capital gains tax on property transactions and the minimum price of properties that foreign investors can buy to curb speculation in real estate. The policies seem to be working, as the increase in household debt slowed in 2013. Banks are generally in good financial shape and loan impairments are low at this time.

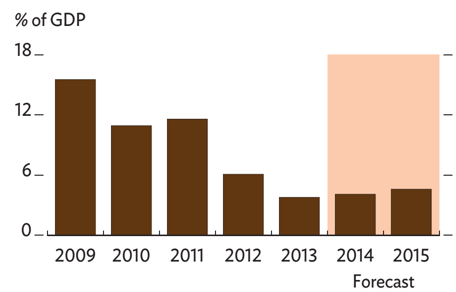
Still, rising debt could test household debt-servicing capacity when interest rates rise or growth in employment and incomes falters. Also, the higher housing prices rise, the greater the scope for them to deflate. Such developments could erode the strength of the banks and hurt their ability to finance the economy.

3.26.8 Inflation



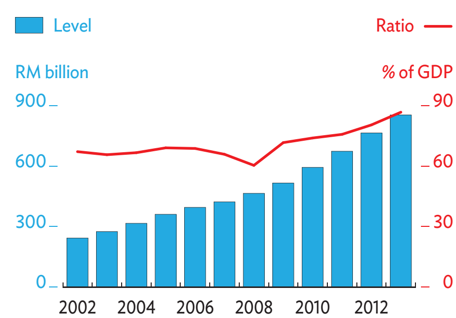
Source: *Asian Development Outlook* database.

3.26.9 Current account balance



Source: *Asian Development Outlook* database.

3.26.10 Household debt



Source: CEIC Data Company (accessed 24 March 2014).

Myanmar

Stronger investment contributed to faster GDP growth last year and is expected to drive further expansion this year and next. The government maintained momentum on policy reform. Sustaining this reform agenda depends on strengthening institutions and capacity development at all levels of government. It also requires concerted efforts to reform and develop electricity supply.

Economic performance

GDP growth accelerated to an estimated 7.5% in FY2013 (ended 31 March 2014) from a revised 7.3% in FY2012. Growth was supported by rising investment propelled by improved business confidence, commodity exports, buoyant tourism, and credit growth, complemented by the government's ambitious structural reform program.

Higher imports of capital goods reflected the stronger investment. Capital goods imports surged by 59.5% to $5.8 billion in 2013 (Figure 3.27.1).

Business confidence has markedly improved in recent years, as reflected in a rapid increase in new business registrations, which exceeded 5,000 in the 10 months to January 2013, more than in the whole of the previous fiscal year. Registrations of new foreign-owned businesses rose to 375. Private sector credit maintained a rapid growth pace of 46% in FY2013.

Agriculture, which employs more than half the workforce, recovered in FY2013 after being hit by flooding in mid-2012. Natural gas output expanded with the Shwe and Zawtika gas fields starting production.

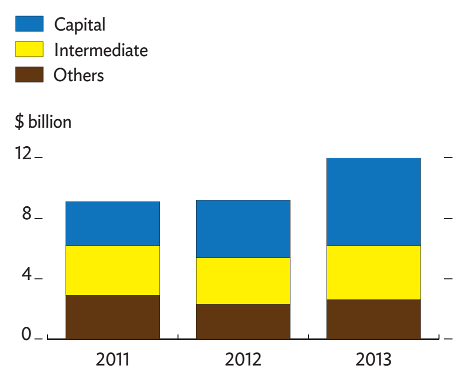
Exports of natural gas increased by 68.8% to 7.7 trillion cubic feet in the 12 months to September 2013. Gas exports were valued at $3.6 billion, accounting for almost 40% of all exports.

Inflation quickened to an estimated 5.8% in FY2013, driven by higher food prices and some pass-through to domestic prices since the depreciation of the Myanmar kyat (Figure 3.27.2). Following the adoption of a managed float in April 2012, the kyat has depreciated against the US dollar, falling by 11% from April 2013 to March 2014.

The current account deficit widened to an estimated 4.8% in FY2013, reflecting the strong imports of capital goods. This deficit was partly financed by foreign direct investment and a surge in remittances from abroad. The balance of payments recorded an estimated surplus equal to 0.6% of GDP, and gross official reserves rose to an estimated $4.9 billion in FY2013, covering 3.3 months of imports.

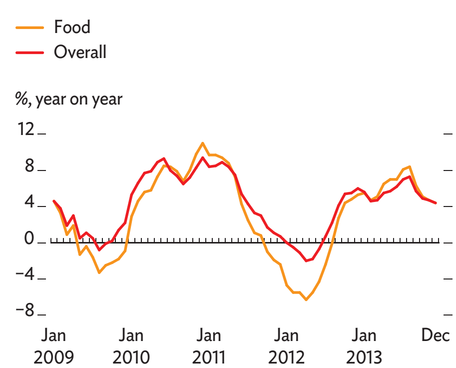
The government budget for FY2013 amounted to $19.5 billion, equal to 32.8% of GDP. Spending on education was boosted by 30% from the

3.27.1 Imports by product



Source: CEIC Data Company (accessed 20 March 2014).

3.27.2 Monthly inflation



Source: Central Statistical Organization.

This chapter was written by Peter Brimble of the Myanmar Resident Mission , Asian Development Bank, Yangon; and Poullang Doung of the Cambodia Resident Mission, Asian Development Bank, Phnom Penh.

previous year, and on health care by 78%. The consolidated fiscal deficit widened to an estimated 4.9% of GDP in FY2013 from 3.8% in FY2012. Total external debt declined to $10.7 billion, or 19% of GDP, in FY2013 from $13.5 billion in FY2012, following a restructuring of debt arrears.

Economic prospects

The economy is forecast to post higher growth of 7.8% in both FY2014 and FY2015, benefiting from rising investment and improved business confidence since the government started to rejuvenate and open the economy 3 years ago (Figure 3.27.3).

A number of developments last year contributed to raising Myanmar's international profile as an investment destination, including the award of telecommunications licenses to Norway's Telenor and Qatar's Ooredoo, selection of investors from the Republic of Korea, Singapore, and Japan as preferred bidders for developing airports, and hosting of the World Economic Forum on East Asia and of the Southeast Asia Games.

Inflation is forecast to accelerate to 6.6% in FY2014 and 6.9% in FY2015 (Figure 3.27.4). Factors contributing to inflation include a boost to public sector wages, higher electricity tariffs, and rising property prices in cities. Reduced credit to the government from the central bank should help to contain inflationary pressures over the medium term.

Liberalized import restrictions coupled with relaxed foreign exchange controls are likely to maintain the current account deficit in FY2014 and FY2015 at around 5% of GDP (Figure 3.27.5). Gross official reserves are expected to reach $6 billion in FY2014, covering 3.6 months of imports.

The fiscal deficit is seen narrowing to 4.5% of GDP in FY2014, partly due to one-time revenue from telecommunications licenses and higher gas revenue. The restructuring of debt arrears under agreements with Japan, the World Bank, and the Asian Development Bank has paved the way for the government to receive new lending.

External debt is projected to increase to $11.7 billion, or 19.4% of GDP. Myanmar's risk of debt distress is expected to remain low, reflecting less reliance on commercial financing as more concessional resources become available following the resolution of debt arrears.

The government has initiated a broad array of reforms: unifying the exchange rate, improving monetary policy, increasing tax collection, reorienting public expenditure toward social and physical infrastructure, improving the business and investment climate, developing the financial sector, and liberalizing agriculture and trade. A new central bank law grants the central bank greater operational autonomy. The government has also prepared a strategy for sequenced and comprehensive public financial management reforms.

Efforts have been made to strengthen transparency and accountability with the establishment of a senior anticorruption committee and the government's commitment to join the global Extractive Industries Transparency Initiative. Notably, the award of telecommunications licenses in a strongly contested public tender went to established international companies without domestic partners.

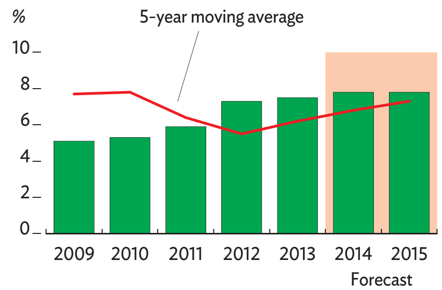
Nevertheless, the World Bank ranked Myanmar 182 of 189 countries for ease in its Doing Business 2014 report, illustrating the challenges still

3.27.1 Selected economic indicators (%)

	2014	2015
GDP growth	7.8	7.8
Inflation	6.6	6.9
Current account balance (share of GDP)	–5.1	–4.8

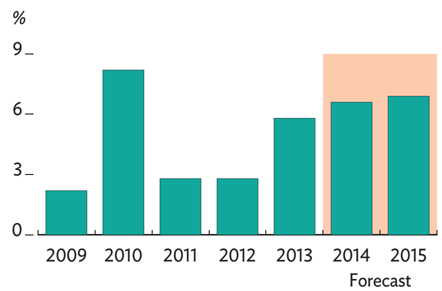
Source: ADB estimates.

3.27.3 GDP growth



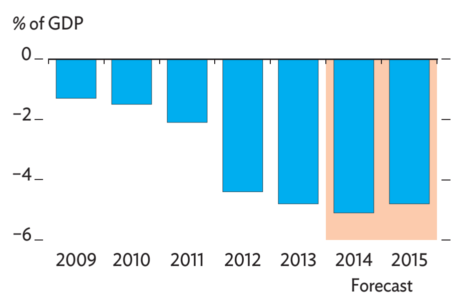
Note: Years are fiscal years, ending 31 March of the following calendar year.
Sources: International Monetary Fund; ADB estimates.

3.27.4 Inflation



Sources: International Monetary Fund; ADB estimates.

3.27.5 Current account balance

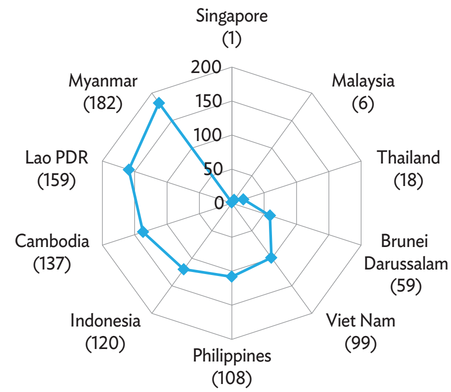


Sources: International Monetary Fund; ADB estimates.

to be met to improve the business climate (Figure 3.27.6). Sustaining the reform agenda will depend on strengthening institutions and capacity development at all levels of government. Progress in reform and ensuring access to public services and employment, especially in rural areas and among disadvantaged groups, would help make growth more inclusive.

Risks to the outlook come from ethnic and sectarian tensions, and vulnerability to bad weather.

3.27.6 Ease of doing business



Lao PDR = Lao People's Democratic Republic.

Note: Numbers in parentheses show ranking out of 189 countries worldwide. 1 = best, 189 = worst.

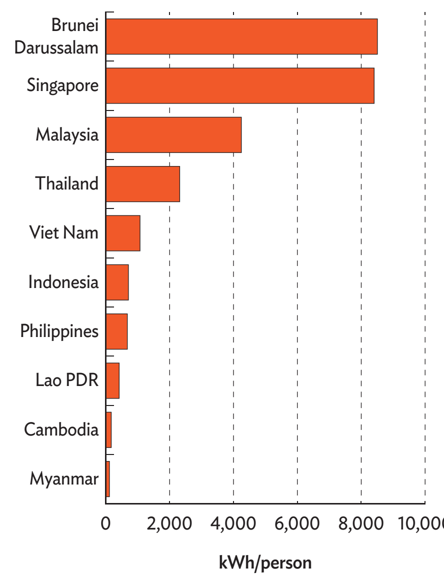
Source: Doing Business database (accessed 20 March 2014).

Policy challenge—powering the economy

Myanmar has abundant energy resources, notably hydropower and natural gas. However, its power sector is one of the least developed in Southeast Asia. Only just over half the total installed capacity of 3,593 megawatts is firm, or highly reliable, because weather-dependent hydropower accounts for 75% of total electricity generation. Consequently, the supply of electricity is limited and unreliable.

With a population estimated at 60 million, Myanmar's per capita electricity consumption was only 160 kilowatt-hours in 2011, the lowest in Southeast Asia (Figure 3.27.7). This is the result of a low electrification rate estimated that year at 28% of the population, weak industrial development, and a lack of investment. Electrification is concentrated in cities.

3.27.7 Per capita electricity consumption, 2011



kWh = kilowatt-hour, Lao PDR = Lao People's Democratic Republic.

Source: World Bank. World Development Indicators; ADB estimates.

On the cost side, electricity tariffs are heavily subsidized and among the lowest in Southeast Asia. However, in March 2014 the government announced reforms to electricity pricing that will largely eliminate existing unsustainable subsidies while maintaining lower tariffs for low-income users.

A study by development partners estimated that investment of around $18 billion would be required through 2030 to fuel annual average economic growth of 7.5%. Efforts by the government and development partners to address the needs of the energy sector include the preparation of plans, regulatory tools, and legal instruments to guide investments aimed at improving power distribution and reducing energy losses, supporting renewable power sources, rehabilitating existing energy infrastructure, and stimulating new generation and transmission capacity.

The required investments are far beyond the combined means of the government and its development partners, so steps are being taken to promote public–private partnership, especially in power generation, by developing power purchase agreements that meet international standards, building the capacity of government agencies to handle open and transparent bidding and tendering processes, and catalyzing private sector investments.

Given large gaps between cities and rural and remote areas, attention is being paid to developing off-grid energy sources such as mini hydropower, biomass, wind, and solar energy.

Meeting the energy challenge will play a major role in poverty reduction and stimulating regional development. In addition, improved power supply to all ethnic groups will contribute to the peace dividend.

Philippines

Robust private consumption and investment drove economic growth higher in 2013. Strong growth is expected to continue in the forecast period, though moderating from last year. Rehabilitation and reconstruction in areas hit by natural disasters may have a significant impact on the economy in late 2014 or 2015. Inflation is forecast to pick up this year but remain within the central bank's target range. The challenge is to translate solid economic growth into poverty reduction by generating more and better jobs.

Economic performance

Despite natural disasters that devastated parts of the country in the fourth quarter of 2013, GDP grew by a solid 6.5% in that period, bringing full-year growth to 7.2% (Figure 3.28.1), well above the 4.7% average recorded from 2008 to 2012.

An earthquake of magnitude 7.2 on the Richter scale struck the Central Philippines in October, followed by Super Typhoon Haiyan in November, which left nearly 8,000 people dead or missing and destroyed buildings, infrastructure, and livelihoods in some parts of the Visayas.

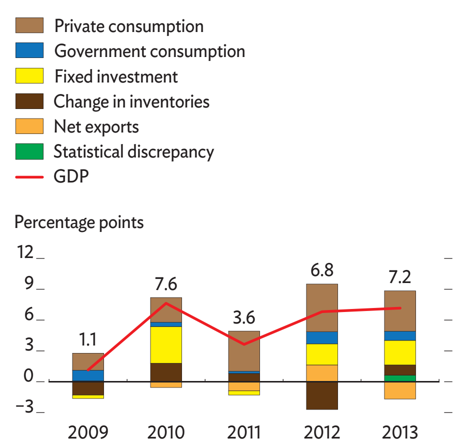
Nevertheless, broad-based domestic demand drove economic growth through last year. Private consumption grew by 5.6% and contributed more than half of the increase in GDP. Consumer spending benefitted from growth in employment, largely in services and construction, as well as in remittances from overseas Filipinos, which rose by 8.6% to $25.4 billion, or by 9.4% in peso terms.

Fixed investment increased by 11.7%, accelerating from 2012 and adding significantly to GDP growth (Figure 3.28.2). Construction contributed about one-third of this growth. Encouragingly, investment in machinery and equipment rose by a robust 14.4%. The ratio of fixed investment to GDP improved by nearly 1 percentage point, to 20.2%.

Buoyant government spending was linked in part to legislative elections in May. The government raised spending on infrastructure and social services, including the national health insurance program and conditional cash transfers to poor families. Relief efforts following the natural disasters added to government spending. However, net exports of goods and services fell, acting as a drag on growth.

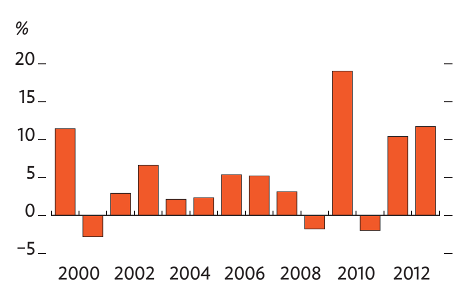
From the production side, the expansion last year was driven by services, manufacturing, and construction. Services, accounting for 57% of the economy, grew by 7.1% and contributed more than half of the increase in GDP. Strong growth was recorded in retailing, finance, real estate, and business services, which includes business process outsourcing (BPO). Manufacturing expanded by 10.5%, double the pace

3.28.1 Demand-side contributions to growth



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 14 March 2014).

3.28.2 Fixed investment growth



Source: CEIC Data Company (accessed 14 March 2014).

This chapter was written by Joven Balbosa and Teresa Mendoza of the Philippines Country Office, Asian Development Bank, Manila.

of the previous year, as domestic demand strengthened and exports expanded for some industries including processed food, furniture, and chemical products. Construction sustained double-digit expansion, with increases in both the public and the private sector. Industry as a whole contributed more than 40% of GDP growth.

Bad weather contained growth in agriculture to just 1.1% in 2013. Rice production increased slightly, while harvests of corn, coconut, sugar, and banana declined.

Notwithstanding buoyant domestic demand, inflation eased for most of 2013, turning up late in the year when the natural disasters disrupted food supplies (Figure 3.28.3). Soft global commodity prices and a good domestic harvest early in the year helped to contain prices until then. For the year, inflation averaged 3.0%.

With inflation at modest rates, Bangko Sentral ng Pilipinas, the central bank, kept policy interest rates at record lows of 3.5% for the overnight borrowing rate and 5.5% for the overnight lending rate. Low interest rates, buoyant economic growth, strong remittances, and capital inflows fueled the rapid expansion of domestic liquidity, accelerating growth in broad money (M3) to 32.7% in December, the fastest rate since 2002. Actions by the central bank to encourage a shift of funds out of its special deposit accounts into lending for productive purposes added to liquidity. Lending to the private sector increased by 17.3%.

Faster growth in government revenue than in expenditure narrowed the fiscal deficit to 1.4% of GDP from 2.3% in 2012 (Figure 3.28.4). Revenue increased by 11.8%, getting a lift from higher taxes on alcohol and tobacco and from stronger tax enforcement. The ratio of tax collection to GDP improved to 13.3%. Expenditure, excluding interest payments, rose by 6.3%, with nearly one-third channeled to infrastructure.

Merchandise exports fell by 3.6% in US dollar terms last year, largely due to a slump in semiconductors, which comprise one-third of the total. Exports turned up slightly in the fourth quarter. Imports fell by 3.1% in US dollar terms, reflecting weak demand for electronic components for processing, while imports of consumer and capital goods rose.

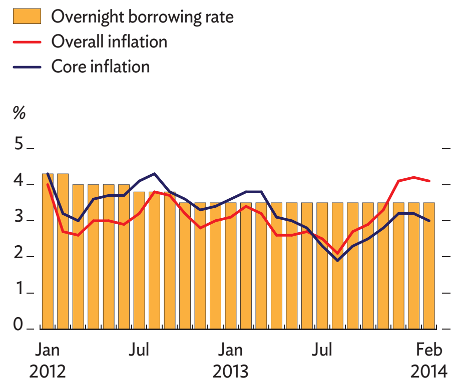
A narrower trade deficit, coupled with higher inflows from remittances, BPO, and tourism, raised the current account surplus by 35.6% to $9.4 billion, equivalent to 3.5% of GDP (Figure 3.28.5). Net inflows of foreign direct investment rose to $3.9 billion, improving from an average of $2.0 billion over recent years but still low by the standards of other major Southeast Asian countries. Portfolio investment inflows fell. Gross international reserves were little changed at $83.2 billion, providing a high 11.5 months of import cover.

Along with other Southeast Asian currencies, the peso weakened when the US reported it would reduce its monetary stimulus. It depreciated by 7.6% against the US dollar over 2013.

Economic prospects

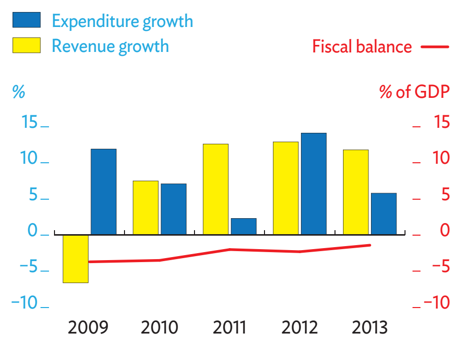
Relatively high rates of economic growth are projected over the forecast period, though easing from the fast pace in 2013. GDP growth is forecast at 6.4% in 2014 and 6.7% in 2015 (Figure 3.28.6).

3.28.3 Inflation and policy rates



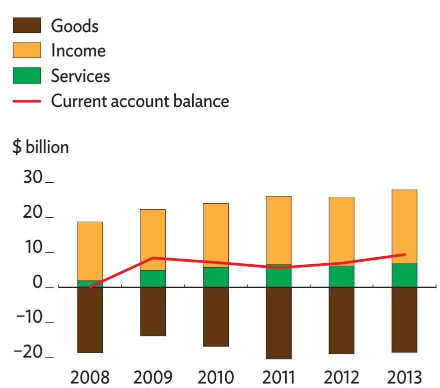
Source: CEIC Data Company (accessed 14 March 2014).

3.28.4 Fiscal indicators



Sources: CEIC Data Company; Bureau of the Treasury. http://www.treasury.gov.ph (both accessed 19 March 2014).

3.28.5 Current account components



Source: CEIC Data Company (accessed 14 March 2014).

Signs are positive for continued growth in investment. Improved business confidence and rising inflows of foreign direct investment will support private investment. Confidence has been reinforced by the achievement last year of investment grade sovereign credit ratings and improvements in several global competitiveness indices. For example, the Philippines' ranking in the World Bank's *Doing Business* survey jumped by 30 places to 108th of 189 economies in 2013.

Other positive indicators for investment are sustained expansion in credit to businesses, increased investment in machinery and equipment, and a buoyant stock market, backed up by rising corporate earnings.

Private consumption will continue to benefit from remittance inflows and positive consumer sentiment, though higher inflation and interest rates will likely dampen the pace of growth in consumer spending. Remittances rose by 6.8% in January, easing after the year-end holiday season (Figure 3.28.7).

The pace of increase in government spending is also expected to ease from 2013. That trend started late last year when government spending slowed after the elections and government agencies appeared to become more cautious about disbursing funds in response to a public outcry over allegations of misuse of some government funds. This issue has continued into 2014. The government targets a budget deficit of 2.0% of GDP in 2014.

Rehabilitation and reconstruction in areas hit by the natural disasters may not have a significant impact on the economy until late in 2014 and 2015. The direct and timely transfer of national government resources to local governments and affected communities has been hindered by highly centralized national government systems. Also, regional and local administrations have limited capacity to implement reconstruction and rehabilitation programs. These matters are being addressed, which could accelerate work in the affected areas.

The damaged regions contributed 17% of GDP in 2010–2012, with Eastern Visayas, the worst hit, accounting for 2.5% of GDP.

From the production side, manufacturing is expected to perform well during the forecast period, underpinned by robust domestic demand and an improvement in exports as demand picks up in the US and the euro area. Manufacturing production indices continued to expand through January with gains in chemicals, furniture and fixtures, rubber and plastic products, and transport equipment. Sustained growth in credit to manufacturers, rising by 12.7% year on year in January, and high manufacturing capacity utilization bode well for investment in manufacturing (Figure 3.28.8).

Construction is forecast to remain buoyant, though the rapid growth in building approvals seen in recent years started to cool in 2013. Private investment focuses on offices, shopping malls, and housing, where demand is strong. The government raised its infrastructure budget in 2014 to the equivalent of 3.0% of GDP for projects such as constructing national roads and bridges, rail systems, and ports to provide better access to the provinces.

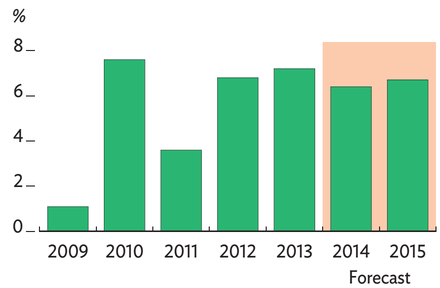
Growth in services will be driven by consumption spending and the expansion of BPO and tourism. Tourist arrivals rose by 10.0% to 4.7 million in 2013 with revenue up by 15.1% to an estimated $4.4 billion.

3.28.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.4	6.7
Inflation	4.3	4.0
Current account balance (share of GDP)	3.4	3.2

Source: ADB estimates.

3.28.6 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board. http://www.nscb.gov.ph (accessed 15 March 2014).

3.28.7 Remittances and consumer confidence

Source: CEIC Data Company (accessed 29 March 2014).

The government aims to attract 6.8 million tourists in 2014 and 10.0 million by 2016, and it has liberalized aviation policy and removed two taxes on international airlines to spur growth.

BPO revenue rose by an estimated 16% to $15.5 billion in 2013, and the number of full-time employees in the industry reached 900,000.

Inflation in the first 2 months of 2014 quickened to 4.2% as bad weather drove up food prices. It is forecast to average 4.3% in 2014, increasing from 2013 due to the impact of last year's natural calamities on food supplies, rising domestic demand, and expected increases in utility tariffs (Figure 3.28.9). Peso depreciation from last year will push up import prices. In 2015, inflation is seen abating to 4.0%, assuming softer global commodity prices.

There is, however, a risk that inflation expectations could build if M3 liquidity continues to surge; it accelerated by 38.6% in January 2014 (Figure 3.28.10). The central bank increased the bank reserve requirement effective April 2014 to guard against the risks from strong liquidity growth and rapid credit expansion.

As inflation is projected to be within the central bank's target range of 3%–5% in 2014 and 2%–4% in 2015, monetary stance could remain accommodative to economic growth, though policy rates are likely to be nudged up from record lows.

In light of the uptrends in consumption and investment, imports of goods and services are likely to rise relatively strongly, outpacing export growth. This is reinforced by the import intensity of electronics, the main export products. Consequently, declining net exports are expected to restrain economic growth.

Current account surpluses are projected to ease as a ratio to GDP during the forecast period. Merchandise exports picked up in late 2013 and, though they decelerated in January 2014, still grew by 9.3% (Figure 3.28.11). For 2014 as a whole, merchandise exports are expected to increase by 8.2% in US dollar terms, but imports are likely to rise by 9.4%.

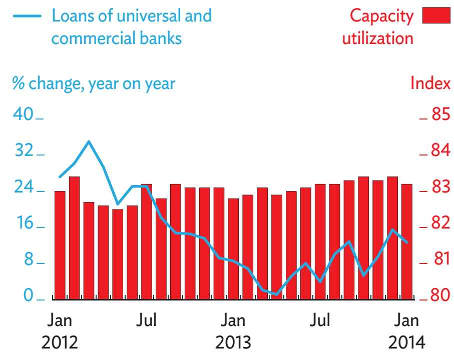
A risk to the outlook comes from the possible impact on investment of national elections scheduled for May 2016. Investors could become increasingly cautious until the new government clarifies policy directions. Steady progress on reform will be important to sustaining market confidence.

A trend of improved fundamentals over several years has strengthened the economy's resilience to shocks. The current account has been in surplus since 2003. Total external debt as a share of GDP has been on a downtrend since 2003, to 21.5%. Fiscal and debt consolidation give the government greater flexibility to respond to downturns. Public debt has fallen steadily since 2008 to reach in December 2013 the equivalent of 49.2% of GDP, and the government has sourced its financing largely from domestic sources. Finally, the banking system's capital adequacy ratio is well above 10%, and nonperforming loans remain low at about 3% of all loans.

Policy challenge—generating more and better jobs

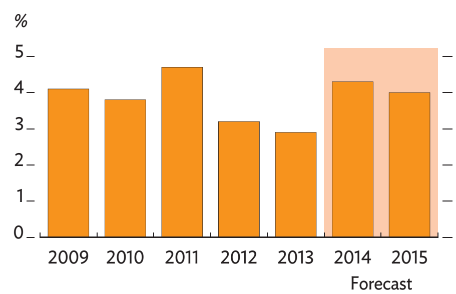
While economic expansion has exceeded 6% in the past 2 years, it has not generated enough jobs to reduce poverty (Figure 3.28.12).

3.28.8 Credit to and capacity utilization of manufacturing



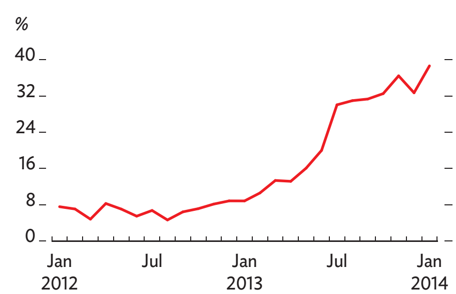
Source: CEIC Data Company (accessed 14 March 2014).

3.28.9 Inflation



Source: Asian Development Outlook database.

3.28.10 M3 growth



Source: CEIC Data Company (accessed 14 March 2014).

The unemployment rate rose to 7.5% in January 2014 from 7.1% in January 2013, and the rate of underemployment remained elevated at 19.5%. The youth unemployment rate stood at 17.3%, up from 16.8% a year earlier and more than double the unemployment rate for the workforce as a whole. Improving the quality of jobs also remains a challenge, as nearly 40% of the workforce is in the informal sector or in vulnerable employment (Figure 3.28.13).

Reflecting the lack of good jobs, the poverty rate was 25.2% in 2012, only a small improvement on 26.3% in 2009. Persistent poverty has hindered progress toward achieving Millennium Development Goals relating to maternal health and primary education.

In an update to its development plan for 2010–2016, the government has heightened the emphasis on employment generation and poverty reduction. Its goals are to cut the unemployment rate to 6.5%–6.7% and underemployment to 17.0% by 2016, and to reduce poverty to 18.0%–20.0% by that year.

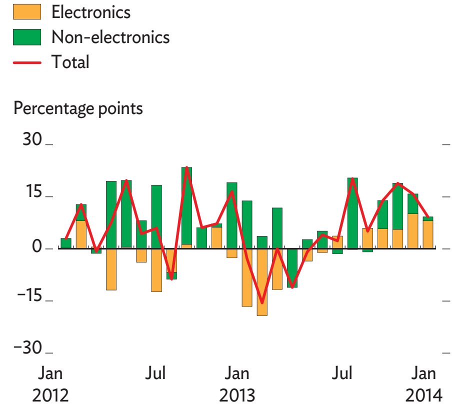
The government's strategy is to raise public investment on infrastructure, agriculture, education, and health, while improving the investment climate and expanding manufacturing. Public-private partnerships are a key strategy to raising investments and enhancing competitiveness. Poor infrastructure is a nagging constraint on investment. The Philippines ranks behind most major Southeast Asian countries in terms of infrastructure.

Although manufacturing grew at a brisk pace last year, it accounts for a small share of GDP and employment compared with other major economies in the subregion. A stronger manufacturing industry would generate more and better jobs, and manufacturing linked to agriculture would enable the poor in rural areas to rise out of poverty. Manufacturing sector roadmaps are being prepared by the private sector and the government to identify constraints on growth in manufacturing and decide what type of support would address them.

The government is also improving its approach to poverty reduction by adjusting interventions in accordance with local socioeconomic conditions. Provinces are categorized in terms of resource endowments, sector growth, and employment opportunities to ensure that government policies are well targeted. The strategy takes into consideration which areas are prone to disasters and how to make them more resilient. The poverty rate in the Eastern Visayas was a very high 45.2% even before the region was battered by Typhoon Haiyan.

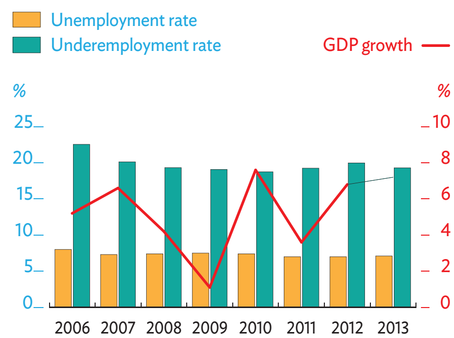
Progress achieved in the Bangsamoro agreement, a roadmap for a political settlement between the government and the Moro Islamic Liberation Front (MILF), should lead to development on the large southern island of Mindanao, where poverty is worse than in the central Visayas or on the large northern island of Luzon. The government and the MILF signed the Comprehensive Agreement on the Bangsamoro in March 2014, which includes agreements such as those on revenue and wealth sharing, power sharing, and transitional arrangements. The government aims to have the Bangsamoro Basic Law approved by 2016.

3.28.11 Contributions to merchandise exports growth



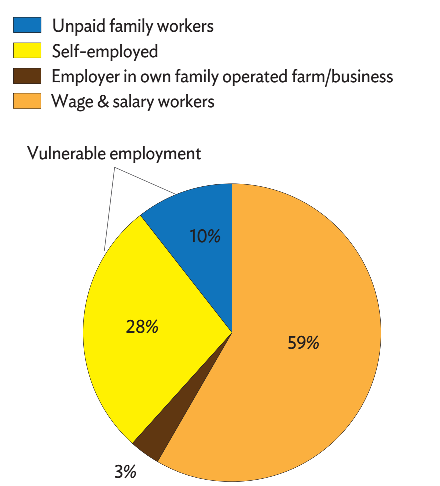
Source: CEIC Data Company (accessed 14 March 2014).

