ASIAN DEVELOPMENT OUTLOOK 2015

FINANCING ASIA'S FUTURE GROWTH

ASIAN DEVELOPMENT BANK

ADB

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Printed in the Philippines.

ISBN 978-92-9254-895-7 (Print), 978-92-9254-896-4 (PDF)
ISSN 0117-0481
Publication Stock No. FLS157088-3

Cataloging-In-Publication Data

Asian Development Bank.
Asian development outlook 2015. Financing Asia's future growth.
Mandaluyong City, Philippines: Asian Development Bank, 2015.

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

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Contents

Foreword v
Acknowledgments vii
Definitions viii
Abbreviations ix

ADO 2015—Highlights xi

Part 1 Oil in the gears of growth 1

Steady growth and stable prices in developing Asia 4
How lower oil prices affect Asia 18
Is Asia's rising debt a threat to growth? 25
Annex: Low oil price supports recovery 32

Part 2 Financing Asia's future growth 45

The case for financial sector deepening 48
Financial development for growth 58
Financial access for inclusion 71
Financial stability to safeguard inclusive growth 80
Financing Asia's future growth 92
Annex: Financial structure in developing Asia, 2011 102

Part 3 Economic trends and prospects in developing Asia 103

Central Asia 105

Armenia 107
Azerbaijan 111
Georgia 115
Kazakhstan 119
Kyrgyz Republic 124
Tajikistan 128
Turkmenistan 132
Uzbekistan 135

East Asia 140

People's Republic of China 141
Hong Kong, China 149
Republic of Korea 153
Mongolia 158
Taipei,China 162

South Asia 166
Afghanistan 167
Bangladesh 170
Bhutan 177
India 181
Maldives 188
Nepal 192
Pakistan 196
Sri Lanka 202

Southeast Asia 207
Brunei Darussalam 209
Cambodia 212
Indonesia 215
Lao People's Democratic Republic 220
Malaysia 223
Myanmar 227
Philippines 230
Singapore 234
Thailand 238
Viet Nam 243

The Pacific 248
Fiji 249
Papua New Guinea 253
Solomon Islands 258
Timor-Leste 261
Vanuatu 265
North Pacific economies 269
South Pacific economies 273
Small island economies 278

Statistical appendix 281

Foreword

Developing Asia remained the main source of global economic growth in 2014. Domestic policy reform, benign commodity prices, and some strengthening of demand from the advanced economies supported the region's growth. *Asian Development Outlook 2015* forecasts that the 6.3% rate of gross domestic product (GDP) expansion achieved in 2014 will continue into 2015 and 2016. The steady outlook for the region sees growth picking up enough in India and most member economies of the Association of Southeast Asian Nations (ASEAN) to compensate for moderating growth in the People's Republic of China (PRC).

Low oil prices and accommodative monetary policy will support ongoing efforts in the euro area and Japan to achieve steady recovery. Meanwhile, the United States (US) is finally showing signs of more robust, sustainable growth momentum, to the extent that its normalization of monetary policy is now widely expected in mid-2015. Together, the major industrial economies are envisaged expanding by 2.2% in 2015, up from 1.6% growth in 2014, and accelerating further to 2.4% in 2016.

Continued reform implementation in the PRC and India—both of which expanded by 7.4% in 2014—provides the foundation for the region's prospects. The PRC is forecast to achieve the government's growth target of about 7.0% in 2015 and 2016, with reform helping to shift the economy toward a more balanced growth model. India is poised to expand by 7.8% in 2015 and 8.2% in 2016, as reform lifts investor confidence, monetary policy eases, and capital expenditure rises. Moreover, strengthening growth is anticipated in Southeast Asia, and regional economic integration there will gain further traction with the establishment of the ASEAN Economic Community at the end of 2015.

To achieve the steady growth envisaged in this report, policy makers in developing Asia need to be vigilant of potential risks. Risks to Asia's growth prospects could come from an unwieldy resolution of the Greek debt crisis, deepening recession in the Russian Federation, and possible capital outflows in response to the imminent rise in US interest rates. Falling oil prices have largely been a boon for the region's outlook, supporting higher growth and low inflation. However, geopolitical tensions in the Middle East remain a real risk that could produce a sudden reversal of prices. Authorities need to be ready to deploy mitigating policy responses if any of these risks materialize.

Asia has seen rapid credit growth in recent years as total domestic debt nearly doubled from $18 trillion in 2009 to $34 trillion in 2013, with private borrowing accounting for the bulk of new debt. Although debt remains at manageable levels, policy makers must carefully attend to credit growth to ensure the maintenance of sound financial systems that are efficient, well-regulated, and inclusive—and therefore able to help sustain regional growth momentum and stability, as well as foster greater equity.

Developing Asia may be somewhat more financially developed than Latin America, but it lags far behind the advanced economies. As a result, the region must bear relatively costly capital and suffer difficult access to finance, which may inhibit future growth. The positive effect of finance on growth is well documented, but its effect on income inequality is uncertain. In Asia, widening inequality remains a concern—one that financial deepening can either worsen or improve. Financial development can enhance equity if it is accompanied by steps to ensure broad access to finance for households and firms. Further developing the financial sector to broaden access to finance and lower the cost of capital would set a cornerstone for inclusive growth.

But such development requires vigilant monitoring of financial stability. Bank regulation provides the first line of defense against financial shocks, while macroprudential policies have potential to safeguard regional financial stability. For regulators, the challenge is to find the balance that convincingly strengthens the governance of financial institutions to protect stability, while exploring the benefits of flexible regulation able to promote investment, productivity, innovation, and economic growth.

TAKEHIKO NAKAO
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Acknowledgments

Asian Development Outlook 2015 was prepared by staff of the Asian Development Bank (ADB) in the Central and West Asia Department, East Asia Department, Pacific Department, South Asia Department, Southeast Asia Department, and Economic Research and Regional Cooperation Department, as well as in ADB resident missions. Representatives of these departments constituted the Regional Economic Outlook Task Force, which met regularly to coordinate and develop consistent forecasts for the region.

The authors who contributed the sections are bylined in each chapter. The subregional coordinators were Christopher Hnanguie and Dominik Peschel for Central Asia, Yolanda Fernandez Lommen for East Asia, Sarah Carrington for South Asia, Sona Shrestha for Southeast Asia, and Christopher Edmonds and Rommel Rabanal for the Pacific.

A team of economists in the Economic Research and Regional Cooperation Department, led by Joseph E. Zveglich, Jr., director of the Macroeconomics Research Division, coordinated the production of the publication, assisted by Edith Laviña. Technical and research support was provided by Shiela Camingue-Romance, Cindy Castillejos-Petalcorin, Gemma Esther Estrada, Nedelyn Magtibay-Ramos, Pilipinas Quising, Aleli Rosario, Dennis Sorino, Lea Sumulong, Charisse Tubianosa, and Mai Lin Villaruel. Shikha Jha provided technical advice on a country chapter. Additional research support was provided by Zemma Ardaniel, Abigail Golena, Russ Jason Ng Lo, and Roselyn Regalado. The economic editorial advisors Robert Boumphrey, Joshua Greene, Richard Niebuhr, Anthony Patrick, and Reza Vaez-Zadeh made substantive contributions to the country chapters and regional outlook. Margarita Debuque provided editorial advice on the theme chapter.

Peter Fredenburg edited manuscripts for ADB style and English usage. Alvin Tubio handled typesetting and graphics generation, in which he was assisted by Elenita Pura. Art direction for the cover design was by Anthony Victoria, with artwork from Design Muscle. Critical support for the printing and publishing of the report was provided by the Printing Services Unit of the ADB Office of Administrative Services and by the Publishing and Dissemination Unit of the ADB Department of External Relations. Heili Ann Bravo, Fermirelyn Cruz, and Rhia Bautista-Piamonte provided administrative and secretarial support.

The Department of External Relations, led by Satinder Bindra, Omana Nair, and David Kruger, planned and coordinated the dissemination of *Asian Development Outlook 2015*.

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Definitions

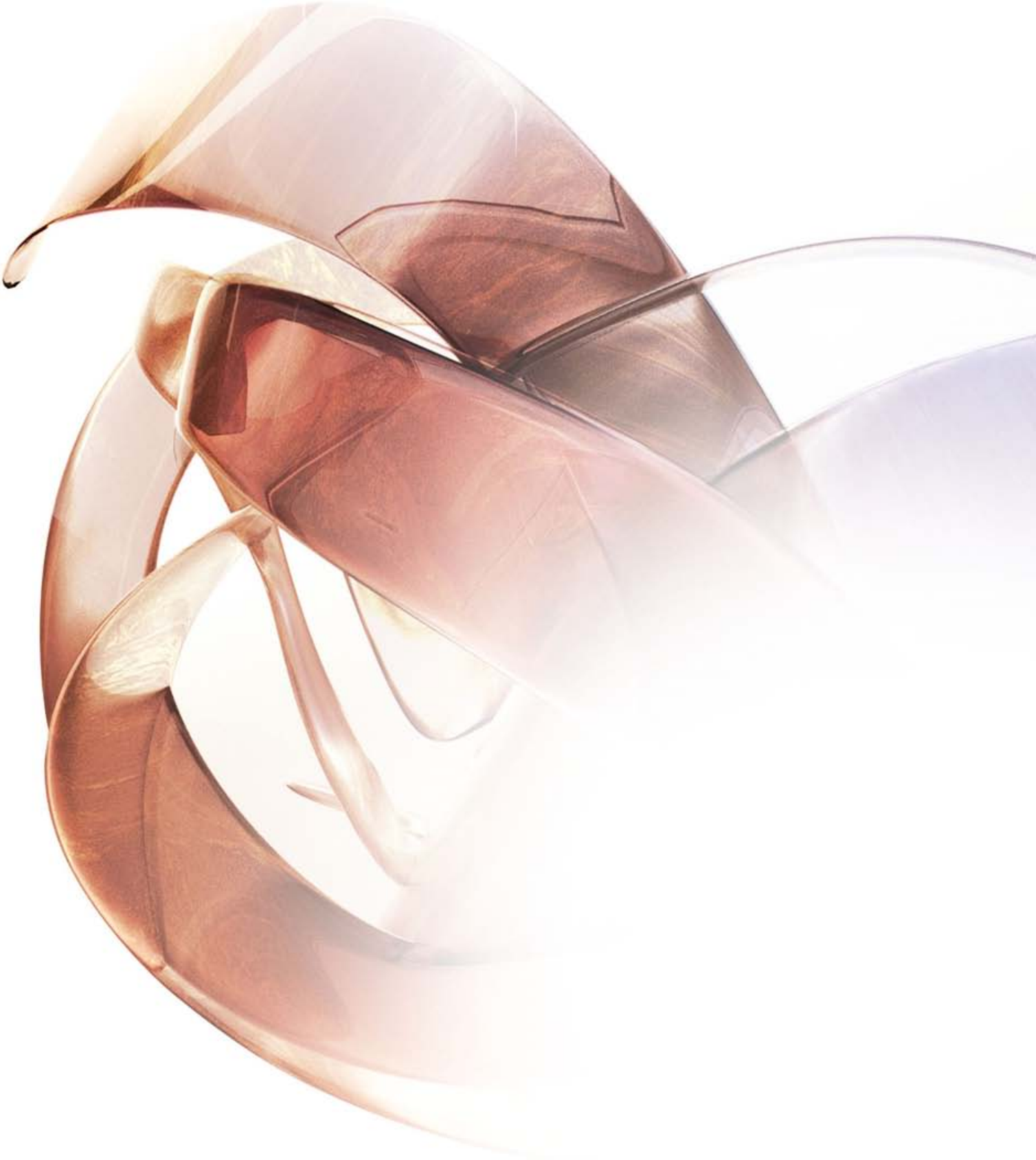
The economies discussed in *Asian Development Outlook 2015* (*ADO 2015*) are classified by major analytic or geographic group. For the purposes of this publication, the following apply:

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

Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars. *ADO 2015* is generally based on data available up to **6 March 2015**.

Abbreviations

ADB	Asian Development Bank
ADO	*Asian Development Outlook*
ASEAN	Association of Southeast Asian Nations
ATM	automated teller machine
CIF	Consolidated Investment Fund (Tuvalu)
CPI	consumer price index
ECB	European Central Bank
EEU	Eurasian Economic Union
EME	emerging market economy
EU	European Union
FDI	foreign direct investment
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
GFC	global financial crisis
GNI	gross national income
ICT	information and communication technology
IMF	International Monetary Fund
Lao PDR	Lao People's Democratic Republic
LNG	liquefied natural gas
M1	money that includes cash and checking accounts
M2	broad money that adds highly liquid accounts to M1
M3	broad money that adds time accounts to M2
MMA	Maldives Monetary Authority
NFRK	National Fund of the Republic of Kazakhstan
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PNG	Papua New Guinea
PPP	public–private partnership
PRC	People's Republic of China
RMI	Republic of the Marshall Islands
saar	seasonally adjusted annualized rate
SCB	state-owned commercial bank
SME Bank	Small and Medium Enterprise Development Bank (Thailand)
SMEs	small and medium-sized enterprises
SOE	state-owned enterprise
SOFAZ	State Oil Fund of the Republic of Azerbaijan
TTF	Tuvalu Trust Fund
TVET	technical and vocational education and training
US	United States of America
VAT	value-added tax



ADO 2015—Highlights

Developing Asia will grow at a steady 6.3% in 2015 and 2016—the same pace as 2014—supported by a strengthening recovery in the major industrial economies and soft global commodity prices.

The drop in international oil prices is taking pressure off of consumer prices. Inflation will slow from 3.1% in 2014 to 2.6% this year. As oil prices gradually rebound, inflation will pick up to 3.0% in 2016.

As low oil prices are supporting growth in developing Asia, a sudden sharp reversal could undermine the outlook and require policy response. Similarly, while capital inflows to the region have been beneficial for growth, policy makers must carefully manage credit expansion to ensure that it does not lead to excessive leverage and asset price bubbles.

Developing Asia needs a deep, robust financial sector to sustain growth. Policy makers will be challenged to ensure that financial sector development is inclusive, providing broad access to households and firms. Financial stability must also be maintained to enhance growth and equity.

Oil in the gears of growth

Steady growth and stable prices in developing Asia

- **Growth in developing Asia maintains a steady pace.** Gross domestic product (GDP) in the region is forecast to expand by 6.3% in 2015 and 2016, as in 2014. Soft commodity prices and recovery in the major industrial economies generally aid the region's growth momentum. The expected pickup in India and in most members of the Association of Southeast Asian Nations (ASEAN) could help balance gradual deceleration in the region's largest economy, the People's Republic of China (PRC).

  - **Growth in the United States leads the major industrial economies.** The US recovery seems to have turned a corner, with strengthening conditions allowing for the normalization of monetary policy from mid-2015. While signs are somewhat mixed in the euro area and Japan, soft oil prices and accommodative monetary policy will support growth there. The major industrial economies are collectively forecast to expand by 2.2% in 2015, up 0.6 percentage points from 2014, and accelerate further to 2.4% the following year.

  - **Targeted support will guide the PRC gradually to its new normal.** Growth decelerated in 2014 as investment in the PRC slowed, particularly in real estate. Weaker investment is expected to further curtail growth to 7.2% in 2015 and 7.0% in 2016. This is a much more moderate rate than the average growth of 8.5% recorded in the period since the global financial crisis but still in line with the government's loose target of about 7.0%.

  - **Structural reform is expected to boost India's prospects.** The initial phase of the government's effort to remove structural bottlenecks is lifting investor confidence. With the support of stronger external demand, India is set to expand by 7.8% in FY2015 (ending 31 March 2016), a sharp uptick from 7.4% growth recorded in FY2014. This momentum is expected to build to 8.2% growth in FY2016, aided by the expected easing of monetary policy in 2015 and a pickup in capital expenditure.

  - **Growth picks up as the ASEAN Economic Community approaches.** The combined GDP of the 10 ASEAN economies is forecast to expand by 4.9% in 2015, lifted from 4.4% in 2014 by recovery in Indonesia and Thailand. Though outcomes vary widely among the economies in the subregion because of their diverse circumstances, collectively the group is expected to enjoy further growth acceleration to 5.3% in 2016, the inaugural year of the ASEAN Economic Community.

- **Developing Asia has been the main source of global growth since the crisis.** From the trough of the global financial crisis in 2009, the region contributed 2.3 percentage points to global GDP growth—nearly 60% of the world's annual 4.0% pace. Eight economies in the region posted growth exceeding 7.0% in nearly every year of the post-crisis period, including the PRC, the Lao People's Democratic Republic, and Sri Lanka. However, the oil and mineral exporters among those with consistently rapid growth may see their fortunes turn in the coming years as commodity prices stumble.

- **Falling international commodity prices have contained inflation.** Regional inflation is forecast to slow from 3.1% in 2014 to 2.6% in 2015 before bouncing back to 3.0% in 2016. Global commodity prices are expected to stay moderate in the forecast horizon, removing price pressure on consumer items. Tamed inflation provides space for monetary policy to shore up weak domestic demand if necessary. Central Asia is an exception, as depreciating currencies are expected to exacerbate inflation in the next 2 years.

- **Lower import bills will temporarily widen the current account surplus.** The drop in commodity prices, for oil in particular, will enlarge developing Asia's current account surplus by 0.2 percentage points to 2.5% of GDP in 2015. However, as food price declines flatten out and the price of crude picks up, the current account balance will revert to 2.3% of GDP in 2016. While the trend reflects the region's position as a net oil importer, oil exporters like those in Central Asia will see their surpluses whittled away, with Kazakhstan even falling into current account deficit.

- **Reversals in an otherwise supportive environment could dampen growth.** If the PRC falters as it adjusts to its new normal, or if India reforms less decisively than anticipated, their slower growth could spill over to others in developing Asia. Outside the region, the Greek debt crisis and deepening recession in the Russian Federation may have global consequences. The impending rise in US interest rates may reverse capital flows to the region, requiring monetary responses to maintain stability. Finally, the benefits flowing from the low price of crude oil could evaporate if geopolitical tensions push it sharply higher.

How lower oil prices affect Asia

- **Low oil prices have been a boon for the global recovery and growth in Asia.** An environment of low oil prices fuels higher economic growth globally, particularly in the major industrial economies. It slows inflation and hence enhances the scope for lower interest rates that can continue stimulating economic activity. Policy makers should take advantage of this moment to pursue structural reform. For oil importers, falling oil prices present an opportunity for governments to eliminate costly fuel subsidies or even raise fuel taxes with minimal disruption to household and business budgets. Oil exporters may similarly find that the time is ripe to pursue subsidy and tax reform to ease the strain on their public finances, as well as take steps to diversify their economies.

- **A spike in oil prices could unsettle Asia's stable growth prospects.** Simulations using a global macroeconomic model show that the impact of a sharp rebound in oil prices would be stronger in Asia than elsewhere. Were the oil price to return to $100 per barrel in a year, growth in Asia could slow by as much as 1 percentage point in 2016. Differences between advanced economies' interest rates—which remain low in the baseline—and those in developing Asia play a part in the region's steeper slowdown. This suggests that monetary easing in the region could soften the blow to output.

- **How oil prices affect inflation differs widely across the region.** The immediate impact of an oil price change on consumer price inflation is small in all economies across the region. It is largest in Thailand, where a 10% drop in the crude oil price slows inflation by less than 0.2 percentage points after 1 month. The impact is even lower in economies where prices at the pump are not determined by the market. While consumer prices in all economies adjust somewhat, eventually, if a change in the international price persists, the overall effect on inflation is lower in major oil-producing economies.

Is Asia's rising debt a threat to growth?

- **Asia has experienced rapid credit growth since the global financial crisis.** From 2009 to 2013, proliferating bank loans and bonds in the 14 large economies of developing Asia almost doubled total domestic debt from $18.3 trillion to $34.1 trillion. While the banking sector remains the largest part of the financial system, bonds have been gaining ground as sources of finance. A large portion of the growth in debt comes from rapid credit expansion in the PRC, which accounted for two-thirds of total debt in 2013. Most of the new debt is in the private sector, where indebtedness more than doubled from 2009 to 2013, while government debt increased by just 58%.

- **Credit expansion supports growth, but excessive debt exposes economies to financial crises.** Debt naturally grows as economies expand their financial systems, which is a positive development for growth. However, when credit expands too quickly, lending standards can give way, potentially allowing excessive leverage and asset price bubbles. While some economies have experienced rapid credit growth recently, their debt remains manageable so far.

- **Policy makers need to carefully manage credit growth.** The surge in capital inflows has helped to ease regional liquidity. Monetary policies in the region have been relatively expansionary in response to weaker global economic conditions and low inflation. These conditions have helped fuel rises in asset prices. Macroprudential policy can be applied to directly tackle excessive credit to certain sectors. For example, policy makers have slowed credit to the property sector by requiring higher down payment percentages for mortgages.

- **Macroprudential policy can mitigate risks to financial stability from credit growth.** More broadly, as explored in the theme chapter, a sound, efficient, and well-regulated financial system can help sustain the region's growth momentum without jeopardizing stability. Further, an inclusive financial system that broadens access to finance is a cornerstone of more inclusive growth.

Outlook by subregion

- **Steady growth in developing Asia masks divergent paths in its subregions.** As the PRC and India both pursue reform to square their economies for long-term growth, the upshot in the short run is very different for the two giants. The external environment supports growth in most subregions. The exception is Central Asia, a major oil and gas exporter, hit by soft commodity prices and recession in its common partner for trade and remittances. The prospects for individual economies across heterogeneous developing Asia differ as political tensions and reconciliation ebb and flow, and as natural disasters follow their whims.

- **East Asia pauses as the PRC adjusts to its new normal of moderate growth.** Economic growth in East Asia will slow from 6.6% in 2014 to 6.5% this year and 6.3% in 2016. The subregional average reflects growth moderation in the PRC to 7.2% and then 7.0% as the authorities implement reform and rein in credit growth to build a sounder foundation for future growth. Mongolia will see growth decelerate sharply in 2015 as foreign direct investment dries up and fiscal and monetary policies are tightened to resist pressure on the balance of payments, but growth should rebound somewhat in 2016 as restrictive policies are eased. Growth will be stable in Taipei,China but accelerate in the rest of the subregion, reflecting rising domestic demand and an improving global economy. Inflation will stay subdued in East Asia except in Mongolia, where it will remain high despite some relief. It is forecast to slow from 1.9% in 2014 to 1.7% this year and bounce back to 2.2% in 2016.

- **South Asia advances steadily as economic policy reform bears fruit.** Growth in the subregion accelerated to 6.9% in 2014 and is projected to trend higher to 7.2% in 2015 and 7.6% in 2016. These figures reflect the heavy weighting of India, where a recently released GDP series suggests growth edging up to 7.8% this year and 8.2% in 2016 as reform to overcome long-standing structural inefficiencies begins to lift investment from its deep slump. Both Bangladesh and Pakistan are following through with wide-ranging economic reforms that include efforts to overcome power shortages, though the headwinds of street politics may limit progress in 2015. Postwar economic recovery in Sri Lanka is expected to moderate in 2015 as investors await clarity on the new administration's plans for governance reform and economic policy. Inflation in South Asia fell sharply to 7.1% last year, reflecting strong monetary action in India and the large drop in prices for oil and other commodities. The subregion will continue to benefit from soft commodity prices, with inflation projected to average 5.1% in 2015 and 5.6% in 2016.

- **Southeast Asia is poised for a growth rebound in 2015.** The member economies of ASEAN experienced a second year of decelerating growth as 7 of the 10 recorded slowdowns that edged the subregional average down to 4.4% in 2014. Indonesia and Thailand, the two biggest members of ASEAN, were both among those decelerating for a second consecutive year, Indonesia weighed down by stabilization policy and sluggish exports and Thailand by political disruptions. By contrast, Brunei Darussalam, Malaysia, and Viet Nam lifted their performances last year. Aggregate growth is seen rebounding to 4.9% in 2015 and 5.3% in 2016 as recovery in Indonesia and Thailand leads the way, and with most of the subregion expected to trend up and benefit from rising exports and lower inflation. However, Malaysia will see growth this year more subdued than last. Southeast Asia's inflation rate in 2014 was, at 4.1%, little changed from the previous year. Inflation is forecast to subside to 3.1% in the next 2 years in line with lower global oil and commodity prices.

- **Central Asia is stymied by weak oil prices and recession next door.** The factors that slowed average growth by 1.5 percentage points to 5.1% in 2014 are poised to affect 2015 GDP as well. Growth will slacken in Kazakhstan, Turkmenistan, and Uzbekistan as lower petroleum exports constrain domestic spending. The weak economy in the Russian Federation will curb export and remittance flows, slowing growth in Armenia, Georgia, the Kyrgyz Republic, and Tajikistan. Average growth in the subregion is expected to fall further to 3.5% in 2015 as a result. Expected recovery in the Russian Federation should restore average growth in the subregion to 4.5% in 2016. Inflation in Central Asia, which declined slightly to 5.7% in 2014 from 5.8% in 2013, is projected to jump to 6.7% in 2015 as local currencies sag along with the weakening ruble, worsening the consequences for prices in every economy except Kazakhstan. Inflation is projected to ease slightly to 6.6% in 2016.

- **The Pacific picks up the pace as natural gas flows from Papua New Guinea.** Reaching 6.3%, average GDP growth accelerated in 2014 for the first time in 3 years as natural gas exports began in Papua New Guinea (PNG), the subregion's largest economy, and expansion picked up in most other economies. The notable exception was Solomon Islands, which suffered severe flooding. In 2015, the first full year of gas production in PNG, growth in the Pacific is expected to peak at 9.9%. Lower commodity prices will support further expansion in most economies. However, output in Vanuatu will likely contract in the wake of a cyclone in March 2015, and a drop in public spending will weigh on prospects in Timor-Leste. Subregional growth is expected to decline to 4.8% in 2016, with only a few economies growing faster than in the previous year. Despite high inflation in PNG, driven by government spending and currency depreciation, subregional inflation dropped to 3.6% in 2014 reflecting falling energy and commodity prices. Inflation is expected to rebound to 5.0% in 2015 before slowing to 4.1% in 2016.

Financing Asia's future growth

The case for further developing the financial sector

- **Developing Asia needs a deep, robust financial sector to sustain growth.** After policy makers saw questionable financial practices and products in the advanced economies snowball into the global financial crisis of 2008–2009, many became cautious of expanding the sector, even in underleveraged emerging economies. Yet developing Asia's bank deposits equal only 60% of regional GDP, compared with the average of 110% among members of the Organisation for Economic Co-operation and Development, and its bond markets equal less than half of GDP, a third of the 140% found in the advanced economies. Developing Asia may be somewhat more financially developed than Latin America, but it still endures relatively costly capital and difficult access to finance. This may inhibit future growth.

- **Empirical evidence points to growth benefits from closing the finance gap.** For example, boosting developing Asia's average ratio to GDP of liquid liabilities—currency plus checking and interest-bearing accounts in financial institutions—from about 65% to 75% adds almost 0.4 percentage points to average annual GDP growth per capita. The evidence indicates that growth can come from developing either banks or capital markets.

- **Yet one cannot assume that all such growth will be inclusive.** Worsening inequality has emerged as a concern for regional policy makers. Financial deepening can either widen the income gap, if its benefits accrue largely to the wealthy by enhancing returns to capital or the earnings of senior finance professionals, or it can narrow the gap if the poor gain greater access to financial services or jobs. Empirical evidence reflects this dichotomy. While financial development tends to alleviate inequality in its early stages, inclusion does not come automatically as financial development deepens.

- **Financial stability must be maintained to enhance growth and equity.** However beneficial financial development, innovation, and liberalization generally are, they sometimes destabilize financial systems. Financial instability can seriously undermine economic growth, especially when financial crises result. As the Asian financial crisis peaked in 1998, for example, Indonesia suffered GDP contraction by 13%, Thailand by 11%, Malaysia by 7%, and the Republic of Korea by 6%. Further, the inclusiveness of growth depends on financial stability because the poor are disproportionately defenseless against financial crises. After the global financial crisis, the unemployment rate doubled in many European Union economies—and tripled in the hardest hit.

- **Financial sector reform priorities differ in developing and advanced economies.** In financially well-developed advanced countries, the key challenge is to safeguard financial stability to prevent disruptions such as the global financial crisis. Financially backward developing countries, on the other hand, must strive to leverage financial development for growth while maintaining financial stability.

Financial development for growth

- **High quantity and efficient finance boosts investment, productivity, and growth.** Underdeveloped financial sectors in the region, especially in lower-income economies, channel too little credit to firms. Inefficient sectors typically have high interest rate spreads that raise the cost of finance. In some cases, the over-allocation of credit to state-owned firms at the expense of the more dynamic private sector erodes the link between finance and growth.

- **In developing Asia, banks underlie sound and efficient financial systems.** Banks continue to dominate the financial landscape across the region despite the rapid growth of capital markets in middle-income countries. On average, a 10 percentage point increase in developing Asia's average ratio of private credit to GDP is associated with higher growth in GDP per capita by about 0.3 percentage points per year. Therefore, a well-tuned banking subsector that efficiently channels resources to investment and other productive activities is indispensable for sustaining growth.

- **Capital built by long-term finance is vital for productivity growth and innovation.** Despite Asia's large pool of savings, it offers only limited instruments for the long-term finance that is indispensable for building capital, both tangible and intangible. Top priorities to address barriers to long-term finance are to build deeper and more liquid capital markets, resist short-term biases when allocating the assets of investors willing to invest for the long term, and foster a long-term investor base that is broader and more diverse.

- **Bond market development in particular deepens the pool of long-term financing.** Asia leads other developing regions in bond market development, but with big differences across countries. While markets in the Republic of Korea, Malaysia, and some other countries are relatively well-developed—and others are expanding rapidly, notably in the PRC, India, and Thailand—markets remain largely underdeveloped in many other regional economies. Markets for corporate bonds are less developed than those for sovereigns. Local currency bond markets are developing rapidly, and this trend will reduce vulnerability to exchange rate shocks. Despite good progress, the current state of bond market development in Asia leaves substantial room for further growth.

- **The approach to developing the financial sector must fit each country's circumstances.** The region's low-income economies have financial systems based heavily on banks. They can benefit from banking system reform that mobilizes domestic savings, lowers the cost of credit, improves access, and promotes the allocation of credit to the most productive sectors. The successful reform of state-owned banks in the PRC is a case in point. Middle-income economies can reap productivity gains by deepening their financial markets. Policies that further develop their equity and bond markets can lower the cost of long-term capital to facilitate investment and innovation.

Financial access for inclusion

- **Growth from financial development is inclusive only if the poor have access.** Despite having a deeper financial sector than other developing regions, Asia lags its peers in meeting the financing needs of households and firms.

  - » **Personal bank accounts are rare in parts of Asia.** While nearly all adults in the Republic of Korea and Singapore have an individual or joint account at a formal institution, fewer than 5% do in Cambodia, the Kyrgyz Republic, Tajikistan, or Turkmenistan. Across developing Asia, fewer than 27% of adults have a bank account. This is well below the global median of 38%.

  - » **Asian firms lack bank services, especially credit.** Only 84% of firms in developing Asia have a checking or savings account, which is comparable to Africa but trails Latin America's 89% and emerging Europe's 92%. Only 33% of firms in developing Asia have a line of credit or loan from a financial institution—far fewer than Latin America's 54% and emerging Europe's 41%.

- **A range of barriers impede Asian household and corporate access to finance.** More than simply a lack of money holds Asian households back from opening bank accounts. Household surveys find that account fees, difficult geographic access, and stiff documentation requirements get in the way. For Asian firms, the major deterrents to borrowing are unfavorable interest rates, complex application procedures, and high collateral requirements.

- **Innovations and policies to improve financial inclusion in Asia must address cost and risk.** The fixed costs of extending traditional financial services, such as establishing a branch in a rural area, often make it prohibitively expensive to reach the poor. More cost-effective delivery channels, such as mobile phones and banking agents, can reduce costs by as much as 19%. Further, serving clients with no steady income flow, formal property title, or even personal identification entails high risk. However, biometric identification initiatives such as India's Aadhaar program, for example, can address the lack of proper identification and facilitate access for the poor to financial services.

Financial stability to safeguard inclusive growth

- **External and domestic risks demand vigilant monitoring of financial stability.** Asia's financial systems have become much healthier since reform following the Asian financial crisis of 1997–1998. Even so, external shocks have the power to unsettle local markets, as they did in May 2013, when news of a possible change in US monetary policy decimated Asian stock prices and currency values in the so-called taper tantrum. Lurking in the background, meanwhile, are such homegrown risks as large shadow banking systems in some economies and unrestrained household debt expansion in others.

- **Bank regulation is the first line of defense against financial shocks in Asia.** International experience during the global financial crisis provides valuable lessons for Asian bank regulators. Above all, the crisis underlined that sound and effective bank regulation is vitally important to financial stability. The crisis reflected the failure of the regulatory authorities to keep pace with financial innovation. The sobering lesson for Asia is that even financially advanced economies are susceptible to risks from lax regulation and reckless lending.

- **Macroprudential policies have potential for shoring up regional financial stability.** Macroprudential policies seek to mitigate risks that could undermine the entire financial system by imposing, for example, capital requirements and limits on foreign currency borrowing that apply to all banks. They are designed to complement microprudential regulation, which monitors risks specific to individual institutions. Evidence indicates that macroprudential policies can indeed manage and mitigate macroeconomic risk in Asian economies.

- **Foreign direct investment and diverse foreign funding can cushion external financial shocks.** The literature offers ample evidence that a higher share of foreign direct investment in foreign liabilities stabilizes financial markets. Empirical analysis across economies further shows that those with more diversified foreign funding when the taper tantrum struck suffered less exchange rate depreciation. When borrowing foreign currency, it is prudent to minimize currency mismatch.

Toward finance that fosters stable and inclusive growth

- **Financial sector development can foster inclusive growth in Asia.** Finance has a generally positive effect on growth. The benefits of growth will be even larger if finance promotes a more market-based allocation of resources. Experience in the PRC shows, for example, that the entry of private foreign banks can enhance the efficiency of state-owned banks. But the impact of finance on equity is uncertain. To safeguard inclusive growth, further sector development must be accompanied by steps to ensure broad access to finance for households and firms.

- **Regulators will be challenged, however, to find the right balance.** The region's financial institutions are well placed to meet the more stringent regulatory standards being adopted globally, as many already surpass requirements under Basel III. Yet regulators must act to strengthen financial institution governance and clamp down on inefficient and inequitable practices like crony lending and insider trading. They must appreciate how strong regulation protects stability by preventing the accumulation of systemic risks, but weigh it against the potential benefits of flexible regulation that promotes investment, productivity, innovation, and economic growth.

Growth rate of GDP (% per year)

Subregion/Economy	2012	2013	2014	2015	2016
Central Asia	**5.6**	**6.6**	**5.1**	**3.5**	**4.5**
Azerbaijan	2.2	5.8	2.8	3.0	2.8
Kazakhstan	5.0	6.0	4.3	1.9	3.8
East Asia	**6.6**	**6.8**	**6.6**	**6.5**	**6.3**
China, People's Rep. of	7.7	7.7	7.4	7.2	7.0
Hong Kong, China	1.7	2.9	2.3	2.8	2.9
Korea, Rep. of	2.3	3.0	3.3	3.5	3.7
Taipei,China	2.1	2.2	3.7	3.7	3.6
South Asia	**5.1**	**6.5**	**6.9**	**7.2**	**7.6**
Bangladesh	6.5	6.0	6.1	6.1	6.4
India	5.1	6.9	7.4	7.8	8.2
Pakistan	3.8	3.7	4.1	4.2	4.5
Sri Lanka	6.3	7.2	7.4	7.0	7.3
Southeast Asia	**5.8**	**5.1**	**4.4**	**4.9**	**5.3**
Indonesia	6.0	5.6	5.0	5.5	6.0
Malaysia	5.6	4.7	6.0	4.7	5.0
Philippines	6.8	7.2	6.1	6.4	6.3
Singapore	3.4	4.4	2.9	3.0	3.4
Thailand	6.5	2.9	0.7	3.6	4.1
Viet Nam	5.2	5.4	6.0	6.1	6.2
The Pacific	**6.0**	**4.4**	**6.3**	**9.9**	**4.8**
Fiji	1.8	4.6	4.2	4.0	4.0
Papua New Guinea	7.7	5.1	8.0	15.0	5.0
Developing Asia	**6.2**	**6.5**	**6.3**	**6.3**	**6.3**
Major industrial economies	**1.2**	**1.2**	**1.6**	**2.2**	**2.4**

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

(*continued on the next page*)

Inflation (% per year)

Subregion/Economy	2012	2013	2014	2015	2016
Central Asia	**5.1**	**5.8**	**5.7**	**6.7**	**6.6**
Azerbaijan	1.1	2.4	1.4	6.0	5.5
Kazakhstan	5.1	5.8	6.7	6.0	6.2
East Asia	**2.6**	**2.4**	**1.9**	**1.7**	**2.2**
China, People's Rep. of	2.6	2.6	2.0	1.8	2.3
Hong Kong, China	4.1	4.3	4.4	3.3	3.4
Korea, Rep. of	2.2	1.3	1.3	1.3	2.1
Taipei,China	1.9	0.8	1.2	0.5	1.0
South Asia	**10.1**	**9.0**	**7.1**	**5.1**	**5.6**
Bangladesh	8.7	6.8	7.4	6.5	6.2
India	10.2	9.5	7.0	5.0	5.5
Pakistan	11.0	7.4	8.6	5.8	5.8
Sri Lanka	7.9	6.9	3.3	2.0	5.0
Southeast Asia	**3.8**	**4.2**	**4.1**	**3.1**	**3.1**
Indonesia	4.0	6.4	6.4	5.5	4.0
Malaysia	1.7	2.1	3.1	3.2	2.9
Philippines	3.2	3.0	4.1	2.8	3.3
Singapore	4.6	2.4	1.0	0.2	1.5
Thailand	3.0	2.2	1.9	0.2	2.0
Viet Nam	9.1	6.6	4.1	2.5	4.0
The Pacific	**4.3**	**5.0**	**3.6**	**5.0**	**4.1**
Fiji	3.4	2.9	0.5	2.5	2.5
Papua New Guinea	2.2	4.0	8.3	7.0	5.0
Developing Asia	**4.1**	**3.8**	**3.1**	**2.6**	**3.0**
Major industrial economies	**2.0**	**1.3**	**1.5**	**0.7**	**1.9**

(continued from the previous page)

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

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

1

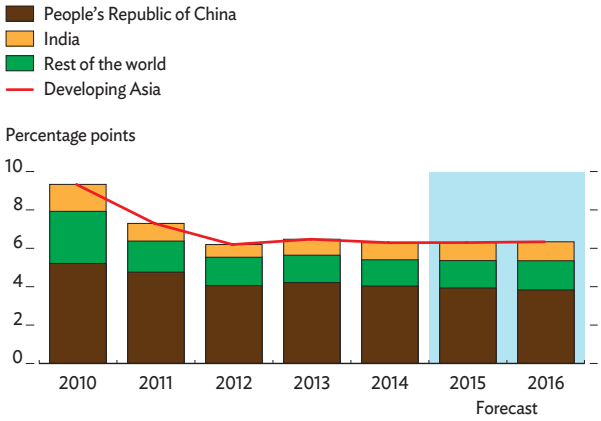
OIL IN THE GEARS OF GROWTH

Oil in the gears of growth

Developing Asia will drive world growth in 2015 and 2016, as it has done for the past several years. Since the global financial crisis, the world's average annual growth rate has been 4.0%, with developing Asia contributing 2.3 percentage points, or nearly 60%. Resilient growth in the region has been underpinned by conscientious reform in many countries. The outlook for developing Asia is for steady growth to continue in the next 2 years. Tempered international commodity prices and the strengthening of major industrial economies, not only in the United States (US), but also in Japan and the euro area, should support the region's growth momentum in the coming quarters.

For developing Asia as a whole, growth is projected at 6.3% in 2015 and 2016, as in 2014. An expected pickup in India will partly balance gradual deceleration in the People's Republic of China (PRC), the region's largest economy (Figure 1.0.1). Reversals in an otherwise supportive environment could dampen prospects. Growth in the PRC or India that disappointed expectations would be a concern for the whole region because of the two giants' economic weight—all the more so if the slowdown stemmed from failure to carry out current programs of reform. Other problems could arise if geopolitical tensions intensified or the US tightened monetary policy faster than is now anticipated. Further economic deterioration in the Russian Federation would weaken economies in Central Asia.

1.0.1 Contributions to growth in developing Asia



Source: Asian Development Outlook database.

Click here for figure data

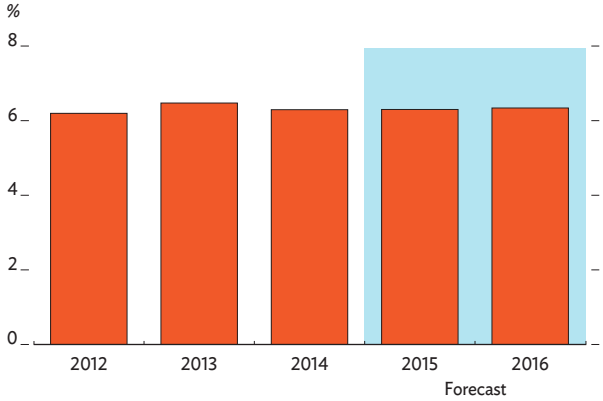
Policy makers in the region have the tools they need to respond if any of these shocks materialize. Governments in developing Asia should nevertheless continue to pursue structural reform toward strengthening resilience to shocks. The drop in oil prices provides an opportunity for many governments to take action now by, for example, reining in or eliminating counterproductive energy subsidies. But the window of opportunity is expected to be fairly short, as a gradual rise in oil prices is expected in 2015 and 2016. Similarly, moderating growth in the PRC highlights the need for closely linked economies to diversify. Besides diversifying industrial bases and export markets, the crucial steps toward a steady growth path continue to include adopting more prudent fiscal frameworks and developing sounder and more efficient financial systems.

This chapter was written by Akiko Terada-Hagiwara, Arief Ramayandi, Madhavi Pundit, Thiam Hee Ng, Shiela Camingue-Romance, Nedelyn Magtibay-Ramos, and Pilipinas Quising of the Economic Research and Regional Cooperation Department, ADB, Manila.
Background materials from Ruben Carlo Asuncion are gratefully acknowledged.

Steady growth and stable prices in developing Asia

Steady growth is forecast for developing Asia. After expanding by 6.5% in 2013, aggregate growth in the region slowed to 6.3% in 2014 (Figure 1.1.1). In 2015 and 2016, growth in the region is expected to continue at this pace as opposing developments in some of the region's larger economies balance out at the regional scale. That said, expected moderation in the PRC offsets some of the positive momentum in many economies in developing Asia that are supported by lower commodity prices and recovery in global economic activity (Box 1.1.1). Average inflation in the region slowed to 3.1% in 2014 and is expected to slow further to 2.6% in 2015, because of lower oil prices, before rising to 3.0% in 2016 (Figure 1.1.2). The region's aggregate current account surplus is forecast to continue expanding to 2.5% of GDP in 2015 from 2.4% in 2014 as lower oil prices reduce import bills. This trend is expected to reverse, however, in 2016 with the expected upturn in global commodity prices (Figure 1.1.3).

1.1.1 GDP growth in developing Asia



Source: Asian Development Outlook database.
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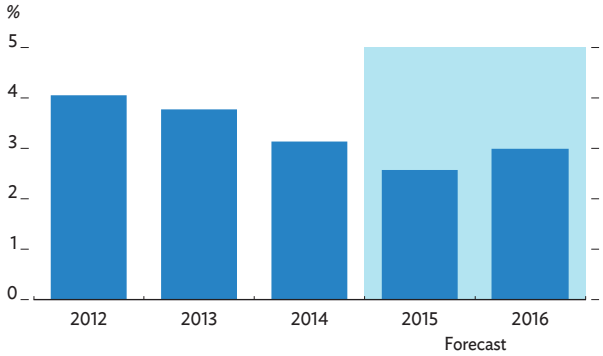
Factors underlying growth

Developing Asia lost some growth momentum in 2014 but nevertheless remained the main source of global economic growth. Various reforms introduced last year to resolve infrastructure deficits, remove structural bottlenecks, and rebalance national economies played a great role in the region's expansion, though to varying degrees in different economies. In India, reform to ease regulation and encourage investment has proven to be a successful first step toward resolving the economy's persistent infrastructure problems, boosting growth in the process. Meanwhile in the PRC, targeted reform to guide the economy to a so-called new normal of slower, sounder growth has calmed jitters in the real estate market. This eased growth in investments in the PRC and, with them, GDP growth, as financing conditions for developers and home buyers tightened and home prices declined.

In other economies, the success of reform has been mixed, sometimes stymied by market rigidity, implementation delay, or structural challenges. Fuel subsidy reform in Indonesia, following the inauguration of a new government in October 2014, helped boost government finances last year and freed up significant resources for social and physical infrastructure. Although new reforms to ease regulation and encourage private investment in Indonesia have yet to gain momentum, improvement already achieved in the business

1.1.2 Inflation in developing Asia



Source: Asian Development Outlook database.
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1.1.1 Industrial economies gradually recovering

Lower prices for oil and other commodities continue to underpin the growth prospects of the major industrial economies. The combined economies of the US, the euro area, and Japan are expected to gain momentum during the forecast period. Collectively, the weighted growth rate of these economies is expected to accelerate from 1.6% in 2014 to 2.2% in 2015 and 2.4% in 2016 (box table). Inflation is projected to be muted, as international commodity prices remain soft and the industrial economies continue to operate below their potential.

GDP growth in major industrial economies (%)

	2013	2014	2015	2016
Area	Actual		*ADO projection*	
Major industrial economies	1.2	1.6	2.2	2.4
United States	2.2	2.4	3.2	3.0
Euro area	–0.4	0.9	1.1	1.4
Japan	1.6	0.0	1.1	1.7

ADO = Asian Development Outlook.

Notes: Average growth rates are weighted by gross national income, Atlas method. More details in Annex table A1.1 on page 32.

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

US economic activity accelerated during the second half of 2014, bringing expansion to 2.4% for the year as a whole. Solid growth in private consumption contributed 1.7 percentage points to growth, while higher investment beginning in the second quarter further strengthened the year's growth momentum. Net exports subtracted from growth, however, as imports grew faster than exports. The labor market improved as the average duration of unemployment gradually declined throughout the year and the unemployment rate improved from 6.6% in January 2014 to 5.7% in December, and further to 5.5% in February 2015. Inflation remained subdued, with minimal risk of taking off.

As the economic recovery picks up speed, the Federal Reserve is expected to move gradually to normalize its monetary policy, but only in the second half of this year. Liquidity is expected to remain loose in 2015 and will continue to encourage commercial banks to lend. Positive indications from investment, employment, credit, housing, and consumption indicate that the US economy is on track for continued gradual strengthening. GDP growth in the US is forecast to accelerate to 3.2% in 2015 and ease back to 3.0% in 2016.

In the fourth quarter of 2014, euro area GDP recorded its largest expansion since the first quarter of 2011, growing at a seasonally adjusted annualized rate of 1.4% over the previous quarter. This raised annual growth to 0.9%, reversing the 0.4% contraction in 2013. Although growth rates varied across economies, expansion in the fourth quarter was broadly based. Recovery in investment added to the steady rise in private and government consumption. Net exports improved on lower import bills.

The outlook for the euro area is generally positive, with GDP growth forecast at 1.1% in 2015 and 1.4% in 2016. Recent indicators are somewhat mixed. Although industrial production was still soft in the last quarter of 2014, the purchasing managers' index is rising. Consumption appears to be strengthening, and consumers are more optimistic about the region's prospects. However, the outlook has some downside risks. Strong deflationary pressures could slow growth and hinder some countries' efforts to consolidate debt. Fallout from a possible Greek debt default is a risk, as is a possible Greek exit from the euro area (dubbed Grexit). Nevertheless, low global oil prices may boost investment and consumption, and expansionary monetary policy should support growth.

Japan's GDP contracted sharply following the April 2014 hike in its value-added tax (VAT). Disappointing recovery in the fourth quarter spelled zero growth in 2014 as a whole. Seeing the output gap widen from 0.4% of GDP at the start of the year to 2.8% by year-end prompted the government to postpone the planned second VAT hike to April 2017, to avert another drop in consumption and a return to deflation. Private consumption rebounded from the sharp drop in the second quarter but was unable to offset the decline in residential investment. Business conditions are generally seen as improving, but the recovery has not yet been fully transmitted to business investment and wage increases.

The growth outlook for Japan appears generally positive, but uncertainties remain over the forecast period. Postponing the second VAT increase, from 8% to 10%, will support growth momentum in the short run but at the cost of temporarily halting fiscal consolidation. As prudence is expected to guide fiscal expenditure, growth will have to rely on private sector demand. Domestic consumption and investment are assumed to recover gradually in 2015, while external demand, particularly from the euro area, will strengthen during the second half of 2015. Housing investment and private consumption of durable goods are assumed to pick up somewhat in 2016 in anticipation of the second-round rise in the VAT on 1 April 2017. GDP growth in Japan is projected at 1.1% in 2015 and in 1.7% in 2016.

climate is providing impetus for growth in the next 2 years. Meanwhile, 10 member economies of the Association of Southeast Asian Nations (ASEAN) are pushing various reforms toward forming the ASEAN Economic Community to improve the business environment. They include significant tariff liberalization, simplification of customs procedures, and allowing skilled professionals to move across the subregion to maximize the value of their labor.

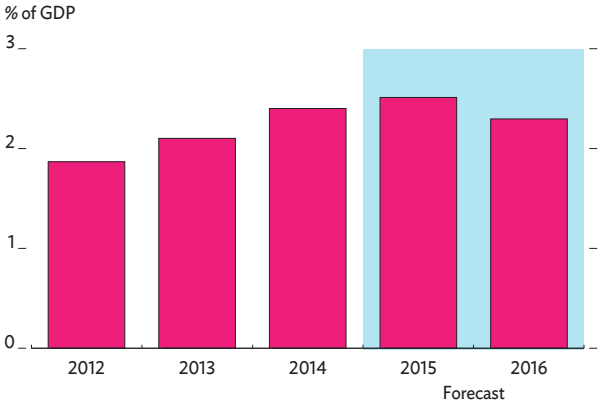
Slight deceleration in developing Asia last year largely reflected slower growth in the PRC and the larger economies of Southeast and Central Asia. The PRC expanded by 7.4%, down from 7.7% in 2013, as the pace of investment was tempered by tighter financing conditions for developers and homebuyers, declining house prices, and housing oversupply in some small and medium-sized cities, which halved growth in real estate investment in 2014. Declining exports from Indonesia and the slump in investment in the Philippines, Singapore, and Thailand tamped down average growth in Southeast Asia from 5.1% in 2013 to 4.4% in 2014. Oil-rich Kazakhstan also faltered in 2014, hit by the economic slowdown in the Russian Federation, the country's major export market, and by cuts in the production of oil and metals. This accounted for much of Central Asia's growth slowdown to 5.1% from 6.6% in 2013.

However, moderation in the PRC was offset by faster growth elsewhere, notably India, as lower oil prices and higher investment in manufacturing boosted domestic demand. More than half of the economies in the region saw faster expansion in 2014, a third of them accelerating for at least a second year in a row. Growth in the Republic of Korea, Malaysia, Pakistan, and Taipei,China benefitted from higher private consumption, and in Malaysia and Taipei,China from stronger exports. All South Asian economies except Afghanistan grew faster in 2014 than 2013. This reflected higher consumption, stronger income, continued remittance inflows, and steady recovery in the region's dominant economy, India, which boosted trade in the subregion.

Looking at the 10 economies in developing Asia for which a demand-side GDP breakdown is available, domestic demand generated by private and government consumption remained the major source of expansion, contributing more than half of overall growth in most of these economies (Figure 1.1.4). External demand recovered in most economies, boosting exports and compensating for slack in domestic demand in some economies. Oil exporters, particularly those in Central Asia, lost heavily from the drop in oil prices and the slowdown in the Russian Federation.

Industrial production indices confirm that growth has been generally stable. In five of the Southeast Asian economies examined, industrial production picked up slowly toward the end of 2014, while it weakened somewhat in the Philippines and Singapore as the production of electronic and electrical machinery declined.

1.1.3 Current account balance in developing Asia



Source: Asian Development Outlook database.

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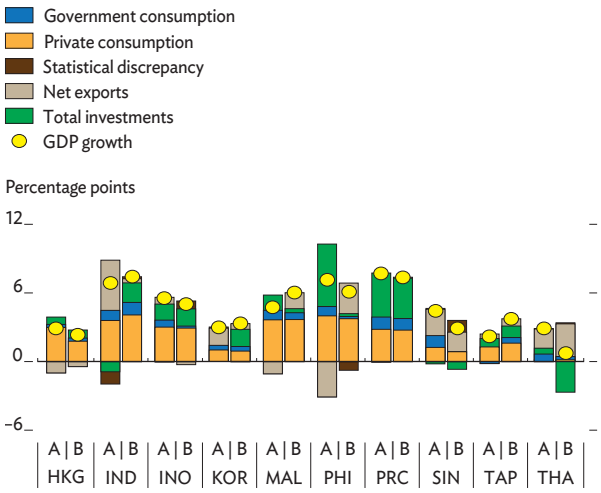
1.1.4 Demand-side contributions to growth, selected economies



A = 2013, B = 2014.

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

Note: The GDP growth data used for India are GDP at constant market prices and reflects the revised series.

Source: Haver Analytics (accessed 5 March 2015).

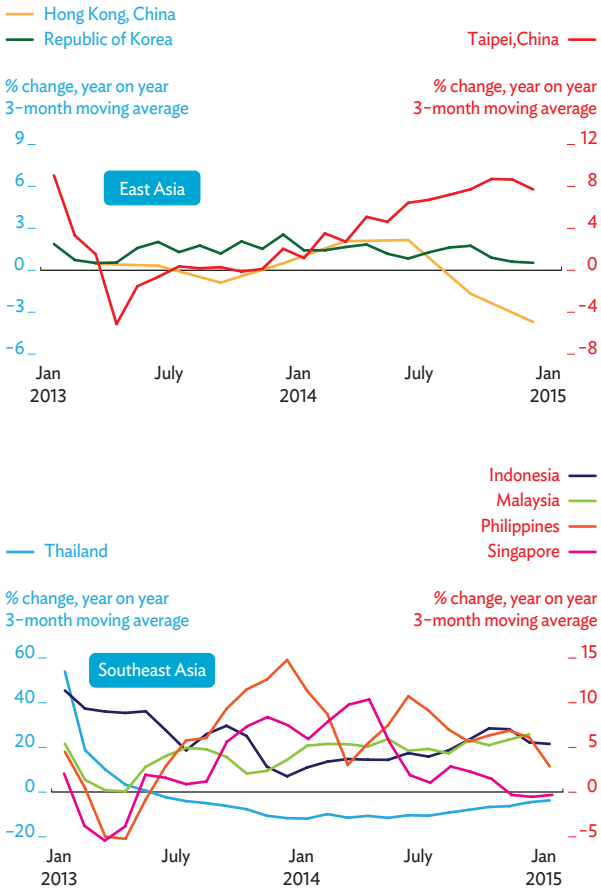
Click here for figure data

Output in Thailand fell for the second consecutive year as the manufacture of furniture, motor vehicles, and other transport equipment has not yet recovered. The industrial production index was softer in East Asia, particularly in Hong Kong, China, because of weak external demand. The index has steadily improved since the second quarter of 2013 in Taipei,China, boosting industrial activity as global demand strengthened for mobile phones and other information technology products, particularly in the US and the euro area (Figure 1.1.5).

Consumer confidence in the region last year was generally bleak, as most of the economies in East and Southeast Asia experienced drops in some quarters (Figure 1.1.6). Consumer sentiment improved in the PRC and Taipei,China, reflecting better income prospects, and in Indonesia on heightened expectations after the presidential election. It started weak in Malaysia and Thailand but improved significantly toward the end of the year. In Malaysia, sentiment weakened in response to cuts in subsidies for fuel and electricity, but the announcement of a new goods and services tax to take effect later this year lifted sentiment as consumers brought forward purchases to avoid the higher tax. In Thailand, consumer confidence slowly recovered from a trough in April in anticipation of a calmer political situation after the military intervened to end a year-long political struggle.

Elsewhere in the region, consumer confidence fluctuated for various reasons. Confidence in the Philippines took a hit in the third quarter of 2014 from high prices for basic commodities and political issues surrounding government funds for infrastructure projects, but brisker business activity

1.1.5 Industrial production index, selected developing Asia



Sources: CEIC Data Company; Haver Analytics (accessed 5 March 2015).
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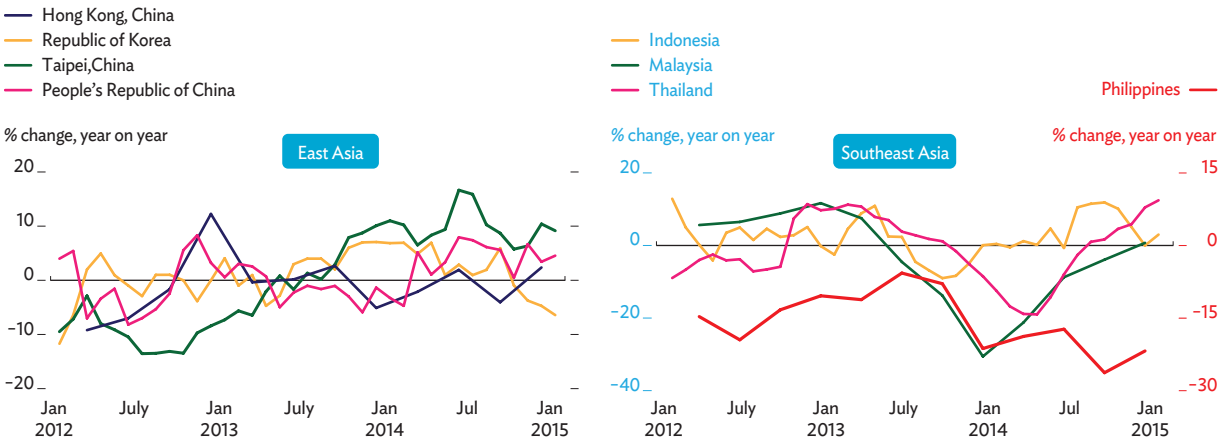
1.1.6 Consumer confidence and expectations, selected developing Asia



Notes: Data for Hong Kong, China; Malaysia; and the Philippines are quarterly. Data for the Philippines refer to consumer expectations, computed as the percentage of households that answered in the affirmative less the percentage of households that answered in the negative. A positive percentage point change indicates a favorable view, negative unfavorable.

Sources: CEIC Data Company; Haver Analytics (accessed 5 March 2015).
Click here for figure data

toward the end of the year improved sentiment in the fourth quarter. In Hong Kong, China, sentiment weakened in the third quarter of 2014 during the height of disruptions to public order, but rebounded toward the fourth quarter, as the PRC economy stabilized. The blow to sentiment in the Republic of Korea caused by the April 2014 Sewol ferry disaster lingered to the end of the year.

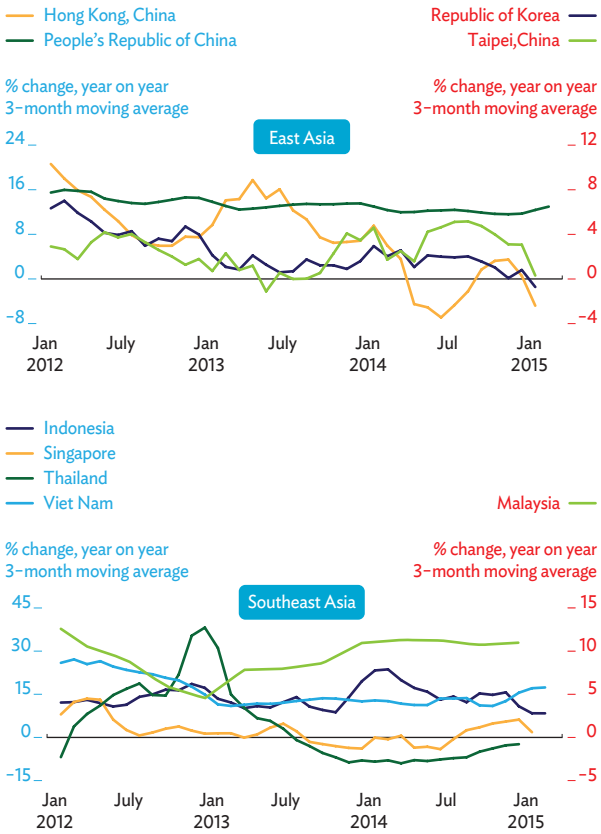
As consumer sentiment weakened, retail sales tumbled in a few of the larger economies in East and Southeast Asia but remained resilient in most (Figure 1.1.7). Growth in retail sales slowed but remained strong in the PRC, and it accelerated for most of the year in Taipei,China thanks to higher incomes and the continued rise in tourist arrivals from the PRC. Retail sales began at a healthy rate in 2014 in the Republic of Korea but worsened toward the end of the year as low consumer confidence and rising service payments for household debt tempered spending. In Hong Kong, China, retail sales were volatile, declining in the second quarter of 2014 after a good start, then falling again toward the end of the fourth quarter after a rebound in September. The trend mainly reflects cautious spending by locals but also subdued spending by tourists from the PRC.

Retails sales were stable for most of the year in Malaysia and Viet Nam. They slid in June in Indonesia as monthly consumption of motor fuel, food, and beverages declined, then recovered from July as spending for Ramadan and other religious festivities rose. In Singapore, retail sales fell initially but recovered by mid-July as lower gasoline prices boosted spending. In Thailand, retail sales continued to shrink until the end of the year as political turmoil continued to affect consumer spending.

In East Asia, investment was positive overall, slowing a bit in the PRC and Hong Kong, China but rising in the Republic of Korea and Taipei,China (Figure 1.1.8). Private investment grew convincingly in the latter two economies, as firms continued to enhance manufacturing capacity to meet stronger external demand. In the Republic of Korea, investment for manufacturing rose but investment for construction slowed as building construction and government capital spending declined. Meanwhile, cautious business sentiment caused investors to delay machinery and equipment acquisitions in Hong Kong, China, and growth in real estate investment in the PRC halved as financing conditions tightened in a market for homes with falling prices and oversupply.

While investment remained resilient in East Asia, it slowed in Southeast Asia, reflecting steep inventory decline and, in two of the region's larger economies, investment decline. Investment fell the most in Thailand, on large drawdowns of inventory. However, Thailand's destocking was in line with improving economic activity and possible

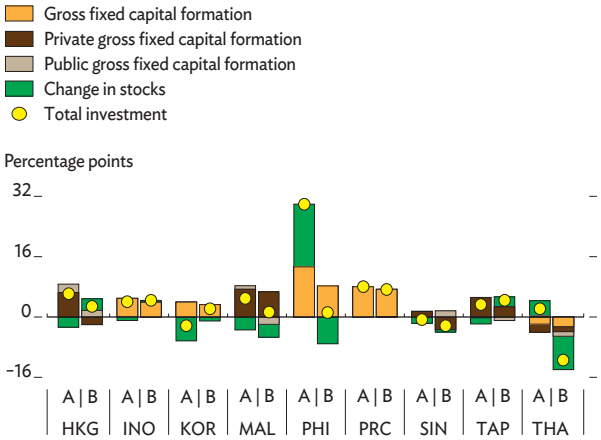
1.1.7 Retail sales, selected developing Asia



Sources: CEIC Data Company; Haver Analytics (accessed 5 March 2015).

Click here for figure data

1.1.8 Contributions to investment growth, selected developing Asia



A = 2013, B = 2014.

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

Source: Haver Analytics (accessed 5 March 2015).

Click here for figure data

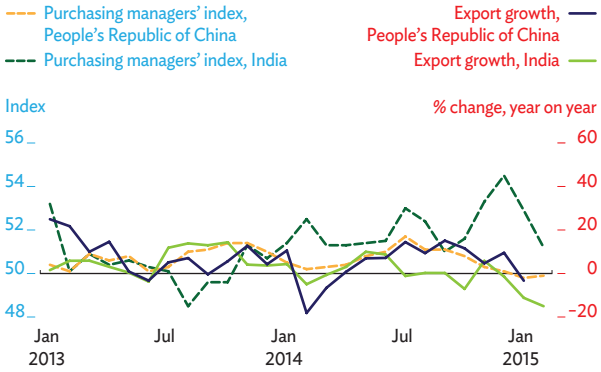
recovery in production this year. Some planned investments were hampered by continued political disruption and legal challenges, while uncertain business conditions constrained private firm expansion. In Singapore, the drop came mainly from a decline in private investment that reflected private construction hamstrung by weak government land sales and limited stock of office space, along with lower government spending on upgrading programs for public housing. In the Philippines, huge destocking in the first half of the year constrained total investment. The slow implementation of infrastructure projects hampered by budget controversies and delays in project execution contributed to the decline, but total investment remained positive. Similarly, investment slowed but remained positive in Malaysia as public investment decelerated. Investment increased marginally in Indonesia as inventories expanded.

Reform aims for healthy growth in the PRC and India

Growth in the PRC and India diverged but remained strong in 2014. Both showed signs of deterioration in manufacturing at the start of this year, indicating a likely slackening of economic activity in the immediate quarters ahead (Figure 1.1.9). Otherwise, growth in developing Asia's two giants looks set to diverge again in 2015 and 2016. The PRC is likely to slow further to 7.2% in 2015 and 7.0% in 2016, while India looks set to expand by 7.8% and then 8.2%. The differences largely reflect contrasts in each government's reform program. Policy makers in the PRC will use such tools as targeted credit restriction and general monetary easing to avoid a sharp deceleration and shore up growth, if necessary, but they aim for a rate of around 7.0%, which is more moderate than the historical average of 8.5% since the global financial crisis. The government has emphasized attaining high-quality growth by rebalancing the economy, stabilizing the housing market, and eliminating excess capacity. Indian policy makers are working to unclog structural bottlenecks that have hampered investment over the past 2 years. Reform looks promising at this stage, but significant challenges remain as some planned actions require parliamentary ratification.

Low oil prices should boost domestic demand in the PRC and India. Although net imports of crude oil in 2013 equaled only about 2.4% of GDP in the PRC and 7.9% in India, both economies could profit by global oil prices remaining low until 2016. In India, wholesale inflation eased by 0.5% in the fourth quarter of 2014, and consumer price inflation by 4.8%, and in January 2015 both measures stayed well below their 2014 averages. The consumer price index trend is the same in the PRC, reaching a 5-year low of 0.8% in January 2015. The lower cost of production should raise PRC corporate profits and thereby boost growth. In India, the benefits for households may not be large because the government continues to raise excise duties on retail fuel.

1.1.9 Merchandise exports and purchasing managers' index in Asia's giants



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

Sources: Bloomberg; Haver Analytics (both accessed 5 March 2015).

Click here for figure data

1.1.1 Top performers in developing Asia

	Average growth rate				Number of years with >7% growth	Number of years with >7% growth	Number of years with >5% growth
	2000–2008	2009 (GFC)	2010–2014	2015–2016	2000–2014	2010–2014	2010–2014
People's Republic of China	10.4	9.2	8.5	7.0	15	5	5
Turkmenistan	15.2	6.1	11.1	9.5	14	5	5
Uzbekistan	6.3	8.1	8.2	7.1	11	5	5
Mongolia	7.1	–1.3	11.1	4.0	10	4	5
Lao People's Democratic Republic	6.8	7.3	7.7	7.1	10	5	5
Cambodia	9.4	0.1	6.9	7.4	10	3	5
Myanmar	10.9	5.1	6.8	8.3	10	3	5
Kazakhstan	9.4	1.2	6.0	2.8	10	2	3
Azerbaijan	16.6	9.3	3.2	2.9	10	0	1

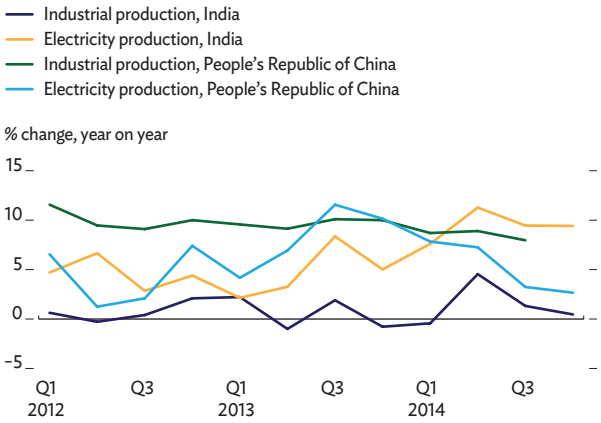
GFC = global financial crisis.

Note: Sorted by the number of years with 7%+ growth during 2000–2014.

Source: ADB estimates.

India's manufacturing purchasing managers' index reached a 3-year high of 54.5 in December 2014. It later fell in February 2015 to 51.2, which is still above the 50.0 line between growth and decline. New orders from abroad continued to rise in February for the 17th consecutive month, indicating a positive environment for business expansion. Electricity production also continued to rise and contribute to industrial production, though it stabilized in the last quarter of 2014 (Figure 1.1.10). In the PRC, by contrast, the manufacturing purchasing managers' index fell below 50.0 for a second straight month in February on unsteady exports and slowing investment, reflecting the PRC's new normal of slower but better-quality growth. Exports are expected to remain healthy in both economies, as lower commodity prices continue to reduce import bills and invigorate global demand exports.

1.1.10 Industrial production and electricity generation in Asia's giants



Q = quarter.

Source: CEIC Data Company (5 March 2015).

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Perspectives on growth in developing Asia

Developing Asia contributed 2.3 percentage points to the 4.0% average global GDP growth since the global financial crisis (GFC), or nearly 60%. This raises two questions: Which economies contributed the most to this impressive result and can they sustain their pace?

Considering growth performance since 2000, the nine best performers in developing Asia in real GDP terms, measured by the number of years with growth faster than 7.0%, were the PRC, Mongolia, the four oil and mineral exporters in Central Asia, and the three lower-income members of ASEAN (Table 1.1.1). All of these economies posted growth at above 7.0% in at least 9 years during 2000–2014.

1.1.2 Seven developing Asian economies with growth <7.0% since 2000

	Average growth rate				Number of years with >7% growth	Number of years with >7% growth	Number of years with >5% growth
	2000–2008	2009 (GFC)	2010–2014	2015–2016	2000–2014	2010–2014	2010–2014
Federated States of Micronesia	0.3	0.9	–0.4	5.1	0	0	0
Brunei Darussalam	1.8	–1.8	0.7	0.3	0	0	0
Tonga	1.2	3.2	1.8	2.3	0	0	0
Marshall Islands	2.2	–1.8	1.9	2.5	0	0	1
Fiji	1.2	–1.4	3.3	4.0	0	0	0
Nepal	3.8	3.9	4.3	4.9	0	0	1
Indonesia	5.1	4.6	5.8	5.8	0	0	4

GFC = global financial crisis.
Source: ADB estimates.

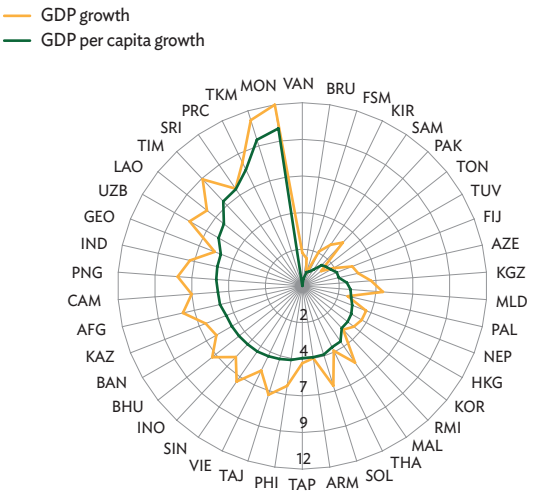
More recently, four of these economies met the growth minimum every year in the post-GFC period of 2010–2014, and were joined by two large energy exporters in the Pacific: Papua New Guinea and Timor-Leste.

Several economies grew more slowly, never posting growth above 7.0% since 2000 (Table 1.1.2). In these seven economies, average annual growth rates since 2000 ranged from zero to just above 5.0%. More than half of them have populations of less than 1 million and are in the Pacific, where economic opportunities are largely limited to tourism, fisheries, and the public sector. The notable exception is Indonesia. Unlike others in the list, it grew by more than 5.0% in 7 years, or about half of the time since 2000, but never above 7.0%. Except for Indonesia, however, the picture does not change even if the threshold is changed to 5.0% growth.

Using per capita GDP growth would not change the broad trend in GDP growth performance across economies (Figure 1.1.11). The Lao People's Democratic Republic, Mongolia, the PRC, and Turkmenistan are still the top performers, but Uzbekistan ranks lower because of its rapid population growth of more than 2% annually.

Growth performance measured in terms of gross national income (GNI) does not alter the broad picture either (Figure 1.1.12). However, there are notable differences across economies because GNI includes net financial income from abroad, such as dividends, interest, and profit. During the post-GFC period (in which GNI data are available to 2013), GNI is smaller than GDP in more than 60% of the 26 economies in developing Asia that have comparable data on GDP and GNI. The reason is that many of these economies rely on foreign capital in the form of foreign direct investment. The repatriation of profits earned by foreign firms subtracts from GDP, causing GNI to be smaller. However, GNI and GDP grew at similar rates in each of these economies.

