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Foreword

This issue of the *Asian Development Outlook* is the eighth in a series of yearly economic reports on the developing member countries (DMCs) of the Asian Development Bank. Against a background of stable, yet increasingly fragile economic developments in the world economy, the *Outlook* analyzes recent economic performance and prospects for the DMCs and reviews and assesses pertinent policy issues facing these economies.

This *Outlook* broadly follows the format of previous issues. Part I contains a summary of recent growth experience and future prospects for the the world economy, with particular reference to the Asian region. Part II surveys recent economic developments and analyzes future prospects for 34 DMCs in Asia and the Pacific. Part III, which has been expanded in coverage for this issue, discusses the subject of international cooperation and integration with special reference to Asia and the Pacific. International trade and capital movements are covered as is labor migration. Regional and subregional cooperation arrangements are reviewed and assessed and suggestions are made for ways to increase cooperation. Environmental considerations and concerns receive special mention.

In 1995, the world economy continued its recovery from the slow growth regime which characterized the early years of the decade. Growth in industrial countries fell somewhat vis-à-vis 1994; however, this was regarded by many observers as a healthy sign which could foreshadow a prolonged period of modest but sustainable growth accompanied by low rates of inflation. The increase in the volume of world trade was brisk and the terms of trade for primary producers remained firm. However, little progress was made in improving labor market conditions as unemployment remained high in Europe, increased in Japan, and fell only slightly in North America.

Developing economies in Asia continued to prosper; growth was robust and living standards improved. Inflation worsened and external balances deteriorated in a few countries; however, these were often just symptoms of rapid growth. Care must be taken to prevent serious macroeconomic imbalances. Competitiveness in international markets improved as policy adjustments were made to facilitate international trade and the free flow of capital and technology across national boundaries. The potential crisis in financial markets created by the crisis in Mexico at the beginning of the year had a marginal and temporary effect on the developing economies in Asia; performance of stock markets moderated, and there was a leveling in the rate of increase in foreign direct investment as emerging markets

worldwide generally became less attractive as destinations for foreign funds. Several countries in Latin America suffered from the Mexican financial crisis and growth in this region was generally subdued as a result. Some countries in Africa continued to benefit from the adoption of outward-looking policies, although the region as a whole continued to grow slowly. Many transition economies demonstrated renewed and continuing economic vigor in 1995, particularly those that had undertaken wide-ranging economic reforms earlier.

Economic prospects for the world economy in the medium term will depend, to a considerable extent, upon the ability of industrial countries to achieve moderate and sustainable economic growth without inflation. Implementation of prudent macroeconomic policies will play a critical role in achieving these goals.

Within the developing economies of Asia, the challenge will be to achieve high rates of growth while maintaining stability in domestic and external markets. Achievement of these objectives could be complicated by greater volatility in external markets for goods and capital as openness and competition in the world economic community increases.

While on balance developing Asia does well, we must not forget that there is still a hidden Asia where economic progress is slow and grinding poverty remains the norm. In terms of absolute numbers, the overall dimension of poverty still dwarfs that in other regions and, within the poorest countries in Asia, the incidence of poverty remains extraordinarily high.

Nevertheless, it is encouraging to note that significant progress continues to be made in reducing poverty in Asia. The effectiveness of transfers of resources through development assistance, coupled with domestic efforts and private resource flows, is laudable and is helping to achieve the humanitarian objectives of raising living standards for the lowest segments of society as well as for those with higher status.

The *Asian Development Outlook 1996 and 1997* was prepared by the staff of the Asian Development Bank and the analyses and assessments contained herein do not necessarily reflect the views of the Board of Governors or the Governments they represent.

Mitsuo Sato
President

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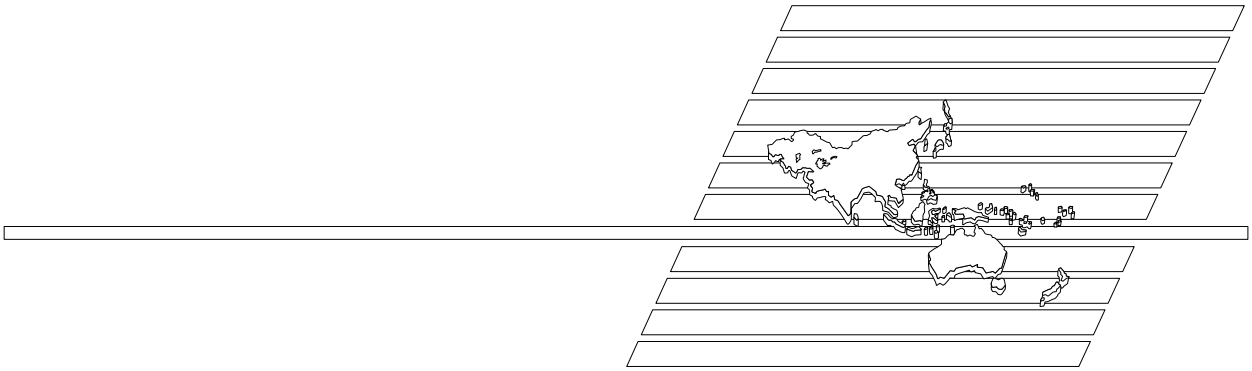


Hong Kong

During 1995, links with the US dollar and US financial markets, and the economic developments in China continued to be the principal influences on the performance of the Hong Kong economy. In addition, increases in interest rates, a slump in the real estate market, and depressed domestic consumption contributed to a further decline in the growth rate. By midyear, however, expectations of lower interest rates, the bottoming out of the real estate market, and improved Sino-British relations restored some investor confidence and led to increased stock market activity. Export growth was higher than in 1994, although a slowdown became apparent toward the end of 1995. The investment climate remained slightly weak because of China's continued tight monetary policy. The strength of the US dollar toward the end of 1995 translated into higher costs for foreign investors intending to invest in Hong Kong.

Being a predominantly service-oriented economy, Hong Kong's future economic performance will depend on continued recovery in the financial and real estate markets as well as on the level and nature of infrastructure investment. Relations with China will be the most relevant factor influencing the future development of Hong Kong (Figure 2.1).

Recent Trends and Prospects

Growth, Investment, and Employment. GDP growth declined to 4.6 percent in 1995, nearly one percentage point less than in the previous year. Increased public investment in infrastructure helped keep construction activity robust, although private sector construction declined because of lowered private investor confidence. Closer economic ties with China and strong growth of the Chinese economy continued to benefit tourism. The number of visitors from China increased by over 20 percent during the year. Tourism was also helped in early 1995 by the weakening of the US dollar.

Increased tourist spending offset some of the decline in domestic consumption expenditure, which was instrumental in keeping the growth rate below 5 percent in 1995. The main factor leading to the decline in consumption expenditure was the sharp decrease in property prices, which fell by over 30 percent from their peak levels in 1994. As a result, private saving increased over the year. Public sector investment, mainly because of spending on infrastructure projects, also increased, as did private investment other than for property development. Gross domestic saving increased to 34.5 percent of GDP compared with 33.9 percent in 1994, while gross domestic investment increased to over 33 percent of GDP in 1995 compared with 31.8 percent in the previous year. The domestic resource surplus thus decreased to 1.4 percent of GDP in 1995 from 2.1 percent in 1994.

Employment during 1995 registered a sharp increase of 4.1 percent over that in the previous year; however, this was more than offset by a rapid increase in immigration. Also as a result of immigration, the shortages in the labor market experienced in recent years disappeared. Unemployment increased to a ten-year high during 1995 and underemployment in manufacturing, and particularly the construction sector, also increased.

Table 2.1 Major Economic Indicators: Hong Kong

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	6.4	5.4	4.6	4.5	4.5
Gross Domestic Investment	% of GDP	27.7	31.8	33.1	31.1	31.0
Gross Domestic Saving	% of GDP	34.6	33.9	34.5	33.7	33.5
Inflation Rate	% change in CPI	8.5	8.1	8.7	7.5	6.1
Money Supply Growth	% change	16.0	13.2	15.1	14.2	13.6
Merchandise Exports	$ billion	135.2	151.4	176.7	204.3	235.5
	% change	13.1	12.0	16.7	15.6	15.3
Merchandise Imports	$ billion	139.0	162.3	191.2	219.6	254.0
	% change	12.6	16.8	17.8	14.8	15.7
Trade Balance	$ billion	-3.8	-10.9	-14.5	-15.3	-18.5

Sources: Data collected from the Census and Statistics Department of Hong Kong by EDRC for the Asian Development Bank *Annual Report 1995;* Hong Kong Monetary Authority, *Monthly Statistical Bulletin* (Hong Kong, November 1995); Census and Statistics Department, *Quarterly Estimates of Gross Domestic Product* (Hong Kong, November 1995) and *Hong Kong Monthly Digest of Statistics* (Hong Kong, September 1995); and staff estimates.

Paradoxically, the construction sector also attracted most of the migrant workers. In terms of sectoral employment, the services sector continued to increase its share, while that of manufacturing declined. Employment in wholesale trade and import/export services rose; however, the fall in domestic consumption expenditure led to a decline in employment in retail trade, restaurants, and hotels.

Economic growth in Hong Kong is expected to weaken slightly to 4.5 percent annually in 1996 and 1997. Property prices are not expected to rise noticeably in the near future and consumption expenditure is likely to remain weak as consumer uncertainty persists. Although investment in infrastructure is likely to remain strong, gross domestic investment is expected to decline slightly to about 31 percent of GDP in both 1996 and 1997. The savings rate in 1996 is projected to be slightly lower than in 1995 at 33.7 percent of GDP. With lower saving, the surplus available for overseas investment is also likely to decline.

In late 1995, the Government revised the labor importation scheme and reduced the quotas allowed. While this will lessen the official inflow of workers, the need to import certain categories of workers, which are in short supply, will not diminish over the next two years. The new scheme allows for some degree of flexibility although both labor unions and employers are skeptical of its success in bringing down the unemployment rate. Despite higher unemployment, the inflow of workers outside the labor importation scheme is also likely to continue, thus exacerbating pressure on the labor market.

Budget, Money, and Prices. Government expenditure during 1995 was slightly lower than initially estimated for several reasons. Prolonged negotiations over the financing package for the new airport project led to delays in funding for the Provisional Airport Authority. There were also delays in funding for the Mass Transit Railway and, in general, many infrastructure projects were behind schedule. Despite this, however, government expenditure increased to 16.7 percent of GDP during 1995. Government revenues over the year were 16.4 percent of GDP compared with 17.1 percent in 1994 mainly because of lower tax rates and increased exemptions. Thus, the overall balance turned into a small deficit of 0.2 percent of GDP from a surplus of 1 percent of GDP in 1994.

Under the linked exchange rate system with the US dollar, there is little scope for an independent monetary policy in Hong Kong. The money supply is endogenously determined and, with the inflation rate at a high level, broad money (M2) has been growing at a steady rate of around 14–15 percent per annum. During the early part of 1995, the money

supply grew rapidly as a result of conversion of other assets into deposits because of uncertainties in the financial markets and the slump in property values. However, as activity in the equity market improved in the latter part of the year, the rate of growth of the money supply slowed down. By end-1995, M2 had grown by a little over 15 percent, higher than in the previous year.

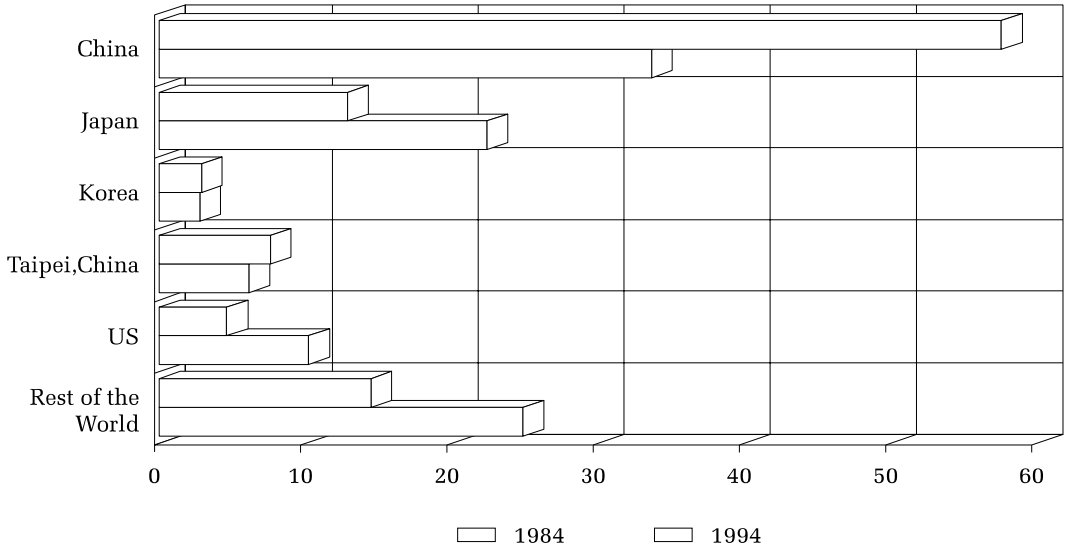
Hong Kong's inflation rate during 1995 rose to 8.7 percent from 8.1 percent in 1994. Inflationary pressures resulted from higher commodity prices and increased import prices due to the strengthening of the US dollar in the latter half of 1995. Some of the moderation provided by lower property prices disappeared as the real estate market bottomed out. With the unemployment rate increasing over the year, upward pressure on wages declined because unemployed workers were willing to accept lower wages. On the other hand, civil servants' wages increased by 10 percent over the year.

Public expenditure, which includes that by the Housing Authority and the urban and regional councils, exceeded government expenditure, and is expected to increase over the next couple of years as public sector infrastructure projects continue to absorb the bulk of spending. Apart from the new airport and associated projects, there are major road construction and railway projects in the pipeline. The Government is also committed to some expensive environmental projects and to the construction of additional homes for the elderly. With reductions in business profits, lower land prices, and fewer property transactions, government revenue is expected to decline, leading to small deficits over the next two years.

Growth in the money supply is forecast to be slightly lower over the next two years at 14.2 percent in 1996 and 13.6 percent in 1997. Inflation is expected to be lower at about 7.5 percent in 1996, declining further to around 6 percent in 1997. Lower inflation expectations throughout the world insofar as they lead to lower import costs will help to moderate inflation in Hong Kong.

External Trade and Payments. A feature of Hong Kong's external trade performance in

Figure 2.1 Share of Reexports by Origin, 1984 and 1994: Hong Kong
(percent)



Sources: Census and Statistics Department, *Annual Digest of Statistics* (Hong Kong, 1993); and Census and Statistics Department, *Hong Kong Monthly Digest of Statistics* (Hong Kong, September 1995).

1995 was a reversal in the decline of domestic exports that has occurred over recent years as a result of the relocation of production into China. However, this changed in 1995 as domestic exports grew by 5 percent in real terms. With reexports increasing by 19 percent, total merchandise exports rose by 16.7 percent in 1995, sharply higher than the 12 percent growth recorded in 1994.

The growth in exports was helped in the early part of 1995 by the weaker US dollar and increased demand for Hong Kong products in its overseas markets. Export growth slowed down during the latter part of 1995 as the US dollar appreciated. Economic recovery of Hong Kong's principal trading partners – the US and Japan – slowed, and fiscal tightening in China continued. Merchandise imports also grew by nearly 18 percent during 1995. The strong growth reflected increased imports of machinery and capital equipment for the manufacturing sector and for the vigorous infrastructure development program under way. Imports of office equipment also increased dramatically – an indication of the economic restructuring taking place. Overall, capital goods imports rose by over 29 percent in real terms. With imports rising more rapidly than exports, the trade deficit widened to $14.5 billion in 1995 compared with $10.9 billion in 1994.

Prospects for external trade over the next two years will be influenced primarily by China's economic performance. With economic growth projected to slow down in China, the rate of growth of Hong Kong's reexports to the mainland will not be as high as it was in 1995. Also, overseas demand for Hong Kong products is likely to be sluggish. One effect of the slowdown will be declining capital goods imports because investment in the manufacturing sector will be curtailed. However, infrastructure investment is expected to continue at much the same pace over the next couple of years, and imports of construction machinery will increase further. The trade deficit is expected to continue rising; it will be over $15 billion during 1996 and higher at $18.5 billion the following year.

The prospects for foreign investment in Hong Kong are fairly positive. Foreign investors have been attracted by the island's geographic proximity and links to China, as well as by its low tax rates and open trading environment. Recent declines in rents and property prices have also been positive for foreign direct investment. At the same time, any strengthening of the US dollar will dampen foreign investment by reducing Hong Kong's competitiveness, and competition from Singapore in recent years has also tended to divert some FDI away from Hong Kong. Investors' perceptions of policy stability and transparency after 1997 are also important. The net effect of these factors is unclear; however, it is generally expected that foreign investment will remain fairly robust in the near future and Hong Kong's role as an entrepôt center for China will continue.

Policy and Development Issues

The most important policy issue facing Hong Kong is its role and function after its reunification with China in 1997. To maintain its attractiveness to foreign investors, not only will Hong Kong's trade and investment links with China need to be maintained and strengthened, but efforts must also be made to ensure that rising costs do not deter potential investors.

An important factor influencing the investment climate in Hong Kong is the policy of linking its exchange rate to the US dollar. This policy will clearly need to be reviewed in the context of Hong Kong's future relations with China, and any changes are likely to have important impacts on investment, prices, and trade prospects.

The growth and development of services, with the continued restructuring of the economy toward high technology activities is of crucial importance to the maintenance of Hong Kong's competitiveness. It is precisely these features that need to be emphasized to ensure the dynamism of Hong Kong's economy as its status vis-à-vis China changes in a little over a year's time.

Republic of Korea

After a robust recovery in 1994, Korea's economic growth unexpectedly accelerated further in 1995, mainly because of brisk investment and vigorous export growth. Despite phenomenal expansion, the economy did not overheat. In fact, inflation in 1995 was reduced from the previous year's rate as excess demand pressure was moderated; moreover, wage increases were kept modest, in part because of improved business-labor relations.

Economic activity is projected to moderate somewhat over the next two years, with the GDP growth rate more consonant with Korea's economic potential. Exports will continue to be the main engine of growth, with new investment playing a lesser role; inflation is projected to continue declining in 1996 and 1997 to historically low levels.

In the coming years, Korea will face new external influences as liberalization of the capital account is accelerated and the country's membership in the OECD takes effect by the end of 1996. Monetary policy is likely to have a bigger task in maintaining domestic price stability and in dealing with larger capital flows and wider exchange rate fluctuations. For a smooth adjustment to greater openness, the Government plans to reduce interest rate differentials by maintaining stable prices and wages. Both monetary and fiscal policies will have to conform to the requirements of macroeconomic stability while financial and fiscal reforms continue.

Recent Trends and Prospects

Growth, Investment, and Employment. The remarkable economic upswing that occurred in 1994 persisted unexpectedly in 1995, with GDP growth rising to 9.2 percent from 8.4 percent in 1994. All principal sectors shared in the improved performance. Agriculture registered the strongest improvement, with output expanding by slightly above 6 percent compared with 1.2 percent in 1994. Forestry and fisheries output, however, contracted. Industrial production rose by 11.4 percent, with manufacturing output expanding at 11.5 percent, up from 10.4 percent in 1994. Heavy and chemical industry products for export continued to be the main players in manufacturing. The services sector expanded by 8.5 percent in 1995, slightly better than in 1994, with transportation and communications taking the lead.

Private consumption growth, in real terms, picked up from 7.4 percent in 1994 to 8.1 percent in 1995 with increased spending on durable and semi-durable goods. By contrast, government consumption remained weak, with growth diminishing to 3.1 percent from 4.4 percent in the previous year, as some expenditures were postponed for countercyclical fine-tuning.

As in 1994, investment played a leading role, maintaining real growth of nearly 16 percent, with equipment investment alone increasing by around 13 percent. This was brought about by the continuing expansion of capacity in the heavy and chemical industries, particularly electronics, semiconductors, and automobiles which are also major export industries (Figure 2.2). Investment in construction climbed at a more modest rate of 9.2 percent, but even this was an advance on the previous year's 4.6 percent increase. Overall, gross domestic investment rose further

to 36.6 percent of GDP in 1995 from just below 36 percent in 1994. However, with the savings rate increasing to 37 percent of GDP, a small surplus emerged. Employment growth was robust at about 2.5 percent, with the construction industry and the services sector registering the largest increases. Although employment expansion in manufacturing was more modest, it was a significant improvement over that in 1994. The overall unemployment rate dropped in 1995 to an historical low of under 2 percent. The consequent tightening of the labor market is leading the Government to consider the admission of more foreign workers, who currently number between 80,000 and 100,000, excluding illegal migrant laborers.

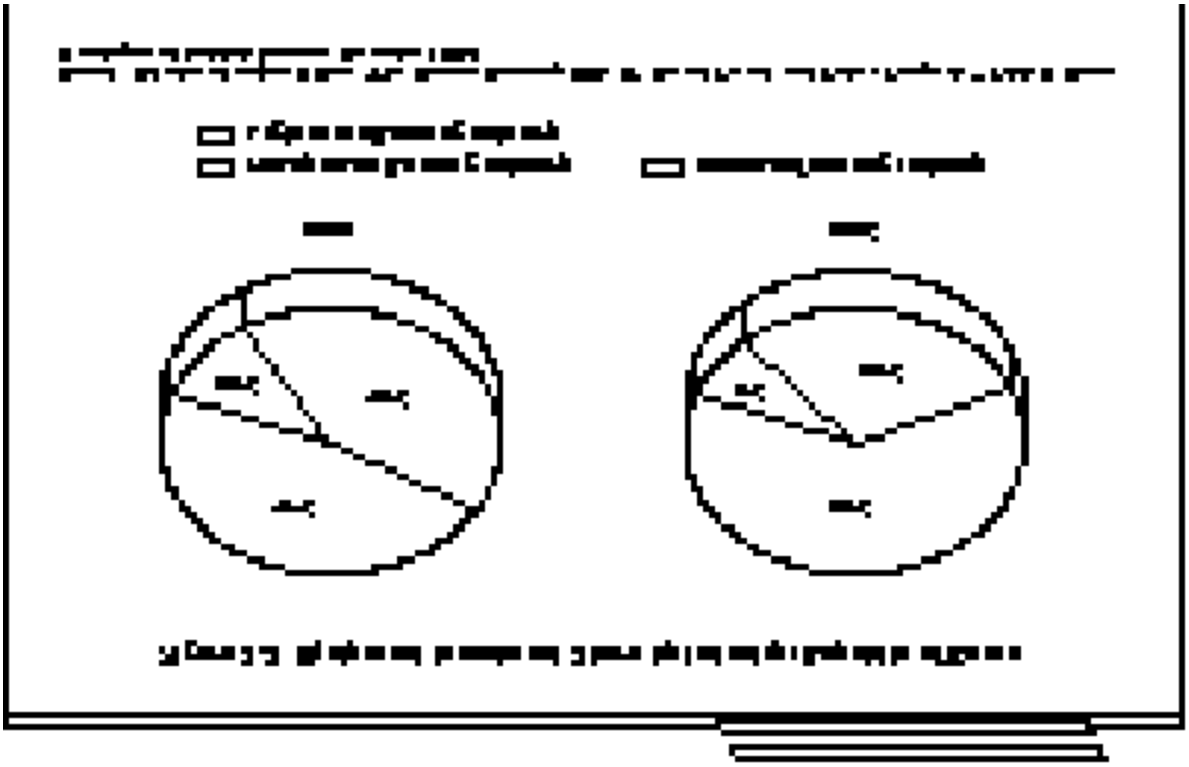
The economy is forecast to move toward a more sustainable growth path of 7–7.5 percent in 1996 and 1997. This should be achievable as there are no signs of overheating at this phase of the business cycle, in contrast to the experience during previous economic upswings. The industry sector is likely to expand at the same rate as the aggregate economy; the services sector will expand at a somewhat higher rate. Agricultural growth is expected to slow considerably to 2–2.5 percent over the same period. Although the growth of exports and investment is expected to diminish with the slower pace of overall economic activity, exports are projected to keep the growth momentum from falling below the economy's potential. Private consumption, which is likely to be influenced more by income and wage increases than by wealth changes as happened in 1994 and 1995, will grow by just above 7 percent annually during 1996 and 1997.

Gross domestic investment will recede slightly to about 35.4 percent of GDP on average in the next two years; however, the savings rate is likely to remain at 37 percent or better, thereby improving the surplus achieved in 1995. While the new comprehensive income tax system, which will cover interest and dividend incomes, and the new installment credit system will have a negative effect on private saving, this will be offset by a staged increase in the contribution rate to the national pension plan from the current 6 percent to 9 percent by 1998. The unemployment rate is projected to edge up to around 3 percent owing to lower

Table 2.2 Major Economic Indicators: Republic of Korea

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	5.8	8.4	9.2	7.5	7.0
Agriculture	% change	-2.9	1.2	6.1	2.5	2.0
Industry	% change	4.9	10.2	11.4	7.6	6.7
Services	% change	7.3	8.4	8.5	8.0	7.3
Gross Domestic Investment	% of GDP	35.1	35.9	36.6	35.5	35.2
Gross Domestic Saving	% of GDP	35.4	35.5	37.0	37.1	37.2
Inflation Rate	% change in CPI	4.8	6.2	4.5	4.3	3.9
Money Supply Growth	% change	16.6	18.7	15.0	14.5	14.0
Merchandise Exports	$ billion	80.9	93.7	124.0	141.8	161.9
	% change	7.7	15.7	32.4	14.3	14.2
Merchandise Imports	$ billion	79.1	96.8	129.0	144.2	163.0
	% change	2.3	22.3	33.3	11.8	13.0
Current Account Balance	$ billion	1.0	-3.9	-8.6	-5.9	-4.4
	% of GDP	0.3	-1.0	-1.9	-1.2	-0.8
External Debt Outstanding	$ billion	47.2	54.5	48.0	44.5	42.1
Debt-Service Ratio	% of exports	9.2	6.8	4.9	4.8	4.7

Sources: International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); Jun Il Kim, "The Korean Economy 1995–97, Recent Trends and Future Prospects," Korea Development Institute (mimeo, December 1995); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington DC, 1996); and staff estimates.



economic growth and the likely adverse effects of the unemployment insurance plan on the labor supply.

Budget, Money, and Prices. In the 1995 budget, total expenditure and net lending together rose by almost 15 percent compared with the 21.3 percent increase in 1994. A smaller deficit of roughly 0.3 percent of GDP, which was programmed at the beginning of the year, was easily achieved because of higher-than-expected growth in tax revenue. The excess revenue of about won (W) 1.8 trillion more than covered increased spending for special investment and for educational facilities, as well as expenses for rice donations to North Korea. The surplus was in fact much larger at midyear as the Government deliberately reduced spending during the first half of the year to forestall a possible overheating of the economy. Capital spending was instead concentrated during the second half of 1995.

Expansion of the money supply (M2) was tighter at 15 percent compared with 18.7 percent in 1994. Private and foreign sources were dominant, with the contribution of the government sector being negative. Despite the robust growth of investment and relatively tight money supply, interest rates remained low, with the corporate bond yield hovering at around 12–13 percent. Low interest rates can be attributed mainly to stable consumer prices, higher cash flows and business profits of large firms, and increased foreign currency loans that facilitated the financing of private sector investment.

Despite the economic boom in 1995, inflationary pressures were moderate by historical standards, with the increase in the CPI falling to 4.5 percent from the previous year's 6.2 percent. Excess demand pressure, which had been mounting since early 1993, tapered off in 1995. Wage increases were moderate and were linked to steady gains in productivity. Wage stability may be attributed at least in part to improved business-labor relations and the new flexible wage bargaining system.

The budget for 1996 is characterized by the same structure and priorities as the 1995 budget. More resources will be allocated to infrastructure investment, education, technology development, industrial restructuring, and social welfare. Total expenditure is programmed to rise by 16 percent in 1996, somewhat faster than the rate of growth in nominal income. The overall deficit is projected to be smaller at W0.9 trillion compared with W1.1 trillion in 1995, in line with the aim of achieving a smooth transition to lower rates of economic growth in 1996 and 1997.

Given this aim as well as the desire to position the economy for the effects of capital account liberalization, monetary policy for the next two years will be moderately restrictive. Money supply growth is likely to be slightly lower than in 1995 at about 14 percent. Interest rates will also decline somewhat to about 10–12 percent, owing to the expected slowdown in investment demand. Inflation is forecast to be just above 4 percent in 1996 and lower than 4 percent in 1997, as aggregate demand pressure continues to soften, and wage rates remain stable.

External Trade and Payments. Merchandise exports grew by over 32 percent in 1995, about double the previous year's rate. This remarkable export performance was attributable in particular to the strength of the yen. Heavy and chemical industry products dominated the export sector in 1995, expanding by close to 50 percent and accounting for about 70 percent of all merchandise exports. By contrast, light industry shipments increased by only 16 percent, although this was more than double their rate of growth in 1994.

Because of strong domestic demand, particularly for equipment investment, imports expanded even faster than did exports at more than 33 percent, resulting in a worsening of the trade deficit. The rapid growth in imports was largely accounted for by raw materials and capital goods, which grew by more than 30 percent and 40 percent, respectively. Commodity imports for export production alone expanded by nearly 50 percent compared with the increase in imports for domestic use at over 30 percent. Still, the rise in consumer goods imports was higher than in 1994, reflecting the rapid growth in income and high import elasticity. The current account deficit nearly doubled in 1995 to $8.6 billion or 1.9 percent of GDP compared with 1.2 percent in 1994.

With increasing production costs in Korea, the inflow of FDI continued to decline in 1995, while direct investment abroad rose, especially to Southeast Asia and China. By contrast, portfolio investment was brisk, helping fuel the recovery of the stock market and contributing to a capital account surplus of $13–14 billion. Korea's external debt declined slightly to $48 billion from $54.5 billion in 1994, despite the widening current account deficit. The debt-service ratio was stable at 4.9 percent which is low by both historical and international standards. One aspect of some concern is the maturity structure of the external debt as the proportion of short-term debt has been rising in recent years.

Exports are projected to grow less strongly in the next two years, particularly if competitiveness is adversely affected by changes in the yen/won exchange rate. Chemicals, textiles, and garments will be hit the hardest by price effects while computer chips and computer peripherals will continue to do well as exporters improve market share following significant spending on research and development. Export growth is expected to be around 14 percent. Given the slowdown in investment growth, the increase in imports is forecast to decelerate even more sharply to about 12 percent, leading to a narrowing of the trade gap. Thus, the current account deficit will steadily improve to 1.2 percent of GDP in 1996 and to less than 1 percent in 1997.

The capital account balance will continue to record a substantial surplus owing to net inflows as the capital market is further liberalized and the won becomes stronger. External debt is expected to decrease during 1996 and 1997 as private sector borrowing falls with declining investment demand. Likewise, the debt-service ratio is expected to improve.

Policy and Development Issues

Korea has taken a number of steps to make its economy more open in preparation for joining the OECD. Measures introduced during the last two years aim to increase access of foreign investment to equity and bond markets, to liberalize the capital account, and to relax requirements for establishing banks and securities firms. The challenge now is to adopt appropriate macroeconomic policy responses given the potential macroeconomic volatility which these liberalization measures could entail. The Government needs to address the issue of further reform of the trade regime for agricultural products and to improve the delivery of services as well as the autonomy of local governments. Also, structural adjustment by small- and medium-scale industries must be accelerated through policies that provide additional financial resources and relax labor market restrictions.

Singapore

Despite continued appreciation of the Singapore dollar (S$) against major currencies, the economy again performed better than expected in 1995. Strong global demand for electronic products and high economic growth in neighboring economies were the key factors behind the good economic performance.

The country's near-term economic prospects remain bright given the buoyancy in global demand for electronic goods, low inflation, high productivity growth in most sectors, and further liberalization of the labor market. However, its longer-term economic prospects depend on how successfully the country addresses the erosion of external competitiveness resulting from its rising labor and business costs and exchange rate appreciation. Recent economic measures included raising productivity by applying new technology, cutting labor and business costs by restricting the increase of wage and fringe benefits in the public sector and reducing the overall tax burden, and strengthening economic linkages with economies in the region through trade and investment.

Recent Trends and Prospects

Growth, Investment, and Employment. Growth of GDP slowed to 8.9 percent in 1995 from double-digit growth rates in previous years. The slowdown, however, was considered a healthy development since double-digit growth was judged unsustainable and would eventually lead to the buildup of inflationary pressure.

Slower economic growth was due primarily to the decline in manufacturing sector growth in the first half of 1995 to 8.1 percent. However, the sector staged a strong rebound in the second half of the year, registering average growth of 12.3 percent. The upswing was spurred by the electronic industry, which accounts for 41 percent of total manufacturing output, particularly personal computers and computer-related electronic products. Construction sector growth, however, declined to 4.8 percent from 15.6 percent in 1994 because of a slowdown in housing construction and public investment.

The services sector, which contributes close to two thirds of GDP, grew by 8.6 percent in 1995, slightly higher than in the previous year. Activity in the commerce and transport and communications sectors remained strong, expanding by 9.1 percent and 11.5 percent, respectively, in 1995, compared with 9.1 percent and 10.8 percent in 1994. The two sectors continued to benefit from strong regional growth and Singapore's status as a regional investment hub and entrepôt trade center. Growth in financial and business services slowed to 4.8 percent in 1995, about half of the rate in 1994. The slower growth reflects lackluster trading in Singapore's equity market.

Economic growth was mainly driven by external demand which accounted for more than 80 percent of growth in total demand. Exports of goods and services in real terms increased by 12 percent in 1995 because of strong growth in merchandise exports to the US and Japan. However, growth in total consumption expenditure remained subdued, mainly owing to slowed private consumption. Growth in gross fixed capital formation in real terms likewise receded to 4.8 percent from 7.6 percent the previous year because of slower growth in private investment and a moderate decline in public investment.

Gross domestic saving in 1995 reached a record

level at 55.6 percent of GDP. The high savings rate was primarily the result of high mandatory saving through the Central Provident Fund (CPF), slow growth in private consumption, and a government budgetary surplus. Strong profit results in the electronic, financial, and real estate industries also boosted corporate saving. However, the increase in gross capital formation continued to lag behind that of gross domestic saving, which further widened the gap between domestic saving and investment (Figure 2.3). The slow growth of capital formation was due, to a large extent, to the slowdown of public investment. Despite high domestic saving, the country continued to attract a large amount of FDI. Net FDI commitments were $4.6 billion in 1995 compared with $5.78 billion in 1994.

The widening gap between domestic saving and investment implies that Singapore has invested heavily abroad, particularly in neighboring high-growth economies. Spurred by rising domestic costs, growing economic opportunities in the region, and the Government's regionalization strategy, Singapore's outward FDI has accelerated since 1990, reaching $10.5 billion in 1994 compared with $840 million in 1990. Of the total outward FDI, 54 percent was invested in Asia, mainly in Malaysia and Hong Kong.

Employment creation increased to 90,300 jobs in 1995 from 72,100 in 1994. Although all sectors registered a net increase, transport and communications in particular showed robust employment growth. The unemployment rate was only 1.4 percent in 1995 compared with 2.6 percent in the previous year. This indicates that the country's labor market is still tight; the unemployment rate is projected to remain at 2 percent in the near term. Therefore, Singapore may have to liberalize the labor market further to ease the upward pressure on labor costs. Labor productivity grew by 3.5 percent in 1995, marginally lower than the 3.8 percent achieved in 1994.

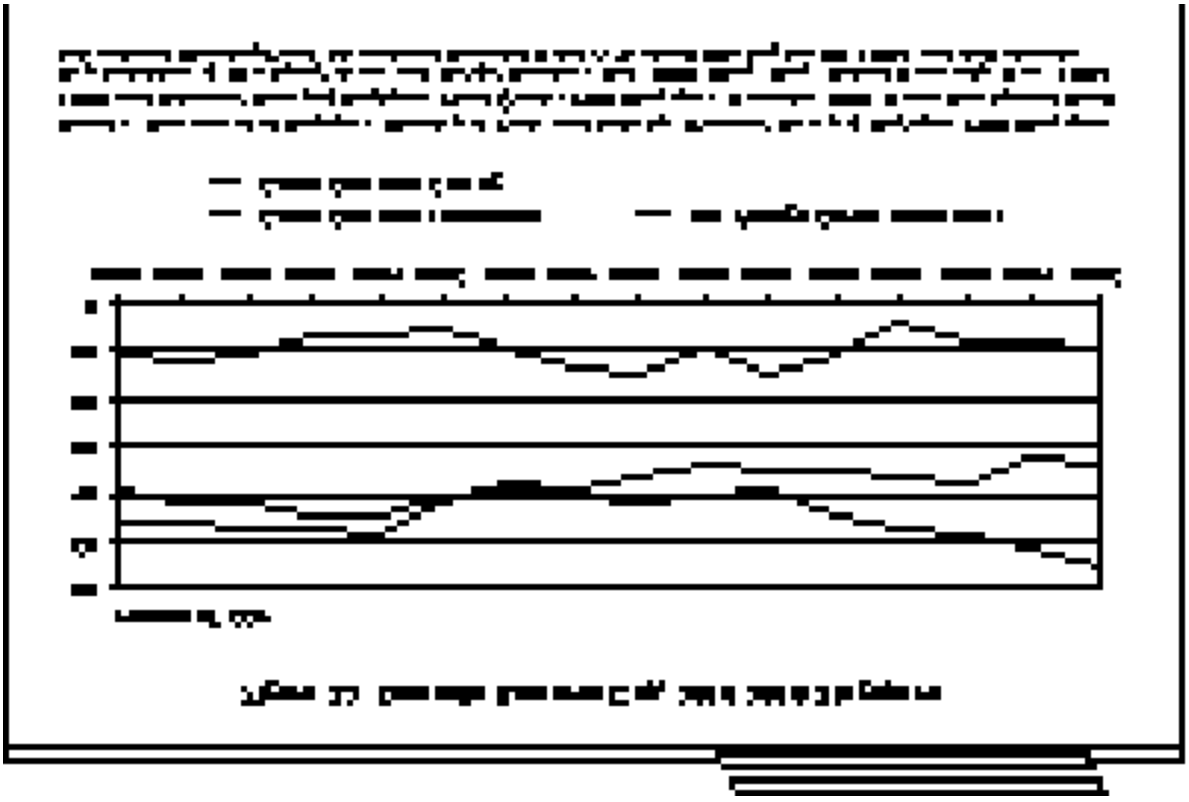
The outlook for Singapore in the next two years is for a deceleration of growth toward its sustainable long-run potential of 7–8 percent. GDP is expected to increase by 8 percent in 1996 and 7.5 percent in 1997, with moderate growth in the manufacturing sector. Although the global electronic demand is expected to remain strong because of increasing diversity of electronic products, manufacturing growth is likely to be tempered by rising costs and stiff regional competition.

The services sector is likely to expand at 8.2 percent on average in 1996 and 1997. Financial and business services are expected to pick up momentum as Singapore positions itself to become a truly international financial hub and global

Table 2.3 Major Economic Indicators: Singapore

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	10.1	10.1	8.9	8.0	7.5
Agriculture	% change	-2.4	5.6	-6.7	-1.5	-1.0
Industry	% change	9.5	13.2	9.4	7.2	7.0
Services	% change	10.6	8.4	8.6	8.6	7.9
Gross Domestic Investment	% of GDP	38.4	32.2	33.9	34.5	35.4
Gross Domestic Saving	% of GDP	48.5	51.3	55.6	55.9	56.4
Inflation Rate	% change in CPI	2.4	3.8	3.2	2.4	2.8
Money Supply Growth	% change	8.5	14.4	12.0	9.0	9.0
Merchandise Exports	$ billion	77.8	98.7	114.0	128.8	144.3
	% change	15.9	26.8	15.5	13.0	12.0
Merchandise Imports	$ billion	80.6	96.6	114.3	129.4	145.3
	% change	17.8	19.8	18.3	13.3	12.2
Current Account Balance	$ billion	5.2	11.9	14.2	15.6	16.8
	% of GDP	9.0	17.3	16.3	16.5	16.4

Sources: Data collected from the Department of Statistics of Singapore by EDRC for the Asian Development Bank *Annual Report 1995*; Government of Singapore, Ministry of Trade and Industry, *Economic Survey of Singapore, Third Quarter 1995* (Singapore, November 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); and staff estimates.



capital market. Growth in the services sector will also be favored by bullish retail trade and increased tourist arrivals.

Among the components of aggregate demand, consumption will show an increase of 8.3 percent in 1996 and 7.9 percent in 1997. Consumer confidence will strengthen as a result of familiarization with the goods and services tax (GST) introduced in early 1994. Fixed investment is expected to grow rapidly due to increasing demand for housing and record investment commitments. Gross domestic investment is projected to rise by 11 percent in 1996 and 12 percent in 1997.

Budget, Money, and Prices. Government fiscal operations remained prudent in 1995 with a fiscal surplus being achieved. Spending on security, social and community services, and economic services was kept below targeted ceilings. Operating revenue exceeded the sum of operating and development expenditure by S$12.3 billion in 1995 compared with S$9.2 billion in 1994. The budget surplus, equivalent to 5.1 percent of GDP, prompted the Government to increase its contribution to the CPF in 1995. The budgetary surplus and high private saving through the CPF helped to sterilize the monetary expansion arising from the large inflow of foreign investment. Money growth was also moderated by efforts to slow consumer credit. As a result, broad money supply (M2) grew by 12 percent in 1995 and narrow money (M1) by 11 percent.

To ease inflationary pressure resulting from rapid economic growth, the Monetary Authority of Singapore continued to allow the Singapore dollar to appreciate against major currencies in 1995; it appreciated by 7 percent against the US dollar in 1995. Inflation eased to 3.2 percent in 1995 from 3.8 percent in 1994. The price shock introduced by the GST in early 1994 disappeared completely. Inflation was kept in check also because of keen competition in the retail sector, weaker sentiment in the property and stock markets, and a continued downward trend in both unit business costs and unit labor costs.

Government fiscal policy will continue to offset the long-term objective of a balanced budget with the need to upgrade infrastructure and to provide for a lower tax environment. Government revenue is expected to increase by around 10 percent in both 1996 and 1997 after a record rise of 19.5 percent in 1995. Total expenditure growth will be lower than that of revenue, at 9.7 percent in 1996 and 8.2 percent in 1997. An overall surplus equivalent to 10.1 percent of GDP in 1996 and 10.4 percent of GDP in 1997 is likely. Money supply (M2) is expected to rise by around 9 per-

cent owing to the effects of government surpluses, slower buildup of net foreign assets, and efforts to dampen the growth of consumer credit. Inflation is expected to remain below 3 percent in 1996 and 1997 given the prospect of a strong Singapore dollar.

External Trade and Payments. Merchandise exports and imports rose by 15.5 percent and 18.3 percent, respectively, in 1995, compared with growth rates of 26.8 percent and 19.8 percent in 1994. As a result, the trade balance shifted to a deficit of $268 million from a surplus of $2.1 billion. An important factor in the continued stemming of export growth has been the shift to Singapore as a source of electronic components primarily because of appreciation of the Japanese yen. Exports to Malaysia slowed due to the shift of lower-end manufacturing activities from Singapore to Malaysia, as well as from the improved industrial capabilities generally in Malaysia. Although merchandise trade was in deficit, the current account maintained a surplus of $14.2 billion in 1995, equivalent to 16.3 percent of GDP compared with $12 billion or 17.3 percent of GDP in 1994. This surplus came largely from an increased services account surplus. The overall balance was also higher at $10.1 billion in 1995 from $4.7 billion in 1994, because of the increased current account surplus and strong net capital inflows.

Although demand in the global electronic market will remain strong in the near future, the prolonged appreciation of the Singapore dollar is expected to hurt the country's external competitiveness. Therefore, growth of merchandise exports is expected to slow down to 13 percent in 1996 and 12 percent in 1997. Merchandise imports are also expected to register lower growth at 13.3 percent in 1996 and 12.2 percent in 1997 owing to a slower pace of reexport activities. However, the current account is expected to continue to show a large surplus of around 16.5 percent of GDP in 1996 and 1997 as an increased services account surplus will more than offset the increased trade deficit. Although promotion of outward investments will spark a larger volume of capital outflows, these will not be enough to offset the current account surplus, and international reserves are likely to continue to increase over the next two years.

Policy and Development Issues

In June 1995, the Government announced a new "supply-side potential" economic growth rate objective of 7 percent per annum to the year 2000, a rate which is substantially higher than the previous 4–6 percent target band. To maintain this rate, Singapore must keep abreast with competition by increasing productivity through new technology and improved skills. A policy change in 1995 exempting employers from CPF contributions is intended not only to strengthen cost competitiveness, but also to have a positive impact on overall labor productivity and immigration management. The establishment in 1995 of the Singapore Productivity and Standards Board is aimed at ensuring that total factor productivity grows by at least 2 percent per annum for the next decade, thus lending support to the 4 percent labor productivity growth target and the 7 percent economic growth rate.

Improvement in productivity will also ease the policy concern of balancing high, sustainable economic growth with macroeconomic stability. Over the past few years, the Government has liberalized the labor market and allowed persistent appreciation of the Singapore dollar to deal with rising labor costs and inflationary pressure. However, exchange rate appreciation has made it more difficult for the manufacturing sector to stay competitive in the global electronic market.

While the share of the services sector in GDP has increased over the past decade, the manufacturing sector still accounts for 28.7 percent. This implies that the country's economic prospects will continue to be dominated by the twin engines of growth: manufacturing and financial and business services. The Government has identified fund management, a capital market, and investment banking as key areas for development in view of the rapidly growing portfolio investment opportunities as well as the rising demand for financial services from companies in the region.

Taipei,China

Economic growth in Taipei,China moderated in 1995. Growth during the early part of the year was maintained at 1994 levels and both private consumption and investment continued to expand. However, difficulties faced by the financial sector and the real estate market during the second and third quarters of the year resulted in GDP growth for the year as a whole being slightly below that in 1994.

Over the next couple of years, growth is expected to continue at a moderate pace; policymakers are consistent in their desire to maintain the expansion of the economy at the current rate. Prospects for the economy of Taipei,China will continue to depend on a more robust recovery of the world economy and on the speed of industrial restructuring. The move toward high-skilled, technology-intensive industries has been taking place but needs to proceed more rapidly if the economy is to remain dynamic and competitive.

The increasing indirect trade links with the People's Republic of China will continue to have an important bearing on the performance of the Taipei,China economy. Both domestic political stability and political and economic relations with China will be significant for future economic growth. Exports to China accelerated and total exports reached a record level during 1995. Imports also grew at an accelerated pace as both private consumption and investment increased. The trade and current account surpluses were again large in 1995 and, although these have been reduced considerably in recent years, they are expected to remain substantial over the next several years. Some uncertainty about Taipei,China's membership in the WTO may have an impact on the performance of the external sector. In general, however, prospects for the economy continue to be favorable.

Recent Trends and Prospects

Growth, Investment, and Employment. In 1995, GDP growth declined to 6.3 percent from 6.5 percent in 1994, mainly as a result of a contraction in the growth rate of the services sector. The share of agriculture in GDP continued to decline and is now only 3 percent (Figure 2.4). After a fall in agricultural output during 1994 of over 4 percent because of a series of typhoons, there was marked recovery during 1995 and the sector grew by 7 percent. The industry sector, now comprising almost 39 percent of GDP, expanded by 6 percent in 1995, improving on the 5.7 percent growth rate achieved the year before. Both manufacturing and energy output increased at an accelerated pace, while there was a slight decline in the growth rate of the construction sector. During 1994 and early 1995, there had been increased construction activity to beat a deadline for expected changes in zoning and construction laws. This resulted in oversupply and a subsequent decline in activity over the latter half of the year. The services sector growth rate declined from 7.8 percent in 1994 to 6.3 percent during 1995. The sharpest contraction was in financial services where, over the year, several scandals hit the banking sector, credit cooperatives, and the stock market. In addition, the real estate market suffered as a result of the problems in the construction sector. Despite

these setbacks, the share of services in GDP was maintained at almost 60 percent.

After a small decline in the ratio of gross domestic investment to GDP during 1994, there was an increase during 1995 to 24.5 percent of GDP. Although there had been some fears that private investor confidence may have suffered owing to the problems with the financial sector, these fears appear to have been short-lived. There was increased growth in private investment, mainly as a result of strong export performance. Public sector investment, however, increased at the same pace as in the previous year with infrastructure projects accounting for the bulk of such investment activity.

The savings rate in Taipei,China has declined gradually over recent years and is now around 26 percent of GDP. Gross domestic saving continued to exceed investment and, as a result, a resource surplus remained; although at 1.9 percent of GDP in 1995, it was significantly lower than in the late 1980s when it was 7.5 percent of GDP. The resource gap is expected to remain positive over the next few years. Foreign direct investment from Taipei,China continued to expand during 1995 with the bulk of outflows destined for the People's Republic of China. Investment from Taipei,China to the Philippines also increased as economic conditions in the Philippines continued to improve.

Private consumption continued to expand fairly rapidly during 1995 although at a lower rate of under 10 percent from 12.7 percent in 1994. Government consumption expanded quite rapidly at close to 4 percent during 1995 after relatively low growth during the previous year of a little over 2 percent. Most of this expansion was a result of increased expenditure on civil service salaries.

With the continued growth of the economy, unemployment remains low at 1.7 percent of the labor force. Nevertheless, the shift in economic structure toward a more services-based economy has led to sizeable differentials between wages in manufacturing and higher wages in the more rapidly expanding services sector. Manufacturing wages have been repressed by the need for industry to remain internationally competitive whereas this has not been as important a consideration with services, which are to a large extent nontradeable. As a result, shortages of labor have developed in manufacturing in recent years. On the other hand, high services sector

Table 2.4 Major Economic Indicators: Taipei,China

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	6.3	6.5	6.3	6.4	6.3
Agriculture	% change	5.4	-4.4	7.0	0.5	0.8
Industry	% change	4.1	5.7	6.1	6.2	6.2
Services	% change	7.9	7.8	6.3	6.9	6.6
Gross Domestic Investment	% of GDP	25.2	23.9	24.5	24.7	25.4
Gross Domestic Saving	% of GDP	27.0	25.8	26.3	26.6	27.1
Inflation Rate	% change in CPI	2.9	4.1	3.7	3.7	3.3
Money Supply Growth	% change	15.1	14.0	8.5	11.2	11.1
Merchandise Exports	$ billion	84.3	92.2	111.2	126.5	143.4
	% change	4.5	9.4	20.5	13.8	13.4
Merchandise Imports	$ billion	72.7	80.3	98.2	111.4	127.2
	% change	7.0	10.3	22.4	13.5	14.1
Current Account Balance	$ billion	6.7	6.2	7.2	7.8	7.7
	% of GDP	3.0	2.6	2.8	2.8	2.6

Sources: Chung-Shu Wu, "Taipei,China Economy: Recent Developments and Near Future Outlook," Academia Sinica (mimeo, December 1995); and staff estimates.

wages have encouraged young persons to gain the advanced academic qualifications in fields such as banking and finance that are relevant to the requirements of an expanding services sector. In addition, the supply of such high-skilled labor has been augmented in recent years by the return of Taipei,China nationals from the US with postgraduate degrees, attracted by expectations of high salaries and easy employment opportunities in a home environment. However, even though the services sector accounts for over 50 percent of employment, it has not expanded fast enough to employ all the high-skilled workers available and, in consequence, there is unemployment among this category of workers.

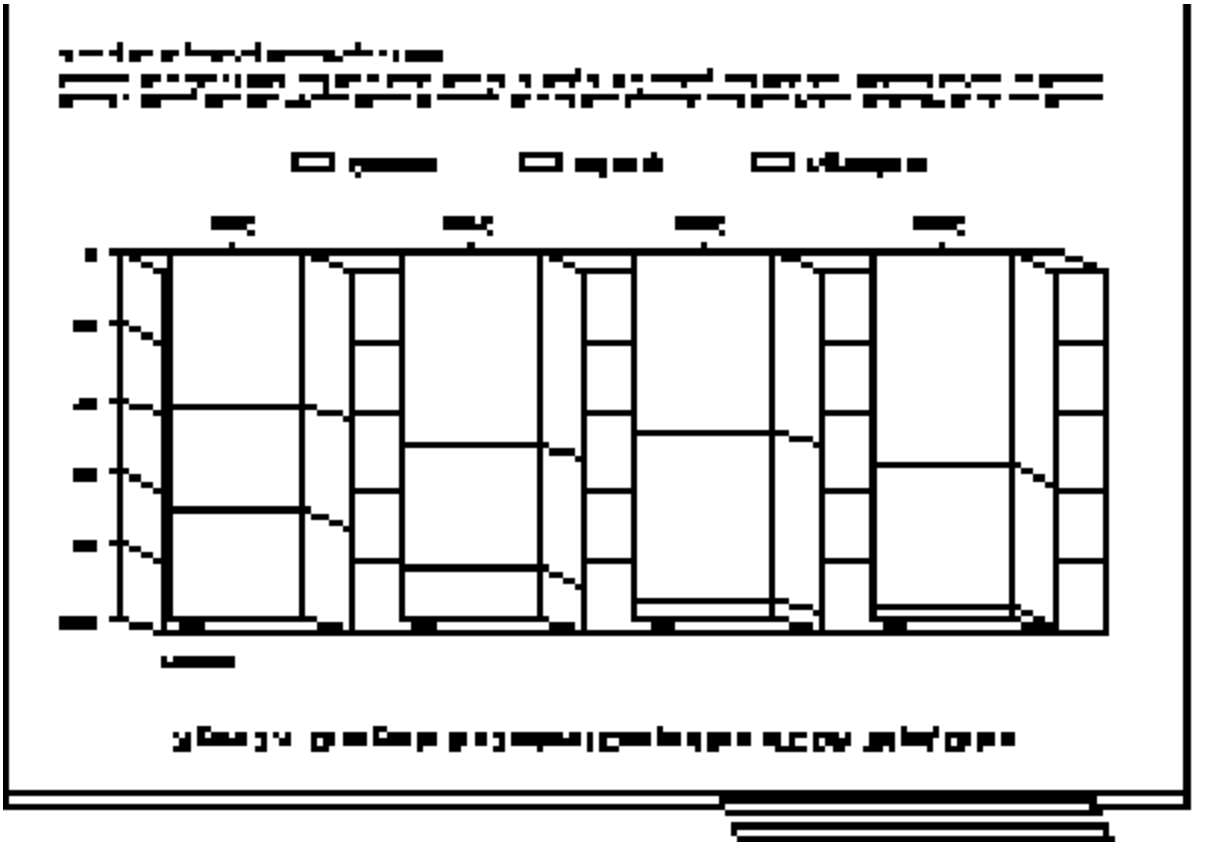
Over the next couple of years, the Taipei,China economy is expected to continue growing at rates similar to those in the recent past: 6.4 percent in 1996 and 6.3 percent in 1997. After the recovery of the agriculture sector following a series of natural disasters, the growth rate is expected to slow down with the sector expanding at rates of 0.5 percent and 0.8 percent over the next two years. The share of agriculture in GDP will continue to decline, albeit marginally. The industry sector will maintain a relatively high growth rate and, in both 1996 and 1997, this is expected to increase to 6.2 percent. Manufacturing, in particular, is projected to increase its growth rate slightly over the next two years, spurred by continued good export performance. Services sector growth is expected to rise to an average of over 6.7 percent annually in 1996 and 1997. Financial services in particular will pick up in 1996 and the increasing specialization of the sector in high value-added services is expected to continue.