3.28.12 Growth and unemployment



Source: CEIC Data Company (accessed 14 March 2014).

3.28.13 Employment by class of worker, 2013



Source: CEIC Data Company (accessed 14 March 2013).

Singapore

GDP will continue to grow at a modest pace in 2014 and 2015. This highly trade-dependent economy will benefit from the expected recovery of the global economy, but ongoing domestic economic restructuring will weigh on growth. A tight labor market will put upward pressure on inflation. Economic and macroprudential policies should be calibrated and targeted to support the transition toward high-productivity growth.

Economic performance

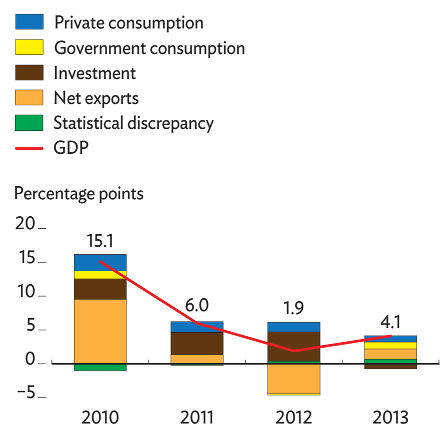
Propelled by improving exports, Singapore's economy expanded by 4.1% in 2013, surprising markets. Export growth more than doubled to 3.6% from 1.4% in 2012, while import expansion slowed from 4.0% in 2012 to 3.0% in 2013. Thus, net exports rebounded from a contraction in the previous year, contibuting 2.2 percentage points to growth (Figure 3.29.1). Domestic demand added only 1.2 percentage points to growth in 2013—in contrast to 2012, when it was the main driver of growth—as weakening private consumption and faltering investment outweighed rising public spending. The contribution of private consumption dropped to 0.9 percentage points. Investment contracted, owing mainly to a sharp decline in private investment on transportation following tighter rules on financing vehicle purchases.

On the supply side, the services sector, which accounts for over 70% of total value added, was the engine of growth. Services, including ownership of dwellings, expanded by 5.2%, contributing 3.3 percentage points to GDP growth in 2013, up from 1.3 percentage points in 2012 (Figure 3.29.2). Growth was robust across the services sector but highest in finance and insurance. Banking activity, which accounts for half of the sector's value added, was driven by the expansion of business loans, while tighter regulation moderated growth in consumer loans.

Industry, which accounts for the remainder of output, as agriculture accounts for less than 1%, grew by 2.2% in 2013, adding 0.7 percentage points to growth. Improved global demand fueled the rebound of electronics manufacturing from a huge contraction in 2012, and of other manufacturing related to rig building projects.

The consumer price index rose by 2.4%, slowing from 4.6% in 2012 with moderation in both housing and transport inflation, which together account for over 40% of the index. This reflected property prices and vehicle quota premiums easing in response to policies that dampened demand. Core inflation, which excludes the costs of accommodation and private road transport, also decelerated, from 2.5% in 2012 to 1.7% on easing oil prices and a moderation in services and food inflation.

3.29.1 Demand-side contributions to growth



Source: CEIC Data Company (accessed 6 March 2014).

3.29.2 Contributions to growth, by industry

Source: Ministry of Trade and Industry. *Economic Survey of Singapore 2013.* http://www.mti.gov.sg

This chapter was written by Minsoo Lee and Arnelyn Abdon of the Economics and Research Department, Asian Development Bank, Manila.

The appreciation of the Singapore dollar has helped temper inflation, given about 40% of what is consumed domestically is imported. Domestic price pressures intensified late in the year as core inflation rose in sync with food prices, which may carry over into 2014 inflation (Figure 3.29.3).

Interest rate developments are largely outside the control of the Monetary Authority of Singapore (MAS), as it implements monetary policy by targeting an undisclosed nominal effective exchange rate band in the context of an open capital account. The Singapore interbank offered rate, to which mortgage rates are usually pegged, generally follows movements of the US federal funds rate.

The MAS has kept the Singapore dollar nominal effective exchange rate (NEER) policy band on its current modest and gradual pace of appreciation since April 2012. In 2013, the NEER appreciated by 2.3% was below the 4.9% recorded in 2012 and 5.4% in 2011 (Figure 3.29.4). This policy was complemented by macroprudential measures to counter the rapid increases in residental property and private transportation prices.

Nevertheless, the low interest rate environment fueled a robust 17.0% expansion in credit, with loans to businesses substantially outpacing those to households. Money supply grew by 7.8%, almost unchanged from 7.2% the previous year.

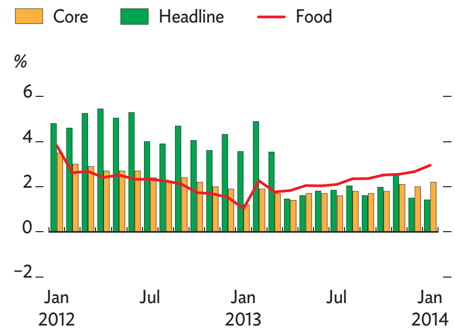
The budget recorded a surplus of S$3.9 billion, or 1.1% of GDP, in FY2013 (ended 31 March 2014), higher than the budgeted 0.7%. Receipts from stamp duties and vehicle quota premium collections were higher than expected and boosted revenues by S$2.1 billion more than budgeted, while delays in implementing public infrastructure projects reduced expenditures to S$1.1 billion below projections. Compared with FY2012, revenues expanded by 2.4% and expenditures by 6.8%.

Exports of manufactured equipment recovered from a 1.9% contraction in 2012 to 2.9% growth in 2013, boosted by exports of electronic components and parts. Imports fell largely because crude petroleum imports declined by 10.8%. Net services receipts narrowed to $311 million from $594 million in 2012, as transport and travel service payments offset gains in financial services. Nevertheless, the current account surplus reached 18.2% of GDP, and the overall balance of payments recorded a surplus of $18.0 billion, or 6.1% of GDP, despite increasing net capital outflows (Figure 3.29.5). Official foreign reserves rose to 9 months of imports.

Economic prospects

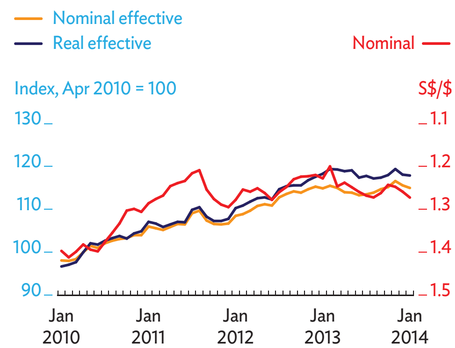
The expected global economic recovery and the consequences of ongoing domestic economic restructuring will shape economic trends in Singapore in the forecast period. With export of goods and services equivalent to twice of GDP, the economy will benefit from improved external demand. On the other hand, the tighter labor market will weigh on growth, with 1.8% unemployment and on a downward trend and vacancies far exceeding job seekers (Figure 3.29.6). On balance, GDP is forecast to grow by 3.9% in 2014, near the upper bound of the government's forecast of 2%–4%, and by 4.1% in 2015.

3.29.3 Inflation



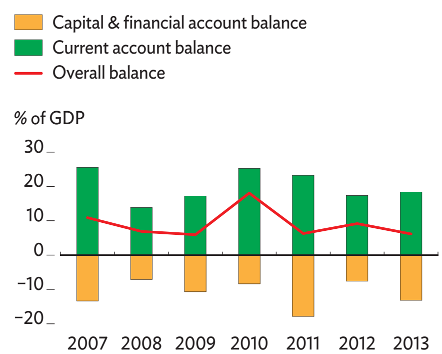
Source: CEIC Data Company (accessed 6 March 2014).

3.29.4 Exchange rates



Sources: Bureau of International Settlements; CEIC Data Company (accessed 6 March 2014).

3.29.5 Balance of payments



Source: CEIC Data Company (accessed 6 March 2014).

3.29.1 Selected economic indicators (%)

	2014	2015
GDP growth	3.9	4.1
Inflation	3.0	2.9
Current account balance (share of GDP)	19.1	18.6

Source: ADB estimates.

The MAS is expected to closely monitor inflation dynamics, particularly in the property and transport markets, and to tweak the macroprudential measures already in place to ensure gradual price corrections in these markets. It will likely maintain its current policy for a gradually appreciating nominal effective exchange rate to help contain domestic costs, albeit tempered by how interest rates respond to US Federal Reserve tapering of quantitative easing. However, the moderation of inflation experienced in 2013 may not be sustained as the pass-through of higher business costs, particularly wages, starts to creep into consumer prices. Reflecting these influences, overall inflation is expected to be 3.0% this year and to ease marginally to 2.9% in 2015.

Fiscal prudence has been the hallmark of public policy in Singapore. Recent budgets, however, put the emphasis on incentives for firms to raise productivity and on budgetary transfers to encourage social mobility and equal opportunity for citizens. A deficit of S$1.16 billion is forecast for FY2014 (ending 31 March 2015), as these social transfers are expected to rise (Figure 3.29.7). This deficit will be easily financed by drawing down government deposits, which are substantial owing to past surpluses.

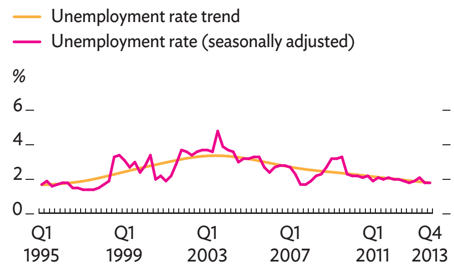
A pickup in external demand is expected in line with higher growth in developed economies. Recent data signal expansion in new orders, and industrial production is on an uptrend (Figure 3.29.8). Exports are expected to expand by 5.0% in US dollar terms in 2014 and 8.3% in 2015, accompanied by similar growth in imports, generating a commensurate expansion in the trade surplus. The current account surplus is expected to expand to 19.1% of GDP in 2014 and then fall back to 18.6% in 2015.

In contrast to last year, when risk flowed mainly from uncertainty over the global economy, the next 2 years will pose risks mainly from domestic developments. The pace of the US Federal Reserve tapering and moderating economic growth in the People's Republic of China continue to pose important risks. Of more serious concern, however, are labor costs rising without corresponding improvement in productivity, which could hinder growth and stoke inflation. In 2013, labor productivity was flat, albeit an improvement on the previous year's 2% contraction. Singapore's experiment in orchestrating higher-quality economic growth has gained steam since it started in 2010, and disbursements under its productivity incentive schemes overshot the budget in 2013. But productivity gains take time to be realized. Another domestic risk to the forecast arises from possible abrupt corrections in the property market, which could weaken the balance sheets of banks and households alike. These risks remain manageable within the forecast period, and Singapore enjoys substantial financial resources to respond to them if they materialize.

Policy challenge—making macroprudential policy more effective

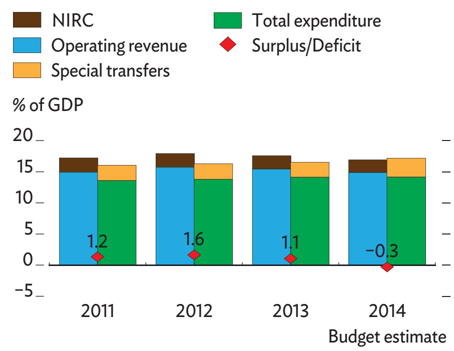
The MAS plays a central role in the development, management, and oversight of the financial system, identifying and providing surveillance on systemic financial risk, and designing and calibrating policy instruments to effectively address any weaknesses. Although the

3.29.6 Unemployment rate



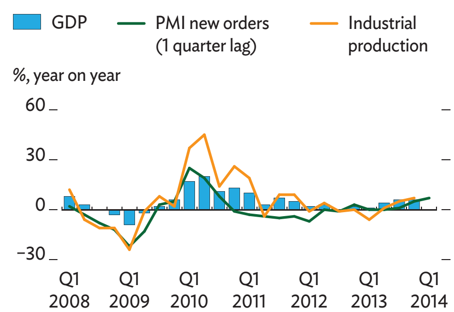
Sources: CEIC Data Company (accessed 6 March 2014); ADB estimates.

3.29.7 Fiscal balance



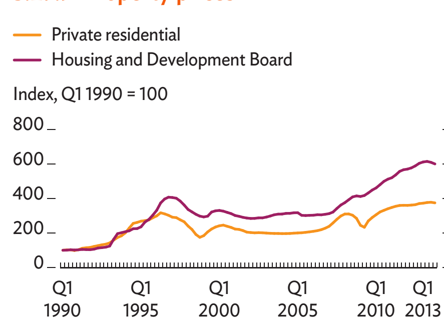
NIRC = Net investment returns contribution.
Source: Minsitry of Finance.

3.29.8 GDP growth, industrial production, and new orders



Sources: CEIC Data Company (accessed 6 March 2014). ADB estimates.

3.29.9 Property prices



Sources: Housing and Development Board; CEIC Data Company (accessed 6 March 2014).

highly developed financial system of Singapore is well regulated and supervised, some risks to financial stability have emerged in recent years stemming from galloping real estate prices, which have surpassed their 2008 peak (Figure 3.29.9). There is concern that these price trends could rekindle inflation expectations and threaten financial stability. Housing loans continue to grow at an elevated rate, and household debt has increased rapidly for 3 years to reach 74% of GDP at the end of 2013, with a corresponding increase in the exposure of locally incorporated banks to the property sector.

The MAS has relied heavily on a number of macroprudential policy instruments to mitigate systemic risks arising from the housing market, fine-tuning them frequently to market conditions (Table 3.29.2). Most recently, it has introduced the total debt servicing ratio (TDSR) framework, the loan-to-value ratios, and restricted retirees' use of Central Provident Fund resources to buy or rent property—a restriction that affects ever more people in an aging population. The measures have largely targeted the more speculative segments of the market, but further tightening has been recommended on the segment of the market owned mainly by foreigners and permanent residents. The measures have been broadly successful. Housing price inflation has moderated recently, and housing affordability metrics remain contained. But risks remain.

If domestic income growth falters or global interest rates start to rise abruptly, the ability of borrowers to service their mortgages can be severely affected, as the majority of housing loans carry variable rates. If home prices fall sharply and a large number of borrowers are affected, the health of financial institutions could be impaired, threatening overall financial stability. Also, as host to a large number of financial institutions that intermediate funds into and out of the economy, Singapore is exposed to cross-border contagion.

To address these concerns, the authorities should continue to respond proactively to new sources of systemic risk as they emerge, enhance their surveillance and analytical frameworks for assessing the likelihood and impact of emerging systemic risks, and design new policy instruments to effectively respond to such risks. As recommended by the International Monetary Fund's Financial Sector Assessment Program for Singapore, conducted in November 2013, Singapore needs to enhance its existing supervisory and regulatory frameworks, further develop its crisis management arrangements, and remain vigilant over credit growth. The bank resolution framework should also be strengthened by enhancing the operational independence of the resolution agency and allowing speedy and decisive action by the MAS to address bank fragility.

3.29.2 Macroprudential measures

September 2009

- Increased government land sales
- Disallowed interest-only housing loans and interest-absorption schemes

February and August 2010

- Introduced the sellers' stamp duty (SSD) of 1%–3% for residential properties
- Lowered the loan-to-value (LTV) limit
- Extended SSD applicability to 3 years
- Doubled minimum cash payment for second mortgages
- Lowered the LTV for second mortgages

January and December 2011

- Increased the SSD, tiered up to 16%
- Lowered the LTV to 60% for second mortgages and to 50% for corporate buyers
- Introduced an additional and different buyers' stamp duty (ABSD) for foreigners, permanent residents, and citizens

October 2012

- Restricted loan tenure for residential properties

January to December 2013

- Raised the ABSD by 5–7 percentage points
- Imposed the ABSD on first mortgages for permanent residents and on second mortgages for citizens
- Lowered the LTV for second and third mortgages and corporate buyers
- Increased the minimum cash payment to 25% for second and third mortgages
- Capped the Housing Development Board (HDB) mortgage servicing ratio to 30%–35% of monthly income
- Restricted permanent residents subletting and owning HDB properties
- Introduced various limits on executive condos
- Introduced SSD on industrial property
- Increased property taxes
- Introduced total debt servicing ratio (TDSR) to 60% of income
- Tightened terms for granting HDB loans and for using Central Provident Fund funds to buy HDB properties
- Reduced tenor of HDB loans
- Refined the executive condominium housing scheme

Sources: International Monetary Fund Article IV Staff Report; JP Morgan Economic Research Note.

Thailand

The economy slowed sharply in 2013 as domestic demand weakened and exports were sluggish. Political disruptions hurt the economy in the second half of last year and cloud the outlook for 2014. Growth is forecast to remain subdued before rebounding in 2015. Policy deficiencies have prompted calls to improve the design and implementation of public programs.

Economic performance

Political tensions weighed on the economy in the second half of 2013, dampening consumption, investment, and government spending. Slack domestic demand and sluggish exports confined GDP growth for the year to 2.9% (Figure 3.30.1). Growth in the fourth quarter, when political unrest intensified, decelerated to 0.6% year on year.

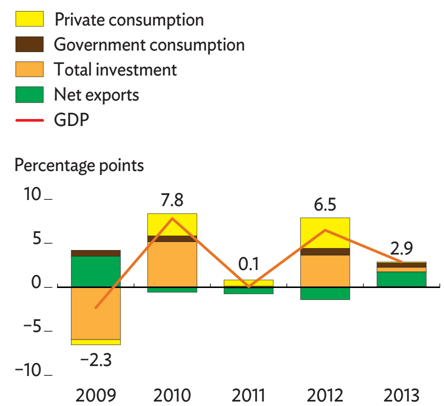
Private consumption edged up in the first half of 2013 but then fell, finally contributing just 0.1 percentage points of GDP growth for the year. In part, this reflected a base effect from 2012, when spending was stimulated by demand to replace household goods after severe floods late in the previous year, and by government flood relief payments. Also, the labor market softened in 2013, and falling prices for major crops hurt farm incomes. Sales of passenger cars dropped by 5.9% last year after a tax rebate expired for first-time buyers of domestically made automobiles. Consumer confidence weakened during the second half as political tensions worsened.

These tensions, together with a lackluster outlook for merchandise exports, weighed on fixed capital investment, which fell steeply in the second half and declined by 1.9% over the year. This result reflected mainly weakness in private investment, but public investment slowed when the government became distracted by political issues and hobbled by legal challenges. Fixed investment also came off a high base in 2012, when it was propelled by reconstruction and replacement after the floods. Total investment made a small contribution to GDP growth in 2013 because of an increase in inventories.

A sharp slowdown in import volumes contributed to higher net exports of goods and services, which added to GDP on the demand side for the first time in 4 years.

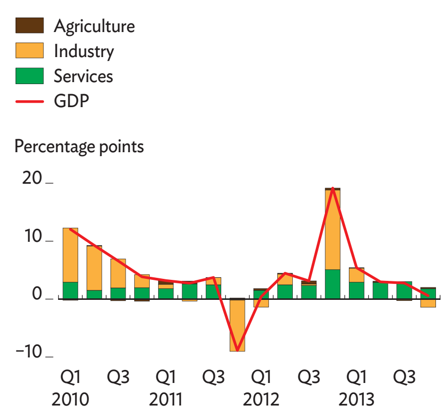
On the supply side, nearly all the growth in GDP was generated by services, while agriculture and industry barely contributed (Figure 3.30.2). Services got a boost from a 19.6% increase in tourist arrivals to 26.6 million in 2013, with the rate of increase ebbing in the fourth quarter as political strife worsened. Tourism contributed to 12.1% growth in hotel and restaurant business and solid expansion in transport and communications.

3.30.1 Demand-side contributions to growth



Source: Office of the National Economic and Social Development Board. http://www.nesdb.go.th (accessed 26 February 2014).

3.30.2 Supply-side contributions to growth



Source: Office of the National Economic and Social Development Board. http://www.nesdb.go.th (accessed 26 February 2014).

This chapter was written by Luxmon Attapich of the Thailand Resident Mission, Asian Development Bank, Bangkok.

Manufacturing was flat in response to slack demand for exports and subdued domestic demand. The production of electronics fell by 6.2% and of electrical appliances by 3.3%. Automobile production, which had soared by 68.3% in 2012 on stimulation from the tax rebate after the floods, rose by only 0.1% in 2013. Construction increased by 1.2% for the year, with all gains in the first half followed by contraction in the second.

Agriculture and fisheries grew by a lackluster 1.4%, hit by a disease that cut shrimp production, a slight fall in the rice harvest, and drop in cassava output. Increases were recorded for natural rubber, palm oil, and livestock.

Inflation abated from 3.6% at the end of 2012 to 1.4% in September 2013 before picking up a little (Figure 3.30.3). The year-average inflation rate at 2.2% was the lowest in 4 years. Lackluster domestic demand and soft world prices for oil and commodities helped ease inflationary pressures.

In the context of low inflation and weak economic growth, the Bank of Thailand, the central bank, lowered its policy interest rate by 50 basis points to 2.25% in 2013 (Figure 3.30.4). Money supply (M2) growth slowed to 7.3%, and growth in credit to the private sector eased to 12.4% as domestic demand weakened and banks became more stringent about lending.

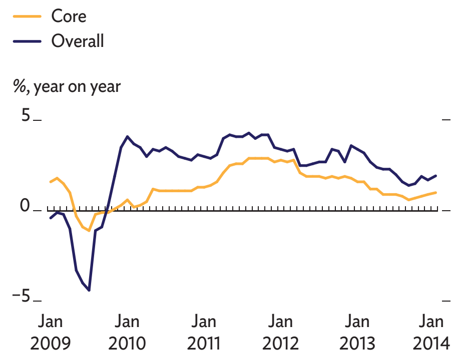
Inadvertently, fiscal policy tightened in FY2013 (ended 30 September 2013) as legal challenges and political distractions frustrated the government's pursuit of planned infrastructure projects. Only $261 million was disbursed from a $11.7 billion off-budget program to build water-management infrastructure. Tax breaks and relief payments to stimulate private consumption after the 2011 floods expired in 2012, though the program to boost farm incomes through government rice purchases continued into 2013. On the revenue side, collections exceeded the target by 2.7% in FY2013. Consequently, the fiscal deficit, including budget and off-budget items, halved to 2.0% of GDP from 4.1%.

In the external accounts, merchandise exports fell by 0.2% to $225.4 billion in 2013 as a result of tepid global demand, a decline in prices for some agricultural export commodities, and the shortfall in shrimp production. Exports of electronics declined by 0.7% and rice by 4.6%, deepening a 28% drop in rice export income in 2012. Shipments of autos and parts rose by 7.6%.

Imports fell by 0.4% to $219.0 billion, owing to weak demand domestically and for use in exports. Purchases of capital goods from abroad dropped by 4.5%, reflecting the decline in fixed investment. By contrast, imports of gold jumped by 21% to $15.0 billion, spurred by a lower global price.

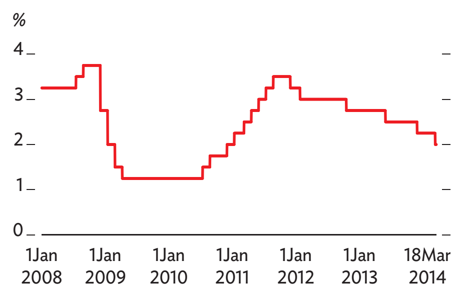
Surpluses in trade in goods and services were more than offset by deficits in income and transfers, producing a current account deficit of $2.8 billion in 2013, equal to 0.7% of GDP (Figure 3.30.5). A big increase in repatriated profits and dividends, particularly by the auto industry, widened this deficit. Also, the current account surplus in 2012 was revised to a deficit of 0.4% of GDP. The capital and financial account recorded net inflows of $1.4 billion, off much larger inflows of $14.4 billion in 2012. Foreign direct investment rose to $12.8 billion, but portfolio investment showed net outflow of $7.6 billion in 2013.

3.30.3 Monthly inflation



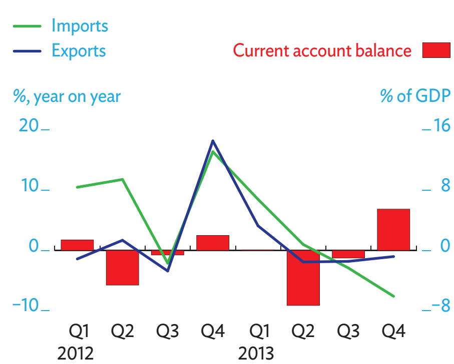
Sources: CEIC Data Company; Bureau of Trade and Economic Indices. http://www.price.moc.go.th (both accessed 26 February 2014).

3.30.4 Policy interest rate



Source: Bloomberg (accessed 12 March 2014).

3.30.5 Current account indicators



Source: Bank of Thailand. http://www.bot.or.th (accessed 26 February 2014).

The balance of payments fell into deficit by $5.0 billion, the first such deficit in 13 years.

International reserves dropped by $14.4 billion to $167.2 billion over 2013 but still maintained a strong position equal to 7.3 months of imports and 2.9 times short-term external debt. The Thai baht fluctuated widely against the US dollar, from B28.55 to B32.86. Over the year, it depreciated by 7.0% against the US dollar. The Stock Exchange of Thailand index fell by 6.7% over 2013.

Economic prospects

The outlook is subject to unusually high uncertainty. After antigovernment protests intensified in November 2013, the government dissolved the parliament in December and scheduled national elections for 2 February. However, disruptions to registration and voting in some areas meant the elections were not completed, leaving the administration in a caretaker role. Such status imposes restrictions on its ability to borrow, spend, or make policy decisions. The Constitutional Court later nullified the 2 February election.

Forecasts assume that government policy making will remain constrained through the first half of 2014. On this basis, economic growth is projected at a modest 2.9%, accelerating to 4.5% in 2015 provided that a stable government is formed this year (Figure 3.30.6).

Major public infrastructure programs had been expected to drive growth in 2014 and 2015: the $11.7 billion water-management projects to mitigate the country's vulnerability to floods and $67 billion in proposed investments through 2020 to upgrade transport infrastructure using off-budget loans. The water-management projects are delayed by legal challenges, and the transport investment program was ruled in March 2014 unconstitutional as structured.

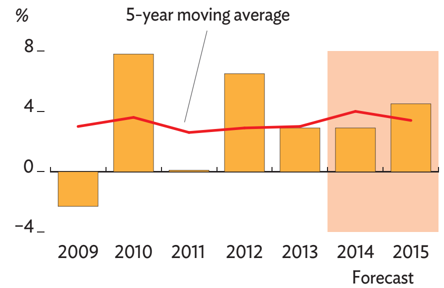
Some significant investments by state-owned enterprises, such as in telecommunications, were on hold in the first quarter of 2014, and many large private sector investments faced delays as the Board of Investment could not approve investment privileges under the caretaker government. Further, the budget for the fiscal year starting in October 2014 could suffer delayed approval.

The political deadlock has damaged consumer and business confidence (Figure 3.30.7). This has hurt private consumption, business activity, and investment. The tourism industry reported that tourist arrivals were virtually flat in January 2014 compared with a year earlier (Figure 3.30.8).

Private consumption faces additional headwinds from delays in government payments to farmers under the rice-pledging program and uncertainty about the program's future. Moreover, high household debt weighs on borrowing for consumption. Household debt is the equivalent of 80.1% of GDP, and households spend on average 33.8% of monthly incomes repaying loans, according to a survey by the Bank of Thailand.

Illustrating the weakness in private consumption early this year, imports of consumer goods fell by 12% in January 2014 year on year and passenger car sales plunged by 60% in that month. A survey of small and medium-sized enterprises conducted by the Ministry of Industry

3.30.6 GDP growth



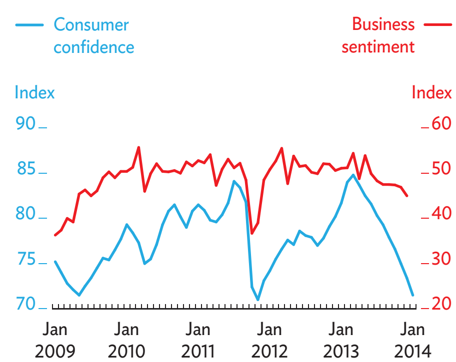
Source: Asian Development Outlook database.

3.30.1 Selected economic indicators (%)

	2014	2015
GDP growth	2.9	4.5
Inflation	2.4	2.6
Current account balance (share of GDP)	−0.1	0.5

Source: ADB estimates.

3.30.7 Consumer confidence and business sentiment



Sources: Center for Economic and Business Forecasting; Bank of Thailand. http://www.bot.or.th (both accessed 11 March 2014).

in January showed significant declines in sales in garments, leather products, and electrical appliances (Figure 3.30.9).

Subdued private investment will likely persist well into 2014. Investors are expected to be cautious, waiting for the new government's policy direction. Imports of capital goods continued to fall in January 2014 and tax revenue from real estate transactions declined, further signs of subdued investment.

Consumption and investment are forecast to rebound in 2015, assuming the political situation improves. Low domestic interest rates will assist the investment revival, as will better international economic prospects.

External demand is expected to improve both this year and next. Major trading partners in the US and euro area will record stronger performances, countered to some degree by more sedate growth in the People's Republic of China. The baht's depreciation will help exports (Figure 3.30.10).

As noted, the government is constrained in pursuing its fiscal policy. The disbursement rate of budget funding fell in the first 3 months of FY2014. Disbursement on larger projects that require cabinet endorsement is difficult during the caretaker period. Only small amounts are likely to be spent this year on the water-management program. The fiscal deficit is projected to be similar to that of FY2013 at about 2% of GDP.

With such limits on fiscal policy, the Bank of Thailand set monetary policy to support the economy, reducing its policy rate by a further 25 basis points to 2.0% in March 2014. The central bank is expected to keep this rate through 2014, edging it up to more normal levels when growth rebounds and international interest rates move higher.

While the FY2015 budget may be delayed because of the political deadlock, the eventual formation of a new government should allow investment in infrastructure to step up in 2015, bolstering the economy next year.

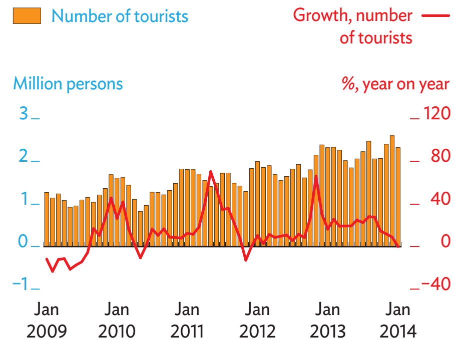
Inflation is forecast to edge up to 2.4% this year because of the baht's depreciation and the phased reduction in the subsidy on gas for household use. In February 2014, inflation quickened to 1.9% year on year as food prices rose. Stronger domestic demand in 2015 is seen lifting inflation slightly next year.

The current account is projected to record a small deficit in 2014 before turning into a surplus in 2015 as exports of goods and services gather momentum (Figure 3.30.11).

Downside risks to the outlook center on the political polarization that could cause political uncertainty to persist longer than currently expected. The unwinding of US monetary stimulus could prompt capital outflows and further baht depreciation, particularly if the domestic political tension drags on. Foreign investors were net sellers of Thai stocks and bonds in the first 2 months of this year. On the upside, GDP growth in 2014 could be significantly above the forecast if a stable government is formed sooner than expected.

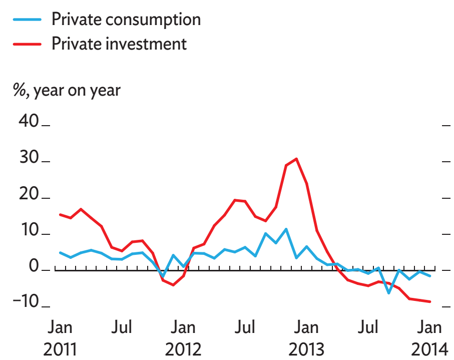
Over the past 6 years, Thailand has suffered bouts of political unrest on top of the global financial crisis and severe flooding. Nevertheless, the economy maintains solid economic fundamentals that support its resilience, with high international reserves, relatively low inflation, a moderate amount of government and external debt, and a strong manufacturing base.

3.30.8 Tourism indicators



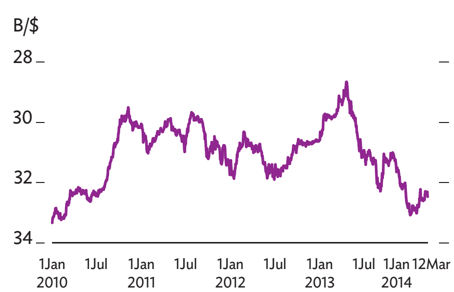
Source: Bank of Thailand. http://www.bot.or.th (accessed 11 March 2014).

3.30.9 Private consumption and investment indexes



Note: Seasonally adjusted, 3-month moving average.
Source: Bank of Thailand. http://www.bot.or.th (accessed 12 March 2014).

3.30.10 Exchange rate



Source: Bloomberg (accessed 12 March 2014).

Policy challenge—policy design and implementation

Thailand has pursued a number of policies over recent years that absorbed considerable public funds only to produce dubious outcomes. Such policies included subsidies to consumers for fuel and to farmers for rice production, tax breaks for first-time purchases of cars, and a debt moratorium for borrowers from state-owned banks. In some years the policies provided useful counter-cyclical stimulus, but they were not well targeted to the most vulnerable groups in society, nor did they strengthen the economy's long-term productive capacity.

The most controversial policy has been the rice-pledging program started in October 2011 to bolster rural incomes. Under this plan, the government tapped funding from a state-owned bank to buy rice from farmers at 40%–50% above the market price. It hoped to sell much of the rice on a rising world market. The program distorted the domestic rice market, reduced exports as other producers undercut Thai rice on the world market (Figure 3.30.12), pushed up domestic rice inventories to an estimated 18 million tons, and imposed losses on the government over 2 years that could exceed 2% of GDP. Further, it mainly benefited larger farmers with surplus rice to sell and reduced incentives for farmers to improve their productivity and reduce costs.