1.1.11 GDP growth versus GDP per capita growth



AFG = Afghanistan, ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, BRU = Brunei Darussalam, CAM = Cambodia, FIJ = Fiji, FSM = Federated States of Micronesia, GEO = Georgia, HKG = Hong Kong, China, IND = India, INO = Indonesia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, KIR = Kiribati, KOR = Republic of Korea, LAO = Lao People's Democratic Republic, MAL = Malaysia, MLD = Maldives, MON = Mongolia, NEP = Nepal, PAK = Pakistan, PAL = Palau, PHI = Philippines, PNG = Papua New Guinea, PRC = People's Republic of China, RMI = Marshall Islands, SAM = Samoa, SIN = Singapore, SOL = Solomon Islands, SRI = Sri Lanka, TAJ = Tajikistan, TAP = Taipei,China, THA = Thailand, TIM = Timor-Leste, TKM = Turkmenistan, TON = Tonga, TUV = Tuvalu, UZB = Uzbekistan, VAN = Vanuatu, VIE = Viet Nam.

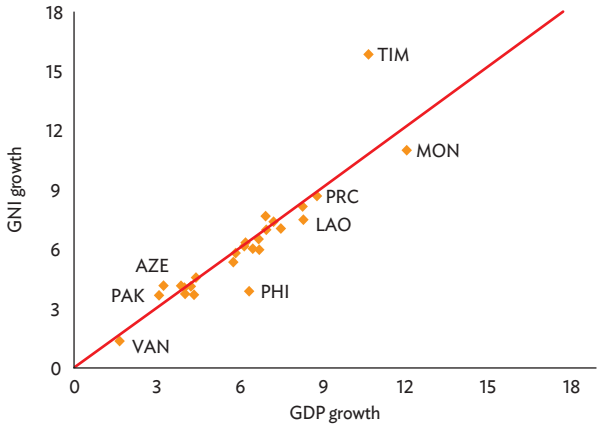
Source: ADB estimates.

Click here for figure data

Meanwhile, in nine economies, or 35% of the 26, GNI exceeded GDP. The gap as a percentage of GDP is particularly large in Timor-Leste, reaching more than 270% of GDP on average during the post-GFC period. The reason is that its major industry, oil and gas, operates offshore, and payment to the Government of Timor-Leste from production is counted as financial income from abroad, adding to its GDP. In other economies, the larger GNI seems to come from significant compensation of workers abroad, as in the Philippines, where GNI has averaged 120% of GDP during the post-GFC period. Other economies with large GNI–GDP gaps are Bangladesh at 7.9%, Pakistan at 4.5%, and Armenia at 4.2%.

The recent trend in soft commodity prices is adversely affecting some of the economies that are rich in natural resources and had been performing well. In Azerbaijan, GDP growth dropped from a robust 16.6% during the pre-GFC years to a mere 3.2% in the post-GFC period and could slow further during the forecast period. Others such as Kazakhstan and Mongolia are following suit. As a result, about half of the economies in developing Asia, including all of the best-performing economies in Table 1.1.1 except Myanmar and Cambodia, are expected to grow at less than their average rate during the post-GFC period (Figure 1.1.13).

1.1.12 GDP growth versus GNI growth, average 2010–2013



GNI = gross national income.

AZE = Azerbaijan, LAO = Lao People's Democratic Republic, MON = Mongolia, PAK = Pakistan, PHI = Philippines, PRC = People's Republic of China, TIM = Timor-Leste, VAN = Vanuatu.

Source: ADB estimates.

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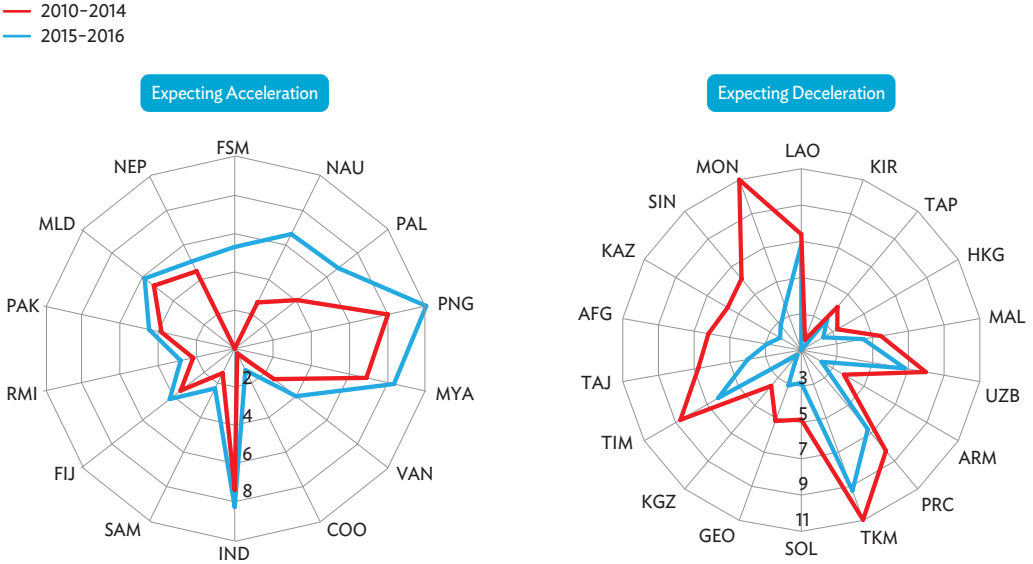
1.1.13 Economies in developing Asia that expect deceleration or acceleration



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Notes: Numbers correspond to average growth rates in percent. Accelerating economies are expected to grow by at least 0.6 percentage points faster in 2015–2016 than in 2010–2014, and decelerating economies by at least 0.6 percentage points slower.

Source: ADB estimates.

Click here for figure data

Meanwhile, many economies in the Pacific are expected to see faster growth in the forecast period, making it the fastest growing subregion in 2015. Papua New Guinea expects hefty 15% growth this year on new production of liquefied natural gas. Smaller Pacific economies such as the Federated States of Micronesia, Nauru, and Palau are also expecting to grow faster than in the past several years, on rising public infrastructure spending and robust tourist arrivals.

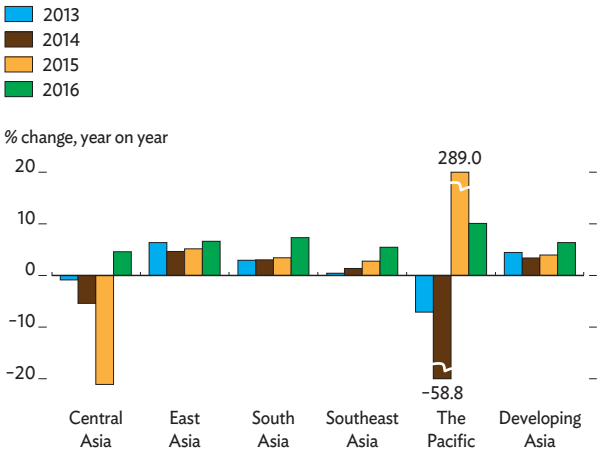
Continuing modest trade growth

Export growth remained weak in developing Asia in 2014, slipping to 3.4% from 4.5% in the previous year, below recent historical levels (Figure 1.1.14). Export growth last year was the lowest since the global financial crisis and just a third of the 10-year average of 11.6%.

Exports from developing Asia contracted by 0.2% in the first quarter of 2014, as shipments fell from the PRC and India, which together account for half of the region's exports. Growth in exports from Southeast Asia recovered in this period and was stronger than elsewhere in developing Asia, but momentum had dissipated by the second half of the year. Exports slid in Indonesia, the largest economy in Southeast Asia, as the investment slowdown in the PRC helped crimp demand for Indonesia's commodity exports. Exports from Central Asia also declined, by 5.4%, with sharp reductions in petroleum shipments and sluggish demand from the Russian Federation. Deceleration in the Pacific resulted largely from downturns in Papua New Guinea's traditional mineral commodity exports: gold, copper, and oil. Exports gradually recovered in the second half of 2014—in East Asia led by the PRC, and in South Asia as India picked up the slack in shipments elsewhere in the region—but not enough to lift exports for the whole of developing Asia (Figure 1.1.15).

Merchandise imports in 2014 similarly registered the smallest increase since the global financial crisis in 2009, which, at 0.7%, were far below the 10-year average of 11.5% (Figure 1.1.16). Imports to the Pacific plunged by 47.5%, and to Central Asia by 9.4%, mainly because of lower commodity imports to the dominant economies in the two subregions: Papua New Guinea and Kazakhstan. Imports of machinery and equipment to Papua New Guinea declined as the construction phase of liquefied natural gas (LNG) development ended. The next largest decline occurred in Southeast Asia, as imports to Indonesia fell by 4.5% and to Thailand by 8.5%. These declines in the subregion's two largest economies came from weak investment demand and hence lower demand for raw materials and capital goods.

1.1.14 Export growth by subregion



Source: Asian Development Outlook database.
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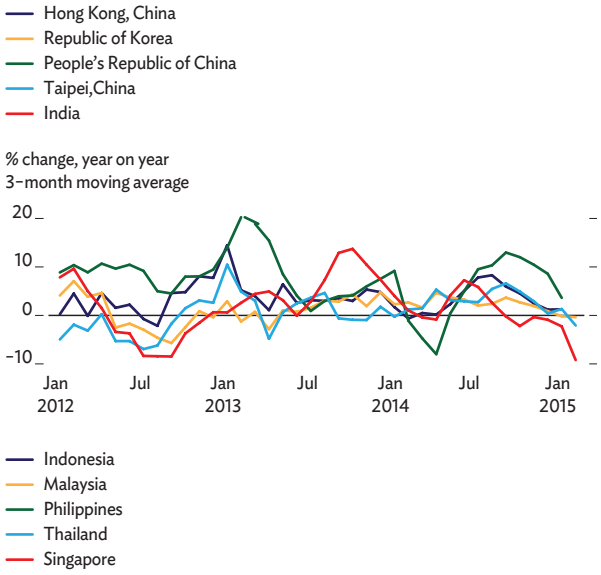
1.1.15 Monthly export growth in developing Asia



Source: CEIC Data Company (accessed 6 March 2015).
Click here for figure data

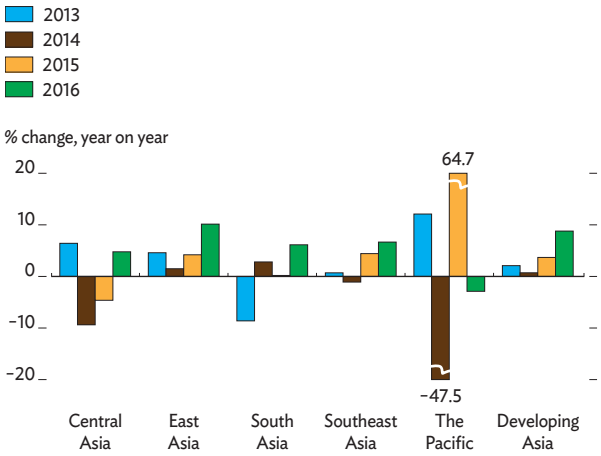
Import growth slowed as well in East Asia, to 1.5%, the lowest rate since the global financial crisis and just one-third of the rate in 2013. This result reflected the low import bill for the PRC because of slowing investment and lower oil prices, for the most part. Growth in imports to South Asia turned positive, after decelerating in 2013, as renewed optimism in India boosted spending on imports of capital and consumer goods (Figure 1.1.17). India's imports of base metals and precious metals such as gold rose sharply, making gold the country's second-biggest import item after oil in 2014.

Export and import growth are both expected to remain moderate in 2015 and pick up only gradually in 2016. The regional current account surplus should improve to 2.5% of GDP in 2015 as growth in exports outpaces growth in imports—however modest growth will be in both cases—and as prospects improve in the major industrial economies. In 2016, the regional current account surplus is expected to return to 2.3% of GDP, as in 2014, as imports outpace exports, partly because of rising oil prices.

Central Asia is expecting a small current account deficit in 2015, rising to a small surplus in 2016. The surplus will be smaller than the 3.8% of GDP average in the past 5 years, in view of the forecast recession in the Russian Federation. The surplus will contract to 3.0% of GDP in the same period in Southeast Asia, as the deficit in Indonesia lingers and the surplus in Malaysia narrows to just half of the 7.4% average of the past 5 years.

The current account surplus in East Asia remains driven by trends in the PRC and is expected to widen by 0.3 percentage points in 2015 before returning in 2016 to the 2014 level of 3.0% of GDP. The 2015 forecast for the Pacific is a surplus equal to 5.0% of GDP, reversing a deficit of 10.7% in 2014, mostly on account of the first full year of LNG production in Papua New Guinea. The surplus should rise to 6.3% in 2016, as LNG production continues.

1.1.16 Import growth by subregion



Source: Asian Development Outlook database.
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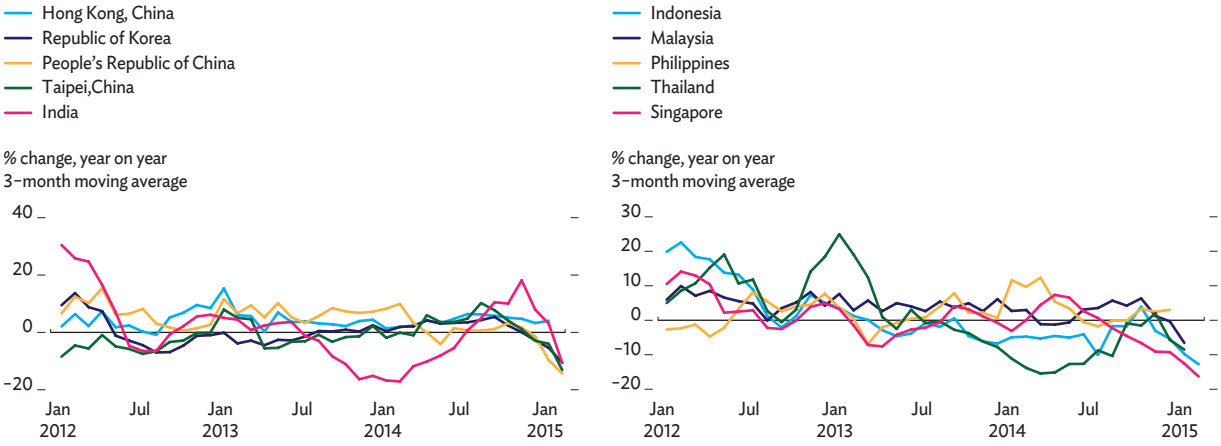
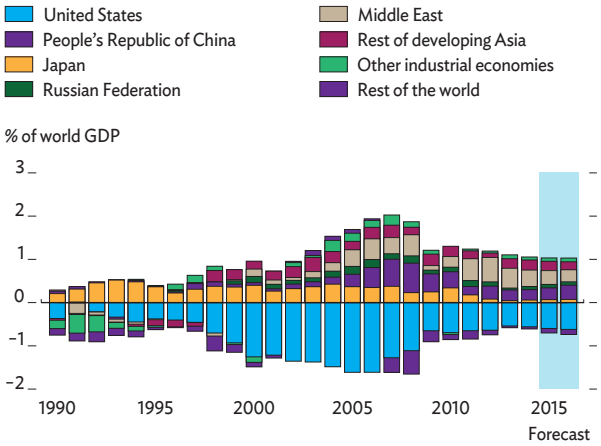
1.1.17 Monthly imports, selected developing Asia



Source: CEIC Data Company (accessed 6 March 2015).
Click here for figure data

Although stronger domestic demand in the US may enlarge that economy's contribution to the world current account deficit, the expansion is seen to be limited. The surplus in the Middle East is shrinking on the soft oil price, while the surplus of the PRC is expanding slightly, in line with the increasing size of the world economy. The world current account balance is expected to remain at around 1% of global GDP, which is half of the peak recorded in 2007, just before the global financial crisis (Figure 1.1.18).

1.1.18 World current account balance



Sources: International Monetary Fund. 2015. World Economic Outlook Database. October. www.imf.org; Haver Analytics (both accessed 5 March 2015).
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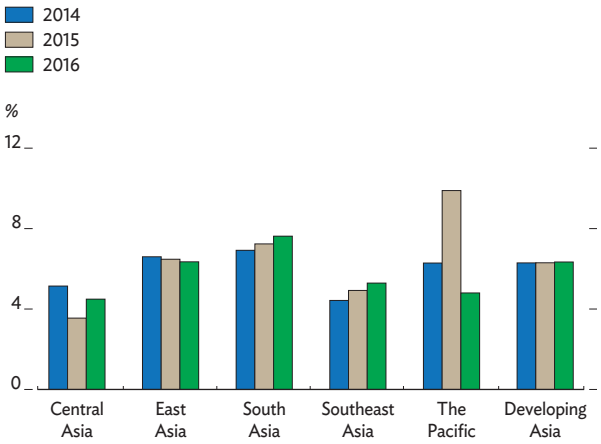
Subregional trends in growth, inflation, and current account balance

Moderating growth in East and Central Asia in 2015 and 2016 will offset the rebound in the other subregions, keeping the rate of expansion for the region as a whole at a solid 6.3% this year and next (Figure 1.1.19). The regional average thus reflects a merging of two different trends in 2015, as growth accelerates in half of the economies and slows in the other half. Most of the economies with faster growth are in South Asia, Southeast Asia, and the Pacific. Growth in East Asia will slow somewhat, mostly reflecting slower growth in the PRC, while growth in Central Asia will slow by a third as the Russian Federation slides into recession this year, crimping remittances and trade across Central Asia. More economies will see improvements in 2016, mainly in Central Asia, as oil prices slowly climb back and the Russian Federation begins to recover.

Inflation is forecast to slow regionally to 2.6% in 2015 before picking up slightly in 2016, as many economies benefit from lower prices for oil and other commodities (Figure 1.1.20). The exceptions are the Pacific and Central Asia. The Pacific is expected to see inflation picking up in 2015 before slowing in 2016. The lack of demand outside of the LNG industry in the subregion's largest economy will reduce inflation in 2016. Central Asia, on the other hand, is likely to experience higher inflation as local currencies suffer devaluation because of economic turmoil in the Russian Federation.

The outlook for the current account balance also features divergent paths across subregions in 2015 and 2016 (Figure 1.1.21). Oil price developments are affecting the outlook, with net exports improving in net resource importers—mostly in East and South Asia, and some economies in Southeast Asia—and net exports weakening in the natural resource exporters of Central and Southeast Asia. The exception is the Pacific. Despite the subregion's status as a net exporter of resources, its current account surplus is set to widen this year. This reflects the end of capital goods imports for LNG plant construction in Papua New Guinea and the ramping up this year of LNG exports that began in 2014.

1.1.19 GDP growth by subregion



Source: Asian Development Outlook database.
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Risks to the regional outlook

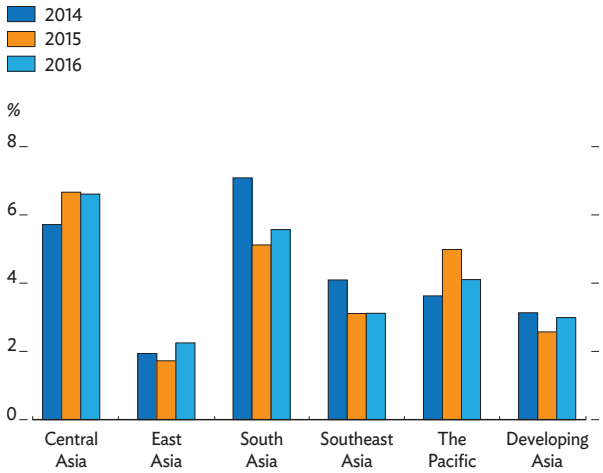
The risk that a major global shock will affect the regional outlook, for better or worse, is considered remote at this time. However, policy makers in the region must be ready to introduce appropriate measures to smooth any negative impacts in case underlying assumptions prove far off the mark. Developments that could challenge several underlying assumptions for developing Asia's outlook demand close attention. These include unexpected changes in the growth trajectory of important trade partners in the region or beyond, possible reversals in capital flows from changes in US monetary policy, and uncertainty in crude oil markets.

Potentially large shocks to economies in developing Asia can come from within the region. Steady economic activity in major trading partners, particularly dominant export destinations, underpin the growth outlook for many economies. The two regional giants, the PRC and India, are important to many of their neighbors, with whom they have tight trade links. The PRC and India are both expected to post healthy growth—but growth that is slowing somewhat in the PRC as the government pursues an ambitious reform agenda. Meanwhile, growth prospects can be disrupted if governments in the region have difficulty correctly implementing planned reform. In the PRC, for example, overly abrupt efforts to cool the real estate sector could cause liquidity shortages and interest rate spikes, as they did in June 2013. Likewise, India's ability to carry out reform to remove investment bottlenecks, an important factor affecting the regional growth outlook, is being tested.

One possible upside risk derives from the 10 Southeast Asian economies of ASEAN forming a regional economic community at the end of this year. Although the net impact is far from certain, particularly in the short-run, the advent of the ASEAN Economic Community is assumed to help sustain steady economic growth in the medium term. One possibility is that the economies of Southeast Asia may accelerate more than anticipated if the business environment receives an immediate boost from reform affecting customs, tariffs, or the movement of skilled labor.

Outside the region, the US recovery is generally considered on track, but the euro area remains fragile. The decision to extend Greece's bailout program has forestalled the risk of the euro area breaking up. Still, concerns remain about Greece's short-term solvency and long-term debt, and about the risk of default. Greece's exit from the euro would cause volatility in global financial markets, but the direct impact on the global economy might be small. A Grexit would nevertheless cause political and economic turmoil in the euro area and undermine its growth outlook. This would adversely affect the global economy, including developing Asia to some extent.

1.1.20 Inflation by subregion



Source: Asian Development Outlook database.
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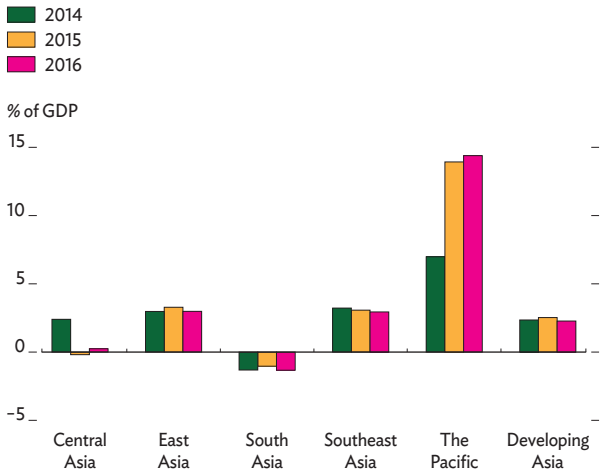
1.1.21 Current account balance by subregion



Source: Asian Development Outlook database.
Click here for figure data

Economic distress in the Russian Federation continues to be a concern in Central Asia, the only subregion of developing Asia to experience significant spillover. Central Asia's outlook assumes that growth returns to the Russian Federation by 2016. But if the sharp depreciation of the ruble, slowing remittances, and weakened demand for imports continue during 2016, Central Asia's growth trajectory would become more negative.

One large risk follows from developing Asia having enjoyed steady capital inflows as the major financial markets, the US in particular, pursued monetary easing. Given the anticipated normalization of US monetary policy later this year, narrowing differentials in interest rates between the US and Asia could prompt outflows of funds from the region. Weaker growth and lower interest rates in some economies in developing Asia make them less attractive as investment destinations. These economies could see lower inflows of funds or even outflows, causing liquidity to tighten and credit growth to slow.

Finally, oil prices are expected to rise gradually through the forecast period, but this projection assumes that global demand for energy increases somewhat with the gradual recovery in global growth rates. Meanwhile, uncertainty is the one constant in crude oil markets, and oil prices could deviate significantly from current projections under different conditions of supply and demand. The slowdown in infrastructure and manufacturing activity poses a risk that future economic growth may fall below projections and hollow out consumption of crude oil and petroleum products. On the other hand, supply disruptions from geopolitical tensions in the major oil producing countries could raise prices beyond what the outlook envisions.

How lower oil prices affect Asia

The low price of oil is propping up economic growth in Asia and other regions around the globe, excluding the major oil-exporting countries. Because the decline in oil prices has supported growth and contained inflation, it has considerable implications for macroeconomic management. At a minimum, the low oil price has lowered inflation globally, particularly in the US, the euro area, and Japan, and provided room for maintaining low interest rates to stimulate growth. Although the impact on growth may differ between economies that are net importers of oil and those that are net exporters, the net effect on global growth is perceived to be positive. In addition, the decline in oil prices has provided an opportunity for governments to institute reform that will benefit their growth prospects over the longer term. For example, it has opened up opportunities for countries that still heavily subsidize their energy sectors to rationalize their expenditures to make them more productive. To the oil-producing countries, the decline in oil prices provides further incentive to diversify their economies.

This outlook projects that oil prices, as measured by the Brent crude price, will gradually recover from their current lows but remain below their highs of the past 4 years. While it is unlikely that supply will grow quickly, demand is projected to pick up following the expected recovery in the global economy. The baseline assumes that gradual improvement in the global economy will revive demand for energy and push the Brent crude price to an average of $65 per barrel in 2015, before it picks up further to $75 in 2016. Despite this rising trend, the price of oil in 2016 will still be less than three-quarters of its average price in 2014. Over the long run, however, supply constraints should put upward pressure on the price of oil, though energy-saving technological advances may slow the increase.

Uncertainties surrounding the oil price projection

A lot of uncertainty surrounds the oil price, as risks threaten any assumption from both sides. Supply disruptions from heightened geopolitical tensions could push up the price, and slower economic growth could hold down oil consumption, demand, and prices. Such high uncertainty makes oil prices volatile and forecasts prone to error.

Figure 1.2.1 shows how the price of Brent crude has moved in the past 15 years. The price has been volatile historically, generating a quarterly standard deviation of about $33 per barrel. Volatility has worsened in the past decade, with sharp movements taking place in a 2–3 year cycle—but nothing regular enough to make volatility any less of a risk to the outlook. While a lower global price for oil mostly promotes

1.2.1 Brent crude prices: 2000–2015

Source: Bloomberg (accessed 16 March 2015).

Click here for figure data

economic growth, steep falls and rapid rebounds can be detrimental. A rebound to pre-2014 prices is unlikely but possible within the forecast horizon, as a positive shock within the standard deviation is enough to drive Brent crude price back to above $100 per barrel by 2016.

Probable implications of a steep rebound in oil prices

To illustrate how a sharp and quick rebound in oil prices could affect growth in the region, this analysis considers a high oil price scenario in which Brent rises slightly higher than the baseline assumption to $70 per barrel in 2015 and jumps to an average of $100 in 2016 (Figure 1.2.2). A price hike to $100 per barrel is seen as consistent with the average Brent price going back almost 4 years before the price collapse in the second half of 2014. The price is considered to be within the price range desired by the Organization of the Oil Exporting Countries (OPEC) in the past few years, as the OPEC secretary general referred to it as a a level that makes everyone happy (OPEC 2014). To see how such shocks play out in the global economy, the scenario is simulated using the framework of the global projection model GPM7, which divides the global market into seven blocks, one of which is the PRC and another comprising Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand (Blagrave et al. 2013). The model is calibrated to reflect *ADO 2015* baseline projections.

1.2.2 Alternative trends in Brent crude price: baseline versus high-price scenario

Q = quarter.
Source: ADB estimates.
Click here for figure data

Applying the high oil price scenario in Figure 1.2.2 on top of the underlying outlook, forecasts in a GPM7 environment suggest that a sharp and quick rebound in oil prices would likely be detrimental to global economic growth, as higher energy costs would limit consumption and investment. This implies that a return of oil prices to their average in the past 4 years could arrest progress in global economic recovery and deflect the global output gap away from its closing trend. The widening output gap would exert downward pressure on interest rates, which is determined endogenously in the model.

Table 1.2.1 suggests that a steeper rebound in oil prices, if imposed on trends of relatively soft growth momentum like those in the baseline, could be substantial but not uniform across the sample economies. A return of oil prices to $100 per barrel could shave as much as 1 percentage point off of average growth in developing Asia in 2016, while the growth slowdown in the US, the euro area, and Japan would be less severe on average, at about 0.6 percentage points. This difference in the severity of the growth slowdown derives mainly from the interest rate differential between the two blocs and the inflationary impact of the rise in oil prices on these economies. As interest rates in Europe and Japan are practically glued to the floor, the inflationary impact of higher energy costs would mean negative real interest rates in these economies. A negative real interest rate would also be the case in the US, but not

1.2.1 Macroeconomic implications of higher path of oil prices

	ADO 2015 baseline		Changes from the baseline	
Economy	**2015**	**2016**	**2015**	**2016**
GDP growth				
Major industrialized economies:				
United States	3.2	3.0	–0.1	–0.6
Euro area	1.1	1.4	–0.1	–0.6
Japan	1.1	1.7	–0.1	–0.7
PRC	7.2	7.0	–0.2	–0.9
Emerging Asia excluding the PRC	5.4	6.1	–0.2	–1.1
Inflation				
Major industrialized economies:				
United States	0.8	2.3	0.2	0.7
Euro area	0.1	1.1	0.1	0.2
Japan	1.2	1.3	0.0	0.1
PRC	1.8	2.3	0.0	0.2
Emerging Asia excluding the PRC	3.9	4.1	0.0	0.5

ADO = *Asian Development Outlook*, PRC = People's Republic of China.
Source: ADB estimates.

in Asia. Given Asia's relatively high nominal interest rates, positive real interest rates would still prevail in Asian economies, appreciating currencies in real effective terms, which could adversely affect competitiveness and export performance. This additional effect explains most of the growth differential seen in Table 1.2.1.[1]

Under normal circumstances, an oil price shock would stoke inflation, at least to the extent of raising the energy component of domestic prices. The impact would depend, however, on the weight of the energy component in the price index and the degree of pass-through from oil to domestic inflation. In addition, the impact would depend on the economy's aggregate demand–supply balance before the shock. Economies with negative output gaps to begin with—economies performing below their potential, like most of those in Table 1.2.1—would see the gap worsening after the oil price increase, which would weaken inflationary pressure. The simulation suggests that core inflation (which strips out food and energy) would be lower after a shock that widened the output gap. These two competing effects play a crucial role in determining the way inflation responds to an oil price shock. The simulation suggests that the economies with relatively high nominal interest rates before the shock would ease their monetary policy somewhat to soften the blow to growth. This would mean monetary policy easing in Asia, and US interest rates rising less quickly than in the baseline. Although positive, the impact on aggregate inflation is generally seen to be manageable.

Pass-through to domestic inflation

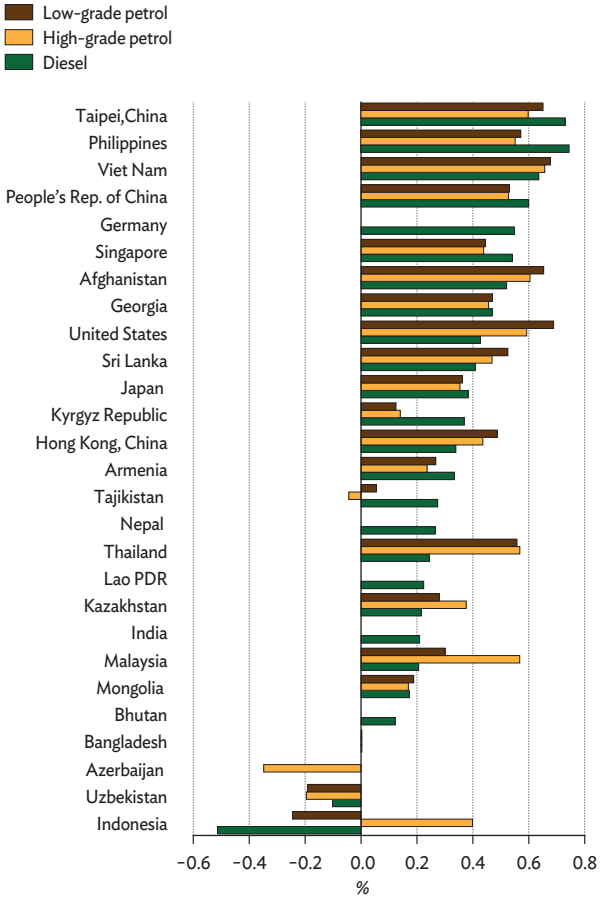
Prices at the pump

Domestic fuel prices fell sharply in many economies with the decline in world oil prices. Figure 1.2.3 examines how much the world oil price change transmitted to domestic retail fuel prices by ranking economies in order of the change in domestic diesel prices relative to world prices. It also includes information on changes in prices for low-grade and high-grade gasoline where available.[2] The survey of 25 economies found that domestic fuel prices did not decline by as much as the fall in crude oil prices.[3]

The average transmission to domestic fuel prices in the sample period was 32%. Within the region, the highest pass-through was in East Asia, followed by Southeast Asia, South Asia, and finally Central Asia. Taipei,China showed the highest relative decline in fuel prices, while Bangladesh recorded a negligible drop. In Azerbaijan, Uzbekistan, and Indonesia, average prices at the pump increased because of government intervention. In Uzbekistan, the government raised in January 2015 a fuel consumption tax on transport vehicles that use gasoline, diesel, or liquefied petroleum gas. In Indonesia, the government raised gasoline and diesel prices in November 2014 to rein in subsidies, then reduced prices in January 2015 to reflect falling world oil prices. In Azerbaijan, only high-grade gasoline, which is not regulated, rose in price, while there was no change in the prices of low-grade gasoline or diesel, which the government controls. More generally, in economies where the market typically determines domestic fuel prices—such as Georgia, the Philippines, Singapore, and Hong Kong, China—the pass-through to fuel prices was larger than in economies where the government controls the prices. Price transmission in these economies was comparable to that of the advanced countries, where prices are also typically determined by the market, as in the US, Japan, and Germany.

Retail prices may not fully reflect world oil price changes for various reasons, such as when the oil was bought, the effects of trade agreements, the inclusion of fixed costs in prices, and different domestic pricing policies involving taxes and subsidies, which need not necessarily move with world price changes. For example, in the sample, many governments did not implement any changes in subsidies or taxes between June 2014 and January 2015, when world oil prices declined a lot. Others, such as India, Nepal, Turkmenistan, Timor-Leste, Indonesia, and Thailand, took advantage of the price fall to reduce subsidies on energy.

1.2.3 Transmission of world oil prices to domestic fuel prices



Lao PDR = Lao People's Democratic Republic.

Sources: World Bank Commodity Price Data (Pink Sheet), http://www.worldbank.org (accessed 6 March 2015); Indian Oil Corporation Ltd.; ADB estimates.

Click here for figure data

Aggregate consumer price index

A fall in prices at the pump can affect the consumer price index (CPI) directly by bringing down the cost of the energy-related items that contribute to CPI, such as household fuel, motor fuel, and electricity.

Households and firms may shift consumption away from other energy sources into oil-based energy sources, likely lowering prices for close substitutes and, hence, the CPI. These pass-through effects from a change in international oil prices may be seen in CPI inflation in the short term and depend on, among other factors, the weight of the energy component in the economy's CPI basket. Over a longer period of time, falling oil prices can affect non-energy components of CPI through lower production costs, which producers may pass on to consumers, and through other second-round effects such as lower transport costs.

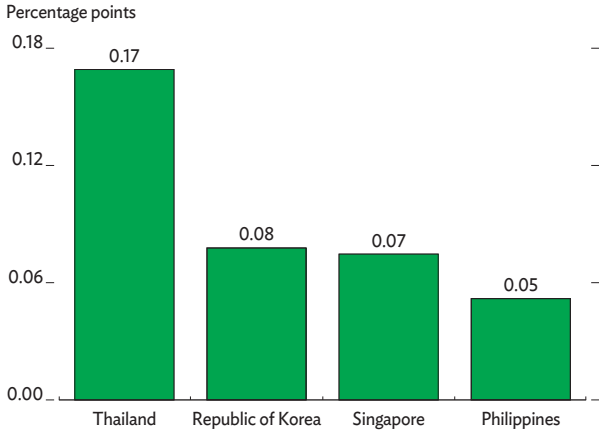
In economies where the domestic price of oil is determined by the market, the pass-through of an oil price change into CPI inflation can be expected to be larger. The extent of transmission will be based on, among other factors, oil self-sufficiency, intensity of oil use, energy efficiency, and the persistence of the oil price shock. On the other hand, when domestic fuel prices are administered or regulated by the government through price caps, adjustments to subsidies and taxes, or other indirect interventions, the oil price change passes through to domestic fuel prices incompletely, which limits direct inflationary or deflationary effects. The impact on domestic inflation may also differ in an economy that is a net oil importer from the impact in a net exporter, depending again on the extent to which the government controls fuel prices.

Empirically, the impact on inflation in each economy was assessed by estimating the pass-through of oil price change to CPI inflation (Box 1.2.1). The estimation controlled for the following lagged changes: rates of inflation, to capture its persistence; output gap, to represent inflationary pressures from the real economy; oil prices, to reflect direct inflationary pressures from world oil price volatility; and the real exchange rate, to capture the inflationary implications of relative price change in an open economy, as spillover to other sectors from declining oil prices changes the price of the domestic goods compared with world prices.

The immediate pass-through of an oil price change into CPI inflation was small in all economies, with only some coefficients positive and significant: Thailand, the Republic of Korea, Singapore, and the Philippines (Figure 1.2.4). These are economies where the domestic price of fuel is mostly determined by the market, so it makes intuitive sense that the world oil price transmitted to domestic prices. For example, if the world oil price decreased by 10%, the pass-through to CPI inflation in Thailand would be 0.17% after 1 month. The impact was smaller in other economies, and this result was consistent with prices not adjusting instantly. Summarizing the results for all economies in the sample, the absolute pass-through was, on average, highest in South Asia and lowest in Central Asia, and the magnitude of pass-through was slightly larger in economies where the market determined domestic fuel prices than where prices were administratively set.

If the oil price change persists, the pass-through to inflation is positive in all economies and higher than the immediate impact (Figure 1.2.5). The magnitude of the impact still varies across the region, with major

1.2.4 Immediate oil price pass-through to inflation



Note: Estimates correspond to a 10% change in oil price.
Source: ADB estimates.
Click here for figure data

1.2.1 Estimating the pass-through of oil price change to consumer price index inflation

Analyzing the pass-through of oil prices to inflation starts with the following equation:

$$\pi_t = \alpha_0 + \alpha_i \sum_{i=1}^{k} \pi_{t-i} + \sum_{i=1}^{k} \theta_i \Delta poil_{t-i} + \varepsilon_t \quad (1)$$

where π_t represents CPI inflation, the change in the log of CPI (p_t), and $poil_t$ is the log of world average price of oil. The coefficient θ_1 is the total immediate effect of the oil price change in period $t-1$ on inflation in period t.

As inflation is also determined by output gap, the lagged value output gap, defined as the difference between log of output y_t and its Hodrick-Prescott filtered trend $\tilde{y}_t$ is included. Apart from the direct effect, oil price volatilities can be transmitted to other sectors, which may affect a country's relative competitiveness and separately affect inflation. Hence the change in the real effective exchange rate ($\Delta reer$) is included to represent changes in relative foreign prices. REER is the exchange rate against a basket of currencies and an increase indicates appreciation. The augmented model is as follows:

$$\pi_t = \alpha_0 + \alpha_i \sum_{i=1}^{k} \pi_{t-i} + \beta(y_{t-1} - \tilde{y}_{t-1}) + \sum_{i=1}^{k} \theta_i \Delta poil_{t-i} + \sum_{i=1}^{k} \gamma_i \Delta reer_{t-i} + \varepsilon_t \quad (2)$$

As these series are typically not stationary, an equilibrium relation may exist between prices, output, oil prices, and the exchange rate in levels, which is given by the following:

$$p_t = \mu + \tau_{ipi} y_t + \tau_{oil} poil_t + \tau_{reer} reer_t + ECT_t \quad (3)$$

If the series are cointegrated, then ECT_t is the error correction term that represents the short-term deviation of the system from equilibrium. Hence, the following can estimate the model

$$\pi_t = \alpha_0 + \alpha_i \sum_{i=1}^{k} \pi_{t-i} + \beta(y_{t-1} - y_{t-1}) + \sum_{i=1}^{k} \theta_i \Delta poil_{t-i} + \sum_{i=1}^{k} \gamma_i \Delta reer_{t-1} + \rho ECT_t + u_t \quad (4)$$

to assess the immediate pass-through of oil prices to inflation. The coefficients of interest for oil prices are interpreted as follows: θ_1 is the partial short run pass-through to inflation of an oil price change. The total short run pass-through is given by $\theta_1 + \rho\tau_{oil}$ to include the adjustment back to equilibrium after a deviation. So, if oil prices change by 1%, the pass-through to inflation in the next month is $\theta_1 + \rho\tau_{oil}$%. τ_{oil} is the coefficient representing the pass-through in the equilibrium relation, and ρ is the speed of adjustment after a deviation.

The analysis includes 16 economies for which data on all series are available for the time periods in the box table. Analysis uses monthly data for the CPI, industrial production index, and real effective exchange rate obtained from CEIC Data. Oil price is the average spot price, weighted according to global trading volume, of West Texas intermediate, Brent crude, and Dubai crude, the series obtained from World Bank Commodity Price Data.

All series are expressed in logarithms. For each economy, analysis uses the Augmented Dickey Fuller test to check for stationarity. The Johansen cointegration test enables determination that a cointegration relation exists as described in equation (2). Optimal lags are chosen based on the Schwarz Information Criteria. Equations (2) and (4) are then estimated, and the standard errors are computed using the Newey-West HAC matrix to account for autocorrelation and heteroskedasticity in the error terms.

Time period for each economy

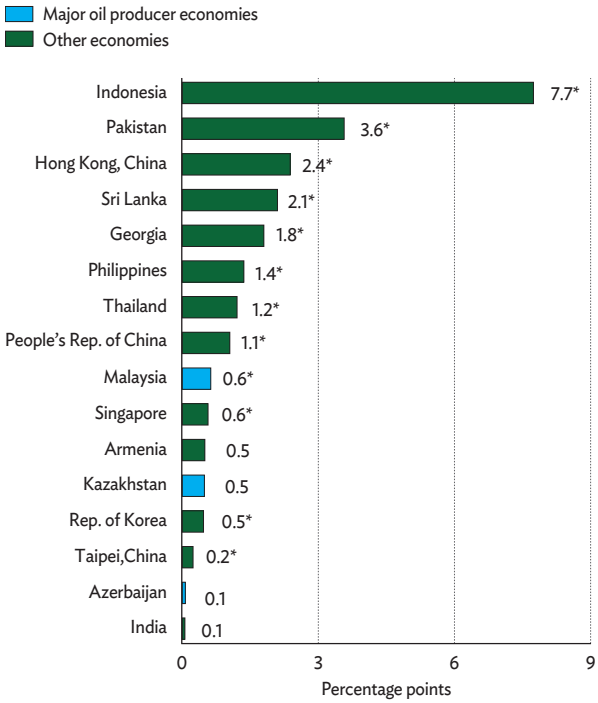
Economy	Period
Central Asia	
Armenia	Jan 2006–Nov 2014
Azerbaijan	Jan 2009–Nov 2014
Georgia	Jan 2001–Sep 2014
Kazakhstan	Jan 2002–Aug 2013
East Asia	
People's Republic of China	Jan 1994–Oct 2014
Hong Kong, China	Jan 2005–Sep 2014
Republic of Korea	Jan 1994–Nov 2014
Taipei,China	Jan 1994–Dec 2014
South Asia	
India	Jan 1994–Oct 2014
Pakistan	Jan 1990–Oct 2014
Sri Lanka	Jan 2009–Oct 2014
Southeast Asia	
Indonesia	Jan 1994–Dec 2014
Malaysia	Jan 1979–Sep 2014
Philippines	Jan 2000–Oct 2014
Singapore	Jan 1997–Nov 2014
Thailand	Jan 2000–Dec 2014

Sources: CEIC Data Company; Haver Analytics.

oil producers—Malaysia, Kazakhstan, and Azerbaijan—passing through lower rises on average. Among the other economies, most of which are net importers of oil, Indonesia has the highest estimated pass-through, and India, whose coefficient is insignificant, the lowest. In both, as in many other economies in developing Asia, the government used price controls to limit the effect of oil price volatility on domestic consumer prices over the sample period.

Why is the pass-through in Indonesia much higher than elsewhere? Large increases and volatility in world oil prices have forced the Government of Indonesia to reduce and reintroduce subsidies, causing large changes in domestic fuel prices. Looking back to 2005, Indonesia raised domestic fuel prices by 29% in March and then doubled them in October of that year in response to the increases in the world prices. In May 2008, the government cut the fuel subsidy further, raising average domestic fuel prices by 30%. However, in December 2008, the government reacted to the decline in world oil prices by once again increasing its fuel subsidy contribution, which caused domestic fuel prices to fall by an average of 15% (Ramayandi and Rosario 2010). The immediate and longer-term impact of these changes on CPI inflation is possibly reflected in the high pass-through coefficient for the time period under analysis. In India, before the reform of gasoline and diesel subsidies, retail fuel prices were stable (Figure 1.2.6). For example, the government froze gasoline and diesel prices between February 2007 and February 2008, and similarly the prices of other domestic fuels like subsidized liquefied petroleum gas and kerosene (Kojima 2009, 2012), possibly limiting pass-through to CPI.

1.2.5 Oil price pass-through to inflation over time



Notes: Estimates correspond to a 10% change in oil price. * indicates coefficients that are significant at 5%.

Source: ADB estimates.

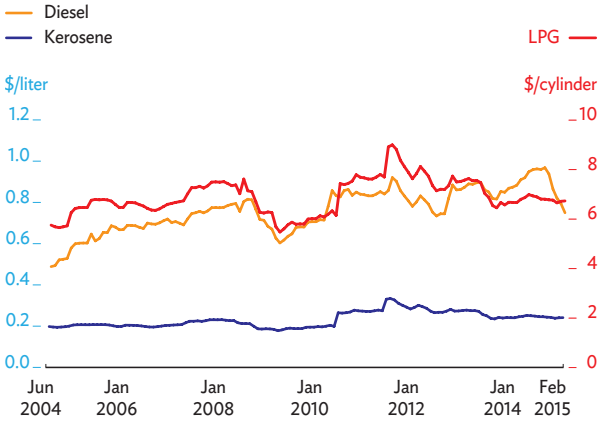
Click here for figure data

Lessons for policy

Many domestic policy decisions should be informed by the extent to which world oil price fluctuations are passed through to CPI inflation. On the fiscal side, depending on whether an economy is a net exporter or net importer of oil, the government decides on the magnitude of subsidies to offer and tariffs to impose on producers and consumers. For example, when faced with an unprecedented rise in oil prices to over $100 a barrel, several governments in oil-importing economies in Asia increased oil subsidies (Baig et al. 2007) or used targeted subsidies or other price controls to protect domestic consumers from the price rise (Kojima 2009). The insights from the estimation show that, over a period of time, the pass-through to CPI inflation is positive in all economies. Governments can take advantage of the steep fall in oil prices to implement tax reform and reduce or eliminate subsidies, thereby boosting their future fiscal flexibility with only minimal disruption to household and business budgets. Similarly, tame inflation and current account improvement can allow monetary policy to be eased.

In oil-exporting countries, the oil price fall can force down export earnings and fiscal revenue, thereby straining public finances. Governments in these economies have to consider reforming the structure of taxes and subsidies in the energy sector and diversifying their economies. As current account deterioration can bring inflation and pressure on the currency, monetary policy has to balance these considerations against growth objectives.

1.2.6 LPG and kerosene prices in Delhi, 2004–2015



LPG = liquefied petroleum gas.

Source: Indian Oil Corporation Ltd.

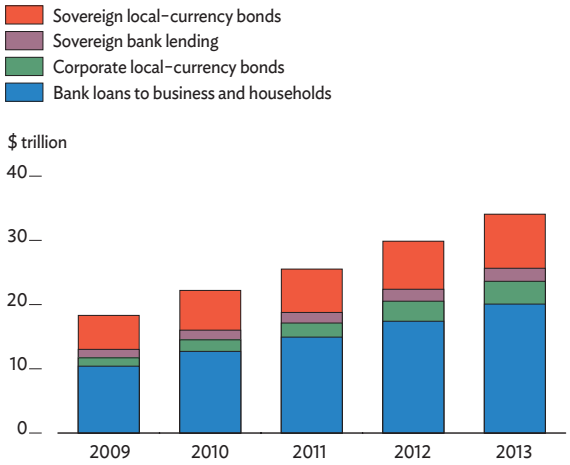
Click here for figure data

Is Asia's rising debt a threat to growth?

Following the global financial crisis of 2008–2009, total debt has risen in developing Asia. Plentiful global liquidity and expansionary monetary policy in advanced economies have supported the surge in credit. The rapid rise in debt has raised concern about the risk of a credit slowdown or bust that could affect the economy. The risk has intensified now that the US Federal Reserve is on the cusp of raising interest rates. The region had a brush with the impact of a Fed policy reversal—or talk of such a reversal—when liquidity tightened during the so-called taper tantrum in the second half of 2013. At that time, interest rates went up and new bond issuances stalled. While 2014 saw funds return to the region and liquidity improve, tighter liquidity looms in 2015 as the US stands poised to raise interest rates.

As much as total debt has risen in Asia, it is not clear that its growth has been excessive. Some of the rise in debt is a natural consequence of financial development and reflects the progress regional economies have made in improving their financial systems. As such, growth in debt can be seen as supporting economic growth. However, a rapid rise in debt could also worsen macroeconomic vulnerability. When lending rises quickly, lending standards tend to become relaxed, potentially allowing excessive leverage and asset price bubbles. There have been several times in the past when financial crises followed on surges in domestic lending. Gourinchas and Obstfeld (2012) showed that domestic credit growth and real currency appreciation robustly predict crises. Worryingly, Taylor (2012) found that those economic downturns that followed rapid expansion of credit tended to be more severe.

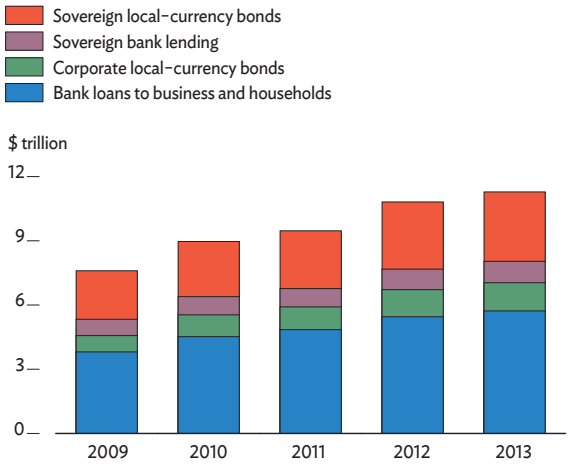
1.3.1 Bank loans and local-currency bonds outstanding in Asia



Sources: International Monetary Fund. International Financial Statistics; Bloomberg (both accessed 6 March 2015).

Click here for figure data

1.3.2 Bank loans and local-currency bonds outstanding in Asia, excluding the People's Republic of China



Sources: International Monetary Fund. International Financial Statistics; Bloomberg (both accessed 6 March 2015).

Click here for figure data

Trends in Asian debt

Asia has experienced rapid credit growth since the global financial crisis. To chart the rise in total debt in the region, data were assembled on domestic bank loans and bonds outstanding in 14 larger Asian economies: Bangladesh; the PRC; Hong Kong, China; India; Indonesia; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Sri Lanka; Thailand; and Viet Nam. From 2009 to 2013, total debt in the region almost doubled, climbing from $18.3 trillion to $34.1 trillion (Figure 1.3.1). The banking sector remains the dominant part of the financial system in the region, accounting for more than half of total debt, but bonds have been gaining popularity as

sources of financing. A large portion of the growth in total debt has been driven by the rapid credit expansion in the PRC. Debt in the PRC accounts for two-thirds of debt in the region. Excluding the PRC, the amount of debt in the region is lower but the rapid buildup of debt presents a similar picture (Figure 1.3.2).

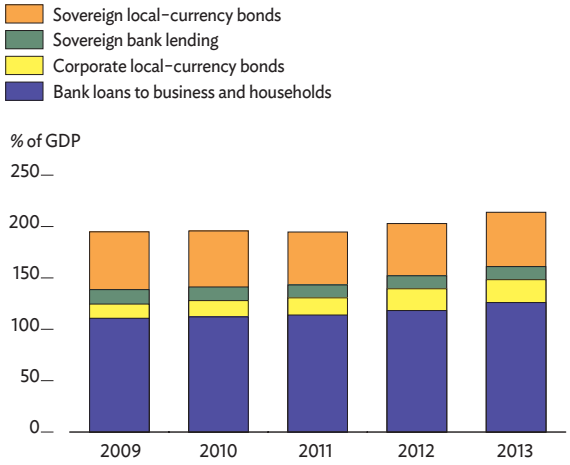
Most of the debt has been accumulated by firms and households, their debt more than doubling from 2009 to 2013. In the same period, government debt increased by just 58%. Companies in the PRC are responsible for a large share of the rise in private debt. Excluding the PRC, company and household debt has still outpaced government debt, but the difference is smaller, with company and household debt rising by 54% and government debt by 40%.

As some of the rise in debt was needed to finance expanded economic activity, it may be useful to look at the trend in debt as a share of GDP. Growth in debt has convincingly outpaced that of GDP, pushing the ratio of debt to GDP from 195% in 2009 to 214% in 2013, a jump of almost 20 percentage points (Figure 1.3.3). While some of that reflected financial development, the largest increases in debt as a share of GDP have occurred in economies with relatively well developed financial sectors. The rapid rise reflected an especially strong increase in debt in the PRC. Excluding the PRC, the ratio of debt to GDP in the rest of the region still increased but by only half the magnitude, slightly less than 10 percentage points, from 172% to 181% (Figure 1.3.4).

Individual economies display considerable divergence. The largest increases in debt as a share of GDP since 2009 have been, in descending order, in Hong Kong, China; Malaysia; Singapore; and Thailand (Table 1.3.1). In fact, the rise in debt from 2009 is mostly in East and Southeast Asia. These are all economies with highly developed financial sectors by regional standards and strong economic track records. Singapore and Hong Kong, China are regional financial hubs with global standing. Their possession of highly developed financial sectors made these economies the most capable in the region of ramping up lending after the global financial crisis. These economies are likely to have benefited the most from the increased flow of funds into the region.

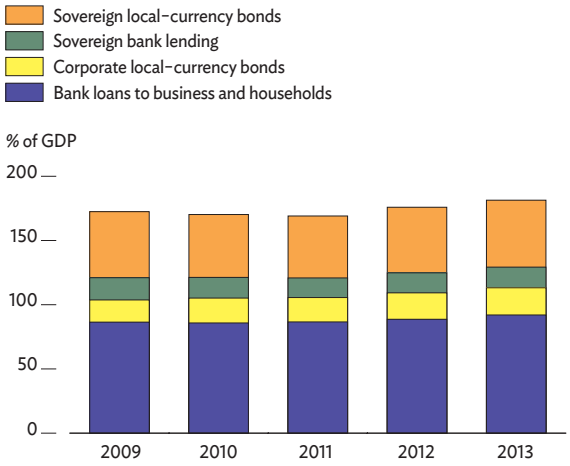
Some of the increase in total debt has been fueled by the increased use of bonds for financing. The development of local-currency bond markets can been seen as a positive sign, as they provide alternative sources of funding for companies in the region. Growth in bonds outstanding has been faster than that of bank loans, albeit from a much smaller base. Local currency bonds outstanding in Asian economies grew from around $6.6 trillion in 2009 (70% of GDP) to $13.2 trillion in 2014 (79% of GDP). Most of the increase was in bonds issued by corporations, and it was mostly driven by strong growth in the PRC bond market, which accounted for 80% of the increase in corporate bonds.

1.3.3 Bank loans and local-currency bonds outstanding in Asia



Sources: International Monetary Fund. International Financial Statistics; Bloomberg; CEIC Data Company (all accessed 6 March 2015).
Click here for figure data

1.3.4 Bank loans and local-currency bonds outstanding in Asia, excluding the People's Republic of China



Sources: International Monetary Fund. International Financial Statistics; Bloomberg; CEIC Data Company (all accessed 6 March 2015).
Click here for figure data

1.3.1 Debt as a share of GDP, selected Asian economies (%)

Economy	2009	2013	Percentage point change (2009–2013)
Hong Kong, China	234	307	72
Malaysia	242	277	36
Singapore	201	233	32
Thailand	193	224	31
Pakistan	64	86	22
People's Republic of China	215	235	20
Philippines	91	99	8
Bangladesh	67	74	7
Indonesia	57	64	7
Republic of Korea	274	277	4
Viet Nam	125	129	4
India	164	161	–3
Sri Lanka	92	89	–3
Kazakhstan	85	65	–20

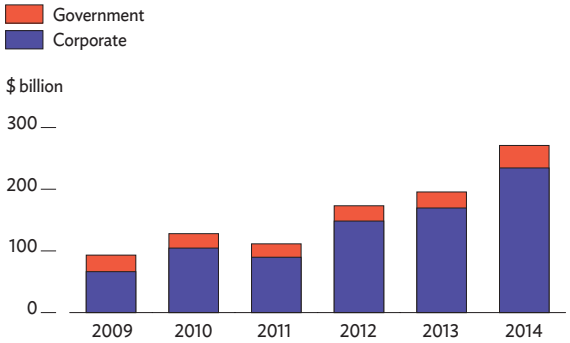
Sources: International Monetary Fund. International Financial Statistics; Bloomberg; CEIC Data Company (all accessed 6 March 2015).

In some economies, governments were the main borrowers. The governments of both Malaysia and Pakistan increased their bond issuance substantially following the global financial crisis. One concern is that excessive public debt can be a drag on the economy and even precipitate a loss of confidence in it. Reinhart and Rogoff (2010) warned that high public debt could hurt growth prospects. The research found that when public debt exceeded 90% of GDP, growth performance tended to decline. However, more recent research by Pescatori, Sandri, and Simon (2014) did not find a clear threshold at which public debt had this association.

In addition to the rise in domestic debt, the region has seen an increase in foreign currency borrowing. With US interest rates close to zero and liquidity plentiful, foreign investors have flocked to the region in search of higher yields. Corporations have responded to the increased appetite for bonds by issuing a record amount. Total foreign-currency bond issuance reached a record of $271 billion in 2014, nearly 3 times the 2009 level (Figure 1.3.5).

Almost all of the shift toward foreign-currency borrowing has been by corporations. Governments have continued to finance themselves almost entirely in local currency. The share of foreign-currency bonds in all corporate bonds has risen to about 11% in 2014 from 9% in 2009 (Figure 3.1.6). This means that the region's companies are becoming more exposed to risk from exchange rate fluctuation, but it is important to emphasize that the vast majority of the region's bonds are still in local currency. While exchange rate risk is rising, it is still small.

1.3.5 Foreign-currency bond issuance in developing Asia



Source: Bloomberg (accessed 6 March 2015).
Click here for figure data

Has debt been rising too quickly?

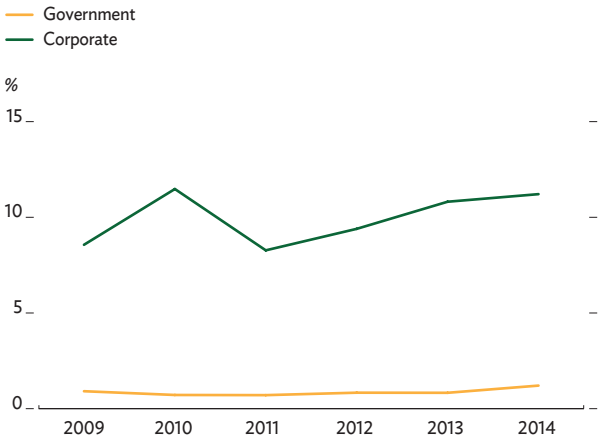
Asia's ratio of debt to GDP has increased dramatically. One concern is that the debt level may have risen too high for the region. This is difficult to judge because some of the increase reflects progress in developing the financial systems of regional economies. In addition, economies with better financial systems are better able to manage higher debt and ensure that it contributes to their development. These caveats suggest that it would be difficult to establish a threshold for the ratio of debt to GDP beyond which debt is considered too high, because the economies of developing Asia are too diverse.

In addition to concerns about the level of debt are concerns about the speed at which debt has grown. Policy makers tend to be concerned about any rapid rise in debt, as excessive growth in credit has been linked with increased probability of crisis. In addition, it is a vexing problem to determine when credit growth is too high. One indicator suggested by Mendoza and Terrones (2012) to classify credit booms compares the debt level to the historical trend to see if growth exceeds a certain threshold. This allows analysts to take into account financial deepening in each economy. Using this methodology, deviation from trend in each economy is calculated from 2000 to 2013 using the Hodrick–Prescott filter with a smoothing factor of 100. Following Mendoza and Terrones (2012), any deviation that exceeds 1.65 times the standard deviation of the cyclical component is considered to be excessive. This threshold identifies six episodes of excessive credit growth: in the PRC in 2003, India in 2003, Kazakhstan in 2007 and 2009, Sri Lanka in 2003, and Viet Nam in 2010.

In Kazakhstan, the credit boom was fueled by banks' large external borrowings, which dried up during the global financial crisis. The devaluation of the Kazakh tenge in 2009 further weakened the banks' positions. The government was forced to step in to rescue the three largest banks. Since then, Kazakhstan has been deleveraging, and the ratio of debt to GDP fell by 20 percentage points from 2009 to 2013. Viet Nam did not experience a banking crisis following its recent credit boom episode. However, the rate of credit expansion dropped, and there are concerns about the rising prevalence of nonperforming loans in the banking system since the boom.

More recently, Malaysia, Singapore, and Pakistan have experienced rapid credit growth that brought their ratio of debt to GDP close to the threshold that defines a credit boom. If the trend of rapid growth were to continue, these economies could face increased risk of financial crisis. While the large increase in debt in the PRC in 2009 brought it close to the threshold, slower credit growth since then has brought its ratio of debt to GDP close to the trend.

1.3.6 Share of foreign-currency bonds in all bonds in developing Asia, 2009–2014



Source: Bloomberg (accessed 6 March 2015).

Click here for figure data

What can governments do to manage credit growth?

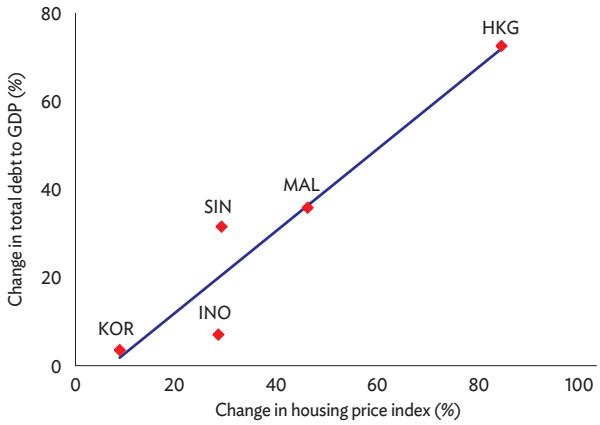
While the rapid rise of debt causes some concern to policy makers, no clear consensus exists on what should be done. It is difficult to separate out episodes of excessive surge in credit. One factor contributing to the rapid rise in debt in the region is the spate of capital inflows. Immediately following the global financial crisis of 2008–2009, the region witnessed a swift resumption of capital inflows. These where used both to finance bank lending and to generate demand for bond issuance. Easy liquidity has been partly driven by expansionary monetary policies in the advanced economies and arguably threatens to undermine lending standards. As capital flows into the region have continued to grow, concerns rise that they could inflate asset bubbles and destabilize asset prices and domestic financial markets.

While the rise in debt can help facilitate faster growth in the region, it could also deepen any crisis. Monetary policies in the region have been relatively expansionary, partly in response to weak global economic conditions. But governments have been quite reluctant to raise rates. One reason has been that inflationary pressures have been muted in the region, revealing little sign of overheating in the economy. This calm makes it more difficult for policy makers to use monetary policy to slow down growth in credit. And interest rate hikes are not without risk. They could push vulnerable companies into default, and higher domestic interest rates could encourage domestic borrowers to seek funds in foreign currency. To a certain extent, this is already reflected in the increased issuance of foreign-currency bonds by property companies in the PRC in response to difficulty in obtaining funds domestically.

More recently, macroprudential policy has been touted as a more targeted tool for directly tackling the problem of excessive credit. Its advantage is that it can be aimed at a specific sector and implemented without wide-ranging side effects on other sectors. Traditional macroprudential measures include capital and liquidity requirements, limits on the growth and composition of credit, and restrictions on the type of borrowers allowed access to loans.

Policy makers are concerned that the rise in debt has been fueling an asset bubble. Housing price data are limited, but where available they show the rise in debt accompanied by rising property prices (Figure 1.3.7). Zhang and Zoli (2014) found that policy makers in Asia have been addressing higher property prices with such macroprudential measures as requiring higher down payment percentages for mortgages.

1.3.7 Change in total debt and housing price, 2009–2013



HKG = Hong Kong, China, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, SIN = Singapore.

Sources: International Monetary Fund. International Financial Statistics; Bloomberg; CEIC Data Company (all accessed 6 March 2015).

Click here for figure data

Conclusions

While total debt has risen quickly in Asia, it does not pose a threat to growth in the near term. However, experiences in individual countries are quite diverse, with debt having even fallen in a few economies. As rapid growth in credit has been concentrated in economies with more developed financial sectors, they are likely to be relatively well prepared to manage it. Policy makers in these economies have actively applied macroprudential measures to target excessive lending to particular sectors.

Endnotes

1 Under the baseline scenario, output gaps are mostly negative to begin with, so negative real interest rates can spur growth, at least in the short-term. If persistent, however, negative real interest rates would tend to promote excessive credit growth and consumption, stoking high inflation that could harm growth.

2 Following International Monetary Fund (2008), the pass-through is calculated as the change between two periods in the domestic fuel price, valued in dollars at prevailing exchange rates, divided by the change in the world oil price.

3 The numbers are based on an informal survey conducted by regional offices of the Asian Development Bank. Some governments also publish detailed retail price survey data (Kojima 2012). Another source of cross-country information on fuel price data is https://energypedia.info/index.php/International_Fuel_Price

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Annex: Low oil price supports recovery

Benefitting from lower oil prices, the major industrial economies of the US, the euro area, and Japan are expected to maintain growth momentum in the next 2 years. Combined GDP growth for these economies will reach 2.2% in 2015 from 1.6% in 2014. Expansion will continue in 2016, when growth is expected at 2.4%. With the decline in commodity prices, inflation is expected to be muted in 2015 and stay below 2.0% in 2016 (Table A1.1).

Recent developments in the major industrial economies

United States

The US economy expanded by 2.4% in 2014. GDP growth has accelerated since the second quarter, following a severe winter that caused a contraction in the first quarter. The economy continues to

A1.1 Baseline assumptions on the international economy

	2013	2014	2015	2016
	Actual	*Estimate*	*ADO 2015 Projection*	
GDP growth (%)				
Major industrial economies[a]	1.2	1.6	2.2	2.4
United States	2.2	2.4	3.2	3.0
Euro area	–0.4	0.9	1.1	1.4
Japan	1.6	0.0	1.1	1.7
Prices and inflation				
Brent crude spot prices (average, $ per barrel)	108.9	98.9	65.0	75.0
Food index (% change)	–7.1	–7.1	–6.0	0.0
Consumer price index inflation (major industrial economies' average, %)	1.3	1.5	0.7	1.9
Interest rates				
United States federal funds rate (average, %)	0.1	0.1	0.4	1.7
European Central Bank refinancing rate (average, %)	0.5	0.2	0.0	0.0
Bank of Japan overnight call rate (average, %)	0.1	0.1	0.1	0.1
$ LIBOR[b] (%)	0.2	0.2	0.5	1.8

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

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

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

benefit from solid growth in private consumption, which contributed 1.7% to the annual growth rate. A jump in investment in the second quarter strengthened growth momentum and increased investment's contribution to annual growth (Figure A1.1). Net foreign trade and services acted as a drag, as imports grew much faster than exports, consistent with the strengthening of domestic demand and a stronger US dollar.

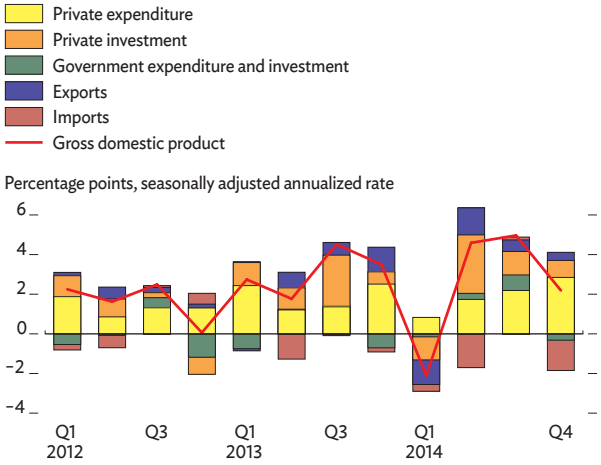
GDP grew at a solid seasonally adjusted annualized rate (saar) of 5.0% in the third quarter of 2014 and a lower but still solid 2.2% in the fourth. Despite slower expansion in the fourth quarter overall, the growth rate of private consumption was actually the strongest during the year, having accelerated in each quarter (Figure A1.1). The US consumer confidence index rose continuously in 2014 and returned to its pre-recession level in January 2015. The trend appears likely to continue this year (Figure A1.2). Somewhat echoing this trend is retail sales, which generally increased during the period. Retail sales weakened somewhat in December 2014 and January 2015, but this appears to be a temporary setback. Retail sales should turn upward again as suggested by strong consumer confidence and rebounding hourly earnings for workers in January 2015.

Investment generally increased during 2014. Investment growth rebounded sharply in the second quarter and contributed positively to growth in the following quarters. Fixed investment continued to expand, driven mainly by strong growth of 6.3% in real nonresidential fixed investment, reflecting a continuing rise in spending for equipment. Purchasing managers' index values remained solid despite the fall from 58.7 in November 2014 to 56.3 in both December 2014 and January 2015, as the value well above 50 indicates that manufacturing continued to expand. The industrial production index rose steadily throughout 2014, from 101 in the beginning of the year (2007 = 100) to 106 in December. These trends in manufacturing and industrial production reaffirm last year's conjecture on the increasingly important role of investment in supporting the US economic recovery.

The labor and housing markets continued to underlie improvement in the US economy in 2014. The unemployment rate declined persistently, dropping from 6.6% in January 2014 to 5.5% in February 2015. The average duration of unemployment has also shortened gradually, from 36 days at the beginning of the year to 33 days toward the end of February. The growth in nonfarm employment, supported by the addition of jobs in industry, has also shown a gradually strengthening trend (Figure A1.3). The housing price index extended its upward trend that began in 2012. Housing starts showed a similar trend, suggesting continued recovery in residential construction.

Inflation, both headline and core, remained below the Federal Reserve's target, as low energy prices continued to

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



Q = quarter.

Sources: US Department of Commerce. Bureau of Economic Analysis. http://www.bea.gov; Haver Analytics (both accessed 2 March 2015).

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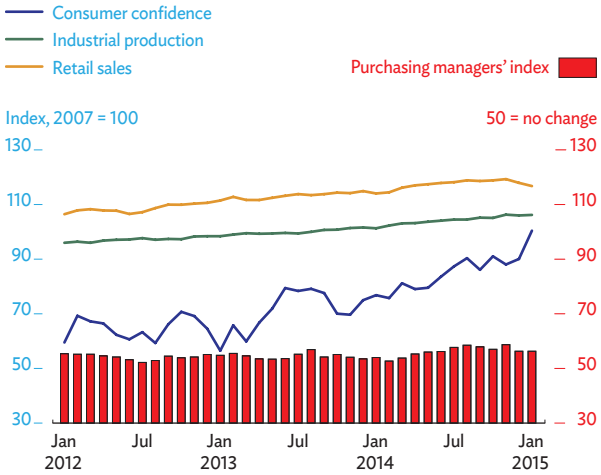
A1.2 Business activities and consumer confidence indicators, United States



Note: For the purchasing managers' index, a reading <50 signals deterioration of activity, >50 improvement. The index is compiled by the Institute for Supply Management.

Sources: CEIC Data Company; Haver Analytics (both accessed 4 March 2015).

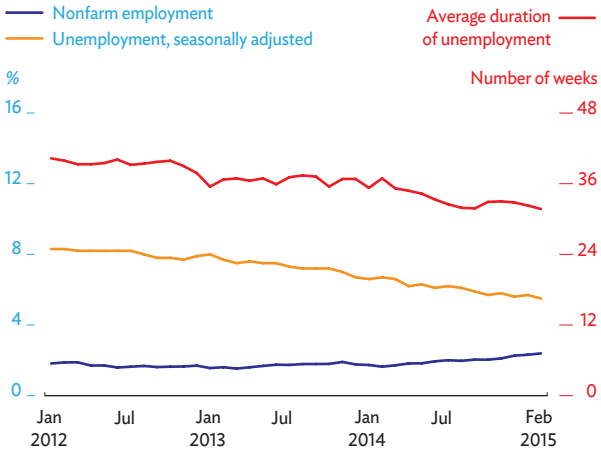
Click here for figure data

limit inflation throughout the year (Figure A1.4). The risk of inflation taking off before this year is negligible in view of the prospects for international commodity prices, and the Federal Reserve projects inflation approaching its 2% target only in 2016. In January 2015, US consumer prices fell. This decline does not signal a turn to deflation, however, as it mainly reflected very low food and oil prices. Core inflation stayed at its December rate in January as headline inflation fell.

In 2014, the Federal Reserve ended its program of monthly asset purchases (so-called quantitative easing) but it has been cautious about normalizing policy rates. While the Federal Reserve is expected to begin raising policy rates this year as US economic performance improves, it will likely adopt a gradual approach beginning in the second half of this year in light of inflation remaining muted and despite the strengthening labor market. The US policy rate is forecast to average 0.4% in 2015 before increasing to around 2.0% by the end of 2016. Thus, overall liquidity should remain loose in 2015, continuing to encourage growth in credit from commercial banks.