With the slight increase in economic growth, gross domestic investment as a share of GDP is expected to expand slightly to around 24.7 percent during 1996 and to 25.4 percent in 1997. Gross domestic saving as a proportion of GDP will also rise slightly to 26.6 percent during 1996, increasing again to 27.1 percent in 1997. Gross domestic saving will continue to remain above gross domestic investment; however, the surplus will remain relatively small. Both private consumption and government consumption will continue to increase, with continued expansion in economic activity. The level of unemployment is likely to remain low and, with the share of services in the economy continuing to expand, the surplus of skilled workers now available for employment in the services sector is likely to diminish over the next two years.

Budget, Money, and Prices. The depressed activity in the real estate and stock markets in 1995 had a negative impact on indirect tax revenues; however, this decline was matched by increases in direct tax revenues, particularly from income taxes. As a result, government revenues grew at a slightly higher rate during 1995 than they had in the previous year. Owing to the downsizing of government, current expenditure did not grow as fast during 1995 as in 1994, resulting in an increase in the current surplus. However, capital expenditure necessary for the implementation of the Six-Year National Development Plan increased during 1995. Such expenditure grew at over 7.5 percent, leading to total expenditure exceeding total revenue by a significant amount. Total consolidated government expenditure, both current and capital, was over 29 percent of GDP. Tax revenues, on the other hand, were less than 24 percent of GDP, leading to an overall deficit of 5.5 percent of GDP, only slightly less than the overall deficit during 1994.

Over the past three years, there has been a decreasing trend in the growth rate of money supply (M2), resulting from the tight monetary policy being pursued by the Central Bank. In 1995, the target was to keep the growth rate of M2 below 15 percent. During the first half of the year, however, money supply grew by only slightly more than 10 percent and the slump in the real estate and stock markets during July and August contracted the growth of the demand for money even further. Despite attempts by the Central Bank to alleviate the situation, the growth rate of M2 was only 8.5 percent during 1995, well below the target rate.

The series of typhoons that struck Taipei,China during 1994, which resulted in higher prices of most essential food items, did not recur in 1995. A more moderate growth rate of the economy accompanied by slow growth in money supply resulted in the inflation rate declining to 3.7 percent in 1995 compared with over 4 percent in the previous year. Food prices did not increase much during 1995 and there was a moderation in



land and property prices as a result of the oversupply of housing. Most of the increases were in education and entertainment fees and in the prices of imported goods.

Given the expected growth rate over the next two years, consolidated government revenues are likely to increase by 4.5 percent during 1996 and a little over 6 percent the following year. While current expenditure is expected to increase at lower rates in 1996 and 1997, increased capital expenditure on the Six-Year National Development Plan is expected to expand the overall deficit to around 5.7 percent during 1996, declining to 5.4 percent the following year.

Both the slowing down of the economy and a deliberate loosening of monetary policy are expected to lead to a slight increase in the growth rate of M2 during 1996 to a little over 11 percent. This growth is, however, still lower than the Central Bank target. Consumer price inflation over the next two years is expected to be in the range of 3.3–3.7 percent annually. Although inflation in Taipei,China is fairly low by international standards, policymakers would like to keep the inflation rate below 4 percent.

External Trade and Payments. Export performance reached a record level during 1995 with growth reaching close to 21 percent. Chemical exports grew at a phenomenal rate of close to 40 percent and both machinery and electrical equipment displayed robust increases. Exports to the People's Republic of China through Hong Kong increased rapidly and, for the first time, Hong Kong became in 1995 the largest trading partner of Taipei,China, replacing the US. Exports to both the US and Japan, the third largest trading partner, also increased substantially in 1995.

On the import side, raw materials and capital goods continued to dominate. There was a sharp increase in the total value of imports, with the growth rate exceeding 22 percent. Chemicals had the highest growth rate, exceeding 38 percent during 1995, while both machinery and electrical equipment imports also grew at a rapid pace. A slight depreciation of the New Taiwan dollar (NT$) helped boost imports, as did substantial increases in private consumption. In addition, machinery and equipment needed for the Six-Year National Development Plan

and infrastructure rehabilitation added to the high import growth rate.

Despite import growth exceeding export growth, the trade surplus increased slightly from $12 billion during 1994 to $13 billion during 1995. The current account surplus increased to $7.2 billion in nominal terms; and, as a ratio of GDP, it rose to 2.8 percent during 1995 compared with 2.6 percent in the previous year. As in 1994, the NT dollar depreciated slightly during 1995. Some of this was due to a stronger dollar in world markets; however, some of it was also because of large capital outflows, mainly a result of uncertainty about relations with China.

With the continuing high growth of China's economy and with the demand for its exports remaining strong, exports from Taipei,China should also continue to be buoyant. Export growth is expected to be around 13–14 percent annually over the next two years. Strong domestic demand and continued investment in the Six-Year National Development Plan is expected to keep imports growing at a fairly high pace. However, the growth rate will fall to around 13–14 percent annually over the next two years. As a result, the trade surplus will increase and the current account is expected to maintain a surplus of 2.8 percent of GDP in 1996 and 2.6 percent in 1997.

Policy and Development Issues

The main uncertainty facing the Taipei,China economy is of a political nature. The domestic political situation, with presidential elections scheduled for early 1996, will determine to some extent future relations with the People's Republic of China. In fact, China's policies and attitude toward Taipei,China are perhaps the most pressing policy issues facing the island economy. For example, although China's application to join the WTO is still pending, this has created serious doubts whether Taipei,China will be allowed membership. Some complications could also arise during 1997 as Hong Kong reverts to China, and the future framework for trade and investment links between Hong Kong and Taipei,China will need to be considered. As a result, uncertainty regarding external sector performance and, thus, the growth of GDP has become of concern to policymakers.

The Taipei,China economy has matured considerably in recent years and is fast becoming a primarily services-based economy. The move toward high value-added industry and sophisticated commercial and business services has succeeded reasonably well and the economic restructuring of Taipei,China is expected to continue. The surplus of highly skilled and educated people available should help this process considerably and all indications are that appropriate changes in investment patterns are already taking place. Changes in the industrial structure toward high technology industries and activities should also help alleviate concerns about Taipei,China's competitiveness.

However, with the changing structure of the economy, some concerns are being expressed about possible shortcomings of the country's present infrastructure. With higher income levels and increasing affluence, the demand for better quality urban services, such as for improved public transport and urban roads, has been increasing. The Six-Year National Development Plan emphasizes the upgrading of urban infrastructure to keep pace with this demand, and increased spending under the Plan should help alleviate these problems. Problems with the financial markets must also be addressed. With increased liberalization expected, there is a need to ensure adequate regulatory safeguards to reduce uncertainty. The slow pace of the privatization program must also be dealt with. On balance, however, the Taipei,China economy appears to be on a path of stable growth and increasing affluence.

People's Republic of China

China's economy in 1995 experienced its fourth year of double-digit growth, although at a slower rate than in 1994, in reflection of the lagged effects of the tight fiscal policies that have been in force since mid-1993. Fixed asset investment and public expenditure moderated considerably, imparting a contractionary impact on GDP growth. The easing of aggregate demand, in turn, helped to reduce inflationary pressure.

Wide-ranging reforms introduced in a phased manner since January 1994 have had a positive effect on the trade account, exchange rate stability, and household saving. Orderly conditions prevailed in the financial markets except for the quickly resolved disruption in the Shanghai bond market at the beginning of the year. The trade balance was in record surplus which, in turn, led to an increase in external reserves by more than 42 percent during 1995. Central Government finances, however, continued to be strained despite reforms in intergovernmental fiscal relations designed to improve revenue collection.

The reform agenda progressed reasonably well and led to the strengthening of the Central Bank and improvement of the investment climate. However, reform of the state-owned enterprise (SOE) sector progressed slowly.

Recent Trends and Prospects

Growth, Investment, and Employment. The continuing tight fiscal and monetary policies enforced by the Government during the year resulted in a contraction of economic growth from 11.8 percent in 1994 to the more sustainable rate of 10.2 percent in 1995, with a significant moderation of inflationary pressures. China's growth rate in 1995, however, remains one of the highest in the world.

The agriculture sector grew by 4.5 percent in 1995 compared with 4 percent in 1994. This improvement resulted both from good climatic conditions and from the incentives to production given by the adjustment in mid-1994 of the procurement price for grains and cotton by 40 percent and 60 percent, respectively. Grain production is estimated at a record of 460 million tons in 1995.

Industrial output growth contracted from 17.4 percent in 1994 to 13.6 percent in 1995, primarily because of slower aggregate demand growth and the lagged effect of slower investment by the SOEs. Even at this growth rate, there were strains on the supply of electric power, transport services, and communications facilities. Private companies recorded the highest increases in output at 18.1 percent, followed by collectively owned enterprises at 12.8 percent and the state sector at 8.1 percent.

The services sector grew by 8 percent in 1995 compared with 8.2 percent in 1994. Financial, accounting, legal, wholesaling, retailing, and other support services all expanded strongly. As is the case with most transitional economies, the services sector in China is not well developed; its share in GDP is only 28 percent compared to the average of 65 percent for Hong Kong, Korea, Singapore, and Taipei,China.

The Central Government continued to impose controls on the approval of new investment projects in an effort to cool down the economy and to maintain the budgetary deficit within manageable limits. As a result, growth

in fixed asset investment was contained at 17 percent, somewhat lower than its growth rate of 34 percent in 1994. To increase agriculture output and reduce dependence on food imports, the Government also increased supportive infrastructure investment in the sector by 33.4 percent. Overall, gross domestic investment declined to 39.5 percent of GDP compared with 40 percent in 1994, while gross domestic saving increased to 42.2 percent of GDP from 41.4 percent in 1994. The resource surplus thus increased from 1.4 percent of GDP in 1994 to 2.7 percent in 1995. The sources of finance for fixed asset investments have changed radically since the reform process began in the late 1970s, with budgetary appropriations comprising 3 percent of the total in 1994 compared with 45 percent in 1980 (Figure 2.5).

The official unemployment rate remained low at 2.9 percent in 1995, marginally higher than the 1994 rate of 2.8 percent. Employment in primary industry grew by 14.4 million jobs in 1995, down by 463,000 compared with 1994, while employment in secondary industry grew by 35.4 million, 1.1 million less than in 1994. However, taking into account the 23 million redundant workers in the SOEs and the estimated 170 million migrant workers from the rural areas who may or may not be fully employed in the informal sector, the unemployment rate could be as high as 8–10 percent. Providing employment opportunities in the rural areas and, hence, reducing poverty is an important objective of the Government's Eight-Seven Poverty Reduction Plan (Box 2.1).

The gradual slowdown of the economy is expected to continue over the next two years with GDP growth receding to 8 percent in 1996 and 9 percent in 1997. The greater emphasis given to the agriculture sector is expected to enable its growth performance to be maintained at an average of 4.5 percent over the next two years. Barring bad weather, grain production is expected to increase by an average of 10 million tons per annum given the additional acreage that has been brought under cultivation and the limitations that have been imposed on converting agricultural land for industrial and other nonagricultural purposes.

Industrial production is expected to stabilize at a growth rate of 8.5-9 percent per annum

Table 2.5 Major Economic Indicators: People's Republic of China

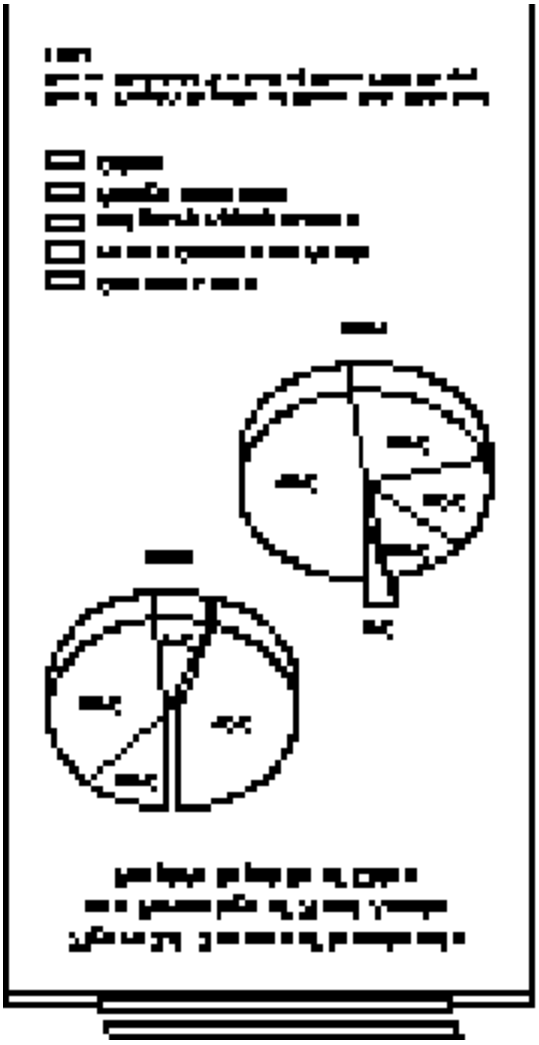
		1993	1994	1995	1996	1997
Gross Domestic Product	% change	13.5	11.8	10.2	8.0	9.0
Agriculture	% change	4.7	4.0	4.5	4.5	4.5
Industry	% change	20.7	17.4	13.6	8.5	8.9
Services	% change	9.5	8.2	8.0	10.0	12.0
Gross Domestic Investment	% of GDP	43.5	40.0	39.5	38.7	38.7
Gross Domestic Saving	% of GDP	41.5	41.4	42.2	40.2	39.2
Inflation Rate	% change in RPI	13.0	21.7	14.8	10.0	14.0
Money Supply Growth	% change	24.0	49.0	29.4	24.5	29.0
Merchandise Exports	$ billion	75.7	102.6	126.2	140.0	164.1
	% change	8.8	35.6	23.0	11.0	17.2
Merchandise Imports	$ billion	86.3	95.3	108.6	134.7	161.6
	% change	34.1	10.5	14.0	24.0	20.0
Current Account Balance	$ billion	-11.7	6.5	16.5	4.1	1.0
	% of GDP	-2.0	1.3	2.4	0.5	0.1
External Debt Outstanding	$ billion	84.2	100.5	110.6	125.6	140.6
Debt-Service Ratio	% of exports	11.2	8.9	9.1	9.3	9.1

Sources: People's Republic of China, State Statistical Bureau, *Statistical Yearbook of China 1995* (Beijing, 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996): World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); data collected from the State Statistical Bureau, People's Republic of China by EDRC for the Asian Development Bank *Annual Report 1995*; and staff estimates.

over the next two years in line with the Government's efforts to prevent economic overheating and to rationalize investment in the SOE sector in line with sustainable growth of the economy generally. The non-state sector will continue to increase its share in industrial output growth and employment generation. As enterprise reforms continue to deepen and the bankruptcy law is applied more widely, the share of the state sector in total industrial output will continue to decline from 44 percent in 1995 to below 40 percent by 1997. In the last quarter of 1995, a yuan (Y) 120 billion program to upgrade technology and enhance product quality in some 900 large- and medium-sized SOEs was launched. The program is scheduled for completion in 1997. When fully implemented, approximately 70 percent of the total amount under the program will have gone to projects in energy, raw materials, and the transport and communications industries, all of which have become bottlenecks in the way of sustaining the high growth rate of the economy.

The Government's efforts to encourage the growth of the services sector to absorb the rapidly expanding labor force, and to meet new demands for the types of services generated by the increasingly market-oriented economy, will lead to the continued expansion of this sector over the medium term. The sector is expected to grow by 10 percent in 1996 and 12 percent in 1997. Recent measures to open up the financial sector, particularly banking and insurance and the retail and wholesale trades, to foreign investment, as well as rapid expansion in transport and communications services, will help sustain the near-term growth of services.

Budget, Money, and Prices. Despite the fiscal reforms introduced since March 1994 to improve revenue collection and control expenditure on nonpriority items, the budgetary balance remained strained in 1995. The planned budget deficit of Y66.7 billion was exceeded by 5.3 percent to reach Y70 billion. Part of the problem is that fiscal reforms depend critically on the progress of SOE and financial sector reforms. Although the planned budget deficit was a mere 1.2 percent of GDP, this underestimates actual spending by the State. Taking hidden subsidies into consideration, the total budget deficit is estimated at 8 percent of GDP in 1995.



Government revenue as a proportion of GDP has declined in recent years owing to the reduced profitability of SOEs and the poor revenue buoyancy of indirect taxes, especially the VAT. The amount collected from the consumption tax and VAT – the main sources of revenue for the Government – was 6 percent below the target for the year, largely because of SOE tax arrears. As the newly established National Tax Service matures and provincial level capacity to enforce the tax codes correctly is improved, it is expected that revenue buoyancy will be improved.

Despite pressures from the SOEs and the faster-growing provinces, monetary policy remained tight during 1995 in line with the stance of bringing the overheated economy to a soft landing. The main factor influencing domestic money supply growth since mid-1994 has been the large external surplus, which is gradually being reduced. Broad money supply (M2) grew by 29.4 percent in 1995

compared with 49 percent in 1994 while narrow money (M1) grew by 18 percent compared with 10 percent. Currency in circulation rose by the more modest rate of 14 percent, attributed to the efforts of the Central Bank to promote the use of checks. Although the deceleration in money supply growth is encouraging, M2 growth was still well above the official target of 24 percent for the year.

With the slowdown in money supply growth, inflation fell sharply in 1995; the increase in the national retail price index (RPI) dropped from 21.7 percent to 14.8 percent in 1995, slightly below the targeted rate of 15 percent announced at the beginning of the year. The increase in the broader consumer price index (CPI), which includes services as well as retail goods, remained slightly higher at around 17 percent. Various administrative measures were taken to restrain the rate of increase of prices, including improving food supplies by increasing the use of subsidized agricultural inputs, controlling fixed asset investments, temporarily reimposing price controls, freezing price reforms, and clamping down on unfair trade practices. However, the Government recognizes that none of these measures are permanent remedies for controlling inflation. Reimposition of price controls has delayed the one-time impact of liberalizations on inflation and created longer-term macroeconomic management problems. Furthermore, subsidizing interest rates on bank deposits has been a costly way of encouraging saving during periods of high inflation. Nevertheless, indirect instruments of monetary policy are gradually being put in place and, when completed, should result in better control of inflation without distorting factor markets.

The fiscal situation of the Central Government over the next two years depends on the performance of revenue and the extent to which SOE reforms are implemented. As new tax measures and the tax collection system become more entrenched, revenue buoyancy is expected to improve and, consequently, the tax/GDP ratio will rise. Expediting SOE reforms will also significantly reduce subsidies channeled to them through the budget. The Government's consolidated budget deficit is expected to fall significantly below that in 1995 mainly because of reduced support to the loss-making SOEs expected over the next two years and stricter implementation of the Budget Law and Auditing Law enacted in 1994 which limit recourse to Central Bank credit.

With the tight monetary policies having yielded the intended results of restraining inflation, there have been pressures for the easing of credit supply. These pressures have come from the SOEs, which have been deprived of investment and working capital under the austerity program, and the local governments, which are faced with escalating social security expenses and falling enterprise tax revenues. However, it is unlikely that the Central Bank will move aggressively in the near term to restimulate the economy, given the painful memories of the 1993 inflation blowout and how long it has taken to stabilize the economy. At the same time, the sweeping trade reforms scheduled for 1996 will also deter the authorities from acting aggressively; the combination of loose monetary policy and a deep cut in tariffs could seriously undermine China's external balance and cause currency market instability. The improved inflation outlook and the slower money supply growth will prompt the monetary authorities to selectively ease monetary policy from mid-1996. Despite this, money supply (M2) growth is projected to slow further to 24.5 percent in 1996 before rising again to 29 percent in 1997.

The anticipated further contraction of money supply growth in 1996, the continued strict control over fixed asset investment, and the weakening of consumption demand has prompted the Government to set an inflation target of 10 percent for 1996, which is achievable given the aggregate supply and demand conditions that will most likely prevail in the economy during that year. With the expected easing of monetary policy and the implementation of projects under the Ninth Plan beginning in earnest to break supply bottlenecks in infrastructure, inflation is projected to pick up moderately in 1997 to 14 percent.

External Trade and Payments. With sustained external demand and continued progress in trade and foreign exchange reforms within China, total trade expanded strongly again in 1995. Exports rose by 23 percent to $126 billion while imports grew by 14 percent to $109 billion. The merchandise trade surplus thus increased to $17.5 billion in 1995 from $7.3 billion in 1994. Manufactured goods comprise the bulk of China's exports, with their share having risen over the past decade

Box 2.1 China's Eight-Seven Poverty Reduction Plan

The Government's approach to poverty alleviation took a new turn with the launching of the Eight-Seven Poverty Reduction Plan (ESPRP) in July 1993, shifting from providing relief assistance and transfer payments to creating more opportunities for the poor to engage in income-earning opportunities and to achieve self-reliance. The basic objective of the ESPRP, which is to run from 1994 to 2000, is to lift the incomes of all people living below the poverty line through targeted interventions.

The specific aim is to raise annual per capita incomes in 592 designated poverty areas to at least Y500 (in constant 1990 prices) by the turn of the century. This will be done by increasing the income-earning opportunities of the poor, building infrastructure in poor areas, and increasing expenditure on human resource development (HRD). High-yielding farmland for cash crop and livestock production is being made available and at least one member of each poor household is being provided with the opportunity to work in a township or village enterprise or in an urban center. Infrastructure development is aimed at increasing access to potable water, building farm-to-market roads, and ensuring that all designated poverty townships have access to electricity. HRD includes providing compulsory primary education, providing vocational and technical education to adult workers, improving the delivery of rural health care services, and promoting family planning practices.

Public funds and credit for poverty reduction have been progressively increased. Between 1986 and 1990, budgetary allocations for poverty reduction were Y5 billion a year. In July 1993, the amount was increased to Y9 billion; an additional Y2 billion was later added for work relief programs and for interest subsidies.

Beginning in 1994, all existing credit funds to assist the poor previously held by the People's Bank of China and specialized banks came under the unified control of the newly established Agricultural Development Bank of China. Fund allocation has also been revised. Since ESPRP began, half of the Central Government's funds used to assist the needy in the more economically developed coastal provinces have been diverted to assist the poor in the more impoverished regions in the central and western parts of the country. From 1996, developed provinces will be responsible for assisting their poor, with the Central Government's poverty allocation being used entirely for the most impoverished provinces and autonomous regions. A two-pronged strategy will be used in the distribution of these funds: for development projects capable of producing economic returns, assistance will be provided through loans with subsidized interest rates; and for projects that have significant social benefits but no immediate financial benefits, grant assistance will be available.

Since the ESPRP began, an estimated 10 million people have been brought out of absolute poverty. At this rate, the Central Government's current strategy should help raise the incomes of between 35 million and 40 million people to above the poverty line by the end of the century.

from 50 percent to 85 percent of total exports. Labor-intensive products are predominant. The trade of foreign-funded enterprises accounted for about 28 percent of China's total trade value, reflecting the growing importance of the non-state sector in both exports and imports. Of the 235,000 foreign-funded enterprises approved to the end of 1995, more than 110,000 have begun operations, employing 15 million workers. Industrial products accounted for 90 percent of total exports. Japan remained China's biggest trading partner in 1995, with the total value of trade between the two countries reaching $53 billion for the year.

The current account surplus in 1995 was $16.5 billion, equivalent to 2.4 percent of GDP, compared with $6.5 billion or 1.3 percent of GDP in 1994. The services account remained in deficit, reflecting the underdeveloped state of this sector particularly in those services associated with international trade. Inflows of FDI remained strong in 1995, with realized FDI totaling $37 billion, a growth of 11 percent compared with inflows in 1994. Infrastructure, technology, and capital-intensive projects accounted for the largest proportion of total realized FDI, although in terms of absolute numbers they were small compared with light industrial projects, most of which were investments from Hong Kong; Macao; Singapore; Taipei,China; and Thailand. Investments from Japan and the US were generally in higher technology production. Total foreign exchange reserves increased by over 42 percent in 1995, reaching $73.5 billion by the end of the year.

Total external debt reached $110.6 billion at the end of 1995, an increase of 9.5 percent over the level in 1994. The debt-service ratio rose to 9.1 percent compared with 8.9 percent in 1994, reflecting the slower growth of exports of goods and services. The debt ratio fell to 16 percent of GDP in 1995 compared with 19.3 percent in 1994. Exports are projected to grow at a more moderate rate of 11 percent in 1996, accelerating somewhat to 17.2 percent in 1997. The primary factor for the slowing of export growth is the reduction in VAT export refunds from 14 percent to 9 percent beginning 1 January 1996. Other factors include the stricter enforcement of copyright and patent laws by the authorities and continuing trade problems with major trading partners such as the US, Japan, and the EU. The expected easing of credit from mid-1996 and the pickup in retail sales from the continued increase in disposable incomes is also expected to divert some exports to domestic consumption.

Imports are expected to grow by 24 percent in 1996 and at a slightly lower rate of 20 percent in 1997 mainly because of sweeping customs duty reductions and the strong domestic demand for advanced technology items needed for improving infrastructure and for technological renovation in the state-owned sector. In addition, strong inflows of FDI will be accompanied by increased imports of machinery and equipment. A 30 percent tariff cut on more than 4,000 items in 1996 will reduce the average tariff to 23 percent from 36 percent; and further tariff cuts planned for 1997 will reduce the average tariff to 15 percent. In addition, a policy decision was made to move to full convertibility of the yuan by the end of 1997. These reforms are expected to give a strong impetus to China's external trade.

Given the projections for exports and imports over the next two years, the very large merchandise trade balance achieved in 1995 will sharply decline to $5.4 billion in 1996 or 0.7 percent of GDP and $2.5 billion or 0.3 percent of GDP in 1997.

External debt outstanding is forecast to increase by an average of $15 billion over the next two years with a sizeable portion of this debt being attributable to the Three Gorges Project along the Yangtze River. The debt-service ratio as a percentage of GDP is projected to increase slightly to 9.3 percent in 1996 before declining to 9.1 percent in 1997.

Policy and Development Issues

The broad thrust of the planned reform program and the way in which reforms have been sequenced to date provide grounds for optimism regarding the future. While much progress has been made in introducing commercially oriented management practices in the SOEs, efforts to reform the enterprises are generally perceived to be slow with inadequate progress being made in reducing the drain on the budget and retarding improvements in the efficiency of the economy. SOE reform remains incomplete because of the Government's concern with balancing the twin objectives of economic and social stability. Further reforms can only be implemented when alternative social safety nets are well in place and incentives for labor mobility increased. Infrastructure bottlenecks generated by rapid economic growth also need to be addressed. The funds required to finance China's infrastructure needs exceed the amount available through traditional sources of financing. New methods of financing infrastructure, including mobilizing private long-term finance, need to be explored and developed. A number of perceived risks – such as the absence of a clear legal and regulatory framework to cover issues such as the convertibility of yuan revenues for foreign debt-service obligations and profit repatriation, transparency, and competition – have deterred both domestic and private investors from investing in long gestation projects in China. Unless an enabling environment for private sector investment in infrastructure can be created, it will be difficult for China to mobilize the resources necessary to finance planned infrastructure development.

Rural development and agricultural growth and productivity also need to be accelerated. Slower economic development in rural areas has contributed to widening rural-urban income disparities and widespread rural-urban migration, which is estimated to reach 200 million by the year 2000. Job creation has been insufficient to absorb this surplus rural labor. Also, urban infrastructure has been placed under tremendous pressure.

Finally, revenue collection and administration need to be strengthened to restore the ability of the Central Government to conduct effective fiscal policy. Revenue sharing and fiscal equalization would help to improve the provision of social services in poor areas.

Mongolia

With positive growth in 1994 and 1995, the Mongolian economy emerged from the crisis of 1990 to 1993 during which its output had declined by 23 percent. Mongolia's relatively more successful economic performance compared to that of other members of the former Council for Mutual Economic Assistance (CMEA) is attributable to its commitment to macroeconomic stabilization and structural reforms. Despite some slippage in the initial months, performance targets were generally achieved in 1995 for the second annual arrangement under the ongoing Enhanced Structural Adjustment Facility (ESAF). Although the rate of inflation declined, it was still well in excess of the target of 23 percent in 1995. There was further progress in structural reforms, including the removal of price controls on a number of items. The achievement of a trade surplus helped to reduce the size of the current account deficit and build up net international reserves. The budget deficit was fortuitously much lower than expected, but important changes in taxation structure and government administration are needed if a sound fiscal performance is to be achieved consistently. Continued macroeconomic stability will be essential if the growth momentum is to be maintained in the coming years.

Recent Trends and Prospects

Growth, Investment, and Employment. The Mongolian economy continued on its recovery path in 1995 with GDP growth improving markedly to 6.3 percent from 2.3 percent in 1994. Agricultural output increased by 5.7 percent despite some decline in the area under cultivation. Livestock numbers increased by more than 400,000 in 1995, exceeding 28 million for the first time. Price controls on grain and other agricultural commodities resulted in the withdrawal of some land from cultivation and a virtual cessation of investment in this sector; however, the recent removal of price controls and grain procurement requirements should encourage a reversal of these trends.

Industrial growth of 16.2 percent was broad based with output declining in only three subsectors: energy, furniture and wood processing, and leather processing and shoes. The private sector has begun to play an important role in industries such as leather products and garments, the processing of cashmere, and gold mining where 80 percent of mines are now operated privately. Services sector growth almost exclusively reflects increased private sector activity. Official statistics underestimate actual sectoral growth, especially of industry and services, because the statistical system inherited from the earlier regime does not fully capture private sector activities. Development of the private sector, combined with liberalization of the trade regime, has markedly improved the supply situation in Mongolia.

After several years of decline, gross domestic investment increased strongly after 1992, reaching 20.9 percent of GDP in 1994 and rising further to 23.7 percent in 1995. The savings rate has also improved steadily in recent years to reach 17 percent of GDP in 1995. The energy sector continues to absorb a large share of public investment, directed

Table 2.6 Major Economic Indicators: Mongolia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	-3.0	2.3	6.3	4.5	4.5
Agriculture	% change	-7.1	4.7	5.7	5.8	5.4
Industry	% change	-11.4	4.4	16.2	11.6	9.7
Services	% change	-1.4	3.1	1.5	1.2	2.5
Gross Domestic Investment	% of GDP	18.8	20.9	23.7	24.4	25.9
Gross Domestic Saving	% of GDP	12.2	12.8	17.0	15.7	17.2
Inflation Rate	% change in CPI	268.4	87.6	56.8	30.0	15.0
Money Supply Growth	% change	227.6	79.5	32.9	35.0	25.0
Merchandise Exports	$ million	366	367	451	496	545
	% change	2.8	0.3	22.9	10.0	9.9
Merchandise Imports[a]	$ million	375	371	473	520	572
	% change	-10.5	-1.1	27.7	9.9	10.0
Current Account Balance[b]	$ million	-39.9	-40.3	-63.7	-84.4	-88.4
	% of GDP	-7.5	-5.9	-7.3	-10.4	-11.3
External Debt Outstanding	$ million	366	474	507	528	610
Debt-Service Ratio	% of exports	10.6	16.3	14.1	12.6	9.8

[a] Cost, insurance, and freight.
[b] Excludes net official transfers.

Sources: Data provided by the State Statistical Office of Mongolia; and staff estimates.

primarily towards modernizing and rehabilitating existing capacity. Investment laws, including those for foreign direct investment, have been liberalized and this has encouraged private sector investment in the manufacturing and services sectors. Foreign direct investment at $10 million is still marginal, although there has been some interest in acquiring selected state-owned enterprises. In 1995, foreign direct investment was successfully attracted to the telecommunications sector.

With the pickup in economic activity, unemployment levels declined during 1995. Registered unemployment, which peaked at 74,900 in 1994, declined by 32 percent to 51,000 during 1995. Employment generation projects, largely financed by external donors, contributed to the fall in unemployment levels and, in consequence, the number of people living below the poverty line declined. Somewhat slower growth over the next two years will mean less progress in reducing unemployment and poverty. Nevertheless, some progress can be expected as employment generation should exceed the number of new entrants into the labor force.

Structural adjustments have caused some disruption in the social sectors. Increases in the cost of education due to lower budgetary support and employment of school age children in the agriculture sector have resulted in an increase in the number of school dropouts. On the other hand, the shift to universal health insurance from a government-managed and funded system of health care, completed in 1994, has improved the delivery and efficiency of services. Over 92 percent of the population is now covered by health insurance.

Mongolia's economic recovery is only two years old and its macroeconomic situation is still fragile. If macroeconomic stability is achieved, the economy can be expected to grow at around 4.5 percent in both 1996 and 1997, with agricultural output increasing over the next years at much the same rate as in 1995. The industry sector, which contributes about 35 percent of GDP, will again provide strong growth impetus, with output forecast to expand by 11.6 percent in 1996 and 9.7 percent in 1997.

Gross domestic investment is projected to increase further to an average of over 25 percent of GDP for the next two years. However, with gross domestic saving at an average of about 16.5 percent in 1996 and 1997, the resource gap will widen by some two percentage points over its 1995 level.

Budget, Money, and Prices. After some slippage in the first half of 1995, because of higher expenditure on increased wages and advances to the energy sector and flour mills, fiscal performance improved. The overall budget deficit in 1995 was 11.4 percent of GDP compared with the original estimate of 13 percent. As in previous years, this was financed entirely by external concessional resources. The current budget was in surplus to the extent of 4.2 percent of GDP compared to the indicative target of 3.9 percent. The improvement in fiscal performance was largely a result of an unexpected increase in tax revenues from Erdenet Corporation, the state-owned monopoly for the processing and exporting of copper concentrate. Erdenet's profits and tax liability increased because of high international copper prices. There was also a marked improvement in monies collected from those taxpayers with large tax liabilities following the creation of a special unit for this purpose in the newly established Department of Taxation. This enabled the Government to finance the cost of a 71 percent increase in government salaries without borrowing from the Bank of Mongolia. The Government was also successful in curtailing net lending to state-owned enterprises. Targeted at tugrik (tug) 22.3 billion for 1995, actual net lending to state-owned enterprises was only tug1.38 billion at the end of September 1995.

Monetary and credit expansion has been kept under control, with the Bank of Mongolia being able to restrict its lending to government and state-owned enterprises. Net credit to government and state-owned enterprises was below targeted levels in 1995. Excessive credit expansion by commercial banks was brought under control with the Bank of Mongolia being able to finalize enforceable contracts on credit limits with each bank in September 1995. Expansion of broad money supply in 1995 was limited to the target of nearly 33 percent compared with an increase of 79.5 percent in 1994. Two factors were responsible for the expansion of the money supply. First, working capital advances by the Bank of Mongolia to gold mines could be liquidated only with a lag after refining the gold received from them. Second, there was an increase of $30 million in international reserves held by the Bank of Mongolia and commercial banks. Both these factors created inflationary pressure and required a compensatory contraction in domestic credit expansion and net credit to the Government. Overall, the monetary situation was better managed in 1995 with firmer control being exercised by the Bank of Mongolia.

The rate of inflation eased from over 87 percent in 1994 to nearly 57 percent in 1995. This still high inflation rate is a major cause of concern as it constitutes a destabilizing threat for the economy. The effect on prices of money supply increases was accentuated by a near doubling of grain and meat prices during the festival season in July, and there were also increases in urban fares, energy charges, and bread prices.

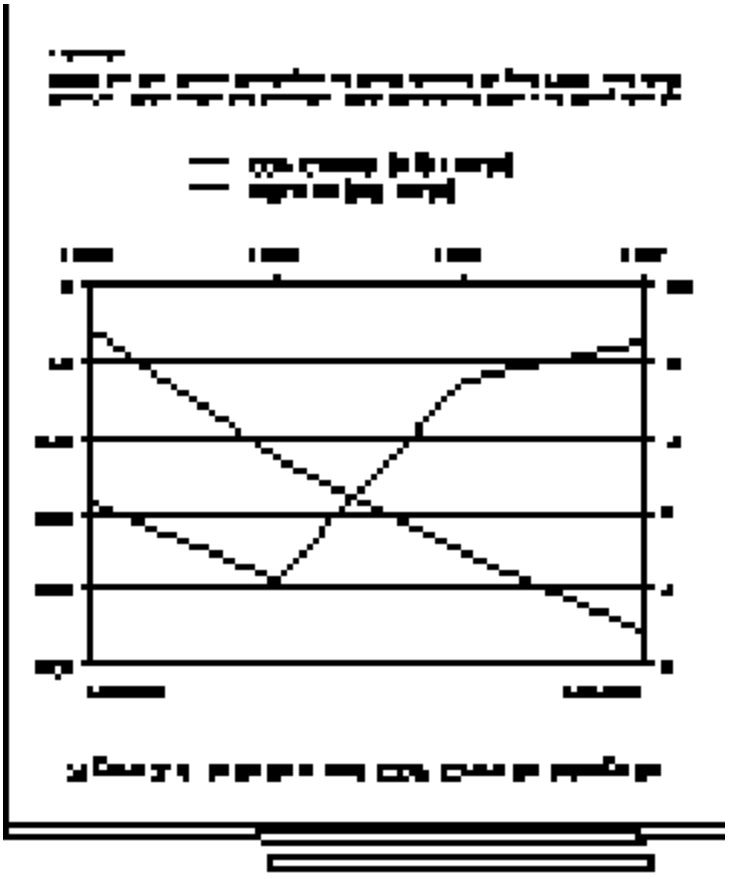
Some improvement in fiscal performance is likely during the next two years, with further reduction in expenditure and a decline in the overall deficit as the Government seeks to place the economy on a sounder macroeconomic footing. Structural reforms in tax administration, reduction of transfers to the energy sector, and rationalization of government administration are needed if this is to be achieved. An improved fiscal outcome, tighter credit ceilings on commercial banks, and better management of the supply of basic goods, especially in periods of peak demand, will help to bring down inflation. This will be affected by the speed with which the markets react to the expected removal of controls on energy and other utilities prices. Inflation is forecast to fall to 30 percent in 1996 and 15 percent in 1997.

External Trade and Payments. Mongolia's external trade increased dramatically in 1995. Export earnings rose by 23 percent, principally because of sustained demand and high international prices for copper, returns from which were 31 percent higher than in 1994. Imports also increased substantially by 28 percent, with capital goods and energy imports accounting for about half of total imports in 1995. The import surge reflected

the strong growth of the economy, the readier availability of foreign exchange, and the spurt in gross domestic investment.

Copper exports comprised 55 percent of total exports while cashmere, wool, leather, and meat and related products contributed another 13 percent. Gold exports, primarily from newly privatized mines, were also important, at more than twice what they were in 1994.

The year saw further diversification in the destination of Mongolian exports and sources of imports. The share of former CMEA countries, mainly Russia, in total imports to Mongolia declined from 79 percent in 1991 to 55 percent in 1995. Exports to former CMEA countries contracted to 29 percent of the total in 1995 from 73 percent in 1991 and Russia's share declined from 69 percent to 13 percent in 1995. The principal switch of export destination was to OECD countries whose share increased to 40 percent of total exports in 1995. Mongolia's trade with China has declined over the past two years with exports to that country falling to 14.5 percent of the total in 1995 compared with 31 percent in 1993.



The external current account deficit (excluding official transfers) increased to 7.3 percent of GDP in 1995 from 5.9 percent in 1994, and was fully financed by foreign capital inflows, which also permitted a buildup of net international reserves. These reserves increased to $50 million at the end of 1995 from $37.2 million in 1994. Gross official reserves were estimated at $97.5 million, sufficient for 11 weeks of imports. The tugrik exchange rate depreciated by 14 percent during 1995. The differential between the official and market exchange rates almost disappeared. In real terms, the currency has appreciated and this may begin to adversely affect exports. External debt continued to increase in nominal terms, rising to $507 million at the end of 1995. This was equivalent to 58 percent of GDP compared with 69 percent at the end of 1994. The debt-service ratio at 14.1 percent in 1995 remained well within prudential levels.

Export earnings are expected to increase by about 10 percent on average in 1996 and 1997. With sustained growth of the economy and import restrictions being completely removed, import growth is expected to be about 10 percent in both years. Although the trade deficit will remain modest in 1996 and 1997, a large invisibles payment for interest and remittances abroad will result in a widening of the current deficit to about 11 percent of GDP on average in the coming two years. Inflow of external finance is expected to be sufficient to cover the deficit and also to permit a further buildup of foreign exchange reserves to a likely level of $60 million in 1996 and $70 million in 1997. While external debt, which is made up almost exclusively of concessional loans, is likely to increase, the debt-service ratio is projected to decline to 12.6 percent in 1996 and 9.8 percent in 1997.

Policy and Development Issues

Maintaining macroeconomic stability and improving the Government's fiscal balances were considerable policy achievements

for 1995. Net lending to state-owned enterprises was substantially reduced; some types of government expenditure, including price supports, were cut sharply; and credit expansion by commercial banks was brought under control. Other policy initiatives taken include the freeing of grain and meat prices; the sale of Government equity in the telecommunications sector through international bidding; the lifting of foreign exchange surrender requirements for selected state-owned enterprises; the privatization of gold mines; the implementation of a poverty alleviation program; the establishment of an employment generation program with assistance from ADB; and the initiation of steps to restructure the social security and health insurance systems.

Mongolia's banking sector has evolved from a single bank system which operated in a centrally planned economy. Substantial progress has been made during the last four years to establish a two-tiered banking structure with the autonomous Central Bank, the Bank of Mongolia, at the apex and 14 commercial banks operating in a competitive environment. The basic legal and institutional framework for commercial banking has been created. Successfully completing the transition from a mono-banking system to a modern commercial banking sector which can serve the needs of a market-based economy takes time and involves some learning costs. However, the Mongolian banking sector is presently faced with some severe financial problems arising from a lack of required skills and inexperience with modern banking practices and norms. The Government is committed to a comprehensive program of further reforms which will lead to a restructuring and reorganizing of the sector, enabling it to play an effective role in mobilizing and allocating financial resources in the economy. ADB, in collaboration with the World Bank and the IMF, is providing assistance to the Mongolian Government to enable it to complete these reforms of the banking sector.

Required structural reforms in other sectors include privatizing state-owned enterprises, increasing tariffs in the energy sector to reduce subsidies, rationalizing government administrative structures, improving tax administration, and establishing an internationally acceptable system of government and corporate accounts. Important policy issues for the coming two years will be the maintenance of macroeconomic stability, the reduction of the number of people living below the poverty line, and the establishment of a comprehensive social security system.

Kazakhstan

The transition toward a market-based economy in Kazakhstan, initiated after independence, has been accompanied by a steep fall in GDP, substantial unemployment, and a widespread increase in the incidence of poverty. The Government, however, has achieved noticeable progress in its efforts toward macroeconomic stabilization, especially in the reduction of inflation. These efforts are setting the stage for moderate growth in the next few years. Structural reform measures, such as privatization and the establishment of the broad legal framework for a market system, have been well started; however, there is a significant unfinished agenda that must be completed for any recovery to provide for sustainable growth.

Recent Trends and Prospects

Immediately after independence, in common with most other former Soviet Union (FSU) republics, Kazakhstan's economy experienced serious economic difficulties. GDP declined on average at about 18 percent per annum between 1992 and 1994, and fell an additional 9 percent in 1995.

All economic sectors suffered. Following independence, the regular supply of inputs and the market for outputs were suddenly interrupted as trade arrangements among the FSU countries disintegrated. Output marketing was similarly disrupted. Heavy industry experienced a particularly large output contraction, reflecting directly the collapse of the Soviet military-industrial system. However, there are some indications that the contraction of the economy is coming to an end. In the last quarter of 1994, industrial production indices for some products began to show moderate increases relative to the 1993 levels, increases that were sustained through 1995. Moderate strength is discernible in nonferrous metals and in chemicals and petrochemicals. Some of these subsectors have benefited from newly developing export markets in Europe.

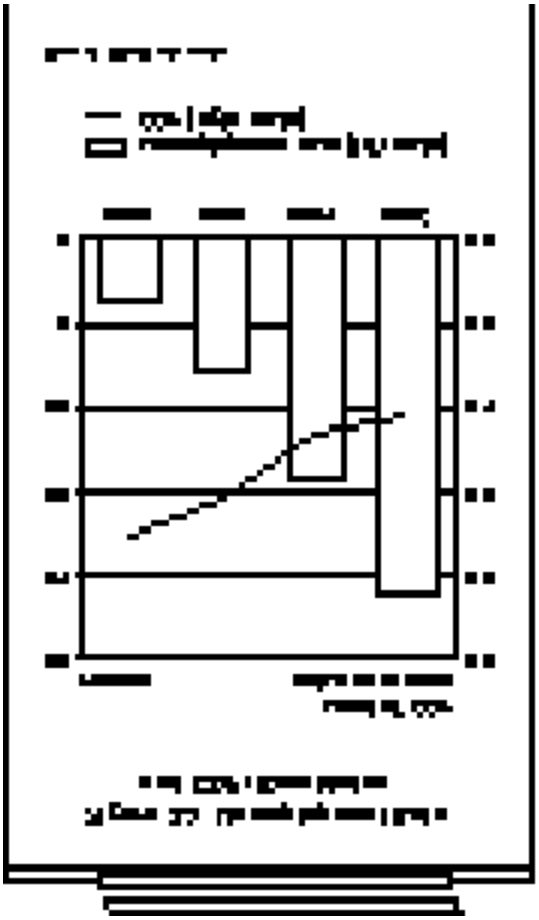
The collapse of central planning resulted in a deterioration in the terms of trade for agriculture and a serious erosion in farm incomes and profitability. Production has declined since independence for nearly all crops and products. Estimates for 1995 suggest a decline of between 22 percent and 33 percent in grain production compared with that in 1994. Poor weather conditions were a major contributory factor; average yields appear to have declined by more than 40 percent in 1995. The most important problems in agriculture include difficulties in the supply of inputs, lack of incentives for farm production, and a failure to restructure farm enterprises. In 1994, the Government began to reduce its presence in the sector, in particular by reducing orders for agricultural commodities; and in 1995, compulsory delivery requirements were abolished. Public needs are in the future to be satisfied through purchases in the market.

There are no reliable current estimates of saving and investment for Kazakhstan. Given the depressed and unstable economic conditions, new investment in plant and equipment was probably negligible in recent years. However, there still was significant inventory investment. The latter reflects the ability

of nonviable enterprises to continue production supported by soft credit either from suppliers or from official sources. Responding to the sharp fall in real income, saving has also declined. From a balance-of-payments perspective, the reduction in the public budget deficit in 1995 coupled with a large current account deficit suggests that private sector investment in relation to GDP is approximately 3–4 percentage points greater than private saving.

Labor markets under the former Soviet system were characterized by certainty and security. Employment was guaranteed; wages were paid in cash and were relatively undifferentiated; and there was generous additional support through a comprehensive system of transfers, social security, and special allowances. With the deterioration of the Kazakhstan economy, this situation changed dramatically. The sharp drop in output resulted in a large increase in unemployment. Combined open and hidden unemployment rose from 4 percent of the formal labor force at the end of 1992 to over 25 percent in 1995 (Figure 2.7). Companies are reluctant to fire employees partly because keeping employees on wage rolls at minimum wages can reduce the tax base for the enterprise. In addition, there are social and political pressures on firms to avoid mass labor shedding. As a result, many workers are put on forced leave resulting in hidden unemployment.

The poor economic performance has meant considerable welfare losses for most of the population. The deterioration of social infrastructure caused by a drop in public spending, the growth of unemployment, and the reduction of income has had a severe impact on the social conditions of the majority of the Kazakh population. This can be seen in the growing incidence of poverty. Using household survey data, in mid-1995 approximately 37 percent of the total population fell below the poverty line compared with 20 percent in 1992. Most affected are those people living in isolated industrial centers and rural agricultural areas, as well as particularly vulnerable groups such as pensioners, unemployed youth, and women. The latest internationally comparable per capita income measure is $1,540 for 1993, down from $1,880 in 1992, while estimates using current GDP figures and exchange rates show a figure for 1995 of under $1,000 per person.



Fiscal difficulties have hindered government efforts to mitigate the socioeconomic costs of the transition to a market economy. In an effort to rationalize administration and collection, a new tax code was adopted in April 1995 that reduces the number of different taxes. Although the new code results in a simplification of the entire system, it contains some preferential elements that will hinder efforts to increase revenues. Total revenues for consolidated government operations in 1995 were 20.1 percent of GDP, little changed from the 1994 revenue effort. Net lending in 1994, at 8 percent of GDP, was the result of quasi-fiscal operations to clear accumulated enterprise arrears. With net lending in 1995 at negligible levels, and despite relatively constant revenues, the budget provided for increased expenditures. Total current and capital expenditures declined slightly to 23.6 percent of GDP, from 27.3 percent of GDP in 1994. Expenditures were increased, while the overall budget deficit was reduced in 1995 to 3.5 percent of GDP from 7.9 percent in 1994.

Constrained public spending has resulted in sharply lower resources committed to the social sectors and social assistance. As a result, the provision of social services for education and health and access to social assets such as kindergartens and public housing have declined. Government spending on health and education fell from 10.1 percent of GDP in 1990 to 6.2 percent in 1995. Social safety net spending on social assistance and social protection has also fallen, from 4.4 percent of GDP in 1990 to 3.5 percent of the much smaller 1995 GDP. Reduced social service provision and a weaker social safety net have increased the hardships of the most vulnerable groups in society during this difficult period of transition.

Hyperinflation characterized all the FSU economies in the ruble zone after the breakup of the Soviet Union, and in Kazakhstan annual inflation remained above 1,500 percent through 1994. The establishment of a national currency, the tenge (T), in November 1993 and the development of the tools of monetary control by the Central Bank offered the Government the opportunity to target a reduction in inflation. Serious anti-inflationary action began in the second half of 1994, and resulted in the average inflation rate in 1995 being reduced to 176 percent. Furthermore, by the end of 1995, inflation had been reduced to an annual rate of less than 60 percent. This significant progress towards macroeconomic stabilization necessitated tight controls on credit creation and directed lending and reflects the commitment by the Government to move toward the goal of lower inflation.

Progress on inflation and generally tightened monetary conditions have provided for some stability for the tenge. After the introduction of the national currency in 1993, at T4.7 to one US dollar, the tenge steadily depreciated, falling to T63.3 to one US dollar by mid-1995. Subsequently, with increasing monetary restraint, the tenge appreciated against the US dollar, rising briefly to T59 to one US dollar in the third quarter before again falling to T64 to one US dollar at the end of the year.

The merchandise trade deficit in 1995 is estimated to have been over $0.9 billion, equivalent to 5.9 percent of GDP. This deficit is worrisome because it is occurring during a deep depression of levels of imports that would be too low to sustain positive growth. Should the economy begin to grow as a result of higher domestic aggregate demand, higher levels of imports would be required. In particular, higher purchases of natural gas from Uzbekistan, electricity from the Kyrgyz Republic, and transport vehicles from the industrial world would be needed.

Although there are some indications that the worst of the deep output contraction in Kazakhstan has passed, GDP is likely to continue to fall in 1996 and thereafter experience only a slow recovery, though this is dependent on simultaneous economic recovery in Kazakhstan's trading partners, especially the Russian Federation which remains a major trade partner. In the near term, the economy will benefit from a return to normal weather conditions; agriculture in 1996 is unlikely to see a continuation of the drastic slide in output experienced in 1995. Overall, Kazakhstan appears to be following a pattern similar to that seen in other economies in transition, where positive growth emerged in two to three years after significant progress on macroeconomic stabilization.

Despite the new tax program, there will be little improvement in government revenue in 1996 because of the continued weakness in national income. This will mean continued restraints on public spending consistent with maintaining a public sector deficit target of between 3 percent and 4 percent of GDP. Continued monetary restraint will likely bring further progress in lowering inflation with the average price increase falling to less than 50 percent for the year.

With the projected slow recovery, the current account of the balance of payments will likely require approximately $1 billion in annual financing. Some financing is expected to come from foreign direct investment; however, the major portion of the balance-of-payments financing is expected to come from medium- and long-term lending by multilateral development institutions or bilateral assistance programs. The debt/GDP ratio improved in 1995 on the strength of the cancellation of much of Kazakhstan's debt to the Russian Federation. In 1996, it is expected to increase, moving above 20 percent of GDP.

Policy and Development Issues

Over the longer term, recovery of growth and sustainable development will depend on the

resolution of the unfinished reform agenda. Particularly important steps to take will include continued efforts toward macroeconomic stabilization and a widening and deepening of the structural reform initiatives. The current macroeconomic stabilization program has been drawn up with the support of the IMF through a Standby Arrangement approved in June 1995. The present program focuses on reducing inflation and fiscal and external imbalances through tight monetary and fiscal policy. The relatively good performance under the current program is setting the stage for a possible shift in 1996 to the use of an Extended Fund Facility, which would involve a three-year program with a focus on structural reforms.

Two aspects of structural reforms will be important. One is the completion of those actions that are needed for the creation of a viable market economy. The other is the encouragement of competitive forces within such an economy. With respect to market creation, the Government took important moves in 1995 to reduce the size of the state order system for agricultural goods and to eliminate its compulsory aspects. International trade was liberalized by removing the remaining foreign exchange restrictions on current transactions, including the mandatory surrender requirements, and by eliminating most administrative restrictions such as export quotas that were completely abolished in the first half of 1995. In the domestic market, entry into different sectors has been promoted through the replacement of most licensing requirements by a more transparent registration process. At the same time, exit procedures have been provided through a new Bankruptcy Law approved in April 1995. Of the unfinished agenda in market creation, particularly important will be enhancing the development of relatively efficient land markets through the completion of land reform.