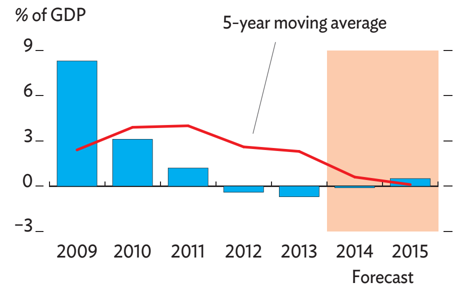
From late 2013, the government fell behind in payments to farmers. In February 2014, the program expired. Its future will be determined by the next administration.

Instead of unsustainable subsidies to farmers, government programs to address large rural-urban and regional income gaps could focus on greater public investment in rural infrastructure and social services (Figure 3.30.13). Direct cash transfers targeted to poor farmers, perhaps conditioned on school attendance to improve labor market opportunities for their children, also would promote inclusive and sustainable growth.

Deficiencies in rice pledging, and in other fiscal programs, have prompted calls for improvement in the design and implementation of public policies and for more rigorous analysis of their fiscal sustainability.

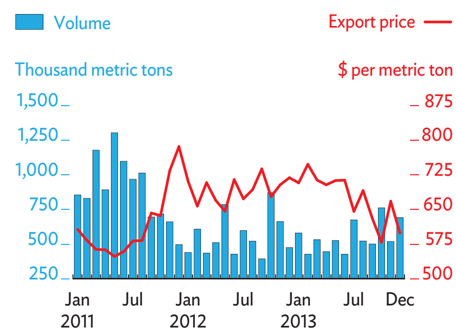
One proposal is for a nonpartisan agency, modeled on the Congressional Budget Office in the US, to project the potential cost, revenue, and other outcomes of legislation and fiscal proposals, with the aim of better informing parliamentary and public discussions. Wider public participation in and scrutiny of policy making would be useful, as would the strengthening of policy institutes and networks of nongovernmental organizations.

3.30.11 Current account balance



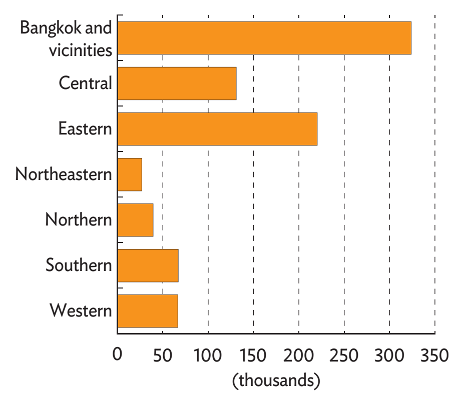
Source: Asian Development Outlook database.

3.30.12 Rice exports



Source: CEIC Data Company (accessed 26 February 2014).

3.30.13 Average GDP per capita by region, 1995-2011



Source: CEIC Data Company (accessed 12 March 2014).

Viet Nam

This economy now enters its third year of macroeconomic stability with lower inflation, strong external trade and capital flows, and a firmer exchange rate. GDP growth edged up in 2013 and is expected to recover further over the next 2 years. Inflation is forecast to remain relatively subdued. A return to the faster economic growth of previous years is hampered by the cautious pace of reform to banks and state enterprises.

Economic performance

Economic growth picked up slightly to 5.4% in 2013 (Figure 3.31.1), still well below the 7.0%–8.0% pace seen in 2004–2007. Services accelerated to 6.6%, making the biggest contribution to GDP growth. Hotels and restaurants grew by 9.9%, buoyed by an 11% increase in tourist arrivals, and banking and finance expanded by 6.9%, helped by easier credit. Reflecting subdued private consumption, growth in wholesale and retail trading decelerated to 6.5%.

The improved services performance offset a slowdown in industry, which grew by 5.4%. Mining output contracted as coal and crude oil production fell, but manufacturing expanded by 7.4%, driven by exports of manufactures from foreign-invested factories. Construction continued to recover from a slump to grow by 5.8% last year.

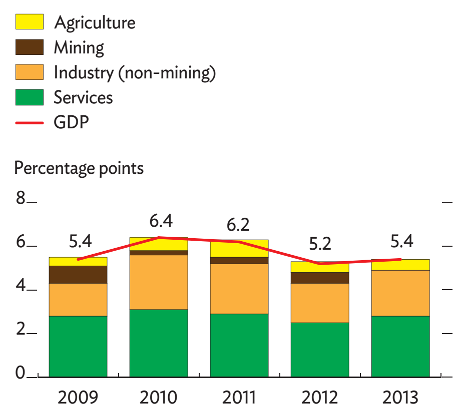
Agriculture and fisheries maintained modest growth at 2.7%. Fisheries now contribute 20% of this sector's output, about double their share 10 years ago.

From the demand side, increases in foreign direct investment and off-budget government outlays on infrastructure drove a 5.5% expansion of investment. This was from a low base in 2012, and gross capital formation as a ratio to GDP remained, at 27% in 2013, far below earlier peaks. Weakness in the labor market and lackluster consumer confidence held growth in private consumption to 5.2%. Public consumption rose by 7.3% in line with the government's policy to grow recurrent expenditure. Net exports of goods and services also contributed to GDP growth.

Inflation abated to average 6.6% last year, maintaining a steep decline from 18.6% in 2011 (Figure 3.31.2). Subdued domestic demand, steady food production, and soft international commodity prices contributed to dampening inflation. With food price inflation under control, the government raised administered prices for electricity, fuel, and medical services.

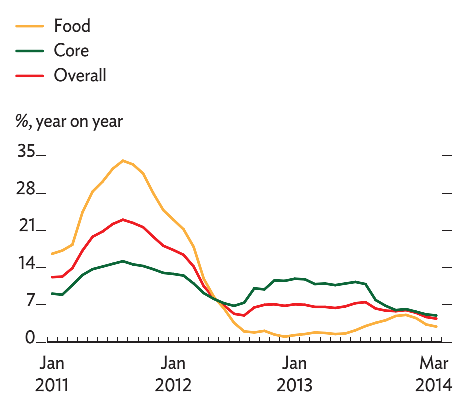
To help struggling businesses and lift growth, the State Bank of Viet Nam (SBV), the central bank, lowered its key policy interest rates

3.31.1 Supply-side contributions to growth



Source: Asian Development Outlook database

3.31.2 Inflation



Source: General Statistics Office of Viet Nam.

This chapter was written by Dominic Mellor, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, Asian Development Bank, Ha Noi.

by 200 basis points in 2013, following cuts of 600 basis points in 2012 (Figure 3.31.3). The SBV also reduced caps on certain deposit and lending rates.

Nevertheless, growth in credit was sluggish until late in 2013, when some banks extended temporary credit to meet a government target of 12.0% credit growth. For the year, credit grew by an estimated 12.5% (Figure 3.31.4). Credit growth remained constrained by uncertainties over the prevalence of nonperforming loans (NPLs), the slow progress of banking reform, and slack demand for credit. Broad money supply (M2) increased by an estimated 18%, above the SBV's 2013 target range of 14%–16%.

The Viet Nam dong was relatively stable through 2013. The currency was supported by easing inflation, strong external accounts, and positive real interest rates. An additional factor was the active sterilization of excess liquidity through the issuance of central bank bills. The SBV devalued the dong by 1% against the US dollar in June to stimulate exports.

Fiscal policy provided support to economic growth, with tax breaks for small- and medium-sized enterprises and increases in recurrent spending (Figure 3.31.5). The budget deficit as defined by the government widened to 5.5% of GDP in 2013 from 4.3% in 2012. Off-budget spending likely added to the overall fiscal deficit, though shortcomings regarding transparency in fiscal information make estimates difficult. Tax revenue has been hurt by the sluggish economy over the past 2 years, tax concessions, and reductions in import tariffs.

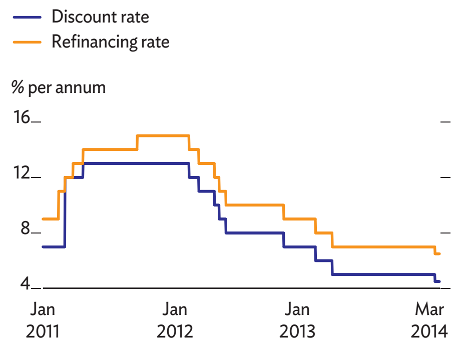
The government responded to revenue constraints by taking steps to improve the efficiency of public investment and by restraining capital spending from the budget. Total capital spending was estimated at 5.8% of GDP in the past 2 years, down from 8.4% in 2004–2011. Capital spending declined from roughly 72% of total spending in 2010 to 40% in 2013, partly because of a government decision to maintain in real terms recurrent spending to social sectors.

In the external accounts, merchandise exports rose by an estimated 15.3% on a balance of payments basis, with foreign-invested companies contributing 13 percentage points of this growth. Customs data showed exports of mobile phones jumped by 69% last year, computers and electronics by 36%,and textiles by 19%. Gains in manufactured exports offset declines in the value of agricultural and crude oil exports. Merchandise imports rose by an estimated 15.1%, driven by raw materials and inputs for manufacturing.

A trade surplus of $11.6 billion contributed to a current account surplus estimated at 6.5% of GDP, the third consecutive surplus achieved through growth in merchandise exports, tourism receipts, and remittance inflows. Net inflows of foreign direct investment were down a bit from the previous year at $7 billion, and net financing and portfolio inflows also fell. The balance of payments recorded a surplus estimated at 0.4% of GDP, and international reserves were estimated at 2.3 months of imports of goods and services (Figure 3.31.6).

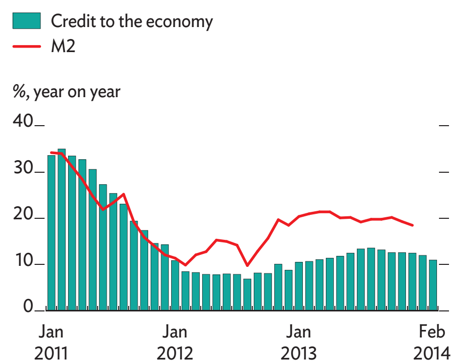
To mitigate vulnerabilities in the banking sector, the government took several steps that addressed impaired bank balance sheets, insufficient bank capital, and inadequate prudential standards.

3.31.3 Interest rates



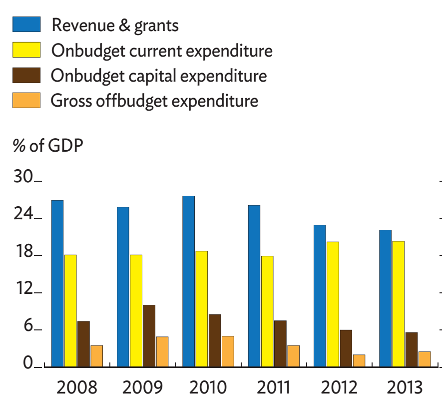
Source: State Bank of Viet Nam.

3.31.4 Credit and money supply growth



Sources: State Bank of Viet Nam; ADB estimates.

3.31.5 Budget revenue and expenditure indicators



Source: Ministry of Finance.

Most notably, it established the Viet Nam Asset Management Company (VAMC) primarily to acquire, restructure, and sell NPLs. By year-end, the VAMC had purchased the equivalent of $1.9 billion in bad debts from 35 banks (estimated at 1.1% of all outstanding loans). As payment, the VAMC issued special bonds of up to 5 years with zero interest, which the banks can use as collateral to access the SBV's refinancing facility.

The SBV reported that the NPL rate had declined to 3.6% of all loans by the end of 2013, owing mainly to transfers to the VAMC, but it added that NPLs could be 9% if restructured loans were included. Rating agency Moody's estimated NPLs could exceed 15% if international accounting and provisioning standards were applied (Figure 3.31.7).

In addition, the government is gradually implementing a program to strengthen state-owned enterprises (SOEs). This plan includes equitizing, or partly privatizing, more state firms and sharply reducing the number of SOEs to 690 by 2015 and 200 by 2020. SOEs have been instructed to divest themselves of risky noncore operations. In June 2013 the government simplified SOE reporting requirements in a move expected to encourage their disclosure of financial information.

Economic prospects

Official statements indicate that the government will act to support economic growth in the next 2 years, though its priority is to maintain macroeconomic stability. The forecasts below assume policy stimulation will be moderate and that the government will make further gradual progress on structural reform to the financial and SOE sectors.

The budget deficit target for 2014 is close to last year's, but the government increased the bond-issuance ceiling, which suggests that it could raise off-budget spending. Growth should get a lift from efforts to accelerate lagging programs as illustrated by a $1.4 billion housing assistance package unveiled in early 2013. Only 4% of this amount was disbursed by February 2014.

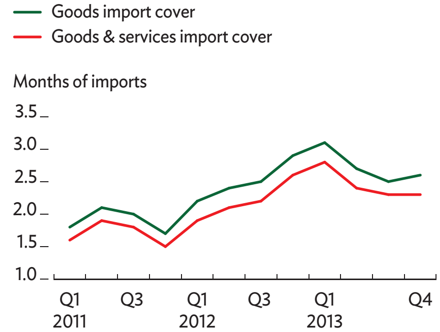
On the monetary side, the SBV further trimmed policy rates by 50 basis points in March 2014, taking the refinancing rate down to 6.5% and the discount rate to 4.5%. It also reduced the caps on certain deposit and lending rates. With policy rates at the lows seen in the last easing cycle, there is limited room for further monetary support. Interest rates could start to turn up next year.

To meet a target of 7% inflation, the SBV set targets of 12%–14% for credit growth, and 16%–18% for growth in total liquidity, all slightly higher than the 2013 targets.

Growth in private consumption will get support from lower inflation, but the labor market remains slack and consumer confidence lackluster. Strong disbursements from committed foreign direct investment, particularly from Japan and the Republic of Korea, will bolster investment in high-tech manufacturing (Figure 3.31.8). On the other hand, private domestic investment will still be dampened by banking system weaknesses.

Prospects for better performances in the US and euro area economies, two of Viet Nam's major markets, suggest that growth in exports can be maintained. Coffee exports should get a lift

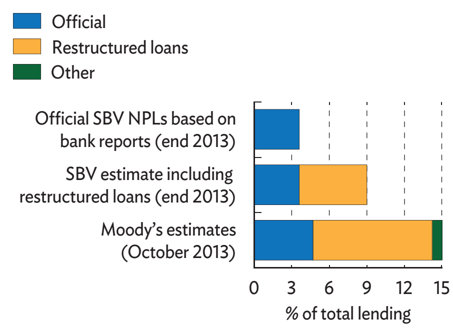
3.31.6 Gross international reserves



Note: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations. Imports are on free-on-board basis.

Sources: International Monetary Fund; ADB estimates.

3.31.7 Nonperforming loans



NPL = nonperforming loan, SBV = State Bank of Viet Nam

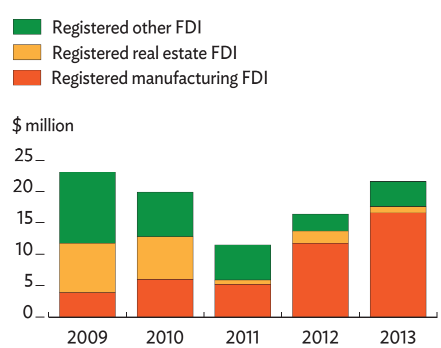
Sources: State Bank of Viet Nam; Moody's.

3.31.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.6	5.8
Inflation	6.2	6.6
Current account balance (share of GDP)	4.1	3.0

Source: ADB estimates.

3.31.8 Foreign direct investment by sector



FDI = Foreign direct investment

Source: General Statistics Office of Viet Nam.

from stronger global coffee demand in 2014 and export-oriented manufacturing industries continue to expand. However, growth in the manufacture of high-tech products also propels imports, because inputs to these factories are sourced largely from abroad.

Data for the first quarter of 2014 show that GDP rose by 5.0%, slightly faster than in the year-earlier quarter. Services expanded by 6.0% in January-March, industry and construction by 4.7%, and agriculture by 2.4%. As a sign of how the year started for manufacturing, the purchasing managers' index for February showed that output continued to grow, but the pace eased to the slowest in 4 months.

Considering these factors, GDP growth is forecast to rise slightly to 5.6% in 2014, picking up further to 5.8% in 2015 (Figure 3.31.9) with economic recovery in the US and the euro area and as progress is made in addressing domestic banking sector weaknesses.

Inflation is expected to average 6.2% in 2014, assuming reasonably stable food production, moderate policy stimulation, and only slight depreciation of the dong (Figure 3.31.10). Inflation eased to 4.4% in March 2014. Changes in assumptions, or unexpectedly large price increases for subsidized goods and services, would generate higher inflation. Inflation is forecast to average 6.6% in 2015 as economic activity picks up.

Trade and current account surpluses are projected over the forecast period, but narrowing from 2013. A relatively stable dong exchange rate since April 2011 has improved perceptions about the currency, but periodic internal flight to foreign currency and gold suggests that sentiment toward the dong remains fragile. Prices for gold that are higher domestically than overseas indicate that investors favor gold as an inflation hedge.

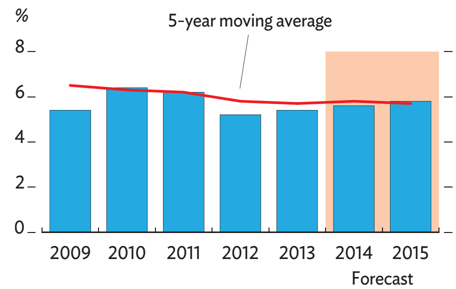
Negative errors and omissions in the balance of payments swelled to an estimated 6% of GDP in 2013, which may reflect large volumes of gold outside the banking system (Figure 3.31.11).

A return to the faster economic growth of previous years is hampered by the cautious pace of reform to the banking system and SOEs. The SBV has stepped up its supervision of bank lending, merged and restructured some of the weaker banks, and eased restrictions on foreign investment in domestic banks. After a year's delay, new loan classification and provision standards intended to close the gap with international norms will come into effect in June 2014.

However, these new standards are less ambitious than originally intended, and further delay affects some key measures such as the requirement to adjust loan classifications based on credit information center data. Also, banks will continue to enjoy flexibility when restructuring overdue loans and the discretion to avoid declaring them as bad debt. Accelerating progress on resolving NPLs is likely to require setting firm targets and timelines for closing the gap between national and international standards.

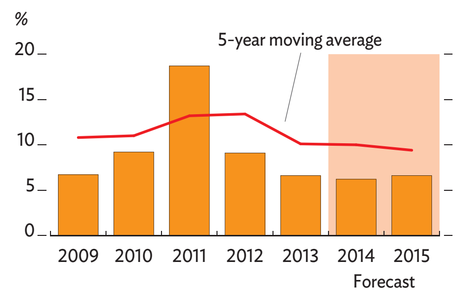
In 2014, the VAMC plans to purchase the equivalent of up to $4.8 billion of bad debt from banks. Among the challenges facing the asset-management company are to build sufficient capacity to undertake complex debt restructuring and to pursue the task with initial capital of only $24 million. Effective mechanisms to price and auction bad debts,

3.31.9 GDP growth



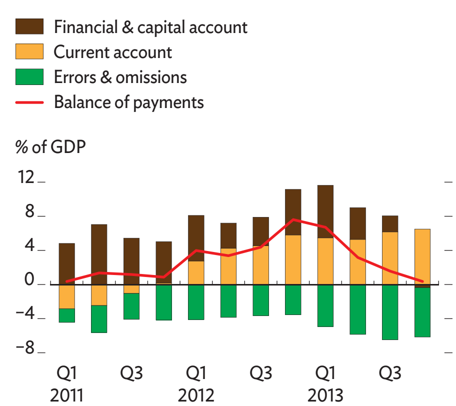
Source: *Asian Development Outlook* database.

3.31.10 Inflation



Source: *Asian Development Outlook* database.

3.31.11 Balance-of-payments indicators



Sources: State Bank of Viet Nam; International Monetary Fund; ADB estimates.

and to auction collateralized assets, have yet to be put in place. Changes are required in the regulatory framework and bankruptcy law to allow the VAMC to handle debt and related collateral in a timely way.

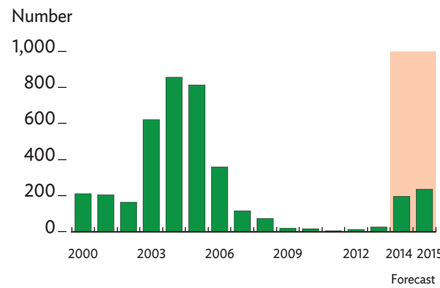
As the banks clean up NPLs they will still need capital injections, but it is unclear how and when they will be recapitalized. Bank recapitalization and SOE reform need to be pursued together with NPL resolution.

On SOE reform, the government aims to partly privatize 432 SOEs during 2014–2015 (Figure 3.31.12). That appears ambitious, considering that only 99 SOEs were equitized during 2011–2013. The domestic stock market has rallied to push the share price index up by 30% from August 2013 to March 2014. But total stock market capitalization remains fairly small relative to the capital needed to ensure a successful equitization program. The government has approved share sales at below par value, which could help set prices that attract investors.

A new constitution for Viet Nam approved by the National Assembly in November 2013 reaffirmed the dominant economic role of SOEs, disappointing business groups and others who hoped the role of the private sector would be more explicitly recognized. In a decision that should improve the accountability and management of SOEs, the government also approved a new procurement law that extends coverage to include SOEs.

In another reform, a new land law that takes effect in July 2014 will improve transparency in land administration. If implemented well, this law will help minimize conflicts and delays in infrastructure projects.

3.31.12 State owned enterprises equitized



Source: Ministry of Finance.

3.31.2 Ranking of infrastructure, selected economies

	2013–2014
Malaysia	29
Thailand	47
Indonesia	61
Viet Nam	82

Source: World Economic Forum. 2013. *The Global Competitiveness Report 2013–2014.* http://www.weforum.org

Policy challenge—public–private partnership

The quality of infrastructure in Viet Nam lags behind that of most other major Southeast Asian economies (Table 3.31.2). According to the government, Viet Nam needs to invest $170 billion in physical infrastructure such as electricity and water supply, transportation, and sewerage from 2011 to 2020. Public funding and official development assistance are expected to meet only half this need. The government's capital spending is constricted by a persistent fiscal deficit, which averaged 5% of GDP in 2010–2013.

Attracting private investment in infrastructure, mainly through public–private partnership (PPP), could substantially contribute to funding projects but also help gain access to international expertise and technology that improves efficiency and service delivery.

So far, however, private investment in infrastructure has been very limited. For a start, the existing regulatory framework is not conducive to facilitating PPP transactions. Also, government agencies have developed their own practices in build-operate-transfer projects, the favored PPP structure, that depart from standard international practice. Most such projects have not been awarded through competitive bidding.

The private sector views the bidding and negotiating process for PPPs in Viet Nam as unpredictable and lengthy. It is further concerned about the adequacy of PPP feasibility studies.

To address these issues, the government established the National Steering Committee on PPPs in 2012, chaired by the deputy prime minister. The committee is an advisory board to the government, not the PPP authority for projects. The Ministry of Planning and Investment established a PPP office that has become the central coordinator of PPP projects.

Last year, the government directed the Ministry of Planning and Investment to draft a decree that would improve the regulatory framework for PPP, replacing earlier PPP-related legislation in favor of a framework that is more user-friendly and easier to administer. The draft decree, now undergoing consultation with government officials, development partners, and the private sector, proposes comprehensive regulation of PPP and includes greater emphasis on competition in the selection of investors. It further introduces principles for sharing risk between private investors and the government.

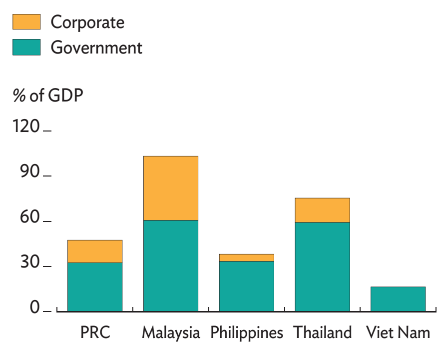
The decree is expected to be adopted by the government later this year. Separately, a new procurement law that will govern selection procedures for PPP investors will take effect in July 2014.

The financial viability of some infrastructure—urban transport, waste water, sanitation, and renewable energy—needs to be enhanced, given low tariffs the public pays for these services. The government could consider options to provide viability gap funding by, for example, making land available at no cost or through grants to selected projects. Such subsidies should be time-bound and targeted, and backed by explicit government policy, to achieve their declared outcomes regarding, for instance, environmental and social equity objectives.

While the authorities have committed to a level playing field for bidders competing for PPP opportunities, the private sector is concerned about bidding transparency and SOE access to state-directed or preferential financing. A level playing field will require progress on SOE reform, including improved corporate governance. Also important is to ensure greater policy clarity and consistency with respect to private sector participation in the economy, including through PPPs, and continuing government attention to constraints faced by partners involved in PPPs.

Another need is to develop the domestic financial system to improve access to long-term funding for infrastructure through bank loans and debt markets. The Viet Nam capital market remains relatively shallow (Figure 3.31.13). Foreign banks are a potential source of medium- and long-term lending in foreign currencies but require credit enhancements and guarantees, such as those from export credit agencies. Until Viet Nam has a more established track record for PPP, the government may need to provide credit enhancements and underwrite guarantees.

3.31.13 Local currency bond market, 2013



PRC = People's Republic of China.

Note: Data for Philippines and Thailand are as of September 2013.

Source: Asian Development Bank. Asian Bonds Online. http://asianbondsonline.adb.org/ (accessed 15 March 2014).

THE PACIFIC

Fiji

Papua New Guinea

Solomon Islands

Timor-Leste

North Pacific economies

South Pacific economies

Small island economies

Fiji

Economic growth picked up in 2013, stimulated by an expansion of government expenditure to rehabilitate and upgrade the country's road network, and by increased domestic investment and consumption. Business confidence continues to strengthen as clear progress is made toward elections scheduled for September 2014. Sustaining recent increases in domestic demand and private sector investment is vital to maintaining growth and achieving fiscal sustainability in the long run.

Economic performance

The latest official estimate is that Fiji posted 3.6% GDP growth in 2013 as the economy rebounded from poor performances in agriculture and mining, and from severe flooding at the start of 2012 (Figure 3.32.1). Recovery in agricultural output and stronger performances in wholesale and retail trade, transport and storage, communication, and financial intermediation contributed to broad-based economic growth. As preparations for elections in September 2014 have achieved their milestones, domestic investor confidence has improved and private sector activity has rebounded after a weak 2012.

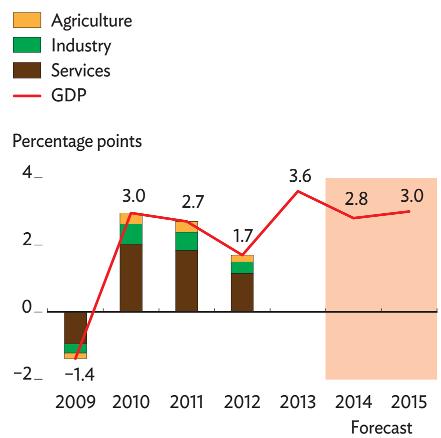
The government's expansionary fiscal policy increased expenditure by 12% in 2013, boosting both public and private investment. Projects to rehabilitate and upgrade the country's road network drove an increase of more than 30% in capital expenditure during the year. Buoyant construction drove domestic cement sales up by 20% in 2013 and imports of investment goods up by 27% from January to November 2013.

Consumption indicators also showed consumer spending strengthening over the course of the year, supported by higher disposable incomes. Tax cuts and higher tax thresholds, combined with strong remittance inflows—which rose by 6.9% over the year to October—fueled consumption growth. Higher consumption spending was reflected in higher value-added tax revenues, which increased by 11.1%.

The performance of Fiji's leading production sectors—sugar, tourism, and gold—was mixed in 2013. Total production of sugar, Fiji's primary agricultural commodity, increased by 16.2%, reversing a contraction of 7.1% in 2012. Better-quality cane and recent investments that improved the operational efficiency of mills contributed to growth. Latest data from the Fiji Bureau of Statistics indicate that the value of sugar exports in 2013 was only 3.6% higher than in the previous year because international prices for the commodity fell (Figure 3.32.2).

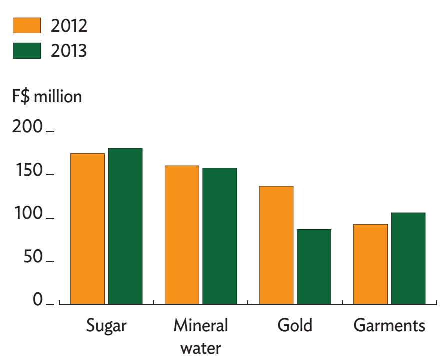
Gold production, which declined by 8.0% in 2012, fell even further by 15.6% in 2013 as production performed below expectations.

3.32.1 Supply-side contributions to growth



Sources: Fiji Bureau of Statistics; ADB estimates.

3.32.2 Principal exports



Sources: Fiji Bureau of Statistics; ADB estimates.

This chapter was written by Caroline Currie of the South Pacific Subregional Office, Asian Development Bank, Suva; and Christopher Edmonds and Rommel Rabanal of the Pacific Department, Asian Development Bank, Manila.

Lower gold prices meant that the value of gold exports fell by 36.4% during the year. Vatakoula Gold Mines, the operator of the country's single gold mine, is investing in capital works and exploration aimed at improving production from the mine.

Tourist arrivals stabilized over the first 3 quarters of 2013 with a small increase of 0.4%, following a 2.5% fall in 2012. Arrivals from Australia, by far the largest source of foreign tourists, mirrored this trend, growing by 0.4% in 2013. The number of arrivals from New Zealand, Fiji's second-largest overseas tourist market, posted 7.2% growth over the year (Figure 3.32.3). Tourism receipts registered a 1.7% increase over the first 3 quarters of the year, suggesting rising expenditure per tourist.

Inflation moderated to an average annual rate of 2.9% from 3.4% in 2012 (Figure 3.32.4). Early inflationary pressures from supply disruptions caused by Cyclone Evan dissipated quickly, then lower international commodity prices kept inflation low until late in the year, when rising fuel prices began to push it up again.

The current account deficit spiked last year, rising from 1.5% in 2012 to 18.5% in 2013 (Figure 3.32.5). Fiji Airways' purchase of three new aircraft at a total cost of about $600 million was the main factor behind the large deficit. Also, export revenues contracted by 5.0% during the year as revenues from gold and other commodity exports such as mineral water declined. The value of the country's imports of manufactured goods increased by 5.8% from January to October 2013. At the end of January 2014, foreign reserves stood at almost F$1.8 billion, equivalent to 4.7 months of import cover.

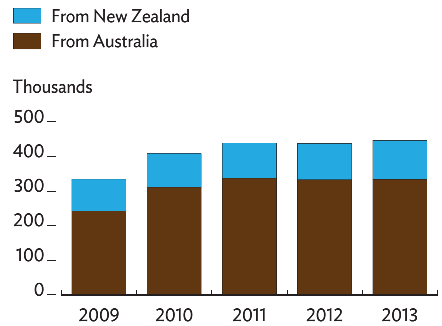
Economic prospects

Growth is projected to moderate to 2.8% in 2014, as record investment growth levels off and the stimulatory effects of one-off tax cuts and higher tax thresholds in 2013 dissipate. The economic outlook continues to improve on previous projections, though, and early growth indicators are positive for 2014. In the near term, recently completed, ongoing, and planned projects including the Damodar City project in Suva, a couple of large hotel and resort developments, and the upgrading of Nadi International Airport, are expected to boost employment and economic activity. In the longer term, these projects are seen to benefit tourism and related sectors such as transport and wholesale and retail trade.

Growth is projected to accelerate to 3.0% in 2015 with development partner financing in the post-election period, continued improvement in investor confidence, and rising private sector activity stemming from greater policy certainty. The current dependence on consumption-driven growth is unsustainable in the medium term, however, and some rebalancing toward broader-based growth is essential. One downside risk to growth is the large public debt, which was equal to 48% of GDP in 2013. A related risk is high contingent liabilities, which equaled 30% of GDP in the same year.

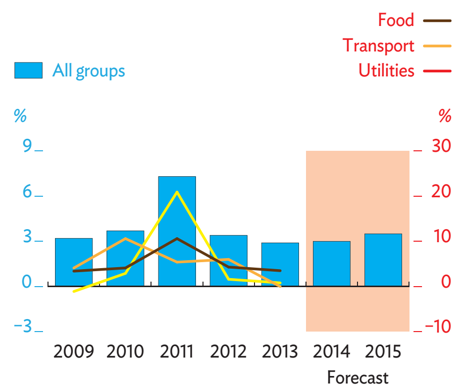
Fiji's inflation rate has moderated in recent years and is expected to remain at 3.0% in 2014, as projected declines in international food and fuel prices are offset by continued fiscal expansion. Inflation is

3.32.3 Tourist arrivals from Australia and New Zealand



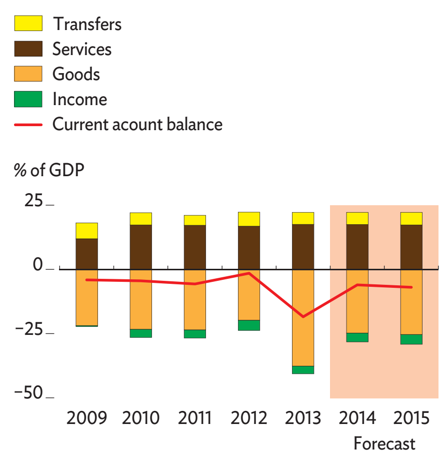
Sources: Australian Bureau of Statistics; Statistics New Zealand.