Looking ahead, relatively strong growth momentum will continue to support gradual economic recovery in 2015 before picking up further in 2016 as the economy closes more of the output gap. Expanding private sector activity appears likely to continue leading the measured economic recovery. Continued positive signs in investment, consumption, housing, employment, and credit suggest that the economy should continue to strengthen gradually. GDP in the US is forecast to grow by 3.2% in 2015 and 3.0% in 2016. Inflation is projected to remain low at 0.8% in 2015 before picking up further to 2.4% in 2016, partly reflecting the low base.

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



Source: CEIC Data Company (accessed 16 March 2015).
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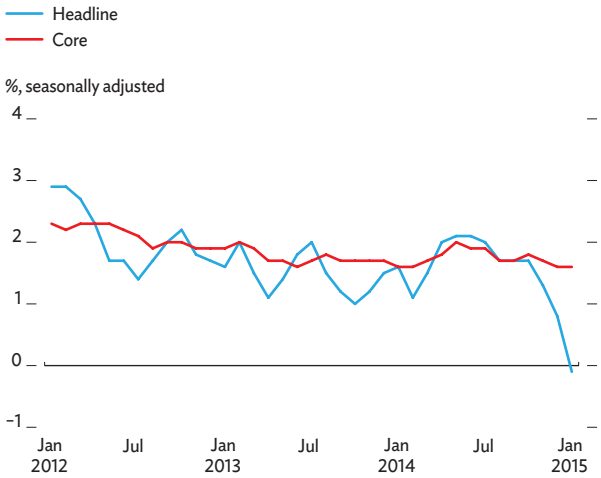
A1.4 Inflation, United States



Source: CEIC Data Company (accessed 4 March 2015).
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Euro area

The euro area showed signs of a mild pickup toward the end of 2014 and into the current year, aided by falling oil prices and a weak euro. Positive business and consumer sentiment has buoyed the recovery, despite turmoil from the Greek crisis. However, industry in the euro area is struggling, and cross-country differences in GDP growth persist. High unemployment, a drop into deflation, and uncertainty surrounding Greece's future in the currency union are major concerns for European policy makers and could stymie growth in the region.

GDP in the fourth quarter of 2014 grew by a saar of 1.4% over the previous quarter, the highest since the first quarter of 2011. This raised growth for the year to 0.9%, reversing the 0.4% contraction in 2013 (Figure A1.5). Among the major economies, Germany and Spain achieved relatively high growth rates of 2.8%, while GDP in France increased by a slight 0.3% and Italy stagnated. Among the peripheral economies, Greece recorded a drop of 0.8% in the fourth quarter.

Disaggregating the area's GDP growth shows a relatively balanced contribution from all components, suggesting that the recovery extends

beyond private consumption. In particular, gross fixed capital formation added 0.3 percentage points to growth in the fourth quarter of 2014, compared with none in the previous quarter. Net exports contributed 0.9 percentage points to growth, as exporters may be starting to benefit from the depreciation of the euro since June of last year. The contributions of consumption were similar to those in the previous quarter, at 1.0 percentage point for private consumption and 0.1 percentage points for public.

Despite the rebound in investment, industrial production in the euro area stagnated, with average growth of 0.2% month on month in the last quarter of 2014 and a decline of 0.1% in January 2015. However, the sector may improve, albeit at a slow pace, as the purchasing managers' index rose in December, January, and February to a 7-month high of 53.3. A value above 50 indicates expansion in economic activity, and the consecutive increases in the index bode well for GDP growth in the first quarter of 2015. The European Commission's economic sentiment index also improved in January.

Consumption in the euro area appears to be strengthening. Retail sales rose steadily from October 2014 to January of this year, growing by 1.1% in January. February's rise in the consumer confidence index, on the back of the previous few months' improvements, suggests that consumers are more optimistic about Europe's prospects than in the past (Figure A1.6).

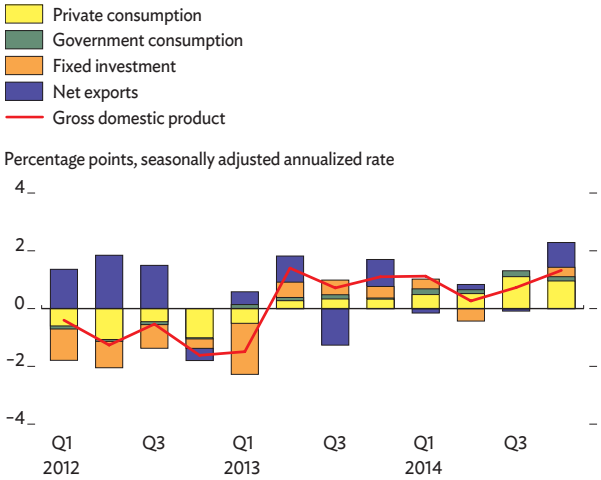
Supporting stronger consumption demand, unemployment fell in January for the third consecutive month to reach its best level since April 2012. Nevertheless, the rate is still historically high at a seasonally adjusted 11.2%, and labor market conditions vary considerably across countries. The highest unemployment rates—in double digits—were in Greece at 25.8% in November, Spain at 23.4%, and Cyprus at 16.1%. At the better end of the scale were Germany at 4.7%, Austria at 4.8%, and Luxembourg at 5.9%.

Inflation in the euro area has remained under the 2% target of the European Central Bank for almost 2 years. Inflation turned negative early in 2015, with the harmonized index of consumer prices recording −0.6% in January and −0.3% in February (Figure A1.7). While the bank has kept its policy rate unchanged at 0.05% since September 2014, in January 2015 it announced an expanded asset purchase program to include the purchase of sovereign bonds, with the aim of reviving the economy and hoisting inflation close to the target rate (Box A1.1).

Recent indicators suggest that growth will accelerate in 2015. Lower oil prices may boost consumption and investment and, together with an expansionary monetary policy, can support growth. The forecast for growth in the euro area is 1.1% in 2015 and 1.4% in 2016.

But risks to the outlook persist, mainly from two sources. One is that deflationary pressures are strong, as suggested

A1.5 Demand-side contributions to growth, euro area



Q = quarter.
Source: CEIC Data Company (accessed 9 March 2015).
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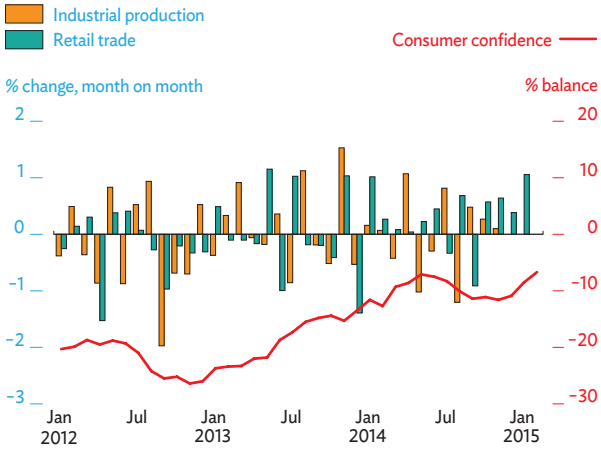
A1.6 Selected economic indicators, euro area



Source: Haver Analytics (accessed 9 March 2015).
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A1.1 European Central Bank quantitative easing

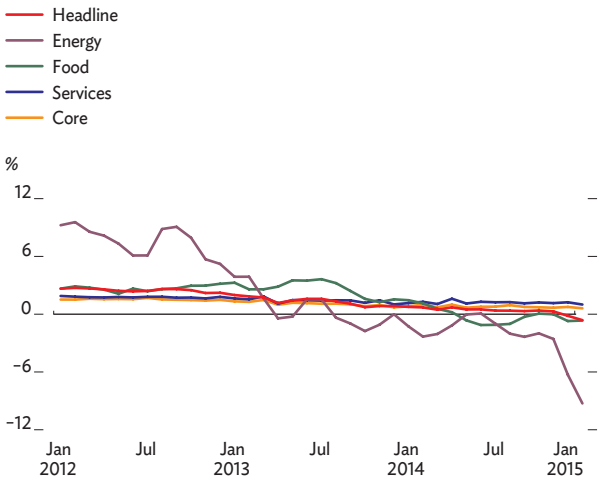
On 22 January 2015 the European Central Bank (ECB) announced a quantitative easing program starting on 9 March and extending at least until September 2016. It involves purchases of euro-denominated sovereign bonds on top of the existing purchases of asset-backed securities and covered bonds. The ECB plans to purchase a total of €60 billion in public and private bonds every month in this period, for a total of about €1.1 trillion in purchases. In line with its objective of raising the rate of inflation in the euro area from –0.2% in February to something near the central bank's target of 2.0% in the medium term, the ECB kept the program's deadline potentially open-ended until it sees, as the ECB president stated when announcing the program, "a sustained adjustment in the path of inflation."

National central banks will purchase securities according to their share of ECB capital, which reflects their country's share in the combined population and gross domestic product of the European Union. Under the program, national central banks can buy assets with residual maturities of 2–30 years at the time of purchase. Purchases of debt with negative yield are allowed so long as the yield is above the ECB deposit rate (currently –0.2%). According to the program, the national central banks will assume most of the risk, with only 20% of the purchases subject to risk-sharing by the ECB. This arrangement addresses the concerns of some core euro area countries that the ECB bond purchases will discourage debt-ridden peripheral countries from limiting their debt. In addition, the ECB will buy not more than 25% of each issue and only up to 33% of each issuer's outstanding debt, to avoid becoming the dominant creditor.

by the drop in core inflation (which omits energy and food) to a low of 0.6%. With spare capacity in the region and demand subdued by high unemployment, a prolonged period of deflation can slow growth as well as hinder countries' debt-consolidation efforts.

Second, the potential of Greece defaulting on its debt and exiting the euro (dubbed Grexit) poses a risk to the area's growth prospects. The other euro area countries, along with the European Central Bank and the International Monetary Fund, agreed to a 4-month extension of the current bailout program along with a loan equivalent to €240 billion. The program was extended on the condition that Greece would implement economic reforms and austerity measures to control its debt. While this reduces the immediate risk of Grexit, the long-term unsustainability of Greece's fiscal position remains a source of uncertainty for the euro area.

A1.7 Inflation, euro area



Source: Haver Analytics (accessed 9 March 2015).
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Japan

The Japanese economy contracted sharply in the 2 quarters following the April 2014 rise in the value-added tax (VAT) rate. Disappointing recovery in the fourth quarter meant no growth for the whole of 2014. The Cabinet Office estimates that the negative output gap widened to 2.8% of GDP, or ¥15 trillion, by the end of 2014—substantially greater than the 0.4% of GDP recorded at the beginning of the year. The government decided to postpone the second VAT hike by 18 months, to April 2017, to avoid another drop in consumption and return to deflation.

While boom and bust in domestic demand around the time of the VAT hike was anticipated, the magnitude and duration of the swings were not. Private consumption rebounded from the second quarter's

record drop by a saar of 18.7% to a mild increase at a saar of 1.6% in the second half of 2014 (Figure A1.8). The recovery in consumption could not offset the correction in residential investment or private destocking, which subtracted 4.4 percentage points from growth during the same period. However, business conditions are generally considered to be improving. Moreover, the labor market is tightening, with the unemployment rate declining to 3.6% from the peak of 5.5% recorded in July 2009. However, the recovery has not yet passed through fully to business investment or wages, which returned to positive growth only in the fourth quarter, reaching 0.1% and 0.4%, respectively.

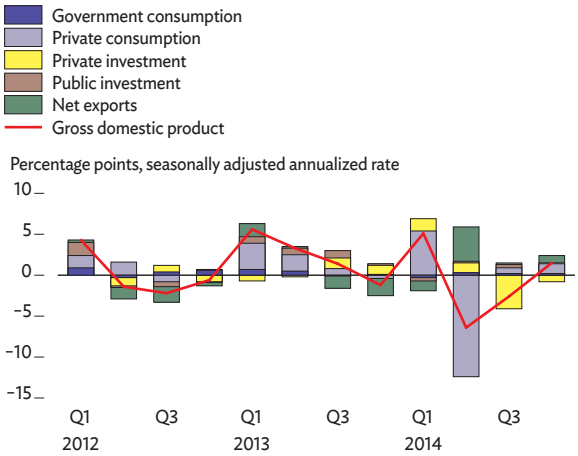
The accelerating US economic recovery and the Bank of Japan's continued monetary easing weakened the Japanese yen in 2014. The currency depreciated by almost 14% against the US dollar and by 5.9% in real effective terms from January 2014 to January 2015. While the depreciation has not boosted exports, the fall in imports more than halved the deficit in trade of goods and services to $12.6 billion over the year. Imports of both capital goods and consumer goods declined, but the contraction in imports of consumer durable goods was particularly severe at 7.3%, reflecting a correction from the advance purchase of durables before the VAT hike. Primary income from financial assets offset the trade deficit sufficiently to allow a current account surplus of 0.5% of GDP for 2014 as a whole. The external sector's contribution to GDP was nil this year, which improved on being a drag on growth in 2013.

When the government hiked the VAT rate from 5% to 8% in April 2014, headline consumer price inflation jumped from 1.5% in the first quarter to 3.6% in second. However, the collapse of oil prices in the second half of last year slowed inflation to 2.4% by January 2015. The GDP deflator finally stopped falling in 2014 and rose by 1.6%, after the decline of 0.6% in 2013. The rise in the GDP deflator was the first since 1997, similarly coinciding with an increase in the VAT rate from 3% to 5% (Figure A1.9).

Japan's growth outlook is generally positive but faces uncertainties. With higher VAT revenues, the primary fiscal deficit is estimated to have narrowed to 3.6% of GDP in FY2014 from 5.2% in the previous fiscal year. Postponing the second phase of the VAT increase will support growth momentum in the short run but halt fiscal consolidation on the revenue side. The government is expected to pursue prudent measures on the expenditure side to arrive at primary budget balance by 2020. Hence, public demand, both consumption and investment, should be muted during the forecast period. Growth will have to rely on private demand that is still somewhat fragile.

Private consumption started rising in the second half of last year but not enough to reverse the drop in the first half, thus subtracting 0.7 percentage points from growth in 2014. Recovery is expected to remain slow in view of weak price pressures expected

A1.8 Demand-side contributions to growth, Japan

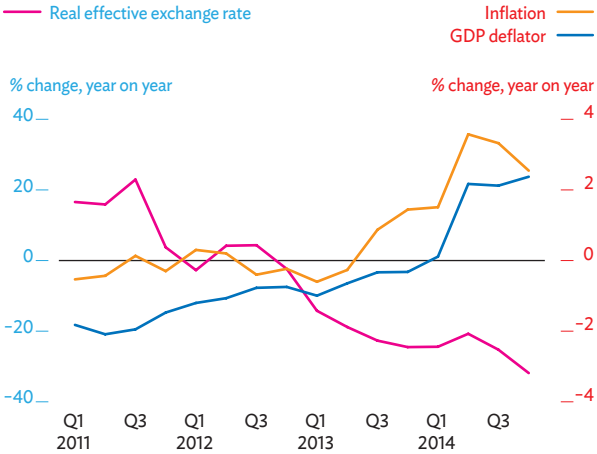


Q = quarter.

Source: Economic and Social Research Institute, Cabinet Office, http://www.cao.go.jp/en/about.html (accessed 9 March 2015).

Click here for figure data

A1.9 Consumer price, GDP deflator, real effective exchange rate, Japan



Q = quarter.

Sources: Haver Analytics; Economic and Social Research Institute, Cabinet Office, http://www.cao.go.jp/en/about.html (accessed 9 March 2015).

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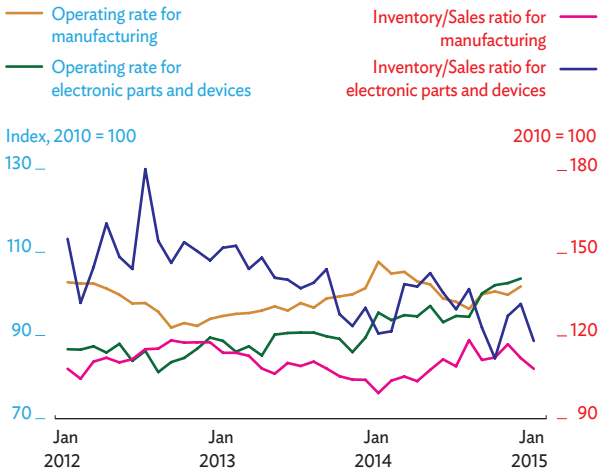
this year. Investment is expected to pick up as corporate profits improve, but again only gradually, as production is well under full capacity and inventories remain high relative to sales in most industries, except perhaps electronic parts and devices (Figure A1.10). Construction weakened sharply after the VAT hike. Housing and building starts, both residential and nonresidential, have continued to decline since the second quarter of last year (Figure A1.11).

One positive development is an agreement, reached in February of this year, to reshape the historically protected and uncompetitive agriculture sector. The agreement to weaken the authority of the Central Union of Agricultural Cooperatives—Japan's powerful farm lobby—is expected to help advance within this year the Trans-Pacific Partnership negotiations with the US on agricultural products. This may improve sentiment toward investment in agriculture to help the government reach its goal of doubling food exports by 2020, though the short-run impact may be limited.

The baseline scenario for 2015 assumes that domestic consumption and investment will recover gradually, while external demand, particularly in the euro area, will strengthen in the second half of the year. The rise in the GDP deflator will decelerate somewhat but remain positive. For 2016, the baseline assumes that private consumption of durable goods and investment in housing will rise somewhat in anticipation of the further rise in the VAT from 8% to 10% on 1 April 2017. In sum, Japan's growth rate in 2015 is forecast at 1.1%, rising to 1.7% in 2016.

The Bank of Japan estimates that low oil prices will reduce consumer price inflation by 0.7–0.8 percentage points in 2015 but add 0.1–0.2 percentage points in 2016. Meanwhile, monetary policy is expected to remain accommodative, with the possibility of an additional boost if inflation is weaker than expected. With potential output estimated to grow by 0.7% in 2015 and 0.8% in 2016, the output gap is likely to remain negative during the forecast period. If the global oil price rises only gradually, as now expected, and the negative output gap remains, headline inflation is likely to hover just above 1% during the forecast period.

A1.10 Operating rate and inventory-to-sales ratio of manufacturing and electronic parts and devices, Japan



Source: Haver Analytics (accessed 9 March 2015).
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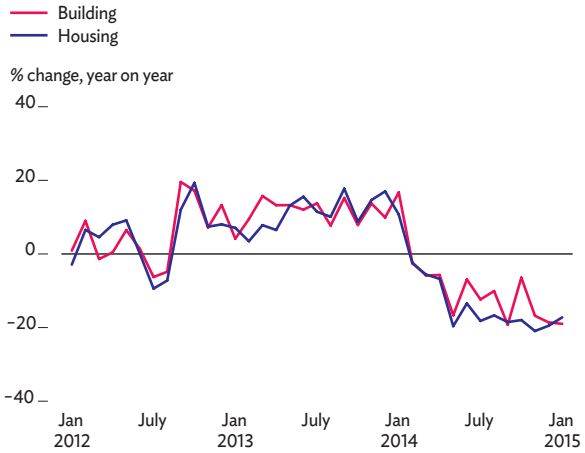
A1.11 Housing and building starts in Japan, by floor area



Source: Haver Analytics (accessed 9 March 2015).
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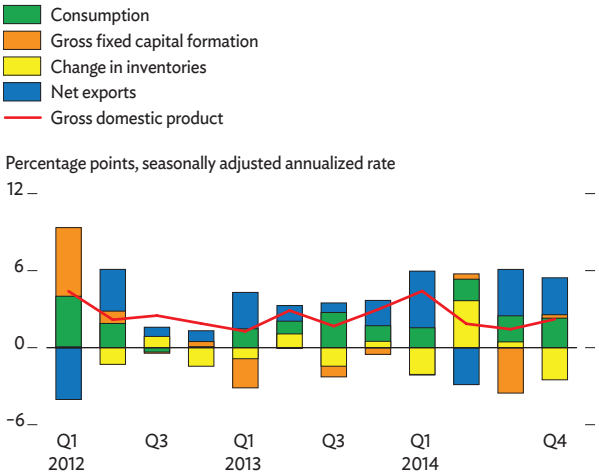
Australia and New Zealand

In the fourth quarter of 2014, Australia's economy expanded by a saar of 2.2%, faster than the 1.4% growth in the previous quarter. The increase came mainly from consumption, which contributed 2.3 percentage points to growth, while fixed capital investment reversed from contraction to mild expansion but changes in inventories dragged growth down by 2.5 percentage points (Figure A1.12). Seasonally adjusted retail sales grew by 0.2% in December, marginally above the 0.1% growth in November. Consumer sentiment returned to positive territory in February, rising to 100.7 points from January's 93.2 points. However, the seasonally adjusted

unemployment rate increased to 6.4% in January from 6.1% in December, reflecting 12,200 jobs lost. The Australian Industry Group's performance of manufacturing index, where 50 is the threshold for growth, fell to 45.1 in February 2015 from 49.0 in January, indicating a further slowdown in manufacturing. Inflation slowed to a seasonally adjusted 1.6% in the last quarter of 2014 from 2.2% in the third. Declining oil prices and lower interest rates should boost household consumption, so a pickup in consumer spending should buoy the economy. The consensus forecast is for GDP to grow by 2.6% in 2015 and pick up to 3.0% in 2016.

New Zealand's GDP accelerated to a saar of 5.5% in the third quarter of 2014 from 0.7% in the second. The expansion reflected strong private consumption, which contributed 3.6 percentage points to growth, and fixed investment, which contributed 3.5 points (Figure A1.13). In the fourth quarter, seasonally adjusted retail sales rose by 1.6%, higher than the previous quarter's 1.1%. Manufacturing continued to expand, with the performance of the manufacturing index above the threshold of 50. That said, it fell to 50.9 in January 2015 from 57.1 in December. Business confidence recovered in October to 26.5 from a low 13.7 in the previous month, and in February 2015 it improved further to 34.4. Consumer confidence remained positive, though the index decreased by 1.6% in the fourth quarter to 114.8 points. Inflation slowed to 0.8% in the last quarter from the third quarter's 1.0%, but the seasonally adjusted unemployment rate increased to 5.7% from 5.4%. Rising construction, higher net migration, a robust labor market, and strong private consumption are expected to sustain growth. Following growth estimated at 3.2% in 2014, Consensus Forecasts panelists foresee the economy expanding by 2.9% in 2015 and 2.6% in 2016.

A1.12 Demand-side contributions to growth, Australia



Q = quarter.
Source: Haver Analytics (accessed 9 March 2015).
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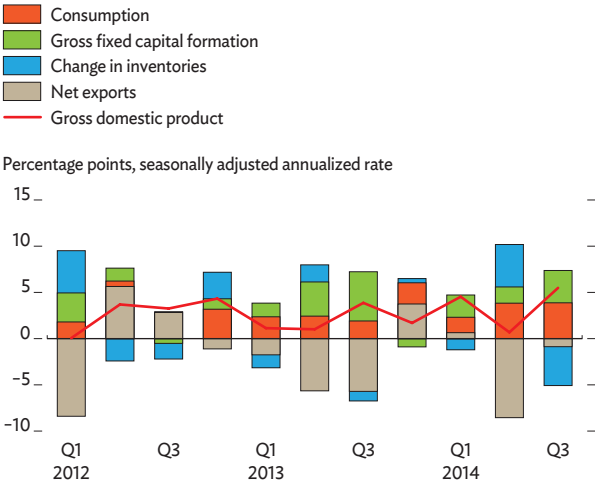
A1.13 Demand-side contributions to growth, New Zealand



Q = quarter.
Source: Haver Analytics (accessed 9 March 2015).
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Commodity prices

Supply factors will continue to dominate the outlook for commodity prices. The sharp decline in oil prices will leave Brent crude well below its 2014 price in both 2015 and 2016. However, with growth forecast to pick up in the major industrial economies and some adjustments to supply likely, oil will rise somewhat. With low oil prices restraining input price pressures and supply providing enough cushion for changes in demand, food prices will continue to decline in 2015. In 2016, though, the expected pickup in fuel prices will likely leave food prices generally flat.

Oil price movements

Oil prices plunged in the second half of 2014, ending almost 4 years of relatively stable but elevated prices that averaged around $110 per barrel (Figure A1.14). From its peak of $115 per barrel on 19 June 2014, oil prices fell by more than half to end the year below $60. While dramatic, the

decline was not unprecedented. The market has experienced six episodes of sharp price decline since 1980, the most severe of which coincided with the sudden onset of the global financial crisis in 2008 (Figure A1.15). The most recent decline was the longest by far, but its 60% drop from peak to trough was not nearly as steep as the July–December 2008 decline, when oil prices plummeted by 77% from $146 per barrel to $34.

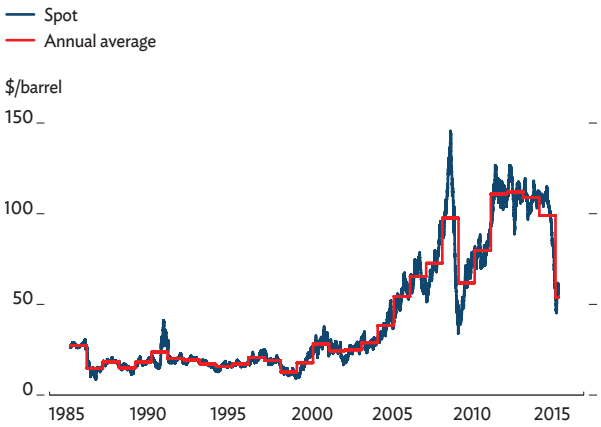
The recent price-drop episode was mainly supply driven. Spurred by the high oil prices that prevailed for more than 3 years before the current drop, companies in North America invested in new technologies to open up hard-to-extract resources. Crude oil production in the US alone soared from an average of 5.6 million barrels per day in 2011 to an average of 8.3 million in the first half of 2014.

Initially, the increased US production was largely offset by production declines caused by civil war in Libya, an offensive by Sunni militants in Iraq, and sanctions on Iran imposed by the US and the European Union. The US Energy Information Administration reported that these and other conflicts removed 3.2 million barrels per day from the market in the first half of 2014. But many of these disruptions started easing in the second half of 2014. Libya surprised markets by producing 900,000 barrels per day in October amid political turmoil, while Iran was able to sustain production despite sanctions. Supply disruptions in Iraq from the ongoing Islamic State incursion eased, and oil production there bounced back by 600,000 barrels per day from August to December.

With global GDP growth relatively slow, world oil supply growth has outpaced demand growth, pushing crude oil prices down. As international oil transactions are settled in US dollars, the appreciation of the dollar has kept the local currency price of oil from falling as much as international prices, tempering demand from countries that do not peg to the dollar. Moreover, improved energy efficiency and developments in natural gas and renewable energy have lowered the oil intensity of global GDP. According to the International Energy Agency, demand for oil in member economies of the Organisation for Economic Co-operation and Development fell from an average of 46.1 million barrels per day in 2013 to 45.6 million in 2014. The gap between production and use has lifted oil inventories, which had been run down prior to the 2008 price drop (Figure A1.16).

Another factor causing a faster decline in oil prices was a change in the policy objective of the Organization of the Petroleum Exporting Countries (OPEC). Markets had expected OPEC to cut production to stabilize oil prices and were surprised by the announcement after the 27 November 2014 policy meeting that it would maintain current production to defend market share. Thus the combined effect of increased US production, revived Middle East production, subdued global GDP growth, and the change in OPEC policy caused oil prices to plummet from a peak of $115 per barrel

A1.14 Price of Brent crude



Sources: Bloomberg; World Bank Commodity Price Data (Pink Sheet), http://econ.worldbank.org (both accessed 5 March 2015).

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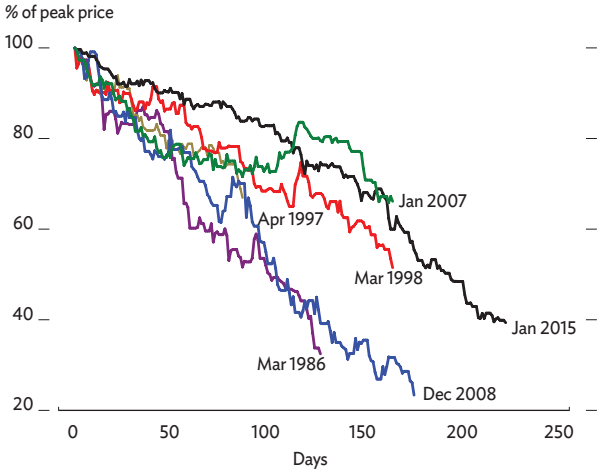
A1.15 Oil price declines



Source: Bloomberg (accessed 5 March 2015).

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in June 2014 to $45 in late January 2015, though it bounced back to trade closer to $60 per barrel in February. It is currently trading in the narrow band of $54–$61.

Oil price prospects

With the forecast improvement in the world economy, global oil consumption is forecast to strengthen but remain fragile. The International Energy Agency forecasts global consumption to increase slightly by 1 million barrels per day in 2015 and 2016. The diminishing role of oil in the fuel mix as economies become more energy efficient and shift to renewable sources of energy will weaken the ability of lower oil prices to revive oil demand.

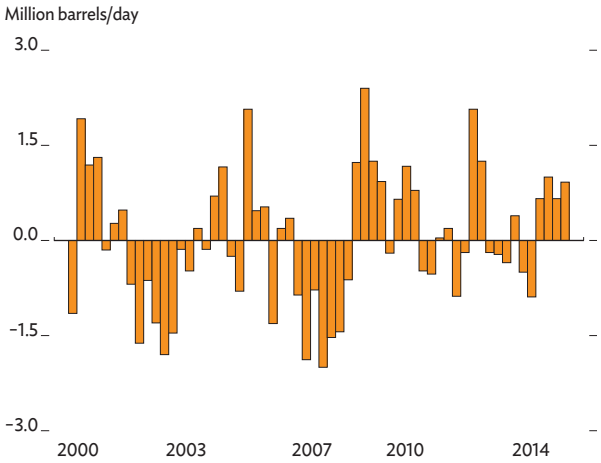
On the supply side, the wide variance in estimates of the breakeven price for US oil production make it difficult to predict how much extended low oil prices will affect production there. Although estimates of North American production have been reduced, the Energy Information Administration still expects US crude oil production to grow by 7.8% in 2015 and by another 2.4% in 2016, making North America the foremost contributor to global oil supply growth. Oil supply outside of OPEC is forecast to rise by 900,000 barrels per day in 2015 and 700,000 barrels per day in 2016.

As for OPEC, the November 2014 meeting called for continued production of 30 million barrels per day for 6 months. In the intervening 3 months, there has been no sign that OPEC will change its current stance, as some key member countries continue to defend their market share by offering discounts to Asian consumers (Figure A1.17).

Although threats to oil production and exports remain, the Energy Information Administration noted that continuing growth in non-OPEC production and strong Saudi Arabia production have made the current volume of supply disruption less important. Supply disruptions will still affect oil prices, but the severity of disruption that the market can tolerate has risen in light of robust global production.

With the lag between capital investments and the price changes that come in response, supply factors will continue dominate price movements through 2015. However, because shale oil has a shorter investment cycle than conventional oil, the lag in response has become shorter, making non-OPEC supply more responsive to price swings than suppliers were during past price declines. With rising demand and weakening supply, the market will be more balanced toward the latter part of 2015. Current futures prices suggest that the Brent crude oil price will stay within the range of $60–$70 per barrel for the remainder of 2015 (Figure A1.18). As faster global growth raises demand, prices will likely rise in 2016 but remain below the highs of the last 4 years. Barring additional major supply disruptions and weaker-than-expected global demand growth, the Brent crude oil price is forecast to average $65 per barrel in 2015 and $75 in 2016.

A1.16 Change in oil inventories



Sources: Bloomberg, US Energy Information Administration, http://www.eia.gov
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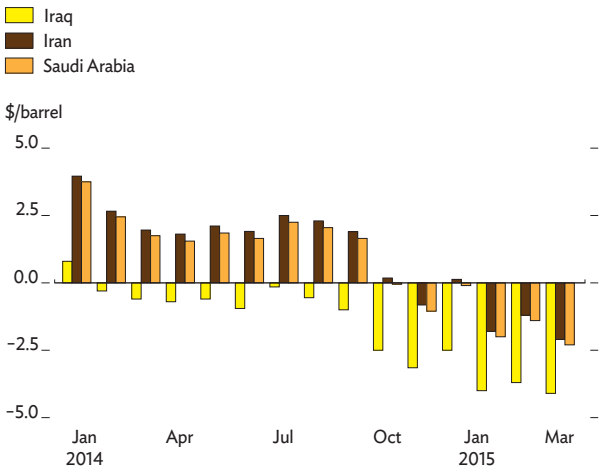
A1.17 Price discounts to Asia



Note: Data refers to light crude price differential to the Oman/Dubai Benchmark.
Source: Bloomberg (accessed 4 March 2015).
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Food price movements and prospects

Along with transportation and some manufacturing industries, agriculture would be a major beneficiary of lower oil prices. Lower oil prices usually coincide with low agricultural commodity prices (Figure A1.19). Agriculture commodity prices are linked to oil prices through the cost of inputs such as chemical fertilizer and hauling, and increasingly through demand for grains and oilseeds to produce biofuels.

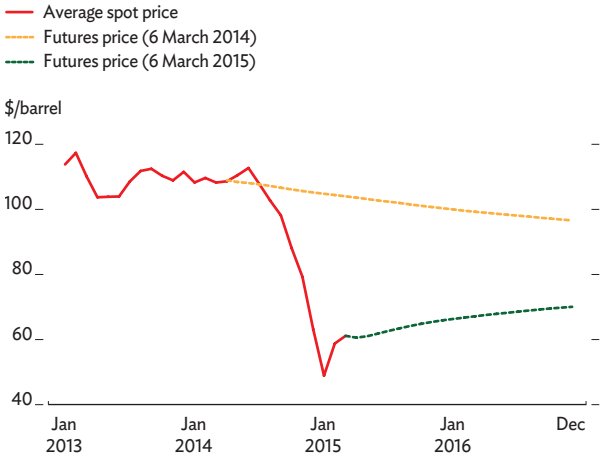
Agricultural commodity prices, especially for food, remained weak in 2014 (Figure A1.20). The overall agricultural commodity price index fell by 3.4% in 2014, with the sub-indexes for both food and raw materials declining. The edible oil price index declined by 6% in 2014, mainly reflecting record increases in global soybean production on unprecedentedly large yields in the US and South America. At the same time, the slump in crude oil prices depressed demand for palm oil and soybeans for use as biodiesel feedstock. The only sub-index posting an increase was the "other food" index, which rose by 4.3% in 2014 as tight supply and soaring demand for meat products supported prices.

Global food prices fell by 7.2% in 2014 as supply growth exceeded growth in demand for major crops, and as bumper crop harvests tempered price expectations. Increased wheat production in the US, Argentina, and the Commonwealth of Independent States pushed estimates of global production in the 2013/2014 crop year to an all-time high. The benchmark wheat price declined by 8.8% in 2014, its third consecutive year of decline (Figure A1.21). Similarly, sharp maize production increases in Canada, the Commonwealth of Independent States, the European Union, South Africa, and the US pushed international maize prices down by 26% in 2014. While supply increases pushed up the stock-to-use ratios for both wheat and maize—from 25.8 to 26.6 for wheat and from 16.0 to 18.2 for maize—the opposite was true for rice. The ending stock for rice declined in 2013/2014 as growth in consumption exceeded growth in supply. However, prices still declined in 2014 after their run-up in 2013 because of irregularities surrounding the paddy pledging scheme of the Government of Thailand.

The decline in food prices has continued into 2015, with the index dropping by 11.8% in the first 2 months. Prices for wheat, maize, and rice were all lower, but the decline was most pronounced for wheat. This reflects continued improvement in the prospects for wheat production in 2015, with world inventories already large.

The decline in food prices will continue this year, assuming no major production setback. A mostly favorable outlook for 2015 crop production provides a good backdrop for softer prices. The US Department of Agriculture forecast in its March 2015 report that 2014/2015 grain production would reach 2,475 million tons, up from an estimated 2,473 million in the previous crop year. The report envisages

A1.18 Brent crude futures and spot price



Source: Bloomberg (accessed 5 March 2015).
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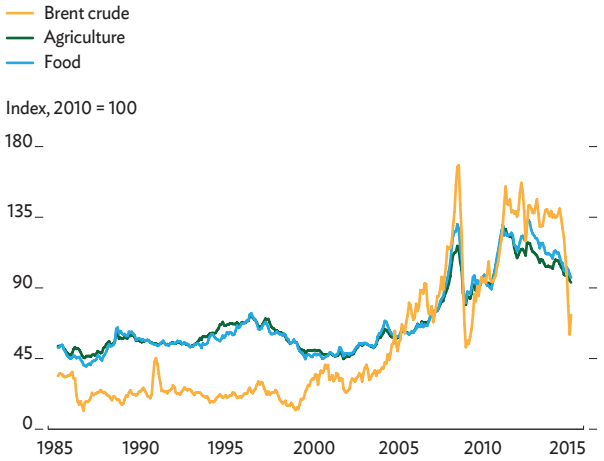
A1.19 Commodity prices



Source: World Bank Commodity Price Data (Pink Sheet), http://econ.worldbank.org (accessed 5 March 2015).
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a 1.2% increase in wheat production, and maize production essentially unchanged. As adverse weather in Thailand and Cambodia have weakened rice production prospects, rice production is forecast to decline by about 1% in the 2014/2015 crop year.

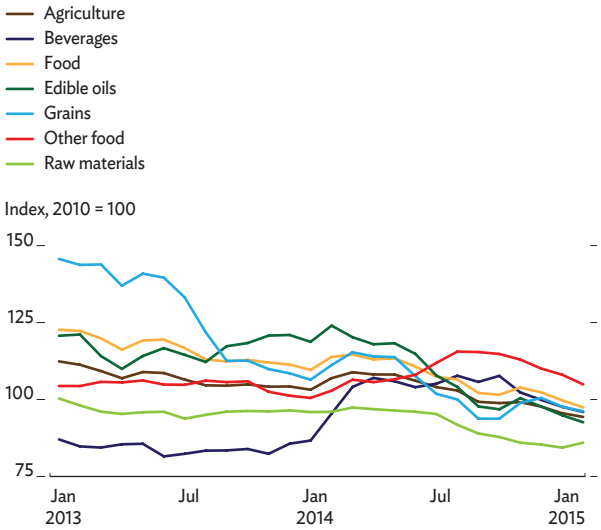
Concern over heavy flooding in Malaysia, the second-ranked palm oil producer and exporter, put upward pressure on vegetable oil prices in late January. However, low crude oil prices continue to temper increases in palm oil prices, as they raise concern about weak demand for palm for biofuel. Forecasts for soybean production in 2014/15 have been raised, reflecting prospects for good harvests in Argentina, Brazil, and the US. The downward pressure on prices induced by production increases will be offset by upward pressure from some policy changes pertaining to biodiesel. For example, France raised the concentration of biodiesel sold to the public from 7% to 8% from January 2015, and Brazil raised the mandatory amount of ethanol to be blended into commercial gasoline in March 2015. The higher ethanol blending mandate will provide major support for Brazilian ethanol demand and the sugar price.

With low oil prices holding back input price pressures, and supply providing enough cushion for changes in demand—and assuming no adverse weather or upshot from protectionist food policies—food prices are forecast to decline by 6% in 2015 and remain flat in 2016.

External environment in sum

The external environment should support steady GDP growth and muted inflation in developing Asia. The pickup in the pace of recovery in the major industrial economies should boost demand for the region's exports. The baseline forecasts assume monetary expansion in both the euro area and Japan to keep these economies from falling into extended deflation. Lower international oil prices should prove beneficial for global growth. While the dampening effect on inflation from relatively cheap oil will be short-lived, with prices expected to bounce back somewhat in the remainder of 2015 and through 2016, declining global food prices will keep inflation in check.

A1.20 Agricultural commodity prices



Source: World Bank Commodity Price Data (Pink Sheet), http://econ.worldbank.org (accessed 5 March 2015).

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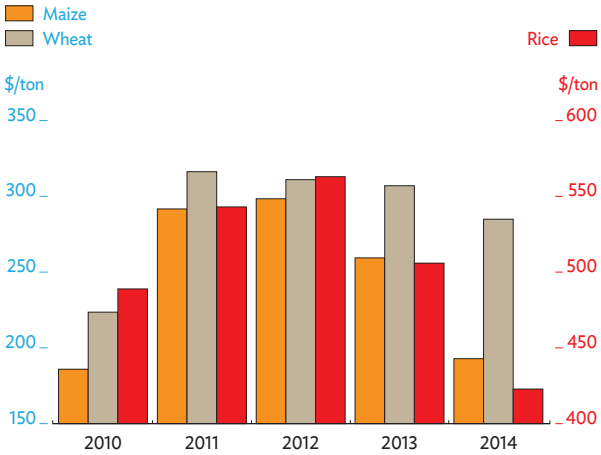
A1.21 International grain prices



Note: Prices for maize refer to US no. 2 yellow, for rice to Thailand 5% broken milled white rice, and for wheat to US no. 1 hard red winter.

Source: World Bank Commodity Price Data (Pink Sheet), http://econ.worldbank.org (accessed 5 March 2015).

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2

FINANCING ASIA'S FUTURE GROWTH

Financing Asia's future growth

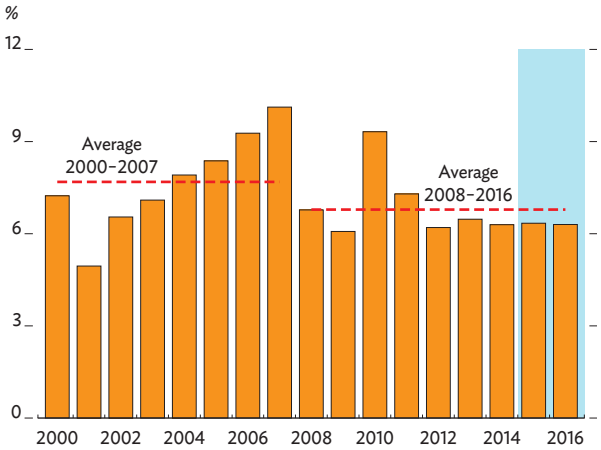
Why worry about financial development? The remarkable story of growth in developing Asia is well known. Yet, other than in the financial centers of Singapore and Hong Kong, China, the region's financial systems—its commercial banks and its bond and equity markets—remain relatively backward. Despite considerable widening and deepening since the Asian financial crisis of 1997–1998, developing Asia's financial sector lags well behind the advancing frontier of global finance. The stark contrast between Asia's dynamic real sector and its backward financial sector poses the question why now is the time for policy makers to turn their attention toward the sector.

Moreover, the global financial crisis of 2008–2009 made many suspicious of unfettered financial development and innovation. To many observers, the global crisis was the result of too much financial innovation and too many sophisticated products like mortgage-backed securities and collateralized debt obligations that profited only a narrow group of firms while exposing the entire financial system—and ultimately the real sector—to excessive risk. Although developing Asia is a long way from that state of financial sophistication, the extent of the global crisis has engendered a certain caution toward the sector.

Yet there are a number of reasons why a sound and efficient financial system matters more than ever for developing Asia. First, Asia's growth slowed in the wake of the global crisis (Figure 2.1.1), but a robust financial sector can help allocate resources more efficiently, fostering a dynamic private sector to reignite growth. Second, financial development can be inclusive, but this outcome cannot be taken for granted. Action is needed to ensure that financial development aligns with social equity goals. Finally, safeguarding financial stability must be a cornerstone of the financial development agenda. Financial instability, especially financial crisis, can derail growth and harm the poor, wiping out the benefits from financial deepening.

Thus the convergence of three strategic challenges—reigniting economic growth, tackling rising inequality, and maintaining financial stability—adds urgency to the long-standing task of building sound and efficient financial systems in developing Asia.

2.1.1 Aggregate GDP growth rates in developing Asia, 2000–2016



Source: Asian Development Outlook database.
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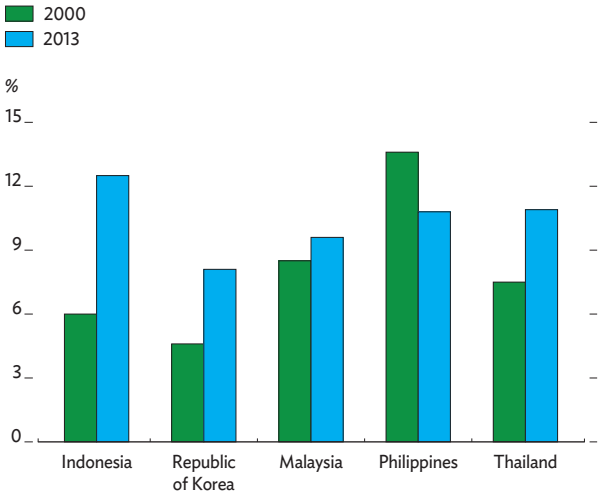
This chapter was written by Donghyun Park with Gemma Esther Estrada, Minsoo Lee, and Arief Ramayandi, all in the Economic Research and Regional Cooperation Department. It draws on the background papers listed at the end of the chapter. Background materials from Noritaka Akamatsu, Christopher Edmonds, and Joshua Greene are gratefully acknowledged.

The case for financial sector deepening

The region's financial system appears to be in much better shape today than it was during the Asian financial crisis of 1997–1998. While that crisis had multiple causes, inefficient financial systems that failed to allocate capital inflows to productive uses lay at the heart of it. The consequent deterioration in the quality of investments eventually precipitated capital outflows and the outbreak of the crisis. Extensive reform and restructuring greatly improved the health of the region's banking system after that financial debacle (Figure 2.1.2).

The impression remains that finance is relatively backward in developing Asia, but the data suggest otherwise. The financial sector in the region compares well with those of its developing economy peers outside Asia. Yet it clearly lags far behind financial sectors in the advanced economies. Should policy makers be concerned about this gap? The answer depends on the extent that financial development supports the economy's broader development goals. Turning to the evidence will help make the case that closing the gap is important for future growth in the region.

2.1.2 Bank capital to total assets in crisis-hit Asian countries



Source: World Bank, World Development Indicators online database (accessed 15 September 2014).

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The state of Asian financial systems

Evaluating the state of developing Asia's financial systems entails benchmarking the region against financial development in other parts of the world. To get a clear view of the issues, one must factor in wide heterogeneity within the region. Using the latest data from the World Bank's financial structure database, Table 2.1.1 shows the size of banking system deposits, stock markets, and public and private bond markets, all measured as a percentage of GDP for each region of the world and each subregion within Asia.

Developing Asia has on average a banking system that equals 60% of GDP, stock market capitalization at 71% of GDP, public bond markets at 26% of GDP, and private bond markets at 20%. Comparing developing Asia with other developing regions around the world, its financial system—whether measured by bank deposits or stock and bond market size—is larger than those of other developing regions, and also larger than those of high-income economies that are not members of the Organisation for Economic Co-operation and Development (OECD). On the other hand, compared with OECD members, developing Asia has a banking system and especially bond markets that are quite small.

Asia has two subregions whose financial systems are quite underdeveloped: Central Asia and the Pacific. More specifically, the financial systems of these economies are heavily dominated by banks,

2.1.1 Financial structure around the world, 2011

Economy/Subregion	Banking system	Stock market	Public bonds	Private bonds
Developing Asia	60.0	71.0	25.7	20.4
Central Asia	23.1	25.0	0.0	0.0
East Asia	60.1	73.4	25.9	27.8
South Asia	57.0	60.3	27.0	4.0
Southeast Asia	67.9	77.7	28.3	11.8
The Pacific	44.5	54.1	0.0	0.0
Rest of the developing world	43.5	50.2	18.4	8.5
Europe and Central Asia	42.7	25.4	17.5	0.8
Latin America and the Caribbean	41.9	47.3	25.2	13.5
Middle East and North Africa	67.4	40.1	1.9	0.0
Sub-Saharan Africa	38.4	103.5	8.7	5.2
High income	104.3	82.0	78.7	53.0
OECD members	110.2	84.7	85.3	57.6
Others	41.2	49.3	2.8	0.0

OECD = Organisation for Economic Co-operation and Development.

Notes: Banking systems are measured by the amount of deposits, stock markets by capitalization, and public and private bond markets by bonds outstanding, all expressed as a percentage of GDP. Regional averages are weighted by GDP. The OECD consists of Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Other high-income economies are Antigua and Barbuda; Aruba; Bahamas; Bahrain; Barbados; Bermuda; Croatia; Cyprus; Equatorial Guinea; Kuwait; Latvia; Lithuania; Macau, China; Malta; Monaco; Oman; Puerto Rico; Qatar; the Russian Federation; Saudi Arabia; Trinidad and Tobago; the United Arab Emirates; and Uruguay.

Source: ADB estimates based on data from Beck, Demirgüç-Kunt, and Levine (2000, 2009) and Cihak et al. (2012).

and the bond and stock markets remain underdeveloped (Annex table, page 102). Thus, funding in Central Asia and the Pacific comes largely through the banking system. Within Central Asia, Kazakhstan has the largest financial system, with a banking system amounting to 27% of GDP and a stock market at 28%. The financial systems of other economies in the region are much smaller by comparison.

In the Pacific, Papua New Guinea is the only economy with a stock market, which is large relative to GDP, at 80%. Banking systems in the region are rather small except in Vanuatu, where it equals 73% of GDP. The financial sectors in the three other Asian subregions—East Asia, Southeast Asia, and South Asia—are much more developed. Variation exists within each subregion, but on average financial sectors are larger than those in Central Asia and the Pacific.

As the comparison in Table 2.1.1 shows, developing Asia's financial sectors compare well with those in other parts of the developing world. However, much of this comes from the relatively advanced state of financial institutions in East Asia and Southeast Asia—especially those in Singapore and Hong Kong, China, which have become global financial centers. Cross-country variation reveals that some economies in the region suffer a financial sector gap in comparison with even other developing economies (Annex table, page 102).

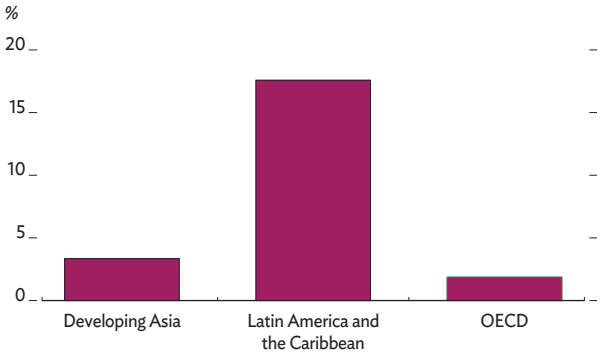
Relative financial backwardness has consequences for the cost of capital. Businesses in economies with lower financial development generally have to pay a higher premium over the deposit rate than those operating in financially advanced economies. Looking at the

average interest rate spread, developing Asia again compares well with Latin America but faces a considerable funding disadvantage against the advanced economies (Figure 2.1.3).

Somewhat contrary to the conventional wisdom of financial backwardness, the review above finds Asia's financial development comparing favorably with that of other parts of the developing world, though it is still well behind the advanced economies. But purely quantitative measures of financial development—such as the ratio of bank deposits or liquid liabilities to GDP—are far from perfect, as comparisons of sector size do not always capture differences in quality or efficiency. For example, Dekle and Pundit (forthcoming) points out financial development indicators should ideally encompass access and efficiency in addition to depth. And, according to Aizenman, Jinjarak, and Park (2015), the quality of finance, evident in the direction of credit to the most productive sectors of the economy, matters at least as much as the quantity of finance. However, greater liquid liabilities (a measure of financial development) often mean a tighter lending–deposit spread (a measure of financial efficiency), suggesting a positive relationship between the two (Figure 2.1.4).

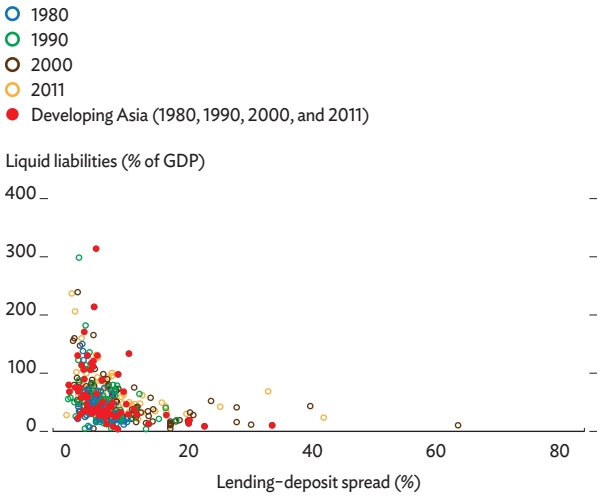
As noted above, the case for a sound and efficient financial sector in Asia rests on three pillars. First, financial sector development can yield a growth dividend in light of the large gap that still separates the region from the advanced economies. Second, financial access must be expanded and broadened to achieve more inclusive growth. Third, the region must safeguard its financial stability even as it develops its financial sector. The next three sections examine each pillar in turn.

2.1.3 Lending–deposit spreads, 2011



OECD = Organisation for Economic Co-operation and Development.
Sources: Beck, Demirgüç-Kunt, and Levine 2000, 2009; Cihak et al. 2012.
Click here for figure data

2.1.4 Liquid liabilities and lending–deposit spread



Sources: Beck, Demirgüç-Kunt, and Levine 2000, 2009; Cihak et al. 2012.
Click here for figure data

Financial development and growth

A robust and efficient financial system promotes growth by channeling resources to their most productive uses, thereby fostering more efficient resource allocation. A stronger and better financial system can buoy growth by boosting aggregate savings and investment rates, thereby speeding the accumulation of physical capital. Financial development further promotes growth by strengthening competition and stimulating innovation, thereby fostering dynamic efficiency.

Does the evidence support a positive link between finance and growth? Many studies have shown—using cross-country data, panel data that span time and economies, corporate data, or country case studies—that financial system depth significantly facilitates growth. In particular, higher growth is often associated with having a bigger financial system, as measured by liquid liabilities, private credit, and stock market capitalization.

Revealing cross-country regression studies include King and Levine (1993), which finds that financial depth positively influences growth in income, capital stock, and productivity in a sample of

77 countries during 1960–1989; Levine and Zervos (1998), which finds that banking development and stock market liquidity positively predict these same three variables even after controlling for political factors; and Beck and Levine (2004), which reexamines the issue by applying panel econometric techniques to new data and finds stock markets and banks positively influencing economic growth. More recently, Cihak et al. (2013) replicates the model of King and Levine (1993), using an updated version of the World Bank Global Financial Development Database and confirms the growth-enhancing effects of financial development previously cited.

Despite numerous studies that have explored the relationships between finance and growth, weaknesses remain in measures of financial development (Demirgüç-Kunt and Levine 2009). Unfortunately, no existing indicator adequately captures these financial services, so empirical studies continue to rely on traditional measures of financial development (Levine and Zervos 1998, Demirgüç-Kunt and Levine 2009).

Like measures of financial development, causality is the other issue that clouds understanding of the finance–growth relationship. Because fast-growing economies require more finance, it may be that growth promotes finance, rather than the other way round. A seminal study by Rajan and Zingales (1998) is one of the very few papers that effectively addresses causality. To mitigate the issue of endogeneity, or two-way causality, the empirical analysis in this section uses generalized method of moments to generate estimates.

Analysis in this section further assesses the empirical relationship between financial development and economic growth. Building upon the large body of existing research, it has three noteworthy features. First, it updates the sample period to 2011. Second, it looks at how country characteristics—such as advanced versus developing status—affect the finance–growth nexus. Third, it incorporates new variables, distinguishing in particular between fixed and flexible exchange rate regimes. Box 2.1.1 explains the data and methodology used for the econometric analysis.

Several interesting findings emerge from the empirical analysis (Table 2.1.2). The most important is that, regardless of the structure of the financial system, financial development benefits economic growth (model 1). The results clearly show that, regardless of the relative importance of banks versus capital markets (as the financial system in some economies may be dominated by banks, while capital markets play a bigger role in others), the development of the financial system as a whole has a positive and significant effect on economic growth. Larger shares of banking sector (model 2) and stock market activity (model 3) relative to GDP are both positively associated with higher economic growth. The positive effect of financial development on growth is especially evident in developing economies, and even more so in developing Asia. This finding is consistent with studies that find financial development having an effect on growth that is not linear (e.g., Ju and Wei 2011). Estrada, Park, and Ramayandi (forthcoming) offers a comprehensive discussion of all empirical results, including those pertaining to developing countries.

2.1.1 Data and methodology for analyzing the relationship between financial development and economic growth

A new study by Estrada, Park, and Ramayandi (forthcoming) explores the impact of financial development on economic growth. Following the general approach in the literature, econometric techniques are applied to examine the relationship between financial development and growth, with the following basic structure:

$$x_{i,t} = \alpha + \beta_1[FD]_{i,t} + \gamma[ER] + \lambda[Other]_{i,t} + \varepsilon_{i,t}$$

where a number of financial sector development indicators [*FD*], the exchange rate regime [*ER*], and a number of financial and nonfinancial control variables [*Other*] are assumed to affect economic growth (x).

For measures of economic growth, the paper uses a series of non-overlapping 5-year averages of GDP growth per capita for each of the sample countries.

Three indicators of financial development are used in this study:

(i) **Total liquid liabilities relative to GDP.** This measures the relative size and depth of the financial sector, consisting of currency plus demand and the interest-bearing liabilities of banks and nonbank financial intermediaries. This is the broadest measure of financial intermediation activity, as it covers all banks, central banks, and nonfinancial intermediary activities.

(ii) **Private credit from deposit money banks relative to GDP.** This measure isolates the impact of the banking sector.

(iii) **Stock market capitalization relative to GDP.** This gauges the size of an equity market relative to the economy.

Data on liquid liabilities are obtained from the Financial Development and Structure Dataset of Beck, Demirgüç-Kunt, and Levine (2000, 2009) and Cihak et al. (2012), updated in November 2013. Data on private credit and stock market capitalization are taken from the World Bank's World Development Indicators online database.

Representation of exchange rate regimes considers both the de facto classification and the International Monetary Fund official classification constructed by Reinhart and Rogoff (2004) and updated by Ilzetski, Reinhart, and Rogoff (2011).

A number of variables are included to control for other factors affecting growth, represented by [Other] in the behavioral equation. The choice of these variables closely follows those used in many growth regression analyses done previously (Beck, Levine, and Loayza 2000, Edison et al. 2002, Levine and Zervos 1998).

In addition, the present study includes three measures of financial openness, two de facto and one de jure. Financial openness is included because it is related to financial development, yet distinct from it, and it may influence growth.

The full sample of the GDP per capita growth regression is a cross-country panel data set covering 108 economies (of which 20 are in developing Asia) with five non-overlapping 5-year periods from 1977 to 2011. A full treatment of data and methodology is in Estrada, Park, and Ramayandi (forthcoming).

2.1.2 The impact of financial development on growth

	(1)	(2)	(3)	(4)	(5)	(6)
	Ilzetski, Reinhart, and Rogoff de facto			International Monetary Fund de jure		
Variables	Total flows	L and M-F	Chinn and Ito	Total flows	L and M-F	Chinn and Ito
Model 1						
Liquid liabilities, % of GDP	2.723**	2.778*	3.033**	2.612**	2.854*	2.797*
	(1.360)	(1.534)	(1.484)	(1.296)	(1.485)	(1.434)
Model 2						
Private credit, % of GDP	1.509*	1.507*	1.608**	1.525*	1.748**	1.745**
	(0.821)	(0.774)	(0.715)	(0.837)	(0.832)	(0.729)
Model 3						
Stock market capitalization, % of GDP	1.485*	1.341*	2.252***	3.028***	2.400***	3.516***
	(0.796)	(0.792)	(0.752)	(0.530)	(0.439)	(0.656)

Note: Total flows, Lane and Milesi-Ferretti (L and M-F, 2007), and Chinn and Ito (2008) refer to different measures of financial openness. Ilzetski, Reinhart, and Rogoff (2011) de facto and International Monetary Fund de jure refer to different definitions of foreign exchange rate regime. Robust standard errors are in parentheses; *** p <0.01, ** p <0.05, * p <0.1. Estimations were done through the generalized method of moments, with the following control variables: initial income per capita, government spending, inflation, years of schooling, trade openness, foreign exchange rate regime, and period indicators.

Source: Estrada, Park, and Ramayandi, forthcoming.

The results for the example of developing Asia illustrate the potential size of the effect on economic growth. For example, boosting developing Asia's average ratio to GDP of liquid liabilities—currency plus checking and interest-bearing accounts in financial institutions—from 65% to 75% adds almost 0.4 percentage points to average annual GDP growth per capita.[1] Also, on average, an increase of 10 percentage points in developing Asia's average ratio of private credit to GDP (an alternative measure of financial depth) is associated with higher growth in GDP per capita by 0.3 percentage points per year. These numbers are far from definitive but do give us a rough, first-order indication of the effect of finance on growth.

Interestingly, analysis does not yield any robust results about the effect of the exchange rate regime on growth or the finance–growth nexus. While many Asian economies have moved toward more flexible exchange rates since the Asian financial crisis, evidence suggests that more flexible exchange rates do not necessarily promote economic growth.

The finance–inclusion link

The role of financial development in tackling inequality has received much less attention than, say, that of fiscal policy. So how exactly does financial development influence income inequality? Economic theory provides conflicting predictions.[2] On the one hand, by making financial services more available to the poor, financial development can narrow income inequality. Financial services can enhance opportunities for the poor to pursue more education, for example, or start a new business. On the other hand, if financial development largely benefits senior finance professionals and other wealthy individuals, with little benefit for the poor, it may exacerbate income inequality.

The relationship between financial development and income inequality can be through indirect channels. Demirgüç-Kunt and Levine (2009) argued that financial development can affect income inequality indirectly by changing the composition of labor demand. If expanded financial services boost demand for low-skilled workers, wages for low-skill workers increase, mitigating income inequality. On the other hand, if increased financial services raise demand for high-skilled workers and hence their wages, income inequality can worsen.

As conceptual grounds exist for both beneficial and adverse effects, the nexus between financial development and inequality is ultimately an empirical issue that must be settled by empirical analysis. Such an exercise is performed here, analyzing the factors possibly affecting the extent to which financial development influences income inequality, using the data and methodology outlined in Box 2.1.2.

From the empirical analysis, financial development has a U-shaped effect on income inequality (Table 2.1.3). As the financial system develops, inequality improves until it approaches the mean level of financial development, but then tends to deteriorate as the financial system continues to develop. To test the robustness of the results, two additional analyses—instrumental variables estimation and growth form regression—are performed to address possible endogeneity issues. By and large, the results of both analyses are consistent with earlier results.

2.1.2 Data and methodology for analyzing the relationship between financial development and income inequality

This box describes the data and econometric methodology used to explore the impact of financial development and income inequality. Financial development is measured using three ratios: liquidity liabilities to GDP, private credit from deposit money banks to GDP, and stock market capitalization to GDP. The analysis applies data obtained from the World Bank's Global Financial Development Database for financial development indicators. The summary statistics are reported in Park and Shin (forthcoming a).

The exercise uses panel regression with fixed effects because it is essential when investigating the causal effect of financial development to control for unobserved variables specific to individual economies. The analysis experiments with two alternative measures of income inequality: the Gini coefficient of market income and the Gini coefficient of disposable income. In light of the well-known nonlinear relationship between per capita GDP and income inequality—the Kuznets curve—the linear, square, and cube terms of per capita GDP are included in the regressions. Nonlinearity in financial development is similarly taken into account.

A number of other factors expected to affect income inequality have likewise been added: economic openness, the share of high technology exports in manufacturing exports, the share of agriculture in employment, and government size.

Two significant drivers of income inequality are globalization (here interpreted as trade openness and measured by the ratio of the sum of exports and imports to GDP) and progress in acquiring and deploying technological skills (see, for example, Jaumotte, Lall, and Papageorgiou [2013] and the literature surveyed in the paper). Trade influences income inequality by widening the wage gap between high- and low-skilled workers. Skills-biased technological progress raises the wages of highly skilled workers more than of low-skill workers, which widens income inequality. A higher share of agriculture in employment is expected to worsen income inequality as agricultural workers tend to earn low wages. Finally, government size, measured as the share of government expenditure in GDP, is included as some government expenditure redistributes wealth.

While the panel regression results are suggestive, they do not prove causal relation running from financial development to income inequality. To overcome this problem, two additional analyses are performed. The first uses instrumental variables estimation. The second entails transforming regression into its growth form. As the regressions are based on panel regression with fixed effects, one cannot use legal origins or latitude as an instrumental variable because they do not vary over time. Analysis uses, instead, data on law and order collected from the International Country Risk Guide, which assesses law separately from order, each with a score of 0–3 points. The law score captures the strength and impartiality of the legal system, while the order score considers popular observance of the law.

Factors that influence how much financial development affects income inequality are investigated, with the following being of particular interest:

(i) **Ratio of primary schooling.** A main channel by which financial development influences income inequality is through the provision of opportunities for the poor to build human capital. If the rich and the poor had similar stocks of human capital, the impact of financial development on equity would be lower.

(ii) **Institutions.** Stronger institutions and better governance encourage financial institutions to lend on the basis of commercial merit rather than personal or business connections, which provides more opportunities to the poor.

(iii) **Macroeconomic stability.** Macroeconomic stability multiplies the benefits of financial development.

To get the ratio of primary schooling, average years of primary schooling is divided by average years of total schooling, based on data collected from Barro and Lee (2013). While this ratio does not directly capture the education gap between the rich and the poor, a high ratio implies there is more scope for the poor to receive additional education. The quality of institutions is measured by law and order. Finally, macroeconomic stability is measured by the inflation rate. Park and Shin (forthcoming a) explains in more depth the data and methodology.

2.1.3 Gini coefficient and financial development

	Gini index (market income)			Gini index (disposable income)		
Variables	1	2	3	4	5	6
Liquid liabilities	−0.080	−0.209**	−0.224	−0.107*	−0.251***	-0.234*
(% of GDP)	[0.050]	[0.099]	[0.138]	[0.059]	[0.091]	[0.128]
Square of liquid liabilities	0.012	0.027*	0.034*	0.015*	0.034**	0.034**
(% of GDP)	[0.008]	[0.014]	[0.018]	[0.009]	[0.013]	[0.017]
Observations	3,475	1,961	1,524	3,475	1,961	1,524
Adjusted R-squared	0.034	0.161	0.107	0.009	0.091	0.074
Number of groups	153	131	121	153	131	121

Notes: In columns 1, 2, and 3, the dependent variable is the Gini index of market income, while in columns 4, 5, and 6 the dependent variable is the Gini index of disposable income. Each column refers to a different specification, with a different set of independent variables. The ratio of liquid liabilities to GDP is used as a proxy for financial development. The regression results are from a panel regression with fixed effects. Numbers in parentheses are standard errors. The statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *. Control variables not reported above are openness, share of agriculture in total employment, government expenditure, and high technology exports.

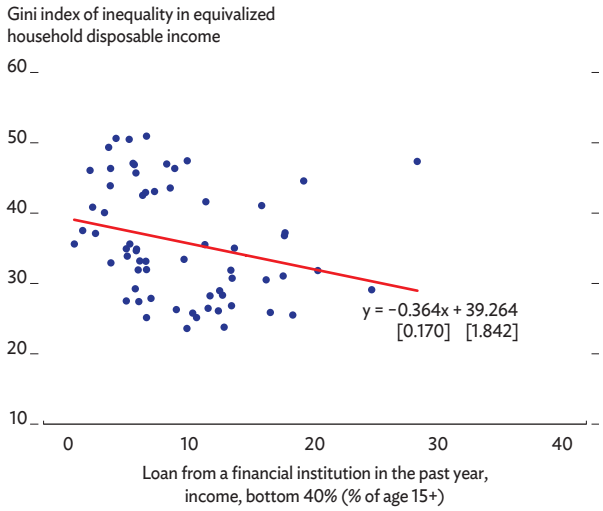
Source: Park and Shin, forthcoming a.

With respect to the impact of financial development on income inequality, an interesting and natural follow-up question is to ask what factors influence the degree of the impact. That is, what are the factors that determine whether or not financial development will have a significant effect on income inequality? To answer this, one needs to look at three factors for which there are conceptual grounds for an effect on the finance–inequality nexus: the ratio of primary schooling to total schooling, law and order, and macroeconomic stability.

As expected, the empirical evidence indicates that when the ratio of primary schooling increases and law and order improves, financial development becomes more effective at reducing inequality. On the other hand, macroeconomic stability does not affect the relationship. The findings imply that an important channel for the pro-equity effect of financial development is education, reaffirming the potential of education as an equalizing force. The education channel can be strengthened by policies that make it easier for the poor to finance their education by borrowing from financial institutions.

The salient policy implication of the empirical analysis for developing Asia is that financial development per se does not automatically reduce income inequality. In fact, the empirical evidence is mixed and does not point to a clear, definite relationship between the two. Empirical ambiguity thus mirrors theoretical ambiguity. Intuitively, reduced inequality is more likely the product of financial inclusion than of financial development. It would therefore be worthwhile to include financial inclusion as an additional independent variable in the empirical analysis—if only the data were available. There is, however, negative correlation between the Gini coefficient and financial inclusion, which supports the conjecture (Figure 2.1.5). Financial development must be accompanied by financial inclusion to foster inclusive growth.

2.1.5 Income inequality and financial inclusion, 2011



Source: Park and Shin, forthcoming a.

Click here for figure data

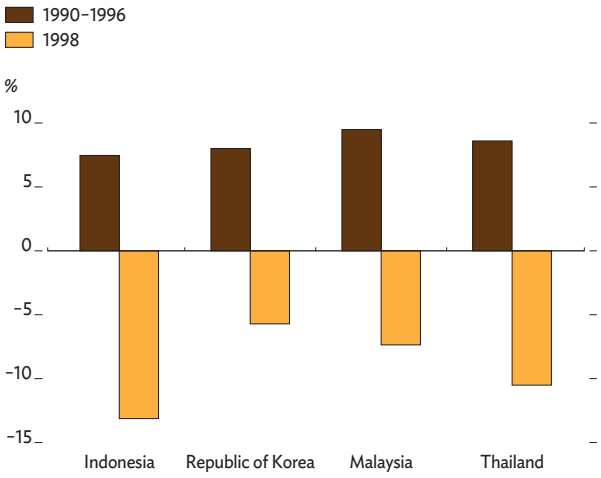
Issues surrounding financial stability

However beneficial financial development, innovation, and liberalization generally are, they sometimes destabilize financial systems. While these virtues strengthen and improve the financial system in the long run, they may jeopardize stability in the short run. Yet financial instability in general and financial crisis in particular can have huge repercussions on growth. The global financial crisis of 2008–2009 quickly spilled over from the financial sector into the real economy and almost brought the world to its knees. In 2009, global output stood virtually still—its worst performance in the postwar era—and the volume of world trade fell by over 10%. The global crisis sparked widespread fears of a repeat of the Great Depression, which also had its origins in the financial markets. Furthermore, the damage that a financial crisis inflicts on growth can be long lived. The world economy did not fully recover from the Great Depression until World War II; it is still struggling to shake off the effects of the global economic crisis more than half a decade later.

Closer to home, the devastating Asian financial crisis of 1997–1998 brought the East Asian Miracle to a rude halt. The result of a toxic combination of large capital inflows and financial underdevelopment that eroded the quality of investment, the Asian financial crisis inflicted on several high-flying miracle economies real GDP contraction as it peaked in 1998: Indonesia by 13%, the Republic of Korea by 6%, Malaysia by 7%, and Thailand by 11%—in each case a sharp drop from the period immediately before the crisis (Figure 2.1.6). While the sky-high pre-crisis growth rates may have partly reflected unsustainably high investment rates, the legacy effects of the crisis itself may have contributed to the long-term decline in growth since then. It is therefore of paramount importance for Asia that the financial system itself does not generate growth-crippling instability or crisis.

Financial instability not only harms growth but also exacerbates poverty and inequality. Intuitively, financial instability adversely affects inclusive growth because the poor are disproportionately defenseless against financial crises. For example, the sharp increase in the unemployment rate that often accompanies crisis-induced recessions has a bigger impact on the poor because, by definition, they have less financial and real wealth to tide them over the hard times. After the global financial crisis, the unemployment rate doubled in many European Union economies—and tripled in the hardest hit (Figure 2.1.7). During the Asian financial crisis, many households were hurt by unemployment and reduced earnings made all the worse by rising prices. Lacking in assets and social protection, the poor and near-poor suffered the worst. Suryahadi, Sumarto, and Pritchett (2003) showed that the poverty rate in Indonesia more than doubled from about 15% at the onset of the

2.1.6 Growth rates before and after the Asian financial crisis, selected Asian economies



Source: International Monetary Fund, World Economic Outlook Database, October 2014.

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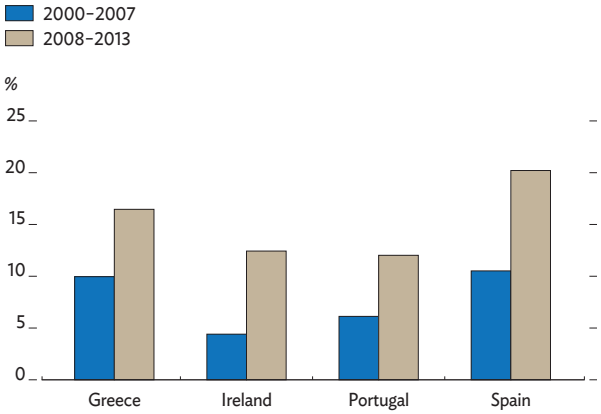
2.1.7 Unemployment rates before and after the global financial crisis, selected European Union economies



Source: International Monetary Fund, World Economic Outlook Database, October 2014.

Click here for figure data

crisis in mid-1997 to a high of 33% near the end of 1998, pushing some 36 million into poverty. Knowles, Pernia, and Racelis (1999) showed that income distribution worsened during the crisis in Thailand and the Philippines.