The development of competitive markets is a significant challenge, requiring in particular the distribution of state assets, enterprise reform, and the creation of strong financial markets. Significant progress has been made in the distribution of state assets. By the beginning of 1995, approximately 20 percent of all small and medium state enterprises had been privatized and more than one third of the 2,500 agriculture farms or farm enterprises had been transferred to the private sector. Although privatization activities have often resulted in a change in formal ownership, neither the system of management nor the incentives for management behavior have changed. Enterprise reform will require the full restructuring and privatization or the liquidation of the remaining large state enterprises, the breakup of the large semi-privatized holding companies that exert monopolistic control over emerging markets, and the institution of hard budgets for remaining state and semi-privatized firms.

Some progress has been noted in the strengthening of the financial sector, and the development of institutions that can provide funds on commercial terms, encourage domestic resource mobilization, and facilitate domestic and international payments. By mid-1995, the private bank sector comprised approximately 150 banks. However, the majority of these are small establishments created mainly to get direct access to centralized credit resources. The prospects for these banks are problematic. They are burdened with nonperforming loans and have little institutional capacity to function in a commercial environment. The other banks are, however, not in much better condition; most institutions are technically insolvent and few have the institutional capacity to evaluate lending or borrowing on commercial terms.

The process of economic transformation has been accompanied by a widespread increase in poverty and a decline in the environmental resource base of the economy. The former is especially important in Kazakhstan where the needs of vulnerable groups such as the elderly poor or families headed by women may not be met given the rapid economic transformation. Environmental concerns are also important. Under the Soviet regime, natural resources were exploited in an environmentally unsound and unsustainable manner. Areas of ecological catastrophe are present throughout the country and include radiation contamination, increased flooding near the Caspian Sea, and desiccation and pollution of the Aral Sea. Checking pollution and safekeeping common resources will be necessary complementary activities for the development of a market system.

Kyrgyz Republic

From a position as a constituent entity within a continent-wide economy, the breakup of the Soviet Union brought to the Kyrgyz Republic the immediate need to function as an independent state. Faced with severe economic difficulties, the Government chose to restructure the economy on the basis of market institutions. These difficulties included the breakup of the interrepublican payment mechanisms; the loss of traditional markets in the FSU; the cessation of large transfers from the Central Government; a deterioration in the terms of trade; and hyperinflation which discouraged saving and investment. The period since independence has been characterized by immense social costs and a massive decline in GDP. However, substantial progress has been made by the Government in macroeconomic stabilization and structural reform and the creation of a market economy.

Recent Trends and Prospects

The economic disruption encountered by all FSU republics has been particularly severe for the Kyrgyz Republic. Real GDP fell by nearly 50 percent from 1991 to 1994. Further contraction of 6.2 percent occurred in 1995, more in industry than in agriculture. The decline in agricultural output in 1995 was restricted to 2.0 percent, much less than its 1994 level of 17 percent. There appeared to be some stabilization in the output of some important products such as milk and meat along with a shift toward industrial crops such as sugar beets, cotton, and oil seed, and to vegetables and cereals at the expense of wheat production. The latter is a generally positive development. Increased cultivation of wheat had come in the past few years as a result of government policies directed toward encouraging food security, irrespective of the underlying comparative advantage for the nation's farms. With the slow reestablishment of interrepublican trade and the spread of market-based incentives, farmers are moving toward a more efficient use of their resources. At the same time, the Government is withdrawing from administrative interference in the sector, most noticeably by the continued dismantling of the state order system.

Industrial output declined by 12.5 percent in 1995 as the Government continued to restrict credit to nonviable firms and to encourage industrial restructuring. Only about one fifth of all enterprises managed to increase production in 1995. The most severe impacts occurred in the heavy industry subsectors that had developed under the system of central planning as integral parts of the economy of the Soviet Union. With the collapse of that economy, the demand for the products of Kyrgyz heavy industry fell, both because of the decline in investment throughout the FSU and because of the collapse of the Soviet defense industry. In 1995, the output of the Kyrgyz machinery industry was less than one sixth of its 1990 level. The construction sector also suffered large declines in output, with the production of major building materials falling to between 25 percent and 50 percent of the already depressed 1994 levels.

The economic depression has had a profound impact on the country's labor markets.

The rigid Soviet economy was not only characterized by a lack of occupational choice, but also by security of job tenure. In 1991, nearly 80 percent of the working age population were employed and less than 200 people were officially registered as unemployed. By the end of 1995, registered unemployment was 100,000 or 6percent of the economically active population.

As the unemployment and GDP figures suggest, the social and economic costs of the transition period have been immense. Average incomes have fallen between one third to one half. A comprehensive survey on poverty in late 1993 suggested that 40 percent of all households were living below the poverty line. In 1995, the Government began to address the problem of increased poverty through better targeting of social assistance payments.

Data on investment and saving are sparse and unreliable; however, for 1993, gross domestic investment was estimated at 30 percent of GDP and gross domestic saving at 22 percent, leaving a gap of 8 percent of GDP to be met from foreign saving.

Problems in the Government's macroeconomic stabilization program are evident in the public sector (Figure 2.8). Most importantly, tax efforts lag behind program targets, resulting in a curtailment of needed public spending. As a result of the weak tax effort, total revenue, including grants, in 1995 was approximately 10 percent of GDP, nearly 15 percentage points below the budget target. Despite the lack of revenue, public spending grew to almost 22 percent of GDP in 1995, from 17 percent in 1994. Moreover, the overall budget deficit, including grants, rose to 11.4 percent of GDP in 1995, by over 3 percentage points from 1994. The Government is attempting to increase domestic revenue mobilization; however, given the current weak economy, there is unlikely to be any major increase in tax efforts in the next year.

The current level of public spending is too low to support economic development. As a result of the fiscal crisis, public sector infrastructure investment has been virtually nonexistent. Infrastructure facilities and equipment are going on without minimal operations and maintenance expenditures. Social spending, including social insurance, social assistance, and the provision of social services such as health and education, has also declined sharply in real terms.

There has been striking success in moderating inflation. Hyperinflation had characterized all the FSU economies in the ruble zone after the breakup of the Soviet Union. In the Kyrgyz Republic, in 1992 and 1993, inflation averaged about 1,000 percent. With the establishment of the national currency, the som, in mid-1993, the development of monetary control tools by the Central Bank, and substantial completion of price liberalization for most goods and services, inflation began to moderate. By the end of 1994, inflation had declined to under 100 percent and was estimated to be less than 50 percent in 1995.

Independence and the breakdown in the interrepublican payment mechanisms resulted in a virtual collapse in trade with other FSU economies. Improvements since 1992 have been reflected in rising levels of trade and in some diversification toward non-FSU markets. However, FSU markets still account for more than two thirds of Kyrgyz exports and imports. The Republic, located in the extreme corner of Central Asia, faces severe difficulties in developing new markets, especially in the industrial world. On balance, the Kyrgyz economy has been running a trade deficit, averaging close to $100 million in 1994 and 1995, about 10 percent of GDP.

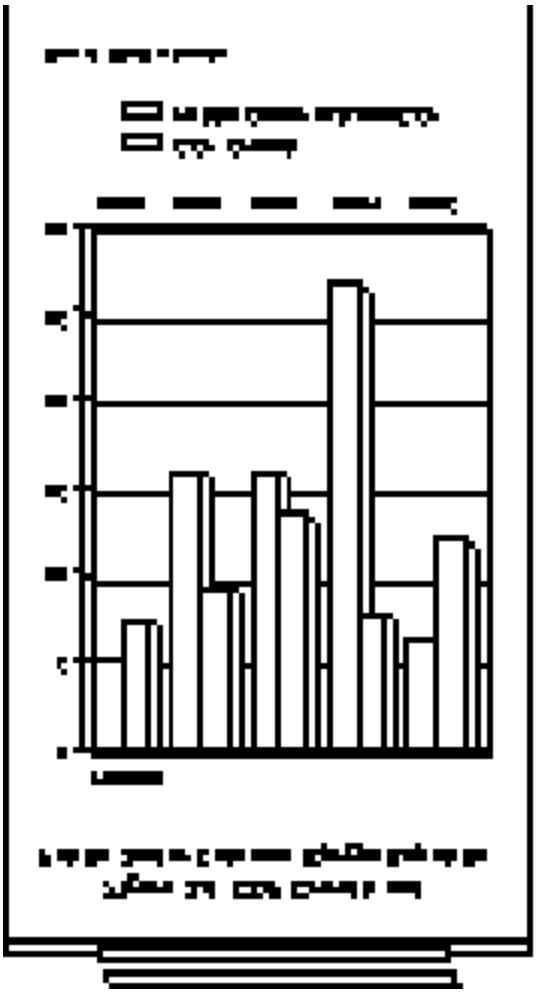
The current account deficit has been slightly smaller than the trade deficit, as private transfers out were offset by inflows of official transfers. The private outflows result from the substantial emigration of people from the Republic. Offsetting this, official transfers or grants-in-aid have provided considerable balance-of-payments support to the economy, averaging more than $70 million in 1994 and 1995. The net current account deficit was financed substantially by medium- and long-term loans from multilateral financial institutions and bilateral assistance programs.

The country's foreign debt at the end of 1995 was $535 million. A substantial portion of this resulted from the assumption of inter-enterprise arrears with other FSU states. The debt assumed was structured on commercial terms and scheduled for repayment between 1995 and 1999. The repayment of these obligations raised the debt-service ratio to nearly 25 percent during 1995, up from 5 percent in 1994. The sharp growth of debt service is worrisome. Under advice from the IMF, the Government is restricting its new borrowing largely to concessional funds;

the debt-service ratio should shrink as the commercial debt is repaid.

The Kyrgyz Republic has registered a continuous decline in GDP since independence. The formal sector of the economy is unlikely to show positive growth before 1997. Growth in the informal sector, however, could offset much of this continued decline. The Government estimates that the informal economy was 30 percent of GDP in 1994 and that it has been growing rapidly since 1990. If growth in the informal sector continues and the decline in the formal sector continues to moderate, then the economy as a whole could show positive growth by the end of 1996.

In 1996 and 1997, the Government is expected to work toward a reduction in the public sector budget deficit. Program targets call for a reduction from over 10 percent of GDP in 1995 to between 6 percent and 7 percent in 1996. This cannot be done without achieving at least modest increases in revenue as expenditures cannot easily be further reduced. Revenue then would have to increase to about 20 percent of GDP. This will not be an easy task.



The projection, even of a slow recovery, is highly sensitive to developments in the other Central Asian Republics and in the Russian Federation. Similarly, any slackening of growth in China would result in a fall-off of demand for raw material inputs and have repercussions for the Kyrgyz Republic. Even with the projected slow recovery, the current account balance will likely require $200 million in annual financing, the bulk of which will have to come from medium- and long-term lending by multilateral development institutions or from bilateral assistance programs.

Policy and Development Issues

The Government has continued its broad program involving structural reforms of the economy as well as its efforts toward macroeconomic stabilization. In 1995, considerable efforts were made to help create basic market institutions as well as to ensure that these markets develop in a workably competitive fashion. In agriculture, the state order system was restructured to eliminate the compulsory delivery and pricing aspects; future state orders will be conducted through market institutions. In international trade, measures were taken to support the development of international payment mechanisms. These included making the som a fully convertible currency in March 1995; phasing out most intergovernmental trade agreements, except for some energy trade; and eliminating most restrictions on international trade, such as export quotas.

The Government has made notable progress in enabling market institutions to allocate resources. There has, for example, been extensive privatization of state enterprises and nearly all price controls have been lifted. However, the unfinished areas of reform are still considerable. Among the more important areas requiring concerted government efforts are the completion of land reform and the distribution of land and farm assets; enterprise reform, including the full restructuring and privatization or the liquidation of the remaining large state enterprises; and a reduction in government direction of production and employment in semiprivatized enterprises.

Cambodia

In recent years, Cambodia has made good progress in strengthening its macroeconomic management. Although the balance-of-payments deficit remained large in 1995, external assistance and FDI inflows have more than filled the gap. The exchange rate has remained stable and official reserves have increased by more than projected. The fiscal reform framework enacted in 1994 has resulted in increased budgetary control, and preparatory steps have been taken to privatize public enterprise. Financial sector reform, however, has been slow.

Recent Trends and Prospects

Growth, Investment, and Employment. The rate of growth in real GDP in 1995 increased sharply to 7.5 percent from 4 percent in 1994. Agriculture is still the mainstay of the economy, accounting for nearly 50 percent of GDP in nominal terms and providing employment for the bulk of the country's labor force. Agricultural output, which had not risen in 1994, improved by 6.2 percent in 1995, led by an increase in rice production of 25 percent (Figure 2.9). Output of livestock and fisheries also improved relative to the 1994 levels, increasing by 4 percent in both subsectors. Rubber production grew rapidly at 15 percent following outstanding growth of 57 percent in 1994. Forestry output fell by 40 percent after the imposition of a log export ban early in the year.

The industry sector, whose share of GDP is relatively low at 19 percent, grew by nearly 10 percent in 1995 compared with 7.5 percent in 1994. Manufacturing and construction also increased at similar rates. The share of industrial production accounted for by state enterprises was about 50 percent; however, this share is falling, mainly because the vitality of the household and small-scale sectors has increased following economic liberalization.

Services sector output, which accounts for 37 percent of GDP, increased by 8 percent in 1995, somewhat higher than the rate of growth achieved in 1994. Wholesale and retail trade grew even faster at 8 percent, up from nearly 6 percent in 1994. Transport and communications and hotel and restaurant services also expanded rapidly as the economy attracted more foreign visitors and FDI.

Investment continued to accelerate in 1995 to nearly 22 percent of GDP from 14.3 percent in 1993 and 19.5 percent in 1994. Private sector investment, which responded to new incentives and increased political and economic stability, accounted for more than 70 percent of the total. The national savings rate, which had increased steadily from 8.3 percent of GDP in 1992 to 10.2 percent in 1994, mainly due to a reduction in public dissaving, remained at about 10 percent in 1995. Nevertheless, the savings-investment gap widened from 8.6 percent of GDP in 1993 to 11.6 percent in 1994 and 13.2 percent in 1995. Approximately half of the foreign savings inflow in 1995 was associated with the financing of the budget deficit.

Information on unemployment, underemployment, and poverty is incomplete. Although rising incomes and improved economic conditions have had the secondary effect of increasing employment opportunities,

Cambodia remains one of the poorest countries in the world.

In 1996 and 1997, the main objectives of public policy will be to increase the rate of real output growth to 7.5 percent; reduce the rate of inflation to 5 percent by 1997; improve the fiscal position by broadening the tax base with the aim of a sustainable increase in the revenue/GDP ratio; and strengthen the external position. The projected increase in output growth is based on agriculture sector growth of 5.2 percent in both 1996 and 1997 as a result of the expected return of normal weather patterns.

These projections assume strong expansion in the industry sector by 11.8 percent in 1996 and 9.8 percent in 1997, facilitated by the implementation of the Government's First Socio-economic Development Plan and improvements in the country's infrastructure. Thus, investment as a share of GDP is projected to rise gradually to 23 percent by 1997, mostly from an increase in private investment. To achieve this growth target, further progress in privatization will be important. Policies will continue to encourage the growth of the services sector, which has the potential to absorb surplus labor and to earn foreign exchange. The sector is forecast to grow by 8.2 percent in 1996 and 9 percent in 1997 as the economy continues to modernize and the demand for commercial and support services increases.

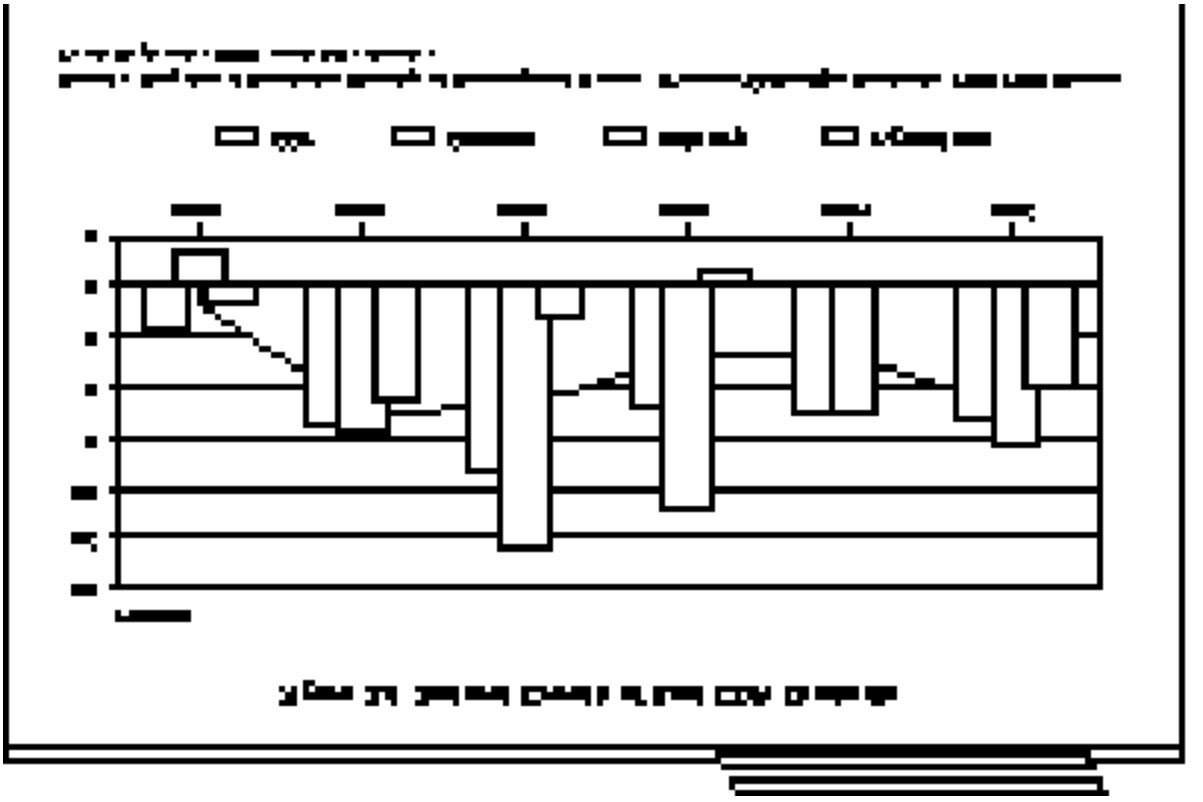
Budget, Money, and Prices. Government revenue in 1995 is expected to be lower than projected in the revised budget as a result of a shortfall in customs collections, partly coming from institutional weaknesses and the limited experience of customs agents. Expenditure control was tightened in 1995, notably with respect to operating expenditure and transfers to state-owned enterprises. Spending on defense and security, although significantly higher than envisaged in the initial budget for 1995, is projected to remain in line with the revised budget. The deficit in the recurrent budget for 1995 was 0.8 percent of GDP, somewhat lower than the revised budget target.

Table 2.7 Major Economic Indicators: Cambodia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	4.1	4.0	7.5	7.5	7.5
Agriculture	% change	-1.0	0.0	6.2	5.2	5.2
Industry	% change	13.1	7.5	9.5	11.8	9.8
Services	% change	7.2	7.5	8.0	8.2	9.0
Gross Domestic Investment	% of GDP	14.3	19.5	21.5	22.6	23.0
Gross Domestic Saving	% of GDP	5.7	7.9	8.3	10.1	11.5
Inflation Rate	% change in CPI	31.0	26.1	3.5	5.0	5.0
Money Supply Growth	% change	40.0	29.4	38.0	20.0	30.0
Merchandise Exports	$ million	283.6	472.0	735.0	657.8	649.9
	% change	7.2	66.4	55.7	-10.5	-1.2
Merchandise Imports	$ million	-471.0	-692.0	-1,052.0	-1,090.9	-1,125.8
	% change	6.2	46.9	52.0	3.7	3.2
Current Account Balance[a]	$ million	-251.0	-280.0	-378.0	-241.0	-272.0
	% of GDP	-8.6	-11.6	-13.2	-7.5	-7.5
External Debt Outstanding[b]	$ million	383.3	475.0	621.1	712.7	833.7

[a] Excluding official transfers. Data may differ from the series contained in the Statistical Appendix (see Statistical Notes).
[b] Refers to debt to the convertible area only.

Sources: Data collected from the Kingdom of Cambodia, Ministry of Planning and National Bank of Cambodia by EDRC for the Asian Development Bank *Annual Report 1995*; Ministry of Economy and Finance, *Economic Outlook for Cambodia, 1995–2000* (Phnom Penh, September 1995); and staff estimates.



Capital expenditure exceeded expectations, in large part as a result of more rapid disbursements of project-related external assistance. The overall deficit, which is all externally financed, is estimated at 7.1 percent of GDP, also below the budget target for 1995.

In 1995, liquidity growth accelerated to an annual rate of 38 percent compared with 30 percent targeted under the Economic Structural Adjustment Facility (ESAF). The substantially higher rate of expansion was reflected in a higher-than-anticipated increase in the net foreign asset position in the banking system. Net credit to the Government remained virtually unchanged; growth in credit to the private sector subsided after a large increase in the first quarter of the year, related in part to the prefinancing of log exports prior to the reimposition of the export ban. While some of the recent increase in liquidity could reflect a shift away from foreign cash in circulation to foreign currency deposits as confidence in the banking system increases, the majority of the increase in measured liquidity is more likely because of capital inflows. These flows represent a net addition to total liquidity and could, therefore, lead to intensified inflationary pressures.

Following a substantial decline during the first quarter of 1995, the CPI increased at an average monthly rate of nearly 2 percent until the autumn harvest again exerted downward pressure on prices. This resulted in an overall CPI increase for the year of about 3.5 percent.

The Government's fiscal position is expected to improve over the next two years as the tax/GDP ratio rises as a result of improved tax administration under the new tax system, reduced spending on defense and security, and reforms in the civil service system. The main objectives of fiscal policy in 1996 include a reduction in the reliance on external borrowing for current expenditure; a shift away from trade-related receipts toward domestic revenue sources; greater attention to the social sectors; and a broadening of the coverage of fiscal operations to reduce off-budget spending and improve transparency of budgetary transactions. The overall budget deficit is projected to be 7.4 percent of GDP in 1996 and 5.5 percent of GDP in 1997.

Inflation is projected to be maintained at about 5 percent in 1996 and 1997. This will require greater monetary control through blunt measures such as credit ceilings as well as progress in financial sector reforms, which

will increase the instruments of monetary control at the disposal of the Central Bank.

External Trade and Payments. The bulk of Cambodia's exports are primary products. Growth in total exports of 55.7 percent in 1995 was lower than in the previous year, mainly because of a rapid increase in reexports, which rose from $242 million in 1994 to $524 million in 1995.

While petroleum products, cement, and machinery continue to dominate imports, there has been a shift in the composition of total imports toward some consumer goods, notably motorcycles and automobiles. As a result, the trade deficit rose to 11.3 percent of GDP in 1995, and the current account deficit, including official transfers, to 5.4 percent of GDP.

The capital account balance was bolstered by a large increase in private capital inflows. FDI increased from $10 million in 1994 to $100 million in 1995, reflecting the international community's increasing confidence in the country's growth potential and market opportunities as well as recent streamlining of bureaucratic procedures under the new Investment Law. Official loan disbursements also rose in 1995 to $80 million from $61 million in 1994, reflecting continued dependence on large-scale financial assistance from official sources. The capital account recorded a net position of $159 million in 1995, largely offsetting the current account deficit (including official transfers) of $153 million. The overall balance registered a surplus of $6 million.

At the end of 1995, Cambodia's total debt stock in convertible currencies was estimated at $621 million or 22 percent of GDP, of which $427 million was long-term debt. Most long-term debt is owed to multilateral and bilateral creditors and is concessional.

Exports are projected to fall by 10.5 percent in 1996 and by a more moderate 1.2 percent in 1997. There are currently export restrictions on logs, sawn timber, gems, gold, silver, and antiquities; however, these restrictions will be reviewed during 1996. A ban on rice exports was lifted in March 1995. Imports are projected to grow gradually by 3.7 percent in 1996 and 3.2 percent in 1997. The Government intends to avoid rapid increases in imports through an aggregate demand management policy while further reducing import tariffs consistent with revenue objectives. The trade and current account deficits are projected to remain high as a percentage of GDP in 1996. The current account deficit, excluding official transfers, will be below 10 percent in 1996 and 1997. These deficits will be offset by capital inflows as official investment and FDI increase.

External debt outstanding is forecast to rise to around $713 million in 1996 and $834 million in 1997, of which long-term debt will be $476 million and $575 million, respectively. All long-term debt will be owed to multilateral and bilateral creditors and be concessional.

Policy and Development Issues

The Government's commitment to market-oriented policies has substantially improved the investment climate in recent years; therefore, continued growth of the economy can be expected over the medium term. However, to meet the growth targets of the Government's First Socio-economic Development Plan, Cambodia's economic performance will rely heavily on the availability of external financing. Economic performance will also depend on political and economic stability and on progress in overcoming bottlenecks in certain infrastructure services. Further progress in structural reforms, including public sector and financial sector reforms, will be crucial.

Given the current fiscal performance, diversification of tax sources and improvements in tax administration are necessary. It is critical that prudent fiscal policy be maintained to reduce the inflationary effect of government deficits financed through the banking system. Effective macroeconomic management over the longer term will require the further development of monetary control mechanisms such as reserve requirements, open market operations, and interest rate adjustments. The lack of banking networks in the rural areas must be addressed to increase savings mobilization. Most provincial branches have not been able to mobilize sufficient deposits to meet the demand for loans and have, therefore, continued to depend on borrowing from the Central Bank. The persistence of high balance-of-payments current account deficits points to the need for policies to improve the rate of domestic saving and thus reduce reliance on foreign saving, the flow of which can be adversely affected by external events.

Indonesia

The Indonesian economy continued to grow strongly in 1995 and, driven by strong private consumption and investment demand, can be expected to maintain that momentum over the next two years. As the economy is operating at a very high level of capacity, macroeconomic policy is critical to the maintenance of stable growth and to the avoidance of overheating. Although inflation shows signs of moderating, it remains high; and the current account deficit, which deteriorated in 1995, must be addressed in a timely manner.

It will be important to continue deregulation measures in 1996 and 1997 to increase competition and improve economic efficiency. A trade deregulation package, including tariff reductions and a schedule for further liberalization, was introduced in May 1995 and another in January 1996. However, less progress has been made in removing nontariff barriers in agriculture and in deregulation of domestic distribution. The drive for increased productivity and competitiveness requires improvements in the technological capabilities of the country's human resources as well as further reform of the present regulatory framework that imposes large, unnecessary costs on business.

Recent Trends and Prospects

Growth, Investment, and Employment. Economic growth in 1995 at 7.6 percent was slightly higher than in 1994. The agriculture sector recovered from the 1994 drought and grew at 2.5 percent. The industry sector, including infrastructure-related activities such as electricity and gas, continued to expand strongly at 10.6 percent, slightly lower than that experienced in 1994. Construction activity grew at a slower pace than in the previous two years because of an oversupply of apartments and commercial properties and rising interest rates. The services sector has usually grown in tandem with the overall economy; however, in 1995, the sector grew by only 6.7 percent because of a slowdown in the growth of banking services. Private sector consumption and investment expanded strongly in 1995; government consumption increased only modestly. Gross domestic investment in 1995 remained high at over 38 percent of GDP, while domestic saving increased to 36 percent of GDP.

Rapid economic growth over the past few years has contributed to growth in employment. Nevertheless, there is still considerable slack in the labor market. While the official unemployment rate is a modest 4.4 percent, the rate of underemployment remains high; nearly 45 million people work less than 35 hours per week. Progress in achieving full employment has also been slow because jobs for 2.7 million new entrants into the labor force must be created each year. Considerable progress has been made, however, in reducing poverty. The proportion of the population living below the poverty line in 1993 was 14 percent and the number of poor people has been reduced to about 26 million, from 70 million in 1970.

Minimum wage legislation has been strengthened in recent years. Mandated wage levels have been raised and coverage has been extended to most of the non-oil manufacturing

sectors and to some service industries. While this legislation has helped to raise living standards for those employed, care must be taken to ensure that the competitiveness of the dynamic labor-intensive manufacturing sector is not adversely affected.

Growth of the Indonesian economy in 1996 and 1997 is projected to be almost as strong as in 1995. Continued robust consumer demand and a high level of investment spending, especially for infrastructure development and export-oriented manufacturing, will help to sustain high growth. The investment boom is projected to add appreciably to productive capacity over the next two years. Net exports will make a modest contribution to GDP growth; import growth is expected to moderate and non-oil export growth will strengthen. The industry sector is projected to expand at 10 percent with a continued strong performance from manufacturing, telecommunications, and power generation. Oversupply of commercial real estate is likely to continue to restrain the construction sector. The services sector will experience growth in line with that of the economy, averaging at 7.5 percent for 1996 and 1997, with new services, especially in the financial and business sectors, making a large contribution.

Budget, Money, and Prices. The 1995 budget provided for a modest increase in expenditure of 2 percent in real terms. The budget reflected a commitment to decentralization, with increases in regional development expenditure and a larger share of land taxes being retained by underdeveloped regions such as those in Northeast Indonesia (Box 2.2). Continued emphasis on improving tax collection was reflected in a 26 percent rise in revenue from the value-added tax (VAT). The Government also continued to give priority to infrastructure development, which saw increasing involvement of the private sector. In terms of its effect on the economy, the budget was estimated to be slightly contractionary with a negative

Box 2.2 Northeast Indonesia: Development Through Regional Cooperation

Northeast (NE) Indonesia – comprising East Kalimantan, West Kalimantan, and North Sulawesi – is perhaps the most underdeveloped area of the country. More than half of the sparsely populated territory is covered by rain forest. Most of its residents are poor and are engaged in farming, forestry, or fisheries.

The marginalized socioeconomic conditions prevailing in NE Indonesia are in large part because recent development plans have directed proportionately greater resources to the development of the island of Java. To redress this deficiency and promote regional equity, the Indonesian Government in its latest national plan, *Repelita VI*, has accorded priority status to NE Indonesia in its economic and investment policies. A major strategy in this regard is the Government's promotion of economic cooperation with neighboring economies.

Indonesia is currently participating in regional economic cooperation ventures, such as the Indonesia-Malaysia-Singapore (IMS) and Indonesia-Malaysia-Thailand (IMT) growth triangles. These ventures exploit economic complementarities among geographically contiguous areas of the participating countries to gain a competitive edge in export production. Objectives are achieved through a combination of public sector policy interventions and incentives and private sector investments.

Drawing on these experiences with the objective of developing its remote northeastern provinces, the Indonesian Government agreed to participate in an initiative to explore potential areas of cooperation within the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA). A distinguishing feature of the BIMP-EAGA is that, with the exception of Brunei Darussalam, the state of development of the component subregions lags significantly behind that of the "heartlands" of their respective countries. Thus, in a sense, BIMP-EAGA may be one of the last "frontiers" of Southeast Asia, an unexplored periphery with vast potential still waiting to be tapped.

The development of NE Indonesia, however, largely depends on overcoming the constraints associated with the past neglect toward the subregion. These constraints include centralized development planning and control; limited local autonomy; weak infrastructure; tariff barriers and other protection measures leading to uncompetitive products; and rigid regulations and complex procedures in investment, banking, and even immigration.

domestic impact estimated at Indonesian rupiah (Rp) 5.4 trillion or 1.8 percent of GDP.

The monetary authorities have focused on managing monetary aggregates with a view to dealing with inflationary pressure and the effects of large inflows of international capital. Using open market operations in Bank Indonesia Certificates (SBIs) and money market securities (SBPUs), the authorities adopted an expansionary stance in response to capital outflows in the first two months of 1995 in the wake of the Mexican financial crisis. In contrast, a contractionary stance was adopted in June and July to offset large capital inflows resulting from widened spreads between domestic and international rates of interest. In September, monetary policy was again eased in response to devaluation rumors caused by nervousness associated with worsening of the current account deficit and falling interest rates. In response to increased capital flows, the Central Bank also adopted more flexible interest rate and exchange rate policies to enhance the effectiveness of money supply control. Interest rate targeting was abandoned in favor of auctioning a specified quantity of SBIs. This change in policy aimed to make the SBI rate, which is closely related to other domestic rates, adjust more quickly to changes in rates abroad. The exchange rate has also been used to stem speculative capital flows by gradually broadening the daily rupiah-dollar trading band to increase the cost of currency speculation. Further, to encourage the development of a domestic market for swaps and to insulate the foreign reserves held by Bank Indonesia from speculative pressures, the swap facility provided by Bank Indonesia was suspended.

The growth of narrow money (M1) slowed in 1995 to an estimated 14 percent compared with 23 percent in 1994, while broad money (M2) grew by about 24 percent. M1 growth was lower than targeted by the Government while M2 growth was higher than the Government's target of 19 percent and also higher than the rate of increase in the last four years. Despite the substantial slowdown in reserve money growth, M2 continues to expand as high interest rates still make it attractive for both domestic and international investors to place funds in interest-bearing instruments.

Although there was a slowdown in credit for property development, overall credit growth in 1995 rose by 23 percent as consumer demand remained buoyant. Credit by private domestic banks continued to rise but at a slower rate than in 1994. State banks also experienced an increased rate of credit expansion after sluggish growth in earlier years.

Inflation was relatively high in the early part of 1995 because of higher prices of rice and cement, and an increase in minimum wages. Thereafter, the growth in the CPI moderated; for 1995 as a whole inflation was 9.4 percent compared with 8.5 percent in 1994.

The draft budget for 1996 allows for a nominal rise in expenditure of 16 percent compared with budgeted expenditure in 1995. This increase is higher than in 1994 and 1995 when the nominal increases were 13 percent. Civil servants' salaries are to be increased by 19 percent and VAT revenues are projected to rise by 31 percent. It is expected that the recurrent budget will run at a surplus which could be spent on retiring government debt, especially high interest rate

To address these development issues and constraints, three major programs under the BIMP-EAGA scheme are being proposed by an ADB regional technical assistance study: (i) human resource development (HRD); (ii) infrastructure development; and (iii) development of productive sectors.

The proposed HRD initiatives focus on facilitating labor mobility, establishing and improving training centers, and improving working conditions. The short-run objective is to create a skill base that will support directly productive activities and will allow the private sector to realize the significant market opportunities to be generated in the BIMP-EAGA.

Initiatives for infrastructure development center on improving the existing system rather than on providing new facilities. The projects seek the deregulation of existing policies and the establishment of common sea and air transportation laws to enhance cross-border movements of goods, people, and information.

Finally, the initiative emphasizes the need to promote the development of productive sectors, specifically agriculture, fishing, forestry, and tourism.

Table 2.8 Major Economic Indicators: Indonesia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	7.3	7.5	7.6	7.8	7.7
Agriculture	% change	1.7	0.6	2.5	2.4	2.5
Industry	% change	9.8	11.2	10.6	10.0	10.1
Services	% change	7.4	7.0	6.7	7.7	7.2
Gross Domestic Investment	% of GDP	33.2	34.0	38.3	39.0	39.0
Gross Domestic Saving	% of GDP	35.3	35.3	36.0	37.4	38.5
Inflation Rate	% change in CPI	9.6	8.5	9.4	7.5	8.0
Money Supply Growth	% change	22.0	20.2	24.1	22.0	20.0
Merchandise Exports	$ billion	36.6	40.2	44.7	51.2	59.4
	% change	8.3	9.9	11.1	14.5	16.0
Merchandise Imports	$ billion	28.4	32.3	39.8	45.7	51.7
	% change	6.0	13.9	23.1	14.8	13.1
Current Account Balance	$ billion	-2.1	-2.8	-8.0	-9.2	-7.9
	% of GDP	-1.3	-1.6	-4.0	-3.8	-2.8
External Debt Outstanding	$ billion	89.5	96.5	104.0	108.0	111.0
Debt-Service Ratio	% of exports	33.8	30.0	33.7	33.0	32.0

Sources: Data provided by the Central Bureau of Statistics (Biro Pusat Statistik) of Indonesia and Center for Strategic and International Studies; International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

loans. Development expenditure is to be increased by a modest 12 percent in nominal terms. The overall impact of the budget on the economy is again expected to be slightly contractionary, about the same order of magnitude as in 1995; this does not provide a strong signal about the Government's commitment to cooling down the economy.

The overall inflation rate is projected to moderate somewhat to 7.5 percent in 1996 and 8 percent in 1997. With the prospect of a better harvest in 1996, food price increases are unlikely to have as strong an influence on the CPI as they had in 1995. However, other sources of inflationary pressure will be present. These include wage increases, such as the scheduled increase in minimum wages by 10 percent from April 1996 and the increase in civil servants' salaries, which could in turn put upward pressure on private sector wage rates. Also, increases in administered prices, such as for fuel and energy, are likely. In 1997, there will be continued pressures from strong private sector demand and, because of the election in that year, from a more expansionary fiscal stance by the Government.

The challenge faced by the Government to manage stable growth remains. Since fiscal policy cannot be expected to play a major role, monetary authorities will continue to develop instruments to ameliorate the impact of these on the money supply and economic activity in general. Credit growth is targeted to slow down to 16 percent, and narrow money (M1) supply to 15 percent. However, since interest rates can be expected to remain relatively high and given expectations of large capital inflows, the growth rate of broad money (M2) is likely to be higher at 22 percent in 1996 and 20 percent in 1997.

External Trade and Payments. The external balance deteriorated sharply in 1995, primarily as a result of an increase in imports of over 23 percent and a rise of close to 13 percent in the services deficit. As a result, the current account deficit was more than double that of 1994, up from about $3 billion to an estimated $8 billion, an increase from 1.6 percent of GDP to 4 percent. Export performance was strong, as both non-oil and oil exports increased at double-digit rates. Robust growth in exports of minerals, rubber, metals, and

electronic products helped to offset declines in plywood and coffee exports and the slow growth in the export of textiles and apparel. However, the increase in exports was more than outweighed by import growth. Although capital goods imports rose, consumer and intermediate goods accounted for most of the increase in imports. Imports of rice and other cereals accelerated as stocks were rebuilt; while imports of intermediate goods, which account for the bulk of total imports, surged to meet increasing domestic demand, particularly in the automobile industry. The widening of the services account deficit from $11.3 billion to $13 billion was due mainly to an increase in debt-servicing costs and appreciation of the yen.

Foreign investment approvals reached an all-time high in 1995, rising from $23.7 billion in 1994 to $39.9 billion, a 68 percent increase. However, almost half of this was in the petrochemical sector. The UK was the leading source of investment, surpassing Japan. Net foreign investment flows in 1995 were substantial at close to $6 billion, reflecting the high levels of investment approvals in 1994 (Figure 2.10). Other short-term borrowing and capital flows were close to $5 billion in 1995 compared with around $2 billion in the early years of the decade. Total official and non-official capital flows resulted in an estimated net capital inflow of $10 billion in 1995, sufficient to offset the current account deficit and add around $2 million to reserves, which at the end of the year reached $15 billion, equivalent to four-and-a-half months of imports.

The current account deficit in 1996 is likely to lower somewhat to 3.8 percent of GDP before falling further to 2.8 percent in 1997. Owing to the lag between investment and its effect on increasing production and export capacity, continued growth of capital goods imports will persist even as new exports are realized. Non-oil exports are expected to increase by around 19 percent over the next two years, while oil exports are not projected to increase much in view of rising domestic consumption and stable prices in the international markets. Import growth is expected to moderate to about 15 percent in 1996 and further to 13 percent in 1997. While the trade surplus will increase somewhat as export growth accelerates and import growth decreases, the services balance will continue to deteriorate. In sum, this will result in a current account deficit in 1996 of $9.2 billion or 3.8 percent of GDP, slightly lower than in 1995. In 1997, further improvement in the trade balance will bring about a modest decline in the current account deficit to $7.9 billion or 2.8 percent of GDP. The debt-service ratio is expected to remain at about 33 percent in both years.

Policy and Development Issues

The main challenge for macroeconomic policy in the next two years is to ensure growth with reasonable price stability and manageable fiscal and current account deficits.

Ensuring that productive and export-generating investments are made is a key component in reducing external imbalances. A transparent and competitive investment climate is needed so that investments and resources can be allocated efficiently and productively. This will entail, among other things, further deregulation and removal of impediments to private decision-making and resource use, streamlining of bureaucratic procedures, and ensuring more transparency in decision-making generally, but especially about large projects. Attention to the prioritization and phasing of large-scale infrastructure projects will be an important element of macroeconomic management. Such projects can have a significant impact on domestic demand and, as they are import intensive and do not lead to increased exports in the short run, they contribute to external imbalances.

Serious attention should also be focused on ensuring that export competitiveness is maintained and developed. This is important not only to preserve the country's growth momentum and competitive advantage but also to avoid a burgeoning of the current account deficit. Exports of new products, such as audio-visual equipment, electrical appliances, and footwear, are growing, although not as robustly as in previous years. Indonesia faces challenges in increasing its sources of competitiveness in the face of rising labor costs and lower labor productivity compared with other Asian economies. Maintaining a significant flow of FDI oriented toward export development is important in this context.

Management of large flows of capital is another critical issue which the monetary authorities will continue to face. Running a tight monetary policy with high interest rates

is the appropriate action when inflationary pressures are present. However, given that international rates are steady or falling, such a policy invites capital inflows which, in turn, need to be sterilized. Experience in 1995 indicates that these flows are very susceptible to external events such as the Mexican financial crisis and appreciation of the yen, and unfavorable perceptions of domestic policy changes.

Given that elections will be a preoccupation for the next two years, it may be more difficult for the Government to enact a contractionary fiscal policy to assist in macroeconomic management. However, the Government has indicated that it intends to reevaluate and prioritize government projects, streamline government procedures, and rationalize the civil service. Other than that, the potential for increasing tax collection by expanding the tax base and reducing leakages remains great. The ratio of tax revenue/GDP for Indonesia in 1994 was only 14.7 percent compared with Malaysia at 33 percent and Thailand and Singapore at over 17 percent each.

Over the next two years, increased tax revenues and proceeds of initial public offerings of shares of state-owned enterprises should be earmarked for funding long-term liabilities such as debt prepayments and civil servants' pension funds. At the same time, efforts to rationalize and improve the management of state-owned enterprises should also be undertaken to enhance their profitability and reduce their burden on the budget.

Since 1994, much progress has been made in trade and investment deregulation. Restrictions on foreign investment have been virtually eliminated and a major trade deregulation package announced in May 1995 included not only some immediate tariff reductions, but also set out a schedule for further tariff reductions over the next few years. Progress on the removal of existing nontariff barriers, however, has been disappointing. Although import licensing procedures for some products have been eased, major items such as soybean meal, automotive products, wheat, sugar, and rice are still closely regulated. Furthermore, there has been an increasing number of complaints over the last two years about lengthy customs clearance procedures and other inefficiencies which impede imports and raise business costs.

The main medium- and long-term challenge facing the Indonesian economy in the context of an increasingly competitive and open world economy is how to ensure efficient and productive investment, whether for the domestic or export market. Other than providing a consistent and transparent investment climate, a fair competitive environment also needs to be created, crucial physical infrastructure bottlenecks need to be alleviated, and human resource development to increase productivity needs to be emphasized.

Lao People's Democratic Republic

Despite flooding which had an adverse effect on agricultural output, overall economic growth remained strong in the Lao PDR in 1995, led by continued good performance of the industry and services sectors. There was, however, a slackening of fiscal and monetary discipline which resulted in an acceleration of inflation and weakening of the currency. These developments underscore the need to make further progress in macroeconomic management, particularly in prudent fiscal policy and control of monetary aggregates. These measures must be coupled with continued deepening of the financial system, development of instruments of monetary control, comprehensive tax reform, and liberalization of regulations so that the export base can expand and diversify.

Recent Trends and Prospects

Growth, Investment, and Employment. Growth of real GDP in 1995 at 7.1 percent was somewhat lower than in 1994, when GDP increased by over 8 percent. Nevertheless, the outturn was commendable in view of the poor performance by the agriculture sector, which was adversely affected by severe flooding resulting in output growing by only 4.9 percent in 1995 compared with 8.3 percent in 1994.

The transition from a centrally planned to a market economy has been very slow in the agriculture sector. Poor and limited transport infrastructure, undeveloped market systems, and declining fertility of soils in the uplands are serious constraints on development. In addition, the lack of a skilled work force and of a national research and extension system, together with the underdeveloped rural savings and credit systems, are constraints that have to be overcome before a transition to an efficient market system in agriculture can be achieved.

Industrial output grew at a double-digit rate for the third year in a row. The mining and construction sectors performed particularly well, with construction output increasing by 22 percent in 1995 following growth of over 11 percent in 1994. However, the larger manufacturing sector, including the nascent garment industry, small vehicle assembly, and other light industrial enterprises, was hampered by infrastructure bottlenecks and slow progress in privatization, and grew by only 7 percent in 1995, the same as in 1994. Limited infrastructure, which has permitted growing competition from imports in most regions accessible to border markets, and cautious private sector investment are some of the factors responsible for lower growth in manufacturing. During the past three years, progress in privatizing the remaining public enterprises has slowed, and divestiture has most frequently been limited to fixed-term lease contracts for operations only, without the sale of state assets. This practice has not encouraged confidence in the permanence of the privatization policy. Growth, even in the more dynamic manufacturing industries, has also to some degree been impeded by such factors as the high cost of imported inputs, high cost of transport, relatively higher taxes levied on import/export companies, and cumbersome customs procedures.

Services sector growth picked up to 8.5 percent in 1995 from 5.5 percent in 1994. Growth in hotel and restaurant services was particularly

strong; financial services output also improved on that in 1994. Growth in wholesale and retail trade, which claims the largest share of the services sector and accounts for over 8 percent of GDP, increased to 8.9 percent in 1995 from 7.9 percent in 1994. Public services, as indicated by the public sector wage bill, continued to decline, which reflects the Government's policy to reduce the size of government and shift services to the private sector.

Structural weaknesses in the economy are highlighted by the large imbalances between saving and investment. Estimates indicate that gross domestic saving has risen from 4 percent of GDP in 1990 to as much as 7 percent in 1995, reflecting some strengthening of confidence in the economy and the financial sector. Nevertheless, the resource gap remains wide, with the investment rate remaining at about 21 percent of GDP. Foreign resources continue to be relied upon to finance this gap.

While real per capita income has been growing at a fairly high average rate of 3.8 percent over the past six years, there has been less progress in rural areas where the economy is largely nonmonetized and rice deficiencies are common during years of poor harvests. As a result, there has been only limited progress in reducing poverty and increasing employment. Some unemployment is now appearing in the urban areas; this has affected young men in particular as many of the new firms in manufacturing preferred to recruit women. Concern has also arisen over the enforcement of labor standards as firms seek to reduce costs and extend hours.

Growth prospects for 1996 and 1997 will continue to depend on weather conditions since productivity increases in the nonagriculture sectors are not expected to be significant in the short term. GDP should continue to expand at 7–7.5 percent, and the share of agriculture will continue to decline slowly. Acceleration of industry and services sectors growth can be expected if financial sector reforms are not delayed, and if regulation of the private sector is further streamlined.

Budget, Money, and Prices. In the early 1990s, the Lao PDR improved its fiscal management, and the recurrent account deficit was reduced through tax reform measures and limitations on expenditure growth. While government revenue remains low compared with that in other developing economies in the Asian region, there were improvements in the revenue to GDP ratio – from under

Table 2.9 Major Economic Indicators: Lao PDR

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	5.9	8.1	7.1	7.5	7.0
Agriculture	% change	2.7	8.3	4.9	5.4	4.2
Industry	% change	10.3	10.7	11.4	11.0	11.3
Services	% change	7.7	5.5	8.5	9.0	9.0
Inflation Rate	% change in CPI	6.3	6.7	19.4	13.8	5.8
Money Supply Growth	% change	64.6	31.9	16.6	16.6	16.6
Merchandise Exports	$ million	240.5	300.4	347.9	385.0	419.0
	% change	81.3	24.9	15.8	10.6	8.9
Merchandise Imports	$ million	431.9	564.1	589.2	678.0	737.0
	% change	62.7	30.6	4.1	15.5	8.7
Current Account Balance[a]	$ million	-146.1	-231.0	-201.0	-256.0	-278.0
	% of GDP	-11.0	-15.0	-11.4	-13.9	-13.3
External Debt Outstanding[b]	$ million	495.3	579.6	677.6	802.0	039.0
Debt Service Ratio	% of exports	4.2	3.4	4.8	5.4	7.0

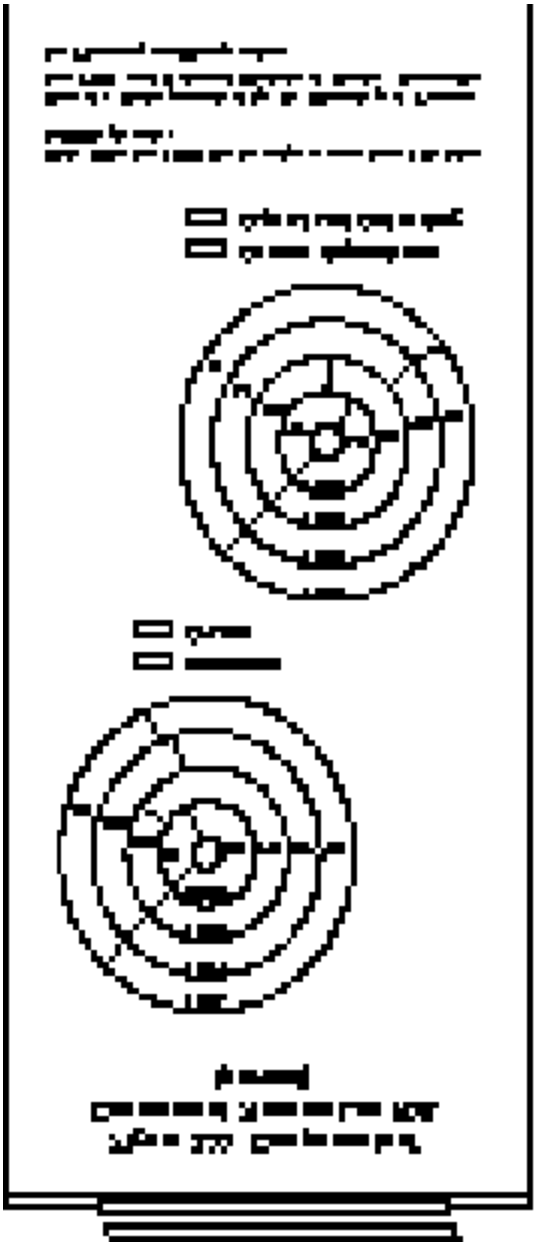
[a] Excluding official transfers.
[b] Refers to debt to the convertible area only. Data may differ from the series contained in the Statistical Appendix.

Sources: Data provided by the Government of the Lao People's Democratic Republic; and staff estimates.

10 percent in 1990 to over 12 percent in 1995 – due to improved tax administration procedures. Revenue began covering current expenditures in 1993 (Figure 2.11). However, capital spending, which is still financed primarily by external grants or borrowing, increased from 7 percent of GDP in 1993 to over 11 percent of GDP in 1995 as the need to improve the physical and human resource infrastructure led to an expansion in the public investment program.

Over the past few years, the money supply has grown rapidly as the monetization of the economy deepened. There has been rapid growth in private sector credit and a large increase in net foreign assets. Deposits in commercial banks have swelled enormously, from kip (KN) 25.8 billion in 1990 to over KN140.0 billion in 1995, reflecting increasing confidence in the banking and financial system. However, to some extent, the increase in the money supply also reflected inadequacies in monetary policy, particularly the inability to offset foreign capital inflows through open market operations and to control the growth of credit to the private sector. The relatively more expansive monetary and fiscal policies played a role in the 1995 inflation, as prices rose sharply compared with experience in previous years. As inflation accelerated, real interest rates fell and bank deposit levels declined. The Central Bank experienced considerable difficulty in influencing the market because of limited linkages between Treasury bills, the commercial banks' liquidity management, and interest rates. Ultimately, it resorted to direct credit controls to reduce the rate of money supply growth.

To improve the effectiveness of monetary policy, a number of new monetary instruments have recently been put in place. Starting in March 1994, open market instruments in the form of Treasury bills have been issued and made negotiable, with auctions held each month. Government bonds of various maturities have also been issued. A discount window replaced the credit window in 1994, and the Central Bank is now using penalty discount rates, which will help to build up the interbank market. Despite the introduction of these instruments, secondary market activity is still rudimentary; banks have only recently begun to trade these instruments, while at the same time there are not enough instruments to make a robust market.



Measured by the consumer price index in Vientiane, inflation increased sharply from 6.7 percent in 1994 to 19.4 percent in 1995. The rate of monetary expansion exceeded the demand for liquidity. Shortages in construction materials and services, combined with supply shocks in the food sector following the floods and higher import prices as a result of currency depreciation, also contributed to inflationary pressure.

The budget for 1996 proposes to curb fiscal expansion by reducing the overall deficit to within 9 percent of GDP. Revenue improvements are expected to increase the revenue/GDP ratio by a further 2.5 percent

of GDP. Improvements in the instruments of monetary control should enable money supply to be maintained at its 1995 level of 16.6 percent, thereby enabling the rate of inflation to be contained to 13.8 percent in 1996 and further to 5.8 percent in 1997.

External Trade and Payments. Although the balance-of-payments position initially strengthened in the early 1990s, there was a deterioration in 1994. In response to trade liberalization measures and other structural reforms, merchandise exports increased between 1990 and 1993 by an average annual rate of about 40 percent. However, export growth slowed down to 25 percent in 1994; and further to 15.8 percent in 1995 mainly because exports of forest products, which in the recent past have comprised about 30 percent of total exports, declined. Exports of motorcycles also declined. Exports of garments increased in 1995 at a faster pace than in 1994; while manufactures and especially coffee showed strong gains. Import growth in 1994 at 30.6 percent was half its 1993 level; it contracted even further to 4.1 percent in 1995. Imports of consumption goods slowed down to only 3 percent in 1995 while imports of investment goods rose by some 29.5 percent. With exports increasing more than imports, the trade deficit improved from 17 percent of GDP in 1994 to 13.6 percent in 1995. With a positive balance on the services account in both years, especially for travel, transportation, and embassy expenditures, the current account deficit (excluding official transfers) was 11.4 percent of GDP in 1995 compared with 15 percent in 1994. Official transfers and capital movements resulted in an overall balance-of-payments surplus of 0.8 percent of GDP in 1995 compared with a deficit of 0.8 percent in the previous year. Gross foreign reserves increased to almost four months of import cover in 1995 from over three-and-a-quarter months in 1994.