3.32.4 Inflation



Sources: Australian Bureau of Statistics; Statistics New Zealand.

3.32.5 Current account balance



Source: International Monetary Fund. 2013. Republic of Fiji: Staff Report for the 2013 Article IV Consultation. December.

seen to accelerate to 3.5% in 2015 in line with the projected acceleration in growth.

The current account deficit is expected to show an improvement over 2013, narrowing to 6.1% of GDP in 2014 as tourism earnings and personal remittances rise. Exports are forecast to grow by 5.3% in 2014, while imports are expected to decline by 16.4% toward a more typical level following last year's aircraft purchases. The 2015 current account deficit is projected to widen to 7.1% of GDP, reflecting stronger investment and consumer demand in the economy.

Government expenditures are set to increase further by 28% in the 2014 budget as both recurrent and capital expenditure increase (Figure 3.32.6). Free primary and secondary education is a significant addition to recurrent expenditure. The budget forecasts a deficit equivalent to 1.9% of GDP, which would improve on the deficit of 2.8% recorded in 2013. The government's revenue forecast anticipates that continuing high domestic investment and consumption spending will bring an 11% increase in tax revenues, led by a projected 14% rise in value-added tax collections. If actual economic performance falls short of projections, the deficit will be wider. The target deficit counts revenue from the one-time sale of strategic assets, including overseas embassies and some of the better-performing state-owned enterprises, which will boost revenue only temporarily.

Policy challenge—balancing fiscal sustainability and inclusive growth

The government is stepping up to the challenge of promoting inclusive growth to reduce poverty and achieve the Millennium Development Goals. A poverty benefit scheme budgeted at F$22 million will more than double coverage of the poor, from 3.0% to 6.4%. A F$3 million social pension fund will support those aged 70 and over who have no other pension, and a separate F$4.5 million fund will protect children. The introduction of free education, while untargeted, is a pillar of the government's strategy to alleviate poverty.

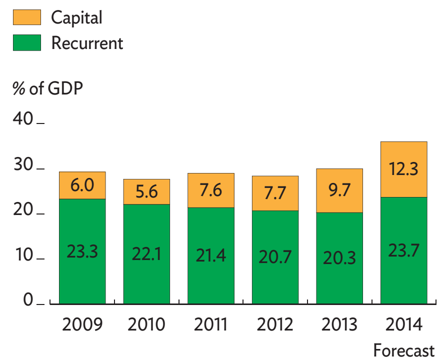
However, financing the increased public expenditure on social programs could require the government to take on substantial new debt or sell off public assets unless growth accelerates sharply. Balancing the goals of inclusive growth and fiscal sustainability will require the reinvigoration of private sector investment, which depends on improvements in the business environment. The main issues investors report relate to barriers faced in starting a business, trading across borders, and paying taxes. A return to elected government should be an important step toward restoring investor confidence. Greater public participation in policy development and progress in regional cooperation and integration initiatives should catalyze external demand and foreign investment.

3.32.1 Selected economic indicators (%)

	2014	2015
GDP growth	2.8	3.0
Inflation	3.0	3.5
Current account balance (share of GDP)	–6.1	–7.1

Source: ADB estimates.

3.32.6 Components of government expenditure



Source: Fiji Ministry of Finance. Economic and Fiscal Update: Supplement to the 2014 Budget Address.

Papua New Guinea

Growth is forecast at 6.0% in 2014 and a record 21.0% in 2015, led by the commencement of gas exports in late 2014. In contrast with mining and petroleum, the rest of the economy will grow by just 1.6% in 2014. A challenge for the government is to share the benefits of growth and to narrow regional inequality by expanding services in rural areas and employment through a more conducive business environment.

Economic performance

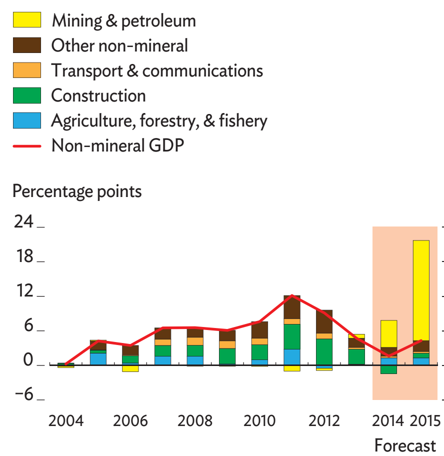
Economic growth in Papua New Guinea (PNG) slowed to 5.1% in 2013 as construction on a $20 billion liquefied natural gas (LNG) project wound down toward completion in mid-2014 (Figure 3.33.1). Growth in construction halved from 24% in 2012 to 12% in 2013, and this deceleration spilled over into the broader economy, slowing growth in wholesale and retail trade from 20% in 2012 to 5% in 2013. Long-term declines continued at a number of older mining and oil operations, but they were more than offset by increased output from a new nickel project, such that mining and quarrying as a whole expanded by 15% in 2013.

Agriculture, forestry, and fisheries grew at a modest 0.5% in 2013. Although this improved on the 1.6% contraction in 2012, conditions in the sector continue to be hampered by falling commodity prices, declining yields from aging plantations, inadequate pest control, and poor transport infrastructure. Further, an elevated exchange rate for much of the year discouraged farm output, especially of labor-intensive cash crops like copra, cocoa, and coffee.

National budget appropriations grew by 20% in 2013, while revenue growth was a more modest 9.5%. This widened the official fiscal gap to the equivalent of 7.9% of GDP and brought central government debt to 31% of GDP, up from 26% in 2012 (Figure 3.33.2). Funding for the government's four priority "development enablers"—infrastructure, education, health, and law and order—continued to grow rapidly, increasing by 38% over 2012 (Figure 3.33.3). The share of total funding for these four priorities doubled from 20% of the budget in 2003 to 40% in 2013.

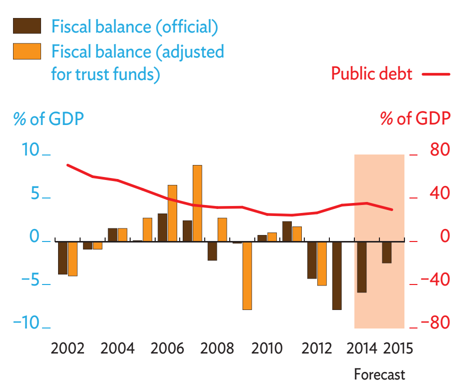
A major challenge to budget execution continues to be implementation capacity, particularly for new national infrastructure projects, which suffer weak monitoring and oversight. Allocations continue to be assigned to many projects before the completion of their feasibility studies and preparatory design. As of November 2013, only 35% of the budget allocation for new capital projects had been spent, with most allocations sitting unused in project trust accounts rather

3.33.1 Supply-side contributions to growth



Sources: PNG Department of Treasury. *National Budget.* Various years; ADB estimates.

3.33.2 Fiscal balance and public debt



Sources: PNG Department of Treasury. *National Budget.* Various years; ADB estimates.

This chapter was written by Aaron Batten of the Papua New Guinea Resident Mission, Asian Development Bank, Port Moresby.

than flowing into the economy (Figure 3.33.4). As a result, the planned fiscal stimulus for 2013 had only a limited effect on economic activity during the year.

Inflation continued to remain moderate in 2013, with the consumer price index estimated to have risen by 4% at year-end (Figure 3.33.5). Subdued international food and commodity prices and low inflation in key trading partners, notably Australia, contributed to this outcome. The relatively high value of the PNG kina helped restrain import prices (Figure 3.33.6).

Motivated by moderate inflation and slowing growth in the economy, the central bank continued to ease monetary policy during 2013, lowering the target policy rate to 6.25% in March 2013 from a peak of 7.75% in September 2011. However, persistently high excess liquidity in the commercial banking system keeps policy rates largely disconnected from actual market rates. Even as aggregate output growth slowed during the year, growth in credit to the private sector accelerated, expanding by 18% in 2013, up from 7% in 2012. This somewhat counterintuitive trend reflects the winding back of runaway profit growth in many sectors resulting from investment in the LNG project. As profit growth has slowed, many firms are now looking again to the commercial banking system to fund their investment plans, rather than self-financing them through retained earnings.

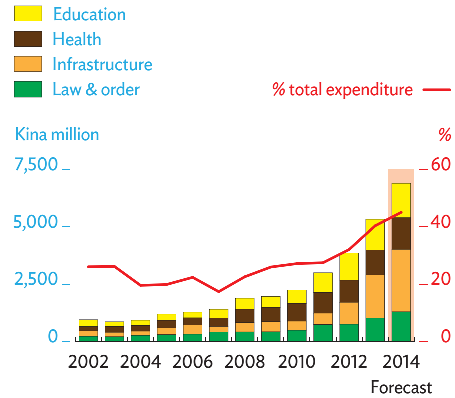
The current account recorded a deficit of 13.7% of GDP in 2013, driven by large capital imports and service payments related to LNG project construction (Figure 3.33.7). As these payments are primarily funded by foreign direct investment and medium- and long-term loans, they pose little risk to PNG's external stability. Although international reserves declined by 18.0% during the first half of 2013, they remain healthy, sufficient for 10.9 months of import coverage.

Economic prospects

GDP growth is forecast at 6.0% in 2014, picking up to a record 21.0% in the following year although ongoing challenges with the quality of macroeconomic data continue to limit the accuracy of these forecasts (Box 3.33.1). Leading this growth is oil and gas, as LNG production is expected to commence in late 2014, making 2015 the first full year of production. The rebound in mining and quarrying is expected to continue as new operations further expand production, boosting real growth in that sector to 14.0% in 2014 before it falls back to 3.1% in 2015.

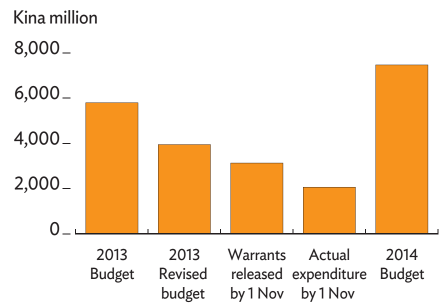
In contrast with mining and petroleum extraction, activity in the rest of the economy is expected to continue to slow, with growth forecast at just 1.6% in 2014. Construction is forecast to contract by 6.4% in 2014, following the completion of the LNG production facilities and pipeline by the middle of the year. Growth in transport and logistics, wholesale and retail trade, and financial services will ease from the highs recorded over the previous 3 years. The agriculture, forestry, and fisheries sector is expected to recover, with growth of 4.0% in both 2014 and 2015. Agricultural output is expected to be boosted by the kina's decline at the end of 2013, which has improved the export competitiveness of cash crops.

3.33.3 Expenditure by development enabler



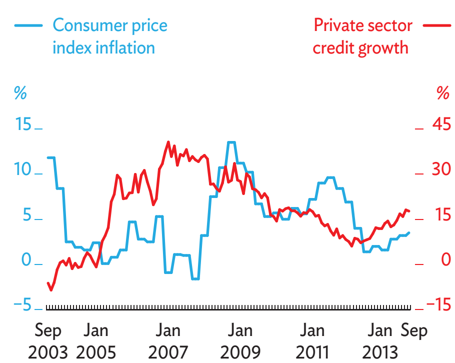
Sources: PNG Department of Treasury. *National Budget*. Various years; ADB estimates.

3.33.4 Budget implementation



Sources: Department of National Planning and Monitoring. *National Budget*. Various years; ADB estimates.

3.33.5 Inflation and private sector credit



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues.

3.33.1 Macroeconomic data limitations

The accuracy of macroeconomic monitoring and forecasting in PNG is increasingly hampered by deficiencies in official data collection and compilation. GDP data were last published by the National Statistics Office for 2006 and last reported to the International Monetary Fund for 2004. The Treasury Department has made do with its own GDP estimates since 2002, but they suffer from extremely limited source data and their coverage from the perspective only of sector-based production. Income and expenditure accounts have remained unavailable since 2007.

Further undermining GDP data is the use of the outdated base year of 1998 for calculating real GDP figures. As the structure of the PNG economy has changed rapidly over the past decade—a trend that will likely continue during the forecast period—this problem continues to create significant biases in GDP growth rates overall and by sector.

The National Statistics Office compiles a quarterly consumer price index and an unpublished wholesale price index. Both are based on expenditure weights that are 39 years old, and the lack of data collection means the index now excludes a number of key items such as accommodation. These limitations significantly hinder the reliability of inflation calculations and estimates.

Regarding external accounts, official data on exports and imports of goods differ markedly from those reported by trading partners. Financial accounts data suffer from deficiencies in collection, especially regarding private external debt and foreign direct investment.

Poor macroeconomic data significantly hamper the ability of policy makers to monitor emerging economic trends and risks, or to implement in a timely way countercyclical monetary policies. They also create financial costs for the economy. Standard and Poor's highlighted in its January 2014 update that gaps in PNG macroeconomic statistics constrained the country's creditworthiness.

In partnership with the International Monetary Fund, the government has begun to address some of these issues. Prioritizing this effort during 2014 will be vital to ensure that official macroeconomic statistics are able to give more accurate insights into PNG's real economy and to improve the quality of macroeconomic management in the future.

Although GDP growth is expected to hit record highs in 2015, this will have only limited immediate impact on the broader economy and job creation. As international investors own some 80% of the LNG project, it is likely most earnings will remain offshore. And, as the project comes onstream, employment in the project will drop dramatically, from a peak of about 16,000 workers during construction to a few hundred once the project is fully operational. As a result, the project will have much less impact on gross national income than on GDP. The project's key transmission mechanism to the domestic economy will be dividend and tax payments to the national government, which are expected to peak in the early 2020s. During the initial years of production, some of these revenues will likely be required to service loans that fund the state's equity holding in the project. They may also be used for investment in further resource development.

3.33.1 Selected economic indicators (%)

	2014	2015
GDP growth	6.0	21.0
Inflation	6.5	5.0
Current account balance (share of GDP)	–7.0	13.0

Source: ADB estimates.

The 2014 budget remains expansionary, with a planned fiscal deficit equivalent to 5.9% of GDP. Despite the dampening effect of lower global commodity prices and a growth slowdown in the non-mineral economy, revenue collection is forecast to grow by a record 23% in 2014, underpinned by planned improvements in tax compliance and enforcement. The depreciation of the kina against major currencies such as the Australian and US dollar during the latter part of 2013 is expected to bolster tax receipts from commodity exports and development assistance, both of which are largely denominated in these foreign currencies.

Despite the implementation challenges experienced in 2013, infrastructure is again a major recipient of new funding in 2014, with allocations increasing by 42%. Additional expenditure in the 2014 budget remains broadly aligned with the government's other medium-term development enablers: education, health, and law and order.

Central government debt is expected to reach 35% of GDP in 2014. While this is broadly sustainable and in line with the limits established in the government's medium-term fiscal strategy for 2012–2017, a number of additional liabilities raise fiscal risks. Unpaid superannuation arrears and the financing of the government's equity stake in the LNG project bring gross public debt to approximately 56% of GDP. Further, the inclusion of public enterprise debt estimated at 7.5% of GDP (as recorded in 2010) would bring combined indebtedness to over 63%.

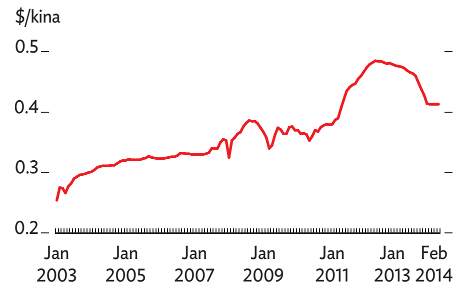
Inflation is anticipated to accelerate to 6.5% in 2014, as public investments originally planned for 2013 finally roll out and as kina depreciation in late 2013 passes through to imported prices. In 2015 inflation is expected to return to its long-run average and is forecast at 5.0%, but this depends on the government reining in expenditure growth and on the central bank maintaining prudent monetary policies. Domestic deposit rates are anticipated to remain near zero for the foreseeable future unless the central bank undertakes monetary interventions sufficient to soak up liquidity in the banking system.

The current account deficit is expected to narrow to 7.0% of GDP in 2014 before becoming a surplus of 13.0% in 2015. The improvement in the external balance is driven largely by the commencement of LNG exports in late 2014, but also by expanding nickel production at the new mine. In line with LNG exports, payments from abroad are expected to increase substantially from 2015, mainly through income and dividend payments to the government.

Policy challenge—addressing regional fiscal inequality for inclusive growth

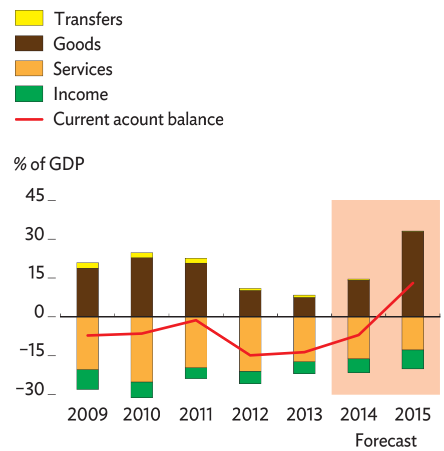
Royalty payments from resource projects and larger value-added tax collections in major urban centers mean that the ability of PNG's 22 provincial governments to raise own-source revenues varies significantly. In 2009, the Government of PNG undertook reforms to address this, allocating 5.6% of non-mineral revenues to create a pool of national funds to compensate poorer provinces with higher national government grants. The compensation provided to each province would

3.33.6 Exchange rate



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues.

3.33.7 Current account components



Sources: PNG Department of Treasury. *National Budget*. Various years; ADB estimates.

be based on its ability to raise own-source revenue relative to what the government's National Economic and Fiscal Commission estimates it should cost the province to deliver 11 minimum priority activities: the provision of school materials, the supervision of education staff, district education office operations, rural health facility operation, integrated health patrols, medical supply distribution, road and bridge maintenance, airstrip maintenance, wharf and jetty maintenance, agricultural extension services, and operational materials.

Following these reforms, significant progress has been made in narrowing provincial fiscal inequality. Prior to reform, six provinces received less than half of what the commission calculated they needed to fund the minimum set of activities, and another four received less than 70%. By 2012, only three provinces received less than 70% of their needs, with the lowest-funded province receiving 65% (Figure 3.33.8). This has placed previously marginalized provinces in a much stronger fiscal position to fund routine service delivery.

Further, because provinces rely increasingly on so-called function grants from the national government, and because function grant spending is tied to a priority list of activities, the proportion of provincial government spending on key development activities has increased. Spending on the national government's development enablers has increased by 160% since the reforms.

Yet, while provincial fiscal reform has helped to equalize the financial capability of provincial governments, a number of challenges remain to translating this additional money into inclusive development outcomes.

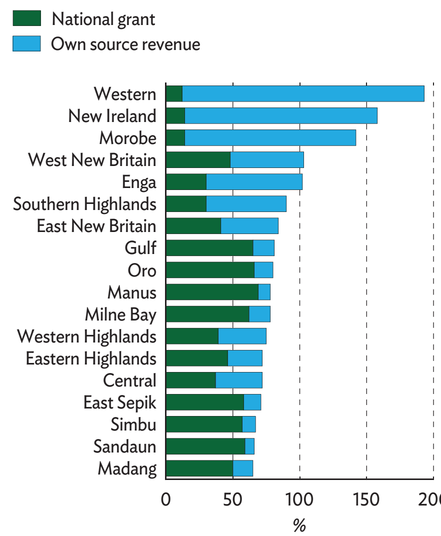
One challenge is the allocation of Provincial Government's own source revenues which continue to fund non-priority activities—in particular those related to wages and salaries of government staff. The National Economic and Fiscal Commission calculates that in 2012 provincial governments overspent on administration by 123%.

Another challenge is the timing of function grant release, which is often slow and unpredictable. In many cases, provinces receive their allocations too late in the year to use them effectively. In 2012, for example, eight provinces had to wait until the final fiscal quarter to receive more than 40% of their annual allocations.

Yet another challenge is weak implementation capacity in provincial governments, which lack skills for project costing, contracting, and management. Greatly expanded funding has strained procurement systems, while control and accountability mechanisms are rarely able to account for funds once they have been released.

Ensuring that improved provincial fiscal equity translates into inclusive development outcomes will require focusing not just on financing capacity but also on improving provincial governments' underlying systems of accountability and implementation for essential public services.

3.33.8 Provincial fiscal capacity, 2012



Source: National Economic and Fiscal Commission. 2013. *Provincial Expenditure Review.*

Solomon Islands

Economic growth moderated in 2013 as forestry, agriculture, and mining declined. A slight pickup in growth is forecast for 2014, but rapid population growth will rule out much improvement in GDP per capita. Slower growth in recent years has placed pressure on the government budget and reinforced the need to control government expenditure and improve its quality to meet the needs of an expanding population.

Economic performance

Growth slowed to 2.9% in 2013 from 4.8% in the previous year (Figure 3.34.1). This weak outcome, which reflected mainly declines in earnings from gold and agriculture, only slightly outpaced population growth at 2.5%. The value of gold production fell by 15% in 2013, mainly because gold prices were lower and the gold processing plant underwent major refurbishment. Agricultural production fell in 2013, with most agricultural commodities recording output declines because of poor weather in the first half of the year and lower prices.

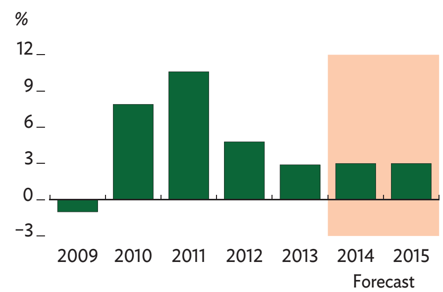
Logging fell by 3.0% because of weather and prices but still recorded the country's third-largest annual harvest (Figure 3.34.2). This rate of extraction, and its heavy reliance on logging previously harvested forests, appears unsustainable, such that production is expected to continue to contract as forest stocks decline.

Growth in 2013 was driven by expansion in construction, manufacturing, and services. In particular, investment in the Gold Ridge mine and expanded production at the Noro tuna-processing factory boosted growth.

Consumer price index inflation averaged 6.0%, up slightly from 5.9% in 2012 (Figure 3.34.3). Inflation was high in the first half of 2013, largely because unusually heavy rains in the second quarter drove up food prices, but it moderated in the second half. Falling prices for imported goods helped subdue the inflation average for the whole year. The appreciation of the Solomon Islands dollar against the Australian dollar in particular helped tame inflation because Australia is the main source of imports.

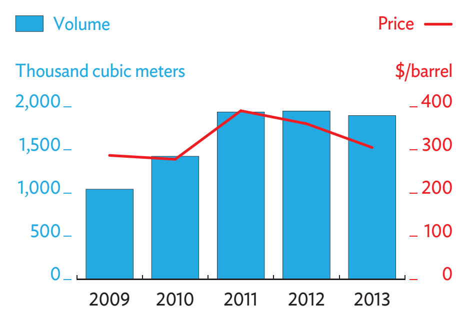
After a small current account deficit in 2012, the deficit widened to 2.0% of GDP in 2013 as export earnings from gold, logging, and agricultural commodities fell and imports expanded to support major investment projects. Despite the deteriorating current account deficit, foreign reserves remained high, bolstered by large inflows of grants and foreign direct investment. As of December 2013, foreign exchange reserves provided 7.8 months of import cover, down from 8.5 months in December 2012.

3.34.1 GDP growth



Sources: Central Bank of Solomon Islands; ADB estimates.

3.34.2 Timber exports



Sources: Central Bank of Solomon Islands; World Bank. Commodity Price Data (Pink Sheet). http//econ.worldbank.org (accessed 15 March 2014); ADB estimates.

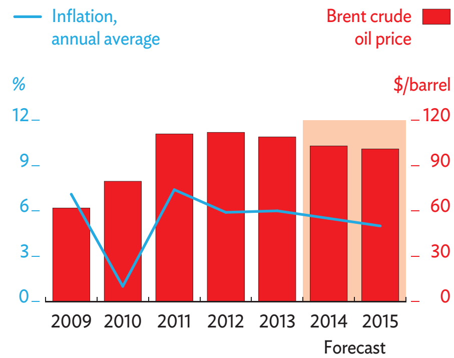
This chapter was written by Milovan Lucich of the Pacific Liaison and Coordination Office, Asian Development Bank, Sydney.

In 2013, the Central Bank of Solomon Islands undertook short-term measures to alleviate inflationary pressure, including mopping up liquidity by issuing short-term bills. Although the central bank formally moved to peg the Solomon Islands dollar to a basket of currencies in October 2012, it has continued in practice to intervene in currency markets to limit fluctuations in the US dollar–Solomon Islands dollar exchange rate. The appreciation of the US dollar in 2013 therefore meant that the Solomon Islands dollar appreciated strongly against the Australian dollar over the year. Following a major Australian bank's withdrawal of trade financing for logging exports in response to environmental concerns about logging practices, the Solomon Islands government offered additional banking licenses. So far, however, only one provisional license has been granted—to a domestically incorporated bank with ties to Sri Lanka—and this bank has yet to start operations.

The government budgeted a small fiscal surplus in 2013, but revenue growth disappointed. Domestic revenues actually fell, inducing the government to reduce capital expenditures. The buildup of large spending arrears necessitated the approval of a supplementary budget in September 2013. For the year, the overall deficit equaled 0.7% of GDP.

The government continued to make progress in controlling external debt, which fell from the equivalent of 13.0% of GDP at the end of 2012 to 11.4% a year later. The government's debt-management strategy provides for an annual limit on new borrowing based on an annual analysis of debt sustainability undertaken as part of the budget process. A debt-management advisory committee composed of senior government officials with expertise in debt management, planning, and economic and monetary policy was established to provide advice to the finance minister on proposed new borrowing by the public sector.

3.34.3 Inflation



Sources: Central Bank of Solomon Islands; World Bank. Commodity Price Data (Pink Sheet). http//econ.worldbank.org (accessed 15 March 2014); ADB estimates.

Economic prospects

Growth is expected to pick up slightly, to 3.0%, in 2014. Agricultural production and gold output are projected to increase and offset declining log production as forest resources dwindle. Gold mining is expected to scale up as the Gold Ridge mine moves towards full production capacity of 95,000 ounces per year, well above the production of 57,400 ounces in 2013. The recovery in agriculture output in the second half of 2013 is predicted to continue in 2014.

In 2015, growth is projected to hold steady at 3.0%, driven by fiscal stimulus from investment projects and their spillover effects on the economy. Modest increases in gold production are also expected as planned improvements in production processes are implemented. Logging is expected to continue to decline in the medium term at an average annual rate of 8.0%.

Inflation is expected to moderate slightly in 2014, falling to an average annual rate of 5.5% as the inflationary impact of poor weather in mid-2013 dissipates. Reflecting the country's modest growth expectations and continued declines in import prices, inflation is expected to moderate further, to 5.0%, in 2015.

A balanced budget is planned for 2014, but its achievement appears uncertain. The target assumes a 7.2% increase in recurrent revenue, but

3.34.1 Selected economic indicators (%)

	2014	2015
GDP growth	3.0	3.0
Inflation	5.5	5.0
Current account balance (share of GDP)	–6.0	–10.0

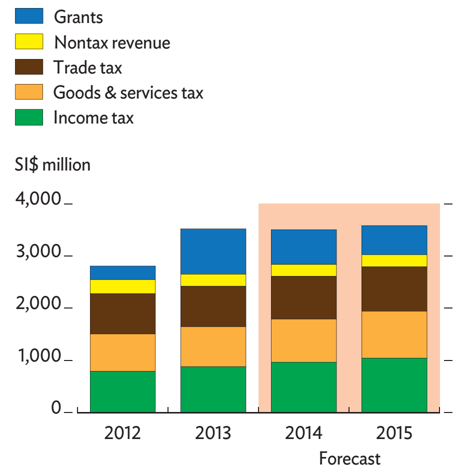
Source: ADB estimates.

this will depend upon stronger economic growth and improvements in revenue administration and compliance (Figure 3.34.4). In 2014, some increase in expenditure is expected to cover the 2014 election, including one-time grants worth more than $50,000 to politicians upon their leaving office. The government has decided to reduce constituency and discretionary funding for members of parliament by one-third in 2014 to offset expected election costs, but this is one area where expenditures could exceed estimates. Tertiary education is another, as expenditure has exceeded the budget in recent years.

The central bank is expected to continue to soak up excess liquidity by selling short-term bills as credit growth recovers from the lows of recent years. Over time, the effects of the central bank's use of a currency basket rather than a peg to the US dollar should become more pronounced, and the Solomon Islands dollar can be expected to track more closely the movements of the currencies of its major trading partners, particularly Australia.

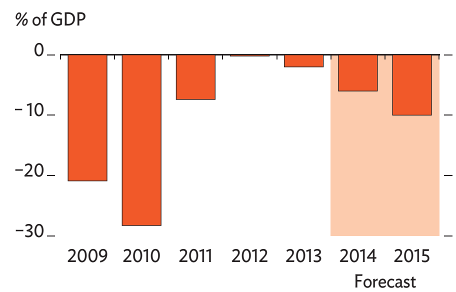
The current account deficit is expected to deteriorate further in 2014, widening to the equivalent of 6.0% of GDP in 2014 and 10.0% in 2015 (Figure 3.34.5). Rising deficits will stem primarily from expected declines in logging exports, while import growth is seen to continue, driven by imports of construction and mining equipment. The deficit will be funded through continued assistance inflows from development partners and foreign direct investment. Import cover is expected to remain comfortable at 6–7 months through 2014 and 2015.

3.34.4 Composition of government revenue



Source: Ministry of Finance and Treasury. *Solomon Islands Budget 2014, Budget Strategy and Outlook, Budget Paper: Volume 1.*

3.34.5 Current account balance



Sources: Central Bank of Solomon Islands; ADB estimates.

Policy challenge—improving the quality of government spending

The strong growth outcomes experienced by Solomon Islands since 2003, in the years following ethnic tensions, have translated into only mixed outcomes in terms of improved social indicators. This suggests that the government needs to free up fiscal space for essential development expenditures to facilitate more inclusive growth. To accomplish this with slower growth and weaker revenues will require significant adjustments to government spending priorities and improvement in the quality of public expenditure.

Spending on tertiary scholarships is a concern that warrants particular attention. The 2014 budget describes the government's decision to provide free university education last year as the most significant risk to fiscal sustainability in Solomon Islands. Funding for tertiary education grew fivefold from 2009 to 2013. Scholarships are supposed to be allocated through a nomination review committee, but it appears that committee review has often been sidelined by ministerial intervention. A result is more scholarships being granted than initially budgeted. There appears to be inadequate linkage between the skills demanded by the labor market and the areas of study enjoying scholarship support. Finally, the large increases in tertiary funding seem to have crowded out much-needed expenditure on basic education, which tends to be more inclusive because the cost of access is low.

Another concern in regard to the government's ability to spend to promote inclusive growth is the rapid expansion of the public payroll in recent years. Expenditure on public sector employees has been growing at an average annual rate of 10% over the past 6 years. While base salaries have not increased substantially, growth in rental subsidies, allowances, and overtime payments has fueled higher expenditures, as have "grade creep" and proliferation in the number of public workers. Controlling payroll expenditure and ensuring sufficient funding for other budget items are essential to the sustainable delivery of other government services.

Constituency funds, which are funds allocated directly to parliamentarians to spend on projects in their districts, are another area where expenditure overruns have been common.

Government action is under way to address these problems and ensure that public expenditure promotes inclusive growth. The government has agreed to limit the number of scholarships awarded for Solomon Islands National University after 2013, and an education sector review scheduled to take place this year will assess the balance of funding between primary and tertiary education. This year will also see a review of public sector remuneration. Regulations for operationalizing the Constituency Development Funds Act, 2013 are being introduced, and a 2012 audit of constituency fund spending is being finalized. These measures are being incorporated into the performance benchmarks for an extended credit facility arrangement with the International Monetary Fund and for budget support programs. They warrant close monitoring in the run-up to the election scheduled for late 2014.

Timor-Leste

The strong growth of the past 6 years continued on the back of public expenditure and private sector activity, and this performance is expected to be maintained. Inflation moderated in 2013 but will likely reaccelerate if planned increases in public spending are fully implemented. A major policy challenge is to design fiscal policies to translate oil and gas revenues into sustainable and inclusive growth.

Economic performance

GDP excluding the offshore petroleum industry is estimated to have grown by 8.0% in 2013 as rapid private sector growth helped offset reductions in public investment (Figure 3.35.1). The public sector continues to be the main source of demand. While government expenditure of $1.3 billion was lower than in 2012, it remained close to recent highs, equivalent to 86% of non-oil GDP.

Royalty payments to the government from offshore oil and gas production totaled $3.1 billion in 2013. This dwarfed tax and other non-oil revenues of $150 million and enabled the government to post a $2.1 billion budget surplus that was deposited in the Petroleum Fund. Public savings, defined as the Petroleum Fund plus foreign exchange reserves, are $14.9 billion, which is 9.2 times annual non-oil GDP or about $12,400 per capita.

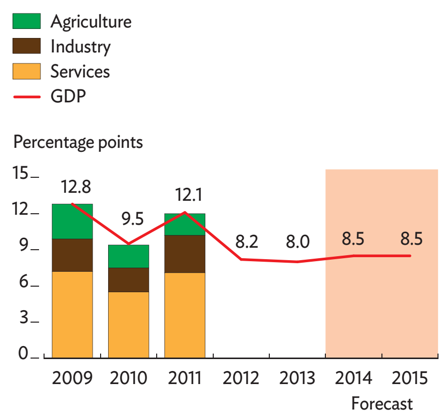
The 2013 budget planned $807 million in capital investment, but delays in project implementation meant only 43% of this was spent. The budget planned a 22% increase in recurrent expenditure over 2012, but actual spending was only 4% higher as reduced expenditures on transfers offset increased spending on salaries, wages, goods, and services.