The need for financial development

To sum up, developing Asia now compares favorably with other parts of the developing world in terms of financial depth, but it still lags the advanced economies by a wide margin. Because financial depth has a significant and positive effect on economic growth, this finding suggests that the region can reap a growth dividend from further financial development. But financial development does not necessarily promote more inclusive growth. Further, the region does not visibly outperform other developing regions in terms of financial inclusion. This means that developing Asia has scope for extending access for the poor to financial services, which currently leave them underserved. Finally, the high costs of financial crises on growth and equity calls for continued vigilance against financial instability—all the more so as external and homegrown risks to stability lurk in the background, notwithstanding the improved health of the region's financial system.

Financial development for growth

Four key areas of Asia's financial development will matter greatly for sustaining growth in the coming years. First, the region will require efficient finance to continue channeling affordable credit to firms in adequate amounts and support much-desired investment. Second, banks in particular have to be kept well-tuned, as they remain an essential component of robust financial systems in the region. Third, the mounting importance of productivity growth as a driver of growth in Asia highlights the need to knock down barriers to long-term finance, especially for infrastructure and innovation. Finally, to deepen the pool of long-term capital, it is important that the region continues to develop domestic bond markets, building on the considerable progress already made in this area.

Credit, investment, and growth in Asia

High rates of investment, fueled by high saving rates, helped developing Asia rapidly build up its stock of productive capital. This capital contributed greatly in turn to the region's outstanding growth record in recent decades. Today, productivity growth is due to take a bigger role in sustaining the region's growth. Even so, investment remains an important factor. The distinction between the two is in truth sometimes blurred. Investment in infrastructure such as roads, ports, and power plants, for instance, can improve the productivity of all firms and industries.

The most immediate and direct contribution of the financial system to economic growth in Asia would therefore be to channel credit to firms and industries for investment and productivity. In this regard, the biggest challenges would be to increase the availability of funds and to lower their cost. To date, the region still struggles with inefficient finance, especially in lower-income economies, where financial sectors are largely underdeveloped (see *Banking sector development, credit, and investment* on the next page). The narrow availability and high cost of credit traces largely to inefficiency in the financial sector, which is indicated by high interest rate spreads and sometimes excessive allocation of credit to state-owned firms at the expense of the more dynamic private sector.

Financial sector efficiency and credit

As financial systems become more efficient, the availability of credit rises and its cost goes down. A widely used indicator of financial sector efficiency is the interest rate spread, or the gap between the lending rate and the deposit rate. While it is an imperfect measure, affected by such factors as government-imposed interest rate controls, it nevertheless indicates comparative efficiency, with a narrower spread showing

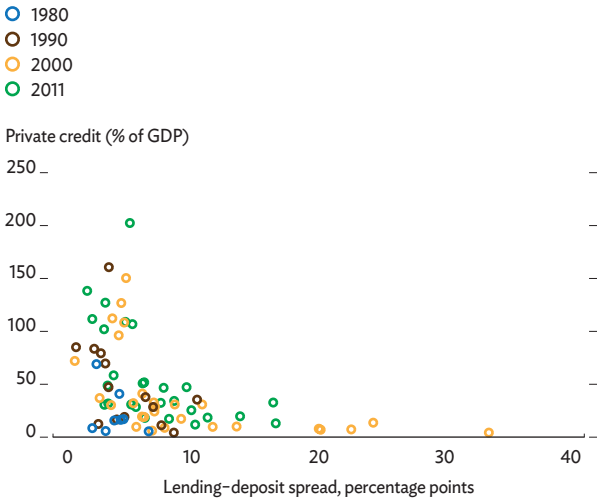
greater competitiveness and, therefore, efficiency. Data for developing Asia show a tighter interest rate spread associated with a higher share of private credit in GDP (Figure 2.2.1) and credit at lower cost (Figure 2.2.2). This suggests that a more efficient financial sector can indeed unlock more affordable credit in the region.

Credit for state and private enterprise

In some Asian economies, the government directs banks to funnel a substantial share of credit to state-owned enterprises (SOEs). This is especially true if the banks themselves are owned by the state. But SOEs tend to be less efficient than private firms. They are subject to government interference and are less driven by the profit motive. As credit to SOEs siphons credit away from the more efficient private sector, it weakens productivity across the entire economy. The People's Republic of China (PRC) is perhaps the most widely recognized example of an economy facing such problems.

Several studies provide evidence that resource misallocation by imperfect financial markets can substantially reduce productivity and growth in the PRC. One by Hsieh and Klenow (2009) finds that reallocating capital and labor within the manufacturing sector to equalize marginal products (or make the most efficient use of inputs) to the extent observed in the US could increase total factor productivity by 30%–50% in the PRC and by 40%–60% in India. Another study by Dollar and Wei (2007) finds that transferring some of the capital employed by SOEs to the private sector to equalize the marginal revenue product of capital could raise GDP by 5%, and still others by Brandt, Tombe, and Zhu (2013) and Song, Storesletten, and Zilibotti (2011) find that credit extended to SOEs significantly retards economic growth.

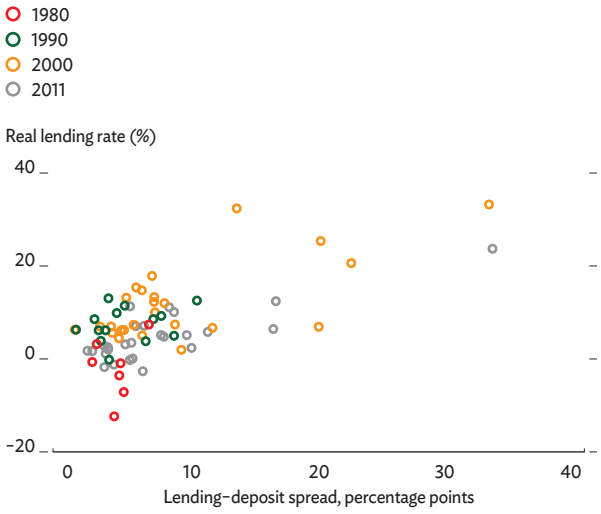
2.2.1 Private credit and lending–deposit spread, developing Asia



Source: World Bank, World Development Indicators online database (accessed 15 September 2014).

Click here for figure data

2.2.2 Real lending rate and lending–deposit spread, developing Asia



Source: World Bank, World Development Indicators online database (accessed 15 September 2014).

Click here for figure data

Banking sector development, credit, and investment

Banks underlie sound and efficient financial systems in developing Asia. Even with the rapid growth of capital markets in middle-income countries, they continue to dominate the financial landscape across the region. For that reason, a well-functioning banking sector that efficiently channels resources to investment and other productive activities remains indispensable for economic growth.

Vibrant capital markets complement sound and efficient banks but do not substitute for them. Financially advanced economies such as the US and United Kingdom have large and sophisticated banks in addition to deep and liquid equity and bond markets. It therefore makes sense for middle-income Asian countries to continue developing their banking sectors even as they nurture their bond markets. However, for

2.2.1 Banks in the Pacific

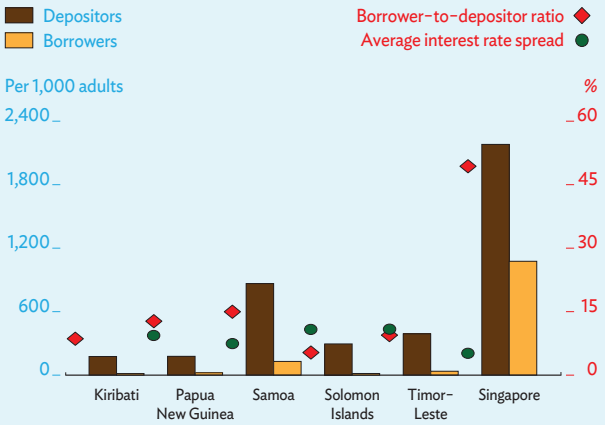
The availability of commercial banking services in the Pacific is generally low, and customers in most countries have few choices. Kiribati and Tuvalu have only one commercial bank each, while the Republic of the Marshall Islands and the Federated States of Micronesia have two, one domestic bank and one branch of a US bank. No commercial bank has operated in Nauru since 2006, when the Bank of Nauru went bankrupt.

Bank coverage in the Pacific appears to be in line with that found in other less-developed regions. The Pacific banking system's total assets as a proportion of GDP is comparable with the proportion in low-income economies in Asia, and banks are generally well capitalized. Rising mobile phone usage has opened up opportunities for mobile banking and is expanding financial inclusion, particularly in remote rural areas.

The number of depositors is more or less comparable with numbers found in other low- and middle-income economies. However, the relatively small number of borrowers suggests there may be excess liquidity (box figure). Large public institutional investors—provident or trust funds—provide a large portion of deposits in many banking systems in the Pacific, which may partly explain the gap between bank deposits and lending in the region.

Lending in the Pacific is hindered by the difficulty of using land as collateral because of customary systems of communal land ownership. To alleviate this, Pacific governments are working with development partners on reform to secured transactions that will facilitate the use of such movable property as crops, machinery, vehicles, and future earnings as collateral for commercial loans.

Commercial bank deposits and loans in Singapore and the Pacific



Notes: Depositor and borrower data are for 2012, except 2011 for Papua New Guinea. Average interest rate spreads are calculated based on quarterly data from 2009 to 2014.

Sources: World Bank World Development Indicators and IMF International Financial Statistics online databases.

Click here for figure data

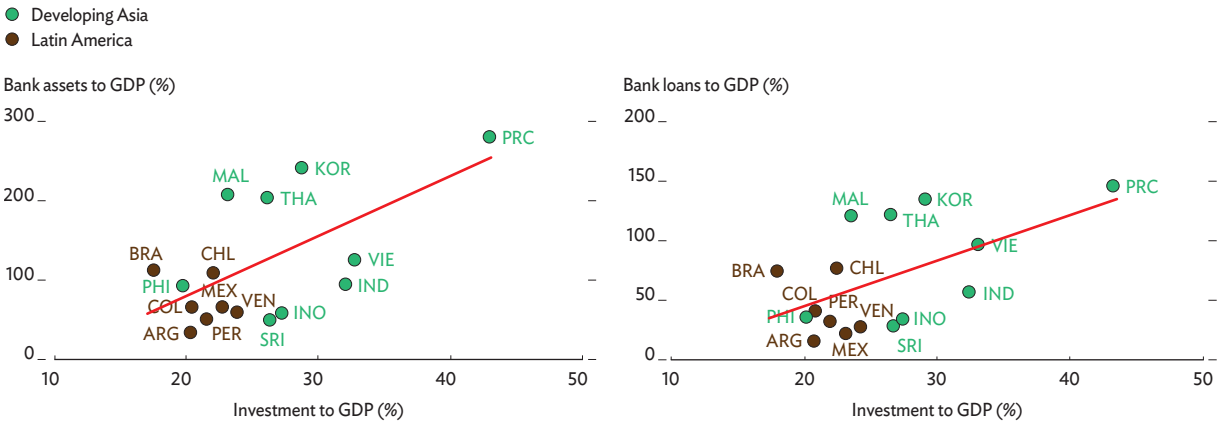
Meanwhile, limited opportunities for productive private investment constrain demand for credit. Another constraint on demand is the high cost of credit, as interest rate spreads in the Pacific are generally wider than in other developing regions. High lending rates reflect not only heightened political and macroeconomic risks, but also the high transaction costs of catering to a small and dispersed clientele.

lower-income Asian countries such as the Pacific island states, where banks are the predominant form of finance, bank reform remains the overriding challenge of financial sector development (Box 2.2.1).

In Asian economies where banks and capital markets are currently underdeveloped, more efficient finance can ratchet up investment by channeling cheaper credit to firms and thereby boosting productive capacity and growth potential. Data from a sample of major countries in developing Asia and Latin America, where banks are often the main source of financing for firms, highlight the nexus between finance and investment as well as that between investment and growth. Figure 2.2.3 shows a positive relationship between the ratio of bank assets (and particularly loans) to GDP and the ratio of investment to GDP, and Figure 2.2.4 displays a positive relationship between the investment rate and economic growth. Together, the two figures show that countries with larger banking sectors invest more and grow faster.

When comparing Asian and Latin American economies, an interesting and significant pattern emerges. The positive relationship between the banking sector and investment on the one hand, and between investment and economic growth on the other, appears more pronounced in Asia.

2.2.3 Banking sector and investment



ARG = Argentina, BRA = Brazil, CHL = Chile, COL = Colombia, IND = India, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, MEX = Mexico, PER = Peru, PHI = Philippines, PRC = People's Republic of China, SRI = Sri Lanka, THA = Thailand, VEN = Venezuela, VIE = Viet Nam.

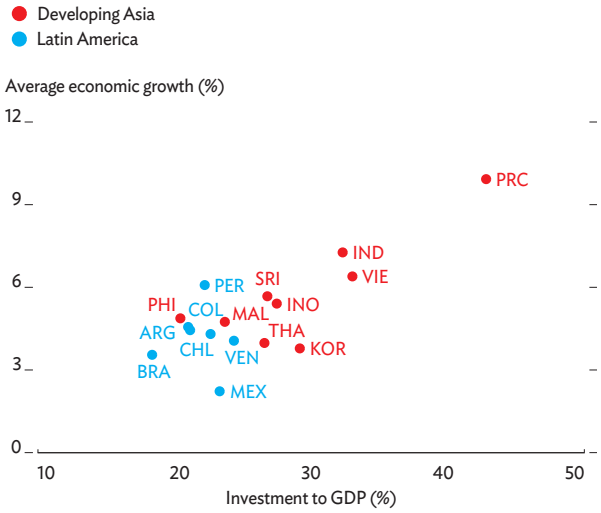
Note: Data on bank assets and bank loans refer to December 2013 or March 2014, while data on investment refer to 2000–2013 average.

Source: Cline, forthcoming.

Click here for figure data

This suggests that financial development matters more for economic growth in Asia than in the rest of the world. Figure 2.2.5 shows the relationship between private credit and investment, and it confirms the tighter link between financial sector development and investment in developing Asia than elsewhere. An important caveat, however, is that the evidence presented are correlations that do not necessarily indicate causation, so it is possible that countries that invest more have greater demand for financing.

2.2.4 Investment and economic growth, 2000–2013



ARG = Argentina, BRA = Brazil, CHL = Chile, COL = Colombia, IND = India, INO = Indonesia, KOR = Republic of Korea, MAL = Malaysia, MEX = Mexico, PER = Peru, PHI = Philippines, PRC = People's Republic of China, SRI = Sri Lanka, THA = Thailand, VEN = Venezuela, VIE = Viet Nam.

Source: International Monetary Fund 2014.

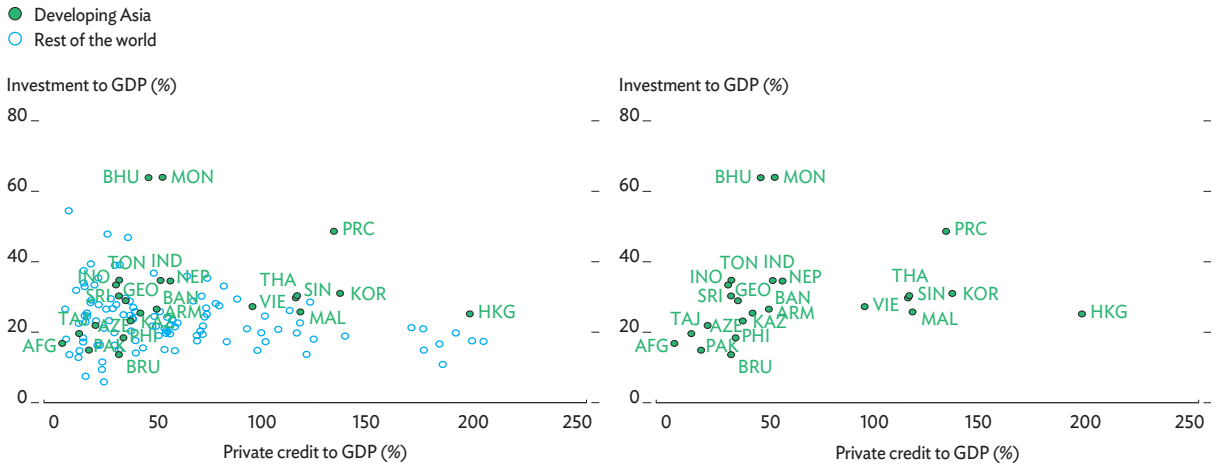
Click here for figure data

Long-term finance for productivity-led growth

Developing Asia's strong economic growth over the past 3 decades has been the envy of the world, dented only during the Asian financial crisis of 1997–1998 and the global financial crisis of 2008–2009. The impressive growth record, largely credited to investment and capital accumulation, not only raised incomes and reduced poverty but also expanded the region's global influence. While capital deepening continues to be important, the region will need to rely increasingly on higher productivity growth to sustain rapid growth (Box 2.2.2).

Reform offers, however, no single path to productivity growth. Rather, reform needs to create a mix of virtues, including better infrastructure and human capital, more open trade, an efficient and well-developed financial system, and economic institutions that promote competition and encourage entrepreneurship and innovation.[3] Only an appropriate set of targeted and interlocking reforms can achieve structural change, improve resource allocation, and increase technology transfer. Reform priorities will have to vary depending on the income group targeted and how technologically advanced the economy is.

2.2.5 Investment and private credit, 2012



AFG = Afghanistan, ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, BRU = Brunei Darussalam, GEO = Georgia, HKG = Hong Kong, China, IND = India, INO = Indonesia, KAZ = Kazakhstan, KOR = Republic of Korea, MAL = Malaysia, MON = Mongolia, NEP = Nepal, PAK = Pakistan, PHI = Philippines, PRC = People's Republic of China, SIN = Singapore, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, TON = Tonga, VIE = Viet Nam.

Source: World Bank, World Development Indicators online database.

Click here for figure data

2.2.2 Asia's long-term growth prospects and the role of productivity

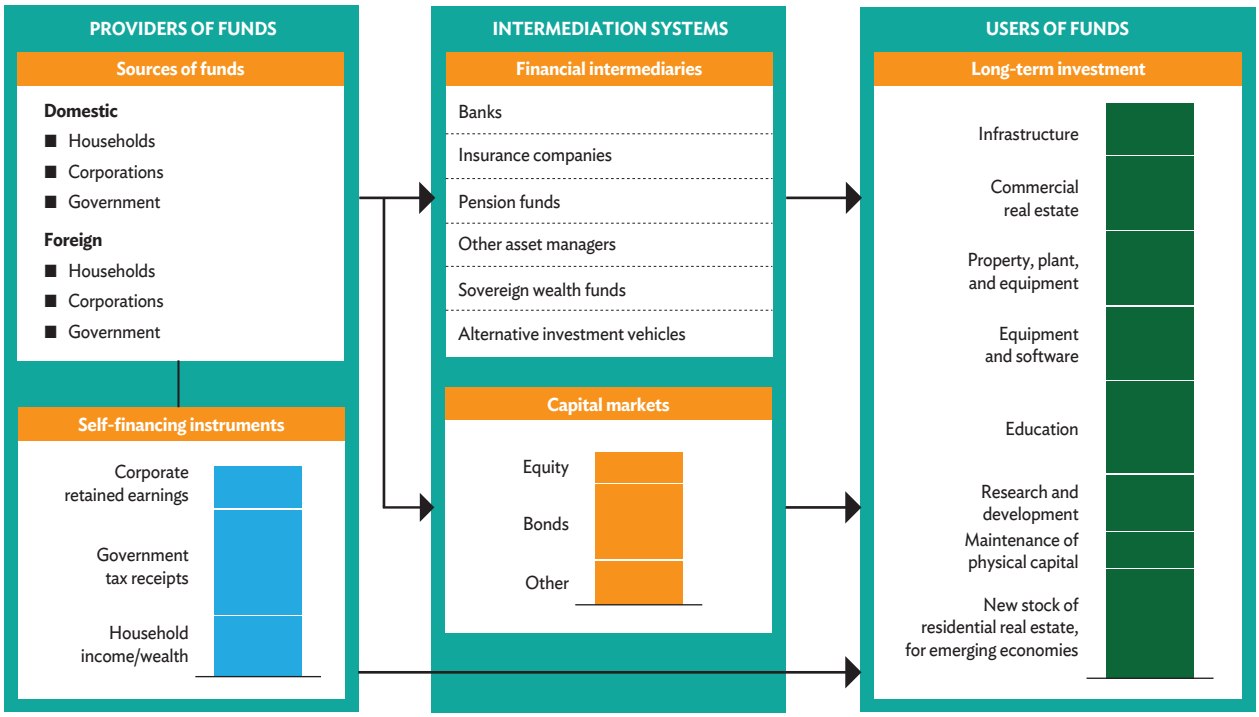
Asia's admirable economic growth and transformation has been the subject of many empirical studies. Lee and Hong (2010) and Park and Park (2010) apply a growth accounting framework to find that growth in capital accumulation has been a key factor behind developing Asia's remarkable economic expansion, especially in the 1980s and 1990s. The analysis in Lee and Hong (2010) and Park and Park (2010) covers the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam, which together account for 95% of developing Asia's GDP, thus making this group representative of regional trends. Their results also show the other side of the coin: that the contribution of labor, education, and total factor productivity to real GDP growth has been only moderate. The Park and Park (2010) study, however, finds an important structural shift in the pattern of developing Asia's economic growth in around 2002, when total factor productivity began to play a larger role in regional growth.

Projections by Lee and Hong (2010) address the central question of whether developing Asia's rapid growth can continue in the next 2 decades. They suggest that, without significant reform, future growth will tend to be lower than historical performance in most of the Asian economies analyzed. In particular, as these economies have already registered high rates of capital accumulation in the past 3 decades, the marginal productivity of capital appears set to decline. Furthermore, for many economies the demographic dividend is projected to wane, constraining the contribution to growth from labor. Park and Park (2010) reaches a similar conclusion and highlights the importance of policy makers pursuing supply-side policies that foster productivity growth to sustain developing Asia's future growth.

The common conclusion of various studies of Asia's historical growth record and future prospects is that growth will need to rely increasingly on improvements in productivity growth and less on capital deepening. Although investment and factor accumulation will still be important drivers of growth in low-income countries, and in middle-income countries with large infrastructure gaps, productivity will need to become a more important driver of growth in developing Asia. Although there is no single reform path to spur productivity growth, and though policy needs vary across income groups, financial system deepening remains central to a more efficient allocation of capital across sectors and crucial for facilitating innovation and technology transfer.

Yet, despite differences between economies in the set of productivity-enhancing reforms they need, the common need is to build a strong domestic financial system, one able to provide long-term finance to match the long-term investments desired (Chopra, forthcoming). As developing Asia has an infrastructure deficit that hampers productivity, particular attention has to be placed on funding infrastructure needs.

2.2.6 Framework for the provision of finance for long-term investment



Source: McKinsey Global Institute as cited in Group of Thirty (2013).

When finance and investment are for the long term, they enhance the productive capacity of an economy. They cover a wide range of tangible assets—energy, transport and communication infrastructure, factories, commercial buildings, hospitals, and new housing—that generates returns for society, as well as intangible assets such as education and research and development, which store up prospects for future innovation and competitiveness (Asian Development Bank, forthcoming, European Commission 2013, Group of Thirty 2013).

Being less procyclical than short-term finance, long-term finance exerts a stabilizing influence on the financial system and may be more supportive of sustained long-term growth.[4] This improves the quality of intermediation, not just its quantity. Long-term capital is important for financing innovation in particular, as innovation is inherently uncertain and hard to keep to deadline.

Long-term finance flows from the providers—households, corporations, and governments—through the intermediation process to the end users (Figure 2.2.6). Except in the case of self-financing, finance flows through financial institutions such as banks, insurance companies, and pension funds, or else it gets channeled through capital markets. Under this framework, investors with long time horizons and financial instruments with long maturities are evidently needed for long-term investment.

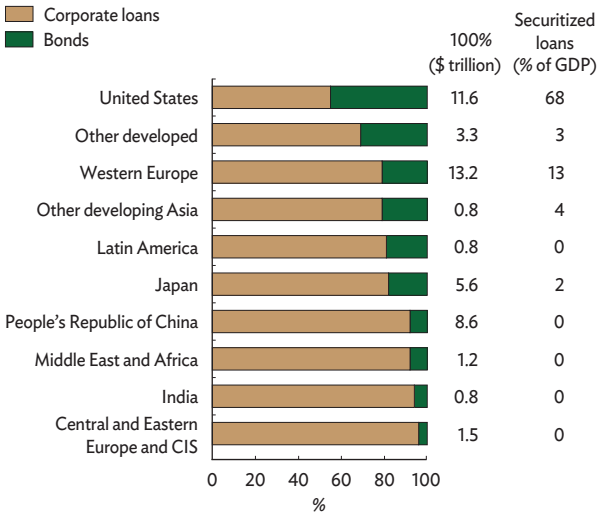
But even with the large pool of savings in developing Asia, the region's range of instruments for long-term financing remains narrow (Didier and Schmukler 2014). Banks still dominate the financial sector in Asia, as they do in Europe—and in contrast with the US, where equity and bond markets play a larger role. However, commercial bank loan

maturities average only 2.8 years in emerging economies and 4.2 years in developed economies, which is much shorter than bond maturities (Group of Thirty 2013). Moreover, although many countries in developing Asia have improved the size and liquidity of their bond markets in recent years, these markets remain dominated by low-risk issues, especially from governments.

In addition to a lagging corporate bond market, developing Asia has underdeveloped securitization and equity markets despite possessing a rising share of the world's wealth (Figure 2.2.7). Long-term institutional investors such as pension funds and insurance companies, whose liabilities have long dates, do not contribute sufficiently to the development of local markets, preferring to put the bulk of their portfolios in government bonds and deposits.[5]

This "trap," as it is decried in Didier and Schmukler (2014), keeps Asian investors out of local capital markets and keeps the markets underdeveloped. The situation in Asia leaves considerable scope for policy action to help channel available funds and foster local markets for long-term financing. Policy requirements to address barriers to long-term finance are inevitably multifaceted, but the following are worth highlighting for Asia.[6]

2.2.7 Debt financing of nonfinancial corporations by region, year-end 2011



CIS = Commonwealth of Independent States.

Source: McKinsey Global Institute as cited in Group of Thirty (2013).

Click here for figure data

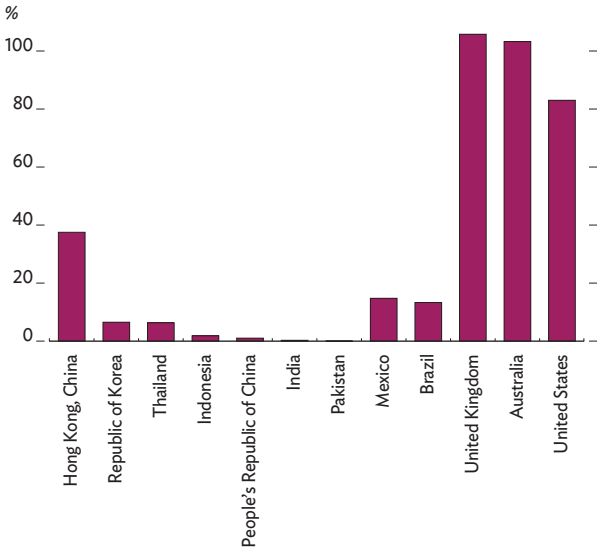
First, policy should help investors adopt a long-term horizon for their investment decisions. This will require national and international regulatory bodies to remove short-term biases when allocating the assets of investors willing to invest for the long term. National regulatory and accounting treatment that favors short-term horizons should be reconsidered, weighing the pros and cons of gradually removing from insurance and bank regulations the preferential treatment accorded to sovereign debt (Group of Thirty 2013).

Second, policy should further efforts to develop debt and equity capital markets to widen the spectrum of financing instruments. Although local-currency bond markets have grown in Asia over the past decade, the region's continued heavy reliance on bank financing tends to make long-term investment decisions dependent on risky and volatile maturity transformation, or the funding of longer-term commitments with shorter-term deposits or investments. Policies should therefore aim to build deeper and more liquid bond markets, especially for corporate bonds, as this could reduce risk premiums and lower the cost of capital, as well as enhance financial stability.[7]

Third, policy should facilitate the building of a broader and more diverse long-term investor base, in part by promoting institutional investors and foreign participation. It is essential to generate stable sources of finance. The region lags the advanced economies by a wide margin in its development of long-term institutional investors such as pension funds (Figure 2.2.8). Long-term pension and insurance-based savings could be fostered by, for instance, setting up compulsory auto-enrollment saving programs (Group of Thirty 2013). Such institutions would aggregate more savings into funds with long investment horizons, especially where household wealth is concentrated in bank deposits and other short-term instruments.

Finally, policy needs to take into account how important cross-border capital flows are for the efficient allocation of capital to long-term investment on a global scale. Policy makers should enhance their understanding of the regional and global perspectives they will need to effectively address stiffening regulatory and supervisory challenges as financial systems deepen and become more integrated and complex (Group of Thirty 2013, Zhu 2014). In particular, as regulators and supervisors encourage prudent financial innovation, they will need to ensure that they have good cross-border cooperation and adequate regulatory powers to act and stay alert to risks.

2.2.8 Ratio of pension assets to GDP in selected economies, 2013



Note: Data for India refer to 2012 and for Indonesia 2011.
Source: Organisation for Economic Co-operation and Development 2015.
Click here for figure data

Bond market development in Asia

Bond markets are important features of diversified financial systems and have an important role in building a pool of long-term financing to benefit the wider economy. On a macro level, financial development has been consistently linked to higher economic growth and greater poverty reduction (Levine 2005, 2008). In the context of emerging market economies (EMEs), including those in developing Asia, the growth of local-currency bond markets has improved financial stability by reducing currency mismatches and vulnerability to currency crises.

The positive effect likely extends to the global economy, as it was the lack of reliable financial instruments in EMEs that drove capital to developed markets and helped spark the global financial crisis (Caballero, Fahri, and Gourinchas 2008). The development of local-currency bond markets thus strengthens financial stability not only in individual countries, but also globally. Bond market development also supports financial inclusion, as the factors that enable debt markets are, at core, the same as those that enable borrowing and lending within an economy (Burger and Warnock 2006).

Bond market structure in developing Asia and the world

Global bond markets have seen impressive growth over the past decade, almost tripling in size from $30 trillion in 2001 to $83 trillion in 2011. Although rapid progress has been seen across regions, bond markets in advanced economies remain much larger than those in developing Asia, equaling 164% of GDP in advanced economies but only 41% in developing Asia (Table 2.2.1).

A fundamental change in global financial structure has been the growth of local-currency bond markets in EMEs. As a result, the share of EME bonds denominated in foreign currency more than halved from 25% in 2001 to 13% in 2011 (Table 2.2.2). The trend has been particularly striking in Latin America. In 2001, slightly more than half of Latin American bonds were denominated in foreign currency, but by 2011 local currency bond markets had grown such that only a quarter of bonds in the region were issued in foreign currency. Improvement in macroeconomic stability and institutional factors such as the rule of law have contributed to bond market development in EMEs (Box 2.2.3).

2.2.1 Bond market characteristics: summary statistics by region, 2011

		Total	Local currency denominated			
		$ billion	$ billion	% of GDP	% of total	Government share (%)
Advanced economies	Total	74,371	67,912	164	91	49
	Euro area	22,106	20,147	157	91	39
	Other	22,857	19,134	140	84	72
	United States	29,409	28,630	191	97	40
Emerging market economies	Total	8,119	7,070	32	87	59
	Europe	699	500	24	72	89
	Latin America	1,406	1,053	22	75	80
	Asia	5,667	5,260	41	93	50
	Other	347	255	11	74	75

Source: Burger, Warnock, and Warnock, forthcoming.

2.2.2 Bond market development

		Local currency denominated						
	Total	2011			2006		2001	
	$ billion	$ billion	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total
Advanced economies	**74,371**	**67,912**	**164**	**91**	**134**	**91**	**107**	**93**
Euro area advanced economies	**22,106**	**20,147**	**157**	**91**	**133**	**91**	**94**	**89**
Other advanced economies	**22,857**	**19,134**	**140**	**84**	**104**	**81**	**84**	**87**
United States	**29,409**	**28,630**	**191**	**97**	**158**	**96**	**131**	**98**
Emerging market economies	**8,119**	**7,070**	**32**	**87**	**31**	**83**	**26**	**75**
Europe	699	500	24	72	30	77	25	76
Latin America	1,406	1,053	22	75	20	70	19	54
Asia	5,667	5,260	41	93	39	90	33	88
China, People's Republic of	2,956	2,938	40	99	27	98	18	95
Hong Kong, China	116	45	18	39	19	53	15	54
India	515	489	26	95	30	95	25	97
Indonesia	113	84	10	74	15	87	27	96
Korea, Republic of	1,265	1,117	100	88	94	91	85	91
Malaysia	260	233	81	90	59	79	57	77
Pakistan	34	32	15	94	15	90	22	96
Philippines	101	63	28	62	26	50	21	48
Singapore	130	90	37	69	40	60	35	69
Thailand	175	170	49	97	37	89	28	80
Other emerging market economies	**347**	**255**	**11**	**74**	**11**	**69**	**10**	**50**
Russian Federation	156	91	5	59	3	41	2	13
South Africa	191	164	40	86	39	90	32	87

Source: Burger, Warnock, and Warnock, forthcoming.

2.2.3 Why some emerging markets have bigger bond markets

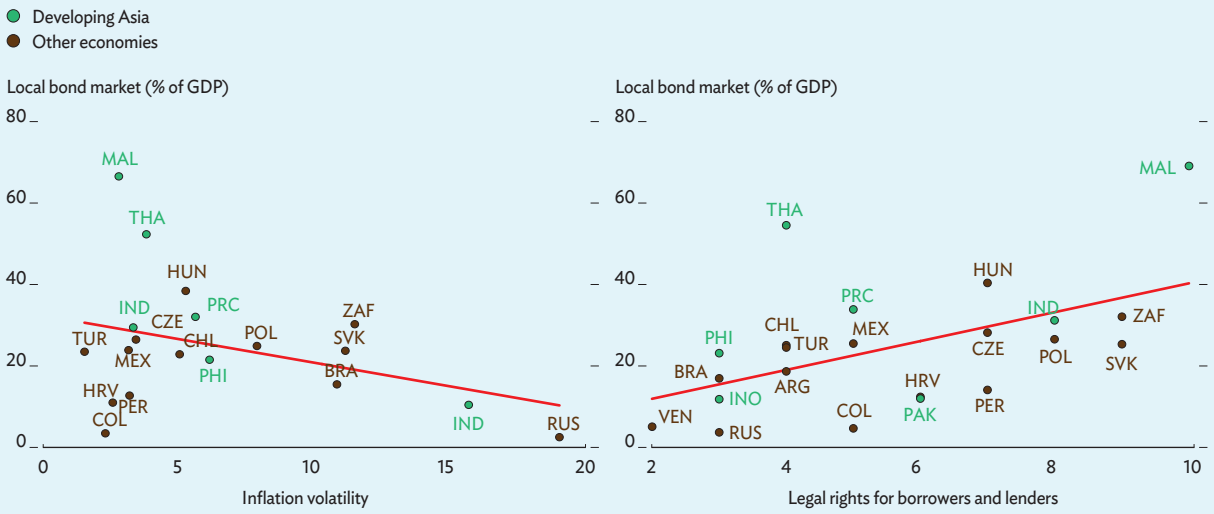
The development of local-currency bond markets in EMEs has clearly been remarkable, but each economy varies in its ability to develop its bond markets. Why is it that some EMEs have larger local-currency bond markets than others? If the answer were "original sin," then the reason would simply be that some countries are naturally larger than others. If nothing other than sheer country size distinguishes one economy from another, bond markets in smaller economies would be inconsequential forever.

But the original sin hypothesis falls apart in the real world. As some studies have shown, economies can put in place institutions and policies that foster the development of debt markets, and have done so (e.g., Burger and Warnock 2006). Economies with better historical inflation performance—an outcome of creditor-friendly policies—have generally more developed local bond markets, both private and government, and rely less on foreign currency debt. Creditor-friendly laws seem to matter. Strong rule of law correlates with deep local bond markets, while countries with better creditor rights have been able to issue a higher share of bonds in their local currency.

Stronger institutions, less volatile exchange rates, and more competitive banking sectors have positively influenced bond market development (Eichengreen and Luengnaruemitchai 2006). The size of government bond markets in particular positively associates with deeper domestic financial systems, lower inflation, larger fiscal deficits, stronger legal origin, and more open capital accounts (Claessens, Klingebiel, and Schmukler 2007).

An updated study on local-currency markets in EMEs confirms earlier findings that economies with less volatile inflation and stronger legal rights tend to have more developed local bond markets (Burger, Warnock, and Warnock 2012; see box figure). Over the past decade, some countries with historically high and volatile inflation, such as Mexico and Brazil, have made the necessary policy adjustments to bring inflation under control, allowing local-currency bond markets to flourish. Other EMEs, including Argentina, the Russian Federation, and Pakistan, have had less success in bringing inflation under control. As a result, their local-currency bond markets continue to be less developed and attractive.

Some determinants of local bond market development



ARG = Argentina, BRA = Brazil, CHL = Chile, COL = Colombia, CZE = Czech Republic, HRV = Croatia, HUN = Hungary, INO = Indonesia, IND = India, MAL = Malaysia, MEX = Mexico, PAK = Pakistan, PER = Peru, PHI = Philippines, POL = Poland, PRC = People's Republic of China, RUS = Russian Federation, SVK = Slovakia, THA = Thailand, TUR = Turkey, VEN = Venezuela, ZAF = South Africa.

Note: Inflation volatility is the standard deviation of quarterly year-over-year inflation computed over the period 2004–2013. The legal rights for both borrowers and lenders are from the World Bank's *Doing Business 2015* report and range from 0 (poor rights) to 12 (best rights).

Source: Burger, Warnock, and Warnock, forthcoming.

Click here for figure data

2.2.4 Lessons for Asia from Thailand's bond market

Concerted efforts in Thailand to develop its bond markets after the Asian crisis have met success and may offer lessons for the region (box figure). The crisis caused businesses and financial institutions to fail across Thailand. To finance the losses and sustain the economy, the Ministry of Finance needed to swiftly issue B500 billion worth of government bonds, then equal to about 10% of Thailand's GDP. While tackling the urgent need to place these issues, the ministry recognized a clear opportunity to develop a local currency bond market in Thailand.

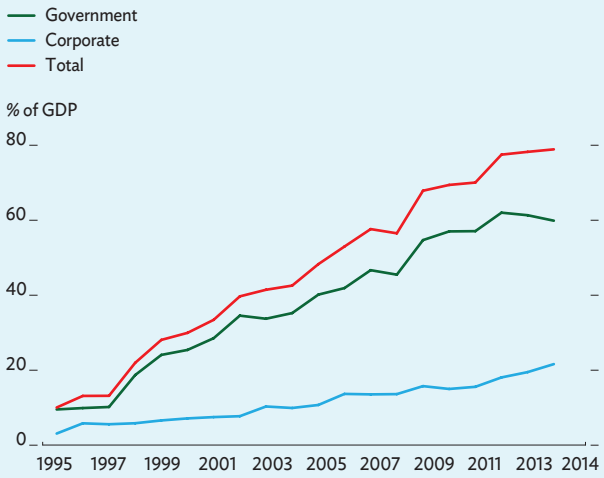
In 1999, the ministry established the Domestic Bond Market Committee to focus on the bond market. Within its bureaucracy, the ministry mobilized the participation of the Fiscal Policy Office, Comptroller General's Department, Office of Insurance Commission, and Revenue Department. In the initial phase, parts of Fiscal Policy Office and the Comptroller General's Department were carved out and merged to form the Public Debt Management Office, which subsequently played a leading role in the effort of the Domestic Bond Market Committee, particularly while emphasis was placed on the government bond market.

The committee drew up a comprehensive roadmap to concentrate the efforts of members around the following pillars:

(i) building comprehensive public debt management capacity;
(ii) enhancing the primary bond market;
(iii) enhancing the secondary bond market;
(iv) enhancing the clearance and settlement of bond trades;
(v) rationalizing bond taxation;
(vi) enhancing bond market information technology infrastructure; and
(vii) standardizing bond market business practices.

Policy actions have to be appropriately sequenced, as certain reforms and developments must take place first for other reforms to be effective. The committee focused on the government bond market, which differs significantly from a corporate bond market in terms of credit, liquidity, instrument design and diversity, and prudential rules—and, therefore, the investor base.

Thailand's local currency bonds outstanding



Source: Asian Development Bank, Asian Bonds Online (accessed 4 March 2015).
Click here for figure data

Over time, the committee revised the pillars to shift the focus toward a corporate bond market. However, the establishment of a well-functioning government bond market clearly laid a solid foundation for market sustainability and facilitated the subsequent development of a corporate bond market. Success came partly because the government bond market was large, liquid, and able to generate transaction volume high enough to ensure the viability of sophisticated market infrastructure such as trading and settlement systems. A corporate bond market can benefit from such market infrastructure, though it cannot by itself support them because it is too diverse, fragmented, and illiquid. Banks also gained experience in investing in fixed income instruments while managing their liquidity and interest rate risks.

Thailand still needs to work on further developing its corporate bond market. With a significant and growing contractual savings and asset management sector, Thailand should be prepared to tackle this challenge even in the face of the tighter prudential requirements for banks today.

Among Asian EMEs, improvement in the currency structure of bond markets has been rapid, with the proportion of foreign-currency bonds falling from 10% around 2000 to just 4% in 2013. In the PRC, India, Malaysia, Pakistan, and Thailand, more than 90% of bonds are now denominated in local currency. However, some economies still have a high proportion of foreign-currency bonds, such as the Philippines with 38% and Indonesia with 26%.

It should be noted that big differences exist across Asia, and bond markets in many financially underdeveloped countries are still

embryonic or nonexistent (Annex table on page 102). Further, in the region as a whole, the market for corporate bonds remains less developed than the market for sovereign bonds. This remains true in economies such as Thailand that have made good progress in bond market development (Box 2.2.4). On the whole, the region has made a lot of progress, but considerable scope remains to further develop bond markets, especially corporate bond markets.

Country-specific paths to financial development

Policies to improve productivity and growth performance must be designed to specific contexts. They must take into account an economy's distance from the global technology frontier, which defines its productivity gap with the rest of the world (Aghion and Howitt 2006 and 2009). In a recent empirical study, Dabla-Norris, Ho, and Kyobe (2013) confirmed that reform to drive productivity growth operates with differing force across groups of economies depending on their distance from the technology frontier, as approximated by a country's real per capita GDP or productivity gap with the US. In the area of financial sector reform to spur productivity growth, the general policy priorities they highlight are as follows for different income groups (see also Dabla-Norris et al. 2013).

Low-income and lower-middle-income countries. As economies in this group tend to have financial systems heavily based on banks, they stand to benefit most from further bank reform.[8] Reform in these economies should aim to mobilize domestic savings, lower the cost of credit to improve access, and promote the allocation of financial resources to the most productive sectors. In addition, where financial repression is still present, reducing restrictions on the price or quantity of credit can help resources find the most productive uses within and across sectors. To prevent excessive risk taking and to promote the quality of intermediation over its quantity, however, reform must be complemented by strong prudential policies. Batten et al. (forthcoming) discusses the key challenges to financial sector development in five low-income and lower-middle-income Asian countries.

Upper-middle-income countries. Empirical results suggest that upper-middle-income countries can reap significant productivity gains by further deepening their capital markets (Dabla-Norris, Ho, and Kyobe 2013).[9] Policies that encourage the formation and development of markets for equity, securities, and bonds, particularly local-currency bonds, can be particularly effective at increasing total factor productivity and labor productivity by lowering the cost of capital and facilitating the financing of new capital and innovation. Although many large EMEs have achieved significant capital market development in terms of generating a larger menu of financial instruments, improving market infrastructure, and diversifying their investor base, capital markets in upper-middle-income countries still lag those in advanced economies in size, turnover, liquidity, and the development of institutional investors.

The need to tailor financial sector development to the country context is especially evident in developing Asia, home to a great deal

of diversity in stages of development, both financial and economic. In particular, the more financially developed economies in the region have a good mix of banks and capital markets, while the less financially developed ones remain heavily reliant on banks. Nevertheless, regardless of the development and composition of their financial systems, all Asian economies must strengthen the governance of both banks and capital markets toward maximizing the positive impact of finance on growth.

Governance for banks and capital markets that promote growth

The glue that links finance and growth is good governance in financial institutions and markets. Good governance makes capital more likely to flow to productive investments that contribute to growth and reduces the risk that it will be wasted or misallocated to unproductive ventures.

Banks and capital markets alike are susceptible to bad governance. Owners, managers, and directors can breach their fiduciary duties to depositors and shareholders by using their positions to benefit themselves at the expense of their institutions and those who rely on the institutions financially. Owners, directors, and managers of banks, for example, can arrange loans for themselves, family members, or friends on unusually favorable terms or disregard norms for prudent lending.

Similarly, bank holding companies and industrial combines that include banks can instruct wholly owned bank subsidiaries to finance projects that would otherwise fail to meet lending standards. In capital markets, owners, managers, and shareholders can use inside information to buy or sell company shares to their own advantage at the expense of others. They can manipulate corporate rules to restrict the rights of minority shareholders or fail to disclose material information when issuing bonds or stock.

Experience has shown repeatedly that neither companies nor markets can be expected to police themselves sufficiently to ensure satisfactory governance at banks and other financial institutions. Appropriate regulations are therefore needed to limit governance problems. For banks, regulations can limit or prohibit so-called "connected lending" to owners, directors, and managers. In addition, many countries limit the maximum size of individual loans to a certain percentage of the bank's paid-in capital. Regulations can bar banks from lending to other firms in a conglomerate or bank holding company.

For capital markets, regulations can prohibit owners and managers from trading shares on the basis of inside information. They can stipulate certain rights for minority shareholders. In addition, regulations can require the disclosure of key information for firms listed on stock markets or attempting to issue stock or bonds. They can establish rules for trading shares and bonds on exchanges, including regulations designed to limit how much a market may move up or down during a single trading day.

Financial access for inclusion

Policy makers around the world have placed financial inclusion—or ready access for households and firms to reasonably priced financial services—at the top of the development agenda. This policy direction is backed by a growing body of research that shows significant benefits from financial systems that cater to the low end of the market. Although financial development generally promotes growth, it does not necessarily promote equality. Growth from financial development can be inclusive only by meeting the financing needs of households and firms, even the underprivileged.

In the absence of inclusive financial systems, poor people must rely on their own resources to meet their financial needs and cope with income shocks, while small enterprises rely on their earnings to pursue promising growth opportunities (Demirgüç-Kunt and Klapper 2013). However, the poor in developing Asia have limited access to financial services (Figure 2.3.1). Unfortunately, the broader consequences are the perpetuation of income inequality and slower economic growth.

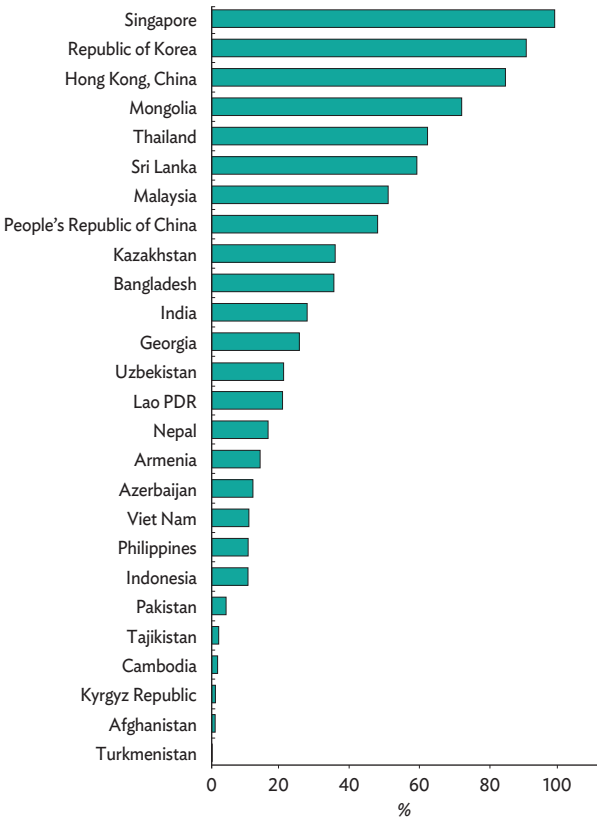
Financially developed economies generally provide financial access to a greater number of households and firms, but not always. While developing Asia performs better than other developing regions in terms of financial development, it does not do so regarding financial inclusion, either for households or firms.

Household access to finance

One indicator of financial inclusion is household access to finance. This can be measured by account penetration, defined as the percentage of adults who have an individual or joint account at a formal financial institution such as a bank, credit union, cooperative, post office, or microfinance institution. Based on the Global Findex database, which culls information from survey interviews, the median worldwide for this measure is 36.7% (Demirgüç-Kunt and Klapper 2013).[10] With account penetration of 26.7%, developing Asia fares better than other developing areas, such as sub-Saharan Africa and the Middle East and North Africa, but still falls below the global median (Figure 2.3.2).

Wide diversity exists within developing Asia (Figure 2.3.3). While account penetration is nearly universal in Singapore and the Republic of Korea, it is much lower in other economies: less than 1% in Turkmenistan, and less than 5% in Cambodia, the Kyrgyz Republic, and Tajikistan.

2.3.1 Adults with an account at a formal financial institution, bottom 40 percentile by income, 2011

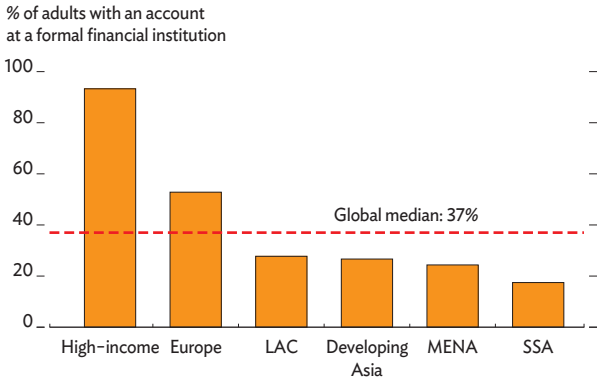


Lao PDR = Lao People's Democratic Republic.

Source: Estrada et al. (forthcoming) based on data from Demirgüç-Kunt and Klapper (2013).

Click here for figure data

2.3.2 Formal account penetration across the world, 2011



LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, SSA = sub-Saharan Africa.

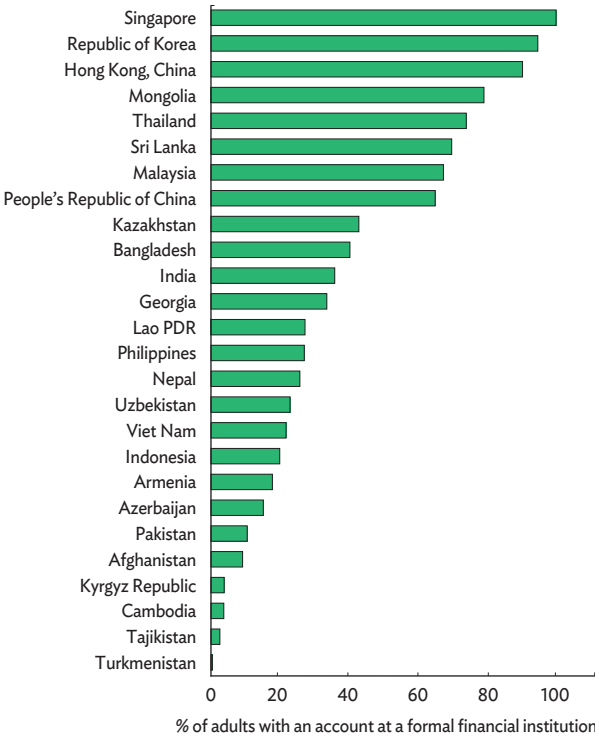
Source: Ayyagari and Beck (forthcoming) based on data from Demirgüç-Kunt and Klapper (2013).

Click here for figure data

Household access also varies across economies in developing Asia by demographic variable (Figure 2.3.4). In South Asia, where the gender gap is widest, 43% of men are likely to have an account but only 30% of women. In East Asia, where account penetration is highest, 85% of adults in the top 60 percentile of the income distribution report having an account but only 67% do in the bottom 40 percentile. The gap by income is smallest in Central Asia, where 22% of the top group and 16% of the bottom group report having an account. Meanwhile, across developing Asia, adults with at least secondary education, and adults aged 25 and older, are more likely to have access to finance than adults with primary education or less, and those aged 15–24.

A complementary picture emerges if one looks at indicators from the supply side of finance such as the number of commercial bank branches per 100,000 adults and the number of ATMs per 100,000 adults. Based on a survey on financial access conducted in 2011 by the International Monetary Fund, the median in developing Asia is the lowest except in sub-Saharan Africa (Figure 2.3.5). Within the region, again, large differences exist across countries. The number of ATMs per 100,000 adults ranges from over 75 in Brunei Darussalam and Thailand to fewer than 5 in Afghanistan, Bangladesh, the Marshall Islands, Pakistan, and Uzbekistan (data are unavailable for the Republic of Korea).

2.3.3 Formal account penetration in developing Asia, 2011

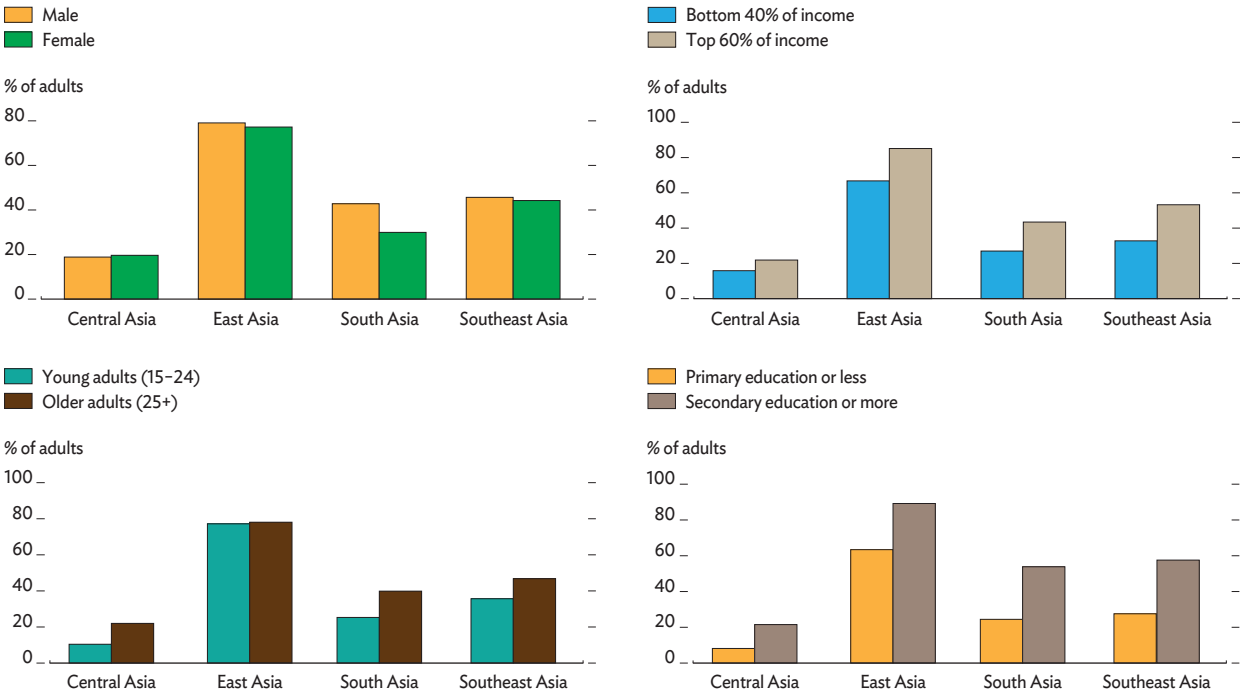


Lao PDR = Lao People's Democratic Republic.

Source: Ayyagari and Beck (forthcoming) based on data from Demirgüç-Kunt and Klapper (2013).

Click here for figure data

2.3.4 Account penetration in developing Asia by demographic variable, 2011



Source: Ayyagari and Beck (forthcoming) based on data from Demirgüç-Kunt and Klapper (2013).

Click here for figure data

Barriers to households' use of finance

Multiple barriers limit financial inclusion across the world, some of them supply factors such as physical distance and high transaction costs for banks when operating in remote locations, and others demand factors such as lack of financial literacy, erratic cash flow, or low income.

In developing Asia, the most frequently mentioned reasons for not having a bank account, according to the Global Findex survey, are the lack of money at 76.2%, cost at 21.9%, and travel distance at 21.8% (Figure 2.3.6). Clearly, the fixed costs associated with opening and maintaining an account impede access to finance. This helps explain the success of social banking programs such as one in India from 1969 to 1990 that aimed to improve for the poor physical access to finance by emphasizing branch expansion into unbanked rural locations. Physical barriers have been quite high in developing Asia, which is at the low end of the spectrum in terms of bank branching and ATM density.

Lack of documentation is a reason cited by 17.5%. In other parts of the world, these barriers are overcome by technology and such alternative delivery channels as mobile banking, e-finance, and phone finance, but such channels do not seem to be very prevalent in developing Asia. For instance, the median percentage of respondents who paid bills used wire transfers or online payment, or shopped online using money from their accounts, was only 2.1% in developing Asia, compared with 44.8% in the high-income group. Table 2.3.1 shows the relative importance of physical access, affordability, and eligibility as barriers to deposit services in selected Asian economies.

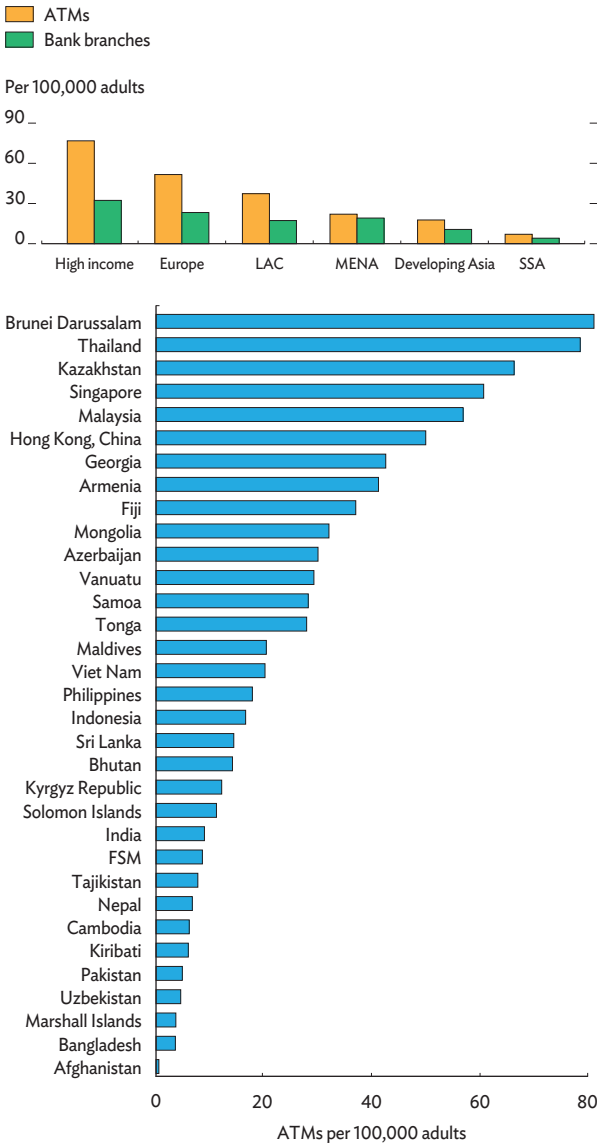
Firms' access to finance

Financial constraints affect firms in developed and developing countries alike, and this is an active area of research in corporate finance. Research has shown that the lack of access to finance is a critical constraint on growth and innovation. As small firms are the most adversely affected, they are likely to benefit the most from financial and institutional deepening.

World Bank Enterprise Surveys from 2006 to 2014 sampled firms formally registered in over 100 economies to study business climate constraints on private sector growth and performance.[11] Regional comparisons show that the proportion of firms in developing Asia with a checking or savings account is 84.2% (Table 2.3.2). This is comparable to the percentage of firms with a checking or savings account in sub-Saharan Africa (83.9%), but lower than in Latin America and the Caribbean (88.8%) or emerging Europe (92.1%).

Similarly, the proportion of firms that have a credit line or loan from a financial institution in developing Asia is

2.3.5 ATMs and bank branches per 100,000 adults

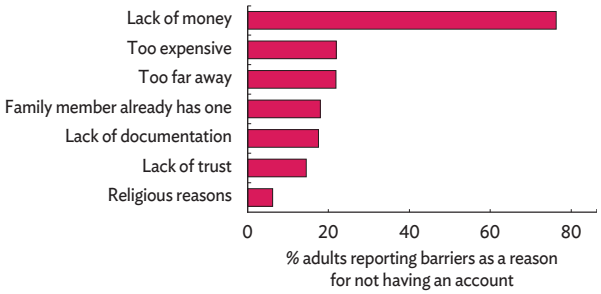


FSM = Federated States of Micronesia, LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, SSA = sub-Saharan Africa.

Source: Ayyagari and Beck (forthcoming) based on data from the 2011 Financial Access Survey.

Click here for figure data

2.3.6 Barriers to account penetration in developing Asia, 2011



Note: Respondents were allowed more than one response. The data for lack of money reports the percentage of adults who reported only this reason.

Source: Ayyagari and Beck (forthcoming) based on data from Demirgüç-Kunt and Klapper (2013).

Click here for figure data

33.0%, which lags 53.7% in Latin America and the Caribbean and 40.9% in emerging Europe. Within developing Asia, East Asia and the Pacific perform better than the other regions in terms of both access to a credit line or loan and firms' use of savings or checking accounts. While a large percentage of firms use a checking or savings account, firms' access to external finance is limited.

2.3.1 Barriers to deposit services in selected Asian economies

	Physical access	Affordability		Eligibility
	Locations to open deposit account (score 1–3)	Minimum amount to open a checking account (% of GDPPC)	Annual fees for a checking account (% of GDPPC)	Number of documents to open a checking account (1–5)
Armenia	1.8	11.0	0.4	2.9
Bangladesh	2.0	2.3	0.0	4.6
China, People's Republic of	3.0	0.0	0.0	1.0
Georgia	2.6	0.0	0.3	1.7
India	2.0	8.9	0.0	2.7
Indonesia	2.5	9.5	2.8	3.2
Korea, Republic of	2.1	3.3	0.1	1.9
Pakistan	2.0	1.6	0.0	2.6
Philippines	2.0	14.5	0.0	3.2
Sri Lanka	1.8	15.8	0.7	2.6
Thailand	2.5	6.7	1.3	1.2
Median	**2.0**	**6.7**	**0.1**	**2.6**
Average	**2.2**	**6.7**	**0.5**	**2.5**

GDPPC = gross domestic product per capita.

Note: Locations to open deposit account take the value 1 if an account can be opened at headquarters only, 2 if at headquarters or a branch, and 3 if at headquarters, branches, or a non-branch outlet. The minimum amount to open or maintain a checking or savings account is the minimum balance required to open or maintain a checking or savings account. Annual fees for checking or savings accounts are the fees associated with maintaining the account. Documents needed to open a checking or savings account consist of identification, payment slip, letter of reference, proof of domicile, and any other document a bank requires. This indicator varies from 1 to 5 depending on the number of documents required.

Source: Ayyagari and Beck (forthcoming) based on a bank-level survey in Beck, Demirgüç-Kunt, and Martinez Peria (2007).

2.3.2 Financial use and access across firms in developing countries

Developing countries in	Percentage of enterprises that have a checking or savings account (%)	Percentage of enterprises that have a line of credit or loan from a financial institution (%)
Middle East and North Africa	54.4	13.9
Developing Asia	84.2	33.0
Central Asia	88.2	29.7
East Asia	91.8	35.6
South Asia	79.7	31.2
Southeast Asia	77.2	35.5
The Pacific	94.6	39.4
Sub-Saharan Africa	83.9	19.0
Latin America and Caribbean	88.8	53.7
Emerging Europe	92.1	40.9

Source: Ayyagari and Beck (forthcoming) based on data from the World Bank Enterprise Surveys, 2006–2014.

Focusing on firm size, one finds that in each of the countries in developing Asia, the percentage of small firms with 5–19 employees that report having a line of credit or loan from a financial institution is much lower than the percentage of medium-sized firms with 20–99 employees or large firms with more than 100 employees (Figure 2.3.7). Across firm size, retained earnings finance over 75% of working capital on average (Figure 2.3.8). The share of working capital sourced from banks is another important indicator and varies from 8.2% for small firms to 17.1% for large firms. The findings suggest that, in developing Asia, small firms' access to credit is particularly constrained.

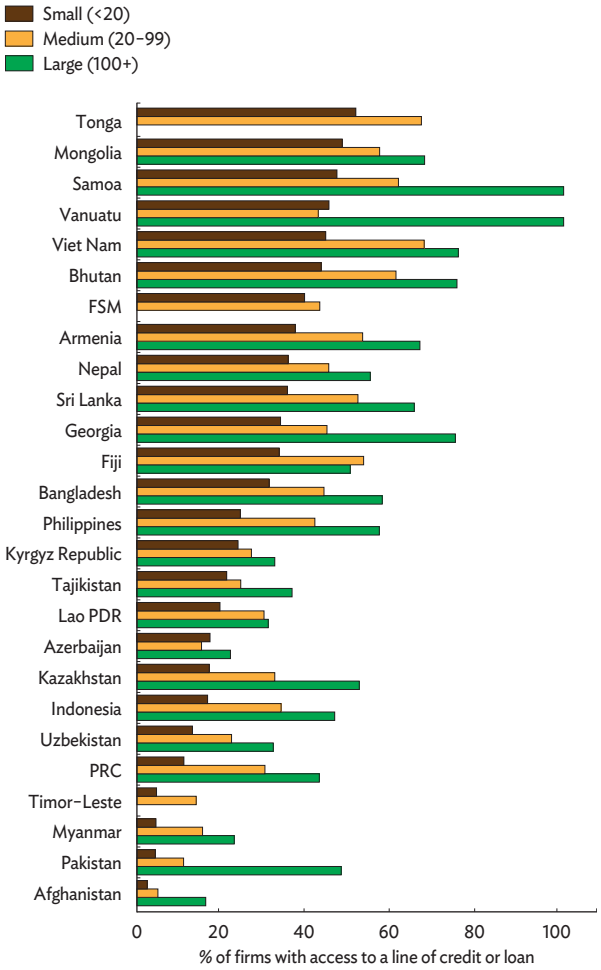
Barriers to firms' use of finance

In developing Asia, weak access to finance is not the only obstacle to firms' growth, but it is the most constraining (Figure 2.3.9). As shown above, bank finance is the largest external source of working capital in the region, yet a large percentage of firms have no access to bank loans or credit lines. The data suggest that, while some firms in the region are excluded from bank finance because of high interest rates, collateral requirements, and/or onerous paperwork, a majority of 55.4% simply have no need to borrow because they have no good projects to finance (Table 2.3.3). Other reasons firms cite for not applying for loans are unfavorable interest rates at 14.8%, complex application procedures at 10.8%, and collateral requirements at 8.2%.

These numbers hide a great deal of variation across countries. For instance, the percentage of firms that report stringent collateral requirements is as high as 18% in Indonesia and Afghanistan. Secured loans are the most common type of loans in the formal financial sector across the world, with three-fourths of firms reporting that their most recent loan or credit line required some form of collateral. This number is highest in developing Asia, at 88% (Figure 2.3.10).

A complementary picture arises from the supply side using bank data collected in 2005–2006 (Beck, Demirgüç-Kunt, and Martinez Peria 2008). The data on physical access to loans (operationally, the number of locations where a loan application can be submitted, with a maximum of five) suggest that banks in developing Asia do not encourage the use of alternative channels, as the median across the sample of developing countries in Asia is way below five (Table 2.3.4). With regard to affordability, the fees associated with loans are as high as 6.5% for a typical business loan and 2.6% for a typical loan to a small- or medium-sized enterprise (SME) in Bangladesh. However, the median in the sample of 12 economies for which data are available is only 0.9% for a typical business loan or SME loan.

2.3.7 Percentage of firms with a line of credit or loan in developing Asia, by firm size

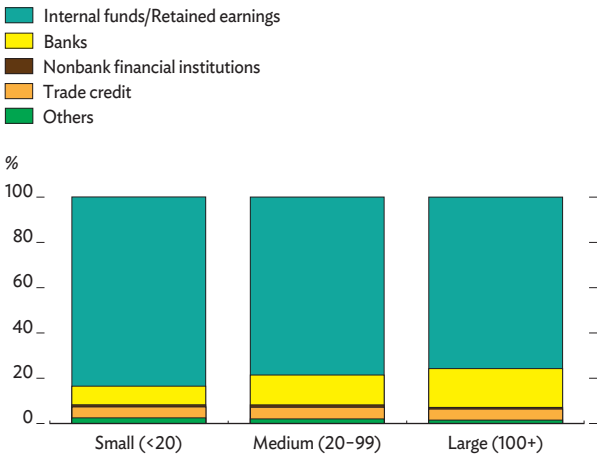


FSM = Federated States of Micronesia, Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.

Source: Ayyagari and Beck (forthcoming) based on data from the World Bank Enterprise Surveys, 2006–2014.

Click here for figure data

2.3.8 Sources of working capital in developing Asia, by firm size



Source: Ayyagari and Beck (forthcoming) based on data from the World Bank Enterprise Surveys, 2006–2014.

Click here for figure data

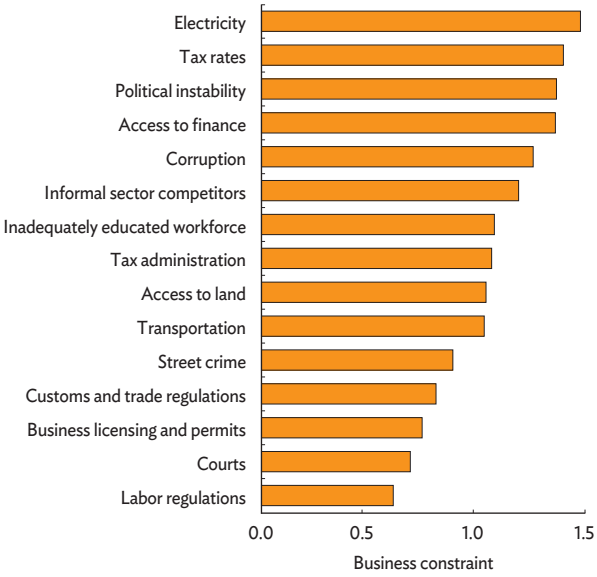
Policy options to improve financial inclusion

Fixed costs and high risk are the two main hurdles to expanding access to financial services to rural and low-income segments of the population. The fixed costs that come with traditional finance often make financial services for the poor prohibitively expensive. High risk is inherent for those who would provide credit and insurance to clients who do not have formal or steady income, are subject to high income shocks, or lack formal property titles or often even personal identification. Innovations and policies have to address these two barriers.

Microcredit. Microcredit has long been seen as an important tool for financial inclusion and poverty reduction. Bangladesh was one of the first countries to see a large expansion of microcredit institutions, several of which, notably BRAC and Grameen Foundation, branched out beyond financial services. Distinguishing themselves from conventional banks, microfinance institutions have introduced such innovations as joint liability for a group of borrowers to facilitate their outreach to the poor and marginalized, especially women. The evidence indicates that microcredit has a positive but limited effect on household welfare and enterprise growth.

Microsavings. Experience across Asia and the rest of the developing world has shown the importance of looking beyond credit to other financial services, including savings, insurance, and payments. As discussed in the survey by Karlan, Ratan, and Zinman (2014), low-income individuals and households face different barriers to formal savings services, some of which mirror similar barriers to other financial services and some more specific to savings. Having a savings account appears to help a household manage its resources better and prioritize expenditure categories such as education and food consumption more effectively.

2.3.9 Constraints faced by firms in developing Asia

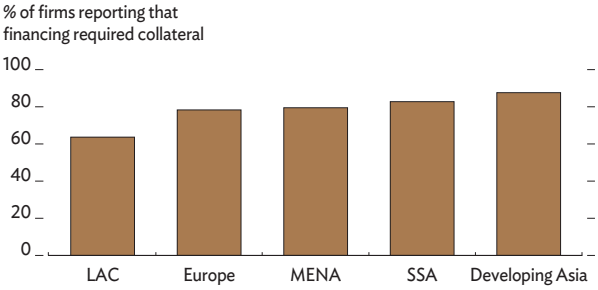


Note: The figure shows the mean response of firm managers who were asked to what extent various issues constitute an obstacle to the growth and operation of their businesses, on a scale of 0 (no obstacle) to 4 (very severe obstacle).

Source: Ayyagari and Beck (forthcoming) based on data from the World Bank Enterprise Surveys, 2006–2014.

Click here for figure data

2.3.10 Financing requiring firms to pledge collateral



LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, SSA = Sub-Saharan Africa.

Source: Ayyagari and Beck (forthcoming) based on data from the World Bank Enterprise Surveys, 2006–2014.

Click here for figure data

2.3.3 Why firms not apply for loans

	Developing Asia	Emerging Europe	Latin America and the Caribbean	Middle East and North Africa	Sub-Saharan Africa
No need	55.4	64.8	65.4	48.3	37.2
Unfavorable interest rates	14.8	19.8	12.3	11.7	19.3
Complex application procedures	10.8	7.1	5.8	9.6	17.4
Collateral requirements	8.2	4.9	4.6	7.6	11.6
Size of loan and maturity are insufficient	3.4	1.1	1.1	3.8	2.3
Did not think loans would be approved	3.2	0.4	2.4	3.0	6.1
Other	4.3	1.8	8.4	15.9	6.3

Source: Ayyagari and Beck (forthcoming) based on data from the World Bank Enterprise Surveys, 2006–2014.