The country's medium- and long-term external hard currency debt was $677.6 million or 37.5 percent of GDP by the end of 1994 and was projected at $635 million at the end of 1995. As most debt is at concessional rates, the debt-service ratio is low, at about 4.8 percent of exports of goods and services in 1995.

Improvement in the regulatory environment will affect export potential, fostering more rapid expansion of light manufacturing and commercial agriculture which, in turn, will generate employment in some urban areas. Urban economic activity will continue to fuel imports of consumer and investment goods. With import growth expected to exceed the expansion of export capability, the current account deficit is expected to widen to 13.9 percent of GDP in 1996 but to fall slightly to 13.3 percent in 1997. However, as most of this will be financed by concessional lending, debt service can be expected to remain below 4 percent of exports of goods and services.

Policy and Development Issues

While substantial achievements have been made over the past decade, much remains to be done. Improvements made in the fiscal area need to be consolidated through comprehensive tax reforms. Public saving must be increased to allow a higher share of the budget to go to physical infrastructure and human resource development and, at the same time, public sector investment must become more efficient. The restructuring of the industry sector remains a reform challenge, requiring further privatization of the remaining state-owned enterprises. More rapid industrial expansion hinges on a renewed commitment to allow the private sector to grow without arbitrary restrictions. Further liberalization of regulations to expand and diversify the export base is also needed. Factor markets need to be reformed to improve efficiency. This is particularly true in agriculture, where product markets would also benefit from fuller decontrol paired with infrastructure support. A comprehensive reform program for agriculture is needed to speed up the present slow economic development outside the urban areas. In the financial sector, measures already taken should be developed further to improve the working of the market so that the Government can conduct its monetary policy through open-market operations. Strengthening of the financial system will also help to improve domestic resource mobilization, and elaboration of the legal system will promote confidence among investors as well as consumers. Much of the weakness in the economy reflects the weak human resource base and lack of institutions; efforts must continue to build the management skills and institutions required to increase absorptive capacity.

Malaysia

The Malaysian economy continued to grow rapidly in 1995. The effectiveness of the macroeconomic management of the economy is reflected in the high growth rate, with price stability, achieved since the economic boom began in 1988. The medium-term outlook for the economy remains positive; strong domestic demand and continued outstanding export performance should sustain the rate of growth. The high rate of economic growth and existing low level of unemployment will exert upward pressure on the price level; however, tight monetary policy and reductions in import duties should help contain inflation. The current account deficit, while increasing in absolute terms, is likely to decline as a proportion of GDP over the next two years, and it can be financed easily with continued strong inflows of FDI.

Recent Trends and Prospects

Growth, Investment, and Employment. In 1995, GDP grew by 9.3 percent. As in the past, the manufacturing sector and export expansion continued to be the driving forces, aided in 1995 by a turnaround in agriculture and mining.

Growth in the agriculture sector recovered to over 4 percent in 1995. The high commodity prices prevailing in 1994 and 1995 induced a large increase in the production of palm oil and rubber, the two commodities which together account for over 70 percent of the cropped area in Malaysia. The increase in palm oil production was also aided by recovery from tree stress which affected output in 1994, and the coming into maturity of additional areas. However, owing to continuing labor shortages in agriculture, growth in production of most other crops, livestock, and fishing slowed further. Also, sawlog output continued to decline in line with the Government's policy of promoting sustainable forest resource management. The increase in production in Sarawak and Sabah was more than offset by the reduction in output in Peninsular Malaysia.

Industrial production increased by over 13 percent in 1995. Output in the mining sector, where oil and gas production account for about 80 percent of the total, expanded sharply. The production of crude oil increased by 5.2 percent, largely because of the coming-on-stream of a new oil field off Sarawak in early 1995; and gas output increased by 24 percent in response to continued strong growth in demand and expansion in the natural gas processing and distribution system. However, tin-in-concentrate production declined for the sixth consecutive year and is now less than 20 percent of what it was in 1989.

Manufacturing growth was still high at 13 percent in 1995. Production in the electrical and electronics sector, which is by far the largest industry in Malaysia, grew by 24 percent, driven largely by strong external demand. Other important industries with improved growth performance in 1995 were transport equipment, iron and steel, fabricated metal products, and petroleum products. The higher growth in these industries reflected increased capacity and strong domestic demand, particularly for passenger cars and construction materials. However, the performance of the textile and apparel industry was disappointing. Growth in the production

Table 2.10 Major Economic Indicators: Malaysia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	8.3	9.2	9.3	8.5	8.0
Agriculture	% change	4.3	-1.0	4.1	2.8	2.6
Industry	% change	10.1	12.4	13.1	11.5	10.8
Services	% change	8.1	9.9	7.0	6.9	6.3
Gross Domestic Investment	% of GDP	35.1	38.7	40.6	41.0	41.5
Gross Domestic Saving	% of GDP	35.4	37.6	37.2	37.5	38.0
Inflation Rate	% change in CPI	3.6	3.7	3.4	3.7	4.0
Money Supply Growth	% change	22.1	14.7	22.8	16.0	17.0
Merchandise Exports	$ billion	46.2	56.9	72.1	85.4	99.5
	% change	16.1	23.1	26.6	18.5	16.5
Merchandise Imports	$ billion	43.2	55.3	72.3	85.3	99.0
	% change	17.8	28.1	30.6	18.0	16.0
Current Account Balance	$ billion	-2.8	-4.1	-7.6	-7.7	-7.5
	% of GDP	-4.5	-5.9	-8.9	-8.0	-7.0
External Debt Outstanding	$ billion	23.3	24.8	27.0	29.0	31.0
Debt-Service Ratio	% of exports	7.8	7.7	6.0	6.0	6.0

Sources: Government of Malaysia, Ministry of Finance, *Economic Report 1995/1996* (Kuala Lumpur, 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

of textiles moderated in 1995, while output of the apparel industry declined in the face of increasing competition from labor-abundant countries.

Growth in the construction sector accelerated to 15.2 percent in 1995. Rapid urbanization and rising disposable incomes continued to generate a growing demand for housing, as well as for retail space. At the same time, high rates of investment in the manufacturing sector generated demand for factory premises and industrial buildings, while rapid growth in tourism promoted the construction of new hotels, theme parks, and other tourism-related facilities. Growth in the construction sector was also boosted by the large number of major infrastructure projects being implemented.

The services sector expanded by 7 percent in 1995, substantially below the 1994 growth rate of about 10 percent. The slowdown was largely the result of a fall in the growth rate of government services, which is an indicator of the success of the official policy of downsizing the public sector. The financial services and transport and communications sectors maintained double-digit growth rates.

While Malaysia is considered to be a model of export-oriented growth, in an accounting sense, its recent growth has been driven primarily by domestic demand, as the net contribution of the external sector to aggregate demand has been negative in seven of the past eight years. The reason for the seeming contradiction between the popular perception about Malaysia's recent economic growth, on the one hand, and that shown by analysis of components of demand, on the other, is that a large proportion of the investment component in domestic demand is FDI financed by foreign investors themselves. This investment increases imports of machinery and equipment and thus adds to the current account deficit; however, at the same time, it provides the financing both for their imports and for the deficit. This factor must be kept in mind in any analysis of aggregate demand, the savings-investment gap, and the balance-of-payments deficit of Malaysia.

In 1995, growth in domestic demand of about 15 percent again substantially exceeded growth in GDP. Rising levels of per capita income, cuts in personal income taxes, and

easy availability of consumer credit stimulated private consumption, the growth rate of which almost doubled to 13.7 percent in 1995. Both public and private investment continued to expand rapidly, buoyed by increases in infrastructure spending, housing starts, and FDI.

The expansion in fixed capital formation resulted in an increase in the investment rate to 40.6 percent of GDP, the highest level ever achieved by Malaysia. However, the gross domestic savings rate declined slightly to 37.2 percent of GDP because of a sharp fall in public sector saving resulting from stagnation in federal government revenues. Consequently, the savings-investment gap widened further and was met through increased FDI inflows and external borrowing by some public enterprises.

Rapid economic growth continued to generate new jobs in significant numbers and the unemployment rate declined further to 2.8 percent of the labor force in 1995. Most of the new jobs were in construction, manufacturing, and the trade, hotels, and restaurants sectors. The employment share of agriculture and government services declined further to about 19 percent and 11 percent of total employment, respectively. Labor shortages are now widespread in both skilled and unskilled occupations; this is reflected in the high incidence of worker turnover in all sectors of the economy. To alleviate the shortage of skilled labor, the coverage of the Human Resource Development Fund was extended to more employers and industries in the services sector. In addition, existing private technical training institutions were given tax incentives to upgrade their facilities, and legislation aimed at promoting technical and higher education was enacted.

The growth rate of the Malaysian economy is expected to slow down to 8.5 percent in 1996 and to 8 percent in 1997. Agriculture sector growth is likely to be lower because of perennial labor shortages and a decline in commodity prices from the unusually high levels reached in 1995. Sawlog production will be reduced further in line with government policy. Growth of industrial output will continue to be strong although somewhat slower than in 1995, as recent measures to tighten consumer credit begin to affect sales of consumer durables. Expansion in the services sector is also expected to moderate.

Strong domestic demand – both consumption and investment – and sustained exports will provide the impetus for growth. The ongoing massive infrastructure investment program is likely to boost the gross domestic investment rate further to 41 percent of GDP in 1996. Some recovery in public saving should raise the overall savings rate to 37.5 percent of GDP, and thus maintain the savings-investment gap at about the same level as in 1995. As a consequence of strong growth, pressure in the labor market is unlikely to ease and, with the unemployment rate declining to 2.7 percent by 1997, labor shortages will continue to be felt in most sectors.

Budget, Money, and Prices. There was some loosening of fiscal policy in 1995. The Federal Government's operating and development expenditures rose by 9 percent and 15 percent, respectively. Government revenue, however, increased by only 2 percent because of cuts in income and corporate taxes and excise and import duties. As a result, the budget surplus declined to 0.3 percent of GDP from 2.4 percent in 1994. The fiscal impact of the overall public sector (i.e., including public enterprises) was, however, expansionary in 1995. This was largely because of a 32 percent increase in capital expenditure by public enterprises, primarily in the telecommunications, power, and oil and gas sectors. As a result, while total public revenue remained virtually constant, operating expenditure increased by 10 percent and development expenditure by 28 percent. Thus, an overall public sector surplus of 1.8 percent of GDP in 1994 was followed by a deficit of 3.5 percent in 1995.

The Central Bank followed a policy of monetary restraint in 1995. Bank Negara used open market operations, including direct money market borrowing and the issue of Bank Negara Bills complemented by generally higher interest rates, to reduce excess liquidity. At the end of 1995, interbank and deposit rates in Malaysia were about 150 basis points higher than a year earlier, while the base lending rate (BLR) was about 100 basis points higher. In November 1995, Bank Negara introduced a new framework for calculating the BLR by commercial banks to make the lending rates more responsive to the Central Bank's interventions in the money market. Despite the tight monetary policy, growth of narrow money (M1) was virtually unchanged, while that of the broader monetary aggregates increased sharply. In 1995, M2 and M3

both grew by over 20 percent. This was almost entirely because of the 23 percent expansion in credit to the private sector, as private investment and expenditure on consumer durables accelerated.

Malaysia continued to enjoy relative price stability in 1995 despite the expansionary public sector position, high GDP growth rate, and tight labor market. Inflation (as measured by the consumer price index) at 3.4 percent was down slightly from the 3.7 percent recorded in 1994. Important factors contributing to the price stability were the Government's monetary restraint and import liberalization policies. In recent years, Malaysia has followed a policy of reducing inflationary pressure by cutting tariffs and thereby reducing import prices. The success of this policy can be seen from the fact that, while the producer price index (PPI) for local production increased by 9percent in 1995, the PPI for imports declined by 1 percent (Figure 2.12). The Figure also indicates that there may be some basis for the widely held view that the CPI is not a good measure of inflation in Malaysia, as a substantial proportion of the items included in it are at government-controlled prices. From the Figure it can be seen that, while other price indexes show considerable fluctuations in inflation from year to year, the CPI is virtually a straight line with a slight downward slope. Moreover, the other price indexes show increasing inflationary pressure in the economy since 1993, kept only partially in check by declining domestic prices of imported goods. This is what would be expected in a period of high GDP growth with full employment, acceleration in the growth of money supply, and an expansionary public sector position.

The 1996 federal budget proposes an increase of 7.6 percent (two thirds of it because of salary revision) in operating expenditure and an 8.7 percent increase in development expenditure. A buoyant economy should ensure a healthy increase in revenues, which were projected to grow by 8 percent. However, actual revenue growth is likely to be smaller than this because of a reduction in personal income tax rates, tariffs, and excise duties proposed in the budget, and only a small surplus is expected in 1996. The Government announced a number of specifically targeted fiscal and other measures in the budget. To promote saving, the contribution by employees to the Employees Provident Fund (EPF) and the maximum deduction allowed (for income tax purposes) for contributions by employers to EPF and other approved savings schemes were increased. Both the minimum monthly payment on credit cards and the road tax for luxury cars were increased as a means of curbing consumption. Import duties and/or sales tax on more than 1,500 items – including 800 items of raw materials, intermediate goods, and equipment – were abolished or reduced, the aim being to reduce business costs, increase competition, and curb inflationary pressure. To control the growing deficit on the services account of the balance of payments, the coverage of fiscal incentives was expanded to include investment in service industries such as communications, public utilities, and transportation.

It is expected that the Central Bank will continue with its tight monetary policy for the foreseeable future. Bank Negara made its intentions clear in this regard by raising the financial institution's statutory reserve requirements by 1 percentage point to 12.5 percent in early 1996. However, Bank Negara will have to be careful not to repeat the mistakes of 1993, when tight monetary policies and the accompanying higher interest rates resulted in massive short-term capital inflows. These in turn led to problems of monetary control and accumulation of huge losses by the Central Bank on its sterilization operations and in the management of excess foreign exchange reserves. This is a real danger because in 1996, as in 1993, Malaysian interest rates are rising, while international interest rates are declining. The strong domestic demand and the high rate of growth with full employment will ensure continuing inflationary pressure. However, budgetary restraint, tight monetary policy, and import duty reductions should help contain the rate of inflation, which (as measured by the CPI) is expected to increase only slightly over the next two years.

External Trade and Payments. Capacity expansion in the manufacturing sector and higher prices of Malaysia's major agriculture exports resulted in further improvement on the strong export performance of 1994. In value terms, exports grew by about 27 percent in 1995, with manufactured exports increasing by 28 percent. Agriculture and mineral export earnings also recovered because of higher export unit values as well as increased volumes

of palm oil, natural rubber, crude oil, and liquefied natural gas.

The growth in manufactured exports was led by electrical and electronic products, which accounted for about 65 percent of Malaysia's manufactured exports. All subsectors had strong growth, with exports of electronic components (semiconductors) increasing by 31 percent, consumer electronics (audio and video recorders, radios, and televisions) by 36 percent, and cables and wires by 35 percent. The second largest foreign exchange earner was the chemicals industry, exports of which increased by over 50 percent in 1995 as new capacity continued to come on stream. However, the export performance of the textiles, apparel, and footwear industries continued to be mixed, with new capacity resulting in an increase of over 35 percent in exports of textile yarns and fabrics, while exports of apparel and footwear either stagnated or declined. Because of rising wages, Malaysia is rapidly losing its competitiveness in labor-intensive industries such as garments and footwear.

Import liberalization and strong domestic demand resulted in acceleration of import growth to 31 percent in 1995. With imports expanding faster than exports, the merchandise trade account moved into a deficit for the first time since 1982. On the services account, large deficits have been incurred on a regular basis, mainly because of substantial outflows of FDI earnings and freight and insurance payments. In 1995, gross outflows in these two categories were $6 billion and $4.5 billion, respectively; the services account deficit increased significantly in value terms, although as a proportion of GDP it remained at about 8.5 percent. However, deterioration in the trade account resulted in a widening of the current account deficit to 8.9 percent of GDP in 1995 from 5.9 percent in 1994.

A significant proportion of the profits and dividends shown as outflows on the services account are actually reinvested in Malaysia and thus appear as investment on the capital account. Net corporate investment increased to $5.9 billion in 1995 which, together with a net inflow of $1.5 billion of official long-term capital (mainly borrowing by public enterprises), was sufficient to cover the deficit on the current account. Thus, the basic balance, as in the past, remained in surplus; foreign exchange reserves at $27 billion exceeded external debt, and the debt-service

ratio, at about 6 percent of export earnings, continued to be very manageable.

Exports of electrical and electronic products, Malaysia's largest export earner, should continue to grow strongly, given buoyant world demand; and this should help sustain growth in manufactured exports at recent high levels. However, possible softening of prices of major agricultural commodities, such as rubber, palm oil, and sawlogs, as well as prices of crude oil and natural gas, could result in a deceleration in the rate of growth of merchandise exports. In line with the slower output growth in the manufacturing sector and because of a sharp decline in imports of large items such as commercial aircraft by Malaysian Airlines and ships by the Malaysian Shipping Corporation, total merchandise imports are also expected to increase at a slower rate. Moreover, the growth in exports should exceed that for imports, resulting in the reemergence of a small trade surplus. The deficit on the services account is likely to increase only marginally and, therefore, the deficit on the current account of the balance of payments as a proportion of GDP is expected to decline somewhat. The deficit will be financed primarily by FDI. External borrowing by public enterprises is expected to be less than in 1995. Malaysia will maintain its current comfortable international reserves position, although large short-term capital inflows, because of favorable interest rate differentials, could boost these considerably.

Policy and Development Issues

During the past eight years, the Malaysian economy has outperformed many other economies in Asia. Growth has been outward oriented with Malaysia having one of the most open trade regimes in the region. The Government has also pursued an ambitious privatization program and Malaysia has probably gone further than any other country in Asia toward the private provision of infrastructure services. Downsizing of the government sector and a prudent fiscal policy have resulted in federal budget surpluses for the last three years. Political and macroeconomic stability, good infrastructure, and private sector-oriented government policies have attracted large amounts of FDI and short-term capital, resulting in accumulation of substantial international reserves.

While the economy is being managed effectively and doing extremely well, shortages of skilled and technical human resources could adversely affect Malaysia's export-oriented growth over the medium term. Malaysia has been successful in delivering general education at the primary and the secondary level. However, the country's tertiary school enrollment rates lag behind those of its neighbors. Also, while the rate of labor force participation by women has increased, it is still significantly below the participation rate for men. With Malaysia having achieved virtual full employment, it is likely that opportunities for the participation of women in the labor force will increase. The extent to which women are able to take advantage of these opportunities, however, will depend on how well their education and skill levels match the emerging employment opportunities. Thus, the expansion of the tertiary education system in Malaysia, particularly for women in technical and scientific education, is necessary. The Government is well aware of this, and legislation has been enacted to encourage the private sector to enter the field of tertiary education to upgrade Malaysia's human resources. Expanding the domestic supply of high-level skills will also help to deal with the problem of the growing deficit on the services account of the balance of payments.

An emerging economic issue in Malaysia is growing regional imbalance. Malaysia has made rapid progress in reducing poverty over the last two decades, with the incidence of poverty declining from about 60 percent in 1970 to about 9 percent in 1995. This is an impressive record by any standard, and more so because the official poverty line in Malaysia is liberal by international comparison. However, poverty reduction has been uneven geographically; most of the country's industrial development has been concentrated in the western corridor from Penang in the north to Johor in the south. The Government is encouraging development of the lagging regions of the country by providing fiscal incentives, improving road links along the east coast of the Peninsula, and promoting subregional cooperation arrangements, such as the Indonesia-Malaysia-Thailand growth triangle in the north and the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) for Sabah and Sarawak in East Malaysia.

Myanmar

Myanmar recorded another year of buoyant growth in 1995. However, poor infrastructure, an overvalued exchange rate, and scarcity of capital remain the major bottlenecks for sustaining high growth. The flow of external assistance and foreign private capital is still limited, as foreign investors and donors are waiting to see further progress in economic and political reforms. On a more positive note, further reform measures were introduced in the move toward a market economy and Myanmar now has observer status in ASEAN.

Recent Trends and Prospects

Real GDP is estimated to have risen by over 7.5 percent in 1995 following growth of 6.8 percent in 1994. Agriculture, which is still the single largest sector, grew by 7.3 percent, though this estimate must be treated with caution in view of serious index number and other data problems. Industry grew by 11.4 percent, the fastest growth being recorded in mining, including oil and gas. Mining grew by over 18 percent, largely with the help of foreign investment. Construction activity was also brisk in 1995, driven by the rapid increase of tourism and transportation, the two fastest-growing service sectors.

Gross domestic investment was 13 percent of GDP in 1995 while gross domestic saving was marginally lower at 12.2 percent, leaving a small domestic savings-investment gap. While investment has recovered in recent years compared to the crisis years of the late 1980s, mainly in response to the recent market-oriented reforms and greater openness of the economy, it is still well below the average level of about 19 percent achieved in the early 1980s. The current investment rate is too low to provide for expansion of infrastructure at the pace necessary to sustain the high rates of growth achieved in recent years. Also, much of the recent increase in investment has come from the private sector with public investment continuing to fall in real terms. Following enactment of the Foreign Investment Law in 1988, which was designed to encourage the inflow of foreign capital, foreign investment projects of over $3 billion had been approved in the period up to mid-1995. However, the range of approved projects was rather limited; over two thirds were in the oil and gas industry and hotels and tourist facilities. Also, much of the approved investment has yet to be realized.

Of the estimated population of about 25 million persons in the working age group 15–59, only 17 million were employed. The difference is shared between those not in the work force and those who are unemployed or underemployed. Although reliable underemployment and unemployment data are not available, limited surveys suggest that the incidence of unemployment is still high.

Reducing the fiscal deficit has been an important goal of the ongoing reforms in Myanmar. The deficit was reduced to less than 1.4 percent of GDP by 1993 compared with around 6 percent in the late 1980s. However, this compression was achieved

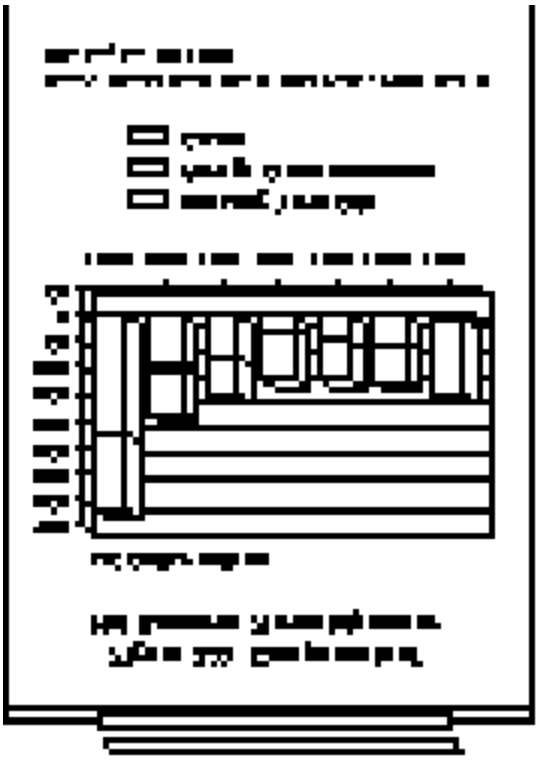
1995 refers to fiscal year 1995/96, ending 31 March.

mainly through cuts in expenditure, particularly capital expenditure, not through an increase in revenues. In fact, the revenue base has continued to shrink and this has been only partially and temporarily offset by the limited sale of public assets under the privatization program. The deficit for 1995 is estimated at 2.6 percent of GDP. This was largely financed by borrowing from the Central Bank and through external borrowing.

Money supply growth has remained high, driven in part by the large-scale monetization of public debt, which has led to high rates of inflation. In 1995, broad money (M2) grew by about 22 percent, while consumer prices rose by almost 25 percent in Yangon, the only city for which price indexes are available. These are official indexes, which do not reflect the increase in black market prices. Excess liquidity was the major factor leading to price increases. However, particularly in the case of rice, black market prices were pushed up by large-scale exports which depleted domestic supplies.

Exports, consisting largely of rice, beans, and teak, grew by about 26 percent in 1995. As yet, there is little diversification of exports to nontraditional items. Merchandise imports are estimated to have grown by about 13 percent, mainly because of imports of equipment and materials for construction, tourism, and transportation. The deficit in the balance of trade decreased to about $725 million. The principal constraint to improving the trade balance is the continuing policy of maintaining a highly overvalued exchange rate. The official trade estimates do not reflect unreported border trading. There is probably a large deficit on this account because, despite the surplus balance coming from services and net current transfers, there is still a current account deficit of about $311 million. This is being financed mainly through the accumulation of long-term debt (which is about 10 percent of GDP) and buildup in arrears since the flow of FDI is still limited and portfolio investment flows are also low (Figure 2.13).

Assuming that the pace of pro-market reforms is maintained and that there are no adverse weather shocks, the economy could grow at around 6–7 percent in 1996. The need to meet domestic rice requirements may lead to a slight slowdown in exports while imports could continue to grow at 17.6 percent. There could, therefore, be a further increase in the trade and current account deficits.



Policy and Development Issues

Development of infrastructure, tourism, and agriculture and the establishment of a properly functioning market remain the major policy priorities of the Government. Both public and private investments have been directed to the development of infrastructure, especially tourism-related projects such as hotels. Private investment in the oil and gas sector has occurred in response to government incentives for private foreign investment. Positive steps toward reducing state control include a reduction in subsidies and capital provided to state-owned enterprises; however, progress with privatization has been limited and many sectors or markets are still controlled by the state.

The investment required to sustain the high rate of growth achieved in recent years will have to be financed substantially through external capital flows since the domestic savings rate is quite low. However, external flows, particularly from multilateral agencies, are likely to remain depressed unless the exchange rate is liberalized and there is more progress on economic and political reforms. As a result, private capital flows, which often follow official signals, are also likely to remain restrained.

Philippines

The Philippine economy is moving to a higher growth path, having recovered from the recession of the early 1990s. The recovery strengthened in 1995 with GDP growing strongly for the second successive year. Helped by the restoration of political stability and recent economic reforms, exports grew at a healthy pace, and the current account deficit in the balance of payments declined. The macroeconomic picture would have been better had the inflation rate not risen to double-digit levels in September 1995; however, the average inflation rate for the year was lower than in 1994.

In the past, the Philippines has experienced a series of volatile "boom-bust" economic cycles. The current recovery, however, is qualitatively different and has the potential to lead the economy onto a self-sustained growth path. A decade of structural reforms has significantly reduced macroeconomic distortions and liberalized a once highly protected economy. Manufactured goods now constitute the bulk of exports, reducing the country's traditional reliance on volatile commodity earnings. External debt and debt-service payments are now significantly lower in real terms than they were in the late 1980s. Moreover, international investors' confidence in the economy is now stronger than perhaps at any time in the recent past.

Recent Trends and Prospects

Growth, Investment, and Employment. The economic recovery which began in 1994 strengthened in 1995, with GDP growing by 4.8 percent. Although this growth rate is lower than the Government's target, it was achieved in a year in which the agriculture sector slowed down considerably, due initially to less than normal rain in the planting season and, subsequently, to excessive rain and floods in the harvesting season. Agricultural production increased by only 0.9 percent in 1995 compared with 2.6 percent in the previous year.

Growth in the industry and services sectors more than compensated for the slowdown in agriculture. With improved electric power supply and the easing of supply-side constraints, the industry sector is responding positively to the reform measures initiated by the Government. Industrial production grew by 7.3 percent in 1995, surpassing the growth rate of 5.8 percent achieved in the previous year. With the exception of agro-industries, the acceleration in industrial growth has been broadly based. Manufacturing, which accounts for about 70 percent of industrial output, grew by 6.9 percent, a marked improvement on the growth rate of 5 percent achieved in 1994. Construction and utilities maintained their double-digit growth rates for the second consecutive year in 1995. Within manufacturing, industries such as machinery and transport equipment, minerals and metals, paper and paper products, petroleum products, and chemicals grew most impressively, whereas growth of industries such as beverages and food processing slowed down. The services sector, which accounts for about 43 percent of GDP, expanded by 4.9 percent in 1995 compared with growth of 4.3 percent in 1994.

Gross domestic investment contracted in 1995 to 22.3 percent of GDP compared with 24 percent in 1994. Slackening power sector investment demand after a two-year rehabilitation program contributed to the decline in the investment rate. At about 15 percent of GDP, gross domestic saving remained much the same as in the previous year, with the result that the resource gap narrowed by 1.5 percent of GDP.

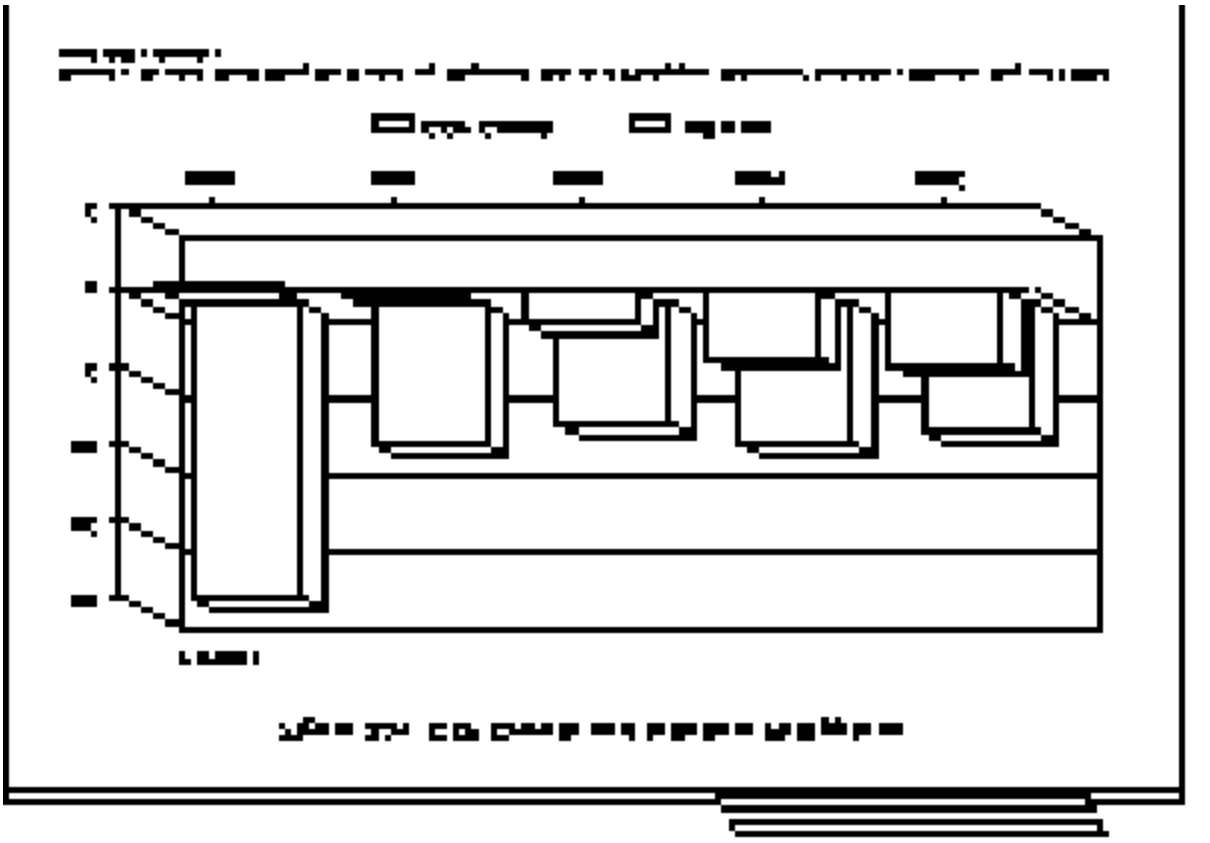
It is somewhat premature to assess the impact of the current recovery on employment and poverty. The conventional unemployment rate, which measures the percentage of the labor force who did not work for lack of opportunities, has remained stable at about 9.5 percent since 1993. However, the underemployment rate, which measures the percentage of those employed who wanted more work, has declined from 21.4 percent in 1994 to 19.8 percent in 1995. These rates indicate that the current recovery has achieved a modest improvement in the employment situation although output growth has been driven more by gains in labor productivity than by increased employment. This is normal in the initial stages of an economic recovery. Preliminary evidence suggests that, with the resumption of growth, the percentage of families living below the official poverty line has declined from 39 percent in 1991 to 36 percent in 1994.

The growth prospects over the medium term appear reasonably bright. GDP is expected to grow at an annual rate of about 5.5 percent in 1996 and 5.7 percent in 1997. The industry sector will spearhead growth, with industrial output expected to increase at about 8 percent in both years. Services output is forecast to increase by about 5 percent in 1996 and 5.2 percent in 1997. Assuming normal weather conditions, agricultural output should improve at about 2.5 percent annually in the next two years. Growth of the economy generally will be driven largely by investment and exports. Led mainly by private investment, gross investment as a ratio of GDP is expected to increase to 23.7 percent in 1996 and by a further percentage point in 1997. Since the increase in investment will be matched only partially by increased private savings, the

Table 2.11 Major Economic Indicators: Philippines

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	2.1	4.4	4.8	5.5	5.7
Agriculture	% change	2.1	2.6	0.9	2.5	2.5
Industry	% change	1.6	5.8	7.3	8.0	8.0
Services	% change	2.5	4.3	4.9	5.0	5.2
Gross Domestic Investment	% of GDP	24.0	24.0	22.3	23.7	24.7
Gross Domestic Saving	% of GDP	13.8	14.9	14.7	16.1	16.9
Inflation Rate	% change in CPI	7.6	9.1	8.1	9.0	7.5
Money Supply Growth	% change	24.6	26.5	28.0	22.0	18.0
Merchandise Exports	$ billion	11.4	13.4	17.3	21.7	27.1
	% change	15.8	18.1	28.9	25.0	25.0
Merchandise Imports	$ billion	17.6	21.2	26.4	31.7	37.4
	% change	21.2	20.7	24.4	20.0	18.0
Current Account Balance	$ billion	-3.3	-2.8	-2.1	-2.5	-3.0
	% of GDP	-6.0	-4.4	-2.8	-3.1	-3.2
External Debt Outstanding	$ billion	35.9	39.3	41.0	43.5	46.0
Debt-Service Ratio	% of exports	25.5	18.5	15.1	15.0	14.0

Sources: Government of the Philippines, National Statistical Coordination Board, "The National Accounts of the Philippines, CY1993 to CY1995" (mimeo, January 1996); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.



resource gap is expected to worsen somewhat over the period.

Despite the good growth prospects, progress in reducing the unemployment rate is likely to be modest over the next two years. Even if employment opportunities grow somewhat faster than does the labor force, the underemployed are likely to benefit the most as firms start making better use of their existing but underemployed workers.

Budget, Money, and Prices. For the second consecutive year, the Central Government achieved a fiscal surplus in 1995, equivalent to about 0.5 percent of GDP. The consolidated public sector deficit, which was about 2 percent of GDP in 1993, had already been reduced to nearly 1 percent by 1994. In 1995, it was virtually eliminated. Most of the reduction in the public sector deficit was brought about by increased privatization receipts and a turnaround in the position of the Central Bank. Receipts from privatization constituted about 1.5 percent of GDP in 1994 and 1995. Similarly, in contrast to losses of about 1.5 percent of GDP in 1992, the Central Bank achieved a modest surplus in 1994, following financial restructuring in late 1993. Adjusting for these temporary increases in revenues, the reduction in the public sector deficit has, however, been of a much smaller magnitude.

There has not been much progress in reducing government expenditure in the last two years. Central government expenditure, which was about 20 percent of GDP in 1990, was reduced to around 18 percent by 1994. The fact that there has not been any significant reduction in these expenditures is partly because of their inflexible structure. Over 70 percent of Central Government spending consists of salaries and wages, interest payments on government debt, and mandatory allotments to local governments.

During the first half of 1994, necessitated by the need to check rising inflation, the Government followed a tight monetary policy through sterilization of a significant portion of foreign capital inflows. This strategy, however, pushed up interest rates, attracted further capital inflows, and strengthened the peso, thereby threatening export competitiveness.

In response, beginning in the second half of 1994, the Government switched to an expansionary monetary policy aimed at

stemming the appreciation of the peso. Coinciding with the Mexican crisis in early 1995, this policy stance checked the nominal appreciation of the peso. However, monetary aggregates continued to grow briskly with broad money supply increasing by 26.5 percent in 1994 and at the slightly higher rate of 28 percent in 1995. Recognizing the dangers of accelerating growth in money supply, the Government began to tighten monetary policy toward the end of 1995.

The average inflation rate in 1995, although slightly lower than in 1994, remained relatively high at 8.1 percent. Inflation increased in the second half of the year to double-digit levels, partly because of the weather-induced failure of the rice crop, and partly because of the sustained growth in money supply. The Central Government's budget for 1996 aims at a fiscal surplus of Philippine peso (₱) 17.5 billion, equivalent to about 0.8 percent of GDP. The revenue/GDP ratio is projected to remain at its 1995 level of about 19 percent. On the expenditure side, the budget aims at a mild restructuring away from current operating expenditure and toward capital expenditure. The former is programmed to decline by about 0.5 percent of GDP and the latter to increase by about the same magnitude. The consolidated public sector deficit is projected to be close to zero in 1996. To achieve these fiscal targets, the Government has already introduced the much-delayed expanded value-added tax (EVAT) effective January 1996, which is expected to yield additional revenue of about ₱15 billion a year. The Government has also raised the administered price of petroleum products in an attempt to arrest the growing deficit in the oil price stabilization fund, which had reached ₱7.6 billion in December 1995. Money supply growth is expected to be lower at about 22 percent in 1996 and about 18 percent in 1997.

There will be two sets of factors working in opposite directions to affect prices in 1996 and 1997. On the one hand, if the tight monetary stance is maintained during 1996, there should be a gradual downtrend in the inflation rate. On the other hand, the increase in the administered prices of petroleum products in early February 1996 could put upward pressure on prices. Taking these factors into account, the inflation rate is expected to decline only gradually to about 7.5 percent by the end of 1996, averaging 9 percent for the year as a whole. For 1997, inflation is expected to decline to 7.5 percent.

External Trade and Payments. Merchandise exports grew by an impressive 29 percent in 1995, following 18.1 percent growth in 1994. To some extent, this reflects improvements in the power supply in the recent past; however, it also indicates that the removal of quantitative restrictions on trade and the rationalization of tariffs is beginning to have a favorable effect on exports.

The composition of Philippine exports has changed in the last decade. Manufactured products now account for about 80 percent of exports compared to less than 50 percent nearly a decade ago. In 1995, manufactured exports increased by about 30 percent and were fairly broad based. Exports of machinery and transport equipment, non-metallic mineral manufactures, chemicals, textile yarn and fabrics, footwear, electronics, and travel goods all increased faster than did total exports. Import growth was also strong at about 24 percent in 1995. Consistent with its stage of development, two thirds of Philippine imports consisted of raw materials and intermediate and capital goods. In 1995, the value of raw materials and intermediate imports grew by about 26 percent and that of capital goods imports by some 10 percent.

The trade deficit in 1995 was higher than in the previous year at about $9 billion. Because of the large net inflow from services, the current account deficit declined from 4.4 percent of GDP in 1994 to 2.8 percent in 1995. Continued capital inflows, both official and private, have not only enabled the country to finance the current account deficit but also allowed the Central Bank to build up its foreign exchange reserves by about $600 million. External debt increased to $41 billion in 1995; however, the debt-service ratio declined to about 15 percent of exports from 18.5 percent in 1994.

The prospects for the continued growth of manufactured exports appear good over the medium term. The recent agreements to liberalize trade through the World Trade Organization and the ASEAN Free Trade Area should be beneficial to exports from the Philippines. Increasing foreign direct investment should also continue to improve domestic access to foreign technology and

Box 2.3 The Challenges of Managing Infrastructure in the Philippines

Given the past underinvestment and the prospect of continued rapid urbanization, the capital requirements of the infrastructure sectors such as power, transportation, water supply, and telecommunications are indeed large at an estimated $5 billion annually or about 6.5 percent of GDP. Because of the resource constraints facing the public sector, the Government's strategy is to rely increasingly on the private sector for such infrastructure investment.

With the deregulation of telecommunications since 1993, the sector has already attracted private investment and further significant investment is expected. The Government will need, through its regulatory body, the National Communications Commission, to be vigilant about unfair trade practices and predatory behavior on the part of any dominant firm. It will need to develop appropriate policies for the maintenance of competition in an industry where economies of scale are an important determinant of the viability of investment.

Private investors have so far committed about $3 billion to power projects; however, achieving the Government's goal of meeting all future power requirements from private investment will require attention to a number of issues. These include the development of clear and transparent government policies for private power producers; independent pricing of transmission; restructuring of the National Power Corporation, the largest power supplier in the country; and promotion of greater competition among power producers.

Attracting private investment for the provision of water supplies is not likely to make much progress until some technical and organizational problems are remedied. These include poor levels of maintenance of existing facilities; substantial losses of revenue through leakage, as in Metro Manila; inappropriate tariff structures that encourage wasteful use; and the small size of administrative authorities which prevents the achievement of economies of scale. An appropriate regulatory framework is also required if, for technical reasons, competitive supply is not feasible.

In the case of ports, private sector contractors under franchise or lease agreements with the Philippine Ports Authorities (PPA) provide most of the port services to shipping operators. Investment in private port facilities is discouraged by the PPA. The PPA, which owns major public ports, serves as the regulator of its competitors in the service, bringing about an obvious conflict of interest. To encourage the flow of private resources into port development and operations, the regulatory framework has to be reformed and port activities have to be deregulated.

Even as the private sector increasingly participates in the provision of infrastructure, however, the public sector will continue to play an important role. Certainly, in recent years the private sector has invested in sectors once considered unsuited for private investment. Despite this trend, the private sector still invests primarily where returns are high and the pay-back period short. In the transport sector, for example, ports and airports may offer financially viable projects for the private sector, but the public sector is likely to have an important role in the financing of road construction and maintenance. Similarly, in the provision of water supply and sanitation, the public sector will have to be a key investor.

As the private sector increasingly participates in infrastructure provision and as the number of infrastructure providers increases, the Government's policy-making and regulatory roles will assume greater importance and require strengthening.

Overall, the public sector's role will have to change, from that of a predominant, and often monopolistic investor, to one of a partner in investment and a fair enforcer of the regulatory requirements for effective and efficient supply of infrastructure services. A key challenge for the Government is to forge such a public-private partnership.

help to raise productivity. Coupled with normal agricultural growth in the next two years and the pickup in agricultural exports, all these factors should enable exports to grow at an annual rate of about 25 percent in 1996 and 1997. As the economy's production structure diversifies and becomes better integrated with the export sector, the import intensity of exports should gradually decline, leading to somewhat slower growth in imports. Imports are, therefore, expected to grow by about 20 percent in 1996 and by around 18 percent in 1997. The resultant trade deficit will be about $10 billion in each year. Continued buoyancy in the remittances of overseas workers should, however, help to

contain the current account deficit to about $2.5 billion in 1996 and $3 billion in 1997. External debt is projected to rise to $43.5 billion in 1996 and further to $46 billion in 1997. The rapid increase in exports over these years will result in a fall in the debt-service ratio to 14 percent of exports in 1997.

Policy and Development Issues

The recent stabilization and structural adjustment measures have laid the foundations for sustaining strong growth. However, concerted efforts are needed to maintain the growth momentum while controlling inflation. Besides the maintenance of firm monetary policies, continued growth would require the provision of adequate infrastructure, increased agricultural investment, further fiscal consolidation, and measures to enhance the economy's international competitiveness.

Economic growth in the Philippines in the past has often been hampered by infrastructural constraints. The recovery of 1987–1990, for instance, was cut short by severe power shortages. It is important that steps are taken to guard against the reemergence of such constraints, whether they be in power, transportation, or water supply, especially by encouraging private sector infrastructure investment (Box 2.3).

In recent years, overall agricultural production has barely kept pace with population growth. Slow agricultural growth has limited the capacity of the rural economy to absorb labor and reduce poverty, thus increasing migration to the cities and further straining urban infrastructure. It is, therefore, important that the Government takes steps to achieve faster growth of agricultural production, which in the past has come from increased yields, especially of food crops. The growth in yields has, however, leveled off in recent years. Given the inescapable time lags in the application of some of the technological breakthroughs currently being achieved in the area of high-yielding rice for the Philippines, increases in agricultural production in the medium term will have to come largely from increased irrigation. Increased public investment in irrigation is, therefore, crucial for achieving faster growth of agricultural output over the medium term.

Continued fiscal adjustment will be another key requirement for maintaining macroeconomic stability and the current growth momentum. Given the need for large public investments in irrigation and infrastructure, fiscal adjustment from now on will have to concentrate on stepping up public investment while, at the same time, keeping a tight hold on the public sector deficit. This would require a significant increase in government savings, which, in turn, would require controlling the growth of current expenditure, on the one hand, and raising additional revenues, on the other. Measures such as civil service reforms and abolition of fiscal subsidies and tax expenditure would be crucial for containing current expenditure. On the revenue side, privatization receipts are likely to dry up soon; in any case, these are more properly used for debt reduction or new capital expenditure. The Government's tariff reduction program may also involve some decline in revenues. Replacing these revenue losses, let alone increasing the revenue/GDP ratio, will be a challenging task, requiring a comprehensive tax reform program involving fewer but more broadly based taxes, reasonable tax rates, and strictly enforced tax collection. The Government has drawn up a tax reform program which addresses some of these issues and the implementation of the program is high on the policy agenda.

Although the Philippines has made significant progress in the liberalization of the economy, there is scope for further efforts in this direction. The priorities include deregulation of the energy sector; further reduction and rationalization of tariffs; phasing out of the remaining quantitative restrictions on imports; removing restrictions on foreign investment in retail trade; restructuring the National Power Corporation and privatizing its generation facilities; extending the privatization program to areas such as water management, ports, and railways; and adapting the legal, regulatory, and administrative capacity to manage rising private sector participation in the economy.

Thailand

Thailand's economy has made remarkable progress over the past ten years. Real GDP rose at an average rate of 9 percent per annum while inflation was limited to around 4 percent. Exports of manufactured goods have grown very rapidly and now figure more prominently than do agricultural products in Thai exports. Investment also surged and the flow of foreign investment from Japan and the newly industrializing economies helped in significant ways to ease the current account deficits that in recent years have become a conspicuous feature of the Thai economy.

The economy is likely to continue its strong performance in 1996 and 1997. However, containing inflation may prove difficult and the current account deficit may widen further. Although the medium-term outlook remains bright and the country is well positioned to take advantage of the newly emerging world trading environment, it needs to continue its efforts at stimulating structural change. To promote a shift to higher value-added products, it will be necessary to increase significantly the availability of skilled labor and the quality of physical infrastructure. Liberalization of the financial sector should be widened and deepened if the Government's hope of turning Thailand into a regional financial center is to be realized.

Recent Trends and Prospects

Growth, Investment, and Employment. Buoyed by strong domestic demand and further expansion in exports, GDP continued to grow rapidly at 8.6 percent in 1995, almost the same rate as in 1994. Heavy flooding seriously affected agricultural production, especially that of rice; in consequence, agriculture sector growth fell to 3.2 percent in 1995 from 5.5 percent in 1994.

Industrial output expanded by nearly 12 percent in 1995 compared with below 10 percent in 1994. Production of automobiles and automobile parts, petroleum products, integrated circuits, compressors, and plastic products increased strongly; textile output increased only marginally because of raw material shortages. Construction output grew by 9.4 percent in 1995 compared with 8.2 percent in 1994, as the demand for commercial and factory buildings strengthened. The tourism sector experienced a sharp increase in its growth rate to about 14 percent in 1995 from only 5 percent in the previous year.

Domestic demand was strong in 1995. Rural incomes benefited from the increase in agricultural export prices as well as in domestic food prices, while increased wages and salaries of public and private sector employees lifted urban incomes. Private investment expanded by 12 percent, a slightly higher rate than in 1994, reflecting greater investment in infrastructure and production capacity for the domestic and external markets. The growth of public investment expenditure moderated in 1995 to 14 percent, from above 16 percent in 1994 when sizeable public investment expenditure occurred.

The share of resources devoted to saving and investment in Thailand has grown rapidly in the past decade. Gross domestic saving, which was 24 percent of GDP in 1985, reached over 34 percent in 1995. Somewhat

Table 2.12 Major Economic Indicators: Thailand

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	8.3	8.7	8.6	8.3	8.0
Agriculture	% change	-1.9	5.5	3.2	4.0	3.0
Industry	% change	10.6	9.9	11.9	11.5	11.0
Services	% change	9.2	8.5	7.1	6.4	6.2
Gross Domestic Investment	% of GDP	40.4	41.0	40.0	41.0	41.0
Gross Domestic Saving	% of GDP	35.0	35.2	34.2	35.0	35.0
Inflation Rate	% change in CPI	3.4	5.1	5.8	5.5	5.5
Money Supply Growth	% change	18.4	12.9	17.4	16.0	15.0
Merchandise Exports	$ billion	36.4	44.5	55.4	64.8	75.2
	% change	13.4	22.2	24.5	17.0	16.0
Merchandise Imports	$ billion	40.6	48.2	61.9	74.2	89.1
	% change	12.1	18.5	28.4	20.0	20.0
Current Account Balance	$ billion	-7.0	-8.4	-12.3	-13.9	-15.7
	% of GDP	-5.6	-5.9	-7.5	-7.6	-7.6
External Debt Outstanding	$ billion	45.8	61.0	68.2	75.0	85.0
Debt-Service Ratio	% of exports	18.5	15.6	11.7	14.0	14.0

Sources: Data collected from the Bank of Thailand by EDRC for the Asian Development Bank *Annual Report 1995*; Royal Thai Government, National Economic and Social Development Board, *National Income of Thailand*, 1994 Edition (Bangkok, 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

in parallel with the rise in domestic saving was a secular decline in household saving. A large part of this decline reflects consumption smoothing. As the financial market was liberalized, consumers' ability to borrow against wealth and future income increased, thereby bringing about an adjustment in the pattern of lifetime consumption and saving. Gross domestic investment rose from 28 percent of GDP in 1985 to 40 percent of GDP in 1995. The savings-investment gap, as reflected in the current account deficit, stood at more than 7 percent of GDP in 1995.

The unemployment rate in 1995 remained at less than 3 percent and the labor market is experiencing worsening shortages, as reflected in rising wages in Thailand. The minimum wage rate in Bangkok and six major provinces was increased in July 1995 by 32 percent from Thai baht (B) 110 to 142 per day, making Thailand's minimum wage rate four to five times higher than that of regional competitors, such as China, Indonesia, and Viet Nam. While Thailand continues to export unskilled and semi-skilled labor to other Asian and Middle Eastern countries, it suffers from an acute shortage of the skills required to move Thai industries into more sophisticated skill-intensive production.

The outlook for the Thai economy remains bright with overall GDP growth projected at 8.3 percent in 1996 and 8 percent in 1997. Agriculture sector growth is expected to be 4 percent in 1996 and 3 percent in 1997, while the industry sector should continue to grow strongly at about 11 percent per annum over the same period. Services sector output is expected to increase by over 6 percent in 1996 and 1997. Though financial sector liberalization will continue in 1996 and 1997, it will be at a slower pace and have a more limited scope than previously expected.

Gross domestic investment is projected to increase slightly to about 41 percent of GDP in both 1996 and 1997, while domestic saving will increase marginally to about 35 percent of GDP, thereby reducing the savings-investment gap. The unemployment rate will remain low at less than 3 percent over the next two years. The persistent shortage of

labor is likely to put further upward pressure on labor costs, unless these constraints are eased by the freer movement of labor from neighboring countries.

Budget, Money, and Prices. In 1995, the Government achieved an overall budget surplus of 2.8 percent of GDP, much the same as in 1994. Strong economic activity and improved tax administration, particularly as regards the value-added tax, enabled revenue to increase by nearly 11 percent. Total expenditure was 10.5 percent higher than in 1994. There was a significant increase in public sector wages and salaries, an increased emphasis on education, and greater attention to infrastructure projects, notably for the alleviation of Bangkok's serious traffic congestion.

Notwithstanding a tighter monetary policy adopted by the Government, money supply (M2) grew by 17.4 percent in 1995 as compared with about 13 percent in 1994, reflecting continued foreign capital inflows and credit growth generated through domestic banks. To limit the expansion of credit, the Bank of Thailand introduced a number of monetary and prudential measures, including raising the bank rate, issuing Central Bank securities to absorb liquidity and sterilize capital inflows, monitoring credit expansion including that by offshore banks, and imposing indicative credit expansion limits for banks.

Inflation continued on an upward trend, rising to 5.8 percent in 1995 compared with about 5 percent in 1994. Food prices rose by 8.1 percent compared with an increase of 6.9 percent in 1994, reflecting both a fall in domestic output as a result of severe flood damage and an increase in international food prices. Nonfood prices rose less strongly at 4.2 percent compared with 3.8 percent in 1994.

Though it is proposed that the budget for 1996 will be in balance, the increase in total expenditure by nearly 18 percent in 1996 compared with less than 11 percent in 1995 will add to inflationary pressure in the economy as will the adverse effects on output caused by the floods. While the measures taken by the Bank of Thailand to check credit expansion are expected to moderate inflationary pressure, the inflation rate is not likely to decline to less than 5.5 percent in 1996.

A plan for the reform and development of the financial and banking system was announced in February 1995. The objectives of the plan include improving the mobilization of both domestic and foreign saving, promoting competitiveness in the financial sector, and channeling credit to provincial areas to stimulate development outside Bangkok. To improve the competitiveness of the financial sector, a number of new banking licenses are to be issued. The new banks are to locate their headquarters outside Bangkok, presumably to ensure a more equitable spatial distribution in credit supply. The plan also allows for 7 of the existing 21 foreign banks, which at present operate as offshore banks in Thailand under the Bangkok International Banking Facility (BIBF), to open full branches in Thailand. As financial market liberalization deepens and widens, the Bank of Thailand will have to rely more on indirect instruments of monetary control, such as the bank rate and open market operations in interest-bearing securities, and less on direct mechanisms such as the credit plan, which sets quantitative guidelines on the amount of credit each bank can extend. Indeed, the efficiency of the credit control mechanism has already been significantly eroded by the operations of the BIBF, which are not included in the credit plan.