Slower growth of total government expenditure (in particular recurrent expenditure), lower international food prices, and US dollar appreciation against the currencies of most of Timor-Leste's major trading partners contributed to lower inflation in 2013. Average annual inflation fell to 9.5% from 10.9% in 2012 (Figure 3.35.2). Toward the end of 2013, inflationary pressures waned as government expenditures and import prices fell, taking year-on-year inflation in December to just 4%.

Agricultural production declined in 2013. Coffee exports slipped from the high recorded in 2012, and cereal production fell by 20% because of reduced rice planting and unfavorable weather. Spending on imported grain fell by 27% in 2013, though global and regional grain prices were down by less than 10%, implying weaker demand and reduced grain imports. A 13.6% expansion in private sector credit supported strong business growth, but financial markets remain

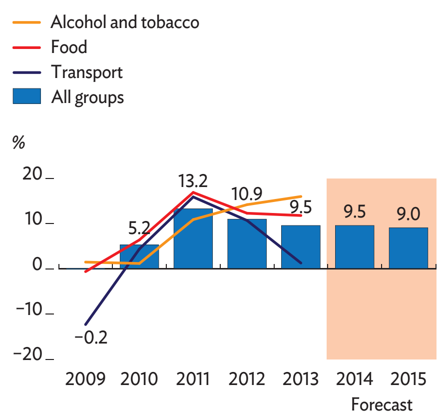
This chapter was written by Christopher Edmonds of the Pacific Department, Asian Development Bank, Manila; and David Freedman, consultant, Timor-Leste Resident Mission, Asian Development Bank, Dili.

3.35.1 Supply-side contributions to growth



Sources: Timor-Leste National Statistics Directorate; ADB estimates.

3.35.2 Inflation



Sources: Timor-Leste National Statistics Directorate; ADB estimates.

underdeveloped, with the ratio of private sector credit to non-oil GDP only 11.3%.

Export growth lagged behind the rise in imports despite strong growth in services exports reported by the International Monetary Fund. Timor-Leste had another large trade deficit, but income from oil and gas royalties greatly exceeded the deficit, allowing the country to register a large current account surplus of $1.9 billion, or 1.2 times non-oil GDP (Figure 3.35.3).

Economic prospects

Growth is forecast to remain strong at 8.5% in 2014 and 2015 as government expenditure increases and the private sector continues to expand. Although earlier plans for major capital investments have been scaled back amid concerns about implementation capacity and expenditure effectiveness, the 2014 budget projects a 38% rise in recurrent expenditure and a 47% increase in government capital investment. However, the effect of this spending on growth and inflation is hard to gauge, as actual expenditures have fallen short of budgeted amounts in recent years.

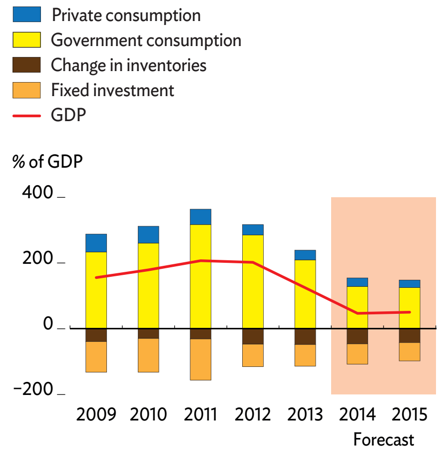
The development of basic infrastructure is a government priority, with 27% of spending from the government's multiyear infrastructure fund allocated to road and bridge construction in 2014. Funding for the Tasi Mane project—intended to catalyze development on the south coast—has been reduced but still accounts for 13% of planned infrastructure spending, while spending to expand electricity service accounts for 15%.

In previous years, infrastructure bottlenecks and limited private sector capacity meant that rising government expenditure—especially recurrent expenditure that is weighted toward local content—has caused inflation. Strong demand flows from increased government spending mean that inflation is forecast to remain high at 9.5% in 2014, easing to 9.0% in 2015 as growth in government spending slows and global prices trend lower.

The offshore Bayu-Udan gas field brings in 95% of Timor-Leste's oil and gas royalties. Estimates of the field's size have recently been downgraded and production is now thought to have peaked in 2012. Conservative forecasts project that reserves in the field will be exhausted by 2021, which is 4 years earlier than previously forecast (Figure 3.35.4). This, together with softening oil prices, is expected to reduce the fiscal surplus from 141% of non-oil GDP in 2013 to 44% in 2014 and 2015 (Figure 3.35.5) and the current account surplus, from 125% of non-oil GDP in 2013 to 47% in 2014 and 50% in 2015.

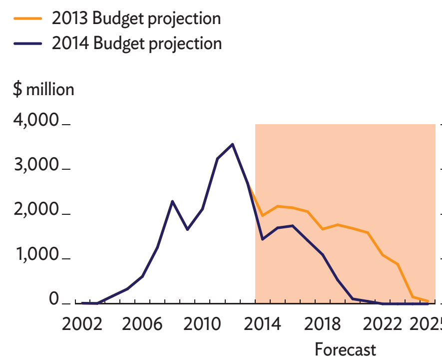
The downward revision in production forecasts also has longer-term implications. The forecasted net present value of future petroleum revenue has been cut from $13.2 billion to $7.0 billion. This lowers the sustainable amount that can be withdrawn from the Petroleum Fund each year by 22% to $632 million which is only 70% of the planned 2014 budget withdrawal of $903 million. Expenditures planned for 2015–2018 are also expected to exceed the estimated sustainable income but by amounts that are small relative to the value of the Petroleum Fund.

3.35.3 Current account components



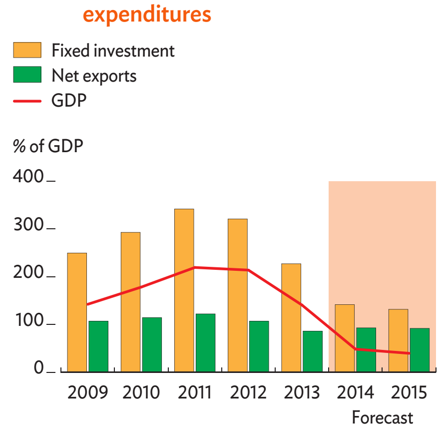
Sources: International Monetary Fund. 2013. Democratic Republic of Timor-Leste: Staff Report for the 2013 Article IV Consultation. December; Timor-Leste 2014 State Budget; ADB estimates.

3.35.4 Adjustment to projected petroleum revenues



Sources: Timor-Leste 2013 and 2014 state budget; ADB estimates.

3.35.5 Government revenues and expenditures



Sources: International Monetary Fund. 2013. Democratic Republic of Timor-Leste: Staff Report for the 2013 Article IV Consultation. December; Timor-Leste 2014 State Budget; ADB estimates.

Policy challenge—fiscal policy for inclusive growth

An enduring challenge for policy makers in Timor-Leste is to translate the country's petroleum wealth into sustainable and inclusive growth that will reduce poverty and provide jobs for the country's young population.

Timor-Leste has made significant progress in expanding primary education and reducing infant and maternal mortality, but recent poverty assessments cast doubt on the inclusiveness of growth from 2006 to 2011. A 2007 survey of living standards found 49.9% of the population living in poverty and high rates of malnutrition in young children. The 2009–2010 Demographic and Health Survey did not measure poverty but found little improvement in childhood nutrition since 2007, with 45% of children under 5 years old underweight and 58% stunted, of whom 33% were severely stunted.

Strong economic growth since 2007 likely reduced measured poverty rates, but the data on childhood nutrition raises questions about the inclusiveness of this growth. Analysis of newly published national accounts for 2000–2011 suggests that the amount the poor spend on food has not kept pace with GDP growth and that high inflation has reduced purchasing power and food consumption (Figure 3.35.6).

Timor-Leste's Strategic Development Plan, 2011–2030 identifies increased agricultural production as a driver of inclusive growth. Ongoing programs to rehabilitate rural roads, improve crop storage, and disseminate improved seed varieties have the potential to make food more available and improve rural livelihoods, provided the rural poor have access to land. The government safeguards food security through a range of policy measures including rice subsidies, a school lunch program, and transfer payments to vulnerable groups such as the elderly and single mothers of school-aged children. In the 2014 budget, funding for the school lunch program rose to $25.8 million, boosting spending per child per day from $0.15 to $0.25. The largest government transfer program pays pensions to veterans of the country's long fight for independence toward achieving a peaceful transition to democracy but does not target poverty reduction as its main objective.

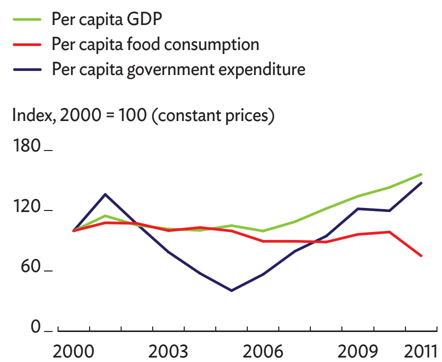
Timor-Leste's policy makers face a trade-off between using scarce public funds for current consumption or for longer-term investment. Targeted transfers to the poor can immediately reduce poverty, but the effect is likely to be temporary and inflationary without accompanying investments that improve poor families' income prospects. Large infrastructure investments like those planned for 2014–2018 have the potential to raise productivity in the long term, but in the short run they risk stoking inflation that undermines real incomes. So it is crucial that the investment program be scaled appropriately and targeted to relieve infrastructure bottlenecks. The government can enhance the contribution that new infrastructure makes to inclusive growth by continuing its reforms to improve service delivery and support job creation in the private sector.

3.35.1 Selected economic indicators (%)

	2014	2015
GDP growth	8.5	8.5
Inflation	9.5	9.0
Current account balance (share of GDP)	47.0	50.3

Source: ADB estimates.

3.35.6 Trends in government spending, GDP, and food consumption



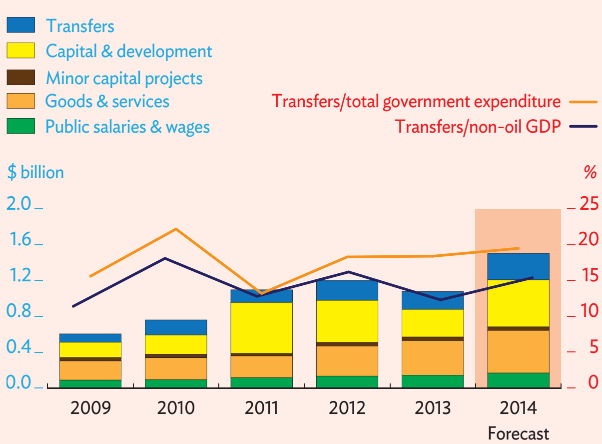
Sources: ADB estimates based on data from Timor-Leste National Statistics Directorate. 2013. Timor-Leste National Accounts 2000–2011: Statistics and analysis. May.

3.35.1 Social transfers as a tool for inclusive growth in Timor-Leste

Following the 2006 conflict, the Government of Timor-Leste initiated ambitious fiscal transfer programs to provide social assistance to selected segments of the population. It could afford these expenditures because its revenues had ballooned from fees and royalties derived from offshore oilfields. While expenditures on social transfers rose rapidly, the country still managed to accumulate significant resources into its Petroleum Fund, which holds $14.9 billion ($12,400 per capita). Three main transfer programs were established along with a number of smaller programs. The largest program pays pensions to veterans of the struggle for independence. The second-largest pays pensions to the elderly and disabled, and the third-largest, a conditional cash transfer program, benefits single mothers with children enrolled in school. The three programs currently have about 110,000 beneficiaries. The number of beneficiaries has increased by more than 16% per annum since 2009 as the government registered eligible citizens. Transfer payments vary greatly across programs. Conditional cash transfers are limited to $240 per year, elderly pensions are $360 per year, and annual veterans' pensions range from $2,760 to $9,000.

From 2009 to 2013, spending on transfer programs averaged 14.0% of government expenditure, or 11.4% of non-oil GDP, making Timor-Leste's social transfers larger than those of its peer countries (box figure 1). The transfers have contributed to post-independence stability and economic recovery, supporting consumption that has fueled retail business formation and associated job creation.

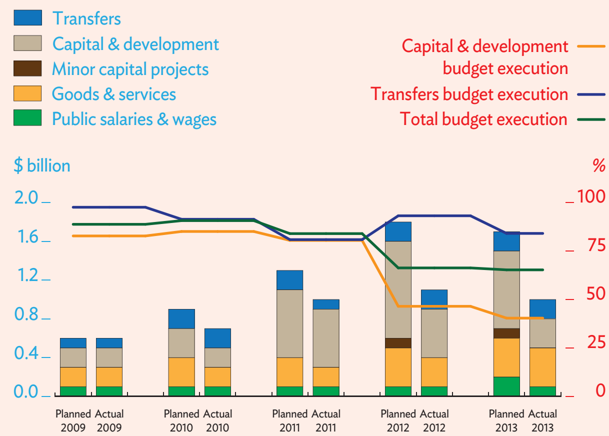
1 Government spending on transfers and other major categories of expenditure in Timor-Leste



Sources: Timor-Leste Budget Transparency Portal (accessed 5 February 2014), 2014 Budget.

In an economy dominated by energy exports that generate little domestic employment, these transfers have helped to transfer benefits of the oil boom to the population. They have been relatively easy to administer and have directly benefited many citizens. Budget execution on the three main social transfer programs averaged 91.1% from 2008 to 2013. This compares favorably with a rate of 70.0% for government capital expenditures (box figure 2).

2 Budget execution in Timor-Leste across major expenditure categories



Source: Timor-Leste Budget Transparency Portal (accessed 5 February 2014).

Before 2012, transfer programs were funded from government revenue and sustainable Petroleum Fund withdrawals. Since 2012, increases in government spending, mainly to develop infrastructure, have required larger withdrawals from the Petroleum Fund, but the transfer programs remained affordable. Although the number of beneficiaries has increased, total payments for veteran pensions will decline over time. This program currently accounts for 60% of transfers, and the Ministry of Finance is applying actuarial modeling to assess its long-term fiscal impact.

How much existing transfer programs reduce poverty is little understood. A few of the transfers are allocated according to need, but younger households with children—the largest demographic group in the country—are underserved. To ensure transfers are sustainable and benefit recipients over the longer term, the economy must expand opportunities for recipients to invest in productive activity, not just consumption. The Government of Timor-Leste clearly recognizes this, as shown by its ambitious plans to expand market access to its more impoverished rural areas.

North Pacific economies

Weak GDP performance prevailed across the North Pacific, including contraction in Palau. However, growth is seen recovering in the near term as delayed infrastructure projects resume in the Marshall Islands and tourism recovers in Palau, though slow growth will likely persist in the Federated States of Micronesia. Along with current fiscal adjustments, stimulating the private sector through improved trade will be crucial over the longer term.

Economic performance

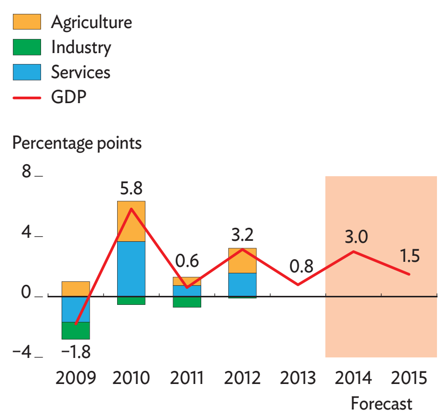
Economic growth in the North Pacific was subdued in FY2013 (ended 30 September 2013 in all three economies). The economy of the Republic of the Marshall Islands (RMI) grew by only 0.8%, slowing from 3.2% in FY2012 (Figure 3.36.1). The slowdown stems from the postponement of construction projects funded by development partners. Also, a severe drought hit the northern RMI midyear, sharply reducing harvests of food crops and copra. However, fisheries continued to perform well, with higher license fees raising revenues.

The Federated States of Micronesia (FSM) remained on a low growth path, with growth of 0.6% in FY2013 only slightly improving on the 0.4% recorded in FY2012 (Figure 3.36.2). Growth was largely driven by fisheries, construction, and their associated activities. However, the lack of private investment, subdued business activity, and a slowdown in major public infrastructure projects continue to weigh on the FSM economy.

Palau's economy is estimated to have contracted by 1.0% in FY2013, a sharp reversal from 4.8% growth the year before (Figure 3.36.3). In FY2012, Palau posted a record 116,856 visitor arrivals, but arrivals declined by 7.1% to 108,522 in FY2013, falling steeply in the second half. This was partly because Palau Airways suspended operations to Taipei,China (the largest source market in FY2012) from late April 2013 amid issues affecting the airline's aircraft leases. Limited accommodation capacity and base effects stemming from 3 consecutive years of rapid growth appear to have contributed to the poorer tourism performance. Aside from the sharp fall in tourist arrivals from Taipei,China, Palau recorded fewer visitors from Japan and the Republic of Korea, both important markets. Despite the sharp decline, FY2013 ranks second after FY2012 in the number of tourist arrivals.

Inflation in the North Pacific declined during the year, tracking international food and fuel price movements. Inflation decelerated to 1.6% from 4.3% in the RMI, 2.2% from 5.8% in the FSM, and 3.0% from 5.4% in Palau. In addition to global price falls, the appreciation of the US dollar helped ease inflation in these economies by reducing

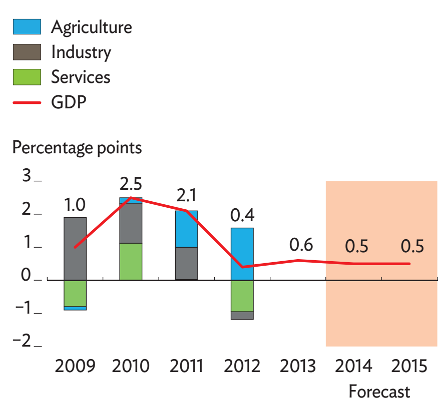
3.36.1 Supply-side contributions to growth in the RMI



Note: Years are fiscal years, ending on 30 September of the same calendar year.

Source: ADB estimates using data from Republic of the Marshall Islands FY2012 Economic Review.

3.36.2 Supply-side contributions to growth in the FSM



Note: Years are fiscal years, ending on 30 September of the same calendar year.

Source: ADB estimates using data from Federated States of Micronesia FY2012 Economic Review.

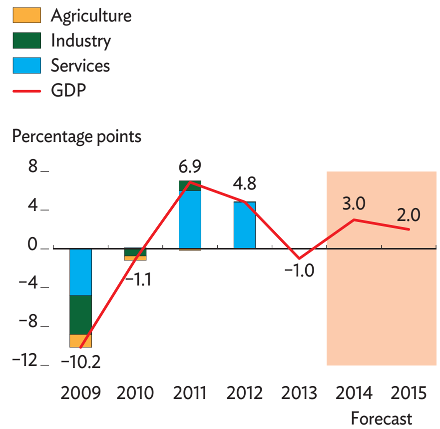
This chapter was written by Rommel Rabanal and Cara Tinio of the Pacific Department, Asian Development Bank, Manila.

the cost of imports not denominated in that currency. All three North Pacific economies use the US dollar as their official currency and none has a central bank. This largely precludes the conduct of independent monetary policy.

The RMI is estimated to have incurred a fiscal deficit equivalent to 0.7% of GDP, unchanged from FY2012, with increased transfers to state-owned enterprises offsetting increased revenues from fishing licenses. Palau's fiscal position similarly remained negative, its deficit growing from the equivalent of 0.2% of GDP in FY2012 to 1.2% as increased tax collections were insufficient to offset higher recurrent spending. The FSM was the only North Pacific economy to achieve a fiscal surplus, having significantly cut recurrent expenditure to realize a surplus equivalent to 2.4% of GDP in FY2013. This marked the FSM's second consecutive year of surplus and its fourth in the past 5 years.

In the North Pacific, large merchandise trade deficits drive current account imbalances that are reduced by official transfers coming primarily from the US. The FSM saw its current account deficit narrow to the equivalent of 9.8% of GDP from 12.0% in FY2012, or to 41.5% from 44.2% excluding official transfers. Palau's current account deficit widened to 12.4% from 7.7%, or to 27.6% from 23.3% excluding official transfers. The RMI's current account deficit expanded to 8.8% from 7.6% but improved to 35.1% from 37.3% excluding official transfers, on a narrower trade deficit and a wider income surplus.

3.36.3 Supply side contributions to growth in Palau



Note: Years are fiscal years, ending on 30 September of the same calendar year.

Source: ADB estimates using data from Republic of Palau FY2012 Economic Review.

Economic prospects

Progress in infrastructure construction is expected to drive growth in the near term. Growth in the RMI is projected to accelerate to 3.0% in FY2014 as work proceeds in earnest on delayed projects, such as the airport runway extension, funded by development partners. Recovery in agricultural production in areas affected by bad weather last year is, along with continued strong fisheries performance, expected to support growth. Growth is projected to moderate to 1.5% in FY2015 as annual decrements continue in sector grants from the US under the Compact of Free Association, and as stimulus from public infrastructure construction wanes.

Similarly, Palau's economy is seen to rebound from contraction. New tourism facilities, which could increase accommodation capacity by about 6%, are seen to drive GDP growth at 3.0% in FY2014. Reconstruction to repair damage from Cyclone Haiyan in November 2013 will likely contribute to output. Growth is expected to fall back to 2.0% in FY2015 as the effects of the capacity upgrade dissipate, but this will be somewhat offset by fiscal stimulus tied to the start of at least one large infrastructure project funded by development partners.

The low growth experienced by the FSM is seen to persist for lack of significant new investment or business formation, combined with a paucity of large infrastructure projects. GDP growth is projected to remain at 0.5% in FY2014 and FY2015, supported mostly by a steady fisheries performance.

The North Pacific's high dependence on imports combines with expectations of falling international food and fuel prices in the near

3.36.1 Selected economic indicators (%)

Marshall Islands	2014	2015
GDP growth	3.0	1.5
Inflation	1.5	1.5
Current account balance (share of GDP)	−20.6	−10.9
Federated States of Micronesia		
GDP growth	0.5	0.5
Inflation	2.0	1.5
Current account balance (share of GDP)	−9.6	−9.3
Palau		
GDP growth	3.0	2.0
Inflation	2.5	2.0
Current account balance (share of GDP)	−9.3	−7.4

Source: ADB estimates.

term to suggest that low inflation will persist. Inflation is projected to slow only marginally to 1.5% in FY2014 and FY2015 in the RMI but more steeply in the FSM, to 2.0% in FY2014 and then to 1.5%, and in Palau, to 2.5% in FY2014 and then to 2.0% (Figure 3.36.4).

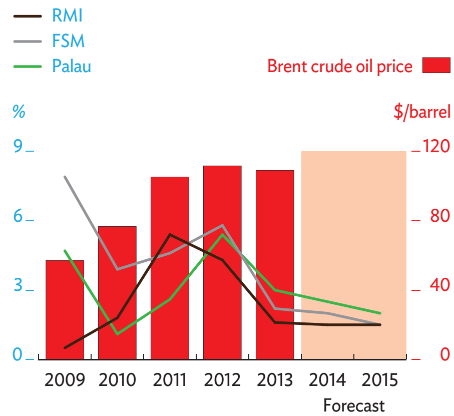
Declining international prices are expected to lower food and fuel import bills, and contribute to improving current account positions in the FSM and Palau (Figure 3.36.5). With income flows from fishing licenses expected to remain robust, the FSM's current account deficit is projected to narrow slightly to the equivalent of 9.6% of GDP in FY2014 and 9.3% in FY2015. A rebound in tourism arrivals and receipts as hotel capacity expands is seen to significantly narrow Palau's current account deficit to the equivalent of 9.3% of GDP in FY2014. This deficit is projected to fall further, to 7.4% of GDP, in FY2015 with continuing modest growth in tourist arrivals and receipts.

The RMI will likely widen its current account deficit, as falling prices for food and fuel imports are more than offset by increased imports of capital inputs for the resumption of work on delayed infrastructure projects. In particular, two ships imported by development partners for interisland transport are expected to raise the RMI's current account deficit to the equivalent of 20.6% of GDP in FY2014. The deficit is expected to revert to 10.9% of GDP in FY2015 as capital imports return to normal and revenues from fish exports and fishing license fees continue to grow. Annual budget support and capital grants from the US play an important role in enabling North Pacific economies to finance their current account deficits.

The governments of the RMI and the FSM are proceeding with fiscal adjustments to prepare for the scheduled expiration in 2023 of their respective Compacts of Free Association with the US. They are seeking to build up trust funds able to generate investment returns sufficient to fund government expenditures and replace annual compact grants. While the FSM has generated modest fiscal surpluses in 4 of the past 5 years, the latest estimates suggest that current rates of saving are inadequate. Tougher fiscal consolidation will likely be required to mobilize revenue through reform to taxes and tax administration, and to make public expenditure more efficient, if the FSM is to avoid graver fiscal adjustments and public service cuts after 2023. Compared with the FSM, the RMI is closer to achieving its Compact Trust Fund target value by FY2023, though further reform is required to generate fiscal buffers to safeguard against possible shocks and variability in investment returns.

The renewal of the economic provisions of Palau's Compact of Free Association has awaited approval from the US Congress for more than 3 years. In the meantime, Palau receives financial assistance in the form of discretionary funding under a continuing US Congress resolution. As with the current RMI and FSM compacts, the proposed renewal for Palau includes provisions that would offset declines in annual grants by increased funding for trust fund contributions and infrastructure projects. Resources arising from a renewed compact will need to be properly managed to avoid sharp fiscal adjustments in the future. In all three North Pacific economies, structural reform to develop the private sector is key to maintaining growth while ensuring fiscal sustainability.

3.36.4 Inflation

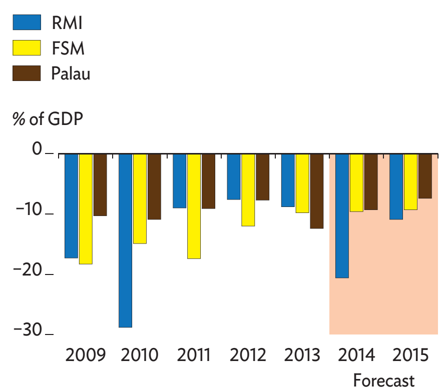


FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Note: Years are fiscal years, ending on 30 September of the same calendar year.

Sources: Federated States of Micronesia FY2012 Economic Review; International Monetary Fund. Republic of the Marshall Islands, *Staff Report for the 2013 Article IV Consultation*; Republic of Palau, *FY2012 Economic Review*; ADB estimates.

3.36.5 Current account balance



FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Note: Years are fiscal years, ending on 30 September of the same calendar year.

Sources: Federated States of Micronesia, *FY2012 Economic Review*; International Monetary Fund. Republic of the Marshall Islands, *Staff Report for the 2013 Article IV Consultation*; Republic of Palau, *FY2012 Economic Review*; ADB estimates.

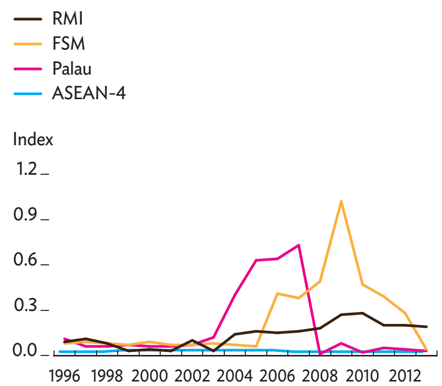
Policy challenge—improving trade performance

Because their domestic markets are small, North Pacific economies must rely on external demand to absorb expanded output from productive sectors and thereby sustain growth. However, their remoteness poses persistent challenges to merchandise trade. Recent cross-country comparisons show North Pacific economies falling further behind in terms of integrating with global markets and easing structural impediments to trade. The United Nations Conference on Trade and Development uses its Liner Shipping Connectivity Index to measure an economy's integration into global shipping networks by the number and size of ships and shipping services visiting its ports. Results show the three North Pacific economies ranked in 2013 among the bottom 10 of 164 countries. Similarly, the World Bank's *Doing Business* survey shows all three economies' rankings in cross-border trade deteriorating in 2014. Among 189 countries covered, the RMI fell from 57th to 62nd, the FSM from 101st to 103rd, and Palau from 95th to 96th.

A measure of trade costs that considers insurance and freight costs as a proportion of free-on-board value found that trade costs increased in the three North Pacific economies in the latter half of the 2000s (Figure 3.36.6). From 1996 to 2003, all three exhibited relatively low trade cost indexes (TCIs) linked to the predominant goods being exported to the US in those years (e.g., coconut oil from the RMI, and garments from the FSM and Palau). Garment exports from Palau to the US ceased in 2004 following the expiration of the World Trade Organization's Agreement on Textiles and Clothing. From 2005 to 2007, Palau's TCI climbed as fish became its primary export to the US. Similar upward trends in the TCIs of the RMI since 2002 and of the FSM in particular from 2008 to 2010 also reflect greater fish exports. The shift in export composition from coconut oil and garments, which are easy to package, store, and transport, to highly perishable fish, which require refrigerated storage and expedited delivery, appears to have raised the average costs to these economies of exporting goods. The low TCIs exhibited by the FSM and Palau in recent years again coincide with much lower fish exports to the US than previously.

The North Pacific economies' poor rankings in international comparisons of trade performance appear to reflect high transport and logistics costs. Trade costs can be reduced by improving port facilities and customs efficiencies toward enhancing capacity for higher-volume shipments. Export diversifications toward niche products can help these economies absorb high transport costs, and hence overcome challenges arising from remoteness. Palau's declaration of its entire exclusive economic zones as a marine sanctuary creates a potential niche market for services trade. With parallel upgrades in basic services, Palau can develop as a high-end ecotourism destination and generate greater tourism revenues.

3.36.6 Trade cost index for North Pacific economies



FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Note: Trade cost is defined as the cost of insurance plus freight as a proportion of free-on-board value.

Source: ADB estimates using data from the US Census Bureau.

South Pacific economies

South Pacific economies still depend on tourism earnings and public infrastructure spending funded by development partners. The winding down of public investments slowed growth in the Cook Islands and Tonga, while construction and increased tourism contributed to expansion in Vanuatu. Samoa's economy contracted following natural disasters. Growth is expected to pick up in the near term as infrastructure spending rises in most South Pacific economies.

Economic performance

Growth in GDP generally weakened in the South Pacific in FY2013 (ended 30 June 2013 in the Cook Islands, Samoa, and Tonga, and 31 December 2013 in Vanuatu) (Figure 3.37.1). In the Cook Islands, GDP growth decelerated to 3.2% from 4.4% in FY2012 because capital investments funded by development partners fell by 24.8%. Tourism boosted the economy as arrivals increased by 3.5%, though well below the 8.7% recorded in FY2012 (Figure 3.37.2). Samoa's economy contracted by 0.5% in FY2013 following devastation caused by Tropical Cyclone Evan in December 2012. The cyclone damaged public infrastructure in the capital and the southern part of the island of Upolu. It badly affected tourism and agriculture, driving Samoa's tourist arrivals and receipts down by 6.0% in FY2013 and agriculture output down by an estimated 3.0%. Growth in Tonga slowed to 0.3% from 0.8% in FY2012 with the withdrawal of the stimulus arising from construction financed by development partners, and continuing declines in private commercial lending.

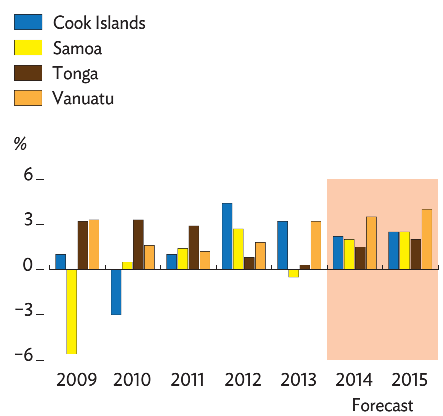
Only Vanuatu maintained its upward growth path in 2013, as GDP growth accelerated to 3.2% from 1.8% in 2012. Tourist arrivals rose by 2.1% overall as air arrivals recovered from declines in 2012 and cruise ship visitors increased. Agricultural production recovered slightly after declining in 2012.

Inflation slowed in the South Pacific in FY2013, cooled by declines in international food and fuel prices and by weaker economic activity in most subregional economies (Figure 3.37.3). Inflation in the Cook Islands averaged 1.9%, down from 3.0% in FY2012 despite an increase of 10.8% in the cost of tobacco and alcohol and of 7.2% for household services.

Despite disruption from the cyclone, prices in Samoa contracted by 0.2%, a reversal of 6.2% inflation recorded in FY2012. Widespread replanting and recovery of supply networks in the wake of the cyclone, together with the continued declines in international food and fuel prices, helped subdue domestic prices.

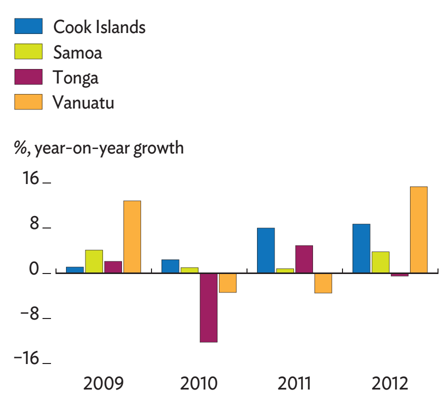
This chapter was written by Caroline Currie, Malie Lototele, and Laisiasa Tora of the South Pacific Subregional Office, Asian Development Bank, Suva; Milovan Lucich of the Pacific Liaison and Coordination Office, Asian Development Bank, Sydney; and Cara Tinio of the Pacific Department, Asian Development Bank, Manila.