2.3.4 Indicators of barriers to business and SME loans

	Physical access	Affordability		Eligibility	
	Locations to submit loan applications (out of 5)	Business loan fee (% of minimum loan amount)	SME loan fee (% of minimum loan amount)	Days to process business loan applications	Days to process SME loan applications
Armenia	2.0	0.2	0.0	9.9	7.6
Bangladesh	2.1	6.5	2.6	34.6	43.3
PRC	2.0	0.0	0.0	50.0	40.0
Georgia	2.5	1.0	1.1	5.0	5.6
India	2.4	0.9	0.8	20.0	10.8
Indonesia	3.1	0.9	1.5	16.6	9.7
Korea, Republic of	3.8	0.3	0.3	2.7	2.7
Pakistan	3.1	0.1	0.2	32.0	33.6
Philippines	2.4	1.4	1.4	44.1	33.3
Sri Lanka	3.0	2.3	2.1	15.6	10.0
Thailand	2.0	0.6	0.9	22.5	23.7
Median	**2.4**	**0.9**	**0.9**	**20.0**	**10.8**
Average	**2.6**	**1.3**	**1.0**	**23.0**	**20.0**

PRC = People's Republic of China, SMEs = small and medium-sized enterprises.

Note: Data are weighted by country averages. Locations to submit loan applications take the value 1 if the application can be submitted at headquarters only; 2 if at headquarters or a branch; 3 if at headquarters, branches, or non-branch outlets; 4 if at headquarters, branches, non-branch outlets, or electronically; and 5 if at headquarters, branches, non-branch outlets, electronically, or over the phone. Fees for business or SME loans are expressed as a share of gross domestic product per capita.

Source: Ayyagari and Beck (forthcoming) based on a bank-level survey in Beck, Demirgüç-Kunt, and Martinez Peria (2007).

Microinsurance. Many households and enterprises in developing countries face significantly higher risks and volatility than their peers in more developed countries. Insurance that can cushion income or expenditure shocks and their effects on consumption are therefore important. The provision of formal insurance products is hampered by high risks and costs, including costs to screen prospective policyholders and to verify claims. Products need to be designed to pay out fairly soon and often to engender trust in potential users. To create trust, rapid payouts are important, as clients' liquidity constraints are often binding.

Other policies and innovations. One important constraint on financial inclusion is physical access to bank outlets. One important policy tool has been regulations on branches as in India, where such regulations caused 30,000 new rural branches to open from 1977 to 1990 and thereby increased deposit and credit volume. Financial literacy programs have so far had only very limited effect on financial behavior, including savings, but fine-tuning such programs may allow them to reach out to individuals, especially the young, as they make financial decisions. Finance that complies with *sharia* restrictions can attract Asian Muslims who are averse to conventional finance. Meanwhile, biometric identification initiatives, such as Aadhaar ("foundation") in India, can provide to the poor the proper identification they need to open an account and conduct financial transactions.

Financial institutions in general have made few efforts to reach low-income segments of the population because the transactions they require are too small to be profitable. A response has been a trend

toward delivery channels that are more cost-effective—famously mobile phones but also banking agents, who are local retailers that handle banking services on behalf of banks. The focus has been mostly on providing payment and savings services, which may explain their successful proliferation. Using data across 10 countries, McKay and Pickens (2010) report that so-called branchless banking is 19% cheaper for clients on average than comparable banking products offered through traditional channels. Savings can be even larger—half of costs—for medium-term savings and paying bills. Another policy option to expand access to formal financial services is public–private partnership, which has allowed the digitalization of government payments in Pakistan.

Policy focus on small- and medium-sized enterprises

Transaction costs and information asymmetries hinder access to external finance for SMEs. Fixed transaction costs for credit assessment and loan processing and monitoring fall per unit as the size of the loan increases, which makes small loans to SMEs relatively costly. Meanwhile, managing risk is a greater challenge in lending to SMEs because, compared with larger firms, their dealings are opaque, their collateral poor, and their financial statements rarely audited. Moreover, if a given sector has few participating SMEs, financial institutions cannot benefit from economies of scale or risk-diversification. Some policy reforms to ease SMEs' financing constraints are discussed below.

Credit registries or bureaus. Constraints on SME financing demand general reform to the business environment and institutions, not necessarily specific to the SME lending market. One institution that can have a positive impact on lending to SMEs is a credit registry or bureau. Brown, Jappelli, and Pagano (2009) found in a sample of economies in transition in Central and Eastern Europe that the introduction or upgrade of credit registries in the 2000s significantly eased constraints on SME financing. Credit registries can expand bank outreach by either increasing competition among them or facilitating the entry of new players. As with policies that help push the financial system toward the frontier, improved access to external finance for SMEs has only indirect effects on economic growth and poverty reduction, so benefits should not be expected in the short term.

Roles of foreign banks and relationship banking. One controversial issue in SME finance has been the role of foreign-owned banks. The empirical evidence is mixed. Firms of all sizes report lower barriers to finance in economies with a higher share of foreign banks (Clarke, Cull, and Martinez Peria 2006). This positive effect can be direct or indirect. Foreign banks can bring in the knowhow and scale that encourage the introduction of new transaction and lending techniques. Further, by competing with domestic banks for a limited field of large corporate clients, they can force domestic banks to go down market to serve smaller companies, where they enjoy a local advantage catering to SMEs (De Haas and Naaborg 2005). The flip side of this is the

evidence that foreign banks are less likely than domestic banks to lend to small companies with opaque operations (Mian 2006, Gormley 2010). This observation echoes the traditional view that SME finance revolves around relationships and long-term connections between a bank and its borrowers.

Partial credit guarantees. To address the problem of many SMEs being able to offer only poor collateral, partial credit guarantees feature prominently in activist policies for the credit market. While private guarantees exist, governments and their development partners in particular have been aggressively pushing to establish guarantees to widen SME access to bank credit. In this regard, issues of pricing, funding, and institutional structure are important. While such schemes can be self-sustainable, they often require significant subsidies and contingent fiscal liabilities to cover losses. While it is difficult to compute such costs in advance, it is even more difficult to measure the benefits, which include adding new borrowers that would not have gained access to finance if not for partial credit guarantees. Only a few studies have rigorously assessed the impact of the guarantees, but those few point to a somewhat positive effect.

Equity finance. Equity finance has not received sufficient emphasis as a source of financing for SMEs. This form of finance can be beneficial when debt finance is not an option or a firm has reached its leverage limit. Although some developing countries have set up second-tier stock exchanges for SMEs, most such exchanges lack the necessary scale, demand, and infrastructure. For example, the over-the-counter exchange of India was established in 1992 as a platform to allow SMEs to generate equity capital, but it had only 60 companies listed as of March 2012. One barrier is the lack of institutional participation (Nair and Kaicker 2009). Private equity might therefore be a more promising route than public toward providing SMEs with access to equity finance. Private equity funds and venture capitalists, including angel financiers, can help. The main constraint on private equity investment in many developing countries, however, is limited scale.

Final thoughts on financial access for inclusion

The lessons from the recent literature on financial inclusion have important policy repercussions for developing Asia. While external finance is critical for SME development, credit might not be the most urgent financial service for previously unbanked individuals. Payment and savings services can help low-income households smooth the effects of income shocks, income fluctuation, and sudden or lumpy consumption needs—and, ultimately, help them better integrate into the modern market economy. In terms of policy repercussions, the message therefore favors the careful expansion of credit with a greater focus on innovation to extend access to savings and payment services to the previously unbanked population. Competition and a favorable regulatory framework are critical. Finally, as Mylenko and Park (forthcoming) point out, more and better data on financial inclusion will help inform and guide the efforts of policy makers to broaden financial access.

Financial stability to safeguard inclusive growth

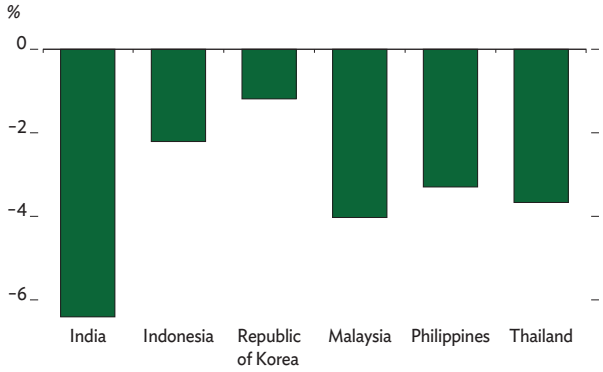
While financial development can contribute to economic growth, it can also pose risks to financial stability, undermining both growth and equity. Liberalizing tightly regulated financial systems—as, for example, the PRC is attempting as it moves from a state-controlled system to a more competitive and market-oriented system—ultimately leaves sounder and more efficient financial intermediation. However, in the short run, it may acerbate volatility.

The challenge for the region is therefore to maintain financial stability even as it develops and liberalizes its financial system. During the global financial crisis of 2008–2009, the world saw the importance of strong and effective prudential regulation. In developing Asia, the regulatory challenges seem even more daunting, as regulators have to maintain financial stability while also encouraging growth-promoting financial development.

Asia's financial systems are fortunately much healthier today, owing largely to reforms that followed the Asian financial crisis of 1997–1998. Even so, external shocks can unsettle local markets. Such an event happened in May 2013, during the so-called taper tantrums, when news of a possible change in US monetary policy decimated Asian stock prices and currency values (see Figure 2.4.1). Home-grown risks still lurk in the background, in the form of large shadow banking systems in some economies and unrestrained household debt expansion in others.

The point of departure for a financial regulatory framework that is strong yet nimble must be adequate prudential regulation and supervision of banks, which still dominate financial systems in developing Asia. Banking regulation is the primary safeguard against financial instability, but it should be supplemented by macroprudential policies and other new policy instruments now available to regulatory authorities.

2.4.1 Nominal rate changes against the US dollar during the taper tantrum, 23 May–30 June 2013



Note: Decline means depreciation.
Source: Estrada et al., forthcoming.
Click here for figure data

Banking regulation in Asia

As economies in developing Asia are quite diverse in population, demographics, and per capita GDP, it is no surprise that they vary widely in the size, structure, and complexity of their banking systems. They all have a common need, however, for supervision and regulation to keep their banking systems safe and sound. This means ensuring that their inevitable problems are manageable and that their bank failures, when unavoidable, are not large or systemic. Meanwhile, banks must remain able to meet credit needs.

2.4.1 Banking crisis outcomes, 1970–2011

Country	Output loss	Increase in debt	Monetary expansion	Fiscal costs	Fiscal costs	Duration	Peak liquidity	Liquidity support	Peak NPLs
	Medians								
	% of GDP				% of financial system assets	Years	% of deposits and foreign liabilities		% of total loans
All	23.0	12.1	1.7	6.8	12.7	2.0	20.1	9.6	25.0
Advanced	32.9	21.4	8.3	3.8	2.1	3.0	11.5	5.7	4.0
Emerging	26.0	9.1	1.3	10.0	21.4	2.0	22.3	11.1	30.0
Developing	1.6	10.9	1.2	10.0	18.3	1.0	22.6	12.3	37.5

NPL = nonperforming loan.

Source: Laeven and Valencia (2012), Table 2, p. 17, using data from authors' calculations.

Given the huge role of banks in Asia and the crippling effect of banking crises on growth, regulatory authorities' first line of defense against financial stability is naturally the sound prudential supervision and regulation of these institutions (Table 2.4.1). In addition, regulatory authorities in the region need to follow guidelines set by Basel III core principles for bank regulation, which were recently introduced to strengthen global regulatory standards in the aftermath of the global financial crisis.

Southeast Asia in particular has unique regulatory and supervisory challenges arising from ongoing regional financial integration. The past 20 years have seen the emergence and expansion of many large banking conglomerates throughout the region. Some of these conglomerates operate banks that are systemically important in more than one economy. Conglomerate interconnectedness poses potential contagion risk—the possibility that problems arising in one affiliate can spread to other affiliates through various mechanisms such as intercompany transactions.

Bank supervisory authorities in jurisdictions where conglomerates operate subsidiary banks need to ensure timely and effective two-way communication and information-sharing with their foreign counterparts. Coordination among supervisors enables better understanding of the risks and financial soundness of the conglomerate parent and its bank and other subsidiaries, as well as the risks posed by transactions between affiliated organizations.

Basel III in developing Asia

Those who set international standards, such as the Financial Stability Board and the Basel Committee on Banking Supervision, pursue reform agendas intended to reduce the risks of bank failure and to mitigate the cost of failures and thereby preserve public confidence in the banking system when they occur. In particular, Asian banks are now confronted with Basel III and the tightening of the Basel Committee's core principles for bank supervision agreed in 2011–2012 in response to the global financial crisis. That crisis resulted partly from a serious failure of bank regulation in the advanced economies. Basel III presents voluntary regulatory standards on bank capital adequacy, stress testing,

2.4.2 Comparison of Basel II and Basel III capital requirements

% of risk weighted assets	Capital requirements							Additional macroprudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer	Additional loss-absorbing capacity for systemically important financial institutions
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	2.0			4.0		8.0			
Memo:	Equivalent to about 1% of an average international bank under the new definition			Equivalent to about 2% of an average international bank					
Basel III	4.5	2.5	7.0	6.0	8.5	8.0	10.5	0.0–2.5	1.0–2.5
New definition and calibration								10.5–15.5	

Source: ADB estimates.

and market liquidity due to be implemented by March 2019. The initial Basel principles were agreed in 1988 and revised in 2004 (Basel II). Table 2.4.2 compares Basel II and Basel III, and Table 2.4.3 outlines the implementation table for Basel III.

Adherence to the more stringent Basel III standards will further strengthen Asian banks' balance sheets and mitigate their vulnerability to shocks. The regulatory framework reduces opportunities for regulatory arbitrage and harmonizes regulatory standards. However, the region must ensure that tightened regulations do not seriously compromise banks' capacity to fulfill their core function of channeling credit to households and firms for investment and production.

2.4.3 Basel III implementation timetable

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage ratio (%)	Supervisory monitoring		Parallel run with disclosure starting 2015				Migration to Pillar 1		
Minimum common equity capital ratio			3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital conservation buffer						0.625	1.25	1.875	2.5
Sum of the above			3.5	4.0	4.5	5.125	5.75	6.375	7.0
Phase-in of deductions from common equity tier 1 capital				20	40	60	80	100	100
Minimum tier 1 capital			4.5	5.5	6.0	6.0	6.0	6.0	6.0
Minimum total capital			8.0	8.0	8.0	8.0	8.0	8.0	8.0
Minimum total capital + conservation buffer			8.0	8.0	8.0	8.625	9.25	9.875	10.5
Capital instruments that no longer qualify as non-core tier 1 or 2 capital	To be phased out over 10 year period starting 2013								
Liquidity coverage ratio	Observation begins				Introduce minimum standard				
Net stable funding ratio		Observation begins						Introduce minimum standard	

Source: ADB estimates.

Banks in Asia appear sound today even under the new stricter standards of Basel III thanks to earlier efforts to strengthen their capital base, reduce nonperforming loans, and bolster loan loss provisions, especially after the Asian financial crisis of 1997–1998. However, another reason is that the region's financial markets are underdeveloped and not as exposed to sophisticated instruments as their counterparts in more financially advanced economies. Bank capital, for instance, is mostly held as simple paid-in capital and retained earnings.

Although they preserve financial stability and improve transparency among banks, the new, stringent regulatory standards raise the cost of financial intermediation and limit the availability of bank credit. In upper-middle-income countries, relatively scant and expensive bank finance will encourage the development of bond markets, as their economies already have a core bond market and a growing institutional investor base such as insurance companies. The tight leverage ratio under Basel III will likely limit the supply of bank finance, as banks in these countries often stretch their balance sheets. Moreover, capital requirements will likely constrain the provision of bank finance for SMEs unless efforts are made to enhance secured and unsecured lending and promote nonbank finance for SMEs.

For lower-middle-income countries, the challenges that Basel III pose are somewhat different and more challenging. The new financial standards, particularly liquidity requirements, are likely to constrain the generation of medium- to long-term bank finance because financial systems are heavily dominated by banks. While solvency policies are designed to encourage very long-term investment by insurance companies, insurance industries are often too small in these economies to compensate for the loss of medium- to long-term finance from banks. Therefore, in addition to developing a base of long-term institutional investors such as insurance companies and pension funds, regulators must, in the meantime, induce banks to meet their capital adequacy requirements by expanding their capital, not cutting back their lending.

Lessons from the global financial crisis

According to Zamorski and Lee (forthcoming), international experience during the global financial crisis provides some valuable lessons for Asian bank regulators. Above all, the crisis underlined that sound and effective bank regulation is vital to financial stability. The crisis reflected the failure of regulatory authorities to keep pace with financial innovation. The sobering lesson for Asia and the rest of the developing world is that even financially advanced economies are susceptible to risks from lax regulation and reckless lending.

Assessments of the global financial crisis of 2008–2009 invariably point to ineffective finance regulation and supervision as the main reasons for the onset of the crisis and its severity. In particular, lapses in banking regulation contributed significantly to the outbreak. Regulators allowed banks to operate with excessive leverage and failed to curtail risky lending, primarily mortgages to subprime homebuyers who were inadequately screened for creditworthiness.

Bank supervision had been weak by any measure. Supervisors did not conduct regular onsite bank inspections or examinations of sufficient depth. They did not properly implement risk-based supervision, and they failed to identify shortcomings in banks' risk-management methods, governance structures, and risk cultures.

Instead, overemphasis on banks' historic operating results and static financial conditions in assessing risk failed to reveal potential vulnerabilities. Meanwhile, offsite surveillance systems relied too heavily on banks' self-reported data to effectively monitor risk. Regulators failed to understand the risk and policy implications of new bank products and services and changing business models, or to establish effective lines of communication with their counterparts in other economies, through which they could have shared vital information.

Post-crisis analysis by the International Monetary Fund, Financial Stability Board, and Basel Committee on Banking Supervision identify additional aspects of bank supervision that could have helped avoid the global financial crisis:

(i) adequately monitoring and controlling macroprudential risk, and not just individual bank risk, as a buildup of such vulnerabilities could hit a number of institutions simultaneously, posing systemic risk;
(ii) conducting comprehensive stress testing of the banking system and other economic sectors, taking into account highly risky scenarios even if they seemed unlikely;
(iii) paying attention to concentrations of risk and to interdependencies, including cross-border risks; and
(iv) considering risks in the shadow banking industry or cross-sector risks posed by nonbank financial intermediaries.

The last major episode of cross-border financial instability and banking crisis in developing Asia occurred more than 17 years ago. To extend this impressive record of relative calm, bank supervisory authorities in the region need to assess their supervisory systems, infrastructure, and actual practices. The lessons learned in the global financial crisis will be useful to this process. If the assessment reveals that changes, enhancements, or remedial action are needed, a definitive plan should be crafted and implemented in a timely way.

Macroprudential policies in developing Asia

Before the global financial crisis, bank monitoring focused primarily on prudential risks to individual institutions and failed to consider that a buildup of macroeconomic risks and vulnerabilities could pose systemic risk by severely affecting a number of institutions simultaneously. The global financial crisis highlighted the need for national bank supervisory authorities to improve surveillance systems and better detect early on the buildup of macroeconomic risks that could threaten the financial system. This requires strong macroprudential policy that includes measures to prevent periods of instability or crisis, as well as a rich set of instruments to alleviate financial risks that stem from vulnerabilities building up in the broader financial system, be they related to credit, liquidity, or capital.

The Basel Committee on Banking Supervision is increasingly guided by the need for a macroprudential perspective on financial regulation. Although much progress has been made on the regulatory front—especially with Basel III tightening of the rules on the quantity and quality of bank capital, requiring for example a countercyclical capital buffer—regulations apply to only some financial institutions. In contrast, macroprudential policy aims to limit the buildup of risk in the entire financial system and enhance its resilience following shocks. Efforts are mainly to identify systemic threats to financial markets that could affect the real economy, and so avoid another financial crisis.

Macroprudential policy measures fall into the following three broad categories (Lim et al. 2011):

(i) credit controls, including caps on ratios of loan to value and of debt to income and on foreign currency lending, as well as ceilings on credit or credit growth;

(ii) liquidity regulations, which place limits on net open currency positions or currency mismatches and on maturity mismatches, while establishing reserve requirements; and

(iii) capital requirements, including countercyclical capital requirements, time-varying/dynamic provisioning, and restrictions on profit distribution.

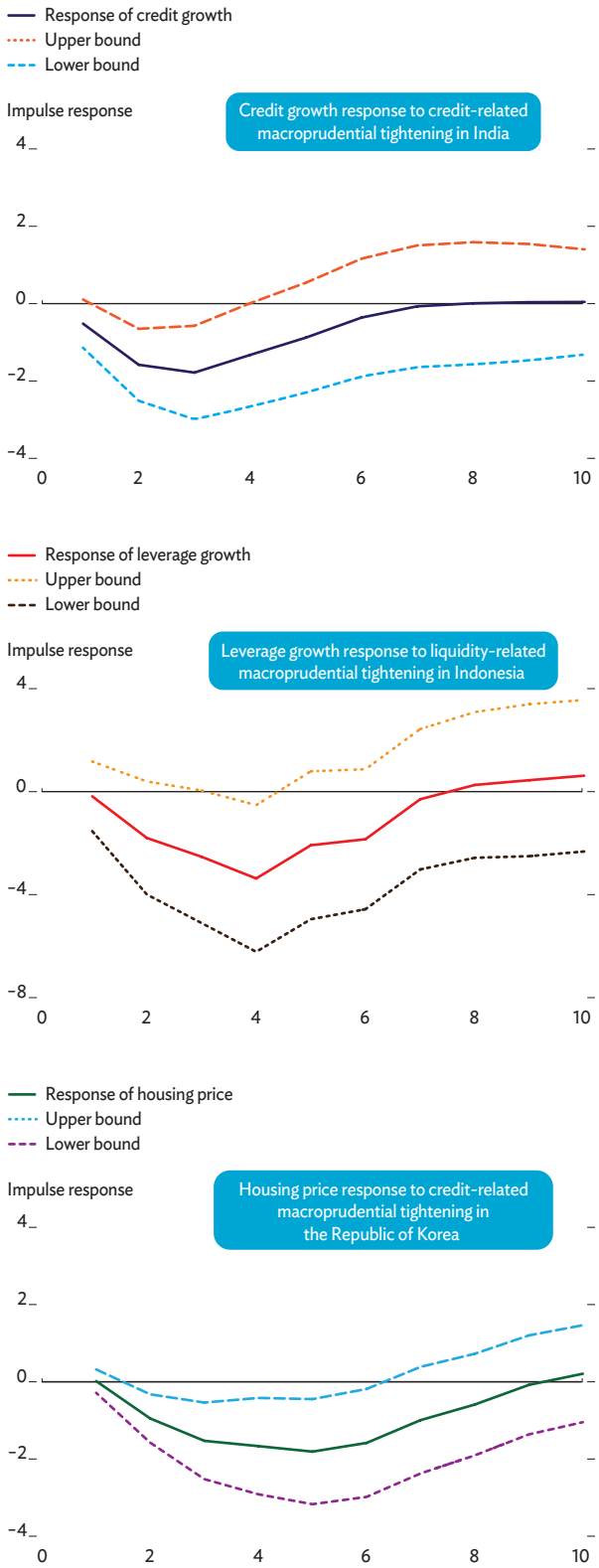
Macroprudential tools such as minimum capital ratios and loan-to-value ratios have been used for some time. Compared with some other regions, Asia has long experience in implementing a variety of macroprudential measures to prevent or address asset price bubbles or other threats to financial stability. This experience is derived primarily from dealing with previous threats to financial stability, especially arising from volatile capital flows.

Can macroprudential policies keep Asian financial systems stable?

In theory, macroprudential measures can safeguard the stability of the banking system and the broader financial system by mitigating risks that affect the entire financial system and therefore the economy. The question is, as always, whether they actually work in practice. This section presents the basic framework of an empirical analysis to gauge how effectively macroprudential policies control credit growth, leverage growth, and housing price appreciation. The broad contours of the methodology and data are described in Box 2.4.1.

Two significant findings emerge. Broadly, macroprudential policies can indeed promote financial stability in Asia. More specifically, different types of macroprudential policies are more effective against different

2.4.2 Responses to selected macroprudential policies in selected economies



Source: Lee, Asuncion, and Kim, forthcoming.

Click here for figure data

types of macroeconomic risks. For example, the results suggest that credit-related macroprudential policy dampens credit growth in India, liquidity-related macroprudential policy reins in leverage growth in Indonesia, and credit-related macroprudential policy helps to control housing price escalation in the Republic of Korea (Figure 2.4.2).

The general pattern across the region suggests that credit-related macroprudential policies can effectively dampen credit expansion and housing price inflation, while liquidity-related macroprudential

2.4.1 Methodology and data

A major innovation of this analysis is defining macroprudential policy as a continuous variable rather than as a binary variable. Tillmann (2014) and Meinusch and Tillmann (2014) recently extended a multivariate dynamic probit model—the qualitative vector autoregression (VAR) model that Dueker (2005) originally applied to forecast business cycle turning points—to uncover the latent propensity to macroprudential policy tightening from the observed binary policy data. This modified methodology can examine the dynamic effectiveness of macroprudential policy and unconventional monetary policy by addressing the exogenous treatment of binary macroprudential policy indicators that are likely endogenous and by tracing out the dynamic adjustment of the endogenous variables following different macroprudential policy shocks.

The binary macroprudential policy indicators often do not properly represent policy stance that leans toward tightening, easing, or maintaining a neutral stance. One advantage of using the qualitative VAR is to uncover latent and unobservable propensity for macroprudential tightening from the observed binary policy data, which provides an endogenous continuous series reflecting the business cycle. A standard VAR with the generated latent series can provide estimates and dynamic impulse response functions for macroprudential policy shocks. Lee, Asuncion, and Kim (forthcoming) comprehensively describe the empirical methodology.

Data came from varied sources such as the International Monetary Fund's International Financial Statistics, CEIC Data Company, the Bank for International Settlements, the Economic Intelligence Unit, and government sources. A database of macroprudential policy instruments draws from Lim et al. (2011, 2013), Shim et al. (2013), Zhang and Zoli (2014), documents posted on the websites of central banks such as annual reports and financial stability reports, the *Annual Report on Exchange Arrangements and Exchange Restrictions* database, and research papers on macroprudential policy in individual economies and the region. The sample period is from the first quarter of 2000 to the fourth quarter of 2013.

The box table shows information about macroprudential instruments that 10 economies have most actively applied in developing Asia during the sample period. In the sample, credit-related macroprudential policy instruments such as ratios of loan to value and of debt to income were used most frequently in Indonesia, the Republic of Korea, Singapore, and Thailand, while liquidity-related macroprudential policy instruments such as reserve requirements and limits on net open currency positions were employed most commonly in the PRC, India, and Indonesia. Capital-related macroprudential policy tools were rarely applied except in India. The tools implemented most often were credit-related macroprudential policy measures.

Specific use of macroprudential policy instruments by economy, 2000–2013

	Economy											
Policy Type	HKG	IND	INO	KOR	MAL	PHI	PRC	SIN	TAP	THA	Total	%
Credit-related[a]	5	6	11	23	6	1	8	13	3	15	92	49.2
Liquidity-related[b]	0	18	7	3	3	10	31	0	6	1	79	42.2
Capital-related[c]	1	4	1	2	0	6	1	1	0	0	16	8.6
Total	**6**	**28**	**19**	**28**	**9**	**17**	**41**	**14**	**9**	**16**	**187**	**100.0**

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

[a] Caps on ratios of loan to value and debt to income, caps on foreign currency lending, and ceilings on credit and credit growth.

[b] Limits on net open currency positions and currency mismatch, limits on maturity mismatch, and reserve requirements.

[c] Countercyclical and time-varying capital requirements, time-varying/dynamic provisioning, and restrictions on profit distribution.

Source: Lee, Asuncion, and Kim, forthcoming.

policy tools moderate leverage growth and housing price escalation. The salient implication for Asian financial regulators is that, while they should explore the use of macroprudential policies, they should assess which exact policies are appropriate for the particular macroprudential risk they face.

Further issues on financial stability for growth

This section discusses three additional approaches relevant for financial stability in Asia. Bank stress tests, which the US and European Union have used extensively since the global financial crisis, offer Asian regulators another potentially useful tool for safeguarding stability. Foreign direct investment and the diversification of external funding sources can reduce the vulnerability of Asian countries to external financial shocks. Finally, the PRC's efforts to liberalize its financial system without upsetting its financial stability is of historic importance for the PRC and provides some valuable lessons for the rest of Asia.

Bank stress tests and their implications for Asia

Bank stress tests assess whether a bank or group of banks are adequately capitalized for stressed economic scenarios. More specifically, stress tests evaluate whether banks have sufficient self-insurance to withstand adverse economic shocks so that a costly banking crisis can be avoided. Bank stress tests have been conducted by the International Monetary Fund since the late 1990s, by central banks and other national regulatory authorities since before that, and even earlier by commercial and investment banks themselves.

What has put bank stress tests in the headlines around the world, however, is of more recent revival. Both the US and the European Union have vigorously implemented bank stress tests in the aftermath of the global financial crisis. Although it is difficult to assess the impact of the stress tests because the crisis management effort had many other elements, some evidence suggests that they helped calm the markets.

Three policy implications can be drawn for Asia from the stress tests conducted in the US and the European Union (Goldstein, forthcoming). First, the credibility of such tests depends in good measure on their institutional framework and design: the legal authority for the test, the independence of the supervisor conducting the tests, and the resources applied. Second, capital shortfalls revealed by stress tests should be remedied in a way that is friendly to economic growth. A higher desired capital ratio should be translated into an absolute amount of capital, rather than allowing banks to achieve the higher capital ratio by cutting back on loans, disposing of assets in fire sales, or manipulating risk weights. Third, because capital ratios that use an unweighted measure of bank assets in the denominator, or leverage ratios, do a much better job from the start of distinguishing sick banks from healthy ones than do risk-based measures of bank capital, a leverage ratio test should be included in all future supervisory-led bank stress tests. Over time, a leverage ratio should become the primary metric for bank stress tests.

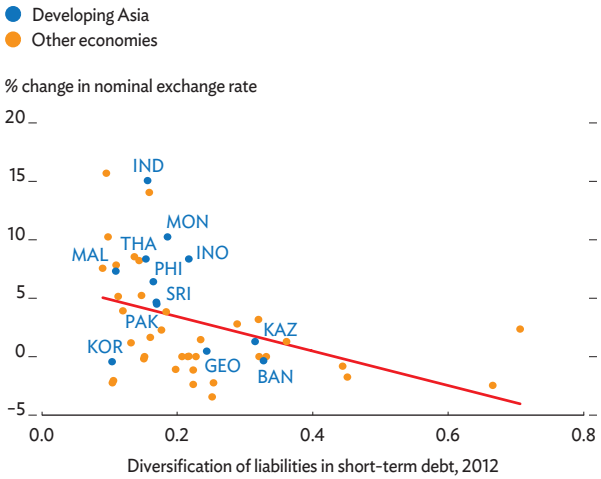
Global shocks and diverse external funding

Limited regional financial integration in Asia means not only that Asians invest relatively little in the region but also that they borrow less from it. The lack of intraregional borrowing had particularly important implications during the global financial crisis because it originated in global financial centers outside of Asia. If the global financial center pulls capital from an economy that is heavily dependent on it for financing, the dependent economy can become unstable even though its fundamentals are sound. For an economy with little diversity in its external funding sources, the impact of a global financial crisis can be especially large, as most external funding will dry up. On the other hand, if funding sources are more diversified—for example, if an economy relies much more on other regional economies—then the other funding sources can be tapped during a global crisis. Therefore, if regional financial integration is strengthened, the member economies can become less vulnerable to global shocks.

To investigate the possibility that diversifying external sources of funding mitigates the impact of shocks originating from the global financial markets, the empirical approach of Eichengreen and Gupta (2013) is applied (Box 2.4.2).

For all four measures of external portfolio liability—total portfolio liability and its three components: equity, long-term debt, and short-term debt—the coefficients of the diversification of external liabilities are negative, indicating that economies with more diversified external funding experienced less currency depreciation. In particular, the coefficient of diversification in short-term debt liabilities is negative and significant (Figure 2.4.3).

2.4.3 Diversification of external liability in short-term debt and currency depreciation



BAN = Bangladesh, GEO = Georgia, IND = India, INO = Indonesia, KAZ = Kazakhstan, KOR = Republic of Korea, MAL = Malaysia, MON = Mongolia, PAK = Pakistan, PHI = Philippines, SRI = Sri Lanka, THA = Thailand.

Source: Park and Shin, forthcoming b.

Click here for figure data

2.4.2 The relationship between funding diversification and vulnerability to global shocks

In May 2013, Ben Bernanke, then the chair of the US Federal Reserve, mentioned the possibility of the US tapering its quantitative easing. This had knock-on effects globally, triggering sharp depreciation of the currencies of many emerging economies. To explore this event, Eichengreen and Gupta (2013) proposed an innovative approach to figure out which countries were more likely to be hit by the Fed's talk of tapering quantitative easing. To understand why some countries were hit harder than others, the authors investigated what factors were responsible for the negative impact of the tapering announcement.

The basic regression equation estimated by Eichengreen and Gupta (2013) took the following form:

$$ERD_i = X_i\beta + \varepsilon_i$$

where ERD_i is exchange rate depreciation experienced by country i between the end of April and the end of August 2013, and X_i is a vector of country-specific factors for country i that are expected to be responsible for currency depreciation. The factors considered were deterioration in the current account deficit and currency appreciation in real exchange rate terms, measures of the size of the financial market, and other variables related to economic fundamentals.

The study of Park and Shin (forthcoming b) extends the analysis by considering diversification of liability, another possibly important factor, to test whether economies with more diversified holdings of liability were less vulnerable to the tapering announcement. For each economy, the shares of liability to all partner economies are calculated, with the standard deviation of these shares serving as the proxy for the diversification of liabilities. Regressions are then run for four cases in 2012, measuring diversification on the bases of total portfolio securities, equity securities, long-term debt securities, and short-term debt securities. Park and Shin (forthcoming b) explains the data and empirical framework in depth.

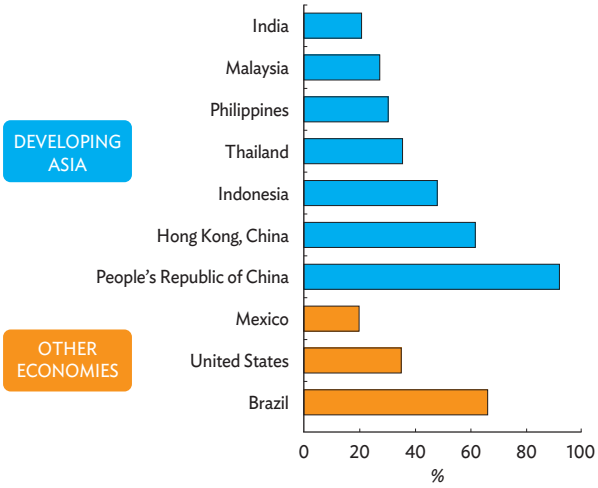
Liability related to bank borrowing, as opposed to portfolio liability, also plays an important role in triggering crises. In emerging markets, crises are frequently characterized by twin crises as banking and currency crises occur simultaneously. Performing the type of empirical analysis described in Box 2.4.1 on bank lending data from the Bank for International Settlements, Park and Shin (forthcoming b) found that economies with more diversified sources of bank lending were generally less vulnerable to the tapering announcement.

Just as diversifying foreign asset holdings has benefits, so does diversifying foreign liability holdings. In particular, the analysis indicates that it helps to mitigate financial instability caused by shocks from global financial markets. This implies that excessive global financial integration can be undesirable. Deeper regional financial integration can replace excessive dependence on global financial markets for external funding and thus vulnerability to global shocks. The evidence therefore provides some support for the efforts of Asian governments to further deepen regional financial integration.

Foreign direct investment and other determinants of vulnerability

There are, of course, other determinants of vulnerability that have been more extensively tested in the literature. In particular, a higher share of foreign direct investment (FDI) in total foreign liability seems to help reduce vulnerability to external financial shocks (e.g., Tong and Wei 2010, Prasad, Rajan, and Subramanian 2007). Intuitively, this is because FDI is geared more toward the long term and hence more stable than other private capital flows. In fact, FDI proved to be remarkably resilient in East Asian economies during the Asian financial crisis of 1997–1998. In sharp contrast, portfolio equity and debt flows—the more short-term flows—suffered large reversals and thus became major causes of volatility. On the other hand, FDI turned out to be less resilient during the global financial crisis, especially in Eastern Europe, where FDI collapsed as sharply as other capital flows. Currently, significant variation exists in the share of FDI in the liabilities of economies in developing Asia (Figure 2.4.4).

2.4.4 Share of foreign direct investment in the foreign liabilities of selected economies, 2012



Sources: International Monetary Fund, International Financial Statistics online database (accessed 2 November 2014); ADB estimates.

Click here for figure data

Turning from liabilities to assets, currency and maturity mismatches in the balance sheets of banks and other financial institutions can cause financial vulnerability. In fact, the twin mismatches were central catalysts of the Asian financial crisis. Before the crisis struck, banks in some East Asian economies borrowed short-term in US dollars to make long-term loans in their national currencies. Park (2011) found that both mismatches were markedly less pronounced before the global financial crisis than before the Asian financial crisis, which helps to explain much greater resilience during the global crisis. One indicator that broadly captures these types of risks is the ratio of short-term foreign debt to foreign exchange reserves,

where a lower ratio indicates reduced vulnerability. Across Asia, the ratio is well below the informal but widely used Greenspan–Guidotti threshold of 1 (Figure 2.4.5).

Yet another indicator is the growth of the ratio of the money supply measure M2 to GDP. In the PRC, rapid growth of the ratio has caused some concern about excessive reliance on bank lending. Overall, though, most indicators suggest that the region's financial system is in relatively good health, though this is no cause for complacency.

Lessons from the PRC on financial development and stability

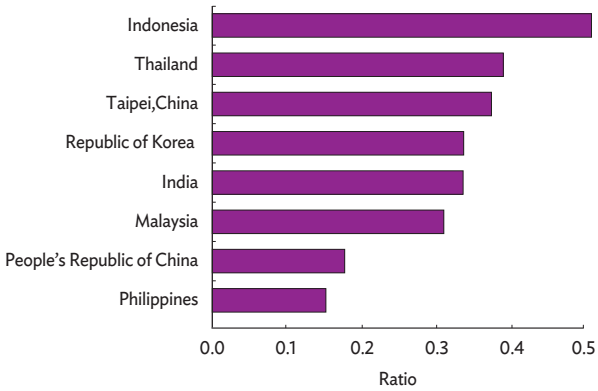
A huge strategic challenge confronting the PRC is how to transition toward a more market-based and efficient financial system without disrupting financial stability. Drawing lessons from the PRC experience for the rest of Asia is difficult because of its unique financial system. In particular, the PRC financial system is set apart by having grown very large relative to GDP at an early stage in economic development (Figure 2.4.6).

Nevertheless, as many other Asian economies share with the PRC a quest for smooth and stable financial development, its experiences hold valuable lessons for the rest of the region. And, like the PRC, some Asian economies have achieved relatively high financial development as measured by quantitative indicators but now face the more difficult challenge of improving the quality of financial intermediation.

Several useful lessons can be drawn from the PRC experience to inform other Asian economies implementing financial reform. The first is that it is possible to rapidly improve the efficiency of state-owned banks, which remain important in many Asian countries (Figure 2.4.7). State-owned banks in the PRC went from being technically bankrupt in the late 1990s to earning large profits less than a decade later. The turnaround required a large injection of capital from the central government and indirect support to offload bad loans to asset management companies. But reform went much further than a simple bailout. State-owned banks dramatically retrenched their staff and branches to boost efficiency. An independent banking regulator was established, and a separate body was created to manage the state's equity interests. The banks brought in strategic foreign investors and sought listings on international exchanges to reinforce improved corporate governance. The result of reform was a dramatic increase in the operational efficiency and profitability of commercial banks in the PRC (Table 2.4.4).

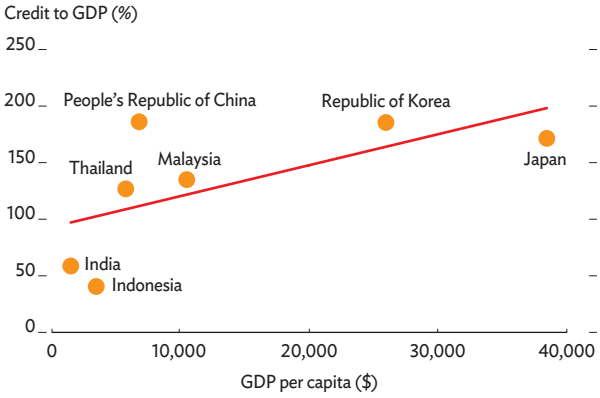
The second lesson from the experience of financial reform in the PRC is that an incremental approach can

2.4.5 Short-term foreign debt to foreign exchange reserves in selected Asian economies, 2013



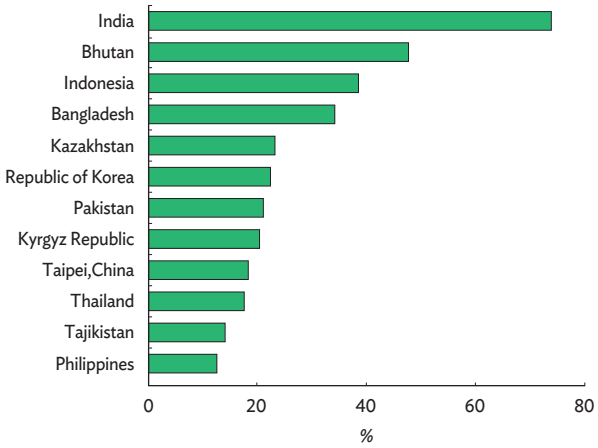
Sources: CEIC Data Company and World Bank, World Development Indicators online database (both accessed 3 March 2015); ADB estimates.
Click here for figure data

2.4.6 Credit to GDP and per capita GDP, 2013



Source: Borst and Lardy (forthcoming) based on data from the Bank for International Settlements and World Bank.
Click here for figure data

2.4.7 Share of banking assets held by entities more than 50% state-owned, 2010



Source: Borst and Lardy (forthcoming) based on data from the World Bank Banking Supervision Survey.
Click here for figure data

2.4.4 Bank performance in the People's Republic of China versus the G-20 average (%)

	Return on assets	Net interest margin	Return on equity	Cost/income ratio
PRC 1999	0.7	1.9	9.8	65.5
PRC 2011	1.1	2.9	18.3	38.3
G-20 2011 (Average)	1.2	3.0	13.5	59.3

G-20 = Group of Twenty, PRC = People's Republic of China.
Source: Borst and Lardy, forthcoming.

have unintended consequences. The authorities in the PRC soundly rejected the big bang approach to financial reform advocated to many developing countries in the 1990s. In the wake of the collapse of many economies following the dissolution of the Soviet bloc, and the turmoil in Asia during the Asian financial crisis, the PRC approach of slow and incremental financial reform seemed vindicated. However, the slow progress of many financial reforms, most notably on exchange rates and the liberalization of interest rates on deposits, has created adverse side effects. The glacial pace of interest rate liberalization has given rise to an unsustainably large increase in credit and the creation of a large shadow banking system. Measured and incremental financial reform may be preferable to overnight liberalization. However, the lack of reform can also create risks within the financial system.

The final lesson to be drawn from the experience of the PRC is the difficulty of rooting out implicit guarantees and moral hazard in a financial system that is dominated by state-owned actors. The PRC has one of the largest banking systems in the world, yet it is only now in the process of creating a deposit insurance system. The Government of the PRC therefore faces a large implicit liability. Even worse, depositors assume that banks will guarantee returns on a variety of other financial products, such as trust and wealth management products, without regard for whether the issuing bank has any legal responsibility to guarantee anything. The government is therefore the ultimate guarantor of these products as well. What are required to meaningfully reduce moral hazard are a paradigm change in the approach of regulators and the introduction of private financial institutions that are allowed to fail.

Final thoughts on safeguarding inclusive growth

As they develop their financial systems, Asian economies must be vigilant about financial stability, as instability harms both growth and equity. Heightened global financial instability since the global crisis—and homegrown risks such as shadow banking in particular—strengthen the case for vigilance. That said, tighter regulations under Basel III complicate the task of Asian bank regulators by potentially limiting finance in bank-dominated economies. Fortunately, the healthy balance sheets of Asian banks give cause for optimism about their ability to balance financial stability and economic growth. Moreover, macroprudential policies and other new tools will help bolster the defense of the region's financial stability.

Financing Asia's future growth

Financial sector development can make a significant, positive contribution to economic growth. The effect of financial development on growth is larger in developing countries and especially pronounced in developing Asia. Moreover, it is the development of the financial system as a whole, rather than any particular component of the financial system, that has a significant, positive effect on economic growth. While Asia compares favorably with other parts of the developing world in financial development, it still lags advanced economies, which suggests scope for further progress and hence a growth dividend. Therefore, at a time when Asian policy makers are seeking new engines of growth, one overlooked engine may be a sounder and more efficient financial system.

The growth benefits of finance will be even larger if a more competitive financial system better allocates resources according to market principles. The PRC experience suggests, for example, that the participation of foreign banks can enhance both competition and the lending quality of state-owned banks and others in the system. The end result will be lending decisions made to a greater degree on commercial considerations that therefore allocate capital to more productive investments and activities. A closely related point is that sustaining growth ultimately requires a vibrant private sector, and access to adequate, reasonably priced capital is essential to a vibrant private sector. Innovation and productivity growth, which will loom larger as the region becomes increasingly middle income, require a well-developed financial system, especially one with adequate sources of long-term capital.

Financial development generally promotes economic growth, but its impact on equity is uncertain. Financial deepening can either widen the income gap, if its benefits accrue largely to senior financial professionals and other wealthy individuals, or narrow the gap if the poor gain greater access to financial services. Empirical evidence reflects this dichotomy. While financial development tends to alleviate inequality in its early stages, inclusion does not come automatically as financial development deepens. Therefore, since financial development does not necessarily promote equity, Asian policy makers must make a concerted effort to advance financial inclusion by expanding access for the poor to financial services. Doing so will improve the odds of finance becoming an engine of inclusive growth.

The global financial crisis underlined the importance of sound and effective financial regulation to safeguard financial stability, which is vital for both growth and equity. The region's financial institutions are well placed to meet the more stringent regulatory standards being adopted globally, as many already exceed requirements under Basel III. Regulators will be challenged, however, to find the right balance. They must appreciate how strong regulation protects stability by preventing the accumulation of systemic risks, but they must weigh it against the potential benefits of flexible regulation that promotes

investment, productivity, innovation, and economic growth. For both banks and capital markets, the key regulatory challenge is to strengthen governance and thereby minimize crony lending, insider trading, and other inefficient and inequitable practices. Good governance tightens the link between finance and growth by directing capital toward productive investments and activities.

In sum, as the region grapples today with the slowdown of growth momentum since the global financial crisis, the case for further financial sector development in developing Asia has never been stronger. A sound and efficient financial sector is simply an indispensable ingredient for the region's ongoing quest for a brighter future achieved through growth that is rapid but also stable and inclusive.

Endnotes

1 This follows from the multiplication of the log difference of the liquid liabilities ratio and its relevant coefficient obtained from the regression. See Table 2.1.2. That is 2.72*[ln(63.9+1)-ln(63.9)]=2.72*0.016=0.04, and 0.04*10=0.4.

2 Demirgüç-Kunt and Levine (2009) surveys the literature on theory and evidence to show the relationship between financial development and inequality.

3 Asian Development Bank (2014b) has a comprehensive discussion of innovation-led growth in Asia.

4 By contrast, short-term horizons and procyclical investment strategies, such as bank lending that relies on imprudent short-term funding and excessive maturity transformation (or the funding of longer-term commitments with shorter-term deposits or investments) is more prone to instability, as demonstrated by the global financial crisis of 2008–2009.

5 In most East Asian economies, insurance companies are the largest institutional investors, their investments equaling 26% of GDP, while mutual funds average 17% and pension funds 15% (Didier and Schmukler 2014).

6 Group of Thirty (2013) offers a more comprehensive list of policy proposals for advanced and emerging market economies globally. European Commission (2013) details policy proposals more specific to Europe, which, like Asia, has financial sectors heavily dependent on banks. Ding, Lam, and Peiris (2014), Felman et al. (2014), Walsh (2014), and Zhu (2014) offer policy proposals more specific to Asia.

7 A number of initiatives are already under way on this front, including the Asian Bond Fund and the ASEAN+3 Bond Market Initiative, which joins seven members of the Association of Southeast Asian Nations with the People's Republic of China (including Hong Kong, China), Japan, and the Republic of Korea.

8 Christensen, Schindler, and Tressel (2013) provides empirical evidence that banking system reform is positively and significantly associated with growth in total factor productivity in low- and middle-income countries.

9 For evidence at the level of the firm of a positive relationship between the use of external finance (both debt and equity) and future productivity growth, see Levine and Warusawitharana (2014), which analyzes data from advanced European economies. The study provides evidence against a reverse-causality explanation. For one economy in their sample, the United Kingdom, direct evidence indicates that firms use financing to invest in productivity enhancement.

10 A new version of the database, based on surveys in 2013 and 2014, is expected to be released in April 2015.

11 The data used in this paper were downloaded in September 2014. Several economies have more than 1 year of survey data, and all years of data on each economy were pooled for this analysis.

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Annex: Financial structure in developing Asia, 2011

Subregion	Economy	Banking system	Stock market	Public bonds	Private bonds
DEVELOPING ASIA		60.0	71.0	25.7	20.4
CENTRAL ASIA	Armenia	18.1	0.3	0.0	0.0
	Azerbaijan	11.7	...	0.0	0.0
	Georgia	21.9	6.8	0.0	0.0
	Kazakhstan	27.5	28.5	0.0	0.0
	Kyrgyz Republic	...	2.1	0.0	0.0
	Tajikistan	...	...	0.0	0.0
	Turkmenistan	...	...	0.0	0.0
	Uzbekistan	...	...	0.0	0.0
EAST ASIA	China, People's Republic of	49.9	58.8	22.4	23.1
	Hong Kong, China	301.6	396.8	36.0	15.3
	Korea, Republic of	72.1	96.2	44.8	59.3
	Mongolia	46.5	15.9	0.0	0.0
SOUTH ASIA	Afghanistan	15.7	0.0	0.0	0.0
	Bangladesh	49.5	17.3	0.0	0.0
	Bhutan	60.1	0.0	0.0	0.0
	India	62.0	69.7	29.6	4.9
	Maldives	79.3	0.0	0.0	0.0
	Nepal	58.7	25.3	0.0	0.0
	Pakistan	27.5	16.9	30.7	0.0
	Sri Lanka	31.6	33.8	0.0	0.0
SOUTHEAST ASIA	Brunei Darussalam	60.4	0.0	0.0	0.0
	Cambodia	32.0	0.0	0.0	0.0
	Indonesia	32.0	45.1	10.8	1.4
	Lao People's Democratic Republic	...	0.0	0.0	0.0
	Malaysia	120.9	144.1	54.0	58.1
	Myanmar	...	0.0	0.0	0.0
	Philippines	51.3	73.9	29.1	1.0
	Singapore	125.8	148.1	45.4	10.0
	Thailand	99.7	81.7	49.8	12.7
	Viet Nam	12.2	15.4	0.0	0.0
THE PACIFIC	Fiji	51.8	38.4	0.0	0.0
	Kiribati	...	0.0	0.0	0.0
	Marshall Islands	...	0.0	0.0	0.0
	Micronesia, Federated States of	...	0.0	0.0	0.0
	Palau	...	0.0	0.0	0.0
	Papua New Guinea	43.1	79.7	0.0	0.0
	Samoa	44.7	0.0	0.0	0.0
	Solomon Islands	30.2	0.0	0.0	0.0
	Timor-Leste	29.1	0.0	0.0	0.0
	Tonga	38.1	0.0	0.0	0.0
	Tuvalu	...	0.0	0.0	0.0
	Vanuatu	73.1	0.0	0.0	0.0

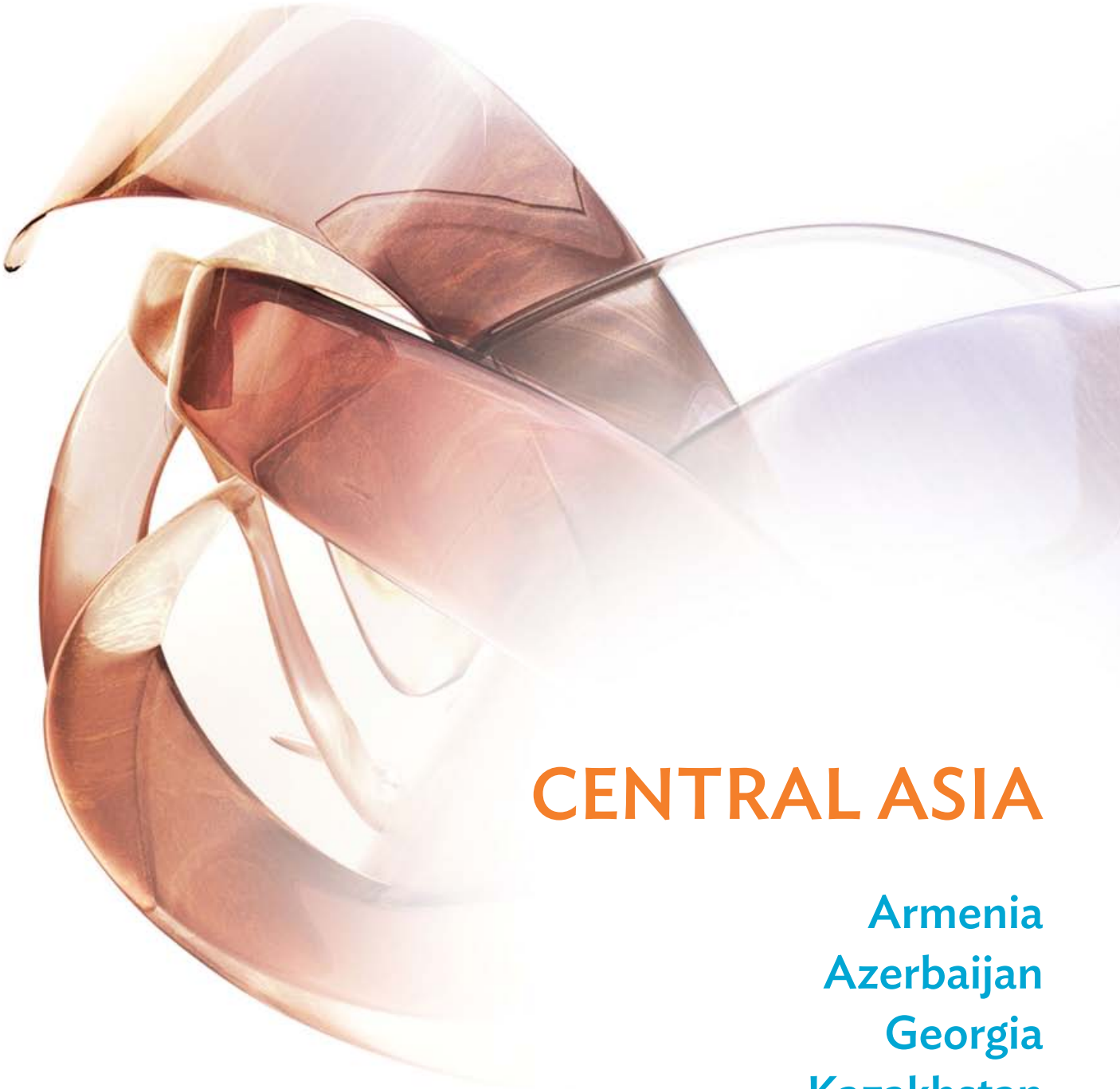
... = data not available.

Note: Reported are banking system deposits, stock market capitalization, and public and private bonds outstanding, all expressed as a percentage of GDP. Regional averages are weighted by GDP.

Source: ADB estimates based on data from Beck, Demirgüç-Kunt, and Levine (2000, 2009) and Cihak et al. (2012).

3

ECONOMIC TRENDS AND PROSPECTS IN DEVELOPING ASIA



CENTRAL ASIA

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

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Armenia

Expansion moderated further in 2014 to 3.4%, and the current account weakened because of deteriorating conditions in the Russian Federation, Armenia's main trading partner. The outlook is for slower growth, higher inflation, and a still weaker external position. The challenge ahead is to boost domestic demand to sustain growth.

Economic performance

Growth slowed to 3.4% in 2014 from 3.5% in 2013. On the supply side, growth was led by agriculture and services (Figure 3.1.1).

Despite gains in food, beverages, and tobacco, industry (excluding construction) contracted by 0.1% as falling prices for nonferrous metals in world markets helped cut output in mining and metallurgy. Construction fell by 3.3% as the government and households curtailed capital outlays. Agriculture expanded by 7.8% in 2014 despite an unseasonably cold spring that destroyed major fruit crops. Much of the growth came from expansion in the area cultivated and higher livestock production. Services rose by 5.2%, driven by gains in trade, food service, finance, insurance, recreation, and health care.

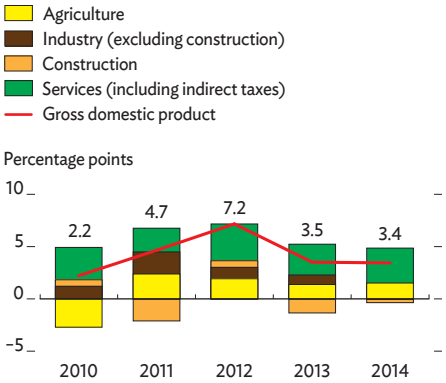
On the demand side, a large statistical discrepancy clouds the analysis, but private consumption appears to have continued as the main source of growth, though expansion slowed to an estimated 0.5% in 2014 from 0.9% in 2013 as remittances from the Russian Federation declined. Higher government spending contributed to a 6.8% rise in public consumption. Investment, as measured by gross fixed capital formation, fell by an estimated 5.0%, reflecting deficiencies in the investment environment and structural weaknesses.

Average annual inflation almost halved to 3.0% in 2014 from 5.8% in 2013 on account of higher food production, favorable global prices, and slackening domestic demand (Figure 3.1.2).

Inflation came mainly from services, where prices rose by 5.1%. The 12-month inflation rate, from December to December, declined to 4.6% from 5.6% in 2013, staying within the 2.5%–5.5% target band of the Central Bank of Armenia. To counter intense pressures on prices and the exchange rate from problems in the Russian Federation, the central bank tightened interest rates, raising the benchmark refinancing rate by 375 basis points to 10.5% in three steps from December 2014 to February 2015. This reversed a rate decline from 8.50% to 6.75% between November 2013 and August 2014 (Figure 3.1.3).

The sharp weakening of the ruble fueled a 15% depreciation of the Armenian dram in October. The central bank intervened daily during

3.1.1 Supply-side contributions to growth



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 2 March 2015).
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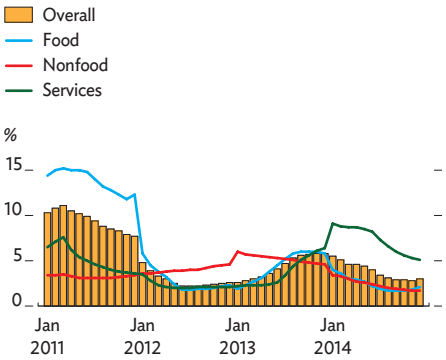
3.1.2 Inflation



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 2 March 2015).
Click here for figure data

This chapter was written by Grigor Gyurjyan of the Armenia Resident Mission, ADB, Yerevan.

December 2014 to restore balance in the exchange market and to soften fluctuations. In addition, it doubled the reserve ratio for foreign exchange deposits, from 12% to 24%, at the end of 2014 before easing it to 20% in January 2015 while requiring banks to hold the reserves in local currency. Nevertheless, central bank sales of foreign exchange during November and December caused gross international reserves to fall sharply to $1.5 billion at the end of 2014 (equivalent to an estimated 3.5 months of imports) from $2.2 billion a year earlier (5.5 months) (Figure 3.1.4).

Fiscal policy remained in line with the government's medium-term budgetary objectives, which aim to keep the deficit and debt manageable for macroeconomic stability. Revenue rose by 6.1% in 2014, primarily reflecting higher tax receipts. Expenditure rose by 7.5% on higher social outlays and a pay hike for public servants in July 2014. The fiscal deficit is estimated to equal 2.0% of GDP (Figure 3.1.5). This is less than the official target of 2.3% in the 2014 state budget, because capital spending fell short and matching pension contributions were below budget following pension reform.

Despite the low deficit, dram depreciation caused the ratio of public debt to GDP to rise from 44.1% in 2013 to 46.6% at the end of 2014, not much below the official ceiling of 50.0% (Figure 3.1.6). In nominal terms, public and publicly guaranteed external debt increased by 13.7% to AMD1.8 trillion (39.7% of GDP), and domestic public debt climbed by 11.5% to AMD312 billion (6.9% of GDP).

The current account deficit widened to an estimated 8.5% of GDP from 8.0% in 2013, reflecting lower remittance inflows and a larger trade deficit (Figure 3.1.7).

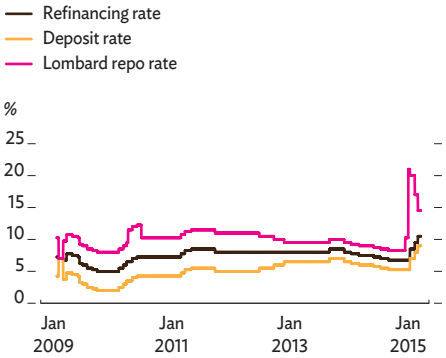
Growth in general merchandise exports slowed to an estimated 1.2% in 2014 from 8.6% in 2013, mostly because exports to the Russian Federation declined. Import growth rose to 0.7% from 0.2% in 2013, as consumption barely increased. Consequently, the trade deficit was estimated to have narrowed to 18.4% of GDP in 2014 from 19.1% in 2013. Remittances, measured as noncommercial transfers through banks, declined by 10% to $1.4 billion in 2014, reversing a rising trend since 2010 (Figure 3.1.8). As the deprecation of the ruble accelerated, it triggered a similar drop in remittances beginning in August 2014. Although debt data for the end of 2014 are not yet available, external debt likely exceeded 80% of GDP, as government debt has consistently been less than half of total foreign debt.

Economic prospects

Regional geopolitical developments leave the economic outlook highly uncertain. The slowdown in the Russian Federation, caused in particular by sanctions and lower oil prices, will likely further depress the Armenian economy. Growth is thus expected to slow again, to 1.6% in 2015, before recovering to 2.3% in 2016 (Figure 3.1.9).

On the supply side, growth is expected to come mostly from agriculture and services. Expansion in agriculture will be underpinned by state assistance that subsidizes farm loans and prices for fuel and fertilizer. Programs to establish agricultural cooperatives and

3.1.3 Dynamics of indirect monetary policy instruments



Source: Central Bank of Armenia. http://www.cba.am

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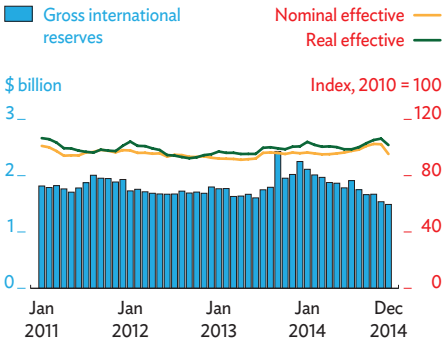
3.1.4 Effective exchange rates and reserves



Sources: Central Bank of Armenia. http://www.cba.am; International Monetary Fund. International Financial Statistics online database (accessed 2 March 2015).

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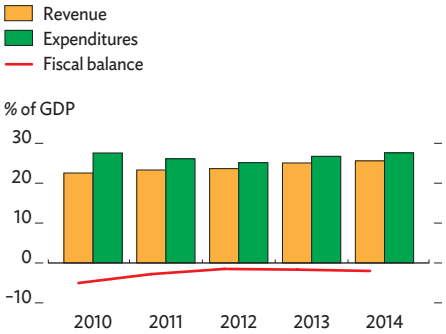
3.1.5 Fiscal indicators



Sources: Ministry of Finance. http://www.minfin.am; National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 2 March 2015).

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associations, and to strengthen links between agricultural producers and the food-processing industry, will be crucial for sector growth. Industry is unlikely to grow as strongly as in the past, mostly due to depressed demand for exports. Domestic factors essential for promoting industry growth include the government's export-led industrial development strategy for 11 selected subsectors, approved in 2012; investment and export promotion by the Armenia Development Fund, which was recently created by merging overlapping agencies; and accelerated structural reform to improve the environment for private sector development. Services are projected to expand primarily on gains in tourism and information and communication technology. Construction is projected to remain depressed before returning to slow growth in 2016.

On the demand side, private consumption and increased public spending are seen as supporting growth, albeit modestly and at a slower pace.

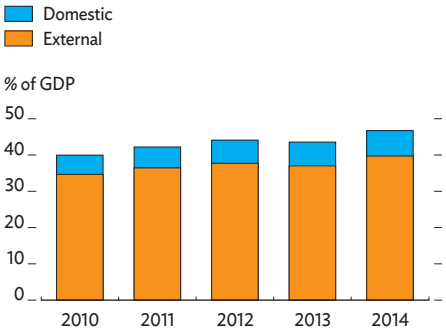
Tight fiscal policy is likely to continue, given the risk to public debt from external shocks. The 2015 budget aims for a deficit equal to 2.3% of GDP, with a moderate rise in revenue and outlays remaining focused on the social safety net. Armenia's 1.13% share of customs duties derived from imports of goods into the Eurasian Economic Union (EEU), which includes several republics of the former Soviet Union, will provide additional revenues for the state budget.

Despite slowing growth, annual inflation is seen rising by half to 4.6% in 2015 before subsiding to 4.1% in 2016. Assuming normal weather, inflationary pressures will intensify significantly in 2015 as ruble depreciation weakens the Armenian currency and as tariffs are harmonized with the new customs regime following Armenia's joining the EEU in January 2015. In the short run, monetary policy is expected to remain tight to combat these pressures before gradually returning to a neutral stance over the medium term.

The current account deficit is projected to widen to 9.2% in 2015 before narrowing to 8.3% in 2016 (Figure 3.1.10). This forecast is subject to significant risks stemming from Armenia's exposure to the Russian Federation, which accounts for a quarter of its imports and exports, more than 80% of remittances, and more than 50% of foreign direct investment.

Armenia may succeed in spurring industrial growth by promoting exports; by exempting imported gas, raw oil, and diamonds from customs fees; and through lower nontariff barriers within the EEU. However, the benefits of EEU membership may be limited by the Russian Federation's geopolitical difficulties and the limited capacity of Armenian agriculture, as 60% of the country's agricultural exports, mainly processed foods and beverages, already go to the Russian Federation (exports of aluminum, copper, and molybdenum products and concentrates go mainly to the European Union). The EEU's relatively high weighted average tariffs on imports into the union may reduce Armenia's exports outside the EEU, though the government negotiated transition periods of 1–8 years for imposing higher tariffs on more than 750 goods. Further, Armenia will have to renegotiate its customs duties with members of the World Trade Organization, which it joined in 2003. Taking these factors into account, general merchandise

3.1.6 Public and publicly guaranteed debt



Sources: Ministry of Finance. http://www.minfin.am; National Statistical Service of the Republic of Armenia. http://www.armstat.am (both accessed 2 March 2015).

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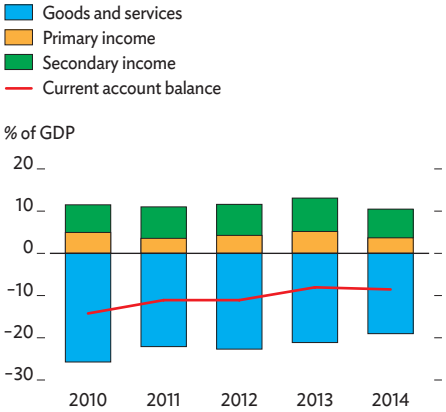
3.1.7 Current account components



Source: Central Bank of Armenia. http://www.cba.am (accessed 2 March 2015).

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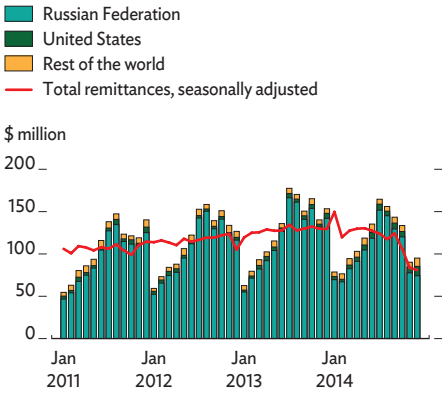
3.1.8 Sources of remittances



Source: Central Bank of Armenia. http://www.cba.am (accessed 2 March 2015).

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imports are projected to rise by 1.5% in 2015 and 1.6% in 2016, as general merchandise exports grow by 1.6% in 2015 and 2.2% in 2016. A recent tax incentive, designed to boost exports, cuts profit tax by 90% (to 2%) for foreign enterprises not in mining whose exports exceed AMD50 billion.

3.1.1 Selected economic indicators (%)

	2015	2016
GDP growth	1.6	2.3
Inflation	4.6	4.1
Current account balance (share of GDP)	–9.2	–8.3

Source: ADB estimates.

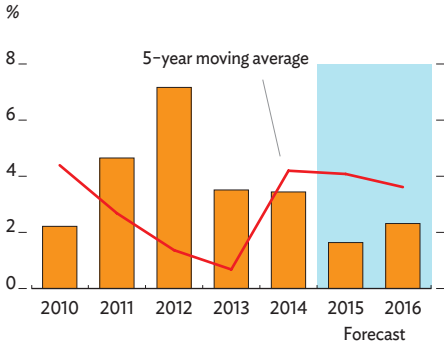
Policy challenge—maintaining growth momentum

Armenia saw remarkable economic growth and poverty reduction in the period preceding the global financial crisis of 2008–2009. However, growth has slowed steadily since then, and the economy remains vulnerable to new setbacks. To minimize the impact on Armenia of the slowdown in the Russian Federation and to leverage the benefits of EEU membership, domestic sources of growth need attention. Requirements include broader efforts to develop the private sector, a stronger emphasis on agriculture and rural development, and higher capital investment in infrastructure. Growth will be more inclusive and sustainable if development objectives are pursued with the private and public sectors assuming complementary roles.

Helping the private sector adjust production to the changing economic situation is critical for sustaining growth. Armenia is well positioned to attract investment into its areas of competitive advantage, thanks to reforms that have improved the business environment over the past several years, a relatively favorable regulatory framework, the customs-free regime within the EEU, and access to an enlarged market—despite a lack of direct overland links to other EEU members. Maintaining competitiveness depends on accelerated and deepened structural reform, especially to improve investor protection and economic competition. Tax reform and better access to credit for small and medium-sized enterprises would also promote growth. Reinvigorating programs that support innovation, scientific discovery, and applied research and development could accelerate growth and speed Armenia's transformation into a knowledge economy. Higher capital investment in economic and social infrastructure would boost output and employment in the near term and expand productive capacity over the longer term.

Agriculture provides 35% of Armenia's jobs, 20% of its GDP, and 30% of its exports. Augmenting existing programs to facilitate farmers' use of modern inputs and boost agricultural productivity could expand Armenia's already substantial agricultural exports to partners in the EEU. Sector development would further benefit from the promotion of farmers' groups and value-added chains with improved access to financial services. Stronger agriculture and rural development are needed to diversify the incomes of rural households, strengthen local economies, and facilitate job creation, thereby narrowing the gap in living standards between the capital and the rest of the country.

3.1.9 GDP growth



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 2 March 2015); ADB estimates.

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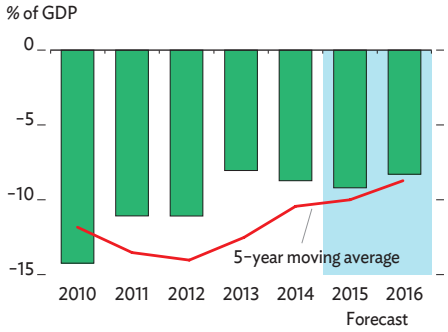
3.1.10 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 2 March 2015); ADB estimates.

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Azerbaijan

Growth halved to 2.8% in 2014 from 5.8% a year earlier as oil output declined. Higher public spending in 2015 is projected to lift growth marginally to 3.0% before it reverts in 2016 to 2.8%, as the expansion of public investment slows. Inflation was subdued in 2014 but will likely return following currency devaluation, while the current account surplus remains sizable. Government spending needs to rely less on oil revenue.

Economic performance

Economic expansion slowed to 2.8% in 2014 from 5.8% in 2013, mainly because the petroleum sector contracted by 2.9% (Figure 3.2.1). Oil production declined by 3.7%, reversing a slight pickup in 2013, as one of the main oil wells at the principal oil field was shut for maintenance. Largely dependent on public investment, the economy outside the oil sector expanded by 7.0%, down from 10.0% in 2013 as spending on infrastructure was constrained.