External Trade and Payments. The revival of growth in the global economy, and the continued strong performance of the East Asian economies, helped Thailand to maintain vigorous export growth at nearly 25 percent in 1995, after growth of 22 percent in 1994. Agricultural exports, including rubber, tapioca, sugarcane, raw coffee beans, and frozen shrimp, as well as manufactured goods, especially footwear, plastic products, computers and computer parts, and electrical appliances, experienced rapid growth. The Association of Southeast Asian Nations (ASEAN) has now emerged as the most important trading partner for Thailand, followed by the US, Japan, and the European Union. Major exports to ASEAN include footwear, rubber, rice, computers and computer parts, and integrated circuits.

Imports grew strongly at about 28 percent in 1995 compared with 18.5 percent in 1994, reflecting high domestic investment and consumption. Imports of raw materials and semi-raw materials increased by 39 percent, while imports of both capital and consumption goods were 25 percent higher than in 1994.

The services account continued to be in surplus, largely because of the strong performance of tourism and workers' remittances. However, the services account surplus as a percentage of GDP has been declining over the years as Thailand spends more on royalties and copyrights, dividend and interest payments, and tourism.

The current account deficit reached an historically high level of 7.5 percent of GDP in 1995 compared with 5.9 percent in 1994. Large capital inflows continued to cover the deficit and raised the official foreign exchange reserve from $30 billion in 1994 to over $36 billion in 1995. However, there was a change in the composition of capital inflows; portfolio and direct investment weakened while short-term inflows to the banking system increased. Net external borrowing also increased because of a surge in lending by foreign banks through the BIBF. This heavy reliance on foreign saving is a source of some concern as a sudden change in international perception about the soundness of the Thai economy could cause serious difficulties for the economy (Box 2.4).

There has been a significant decrease in the net inflow of foreign direct investment, from $1.7 billion in 1993 to $0.6 billion in 1994 (Figure 2.15). The trend was not reversed in 1995. This decline in net inflow of foreign direct investment is attributed to delays in the implementation of some large infrastructure projects and delays in the repayment of loans to foreign banks, as well as to Thailand's declining attraction as a location for investment in labor-intensive industries. However, although foreign investment in traditional Thai export industries such as textiles is on a downward trend, inflows in more technologically advanced areas appear to be on the rise. Yen appreciation has increased the attractiveness of Thailand as a production center for Japanese car producers seeking to expand in the fast-growing markets of Asia.

At the end of 1995, outstanding external debt was $68.2 billion, equivalent to about 41 percent of GDP, which represents a slight increase in absolute terms over what it was in 1994. Over the years, the structure of external debt has undergone significant change. Private sector debt has increased more than has public sector debt. Of the total outstanding debt, about $18 billion is public and $50 billion is private. The debt-service ratio declined to 11.7 percent in 1995 from 15.6 percent in 1994.

Merchandise exports are forecast to increase by about 17 percent in 1996 and by 16 percent in 1997. The share of primary commodities in the country's export structure will continue to fall as the economic structure is diversified and moves toward services and industrial goods. Import growth in both 1996 and 1997 is projected at 20 percent. A large proportion of these imports will be capital goods for upgrading and expanding the country's industrial production capacity. The current account deficit is likely to increase marginally, to be sustained by inflows of foreign capital. Foreign borrowing is expected to raise the outstanding debt to about $75 billion in 1996 and $85 billion in 1997. However, rising exports should allow the debt-service ratio to remain at 14 percent in both 1996 and 1997.

Steep depreciation of the dollar against the yen in the first half of 1995 triggered discussion of possible changes in the exchange rate regime. Although unwilling to embrace a floating rate, the Bank of Thailand is likely to adjust relative weights of currencies in its peg basket to reflect changing directions of trade more adequately, diminishing the weight of the dollar and increasing that of the yen and the deutsche mark, and also possibly bringing in some regional currencies such as the Singapore dollar and the Malaysian ringgit.

Policy and Development Issues

Notwithstanding its impressive performance over the last two decades, the Thai economy is faced with a number of policy and development issues that merit serious attention. First, despite the rapid growth of the economy, the benefits of this growth have been far from equitably distributed among income groups and regions of the country. There is substantial evidence to suggest that, while the incidence of poverty has generally declined in Thailand during the past two decades, both the regional and size distribution of income have worsened. In terms of size distribution, the position of Thailand compares unfavorably with that of other Southeast Asian countries. Similarly, there is wide divergence of incomes among various regions of the economy. For example, the difference in average income

Box 2.4 Thailand and the Current Account Deficit

The external balance on current account is one part of a country's overall balance of payments, which records all transactions between the country and the rest of the world. The current account includes not only trade in goods but also trade in services, interest and dividends to foreign investors, receipts on overseas investments, and migrants' transfers. The capital account records borrowing and lending and other financing items such as foreign aid. The current account deficit must be paid for by a capital account surplus (i.e., an equivalent amount of foreign borrowing or lending or grants) or by drawing on the reserves of foreign exchange at the Central Bank.

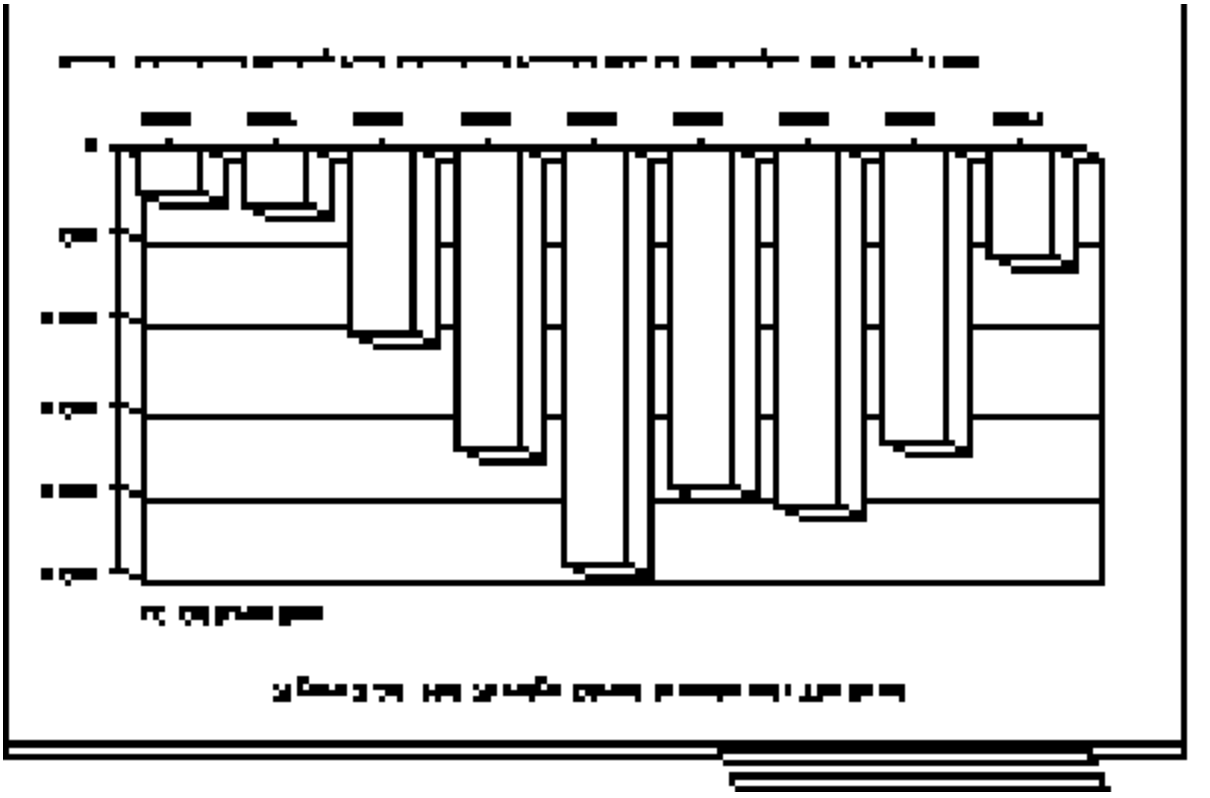
In itself, the current account balance reveals very little. A persistent large surplus may not always be a sign of strength. It could mean that investors find it more profitable to invest abroad or that there is excessive saving. For a poor country, running a current account deficit may make sense if it arises from increased investment. What size of current account deficit is safe depends, among other things, on the stage of development, how the money is being used, and market perceptions about that usage. What is certainly clear is that current account deficits are not always deleterious to the macroeconomic soundness of a country.

After reaching a trough in 1992, Thailand's current account deficit rose steadily to about 5.9 percent of GDP in 1994 and further widened to 7.5 percent in 1995, reflecting both an increase in investment as well as an increase in the cost of imports due to the appreciation of the yen and deutsche mark. The increase in investment was driven by the following factors. First, since 1992, the economy has been experiencing a high degree of capacity utilization. Many of the industries concerned began expanding their capacity, thereby accelerating the investment rate. Second, in the face of increasing global competition and rising domestic labor costs, Thailand began upgrading its industrial capacity, especially industries such as automobile production, chemicals, electrical and electronic products, and basic metals. Third, despite some earlier delays, investment in infrastructure projects, such as the mass transit system and telecommunications, picked up in 1995.

The key question is whether the present level of deficit is sustainable. First, it seems that the persistence of the deficit is related to the continuing high level of investment. The failure of domestic saving to match this level must be a cause of concern; however, at the same time, there is scope for effective policies to raise the savings rate, especially in the household sector. Second, the deficit would be more of a concern in a sluggish economy with weak export performance, which is not the case for Thailand. Third, countries with a large current account deficit often have a large budget deficit. However, Thailand has historically maintained budget surpluses, not deficits. Fourth, the financing of the current account deficit does not consist overwhelmingly of short-term inflows but of more stable components such as foreign direct investment, portfolio investment, BIBF inflows, and public borrowing and trade credits. Finally, Thailand has a relatively strong external financial position. While total external debt at the end of 1995 was relatively high at $68.2 billion, about 41 percent of GDP, the debt-service ratio at 11.7 percent is low by international standards. Also, the country's stock of international reserves stood at $36 billion at the end of 1995, equivalent to seven months of imports.

Thailand's current account deficit is not expected to increase substantially over the next few years and the present strength of the Thai economy indicates that the country should have no major difficulty in financing it. Nevertheless, prudence would suggest the desirability of strong efforts to mobilize domestic saving so that the level of investment and economic growth is less vulnerable to adverse external and internal events that could affect the supply of foreign saving.

per capita between Samut Prakarn Province, adjacent to the Bangkok Metropolitan Area, and Si Sa Ket Province in the Northeastern Region is almost 18 times. Such income disparities contain the seeds of discontent and need to be addressed on a priority basis for the sustenance of longer-term growth and development. The Eighth Plan, which is to be launched in 1997, focuses on human resource development, particularly on expanding and improving rural secondary and tertiary education. The Plan also underscores the need to reduce the concentration of industry in Bangkok and to raise the level of investment



in rural physical infrastructure. These are no doubt moves in the right direction. Thailand also needs to emphasize policies that foster development of, and encourage technological progress in, the agriculture sector, which employs a large part of the labor force.

Second, rising labor costs are already leading to a loss of competitiveness vis-à-vis labor-rich countries such as China, Indonesia, and Viet Nam. The Thai economy will, therefore, need to undergo rapid structural change if its growth performance is to be maintained in the future. Thailand relies heavily on primary commodities and labor-intensive manufactured products for its export revenues. The country needs to reorient its export structure from these categories to more value-added, skill-intensive commodities. At the moment, however, the acute shortage of various skills stands in the way of a rapid advance in such structural change of the economy. The Government needs to intensify its efforts to expand the supply of required skills through its education and training programs. The Government should nevertheless be cautious in its use of fiscal incentives to industries and activities intended to help upgrade the technological base of the economy, for reasons of both effectiveness and to avoid the distortions in resource allocation that such incentives can generate.

Third, Thailand's rapid growth over the past two decades has led to severe strains and imbalances in the economy. One critical imbalance is that of infrastructural bottlenecks, including the transport chaos in Bangkok, which appear to have impeded the process of industrialization of the economy and reduced the attractiveness of Thailand as a destination for foreign investment. The Government has undertaken measures to upgrade infrastructure and tax incentives to relocate industries from the congested Bangkok region to other areas of the country. While these measures are in the right direction, the ultimate success of the effort will depend on the efficiency with which such infrastructure projects are carried out.

Finally, Thailand has emerged as the country with the highest incidence of acquired immuno-deficiency syndrome (AIDS) in Asia, and this problem can place severe strains on the Thai economy. For example, tourism is an important source of income for Thailand and the high incidence of AIDS has the potential to diminish the attractiveness of the country for both foreign tourists and foreign investment.

Viet Nam

Rapid economic growth in Viet Nam continued in 1995, led by the industry sector. Considerable progress has been made in economic liberalization, and 1996 marks the beginning of the new five-year plan that will guide the country into the next century. However, the attempt to create a socialist market economy remains strained by conflicting efforts to maintain government control of the economy to achieve equity objectives and the desire to let market forces increase efficiency. Viet Nam has so far succeeded in maintaining macroeconomic balance with high growth, although the current account deficit has been expanding as a share of GDP. Allowing greater liberalization of financial and capital markets, reducing favoritism to public sector enterprises, and encouraging more private and foreign participation in key infrastructure developments will help to sustain that balance in the future.

Recent Trends and Prospects

Growth, Investment, and Employment. Growth in GDP continued to accelerate from 8.8 percent in 1994 to 9.5 percent in 1995. Agricultural output grew by 4.7 percent despite drought, severe typhoons, and flooding. Besides record rice output of 27.5 million tons, aquacultural production increased by an estimated 4 percent and that of livestock by an estimated 8 percent. Industrial crops also posted strong gains as export incentives continued to be exploited. New tax policies on agricultural land use, along with recognition of land transfer rights, had a positive impact on increasing the effective use of agricultural land. Industrial output grew by 14.2 percent, especially manufacturing, processing, and construction, and was broadly based with both light and heavy industries performing well. Industrial products with high levels of output growth included electricity, coal, crude oil, and cement. Output of many consumer goods such as soap, paper, beer, and bicycle tires grew even faster. Services sector growth increased by 10.7 percent, raising the sector's share of GDP to 38.4 percent, thus continuing the shift in the structure of economic activity from agriculture to industry and services as the country modernizes and urbanizes.

With rapid economic growth, the demand for investment and mobilization of financial resources became more problematic in 1995. Although rising, domestic saving remains well below domestic investment. The share of gross domestic saving increased from 17.6 percent of GDP in 1994 to 19.1 percent in 1995; but this is still well below the share in other countries of the region. The contribution of foreign saving continues to account for about one third of gross national saving.

While there has been rapid growth in the private sector, capital shortage remains a main problem. Also, output from centrally managed enterprises continues to grow more rapidly than that from non-state enterprises.

Gross domestic investment rose to 27.6 percent of GDP and the resource gap widened to 8.5 percent of GDP. Efforts are being made to increase the share of domestic investment in total investment to more than 60 percent from its current level of 55 percent. One problem is the lack of a stock exchange, the creation of which has now been deferred from 1996 to

Table 2.13 Major Economic Indicators: Viet Nam

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	8.1	8.8	9.5	9.8	9.9
Agriculture	% change	3.8	3.9	4.7	4.5	4.5
Industry	% change	13.1	14.0	14.2	14.6	14.6
Services	% change	9.2	10.2	10.7	11.0	10.9
Gross Domestic Investment	% of GDP	20.5	24.1	27.6	32.0	34.0
Gross Domestic Saving	% of GDP	14.8	17.6	19.1	21.1	22.0
Inflation Rate	% change in RPI	5.3	14.4	12.7	13.5	14.0
Money Supply Growth	% change	18.9	28.1	34.4	27.3	25.3
Merchandise Exports	$ billion	2.9	3.6	5.2	6.9	9.5
	% change	15.2	26.3	45.0	32.2	37.7
Merchandise Imports	$ billion	3.5	4.5	7.1	9.7	12.5
	% change	38.3	28.4	58.3	36.1	28.9
Current Account Balance	$ billion	-0.9	-1.0	-1.7	-2.2	-2.5
	% of GDP	-6.7	-6.2	-8.9	-8.9	-7.9
External Debt Outstanding[a]	$ billion	24.4	25.1	26.8	30.8	36.0
Debt-Service Ratio[a]	% of exports	13.6	6.1	10.5	9.1	8.1

[a] Debt and debt-service figures depend heavily on the ruble to dollar conversion rate applied to debt held in rubles which is currently under negotiation.

Sources: Nguyen van Quy, "The Economic Outlook for Viet Nam, 1995-1997," paper prepared for the Eighth Workshop on Asian Economic Outlook (mimeo, November 1995); data collected from the General Statistical Office of the Socialist Republic of Viet Nam by EDRC for the Asian Development Bank *Annual Report 1995*; World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

1997. This is compounded by the lack of securities to trade since privatization efforts have been limited and generally ineffective.

While the majority of the population and employment continues to be rural, urban employment has grown from 23.7 percent in 1993 to 24.5 percent in 1995, as the structure of economic activity shifts further from agriculture to industry and services. The unemployment rate has been estimated at 6 percent. Rural employment programs include reforestation and resettlement, while urban employment centers have been established to help reduce urban unemployment, estimated at 7 percent of the urban labor force. Employment in foreign-financed enterprises increased from 65,000 in 1994 to 90,000 in 1995, while an additional 100,000 laborers or more were engaged in construction or in providing services for foreign-financed projects.

Growth in GDP is expected to continue rising to 9.8 percent in 1996 and 9.9 percent in 1997. The increase in industrial output is expected to reach 14.6 percent in both years, with annual agricultural growth at about 4.5 percent, and services sector growth at about 11 percent per annum. Rapid growth in the private sector will be essential if the large annual increases in the labor force are to continue being provided with job opportunities. To achieve such growth, gross domestic investment will have to continue growing to 32 percent of GDP in 1996 and 34 percent in 1997, approaching the rates of growth of the other rapidly growing Southeast Asian economies. However, it will take time to restore confidence in the financial system and to raise domestic saving substantially. Therefore, gross domestic saving is expected to rise only slowly to 21.1 percent of GDP in 1996 and 22 percent in 1997, widening the resource gap and raising the level of external indebtedness (Figure 2.16).

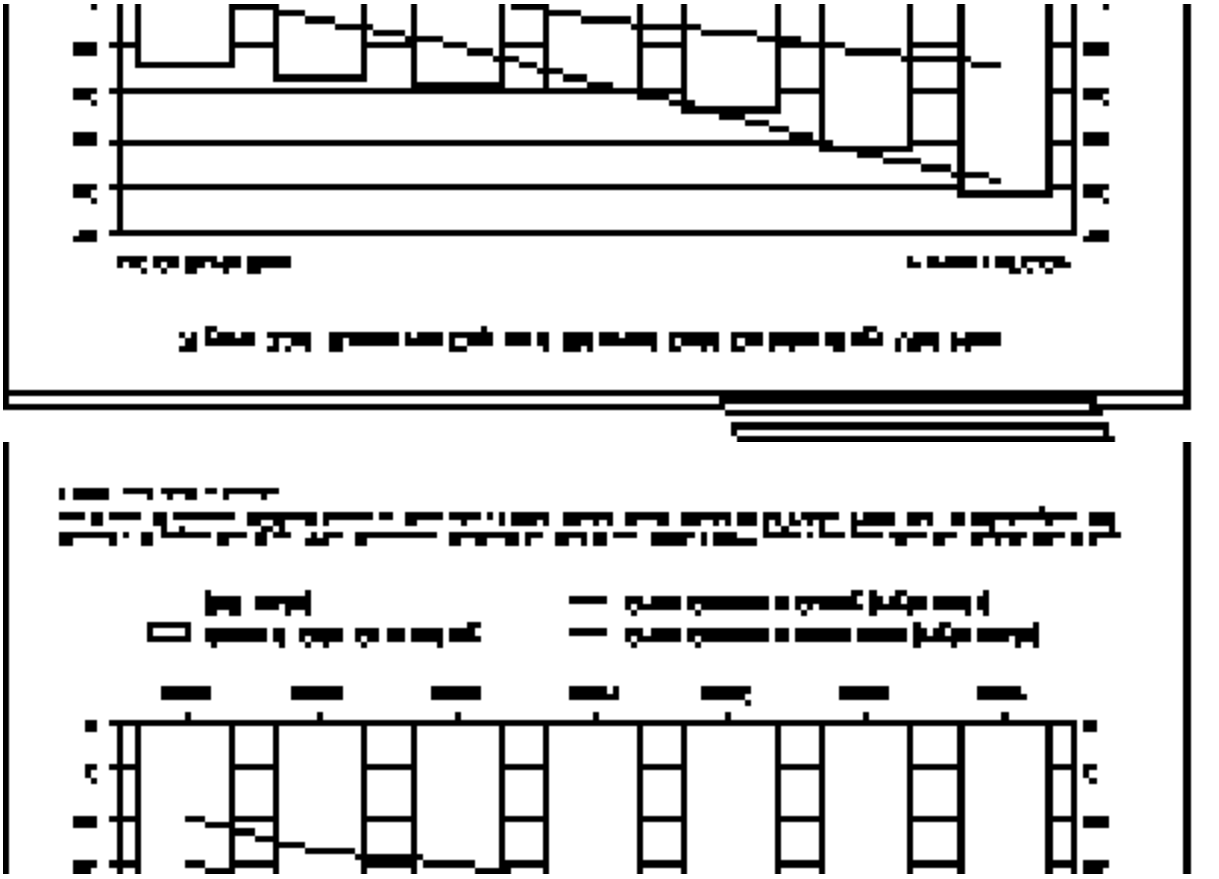
Budget, Money, and Prices. Government revenues fell slightly as a share of GDP, from 24.7 percent in 1994 to 24.5 percent in 1995, despite improved collection efforts and changes in revenue policies. Among the more significant of these changes were the inclusion of

a transport fee in petroleum prices and allowing enterprises to retain depreciation allowances for reinvestment. Revenue collections still remained below target, however, partly because crude oil production was lower than planned. Also, there was increased smuggling of consumption goods, which meant excise taxes were not paid.

Expenditure policy aims to give priority to physical infrastructure and social sector spending while at the same time repaying loans. Recurrent expenditures increased in 1995, especially for health, education, and science and technology, and accounted for 19.2 percent of GDP. Meanwhile, private entrepreneurs complain that state-owned enterprises receive many special privileges, which are not available to the private sector. Even obtaining bank loans is difficult for private companies as credit controls discriminate against them.

The Government tries to follow a principle in which domestic resource mobilization covers all current expenditure and a small portion of capital expenditure, while foreign loans and financial assistance are used only for capital expenditure. However, a resource shortage for capital expenditure in 1994 pushed some spending planned for that year into 1995. With disappointing revenue collection and heavy demand for public expenditure, the budget deficit surged from 2.4 percent of GDP in 1994 to 5.5 percent in 1995. The deficit was financed by foreign grants, concessional loans, and domestic borrowing. Since 1992, the State Bank of Viet Nam no longer officially issues money to cover government budget deficits, and instead organizes Treasury bill auctions to mobilize capital. In practice, however, the State Bank usually has to provide credit for the Central Government when deficits arise, and late repayments of this credit contribute to growth in the money supply.

Credit policies aim to achieve positive real interest rates to reduce the incentive for use of the US dollar instead of the Vietnamese dong. Another aim is to decrease the gap between the interest rate for foreign currency loans and that for local currency loans to encourage more borrowing in local currency. Removing the turnover tax on banks' credit operations has helped to lower interest rates



on bank loans, with little effect on deposit rates. The Government continues to set interest rate floors and ceilings for commercial banks; different interest rates are set for each project, and credit constraints are increasingly binding, especially for the rapidly growing private sector.

In general, the Government has paid more attention to encouraging foreign investment than it has to domestic resource mobilization. The exchange rate has been kept relatively stable in recent years, and this stability is expected to continue. However, use of monetary policy to maintain a stable exchange rate contributes to keeping interest rates relatively high. As a result, banks frequently accept only short-term deposits since borrowing is limited by the high interest rates.

The rediscount rate for commercial banks was increased in 1995 in an attempt to slow money growth. Even so, growth in broad money (M2) rose from 28 percent in 1994 to 34 percent in 1995 as credit expanded rapidly. Rice prices remained high and a jump in cement prices in the third quarter, induced by temporary supply shortages and price speculation, helped to maintain strong growth in the consumer price index. Nevertheless, inflation continued its downward trend – from 14.4 percent in 1994 to 12.7 percent in 1995 – although it was still above target levels.

Government revenue will be affected by various tax changes at the beginning of 1996. First, the number of turnover tax rates was reduced from 13 to 11. Second, the maximum level of import duties was lowered from 200 percent to 60 percent in line with requirements arising from membership in ASEAN. Third, excise taxes were expanded to cover additional luxury goods and some rates were raised, partly to offset the expected revenue decline from tariff reductions. An important tax change in prospect is the introduction of a value-added tax which is to be proposed at the National Assembly meeting in late 1996.

As a result of improved tax collection and the expanded tax base, revenue should rise gradually to almost 25 percent of GDP during 1996 and 1997. Current expenditure will continue to grow. However, its share of GDP will decline as pressing infrastructure needs demand greater capital expenditure. In absolute value, the domestic resources mobilized for capital expenditure in 1996 are expected to be roughly twice those of 1995. Total government expenditure will thus continue to increase its share of GDP to 30.3 percent in 1996 and 30.4 percent in 1997. The overall budget deficit will remain at about the same level as in 1995 at 5.5 percent of GDP over the next two years, financed roughly at 15 percent by foreign assistance and 85 percent by domestic borrowing.

Monetary policy over the next two years will concentrate on managing credit expansion and foreign currency. Lending to non-state enterprises is to become greater than that to state-owned enterprises; credit lines will be maintained for commercial banks while medium- and long-term lending is liberalized; and attempts will be made to use open market instruments more effectively.

In 1996, reserve requirements will be imposed on all financial institutions. Also in 1996, different credit ceilings for long- and short-term credit will be maintained, and interest rate floors will be removed. The same rediscount rate will apply to all commercial banks, while the credit line extended to each bank will vary. A pilot program allowing some enterprises to issue bonds in domestic markets in 1995 is likely to be broadened in 1996.

The money supply will tighten gradually, with growth in M2 slowing to 27 percent in 1996 and 25 percent in 1997; however, this is unlikely to prevent the expansion in credit from pushing up inflation to about 13.5 percent in 1996 and 14 percent the following year.

External Trade and Payments. In the external sectors, major events in 1995 included joining ASEAN and normalizing relations with the US. Viet Nam also experienced an explosion in its international trade. In 1995, exports grew very rapidly and were 45 percent higher than in 1994, reflecting increases in both quantity and price. Major exports in 1995 included rubber, coffee, rice, peanuts, aquaculture products, crude oil, coal, and textiles. Garment exports increased by 20 percent. Rice exports were again around 2 million tons, and benefited from stronger world rice prices. Vigorous demand for raw materials and capital goods led to imports growing even more strongly than did exports, increasing by over 58 percent and resulting in the trade deficit more than doubling from $900 million in 1994 to $1.9 billion in 1995. As a result of the higher trade deficit, the current account deficit rose to $1.7 billion, or about 8.9 percent

of GDP, sustained by higher inflows of both FDI and external assistance as well as by increased short-term borrowing.

Foreign investment commitments since 1988 total $18 billion, of which $7 billion were committed in 1995. However, projects accounting for only about 30 percent of committed funds have been implemented so far. Actual FDI inflows in 1995 were $1.4 billion, mostly in the form of capital equipment. The shortage of domestic resources has resulted to some extent in a shortage of counterpart funds, implying a need to use foreign resources more efficiently.

Trade links with China were reopened in early 1996 after a hiatus of 17 years. Official annual bilateral trade has risen to around $900 million since road links were opened in 1992. Trade growth is expected to slow down, although it will continue to outpace the rapid GDP growth. Growth in exports will remain strong in 1996 and 1997 at about 32 percent and 38 percent, respectively. Crude oil will remain the major export earner for the next two years. Import growth will also continue to be strong, at 36 percent in 1996 and more slowly at about 29 percent in 1997, as a wider variety of goods is produced domestically. As a result, the trade deficit should contract. The current account deficit is projected to be 8.9 percent of GDP again in 1996; however, it is likely to fall to 7.9 percent in 1997. Together with greater FDI, this will help foreign reserves to increase from their current level and reach 9–10 weeks of import cover.

Policy and Development Issues

A major issue is that of reducing the government budget deficit, an essential requirement if inflation is to be restrained. Two other macroeconomic issues that need to be addressed in the near future are the improvement of domestic resource mobilization through banking and finance reforms, and the treatment of state-owned enterprises. The two issues are interrelated because most banks are owned by the Government and preferential treatment given to state-owned enterprises results in disincentives for private saving and investment.

The ability of joint-stock banks to repay loans cannot be assessed by foreign banks which are, therefore, hesitant to advance substantial loans. This is because there are no laws requiring these banks to match international accounting standards. Tight government control of credit allocations is gradually being loosened; however, so far, with deposit rate ceilings and uncertain banking regulations, savers have little incentive to trust their saving to the formal financial system. Meanwhile, subjecting each investment proposal to close government scrutiny is delaying important investments, restricting welfare-enhancing opportunities, and overburdening government offices.

A contentious issue for private entrepreneurs is the preferential treatment accorded state-owned enterprises such as temporary tax exemptions, government guaranteed assistance in borrowing domestically or abroad, and subsidized credit. Also, almost all foreign joint ventures are with state-owned enterprises, and the state sector's rising share of GDP suggests that the Government's grip on economic activity may be increasing even as gradual liberalization proceeds.

Considerable progress has been made in improving the environment for private sector development although much more remains to be done. With the advent of market activities, the lack of an effective legal system has become an obvious lacuna and a special problem for foreign companies. Reforms in banking and finance may be able to be implemented more quickly and would help domestic resource mobilization; however, legal reforms are just as necessary. An antitrust law is being prepared, although it is not expected until 1997. A new enterprise accounting system was also implemented by the Ministry of Finance in 1995, to become nationwide in 1996.

Viet Nam's membership in ASEAN is being greeted with some ambivalence domestically. While the benefits of cooperation are appreciated, there is also concern that Vietnamese producers will face difficult competition from their new partners who produce similar products, and that the required tariff reductions may frustrate efforts to raise government revenue. The great increase in interest by foreign investors and the dynamism in the traded goods sector have also highlighted the country's infrastructure constraints. Road, rail, and port problems are being addressed; however, this will require substantial time and funds. Communications have improved significantly, but remain monopolized by the Government.

Bangladesh

Since the early 1990s, Bangladesh has been endeavoring to carry out a comprehensive set of structural reforms aimed at liberalizing the foreign trade and exchange regimes, restructuring the industry sector, strengthening fiscal and monetary management, encouraging private sector participation, and privatizing state-owned enterprises. As a result, a degree of macroeconomic stability was achieved: the inflation rate declined, fiscal and current account deficits narrowed, exports surged, and foreign exchange reserves increased. Despite these improvements, however, economic growth has remained modest. In many cases, the Government was unable to implement reforms on a wider scale and some of the reform agenda has gone unfinished.

Economic performance in 1995 was mixed. Investment increased and there were some signs of an upturn in private sector activities. However, many major macroeconomic indicators deteriorated – inflation rose, fiscal and current account deficits widened, and overall economic growth slowed down. While the sluggish economic growth was attributed to unfavorable weather conditions which adversely affected foodgrain production, the slower pace of structural reforms also aggravated imbalances in the economy.

The near-term outlook for the economy is clouded by the recent political uncertainty and by the impact of severe floods between June and October 1995. With appropriate fiscal and monetary policies and private sector initiatives, economic growth is expected to recover in 1997.

1995 refers to fiscal year 1994/95, ending 30 June.

Recent Trends and Prospects

Growth, Investment, and Employment. Growth of GDP contracted to 4.1 percent in 1995 from 4.2 percent in 1994 owing to a decline in agricultural output. Foodgrain production fell by 1.8 percent in 1994 and by 5.7 percent in 1995 partly because of unfavorable weather conditions and partly as a result of infrastructure bottlenecks and inappropriate public intervention in the fertilizer market. In contrast, other agricultural output, particularly livestock and fisheries that had been developed largely through private sector initiatives, showed robust growth of more than 8 percent in 1995. However, this was not enough to offset the drastic fall in foodgrain production. Thus, the agriculture sector as a whole suffered a contraction of 1.6 percent during the year.

Industrial output expanded by 8.5 percent in 1995 compared with 7.8 percent in 1994, the higher growth rate resulting primarily from improved performance in manufacturing, construction, and the power and gas industries. Stronger growth in manufacturing production reflected the higher levels of private investment in recent years. Ready-made garments, chemicals, leather, food processing, and basic metals industries all showed vigorous growth. On the other hand, output of cotton and jute textiles and tea declined. Construction activities remained buoyant in 1995 as many public and private projects were launched.

Output in the services sector rose by 5.9 percent in 1995, a slight improvement on the

Table 2.14 Major Economic Indicators: Bangladesh

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	4.5	4.2	4.1	3.6	5.5
Agriculture	% change	1.8	0.3	-1.6	1.0	2.5
Industry	% change	8.0	7.8	8.5	5.5	9.5
Services	% change	5.3	5.8	5.9	4.3	5.4
Gross Domestic Investment	% of GDP	13.2	14.3	14.8	14.0	15.5
Gross Domestic Saving	% of GDP	6.4	8.4	6.8	5.8	7.2
Inflation Rate	% change in CPI	2.7	3.3	8.9	8.8	6.0
Money Supply Growth	% change	10.6	15.4	16.0	16.2	15.0
Merchandise Exports	$ billion	2.4	2.5	3.5	3.9	4.6
	% change	19.6	6.3	37.1	12.0	18.0
Merchandise Imports[a]	$ billion	4.1	4.2	5.8	7.0	8.5
	% change	17.5	2.9	39.2	20.0	22.0
Current Account Balance	$ billion	0.2	0.3	-0.2	-0.9	-1.0
	% of GDP	0.7	1.1	-0.5	-2.8	-3.0
External Debt Outstanding	$ billion	14.9	16.6	17.5	19.0	19.8
Debt-Service Ratio	% of exports	14.6	15.2	13.0	13.0	13.0

[a] Cost, insurance, and freight.

Note: All data are on a fiscal year basis. Data on inflation and trade may differ from the series contained in the Statistical Appendix (see Statistical Notes).

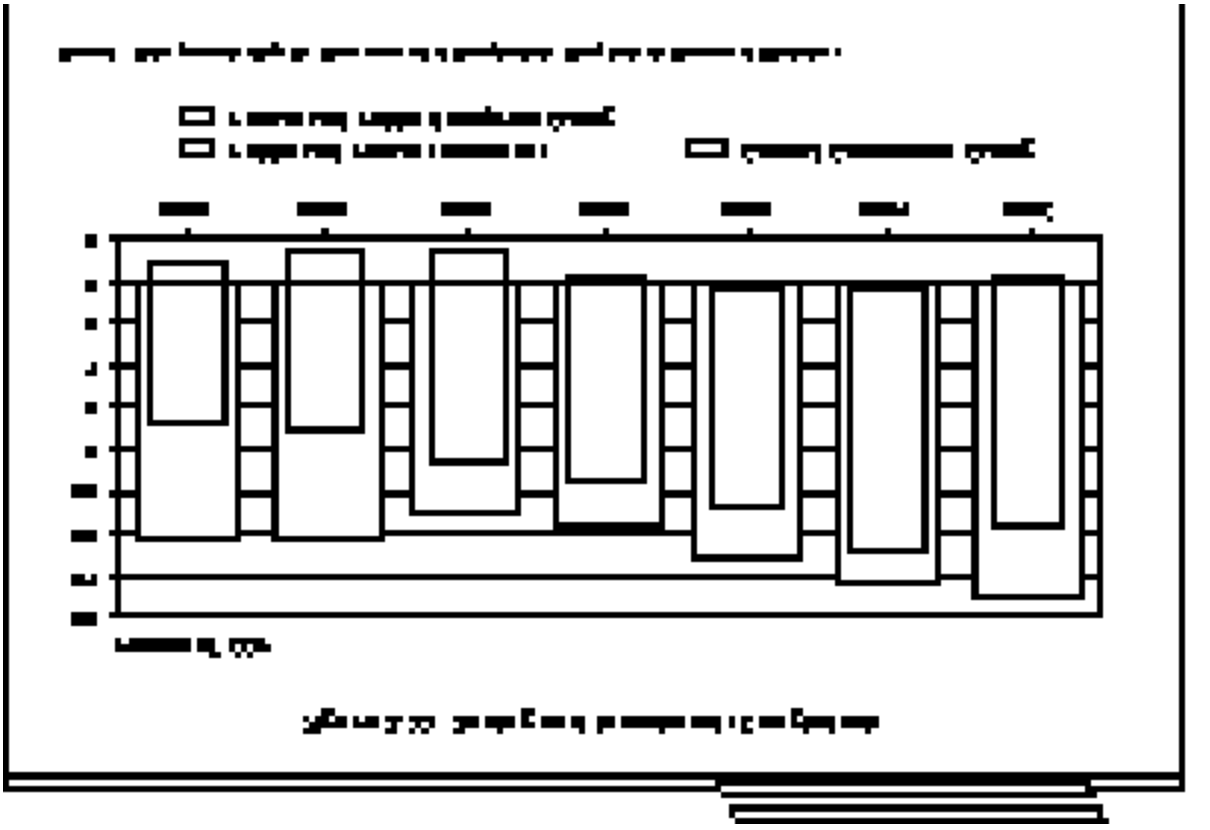
Sources: Data provided by the Government of Bangladesh, Bangladesh Bureau of Statistics; World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

rate of growth achieved in 1994. There was increased activity in transportation and communications, banking, and insurance. An increase in trade services reflected growth in both imports and exports. In the financial sector, the Government approved seven new private banks, a new foreign bank commenced branch banking, and transactions on the Dhaka Stock Exchange doubled. The gains achieved by these activities were partly offset, however, by a slump in public administration services.

Gross domestic investment rose to 14.8 percent of GDP in 1995 from 14.3 percent in 1994 (Figure 2.17). Despite the country's fragile political situation, private investment continued to increase, partly reflecting the Government's liberal stance in its trade, exchange control, capital market development, and foreign investment policies. Credit expansion to the private sector, particularly in construction and trade activities, also stimulated investment. Meanwhile, public sector investment increased with the commencement of some large-scale public projects. However, total investment is still far below its potential because of growing infrastructure constraints, financial sector inefficiencies, and sluggish implementation of crucial reforms.

For the past three years, gross domestic saving has averaged 7.2 percent of GDP per annum, a marked improvement on the average of 3.5 percent of GDP during the previous three-year period, 1989–1992. This reflects better control over the Government's current spending, significant augmentation of public revenue, and a steady rise in private saving, partly in the form of small savings instruments, such as the Grameen Bank (Box 2.5). Gross national saving is usually higher than gross domestic saving, mainly because of workers' remittances from abroad. Gross national saving averaged 11.5 percent of GDP per annum during the past three years compared with 7 percent over 1989–1992.

Providing jobs for the unemployed and 1.8 million newcomers annually in the labor market remains one of the most challenging tasks for policymakers. Among the approximately 60 million members of the labor force



in Bangladesh, 10 percent have regular jobs in the formal sector and 15 percent are classified as casual workers. The remaining 75 percent are either self-employed or unpaid family workers. Because of slow economic growth, demand for labor was low in 1995. The small share of the formal sector in total employment and the vast numbers of unemployed and underemployed have served as an incentive for labor to seek jobs outside Bangladesh. The gross number of migrants has increased in recent years and is currently nearly 250,000 per year. However, this level of labor export is still inadequate to significantly impact on the overall unemployment situation.

Economic prospects for 1996 are clouded by recent political uncertainties. First quarter data for 1996 showed that the macroeconomic situation had worsened. There was a record number of strikes during the first half of 1996 which had a severe impact on the economy in terms of lost working days. The investment climate was also seriously damaged. The consecutive floods between June and October 1995 adversely affected foodgrain production in the early part of 1996. Overall economic growth is expected to be 3.6 percent in 1996; however, this projection depends on sectoral activities not being disrupted again by political events. A reduction in foodgrain production for the second year in a row is likely to be offset partially by strong growth in the livestock and fisheries sectors. Industrial growth is projected at 5.5 percent compared with 8.5 percent in 1995. The services sector is expected to expand by 4.3 percent. Economic growth is forecast to pick up further in 1997, assuming the political situation stabilizes, weather conditions improve, and private sector investment plays a more prominent role in the economy.

Budget, Money, and Prices. The Government's prudent budget management since the early 1990s has brought considerable improvements in revenue by broadening the coverage of the VAT and non-tax revenue sources. The Government exercised tight control over current expenditure which resulted in a current budget surplus. These savings enabled the country to finance one third of the Annual Development Program (ADP) and reduce the overall fiscal deficit from 7.4 percent of GDP in 1990 to 5.5 percent in 1994.

However, despite buoyant revenues, the overall fiscal deficit in 1995 widened to

6.5 percent of GDP. Increased revenues from the VAT and customs duties were offset by a surge in current expenditures, owing, in part, to an unbudgeted increase in government employees' wages. The sizable subsidies aimed at stabilizing food prices also added to the increase in current expenditure.

Although ADP expenditure fell short of the budgeted provision in 1995, it was nonetheless 16 percent higher than in 1994 and reached a record level of over 8 percent of GDP. The Government has introduced a number of measures to improve the quality of ADP spending by emphasizing social sector and infrastructure development. Allocations of ADP funds for poverty alleviation, education, population control, and the power, transport, and communications sectors all rose in 1995.

Broad money (M2) grew by 16 percent in 1995, substantially exceeding the target set for the year, largely because of the expansion in private sector credit. After four years of low growth, lending to the private sector expanded by 24 percent in 1995, reflecting a rise in private sector activities, particularly in construction and trade finance. The failure to reform state-owned enterprises, however, and their continued need for financial support meant that credit to the public sector for this purpose had to be increased. Some steps were taken in 1995 to improve banking regulation and supervision; however, more comprehensive and systematic structural reform measures are needed in the banking sector.

Both the expansionary fiscal and monetary policies and contraction in foodgrain output placed upward pressure on the price level in 1995. As measured by the new CPI, which is based on a nationwide price survey, inflation reached 8.9 percent in 1995, a sharp increase from the previous year's level of 3.3 percent. Foodgrain prices rose by 9.2 percent during the year as a result of the shortfall in rice production. The nonfood group price index also increased by 8 percent, led by rents and fuel, transportation, and communications prices.

The overall fiscal deficit for 1996 is expected to be slightly lower than in 1995 at 5.9 percent of GDP. Tax revenue is expected to grow at a lower rate than that of nominal GDP because of a reduction in customs tariffs and corporate income taxes. Although the growth of ADP expenditure may be checked, the elections are likely to lead to an expansion of other expenditure sufficient to offset any saving that might be made. Broad money supply growth is expected to be contained at 16.2 percent assuming that the expansionary monetary policy in 1995 and the early months of 1996 is modified and the Bangladesh Bank acts more frequently, as it did in September and October 1995, to mop up excess liquidity of the commercial banks. Inflation is expected to remain high at 8.8 percent in 1996. Political disturbances and uncertainties during the general election period would have an adverse impact on consumer goods production and strengthen inflationary pressures. Fiscal conditions are expected to improve in 1997 and inflation could be reduced to 6 percent in that year.

External Trade and Payments. To attain rapid economic growth based on more intensive use of Bangladesh's most abundant factor endowment – labor – the Government has continued to redirect its development policy toward a competitive export-oriented economy by liberalizing the trade and exchange rate regimes. Since 1990, nontariff barriers have been gradually removed and average tariff rates were lowered to 26 percent in 1995 from 58 percent in 1992. These measures have strengthened the country's external position as manifested by a strong export performance. Over the period 1991–1994, the current account, including grants, improved from a deficit of 1.2 percent of GDP to a surplus of 1.1 percent.

In contrast to sluggish overall economic growth, the external sector remained buoyant in 1995. Supported by strong world demand and an expanded role of the private sector in export activities, total exports increased by a remarkable 37 percent to $3.5 billion compared with $2.5 billion in 1994, and was mainly attributable to an increase of 44 percent in exports of ready-made garments. These now comprise over 50 percent of total exports. The low cost of wages, coupled with a supportive policy environment, is the main driving force that has led to the country's continuing success in the garments market. Other leading exports such as leather and frozen shrimp also performed well in 1995.

Merchandise imports also increased sharply by 39.2 percent to $5.8 billion in 1995 from $4.2 billion in the previous year. The strong growth in imports was evident for almost all

Box 2.5 Grameen Bank

The Bangladesh institution that is most widely known internationally may well be the Grameen Bank, a semi-public bank created in 1976 to supply the rural poor with credit at reasonable interest rates. To encourage rural economic development and alleviate poverty, the Grameen Bank provides loans to the landless, illiterate, and especially female, rural poor who do not have traditional forms of collateral for conventional loans and whose only other alternative is to seek finance from local moneylenders. These local moneylenders often have considerable monopoly power among their largely immobile clientele. They charge usurious interest rates and, consequently, many potentially profitable projects are not undertaken.

The Grameen Bank approach deals with this principal-agent problem by providing an incentive for individual borrowers to monitor, assist, and insure each other. The Bank's more than 20 million members, of whom about 94 percent are women, are formed into groups of five or six of roughly equal status (same sex and similar social position) and given a joint credit rating so that, if one defaults, the others also lose their access to credit. Loans are scheduled sequentially for group members, and prompt repayment leads to an increased credit line for future borrowing. As a result, there is considerable peer pressure, and occasionally financial assistance, within each group to ensure repayment on schedule. The Bank's default rate has been exceptionally low.

In essence, the principal (Grameen Bank) transfers much of the cost of assessing credit risk, monitoring behavior and projects, and ensuring repayment by each agent (borrower) to the other agents in the group, for whom these costs are presumably lower due to their greater knowledge of their neighbors. An individual's reputation, in effect, serves as collateral, with peer pressure acting as the motivating force for good repayment behavior.

The Bank encourages fiscal discipline among its borrowers even to the point of requiring them to save and repay debts simultaneously. As an economic development organization, the Bank does not seek to maximize profits and in fact has traditionally lost money. Through partial subsidization of some projects, and through information campaigns, the Grameen Bank also encourages birth control, small families, education, better health and nutrition, and women's employment and empowerment.

A number of studies have tried to assess the developmental impact of the Grameen Bank, which now has branches in more than half of the villages of Bangladesh. These studies found that the Grameen Bank tends to raise average income in the villages where it operates. It has had a small, but positive, impact on child literacy, especially in the case of females, and a small positive impact in lowering malnutrition.

On the other hand, the Bank's financial viability so far has relied on its access to funds at below-market rates to sustain its high operating costs. Its low level of savings mobilization means that it has required continued capital infusions. To continue addressing the developmental challenges of rural Bangladesh, the Grameen Bank must also take steps to ensure its own long-run financial viability.

major products. Imports of capital goods and intermediate products increased by over 30 percent, reflecting robust industrial activities. Foodgrain imports rose by 128 percent due to inadequate domestic foodgrain production. As a result, the current account, including grants, showed a deficit in 1995 at $152 million or 0.5 percent of GDP.

Although FDI in Bangladesh is still very low compared with that in its neighboring countries, the Government has made great efforts to attract foreign investment through several policy measures and incentives. As a result, FDI has increased from $70 million in 1992 to $202 million in 1993 and $175 million in 1994. However, nearly one quarter of FDI during these three years was for a single project – the Karnaphudi Fertilizer Company Limited (KAFCO). With the completion of this project, FDI declined to less than $100 million in 1995. Many foreign investors appear to have deferred their investment decisions because of growing infrastructure constraints and political instability. Foreign exchange reserves built up in the year from $2.8 billion in June 1994 to nearly $3.1 billion in June 1995. External debt outstanding increased from $16.6 billion in 1994 to $17.5 billion in 1995. The debt-service ratio, however, declined from 15 percent in 1994 to 13 percent in 1995.

The strong growth in domestic demand and the expected large-scale food imports

could lead to a further surge of imports in the remainder of 1996 so that, for the year as a whole, import growth is expected to be about 20 percent. The growth of total exports, on the other hand, is estimated at only 12 percent in 1996, reflecting a slower pace of growth in exports of ready-made garments and a decline in exports of frozen shrimp, leather, and jute goods. Infrastructure bottlenecks, especially the shortage of warehouses and inadequate cargo handling and berthing facilities at ports, are major impediments to the rapid expansion of exports. Based on the above projections, the current account deficit is estimated to deteriorate further to about 2.8 percent of GDP in 1996. With a recovery of economic growth, merchandise exports are expected to increase by 18 percent in 1997. The increase in merchandise imports will, however, remain at 20 percent as foodgrain imports drop, assuming production improves from the poor performance in recent years. The current account deficit is projected to decline to 3 percent of GDP in 1997; the debt-service ratio is projected to remain at the 1995 level of 13 percent.

Policy and Development Issues

The major challenge facing Bangladesh is to promote socioeconomic development while pursuing sound macroeconomic management policies. During 1991–1994, the country was successful in maintaining a degree of macroeconomic balance, in improving social indicators, and in achieving some success in structural adjustment reforms. However, the recent worsening of macroeconomic conditions shows that structural adjustments are far from complete.

The restoration of a greater degree of macroeconomic stability than has recently been evident and a resurgence in the pace of structural reform must be high priority tasks if the Government is to make progress with the major development challenge of reducing poverty. On the fiscal side, the budget deficit needs to be rapidly reduced and this requires much stronger efforts to enhance tax revenue, especially through more efficient administration and collection procedures and review of charges for utility and other services. Public expenditure also needs to be more firmly controlled and its efficiency and effectiveness rigorously appraised. This applies to current expenditure, for example, consumer and other subsidies, and particularly to expenditure on ADP projects, for which more effective efforts are needed to establish realistic priorities. Also, the program for privatizing the many government commercial enterprises has languished in recent times and needs to be approached with renewed resolution.

Private sector involvement in the development process has improved in recent years although it has a much greater role to play. A crucial factor in achieving such involvement is the development and reform of financial markets and the creation of conditions, such as stability and transparency of the regulatory environment, that encourage both domestic and foreign investments. The Government has announced a comprehensive package of incentives while it has also opened up new areas for private sector participation. However, these efforts have not yet attracted a large amount of foreign investment because of the absence of a stable political environment, inadequate infrastructure support, shortages of skilled labor, and cumbersome bureaucratic procedures for investment approval.

Financial sector reform has not yet proceeded very far beyond interest rate liberalization, the introduction of some new monetary instruments, and prudential requirements for banks. Further action is needed, particularly to strengthen financial discipline in the banking sector, in particular through improvements in the monitoring and supervisory functions of the Bangladesh Bank. Thoroughgoing reform is necessary, especially the privatization of the state commercial banks, not simply to enhance their efficiency and competitiveness but also that of the financial sector as a whole.

A competitive environment for increased private sector investment would be incomplete without improved physical infrastructure and other related services. Bangladesh's physical infrastructure suffers from underinvestment and severe operational problems. During the recent past, there has been some progress in natural gas supply, flood control, irrigation, and the water and sanitation sectors. However, serious deficiencies remain, among other things, in power generation and supply, provision of roads and telecommunications networks, and availability of port facilities where more investment is urgently needed. The involvement of private investment in these areas should be seriously considered.

Bhutan

Bhutan's economic performance in recent years has been encouraging. The economy has been growing steadily due to high investment rates financed mainly by concessional external resources. The economy is dependent largely on agriculture, forestry, and livestock, although in recent years, with the development of hydropower and some allied industries, the share of manufacturing in GDP has increased. The manufacturing sector is nevertheless narrow in its range of industries, most of which are owned by the state.

Bhutan has close economic and political links with India. The local currency, the ngultrum (Nu), is fixed to the Indian rupee; external trade is predominantly with India; and Bhutan receives substantial budgetary support as well as grants to finance major investment projects from India. With acceleration of growth in India and liberalization of its economic policies, the Bhutan economy is likely to benefit. Much will depend, however, on Bhutan maintaining macroeconomic stability and on much-needed social sector investment being undertaken.

Recent Trends and Prospects

After experiencing somewhat low rates of growth in the early 1990s, Bhutan's GDP growth has accelerated in recent years and is estimated at 5.5 percent for 1995. The domestic investment rate tends to fluctuate considerably from year to year depending on whether a major investment project has been commissioned. In recent years, the investment/GDP ratio has fluctuated between 30 percent and 55 percent. Gross national saving is estimated to be about 10 percent of GDP which means that Bhutan's external resource requirement for financing domestic investment has been large. The resource gap, however, has been easily financed by inflows of concessional assistance and grants (Figure 2.18).

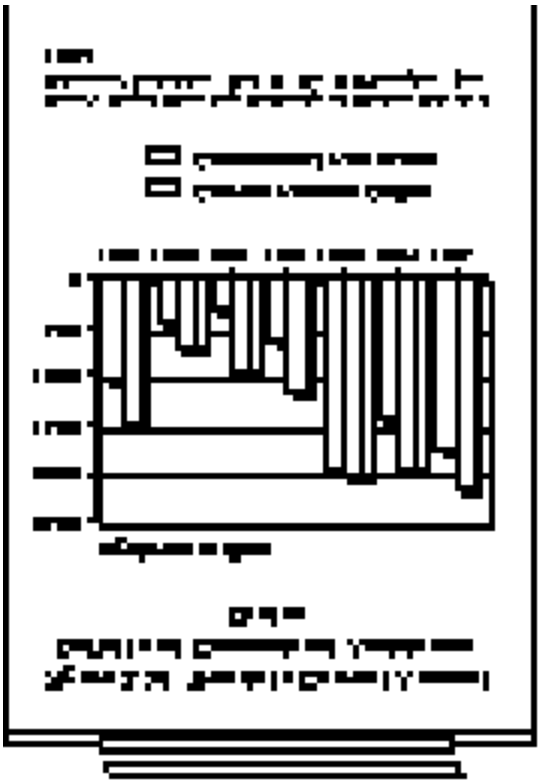
Because of the structure of the economy, Bhutan has an extremely narrow tax base with tax revenue usually being 6–7 percent of GDP. Government revenue consists largely of foreign grants of approximately 30 percent of GDP and profits from public enterprises. Since 1990, the Bhutan authorities have ensured that domestic revenues finance all recurrent expenditure, while foreign grants and concessional loans finance capital expenditure. Revenue and grants amounted to 50 percent of GDP in 1995 (1994/95, ending 30 June) while total expenditure was 52.2 percent of GDP. The overall fiscal deficit was thus about 2 percent of GDP which was financed by foreign resources equal to 1.4 percent of GDP and domestic borrowing at 0.3 percent of GDP. The overall budgetary balance was in surplus in fiscal years 1993 and 1994 but was in deficit in fiscal year 1995 because of a sharp increase in expenditure. In recent years, the Government's current expenditure has risen to meet growing demands for education and health care. On the revenue side, returns from hydropower investment have been somewhat constrained because of subsidized domestic tariffs.