3.37.1 GDP growth in the South Pacific



Sources: Cook Islands Statistics Office; Samoa Bureau of Statistics; Tonga Department of Statistics; Vanuatu National Statistics Office; ADB estimates.

3.37.2 Growth in tourist arrivals to the South Pacific



Sources: Cook Islands Statistics Office; Central Bank of Samoa; National Reserve Bank of Tonga; Vanuatu National Statistics Office.

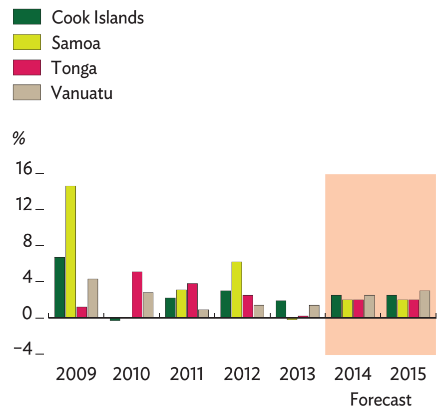
In Tonga, inflation dropped to 0.2% from 2.5% in FY2012. Apart from international price movements, the appreciation of the pa'anga against the currencies of Tonga's main trading partners helped reduce the cost of imports and slow inflation. In Vanuatu, inflation averaged 1.4% in 2013, unchanged from a year earlier, as higher domestic demand related to increased economic activity offset lower international food and fuel prices.

Governments in the South Pacific have implemented fiscal reforms in recent years, but most continue to run budget deficits. The Cook Islands recorded a fiscal deficit of 2.0% of GDP, roughly the same as in FY2012. Unexpectedly high tourism revenues and below-budget expenditures to underwrite Air New Zealand routes helped keep the shortfall below the 2.3% target. Samoa's fiscal deficit is estimated at 4.4% of GDP, only slightly improved from the 5.0% deficit in FY2012 as post-cyclone reconstruction and rehabilitation spending stalled fiscal reforms. The deficit was financed largely by soft loans and grants from traditional development partners. Tonga recorded a budget deficit of 4.9% of GDP. Although this improved on the 6.9% deficit in FY2012, it underperformed relative to the 0.1% surplus targeted in the budget, largely because external grants disappointed expectations and a supplementary budget funded land purchases for airport development. Reductions in current expenditures only partly offset the additional spending. Vanuatu, on the other hand, improved its monitoring of value-added tax receipts and reaped unexpectedly high revenues, which increased by 10% year on year in January–September 2013. Vanuatu recorded a small fiscal surplus equivalent to 0.3% of GDP during this period and estimates its fiscal position to be close to balance in 2013 as a whole.

Monetary policy generally remained expansionary across the South Pacific. Central banks in Samoa and Tonga kept interest rates low to unlock tight credit, spur private borrowing, and promote economic activity. The National Reserve Bank of Tonga's loose monetary policy was enabled by its plentiful foreign reserves, equivalent to 8–9 months of import cover. The growth of credit to the private sector nevertheless continued to slow, though recent signs suggest this is bottoming out. Personal loans other than for housing grew steadily in the second quarter of FY2013, driven by aggressive lending from MBf Bank, a Malaysian-owned commercial bank, and withdrawals from the National Retirement Benefits Fund to pay school fees. In March, the Reserve Bank of Vanuatu cut, for the first time since 2008, its main policy interest rate (the rediscount rate) from 6.0% to 5.5%. Unlike Samoa, Tonga, and Vanuatu, the Cook Islands has no central bank, as it uses the New Zealand dollar.

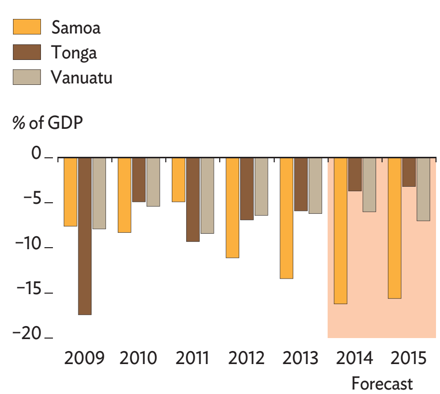
South Pacific economies continued to run current account deficits driven by large imbalances in merchandise trade (Figure 3.37.4). Samoa's current account deficit widened to 13.4% of GDP from 11.1% in FY2012, mainly on a 5.2% increase in the merchandise trade deficit coupled with reduced inflows of services income. In Vanuatu, the current account deficit is estimated at 6.2% of GDP, slightly improved from 6.4% in 2012. The gap was more than covered by foreign direct investment and development partner inflows. Tonga's current account

3.37.3 Inflation



Sources: Cook Islands Statistics Office; Central Bank of Samoa; National Reserve Bank of Tonga; Tonga Department of Statistics; Vanuatu National Statistics Office; ADB estimates.

3.37.4 Current account balance



Sources: National Reserve Bank of Tonga; Reserve Bank of Vanuatu; International Monetary Fund; ADB estimates.

deficit was estimated to have narrowed slightly to 5.9% of GDP from 6.9% in FY2012, as remittances increased by 3.3%. The Cook Islands does not report balance of payments estimates.

Economic prospects

Tourism and public infrastructure spending are seen to continue driving growth in the South Pacific in FY2014 and FY2015.

In the Cook Islands, growth in FY2014 is forecast to slow to 2.2% as business activity traces the fall in capital expenditures and continued weakening in tourist arrivals. Growth is expected to recover to 2.5% in FY2015, assuming tourist arrivals revert to long-term trends and capital projects resume.

The Samoan economy is expected to expand by 2.0% in FY2014 as post-cyclone reconstruction and rehabilitation continues, and tourism bounces back following the reopening of a key resort in Apia and the opening of two new resorts in late 2013. Driven by higher domestic demand and increased fish exports, agriculture is emerging as a significant contributor to growth in FY2014. Growth is seen accelerating further to 2.5% in FY2015.

Tonga is expected to rebound in FY2014, and growth of 1.5% is forecast as the development partner-financed airport runway upgrade proceeds in earnest. Response to the damage caused by Tropical Cyclone Ian, which hit Tonga's Ha'apai islands in January 2014, is expected to trigger additional economic activity through development partner-financed reconstruction and increased remittances in response to lost livelihoods. Stimulus from rehabilitation is expected to carry over into FY2015 and boost growth to 2.0%.

Growth in Vanuatu is expected to pick up to 3.5% in 2014, driven mostly by increased construction spending. A modest increase in tourist numbers is expected from the strengthening Australian and New Zealand economies. These trends are expected to continue and the economy to expand by 4.0% in 2015.

Inflation in the Cook Islands is projected to remain low at 2.5% in FY2014 and FY2015 as major imports are sourced from New Zealand and fuel prices stay stable. Samoa will likely shift out of price contraction and record inflation at 2.0% in FY2014 and FY2015, reflecting higher prices for local agricultural produce. Inflation in Tonga is seen to accelerate to 2.0% in FY2014 and FY2015, and in Vanuatu to 2.5% in 2014 and 3.0% in FY2015, driven in both economies by construction projects and continuing economic recovery.

Monetary policy in the South Pacific will likely remain accommodative to promote domestic economic activity amid expectations that inflation will remain within central bank targets. Although lending to businesses continues to contract in Tonga, lending to households grew steadily in the first half of FY2014. Commercial lending in Samoa continued to contract over the same period as declines in loans to public institutions offset marginal rises in lending to households and private business. This credit crunch will remain a concern as commercial interest rates have started to move upwards. The Reserve Bank of Vanuatu expects to retain its loose monetary

3.37.1 Selected economic indicators (%)

Cook Islands	2014	2015
GDP growth	2.2	2.5
Inflation	2.5	2.5
Current account balance (share of GDP)	...	...
Samoa		
GDP growth	2.0	2.5
Inflation	2.0	2.0
Current account balance (share of GDP)	–16.2	–15.6
Tonga		
GDP growth	1.5	2.0
Inflation	2.0	2.0
Current account balance (share of GDP)	–3.7	–3.2
Vanuatu		
GDP growth	3.5	4.0
Inflation	2.5	3.0
Current account balance (share of GDP)	–6.0	–7.0

... = data not available.
Source: ADB estimates.

stance in the near term but should monitor bank activity to mitigate credit risks amid expectations of higher growth.

Samoa's current account deficit is projected to widen to 16.2% of GDP in FY2014 because of imports for reconstruction, before falling to 15.6% in FY2015. Tonga's external position will likely continue to improve as its current account deficit narrows to 3.7% of GDP in FY2014 and 3.2% in FY2015 on the back of modestly higher growth and improving remittances. Vanuatu's current account deficit is expected to dip to 6.0% of GDP in FY2014, then increase slightly to 7.0% in FY2015 as imports to a recovering domestic economy rise and ongoing construction is funded through continued foreign direct investment and development partner inflows.

Policy challenge—creating the right policy environment for private sector development

Tourism and development partner-funded public infrastructure spending strongly influence growth in the South Pacific, the impact of their fluctuations in recent years highlighting that domestic private sector contributions are limited. This makes promoting entrepreneurship and private investment, and generating employment through greater private business activity, integral to achieving sustainable economic growth and poverty alleviation in the South Pacific. The challenges posed by the remoteness and small size of national markets can be mitigated by reform to the laws and policies that shape the business environment. Making public infrastructure more efficient and reducing the cost of doing business can also contribute to an enabling environment for private business development.

Governments in the South Pacific have implemented a number of legal reforms to promote private sector development, aided by technical assistance from development partners. Vanuatu's Companies Act, 2012 and Companies Insolvency and Receivership Act, 2013—passed to promote local business activity and facilitate administrative process with the government—are prime examples of the type of reform that is needed. The new laws allow the establishment of companies with a single shareholder or director, as well as community-based companies, and provide for an electronic business registry to reduce the cost of opening, running, and closing a business. Samoa has launched such a registry to promote private business in both urban and remote areas. The Cook Islands and Tonga are pursuing similar business law reform.

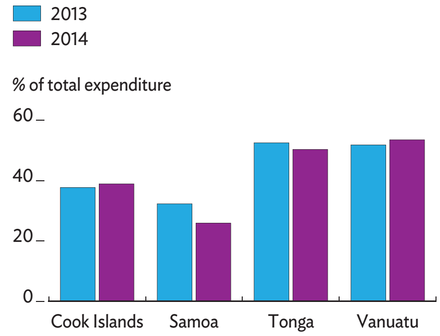
Samoa took steps to simplify private businesses' access to secured financing by passing its Personal Property Securities Act, 2013. Tonga and Vanuatu have also implemented reforms addressing secured transactions. Mindful of the complexities of landownership in the Pacific, these measures facilitate the use of vehicles, farm equipment, and other moveable assets as collateral.

Only limited data are currently available on the impact of these new reforms. However, experience indicates that business law reform dramatically decreases processing time and fees, thereby increasing the number of companies formed and secured loans issued.

Other constraints on private sector investment and development are being addressed. Reform to public financial management and state-owned enterprises (SOEs) can lighten the fiscal burden of public service wages that crowd out other government expenditure (Figure 3.37.5), while improving public service quality and transparency. By creating new fiscal space, such reform can increase the government resources available for purchases of goods and services from the private sector. It can remove the need to increase revenue collection through tax or utility charges, leaving more disposable income. Further, SOE reform can level the playing field and generate new business opportunities for the private sector.

Private sector development reforms have been incorporated in joint policy action matrices agreed by South Pacific governments and their development partners. However, much work remains to ensure actual progress. Apart from continuing with prudent public expenditure management to keep public wages reasonable, further efforts are needed to improve the governance and rationalization—or privatization—of SOEs.

3.37.5 Subsidies and public sector wages



Sources: Cook Islands Ministry of Finance and Economic Management; Samoa Ministry of Finance; Tonga Ministry of Finance and National Planning; Vanuatu Ministry of Finance and Economic Management.

Small island economies

Sustained increases in fishing license revenues have supported GDP growth and solidified fiscal positions in Kiribati, Nauru, and Tuvalu. These and other inflows are expected to boost growth in 2014. Inflation returned after Kiribati and Nauru recorded deflation in 2012, but it is expected to track Australia's relatively low rate. Windfall gains create opportunities for these economies to rebuild fiscal buffers to fund future service delivery.

Economic performance

Economic growth in 2013 in the small island economies of the Pacific was close to rates in the previous year and largely in line with forecasts (Figure 3.38.1). Growth reflected sustained revenue increases from fishing license fees and progress in the construction of major public infrastructure projects.

In Kiribati, GDP growth was 2.0%, slightly down from 2.5% in 2012 despite increases in fishing license revenues, because scheduled infrastructure projects—most notably road construction—suffered delays. In contrast, Tuvalu saw progress in upgrading its airport, strong growth in fishing license revenues, and increased retail activity, which lifted growth to 1.1% from 0.2% in 2012. In Nauru, Australian-financed construction related to the expansion of the Regional Processing Centre (RPC) for asylum seekers supported GDP growth at 4.5% in FY2013 (ended 30 June 2013). This was slightly slower than in 2012, mainly because phosphate production and exports declined (Figure 3.38.2).

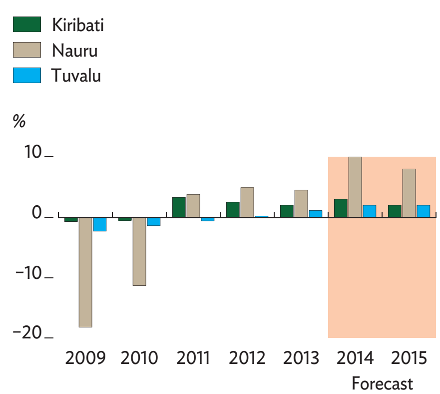
Revenues from fishing license fees continued their strong performance for a second consecutive year, with 2013 revenues exceeding budget projections by 62% in Kiribati, 37% in Tuvalu, and 4% in Nauru (Figure 3.38.3). As parties to the Nauru Agreement, all three economies have benefitted from rising rates under a vessel day scheme, wherein foreign fishing vessels are charged by the number of days they spend in the parties' waters.

In addition to the revenue from fishing licenses, higher income from visa fees and customs duty attributable to the RPC has boosted Nauru's fiscal position, and Tuvalu's position improved with the collection of tax arrears from state-owned enterprises.

Kiribati recorded another large current account deficit, equivalent to 30.2% of GDP, from substantial imbalances in the merchandise and services accounts. In contrast, Tuvalu had a small current account surplus equal to 3.5% of GDP supported by inflows of fishing license revenue and official development assistance. No estimates of Nauru's current account balance were available.

This chapter was written by Milovan Lucich of the Pacific Liaison and Coordination Office, Asian Development Bank, Sydney; and Malie Lototele of the South Pacific Subregional Office, Asian Development Bank, Suva.

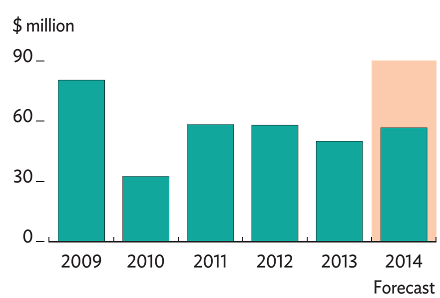
3.38.1 GDP growth



Note: Years are fiscal years, ending on 30 June of the same calendar year for Nauru, and coinciding with the calendar year for Kiribati and Tuvalu.

Sources: Kiribati National Statistics Office; Nauru budget documents; Tuvalu Central Statistics Division; ADB estimates.

3.38.2 Nauru phosphate revenues, 2013



Note: Years are fiscal years, ending on 30 June of the same calendar year.

Sources: Republic of Nauru Phospate Company; Nauru Bureau of Statistics; Ministry of Finance. *2013–14 Budget and the Estimates of Revenue and Expenditure, Budget Paper 1*; ADB estimates.

All three countries use the Australian dollar as legal tender, and none has a central bank, which precludes their having independent monetary policies or exchange rate flexibility. Since the collapse of the Nauru economy in FY2004, the population has been without access to formal banking services. However, the government developed an information memorandum with international assistance to attract a commercial bank to the island. Prospects are positive for the re-introduction of some banking services this year, as the government is in advanced discussions about this with a preferred bank. A weaker Australian dollar, particularly in the middle of 2013, brought inflation back to Kiribati and Nauru, which experienced deflation in 2012, but inflation remained low at 2.0% in Kiribati and Tuvalu and 1.4% in Nauru (Figure 3.38.4).

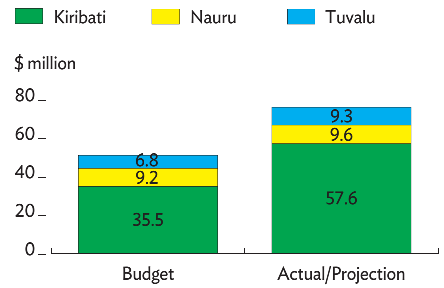
Economic prospects

Infrastructure upgrades are expected to drive growth over the next 2 years. Kiribati's economy is projected to grow by 3.0% in 2014 and 2.0% in 2015 as construction picks up on projects funded by development partners: upgrades of the airports at Tarawa and Kiritimati and of the South Tarawa Road, and the extension of Betio Port. In Nauru, growth is projected at 10% in FY2014 and 8% in FY2015. This will reflect rebuilding and expansion the RPC and associated resettlement villages, higher government spending, and payments to landowners from the liquidation of the Nauru Phosphates Royalties Trust (NPRT). In Tuvalu, the airport upgrade and increased retail competition are seen to drive economic growth at 2.0% in both 2014 and 2015.

Inflation is generally expected to be similar to that experienced in Australia, which targets inflation within a band of 2%–3%. Over 2014 and 2015, inflation is projected to remain at 2.5% in Kiribati. In Tuvalu, inflation is projected to accelerate to 2.5% as growth picks up in 2014, then moderate to 2.0% in 2015 in line with expected declines in international food and fuel prices. Robust economic activity and the introduction of a A$6,000 business visa fee are fueling price pressures in Nauru, and inflation is projected to accelerate to 5.0% in FY2014 and then to 7.0% in FY2015.

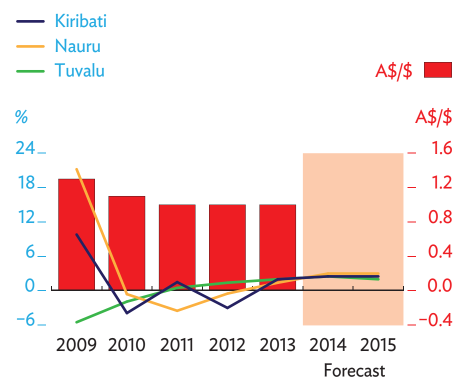
Island governments plan to increase expenditure to support economic growth in the near term. The governments of Kiribati and Tuvalu plan higher recurrent expenditures, to be financed in part by the continuing strength of fishing license revenues and budget support grants, and higher capital spending associated with ongoing infrastructure projects. In Nauru, the FY2014 budget continues recent large increases in spending. Spending will exceed A$96 million, which is more than three times the amount spent 3 years ago. As Nauru is unable to borrow because of its recent history of debt distress, higher spending depends on the government meeting its revenue targets. One additional source that the government is looking toward is a large but controversial increase in visa fees, which are projected to raise A$18 million.

3.38.3 Fishing license revenue, 2013



Sources: Ministry of Finance and Economic Development. *Kiribati Government 2014 Budget*; Ministry of Finance of Nauru. *2013–14 Budget and the Estimates of Revenue and Expenditure, Budget Paper 1*; Ministry of Finance. *Tuvalu Government National Budget 2014 Programme Estimates.*

3.38.4 Inflation



Note: Years are fiscal years, ending on 30 June of the same calendar year for Nauru, and coinciding with the calendar year for Kiribati and Tuvalu.

Sources: Kiribati National Statistics Office; Nauru budget documents; Tuvalu Central Statistics Division; Reserve Bank of Australia; ADB estimates.

3.38.1 Selected economic indicators (%)

Kiribati	2014	2015
GDP growth	3.0	2.0
Inflation	2.5	2.5
Current account balance (share of GDP)	−36.2	−31.3
Nauru		
GDP growth	10.0	8.0
Inflation	5.0	7.0
Current account balance (share of GDP)	...	...
Tuvalu		
GDP growth	2.0	2.0
Inflation	2.5	2.0
Current account balance (share of GDP)	−9.6	−10.5

... = data not available.

Source: ADB estimates.

Policy challenge—saving windfalls to rebuild fiscal buffers that finance services

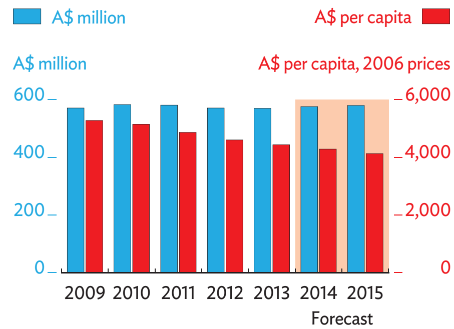
All three of the small island economies urgently need to rebuild fiscal buffers to fund future service delivery. Recent windfall gains from fishing licenses and other revenues provide opportunities for these countries to save the proceeds in trust funds and gradually reduce their reliance on financial assistance from development partners. Near-term revenue generation must be balanced, however, with ensuring the sustainability of revenue sources to the extent that individual country policy can do so.

Proper management of windfall revenue streams from the new fishing license regime can help stabilize trust funds in Kiribati and Tuvalu, whose values fell during the global financial crisis and have struggled to recover amid continuing withdrawals to finance annual budget deficits. Although Kiribati has been able to contain its fiscal deficit using higher fishing license revenues in 2012 and 2013, government revenues have not been sufficient to enable the government to add funds to its Revenue Equalization Reserve Fund, which has recently declined in value in per capita terms and is now well below the government's benchmark of A$4,500 per head (Figure 3.38.5). To improve the financial outlook for the fund over the long run, the government needs to deposit more revenue into it, but this requires enhanced revenue collection and restrained expenditures.

The Tuvalu Trust Fund has also languished below its target maintenance value since 2008. This has prevented the government from transferring resources to the Consolidated Investment Fund, which finances budget deficits, during the past several years. The Consolidated Investment Fund was nearly depleted in 2012, which prompted an A$4 million contribution from Australia (Figure 3.38.6).

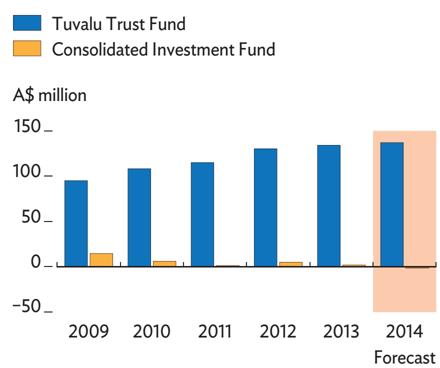
In Nauru, the mismanagement of the NPRT almost completely depleted it in the early 2000s from a peak value of about A$1.5 billion in 1990. Remaining assets are now being liquidated and the capital distributed to landowners. Meanwhile, the emergence of windfall gains from the RPC and fishing licenses has again focused attention on the need for a new trust fund to save excess revenues toward providing a source of income when the phosphate is mined out. Primary phosphate reserves are almost completely exhausted, and secondary phosphate reserves are expected to last only 10–20 years. Such a trust fund would also be useful in managing emerging inflationary pressures, but would need to incorporate lessons from the Tuvalu and Kiribati trust funds to avoid repeating the mistakes of the NPRT.

3.38.5 Kiribati: Revenue Equalization Reserve Fund closing balance



Source: International Monetary Fund. Kiribati, *2013 Article IV Consultation Staff Report*. June.

3.38.6 Tuvalu Trust Fund and Consolidated Investment Fund closing balance



Source: International Monetary Fund. Staff Visit to Tuvalu, August 28 to September 4, 2013, Concluding Statement of the IMF Mission.

Statistical appendix

Statistical notes and tables

The statistical appendix presents selected economic indicators for 44 developing member economies of the Asian Development Bank (ADB) and for Brunei Darussalam, an unclassified regional member, in 18 tables. The economies are grouped into five subregions: Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. Most of the tables contain historical data from 2009 to 2013; some have forecasts for 2014 and 2015.

The data were standardized to the degree possible in order to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. The national income accounts section is based on the United Nations System of National Accounts, while the balance-of-payments data are based on International Monetary Fund (IMF) accounting standards. Historical data were obtained from official sources, statistical publications and databases, and documents of ADB, IMF, and World Bank. Projections for 2013 and 2014 are generally staff estimates made on the basis of available quarterly or monthly data, although some projections are from governments.

Most countries report on a calendar-year basis. Some economies record their government finance data on a fiscal year basis, such as: Armenia; Azerbaijan; Cook Islands; Hong Kong, China; Kazakhstan; Kyrgyz Republic; Lao People's Democratic Republic (Lao PDR); Samoa; Singapore; Taipei,China; Tajikistan; Thailand; and Uzbekistan. Federated States of Micronesia, Nauru, Republic of Marshall Islands, and Republic of Palau (hereafter Palau) report government finance and balance-of-payments data on a fiscal year basis. South Asian countries (except for Maldives and Sri Lanka), Myanmar, Samoa, and Tonga report all variables on a fiscal year basis.

Regional and subregional averages/totals are provided for seven tables (A1, A2, A6, A11, A12, A13, and A14,). For tables A1, A2, A6, and A14, the averages are computed using weights derived from levels of gross national income (GNI) in current United States dollars (US$) following the World Bank Atlas method. The GNI data for 2008–2012 were obtained from the World Bank's World Development Indicators online. Weights for 2012 were carried over through 2015. The GNI data for Cook Islands were estimated using the Atlas conversion factor. Myanmar and Nauru have no GNI data. For tables A11 and A12, the regional and subregional averages were computed on the basis of a consistent sum, which means that if there are missing country data for a given year, the sum of the prior year used for computing the growth rate excludes the corresponding country data. Data for Myanmar and Nauru are excluded from the computation of all subregional averages/totals.

Tables A1, A2, A3, A4, and A5. These tables show related data on output growth, production, and demand. Changes to the national income accounts series for some countries have been made owing to a change in source, methodology and/or base year. The series for Afghanistan, Bhutan, India, Myanmar, and Pakistan reflects fiscal rather than calendar year data, while those for Timor-Leste reflects non-oil, non-United Nations GDP.

Table A1: Growth rate of GDP (% per year). The table shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value-added or similar taxes. Constant factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. Most countries use constant market price valuation. Fiji Islands, India, Pakistan, and Sri Lanka use constant factor costs, while Maldives and Nepal use basic prices. GDP growth for 2008 is excluded for Nauru due to consistency issues.

Table A2: Growth rate of per capita GDP (% per year). The table provides the growth rates of real per capita GDP, which is defined as GDP at constant prices divided by the population. The series for most of the Pacific countries were revised due to a change in source of population data. Data on per capita gross national product in US$ terms for 2011, sourced from the World Bank, World Development Indicators online, are also shown.

Table A3: Growth rate of value added in agriculture (% per year). The table shows the growth rates of value added in agriculture and its corresponding share in 2011. The agriculture sector comprises agricultural crops, livestock, poultry, fisheries, and forestry.

Table A4: Growth rate of value added in industry (% per year). The table provides the growth rates of value added in industry and its corresponding share in 2011. This sector comprises manufacturing, mining and quarrying, construction, and utilities. However, construction in Uzbekistan is included in the services sector.

Table A5: Growth rate of value added in services (% per year). The table gives the growth rates of value added in services, as well as its corresponding share in 2011. Subsectors generally include trade, banking, finance, real estate, public administration, and other services.

Table A6: Inflation (% per year). Data on inflation rates represent period averages. Except for India, which reports the wholesale price index, inflation rates presented are based on consumer price indexes. The consumer price indexes of the following countries are for a given city or group of consumers only: Afghanistan is for Kabul (until 2010), Cambodia is for Phnom Penh, Marshall Islands is for Majuro, Solomon Islands is for Honiara, and Nepal is for urban consumers.

Table A7: Growth in money supply (% per year). This table tracks the annual percentage change in the end-of-period supply of broad money as represented by M2 (for most countries). M2 is defined as the sum of M1 and quasi-money where M1 denotes currency in circulation plus demand deposits and quasi-money consists of time and savings deposits including foreign currency deposits. Data for the Lao People's Democratic Republic is as of end-December 2014.

Tables A8, A9, and A10: Government finance. This set of tables refers to the revenue and expenditure transactions as well as the fiscal balance of the central government expressed as a percentage of GDP in nominal terms. For Cambodia (since 2006), PRC, India, Kazakhstan, Kyrgyz Republic, Mongolia, and Tajikistan, transactions are those reported by the general government.

Table A8: Central government revenues (% of GDP). Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a percentage of GDP at current prices. For the Republic of Korea, revenues exclude social security contributions. For Singapore, revenues includes the Net Investment Returns Contribution. For Kazakhstan, revenues include transfers from the national fund. Grants are excluded in Cambodia, Lao PDR, Malaysia, Singapore, and Thailand; revenues from disinvestment are included for India; only current revenues are included for Bangladesh; and grants and privatization proceeds are excluded for Sri Lanka.

Table A9: Central government expenditures (% of GDP). Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a share of GDP at current prices. For Thailand, expenditures refer to budgetary expenditures excluding externally financed expenditures and corresponding borrowing; while that for Tajikistan includes externally financed public investment programs. One-time expenditures are excluded for Pakistan.

Table A10: Fiscal balance of central government (% of GDP). Fiscal balance is the difference between central government revenues and expenditures. The difference is also computed as a share of GDP at current prices. Data variations may arise due to statistical discrepancies, e.g., balancing items for both central and local governments, and differences in the concept used in the individual computations of revenues and expenditures as compared with the calculation of the fiscal balance. For Fiji, the fiscal balance excludes total loan repayments. For Thailand, the fiscal balance is a cash balance composed of the budgetary and nonbudgetary balances. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan.

Tables A11, A12, A13, and A14: Balance of payments. This set of tables show selected international economic transactions of countries as recorded in the balance of payments (BOP). These items cover annual flows, except for some countries which show data as of a specified period only.

Tables A11 and A12: Growth rates of merchandise exports and imports (% per year). The annual growth rates of exports and imports, in terms of merchandise goods only, are shown in these tables. Data are in million US$, primarily obtained from the balance-of-payments accounts of each country. Exports are reported on a free-on-board (f.o.b.) basis. Import data are generally reported on an f.o.b. basis, except for Afghanistan, Bhutan, Cambodia, India, Lao PDR, Myanmar, Philippines, Samoa, Singapore, Solomon Islands, and Thailand, which value them on a cost, insurance, freight (c.i.f.) basis.

Table A13: Trade balance (US$ million). The trade balance is the difference between merchandise exports and merchandise imports. Figures in this table are based on the exports and imports levels used to generate Tables A11 and A12.

Table A14: Current account balance (% of GDP). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. The values reported are divided by GDP at current prices in US$. In the case of Cambodia, Lao PDR, and Viet Nam, official transfers are excluded from the current account balance.

Table A15: Exchange rates to the US dollar (annual average). The annual average exchange rates of each economy are quoted in local currencies per US dollar.

Table A16: Gross international reserves (US$ million). Gross international reserves are defined as the US$ value of holdings of foreign exchange, special drawing rights (SDR), reserve position in the IMF, and gold at the end of a given period. For Turkmenistan, gold is excluded in the computation. For Marshall Islands and Taipei,China; this heading refers to foreign exchange reserves only. In some countries, the rubric comprises foreign assets and reserves of national monetary authorities and national oil funds, i.e., foreign assets of the Maldives Monetary Authority, net foreign reserves of the State Bank of Pakistan, assets of the National Oil Fund of Azerbaijan, and official external assets of Kiribati. The data for India is as of 14 March 2014.

Table A17: External debt outstanding (US$ million). For most economies, external debt outstanding—public and private—includes medium- and long-term debt, short-term debt, and IMF credit. For Cambodia, Georgia, and Lao PDR, only public external debt is reported. For Azerbaijan; India; Kazakhstan; Kyrgyz Republic; Malaysia, Philippines; and Singapore the figures for 2013 are as of end-September.

Table A18: Debt service ratio (% of exports of goods and services). This table generally presents the total debt service payments of each economy, which comprise principal repayments (excluding on short-term debt) and interest payments on outstanding external debt, as a percentage of exports of goods and services. For Cambodia and Lao PDR, debt service refers to external public debt only. For Papua New Guinea, Samoa, and Viet Nam, exports of goods are used as the denominator in the calculation of the ratio; for the Philippines, exports of goods, services, and income are used as the denominator. For Bangladesh, the ratio represents debt service payments on medium- and long-term loans as a percentage of exports of goods, nonfactor services, and workers' remittances; while for Azerbaijan, the ratio represents public and publicly guaranteed external debt service payments as a percentage of exports of goods and nonfactor services.