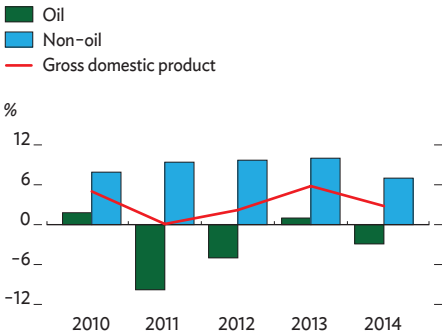
On the supply side, construction and services were the main sources of growth in 2014. The construction growth rate nevertheless plunged to 9.1% from 23.0%, reflecting slower expansion in infrastructure projects and declining demand for real estate. However, growth in services edged up to 7.4% from 7.2% in 2013, driven by gains of 10.0% in wholesale and retail trade, 4.7% in transport and warehousing, 18.2% in tourism, and 15.1% in communications. Growth in industry, excluding construction, slowed to 1.7% as mining contracted by 2.7%—and despite a 4.1% rise in manufacturing, with notable contributions from food, construction materials, and machinery. Agriculture declined by 2.6%, reversing a 4.9% rise in 2013, as bad weather held down the production of wheat and barley (Figure 3.2.2).

On the demand side, cuts in consumer lending held private consumption growth to 9.6% during the first 9 months of 2014, down from 17.2% in the same period of 2013, despite higher incomes and pensions. Investment contracted by 1.7%, after the 15.1% increase in 2013, because of lower public spending, which contributes more than 70% of the total.

Slower economic activity and strict controls over consumer lending helped trim average annual inflation to 1.4% from 2.4% in 2013. Despite the poor harvest, a slowdown in food price inflation to 1.0% offset a 3.2% rise in other prices.

The fiscal deficit declined from 1.2% of GDP in 2013 to 0.5%. This was less than the planned 2.4% deficit because public spending was

3.2.1 Oil and non-oil GDP growth



Source: State Statistical Committee of the Republic of Azerbaijan.
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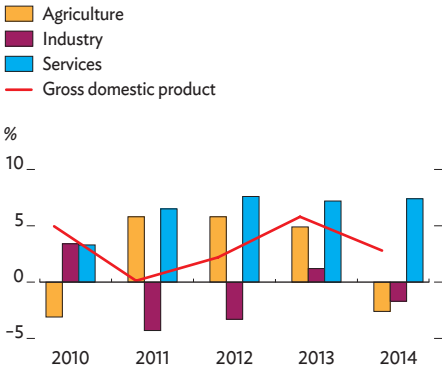
3.2.2 GDP growth by sector



Source: State Statistical Committee of the Republic of Azerbaijan.
Click here for figure data

This chapter was written by Nail Valiyev of the Azerbaijan Resident Mission, ADB, Baku.

constrained for almost all items, especially wages, salaries, and social expenditure. Revenue fell to 31.2% of GDP from 32.9% in 2013, while expenditure declined to 31.7% from 34.1%. Transfers from the sovereign State Oil Fund of the Republic of Azerbaijan (SOFAZ) continued to provide about half of all revenue despite being cut by 17.7% in 2014. Declining oil prices had minimal fiscal impact, as the state budget was based on an oil price of $100 per barrel, which the average price of Azeri Light exceeded for most of 2014.

Monetary policy emphasized sustaining growth. In response to lower inflation (Figure 3.2.3) and the economic slowdown, the Central Bank of Azerbaijan cut its policy rate to 3.50% from 4.75% in May 2014, the first cut since mid-2012. In August, to buoy credit growth and domestic demand, it eased reserve requirements from 3% to 2% on all deposits. Ruble depreciation fueled demand for foreign currency, causing foreign currency deposits to rise by 7.7% in December 2014, while local currency deposits declined by 2.0% after rising earlier in the year. Broad money grew by 11.4%, down from 15.4% a year earlier, and credit to the economy grew by 17.9% versus 7.9% in 2013.

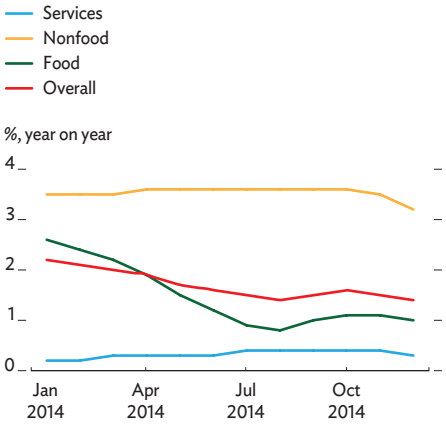
Almost all banks complied with the central bank's higher capital requirement of AZN50 million. Banking risks were moderate as nonperforming loans, at 5.2% of the lending portfolio, barely rose from 5.1% in 2013. The Azerbaijan manat remained at a stable peg to the US dollar throughout the year but appreciated against the euro by 12%. The central bank intervened in the market, sterilizing $1.2 billion during the first 9 months of 2014 to prevent manat appreciation. After November 2014, facing downward pressure, it used $1.5 billion in reserves to limit depreciation. In mid-February 2015, it repegged the manat to a basket comprising the US dollar and the euro and then, on 22 February, devalued the currency, leaving it 25% lower against the US dollar. It did so in part to make local goods more competitive and to promote non-oil exports.

Oil price declines beginning in late 2014 narrowed the current account surplus slightly to 16.0% of GDP from 16.6% in 2013, as slowing oil production (Figure 3.2.4) and lower prices reduced export earnings by 4.7%. Strict control over consumer lending and the introduction of Euro 4 standards for imported cars helped cut imports by an estimated 17.6%, following a 9.4% increase in 2013. Foreign direct investment—more than 85% of which went to the petroleum sector—rose by an estimated 18.7%. Gross international reserves fell by 7.9% in December from the previous month, as the central bank intervened to maintain its then-current peg to the US dollar. Because of earlier currency purchases, however, international reserves ended the year 1.7% higher, at $14.6 billion. Including sovereign wealth assets, external reserves amounted to $53.2 billion, equal to 6 months of imports (Figure 3.2.5).

Economic prospects

Despite a continuing slowdown in the petroleum sector, growth is projected to recover slightly to 3.0% in 2015 before reverting to 2.8% in 2016 as public investment moderates (Figure 3.2.6). Industry is expected to contract by 2.5% in 2015, as lower oil prices may curtail oil output, and then contract again in 2016, but only by 1.6%, as recovering

3.2.3 Monthly inflation



Source: Central Bank of the Republic of Azerbaijan.
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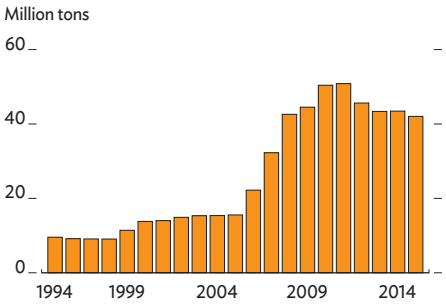
3.2.4 Oil production



Source: Ministry of Finance. http://www.finance.gov.az
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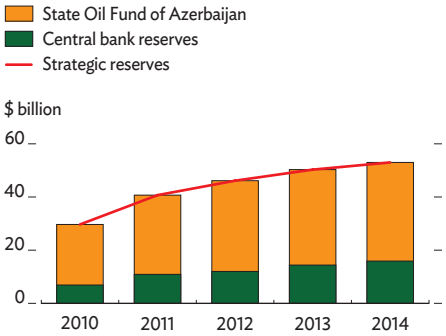
3.2.5 International reserves



Sources: State Oil Fund of Azerbaikan; Central Bank of the Republic of Azerbaijan.
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prices revive oil output. Planned investment in infrastructure should offset declines in the oil sector, aiding non-oil growth in 2015 and 2016. However, growth could be less if declining oil revenue constrains budget outlays more than anticipated.

Subsidized lending to farmers should help agriculture grow by 4.0% in 2015 and 5.0% in 2016. Services are forecast to grow by 8.0% in 2015 and 6.5% in 2016, driven largely by trade and tourism as Azerbaijan hosts the First European Games in 2015 and the Baku European Grand Prix, a Formula 1 race, in 2016. Large infrastructure projects, including road rehabilitation and the reconstruction of water supply, sanitation, and energy facilities, should boost construction in 2015 and 2016. However, infrastructure spending could be trimmed, cutting growth, if oil prices decline further and transfers from SOFAZ fall short of current projections. On the demand side, rising incomes and a salary increase for public sector workers will buoy private consumption. Public expenditure will allow for some growth in investment in 2015, but probably less so in 2016.

Higher public spending, lower interest rates, rising domestic demand, higher prices for imports other than food, and currency depreciation against the US dollar will stoke inflation, despite some decline in foreign prices for food imports. The central bank raised its inflation target from 3% to 5%–7% after adjusting the exchange rate. It will strive to keep inflation in check by raising the policy rate and banks' reserve requirements while enforcing consumer lending regulations to prevent overheating in consumer markets. Average annual inflation is forecast at 6.0% in 2015 and 5.5% in 2016 (Figure 3.2.7).

The budget will remain heavily dependent on oil revenues, and SOFAZ is projected to provide 53.4% of budget revenue in 2015, 12% more than the amount transferred in 2014. The state budget for 2015 anticipated an oil price of $90 per barrel, but currency devaluation will help offset much lower oil prices by boosting oil revenue in local currency terms, and the government may draw additional funds from SOFAZ if revenue falls below budget. Revenue is forecast to reach 31.9% of GDP, and expenditure 34.7%, widening the 2015 deficit to 2.8% of GDP (Figure 3.2.8). However, expenditure could be cut if oil prices remain low and revenue falls short of projections. Public and publicly guaranteed debt will likely remain at around 8%–9% of GDP in 2015 and 2016.

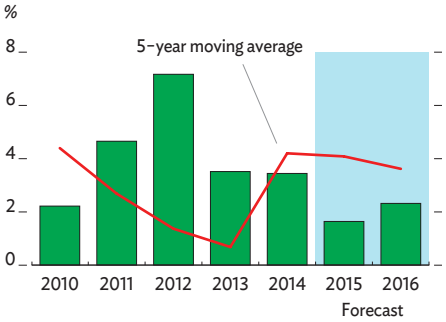
Hydrocarbons are projected to provide as much as 95% of exports. Even with lower oil prices, the current account is forecast to attain a surplus of 12.0% in 2015 and, with a slight rebound in oil prices, 13.4% in 2016 (Figure 3.2.9). With lower oil prices, exports are projected to decline by 15.0% in 2015 and recover by 6.0% in 2016. Imports are forecast to decline by 16.7% in 2015 and a further 7.0% in 2016, as they will be constrained by higher excise taxes, currency depreciation against the US dollar and the euro, and stricter rules on consumer lending. Workers' remittances—a marginal item in the balance of payments but important income for rural households—are expected to decline further because of ruble depreciation. With regular and SOFAZ reserves totaling more than $50.0 billion, however, the external position should remain healthy over the next few years.

3.2.1 Selected economic indicators (%)

	2015	2016
GDP growth	3.0	2.8
Inflation	6.0	5.5
Current account balance (share of GDP)	12.0	13.4

Source: ADB estimates.

3.2.6 GDP growth



Sources: Central Bank of the Republic of Azerbaijan; ADB estimates.
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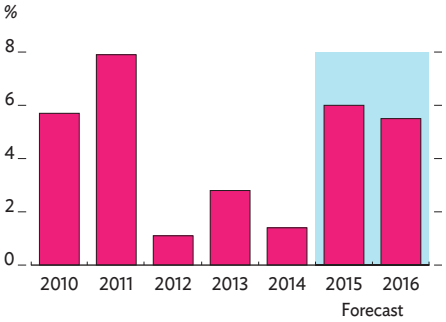
3.2.7 Inflation



Sources: Central Bank of the Republic of Azerbaijan; ADB estimates.
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Policy challenge—reducing reliance on oil revenue

Azerbaijan's growth has come largely from government spending funded by hydrocarbon revenues. High oil prices enabled the government to accumulate substantial savings and use them to support growth in the broader economy. However, the recent decline in oil prices and oil revenues has slowed the expansion of industry and shrunk the current account surplus.

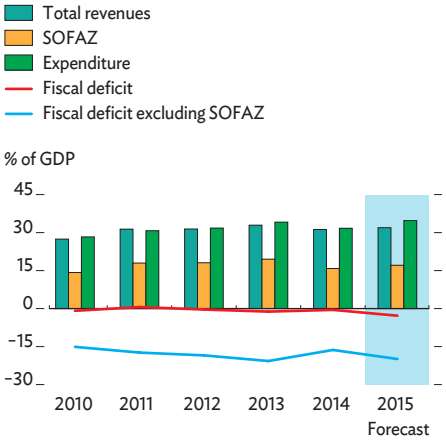
Sustaining growth in this environment will require additional withdrawals from SOFAZ, but weak oil prices could worsen Azerbaijan's fiscal position and dampen economic growth over the long run. Low oil prices will force the government to budget carefully and probably limit expenditure in line with lower oil revenue. The quandary is that lower expenditure will curb non-oil expansion, which relies heavily on public spending, and slow GDP growth.

Transfers from SOFAZ provide more than half of budget revenue and determine the scope of public investment. Construction is a key economic driver and would contract if oil-funded public investment declined. Over time, the economy must become less reliant on oil by diversifying into other industries and strengthening the private sector.

A self-supporting non-oil sector will require structural reform to improve the business climate. The World Bank's *Doing Business 2015* report on 189 economies ranks Azerbaijan at a very low 150 for obtaining construction permits, 159 for getting electricity, 166 for trading across borders, and 104 for securing credit. *The Global Competitiveness Report 2014–2015* of the World Economic Forum gives Azerbaijan a fairly high ranking except for its lagging financial market development. Addressing these problems and leveling the playing field for business would improve the investment climate and make it easier for the private sector to expand.

Given the outlook for oil revenue, public investment in other sectors should increasingly be financed through taxes, not transfers from SOFAZ. This will require continued reform of tax and customs administration and possibly higher tax revenue. In addition, better management is needed to make expenditure more productive and efficient. Transfers from SOFAZ should thus be channeled toward more productive projects that support industrial growth, particularly outside the oil sector.

3.2.8 Fiscal balance



SOFAZ = State Oil Fund of Azerbaijan.

Sources: Ministry of Finance of the Republic of Azerbaijan; ADB estimates.

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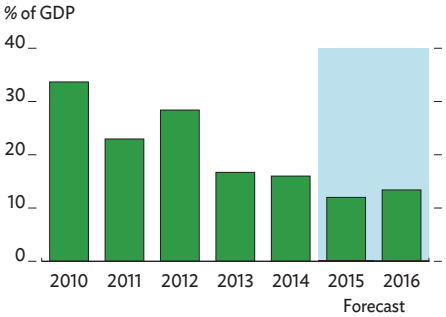
3.2.9 Current account balance



Sources: Central Bank of the Republic of Azerbaijan; ADB estimates.

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Georgia

Growth recovered to 4.7% from 3.3% in 2013, though the current account deficit widened to 9.5% of GDP. The depressed economies of major trading partners will halve growth to 2.0% in 2015 but allow some recovery in 2016 as the external outlook improves slightly. Currency depreciation could raise inflation to 5.0% in 2015 and 2016, as falling exports and remittances expand the current account deficit to 12.0% of GDP before narrowing somewhat in 2016.

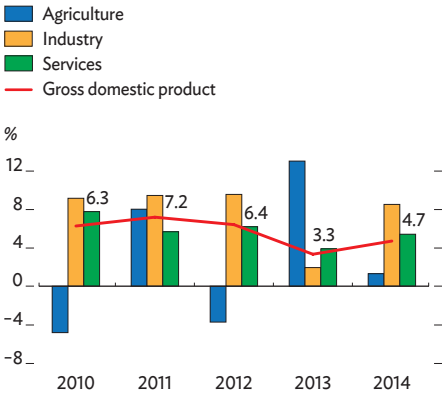
Economic developments

GDP expanded by an estimated 4.7% in 2014, up from 3.3% in 2013. Data through the third quarter of 2014 indicated that the recovery reflected mainly gains of 8.5% in industry, particularly in construction, and 5.4% in services, in particular for financial intermediation and tourism (Figure 3.3.1). In the same period, agriculture expanded by only 1.3%. On the demand side, growth came from a 5.5% expansion in consumption and, in particular, a 21.2% rise in investment, mainly in the private sector. However, a major slowdown began in the fourth quarter and continued into 2015 as the drop in oil prices and the impact of economic sanctions on the Russian Federation triggered recession there and much slower growth in other key trading partners. As a consequence, their imports from and remittances to Georgia plunged. Declining prices for ferroalloys, which represent 10% of Georgia's exports, also reduced export earnings. The decline in foreign exchange inflows put downward pressure on the Georgian lari, which depreciated by about 6% against the US dollar from October 1 to year-end and a further 15% by March 2015 (Figure 3.3.2).

Reversing reported deflation in 2013, annual average inflation reached 3.1% in 2014, driven by increases of 5.5% for health care, 5.2% for food, 4.3% for utilities, and 3.5% for services. December over December, though, inflation slowed to 2.0% in 2014 from 2.4% a year earlier (Figure 3.3.3).

The fiscal deficit amounted to an estimated 3.0% of GDP, which was less than budgeted because revenue exceeded the budget by 1.1% while expenditure reached only 95% of planned outlays (Figure 3.3.4). Revenue and grants together amounted to 28.0% of GDP, while expenditure equaled 31.0%. Total revenue rose by 8.3%, and tax revenue by 8.7% on higher receipts from excise tax on tobacco and value-added tax. Public expenditure rose by 9.8%, reflecting a 14.5% increase in current expenditure, in particular a 13.1% rise for goods and services and 9.1% from higher compensation for government employees. Public debt was estimated at 35.0% of GDP at the end of 2014.

3.3.1 GDP growth by sector



Note: Sector growth in 2014 is for the first 9 months over the same period in 2013.

Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 13 March 2015).

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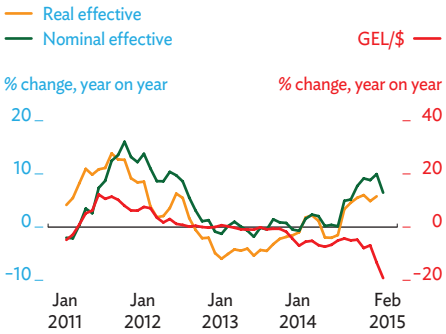
3.3.2 Exchange rates



Sources: National Bank of Georgia. http://www.nbg.gov.ge; Haver Analytics (accessed 5 March 2015).

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This chapter was written by George Luarsabishvili of the Georgia Resident Mission, ADB, Tbilisi.

Monetary policy remained accommodative, the policy rate unchanged at 4.0% until February 2015, when it was raised to 4.5% in response to exogenous shocks. Credit expansion accelerated to 25.4% from 21.2% in 2013, mainly reflecting higher consumer and mortgage lending in line with increased consumption and output. Loans denominated in US dollars grew by 20.4% but decreased as a percentage of all loans to 60.8% from 62.4% at the end of 2013. Broad money (M3) increased by 13.8%, less than in 2013, as net foreign assets declined and the growth in net claims on the government slowed (Figure 3.3.5).

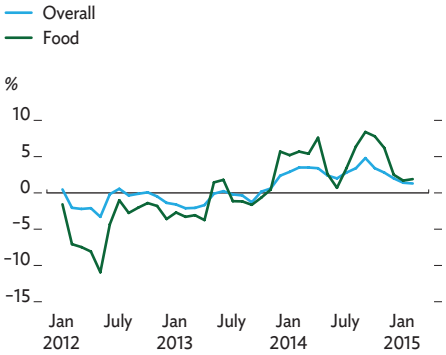
Banks remained well capitalized, their capital adequacy ratio at 18.0% and liquidity ratio at 39.1%. Nonperforming loans stayed modest at 3.6% of all loans with the timely restructuring or writing off of problem loans. However, lari depreciation against the US dollar helped foreign currency deposits rise to 57.1% of all deposits.

To reduce dollarization and improve the monetary transmission mechanism, the National Bank of Georgia started accepting for its refinancing facility a wider range of securities in local currency and promoted loans in local currency with variable interest rates. Average lending rates in lari fell by 1.4 percentage points to 17.5%, while average rates on loans denominated in foreign exchange fell by 1.2 percentage points to 10.5%. Excess bank liquidity helped reduce deposit interest rates by 0.9 percentage points to 5.3%.

The current account deficit widened to an estimated 9.5% of GDP from 5.7% in 2013. Higher growth fueled a 7.1% rise in imports, while exports declined by 1.6%, reflecting a 3.5% drop in the fourth quarter that erased increases in the two previous quarters. Steep currency depreciation in its main trading partners eroded Georgia's competitiveness despite lari depreciation against the US dollar. In addition, Azerbaijan's adoption of Euro 4 automobile standards in April 2014 cut Georgia's exports of secondhand vehicles. The fourth quarter drop in exports—followed by the 30.0% decline year on year recorded in January 2015—also reflected weakening in the economy of the Russian Federation, which by 2014 had become Georgia's third-largest export destination, taking nearly 10.0% of all exports. Tourism receipts declined, and remittances fell by 2.5%, with a notable drop of 16.3% in the fourth quarter and an even heftier decline of 22.5% in January and February 2015 compared with the same period a year earlier. Higher remittance inflows from southern Europe did not offset the drop from the Russian Federation, where remittances to Georgia plunged by 30.1% in the fourth quarter.

Despite a slow recovery in Europe, foreign direct investment performed well, exceeding $1.2 billion by official estimates. Gross international reserves amounted at the end of 2014 to $2.7 billion, down only slightly from $2.8 billion in 2013 and equivalent to 3 months of imports. External debt totaled an estimated 64.0% of GDP, excluding intercompany loans equivalent to about 20% of GDP. In July 2014, Georgia entered into a 3-year standby arrangement with the International Monetary Fund that provides a $155 million cushion against external shocks and sets a framework to discipline macro-fiscal policies.

3.3.3 Monthly inflation



Source: National Statistics Office of Georgia. http://www.geostat.ge (accessed 5 March 2015).

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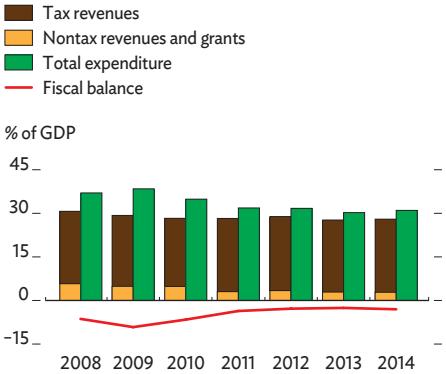
3.3.4 Fiscal indicators



Sources: International Monetary Fund. www.imf.org; Ministry of Finance of Georgia. www.mof.ge (both accessed 5 March 2015).

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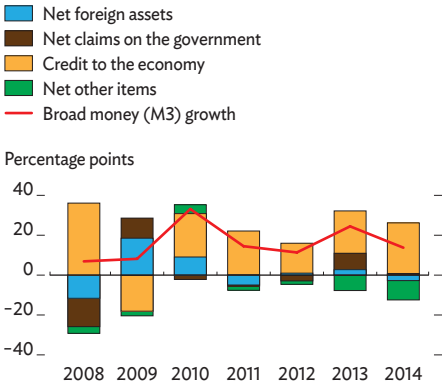
3.3.5 Contributions to money supply growth



Source: National Bank of Georgia. http://www.nbg.gov.ge (accessed 5 March 2015).

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Economic prospects

Growth is expected to slow to 2.0% in 2015 in tandem with slowdowns in the European Union and neighboring Azerbaijan and a projected recession in the Russian Federation (Figure 3.3.6). Some recovery in growth, to 2.5%, is forecast in 2016 as manufacturing strengthens and services pick up. The European Union Association Agreement with Georgia includes provisions for a Deep and Comprehensive Free Trade Area that, along with expected improvement in the global environment, should support exports and remittances during 2016 while boosting foreign direct investment from Europe. Higher public spending and a stable political situation following peaceful parliamentary elections in 2016 would support growth by strengthening consumer and investor confidence.

Despite projected reductions in international prices, domestic food price inflation could worsen if demand increases for Georgian food exports, especially from the Russian Federation. Inflation is forecast to reach 5.0% in 2015 and 2016, in part because of further lari depreciation. The policy interest rate may well be raised further in 2015 and 2016 if the authorities decide to limit currency depreciation, particularly if US interest rates rise from mid-2015.

The fiscal deficit is likely to expand to at least 4.0% of GDP in 2015 as slowing growth squeezes revenue. The 2016 deficit will depend on the macroeconomic environment and the tradeoff between promoting growth and containing the current account deficit. The government has an ambitious reform agenda to improve its management of revenue, expenditure, debt, and fiscal risk. After a 44% rise in social spending from 2012 to 2014, social benefits may level off in 2015. Public debt is projected to climb to 40.0% of GDP at the end of 2015 before subsiding to 38.5% at the end of 2016 (Figure 3.3.7).

After widening in 2014, the current account deficit is projected to expand further to 12.0% of GDP in 2015 before narrowing to 10.5% in 2016 (Figure 3.3.8). Merchandise exports are projected to decrease by 15.0% in 2015, reflecting the slowdown that began in late 2014, before recovering by 5.0% in 2016 as the external environment improves and the positive effects of the free trade area with the European Union are increasingly felt. Imports are projected to decrease by 3.0% in 2015, reflecting the slowdown in growth and remittances, and to increase by 3.0% in 2016 with some improvement in growth. Remittances are expected to decline in 2015 with the sharp deterioration in regional economies before recovering in 2016 as the external environment improves. Gross international reserves are projected to remain low at $2.5 billion at the end of 2015, equivalent to about 3 months of imports, before increasing to $2.6 billion in 2016 (Figure 3.3.9). External debt excluding intercompany loans is projected to reach 75.0% of GDP in 2015 and 74.0% in 2016.

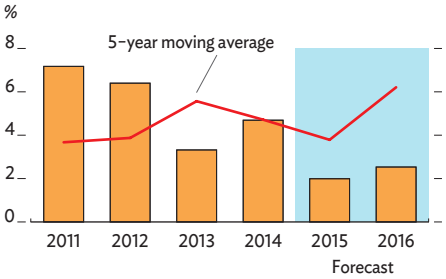
The growth forecast is subject to multiple downside risks: lower exports and remittances from slower European growth or a recession in the Russian Federation that exceeds expectations, stress on exports or tourism from tensions involving Ukraine and other countries in the region, and the impact of further lari depreciation on debt service burdens and household disposable income, as about 68% of mortgages are denominated in US dollars.

3.3.1 Selected economic indicators (%)

	2015	2016
GDP growth	2.0	2.5
Inflation	5.0	5.0
Current account balance (share of GDP)	–12.0	–10.5

Source: ADB estimates.

3.3.6 Annual GDP growth



Source: ADB estimates.
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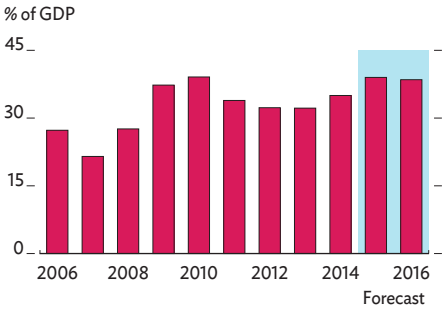
3.3.7 Public debt



Sources: International Monetary Fund. 2014. *Regional Economic Outlook: Middle East and Central Asia*. November. www.imf.org; National Bank of Georgia. http://www.nbg.gov.ge (both accessed on 5 March 2015); ADB estimates.
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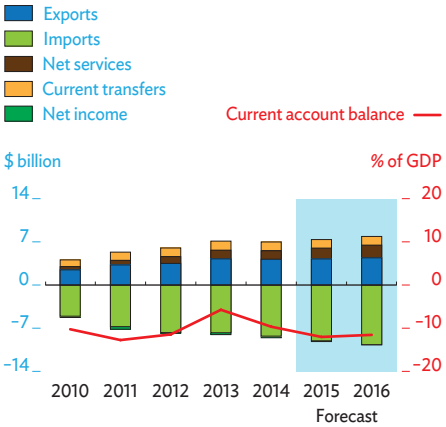
Policy challenge—developing domestic financial markets

Narrow financial markets have been a major constraint on growth in Georgia. The banking system and domestic bond markets are highly dollarized. Over two-thirds of housing loans are denominated in US dollars, and more than 80% of Georgia's public debt is in foreign currency. Banking is highly concentrated, and the domestic bond market remains thinly developed, shallow, and insufficiently liquid, with few institutional investors. Banks are the main purchasers of public debt. Low domestic savings limit nonbank financing for the budget or the private sector, leaving the economy overly reliant on inflows from abroad. Little long-term financing in lari is available.

The government has taken some steps to address the problem. To promote commercial lending in lari, in 2014 the government issued GEL200 million in Treasury securities, depositing the proceeds in commercial banks for onlending. A similar operation is planned for 2015. In addition, international financial institutions issued bonds denominated in local currency in March 2014 and February 2015. Bond issues such as these support the development of the local capital market and help attract the diversified investor base necessary to provide sufficient liquidity and demand in the domestic market.

Besides these measures, the government aims to improve the mobilization of domestic savings. Ongoing pension reform and the planned development of private retirement funds can help in this regard, as private pools of savings promise to create demand from sources other than banks for government securities in local currency. In addition, these pools of savings can provide longer-term private sector financing, including bond issuance. Introducing a deposit insurance system and a secured transaction regime would also be useful. Developing secondary markets for government bonds and other fixed-income securities would help develop capital markets, including nonbank sources of government finance. Measures such as these would strengthen demand for local currency securities while promoting a financial system better able to channel resources toward productive uses that support investment and growth. They could also help mobilize resources to finance infrastructure that would support growth.

3.3.8 Current account components



Sources: National Bank of Georgia. http://www.nbg.gov.ge (accessed on 5 March 2015); ADB estimates.

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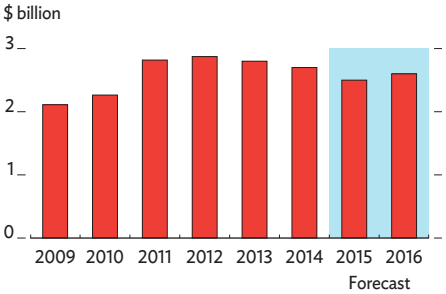
3.3.9 Gross international reserves



Sources: National Bank of Georgia. http://www.nbg.gov.ge (accessed 5 March 2015); ADB estimates.

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Kazakhstan

Adverse external factors caused growth to slow to 4.3% in 2014 from 6.0% a year earlier, but currency devaluation in February 2014 strengthened budget revenues and the current account balance while adding to inflation. Growth is projected to slow further to 1.9% in 2015 before recovering to 3.8% in 2016. Inflation should ease, but weak oil prices will turn the current account into small deficits in both years.

Economic developments

Growth moderated to 4.3% from 6.0% in 2013, mainly because slow global growth cut demand for Kazakhstan's main export commodities: oil, coal, metals, chemicals, and grain. Conditions worsened with a sharp decline in oil prices and spillover from sanctions on the Russian Federation, a major trading partner.

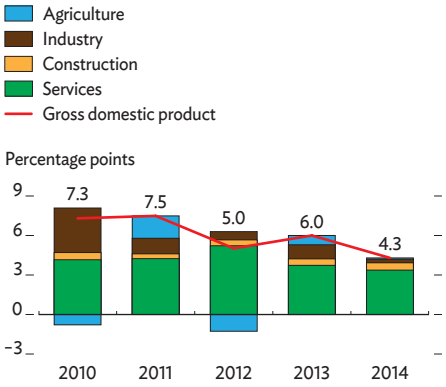
On the supply side, industry grew by only 0.3%, versus 3.0% in 2013, as mining and manufacturing performed poorly. Construction, driven by government programs, expanded by 4.1%, up from 3.5% a year earlier. Expansion in agriculture slowed sharply to 0.8% from 11.2% in 2013 as poor weather limited grain production. Services grew by 6.0%, versus 6.8% in 2013, reflecting slowdowns in transport, trade, and communication (Figure 3.4.1).

On the demand side, 9 months of data show that lower real income and constricted access to credit cut consumption growth to 2.5% from 12.8% in the same period of 2013. Private consumption grew only marginally by 0.4%, but higher government spending, including a pay increase after currency devaluation, boosted public consumption by 11.2%. Investment growth slowed to 3.9% from 6.2% in 2013 as public investment expanded by 24.9% but private investment declined by 0.3%. Meanwhile, a 15.6% drop in imports against a fall in exports half as steep—at 8.6%, reflecting weaker external demand for oil, coal, and metals—meant net exports improved by 7.5%, reversing the 12.7% drop in 2013 (Figure 3.4.2).

Although price administration limited the impact of the devaluation of the Kazakh tenge in February 2014, inflation accelerated to 6.7% from 5.8% in 2013, reflecting price rises for food and other goods. Inflation in services slowed because of restrictions on utility tariffs. The 12-month inflation rate, December to December, was 7.4%, up from 4.8% in 2013 (Figure 3.4.3).

The fiscal deficit in the republican budget expanded to 2.8% of GDP from 2.0% in 2013. Revenue reached 15.5% of GDP, up from 14.7% in 2013, reflecting larger transfers from the National Fund of the

3.4.1 Supply-side contributions to growth



Sources: Committee on Statistics of the Ministry of National Economy of Kazakhstan; ADB estimates.
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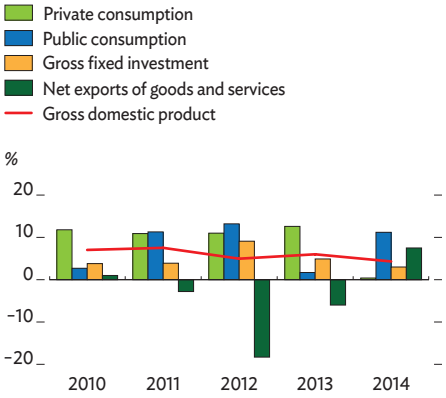
3.4.2 Demand-side contributions to growth



Source: Committee on Statistics of the Ministry of National Economy of Kazakhstan.
Click here for figure data

This chapter was written by Manshuk Nurseitova of the Kazakhstan Resident Mission, ADB, Astana.

Republic of Kazakhstan (NFRK, Box 3.4.1), equivalent to 4.8% of GDP, and a 13.3% rise in corporate income tax revenue. However, the post-devaluation pay rise and higher pensions and social transfers boosted expenditure to 18.4% of GDP from 16.7% a year earlier. In October, Kazakhstan sold $2.5 billion in eurobonds, pushing public and publicly guaranteed debt to an estimated 15.0% of GDP from 13.0% in 2013. State enterprise debt declined to equal 13.4% of GDP at the end of September from 14.3% at the end of 2013.

Monetary policy aimed to combat inflation and rehabilitate the banking system while preventing a post-devaluation downturn; the policy interest rate was maintained. Broad money grew by 10.5%, versus 10.2% in 2013, despite credit growth slowing to 7.2% from 13.4% in 2013. Lending to large firms declined by 6.1%, while loans to small and medium-sized enterprises rose by 38.7% and to households by 12.5%. Deposits expanded by 15.9% (Figure 3.4.4), but a shift into foreign currency accounts limited the supply of long-term loans denominated in tenge. Interest rates on tenge deposits rose in most banks. To boost tenge liquidity, the National Bank of Kazakhstan, the central bank, opened in July a $10 billion window for tenge–US dollar swaps with commercial banks at an implied interest rate of 3%.

Following devaluation in February, the tenge–US dollar exchange rate remained stable within a band of T182–T188 per US dollar. In September, the central bank widened the band to T170–T188. The rapid depreciation of the ruble against the major currencies in the second half of 2014 caused it to depreciate sharply against the tenge as well (Figure 3.4.5).

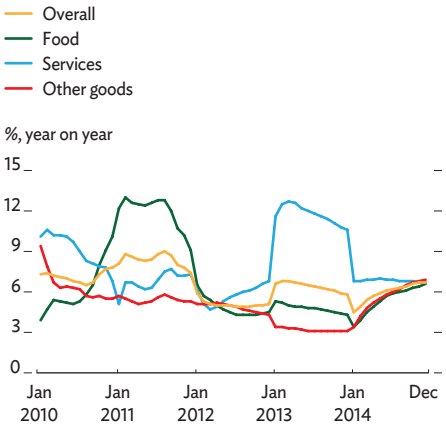
The resulting downward pressure on the tenge against the US dollar induced many firms and households to convert tenge deposits into foreign currency, raising foreign currency deposits by more than 70% to account for 55.6% of all deposits. To prevent speculation and excessive reserve losses, the central bank halted swap operations with banks. Lending slowed in the second half of the year, and some banks stopped lending in tenge (Figure 3.4.6).

Despite banks' efforts to cut nonperforming loans (NPLs), devaluation helped push the NPL ratio to 33.7% in April from 26.3% in November 2013. In response, the central bank asked commercial banks with significant NPLs to develop and implement action plans under its supervision. The discontinuation of tax disincentives for writing off bad loans helped rein in NPLs to 23.6% by the end of 2014. In addition, T250 billion was allocated from the NFRK to capitalize the central bank's fund for purchasing NPLs from banks (Figure 3.4.7).

The current account surplus is estimated to have widened to 1.8% of GDP from 0.5% in 2013. Devaluation initially boosted exports, but declining commodity prices offset the gains and caused export revenue to fall by 8.6%, versus a 1.5% decline in 2013. Imports also fell, by 18.9%, following a 4.1% increase in 2013, as imports of food, chemicals, metal products, and machinery all declined (Figure 3.4.8).

Gross reserves rose to $28.9 billion from $24.7 billion at the end of 2013, and NFRK assets reached $73.6 billion, though heavier use of NFRK funds for budgetary support and infrastructure spending cut growth in NFRK assets to 3.9% from 22.1% in 2013. External debt

3.4.3 Monthly inflation



Source: Committee on Statistics of the Ministry of National Economy of Kazakhstan.

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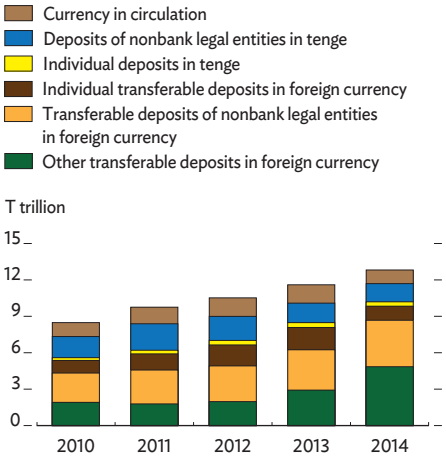
3.4.4 Broad money



Source: National Bank of Kazakhstan.

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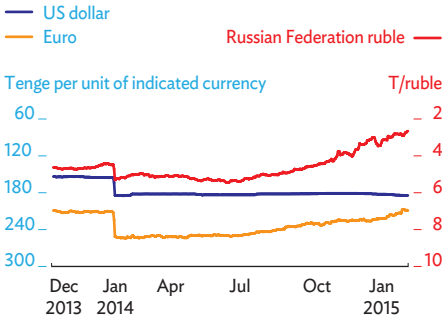
3.4.5 Exchange rate



Source: National Bank of Kazakhstan.

Click here for figure data

including intercompany loans reached an estimated 74.3% of GDP from 64.8% in 2013, while public and publicly guaranteed external debt rose to 3.9% of GDP from 2.7% a year earlier (Figure 3.4.9).

Economic prospects

Despite the launch of the Eurasian Economic Union with Armenia, Belarus, and the Russian Federation, growth is forecast to slow to 1.9% in 2015. This reflects slumping oil prices, economic weakness in the Russian Federation, and tenge appreciation against the ruble, which has hurt the competitiveness of Kazakh exports and boosted imports from the Russian Federation. Growth is projected to recover to 3.8% in 2016 as the economy adjusts to low oil prices and as stimulus measures take hold (Figure 3.4.10).

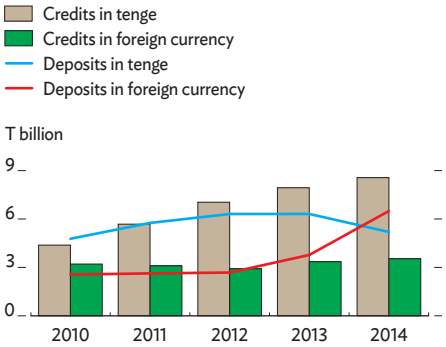
On the supply side, mining is forecast to contract by 10.0% in 2015 and remain unchanged in 2016, dragging down industry by 5.3% in the first year and allowing marginal growth of 0.4% in the second. The slowdown will limit growth in services to 5.0% in both years. Investments in housing and infrastructure under a state program for regional development are projected to boost construction by 4.0% annually, and past investment under the Agriculture 2020 development program is projected to expand agriculture by 2.7% in 2015 and 4.0% in 2016.

On the demand side, government interventions should propel consumption growth by 4.2% in 2015 and 5.0% in 2016. Countercyclical policy will likely see investment supported by NFRK resources rise by 4.0% in 2015 and 4.8% in 2016, as Expo 2017 nears. Net exports are forecast to fall by 15.5% in 2015 on low oil prices and a weak grain crop, which will shrink agricultural exports and export revenue and by 8.0% in 2016, as imports rise by 5% and exports remain unchanged.

Inflation is projected to slow to 6.0% in 2015 in line with lower food prices, slower income growth, cheaper imports from the Russian Federation, and the Kyrgyz Republic entering into the Eurasian Economic Union in May 2015, before accelerating marginally to 6.2% in 2016 (Figure 3.4.11).

On 11 February 2015, the President instructed the government to cut total budget expenditure by 10% but increase financing for agriculture, fund job preservation in industry, and enlarge a government reserve fund. This followed the announcement of the Nurly Zhol countercyclical program in November 2014, which stipulated raising NFRK transfers by $3 billion per year to provide economic stimulus, finance infrastructure development, and support the labor market. A revised 2015 budget based on an oil price of $50 per barrel projects the deficit expanding to 3.0% of GDP. The provisional 2016 budget projects a smaller deficit of 2.4% of GDP. Slower growth, lower oil revenues, cuts in export duties, and constrained imports are expected to limit revenue to 14.2% of GDP in 2015 and 15.3% in 2016. Expenditure is forecast at 17.3% of GDP in 2015 and 17.7% in 2016. Planned wage increases for 2015 have been postponed, and state-owned enterprises are reining in operating costs. Transfers from the NFRK are expected to expand to 6.0% of GDP in 2015 (Figure 3.4.12). The projected deficit suggests that public

3.4.6 Deposits and credits in tenge and foreign currency



Source: National Bank of Kazakhstan.
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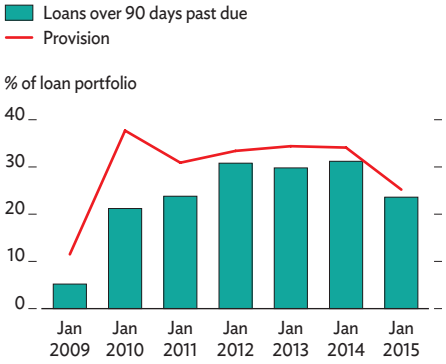
3.4.7 Overdue loans and loan provision



Source: National Bank of Kazakhstan.
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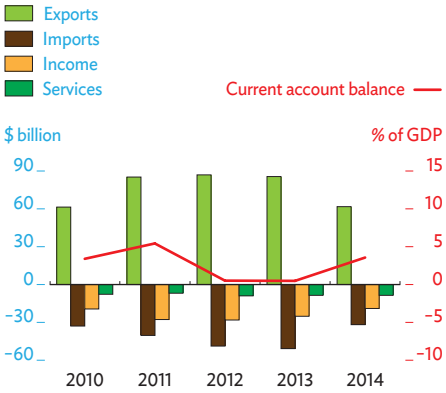
3.4.8 Current account balance



Source: National Bank of Kazakhstan, Committee on Statistics of the Ministry of National Economy of Kazakhstan.
Click here for figure data

and publicly guaranteed debt may increase to 17.9% of GDP in 2015 and 18.5% of GDP in 2016.

Monetary policy for the next 2 years will aim to maintain macroeconomic and financial stability while ensuring economic growth and building Kazakhstan's competitiveness. The goal is to keep broad money growth at around 10.0% each year. Efforts are under way to strengthen the financial system, rehabilitate banks, and develop capital markets. Requirements for higher bank capitalization will take effect on 1 January 2016. In addition, preliminary measures to prepare for inflation targeting will be introduced.

A top priority for monetary authorities will be to chart a path for the exchange rate, deciding when to spend currency reserves to defend the tenge and when to let it depreciate. The central bank plans to dampen exchange rate fluctuation while limiting intervention to conserve reserves. Some further depreciation of the tenge can be expected, in part to offset past appreciation against the ruble. To stem dollarization in the economy, the authorities will double in 2015 the ceiling on deposit insurance guarantees to T10 million. Recommended interest rates for foreign currency deposits will be reset from 4.0% to 3.0%.

The current account balance is projected to move into a deficit of 1.0% of GDP in 2015 and 1.3% in 2016 (Figure 3.4.13).

Declining oil prices are projected to slash exports by 32% in 2015 but leave them unchanged in 2016. Imports are forecast to contract by 10% in 2015 on lower volume and declining prices for goods from the Russian Federation, before recovering by 5% in 2016 on government spending and preparations for Expo 2017. Gross reserves may fall to $25.0 billion in 2015 and further to $22.0 billion in 2016 as reserves are used to dampen the anticipated depreciation of the tenge against the ruble. NFRK assets are forecast to decline to $67.0 billion by the end of 2015 and remain about the same in 2016 because of weak oil revenues and stimulus expenditures. External debt is projected to reach 79.4% of GDP by the end of 2015 and 84.1% a year later, while foreign borrowing drives public and publicly guaranteed external debt to 4.7% of GDP at the end of 2015 and 5.3% of GDP a year later.

Policy challenge—private sector development to diversify the economy

Falling oil prices underscore the need to diversify the Kazakh economy. Despite efforts to restructure the economy after the 2008–2009 oil price decline, dependence on oil has only strengthened. Investment growth has lagged lending, and spending on research and development has declined as a share of GDP to barely a quarter of the average for middle-income countries.

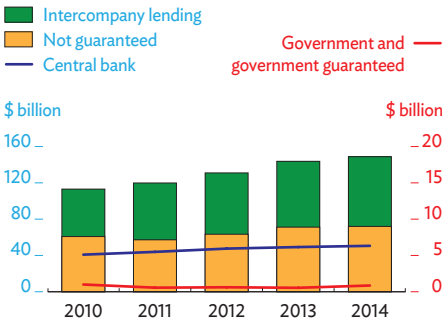
The first priority is to address lost competitiveness from the tenge's tremendous appreciation against the ruble during the past year. In the long run, industry, services, and agriculture will require a comprehensive and modern industrial policy to restore and maintain competitiveness.

3.4.1 Selected economic indicators (%)

	2015	2016
GDP growth	1.9	3.8
Inflation	6.0	6.2
Current account balance (share of GDP)	–1.0	–1.3

Source: ADB estimates.

3.4.9 External debt



Source: National Bank of Kazakhstan.
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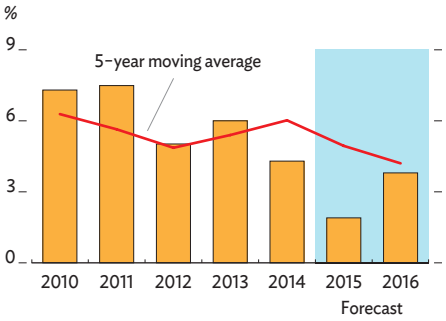
3.4.10 GDP growth



Sources: Committee on Statistics, the Ministry of National Economy of Kazakhstan; ADB projections.
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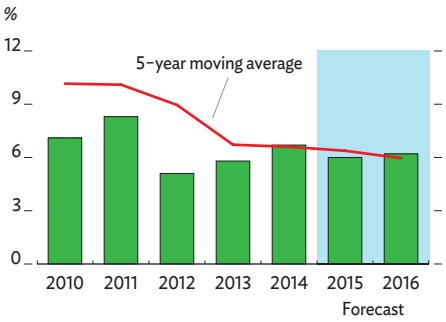
3.4.11 Inflation



Sources: Committee on Statistics, the Ministry of National Economy of Kazakhstan; ADB projections.
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3.4.1 National Fund for the Republic of Kazakhstan

The NFRK was established in 2000 to safeguard the country's petroleum earnings, use them to maintain macroeconomic stability, and ensure their availability for future generations. The NFRK sets aside windfall oil revenues during periods of high prices to limit inflation and ease pressure on the exchange rate. Transfers from the NFRK supplement budget revenue to ensure funding for social and development programs. Since 2010, an annual transfer of $8 billion to the budget has been guaranteed, though the amount can be adjusted up or down by as much as 15%, depending on the economic situation. Since 2013, additional targeted transfers have been allowed for specific investment projects.

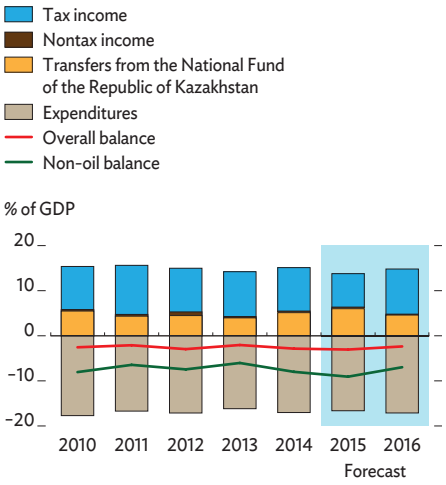
NFRK assets, which rose from $1.2 billion in 2001 to $73.6 billion at the end of 2014, are divided into separate portfolios for saving and stabilization. Most assets are invested abroad. NFRK transfers helped the government respond to the global financial crisis of 2008–2009, and today NFRK transfers support the government's current anti-crisis program for 2015–2017.

Economic diversification will depend on stronger promotion of the private sector and an industrial policy conducive to industries that promise to drive future growth. Structural reform will need to address concerns about the business climate, property rights and the rule of law, bankruptcy procedures, governance issues, and price controls, while nurturing integrated enterprise clusters to promote diversification. Kazakhstan ranked in the top half of 189 countries surveyed in the World Bank's *Doing Business 2015* report. However, addressing two extremely low rankings—154 for dealing with construction permits and 185 for trading across borders—could significantly improve the business climate. Better access to credit for private firms would also help, as would addressing issues raised by *The Global Competitiveness Report 2014–2015* of the World Economic Forum. Kazakhstan's ranking was 50 out of 144 economies surveyed, but it had much lower rankings in a number of areas, including 108 for soundness of banks, 111 for local competition, and 113 for quality of roads.

The government has moved to address some problems, for example using NFRK resources to channel funds through selected banks for discount lending to small and medium-sized enterprises. Government loans to banks rose by nearly 23% in 2014, but government-supported lending cannot overcome banks' unwillingness to lend in tenge or the strong incentives for dollarization in the current uncertain environment. Moreover, research has shown that governments help most by strengthening the business climate and capital market, investing in infrastructure and human capital, and supporting research and development in selected enterprise clusters. The success of efforts to diversify and develop public–private partnership depends critically on effective public finance management that features sound procurement policies, risk assessment, cost–benefit analyses of investment programs, and evaluation of investment program outcomes.

Careful husbanding of past oil earnings has given Kazakhstan considerable resources to support reform. A well-designed and comprehensive policy package could go far toward restoring confidence and macroeconomic stability while promoting diversification and private sector development.

3.4.12 Republican budget



Sources: Ministry of Finance of the Republic of Kazakhstan; ADB estimates.

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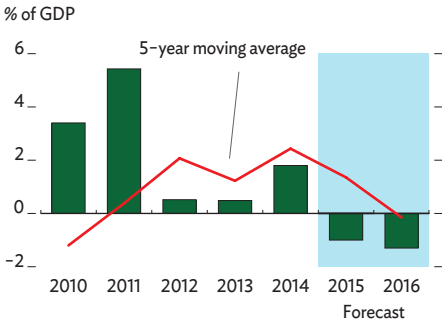
3.4.13 Current account



Sources: Committee on Statistics, the Ministry of National Economy of Kazakhstan; ADB projections.

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click here

Kyrgyz Republic

Growth slowed to 3.6% in 2014 as the economies of the Russian Federation and Kazakhstan weakened, while local currency depreciation of about 19% pushed inflation to 7.5%. With economic contraction expected in the Russian Federation, growth will likely slow further to 1.7% in 2015 before recovering slightly to 2.0% in 2016 as the external environment shows some improvement. Inflation will likely reach or exceed 10%, and the current account deficit 15% of GDP.

Economic performance

A 16% decline in gold production at the main Kumtor gold mine cut GDP growth by two-thirds to 3.6% in 2014 from 10.9% in 2013. Apart from gold mining, GDP rose by 4.6%, buoyed by expansion in services and industry (Figure 3.5.1).

On the supply side, growth in industry was 5.1%, but this was a steep plunge from 30.5% in 2013, in which gold output doubled. Lower gold production contributed to declines of 3.0% in manufacturing and 0.5% in mining, though industry growth remained positive because of expansion in food products by 8%, construction by 24.9%, and minerals other than gold by 6.2%. Services grew by 4.1% as higher consumer demand and improved cross-border trade boosted retail and wholesale trade by 7.2%, hotels and restaurants by 9.6%, and transportation by 4.3%. Agriculture, by contrast, contracted by 0.6% because of adverse weather.

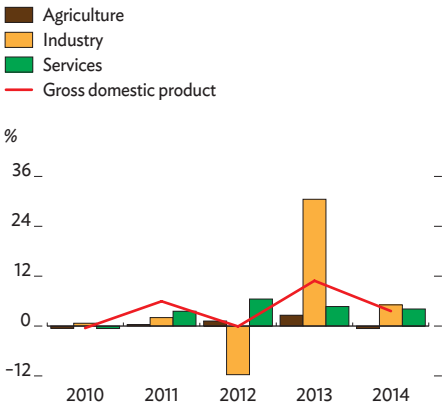
On the demand side, private consumption is estimated to have increased on rising retail trade. Investment expanded by 21.6%, reflecting a jump in private housing construction.

Average annual inflation rose to 7.5% from 6.6% in 2013, as food prices rose by 13.9%, led by wheat. Prices for most other items increased by 6.8%, and utility charges by 5.9%. Inflation accelerated mainly during the second half of the year, when the Kyrgyz som depreciated by 19.1% against the US dollar; the 12-month inflation rate, December to December, jumped to 10.5% from 4.0% in 2013 (Figure 3.5.2).

The fiscal deficit increased to 4.3% of GDP as growth slowed and revenue fell short. Higher grants and cuts in expenditure only partly offset the loss of nontax revenue from the closing of the Transit Center at Manas Airport in July 2014 as the North Atlantic Treaty Organization ended operations in Afghanistan (Figure 3.5.3). Public external debt surged to an estimated 51.0% of GDP at the end of 2014 from 43.7% a year earlier, reflecting in part sharp currency depreciation (Figure 3.5.4).

To limit inflation in the wake of currency depreciation, the National Bank of the Kyrgyz Republic, the central bank, sharply raised its policy interest rate from 4.16% at the beginning of the year to 10.50% at year-end. However, the full impact of the rate hike was limited by

3.5.1 GDP growth by sector



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 6 March 2015).
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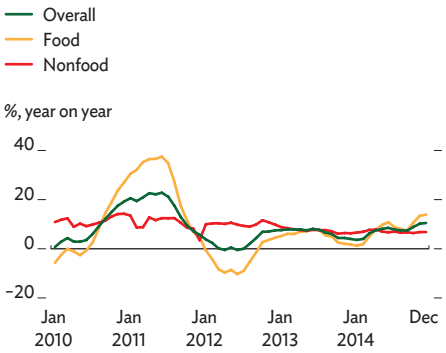
3.5.2 Monthly inflation



Source: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 6 March 2015).
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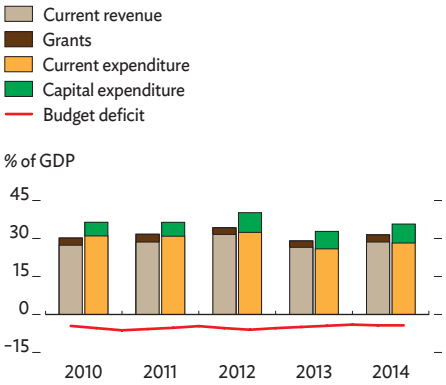
This chapter was written by Gulkayr Tentieva of the Kyrgyz Resident Mission, ADB, Bishkek.

extensive dollarization, as more than half of all bank loans and deposits are in foreign currency and dollarization increased as the currency weakened. The average deposit interest rate rose marginally to 4.8% from 4.3% in 2013, but the average lending rate fell to 17.6% from 18.4%. Moreover, deposits expanded by 22.6% and credit by 45.9%. Nonperforming loans declined to 4.5% of all credit outstanding at the end of 2014 from 5.5% a year earlier.

The Kyrgyz som depreciated in 2014 by 19.1%, from Som49.19 per US dollar to Som58.59 (Figure 3.5.5), despite more than 61 central bank interventions that cost $516 million. By year-end, foreign exchange reserves had fallen to $1.96 billion, equal to about 4 months of imports, from $2.24 billion at the end of 2013.

The current account deficit is estimated to have risen to equal 15.0% of GDP from 14.1% in 2013. Data through December showed a 6.3% decline in exports, reflecting the drop in gold production and weaker sales of fruit, vegetables, and textiles. Imports fell by 4.3% as imports of petroleum products, coal, and apparel declined. Remittances, equivalent to about a quarter of GDP, declined by an estimated 5% to $1.8 billion, largely during the last quarter (Figure 3.5.6). External debt rose to an estimated 53% of GDP.

3.5.3 Budget indicators



Sources: International Monetary Fund. 2011. Country Report No. 11/354. December; 2012. Country Report No. 12/329. December; 2013. Country Report No. 13/376 (December 2013); 2014. Country Report No. 14/200 (July 2014). http://www.imf.org; Ministry of Finance (accessed 6 March 2015).

Click here for figure data

Economic prospects

Growth is likely to slow further to 1.7% in 2015, reflecting recession in the Russian Federation, sluggish performance in Kazakhstan, and a further drop in gold production as the quality of extracted ore declines (Figure 3.5.7). Growth is expected to remain positive, however, with recovery in agro-processing and textiles and more trade as the Kyrgyz Republic joins the Eurasian Economic Union (EEU) on 1 May 2015. The government is developing an action plan to support export-oriented industries such as textiles and agro-processing through fiscal incentives and tax waivers. Growth is projected at 2.0% in 2016 on the assumption of some recovery in the Russian Federation and Kazakhstan and higher remittances. The highly volatile external environment poses downside risks to growth.

On the supply side, processing, light industry, and construction should raise activity outside the gold sector. In addition, EEU accession may boost trade and transportation, though the need to raise tariffs to EEU levels may discourage trade outside the EEU. On the demand side, entry into the EEU may boost external demand, but lower remittances will reduce household incomes and, probably, domestic private consumption.

The economy remains vulnerable to shocks from its largest enterprise, the Kumtor gold mine, which supplied 7.4% of GDP in 2014 and some 40% of exports. A long-standing dispute over mine ownership poses risks to the current forecast and damages the investment climate.

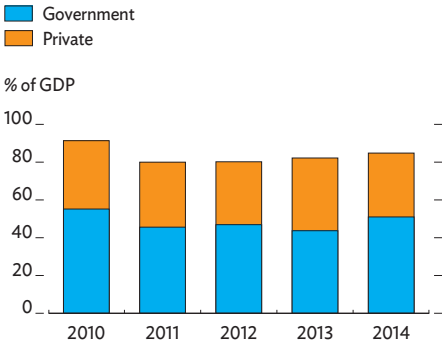
Currency depreciation and tariff increases on imports to comply with the EEU are projected to keep average annual inflation at 10.5% in 2015 and 10.0% in 2016. Continued ruble depreciation could trigger further weakening of the som, which would likely worsen inflation and dollarization.

3.5.1 Selected economic indicators (%)

	2015	2016
GDP growth	1.7	2.0
Inflation	10.5	10.0
Current account balance (share of GDP)	–16.0	–15.0

Source: ADB estimates.

3.5.4 External debt



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

Sources: Ministry of Finance; National Statistics Committee. http://www.stat.kg; National Bank of the Kyrgyz Republic. http://www.nbkr.kg (both accessed 6 March 2015).

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The fiscal deficit is projected to reach at least 5.0% of GDP in 2015 and 2016 as spending on teacher salaries and social protection rise, as announced, by half in 2015. With cautious revenue forecasts, the government has committed to limiting the deficit in the medium term by restraining expenditure on low-priority items. Revenue is projected at around 29% of GDP in 2015 and 2016 on improved tax and customs administration. Expenditure is forecast at 34% of GDP or higher, reflecting modest growth projections for 2015 and 2016 and higher current and capital spending partly related to the election year. Public debt is expected to rise further to 56% of GDP in 2015.

Monetary policy will remain cautious in 2015 as the central bank aims to limit inflation and stabilize the local currency. It will likely raise the policy interest rate again if inflation accelerates. Nominal interest rates should increase if the som depreciates further.

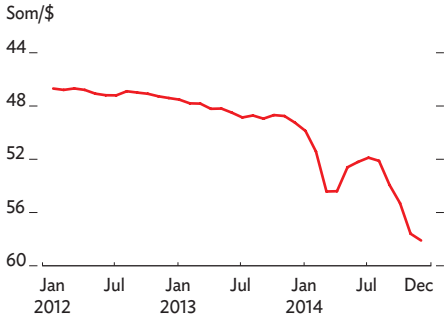
The current account deficit is forecast to stay at or near 16.0% in 2015 because of import-intensive spending on infrastructure, then ease to 15.0% in 2016 (Figure 3.5.8). Exports are forecast to grow by 10.0% in 2015 and 2016, mainly from gains in agricultural products and textiles. However, weaker consumer demand in 2015 in the Russian Federation and other EEU members may worsen the trade outlook. In addition, tariff increases may reduce trade with countries outside the EEU, while failure to meet EEU standards or technical regulations could initially hinder exports to EEU members. In view of these concerns, the government will support export-oriented industries and other measures to smooth the transition period, using $1 billion from the Russian Kyrgyz Development Fund newly established under a 2014 bilateral agreement. Imports are expected to grow by about 10.0% in both 2015 and 2016 because of infrastructure projects. Foreign direct investment will depend largely on political stability and the implementation of proposed structural reform and improvements to the investment climate. Remittances will likely fall by 15% in 2015 with deterioration in the economies of Kazakhstan and the Russian Federation, where most Kyrgyz migrants work, and the prospect of their currencies further depreciating. Lower remittance inflows will constrain household incomes and consumption, possibly putting further pressure on the local currency and worsening poverty, especially in remote parts of the country.

Policy challenge—better access to finance in poorer areas

Wide disparity in economic opportunity arises in part from limited financial development, which is a major obstacle to inclusive growth. Low domestic savings and high interest rates on loans, coupled with a shallow finance sector and inefficient financial intermediation, restrict access to affordable finance and thereby constrain private investment, particularly in the poor and rural areas that need it most.

A variety of factors limit bank lending. Lending rates are high because of such structural problems as risk aversion, a shortage of corporate clients, limited credit information on firms, the high

3.5.5 Exchange rate



Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 6 March 2015).
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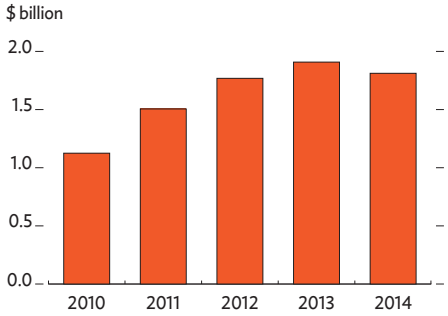
3.5.6 Remittances



Source: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 14 March 2015).
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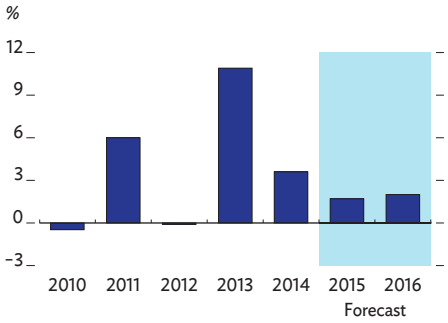
3.5.7 GDP growth



Sources: National Statistics Committee of the Kyrgyz Republic. http://www.stat.kg (accessed 6 March 2015); ADB estimates.
Click here for figure data

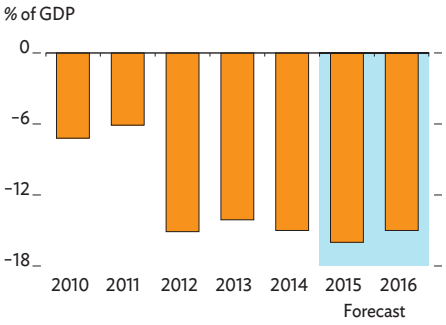
cost of lending to small firms and households, and a lack of credit infrastructure. In the Kyrgyz Republic, interest rates average 20.7% for domestic currency lending and 16.4% for foreign currency lending, both well above the inflation rate and among the highest in Central Asia. Moreover, bank loans have short maturities, are available for only a limited range of activities, and require substantial collateral.

In addition, more than half of all loans are in foreign currency. As a consequence, banks provide only a small fraction of financing for investment, leaving firms to rely mainly on retained earnings and private savings—particularly in rural areas, as 56% of lending and 86% of deposits are concentrated in the capital. Microfinance institutions now account for more than one-third of all credit in the economy, having grown since 2000 from a portfolio of Som500 million in loans to 19,000 borrowers to a 2014 total of around Som24 billion lent to 340,000 borrowers. Microfinance institutions play a limited role in facilitating private investment, however, because they are small and can offer only short-maturity loans at high interest rates.

Under its National Sustainable Development Strategy, 2013–2017 and its Microfinance Development Strategy, 2011–2015, the government has been working to ensure better access to credit information for banks and other finance institutions and to improve the quality of financial products available on the market. The reforms include new laws on the exchange of credit information, payment systems, and microfinance; the introduction of risk management systems in microfinance; a proposed new law on consumer protection; amendments to the Civil Procedures Code to accelerate the enforcement of arbitration awards; and amendments strengthening central bank independence and supervisory capability. Besides limiting state intervention in finance markets, these measures will expand the services and new products offered by financial institutions. This includes mobile banking, which has already been introduced in the country's two largest cities, Bishkek and Osh, with plans to extend it nationwide during the next few years. Such new technologies will make access to financial services more equitable in rural areas as well as cities.

These recent developments should improve financial intermediation and help raise bank assets from the low 35.4% of GDP recorded at the end of 2014. The expanded provision of formal financial services to remoter and poorer areas should help mobilize savings and support private sector growth.

3.5.8 Current account balance



Sources: National Bank of the Kyrgyz Republic. http://www.nbkr.kg (accessed 6 March 2015); ADB estimates.

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Tajikistan

Declines in remittances and the traditional exports of aluminum and cotton slowed growth to 6.7% in 2014 from 7.4% a year earlier. Inflation worsened to 6.1%, and the current account deficit to 7.9% of GDP. Expansion will likely slow further to 4.0% in 2015 before recovering to 4.8% in 2016. Inflation will accelerate to 10.0% in 2015 with currency depreciation before easing to 6.5%. The current account deficit should narrow to 5.9% in 2015 and 4.8% in 2016.

Economic performance

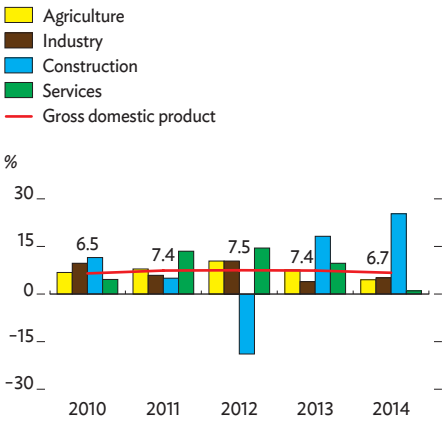
Growth slowed to 6.7% in 2014 from 7.4% in 2013 as remittance inflows, which are equivalent to almost half of GDP, fell sharply by 8.3% in US dollar terms. The fall was most pronounced in the fourth quarter and reflected prolonged economic slowdown, lost jobs, and currency depreciation in the Russian Federation, which hosts up to 90% of the 1 million Tajik migrant workers.

On the supply side, falling remittances helped slash expansion in services, which provide over half of GDP, to 1.0% from 9.7% in 2013. Growth in industry accelerated slightly to 5.1% from 3.9% in 2013, despite an estimated 30% drop in output at the Tajik Aluminum Company, long the economy's main industrial producer and leading exporter. Construction expanded by 25.3%, led by gains of 13.9% for housing and 13.0% for social facilities in response to strong government spending on social welfare. However, growth in agriculture slowed to 4.5% from 7.6% in 2013 as poor weather and seed outweighed gains from the introduction of modern irrigation techniques and measures to increase egg, fish, and poultry production (Figure 3.6.1). In particular, the production of cotton, a key export commodity that accounts for 60% of agricultural output, contracted by 8%.

On the demand side, declining remittances constrained private consumption as approximately 13,000 Tajik migrants left the Russian Federation by the end of 2014 in the wake of wage cuts and layoffs, and with uncertain future job prospects. Rising inflation further dampened household demand and retail sales. Compounding the slowdown was import growth outpacing that of exports, partly reflecting sluggish demand for Tajikistan's leading export commodities: aluminum and cotton.

Inflation accelerated to 6.1% in 2014 from 5.1% a year earlier. The rise came mainly from increases of 10.3% for food and 6.0% for services. Prices for other goods rose by only 3.0%, held down in part by falling global commodity prices, particularly for petroleum products, Tajikistan's largest import.

3.6.1 GDP growth by sector



Source: Tajikistan State Statistics Agency.
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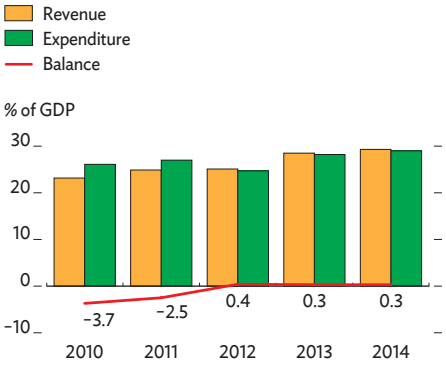
3.6.2 Fiscal balance



Source: Tajikistan State Statistics Agency.
Click here for figure data

This chapter was written by ADB staff.

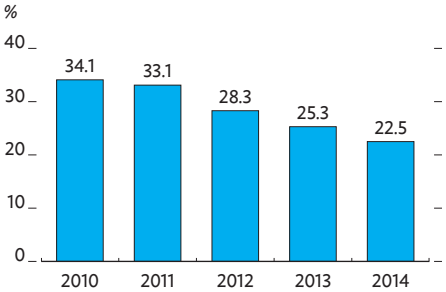
Fiscal policy was broadly neutral during the year (Figure 3.6.2). The budget recorded a surplus equal to 0.3% of GDP, unchanged from 2013. Revenues reached 29.3% of GDP from 28.5% in 2013, notwithstanding a 1% reduction in the corporate tax rate and the abolition of sales tax. Rising revenues reflected the continued benefits of tax reform in the form of a revised tax code, which has made tax administration markedly more efficient, effective, and transparent while enlarging the tax base and improving revenue collection. Total expenditure was 29.0% of GDP, versus 28.2% in 2013. The government met all of its announced commitments for 2014, including social expenditure for pensions, social protection, health care, and education, which together accounted for 60% of outlays. Public and publicly guaranteed debt declined to 22.5% of GDP from 25.3% in 2013 (Figure 3.6.3).

Monetary policy aimed to support growth and cushion the economy from currency depreciation. After lowering the refinancing rate from 5.9% to 4.8% in early January 2014, the National Bank of Tajikistan, the central bank, raised it three times beginning in May to 8.0% in late December. Broad money grew by 7.0% from the end of 2013 to the end of 2014 (Figure 3.6.4). The share of broad money in foreign exchange deposits increased slightly, to about 36% at the end of 2014 from 34% a year earlier.

Like many other currencies in the region, the Tajik somoni depreciated against the US dollar in 2014, by 11.2%, worsening inflation. The central bank avoided further depreciation with interventions totaling $137 million. From 1 January to early March 2015, the somoni depreciated by a further 2.9% (Figure 3.6.5).

The current account deficit widened significantly to 7.9% of GDP from 2.6% in 2013. Exports grew by 3.6%, reversing a 14.4% contraction in 2013, while the decline in remittances helped slow import growth to 7.3% from 9.1% in 2013. The reported rise in exports reflected a 37% increase in exports of electricity to 1.33 billion kilowatt-hours and higher fruit and vegetable exports to the Russian Federation. However, exports of aluminum—the single largest export item, comprising a third of all exports—fell by 37.2% in 2014 to 125,000 tons, compounding a 25% reduction in 2013. The decline reflected lower global prices, the continued depreciation of production facilities, ongoing problems with the supply of power and core inputs, and financial pressures at the Tajik Aluminum Company. Exports of cotton fiber, Tajikistan's second largest export item, also fell steeply, by 24.5% to 86,400 tons, reflecting lower international prices and the diversification of agriculture in Tajikistan as cotton farmers reallocated about 5% of cotton land to cereal and feed crops to supply the rising number of livestock and poultry farms. In 2014, remittance inflows fell for the first time since 2009, by 8.3% to $3.3 billion (Figure 3.6.6). Foreign currency reserves fell to $400 million, equivalent to only about 1 month of imports, from $500 million at the end of 2013.