Broad money supply (M2) expanded rapidly in 1995 at close to 30 percent. Much of the increase in money supply reflected the increase in foreign exchange reserves as a result of large inflows of foreign aid. Given the openness

of Bhutan's economy with India, inflation has remained close to that in India and in 1995 is estimated to have been about 8.6 percent. The monetary authorities have recently taken steps to develop new instruments of monetary policy, strengthen prudential norms and supervision, and enhance competition in the financial system. More notable among the policy measures are the introduction of regular auctions of Central Bank bills and the creation of a government securities market.

Exports in 1995 increased by 6 percent to $71 million. About 93 percent of exports were destined for India. Due to commissioning of new foreign-financed industrial projects, imports increased sharply by 16 percent in 1995 to $102 million. The invisibles account of the balance of payments was also in deficit with the result that the current account deficit in 1995 reached an estimated $45 million or 16 percent of GDP. Net external resource inflows from abroad, mainly concessional official loans and grants, were larger than the current account deficit and thus the overall balance of payments was in surplus. Bhutan added $18.8 million to its foreign exchange reserves in 1995. Reserves in 1995 were estimated at $126 million, equivalent to 13 months of import cover.

With the recent commissioning of ferro-alloy and cement projects, which are predominantly export oriented, GDP growth in 1996 is likely to improve to 7 percent. Inflation is likely to moderate somewhat in 1996 because, with the recent projects having been commissioned, expansion of money supply should slow down. Over the medium term, however, the Government will need to exercise greater fiscal prudence, especially since the revenue base is both narrow and inelastic. Exports are projected to increase in 1996 and 1997 by about 15 percent per annum as the output of recently commissioned projects is exported. Import growth should moderate somewhat; however, the current account deficit is expected to be substantial at about 18 percent of GDP. With inflows of external grants and concessional assistance more than covering the current account deficit, the foreign exchange reserve position is likely to improve further over the next two years. Bhutan's external debt position will remain comfortable and the debt-service ratio is likely to range between 15 percent and 18 percent of exports of goods and services.



Policy and Development Issues

The main industry in Bhutan is hydropower and related activities in which the Government has invested heavily in the past. Recently, however, there have been significant efforts towards reducing state holdings in several public sector companies. While the Government is keen to promote privatization, the results have been somewhat modest because of a lack of entrepreneurial talent in conjunction with a primitive financial system. To promote the role of the private sector, the Government will need to strengthen the legal framework, legislate to protect private property rights, liberalize regulations on imports from countries other than India, and dilute the extant exchange controls. Financial sector reforms are also required, especially the deregulation of interest rates and the liberalization of the regulations governing foreign direct investment.

Over the medium term, Bhutan will have to pay more attention to fiscal issues as demands on both recurrent and capital expenditure are expected to increase. If the Government is to meet these demands while maintaining macroeconomic stability, it needs to take steps to broaden the tax base and to ensure improved tax compliance.

India

In 1995, India was able to sustain a high rate of economic growth as reforms initiated in the wake of the macroeconomic crisis of 1991 took stronger hold and the economic recovery gained further momentum. Reflecting the liberalization of the trade and external payments regimes, increased integration of India into the global economy, and strong pent-up domestic demand, imports rose at a faster pace than did exports. As a result, the deficit in the external current account widened during 1995. Owing mainly to the moderation in capital inflows and bunching of debt-service payments, gross international reserves declined and pressure on the exchange rate emerged.

The Government continued its reform efforts in 1995, albeit at a more moderate pace. Initial measures aimed at improving the efficiency of resource allocation and expanding the productive capacity of the economy were followed by reforms of the financial and capital markets. However, in consolidating its program of structural adjustment, the Government is faced with a number of difficult issues. The fiscal deficit, although lowered over the past two years, is still too high and needs to be reduced further. The country's infrastructure needs to be modernized and expanded; however, to do so will place heavy pressure on public finances unless an attractive climate for private investment in this area can be established. Inadequate progress has so far been made in public sector and labor market reforms, while poverty alleviation and human resource development remain important tasks. There are also institutional constraints arising from the limited progress of reforms at the state government level. These problems need to be addressed with some resolve if the Indian economy is to sustain a high rate of growth over the long run.

Recent Trends and Prospects

Growth, Investment, and Employment. Reflecting a broad-based economic recovery, real GDP is estimated to have increased by 6.2 percent in 1995, virtually the same as in 1994 and significantly better than the growth rate of 5 percent recorded in 1993. Agricultural output, however, was only 0.5 percent higher than in 1994, partly because of adverse weather conditions, but also because sectoral growth in 1994 had been exceptionally high at nearly 5 percent. Foodgrain production in that year reached a record level of 191 million tons, with wheat output increasing by nearly 10 percent and pulses by 6 percent. There were also large increases in the output of sugarcane, and jute and cotton production recovered well from the decline in output experienced in 1993. For the most part, the levels of production reached in 1994 were closely matched in 1995. Although its share of GDP continues to decline as industrialization proceeds, agriculture still accounts for about 28 percent of GDP.

The industry sector, however, continued to be the main driving force behind the high growth rate of the economy over the past two years, supported by a solid performance from the services sector which grew by 6.1 percent

1995 refers to fiscal year 1995/96, ending 31 March.

Table 2.15 Major Economic Indicators: India

		1993	1994	1995	1996	1997
Gross Domestic Product[a]	% change	5.0	6.3	6.2	6.4	6.6
Agriculture	% change	3.3	4.9	0.5	3.0	3.8
Industry	% change	4.2	8.3	12.0	9.4	8.6
Services	% change	6.8	6.0	6.1	6.4	7.0
Gross Domestic Investment	% of GDP	21.6	25.2	24.0	24.5	25.0
Gross Domestic Saving	% of GDP	21.4	24.4	22.5	22.5	23.0
Inflation Rate	% change in CPI	7.5	10.1	9.5	9.0	8.0
Money Supply Growth	% change	18.4	21.2	15.6	15.0	15.0
Merchandise Exports	$ billion	22.7	26.8	32.4	38.2	43.9
	% change	20.3	17.9	21.1	18.0	15.0
Merchandise Imports	$ billion	24.0	31.3	39.6	47.9	56.5
	% change	3.2	30.4	26.7	21.0	18.0
Current Account Balance	$ billion	-0.3	-2.3	-5.1	-6.3	-8.0
	% of GDP	-0.1	-0.8	-1.6	-1.7	-2.0
External Debt Outstanding	$ billion	92.1	99.0	104.3	114.0	125.7
Debt-Service Ratio	% of exports	26.1	26.3	26.7	26.8	27.6

[a] Based on constant 1980 factor cost.

Note: All data are on fiscal year basis. Data on inflation may differ from the series contained in the Statistical Appendix (see Statistical Notes).

Sources: Government of India, Ministry of Finance, *Economic Survey 1995-96* (New Delhi, 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

in 1995 as in 1994. Industrial production, which accounts for about 31 percent of GDP, increased by 12 percent in 1995. This was largely because of strong manufacturing growth, which was widely spread among industries. A number of industries, including food products, wood and wood products, paper, non-metallic mineral products, basic metals, machinery, and transport equipment, grew at 12–15 percent or more. Others, particularly traditional industries such as cotton textiles and yarn, did not fare as well, and had much lower growth rates. The vigor of growth now being displayed by the industry sector in India is related to the various policy initiatives affecting the sector taken by the Government since 1991. These include the deregulation and delicensing of industries, the rationalization and reduction of import tariffs, the removal of import licensing, and the reduction of corporate taxes.

Available data give an unclear picture of the course of investment and saving since the reform process began in 1991. Although gross domestic investment in 1995 declined to an estimated 24 percent of GDP from 25.2 percent in 1994, it was still higher than in the early years of the reform period from 1991 to 1993. Also, in recent years, the share of the private sector in gross fixed capital formation has risen, indicating a positive response from the private sector to the deregulation of the economy. Gross domestic saving also declined for a few years following liberalization, especially in the household sector, and at 22.5 percent of GDP in 1995 was still below the level of 1991. However, saving in the private corporate sector during the past two years has been above that in 1991. The resource gap in 1995 is estimated at 1.5 percent of GDP compared with 0.8 percent in 1994 and 0.6 percent in 1991, and was reflected in a widening of the current account deficit and hence increased reliance on foreign savings.

Data on the current state of employment and labor market conditions in India are relatively sparse. There are, however, indications that the annual increase in employment rose from some 3 million in 1991 to more than 7 million in 1994, augmenting the

labor force by more than 20 million to over 320 million during that period. In 1995, it is estimated that the increase in employment was similar to that in 1994. The informal sector continues to account for the dominant share of total employment (about 90 percent), and has experienced relatively higher growth compared to that of the formal sector in most economic activity, particularly in manufacturing, construction, and transport. Since labor is the principal asset possessed by the poorer strata of society, improvement in employment opportunities is likely to have been associated with favorable trends in living standards and poverty. The introduction of various relief employment programs, the strengthening of the public distribution system for food, and other related measures have also played an important role in assisting the poor.

Given normal weather conditions, GDP growth is expected to increase to 6.4 percent in 1996 and 6.6 percent in 1997. Agricultural output should expand more strongly than in 1995 at 3 percent in 1996 and further to 3.8 percent in 1997. The industry sector is expected to show the fastest growth rates at 9.4 percent and 8.6 percent in 1996 and 1997, respectively. The services sector, which accounts for about 41 percent of GDP, is expected to improve its growth rate to 6.4 percent in 1996 and 7 percent in 1997, with continued strong growth in external trade and financial sector reforms being beneficial influences.

Investment is projected to increase slightly by 0.5 percentage points relative to GDP in each of the next two years, mainly because of higher private investment, although some rise in public investment late in the period would reinforce this trend. The rate of saving is forecast at 22.8 percent of GDP over the next two years and, in consequence, the resource gap will widen slightly. The maintenance of strong economic growth in 1996 and 1997, especially the recovery in agricultural output, should enable employment opportunities to be created at much the same rate as in 1995. Increased spending on various rural employment programs introduced in recent years will help to achieve that result.

Budget, Money, and Prices. Considerable progress in the reduction of the Central Government's fiscal deficit was achieved in 1995. The budget for 1995 provided for a deficit of 5.5 percent of GDP; the deficit was, in fact, 5.3 percent, about one percentage point lower than the 6.5 percent recorded in 1994, and well below that of 1993 when the deficit had moved sharply upwards to 7.5 percent of GDP (Figure 2.19). Even though total revenue exceeded budget estimates, the excess was insufficient to cover over-budget expenditure, especially on subsidies, social services, and loans to the state governments.

Total revenue receipts in 1995 were 21 percent greater than in 1994, rising to 10.1 percent of GDP from 9.6 percent. Tax revenue was up by over 20 percent, reflecting not only the strength of economic growth but also tax reforms introduced in the 1995 budget and previously to widen the tax base, improve tax administration and compliance, and increase buoyancy of the tax system. Capital receipts (excluding borrowing), however, declined by some 26 percent, principally because expected divestment of equity in state-owned enterprises failed to occur.

Total expenditure in 1995 was nearly 14 percent greater than in 1994; however, in GDP terms, it declined fractionally from slightly above 17 percent to 16.8 percent. Nearly all of the increase was accounted for by current expenditure, which rose by 17.5 percent against an increase of only 2.2 percent in capital outlays. Apart from higher recurrent expenditure on socioeconomic services and other items, a major expense in 1995 was a rise of around 18 percent in debt interest payments, which now account for about 30 percent of total expenditure or about 4.8 percent of GDP.

The state governments have so far made relatively little progress in fiscal adjustments to bring their expenditure in line with available revenue, although they have recently initiated some reforms and are considering modifications to their tax systems and improvements in expenditure management. However, unless these reforms are implemented expeditiously and include both revenue-enhancing and expenditure-reducing measures, there is a risk that fiscal adjustments by the Central Government could be undermined by expansionary policies on the part of the states. The fundamental weakness of the states' finances continues to be reflected in the persistence of revenue deficits, large borrowing requirements, and a declining share of investment outlays in total expenditure. The states' fiscal deficit increased from 3.1 percent of GDP in 1993 to

3.6 percent in 1994 and is estimated to have remained at about that level in 1995.

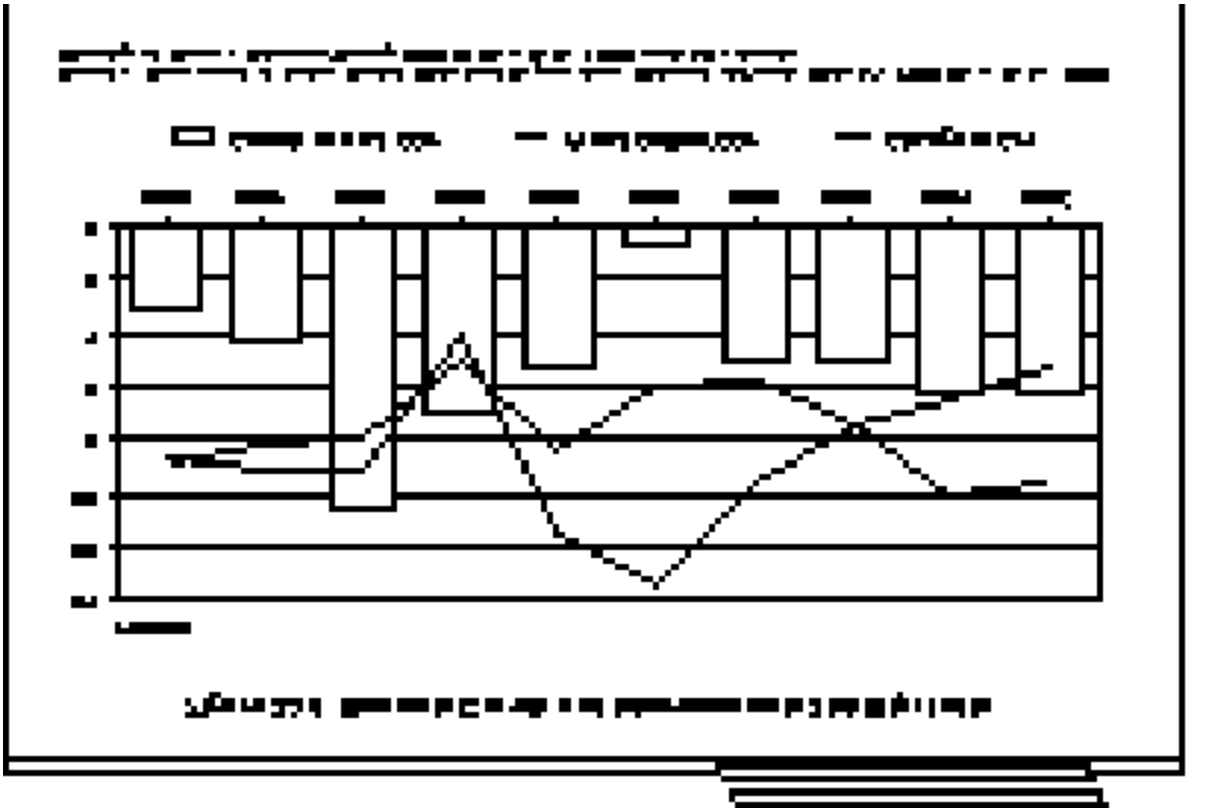
The weak financial performance of public enterprises continues to put pressure on public finances. In many sectors, such as textiles, steel, and fertilizers, the profit margin of these enterprises is negative. The largest drain on public finances is due to the State Electricity Boards which absorb a significant fraction of plan outlays but report heavy losses resulting mainly from transmission and distribution losses and from subsidization of the power tariff for the agriculture sector. Restructuring of these enterprises should focus on increasing their managerial and financial autonomy, improving their physical performance, and making them more commercially viable.

Unlike in 1994, when monetary expansion was mainly due to a surge in capital inflows, growth in the monetary base during the year resulted essentially from recourse to Central Bank credit by the Central Government. To some extent, however, this also reflected a more moderate increase in the placement of government securities with the banking system, effectively constraining the Government's ability to raise finances from this source. For the year as a whole, growth in monetary expansion moderated somewhat. Reflecting lower capital inflows and the absence of large-scale foreign exchange purchases by the Central Bank, broad money is estimated to have increased by 15.6 percent in 1995 compared with 21.2 percent in 1994. With credit to the commercial sector increasing by more than 20 percent (almost double the 1994 rate) due to the strong and broad-based expansion in economic activity and the recovery in private sector investment, interbank and lending rates have risen. Reinforced by other factors, particularly lower inward remittances of foreign currency assets associated with the depreciation of the exchange rate and the Central Bank's brief intervention in the market, the banking system experienced a liquidity crunch during the latter part of 1995. In response to tightened liquidity, and to foster deposit mobilization and facilitate financial intermediation, the Central Bank took a number of measures to relax credit availability, including lowering reserve requirements from 15 percent to 14 percent, increasing interest rates on resident deposits, and deregulating interest rates for certain term deposits. Moreover, almost all lending rates can now be set by the financial institutions without Central Bank restriction. Implementation of these measures will further reduce the pre-emption of banking system resources by the Government, improve the efficiency and profitability of banks' operations, and allow market determination of interest rates to provide signals for the allocation of resources.

Policy has also been directed toward further development of capital markets. In March 1995, the Central Bank issued guidelines for a system of primary dealers and specified eligibility criteria, including minimum capital requirements and risk-weighted capital adequacy standards for participating dealers. By November 1995, the Central Bank had already accredited six financial institutions as primary dealers in government securities. Most reform efforts have focused on modifying the institutional framework to facilitate market transactions and increase market turnover, thereby creating incentives for increased depth and liquidity of the capital markets. Further reforms in this area will need to focus, among other things, on deregulating investments by insurance companies and pension and provident funds, and improving the credit rating system for public sector bonds. Implementation of these measures would contribute to increasing the number of active market participants, thereby improving the marketability of financial instruments.

The rate of inflation showed a tendency to increase in the first few months of 1995; however, with money supply growth kept under restraint, inflation receded in later months. For 1995 as a whole, inflation was 9.5 percent compared with 10.1 percent in 1994.

The budget for 1996, which is an interim one pending parliamentary elections later in 1996, provides for an increase of 17.3 percent in total revenue to 11 percent of GDP. Most of the increased revenue will come from customs and excise duties, and company and personal income taxes. The budget made no changes to existing rates of taxation. Total expenditure is projected to rise by 10.4 percent in nominal terms, although this would represent a decline from 16.8 percent of GDP in 1995 to 16 percent in 1996. The fiscal deficit is, therefore, expected to be reduced to 5 percent of GDP. However, capital expenditure will decline further to 3.3 percent of GDP in 1996 from 3.6 percent in 1995 and 4.1 percent in 1994. This is cause for concern. With interest



payments and defense expenditure amounting to over 61 percent of recurrent expenditure, the brunt of any expenditure reductions to reduce the fiscal deficit must fall elsewhere or, alternatively, even stronger efforts than have so far been made will be needed to improve the revenue flow.

Reduction of the fiscal deficit in 1996 as planned will, however, contribute to reducing reliance on Central Bank financing, thereby helping to reduce the rate of growth in the money supply which is expected to be held to about 15 percent in both 1996 and 1997. In turn, and in the absence of supply-side shocks, this should help to bring down the rate of inflation to 9 percent in 1996 and further to 8 percent in 1997.

External Trade and Payments. India's balance of payments has improved substantially following the implementation of the stabilization and structural reform program in 1991. The external current account deficit has declined from 3.2 percent of GDP in 1990 to 0.8 percent in 1994 and, reflecting large capital inflows including private direct and portfolio investment, gross international reserves increased from $2.3 billion to $20.8 billion during that period. In 1995, exports continued to expand, increasing by more than 21 percent. However, imports rose sharply by nearly 27 percent as the progressive elimination of quantitative restrictions and reduction in tariffs – including a further reduction in the maximum and average tariff rates in 1995 – and buoyancy in economic activity was reflected in higher import demand. As a result, the trade deficit widened in 1995, and the external current account deficit is estimated to have increased to 1.6 percent of GDP.

Like several emerging economies, India has experienced surges in capital inflows since 1993. These inflows have eased external constraints and facilitated the pursuit of the liberalization of trade, foreign investment, and industrial policies. By eliminating restrictions on current account transactions, international confidence in the Indian economy has been built up and formed the basis for capital inflows of a longer duration. During 1995, however, net capital inflows moderated, in part, reflecting the adverse impact of the Mexican financial crisis on flows to emerging markets, but also resulting from an increase in amortization to official creditors and repayment of outstanding commercial borrowing.

The bulk of capital inflows continues to consist of direct investment, estimated to have risen from $1.3 billion in 1994 to $1.8 billion in 1995. Nonresident deposits with the banking system have also increased. Yet, these capital inflows were not sufficient to offset fully the widening of the external current account deficit. As a result, foreign exchange reserves declined by about $3 billion and stood at $17.5 billion in November 1995 compared with $20.8 billion at the end of 1994. This contributed to pressure on the exchange rate: the Indian rupee (Rs)/US dollar rate depreciated from Rs31.5 to about Rs35 per US dollar.

As the impact of the trade liberalization measures and the effects of the exchange rate adjustment work themselves out, growth in exports is likely to moderate to 18 percent in 1996 and 15 percent in 1997, while import growth contracts to 21 percent in 1996 and 18 percent in 1997. The current account deficit is forecast to increase to 1.7 percent of GDP in 1996 and further to 2 percent in 1997. The projected further increase in non-debt capital inflows, reflecting India's potential to efficiently absorb direct investment, will contribute to moderating the increase in external debt and debt service. The debt-service ratio is projected to rise marginally to 26.8 percent in 1996 and 27.6 percent in 1997.

Policy and Development Issues

The Government has made impressive progress in implementing a comprehensive market-based stabilization and structural reform program. Progress in liberalizing industry, trade, and foreign investment included eliminating quantitative import restrictions, rationalizing the tariff system, reducing entry barriers, and abolishing licensing requirements. In the financial sector, interest rate controls have been almost completely abolished, lending rates have been freed, and the reserve and liquidity requirements have been lowered to reduce the implicit taxation on financial institutions. In addition, prudential regulations have been strengthened and a Board of Financial Supervision established. Progress has also been made in deepening capital markets and establishing an improved regulatory framework. Wide-ranging reforms to the tax structure have also been made.

However, progress has been limited in several areas, particularly as regards public sector reform. The emphasis so far has been on improving revenues through revising the tax structure and broadening the tax base, but efforts need to be directed toward rationalization of expenditure and reform of public sector enterprises. Reduction in the public sector deficit would lower borrowing costs, release resources for more efficient private sector utilization, and further moderate pressure on monetary expansion.

Equally important is the need to accelerate reform of the public sector enterprises. Growing competition from private sector entities has compounded the financial difficulties of the public sector enterprises and put additional strain on budget resources. Moreover, consolidation of the public finances would contribute to raising domestic saving and lowering reliance on foreign saving, and thereby reduce pressure on the external current account.

Another important area of concern is the inadequacy of India's infrastructure. While higher domestic saving and inflow of capital, and greater efficiency in capital use can accelerate economic growth, it will not be possible to achieve and sustain such growth without massive investment in the development of infrastructure. Inadequacies in the power, transportation, and telecommunications sectors are major constraints. The recent opening up of these sectors to private sector participation, including foreign investors, is a positive step.

Progress in the reform agenda has been limited mostly to the Central Government. The states' public finances have remained under stress because of the inherent structural weaknesses of their tax systems, heavy expenditure obligations, and a slowdown in their access to ad hoc grant transfers from the Central Government. Given that most of the unfinished reform agenda is a concurrent responsibility of the Central Government and state governments, it is crucial that the states make greater progress in their structural reforms.

Although there has been a significant improvement in social indicators, India still lags behind most Asian countries in these aspects. Poverty remains a serious problem; a large fraction of the population has limited or no formal education and there are substantial disparities in social indicators across the states. To sustain economic growth over the long run, much more rapid progress needs to be made in human resource development than has been the case in the recent past.

Malaysia

The Malaysian economy continued to grow rapidly in 1995. The effectiveness of the macroeconomic management of the economy is reflected in the high growth rate, with price stability, achieved since the economic boom began in 1988. The medium-term outlook for the economy remains positive; strong domestic demand and continued outstanding export performance should sustain the rate of growth. The high rate of economic growth and existing low level of unemployment will exert upward pressure on the price level; however, tight monetary policy and reductions in import duties should help contain inflation. The current account deficit, while increasing in absolute terms, is likely to decline as a proportion of GDP over the next two years, and it can be financed easily with continued strong inflows of FDI.

Recent Trends and Prospects

Growth, Investment, and Employment. In 1995, GDP grew by 9.3 percent. As in the past, the manufacturing sector and export expansion continued to be the driving forces, aided in 1995 by a turnaround in agriculture and mining.

Growth in the agriculture sector recovered to over 4 percent in 1995. The high commodity prices prevailing in 1994 and 1995 induced a large increase in the production of palm oil and rubber, the two commodities which together account for over 70 percent of the cropped area in Malaysia. The increase in palm oil production was also aided by recovery from tree stress which affected output in 1994, and the coming into maturity of additional areas. However, owing to continuing labor shortages in agriculture, growth in production of most other crops, livestock, and fishing slowed further. Also, sawlog output continued to decline in line with the Government's policy of promoting sustainable forest resource management. The increase in production in Sarawak and Sabah was more than offset by the reduction in output in Peninsular Malaysia.

Industrial production increased by over 13 percent in 1995. Output in the mining sector, where oil and gas production account for about 80 percent of the total, expanded sharply. The production of crude oil increased by 5.2 percent, largely because of the coming-on-stream of a new oil field off Sarawak in early 1995; and gas output increased by 24 percent in response to continued strong growth in demand and expansion in the natural gas processing and distribution system. However, tin-in-concentrate production declined for the sixth consecutive year and is now less than 20 percent of what it was in 1989.

Manufacturing growth was still high at 13 percent in 1995. Production in the electrical and electronics sector, which is by far the largest industry in Malaysia, grew by 24 percent, driven largely by strong external demand. Other important industries with improved growth performance in 1995 were transport equipment, iron and steel, fabricated metal products, and petroleum products. The higher growth in these industries reflected increased capacity and strong domestic demand, particularly for passenger cars and construction materials. However, the performance of the textile and apparel industry was disappointing. Growth in the production

Table 2.10 Major Economic Indicators: Malaysia

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	8.3	9.2	9.3	8.5	8.0
Agriculture	% change	4.3	-1.0	4.1	2.8	2.6
Industry	% change	10.1	12.4	13.1	11.5	10.8
Services	% change	8.1	9.9	7.0	6.9	6.3
Gross Domestic Investment	% of GDP	35.1	38.7	40.6	41.0	41.5
Gross Domestic Saving	% of GDP	35.4	37.6	37.2	37.5	38.0
Inflation Rate	% change in CPI	3.6	3.7	3.4	3.7	4.0
Money Supply Growth	% change	22.1	14.7	22.8	16.0	17.0
Merchandise Exports	$ billion	46.2	56.9	72.1	85.4	99.5
	% change	16.1	23.1	26.6	18.5	16.5
Merchandise Imports	$ billion	43.2	55.3	72.3	85.3	99.0
	% change	17.8	28.1	30.6	18.0	16.0
Current Account Balance	$ billion	-2.8	-4.1	-7.6	-7.7	-7.5
	% of GDP	-4.5	-5.9	-8.9	-8.0	-7.0
External Debt Outstanding	$ billion	23.3	24.8	27.0	29.0	31.0
Debt-Service Ratio	% of exports	7.8	7.7	6.0	6.0	6.0

Sources: Government of Malaysia, Ministry of Finance, *Economic Report 1995/1996* (Kuala Lumpur, 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

of textiles moderated in 1995, while output of the apparel industry declined in the face of increasing competition from labor-abundant countries.

Growth in the construction sector accelerated to 15.2 percent in 1995. Rapid urbanization and rising disposable incomes continued to generate a growing demand for housing, as well as for retail space. At the same time, high rates of investment in the manufacturing sector generated demand for factory premises and industrial buildings, while rapid growth in tourism promoted the construction of new hotels, theme parks, and other tourism-related facilities. Growth in the construction sector was also boosted by the large number of major infrastructure projects being implemented.

The services sector expanded by 7 percent in 1995, substantially below the 1994 growth rate of about 10 percent. The slowdown was largely the result of a fall in the growth rate of government services, which is an indicator of the success of the official policy of downsizing the public sector. The financial services and transport and communications sectors maintained double-digit growth rates.

While Malaysia is considered to be a model of export-oriented growth, in an accounting sense, its recent growth has been driven primarily by domestic demand, as the net contribution of the external sector to aggregate demand has been negative in seven of the past eight years. The reason for the seeming contradiction between the popular perception about Malaysia's recent economic growth, on the one hand, and that shown by analysis of components of demand, on the other, is that a large proportion of the investment component in domestic demand is FDI financed by foreign investors themselves. This investment increases imports of machinery and equipment and thus adds to the current account deficit; however, at the same time, it provides the financing both for their imports and for the deficit. This factor must be kept in mind in any analysis of aggregate demand, the savings-investment gap, and the balance-of-payments deficit of Malaysia.

In 1995, growth in domestic demand of about 15 percent again substantially exceeded growth in GDP. Rising levels of per capita income, cuts in personal income taxes, and

easy availability of consumer credit stimulated private consumption, the growth rate of which almost doubled to 13.7 percent in 1995. Both public and private investment continued to expand rapidly, buoyed by increases in infrastructure spending, housing starts, and FDI.

The expansion in fixed capital formation resulted in an increase in the investment rate to 40.6 percent of GDP, the highest level ever achieved by Malaysia. However, the gross domestic savings rate declined slightly to 37.2 percent of GDP because of a sharp fall in public sector saving resulting from stagnation in federal government revenues. Consequently, the savings-investment gap widened further and was met through increased FDI inflows and external borrowing by some public enterprises.

Rapid economic growth continued to generate new jobs in significant numbers and the unemployment rate declined further to 2.8 percent of the labor force in 1995. Most of the new jobs were in construction, manufacturing, and the trade, hotels, and restaurants sectors. The employment share of agriculture and government services declined further to about 19 percent and 11 percent of total employment, respectively. Labor shortages are now widespread in both skilled and unskilled occupations; this is reflected in the high incidence of worker turnover in all sectors of the economy. To alleviate the shortage of skilled labor, the coverage of the Human Resource Development Fund was extended to more employers and industries in the services sector. In addition, existing private technical training institutions were given tax incentives to upgrade their facilities, and legislation aimed at promoting technical and higher education was enacted.

The growth rate of the Malaysian economy is expected to slow down to 8.5 percent in 1996 and to 8 percent in 1997. Agriculture sector growth is likely to be lower because of perennial labor shortages and a decline in commodity prices from the unusually high levels reached in 1995. Sawlog production will be reduced further in line with government policy. Growth of industrial output will continue to be strong although somewhat slower than in 1995, as recent measures to tighten consumer credit begin to affect sales of consumer durables. Expansion in the services sector is also expected to moderate.

Strong domestic demand – both consumption and investment – and sustained exports will provide the impetus for growth. The ongoing massive infrastructure investment program is likely to boost the gross domestic investment rate further to 41 percent of GDP in 1996. Some recovery in public saving should raise the overall savings rate to 37.5 percent of GDP, and thus maintain the savings-investment gap at about the same level as in 1995. As a consequence of strong growth, pressure in the labor market is unlikely to ease and, with the unemployment rate declining to 2.7 percent by 1997, labor shortages will continue to be felt in most sectors.

Budget, Money, and Prices. There was some loosening of fiscal policy in 1995. The Federal Government's operating and development expenditures rose by 9 percent and 15 percent, respectively. Government revenue, however, increased by only 2 percent because of cuts in income and corporate taxes and excise and import duties. As a result, the budget surplus declined to 0.3 percent of GDP from 2.4 percent in 1994. The fiscal impact of the overall public sector (i.e., including public enterprises) was, however, expansionary in 1995. This was largely because of a 32 percent increase in capital expenditure by public enterprises, primarily in the telecommunications, power, and oil and gas sectors. As a result, while total public revenue remained virtually constant, operating expenditure increased by 10 percent and development expenditure by 28 percent. Thus, an overall public sector surplus of 1.8 percent of GDP in 1994 was followed by a deficit of 3.5 percent in 1995.

The Central Bank followed a policy of monetary restraint in 1995. Bank Negara used open market operations, including direct money market borrowing and the issue of Bank Negara Bills complemented by generally higher interest rates, to reduce excess liquidity. At the end of 1995, interbank and deposit rates in Malaysia were about 150 basis points higher than a year earlier, while the base lending rate (BLR) was about 100 basis points higher. In November 1995, Bank Negara introduced a new framework for calculating the BLR by commercial banks to make the lending rates more responsive to the Central Bank's interventions in the money market. Despite the tight monetary policy, growth of narrow money (M1) was virtually unchanged, while that of the broader monetary aggregates increased sharply. In 1995, M2 and M3

both grew by over 20 percent. This was almost entirely because of the 23 percent expansion in credit to the private sector, as private investment and expenditure on consumer durables accelerated.

Malaysia continued to enjoy relative price stability in 1995 despite the expansionary public sector position, high GDP growth rate, and tight labor market. Inflation (as measured by the consumer price index) at 3.4 percent was down slightly from the 3.7 percent recorded in 1994. Important factors contributing to the price stability were the Government's monetary restraint and import liberalization policies. In recent years, Malaysia has followed a policy of reducing inflationary pressure by cutting tariffs and thereby reducing import prices. The success of this policy can be seen from the fact that, while the producer price index (PPI) for local production increased by 9percent in 1995, the PPI for imports declined by 1 percent (Figure 2.12). The Figure also indicates that there may be some basis for the widely held view that the CPI is not a good measure of inflation in Malaysia, as a substantial proportion of the items included in it are at government-controlled prices. From the Figure it can be seen that, while other price indexes show considerable fluctuations in inflation from year to year, the CPI is virtually a straight line with a slight downward slope. Moreover, the other price indexes show increasing inflationary pressure in the economy since 1993, kept only partially in check by declining domestic prices of imported goods. This is what would be expected in a period of high GDP growth with full employment, acceleration in the growth of money supply, and an expansionary public sector position.

The 1996 federal budget proposes an increase of 7.6 percent (two thirds of it because of salary revision) in operating expenditure and an 8.7 percent increase in development expenditure. A buoyant economy should ensure a healthy increase in revenues, which were projected to grow by 8 percent. However, actual revenue growth is likely to be smaller than this because of a reduction in personal income tax rates, tariffs, and excise duties proposed in the budget, and only a small surplus is expected in 1996. The Government announced a number of specifically targeted fiscal and other measures in the budget. To promote saving, the contribution by employees to the Employees Provident Fund (EPF) and the maximum deduction allowed (for income tax purposes) for contributions by employers to EPF and other approved savings schemes were increased. Both the minimum monthly payment on credit cards and the road tax for luxury cars were increased as a means of curbing consumption. Import duties and/or sales tax on more than 1,500 items – including 800 items of raw materials, intermediate goods, and equipment – were abolished or reduced, the aim being to reduce business costs, increase competition, and curb inflationary pressure. To control the growing deficit on the services account of the balance of payments, the coverage of fiscal incentives was expanded to include investment in service industries such as communications, public utilities, and transportation.

It is expected that the Central Bank will continue with its tight monetary policy for the foreseeable future. Bank Negara made its intentions clear in this regard by raising the financial institution's statutory reserve requirements by 1 percentage point to 12.5 percent in early 1996. However, Bank Negara will have to be careful not to repeat the mistakes of 1993, when tight monetary policies and the accompanying higher interest rates resulted in massive short-term capital inflows. These in turn led to problems of monetary control and accumulation of huge losses by the Central Bank on its sterilization operations and in the management of excess foreign exchange reserves. This is a real danger because in 1996, as in 1993, Malaysian interest rates are rising, while international interest rates are declining. The strong domestic demand and the high rate of growth with full employment will ensure continuing inflationary pressure. However, budgetary restraint, tight monetary policy, and import duty reductions should help contain the rate of inflation, which (as measured by the CPI) is expected to increase only slightly over the next two years.

External Trade and Payments. Capacity expansion in the manufacturing sector and higher prices of Malaysia's major agriculture exports resulted in further improvement on the strong export performance of 1994. In value terms, exports grew by about 27 percent in 1995, with manufactured exports increasing by 28 percent. Agriculture and mineral export earnings also recovered because of higher export unit values as well as increased volumes

of palm oil, natural rubber, crude oil, and liquefied natural gas.

The growth in manufactured exports was led by electrical and electronic products, which accounted for about 65 percent of Malaysia's manufactured exports. All subsectors had strong growth, with exports of electronic components (semiconductors) increasing by 31 percent, consumer electronics (audio and video recorders, radios, and televisions) by 36 percent, and cables and wires by 35 percent. The second largest foreign exchange earner was the chemicals industry, exports of which increased by over 50 percent in 1995 as new capacity continued to come on stream. However, the export performance of the textiles, apparel, and footwear industries continued to be mixed, with new capacity resulting in an increase of over 35 percent in exports of textile yarns and fabrics, while exports of apparel and footwear either stagnated or declined. Because of rising wages, Malaysia is rapidly losing its competitiveness in labor-intensive industries such as garments and footwear.

Import liberalization and strong domestic demand resulted in acceleration of import growth to 31 percent in 1995. With imports expanding faster than exports, the merchandise trade account moved into a deficit for the first time since 1982. On the services account, large deficits have been incurred on a regular basis, mainly because of substantial outflows of FDI earnings and freight and insurance payments. In 1995, gross outflows in these two categories were $6 billion and $4.5 billion, respectively; the services account deficit increased significantly in value terms, although as a proportion of GDP it remained at about 8.5 percent. However, deterioration in the trade account resulted in a widening of the current account deficit to 8.9 percent of GDP in 1995 from 5.9 percent in 1994.

A significant proportion of the profits and dividends shown as outflows on the services account are actually reinvested in Malaysia and thus appear as investment on the capital account. Net corporate investment increased to $5.9 billion in 1995 which, together with a net inflow of $1.5 billion of official long-term capital (mainly borrowing by public enterprises), was sufficient to cover the deficit on the current account. Thus, the basic balance, as in the past, remained in surplus; foreign exchange reserves at $27 billion exceeded external debt, and the debt-service

ratio, at about 6 percent of export earnings, continued to be very manageable.

Exports of electrical and electronic products, Malaysia's largest export earner, should continue to grow strongly, given buoyant world demand; and this should help sustain growth in manufactured exports at recent high levels. However, possible softening of prices of major agricultural commodities, such as rubber, palm oil, and sawlogs, as well as prices of crude oil and natural gas, could result in a deceleration in the rate of growth of merchandise exports. In line with the slower output growth in the manufacturing sector and because of a sharp decline in imports of large items such as commercial aircraft by Malaysian Airlines and ships by the Malaysian Shipping Corporation, total merchandise imports are also expected to increase at a slower rate. Moreover, the growth in exports should exceed that for imports, resulting in the reemergence of a small trade surplus. The deficit on the services account is likely to increase only marginally and, therefore, the deficit on the current account of the balance of payments as a proportion of GDP is expected to decline somewhat. The deficit will be financed primarily by FDI. External borrowing by public enterprises is expected to be less than in 1995. Malaysia will maintain its current comfortable international reserves position, although large short-term capital inflows, because of favorable interest rate differentials, could boost these considerably.

Policy and Development Issues

During the past eight years, the Malaysian economy has outperformed many other economies in Asia. Growth has been outward oriented with Malaysia having one of the most open trade regimes in the region. The Government has also pursued an ambitious privatization program and Malaysia has probably gone further than any other country in Asia toward the private provision of infrastructure services. Downsizing of the government sector and a prudent fiscal policy have resulted in federal budget surpluses for the last three years. Political and macroeconomic stability, good infrastructure, and private sector-oriented government policies have attracted large amounts of FDI and short-term capital, resulting in accumulation of substantial international reserves.

While the economy is being managed effectively and doing extremely well, shortages of skilled and technical human resources could adversely affect Malaysia's export-oriented growth over the medium term. Malaysia has been successful in delivering general education at the primary and the secondary level. However, the country's tertiary school enrollment rates lag behind those of its neighbors. Also, while the rate of labor force participation by women has increased, it is still significantly below the participation rate for men. With Malaysia having achieved virtual full employment, it is likely that opportunities for the participation of women in the labor force will increase. The extent to which women are able to take advantage of these opportunities, however, will depend on how well their education and skill levels match the emerging employment opportunities. Thus, the expansion of the tertiary education system in Malaysia, particularly for women in technical and scientific education, is necessary. The Government is well aware of this, and legislation has been enacted to encourage the private sector to enter the field of tertiary education to upgrade Malaysia's human resources. Expanding the domestic supply of high-level skills will also help to deal with the problem of the growing deficit on the services account of the balance of payments.

An emerging economic issue in Malaysia is growing regional imbalance. Malaysia has made rapid progress in reducing poverty over the last two decades, with the incidence of poverty declining from about 60 percent in 1970 to about 9 percent in 1995. This is an impressive record by any standard, and more so because the official poverty line in Malaysia is liberal by international comparison. However, poverty reduction has been uneven geographically; most of the country's industrial development has been concentrated in the western corridor from Penang in the north to Johor in the south. The Government is encouraging development of the lagging regions of the country by providing fiscal incentives, improving road links along the east coast of the Peninsula, and promoting subregional cooperation arrangements, such as the Indonesia-Malaysia-Thailand growth triangle in the north and the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) for Sabah and Sarawak in East Malaysia.

Nepal

Over the last four years, Nepal has made important progress toward achieving fiscal stability and removing major restrictions that impede the development of a more vigorous market economy. Many prices are now market determined, there are few barriers to international trade, and foreign investment and interest rates have been deregulated. Substantial progress has been made toward macroeconomic stabilization; the Government's domestic borrowing requirements have been curtailed, inflation has been reduced, and international reserves have risen. However, the performance of the economy moderated in 1995; agriculture was adversely affected by poor weather and industrial activity was subdued. Although macroeconomic imbalances were reduced as inflation eased, the resource and external balances remained fragile. Saving performance improved slowly while investment was strong. An increase in the pace of economic growth is expected in 1996 and 1997, contingent upon a recovery in agriculture and industry and a resumption of economic reforms designed to increase efficiency and promote an outward-looking industrial strategy.

The implementation of further structural reforms has been seriously delayed owing to a sequence of political events during the last year and a half. A coalition government led by the Nepali Congress party took office in September 1995 following the defeat of the United Marxist Leninist (UML) minority government. With a lack of a political consensus, reform efforts have been at a virtual standstill since July 1994. Moreover, the external position has weakened because of structural problems in the two main export industries – carpets and ready-made garments. The new Government has indicated a strong commitment to fiscal discipline and economic liberalization and has taken steps to revitalize major reform programs on privatization. These steps include the expected introduction of the VAT in 1997, simplifying the tax and tariff structures and strengthening their administration, and improving the environment for foreign investors. However, the Government still faces the formidable challenges of ensuring consistent fiscal and monetary policies and macroeconomic stability.

The main constraints on development continue to be weaknesses in infrastructure and shortages of trained and qualified personnel. A large portion of the population depend on agriculture with continued low productivity. The rugged terrain has made transportation, communications, power supplies, and social infrastructure difficult. Power shortages also continue to impede industrialization. Economic liberalization and fiscal discipline remain the two fundamental elements in the achievement of sustainable market-oriented growth.

Recent Trends and Prospects

Growth, Investment, and Employment. The strong recovery of agricultural output in 1994 boosted real GDP growth to 7.3 percent despite extensive flood damage. GDP growth in 1995 is estimated to have slowed down to 2.3 percent, reflecting a drought-related decline in

1995 refers to fiscal year 1994/95, ending 15 July.

agricultural production and slow growth in the industry and services sectors. Although cash crops and livestock output increased by 6.3 percent and 3.2 percent, respectively, the production of food crops, which contributes about 37 percent of the total agricultural output in Nepal, declined by 7.3 percent. As a result, overall output of the agriculture sector decreased by 0.7 percent.

Industry sector growth contracted to 2.9 percent in 1995, mainly because of a sharp fall in the growth of manufacturing output to only 1.7 percent compared with 8.1 percent in 1994. Services sector growth remained strong in 1995 at 5.4 percent as a result of rapid expansion in transportation, communications, finance, and real estate services.

The capacity to mobilize domestic resources is inadequate. Domestic saving has been stagnant at about 10 percent of GDP, while domestic investment was more than 20 percent of GDP in 1995. As a result, the resource gap has been widening. Required foreign financing to bridge this gap increased to 10 percent of GDP compared with 8 percent of GDP in 1994.

Nevertheless, reform measures have begun to take effect, thereby stimulating saving and investment. Liberalization of the financial sector proceeded rapidly in 1995. New commercial banks and two rural development banks were established and limited progress was made toward restructuring the two large banks, the Nepal Bank Limited (NBL) and the Rastriya Banijya Bank (RBB), that account for over 70 percent of total deposits. The number of finance companies has increased sharply and this should enable the financial sector to provide enhanced facilities to middle-level entrepreneurs. Cooperatives and nongovernment organizations (NGOs) were also permitted to undertake limited banking services, particularly in the rural sector, subject to additional prudential regulations reflecting such portfolio diversification. The increase in the number of cooperatives, NGOs, and rural development banks is an important modality for improving resource mobilization as well as access to and availability of rural financing in Nepal. Furthermore, Nepal Stock Exchange activities

Table 2.16 Major Economic Indicators: Nepal

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	3.3	7.3	2.3	5.6	5.2
Agriculture	% change	-0.6	7.2	-0.7	5.5	4.5
Industry	% change	4.8	8.4	2.9	5.0	5.0
Services	% change	7.3	6.8	5.4	6.0	6.0
Gross Domestic Investment	% of GDP	21.2	20.5	20.2	22.1	23.4
Gross Domestic Saving	% of GDP	11.6	12.4	10.3	10.0	10.6
Inflation Rate	% change in CPI	8.9	8.9	7.6	7.0	7.0
Money Supply Growth	% change	27.7	19.6	14.8	12.0	13.7
Merchandise Exports	$ million	380.0	397.0	360.0	346.0	365.0
	% change	20.8	4.4	-9.2	-3.9	5.5
Merchandise Imports	$ million	-863.0	-1,072.0	-1,337.0	-1,480.0	-1,687.0
	% change	14.7	24.2	24.7	10.7	14.0
Current Account Balance	$ million	-219.0	-179.0	-289.0	-347.0	-340.0
	% of GDP	-6.3	-4.4	-6.5	-7.8	-6.9
External Debt Outstanding	$ million	2,004.0	2,320.0	2,368.0	2,586.0	2,824.0
Debt-Service Ratio	% of exports	7.6	6.8	7.8	6.6	6.8

Note: All data except for that on external debt and debt-service ratio are on a fiscal year basis.

Sources: His Majesty's Government, Ministry of Finance, *Economic Survey (Revised) Fiscal Year 1994–95* (Kathmandu, October 1995) and *Budget Speech of the Fiscal Year 1995–96* (Kathmandu, October 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

have expanded, with the number of registered companies increasing by 11 to 79 during 1995. The value of total share transactions during 1995 reached Nepalese rupee (NRs) 1.1 billion compared with NRs400 million in 1994.

About 90 percent of the total labor force depend on agriculture. According to labor demand projections in the country's Eighth Plan, about 23 percent of the total labor force are unemployed. The problem of underemployment is widespread and surplus labor, mainly in the agriculture sector, often lack the skills and training required for employment in other sectors of the economy. The Government is seeking to provide employment-oriented training to alleviate this problem. The size of public sector employment has remained fairly stable for the past few years, reflecting efforts to streamline civil service administration.

Overall, real GDP growth is expected to increase to 5.6 percent in 1996. Agriculture sector performance is very much determined by the monsoon; as weather conditions were quite favorable during the first quarter of 1996, agricultural GDP is projected to increase by 5.5 percent for the year as a whole, with a significant increase in paddy production. This is a dramatic turnaround from 1995 when output declined. As agriculture accounts for more than 40 percent of GDP and provides livelihood for most of the population, raising agricultural productivity is essential. Accordingly, the Government gives central importance to agricultural development as indicated in its Agriculture Perspective Plan (APP) which emphasizes the complementary roles of the public and private sectors in both investment and support services. Public sector investments in agriculture will concentrate on growth-enhancing projects, such as irrigation, feeder roads, and agricultural research and extension services, and will be supported by arrangements for adequate operation and maintenance.

Industrial GDP is estimated to grow by an average of 5 percent in both 1996 and 1997, aided by the expected removal of the existing restriction on foreign investment in industries having minimum fixed capital of NRs20 million.

Power supplies should improve with strong growth in the energy sector, although some shortages are still likely to be experienced. Power shortages have hampered growth in manufacturing, tourism, and other services sectors. Hence, the exploitation of Nepal's abundant hydropower resources, estimated at around 25,000 MW being economically exploitable, is an important element in the country's overall development strategy. Hydropower development should also improve Nepal's external accounts through power exports to India. The Government intends to undertake large-scale donor-supported hydropower projects, while also creating an environment conducive to private investments in small- to medium-size hydropower projects.

In services, the financial sector, which has been expanding rapidly in recent years, is expected to continue to mature in the next two years as private sector participation increases following economic liberalization efforts. The aviation industry is likewise expected to benefit from a more liberal operating environment. The necessary legal framework will also be established to provide a conducive environment for investors. As a result, services sector growth is estimated to recover to 6 percent in both 1996 and 1997. With good weather, implementation of the APP, and revitalization of reform efforts, GDP growth may continue to exceed 5 percent in 1997.

While domestic saving and investment are both expected to increase in the next two years, the resource gap is likely to widen. Although savings mobilization will be encouraged, particularly through the establishment of rural financial institutions and a growing network of branches, the economic liberalization program not only encourages new investment opportunities for investors but also encourages higher levels of consumption. Therefore, the growth rate in investment is likely to remain greater than that of saving.

Despite relatively buoyant growth, unemployment and underemployment will continue to be a challenge. The unemployment rate is unlikely to fall much and underemployment will remain high. Furthermore, fiscal prudence will mean only a modest expansion in employment opportunities within the Government.

Budget, Money, and Prices. Containment of the fiscal deficit has been one of the goals of fiscal reform. Efforts have been made to mobilize domestic resources, expedite implementation of development projects, and prioritize government expenditure. Fiscal policy has also aimed at achieving an efficient tax system, ensuring adequate resources for critical and productive spending, and

continuing strict control on domestic borrowing. The Government began the process of prioritization in 1995 by classifying development spending into core and noncore projects with social sector development expenditure being given high priority. Also, necessary legislative amendments and other actions are now under way to prepare for the introduction of VAT in 1997. This will further enhance domestic revenue by improving tax collection and administration. Other improvements include reducing the number of bands in the import tariff and introducing an Automated System of Customs Data at the international airport. As a result, domestic sources have contributed a rising share of total government revenue which rose to 67 percent of total expenditure in 1995 compared with 59 percent and 43 percent in 1993 and 1994, respectively, and the share of domestic revenue in GDP increased from 8.5 percent to 10.5 percent between 1993 and 1995 (Figure 2.21). Nevertheless, domestic revenue generation remains low relative to that in a number of other countries in the region. As a result, the overall budget deficit (including grants) declined steadily from 7 percent of GDP in 1993 to 5.2 percent in 1995. Also, domestic borrowing of the Government fell from 2.7 percent of GDP in 1993 to 0.5 percent of GDP in 1995.

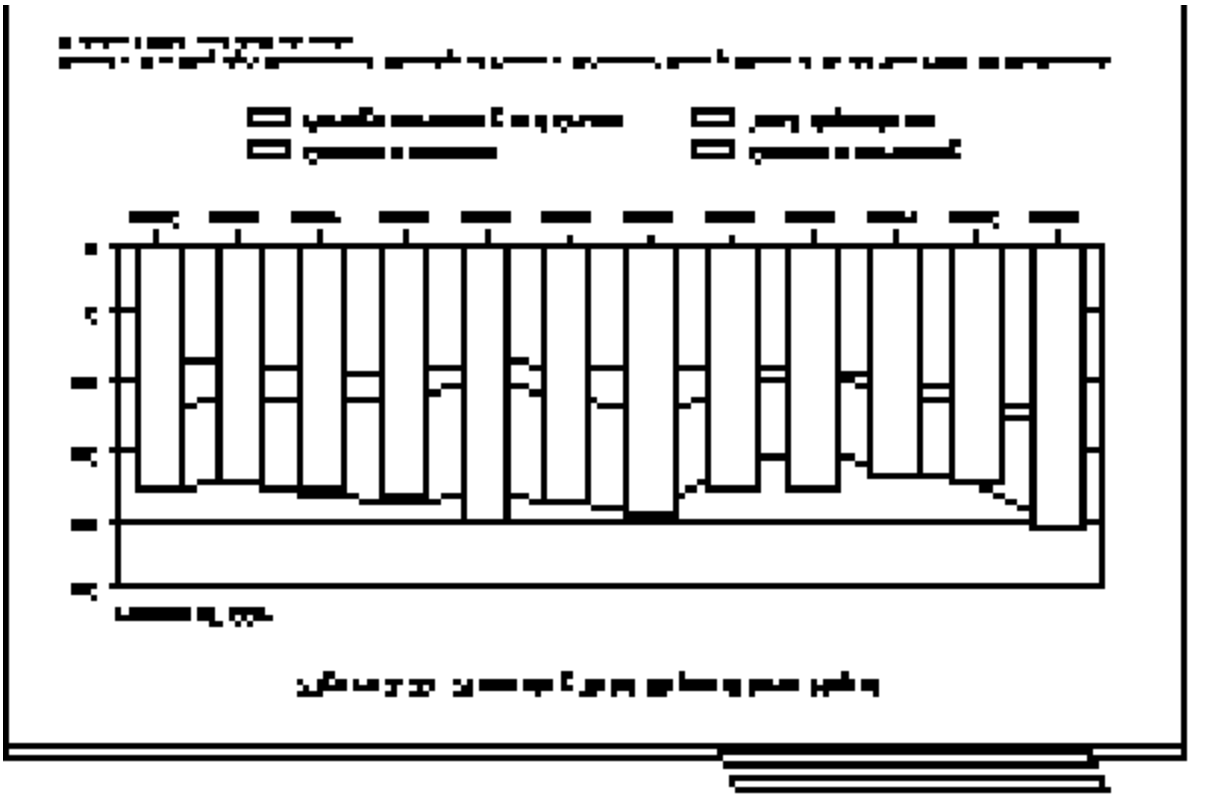
Domestic credit policy is guided by developments in money demand and movements in international reserves. In 1994, the Central Bank – the Nepal Rastra Bank (NRB) – used open market operations in the sale of securities to offset the expansionary impact of rising external reserves; monetary and credit growth were contained. In 1995, the contractionary pressure from declining foreign exchange reserves prompted the NRB to ease the supply of domestic credit, mainly through purchases of Treasury bills at the newly established secondary open market window. Monetary expansion (M2) continued to slow down from nearly 28 percent in 1993 to about 20 percent in 1994 and further to 15 percent in 1995.