Table A1 Growth rate of GDP (% per year)

	2009	2010	2011	2012	2013	2014	2015
Central Asia	3.2	6.8	6.8	5.6	6.5	6.5	6.5
Armenia	–14.1	2.2	4.7	7.2	3.5	4.6	5.0
Azerbaijan	9.3	5.0	0.1	2.2	5.8	5.0	4.8
Georgia	–3.8	6.3	7.2	6.2	3.2	5.5	6.0
Kazakhstan	1.2	7.3	7.5	5.0	6.0	6.0	6.4
Kyrgyz Republic	2.9	–0.5	6.0	–0.1	10.5	6.5	5.5
Tajikistan	3.9	6.5	7.4	7.5	7.4	6.0	5.8
Turkmenistan	6.1	9.2	14.7	11.1	10.2	11.0	10.0
Uzbekistan	8.1	8.5	8.3	8.2	8.0	8.0	7.8
East Asia	6.8	9.8	8.2	6.6	6.7	6.7	6.7
China, People's Rep. of	9.2	10.4	9.3	7.7	7.7	7.5	7.4
Hong Kong, China	–2.5	6.8	4.8	1.5	2.9	3.5	3.6
Korea, Rep. of	0.3	6.3	3.7	2.0	2.8	3.7	3.8
Mongolia	–1.3	6.4	17.5	12.4	11.7	9.5	10.0
Taipei,China	–1.8	10.8	4.2	1.5	2.1	2.7	3.2
South Asia	7.6	8.4	6.4	4.7	4.8	5.3	5.8
Afghanistan	21.0	8.4	7.2	11.9	3.3	3.5	4.5
Bangladesh	5.7	6.1	6.7	6.2	6.0	5.6	6.2
Bhutan	5.7	9.3	10.1	6.5	5.2	6.0	6.8
India	8.6	9.3	6.7	4.5	4.9	5.5	6.0
Maldives	–3.6	7.1	6.5	1.3	3.7	4.5	5.4
Nepal	3.9	4.3	3.8	4.5	3.6	4.5	4.7
Pakistan	0.4	2.6	3.7	4.4	3.6	3.4	3.9
Sri Lanka	3.5	8.0	8.3	6.3	7.3	7.5	7.5
Southeast Asia	1.4	8.0	4.8	5.7	5.0	5.0	5.4
Brunei Darussalam	–1.8	2.6	3.4	0.9	–1.4	1.1	1.2
Cambodia	0.1	6.0	7.1	7.3	7.2	7.0	7.3
Indonesia	4.6	6.2	6.5	6.3	5.8	5.7	6.0
Lao People's Dem. Rep.	7.3	7.5	7.8	7.9	7.6	7.3	7.5
Malaysia	–1.5	7.4	5.1	5.6	4.7	5.1	5.0
Myanmar	5.1	5.3	5.9	7.3	7.5	7.8	7.8
Philippines	1.1	7.6	3.6	6.8	7.2	6.4	6.7
Singapore	–0.8	15.7	6.0	1.9	4.1	3.9	4.1
Thailand	–2.3	7.8	0.1	6.5	2.9	2.9	4.5
Viet Nam	5.4	6.4	5.9	5.2	5.4	5.6	5.8
The Pacific	4.3	6.1	8.9	6.1	4.8	5.4	13.3
Cook Islands	1.0	–3.0	1.0	4.4	3.2	2.2	2.5
Fiji Islands	–1.4	3.0	2.7	1.7	3.6	2.8	3.0
Kiribati	–0.7	–0.5	3.3	2.5	2.0	3.0	2.0
Marshall Islands	–1.8	5.8	0.6	3.2	0.8	3.0	1.5
Micronesia, Fed. States of	1.0	2.5	2.1	0.4	0.6	0.5	0.5
Nauru	–18.2	0.0	3.8	4.9	4.5	10.0	8.0
Palau	–10.2	–1.1	6.9	4.8	–1.0	3.0	2.0
Papua New Guinea	6.1	7.6	11.3	7.7	5.1	6.0	21.0
Samoa	–5.6	0.5	1.4	2.7	–0.5	2.0	2.5
Solomon Islands	–1.0	7.9	10.6	4.8	2.9	3.0	3.0
Timor-Leste	12.8	9.5	12.1	8.2	8.0	8.5	8.5
Tonga	3.2	3.3	2.9	0.8	0.3	1.5	2.0
Tuvalu	–2.3	–1.4	–0.6	0.2	1.1	2.0	2.0
Vanuatu	3.3	1.6	1.2	1.8	3.2	3.5	4.0
Average	6.0	9.2	7.4	6.1	6.1	6.2	6.4

... = data not available.

Table A2 Growth rate of per capita GDP (% per year)

	2009	2010	2011	2012	2013	2014	2015	Per capita GNI, $, 2012
Central Asia	1.4	5.2	5.2	4.0	5.1	5.3	5.5	
Armenia	–14.4	1.9	4.2	6.8	3.2	4.3	4.7	3,720
Azerbaijan	7.1	3.8	–1.1	0.9	4.4	4.5	4.8	6,220
Georgia	–3.9	5.0	6.4	5.5	3.5	5.1	5.9	3,270
Kazakhstan	–0.7	5.5	5.9	3.5	4.5	4.5	4.9	9,780
Kyrgyz Republic	0.7	–1.6	4.6	–2.1	9.7	5.0	4.0	990
Tajikistan	1.8	5.5	7.4	4.7	5.8	4.4	4.2	860
Turkmenistan	4.5	7.6	13.1	9.5	8.6	9.4	8.4	5,410
Uzbekistan	6.3	6.8	5.3	5.6	6.3	6.9	6.6	1,720
East Asia	6.3	9.3	7.6	6.0	6.2	6.2	6.2	
China, People's Rep. of	8.7	9.9	8.8	7.2	7.2	7.0	6.9	5,720
Hong Kong, China	–2.7	6.0	4.1	0.4	2.5	2.8	2.8	36,560
Korea, Rep. of	–0.2	5.8	2.9	1.6	2.3	3.3	3.4	22,670
Mongolia	–2.4	4.5	15.5	10.3	9.4	10.3	7.7	3,160
Taipei,China	–2.2	10.6	3.9	1.1	1.8	2.5	3.0	20,910
South Asia	6.1	6.2	4.9	3.4	3.4	4.0	4.4	
Afghanistan	18.6	6.3	5.2	9.7	1.3	1.5	2.5	680
Bangladesh	4.4	4.7	4.1	4.9	4.7	4.2	4.8	840
Bhutan	3.8	7.3	8.1	4.7	3.4	4.3	5.1	2,420
India	7.1	7.4	5.3	3.2	3.5	4.2	4.7	1,580
Maldives	–5.2	5.3	4.7	–0.4	2.0	2.8	3.6	5,750
Nepal	2.3	2.7	3.1	3.1	2.2	3.1	3.3	700
Pakistan	–1.4	–3.2	1.6	2.3	1.5	1.4	1.9	1,260
Sri Lanka	2.4	6.9	7.1	9.2	6.2	6.4	6.4	2,920
Southeast Asia	0.1	6.0	2.8	4.7	3.4	3.7	4.2	
Brunei Darussalam	–3.1	0.8	1.7	–0.7	–5.6	–0.2	–0.1	31,590
Cambodia	–1.4	4.8	5.2	5.0	5.8	5.5	5.9	880
Indonesia	3.3	3.4	3.6	6.0	3.6	4.5	4.8	3,420
Lao People's Dem. Rep.	5.0	5.3	5.7	6.5	4.6	5.2	5.4	1,270
Malaysia	–2.8	4.8	3.4	4.0	3.2	4.3	3.4	9,820
Myanmar	3.8	4.2	4.9	6.3	6.5	6.8	6.8	...
Philippines	0.5	6.1	1.6	5.0	5.5	3.4	4.9	2,500
Singapore	–3.7	13.7	3.8	–0.6	2.4	2.4	2.6	47,210
Thailand	–3.1	7.2	–0.4	6.0	2.3	2.4	4.0	5,210
Viet Nam	4.3	5.3	5.1	4.1	4.3	4.5	4.7	1,550
The Pacific	2.6	3.8	6.5	5.9	3.1	3.6	11.3	
Cook Islands	8.6	8.4	–18.2	7.3	6.2	5.1	5.4	...
Fiji Islands	–1.9	–0.6	1.4	12.2	3.3	2.3	2.5	4,110
Kiribati	–2.5	–3.9	–0.3	0.9	1.7	0.9	–0.1	2,520
Marshall Islands	–2.1	5.1	–0.4	2.1	–0.2	2.0	0.6	4,040
Micronesia, Fed. States of	1.6	3.2	2.7	0.9	–0.5	0.6	0.6	3,230
Nauru	–19.8	–10.9	–0.9	4.9	1.4	8.5	6.5	...
Palau	–10.7	–1.7	6.2	4.2	–1.6	2.3	1.4	9,860
Papua New Guinea	3.9	5.3	8.9	5.4	2.9	3.7	18.4	1,790
Samoa	–5.9	0.2	1.2	2.4	–0.7	1.8	2.2	3,260
Solomon Islands	–3.3	3.5	7.8	2.4	0.6	0.6	0.8	1,130
Timor-Leste	10.0	6.6	9.0	5.6	5.5	5.9	5.9	2,810
Tonga	2.9	3.0	2.6	0.6	0.0	1.2	1.7	4,220
Tuvalu	–2.8	–1.9	–1.1	–0.3	4.5	0.2	0.2	5,650
Vanuatu	1.1	–0.8	–0.9	–0.7	0.9	1.2	1.7	3,000
Average	5.2	8.2	6.4	5.3	5.3	5.4	5.6	

... = data not available.

Table A3 Growth rate of value added in agriculture (% per year)

	2009	2010	2011	2012	2013	Sector share, 2012, %
Central Asia						
Armenia	5.8	–16.1	14.0	9.5	8.1	20.9
Azerbaijan	3.5	–2.2	–8.0	5.8	4.9	5.5
Georgia	–6.8	–4.8	8.0	–3.7	9.6	8.6
Kazakhstan	13.5	–11.6	23.0	–17.6	10.6	4.5
Kyrgyz Republic	6.7	–2.6	1.9	1.2	2.9	19.2
Tajikistan	10.5	6.8	7.9	10.4	7.6	...
Turkmenistan	...	7.8	0.1	8.1	10.0	8.4
Uzbekistan	5.7	6.8	6.6	7.0	6.8	19.1
East Asia						
China, People’s Rep. of	4.2	4.3	4.3	4.5	4.0	10.1
Hong Kong, China	–4.6	3.9	0.9	–3.2	1.5	0.1
Korea, Rep. of	3.2	–4.4	–2.1	–0.6	5.6	2.6
Mongolia	3.6	–16.6	–0.5	21.6	13.5	16.3
Taipei,China	–3.0	1.7	6.4	–1.6	0.2	1.8
South Asia						
Afghanistan	44.6	–6.4	–7.9	31.5	1.6	27.0
Bangladesh	4.1	5.2	5.1	3.1	2.2	17.7
Bhutan	1.7	1.7	1.6	2.9	2.6	17.5
India	0.8	8.6	5.0	1.4	4.6	17.9
Maldives	–2.5	–0.9	1.1	–0.0	1.7	4.1
Nepal	3.0	2.0	4.5	5.0	1.3	35.7
Pakistan	3.5	0.2	2.0	3.5	3.3	24.4
Sri Lanka	3.2	7.0	1.4	5.2	4.7	11.0
Southeast Asia						
Brunei Darussalam	5.6	–5.8	4.6	11.8	...	0.7
Cambodia	5.4	4.0	3.1	4.3	1.8	35.6
Indonesia	4.0	3.0	3.4	4.2	3.5	14.5
Lao People’s Dem. Rep.	2.4	2.0	1.8	2.5	2.7	27.0
Malaysia	0.1	2.4	5.8	1.0	2.1	10.2
Myanmar	0.4	–0.1	–2.0	1.5	...	30.7
Philippines	–0.7	–0.2	2.6	2.8	1.1	11.8
Singapore	3.1	8.6	3.2	1.9	–3.7	0.0
Thailand	1.3	–2.3	4.1	3.8	1.4	12.3
Viet Nam	1.9	3.3	4.0	2.7	2.7	19.7
The Pacific						
Cook Islands	7.2	1.5	–6.2	3.1	...	4.5
Fiji Islands	–8.1	–2.6	8.1	2.6	...	12.3
Kiribati	–8.2	–2.5	5.7	...	...	...
Marshall Islands	12.4	24.3	4.7	12.4	...	16.5
Micronesia, Fed. States of	–0.8	0.5	4.5	6.6	...	29.9
Nauru	1.7	...	...	...	...	...
Palau	–19.4	–7.7	–3.2	–0.9	...	5.9
Papua New Guinea	0.7	2.9	8.6	–2.7	0.5	28.5
Samoa	–12.3	–2.6	–0.1	–5.4	–3.0	5.3
Solomon Islands	–1.3	...	...	...	...	...
Timor-Leste	8.1	–2.9	–19.6	...	...	...
Tonga	–1.4	0.5	2.0	0.5	0.3	18.8
Tuvalu	0.7	2.2	0.5	...	...	...
Vanuatu	0.7	4.8	6.1	2.2	...	26.7

... = data not available.

Table A4 Growth rate of value added in industry (% per year)

	2009	2010	2011	2012	2013	Sector share, 2012, %
Central Asia						
Armenia	−29.6	6.1	−0.0	5.4	−1.8	32.2
Azerbaijan	10.6	4.4	3.4	−0.6	4.9	63.4
Georgia	−3.5	9.1	9.4	9.5	0.9	24.5
Kazakhstan	1.4	7.2	0.7	1.7	2.3	39.2
Kyrgyz Republic	−0.3	2.5	7.0	−11.7	28.0	25.6
Tajikistan	−6.5	9.7	5.9	10.4	3.9	...
Turkmenistan	...	8.7	26.5	8.6	7.3	51.1
Uzbekistan	9.7	8.3	6.7	8.0	9.8	32.2
East Asia						
China, People's Rep. of	10.0	12.3	10.3	7.9	7.8	45.3
Hong Kong, China	−5.1	7.6	8.9	4.4	0.4	6.9
Korea, Rep. of	−0.6	10.7	5.1	1.7	3.0	39.1
Mongolia	−0.4	4.3	9.1	9.9	20.1	31.9
Taipei,China	−4.1	23.1	6.1	1.7	1.8	30.0
South Asia						
Afghanistan	6.1	6.3	9.8	7.2	2.5	21.5
Bangladesh	6.5	6.5	8.2	8.9	9.0	28.5
Bhutan	4.8	8.0	8.0	3.5	5.0	42.2
India	9.2	7.6	7.8	1.0	0.7	27.2
Maldives	−26.1	4.3	12.1	1.2	−1.2	16.9
Nepal	−0.6	4.0	4.3	3.0	1.6	14.9
Pakistan	−5.2	3.4	4.7	2.7	3.5	22.0
Sri Lanka	4.2	8.4	10.4	10.3	9.9	31.5
Southeast Asia						
Brunei Darussalam	−5.0	1.7	3.2	−1.8	...	71.1
Cambodia	−9.5	13.6	14.5	9.2	10.5	24.3
Indonesia	3.6	4.9	5.2	5.2	5.0	46.8
Lao People's Dem. Rep.	17.4	14.5	14.2	13.7	7.2	30.6
Malaysia	−7.2	8.5	2.1	5.1	3.4	38.9
Myanmar	11.9	13.2	17.5	8.1	...	32.3
Philippines	−1.9	11.6	1.8	6.8	9.5	31.1
Singapore	−1.3	24.9	7.3	1.4	2.2	26.1
Thailand	−5.0	12.8	−3.9	7.2	0.3	43.6
Viet Nam	6.0	7.2	6.7	5.7	5.4	38.6
The Pacific						
Cook Islands	−2.2	−8.7	12.1	10.6	...	9.5
Fiji Islands	1.0	6.5	2.0	1.4	...	21.5
Kiribati	21.3	−9.9	11.8	...	...	...
Marshall Islands	−8.0	−5.5	−6.4	−1.3	...	11.7
Micronesia, Fed. States of	35.8	17.1	12.3	−2.2	...	9.1
Nauru	−41.1	...	...	...	...	...
Palau	−34.1	−8.5	12.4	0.2	...	8.5
Papua New Guinea	8.1	10.8	13.0	14.7	9.9	44.4
Samoa	−15.5	2.7	1.8	4.9	−4.5	25.6
Solomon Islands	1.3	...	...	...	...	...
Timor-Leste	41.7	7.3	33.7	...	...	...
Tonga	12.9	11.6	5.5	1.2	−4.4	21.1
Tuvalu	−14.4	−6.9	−28.7	...	...	...
Vanuatu	27.6	12.6	−19.4	−22.2	...	8.1

... = data not available.

Table A5 Growth rate of value added in services (% per year)

	2009	2010	2011	2012	2013	Sector share, 2012, %
Central Asia						
Armenia	–3.6	4.5	6.1	7.0	5.9	46.8
Azerbaijan	9.1	7.2	–2.1	6.9	7.2	31.1
Georgia	–3.4	7.8	5.7	6.2	3.3	66.9
Kazakhstan	–1.1	7.1	6.0	10.6	7.5	56.3
Kyrgyz Republic	2.3	–1.1	6.9	6.5	5.1	55.3
Tajikistan	9.5	4.6	13.5	14.5	19.3	...
Turkmenistan	...	9.9	8.3	14.7	13.9	40.5
Uzbekistan	9.3	11.6	12.7	10.4	8.0	48.7
East Asia						
China, People's Rep. of	9.6	9.8	9.4	8.1	8.3	44.6
Hong Kong, China	–1.7	6.9	5.2	1.8	3.0	93.0
Korea, Rep. of	1.1	3.9	2.6	2.5	2.5	58.2
Mongolia	0.8	9.8	16.8	16.3	10.0	51.8
Taipei,China	–0.2	4.8	3.2	1.2	1.5	68.2
South Asia						
Afghanistan	17.2	18.1	12.7	7.3	4.3	51.5
Bangladesh	6.3	6.5	6.2	6.0	5.7	53.9
Bhutan	9.1	12.7	13.7	8.0	3.8	40.3
India	10.5	9.7	6.6	7.0	6.9	54.9
Maldives	1.7	8.0	5.8	1.4	4.7	79.1
Nepal	6.0	5.8	3.4	4.5	6.0	49.4
Pakistan	1.3	3.2	3.9	5.3	3.7	53.6
Sri Lanka	3.3	8.0	8.6	4.6	6.4	57.5
Southeast Asia						
Brunei Darussalam	2.1	3.8	3.7	3.8	...	28.2
Cambodia	2.3	3.3	5.0	8.1	8.4	40.1
Indonesia	5.8	8.4	8.5	7.7	7.1	38.7
Lao People's Dem. Rep.	6.2	8.0	8.5	8.0	9.0	42.4
Malaysia	2.9	7.4	7.0	6.4	5.9	50.9
Myanmar	6.7	6.4	6.4	12.1	...	37.0
Philippines	3.4	7.2	4.9	7.6	7.1	57.1
Singapore	–0.7	12.0	5.7	2.0	5.2	73.9
Thailand	–0.2	4.6	3.8	6.2	5.9	44.2
Viet Nam	6.5	7.2	6.8	5.9	6.6	41.7
The Pacific						
Cook Islands	2.4	–2.6	0.1	2.7	...	86.0
Fiji Islands	–0.8	2.9	2.0	1.6	...	66.1
Kiribati	1.1	1.4	–1.2	...	...	...
Marshall Islands	–1.0	3.5	1.2	1.6	...	71.8
Micronesia, Fed. States of	–1.6	1.5	0.2	–1.0	...	61.1
Nauru	1.0	...	...	...	...	...
Palau	–5.2	0.3	6.4	5.2		85.6
Papua New Guinea	9.7	8.5	11.5	9.7	3.4	27.1
Samoa	0.9	0.1	1.5	2.9	1.8	69.1
Solomon Islands	–1.3	...	...	...	...	...
Timor-Leste	13.4	11.1	11.2	...	...	...
Tonga	0.8	1.0	1.8	0.5	1.1	60.1
Tuvalu	3.5	2.5	6.4	...	...	...
Vanuatu	3.3	3.0	3.2	4.4	...	65.2

... = data not available.

Table A6 Inflation (% per year)

	2009	2010	2011	2012	2013	2014	2015
Central Asia	5.9	7.0	8.9	5.1	5.9	9.0	7.4
Armenia	3.4	8.2	7.7	2.6	5.8	4.5	4.0
Azerbaijan	1.5	5.7	7.9	1.1	2.4	4.0	3.5
Georgia	1.7	7.1	8.5	–0.9	–0.5	4.0	5.0
Kazakhstan	7.3	7.1	8.3	5.1	5.8	11.5	8.8
Kyrgyz Republic	6.8	7.8	16.6	2.8	6.6	7.0	6.0
Tajikistan	6.5	6.5	12.5	5.8	5.1	5.5	6.0
Turkmenistan	–2.7	4.4	5.3	5.3	6.0	6.7	6.2
Uzbekistan	14.1	9.4	12.8	12.1	12.1	11.0	10.0
East Asia	–0.1	3.1	5.0	2.6	2.4	2.5	2.9
China, People’s Rep. of	–0.7	3.3	5.4	2.6	2.6	2.6	3.0
Hong Kong, China	0.6	2.3	5.3	4.1	4.3	3.8	3.7
Korea, Rep. of	2.8	3.0	4.0	2.2	1.3	2.1	2.5
Mongolia	7.6	10.1	9.2	14.3	10.4	11.0	8.0
Taipei,China	–0.9	1.0	1.4	1.9	0.8	1.1	1.3
South Asia	5.6	9.4	9.5	7.8	6.2	6.4	6.2
Afghanistan	–12.2	7.7	11.8	6.2	7.4	6.8	7.1
Bangladesh	7.6	6.8	10.9	8.7	6.8	7.5	6.5
Bhutan	7.1	4.8	8.6	10.1	8.6	10.2	8.5
India	3.8	9.6	8.9	7.4	5.9	6.0	5.8
Maldives	4.5	6.1	11.3	10.9	4.0	5.0	4.8
Nepal	12.6	9.6	9.6	8.3	9.9	10.0	9.5
Pakistan	20.8	10.1	13.7	11.0	7.4	9.0	9.2
Sri Lanka	3.5	6.2	6.7	7.9	6.9	5.0	6.0
Southeast Asia	2.7	4.1	5.5	3.8	4.2	4.3	4.0
Brunei Darussalam	1.0	0.4	0.1	0.1	0.4	0.5	0.6
Cambodia	–0.7	4.0	5.5	2.9	2.9	3.5	3.5
Indonesia	4.8	5.1	5.3	4.0	6.4	5.7	4.8
Lao People’s Dem. Rep.	0.0	6.0	7.6	4.3	6.4	5.5	6.0
Malaysia	0.6	1.7	3.2	1.7	2.1	3.2	3.5
Myanmar	2.2	8.2	2.8	2.9	5.8	6.6	6.9
Philippines	4.2	3.8	4.6	3.2	3.0	4.3	4.0
Singapore	0.6	2.8	5.2	4.6	2.4	3.0	2.9
Thailand	–0.9	3.2	3.8	3.0	2.2	2.4	2.6
Viet Nam	6.9	9.2	18.7	9.1	6.6	6.2	6.6
The Pacific	5.2	4.7	8.5	4.2	4.5	5.9	5.1
Cook Islands	6.7	–0.3	2.2	3.0	1.9	2.5	2.5
Fiji Islands	3.2	3.7	7.3	3.4	2.9	3.0	3.5
Kiribati	9.8	–3.9	1.5	–3.0	2.0	2.5	2.5
Marshall Islands	0.5	1.8	5.4	4.3	1.6	1.5	1.5
Micronesia, Fed. States of	7.9	3.9	4.6	5.8	2.2	2.0	1.5
Nauru	21.2	–0.6	–3.5	–0.5	1.4	5.0	7.0
Palau	4.7	1.1	2.6	5.4	3.0	2.5	2.0
Papua New Guinea	6.9	6.0	8.4	2.2	4.0	6.5	5.0
Samoa	14.6	0.0	3.1	6.2	–0.2	2.0	2.0
Solomon Islands	7.1	1.0	7.4	5.9	6.0	5.5	5.0
Timor-Leste	–0.2	5.2	13.2	10.9	9.5	9.5	9.0
Tonga	1.2	5.1	3.8	2.5	0.2	2.0	2.0
Tuvalu	–5.5	–1.9	0.5	1.4	2.0	2.5	2.0
Vanuatu	4.3	2.8	0.9	1.4	1.4	2.5	3.0
Average	1.4	4.4	5.9	3.7	3.4	3.6	3.7

... = data not available.

Table A7 Change in money supply (% per year)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	15.1	11.8	23.7	19.5	14.8
Azerbaijan	−0.3	24.3	32.1	20.7	15.4
Georgia	8.2	33.1	14.5	11.4	24.5
Kazakhstan	19.5	13.3	15.0	7.9	10.2
Kyrgyz Republic	17.9	21.1	14.9	23.8	4.4
Tajikistan	39.6	18.6	33.1	20.1	20.1
Turkmenistan	10.9	43.4	36.3	35.6	29.5
Uzbekistan	40.9	52.4	32.3	27.5	26.4
East Asia					
China, People's Rep. of	27.6	19.7	17.3	14.4	13.6
Hong Kong, China	5.3	8.1	12.9	11.1	12.3
Korea, Rep. of	9.9	6.0	5.5	4.8	4.6
Mongolia	26.9	62.5	37.0	18.8	24.1
Taipei,China	5.8	5.4	4.8	3.5	5.8
South Asia					
Afghanistan	33.1	26.9	21.3	8.9	9.7
Bangladesh	19.2	22.4	21.3	17.4	16.7
Bhutan	24.6	30.1	21.2	−1.0	18.6
India	16.8	16.0	13.2	13.9	11.7
Maldives	14.4	14.6	20.0	5.0	18.4
Nepal	27.0	30.5	12.3	22.6	16.4
Pakistan	9.6	12.5	15.9	14.1	15.9
Sri Lanka	18.6	15.8	19.1	17.6	16.7
Southeast Asia					
Brunei Darussalam	9.7	4.8	10.1	0.9	...
Cambodia	36.8	20.0	21.4	20.9	14.6
Indonesia	13.0	15.4	16.4	15.0	12.7
Lao People's Dem. Rep.	31.3	39.5	28.7	31.0	22.7
Malaysia	9.5	7.2	14.7	9.7	8.4
Myanmar	34.8	36.3	26.3	46.6	37.4
Philippines	9.9	10.0	7.1	8.9	32.7
Singapore	11.3	8.6	10.0	7.2	4.3
Thailand	6.8	10.9	15.1	10.4	7.3
Viet Nam	29.0	33.3	12.1	18.5	18.5
The Pacific					
Cook Islands	65.9	−2.3	−13.4	...	...
Fiji Islands	7.4	4.2	14.8	6.3	15.4
Kiribati	...	...	...	...	...
Marshall Islands	...	...	...	...	...
Micronesia, Fed. States of	...	...	...	...	...
Nauru	...	...	...	...	...
Palau	...	...	...	...	...
Papua New Guinea	21.9	10.0	17.6	10.9	...
Samoa	7.7	10.9	−0.8	−4.0	−0.8
Solomon Islands	16.8	13.3	25.8	17.4	14.5
Timor-Leste, Dem. Rep. of	29.6	18.2	9.3	26.2	22.9
Tonga	−1.9	5.1	2.7	−2.0	7.4
Tuvalu	...	...	...	...	...
Vanuatu	0.5	−6.0	1.3	−0.6	...

... = data not available.

Table A8 Central government revenues (% of GDP)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	22.0	22.6	23.3	23.7	25.0
Azerbaijan	29.0	26.9	30.1	31.6	33.8
Georgia	29.3	28.3	28.2	28.9	27.3
Kazakhstan	20.6	19.7	19.5	19.2	19.0
Kyrgyz Republic	32.2	30.5	27.2	34.5	29.0
Tajikistan	23.4	23.2	24.9	25.1	26.9
Turkmenistan	20.4	16.1	18.3	21.0	17.9
Uzbekistan	33.8	32.4	32.0	32.8	31.8
East Asia					
China, People's Rep. of	20.1	20.7	22.0	22.6	22.7
Hong Kong, China	19.2	21.2	22.6	21.7	21.1
Korea, Rep. of	20.4	20.1	20.5	21.0	21.5
Mongolia	30.3	37.1	40.3	35.4	33.8
Taipei,China	12.4	11.1	12.2	11.9	11.9
South Asia					
Afghanistan	20.6	22.0	20.8	24.7	26.6
Bangladesh	10.4	10.9	11.7	12.5	12.4
Bhutan	40.4	46.4	35.6	35.2	35.7
India	19.6	21.0	19.5	20.9	22.0
Maldives	22.6	24.0	31.4	31.2	33.2
Nepal	16.7	18.2	17.8	18.6	19.8
Pakistan	14.0	14.0	12.4	12.8	13.0
Sri Lanka	15.0	14.9	14.5	14.1	13.8
Southeast Asia					
Brunei Darussalam	39.4	51.9	60.6	55.5	...
Cambodia	11.9	13.2	13.2	15.2	14.9
Indonesia	15.1	15.4	16.3	16.3	15.7
Lao People's Dem. Rep.	14.9	15.7	16.4	17.7	18.1
Malaysia	22.3	20.0	21.0	22.1	21.7
Myanmar	10.7	11.4	12.0	23.3	22.3
Philippines	14.0	13.4	14.0	14.5	14.9
Singapore	14.3	14.5	14.9	15.7	15.4
Thailand	16.4	17.3	18.0	18.3	18.1
Viet Nam	25.8	27.6	26.1	22.9	22.1
The Pacific					
Cook Islands	33.9	32.6	31.7	40.5	39.8
Fiji Islands	25.2	25.5	27.6	27.4	27.2
Kiribati	70.9	72.5	62.1	102.3	98.0
Marshall Islands	64.5	62.0	58.5	52.0	48.3
Micronesia, Fed. States of	65.9	68.0	64.9	66.0	67.0
Nauru	80.7	49.5	62.1	85.4	110.9
Palau	39.1	44.2	41.6	41.3	41.7
Papua New Guinea	29.8	31.4	30.4	29.8	30.3
Samoa	38.6	40.4	42.1	37.8	40.8
Solomon Islands	53.9	57.5	63.8	50.3	41.2
Timor-Leste	249.7	293.0	341.9	321.1	227.3
Tonga	28.5	22.8	22.1	23.3	19.6
Tuvalu	86.5	68.0	70.2	85.9	77.7
Vanuatu	25.9	24.6	22.3	21.8	16.1

... = data not available.

Table A9 Central government expenditures (% of GDP)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	29.6	27.6	26.1	25.2	25.4
Azerbaijan	29.7	27.7	29.6	31.8	33.1
Georgia	38.4	34.9	31.8	31.7	30.2
Kazakhstan	23.5	22.1	21.5	22.2	21.1
Kyrgyz Republic	36.1	36.6	31.8	39.8	32.8
Tajikistan	28.6	26.1	27.0	24.7	27.7
Turkmenistan	13.4	14.1	14.6	14.7	16.4
Uzbekistan	34.3	32.0	31.9	32.7	32.7
East Asia					
China, People's Rep. of	22.4	22.4	23.1	24.3	24.6
Hong Kong, China	17.6	17.0	18.9	18.5	20.5
Korea, Rep. of	24.5	21.2	21.6	22.4	23.3
Mongolia	35.5	36.6	45.1	42.8	35.2
Taipei,China	16.0	14.0	14.0	13.5	13.2
South Asia					
Afghanistan	22.1	21.1	21.3	24.3	24.5
Bangladesh	14.3	14.6	16.1	16.6	16.9
Bhutan	38.5	44.7	37.7	36.3	36.6
India	28.6	27.6	26.9	28.1	28.4
Maldives	43.1	39.6	38.8	40.4	37.9
Nepal	20.0	20.1	20.1	20.8	19.4
Pakistan	19.2	20.2	18.9	21.5	21.0
Sri Lanka	24.9	22.8	21.4	20.5	19.7
Southeast Asia					
Brunei Darussalam	40.9	35.9	33.6	35.3	...
Cambodia	20.5	21.3	20.7	21.6	19.9
Indonesia	16.7	16.2	17.5	18.1	18.0
Lao People's Dem. Rep.	20.7	24.6	24.4	25.6	30.5
Malaysia	28.9	25.5	25.8	26.5	25.6
Myanmar	15.6	16.6	16.9	27.2	27.2
Philippines	17.7	16.9	16.0	16.8	16.3
Singapore	15.1	14.3	13.6	13.8	14.1
Thailand	18.4	16.6	16.4	19.6	18.2
Viet Nam	34.3	34.3	29.9	29.3	29.2
The Pacific					
Cook Islands	36.2	34.7	36.3	42.6	41.8
Fiji Islands	29.3	27.7	29.0	28.5	30.0
Kiribati	82.9	85.2	83.2	109.0	104.0
Marshall Islands	52.1	48.4	48.7	48.7	48.0
Micronesia, Fed. States of	63.9	67.6	65.5	65.2	64.6
Nauru	80.4	43.5	61.4	86.5	110.5
Palau	39.9	45.1	40.5	41.4	43.0
Papua New Guinea	29.9	30.7	28.1	34.1	38.2
Samoa	42.0	47.8	48.0	42.8	45.2
Solomon Islands	52.2	51.8	54.2	46.6	41.9
Timor-Leste	107.2	114.5	122.4	107.1	86.4
Tonga	33.2	32.3	33.7	30.2	24.5
Tuvalu	84.8	90.5	79.2	75.2	77.3
Vanuatu	24.9	27.1	21.9	21.9	15.8

... = data not available.