3.6.3 External public and publicly guaranteed debt



Source: Tajikistan State Statistics Agency.
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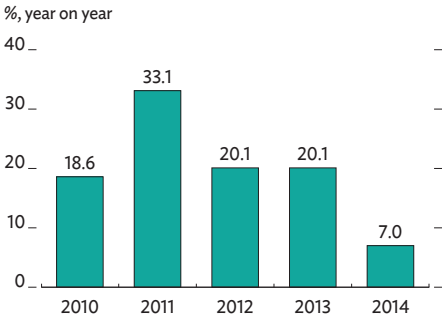
3.6.4 Broad money



Source: International Monetary Fund.
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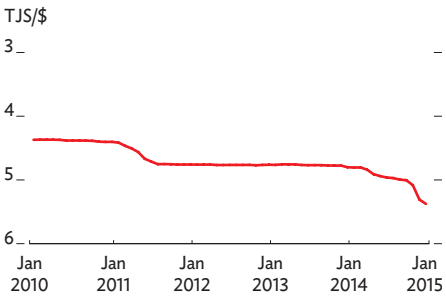
3.6.5 Nominal exchange rate



Source: National Bank of Tajikistan.
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Economic prospects

Growth is projected to slow to 4.0% in 2015, reflecting a recession of at least 3.0% in the Russian Federation and continued weakness in the global economic outlook. Growth could recover somewhat to 4.8% in

2016 with some improvement in the Russian Federation and the external environment generally (Figure 3.6.7). This will likely be supported by new job creation along the Trans-Tajik Gas Pipeline, which was ratified by Parliament in December 2014 and is slated to begin construction this year. Plans to increase social spending and raise public sector wages by 25% beginning in September 2015 should add to growth in 2016.

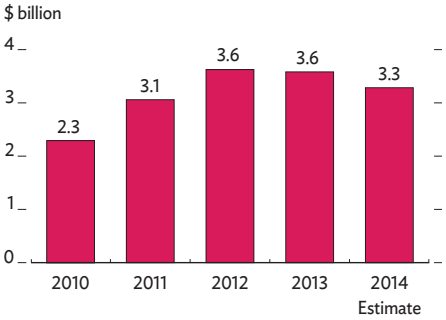
Inflation will likely accelerate in 2015 to 10.0% or more as currency depreciation raises the prices of imported consumer goods. A more stable currency and some recovery in remittances would allow inflation to ease back to 6.5%–7.0% in 2016 (Figure 3.6.8). With growth slowing, the current account deficit is forecast to narrow to 5.9% of GDP in 2015. It could narrow further to 4.8% in 2016 with some recovery in remittances (Figure 3.6.9). Exports are projected to grow by 14% to $1.6 billion in 2015 and a further 13% to $1.8 billion in 2016, while imports are projected to decline by 16% to $4.8 billion in 2015, before recovering by 6% to $5.1 billion in 2016. Remittances will likely contract further in 2015 as new regulations require that migrants to the Russian Federation have Russian language proficiency, as well as medical tests and health insurance that are estimated to cost about $500 per Tajik migrant. This will induce more to return home. Remittances are expected to recover somewhat in 2016 along with the economy of the Russian Federation.

3.6.1 Selected economic indicators (%)

	2015	2016
GDP growth	4.0	4.8
Inflation	10.0	6.5
Current account balance (share of GDP)	–5.9	–4.8

Source: ADB estimates.

3.6.6 Remittances



Source: World Bank .Migration and Remittances data. http://www.worldbank.org/migration (accessed 17 March 2015).

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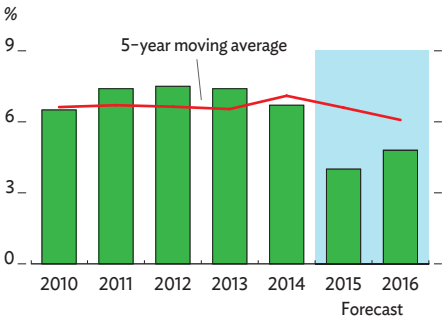
Policy challenge—protecting the economy from external shocks

Landlocked and possessing limited arable land and a narrow industrial base, Tajikistan is highly vulnerable to external shocks. Geopolitical tensions have heightened this vulnerability, given Tajikistan's heavy dependence on remittances and a few export commodities.

Remittances are a critical lifeline for Tajikistan and its primary source of development finance. In 2011, remittance inflows were eight times official development assistance. However, because remittances are used mainly for household consumption, imports, and cover for Tajikistan's rising trade deficit, their potential benefits for domestic growth, job creation, and long-term poverty reduction are limited. Further, remittance inflows are unpredictable and highly sensitive to economic and political developments in the Russian Federation. A 2014 World Bank study estimates that a 1 percentage point reduction in the GDP of the Russian Federation causes a 1 percentage point GDP contraction in Tajikistan. A debt sustainability analysis conducted by the International Monetary Fund in 2013 found that a modest shortfall in remittance inflows can worsen Tajikistan's debt service ratios for a prolonged period.

During the past decade, aluminum and cotton fiber have provided about two-thirds of Tajikistan's exports. Prices and external demand for these commodities are highly volatile. Since 2013, falling aluminum and cotton prices have significantly limited export growth. Tajikistan's longstanding dependence on aluminum and cotton fiber has discouraged industrial diversification. One consequence has been a halving of

3.6.7 GDP growth



Sources: International Monetary Fund. 2014. *World Economic Outlook*. October; Tajikistan State Statistics Agency; ADB estimates.

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the share of manufacturing in GDP from 2000 to 2014, which has undermined the development of alternative export commodities. Currently, Tajikistan's exports constitute less than 17% of GDP, compared with 50% in countries with similar income.

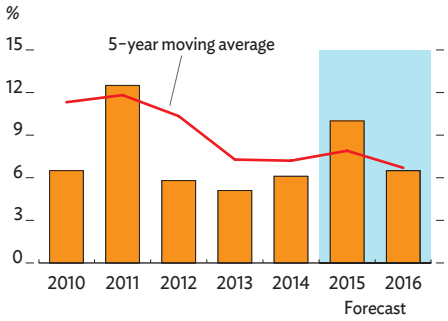
The Ministry of Economic Development and Trade has developed an action plan for risk mitigation in 2015–2016 that identifies medium-term financial and economic risks for the economy. The plan outlines strategies to increase foreign exchange reserves, improve revenue collection, and reduce quasi-fiscal risks, emphasizing the financial operations of two large state enterprises, Barki Tojik and Agroinvestbank. It further aims to strengthen governance in state-owned enterprises by implementing international financial reporting standards, improving financial and operational disclosure, and introducing external auditing. The plan includes targeted social assistance and support programs, as well as steps to enhance the investment climate.

The government anticipates that several factors will counterbalance falling remittances and a deteriorating industrial base. These include planned investments by the People's Republic of China amounting to $6 billion from 2015 to 2017 and recent agreements to increase food exports to the Russian Federation, export surplus summer energy to Afghanistan and Pakistan under the Central Asia South Asia Electricity Transmission and Trade Project, strengthen regional road transport linking member states of the Shanghai Cooperation Organization, and participate in the Turkmenistan–Afghanistan–Tajikistan Railway.

Over the longer term, unlocking the potential of Tajikistan's valuable resources can help it overcome the limitations of being landlocked. The development of road and rail networks in the subregion and beyond offers an opportunity to access niche markets in Asia and Europe for exotic mountain fruits and herbs and for the fish that are abundant in Tajikistan's unpolluted rivers. The country's significant gold and silver resources provide scope for expanding exports of lightweight finished products that can be transported by air, given the country's favorable location for international flights connecting Europe and Asia.

Realizing this potential will require structural reform. Despite some improvement during the past year, Tajikistan still ranks 166 out of 189 economies in the World Bank's *Doing Business 2015* survey of investment conditions, with exceptionally low scores of 168 for getting construction permits, 178 for getting electricity, 169 for ease of paying taxes, and 188 for trading across borders. Tajikistan needs to address these problems to boost its exports and thereby mitigate its vulnerability to external shocks.

3.6.8 Inflation



Sources: International Monetary Fund. 2014. *World Economic Outlook*. October; Tajikistan State Statistics Agency; ADB estimates.

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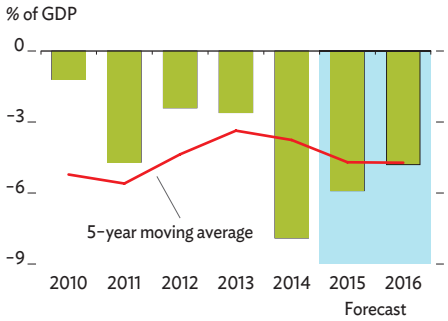
3.6.9 Current account balance



Sources: International Monetary Fund; ADB estimates.

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Turkmenistan

High growth at 10.3% in 2014 reflected robust public investment and gas exports. Strong foreign direct investment nevertheless drove the current account to a deficit of 4.4% of GDP. Growth is projected to slow to 9.7% in 2015 and 9.2% in 2016, and the current account deficit to widen further to 8.4% of GDP before moderating to 6.2% in 2016. Inflation is forecast to reach 7.0% before subsiding to 6.5%.

Economic performance

The government reported growth in 2014 at 10.3%, slightly above 10.2% a year earlier. The large hydrocarbon sector grew by 6.1%, while the rest of the economy expanded twice as fast, by 13.0% (Figure 3.7.1).

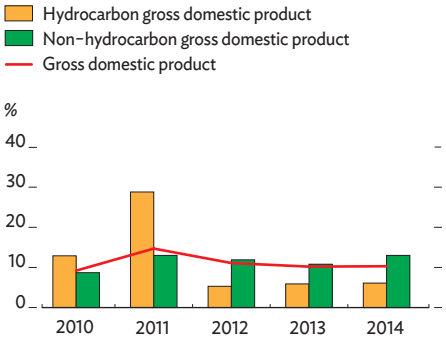
On the supply side, industry and services were the main sources of growth. The government reported that industry expanded by 11.4% in 2014, an improvement from 7.3% in 2013 that reflected faster growth in hydrocarbons, electricity, chemicals, construction materials, textiles, and agro-industrial products. Expansion in services slowed to 10.6% from 12.7% in 2013. Growth in agriculture decelerated to 4.2% from 10.0% in 2013 as unfavorable weather held wheat and livestock production below targets.

On the demand side, strong investment was the main source of growth. Public investment for infrastructure under the National Program of Socio-Economic Development of Turkmenistan for 2012–2016 expanded by 6.7% in 2014, compared with 7.1% in 2013.

Despite some declines in prices for food and services in the first half of the year, inflation rose in the second half with the reduction of subsidies and the concomitant rise in charges for public transportation and utilities. Nevertheless, the consumer price index is estimated to have risen by only 6.0% on an annual average basis, versus 6.8% in 2013, as the government continued to administer prices for basic goods and services and maintained a fixed exchange rate through the end of 2014 (Figure 3.7.2). Tighter monetary policy helped slow broad money growth to 22.6% from 31.1% in 2013, and expansion in private sector credit is estimated to have slowed marginally to 45% from 50%.

The government's fiscal surplus is estimated to have narrowed to 0.8% of GDP from 1.5% in 2013, reflecting higher outlays for social programs and a 10% increase in pensions, students' stipends, and public wages. Revenue was estimated at 16.4% of GDP, and identified budget expenditure at 15.6%. Public investment was also supported by off-budget resources. The large non-hydrocarbon fiscal deficit suggests that hydrocarbon revenues continued to finance growth in the rest of

3.7.1 GDP growth



Sources: International Monetary Fund. 2015. *Regional Economic Outlook, Middle East and Central Asia.* January; ADB estimates.

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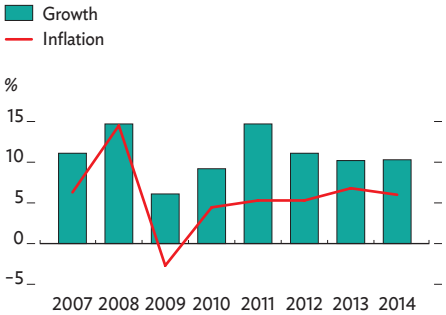
3.7.2 GDP growth and inflation



Sources: International Monetary Fund. 2015. *Regional Economic Outlook, Middle East and Central Asia.* January; ADB estimates.

Click here for figure data

This chapter was written by Jennet Hojanazarova of the Turkmenistan Resident Mission, ADB, Ashgabat.

the economy (Figure 3.7.3). Public debt is estimated to have fallen to 16.8% of GDP in 2014 from 21.1% in 2013.

Imports financed by foreign direct investment for large hydrocarbon projects pushed the current account to a deficit of 4.4% of GDP. Exports were estimated to rise by 3.3% in 2014, while imports grew by 1.8%. Foreign direct investment rose above $4 billion to equal 8.7% of GDP (Figure 3.7.4).

Economic prospects

With hydrocarbons representing more than 90% of exports, the continued decline in energy prices and fluctuating demand for Turkmen gas will likely reduce export revenues, weakening the current account. However, Turkmenistan has strong external buffers, as the International Monetary Fund estimated its foreign exchange reserves equal to 22 months of imports in 2014. Moreover, breakeven petroleum prices for the fiscal and external balance are considered to be the lowest in the region, providing some insulation against fluctuating energy prices.

GDP growth is projected to slow to 9.7% in 2015 and 9.2% in 2016 (Figure 3.7.5), reflecting lower public investment. Growth will slow further if external difficulties persist and require fiscal adjustment.

On 1 January 2015, the government devalued the manat by 19% to TKM3.50 per dollar from the previous TKM2.85, the first such adjustment in 7 years. The move was intended to keep non-energy exports competitive, ease pressure on the currency from falling energy prices, and offset some of the 40% appreciation against the ruble during the second half of 2014. Along with further price increases for gasoline and public utilities, the devaluation will likely spur inflation to 7.0% in 2015 before slowing to 6.5% in 2016.

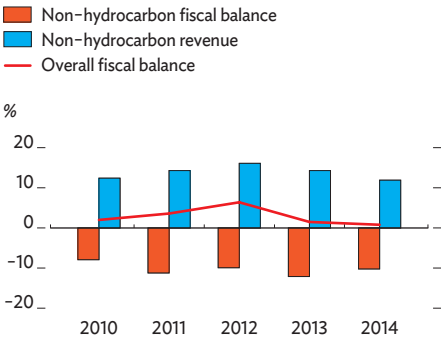
To limit inflation, the government will continue its import-substitution policies and price administration. The Central Bank of Turkmenistan will likely tighten monetary policy by slowing credit expansion. Growth in the money supply is forecast to slow to 19.0% in 2015 from 22.6% in 2014.

The state budget for 2015 is planned to be broadly balanced and anticipates a 9.5% rise in spending and a 13.0% increase in revenues. Under current projections of low prices for hydrocarbons but some recovery in 2016, the current account deficit is forecast to widen to 8.4% of GDP in 2015 before narrowing to 6.2% in 2016. External debt will remain low, decreasing to 18.6% of GDP in 2015 and 16.4% in 2016 as earlier loans are repaid.

Policy challenge—strengthening finance

The National Program of Socio-Economic Development of Turkmenistan for 2011–2030 aims to diversify the economy and increase the role of the private sector. Strengthening the financial system is essential for this goal because it is small, prone to excessive government intervention, and lacking in competition among banks. Banking assets amount to only 43% of GDP, and lending to only 27%.

3.7.3 Government fiscal balances



Note: Non-hydrocarbon fiscal balance and revenue are in percent of non-oil gross domestic product, while overall fiscal balance is in percent of total gross domestic product.

Sources: International Monetary Fund. 2015. *Regional Economic Outlook, Middle East and Central Asia.* January; ADB estimates.

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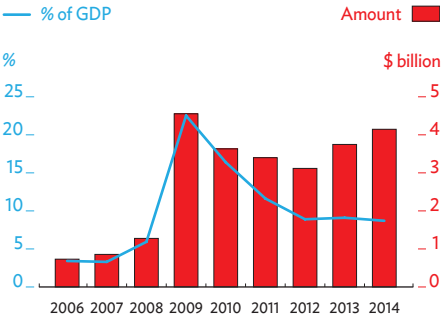
3.7.4 Foreign direct investment



Sources: United Nations Conference on Trade and Development. 2014. *World Investment Report.* New York and Geneva; United Nations; ADB estimates.

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The banking sector accounts for most financial activity and is highly concentrated, with over 80% of all assets in six state-owned banks. The remaining six private and foreign banks play only minor roles. Providing more than half of total credit to the economy, state-owned banks have traditionally directed lending to sectors selected to serve development policy objectives, offering subsidized interest rates and implicit government guarantees. Credit to the private sector represents less than 23% of total lending, well below the average for other countries ranked upper-middle income.

Recognizing the need for a better financial infrastructure, the government has instituted as part of its national reform strategy a program to develop the banking system from 2011 to 2030. The goal is to strengthen the financial sector and improve monetary and foreign exchange policy to enhance competitiveness and long-term growth. The program stipulates gradual restructuring and modernization in three stages, from 2011 to 2015, then to 2020, and finally to 2030. Reform started with the unification of multiple exchange rates and the redenomination of the national currency, which helped to reduce distortions, improve access to foreign exchange, and strengthen confidence in the Turkmen manat. Major laws have been enacted to better govern the central bank, credit institutions, foreign exchange regulation and control, and accounting and financial reporting standards. New laws on small and medium-sized enterprises and microfinance aim to develop the private sector.

To enhance efficiency in intermediating public resources, the State Development Bank was created in 2011 to direct resources from the Stabilization Fund. The new bank is a major innovation and should help phase out directed lending by the central bank. State Development Bank lending accounted for about a quarter of all lending by 2014.

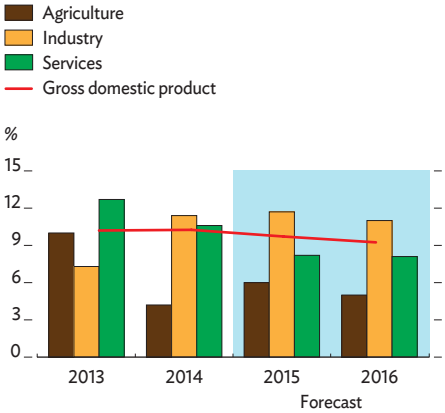
The government's program calls for further reforms to strengthen the legal and regulatory framework, integrate international standards and best practices into the financial sector, develop nonbank institutions, commercialize state banks, and improve the private sector's access to financial products and services. Several additional measures would support government objectives to deepen and broaden financial intermediation and promote private sector development. These include increasing competition among banks by making the sector less segmented and allowing the entry of private and foreign banks, introducing market-based mechanisms for determining interest rates and lending activities, and developing capital markets to support the efficient allocation of long-term savings and investments. The government's program and additional measures such as these will be important for expanding the non-hydrocarbon economy and enhancing Turkmenistan's competitiveness.

3.7.1 Selected economic indicators (%)

	2015	2016
GDP growth	9.7	9.2
Inflation	7.0	6.5
Current account balance (share of GDP)	−8.4	−6.2

Source: ADB estimates.

3.7.5 Growth by sector



Source: ADB estimates.

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Uzbekistan

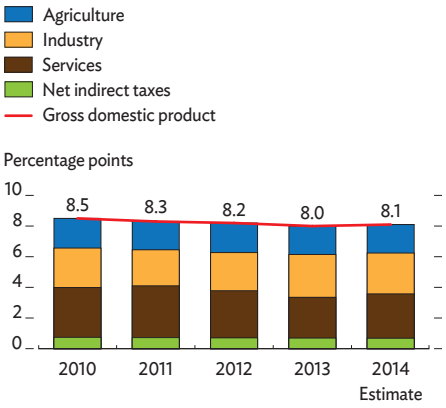
Growth rose marginally to 8.1% as increased lending and public outlays offset the impact of a weakening economy in the Russian Federation. Recession there and sluggish external demand are projected to slow growth to 7.0% in 2015 before it edges back up to 7.2% in 2016 as the external outlook improves. Inflation is projected to reach 9.5% in 2015 and 10.0% in 2016, with the current account showing surpluses of 0.9% and then 1.1% of GDP.

Economic performance

The government reported growth at 8.1% in 2014, slightly above 8.0% in the previous year. Lower growth was expected because of the economic slowdown in the Russian Federation, Uzbekistan's largest trade partner and its major source of remittances. The slowdown there reduced bilateral trade and remittances, while lower export earnings accelerated the depreciation of the Uzbek sum against the US dollar. In response, the government expanded public spending and commercial lending to sustain domestic demand. On the supply side, industry and services were the main contributors to growth, as industry excluding construction expanded by 8.3%, versus 8.8% in 2013, and services expanded by 15.4%, up from 13.7% in 2013. In industry, the ongoing state modernization program, backed by substantial public investment, boosted the production of machinery, metals, and chemicals, which expanded by 10.2% and contributed almost 40% of total industrial output. In services, strong performers were information and communication technology (up by 24.1%) and finance (up by 33.9%), supported by robust demand and domestic lending. Another important service subsector—trade and catering—grew by 17.5%. Despite unfavorable weather, agriculture grew by 6.9%, faster than in 2013, on healthy vegetable harvests and expanded livestock production (Figure 3.8.1).

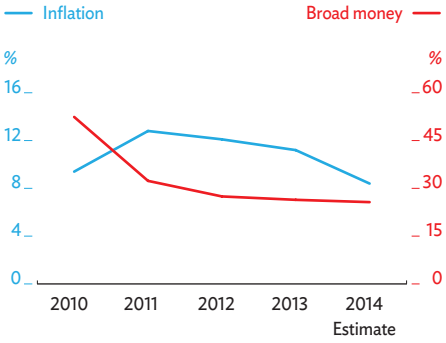
On the demand side, increases in wages and pensions, public investment, and commercial lending were the main sources of growth. Public sector wages rose by 19.1% in 2014, sustaining private consumption. Gross fixed capital formation was reported rising by 10.9%. Capital investment reached $14.6 billion, or 24% of GDP, including more than $3.0 billion in foreign investment. Notable projects completed in 2014 include the expansion of the General Motors Uzbekistan automobile manufacturing plant and the completion of a key branch of the gas pipeline linking Central Asia to the People's Republic of China. Commercial bank lending raised credit to the economy by 31.2%.

3.8.1 Supply-side contributions to growth



Sources: State Statistics Committee; ADB estimates.
Click here for figure data

3.8.2 Inflation and broad money



Sources: International Monetary Fund; ADB estimates.
Click here for figure data

This chapter was written by Iskandar Gulamov of the Uzbekistan Resident Mission, ADB, Tashkent.

The government reported average annual inflation at 6.1% in 2014. Official consumer price index data show that inflation slowed primarily because food prices fell in line with global trends. The International Monetary Fund estimated, using the same data as the government but a different methodology, that inflation slowed to 8.4% from 11.2% in 2013. Inflation is nevertheless believed to have risen in the fourth quarter because of rapid currency depreciation against the US dollar. Unofficial curb market rates show the Uzbek sum losing approximately 20% of its value in 2014, and the pace of depreciation accelerated in the last quarter along with ruble depreciation and falling global fuel prices. In response to slowing exports and currency depreciation on the curb market, the Central Bank of Uzbekistan accelerated its official depreciation of the sum against the US dollar and tightened import controls.

Broad money is estimated to have grown by 26% in 2014, about the same as in 2013, reflecting higher domestic credit. Monetary survey data are not available, but net foreign assets in the banking system may have decreased as domestic credit grew more quickly than broad money (Figure 3.8.2).

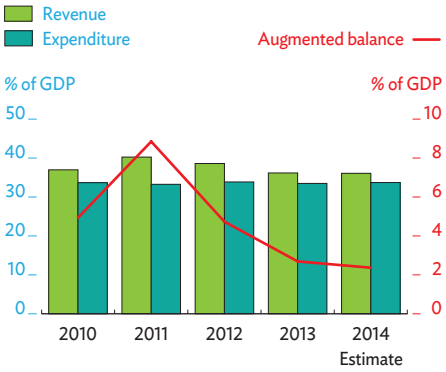
The government reported a budget surplus of 0.2% of GDP in 2014. Factoring in the surplus of the Uzbekistan Fund for Reconstruction and Development, the country's sovereign wealth fund, the augmented budget balance is estimated to have shown a surplus equal to 2.4% of GDP, down from 2.7% in 2013. Budget revenues are estimated to have slipped from 36.2% of GDP in 2013 to 36.1% in 2014, in line with declining international prices for key export commodities. Higher government spending—notably for wages, pensions, health care, and education—raised budget expenditures from 33.5% of GDP in 2013 to 33.7% in 2014 (Figure 3.8.3). Total government debt edged up from 8.5% of GDP in 2013 to 8.7% in 2014 as foreign lending for infrastructure increased.

The current account surplus is estimated to have narrowed to 1.2% of GDP from 1.6% in 2013, reflecting a smaller trade surplus and lower remittances (Figure 3.8.4). External demand remained weak, and international prices for Uzbekistan's key export commodities declined from historic highs. Much of the narrowing in the trade surplus reflected lower earnings from energy, which accounts for about 30% of all exports. Earnings from energy exports have been declining since the third quarter of 2014 in line with retreating global oil prices (Figure 3.8.5). Total exports are estimated to have declined by 2.0%.

Developments in the economy of the Russian Federation during late 2014 profoundly affected Uzbekistan's exports and remittances. Weak consumer demand there, coupled with rapid nominal appreciation of the Uzbek sum against the ruble, hurt bilateral trade. Diminished labor demand in construction and logistics—the main employers of Uzbek migrants—helped cut remittances from the Russian Federation by an estimated 10% to about $5.0 billion. Quarter by quarter, bilateral trade and remittances were both lower than in 2013 (Figure 3.8.6).

Imports of goods and services rose by 1.1%, driven mainly by imports of consumer goods and chemicals. Despite declining by about 10% from 2013, machinery and equipment remained the largest import items,

3.8.3 Fiscal indicators and augmented budget

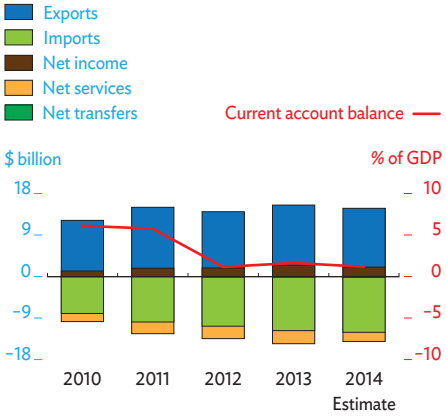


Note: Augmented budget includes the Fund for Reconstruction and Development.

Sources: International Monetary Fund; ADB estimates.

Click here for figure data

3.8.4 Current account indicators



Sources: International Monetary Fund; ADB estimates.

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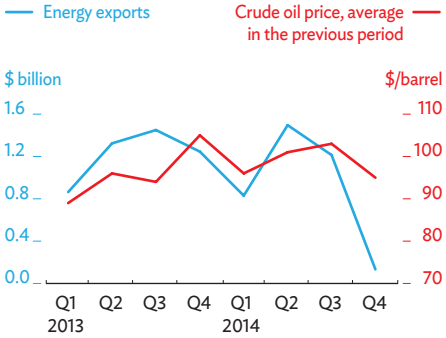
3.8.5 Energy exports and global oil prices



Q = quarter.

Sources: Organisation for Economic Co-operation and Development; State Statistics Committee; ADB estimates.

Click here for figure data

accounting for 40% of imports. This reflects continued but moderating demand for capital goods from state-led infrastructure development and industrial modernization programs scheduled to end in 2015.

With the decline in exports, the trade balance is estimated to have moved into deficit by the end of 2014 (Figure 3.8.7). Public and private external debt is estimated to have increased to 13.4% of GDP in 2014 from 13.0% in 2013. Gross official reserves were estimated at $23.9 billion, equivalent to 2 years of merchandise imports (Figure 3.8.8).

Economic prospects

GDP growth is forecast at 7.0% in 2015 and 7.2% in 2016, reflecting projected contraction of at least 3.0% in the Russian Federation and historically low international commodity prices (Figure 3.8.9). To limit the growth slowdown, the government is expected to boost spending further, particularly for public investment. Gradual recovery in external demand should begin in 2016, but industry will remain the key supply-side driver of growth, with output supported by higher lending. Large industrial enterprises in strategic sectors—mining, oil and gas, and manufacturing—are expected to receive the bulk of additional lending from both the government and commercial banks. Planned wage and pension increases that exceed the inflation rate should support private consumption and demand for services. Agriculture is projected to grow by 6.0% in line with stable production of the key agricultural crops: cotton and wheat.

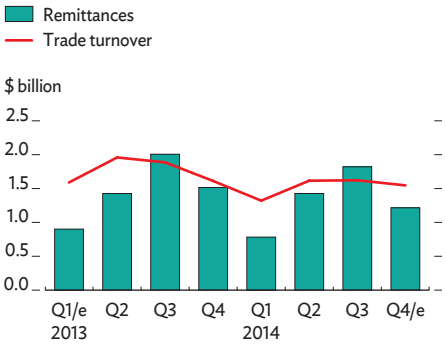
The government is expected to complete its large modernization investment program in 2015. Public investment should increase substantially to achieve the goal of raising industry's share of GDP to 28%, with most investment financed by the Uzbekistan Fund for Reconstruction and Development. Gross fixed capital formation is forecast to increase by 11.0% in 2015 and 12.0% in 2016.

In response to growing external risks and global uncertainties, the government announced in January 2015 reforms to be implemented over 2015–2019 for economic diversification, private sector development, a smaller state presence in the economy, and better corporate governance. In early March 2015, the government adopted a comprehensive structural transformation, modernization, and diversification program for 2015–2019. The program envisages a $19.6 billion investment package to be financed through foreign investments and loans, the Uzbekistan Fund for Reconstruction and Development, and commercial bank lending.

As in 2013 and 2014, the government will continue to stimulate domestic consumption in 2015 and 2016, most likely by raising public sector wages, welfare payments, and pensions. With presidential elections in 2015, additional measures are expected to sustain household spending, including expanded consumer lending. Reflecting these developments, private consumption is forecast to rise by 2.0% in 2015 and 3.0% in 2016.

Inflation is projected at 9.5% in 2015 and 10.0% in 2016 (Figure 3.8.10). Inflationary pressures will emanate from higher government spending and continued depreciation of the local currency. Anticipated declines in global food prices and lower import costs could partly offset these pressures. Nevertheless, containing inflation will remain a key challenge over the medium term.

3.8.6 Bilateral trade with and remittances from the Russian Federation



/e = estimate, Q = quarter.

Sources: State Statistics Committee; Central Bank of Russia; ADB estimates.

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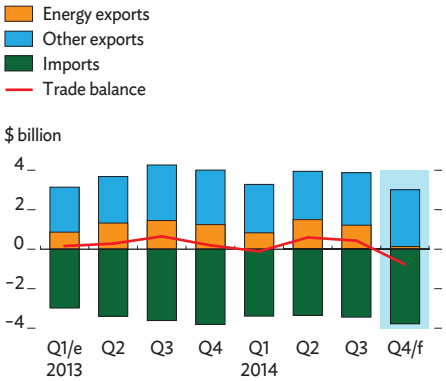
3.8.7 Trade balance, 2013–2014



e = estimate, f = forecast, Q = quarter.

Sources: State Statistics Committee; Central Bank of Russia; ADB estimates.

Click here for figure data

3.8.1 Selected economic indicators (%)

	2015	2016
GDP growth	7.0	7.2
Inflation	9.5	10.0
Current account balance (share of GDP)	0.9	1.1

Source: ADB estimates.

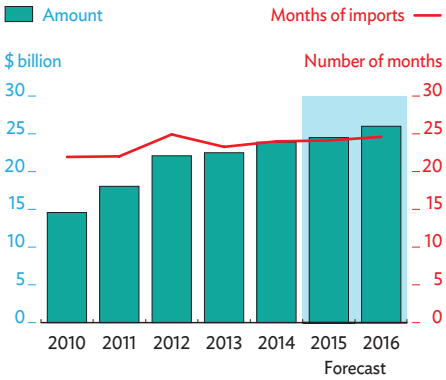
The government officially projected a consolidated budget deficit of 1.0% of GDP in 2015, reflecting efforts to support economic expansion. Factoring in expected surpluses in the Uzbekistan Fund for Reconstruction and Development, the budget is projected to post surpluses of 2.0% of GDP in 2015 and 1.5% in 2016. Budget expenditures are forecast to rise with increases in health care and education outlays, along with higher wage and pension payments. Low international prices for the country's export commodities will limit the potential for revenue growth.

The current account surplus is forecast to narrow further, to 0.9% of GDP in 2015, before expanding modestly to 1.1% in 2016. Falling international prices for the country's main export commodities, weak global trade, the deteriorating economic situation in the Russian Federation, and slow growth in the People's Republic of China will reduce the trade surplus and transfers, including remittance inflows. Also weakening the outlook is the announcement by Gazprom in February 2015 that slashes Russian Federation procurement of Uzbek natural gas from an estimated 4.5 billion cubic meters in 2014 to 1.0 billion in 2015. However, plans by Uzbekistan's national oil and gas conglomerate to raise natural gas exports to the People's Republic of China to 10.0 billion cubic meters in 2015 may offset most of this loss. Potential recovery in the Russian Federation by 2016, albeit gradual, should support exports after 2015. Merchandise exports are projected to rise by 1.3% in 2015 and 3.0% in 2016.

Merchandise imports are projected to rise gradually, by 2.0% in 2015 and 4.0% in 2016. Most demand will come from the public sector in line with continued infrastructure spending. Lower global commodity prices will constrain import payments, as will greater import controls.

The key downside risk is that lower global oil prices and continued US and European Union sanctions induce a recession in the Russian Federation that is deeper than expected. Compounding this risk are a possible tightening of global financing conditions and an expected hike in US interest rates.

3.8.8 Official reserves



Sources: International Monetary Fund; ADB estimates.
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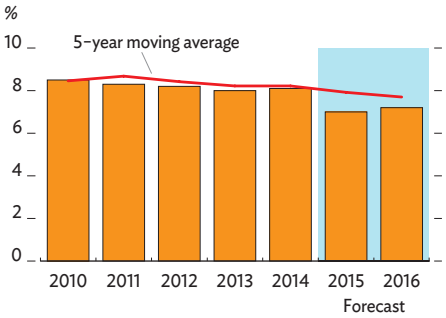
3.8.9 GDP growth



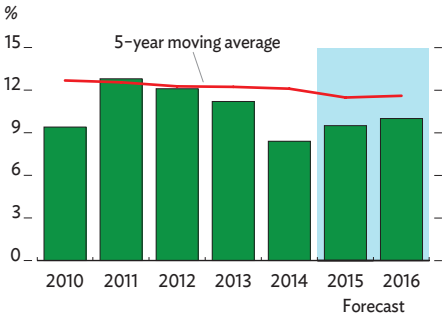
Source: Asian Development Outlook database.
Click here for figure data

Policy challenge—creating jobs through private sector development

As the Russian Federation enters recession, weak labor demand and stricter immigration rules are expected to leave many migrant workers without jobs or incomes. Many thousands of them will likely return to Uzbekistan, at least temporarily, which will intensify pressure on a domestic labor market that is already large and growing. Moreover, one-fifth of the domestic workforce is employed in agriculture, where productivity is low. Recognizing these challenges, the government adopted a program in November 2014 to create 409,500 jobs for returning migrant workers in 2015. The bulk of the new jobs will be in rural areas.

While recent government efforts are important, they need to be matched by adequate demand from the private sector to meet the objectives of sustainable income generation and improved well-being (Box 3.8.1). Experience from other emerging economies shows that

3.8.10 Inflation



Source: Asian Development Outlook database.
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the private sector is more effective than the public sector at creating sustainable employment growth.

The private sector needs to play a greater role in the economy to ensure the sustainability of labor demand. Since 2002, four separate, independent enterprise surveys have identified a recurring set of impediments to private sector growth. These include access to finance and high tax rates (Table 3.8.2).

3.8.2 Top five problems identified by businesses in Uzbekistan

2002	2005	2008	2013
Macroeconomic instability	**Tax rates**	**Tax rates**	Electricity
Uncertainty about regulatory policies	Tax administration	**Access to finance**	Informal sector practices
Tax administration	Cost of finance	Inadequately educated workforce	**Tax rates**
Access to finance	Uncertainty about regulatory policies	Tax administration	**Access to finance**
Tax rates	**Access to finance**	Corruption	Customs and trade regulation

Note: The surveys in 2002 and 2005 where on the business environment and enterprise, conducted under the auspices of the European Bank for Reconstruction and Development and the World Bank. The surveys in 2008 and 2013 on enterprises were under the International Finance Corporation of the World Bank.

Source: www.enterprisesurveys.org

Historically high costs of doing business and state domination in industry, external trade, and finance have shaped the uneven distribution of economic opportunity and limited private sector growth. Official data show the number of private companies, including small enterprises, actually decreasing over the past several years (Table 3.8.3).

3.8.3 Distribution of registered legal entities by form of ownership and sector

	Total entities			Of which private sector			Share of private sector, %		
	2012	2013	2014	2012	2013	2014	2012	2013	2014
Total	301,613	266,397	273,627	101,945	95,637	90,571	34	36	33

Source: State Statistics Committee.

As economic decline in the Russian Federation may persist for some time, a strong and diversified private sector is crucial to generate new jobs and alleviate social pressures. Comprehensive reform is necessary to develop human capital, improve labor market efficiency, and strengthen the business environment. To these ends, policy measures should ensure firms' access to finance and other resources; institute structural changes to liberalize trade and integrate financial services; strengthen governance, regulatory quality, and the rule of law; and ease the tax burden while improving compliance. In addition to generating jobs, these policy measures would provide a foundation for planned modernization and diversification programs.

3.8.1 Sources of growth

Uzbekistan's sources of economic growth have changed remarkably since 2000. Massive programs of infrastructure development and industrial modernization enabled the government to expand lending to state-owned enterprises for capital renovation. During this period, additional capital stock, rather than technological change or higher labor productivity, has driven growth. Conventional growth accounting shows that, starting from 2000, capital was responsible for more than half of GDP growth (box table). An analysis conducted earlier by the International Monetary Fund found similar trends.

Contributions to real GDP growth (annual average % change)

Period	GDP	Capital	Labor	TFP
2000–2007	6.0	5.4	2.4	2.8
2008–2010	8.5	8.5	2.7	1.1
2010–2013	8.3	14.5	2.6	2.6

TFP = total factor productivity.

Source: Institute for Forecasting and Macroeconomic Research. 2014. *The Trends in Socio-economic Development of Uzbekistan (2000–2013).*

Spurring growth in total factor productivity and, consequently, competiveness will require the market-based allocation of capital and labor, removing price distortions including those related to exchange rates and interest rates, and eliminating market bottlenecks.

Given Uzbekistan's relatively high investment rate of 24% of GDP and the declining productivity of investment, further efforts to scale up investment's contribution to growth and poverty reduction will require measures to improve the quality of investment. Important steps to this end include tightly linking infrastructure investments to socioeconomic goals, selecting projects for their effects over time and across sectors and regions, and identifying each project's poverty impact and beneficiaries.

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Growth decelerated in 2014 as investment slowed, particularly in real estate. The government targets the growth rate of 7.0% as the new normal. Inflation will remain low. The surplus in the current account will expand in 2015 but moderate in 2016. The main policy challenge is to reform local government finance to reduce debt and improve transparency without hindering growth.

Economic performance

As the pace of investment slowed, GDP growth in the People's Republic China (PRC) continued to decelerate, falling from 7.7% year on year in 2013 to 7.4% in 2014 (Figure 3.9.1). Growth still met the government target of about 7.5%. As in 2013, the government provided fiscal and monetary support to ensure stability in labor and financial markets but refrained from large-scale stimulus. It thus embraced more closely the new normal of decelerating growth as demographic shifts and the sheer size of the economy make sustaining the high growth rates of the past increasingly difficult.

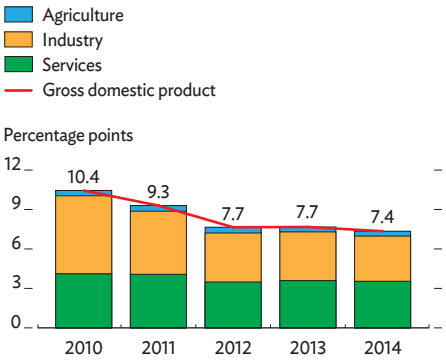
On the supply side, output growth slowed in all sectors except agriculture. The service sector remained the main engine of growth even though a slowdown in hospitality and real estate services tamped down sector growth to 8.1%. Industry (including manufacturing, mining, and construction) expanded by 7.3%, with consumer-oriented manufacturing outperforming heavy industry. Domestic rebalancing from industry to services made further progress as envisioned by the government, such that the share of services in nominal GDP increased to 48.2% while that of industry decreased to 42.6%. Services contributed an estimated 3.5 percentage points to GDP growth, while industry contributed 3.4 points (Figure 3.9.2). Urbanization and rising household incomes remained structural drivers, but services benefited as well from deregulation and the continuing reform of taxes on services. Most of the new 13.2 million urban jobs created in 2014 were in services. Large investments raised agricultural growth slightly to 4.1% in 2014, but the share of agriculture in GPD declined to 9.2%. Almost 30% of the PRC workforce is still employed in this sector, pointing to a reservoir of excess agricultural labor that potentially can be tapped by industry and services.

Domestic rebalancing also progressed on the demand side as the contribution of consumption to GDP growth rose to 51.2% from 50.0% in 2013 while that of investment fell to 48.5% from 54.4% (Figure 3.9.3). Net exports added 0.3% to growth as the positive external shock of lower commodity prices slowed import growth by value as compared with exports.

3.9.1 Economic growth

Source: National Bureau of Statistics.
Click here for figure data

3.9.2 Supply-side contributions to growth



Source: National Bureau of Statistics.
Click here for figure data

This chapter was written by Jurgen Conrad and Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

Growth in fixed asset investment moderated to 15.1% year on year in real terms, down from 19.2% in 2013. Investment in infrastructure slowed less than investment in manufacturing or real estate, as infrastructure benefitted from central government support, including through policy banks. The slowdown was most pronounced in real estate, where investment growth halved to 9.9% year on year in 2014, dragged down by tighter financing conditions for developers and home buyers, the bursting of local housing price bubbles, and oversupply, particularly in small and medium-sized cities. Prices peaked nationwide in April 2014 and have since fallen by about 3.5%. The government cushioned the correction by removing tight purchase restrictions in most cities, improving access to mortgage loans and the housing accumulation fund (a mandatory savings scheme), and accelerating shantytown redevelopment and social housing construction. The housing market has started to stabilize in recent months, and sales growth has reentered positive territory in larger cities.

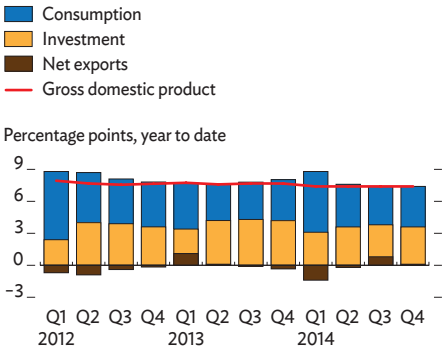
Consumption growth remained more robust, supported by strong income growth as households' real disposable incomes rose by 8% year on year, driven by higher wages and social transfers. For the sixth successive year, rural households enjoyed faster real income growth than did urban households, though urban households still earn 2.75 times more than their rural counterparts (Figure 3.9.4). This disparity, and the reform of the household registration system under way since mid-2014 that makes it easier for migrant workers to apply for and receive social services in small and midsized cities, catalyzed a further rise in the number of migrant workers by 5 million in 2014. According to official figures, income distribution improved, with the Gini coefficient edging further down to 0.469 from 0.473 in 2013. Reflecting these developments, growth in retail sales moderated in 2014 only slightly to 10.9% year on year in real terms. The most dynamic section of the market remained online sales, which skyrocketed by 48.0%.

Consumer price inflation averaged 2.0% in 2014, down from 2.6% in 2013 (Figure 3.9.5). This reflected mainly slower food price inflation in line with global trends, as food accounts for one-third of the PRC consumer price index. Core inflation, which excludes energy and food, slowed only marginally to 1.6%, suggesting that lower inflation owed little to weaker domestic demand. Falling oil prices also pulled inflation down, though energy accounts for only 6% of the index and ongoing reform somewhat raised administered prices for energy, water, and gas.

Average producer price deflation remained unchanged at 1.9% for 2014 as a whole, as global commodity prices continued to fall and excess capacity persisted (Box 3.9.1). Producer price deflation intensified in late 2014 and early 2015 as falling global commodity prices reduced industrial input costs, which are weighted heavily in the producer price index. However, since factory gate prices for finished consumer goods have not fallen as much, profit margins in most industries have not been strongly affected so far, allaying concerns about industrial distress or deflation.

The deficit in the official consolidated budget of the central and local governments narrowed to 1.8% of GDP in 2014 on a cash basis from 1.9% in 2013, undershooting the target of 2.1%. Budgetary revenue grew by

3.9.3 Demand-side contributions to growth



Q = quarter.
Source: National Bureau of Statistics.
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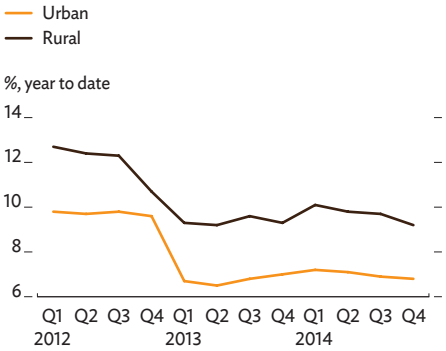
3.9.4 Growth of per capita urban and rural incomes



Q = quarter.
Source: National Bureau of Statistics.
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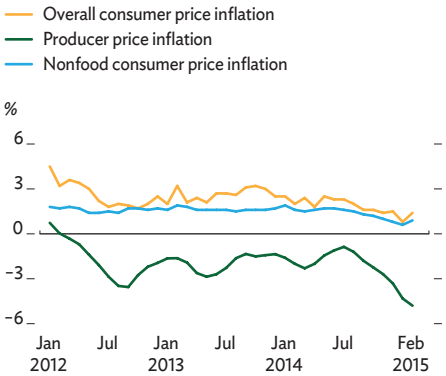
3.9.5 Monthly inflation

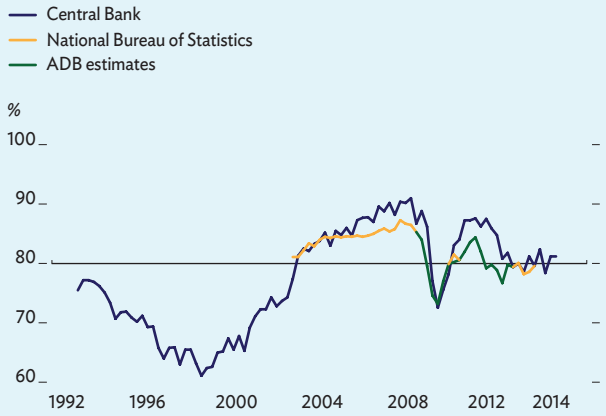


Sources: National Bureau of Statistics; People's Bank of China.
Click here for figure data

3.9.1 Managing excess manufacturing capacity

Manufacturing capacity utilization in the PRC declined to 60% in 1998, gradually improved to beyond 80% in 2002, and started bobbing below 80% in 2008 (box figure 1). Recent performance is mediocre compared with the international norms for capacity utilization of 79%–82% derived from historical data in Brazil, the euro area, Japan, the Republic of Korea, Taipei,China, and the US. In 2013, excess capacity was widespread throughout the manufacturing sector, affecting 19 of 29 subsectors that together shared 87% of sector assets and 84% of profits.

1 Manufacturing capacity utilization



Sources: People's Bank of China quarterly survey of production capacity utilization, National Bureau of Statistics (www.stats.gov.cn); ADB estimates.

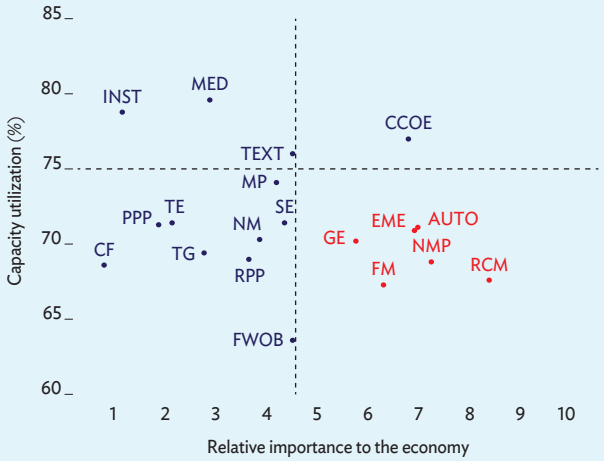
Click here for figure data

As capacity utilization in the PRC has been erratic over the years, historical data do not say much about excess capacity today. However, studies based on the experience of the US and 17 euro area countries indicate a robust relationship between the rate of capacity utilization on the one hand and, on the other, growth in industrial value added and the producer price index. Based on this relationship, the following equation was estimated using data from 2002 to 2013. The regression results obtained are robust, with an R squared of 0.71.

Capacity utilization = 74.5677 + 0.5924 × Growth of industrial value added + 0.5375 × Producer price index

The results indicate that capacity utilization in the fourth quarter of 2014 was 77.6% in manufacturing as a whole, slightly below international norms but not as serious a problem as in some earlier years. However, the impact of excess capacity on the economy could still be significant if it were high in economically important subsectors. Excess capacity is indeed high in these sectors, as indicated by mapping the average share of assets, revenue from principal business, and enterprise profit in 19 manufacturing subsectors against their average rates of capacity utilization. The six largest subsectors (in red) have the lowest capacity utilization rates (box figure 2).

2 Sectors with excess capacity and their economic importance, 2013



AUTO = automobiles, EME = electrical machinery and equipment, FM = ferrous metals, GE = general equipment, NMP = nonmetallic mineral products, RCM = raw chemical materials and chemical products, CCOE = computer, communication, and other electronic equipment, CF = chemical fibers, FWOB = food, wine, and other beverages, INST = instruments, MED = medicines, MP = metal products, NM = nonferrous metals, PPP = paper and paper products, RPP = rubber and plastic products, SE = special equipment, TE = transportation equipment, TEXT = textiles, TG = textile garments.

Note: Economic importance refers to a sector's size measured by its average share of assets, revenues, and profits over the sample period.

Sources: Development Research Center of the State Council; National Bureau of Statistics, and ADB estimates.

Click here for figure data

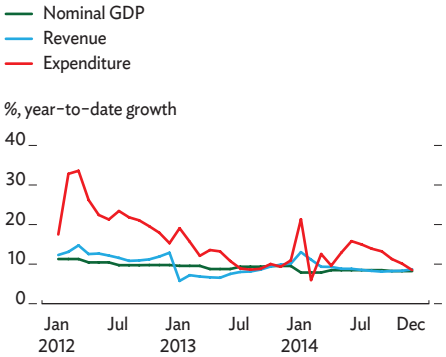
The government recognizes that dealing with excess capacity will make manufacturing significantly more efficient and enhance the quality of economic growth. It started to address the issue in 2013 by boosting domestic demand for selected products, tapping global demand by accelerating its "go global" strategy, and facilitating mergers and acquisitions, while simultaneously strengthening environmental and energy-efficiency standards. In parallel, the government should prioritize reliance on market forces and the elimination of market distortions and inefficiencies created by various indirect subsidies such as land supplied at low prices, the lax implementation of pollution standards, and implicit guarantees for bank loans. Limiting government intervention by reforming administrative management, land use, and factor markets will undercut incentives for unwarranted and inefficient capacity expansion. Emphasis should be placed on better utilizing existing capacity by relocating industries to other regions or countries, as appropriate, and by winding down inefficient enterprises through bankruptcy, closure, mergers, and acquisitions.

8.6% in line with the budget, slightly outpacing nominal GDP growth (Figure 3.9.6). Nontax revenue growth accelerated to 13.5%, mainly on higher profits transferred by state-owned enterprises—and perhaps also asset sales. This compensated for the slowdown in tax revenue growth to 7.8% caused by new policy initiatives. Further, the government allowed automatic stabilizers to work on the revenue side and provided discretionary tax benefits for smaller enterprises to support growth and employment. In addition, tax reform since July 2013 has effectively reduced the tax burden for the service sector and exporters. Government expenditures grew by 8.2%, lagging behind budget and nominal GDP growth, mainly because local governments underspent during the fourth quarter of 2014. The lower budget deficit in 2014 does not necessarily imply a tightening of the fiscal stance, as official figures exclude some off-budget expenditures such as initiatives financed through policy banks and local governments' off-budget activities, whose proliferation in recent years has caused large debt and contingent liabilities to accumulate. In 2014, the government started a major reform initiative to rein in growth in local government debt, but its impact on the overall fiscal stance is not yet known.

Growth in the broad money supply (M2) continued to slow, by more than 2 percentage points to 12.7% on average in 2014, narrowing the gap between money supply and nominal GDP growth (Figure 3.9.7). This development resulted from the policy of the People's Bank of China, the central bank, to mitigate financial risks stemming from rapid credit growth while still supporting sustainable economic growth by ensuring adequate money supply. The central bank faced the challenge of managing the money supply as foreign currency flows reversed early in 2014 from net inflow to outflow. Net foreign assets, which were the main driver of money supply growth in 2013, increased only slightly in 2014. To ensure adequate liquidity, the central bank introduced measures to increase net domestic bank credit, including targeted liquidity injections into the interbank market (which, more than in 2013, succeeded in keeping interbank rates stable), raising some banks' quotas for relending to small businesses and rural areas, and providing the China Development Bank with funds to support social and infrastructure projects. The central bank also lowered regulatory reserve requirements for lending to small and medium-sized enterprises and to rural areas, allowed banks to include a broader range of deposits in the calculation of the regulatory loan-to-deposit ratio (which remained unchanged at 75%), and relaxed mortgage loan requirements. Further, it cut the benchmark loan and deposit rates in November 2014 and again in February, and lowered the required reserve ratio for all banks in February 2015—which, at 19.5%, nevertheless remains high for large banks by international norms.

To mitigate financial risks, the central bank and other regulators kept credit growth outside the banking sector on a declining trend since mid-2013 through stricter regulatory requirements and tighter controls on local government financing vehicles. Other constraints on shadow banking are reduced demand for credit from property developers and investors' heightened awareness of risk. As a result, net issuance of trust loans, entrusted loans, and bankers' acceptances declined by 43.8% in

3.9.6 Fiscal indicators and nominal GDP



Sources: Ministry of Finance; National Bureau of Statistics.
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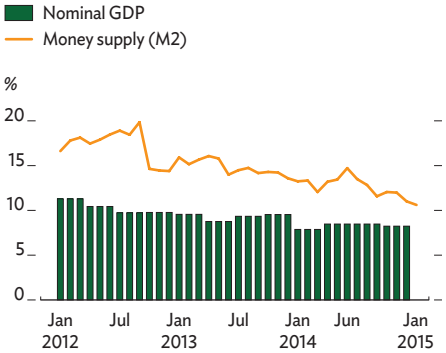
3.9.7 Money supply and nominal GDP



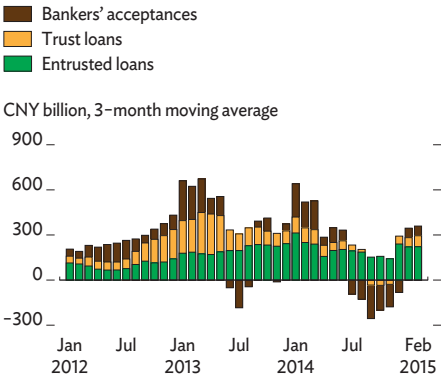
Sources: National Bureau of Statistics; People's Bank of China; ADB estimates.
Click here for figure data

2014 (Figure 3.9.8), slowing the growth of their stock substantially to an estimated 15% in 2014, which is similar to the growth rate of bank credit. The drop in loans from shadow banks was partly compensated by net corporate bond issuance, which increased substantially to equal 19.7% of new bank loans, and by net equity financing, which reached 4.3% of new bank loans. This development has strengthened the roles of banks and bond markets, made credit allocation more transparent, and pointed to a growing role for equity in company finance.

The renminbi–US dollar exchange rate became more volatile during 2014 following the central bank's intervention in the market in February, which was designed to discourage speculative capital inflows, and the widening in March of the exchange rate band for the renminbi from ±1% to ±2%. On average, the renminbi was 0.7% stronger against the US dollar in 2014 than in 2013, though it was 0.4% weaker at year-end (Figure 3.9.9). The nominal effective exchange rate (against a trade-weighted basket of currencies) and the real effective exchange rate (taking inflation into account) both showed renminbi appreciation by 2.5% on average in 2014. The rate of appreciation has intensified since the end of 2014, but the impact on PRC external trade competitiveness has been manageable so far, particularly as the country has benefitted from improved terms of trade for a third consecutive year.

Export growth remained robust at 6.8% by volume, growing more quickly than global trade, while import growth halved to 4.8% because demand from construction declined and regulators cracked down on the misuse of metals as loan collateral. The combined effect of price and volume changes was a record trade surplus equal to 4.6% of GDP (Figure 3.9.10). Despite widening deficits in services and transfers, the current account surplus expanded to 2.1% of GDP. The capital account balance turned from a large surplus in 2013 into a deficit in 2014 as higher inflows were exceeded by even more rapidly rising outflows. This outcome reflected the central bank's successful efforts in early 2014 to discourage one-sided appreciation expectations, as well as higher thresholds for outbound investments that need government approval and new authorization for companies to transfer funds from domestic foreign currency loans to overseas subsidiaries. Reflecting movements in the capital and current accounts, the PRC balance of payments was in equilibrium in 2014, leaving official reserves almost unchanged from 2013.

3.9.8 New loans from shadow banks



Sources: People's Bank of China; ADB estimates.
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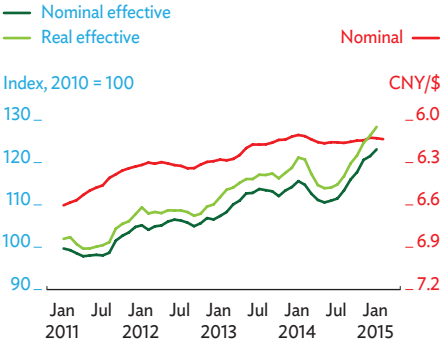
3.9.9 Exchange rates



Sources: Bank for International Settlements; State Administration of Foreign Exchange; ADB estimates.
Click here for figure data

Economic prospects

Further moderate deceleration is forecast for GDP growth, to 7.2% in 2015 in line with the government target of about 7.0%, and 7.0% in 2016, before the rate stabilizes or rises again (Figure 3.9.11). The forecast reflects recent trends and recognizes that the government's emphasis on high-quality growth and its ongoing gradual structural reform will likely moderate growth in the next 2 years. Growth in 2015 will benefit from lower commodity prices, which will bolster domestic consumption and invigorate global demand for PRC exports. Commodity price recovery in 2016 is, however, forecast to have the opposite effect and push GDP growth lower.

3.9.1 Selected economic indicators (%)

	2015	2016
GDP growth	7.2	7.0
Inflation	1.8	2.3
Current account balance (share of GDP)	2.3	2.0

Source: ADB estimates.

Investment will remain the main drag on growth, with real estate its weakest component. Swift government action has helped stabilize the market. Fundamental demand for housing is still strong, reinforced by low household debt and income growth that outpaces real estate price increases. A cyclical recovery in housing sales can therefore be expected in 2015. However, it will be tempered by historically high stocks of unsold existing floor space. Investment in manufacturing and infrastructure will continue to perform better than real estate, but its growth will decelerate too. The government has announced plans to refine and broaden pilot free trade zones in Shanghai and other cities and start rolling out reform nationwide. However, industrial excess capacity persists, and state-owned enterprises remain largely unreformed and burdened by debt, with reform plans still rather vague though a leading group on reform has recently been established.

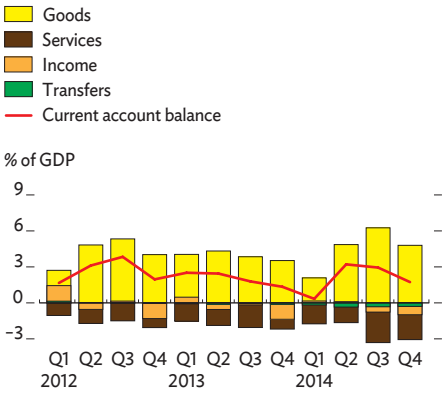
The government foresees sizeable infrastructure investment, some with private participation, but not a large stimulus. Infrastructure investment growth will moderate, as local governments are financially constrained and the private sector is unlikely to fill the gap quickly despite efforts to improve the climate for private investment through further deregulation, service sector reform, and efforts to make the business environment more enabling for public–private partnership.

Consumption will remain relatively robust but not immune to slowdown in the rest of the economy. Moderating investment growth will slow household income growth, particularly in the poorer parts of the PRC where investment is still the main driver of growth. Higher social spending and improved income equality are unlikely to fully compensate for slower wage growth. Household income is still forecast to continue to grow more quickly than nominal GDP, but less so than previously.

The current account surplus is forecast to widen in 2015, only to narrow again in 2016, mainly reflecting movement in commodity prices, which are forecast to languish in 2015 well below 2014 levels but rise again in 2016. Export growth will likely benefit from expanding global growth and trade even if the renminbi further appreciates against most of the PRC's trade partners. The renminbi is pegged to a basket of currencies that is undisclosed, but econometric analysis suggests that the US dollar has a weight of above 90%. Since late 2014, the renminbi has appreciated against the currencies of most of its trade partners in line with a strongly appreciating US dollar. This trend could continue in 2015 in the absence of policy change. However, with both the exchange rate and the balance of payments estimated to be at or near equilibrium, the opportunity exists to make the exchange rate more flexible or to change the composition of the exchange rate basket to reduce the weight of the US dollar.

Inflation is forecast to remain subdued at 1.8% on average in 2015, much below the government ceiling of 3.0%, and at 2.3% in 2016. Moderating GDP and credit growth is expected to limit price pressures (Figure 3.9.12). Falling global commodity prices will help suppress inflation in 2015, more than compensating for the inflationary effect of price reform, which saw price controls on 24 commodities and services removed in early 2015 and will accelerate. Higher inflation in 2016 is likely as commodity prices recover.

3.9.10 Curent account balance



Q = quarter.

Sources: State Administration of Foreign Exchange; ADB estimates.

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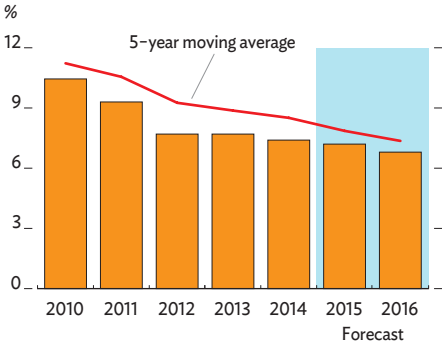
3.9.11 GDP growth



Source: Asian Development Outlook database.

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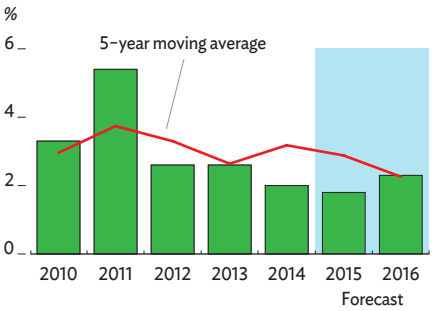
3.9.12 Inflation



Source: Asian Development Outlook database.

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Continued efforts to rein in local governments' off-budget spending will likely translate into a less expansionary fiscal stance in 2015 and 2016. However, bringing part of off-budget spending on-budget will push up the official consolidated budget deficits (which exclude off-budget spending), as revenues are unlikely to increase strongly over the forecast period. In line with this, the government plans a higher consolidated deficit of about 2.7% of GDP in 2015. Deficits could be even larger if reform accelerates. However, as fiscal transparency and discipline improve, fiscal policy will become more effective, likely mitigating the impact of fiscal tightening on growth.

As in the previous 2 years, monetary policy will strike a balance between mitigating risks in the financial and property sectors that stem from past rapid credit expansion, on the one hand, and supporting sustainable economic growth on the other. The money supply is expected to grow over the forecast period at a rate that edges closer to the nominal GDP growth rate. The central bank is expected to take further incremental steps to implement monetary policy using the interest rate as an intermediate target and facilitating cross-border capital flows.

The principal external downside risk to the forecast stems from commodity prices rebounding higher than expected—which may, however, be balanced by unexpectedly strong recovery in the major industrial economies. The principal domestic risk is uncertainty about how industrial restructuring will affect employment and wage growth, potentially undermining confidence and consumption. This risk is mitigated by the government's close attention to the labor market and income growth. Another domestic risk arises from the government's implementation of its ambitious fiscal reform agenda, which may force local governments to cut expenditure excessively as their access to finance is curtailed.

Policy challenge—reforming local government finance

With the announcement from the State Council in June 2014 that the fiscal system would be reformed by 2016, the effort to put local government finance on a sounder footing has taken center stage. In the past, local governments were responsible for most expenditures but received only half of budget revenues and were officially restricted to borrowing only small amounts through the central government. As transfers from the central government did not fill the gap, most local governments established off-budget financing vehicles to cover their expenditures. This has undermined fiscal discipline and transparency. The National Audit Office reports that local government debt, including guarantees and contingent liabilities, increased from around 18% of GDP in 2008 to above 30% in 2013, suggesting sizeable off-budget spending.

Ongoing reform is guided by a principle the authorities call "opening the front door and closing the back door," or allowing local governments to borrow directly to finance deficits and preventing their borrowing off-budget, while bringing legitimate off-budget fiscal activities

on-budget. The key challenge is to ensure neutral fiscal impact during the transition, containing both the risk of a fiscal crunch caused by closing the back door without opening the front, and that of a debt surge if both doors are open simultaneously. Measures taken since May 2014 include allowing selected local governments to issue bonds directly, amending the budget law with effect from 1 January 2015, and adopting regulatory guidelines on debt management. Local governments were required to report their off-budget liabilities to the central government by January 2015, to determine which outlays to bring on-budget. Yet to be determined are the profile and servicing of debt that no longer benefits from an implicit government guarantee, and the possible impact of defaults.

Local governments' access to finance will be enhanced by increasing the number of governments allowed to participate in the local government bond pilot, raising the issuance ceiling, reforming the pricing mechanism to make it more market-driven, and allowing special project bonds in addition to general revenue bonds. However, local government bonds in circulation in 2014 amounted to less than 2% of GDP, and new issuance came to only 0.6%, including provincial bonds issued through the central government. Issuing bonds to service the substantial local government debt that matures over the forecast period may thus stretch the absorptive capacity of the bond market unless policy banks join the ranks of investors. The government also envisages opening new avenues for infrastructure financing by improving the environment for public–private partnership, but these initiatives need time to gain traction. Proceeds from selling land-use rights (another source of local government financing) have been declining recently. One way to compensate for the shortfall to some extent, if allowed, would be to sell local governments' sizeable shares in state-owned enterprises.

In sum, local governments will continue to depend in the foreseeable future largely on transfers from the central government. Plans to reform the transfer system include raising to 60% the share of general transfers in all transfers. The total amount transferred has to be large enough to keep local governments from accumulating additional debt or slashing legitimate expenditures.

The design of the government's fiscal reform initiative and the first steps toward its implementation are promising. The government can be expected to follow through with the reform of local government financing and to manage associated risks by keeping steps incremental, instituting transition arrangements, and fine-tuning the process regularly. Over time, ongoing reform will be complemented by a comprehensive realignment of central and local government revenue and expenditure responsibilities, and by optimizing taxation through, for instance, better use of direct taxes such as on personal income and property.

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Hong Kong, China

Global economic and financial developments continue to weigh on the economy. GDP growth slowed in 2014, but current account and fiscal positions stayed healthy, and inflation remained moderate. Strengthening domestic demand is expected to boost growth in the next 2 years without igniting inflation or preventing continued improvement in the current account. A key challenge over the next 2 years is to implement the new strategy to provide affordable housing.

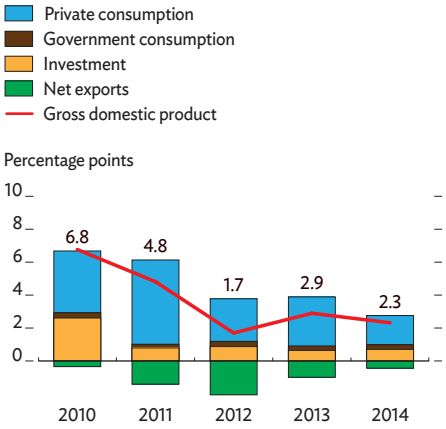
Economic performance

The economy grew by 2.3% in 2014, down from 2.9% in 2013. Sluggish economic performance in Europe and moderating growth in the People's Republic of China (PRC) dampened growth in the first half of the year, but a US economy performing better than expected and higher demand in Asia for exports lifted growth in the second half. Domestic demand was nevertheless the main engine of growth in 2014. Private consumption contributed 1.8 percentage points to growth, buttressed by rising real incomes, moderating underlying inflation, and unemployment at a 17-year low of 3.2% (Figure 3.10.1). These factors outweighed the drag on retail sales from a shift from more expensive items to cheaper consumer goods in the spending of PRC tourists, who are 78% of all arrivals. The contribution of government consumption remained unchanged at 0.3 percentage points despite cutbacks to one-off relief measures from the previous year. Investment grew by 2.8%, mainly for inventory accumulation, and contributed 0.7 percentage points to growth. A recent business tendency survey found cautious business sentiment holding down machinery and equipment acquisition. Building and construction rebounded to 6.5%, however, on large public infrastructure works and private housing projects.

Net exports declined for the sixth consecutive year, subtracting 0.4 percentage points from GDP growth. Export growth moderated because of weak external demand. Another factor could have been 4.0% nominal effective appreciation of the local dollar (Figure 3.10.2). Import growth also slowed in tandem with moderating GDP growth but outpaced that of exports.

Consumer price inflation was up marginally at 4.4% (Figure 3.10.3). Subdued global inflation and softer rental growth kept inflation at bay, though residential property prices rose by 13.5%, reflecting the ongoing low interest rate environment and a tight demand–supply balance. Excluding the one-off relief measures implemented in 2014, including payment of 1 month's rent for public housing tenants and rates concession for 2 quarters, the adjusted overall inflation rate was 3.5%.

3.10.1 Demand-side contributions to growth



Source: CEIC Data Company (accessed 27 February 2015).
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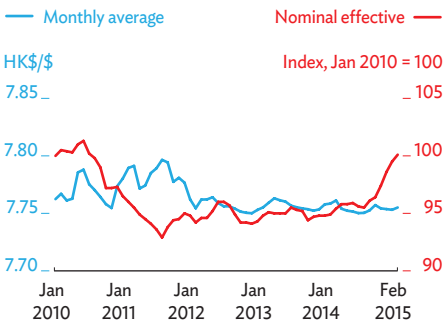
3.10.2 Exchange rates



Source: CEIC Data Company (accessed 27 February 2015).
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This chapter was written by Benno Ferrarini and Cindy Castillejos-Petalcorin of the Economic Research and Regional Cooperation Department, ADB, Manila.

The current account surplus is estimated to have narrowed to 0.2% of GDP owing to weak external demand, the appreciation of the local dollar, and slowing growth in net services receipts. Growth in transportation services and offshore trade was offset by lower tourism receipts and a slowdown in financial and other business service receipts in a sluggish trading environment. The overall balance of payments is expected to record a surplus largely on sustained net portfolio inflows. Gross official reserves rose to nearly $329 billion, or cover for 7.2 months of imports.

On the policy front, the budget is estimated at a surplus equivalent to 2.8% of GDP in FY2014 (ending 31 March 2015), with fiscal reserves reaching HK$819.6 billion (Figure 3.10.4). Revenue is estimated at 9.4% higher than the original estimate for FY2014, mainly because of larger receipts from stamp duties and profits taxes. Expenditure is estimated to be lower at 17.7% of GDP and within the planned target of 20.0% of GDP.

As the local dollar is pegged to the US dollar, accommodative monetary policy in the US kept local interest rates low. Domestic credit rose by 12.1% as loans for manufacturing, utilities, and retail and wholesale trade rose. Growth in the broad money supply (M2) decelerated to 9.5% from 12.4% in 2013. The Hong Kong Monetary Authority introduced a requirement in 2014 that banks hold sufficient stable funds to support their lending business. Several rounds of macroprudential and tax measures introduced since October 2009 have successfully dampened mortgage loan growth and speculation in the property market, curtailing short-term resale (Figure 3.10.5).

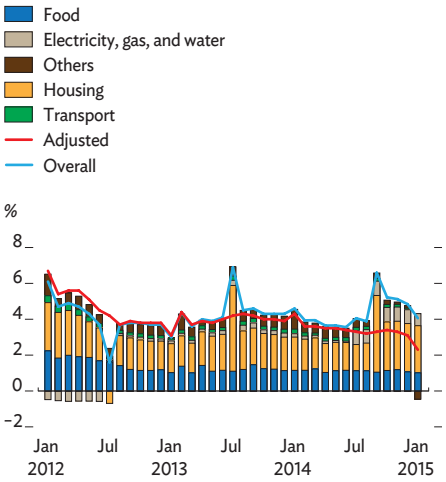
Shifting market sentiment caused the Hang Seng Index, the main index of the stock exchange, to swing from a low in March 2014 to a 6-year high in early September and close the year higher by 1.3% (Figure 3.10.6). Hong Kong, China remains a top-ranked fund-raising hub, second only to New York, with more than HK$232 billion raised in initial public offerings in 2014, a 38% rise on 2013. A $1 billion Islamic government bond was successfully issued in September.

The city's role as the premier center for offshore renminbi trading was bolstered as the monetary authority lifted the daily conversion limit on renminbi for residents, and as a link with the Shanghai Stock Exchange commenced operation, facilitating trade on the two exchanges by investors located in either city. The local monetary authority and the central bank of the PRC renewed the currency swap agreement for another 3 years.