Because of a long common border, price movements in Nepal largely reflect those in India. Nevertheless, there is some scope for independent action on the part of the monetary authority to influence the rate of inflation through appropriate and prudent monetary management. Consumer price pressures moderated in 1995 with the rate of inflation falling to about 7.6 percent compared with 8.9 percent in the previous year.

The budget for 1996 provides for an increase in revenue to 12.6 percent of GDP from 11.1 percent in 1995. Total expenditure is planned to increase to 20.7 percent of GDP from 17.5 percent in 1995, with much of the rise coming from higher capital expenditure, especially on infrastructure improvement. The overall budget deficit, including grants, in 1996 will, therefore, be higher than in 1995 at 5.8 percent of GDP. Virtually all of the deficit will be covered by foreign grants and loans.

The Government has realized the primary importance of improving fiscal management and expenditure control to achieve medium-term fiscal targets. Thus, it will continue wide-ranging reforms to rationalize both the expenditure program and the budget planning and execution procedures. By prioritizing both donor-supported and fully government-funded development projects, controlling fund releases, strengthening the administration of project implementation, and improving project monitoring, the Government aims to improve the overall efficiency of its development spending, raise the disbursement rate of committed foreign aid, and reduce significantly the time lag between expenditure incurred in foreign-assisted development projects and reimbursements by external donors. The Government will continue to pursue a comprehensive agenda for reforming Nepal's tax system aimed at improving tax efficiency and significantly broadening the tax base.

For the next two years, monetary policy will continue to aim at ensuring adequate liquidity growth to meet growing money demand while maintaining a comfortable foreign reserves position, consistent with preserving the country's fixed exchange rate regime vis-à-vis the Indian rupee. Control of annual credit expansion, which is related to annual inflation and foreign reserves targets, will be maintained through indirect monetary management by the NRB. The monetary authorities plan to establish in 1996 an effective mechanism to limit the Government's use of NRB credit, further limiting the scope for financing fiscal deficits through the banking system. Expected improvements in fiscal management and restraint on financing of the budget deficit will permit further growth of bank credit to the private sector in the medium term. Growth of broad money supply is,



therefore, expected to be contained to an average of about 13 percent in both 1996 and 1997. As the fiscal deficit and monetary expansion are expected to be contained, the rate of inflation is likely to be no higher than 7 percent on average during 1996. Inflation fell below 7 percent during the early part of 1996; however, depreciation of the Indian rupee is likely to lead to upward pressure on prices in Nepal during the balance of the year and in 1997.

External Trade and Payments. Considerable progress has been made during the past three years in rationalizing Nepal's trade and exchange system. The external sector has been transformed from a highly distorted and inward-looking trade and payments system to one of full *de facto* convertibility for current account transactions with a liberalized tariff structure. The number of tariff bands was reduced to five and the export fee has been reduced from 2 percent to 0.5 percent. Further action to reduce the number of bands, level, and dispersion of tariff rates will be coordinated with implementation of the broader tax reform agenda to ensure that the Government's revenue objectives are achieved. Low and non-discriminatory import tariffs and eventual qualification for WTO membership continue to be important policy objectives.

During 1995, total exports decreased by 9.2 percent to $360 million compared with an increase of 4.4 percent in 1994. However, imports increased sharply by 24.7 percent resulting in a trade deficit of $976.6 million, the equivalent of 22 percent of GDP.

Nepal's exports are still heavily concentrated in three markets – Germany, India, and the US – and two products – carpets and garments – which account for 72 percent of total exports. Exports of both carpets and garments decreased significantly by 19.9 percent and 13.7 percent, respectively, between 1994 and 1995. However, exports to India, after a long decline in relative importance, increased by 30.6 percent in nominal terms as a result of the new Trade and Transit Treaty and now account for about 18.8 percent of the total.

Major import items in 1995 included machinery and transport equipment and manufactured goods. Although both service receipts and transfers increased, they were not sufficient to offset the trade deficit in 1995. The current account deficit, therefore, widened by $110.3 million, reaching $289 million or 6.5 percent of GDP compared with 4.4 percent in 1994.

Despite rapid growth in the current account deficit, the overall balance-of-payments position remained favorable. The foreign exchange reserves of the banking system are estimated

at $838 million, sufficient to cover seven-and-a-half months of imports. Although outstanding external debt increased to more than 50 percent of GDP in 1995, the debt-service ratio is manageable at 7.8 percent of exports.

The foreign trade position of Nepal is not expected to improve much in the next two years.Power shortages and inadequacies of transport and other infrastructure will continue to be major constraints for the expansion of the export base. Total exports are expected to decline by 3.9 percent to $346 million in 1996. While the carpet industry might recover after the resolution of the child labor and environment issues, the garment industry faces the prospect of a loss of competitiveness after the eventual removal of the quota system. Tourism has considerable growth potential; however, it has been adversely affected by the worsened solid waste management and air pollution situation, particularly in Kathmandu. Government efforts to deal with such problems through infrastructure investment, and to expand the range of export items and markets through its liberalization policies and encouragement of the private sector give rise to the possibility of export growth of about 5.5 percent by 1997.

Imports are projected to grow at 10.7 percent for 1996 and 14 percent for 1997. Under the Government's new Open Sky Policy, private sector airlines are allowed to operate on international routes and that will possibly increase the inflow of service receipts. However, the increase in the surplus on services and transfer accounts will not be sufficient to cover the growing trade deficit. The current account deficit is, therefore, likely to remain high at 7.8 percent and 6.9 percent of GDP in 1996 and 1997, respectively. It is expected that the overall balance of payments will deteriorate slightly and, as a result, official reserves will decline slowly, although they are projected to remain at a comfortable level of six months of imports. The debt-service ratio is likely to stay below 7 percent over the next two years as most of the foreign loans are concessional and substantial repayments are not due to begin for some time.

Policy and Development Issues

To maintain steady and sustainable growth, fiscal discipline and monetary management are crucial. Fiscal management will be improved by prioritization of the expenditure program, and implementation of the three-year rolling expenditure plan and the VAT.

The Government's privatization program is critical to future development. Restructuring and eventual privatization of the two state commercial banks are an important component of private sector development, as are the Government's efforts to establish a liberal and more transparent incentive system. The shortage of skilled and trained labor for large-scale and internationally competitive manufacturing development will require special efforts in human resource development.

Economic liberalization in the industry sector has expanded economic activities and opened new opportunities for income generation. The amendment to the recently approved Foreign Investment and Technology Transfer Act of 1992 to remove the investment floor of NRs20 million will attract small- to medium-scale investors. With financial liberalization, the financial sector has been growing and private sector access to credit has been enhanced. However, interest rates need further liberalization and greater competition is required to lower interest rate spreads.

The cancellation of the Arun III Hydropower Project in August 1995 heightens the need for a review of future power supply development. Private sector participation in small-scale power projects to meet local demand is one avenue that should be explored.

The Government's decentralization policy aims to delegate authority, with appropriate budget allocations, to the local level for development activities, particularly in the social sectors. It aims to strengthen the capacity of local level administration and improve the effectiveness of project outcome. However, given the divergence in institutional capacity among the authorities, close monitoring of performance and capacity building and institutional strengthening might be necessary.

To reduce poverty and improve income distribution, Nepal will need to continue to build the foundations for broad-based economic development, including instituting programs for promoting human resource development and for slowing the high rate of population increase. Economic liberalization and fiscal discipline remain the two crucial planks of the Government's strategy to achieve sustainable market-oriented economic growth. This agenda must be pursued more vigorously.

Pakistan

Economic growth in Pakistan in 1995, though an improvement on that in 1994, was still lower than the trend growth rate achieved over the previous decade. The agriculture and services sectors accounted for the bulk of the increase while industrial output, especially large-scale manufacturing, grew very slowly. The macroeconomic position was not favorable. Inflation, already high in 1994, increased further, while money supply growth showed little reduction and was well in excess of the target. The fiscal deficit was well above the target previously agreed with the IMF in accordance with the ESAF. Progress in tariff reform also failed to meet ESAF targets.

However, in October 1995, the Government implemented a series of major economic measures, including currency depreciation, interest rate increases, and the imposition of additional import duties designed to improve the trade balance which had deteriorated sharply. This action was largely in line with the spirit of the IMF policy goal and, subsequently, the Government and the IMF reached an agreement on further IMF credit.

Progress was made in the implementation of the Social Action Program (SAP), which was launched by the Government in 1993. Despite fiscal constraints at both the provincial and the federal levels, the Government allocated more financial resources to the SAP. Although it is premature to assess the actual impact of the SAP, the financial allocations and policy reforms indicate that the program is being implemented effectively.

1995 refers to fiscal year 1994/95, ending 30 June.

Recent Trends and Prospects

Growth, Investment, and Employment. Economic growth in Pakistan in 1995 improved to 4.7 percent from 3.8 percent the year before, primarily because of good performance by the agriculture and services sectors.

Agricultural output increased by 4.9 percent, as the average production of major crops rose by 6.4 percent. There was good recovery in the output of both wheat and cotton following declines in 1994. However, cotton production continued to be adversely affected by pest attacks and unfavorable weather conditions. Livestock production, which accounts for one third of agricultural output, continued to increase strongly although at a slightly lower rate than in 1994.

Several policy reforms were undertaken in agriculture during 1995. The Task Force on Agriculture made a number of recommendations to be implemented over the next two years such as eliminating export duties on agricultural commodities, particularly cotton; increasing the credit allocation to agriculture; establishing a farmers bank; improving the management of water resources; and providing certified seeds. A crop insurance scheme is being finalized and 20,000 tractors were provided to small farmers under the Awami Tractor Scheme to promote farm mechanization. Several relief measures, especially the rescheduling of loans, were introduced for farmers affected by floods in 1995.

The growth of industrial output in 1995, which was affected by lower growth in

Table 2.17 Major Economic Indicators: Pakistan

		1993	1994	1995	1996	1997
Gross Domestic Product[a]	% change	2.3	3.8	4.7	5.5	5.8
Agriculture	% change	-5.3	2.9	4.9	6.0	4.5
Industry	% change	5.6	4.7	5.0	5.7	7.0
Services	% change	4.6	3.8	4.4	5.1	5.7
Gross Domestic Investment	% of GDP	20.7	19.5	19.1	19.3	20.6
Gross Domestic Saving	% of GDP	14.6	16.8	15.8	16.0	16.5
Inflation Rate	% change in CPI	9.4	12.5	12.9	13.0	11.0
Money Supply Growth	% change	18.0	16.9	16.6	15.0	16.0
Merchandise Exports	$ billion	6.8	6.7	7.9	8.5	9.7
	% change	0.3	-1.4	17.9	8.0	14.0
Merchandise Imports	$ billion	10.0	8.7	10.1	11.7	13.6
	% change	11.7	-13.6	16.7	15.0	16.5
Current Account Balance	$ billion	-3.3	-1.7	-2.1	-3.0	-3.1
	% of GDP	-6.4	-3.2	-3.5	-4.7	-4.3
External Debt Outstanding	$ billion	26.2	29.6	31.9	34.5	34.0
Debt-Service Ratio	% of exports	25.2	34.8	33.4	32.4	24.7

[a] Based on constant 1981 factor cost.

Note: All data, except for that on external debt and debt-service ratio are on a fiscal year basis. Data on inflation and trade may differ from the series contained in the Statistical Appendix (see Statistical Notes).

Sources: Government of Pakistan, Economic Adviser's Wing, *Economic Survey 1994–95*; World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

manufacturing, was barely above the relatively depressed level of 1994. Although construction and power generation picked up, large-scale manufacturing growth was well below that in 1994 because of a delay in commencing sugarcane crushing, the closedown of some textile mills because of high cotton prices, and capacity constraints in petroleum refining. Small-scale manufacturing, however, which accounts for about 21 percent of industry output, continued to grow strongly. The manufacturing sector has been encountering the task of adjusting to an environment of internal and external competition stimulated by deregulation, the opening up of the overall economy, and reduction of tariffs. As a result, some industrial units have had difficulties in adjusting to more competitive market conditions.

The services sector grew by 4.4 percent in 1995, showing improvement over growth in 1994 of 3.8 percent. The transport, storage, communications, and trade sectors recorded improved rates of growth compared with achievements in 1994.

Total investment outlays are estimated at Pakistan rupees (Rs) 356.9 billion in 1995 compared with Rs305.5 billion in 1994, an increase of 16.8 percent in nominal terms. Fixed investment grew by 17 percent. The share of total investment in GDP fell to 19.1 percent of GDP during 1995 compared with 19.5 percent in 1994. This was largely because of the depressing impact of civil unrest in the Karachi area on investment plans. Real investment grew by 2.8 percent in 1995 compared with a decline of 0.9 percent in 1994. Real investment in electricity and gas, which was 19.7 percent of real gross fixed investment, recorded an increased rate of 29.6 percent, whereas construction and transport and communications showed a decrease of 17.8 percent and 13.4 percent, respectively. Public sector investment grew more rapidly than did private sector investment spending. While small-scale manufacturing increased its real investment by 6.8 percent during 1995, large-scale manufacturing declined by 1.8 percent, resulting in a decline of 0.3 percent in total real investment in the manufacturing sector.

The ratio of gross domestic saving to GDP declined from 16.8 percent in 1994 to 15.8 percent in 1995. A fall in public saving was partially offset by an increase in private saving as economic growth increased and incentives to save were improved. The resource gap was 3.3 percent of GDP, a level slightly higher than that recorded in 1994.

Agriculture is still the primary employer – nearly 50 percent of the work force is employed in the sector. Manufacturing and construction account for less than 20 percent of the work force. Only 36 million people are in the labor force. The labor force participation rate in Pakistan is low at less than 30 percent, primarily because of the very low participation rate for women, at 8.6 percent. Wage earners constitute only about one third of employment and are mainly urban based.

The official unemployment rate was 4.7 percent or 1.7 million workers in 1995. This was a decline from the previous year when the rate was 5.8 percent. Partly reflecting the migration to the cities, unemployment in urban areas is 5.9 percent, while in rural areas it is about 4.3 percent. It is likely that unemployment is underestimated and underemployment is substantial. However, there are no firm estimates of its extent.

The Government continued to implement several schemes aimed at creating employment. In particular, the Self-Employment Programme, which promotes small businesses with government-subsidized credit, was expanded further in 1995, and created employment for about 140,000 persons. Also, under the SAP, 33,000 female health workers in rural areas were trained and subsequently employed; while under the Youth Investment Promotion Society, employment was generated for 14,000 persons during the year.

GDP growth is projected to increase to 5.5 percent in 1996 and further to 5.8 percent in 1997. The agriculture sector will continue to play a major role in boosting economic growth during that time. Progress has been made in dealing with the cotton virus which has adversely affected cotton output in the past few years and output of 9.5 million bales is projected in 1996. A further increase to over 10 million bales in 1997 is expected. Output of the other major agricultural crops is projected to be satisfactory. As a result, agriculture sector growth is expected to be a robust 6 percent in 1996, followed by a more modest but still very strong growth of 4.5 percent in 1997.

During 1994 and 1995, a poor cotton crop had a depressing impact on the output of cotton-based textiles. However, early signs suggest a good cotton harvest in 1996. Together with government measures to encourage the textile industry, this should boost manufacturing, despite the possible continuation of the difficult law and order situation in Karachi. Both mining and construction are expected to perform better over the next two years, as the economy continues to pick up. As a result, industry is forecast to grow by 5.7 percent in 1996 and 7 percent in 1997. The services sector is also projected to continue recovering over the next two years, partly because of the expected expansion in industrial production and partly because of the increased role to be played by the private sector under a more deregulated economic system. However, the financial sector, particularly the capital market, is likely to be adversely affected by civil unrest in Karachi, which had a negative impact on equity prices in 1995 and early 1996. Services activities relating to foreign trade and investment may also be sluggish. Hence, the services sector is forecast to grow by 5.1 percent and 5.7 percent in 1996 and 1997, respectively.

Gross domestic investment as a proportion of GDP is expected to rise to 19.3 percent in 1996 as the Government's policy of encouraging private sector investment begins to bear fruit. Private sector investment will be concentrated in manufacturing, housing, and agriculture while public sector investment priorities will continue to be in power, transport and communications, and the social sectors. It is expected that approximately 80 percent of the investment will be financed by national saving, and the remaining 20 percent by foreign sources. Along with the economic recovery and financial deregulation, both household and government savings rates are expected to increase. Government saving should improve, given commitment to the stabilization program over the next two years. Given these developments, gross domestic saving will rise slightly to 16 percent in 1996 and further to 16.5 percent in 1997.

The labor market situation should improve over the next two years as a result of the economic recovery and the Government's strong efforts to foster human resource

development. As economic growth returns to a rate of 5–6 percent, the number of new jobs generated will increase. Under the SAP and involving expenditure of over 2 percent of GDP to promote human resource development, the Government will be continuing its efforts to reduce population growth and to improve the education, skills, and health conditions of the labor force.

Budget, Money, and Prices. The consolidated budget of the Federal Government and provincial governments for 1995 provided for a reduction of the fiscal deficit from 5.9 percent of GDP in 1994 to 4 percent in 1995. This was to be achieved mainly by a substantial increase in tax revenue through new tax measures and improvements in tax administration. The actual budget outturn resulted in a deficit of 6 percent of GDP, mainly as a result of a shortfall in revenue collection owing to budget concessions and tax rollbacks and an unsatisfactory collection rate during the first half of the year. To increase the tax effort, the general sales tax was expanded in 1995 to encompass an additional 277 items. The Government also launched a three-year program of tariff reforms. Under the ESAF/Extended Fund Facility (EFF), certain fees, duties, and surcharges were combined with customs duties, resulting in a drop in the maximum tariff rate. Income tax concessions for women were increased and the corporate income tax rate was decreased by a few percentage points. Concessionary rates of taxation were applied to the power and petroleum sectors with a view to encouraging investment in these sectors, and a five-year tax holiday program was accorded to the fruit processing and toy-making industries to promote exports of these products.

The larger-than-expected fiscal deficit contributed to monetary expansion. Money supply (M2) increased by 16.6 percent, well above the target of 11.8 percent, which reflects the increase in net foreign assets, Government borrowing from the banking system, and increased credit to public enterprises.

Inflation, as measured by the consumer price index (CPI), was 12.9 percent in 1995 compared to the original target of 7 percent. Besides the influence of monetary expansion, prices for a number of food items, such as vegetable oil, increased and shortages of some foodcrops and higher prices for petroleum, gas, and electricity also put additional upward pressure on the price level. There were also increases in support prices of agricultural crops such as rice, and a rise in energy tariffs which further contributed to inflation.

To improve macroeconomic stability, which had deteriorated drastically in early 1995, the Government agreed to a standby credit program with the IMF in December 1995. In line with this program, the Government is aiming for a fiscal deficit target of 4.6 percent of GDP in 1996 compared with 6 percent in 1995. Considering that the GDP share of tax revenue is likely to remain relatively inflexible, the major emphasis in reducing the deficit will be on public expenditure, mainly reduced allocations for development spending. Measures announced by the Government include a 7 percent devaluation of the rupee, an imposition of 10 percent regulatory duty on all dutiable imports, and a 7 percent increase in domestic prices of petroleum products. Together with other measures in line with the IMF credit program, especially privatization of the state-owned enterprises, these actions will contribute to a lowering of the budget deficit/GDP ratio in the next two years. Considering that additional fiscal measures may be forthcoming, it is expected that the deficit will be reduced further to about 4.5 percent and 4 percent of GDP in 1996 and 1997, respectively.

To lower inflation, a fairly tight monetary policy will be pursued in 1996 and 1997. Monetary policy will slow the growth of domestic liquidity by tightening credit policy and raising interest rates and by restructuring government borrowing from the banking system. However, given a lag in the adjustment process, the inflation rate is expected to increase slightly to 13 percent in 1996 before falling to 11 percent in 1997. Growth in money supply (M2) is likely to remain close to 1995 levels over the next two years. Public borrowing continued to increase in the first three months of 1996, while currency depreciation will further contribute to inflationary pressure.

External Trade and Payments. The international demand for Pakistan's exports, which remained depressed in 1994, showed a sharp increase in 1995 as exports rose by 17.9 percent. Rice, cotton yarn, cotton cloth, carpets, textile products, sporting goods, and leather products all did well. Merchandise imports,

which had fallen by over 13 percent in 1994, also rebounded by 16.7 percent mainly due to higher imports of major food items, machinery, chemicals, and petroleum products. Remittances from workers abroad rose by nearly 30 percent in 1995. However, this represented a recovery from the position in 1994 when remittances declined by over 7 percent because of political uncertainties associated with the elections in October 1993 (Figure 2.22). Despite a significant increase in exports and remittances, the current account deficit in 1995 widened slightly to $2.1 billion or 3.5 percent of GDP compared with 3.2 percent of GDP in the previous year.

The net inflow of long-term capital increased by 18.3 percent, mainly owing to a rise of 28 percent in private capital inflows. Portfolio investment also increased. Nonetheless, there was a decrease in net capital inflows, especially of medium- and short-term loans and foreign currency deposits (for nonresidents), and increased outflows of official short-term capital. This resulted in a reduction in the capital account surplus from $1.6 billion in 1994 to $242 million in 1995. International reserves stood at $2.4 billion, equivalent to about three months of imports. The debt-service ratio, as a percentage of export earnings, declined to 33.4 percent in 1995 from 34.8 percent in 1994 as a result of the sharp increase in exports combined with a modest increase in debt-servicing costs.

The prospects for exports in 1996 are mixed. During the first three months of 1996 (July–September 1995), merchandise export receipts dropped by 5.1 percent compared with receipts over the same period in the previous year. Earnings from major export items, including carpets, synthetic textiles, leather products, sporting goods, and fabrics, all decreased sharply. By contrast, an increase in the value of imports of machinery, fertilizer, and insecticides resulted in an expansion of total import payments by 21.6 percent during the same period. As a result, the cumulative trade deficit in the first three months in 1996 soared to $989 million, 126 percent higher than in the corresponding period of the previous year. This deficit was not fully offset by capital inflows and, as a consequence, international reserves fell to about $1.3 billion at the end of October 1995, the equivalent of only one-and-a-half months of merchandise imports. To address these imbalances, the Government, as noted earlier, took important economic measures at the end of October 1995, including a 7 percent depreciation of the Pakistan rupee and increases in interest rates, fuel prices, and

import duties. Accordingly, the Government obtained standby credit from the IMF of $596 billion in December 1995 to be released over the following 15 months.

It is likely that the abovementioned economic measures will have a favorable impact on the trade balance by encouraging exports and discouraging imports. Exports should be further boosted by an improved cotton crop. Imports will be discouraged by higher prices following depreciation of the rupee, although more rapid growth will boost demand for imports of machinery and intermediate materials.

Overall, exports are projected to increase by 8 percent in 1996 and 14 percent in 1997, while the forecast for imports is for an increase by 15 percent in 1996 and 16.5 percent in 1997. The current account balance is projected to deteriorate further to 4.7 percent of GDP in 1996 and 4.3 percent of GDP in 1997; however, it is expected that capital inflows will be sufficient to offset this deficit and also to build external reserves to a more comfortable level than they are at present.

Policy and Development Issues

Although economic growth in Pakistan has improved in recent years, inflation has increased, the balance of payments has deteriorated, and the overall fiscal deficit remains high. Addressing these macroeconomic imbalances is a major task facing the Government.

Fiscal reform must be the cornerstone of macroeconomic adjustment efforts. The overall fiscal deficit has to be lowered through increasing revenues, in combination with containment of government spending. This requires major reforms to remove structural weaknesses in the tax system, such as the existence of exemptions and concessions which adds to uncertainty and opens the way for tax evasion, and the excessive reliance on import tariffs which introduces bias against exports and fosters inefficient domestic industry. Although incomes from agriculture, long exempt, are now formally subject to direct taxation, tax administration and compliance in this area is very weak. A consumption tax, roughly corresponding to a value-added tax, has been introduced; however, it needs to be broadened to include all consumption expenditure, and simplified documentation procedures need to be established to improve compliance and administration and minimize evasion.

To reduce expenditure, the Government could increase its efforts to reduce unnecessary and costly intervention in the economy, including privatization of the SOEs in the power, rail, air transport, telecommunications, and banking sectors. Current expenditure priorities also need to be restructured. Defense and debt-servicing spending together now constitute over 60 percent of current expenditure, crowding out other current expenditure that is vital for socioeconomic progress, such as on primary education, basic health, water supply, and sanitation. In this regard, the Government should make greater efforts to redefine the respective roles to be played by the Government and the private sector.

Short-term measures adopted to reduce the fiscal and current account deficits, such as currency depreciation and high customs duties, have not addressed the more fundamental problem of international competitiveness and economic efficiency, a problem which is rooted in the legacy of an inward-looking macroeconomic strategy and which entailed protection and Government intervention in the economy. In this regard, a comprehensive economic program to boost exports is an urgent task for the Government. This would include a new policy regime which would continue trade liberalization measures begun earlier and stress greater competition and openness. Reform of the import tariff structure is needed to reduce the overprotection of domestic industry which has created a weak and inefficient industrial base.

It is now widely acknowledged that the long-term development potential of an economy is severely constrained by a poor state of human resource development. Unfortunately, Pakistan's social indicators remain among the worst in the world. A concerted effort is needed to raise life expectancy and educational attainment, reduce infant mortality, and improve the economic and social status of women.

The Government has already begun this task with its comprehensive five-year SAP covering 1993–1998. The SAP concentrates on four key concerns: primary education, primary health, population welfare, and rural water supply and sanitation. Although it is too early to assess the status of the SAP, implementation so far appears to have been satisfactory. However, more detailed evaluation is necessary if informed decisions are to be made about the future direction and expenditure needs of this important program.

Sri Lanka

Sri Lanka's economy experienced strong growth during the first half of the 1990s despite persistent macroeconomic imbalances, high inflation, and the armed conflict in the northeast of the country. However, with a major policy shift in the wake of national elections in 1994 and the escalation of the conflict in 1995, economic growth began to decelerate, accompanied by rising budgetary and external current account deficits. Although private saving has been increasing recently, the lack of progress in reducing the recurrent budget deficit has resulted in the absorption of a significant amount of this saving, the crowding out of investment, and an increasing reliance on foreign capital which is sensitive to economic and political conditions in the country.

A substantial reduction in the fiscal deficit is a crucial requirement if the Government is to be in a position, once hostilities cease, to meet the need for substantial rehabilitation expenditure while retaining macroeconomic stability.

Recent Trends and Prospects

Growth, Investment, and Employment. The economy grew by 5.6 percent in 1995, the same as in 1994, but substantially lower than the 6.9 percent recorded in 1993. The gradual deceleration in the rate of economic growth was the result of the resumption of hostilities, an increasing government budget deficit, and labor unrest. Nevertheless, the 1995 growth performance was impressive given these adverse factors and indicates the potential of the economy under more amenable conditions. Agricultural output grew by 2.3 percent in 1995, down from 3.3 percent in 1994. The lower growth rate is attributable to the spread of the civil war to farm areas in the northeast and the subsidy for wheat flour introduced in late 1994 which depressed prices of domestic substitutes such as rice. The industry sector, which accounts for about one third of total GDP, remained buoyant during 1995 with output in manufacturing growing by 9.1 percent in real terms, about the same rate as in the previous two years. The key to this growth performance is the private sector which expanded output by 12 percent and now accounts for almost 90 percent of industrial activity. The services sector, which accounts for about 50 percent of total GDP, grew by 5.4 percent in 1995 compared with 5.1 percent in 1994. Growth during 1995 was particularly strong in the import-export trade subsector, which expanded by 11 percent; energy expanded by 9.3 percent and financial services by 9.2 percent. However, tourism growth was lower in 1995 by about 2 percent as a result of the resumption of hostilities.

Acceleration in the investment rate is the main factor that contributed to Sri Lanka's strong growth performance during the 1990s. Gross domestic investment was 25.7 percent of GDP in 1995 compared with 21.4 percent in 1989. The rise in the investment rate is attributable primarily to government policies favoring private sector development and foreign investment. Nevertheless, uncertainty about the political situation, particularly among foreign investors, had a depressing impact on investment in 1995. In contrast to private

investment growth, public investment has declined from 9.6 percent of GDP in 1991 to 7.6 in 1995 as a result of the Government's efforts to contain public expenditure. Government measures to deregulate the financial sector helped to raise the private savings rate from 13.4 percent of GDP in 1989 to over 19 percent in 1995. However, the domestic savings rate was lower, at only 15.9 percent of GDP in 1995, primarily because of government dissaving through the persistence of recurrent budget deficits. Domestic saving has been augmented by private transfers from abroad, which have been equivalent to about 4 percent of GDP recently. The domestic savings-investment gap has been rising steadily from 6.5 percent of GDP in 1990 to 9.8 percent of GDP in 1995 and reflects the country's increasing inability to generate sufficient saving to meet the investment needs of the economy. As a result, investment has been increasingly dependent on foreign saving that, in adverse conditions, could slow down or even decline.

Unemployment continues to be a major concern. While no official unemployment statistics exist, unemployment was estimated to be 13 percent of the labor force in 1995, an improvement over the 16.6 percent in 1992. However, if underemployment is taken into account, the unemployment rate rises to 35–40 percent. Growth in employment in Sri Lanka is still insufficient to absorb new entrants to the labor force or to have much effect on the numbers of unemployed or underemployed. Furthermore, significant imbalances continue to exist because of a mismatch between the skills acquired through the education system and the requirements of the labor market. There has been a relatively sluggish response of labor markets to the rapid expansion of economic activity because of structural rigidities, stemming, at least in part, from government regulations and hiring practices.

The economy is expected to grow at 5.2 percent in 1996 and 5.5 percent in 1997. Under normal weather conditions, agricultural output

Table 2.18 Major Economic Indicators: Sri Lanka

		1993	1994	1995	1996	1997
Gross Domestic Product[a]	% change	6.9	5.6	5.6	5.2	5.5
Agriculture	% change	4.9	3.3	2.4	2.3	2.7
Industry	% change	9.8	8.1	8.1	7.9	8.5
Services	% change	6.2	5.1	5.4	4.8	4.8
Gross Domestic Investment	% of GDP	23.6	26.3	25.7	24.9	25.2
Gross Domestic Saving	% of GDP	14.1	14.4	15.9	15.9	15.9
Inflation Rate	% change in CPI	11.7	8.4	7.7	9.6	9.7
Money Supply Growth	% change	23.5	19.6	13.5	17.0	17.0
Merchandise Exports	$ million	2,785.7	3,201.8	3,851.3	4,274.9	4,787.9
	% change	21.0	14.9	20.3	11.0	12.0
Merchandise Imports	$ million	3,527.8	4,072.5	4,830.0	5,457.9	6,222.0
	% change	17.0	15.4	18.6	13.0	14.0
Current Account Balance[b]	$ million	-543.0	-710.0	-1019.0	-1,090.0	-1,119.0
	% of GDP	-5.3	-7.9	-8.4	-7.9	-7.6
External Debt Outstanding	$ billion	6.8	7.8	7.6	8.4	9.2
Debt-Service Ratio	% of exports	10.1	9.9	10.0	10.5	11.0

[a] Based on constant 1982 factor cost.
[b] Excluding grants.

Sources: Data provided by the Government of Sri Lanka and the Central Bank of Sri Lanka; World Bank, *World Debt Tables 1996,* Vol.2 (Washington, DC, 1996); P.A. Nimal Siripala, "Asia Economic Outlook 1996–1997 Country Paper," paper prepared for the Asian Development Bank (mimeo, December 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); and staff estimates.

could increase by 2–3 percent, primarily because of higher output of plantation and other high value-added crops. However, growth in rice production may decline because of the Government's policy to subsidize wheat flour (a substitute for rice), and the spread of the civil war to rice-producing areas such as the Mahaweli region. The industry sector is expected to continue to be the main engine of economic growth with output expanding by 7.9 percent in 1996 and 8.5 percent in 1997. As in the past several years, growth in the services sector should continue to follow closely that of the overall economy at about 5 percent in both 1996 and 1997. Energy, financial services, and the retail and wholesale trade subsectors should perform especially well, but tourism growth is likely to be adversely affected by the continuing hostilities.

Budget, Money, and Prices. The aim of fiscal policy in 1995 was to convert the budgetary current account from a deficit of 2.9 percent of GDP in 1994 to a small surplus, to reduce the overall budget deficit to 7.5 percent of GDP from 10 percent of GDP in 1994, and to reduce domestic borrowing to free up resources for use by the private sector. With the resumption of hostilities in April 1995, additional defense expenditure was necessary which the Government financed by increasing the Defense Levy from 3.5 percent to 4.5 percent. However, in subsequent months, there were further demands for defense expenditure as military activity intensified in the northeast. The fiscal situation deteriorated further with an increase in subsidy expenditure following a sharp rise in international wheat prices, and additional expenditure on public sector salaries and pensions. Thus, the overall budget deficit declined only marginally to 9.5 percent of GDP in 1995; however, while the current budget deficit also declined to 1.5 percent of GDP, the desired target of a small surplus was not achieved (Figure 2.23). Domestic borrowing to finance the budget deficit fell from 6.5 percent of GDP in 1994 to 5.3 percent in 1995, although this was still above the target of 3.4 percent of GDP.

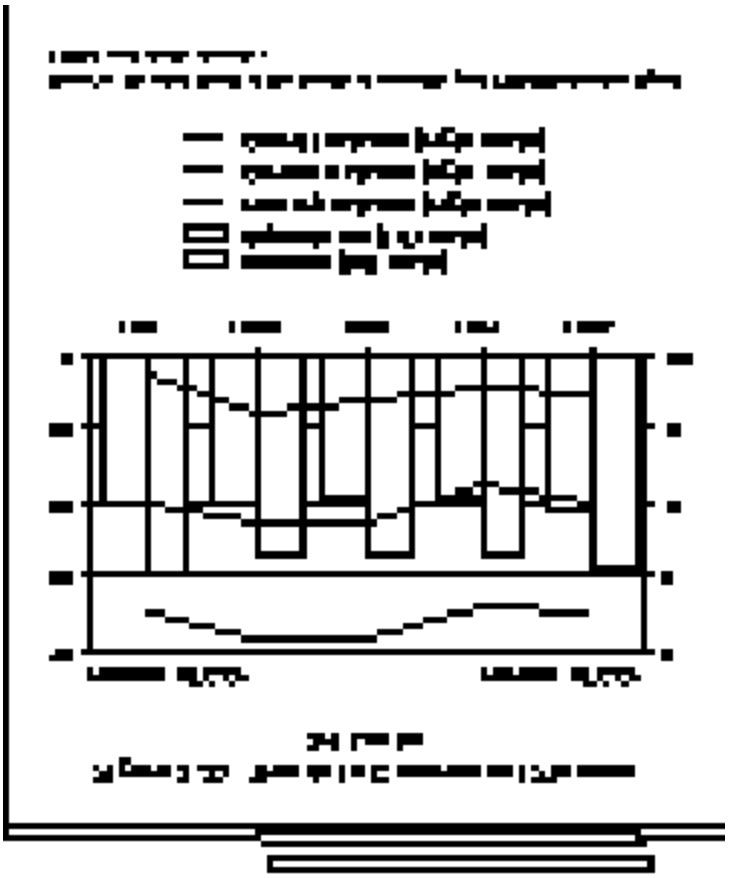
Monetary policy was tight during 1995 with broad money supply (M2) expanding at a rate of 13.5 percent during the year, significantly slower than the 19.6 percent recorded in 1994. Net foreign assets increased by 2.2 percent, while net domestic assets rose by over 15 percent. Credit to the private sector from the banking system rose 22.6 percent. Credit to the public sector decreased by 15.2 percent as more of the budget deficit was financed by captive sources such as government-controlled pension and insurance funds. The statutory reserve ratio of 15 percent for rupee deposit liabilities and 5 percent for foreign currency deposited abroad was maintained at the same level as in 1994. Meanwhile, the market-determined Treasury bill interest rate rose from 13.4 percent in January 1995 to 17.5 percent in December 1995 because of the large budget deficit and expectations of rising inflation.

Inflation, as measured by the Colombo Consumer Price Index (CCPI), fell marginally in 1995 to 7.7 percent from 8.4 percent in 1994. Prices of a large number of consumer items such as fish, vegetables, rice, wheat flour, and coconut registered declines in 1995 because of improved supply conditions. Lower import duties and taxes and lower prices of several commodities administered by the Government that have a significant representation in the CCPI also contributed to the fall in the recorded inflation rate. However, excluding the impact of these administered prices, it is estimated that the core inflation rate was in the 12–14 percent range.

The Government's medium-term developmental objective is to stabilize the economy by correcting long-standing fiscal imbalances; however, the Government recognizes that this is not feasible as long as the peace and order issue remains unresolved. Even if peace were to be achieved in the short term, new expenditure on rehabilitation and restoration of normalcy to the northeast of the country will compel the Government to keep security-related outlays at current levels. Moreover, the Government is committed to continuing the subsidization of several commodities for welfare purposes. The potential for raising revenue from additional taxes is limited since Sri Lanka's revenue/GDP ratio is already high by developing country standards, and the proceeds from the privatization program will most likely be moderate. As a result, it is expected that the fiscal position of the Government will improve only marginally over the next two years. The overall budget deficit is expected to fall only to 9 percent of GDP in 1996 and 8.5 percent of GDP in 1997.

The maintenance of a tight monetary policy is essential to slow down the growth of money supply and to prevent inflation from accelerating. Monetary policy needs to be less accommodating, particularly in relation to the public sector. However, the Central Bank has only limited autonomy and the credit demands of the public sector will undoubtedly be met. Furthermore, there is little scope for reducing money supply growth through higher interest rates as this would have a significant negative impact on private sector investment. Therefore, growth in broad money supply over the next two years is expected to be slightly higher than in 1995, at 17 percent per annum.

Given that the Government will continue to keep the prices of key commodities under its administration low over the short term, the official inflation rate is expected to rise slightly from current levels to 9–10 percent in 1996 and 1997. However, the core inflation rate (estimated by excluding the prices of items administered by the Government) will most likely be higher in the 12–15 percent range. This is consistent with the expected real GDP growth rate and the growth in money supply.



External Trade and Payments. Exports surged in 1995, growing by 20.3 percent to $3.9 billion. This growth was led by garment exports which expanded by 16 percent and accounted for about half of total exports. In contrast, the increase in earnings from agricultural exports was a modest 6 percent, largely owing to depressed prices of tea and coconut products. At the same time, imports grew by 18.6 percent to $4.8 billion. Intermediate goods accounted for half of the import bill, investment goods for 28 percent, and consumer goods for the balance. Almost one half of intermediate goods imports were textiles, mostly imported for the apparel industry. The rapid increase in exports together with a moderation in import growth resulted in a trade deficit of about $1 billion in 1995 compared with $0.9 billion in 1994.

FDI inflows declined slightly to $156 million in 1995 from $158 million in 1994 because of uncertainties created by labor unrest and the escalation of the civil war, as well as by the suspension – pending review – of the privatization program following the change of government. The net inflow of private long-term debt capital also declined, falling sharply to $18 million in 1995 from $278 million in 1994. However, net official capital inflows rose to $323 million in 1995 from $294 million in the previous year, reflecting better utilization of foreign aid. Of total disbursements during the year, 41 percent consisted of project loans from Japan, 23 percent as assistance from the World Bank, and 16 percent from ADB.

Sri Lanka's external debt declined by 2.7 percent to an estimated $7.6 billion or about 59 percent of GDP at the end of 1995. Debt-service payments as a ratio of exports of goods and services, at 10 percent in 1995, were slightly higher than in 1994, but still a relatively low ratio because of the concessional nature of the debt.

Export growth in 1996 is not expected to be as strong as in 1995; it will be led by industrial exports. Garments will continue to be the major export item, although other industrial

products such as leather, rubber and wood products, paper, and ceramics will increase as a proportion of the total. Agricultural exports are also expected to increase, but to a lesser degree because prices of agricultural commodities are not expected to rise in the short term. Assuming that the Government's exchange rate policy maintains the real effective exchange rate at current levels, total exports in dollar terms should increase by 11 percent in 1996 and 12 percent in 1997 compared with 20 percent growth achieved in 1995.

Imports should accelerate slightly in the short term as the investment rate begins to recover and more capital goods are imported. Imports of consumer and intermediate goods should also increase because of lower import taxes and the Government's continued subsidization of commodities such as wheat, diesel, kerosene, and fertilizer. Consequently, total imports are expected to grow by 13 percent in 1996 and 14 percent in 1997. Slower export growth combined with stronger import expansion will cause the trade deficit to widen to $1.2 billion in 1996 and $1.4 billion in 1997. The current account deficit should remain in the 7.5–8 percent of GDP range aided by increases in remittances from overseas workers.

Progress toward the achievement of peace in Sri Lanka will, to a great extent, determine the level of FDI that the country will receive. As the conflict subsides, a resurgence in investment can be expected. Investors from Korea and other countries that have a long-term perspective have demonstrated continuing interest in investing in Sri Lanka.

External debt outstanding is projected to increase by 10 percent in 1996 to $8.4 billion, and 9 percent in 1997 to $9.2 billion. The debt-service ratio should rise moderately to 10.5 percent in 1996 and 11 percent in 1997 as the proportion of interest payments associated with financing defense spending at commercial rates begins to rise.

Policy and Development Issues

Although the main, longer-term developmental concern in Sri Lanka is the reduction of poverty and unemployment, the concern of paramount importance in the short term is the cessation of hostilities, which have not only been costly in human terms but have also led to excessive government expenditure, high budget and external account deficits, inflation, and the erosion of investor confidence. These factors indicate that economic growth at current rates is not sustainable over the medium term, that the underlying macroeconomic situation in the country is rather fragile, and that the Government's efforts to address the issues of poverty and unemployment could be seriously compromised. Therefore, the Government's immediate priority should be to make the fiscal adjustments needed to secure a substantial reduction in the budget deficit even though high levels of defense expenditure may still be required. Measures that should be considered include the reduction or elimination of subsidies, particularly for commodities that are imported, and a reduction in the size of the public services sector. Steps to improve the effectiveness and efficiency of public health and education programs should also be considered.

It is generally accepted that, even if peace were forthcoming in the near future, additional expenditure would be necessary for the rehabilitation and restoration of normalcy in the northeast. Therefore, it is particularly important to begin the process of fiscal consolidation early; otherwise, the peace dividend that is expected with the end of hostilities will in all likelihood not be forthcoming.

To revive domestic and foreign investor confidence in the economy, the Government needs to reinforce its commitment to the process of economic liberalization and the market orientation of the economy. Steps should be taken to create an environment that fosters private sector development through deregulation, particularly in the provision of infrastructure services such as power generation, transport, and telecommunications.

The labor market in Sri Lanka needs special attention. It is segmented, and wages and working conditions are determined by government regulation and strong union pressure and do not reflect the level of unemployment in the country. Policy reforms are needed to ensure that workers looking for new jobs are given adequate support, and that employers have the flexibility to adjust to changing market conditions. Labor market flexibility could make a significant contribution toward promoting economic growth and employment.

Fiji

Fiji's rather uneven economic performance over recent years was evident again in 1995. Although output of some sectors of the economy improved, overall economic growth was well below that recorded in 1994. Although the fiscal deficit increased, the external accounts showed some improvement, with foreign reserves strengthening following two years of decline. Little substantive progress was made, however, in reducing the extent of government involvement in, and regulation of, the economy or in reforming public enterprise. The process of tariff reduction was suspended. Private investment remained at low levels and is unlikely to improve in the near future, especially while political uncertainties about constitutional reform and agricultural leasehold arrangements continue to sap investor confidence. Government policy objectives in a number of areas of concern to the business community also need to be clarified.

Recent Trends and Prospects

A decline in sugar production of some 10 percent from the high level achieved in 1994 when cane quality was exceptionally good was the main factor leading to a contraction in GDP growth in 1995 to 2.2 percent from 4.5 percent in the previous year (Figure 2.25). As regards other sectors, fisheries output increased by 10 percent and forestry by 6 percent. In the industry sector, construction activity continued to improve, while manufacturing output (excluding sugar production) rose by over 6percent, with important gains being made in food production, fish processing, and garment manufacture. In the services sector, although the contribution of community and personal services declined, transport activity rose by some 5 percent and output of the distributive trades, hotels, and activities associated with tourism services increased by more than 8 percent.

Gross domestic investment is estimated to have remained at the relatively low level of around 13 percent of GDP, in line with the average rate during the first half of the 1990s but well below the average of over 20 percent a decade earlier. Private fixed investment, which had averaged about 12 percent of GDP at that time, averaged less than 5 percent annually during 1993–1995.

The Government's fiscal position in 1995 was less satisfactory than in the previous year. The net overall deficit was estimated at 2.6 percent of GDP compared with 1.7 percent in 1994. Higher debt-servicing cost was the main factor in the 4.2 percent rise in current expenditure. Current revenue was slightly below its 1994 levels because of a drop in non-tax receipts. The net deficit was to be financed almost wholly from domestic sources, with net overseas borrowing restricted to less than Fiji dollar (F$) 4 million, about half that in 1994.

Monetary policy in 1995 continued to emphasize the objectives of strengthening external reserves and keeping inflation at a low level. Domestic credit growth was only 1.5 percent compared with over 4 percent in 1994. Private sector credit, the main component, expanded by 4.2 percent, less than half the rate of increase recorded in 1994, a principal factor being a contraction in net agricultural lending. Credit to other sectors of the economy, such as manufacturing and service industries,

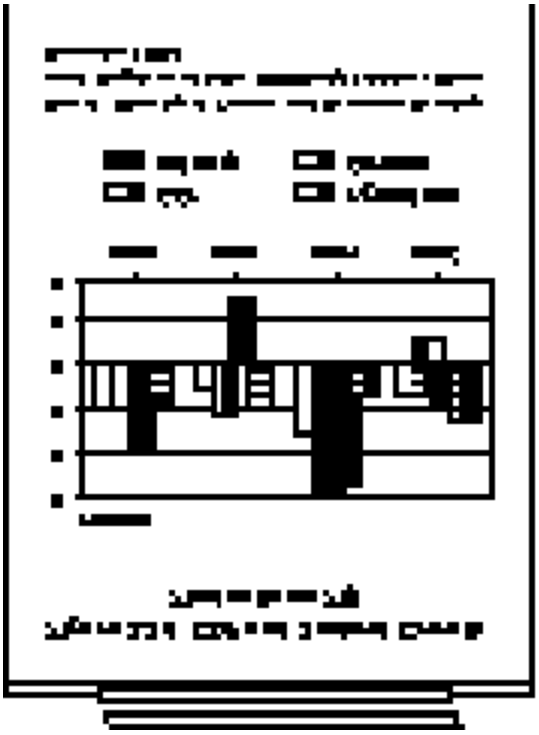
increased during the year. Money supply (M2) growth, though higher than in 1994, was modest at 5.3 percent. The rate of inflation, which was only 0.6 percent in 1994, began to rise early in 1995 but was held in check at 2 percent for the year as a whole. Higher import prices and increases in various government charges and public enterprise prices were largely responsible.

Fiji's balance-of-payments position improved in 1995. With improved export earnings and inputs at much the same level as in 1994, the trade deficit declined. Higher net services earnings, partly because of increased tourism, helped to yield a small current account surplus equivalent to 0.2 percent of GDP, a significant improvement from the deficit of 3.7 percent of GDP recorded in 1994. Allowing for capital transactions, an overall surplus equal to 3 percent of GDP was achieved in 1995. External reserves thus received a useful boost, reaching the equivalent of five-and-a-half months of imports by the end of 1995.

Overall economic growth is expected to improve to about 2.9 percent in 1996. Sugar production is projected to be somewhat higher than in 1995; tourist arrivals should increase; and growth in the output of mining, fisheries, forestry, construction, and industry is forecast.

The government budget for 1996 provides for an increase in total expenditure of 6 percent in real terms as against a rise in revenue of about 4 percent. The net fiscal deficit is estimated to rise to 3.6 percent of GDP and is planned to be covered by higher external as well as domestic borrowing. Money supply (M2) growth is expected to be kept to 5.6 percent, little changed from 1995. Domestic credit expansion will be around 8 percent, with private sector credit increasing more rapidly than in 1995 at 5.6 percent. Credit to government and official entities is projected to rise by around 25 percent. Monetary policy will continue to be used to hold inflation in check at about the 2 percent level, much the same as in 1995.

The external account position is expected to continue improving in 1996. Though exports are likely to rise only marginally, imports will be about the same as in 1995 so that the trade deficit will decline further. With a rise in net services income, especially because of increased tourism, the current account surplus is projected to improve further to about 2 percent of GDP in 1996.



Policy and Development Issues

Achievement of sustainable economic growth over the longer term at a rate sufficient to generate increased per capita incomes and provide employment for the growing labor force requires urgent attention to several issues. The rate of investment needs to be restored at least to the levels enjoyed in the first half of the 1980s. A resurgence of investor confidence is needed, which requires the early and satisfactory resolution of the questions of constitutional rights for the Indo-Fijian population and security of tenure in agricultural land leasehold arrangements, due for renewal in 1997. Also required is government articulation of a credible and transparent strategy for growth, which minimizes the obstacles in the way of the private sector playing a major role in the development process. There needs to be a stronger and more resolute commitment to economic deregulation, substantial corporatization and privatization of public enterprise, and greater emphasis in public expenditure on improving physical infrastructure and human capital development. Finally, restructuring of the productive base of the economy is required to reduce reliance on sugar production. The expansion and diversification of agricultural exports will help to achieve that objective.

Papua New Guinea

Efforts by the Government to remedy the macroeconomic imbalances generated by previous policies were a prominent feature of the economic scene in Papua New Guinea during 1995. Public finances were brought back into balance; the balance-of-payments deficit was eliminated and the rate of inflation brought under control. However, GDP declined sharply.

Expectations are for a return to modest but positive economic growth on average over the next two years. The overall balance of payments will continue in surplus, and prudent fiscal and monetary policies will help to provide an economic climate conducive to the pursuit of wide-ranging structural reform.

Recent Trends and Prospects

A decline in mining and petroleum production and restrictive monetary and fiscal policies combined to produce a fall in GDP of 4.8 percent in 1995 compared with growth of over 3 percent in 1994 and 16.6 percent in 1993. Output declined in most of the non-mining sectors, except in the agriculture sector where output growth, though lower than in 1994, reached 2.6 percent with the aid of favorable export prices, especially for coffee and palm oil. Manufacturing production fell by 3.6 percent; however, increases were recorded in energy production and construction as new mineral ventures began to be developed. The service industries, however, which account for over 30 percent of GDP (Figure 2.29), recorded negative growth.

Though employment in the formal sector has only recently recovered to the level of 1989, there was strong growth in such employment in most sectors of the economy in 1994. Employment growth continued in 1995. While this was mostly in the agriculture sector during the first half of the year, because of seasonal factors during the second half of 1995, the mining and construction sectors played a more prominent role in job provision.

The 1995 budget was delayed until March 1995 to allow time for its formulation in the framework of a structural adjustment program agreed with IMF and the World Bank. Total expenditure was reduced to 26.3 percent of GDP from the 1994 level of 29.7 percent and involved a significant reduction of current expenditure and an increase in capital expenditure. Revenues in 1995 benefited from new measures introduced in late 1994 so that an overall budget surplus of 0.1 percent of GDP was achieved, compared with deficits of 5.9 percent and 2.8 percent of GDP in 1993 and 1994, respectively.

With the floating of the kina toward the end of 1994, the focus of monetary policy shifted from the maintenance of adequate external reserves to that of containing inflationary pressures generated by higher import prices. Monetary policy was tightened in late 1994 and through 1995 with successive increases in the Minimum Liquid Asset Ratio (MLAR) of the commercial banks, which led to significant increases in nominal interest rates. Inflation gathered momentum from late 1994; further upward pressure on prices came from the easing of price controls in mid-1995 on a wide range of goods. The inflation rate, though declining in the second half of 1995,

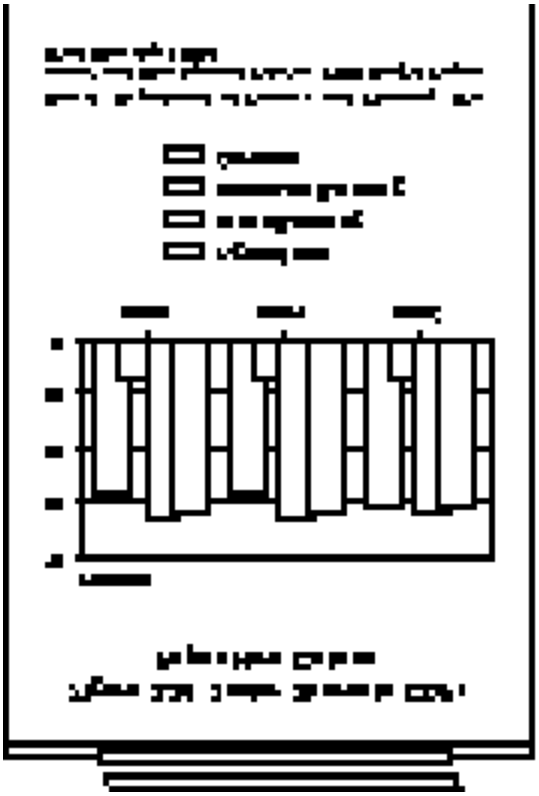
averaged about 15 percent for the year as a whole compared with 2.9 percent in 1994.

The balance of payments on current account was less favorable than in 1994. Export earnings declined by about 1 percent; increased earnings from some mineral and agricultural products were insufficient to offset the effects of sharply lowered returns from petroleum and log exports. Import payments were nearly 15 percent higher than in 1994, reflecting new mining and petroleum developments. The trade surplus thus declined and, with the deficit on the services and investment accounts remaining much the same as in the previous year, the current account surplus slipped to 7 percent of GDP from 10.6 percent in 1994. With net capital movements more favorable than in 1994, the overall balance turned to a surplus equivalent to 3 percent of GDP. External reserves increased to over two months of import cover at the end of 1995, from one month a year earlier.