Table A10 Fiscal balance of central government (% of GDP)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	−7.6	−5.0	−2.8	−1.5	−0.4
Azerbaijan	−0.7	−0.9	0.6	−0.2	0.7
Georgia	−9.2	−6.6	−3.6	−2.8	−2.9
Kazakhstan	−2.9	−2.4	−2.1	−2.9	−2.1
Kyrgyz Republic	−3.7	−6.3	−4.8	−5.4	−4.0
Tajikistan	−5.4	−3.7	−2.5	0.4	−0.8
Turkmenistan	7.0	2.0	3.6	6.4	1.5
Uzbekistan	0.2	2.0	2.0	0.1	−0.9
East Asia					
China, People's Rep. of	−2.3	−1.7	−1.1	−1.7	−1.9
Hong Kong, China	1.6	4.2	3.7	3.2	0.6
Korea, Rep. of	−4.1	−1.1	−1.1	−1.4	−1.8
Mongolia	−5.2	0.5	−4.8	−7.4	−1.4
Taipei,China	−3.5	−3.0	−1.8	−1.6	−1.3
South Asia					
Afghanistan	−1.6	0.9	−0.6	0.4	2.1
Bangladesh	−3.9	−3.7	−4.4	−4.1	−4.5
Bhutan	1.9	1.6	−2.1	−1.1	−0.9
India	−8.9	−6.6	−7.4	−7.2	−6.4
Maldives	−20.5	−15.6	−7.5	−9.2	−4.7
Nepal	−3.3	−1.9	−2.4	−2.2	0.4
Pakistan	−5.2	−6.2	−6.5	−8.8	−8.0
Sri Lanka	−9.9	−8.0	−6.9	−6.4	−5.8
Southeast Asia					
Brunei Darussalam	−1.5	15.9	26.9	20.2	...
Cambodia	−8.6	−8.1	−7.5	−6.5	−5.0
Indonesia	−1.6	−0.7	−1.1	−1.9	−2.3
Lao People's Dem. Rep.	−5.8	−8.9	−7.9	−7.9	−12.4
Malaysia	−6.7	−5.4	−4.8	−4.5	−3.9
Myanmar	−4.9	−5.5	−4.6	−3.9	−4.9
Philippines	−3.7	−3.5	−2.0	−2.3	−1.4
Singapore	−0.3	0.3	1.2	1.6	1.1
Thailand	−4.4	−2.6	−0.9	−4.1	−2.0
Viet Nam	−8.5	−6.7	−3.8	−6.4	−7.1
The Pacific					
Cook Islands	−2.2	−2.1	−4.7	−2.1	−2.0
Fiji Islands	−4.1	−2.2	−1.4	−1.1	−2.8
Kiribati	−12.0	−12.7	−21.1	−6.7	−6.0
Marshall Islands	1.5	3.5	2.2	−0.8	−0.7
Micronesia, Fed. States of	2.0	0.5	−0.6	0.8	2.4
Nauru	0.3	6.0	0.6	−1.2	0.4
Palau	−0.8	−0.9	1.2	−0.2	−1.2
Papua New Guinea	−0.2	0.7	2.3	−4.3	−7.9
Samoa	−3.5	−7.4	−5.9	−5.0	−4.4
Solomon Islands	1.7	5.7	9.6	3.7	−0.7
Timor-Leste	142.5	178.5	219.5	214.0	140.9
Tonga	−4.7	−9.5	−11.6	−6.9	−4.9
Tuvalu	1.6	−22.5	−9.0	10.8	0.4
Vanuatu	1.0	−2.5	0.4	−0.1	0.3

... = data not available.

Table A11 Growth rate of merchandise exports (% per year)

	2009	2010	2011	2012	2013	2014	2015
Central Asia	–32.0	28.4	37.2	1.4	–0.5	3.8	3.3
Armenia	–32.7	57.0	34.4	2.5	8.5	6.2	6.5
Azerbaijan	–31.0	25.5	30.3	–6.1	–1.8	–15.0	–3.3
Georgia	–22.0	30.0	32.2	7.6	27.6	19.0	22.0
Kazakhstan	–39.0	39.8	38.8	2.0	–4.0	6.5	2.5
Kyrgyz Republic	–9.6	5.0	27.7	–13.1	4.8	8.0	8.0
Tajikistan	–28.2	18.3	5.2	41.0	–0.8	5.1	6.4
Turkmenistan	–24.0	8.0	73.1	18.9	2.0	12.6	7.0
Uzbekistan	–4.2	6.0	20.3	–7.6	14.7	11.9	6.0
East Asia	–16.0	30.0	18.4	5.6	6.3	8.8	9.6
China, People's Rep. of	–16.1	31.4	20.4	8.0	7.9	10.3	10.5
Hong Kong, China	–10.6	22.8	12.5	7.0	6.8	8.0	8.3
Korea, Rep. of	–17.6	28.8	19.6	0.4	3.0	6.0	8.0
Mongolia	–25.6	54.3	65.6	–9.0	–2.6	25.0	15.0
Taipei,China	–20.2	34.6	12.3	–2.3	1.4	4.2	7.8
South Asia	–3.3	31.1	24.6	–0.9	4.8	7.7	10.4
Afghanistan	2.1	12.3	–5.1	2.6	–3.4	1.9	4.9
Bangladesh	10.1	4.2	39.2	6.2	10.7	9.0	12.0
Bhutan	–14.9	3.0	26.8	–7.3	–3.9	3.5	9.2
India	–3.5	37.3	23.7	–1.0	4.7	8.0	10.5
Maldives	–49.0	16.8	75.4	–9.2	18.6	4.3	11.0
Nepal	–4.7	–6.3	11.7	5.7	–2.9	3.0	5.0
Pakistan	–6.4	2.9	28.9	–2.6	0.4	2.7	6.0
Sri Lanka	–12.7	21.0	23.2	–7.4	6.3	10.0	15.0
Southeast Asia	–14.7	30.5	15.6	4.7	–0.6	6.5	8.2
Brunei Darussalam	–33.0	30.3	33.2	4.4	–11.9	–5.5	1.0
Cambodia	–10.2	25.1	27.8	11.9	15.9	13.4	15.9
Indonesia	–14.3	32.1	27.0	–6.1	–2.6	4.5	6.0
Lao People's Dem. Rep.	–5.5	57.5	43.2	6.1	3.3	10.0	15.0
Malaysia	–21.0	26.9	14.9	–0.4	–3.6	6.3	8.0
Myanmar	4.7	13.9	16.6	2.2	27.5	12.4	15.9
Philippines	–16.0	26.2	4.1	21.2	–3.6	8.2	7.3
Singapore	–14.2	31.7	6.5	6.4	–2.7	5.0	8.3
Thailand	–13.9	27.1	14.3	3.1	–0.2	6.0	5.5
Viet Nam	–8.9	26.5	34.2	18.2	15.3	15.0	15.0
The Pacific	–24.2	31.0	24.7	–4.4	–11.3	19.7	57.9
Cook Islands	–16.2	11.3	–1.8	–24.4	...	...	...
Fiji Islands	–29.6	34.0	28.8	14.3	–5.0	5.3	4.2
Kiribati	–25.7	–39.5	123.6	–32.6	0.6	0.6	5.3
Marshall Islands	2.7	55.2	55.2	18.0	5.4	...	...
Micronesia, Fed. States of	–6.6	19.4	27.5	33.1	...	...	...
Nauru	–29.8	...	...	...	...	...	...
Palau	–53.8	8.7	27.6	19.9	–22.5	3.5	2.8
Papua New Guinea	–23.9	30.9	21.8	–9.2	–12.9	24.2	71.7
Samoa	7.8	53.7	25.8	38.9	–12.6	12.0	5.7
Solomon Islands	–21.4	35.6	85.6	18.7	–9.4	1.0	5.1
Timor-Leste	–27.3	93.3	–13.8	32.0	12.1	13.5	9.5
Tonga	–43.3	9.7	–16.2	–25.1	36.0	138.6	8.7
Tuvalu	–11.7	–4.0	81.0	–50.1	15.5	–7.0	8.1
Vanuatu	33.2	–8.4	24.9	–13.9	...	...	...
Average	–15.4	30.1	18.6	4.7	4.3	8.1	9.2

... = data not available.

Table A12 Growth rate of merchandise imports (% per year)

	2009	2010	2011	2012	2013	2014	2015
Central Asia	–16.3	7.1	28.1	17.1	4.4	9.5	7.6
Armenia	–25.0	13.4	14.0	2.2	2.5	3.5	4.3
Azerbaijan	–14.0	3.6	50.7	0.3	9.4	3.4	4.0
Georgia	–31.4	17.7	33.6	14.3	–0.5	21.5	17.4
Kazakhstan	–24.6	13.7	22.7	21.6	1.0	10.1	6.2
Kyrgyz Republic	–25.0	5.9	32.0	26.2	8.8	10.0	10.0
Tajikistan	–21.4	3.5	19.9	16.8	9.8	7.9	9.3
Turkmenistan	50.4	–8.0	40.6	27.9	9.4	7.0	6.0
Uzbekistan	–2.7	–4.8	23.4	8.2	9.0	10.3	10.9
East Asia	–15.4	36.0	22.1	3.5	5.2	7.9	9.0
China, People's Rep. of	–11.2	39.1	25.1	4.5	7.1	8.7	9.3
Hong Kong, China	–7.9	27.1	15.4	9.5	7.7	5.7	8.1
Korea, Rep. of	–25.4	31.5	23.4	–1.1	–0.8	9.0	9.0
Mongolia	–34.1	49.7	106.2	2.1	–5.7	0.0	15.0
Taipei,China	–26.9	43.1	12.9	–3.7	–0.4	4.1	8.1
South Asia	–3.8	–39.3	30.7	1.3	–5.8	8.9	11.6
Afghanistan	–0.8	11.6	3.3	10.1	–0.1	0.6	–2.1
Bangladesh	4.2	5.4	52.1	2.4	0.8	10.0	14.0
Bhutan	–9.5	36.1	41.7	–10.0	–6.5	7.8	8.2
India	–2.6	26.7	31.1	0.5	–7.0	9.0	12.0
Maldives	–34.4	14.8	38.9	0.3	9.7	6.5	10.1
Nepal	8.3	35.5	8.9	4.7	10.9	15.0	9.9
Pakistan	–10.3	–1.7	14.9	12.8	–0.6	4.4	5.0
Sri Lanka	–27.6	31.8	50.7	–5.4	–6.2	18.0	18.0
Southeast Asia	–26.9	36.9	34.8	3.8	5.9	11.8	9.3
Brunei Darussalam	–20.2	2.0	9.8	39.7	1.2	2.5	0.7
Cambodia	–13.4	22.2	23.8	16.3	13.8	12.8	13.0
Indonesia	–24.0	43.7	30.3	8.4	–1.4	3.4	4.2
Lao People's Dem. Rep.	2.0	21.2	31.7	34.5	11.8	5.0	8.0
Malaysia	–20.6	33.8	14.4	4.4	–0.1	6.2	8.2
Myanmar	1.9	15.8	27.5	19.1	37.5	7.2	16.2
Philippines	–19.4	24.7	9.5	11.3	–3.1	9.4	8.0
Singapore	–19.2	30.5	8.1	8.8	–3.9	4.8	9.0
Thailand	–25.1	37.0	24.9	8.8	–0.4	8.0	10.0
Viet Nam	–14.3	19.6	25.8	7.5	15.1	19.9	17.0
The Pacific	–14.9	19.7	19.0	11.9	4.8	–3.8	–2.3
Cook Islands	–20.6	3.9	19.3	7.4	...	...	...
Fiji Islands	–37.3	25.4	23.4	2.9	34.0	–16.4	4.4
Kiribati	–3.7	3.3	26.2	17.7	–5.7	–11.1	–11.1
Marshall Islands	4.8	41.1	–10.8	5.8	0.4	...	...
Micronesia, Fed. States of	2.9	4.3	9.0	5.0	...	...	...
Nauru	13.6	...	...	...	...	...	...
Palau	–27.8	9.3	21.7	8.4	–1.1	1.1	0.7
Papua New Guinea	–8.1	23.0	21.5	11.5	–8.3	–1.8	–9.5
Samoa	22.9	10.8	1.7	19.8	3.5	9.1	2.5
Solomon Islands	–14.1	50.8	16.9	5.8	9.9	10.7	3.9
Timor-Leste	19.1	–8.7	22.2	79.7	14.4	13.3	9.1
Tonga	–17.3	–0.1	4.1	4.1	1.3	–0.8	8.9
Tuvalu	–18.2	22.3	15.1	1.0	–5.0	–3.9	–3.4
Vanuatu	–6.1	–2.7	1.7	2.8	...	...	...
Average	–14.9	14.7	24.5	3.5	3.6	8.4	9.3

... = data not available.

Table A13 Trade balance ($ million)

	2009	2010	2011	2012	2013	2014	2015
Central Asia	25,295	46,196	69,686	56,885	51,614	47,379	43,811
Armenia	–2,081	–2,033	–2,078	–2,119	–2,075	–2,100	–2,149
Azerbaijan	14,583	19,730	24,328	22,182	20,621	15,460	14,100
Georgia	–2,399	–2,590	–3,494	–4,214	–3,213	–4,016	–4,470
Kazakhstan	15,004	28,500	44,844	37,852	33,836	34,200	33,000
Kyrgyz Republic	–1,120	–1,202	–1,665	–2,993	–3,336	–3,710	–4,126
Tajikistan	–1,559	–1,463	–1,930	–1,949	–2,328	–2,562	–2,854
Turkmenistan	891	2,253	6,312	6,566	5,710	7,247	7,910
Uzbekistan	1,976	3,000	3,367	1,561	2,400	2,860	2,400
East Asia	330,966	323,774	294,257	371,749	430,544	498,554	567,127
China, People’s Rep. of	249,511	254,180	243,549	321,595	359,900	426,683	494,852
Hong Kong, China	13,288	3,290	–7,477	–18,917	–25,000	–15,000	–15,000
Korea, Rep. of	37,866	40,083	31,660	39,817	60,712	49,049	47,411
Mongolia	–252	–292	–1,781	–2,354	–2,082	–1,014	–1,166
Taipei,China	30,553	26,513	28,306	31,608	37,014	38,836	41,030
South Asia	–148,735	–164,633	–233,720	–245,091	–191,877	–213,596	–243,145
Afghanistan	–6,355	–7,070	–7,539	–8,507	–8,590	–8,611	–8,240
Bangladesh	–4,710	–5,155	–9,935	–9,320	–7,010	–7,977	–9,673
Bhutan	–74	–269	–460	–396	–354	–408	–435
India	–118,202	–130,593	–189,759	–195,656	–146,090	–162,448	–187,141
Maldives	–913	–1,044	–1,379	–1,417	–1,526	–1,633	–1,795
Nepal	–2,733	–4,084	–4,422	–4,623	–5,263	–6,170	–6,830
Pakistan	–12,627	–11,536	–10,516	–15,765	–15,431	–16,536	–17,108
Sri Lanka	–3,122	–4,881	–9,710	–9,409	–7,613	–9,814	–11,924
Southeast Asia	134,904	154,954	155,647	112,993	105,112	102,991	97,684
Brunei Darussalam	4,890	7,014	9,884	9,410	7,823	7,103	7,186
Cambodia	–1,308	–1,508	–1,710	–2,208	–2,393	–2,660	–2,791
Indonesia	30,932	30,627	34,783	8,618	6,149	8,377	12,181
Lao People’s Dem. Rep.	–1,372	–1,109	–1,185	–2,567	–3,179	–3,150	–3,112
Malaysia	39,823	42,455	49,531	40,668	32,603	34,844	37,235
Myanmar	511	487	–198	–2,205	–2,480	–1,825	–2,324
Philippines	–13,860	–16,859	–20,429	–18,926	–18,525	–20,790	–22,776
Singapore	50,275	69,232	68,432	64,304	67,123	71,209	74,442
Thailand	32,620	29,751	16,989	6,015	6,355	2,355	–8,161
Viet Nam	–7,607	–5,136	–450	9,884	11,637	7,527	5,804
The Pacific	–493	13	385	–983	–2,002	–173	5,044
Cook Islands	–83	–86	–130	–131	...	...	...
Fiji Islands	–627	–733	–860	–763	–1,496	–1,001	–1,048
Kiribati	–65	–69	–84	–103	–97	–85	–75
Marshall Islands	–74	–101	–69	–67	–64	...	...
Micronesia, Fed. States of	–127	–128	–134	–129	–129	–132	–130
Nauru	–8	...	...	...	...	...	...
Palau	–81	–88	–106	–113	–117	–118	–118
Papua New Guinea	1,524	2,221	2,712	1,574	1,151	2,576	7,920
Samoa	–239	–260	–260	–306	–322	–351	–358
Solomon Islands	–74	–137	–6	47	–43	–91	–89
Timor-Leste	–320	–277	–349	–639	–732	–829	–904
Tonga	–123	–123	–129	–136	–136	–126	–137
Tuvalu	–13	–15	–17	–18	–17	–16	–16
Vanuatu	–193	–191	–183	–198	...	...	...
Total	341,936	360,305	286,255	295,552	393,392	435,154	470,520

... = data not available.

Table A14 Current account balance (% of GDP)

	2009	2010	2011	2012	2013	2014	2015
Central Asia	0.4	4.6	6.9	3.3	2.7	2.9	3.5
Armenia	–15.8	–14.8	–10.9	–11.2	–9.5	–8.7	–8.0
Azerbaijan	23.0	28.4	25.7	21.4	16.7	16.0	15.0
Georgia	–11.2	–10.2	–12.7	–11.4	–5.9	–8.0	–7.5
Kazakhstan	–3.6	0.9	5.4	0.3	0.1	0.6	2.3
Kyrgyz Republic	–2.2	–7.2	–6.1	–15.3	–10.4	–15.7	–15.1
Tajikistan	–5.9	–1.2	–4.8	–2.0	–1.9	–2.1	–2.3
Turkmenistan	–14.7	–10.6	2.0	0.0	0.5	2.0	2.0
Uzbekistan	2.2	6.1	5.7	2.7	3.7	4.7	3.6
East Asia	5.3	4.3	2.4	2.9	3.0	2.8	2.7
China, People's Rep. of	4.9	4.0	1.9	2.3	2.1	2.0	1.9
Hong Kong, China	9.9	7.0	5.6	1.6	2.1	3.5	3.5
Korea, Rep. of	3.9	2.9	2.3	4.3	5.8	4.1	4.0
Mongolia	–7.5	–14.3	–31.5	–32.6	–27.4	–20.0	–15.0
Taipei,China	11.4	9.3	9.0	10.7	11.7	12.3	12.5
South Asia	–2.7	–2.3	–3.7	–4.1	–1.8	–2.2	–2.6
Afghanistan	–2.8	3.9	3.1	3.9	2.5	1.7	1.2
Bangladesh	2.7	3.7	–1.5	–0.4	1.9	–0.5	–1.5
Bhutan	–6.3	–22.2	–29.8	–21.3	–23.6	–28.6	–26.4
India	–2.8	–2.7	–4.2	–4.7	–2.2	–2.5	–2.8
Maldives	–11.4	–8.9	–19.1	–23.0	–20.5	–21.8	–22.1
Nepal	4.2	–2.3	–0.9	4.9	3.4	3.6	3.7
Pakistan	–5.5	–2.2	0.1	–2.1	–1.1	–1.4	–1.3
Sri Lanka	–0.5	–2.2	–7.8	–6.6	–2.0	–2.6	–3.5
Southeast Asia	7.0	6.1	5.4	2.7	2.2	2.5	2.9
Brunei Darussalam	40.2	48.5	52.4	47.0	43.0	44.0	46.0
Cambodia	–6.0	–7.9	–7.0	–10.0	–10.8	–11.3	–10.9
Indonesia	2.0	0.7	0.2	–2.8	–3.3	–2.9	–2.0
Lao People's Dem. Rep.	–26.9	–18.3	–15.8	–28.5	–29.5	–27.4	–26.0
Malaysia	15.5	10.9	11.6	6.1	3.8	4.1	4.6
Myanmar	–1.3	–1.5	–2.1	–4.4	–4.8	–5.1	–4.8
Philippines	5.0	3.6	2.5	2.8	3.5	3.4	3.2
Singapore	17.8	26.8	22.5	17.8	18.2	19.1	18.6
Thailand	8.3	3.1	1.2	–0.4	–0.7	–0.1	0.5
Viet Nam	–6.2	–3.7	0.2	5.8	6.5	4.1	3.0
The Pacific	14.5	19.1	41.3	27.2	11.3	2.3	13.4
Cook Islands	...	...	...	...	...	...	...
Fiji Islands	–4.1	–4.5	–5.7	–1.5	–18.5	–6.1	–7.1
Kiribati	–22.7	–16.7	–29.3	–31.5	–30.2	–36.2	–31.3
Marshall Islands	–17.3	–28.8	–9.0	–7.6	–8.8	–20.6	–10.9
Micronesia, Fed. States of	–18.3	–14.9	–17.4	–12.0	–9.8	–9.6	–9.3
Nauru	–7.0	...	...	...	...	...	...
Palau	–10.3	–10.9	–9.1	–7.7	–12.4	–9.3	–7.4
Papua New Guinea	–7.2	–6.5	–1.3	–14.9	–13.7	–7.0	13.0
Samoa	–7.6	–8.3	–4.9	–11.1	–13.4	–16.2	–15.6
Solomon Islands	–20.9	–28.3	–7.4	–0.2	–2.0	–6.0	–10.0
Timor-Leste	155.7	179.5	207.4	202.1	125.0	47.0	50.3
Tonga	–17.4	–4.9	–9.3	–6.9	–5.9	–3.7	–3.2
Tuvalu	22.1	–6.3	–36.3	1.3	3.5	–9.6	–10.5
Vanuatu	–7.9	–5.4	–8.4	–6.4	–6.2	–6.0	–7.0
Average	4.0	3.4	2.0	1.8	2.1	1.9	1.9

... = data not available.

Table A15 Exchange rates to the United States dollar (annual average)

	Currency	Symbol	2009	2010	2011	2012	2013
Central Asia							
Armenia	dram	AMD	363.3	373.7	372.5	401.8	409.6
Azerbaijan	Azerbaijan new manat	AZN	0.8	0.8	0.8	0.8	0.8
Georgia	lari	GEL	1.7	1.8	1.7	1.7	1.7
Kazakhstan	tenge	T	147.5	147.4	146.6	149.1	152.1
Kyrgyz Republic	som	Som	42.9	46.0	46.1	47.0	48.4
Tajikistan	somoni	TJS	4.1	4.4	4.6	4.8	4.8
Turkmenistan	Turkmen manat	TMM	2.9	2.9	2.9	2.9	2.9
Uzbekistan	sum	SUM	1,465.6	1,576.8	1,710.9	1,885.4	2,097.2
East Asia							
China, People's Rep. of	yuan	CNY	6.8	6.8	6.5	6.3	6.2
Hong Kong, China	Hong Kong dollar	HK$	7.8	7.8	7.8	7.8	7.8
Korea, Rep. of	won	W	1,275.0	1,155.4	1,107.4	1,125.7	1,094.2
Mongolia	togrog	MNT	1,437.8	1,347.2	1,265.2	1,359.2	1,523.9
Taipei,China	NT dollar	NT$	33.1	31.6	29.5	29.6	29.7
South Asia							
Afghanistan	afghani	AF	49.3	45.8	47.7	50.9	55.5
Bangladesh	taka	Tk	68.8	69.2	71.2	79.1	79.9
Bhutan	ngultrum	Nu	47.8	46.7	45.3	50.3	54.9
India	Indian rupee/s	Re/Rs	47.4	45.6	48.1	54.0	61.5
Maldives	rufiyaa	Rf	12.8	12.8	14.6	15.4	15.4
Nepal	Nepalese rupee/s	NRe/NRs	76.6	74.2	72.1	80.7	87.7
Pakistan	Pakistan rupee/s	PRe/PRs	78.5	83.8	85.5	89.2	96.7
Sri Lanka	Sri Lanka rupee/s	SLRe/SLRs	114.9	113.1	110.6	127.6	130.0
Southeast Asia							
Brunei Darussalam	Brunei dollar	B$	1.5	1.4	1.3	1.2	1.3
Cambodia	riel	KR	4,148.3	4,188.5	4,065.9	4,033.0	4,027.0
Indonesia	rupiah	Rp	10,408.1	9,086.9	8,776.0	9,384.2	10,460.5
Lao People's Dem. Rep.	kip	KN	8,501.0	8,248.6	8,011.4	7,994.0	7,818.0
Malaysia	ringgit	RM	3.5	3.2	3.1	3.1	3.1
Myanmar	kyat	MK	918.0	1,062.0	936.0	880.0	...
Philippines	peso	P	47.7	45.1	43.3	42.2	42.4
Singapore	Singapore dollar	S$	1.5	1.4	1.3	1.2	1.3
Thailand	baht	B	34.3	31.7	30.5	31.1	30.7
Viet Nam	dong	D	17,065.0	18,621.0	20,490.0	20,828.0	20,934.6
The Pacific							
Cook Islands	New Zealand dollar	NZ$	1.6	1.4	1.3	1.2	1.2
Fiji Islands	Fiji dollar	F$	2.0	1.9	1.8	1.8	1.9
Kiribati	Australian dollar	A$	1.3	1.1	1.0	1.0	1.0
Marshall Islands	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Micronesia, Fed. States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	1.3	1.1	1.0	1.0	1.0
Palau	US dollar	US$	1.0	1.0	1.0	1.0	...
Papua New Guinea	kina	K	2.7	2.7	2.3	2.1	2.2
Samoa	tala	ST	2.7	2.3	2.3	2.3	2.3
Solomon Islands	Sol. Islands dollar	SI$	8.1	8.1	7.6	7.4	
Timor-Leste	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Tonga	pa'anga	T$	2.1	2.0	1.7	1.8	1.8
Tuvalu	Australian dollar	A$	1.3	1.1	1.0	1.0	1.0
Vanuatu	vatu	Vt	105.9	97.2	94.6	...	...

... = data not available.

Table A16 Gross international reserves ($ million)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	2,004	1,866	1,932	1,799	2,253
Azerbaijan	5,364	6,409	10,274	11,277	14,401
Georgia	2,110	2,264	2,818	2,873	2,823
Kazakhstan	23,091	28,275	29,328	28,280	24,678
Kyrgyz Republic	1,588	1,719	1,835	2,067	2,238
Tajikistan	278	476	572	650	694
Turkmenistan	19,000	18,800	22,400	26,400	29,300
Uzbekistan	12,226	14,579	18,049	18,346	19,380
East Asia					
China, People's Rep. of	2,453,177	2,914,184	3,255,786	3,387,863	3,951,756
Hong Kong, China	255,816	268,731	285,408	317,336	305,787
Korea, Rep. of	269,995	291,571	306,402	326,968	346,460
Mongolia	1,294	2,197	2,457	4,126	2,248
Taipei,China	348,198	382,005	385,547	403,169	416,811
South Asia					
Afghanistan	4,209	5,403	6,208	6,867	6,660
Bangladesh	7,471	10,750	10,912	10,364	15,315
Bhutan	675	759	796	674	917
India	279,057	304,818	294,397	292,647	297,287
Maldives	261	350	335	305	340
Nepal	2,872	2,759	3,836	4,960	5,614
Pakistan	9,527	13,112	15,662	10,856	6,047
Sri Lanka	5,097	6,610	5,958	6,877	7,200
Southeast Asia					
Brunei Darussalam	1,357	1,563	2,487	3,285	3,377
Cambodia	2,367	2,653	3,032	3,463	3,642
Indonesia	66,105	96,207	110,123	112,781	99,387
Lao People's Dem. Rep.	633	727	679	740	666
Malaysia	96,744	106,590	133,257	139,698	134,601
Myanmar	2,809	3,951	4,026	4,591	4,913
Philippines	44,243	62,373	75,302	83,831	83,187
Singapore	187,809	225,754	237,737	259,307	273,065
Thailand	138,418	172,129	175,124	181,608	167,233
Viet Nam	14,148	12,382	13,531	25,399	25,745
The Pacific					
Cook Islands	...	...	...	...	...
Fiji Islands	565	716	831	915	919
Kiribati	...	...	...	...	...
Marshall Islands	...	...	...	...	...
Micronesia, Fed. States of	35	37	54	56	...
Nauru	...	...	...	...	...
Palau	...	...	...	...	...
Papua New Guinea	2,623	3,092	4,323	4,296	4,684
Samoa	104	176	158	158	163
Solomon Islands	144	266	412	500	520
Timor-Leste	250	406	462	884	213
Tonga	68	88	...	141	143
Tuvalu	24	24	25	27	22
Vanuatu	137	155	172	...	...

... = data not available.

Table A17 External debt outstanding ($ million)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	2,967	3,299	3,568	3,739	3,904
Azerbaijan	3,422	3,734	4,841	5,470	6,059
Georgia	3,658	4,219	4,507	4,829	4,463
Kazakhstan	112,867	118,223	125,350	136,925	147,965
Kyrgyz Republic	4,118	4,381	4,872	5,403	6,004
Tajikistan	1,692	1,911	2,093	2,260	2,149
Turkmenistan	485	2,392	2,923	6,364	7,951
Uzbekistan	4,922	5,804	6,090	6,660	10,700
East Asia					
China, People's Rep. of	428,648	548,938	694,997	736,986	810,000
Hong Kong, China	712,463	879,034	985,042	1,030,583	1,166,362
Korea, Rep. of	345,677	359,757	398,724	409,381	416,595
Mongolia	2,986	5,928	9,627	15,386	15,387
Taipei,China	81,963	101,581	122,528	124,325	122,290
South Asia					
Afghanistan	1,150	1,303	1,242	1,333	1,360
Bangladesh	20,859	20,336	22,086	22,095	23,319
Bhutan	798	887	1,326	1,398	1,705
India	260,935	317,891	360,719	400,259	400,250
Maldives	934	962	913	816	800
Nepal	3,495	3,442	3,658	3,491	3,506
Pakistan	52,331	61,567	66,366	65,478	59,779
Sri Lanka	20,913	24,830	29,387	33,674	22,858
Southeast Asia					
Brunei Darussalam	...	...	...	...	...
Cambodia	2,854	3,295	3,643	4,290	4,822
Indonesia	172,871	202,413	225,375	252,364	264,060
Lao People's Dem. Rep.	2,694	2,809	2,990	3,037	4,611
Malaysia	67,965	73,641	81,009	82,646	96,932
Myanmar	13,207	10,862	13,506	14,042	13,090
Philippines	54,856	60,048	60,442	60,337	58,506
Singapore	1,263,953	1,343,053	1,415,335	1,437,268	1,527,241
Thailand	75,306	100,561	104,634	133,201	139,800
Viet Nam	27,929	32,501	...	...	...
The Pacific					
Cook Islands	...	...	...	67	79
Fiji Islands	430	464	612	674	1,026
Kiribati	14	18	14	14	19
Marshall Islands	94	106	103	100	97
Micronesia, Fed. States of	85	84	87	87	88
Nauru	...	63	...	...	...
Palau	70	66	63	68	...
Papua New Guinea	1,028	922	979	1,142	1,272
Samoa	208	280	294	341	427
Solomon Islands	134	147	125	139	...
Timor-Leste	...	...	...	...	44
Tonga	98	116	162	188	183
Tuvalu	11	11	10	10	9
Vanuatu	103	101	111	108	105

... = data not available.

Table A18 Debt service ratio (% of exports of goods and services)

	2009	2010	2011	2012	2013
Central Asia					
Armenia	5.4	4.7	4.2	9.8	32.3
Azerbaijan	1.3	...	...	...	...
Georgia	5.2	4.9	7.5	11.9	...
Kazakhstan	63.2	32.1	24.2	33.7	26.0
Kyrgyz Republic	41.4	25.9	11.1	11.3	11.3
Tajikistan	20.3	7.5	5.1	...	...
Turkmenistan	5.1	23.3	16.8	29.0	34.1
Uzbekistan	5.8	4.2	3.5	6.4	3.3
East Asia					
China, People's Rep. of	2.9	1.6	1.7	1.6	2.2
Hong Kong, China	52.7	45.8	47.5	46.9	48.0
Korea, Rep. of	7.8	6.8	6.4	7.5	7.5
Mongolia	12.4	11.0	29.4	24.7	33.3
Taipei,China	2.6	1.2	2.2	1.5	1.2
South Asia					
Afghanistan	0.8	1.1	1.3	1.1	1.9
Bangladesh	3.2	2.9	2.5	2.4	2.5
Bhutan	30.5	30.7	51.7	127.1	215.6
India	5.8	4.3	6.0	5.9	6.2
Maldives	2.9	2.5	2.8	3.4	2.9
Nepal	10.2	11.5	11.1	10.6	9.8
Pakistan	17.2	16.7	11.3	14.5	19.0
Sri Lanka	22.4	16.7	12.8	21.3	25.7
Southeast Asia					
Brunei Darussalam	....	...	...	...	...
Cambodia	1.6	1.6	1.6	1.5	1.6
Indonesia	21.1	19.8	21.7	34.9	42.7
Lao People's Dem. Rep.	5.7	4.4	4.4	...	...
Malaysia	6.5	7.5	10.4	10.1	10.3
Myanmar	6.6	5.6	9.1	2.2	2.2
Philippines	11.0	9.9	9.9	7.3	7.6
Singapore	...	...	...	...	...
Thailand	7.6	4.7	3.5	4.2	3.0
Viet Nam	4.2	3.4	3.5	1.3	...
The Pacific					
Cook Islands	...	...	...	...	.....
Fiji Islands	2.0	1.3	12.6	1.1	1.0
Kiribati	5.4	3.7	2.8	2.5	2.6
Marshall Islands	22.9	16.5	8.6	10.2	9.1
Micronesia, Fed. States of	6.3	6.3	6.7	5.5	5.4
Nauru	2.0	...	...	...	...
Palau	5.2	5.9	4.6	4.0	...
Papua New Guinea	0.5	0.3	0.4	0.3	0.3
Samoa	56.9	55.5	0.8	5.3	...
Solomon Islands	3.6	3.0	1.3	0.7	...
Timor-Leste	...	...	...	...	...
Tonga	5.2	9.3	9.3	9.6	9.6
Tuvalu	50.0	120.0	62.5	50.0	120.0
Vanuatu	1.5	1.4	1.4	–0.6	1.9

... = data not available.

Asian Development Outlook 2014
Fiscal Policy for Inclusive Growth

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Printed in the Philippines
Printed on recycled paper