The medium-term outlook for the economy of Papua New Guinea is for a return to positive economic growth of about 1 percent over the 1996–1997 period. Growth is likely to be stronger in the non-mining sectors of the economy; agricultural output is expected to increase by 3–4 percent per annum over the next two years and a high level of construction activity will be sustained. However, mineral output will fall over the period and not recover until new developments come into production in 1998.

The budget for 1996 provides for an overall deficit of 1 percent of GDP. Revenue, including grants, is projected to contract to 25.4 percent of GDP while expenditure will rise slightly to 26.5 percent. Recurrent expenditure is to be reduced by over 4 percent while development expenditure is to more than double to over 6 percent of GDP. Money supply growth in 1996 is projected to be lower than in 1995 and the rate of inflation is expected to be appreciably lower at around 6 percent.

The external accounts are forecast to show a major shift to a current account deficit in 1996 of over 7 percent of GDP. Exports are not expected to be much greater than in 1995 as mining revenues continue to decline and import payments rise by some 30 percent as a result of new mining investment activity. Substantial capital inflows to finance such investment will, however, be sufficient to generate an overall surplus of about 2 percent of GDP with a consequent further increase in external reserves.



Policy and Development Issues

The policy measures taken in late 1994 and in 1995, especially to lower the fiscal deficit, have been successful not only in bringing about a much-needed degree of macroeconomic stability but also in enabling a start to be made on structural reforms necessary for the achievement of sustainable economic growth. Reducing the size of the government sector and restructuring public finances to give more emphasis to basic services such as health, education, and physical infrastructure and to reduce manifest inefficiencies and geographical inequities in their provision are core elements of the structural adjustment program. Deregulation and privatization are pressing requirements so that the private sector can play a more pervasive role in shifting the economy away from its present excessive dependence on the exploitation of natural resources. Continuing adherence to the structural adjustment program will contribute significantly to strengthening the economy in 1996.

Cook Islands

Economic conditions in the Cook Islands continued to deteriorate in 1995. GDP fell sharply, mainly because tourist arrivals were well below those in the previous year. Also, consumer confidence, and hence spending, was seriously affected by a currency crisis in the early part of the year. The Government's financial position became more constrained and it was unable to meet some of its debt-service obligations. Servicing the very high level of public debt incurred over recent years for projects that have yet to generate financial returns continues to present the Government with severe financing problems that need to be addressed by significant restructuring and reduction of public expenditure. Although some reforms in the Government's organizational structure were begun during the year, more rapid progress is needed in reducing the dominance of the public sector in the economy, and in improving the sector's financial and economic management capacity.

Recent Trends and Prospects

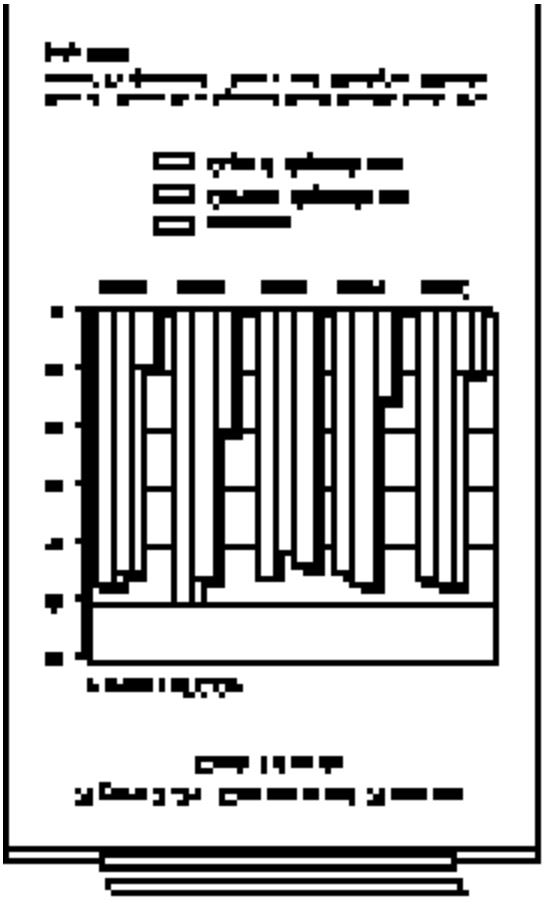
The rate of economic growth, which had been about 1.5 percent on average during 1993 and 1994, worsened sharply in 1995 when GDP declined by an estimated 3.7 percent. One reason was that tourist arrivals were more than 20 percent below the already depressed level of 1994. Another was the significant weakening of consumer spending as confidence in the economy ebbed in the wake of the currency crisis that developed in late 1994. The crisis was a consequence of the Government having financed its deficit by issuing more Cook Islands dollars (CI$) than could be absorbed by the economy. With persistent rumors of devaluation, there was substantial conversion into New Zealand dollars (NZ$) and capital flight. The commercial banks reacted by squeezing domestic credit; the volume of housing loans declined and construction activity dried up. In response, the Government decided in March 1995 to revert to the New Zealand dollar as the sole unit of currency and legal tender. The repurchase of CI$ cost the Government nearly NZ$4.4 million in foreign reserves, an amount it could ill afford.

The Government's fiscal position remained difficult in 1995 (Figure 2.24). The overall deficit was lower than in 1994, largely because of a substantial decline in development spending. However, the slowdown in economic activity impacted adversely on tax revenue, and some special measures had to be taken to shore up total revenue including deferring payments to private sector suppliers of goods and services. Even so, a debt interest payment due in the latter part of the year was not made.

Information on the external position of the Cook Islands in 1995 is not available. However, although there is likely to have been a fall in the rate of importation consistent with the lower level of economic activity, the very large trade deficit would have been little affected. Exports, though only about 5 percent of imports in 1994, have declined over the past four years, but imports have continued to increase and in 1994 were equal to over 90 percent of GDP. The trade deficit has been covered by services earnings, especially

tourism, official grants and concessional loans, and remittances.

The outlook for the economy in 1996 is not encouraging. Although the decline of GDP experienced in 1995 could be halted, a significant recovery of economic activity is not in prospect. In late 1995, there were signs of improved consumer confidence and the decline in tourist arrivals seemed to be coming to an end. Successful completion of negotiations on the financing of the Sheraton Resort project and the resumption of construction work would give a welcome boost to economic activity. The Government's fiscal position, however, is likely to remain difficult. The 1996 recurrent budget provides for a fall of about 1 percent in both revenue and expenditure. Support from New Zealand of about 11 percent of total revenue will be needed to balance the budget. However, the cash flow deficit apparent in the second half of 1995 seems likely to be even more serious in early 1996 when some debt interest payments are due. The external account position is unlikely to show much improvement. Although some decline in the rate of importation can be expected, the trade deficit will remain very large and dependence on tourism receipts, private remittances, and official grants will continue to be substantial.



Policy and Development Issues

The most immediate problem facing the Government is that its current revenue flow is insufficient to meet current expenditure, including substantial debt-servicing costs. Various ad hoc measures have had to be taken to meet the situation. Given the existing level of debt at around 110 percent of GDP and the rundown of reserves that occurred in 1995 with the currency crisis, the Cook Islands' borrowing capacity is negligible. With revenue constrained by recessionary economic conditions, timely and decisive measures are needed to bring public expenditure down to within the limits imposed by current revenue.

The external debt situation also needs urgent attention. More than two thirds of the debt including capitalized interest relate to the Sheraton Resort project which is still uncompleted and yielding no return. However, negotiations for rescheduling the debt and completing the project were expected to be concluded in early 1996. More generally, there is a need for the Government to review its debt policy to ensure that it is consistent with a sound macroeconomic framework and that the legal and administrative infrastructure for its management is put in place.

The critical financial position now facing the Government underscores the need for comprehensive reform of the public sector both to reduce its size in the economy and to increase its efficiency, thereby enabling the private sector to play a much greater role than is currently the case. Some tentative steps have already been taken to improve decision-making efficiency, such as amalgamation of some government departments and the distribution of departmental functions on a more rational basis. However, much more remains to be done if management capacity in the public sector is to be raised to the level needed to establish a strong macroeconomic foundation for future growth. An ADB program of technical assistance to the Cook Islands for this purpose will commence in March 1996.

Kiribati

The economy of Kiribati has performed poorly in recent years with GDP growth having declined in most years since 1988. Although GDP growth was positive in 1995, the main stimulus to the economy came from a sharp expansion in government current expenditure, leading to the emergence of a fiscal deficit. This was a factor behind the rise in the rate of inflation and the decline in the balance-of-payments current account surplus. For the longer term, the achievement of sustainable growth will require significant revisions in the nature and extent of the Government's involvement in the economy and a stronger role for the private sector in the development process than is currently the case. An apparent weakening of the Government's commitment to fostering the private sector is not conducive to the achievement of its development objectives.

Recent Trends and Prospects

In contrast to the experience over the previous six years, when GDP growth declined on average by about 2 percent per annum, growth recovered in 1995 to an estimated 2.6 percent. There was some improvement in agricultural and fisheries output but most of the growth came from government services and trading activities following a large rise in civil service salaries. Manufacturing and construction activities were weak following the completion of some major projects in the previous year, and the performance of state enterprises continued to be disappointing.

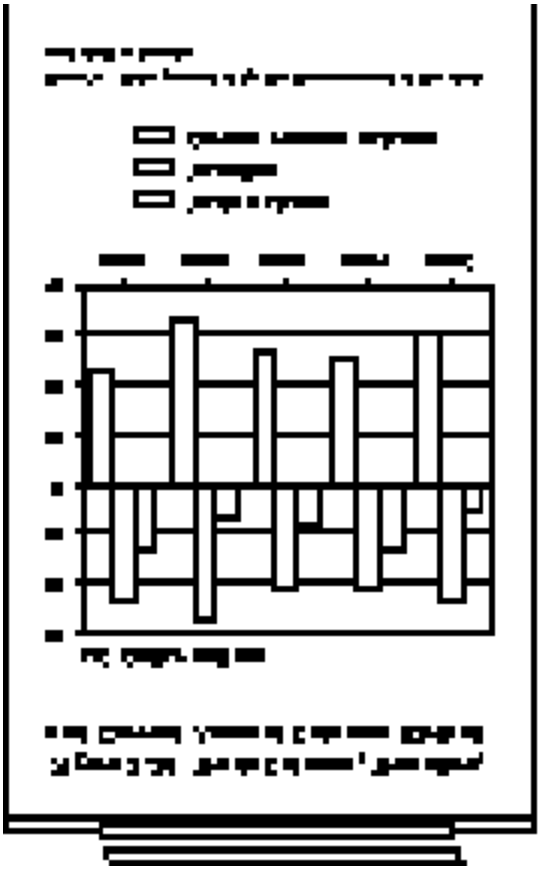
In its budget for 1995, the new Government, elected in late 1994, adopted a fairly expansionary approach to fiscal policy, in contrast to the conservative stance of previous administrations. Current expenditure was budgeted to increase by 56 percent, to over 87 percent of GDP. Wage and salary outlays were to be raised by 46 percent and other expenditure (including that on maintenance, health, and education) by nearly 60 percent. An increase in current revenue to 76 percent of GDP from 64 percent in 1994 was largely accounted for by drawing on interest earnings of the Revenue Equalisation Reserve Fund (RERF). The current fiscal balance thus moved from a surplus of 3.3 percent of GDP in 1994 to a deficit of 10.7 percent in 1995. Development expenditure, though less than planned because of a shortfall in external grants, lifted total expenditure to 128 percent of GDP compared with 104 percent in 1994. The overall balance including grants registered a deficit, estimated at 15 percent of GDP compared with 6.5 percent in 1994.

Inflation in Kiribati was somewhat higher in 1995 at 6.5 percent on average compared with 5.1 percent in 1994. Price changes are strongly influenced by the rate of inflation in Australia, a main source of imports, although prices were also influenced by increases in domestic money incomes in 1995.

The external position was less favorable in 1995 than in the previous year. Export receipts – mainly from copra and marine products – rose marginally but still were equivalent to only about 16 percent of imports, which increased by over 21 percent. The trade deficit thus widened to 75 percent of GDP from 67 percent in 1994 (Figure 2.26). Net services receipts, principally RERF interest,

fishing license fees, remittances from workers abroad, and official transfers, though slightly lower than in the previous year, were sufficient to yield a current account surplus equal to 13.7 percent of GDP. This was much lower than the 1994 level of nearly 35 percent. Net capital outflows led to an overall balance of about 3.7 percent of GDP in 1995. RERF balances – the main component of external assets – were equivalent to about six-and-a-half years of imports at the end of 1995 compared with over seven-and-a-half years in 1994.

The outlook for the Kiribati economy in the immediate future depends very much on the fiscal stance adopted by the Government. A further expansion in government expenditure of the order that occurred in 1995 is not in prospect and thus, in the absence of improved performance in the productive sectors, economic growth is likely to fall below that of 1995. However, the maintenance of expenditure and the fiscal deficit at 1995 levels is likely to require RERF drawdowns above what are necessary to meet the Government's objective of maintaining the real per capita value of the RERF intact over the long term. The balance-of-payments surplus could also be expected to contract further as the demand for imports is maintained.



Policy and Development Issues

The immediate task is to secure a return to a more conservative fiscal stance so that the real value of the RERF is not impaired. Some improvements in revenue, such as indirect taxation, could be made but the prospect also is for a decline in fishing fees, a major source of revenue. The burden of adjustment would thus need to fall primarily on current expenditure (development expenditure usually being kept close to what can be financed from external grants). Short-term expenditure-restricting measures, such as the freezing of staff levels, are possible, but a more constructive and enduring approach would be to hasten reforms in the structure and size of the public sector and improve management efficiency. The system of output budgeting introduced in 1995 is an encouraging innovation; however, a substantial increase in trained staff and rigorous application to all resources – physical and human – are required if the system's potential benefits as a management tool are to be ensured.

Public sector reform should also include a reappraisal of government regulatory activities, many of which do more to impede economic development in Kiribati than to promote it, especially by inhibiting private sector growth. The more restrained attitude to privatization that has emerged over the past year needs to be reconsidered; the privatization of the manifold commercial activities now undertaken by government agencies and enterprises in Kiribati offers considerable scope for efficiency gains to the economy as a whole and could significantly reduce government expenditure or release resources for more beneficial public purposes.

Federated States of Micronesia

Economic activity in the Federated States of Micronesia weakened further in 1995, with real GDP growth being less than the already low level achieved in 1994. Despite a small rise in exports, the trade deficit remained very large as did the fiscal deficit. External grants from the US and elsewhere to finance these deficits amounted to over 50 percent of GDP. Dealing with these two deficits in the context of a stepdown in financial support from the US under the Compact of Free Association is at the heart of the adjustment problem now faced by the FSM. Development of a strategic program for appropriate policy reform was begun in 1995 with support from ADB and others of the donor community.

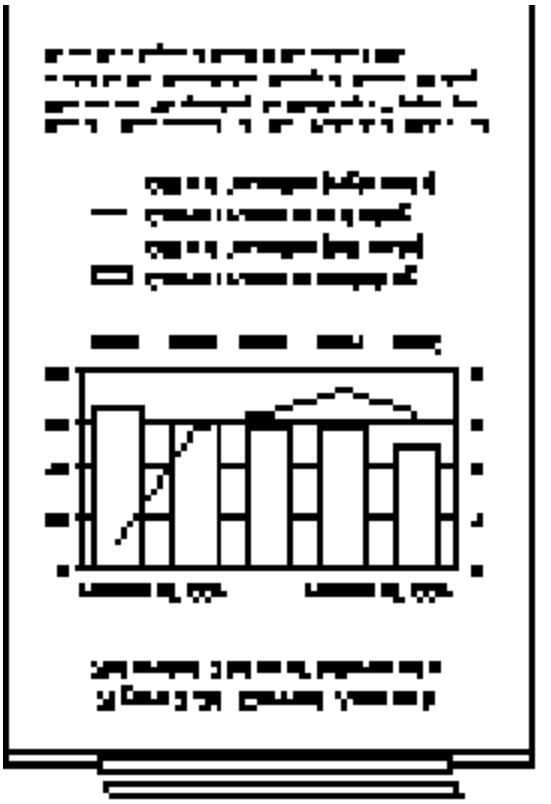
Recent Trends and Prospects

Real GDP growth in 1995 is estimated to have declined to 1 percent compared with 1.3 percent in 1994 and 5.7 percent in 1993. Sectoral data are not available but indications are that agricultural output, which is dominated by subsistence activity, stagnated. Most of the limited growth occurred in fish processing, garment manufacturing, and the services sector.

The consolidated finances of the five constituent governments in 1995 changed little from the 1994 levels. Total revenue, including external grants, declined to 73.6 percent of GDP from 77.6 percent in 1994. External grants (mostly Compact funds) were more than twice domestic tax and non-tax revenues, which together declined by over 6 percent in nominal terms to 24 percent of GDP from 27 percent in 1994. Total expenditure in nominal terms was virtually unchanged from the 1994 level, although it declined to 77.8 percent of GDP from 82 percent in 1994. The share of salaries and wages in total current expenditure, however, increased to 46 percent from 44 percent in 1994, while the share of goods and services expenditure fell from 41 percent in 1994 to 39 percent in 1995. The overall deficit declined slightly from 4.5 percent of GDP in 1994 to 4.2 percent in 1995 after allowing for grants. Excluding grants, the deficit in 1995 was 45 percent of GDP, marginally less than in 1994.

The consolidated FSM finances, however, mask some significant differences in the fiscal position of the constituent governments. The National Government, benefiting as it does from the country's fishing rights revenue, has achieved an overall budget surplus in recent years, with grants at about 35 percent of total revenue, and wages and salaries kept to about 25 percent of current expenditure. In Chuuk, the largest of the constituent states, the overall balance has been persistently in deficit over the past five years, with grants amounting to 82 percent of total revenue and salaries and wages typically about 55 percent of current expenditure.

A serious fiscal crisis developed in Chuuk in 1995 when the state government was unable to meet its expenditure obligations. A reform program was developed with the aim of achieving a greater degree of fiscal responsibility in Chuuk, but the crisis underlined the need for all constituent states to address the problems of the country as a whole and to adjust to a lower level of Compact funding in the future.



Official price data are not collected in the FSM; however, the US consumer price index modified by the Marshall Islands index is used to measure inflation. On this basis, inflation was estimated to be 4 percent in 1995, the same as in 1994.

The external position of FSM improved slightly in 1995. Exports, 90 percent of which consist of fish and garments, increased by nearly 5 percent. Although there was no growth in imports, they were still four-and-a-half times export receipts so that, while the trade deficit shrank a little, it was still very high at 51 percent of GDP compared with 54 percent in 1994. Exports have increased appreciably in recent years, rising from 3 percent of GDP in 1990 to 14 percent in 1995. The services account deficit in 1995 declined to 2.6 percent of GDP from over 7 percent in 1994. Income from fishing rights improved, as did net income from interest and dividends; freight and insurance payments were lower. While private transfers increased slightly, official transfers, mainly comprised of Compact funds, were down by nearly 8 percent; however, they were still substantial at over 47 percent of GDP. Allowing for these official transfers, the current account deficit contracted to 0.2 percent of GDP compared with 1.2 percent in 1994 (Figure 2.28). The overall deficit, allowing for capital movements, also contracted, moving from 8 percent of GDP in 1994 to 2.3 percent in 1995. Reserves declined by some $5 million compared with a fall of over $16 million in 1994 and were the equivalent of 55 percent of GDP at the end of 1995. External debt, most of which had been incurred during 1990–1993 for fisheries development and telecommunications, stood at 35 percent of GDP in 1995.

The prospects in the short term for the FSM economy are not encouraging. GDP growth in 1996 is likely to fall below that of 1995 and could become negative. The private sector, limited in scope as it is, is unlikely to show any growth momentum, especially since measures already being taken to restrict hiring and wage growth in the public sector will impact on consumer spending. The consolidated public budget for 1996 provides for a modest reduction of public expenditure although not by as much as what the emerging fiscal situation would appear to demand.

Policy and Development Issues

The critical problem facing the FSM is that of adjusting its economy to the progressive decline in financial support from the US. The National Government, with support from the states, has built an institutional mechanism to enable the design and implementation of the necessary reforms. Reducing reliance on external funds is a main objective and will require, in particular, a substantial reduction in the size of the public sector wage bill; that, in turn, will require efforts to increase employment opportunities through increasing the size and competitiveness of productive sectors. Another objective is to diversify sources of external funding and investment. A stable macroeconomic environment and a transparent and stable regulatory framework are essential for this purpose. The success of any program will, however, depend critically on the readiness of the state governments and the people of the FSM to accept the necessity of some radical decisions. Inevitably, there will be severe social impacts from the reduction in expenditure on wages and consumer subsidies and the increase in unemployment. The National Government will need to address these issues in its policy reform program.

Solomon Islands

Economic growth in Solomon Islands in recent years has been driven by rapid expansion of exports, especially forestry products. Government revenues have been augmented substantially by forestry taxation; however, public expenditure has increased even more rapidly. High fiscal deficits have placed considerable pressure on the financial system. In 1995, accommodation from the banking system became difficult for the Government to secure and it had to resort to special measures, such as deferring payments to private creditors to secure temporary finance. Inflation in 1995, though lower than in 1994, remained high, but the balance-of-payments deficit on current account (excluding transfers) fell sharply as exports surged.

Prospects for 1996 are not encouraging. Improvement in the fiscal balance is problematic, with doubts about the outcome of the changes in revenue structure provided for in the 1996 budget. The balance of payments is still precarious and management of very limited external reserves is likely to present some difficulties. The reduction of the fiscal deficit and return to a position of macroeconomic balance is still a matter of high priority in providing the foundations for long-term sustainable growth.

Recent Trends and Prospects

Economic growth in 1995 was stronger than in 1994, especially in the second half of the year. GDP growth is estimated at 4 percent compared with only 1.1 percent in 1994; however, it is still well below the rate of 8 percent achieved on average during 1992 and 1993. As in previous years, primary production for export was the main stimulus. Log production was substantially higher than in 1994; there was a large rise in fisheries output because of good weather and improved production and processing facilities. Copra and cocoa output was also higher than in 1994.

Government revenue increased by over 10 percent in 1995, with revenue from log export taxes amounting to 23 percent of the total. Total expenditure rose by an estimated 10.4 percent to yield an overall budget deficit of about 6 percent of GDP compared with a deficit of 7.7 percent in 1994. However, in achieving this apparent improvement, development expenditures were kept well below budget and, in real terms, were some 9 percent lower than in 1994.

The Government encountered considerable difficulty in financing the 1995 deficit. Borrowing from the Central Bank reached the legal limit in August 1995 and the commercial banks were unwilling to lend further to the Government as doubts about the security of Treasury bills increased. The Government in effect financed a part of the deficit by delaying payments to private sector suppliers of goods and services, by failing to make budgeted transfers of timber levies to local authorities, and by deferring some project expenditures.

Money supply (M2) growth in 1995 declined to 15 percent from over 20 percent in 1994. Lower rates of domestic credit expansion, especially to the Government, and the leakage into imports were contributing factors in the decline. Inflation at 9 percent was lower in 1995 than it was in the previous year at nearly 13 percent.

The external accounts showed some improvement in 1995. Export earnings rose by 28.7 percent compared with only 5.8 percent in 1994. Timber exports, which comprise more than half of total exports (Figure 2.30), increased by 21 percent as the rate of logging rose sharply. Fish exports showed the largest gain, rising by 85 percent compared with a rise of only 3 percent in 1994. Cocoa and copra exports also increased but together they comprised only about 7percent of the total. The expansion of exports, however, was virtually matched by higher imports which rose by nearly 26 percent after having fallen by over 1 percent in 1994. Consumer goods formed a substantial part of the total. The increase in the trade surplus was, therefore, modest, improving to 5.1 percent of GDP in 1995, from 3.5 percent in the previous year. With a decline in the deficit on net services and transfers, the current account recorded a surplus of 2.4 percent of GDP compared with a deficit of 0.9 percent in 1994. The capital account, however, was in significant deficit as a result of private debt repayment by logging and fishing companies. Even after allowing for official and other transfers amounting to 3.5 percent of GDP, the overall balance of payments for 1995 was expected to show a small deficit, leaving the external reserves at the low level of about one month's imports. This is a matter of some concern as it leaves little margin for coping with trade and exchange rate fluctuations or capital movements.

Driven as it is by the export sector, economic growth in 1996 is likely to be below that of 1995, perhaps no more than 3 percent at best. Constraints on capacity will mean that any increase in output of the fishing industry will be well below that of 1995, and the same is likely to apply to forestry output. The budget for 1996 provides for a fall in the overall deficit to about 4 percent of GDP. Recurrent expenditure is budgeted to rise by about 6 percent and revenue by over 10 percent. However, the revenue structure incorporates some major changes. Revenues from business and personal taxes, timber, and other export taxes are to decline significantly; this will be compensated by a foreign exchange tax and a bank debit tax which together are projected to constitute nearly a quarter of total revenue. Given problems of administration, compliance, and ease of evasion, revenue shortfall must be expected and a budget deficit in excess of what is programmed, with attendant problems of its financing, could well occur. The outlook for the external sector also is not promising. The high rate of export growth is unlikely to be repeated; however, import growth, though lower than in 1995, could be substantial as a result of the lagged effect of increased incomes in 1995. The foreign exchange tax, however, could restrict the extent of that increase.

Policy and Development Issues

The immediate requirement if macroeconomic stability is to be restored in the near term is the substantial reduction of the fiscal deficit, with emphasis on the containment of recurrent expenditure. The adoption of a more prudent fiscal stance would also put the country in a more resilient position and better able to deal with the effects on government revenue and the balance of payments over the longer term of a necessary reduction in the rate of forest exploitation.

Tonga

The performance of the Tongan economy in 1995 was generally less satisfactory than in the previous year. The rate of economic growth slowed down, the fiscal position worsened, the balance-of-payments deficit was significantly greater than it was a year before, and external reserves declined. Further pressure on the fiscal position is likely in 1996 as civil service wage demands are met. However, the external accounts should improve with better export performance and with the demand for imports kept in check by tighter monetary and credit conditions.

Recent Trends and Prospects

Economic growth in 1995 slipped to 2.2 percent, less than half the rate achieved in 1994. Squash production for export was well down as a result of a combination of factors, such as the effects of the export quota on farming incentives and production management, problems of quality, and external competition. Other primary production for export as well as domestic consumption, such as vanilla, fish, and various food crops, fared better. In the industry sector, manufacturing output declined by 4.9 percent and construction contracted as some major projects were completed. The services sector as a whole showed virtually no growth in 1995.

The Government's fiscal outturn in 1995 was less satisfactory than in the previous year. Total current revenue increased slightly but current expenditure, especially for health and education, rose faster so that the current surplus fell to 3.2 percent of GDP from 4.2 percent a year earlier. An increase in development expenditure from 17.5 percent of GDP to 22 percent shifted the overall balance to a deficit of 3.4 percent of GDP from a surplus equal to 1.4 percent of GDP in 1994.

The method of financing the fiscal deficit had important effects on monetary conditions which had become lax in 1994 and continued to be so in 1995. The Government's external borrowing and building up of deposits with the commercial banks (rather than repaying advances from the Central Bank) provided the basis for expanded commercial bank lending. Increased competition from the establishment of two new commercial banks obliged the Bank of Tonga to relax its very restrictive approach to lending. On the demand side, higher incomes in 1994 from squash production increased the demand for loans, especially for housing. Expectations of continued high incomes also stimulated loan demand in 1995. Consequently, there was a rapid increase in domestic credit to the private sector of 25 percent in 1994 and 43 percent in 1995. Broad money (M2), which had declined by nearly 5 percent in 1993, increased by 11 percent in 1994 and by a further 9 percent in 1995. The impact of these developments was manifested not in the rate of inflation, which was only 2.4 percent in 1994 and close to zero in 1995, but in the external accounts through a sharp rise in imports in both 1994 and 1995 and a consequent fall in international reserves.

The external accounts worsened considerably in 1995. Export earnings from squash

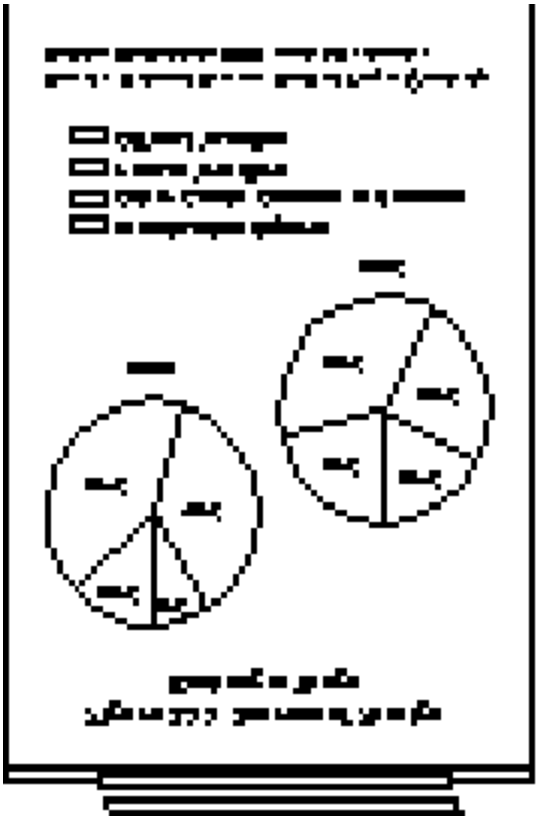
1995 refers to fiscal year 1994/95, ending 30 June.

fell by 40 percent and, although exports of other products such as fish and vanilla improved, total export receipts were 19 percent lower than in 1994 and accounted for 17 percent of foreign exchange earnings in 1995 compared with 8 percent in 1990 (Figure 2.31). With import payments up by about 17 percent, the trade deficit increased to over $51 million in 1995 from about $37 million in 1994. With the surplus on services and transfers nearly the same as in the year before, the current account deficit widened from 0.3 percent of GDP in 1994 to over 8 percent in 1995. Allowing for net capital receipts, the overall deficit was about 5.7 percent of GDP; international reserves fell to three-and-a-half months of imports, about half of what they had been in 1993.

The outlook for the Tongan economy in the near future is very dependent on the speed and extent to which the authorities move to redress macroeconomic imbalances. Present prospects are for economic growth in 1996 to be much the same as in 1995 at 2 percent. The main sources of such growth are likely to be in agriculture with increases in output of various cash crops and fishing and some recovery of squash production. The fiscal balance is projected to worsen. With revenue growth modest and recurrent expenditure rising by nearly 10 percent (nearly all of which as a result of increased wages), the recurrent surplus is expected to decline to just over 1 percent of GDP. Development expenditure, at about the same level as in 1995, will push the overall deficit substantially higher than in 1995 to 5 percent of GDP. This is expected to be covered mostly by foreign loans and capital inflow, but some recourse to domestic financing from the banking system is in prospect, in contrast to the position in 1994 and 1995 when government balances were built up. Assuming that monetary policy is tightened to check the drain on external reserves, growth of domestic credit and money supply should be significantly lower than was the case during the past two years. Inflation should also remain at a low level. The balance of payments is expected to improve with imports restrained to 1995 levels, increased tourism earnings, and some recovery in squash exports. In consequence, the current account deficit is projected to fall to 3.4 percent of GDP, less than half of what it was in 1995. With loans and other capital inflows more than sufficient to cover the deficit, a rise in external reserves to about four months of imports is in prospect.

Policy and Development Issues

An urgent task is that of developing effective monetary policy instruments not only to deal with the immediate problem of excess credit creation and external reserve depletion, but also to establish a climate of macroeconomic stability conducive to the structural reforms that are necessary for the achievement of sustainable economic growth over the longer term. A fundamental need is to diversify the economy away from excessive dependence on a single export crop concentrated on one market as well as on flows of external grants and private remittances. Diversification calls for vigorous private sector involvement which at present is inhibited, among other things, by an uncertain and distortionary taxation structure and by the drain on resources of an inflated public sector. It is necessary to reduce the size of government, and improve its efficiency by reforms in budgetary management to require explicit evaluation of resource use against outcomes and policy objectives.



Tuvalu

As with most other small Pacific island countries, Tuvalu has a dual economy: a large subsistence sector concentrated on fishing and coconut products coexisting with a monetized economy in which the Government plays the dominant role. Although its land-based and human resources are limited, Tuvalu has a very large exclusive economic zone that it has been able to exploit to good effect through the issuance of fishing licenses. Recurrent budget deficits have generally been avoided, with development expenditure being financed largely from external assistance. Inflows of remittances from workers abroad have been an important element of external earning; and investment revenue from the Tuvalu Trust Fund, established in 1987 by external donors, has not only assisted the balance of payments but has also eased the problem of fiscal management.

Economic growth was high in the early 1990s as the fisheries resource began to be exploited and public expenditure was increased. While there are opportunities for further development of the fisheries resource, much more modest rates of growth can be expected in the future. Although there is limited scope for private sector development, this needs to be encouraged wherever possible.

Recent Trends and Prospects

Economic growth in Tuvalu averaged 9 percent per annum during the four years to 1993, but receded to 2.6 percent in 1994 and further to an estimated 2 percent in 1995. In that year, although fishing license revenue improved, the contraction of both current and capital expenditure by the Government served to check the rate of economic growth.

The Government's fiscal position in 1995 was again less favorable than in the previous year. Recurrent revenue, excluding grants, contracted to 34 percent of GDP in 1995 from 47 percent in 1994. This was largely because of a fall in the contribution made by interest and dividend earnings of the Tuvalu Trust Fund (Figure 2.32). Revenue from fishing licenses increased by 30 percent. Recurrent expenditure also contracted from about 47 percent of GDP in 1994 to 42 percent in 1995. Salary and wage payments were virtually unchanged and most of the expenditure reduction occurred in areas such as maintenance and the purchase of goods and services; expenditure on both declined by nearly 27 percent. The deficit on recurrent operations in 1995 was 7.8 percent of GDP compared with a balance in 1994. Capital and development expenditure showed an even more marked contraction, with the total declining from 69.8 percent of GDP in 1994 to 27.9 percent in 1995. The overall deficit, excluding grants, was thus virtually halved to 35.7 percent of GDP from 69.7 percent in 1994. The major source of finance for these deficits was external grants from a wide range of donors although it was also necessary to draw down cash balances and to draw on balances in the Tuvalu Trust Fund.

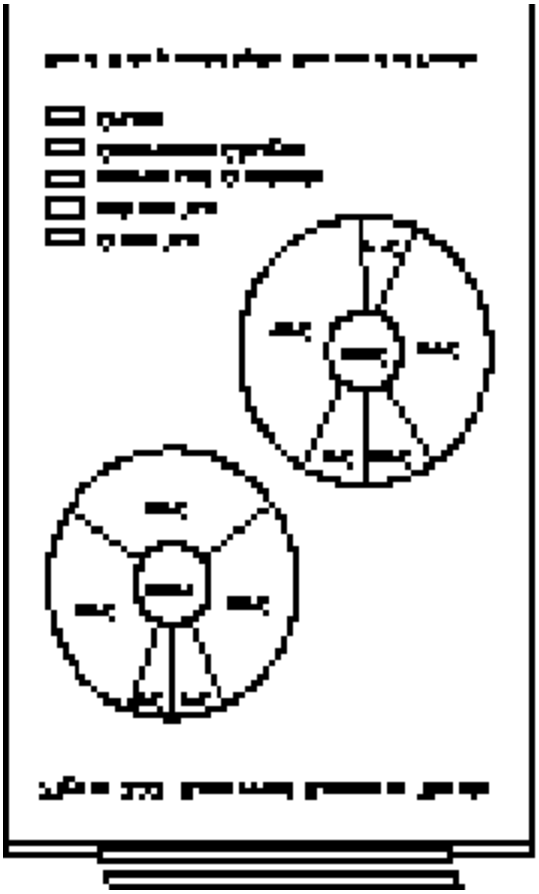
Inflation in Tuvalu is strongly influenced by price movements in Australia, Fiji, and New Zealand, the main sources of imports. Low inflation in these countries over recent years has helped to keep inflation in Tuvalu down to 1.5 percent in both 1993 and 1994;

a similar rate is estimated for 1995. Balance-of-payments data for Tuvalu in 1995 are not available; however, the general features of Tuvalu's external accounts are unlikely to have changed. Commodity export earnings are minimal, amounting to only 3–4 percent of import payments. The trade deficit is typically equal to over 50 percent of GDP. However, income from Tuvalu Trust Fund investments, remittances from overseas workers, and fishing licenses – which rose by some 30 percent in 1995 – along with substantial external grants are usually sufficient to cover the trade deficit, and yield an overall balance-of-payments surplus. External reserves remain fairly comfortable at the equivalent of about nine months of imports.

In the immediate future, the economic outlook for Tuvalu is for continued growth, possibly a little higher than in 1995 at 2.5 percent. The government budget for 1996 provides for very large increases in current revenue and expenditure as well as in capital and development expenditure. Current revenue, excluding grants, is budgeted to rise by 28 percent, with tax revenue up by nearly 50 percent on actual receipts in 1995. Current expenditure is budgeted to increase by 15.1 percent, yielding a recurrent deficit equal to 4.3 percent of GDP, just over half of what it was in 1995. Capital and development expenditure is also budgeted at much higher levels than the outturn for 1995. The total of such expenditure is projected to be Australian dollars (A$) 20.3 million compared with A$4.8 million in 1995, a rise from 27 percent of GDP to over 111 percent, with external assistance providing the necessary finance. However, these estimates of both current and development revenue and expenditure seem unrealistic given the limited absorptive capacity of the Tuvalu economy. Also, in the past there have been substantial differences between budget estimates and actual outcomes. The external accounts of Tuvalu are unlikely to show much change in 1996. The trade deficit will again be largely covered by external grants, services and investment income.

Policy and Development Issues

The achievement of long-run economic growth sufficient to improve per capita incomes in Tuvalu is problematical. The resource base



is limited and the range of options open for development of productive sectors is narrow with further exploitation of its fisheries resource being the only realistic possibility, along with some small-scale commercial agriculture and service activities. Thus, reliance on workers' remittances from abroad, earnings of interest and dividends of the Tuvalu Trust Fund, and especially external assistance to cover the large trade deficit will be necessary for some time to come. Virtually all development expenditure is financed by external assistance. It is important to ensure that projects are properly evaluated on economic terms and do not impose future operational burdens on the public budget which will require levels of taxation that inhibit private sector initiatives. There continues to be a need for considerable strengthening of budgetary management and decision making and for reducing the extent of government involvement in what are essentially commercial activities. Further initiatives to advance this process were provided for in the 1996 budget, along with other measures to promote public sector reform.

Vanuatu

Economic activity in Vanuatu during 1995 continued at the subdued pace established in 1994. Improved export receipts and some recovery in tourism helped to keep economic growth at about the same level as in 1994. On a brighter note, the balance-of-payments current account deficit contracted and an improved revenue performance helped to keep the fiscal deficit at a low level. Inflation also declined over the year despite the imposition of a new turnover tax at the beginning of 1995. Other reforms of the taxation system are being considered. The need for more wide-ranging reforms of the public sector to improve the efficiency of decision making and to enlarge substantially the scope for private sector activity remains a priority.

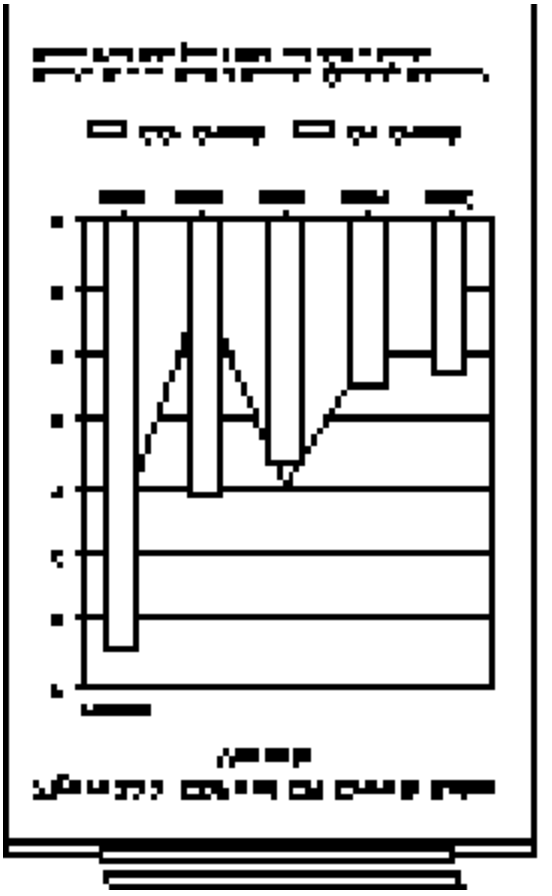
Recent Trends and Prospects

Growth of the Vanuatu economy in 1995 is estimated at 2 percent, the same as in 1994. Although sectoral details are not available, indications are that most of that growth originated in the export-oriented agriculture sector and in service activities related to tourism. Increased income from copra was the main feature in agriculture in 1995; however, that increase came largely from higher world prices rather than from a higher volume of copra production. In the case of tourism, much of the growth occurred in tourist ship arrivals; hotel room occupancy rates declined.

In its fiscal operations, the Government has endeavored to avoid deficits in the recurrent budget, leaving development expenditure to be financed from external grants and concessional loans. In 1995, it was again successful in doing so. A recurrent surplus estimated at 3.7 percent of GDP was achieved, following a surplus of 2.2 percent in 1994. Current revenue rose by nearly 13 percent and current expenditure by about 7 percent. The increase in revenue largely resulted from the imposition in January 1995 of a turnover tax of 4 percent on wholesale and retail trade. To lessen the burden on disadvantaged sections of the community, a number of essential consumer items were exempted from import duties. Steps were also taken to rationalize the import tariff system, which contributes nearly 65 percent of tax revenue, by eliminating various other duty exemptions. Development expenditure in 1995 was estimated at about 11 percent of GDP compared with about 9 percent in 1994. External grants for development projects, other than technical assistance, amounted on average to an estimated 6.6 percent of GDP in 1994 and in 1995. The overall budget deficit after allowing for grants was an estimated 0.9 percent of GDP in 1995 compared with 0.5 percent in 1994 and 2.7 percent in 1993.

Money supply (M3) showed little growth during 1995, increasing by less than 3 percent compared with a more substantial rise in 1994. The rate of inflation declined. There was a sharp increase in prices in the early part of the year following the imposition of the turnover tax; subsequently, prices remained fairly stable so that, for the year as a whole, the average increase in the CPI was 2.3 percent (Figure 2.33).

The external position of Vanuatu showed modest improvement in 1995. Export earnings were up by some 6 percent, mainly because of improved prices for some commodities



such as copra, although there were also increases in exports of several minor cash crops. However, export earnings remained sufficient to cover only 31 percent of imports and the trade deficit declined only slightly to 26.9 percent of GDP. Net services receipts, especially from tourism, together with increased official transfers were 18 percent higher, so that the current deficit at 2.4 percent was less than half of what it was in 1994. Capital movements were sufficient to generate an overall surplus and to enable the external reserves to remain at the equivalent of nearly eight months of imports. External debt remains low at about 22.5 percent of GDP. Most loans have been concessional so that the debt-service ratio is also very low at about 2.5 percent in 1995.

The immediate outlook for the economy is for a continuation in 1996 of the lackluster economic conditions experienced in 1994 and 1995, with growth at 2 percent or less. The main stimulus is likely again to come from tourism. Government fiscal operations should continue to display a prudent stance and there could be some further progress in implementing reforms of the taxation structure as recommended following a review in 1994. Some limited measures toward the privatization of certain commercial activities of the Government are also a possibility. The external accounts are also unlikely to show much change in 1996, with the trade deficit remaining at around 27 percent of GDP and the current account deficit largely covered by external assistance and concessional finance.

Policy and Development Issues

Vanuatu has been fairly successful in maintaining macroeconomic stability in recent years. Inflation has been modest, and the balance-of-payments and fiscal deficits have been kept under control with the aid of external assistance. However, economic growth has declined and has been insufficient to enable any increase in per capita income over the past three years. If the economy is to reach a higher and sustainable growth path, reforms in a number of areas are needed. A major reform would be to reduce the size of the civil service and increase its efficiency in the design of policy and in the management and delivery of essential services such as education, health, and public infrastructure. Privatization of commercial activities should be pursued more vigorously, although the creation of private monopolies needs to be guarded against if economic efficiency is to be served. Private sector involvement in the development process needs to be encouraged; this calls for a much more transparent and coherent policy framework and procedures governing foreign investment and business licensing so that investor confidence can be restored.

Tax reform is an urgent requirement, especially to reduce reliance on import tariffs which impede the development of a more internationally competitive private sector in tradeable goods and services. The lack of skilled workers is also a serious impediment to economic development generally as well as to the maintenance of physical infrastructure. Adult literacy rates are low and only about 9 percent of primary school children advance to secondary school. Real public expenditure on education has declined by 20 percent over the last decade. Reversal of this trend should be a central objective in reforms of the civil service and public expenditure structure.

Western Samoa

A welcome improvement in the state of the Western Samoan economy became apparent in 1995. Economic growth was strongly positive, sufficient to recover much of the ground lost in 1994 when GDP declined sharply as a result of serious damage to the country's main agricultural export crop. The overall balance of payments showed a surplus, aided by some recovery of exports and tourism growth, while international reserves increased after several years of decline. Inflation was reduced substantially from the high level experienced in 1994. Through tight control on public expenditure, a fiscal surplus was achieved which enabled the Government to cope with a large external debt repayment.

Maintaining macroeconomic balance may not be easy in the near term as pressures mount for increased public expenditure. A cautious fiscal policy should be aided by improvements in the scope and effectiveness of monetary policy instruments. In the longer term, strengthening and widening of the productive base and diversification of exports are needed to reduce both the vulnerability of the economy to external shocks and natural disasters and the extent of its reliance on external grants. Fiscal reforms are needed to improve the efficiency of government management and public expenditure and more deliberate efforts are needed to enable the private sector to play a greater role in the development effort.

Recent Trends and Prospects

Over the years, the growth rate of the Western Samoan economy has displayed considerable volatility, largely because of the country's weak productive base and vulnerability to natural disasters. GDP growth was 6 percent in 1993 as the country recovered from successive hurricanes; in 1994, GDP declined by nearly 8 percent, largely as a result of the destruction of its main export crop, taro, by leaf blight disease. The economy recovered again in 1995 with GDP growth reaching 6.7 percent (Figure 2.34). Taro production began to recover, the output of a number of minor agricultural crops improved, and there was increased contribution from coconut products. Output of automotive wiring harnesses for export also increased following the extension of the Yazaki Samoa plant. The contribution of the services sector to growth in 1995 was boosted by a further increase in tourism activity.

The fiscal operations of the Government in 1995 were greatly influenced by the need to meet the large debt obligations of Polynesian Airlines (PA). Substantial cuts in both current and development expenditures were required for this reason as well as because of shortfalls in revenue from customs duties as imports declined. Domestic revenue declined to 39 percent of GDP from 43 percent in 1994, but total revenue rose to nearly 60 percent of GDP in 1995 from over 53 percent in the previous year because external grants virtually doubled to 20 percent of GDP. Total expenditure (current and capital) was cut back by 10 percentage points to 51 percent of GDP. Net lending, however, was over five times greater at 17 percent of GDP in 1995 by comparison with what it was in 1994 and virtually all of that increase of some 14 percent

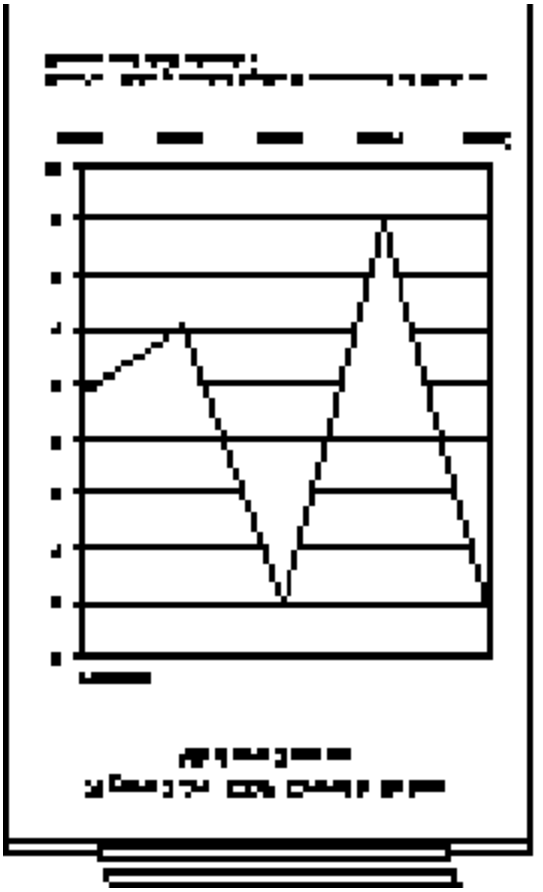
of GDP was accounted for by the repayment of PA debt. The overall balance, after allowing for external grants, was a deficit of some 10 percent of GDP in 1995 compared with nearly 12 percent a year earlier. In contrast with experience in 1994 when the entire deficit was financed from external concessional loans, such sources provided less than half of the deficit financing in 1995; and borrowing from domestic sources amounted to over 6 percent of GDP. Money supply (M2) increased by nearly 14 percent in 1994 and by 22 percent in 1995. Private sector credit growth after declining by 4.6 percent in 1994 picked up following some relaxation of monetary policy in early 1995. The rate of inflation moderated substantially in 1995 to an estimated 1 percent after reaching over 18 percent in 1994. Improvement in domestic food supplies, especially taro, was the main reason for this. The initial effects on prices of the introduction of the value-added goods and services tax (VAGST) in early 1994 were not present in 1995.

Western Samoa's external position continued to improve in 1995 despite the need for further repayments of PA debt. Although export receipts, mainly from coconut products, more than doubled, they were still equivalent to only 8 percent of import payments. Net services income rose by 2.8 percent, mainly as a result of increased tourism and higher net foreign exchange earnings of the Yazaki Samoa automotive wiring plant. (The gross value of exports and imports by this enterprise are not recorded in the trade statistics.) Private and official transfers also improved. Import payments, which had fallen substantially in 1994 following the completion of some major projects, were only $5 million greater than in 1994, an increase that was considerably less than the rise in external income. The current account balance improved accordingly from a surplus of 2.7 percent of GDP in 1994 to a surplus of 5.7 percent in 1995. The capital account also showed modest improvement. External borrowing was about half of what it was in 1994; however, debt repayment was also down. The overall balance of payments thus showed a surplus equivalent to 1.8 percent of GDP, in contrast to deficits in each of the preceding four years. External reserves increased modestly after having declined persistently since 1990. At the end of 1995, they were equivalent to over five-and-a-half months of imports.

The outlook for the Western Samoan economy in the near term is more sanguine than appeared justifiable in early 1995. Action taken to deal with the consequences of the failure of the taro crop and the strains imposed by PA debt repayment on the fiscal and external balances restored a degree of macroeconomic balance. This has enabled the authorities to turn their attention to more general issues relevant to the achievement of sustainable growth over the longer term.

Economic growth is expected to be about 3 percent in 1996. Continued recovery in coconut production will obviate the need to import coconuts for the production of coconut oil and cream; and further increases in the output of other agricultural products such as fruit flowers and root crops both for domestic consumption and exports are also expected. Manufacturing production, aside from agro-processing, will increase as a result of the further expansion of the Yazaki Samoa enterprise and the establishment of several garment factories. The contribution of tourism to GDP is also expected to improve, with new hotels due for completion during the next two years.

The Government's fiscal position in 1996 will be less constrained than in 1995. Expenditures from net lending to public enterprises and settlement of PA debt are projected to fall from nearly 25 percent of total expenditure in 1995 to 4.6 percent in 1996. This means that, although in GDP terms total expenditure will decline to 62 percent of GDP from 69 percent in 1995, both current and development expenditure could be increased in 1996 from the severely compressed levels of 1995. Together, they will rise to more than 59 percent of GDP in 1996 from 51 percent in 1995. Development expenditure will increase more strongly than current expenditure with emphasis being given to grant-financed projects in tourism development, education, and rural infrastructure. Total revenue is budgeted at 58 percent of GDP, virtually the same as in 1995. Domestic revenue will be down; however, increased external grants are expected to make up the fall. Overall, the outturn is expected to be a deficit of just under 4 percent of GDP compared with over 10 percent in 1995. More than half of this will be met from external



financing. The call on domestic financing would thus drop from over 6 percent of GDP in 1995 to 1.5 percent in 1996. To achieve this result will nevertheless require firm resistance to demands for wage increases, or for privatization receipts to be used for current expenditure. Monetary growth is expected to be reasonably restrained in 1996 with a modest expansion in credit to the private sector of about 10 percent. The rate of inflation is expected to be slightly higher than in 1995, at 2 percent.

Western Samoa's external account position is expected to show some improvement in 1996 with the current account surplus increasing to 6 percent of GDP. However, this will be due largely to an increase of about 50 percent in official grants to finance the sharp increase in development spending (and hence in imports) provided for in the 1996 budget. Export earnings will rise only marginally but imports will increase by nearly 16 percent, thereby enlarging the trade deficit. The capital account deficit will be only a third of that in 1995 because PA debt repayments will be much smaller. The overall balance is expected to show an increased surplus of around 5 percent of GDP, enabling reserves to be built up to over seven months of imports.

Policy and Development Issues

The Government's success in dealing with the fiscal difficulties occasioned by PA debt has provided a framework of macroeconomic stability that is essential if progress is to be made with the structural reforms that are needed not only for improved macroeconomic management but also for the achievement of modest but sustained economic growth over the longer term. Fiscal policy needs to remain tight. Planned reductions in corporate taxes and in indirect taxation will need to be accompanied by measures to reduce public expenditure. However, that reduction should be achieved not by economizing on items such as education, health, and public infrastructure, which are important for the growth process, but by divesting those functions that are more appropriate for the private sector and by improving the efficiency of those that are retained. The proposed extension of program budgeting to all departments and the privatization and commercialization of government enterprises so that they no longer require government budgetary support need to be pushed ahead with some speed. In monetary management, the authorities' plans to move away from direct control to a more market-oriented system are to be commended. However, it is important that all financial institutions, including the National Provident Fund which is active in consumer lending, should come within the scope of the Central Bank's monetary control.