Economic prospects

GDP growth is forecast to improve slightly to 2.8% in 2015 and 2.9% in 2016, still below its 5-year average of 3.7% (Figure 3.10.7). Forecasts are premised on a strengthening US economy, sustained resilience in Asian economies, and slowing but healthy growth in the PRC. Domestic demand will be the engine of growth, spurred by strengthening private consumption underpinned by stable real income and full employment. Investment growth will find support in improving business sentiment (Figure 3.10.8) and several ongoing big-ticket infrastructure projects, including the expansion of the mass transit railway, public housing, and

3.10.3 Inflation



Note: Adjusted inflation refers to the rate once the effects of temporary subsidies by the government are removed.
Source: CEIC Data Company (accessed 27 February 2015).
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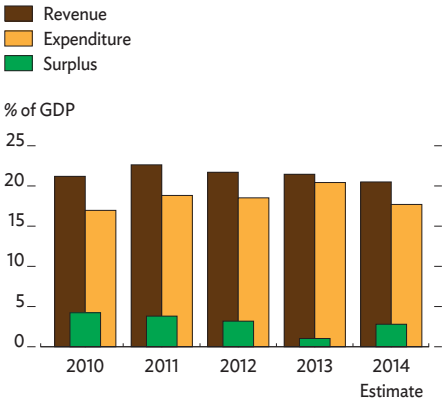
3.10.4 Fiscal indicators



Sources: The Government of the Hong Kong Special Administrative Region of the PRC. The 2015–2016 Budget, and other years. http://www.budget.gov.hk; *Asian Development Outlook* database.
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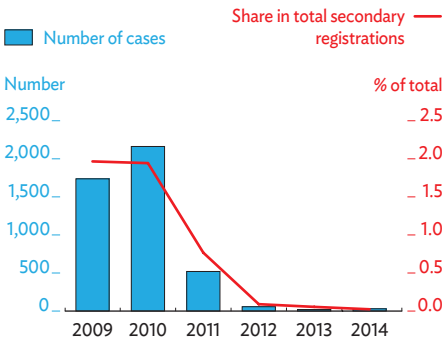
3.10.5 Confirmor sales in secondary residential property market



Source: Hong Kong Monetary Authority.
Click here for figure data

a bridge across the vast Pearl River estuary. Growth in tourism will compensate for any weakness in trade.

Inflation is forecast to decelerate to 3.3% in 2015 and then rebound slightly to 3.4% in 2016. Lower prices for imported food and oil and the knock-on effects of the expected drop in housing prices will outweigh inflationary pressure from the hike in the statutory minimum wage in January 2015. A further drop in housing prices, lower rents, and only a slight uptick in world oil and commodity prices will keep the inflation rate stable in 2016.

The budget for FY2015 is expected to post a small surplus of HK$36.8 billion. Notably, the budget sets out proposals to diversify industries, augment competitiveness, and maintain healthy public finances. Expenditure is not expected to exceed revenue or the target of 20% of GDP.

The outlook for external trade in 2015 will be modest at best. Weak external demand, particularly in the PRC, will continue to impinge on export growth. However, improved demand from the US and regional and bilateral trade agreements should support marginal expansion in exports. Imports are forecast to grow at a similarly modest rate, constrained by tepid demand for capital goods. The resulting trade deficit will be outweighed by a healthy surplus in the services account as professional services and tourism grow, widening the current account surplus to 2.6% of GDP in 2015 and 2.5% in 2016.

The main risks to growth arise from slower recovery in the major industrial economies, a marked slowdown in the PRC economy, and continued appreciation of the US dollar that could undermine export competitiveness. In addition, interest rate hikes in the US could trigger capital outflows, higher local interest rates, and sharp corrections in the residential property market. However, the US Federal Reserve is expected to provide timely forward guidance, which will help build any future rate increase into market expectations, softening their impact. The recurrence of a sharp property downturn is unlikely because speculative buying has subsided. The remaining domestic risk is the possibility of civil disorder as seen in 2014, which could disrupt economic activity in certain areas including tourism, catering, and retail industries.

Policy challenge—providing adequate and affordable housing

The problem of affordable housing—a perennial issue in Hong Kong, China—became acute as demand for housing rose steadily over the past few years, fueled by abundant liquidity, low interest rates, and rising population. As supply response takes time, the resulting shortage has pushed prices up for residential properties. The home purchase affordability ratio rose to 47% in the fourth quarter of 2014, an increase of 19 percentage points over 5 years (Figure 3.10.9). Higher interest rates could drive it even higher.

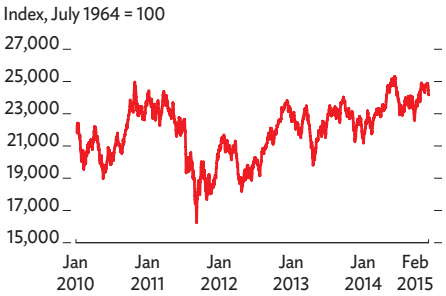
In a major policy shift toward a supply-led strategy of making more housing available, the government promulgated in December 2014 its

3.10.1 Selected economic indicators (%)

	2015	2016
GDP growth	2.8	2.9
Inflation	3.3	3.4
Current account balance (share of GDP)	2.6	2.5

Source: ADB estimates.

3.10.6 Stock market



Source: Bloomberg (accessed 6 March 2015).
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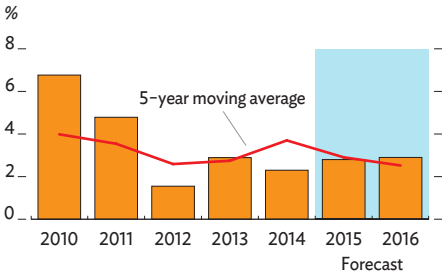
3.10.7 GDP growth



Source: Asian Development Outlook database.
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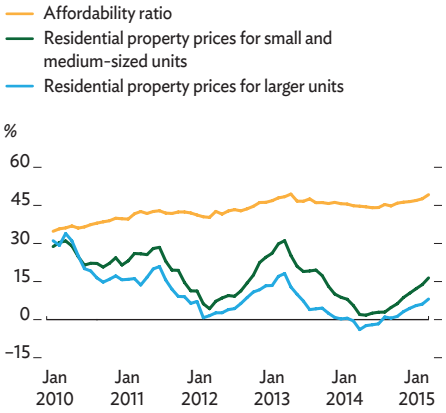
3.10.8 Business tendency survey

Q = quarter.
Note: Net balance of expected quarter-on-quarter changes in the business situation. A positive reading denotes a likely upward trend.
Source: CEIC Data Company (accessed 19 January 2015).
Click here for figure data

Long-Term Housing Strategy, which aims to provide over the next decade 480,000 new housing units, with a public–private split of 60:40. To this end, the government is optimizing the use of existing urban areas and nearby land in the vicinity of existing infrastructure through land-use reviews and boosting development intensity as appropriate. The medium-to-long term will see new development areas, new town extensions, and perhaps reclamation outside Victoria Harbor and the use of underground spaces. Projections of housing demand will be reviewed annually and the supply adjusted as needed. To provide financial resources, the new Housing Reserve has been established with HK$27.5 billion in seed money from investment returns generated in 2014.

The economy's demographic and socioeconomic profile poses challenges for the strategy. Its successful implementation will require ample financing, private sector support, public cooperation, and the timely delivery of housing units. The strategy is not without fiscal risks. Its financing is highly contingent on the fiscal position of the government, and its cost is difficult to estimate. The rising trend in construction costs may continue in the coming years, increasingly burdening government finances. In addition, projections of softer real estate prices in the next 2 years may dampen private participation in construction, leaving more for the government to build. Another challenge for the government is to generate public support for change. Ultimately, the success of the strategy hinges on closely coordinating its short- and long-term aspects and transferring an increasing share of construction to the private sector.

3.10.9 Housing affordability and growth of property prices



Note: The affordability ratio refers to mortgage service payments for a 45-square meter apartment as a percentage of median household income.

Source: CEIC Data Company (accessed 12 March 2015).

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Republic of Korea

Growth picked up only marginally in 2014, as recovery in plant and equipment investment was the sole bright spot in subdued domestic and external demand. Inflation remained stable and low, and the current account surplus expanded. Improved external conditions, supported by accommodative fiscal and monetary policy, should lift growth moderately this year and in 2016. Coping with slowing growth and structural change in the PRC is a key policy challenge.

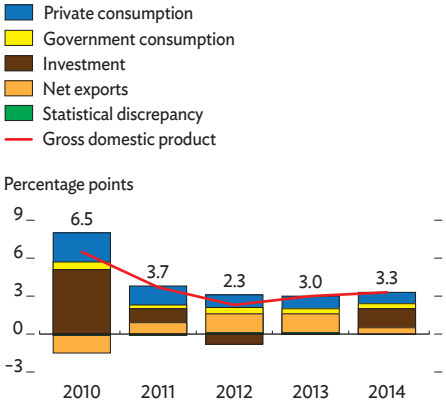
Economic performance

Economic expansion accelerated slightly from 3.0% in 2013 to an estimated 3.3% in 2014. Unexpected weakness in the world economy tamped down the anticipated export-led rebound. The contribution of net exports to GDP growth fell by two-thirds, from 1.5 percentage points in 2013 to 0.5. Domestic demand accounted for the bulk of GDP growth in 2014. Investment, mainly in plant and equipment, contributed 1.5 percentage points, a marked turnaround from 2013, when its contribution was nil (Figure 3.11.1). Private consumption added another 0.9 percentage points, and government consumption's contribution held steady at 0.4 percentage points. Quarter on quarter, growth momentum failed to gain traction during 2014, as the pace of expansion slackened from 0.9% in the first quarter to 0.4% in the fourth, mainly reflecting subdued domestic demand following the Sewol ferry disaster (Figure 3.11.2). Mirroring the continued general weakness of domestic demand and abetted by falling global oil prices, consumer price inflation remained low at 1.3% in 2014, below the central bank target band of 2.5% ±1.0 percentage point. Core inflation, which strips out food and energy, was at 2.0%.

Plant and equipment investment grew by 5.9% after shrinking slightly in 2013 (Figure 3.11.3). Construction investment decelerated sharply to 1.1% in 2014 from 6.7% in 2013, with both residential construction and civic works in the doldrums. Private consumption growth slowed further to 1.7% in 2014, owing to the Sewol ferry disaster, a reduction in a mobile phone subsidy that hurt sales, and sluggish wage growth despite the strong rise in employment (Figure 3.11.4).

Merchandise exports in real local currency terms rose by a mere 2.2% in 2014 (0.5% in nominal US dollars), halving from 4.5% in 2013 as export growth slowed and turned negative in the second half of the year (Figure 3.11.5). The gathering recovery in the US, the sole bright spot in a generally bleak export environment, could not offset

3.11.1 Demand-side contributions to growth



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp (accessed 2 February 2015).

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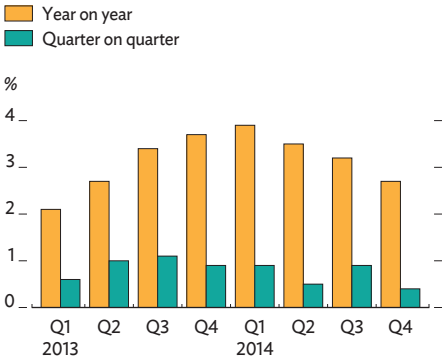
3.11.2 Quarterly GDP growth



Q = quarter.

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp (accessed 2 February 2015).

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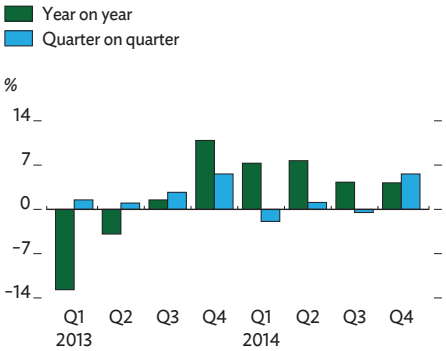
This chapter was written by Donghyun Park and Gemma Esther Estrada of the Economic Research and Regional Cooperation Department, ADB, Manila.

the sluggishness of other main export markets, including the PRC and the European Union. In line with stuttering domestic demand and lower oil prices, merchandise imports grew by even less than merchandise exports, helping to push the current account surplus to a record equal to 6.3% of GDP—this despite the services account recording a deficit, partly because intellectual property rights payments increased. The won appreciated during the first half of the year but closed the year lower in nominal terms at W1,099 per US dollar. In real effective terms, it appreciated by 1.8% during the year.

With slow growth a bigger concern than inflation, the central bank cut its benchmark policy interest rate from 2.50% to 2.25% in August, 2.00% in October, and a 4-year low of 1.75% in March 2015. Fiscal policy was also expansionary in 2014. The fiscal deficit rose to 1.8% of GDP from 1.5% in 2013, and the ratio of public debt to GDP nudged up to 35.1%. A $40 billion stimulus was unveiled in July, and the government signaled its intention to actively support growth through fiscal measures. Reflecting the low budget deficit and public debt in the Republic of Korea, Moody's upgraded its sovereign credit rating in 2014, as did Standard and Poor's.

3.11.3 Growth in plant and equipment investment



Q = quarter.

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp (accessed 2 February 2015).

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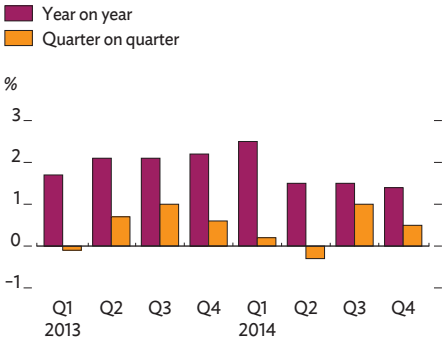
Economic prospects

External and internal factors point to only modest recovery in 2015 that is unlikely to dispel concerns about the economy's loss of momentum since the global financial crisis. GDP growth is likely to rise a bit to 3.5% in 2015 as global output and trade begin to stir (Figure 3.11.6). Domestic demand is likely to rebound, buoyed by the improved terms of trade, much lower global oil prices (as the Republic of Korea imports virtually all of its energy), and a modest recovery in the housing market. GDP growth is expected to rise further to 3.7% in 2016, supported by a strengthening global economy. Subdued inflation and a strong fiscal position will allow both monetary and fiscal policy to support growth.

Merchandise export growth in real local currency terms will accelerate to over 3.0% in 2015, reflecting trends in global output and trade. Continuing weakness in the European and Japanese export markets poses a challenge for high-tech manufactures. The slowdown in the PRC and general sluggishness in Southeast Asia and other main emerging markets further constrain the scope for export growth. Exports of petroleum products, chemicals, steel, mobile phones, and automobiles will be squeezed by intensified competition, especially from the PRC and Japan, but exports of electronics parts and semiconductors could rise as the global glut eases. Despite tepid export growth, the current account surplus is projected to surge to 7.0% of GDP in 2015, owing to the sharp fall in global oil prices and despite a deficit in services, which will widen as construction slumps along with oil in the Middle East. The current account surplus will shrink to 6.3% in 2016 as import volumes expand in line with anticipated stronger growth and domestic demand.

Construction and investment in plant and equipment are projected to remain robust this year and next. Investment will be buoyed by ongoing deregulation initiatives, a W30 trillion government program for

3.11.4 Growth in private consumption



Q = quarter.

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp (accessed 2 February 2015).

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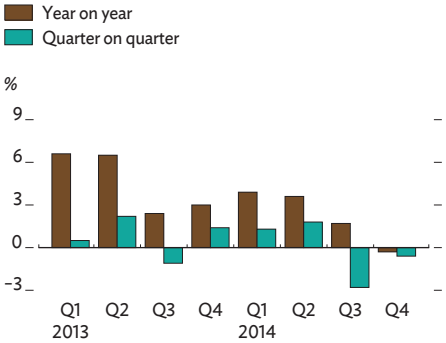
3.11.5 Growth in merchandise exports



Q = quarter.

Source: CEIC Data Company (accessed 2 February 2015).

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cofinancing investment in infrastructure and new growth industries, robust residential construction as the housing market recovers, and large public works projects, including a major rail line on the east coast and an extension for the Seoul subway. Investment growth will be tempered, however, by weak corporate operating profit and low capacity utilization (Figure 3.11.7).

Private consumption is expected to accelerate a little in 2015 as consumer confidence improves (Figure 3.11.8). The steep fall in global oil prices will boost household purchasing power, as fuel costs account for about 10% of their expenditure, and improvement in the terms of trade will stretch incomes. Private consumption will rise with the expanded social welfare budget, continuing tax reform, and strong employment growth, especially among older workers (Figure 3.11.9). Factors that temper consumption growth and improved consumer confidence are rising payments to service household debt, which now exceed 20% of household disposable income, and the reduction of the mobile phone subsidy in October 2014, which adversely affected sales of this major expenditure item.

Consumer price inflation is forecast to remain subdued at 1.3% in 2015, unchanged from 2014 and well below the central bank target. The steep decline in oil prices will outweigh increased domestic demand to firmly cap inflationary pressures. Core inflation will likely be slightly higher. Although inflation has been below 1.0% year on year since December 2014 (for the first time in 15 years), the risk of deflation seems remote, as domestic demand is forecast to grow and output is expected to rise toward full capacity. Inflation is likely to accelerate to 2.1% in 2016, in tandem with rising commodity prices.

Fiscal policy is likely to be mildly expansionary in 2015, geared toward supporting growth in the short term, with both the deficit and the fiscal impulse expanding (Table 3.11.1). However, the expansionary stance will likely be tempered by the need to reduce public debt and pension benefits, raise pension contribution rates, and improve the management of public enterprises. These initiatives reflect concerns about medium-term fiscal sustainability that arise from revenue collection being below target since 2012. With subdued inflation, monetary policy will, like fiscal policy, remain largely neutral in 2015 but tilted toward growth. However, the scope for monetary expansion will be squeezed by deepening household debt and concern that interest rate cuts could encourage excessive household borrowing.

3.11.1 Projected fiscal policy stance

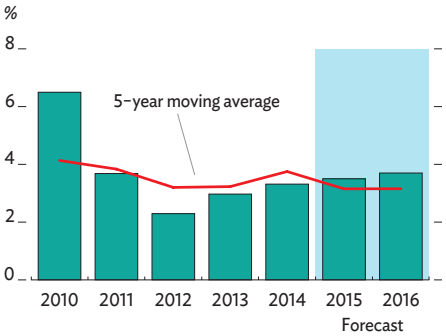
Indicators	2011	2012	2013	2014e	2015f
Fiscal balance, % of GDP	–1.10	–1.40	–1.50	–1.80	–2.20
Public debt, % of GDP	31.60	32.20	34.30	35.10	36.80
Fiscal impulse index	–0.03	–0.10	–0.06	0.04	0.39

e = estimate, f = forecast.

Note: The fiscal impulse index measures the variation in fiscal stance relative to the previous year.

Source: Korea Development Institute.

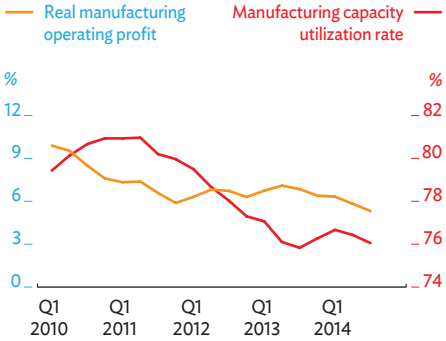
3.11.6 GDP growth



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp (accessed 2 February 2015); ADB estimates.

Click here for figure data

3.11.7 Manufacturing indicators



Q = quarter.

Source: LG Economic Research.

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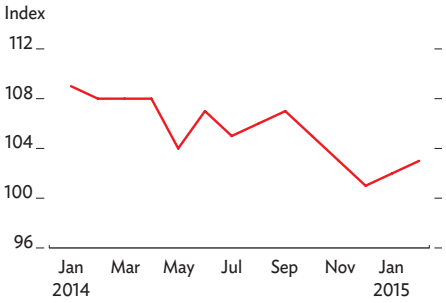
3.11.8 Consumer confidence



Note: A reading above 100 signifies that households who answered positively outnumbered those who answered negatively.

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp (accessed 2 February 2015).

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The balance of risks to the forecast remains slightly biased to the upside in 2015. Domestic risks—such as high household debt on the downside and moderately recovering housing prices on the upside—are overshadowed by external factors. The depth and duration of the oil price decline, and its impact on the economy, are uncertain, as is its impact on exports to oil producers. However, given the huge oil import bill the Republic of Korea typically pays, the effect will be beneficial on balance and may boost GDP growth. The widely expected tightening by the US Federal Reserve may induce financial volatility in the Republic of Korea in light of its highly open capital account. However, the limited volatility experienced during the taper tantrum of May–June 2013, and the economy's robust fundamentals, bode well for its ability to weather even large and unexpected global monetary shocks (Figure 3.11.10). A more difficult challenge in the short and medium term is the slowdown in the PRC, its largest export market.

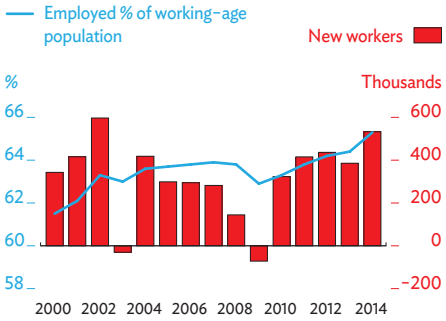
Policy challenge—coping with slower growth and structural change in the PRC

The expected slowdown in the PRC over the next 2 years could have adverse implications for exports and growth in the Republic of Korea. The PRC has been its single biggest export market since 2003, when the giant neighbor replaced the US as its main engine of growth (Figure 3.11.11). The slowdown in the PRC is already being felt. Growth in exports to the PRC has slowed in tandem with deceleration in PRC growth, especially since the second quarter of 2013, and outright contraction marked the two middle quarters of 2014 (Figure 3.11.12). While exports to the PRC mildly recovered toward the end of 2014, it is unlikely that they will return to the high growth seen before the global financial crisis. Deceleration in the PRC will weigh on export prospects for some time to come.

Ongoing structural changes in the PRC will also affect the Republic of Korea. As the PRC moves toward a growth strategy that emphasizes consumption, a larger share of its imports will be consumer goods rather than investment-oriented capital goods. Currently, the bulk of Republic of Korea exports to the PRC are capital goods such as machinery and transport equipment, including vehicles (Figure 3.11.13). Exports of manufactured consumer goods account for only a quarter of the total.

The Republic of Korea clearly needs to further diversify its export markets, in particular toward fast-growing emerging economies. A summit of the Association of Southeast Asian Nations (ASEAN) with the Republic of Korea in December 2014 produced calls to boost trade between the two sides to $200 billion by 2020, double the current amount. While ASEAN is already the second biggest export market of the Republic of Korea—accepting almost 15% of its exports, a twofold increase since 2009—ASEAN's rapid growth, averaging 5.6% during 2010–2014, suggests scope for further expansion. Ongoing progressive tariff reductions under a free trade area combining ASEAN and the Republic of Korea can provide impetus for such expansion.

3.11.9 Employment indicators



Source: Hyundai Research Institute.
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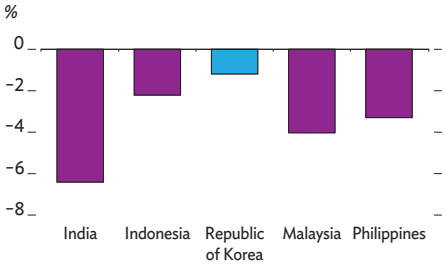
3.11.10 Nominal exchange rate changes, 23 May–30 June 2013



Note: Decline means depreciation.
Source: Bloomberg (accessed 22 September 2014).
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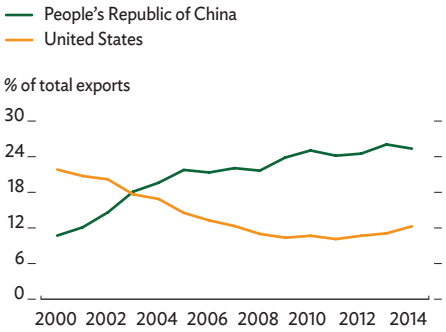
3.11.2 Selected economic indicators (%)

	2015	2016
GDP growth	3.5	3.7
Inflation	1.3	2.1
Current account balance (share of GDP)	7.0	6.3

Source: ADB estimates.

3.11.11 Export shares to selected markets, 2000–2014



Source: CEIC Data Company (accessed 11 February 2015).
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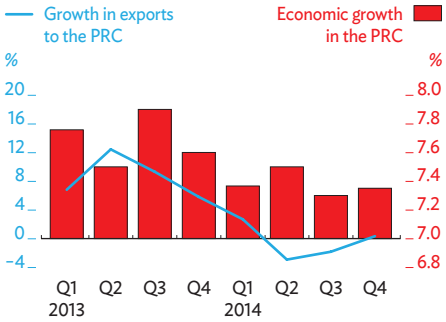
Other policy initiatives could be for the Government of the Republic of Korea to support exports to relatively underexplored markets, such as in Africa and Latin America, through export credit issued by its export–import bank, or export insurance from K-sure, its trade insurance corporation. Such government support could mitigate risks for firms that venture into markets that are unfamiliar but promising.

The structural shift in the PRC from investment toward consumption presents opportunities. Besides diversifying its markets, the Republic of Korea can mobilize KOTRA, its trade promotion agency, and KITA, an international trade association that helps small and medium-sized enterprises enter foreign markets, to support the expansion of exports of consumer goods to the PRC market. The accelerated ratification of a free trade agreement with the PRC, on which negotiations were concluded last year, can be another important vehicle for boosting consumer exports.

The rise of the middle class in the PRC and its growing purchasing power present exciting opportunities for exports of services as well—further strengthening the case for upgrading the service sector in the Republic of Korea, which lags behind its dynamic manufacturing sector, particularly in terms of regulatory reform. The Republic of Korea is already the top destination for PRC tourists, welcoming 6.1 million visitors in 2014, and the PRC is a huge market for K-pop entertainment. Building on these successes—and remedying traditional weakness in modern service industries with high value added such as finance—should allow the Republic of Korea to open up more and better service export opportunities in the PRC and elsewhere.

3.11.12 Exports to the People's Republic of China



PRC = People's Republic of China, Q = quarter.
Source: CEIC Data Company (accessed 11 February 2015).
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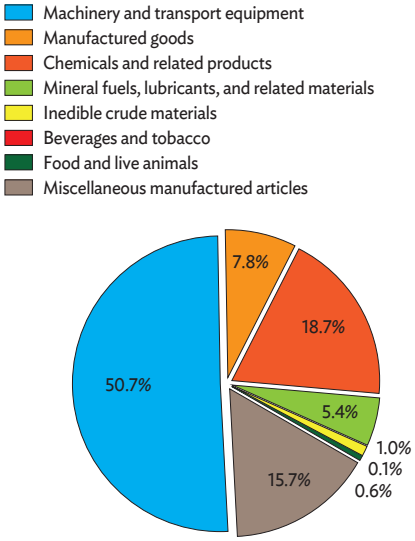
3.11.13 Composition of exports to the People's Republic of China, 2014



Source: CEIC Data Company (accessed 11 February 2015).
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Mongolia

Economic growth decelerated in 2014, reflecting a drop in foreign direct investment. Inflation accelerated despite monetary tightening, but the current account deficit moderated. Fiscal deficits remained high, and international reserves continued to shrink. Growth is forecast sharply lower in 2015 and 2016, with lower inflation but current account deficits persisting or widening. A major policy challenge is to implement prudent macroeconomic management that retains sufficient scope for productive investment and social protection.

Economic performance

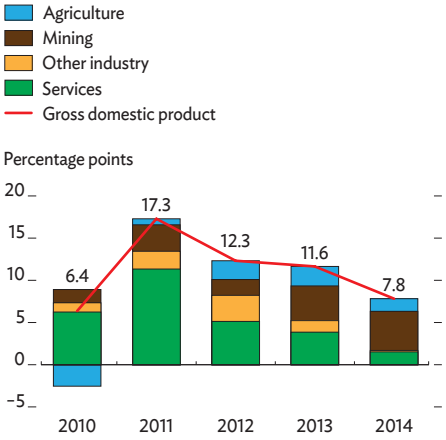
Despite a substantial increase in mining output, GDP growth slowed to 7.8% in 2014 from 11.6% in 2013. Foreign direct investment (FDI) continued to fall, and the sizeable monetary stimulus that kept growth high in the previous year became increasingly difficult to maintain in light of pressures from inflation and the balance of payments (BOP).

As value added in mining increased by 24.2%, reflecting the first full year of production at the vast Oyu Tolgoi copper and gold mine, industrial production expanded by 16.1% and contributed 4.8 percentage points to GDP growth (Figure 3.12.1). This came despite a 16.3% drop in coal production. Agriculture remained a driver of growth, rising by 14.4% with favorable weather. Growth in services slowed to 4.8%, however, as plunging mine investment took its toll. Agriculture and services each contributed 1.5 percentage points to GDP growth, while the contribution from industry other than mining was negligible.

FDI dropped by 80.7% following the completion of the first phase of Oyu Tolgoi and reflecting uncertainty over the economic viability of projects in light of lower commodity prices, as well as over the broader investment climate. Gross capital formation contracted by 33.5%, dragging GDP growth down by 18.4 percentage points. Domestic consumption increased by 8.6% and contributed 6.0 percentage points to GDP growth, with private consumption accounting for nearly all of the increase. As exports grew by 51.4% in real terms and imports by only 4.9%, the trade deficit shrank by 82.7% and the contribution of net exports to GDP growth expanded to 20.3 percentage points. Oyu Tolgoi's contribution to GDP growth thus continued to shift from investment to net exports (Figure 3.12.2).

The current account deficit narrowed significantly to 8.2% of GDP from 25.4% in 2013 as the trade deficit crossed into surplus. Merchandise exports grew by 35.3% as higher exports of copper concentrates more than compensated for a decline in other exports.

3.12.1 Supply-side contributions to growth



Source: National Statistics Office of Mongolia. 2015. *Monthly Statistical Bulletin*. January. http://www.nso.mn

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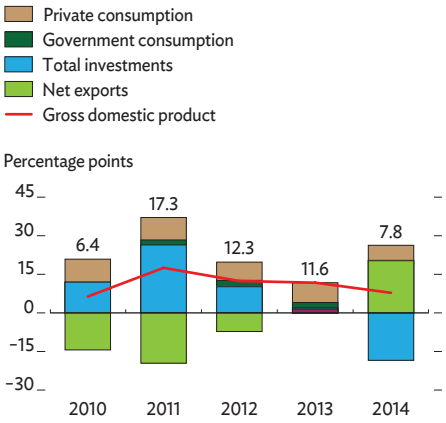
3.12.2 Demand-side contributions to growth



Source: National Statistics Office of Mongolia. 2015. *Monthly Statistical Bulletin*. January. http://www.nso.mn

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This chapter was written by Mark Bezemer and Amar Lkhagvasuren of the Mongolia Resident Mission, ADB, Ulaanbaatar.

Merchandise imports fell by 14.4%, largely reflecting a sharp drop in investment-related material and equipment, as well as lower fuel prices. The services deficit stabilized at $1.3 billion, equal to 11.2% of GDP. Declining capital inflows generated a BOP deficit equal to 3.9% of GDP despite nearly $700 million in government-guaranteed borrowing by the Development Bank of Mongolia (Figure 3.12.3).

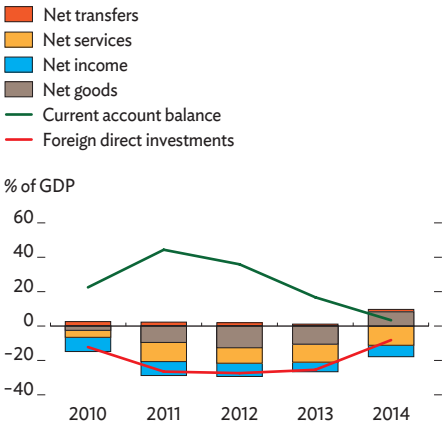
Gross international reserves fell to $1.6 billion—cover for 2.9 months of imports—from $4.1 billion in 2012, and are increasingly financed by short-term foreign liabilities, including a 3-year currency swap arrangement with the central bank of the People's Republic of China (PRC) (Figure 3.12.4). Raising the currency swap ceiling in August 2014 to CNY15 billion (equal to 20% of GDP) provided a liquidity buffer, but withdrawals will eventually need to be repaid or renewed. Public and publicly guaranteed external debt including the foreign liabilities of the Bank of Mongolia, the central bank, stood at 57.3% of GDP at year-end, having more than doubled in 4 years and now approaching the $1.5 billion raised through the US dollar-denominated sovereign Chinggis bond. As capital inflows ebbed, the Mongolian togrog depreciated by 13.8% against the US dollar, having already depreciated by 19.2% in 2013. Meanwhile, ruble depreciation caused the togrog to appreciate in nominal effective terms by 2.3%, and by 11.0% in real terms because of comparatively high inflation in Mongolia.

The government continued its highly procyclical fiscal policy in 2014, largely by channeling substantial expenditures off-budget through the Development Bank of Mongolia and financing them with the proceeds of the Chinggis bond and government-guaranteed external borrowing. The consolidated fiscal deficit, which includes off-budget spending, rose to 11.5% of GDP from 9.8% in 2013. Excluding off-budget spending, the cash deficit expanded to 4.1% of GDP from 0.9% in 2013, and the structural deficit reached 3.7%, breaching the 2% ceiling under the Fiscal Stability Law (FSL) (Figure 3.12.5). Budgetary expenditure remained constant at 32.2% of GDP. However, revenue fell to 28.1% of GDP from 31.3% in 2013 as receipts increased by only 2.6%, falling short of the highly optimistic budget partly because of falling commodity prices. On the positive side, the Glass Account Law will improve the transparency of the procurement, budgets, and finances of government agencies and legal entities with state involvement.

The ratio of public debt to GDP rose in net present value terms to 54.7% in 2014 (breaching the 40% ceiling of the FSL) and to 77.4% in nominal terms including the central bank's foreign liabilities. Interest payments reached 7.1% of government expenditures in 2014 (Figure 3.12.6). Debt sustainability is further affected by the rising share of commercial borrowing since 2012 and the uncertain economic returns of some public investment projects.

Expansionary monetary and fiscal policies and currency depreciation drove consumer price inflation to a peak in July 2014 of 14.9% year on year. Facing inflationary and BOP pressures, the central bank raised the policy rate from 10.5% to 12.0% in July 2014 and 13.0% in January 2015. Despite starting corporate lending worth 1.6% of GDP, the central bank's total quasi-fiscal loans—mainly for housing and construction at subsidized rates—were reduced to 18.7% of GDP from 23.7% in 2013.

3.12.3 External indicators



Sources: National Statistical Office. http://www.nso.mn; Bank of Mongolia. http://www.mongolbank.mn

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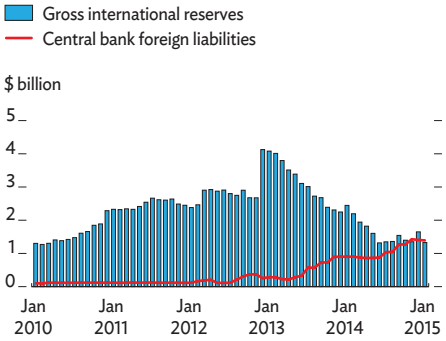
3.12.4 Gross international reserves and foreign liabilities



Source: Bank of Mongolia. http://www.mongolbank.mn (accessed 14 March 2015).

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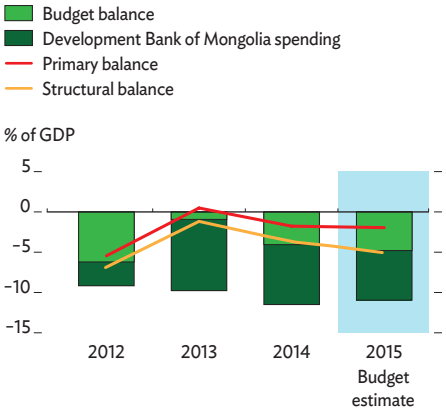
3.12.5 Fiscal indicators



Sources: Ministry of Finance; National Statistical Office. 2015. *Monthly Statistical Bulletin*. www.nso.mn

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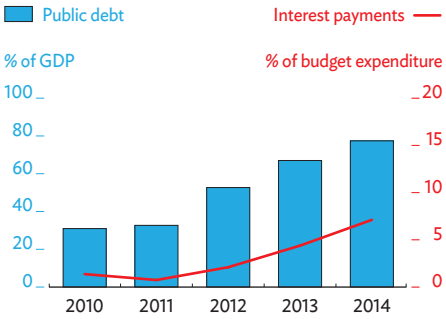
Growth in domestic lending slowed markedly to 16.1%, holding broad money growth to 12.5%. Inflation moderated to 11.0% in December, having averaged 12.8% for the year (Figure 3.12.7).

The quality of bank assets is under pressure in light of their rapid expansion in recent years and slowing economic growth. While commercial banks' stock of nonperforming loans grew by 48.5%, the ratio of such loans rose only slightly to 3.1% of all loans outstanding. However, loan growth is slowing rapidly, and the stock of loans past due—a leading indicator—more than doubled by the end of 2014 to 2.2% of all loans. Moreover, sizeable policy loan programs point to supervisory forbearance and increased exposure to the cyclical construction and housing sector. Banks need bolstering by closer monitoring of asset quality and liquidity buffers, stronger supervision of risk, the adoption of international capital standards, improved corporate governance, and forward-looking provisioning. Some positive steps from January 2015—introducing a 1% provisioning ratio for new loans and imposing higher risk weights on new foreign currency loans to unhedged borrowers—should perhaps be gradually extended to existing loans.

3.12.6 Public debt indicators



Sources: Ministry of Finance. http://www.mof.gov.mn; Bank of Mongolia. http://www.mongolbank.mn

Click here for figure data

Economic prospects

Despite robust growth expected in agriculture and expanded extraction at Oyu Tolgoi, albeit less than in 2014, GDP growth is forecast to slow to 3.0% in 2015 as falling prices for exports are felt and as monetary and fiscal policies are tightened to contain inflationary and BOP pressures. Industrial production will grow more slowly than in 2014 as a credit squeeze affects construction and real estate, and as lower export prices pressure mine operators. Services are projected to grow only marginally as other economic activity slows. Assuming a stable external environment and the resumption of major investment in mining in 2015, economic growth should recover to 5.0% in 2016 even with the continuation of restrictive fiscal and monetary policies (Figure 3.12.8).

Consumer price inflation will moderate to an average of 8.9% in 2015 and 7.7% in 2016, reflecting slower growth and fiscal and monetary tightening (Figure 3.12.9). The forecast assumes that the central bank will prioritize its target of 7.0% year on year for consumer price inflation and achieve it by the end of December 2016. Gross international reserves are likely to remain under pressure in 2015 as FDI inflows stay weak and the current account deficit large. The deficit is forecast to be stable at 8.0% of GDP in 2015 as higher export volume is balanced by falling prices. When large new mining investments start to push up imports in 2016, the current account deficit may almost double to 15.0% of GDP.

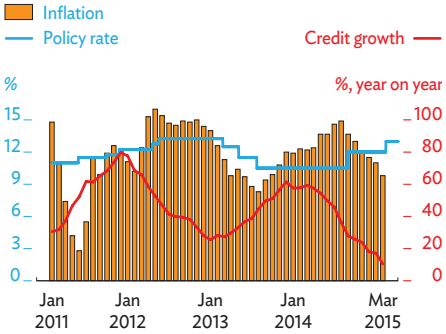
The main risks to the outlook stem from the economy's vulnerability to external shocks. If slowdown exceeds expectations in the PRC—the destination of over 87% of Mongolia's exports—or if prices for exports decline further, the BOP, fiscal balance, and growth could all suffer. The forecast is sensitive to the timing of large FDI projects, such as underground expansion at Oyu Tolgoi or further development of the Tavan Tolgoi coal deposits. The possibility of these projects not going ahead in 2015 constitutes a significant risk to the outlook for 2016.

3.12.1 Selected economic indicators (%)

	2015	2016
GDP growth	3.0	5.0
Inflation	8.9	7.7
Current account balance (share of GDP)	–8.0	–15.0

Source: ADB estimates.

3.12.7 Policy rate, credit growth, and prices



Source: Bank of Mongolia. http://www.mongolbank.mn (accessed 14 March 2015).

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Another major factor is the ability of the government and the central bank to achieve deficit reduction and keep inflation under control. The government faces a difficult challenge to prepare and implement realistic budgets that respect FSL ceilings on debt and the deficit, and the central bank may face pressure to expand its quasi-fiscal lending—in particular to provide direct credit to corporations—or lower its policy rates.

Policy challenge—strengthening debt management

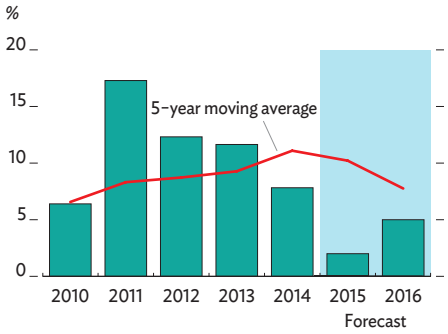
In the long run, Mongolia needs to diversify its economy and better insulate itself from the vagaries of volatile price swings and large-scale FDI. However, the government's immediate policy challenge is to tighten monetary and fiscal policy to address pressure on the BOP while safeguarding financial sector stability, debt sustainability, and the welfare of the population, especially the poor.

Some recent fiscal reforms are steps in the right direction. Development Bank of Mongolia expenditures that were previously off-budget are now partly within structural deficit calculations. Further, the authorities revised the FSL structural deficit and debt ceilings to bring them in line with reality, and will gradually lower them to more prudent levels by 2018.

On the other hand, public debt has been redefined to exclude a number of items as a means to create fiscal leeway without adjusting the ceilings. Such measures weaken debt management and shift the debate on debt sustainability to a myopic focus on raising debt and deficit ceilings or the numeric value of the ratio of debt to GDP. This is unconstructive. The more important issues are debt sustainability, with full appreciation of the nature of different debt instruments, and the productive use of borrowed funds to ensure their contribution to repayment. In addition, preparations are urgently required toward refinancing or repaying in 2017 and 2018 the $580 million eurobond of the Development Bank of Mongolia, credit withdrawn from the currency swap facility with the central bank of the PRC, and the $500 million first tranche of the Chinggis bond.

In light of large consolidated deficits, rising debt and interest payments, and anticipated depressed commodity prices, these issues require open and informed discussion toward designing an effective strategy to manage debt.

3.12.8 GDP growth



Source: Asian Development Outlook database.
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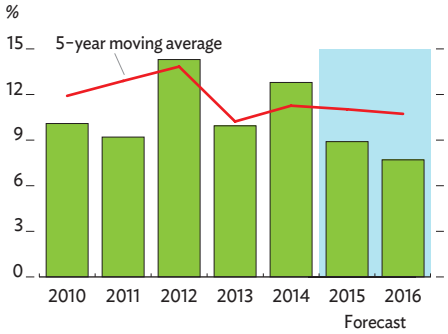
3.12.9 Inflation



Source: Asian Development Outlook database.
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Taipei,China

Improved demand for electronic products raised the growth rate in 2014, while soft oil prices kept inflation low. Growth is expected to be stable in 2015 and 2016 on the back of strong external demand for electronic products and rising tourism services. The economy's major policy challenge remains the need to upgrade its core manufacturing sector.

Economic performance

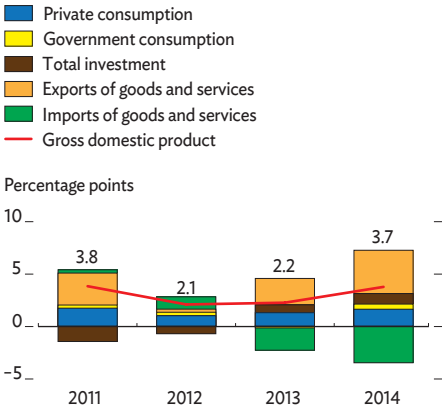
GDP expanded in 2014 by 3.7% year on year, the strongest growth in 3 years, fueled by rising consumption, investment, and exports. All domestic demand components added to growth (Figure 3.13.1). Private consumption expanded by 3.0%, adding 1.6 percentage points to growth as improving consumer confidence boosted private spending. Government consumption grew by 3.4%, adding 0.5 percentage points, and total investments rose by 4.4% to contribute 1.0 percentage point as private investment remained strong despite moderating since 2013 (Figure 3.13.2).

Exports of goods and services, which provide 70% of the economy's GDP, rebounded by 5.7% in 2014 in response to stronger demand from the US, Japan, and the euro area for machinery, electronic products, and electrical equipment. Exports to other Asian economies were mixed, with those to the PRC almost stable and those to Hong Kong, China improving by 7.9%. Imports of goods and services also expanded by 5.4%, as demand picked up for capital equipment and consumer goods. In sum, net exports improved by 7.7%, lifting GDP growth in 2014 by 0.6 percentage points.

On the supply side, the industrial production index, which was almost flat in 2013, rose by 6.1% in 2014, and industrial output grew by 5.7%, contributing 1.9 percentage points to GDP growth. This reflected a rebound in manufacturing by 6.3% as growth in the production of information and communication technology (ICT) products rose by double digits. Mining and quarrying continued to weaken, however, as oil prices declined and growth in construction faltered in a cooling property market. The service sector grew by 2.2% with solid expansion in information and communication, finance and insurance, transportation and storage, and trade, contributing 1.3 percentage points to GDP growth. Agriculture expanded by 3.5%.

Inflation edged up to 1.2% in 2014 as higher food prices outweighed the decline in prices for fuels, lubricants, and transportation equipment. Core consumer prices, which strip out energy and fresh food, rose by 1.3% (Figure 3.13.3).

3.13.1 Demand-side contributions to growth



Sources: Directorate-General of Budget, Accounting and Statistics (DGBAS). http://eng.stat.gov.tw; Haver Analytics (both accessed 6 March 2015).

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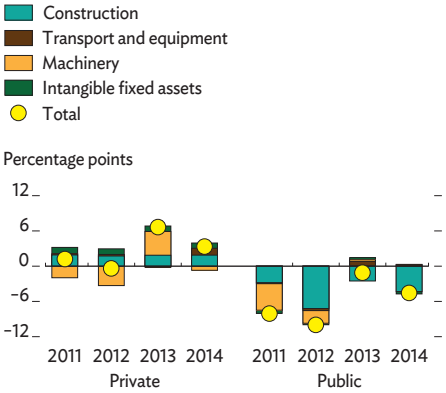
3.13.2 Contributions to growth in gross fixed capital formation



Sources: Directorate-General of Budget, Accounting and Statistics (DGBAS). http://eng.stat.gov.tw; Haver Analytics (both accessed 6 March 2015).

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This chapter was written by Akiko Terada-Hagiwara and Shiela Camingue-Romance of the Economic Research and Regional Cooperation Department, ADB, Manila.

On the policy front, central bank monetary policy remained accommodative, with no change in the rediscount rate. The money supply (M2) climbed by 6.1% in 2014 as banks' net foreign assets rose by 11.0% and bank credit to the private sector grew by 5.7%. The cooling of the property market eased the concentration of real estate in banks' loan portfolios. The budget deficit rose from the equivalent of 0.9% of GDP in 2013 to 1.3% in 2014. Central government revenue declined by 1.4% despite the higher business tax rate for banks and insurance companies implemented in the second half of 2014. Meanwhile, expenditure increased by 3.1% as education, culture, and defense outlays grew.

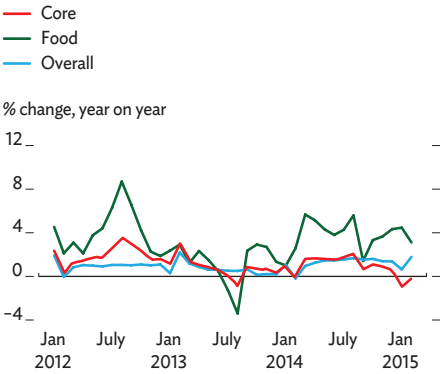
The current account surplus reached a record 12.3% of GDP in 2014 (Figure 3.13.4) on the back of strong exports and net service receipts boosted by tourist arrivals from the PRC. The continued depreciation of the local currency helped boost the current account. Despite increased outflows of $53.0 billion to finance higher investment in foreign debt securities, the balance of payments registered a surplus equal to 2.5% of GDP, higher than the 2.2% recorded in 2013. However, foreign exchange reserves declined by 0.9% to $419 billion as of the end of December 2014, mainly on valuation changes as the US dollar appreciated against other major currencies.

Economic prospects

GDP growth is forecast to remain stable at 3.7% in 2015 on strong external demand and improving prospects for local consumer demand, as well as likely stimulus to production as the drop in global oil prices translates into lower costs and higher corporate profits. Export orders rose by 8.1% in January 2015, on top of a double-digit surge in September and October 2014, with those from the US and Europe surpassing those from the PRC and Southeast Asia (Figure 3.13.5). The outlook is positive for exports, tourism, and repatriated earnings from overseas investments, which are expected to lift the current account surplus to 12.5% of GDP in 2015 and 13.0% in 2016.

Consumption should be robust in 2015. Consumer confidence has been trending up since October 2014, unemployment is low, and real wages will rise with the planned 3.8% increase in the minimum wage by mid-2015. Consumption will receive further boosts from lower fuel and utilities prices and as tourism expands mainly on a likely increase in tourist arrivals from the PRC. The public investment outlook for 2015 and 2016 is somewhat less positive, moderated mainly by the government's continuing efforts to consolidate its budget and uncertainty over energy-related investments. Private investment looks set to expand by the start of 2016 following an announcement from a leading contract chipmaker that it will ramp up production of next-generation chips. Meanwhile, the manufacturing industry sentiment index rebounded in December from a 3-year low, and expectations of rising external demand and tourist arrivals could provide some impetus to investment growth. With the gains from lower oil prices wearing off, and as export competition intensifies further, growth should slip to 3.6% in 2016.

3.13.3 Inflation



Sources: Directorate-General of Budget, Accounting and Statistics (DGBAS). http://eng.stat.gov.tw; Haver Analytics (both accessed 6 March 2015).

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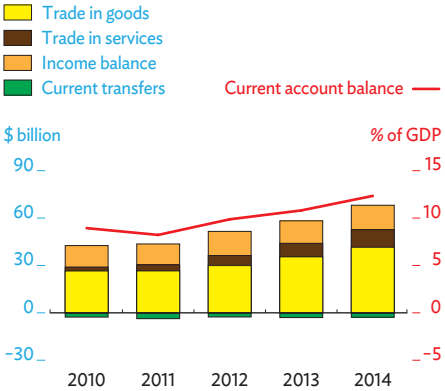
3.13.4 Current account components



Sources: Haver Analytics; http://www.cbc.gov.tw (both accessed 6 March 2015).

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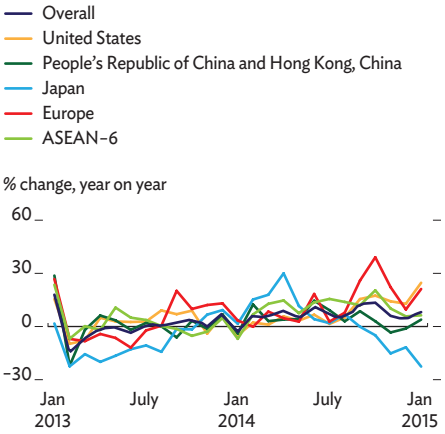
3.13.5 Export orders by economy



ASEAN-6 = Association of Southeast Asian Nations members Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.

Sources: Haver Analytics; http://www.cbc.gov.tw (both accessed 6 March 2015).

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Inflation will trend downward in 2015 to average 0.5% before rising again to 1.0% in 2016 as oil prices gradually recover, employment prospects improve, and incomes rise. Monetary policy is expected to remain accommodative, given the low and stable inflation environment in 2015 and 2016. The central bank has ample room to adjust its monetary policy if required by any sudden economic or financial developments at home or abroad.

Fiscal policy will aim to narrow the deficit, mainly by raising government revenue. Following the increase in business tax rates for banks and insurers under the Sound Finance Program initiated in early 2014, the government is expected to introduce a new top bracket for income tax and a tax on profits from property sales, as well as increase the goods and services tax. Budgetary expenditure may increase as the 2016 election approaches, but the budget deficit is expected to fall to 1.0% of GDP in 2015.

The downside risks to the forecasts arise primarily from the slowdown and production localization in the PRC, and the changing political landscape in Taipei,China. Exports could suffer as competition in ICT products heats up following a free trade agreement signed by the PRC and the Republic of Korea in November 2014, as well as Apple's recent announcement that it would shift to the Republic of Korea a big chunk of its production of chips and other components hitherto produced in Taipei,China. On the other hand, higher-than-expected growth in the US and the euro area could provide an upside surprise, enabling stronger demand for electronic products and positive spillover to propel growth.

Policy challenge—safeguarding growth in semiconductors

The established reputation of Taipei,China as a leading producer of high technology products is a source of economic strength, but its narrow specialization and relatively high domestic production costs are sources of weakness. Growth momentum in the forecast period will likely find support from robust global demand for mobile devices and their components, such as the sophisticated integrated circuits that Taipei,China dominated in 2013 with more than 60% of global sales in integrated circuits foundry production (Figure 3.13.6). However, the sustainability of this growth model is called into question by rapid transformation in information and communication technology (Figure 3.13.7), a fiercely competitive market with expanding production elsewhere in Asia and North America, and relatively high domestic production costs. The authorities face the challenge of designing a two-pronged strategy that preserves the vibrant semiconductor industry while sowing the seeds for developing alternative high-tech industries that could eventually complement ICT exports if they begin to slacken over the medium term as competition stiffens.

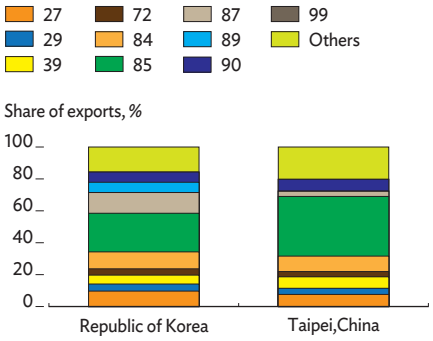
As a first step toward assessing the best approach for developing the domestic semiconductor industry, trade specialization coefficients were computed to compare the evolution of five products: semiconductor

3.13.1 Selected economic indicators (%)

	2015	2016
GDP growth	3.7	3.6
Inflation	0.5	1.0
Current account balance (share of GDP)	12.5	13.0

Source: ADB estimates.

3.13.6 Exports by major commodity, 2013



27 = mineral fuels, mineral oils, products of their distillation, bituminous substances, and mineral waxes, 29 = organic chemicals, 39 = plastics and articles thereof, 72 = iron and steel, 84 = nuclear reactors, boiler machinery, and mechanical appliances, 85 = electrical machinery and equipment and parts thereof, 87 = vehicles other than railway or tramway rolling stock, 89 = ships, boats, and floating structures, 90 = optical, photographic, cinematographic, and other apparatus, parts, and accessories thereof, 99 = commodities not specified.

Sources: Calculated using data from Bureau of Foreign Trade, Ministry of Economic Affairs; UN Comtrade International Trade Statistics Database SITC Revision 3. http://comtrade.un.org (accessed 20 February 2015).

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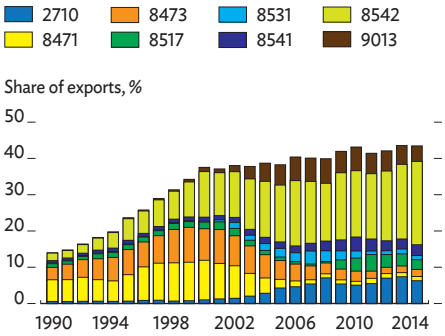
3.13.7 Exports of semiconductors and related products



2710 = petroleum oils and oils obtained from bituminous minerals other than crude, 8471 = automatic data processing machines and units thereof, 8473 = parts and accessories used solely or principally with typewriters and other office machines, 8517 = telephone sets, including cellular and wireless phone sets, 8531 = electric sound or visual signaling apparatuses, 8541 = diodes, transistors, and similar semiconductor devices, 8542 = electronic integrated circuits, 9013 = liquid crystal devices.

Source: Calculated using data from Bureau of Foreign Trade, Ministry of Economic Affairs (accessed 20 February 2015).

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devices, integrated circuits, final products such as notebooks and mobile phones, wafers, and semiconductor manufacturing equipment. Taipei,China was compared with its three main competitors and partners in vertical production chains: the PRC, Japan, and the Republic of Korea.

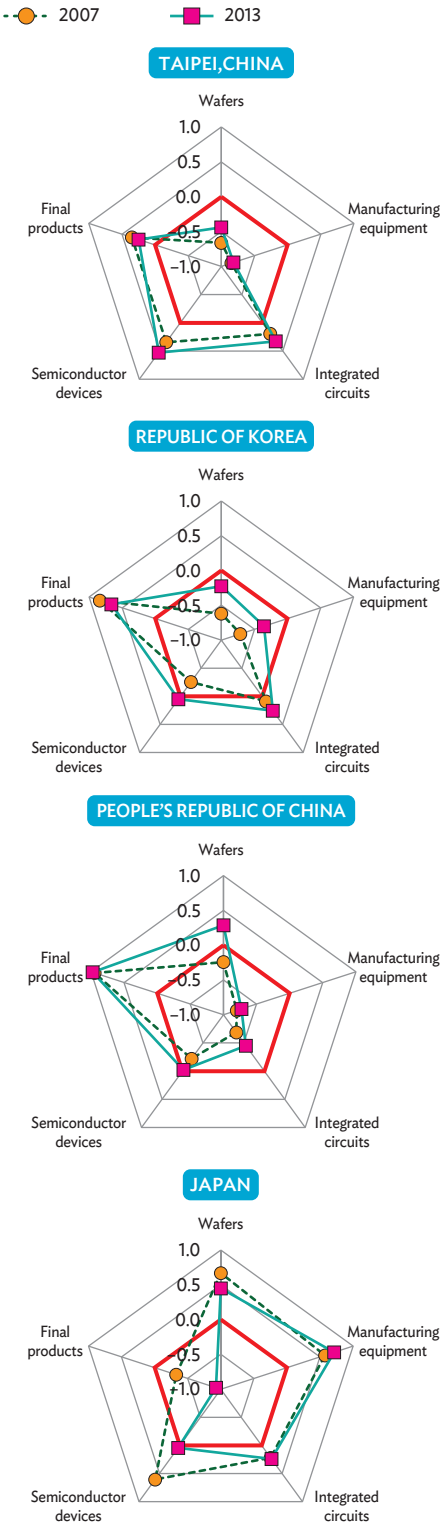
The coefficients are computed as the share of net exports of each product divided by the sum of exports and imports of that product. They can range from –1 for an economy that imports the product but does not export it, to +1 for an economy that exports it but does not import it. A zero coefficient indicates that exports and imports are even. Each economy can therefore have five different ratios determined by the extent of its export and import of each product (Figure 3.13.8).

The results show that Taipei,China is the most specialized of the four economies in semiconductor devices and integrated circuits and the least specialized in manufacturing equipment. While specialization evolved in each economy during 2007–2013 (indicated by the difference between the broken and solid lines in Figure 3.13.8) it has been relatively stagnant in Taipei,China. Comparing Taipei,China with the Republic of Korea is most revealing because of their similarity in export composition, with electric products being the major items and both vying to be major suppliers of integrated circuits, with a common specialization coefficient of 0.3 in 2013 (Figure 3.13.6). The Republic of Korea has expanded its semiconductor devices segment and emerged as a net exporter since 2010. Other economies have expanded too, with the PRC moving into wafer production, and other countries like Malaysia and Singapore expanding into manufacturing equipment. Moreover, as Taipei,China shifted some of its final product assembly to the PRC (largely before 2007), its specialization coefficient for final products fell much lower than that of the Republic of Korea. Indeed, the PRC is the most competitive in this area, with a coefficient close to +1 because it imports hardly any final products.

One option for safeguarding export growth in the semiconductor industry is to move toward producing wafers and manufacturing equipment. This option is consistent with the general need for Taipei,China to develop profitable capital-intensive industries, given its high labor costs. By replacing imports of wafers and manufacturing equipment from Japan or the US, localizing these segments would reduce transportation costs. More importantly, it would help Taipei,China accumulate and develop frontier knowledge.

Also, as the industry evolves quickly, the currently profitable integrated circuit segment needs to prepare for the era after smartphones by moving toward wearable devices and the so-called internet of things. Over the medium term, diversification into other highly capital-intensive industries may be needed to complement the semiconductor industry if market shares start to slip.

3.13.8 Trade specialization coefficients



Note: Final products include personal computers and mobile phones.

Sources: Calculated using data from Bureau of Foreign Trade, Ministry of Economic Affairs; UN Comtrade International Trade Statistics Database SITC Revision 3. http://comtrade.un.org (accessed 20 February 2015).

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SOUTH ASIA

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Afghanistan

Rivals in the disputed presidential election in June 2014 finally agreed in September to form a unity government. The political crisis and the withdrawal of international security forces undermined confidence and the economy. The outlook is for modest recovery helped by large inflows of development assistance and security grants. The new government has energetically sought to improve governance, shore up public finances, and enlist regional cooperation to improve security.

Economic performance

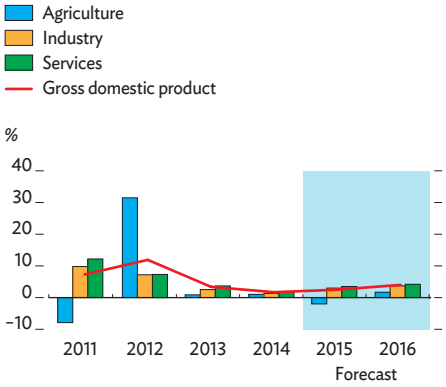
Protracted deadlock and political uncertainty before agreement to share power in a unity government combined with worsening security to sharply curtail economic growth in 2014. Growth is estimated to have fallen to 1.7% from 3.4% in 2013 (Figure 3.14.1). On the supply side, expansion in industry and services fell by half, and agriculture remained flat at about 1.0% as food production achieved its maximum potential for a third consecutive year. Opium production rose by 17%, though its farm gate value of $850 million was 10% less than in 2013. While opium is omitted from official GDP estimates, its earnings boost domestic demand and are a significant source of foreign exchange.

On the demand side, private consumption continued to be the main driver of growth, but at a much slower pace because of uncertainty and income lost in the retrenchment of spending by security forces. Investment decreased, with the number of newly registered firms falling to 2,086 from 3,895 in 2013. These figures include registrations of foreign firms, which halved to 98 from 193.

Inflation fell markedly in the second half of 2014 (Figure 3.14.2). Food inflation dropped to 2.9% in December 2014 from 9.7% a year earlier as prices for vegetables, oil, and fats fell because of ample supply and lower international prices. Nonfood inflation has been declining since 2012, mainly because of falling property rents. Average inflation was 5.0%, down from 7.4% in 2013.

Fiscal policy came under immense pressure in 2014 when domestic revenue fell short of target by a large margin equal to $527 million. Revenues amounted to only AF99.3 billion, far below the budgeted target of AF128.8 billion. Asked to fill the gap, development partners provided only $118 million, leaving the government to finance the difference by drawing down Treasury cash reserves. Domestic revenue financed only 43.9% of the operating expenditures, 11.6% less than in 2013 (Figure 3.14.3). Weak revenue collection was partly due to the economic slowdown, but deteriorating revenue performance since

3.14.1 GDP growth



Source: Asian Development Outlook database.
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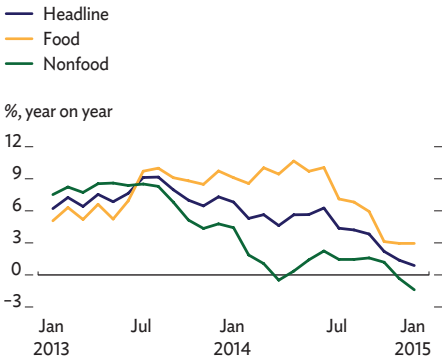
3.14.2 Inflation



Source: Asian Development Outlook database.
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This chapter was written by Rehman Gul of the Afghanistan Resident Mission, ADB, Kabul.

2012 basically comes down to weak governance in tax and customs administration.

Central bank monetary policy continued to be conducted through biweekly foreign exchange auctions. Fluctuation in foreign exchange reserves in mid-2014 reflected inconsistent foreign grant inflows and capital outflows in response to political and security concerns, but reserves stabilized toward the end of the year. Gross international reserves stood at $7.4 billion at the end of December 2014, up slightly from $7.1 billion a year earlier. The value of the afghani has trended downward since 2011 but was broadly stable in 2014, depreciating by less than 1% against the US dollar to AF58.0 (Figure 3.14.4).

Broad money (M2) growth slowed to 8.3% from 9.4% a year earlier, as expansion in demand deposits was only 3.7%. Preference for holding cash reflects continued distrust and weak financial intermediation in the banking sector since the massive failure of the Kabul Bank in 2010.

The current account including grants is estimated to have been a surplus equal to 3.8% of GDP in 2014, up from 3.6% in 2013. This reflected increased earnings from transporting the military equipment of departing international security forces, as well as higher on-budget grants (Figure 3.14.5). Excluding grants, the current account is estimated to have been in deficit equal to 36.6% of GDP, improving on 40.4% in 2013 mainly because imports for grant-supported projects fell.

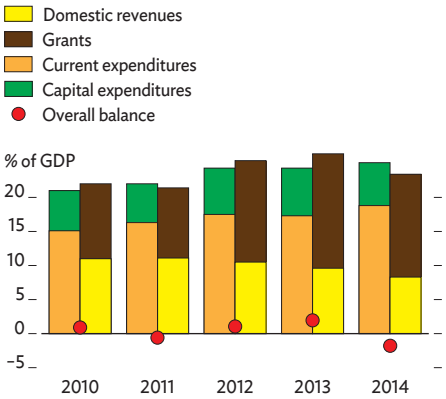
Economic prospects

The economy is projected to grow by 2.5% in 2015, up from 1.7% in 2014, if the political, security, and business environment is stable. With the cabinet not yet fully named at the end of March and parliamentary elections due by June 2015, consumer and investor enthusiasm will remain subdued. As agriculture performed at full potential in 2014 and winter snowfall was meager, agricultural output is expected to decline in 2015. Growth in industry and services is projected to pick up in the second half of 2015 on greater political stability, but demand for services will suffer from the withdrawal of international security forces. Growth in 2016 is projected to edge up to 3.5% on progress with political and security issues.

National budget expenditure for 2015 is set at AF436.2 billion, an increase of 1.8% over 2014 (Figure 3.14.6). The operating budget is allocated AF283.5 billion, or 65% of the national budget, 67% of it for security. Almost 71% of the national budget is financed by foreign grants and loans: 90% of the development budget and 57% of the recurrent budget. Taking grants and loans into account, the deficit is estimated to reach AF7.9 billion in 2015. Loan financing is less than 1% of the total budget.

Inflation is projected steady at 5% in 2015 and 2016 assuming prudent fiscal and monetary policies, good agricultural production, and favorable international commodity prices. The government will continue to manage the exchange rate with the current managed float regime, but the afghani will likely face downward pressure as inflows from development partners shrink.

3.14.3 Fiscal indicators



Note: Years are fiscal years ending on 21 December of that year.

Sources: World Bank. *Afghanistan Economic Update*; International Monetary Fund. *Country Report* No. 12/245; ADB estimates.

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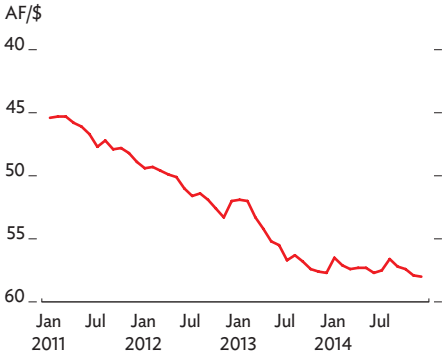
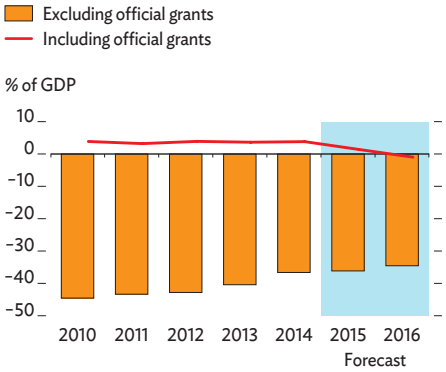
3.14.4 Nominal exchange rate



Source: Da Afghanistan Bank (Central Bank of Afghanistan). http://www.centralbank.gov.af/ (accessed 14 March 2015).

Click here for figure data

3.14.5 Current account balance



Note: Years are fiscal years ending on 21 December of that year.

Sources: World Bank. 2011. *Afghanistan Economic Update.* October; International Monetary Fund. 2011. *Country Report* No. 11/330. November; ADB estimates.

Click here for figure data

The current account balance including grants is projected to be a smaller surplus equal to 1.4% of GDP in 2015 and then move into deficit equal to 1.0% of GDP in 2016 as foreign assistance declines, especially for the operating budget. Excluding grants, current account deficits are projected to narrow to 36.2% of GDP in 2015 and 34.6% in 2016 as externally funded activity winds down.

3.14.1 Selected economic indicators (%)

	2015	2016
GDP growth	2.5	3.5
Inflation	5.0	5.0
Current account balance (share of GDP)	1.4	–1.0

Source: ADB estimates.

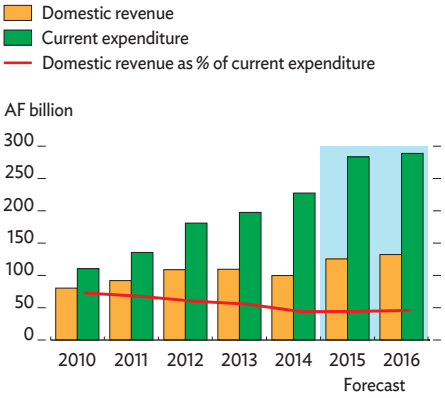
Policy challenge—boosting tax revenue

Afghanistan faces a deteriorating fiscal position, unable to raise revenue even as public expenditures rise. These trends risk an ever-widening fiscal gap. In response to the revenue shortfall, the government adopted strict austerity in the second of half of 2014 that reduced overtime payments to civil servants, set aside some new discretionary development projects, and limited salary increases, bonuses, and other benefits. Despite these measures, a large financing gap fails to cover civilian wages, pensions, and other essential recurrent and development spending, requiring the government to draw down cash reserves.

Missed targets for budget revenue during the past 3 years pose a critical policy challenge in light of the withdrawal of international security forces, contracting inflows of development assistance, and slowing business activity. The government estimates that aid commitments from overseas will shrink to $3.2 billion in 2015 from $5.0 billion in 2014. Revenue mobilization from domestic resources has become critical. The economic slowdown may have contributed to tax collection shortfalls, which should improve as the economy picks up. A large part of the problem, though, is the loss of about one-third of revenues to weak governance and poor tax and customs administration.

Bridging the fiscal gap requires better governance, transparency, and accountability in the use of public funds. In addition, the government must expedite credible reform as stipulated in the Tokyo Mutual Accountability Framework. In particular, reform needs to strengthen tax and customs compliance and broaden the tax base. Officials must ensure the speedy implementation of the newly approved value-added tax, reverse the earlier reduction of the rate from 10% to 5%, and conduct effective risk-based tax audits to improve compliance. The unity government is keen that governance reform streamline government administrative structure by removing parallel operations, repair land administration, monitor development project contracts through the President's Office, revisit the Kabul Bank fraud investigation and court decisions, reform the judiciary with a special focus on eliminating corruption, and provide for removing government officials, including provincial governors, whose performance is unsatisfactory.

3.14.6 Domestic revenue versus current expenditure



Note: Years are fiscal years ending on 21 December of that year.

Sources: World Bank, *Afghanistan Economic Update*; International Monetary Fund, *Country Report* No. 12/245; ADB estimates.

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Bangladesh

Brisk exports helped to maintain growth and a current account surplus despite political disturbances ahead of elections in January 2014. Political blockades and violence in early 2015 will constrain growth and turn the current account into a small deficit. Higher growth and a current account surplus are projected to return next year with political calm. Prolonged strife remains a risk. Eliminating infrastructure bottlenecks and improving the investment climate are top priorities.

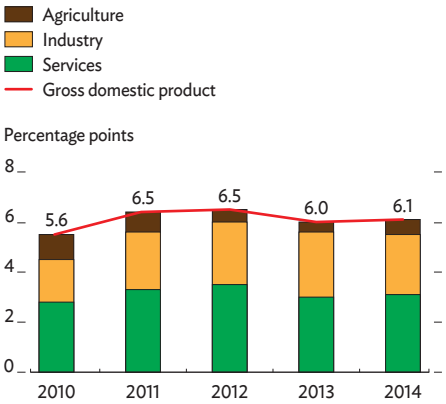
Economic performance

Economic growth in FY2014 (ended June 2014) is provisionally estimated at 6.1%, slightly improved from 6.0% in FY2013 (Figure 3.15.1). Agriculture expanded by 3.3%, aided by good weather and continued government support. Industry growth slumped to 8.4% from 9.6% a year earlier, however, because political unrest before the parliamentary election in January 2014 disrupted the supply of materials and undermined consumer confidence. Services advanced by 5.8%, up slightly from 5.5% the year before, mainly on stronger trade in the second half of the year.

On the demand side, net exports added to growth as garment exports grew briskly. A decline in remittances and weak consumer confidence ahead of the election held down growth in consumer spending. Investment rose slightly to 28.7% of GDP in FY2014 from 28.4% in the previous year, as private investment slipped to 21.4% of GDP from 21.8% in FY2013 while public investment rose from 6.6% to 7.3%. Private investment was constrained by the unsettled political environment, difficulties with infrastructure and skills deficits, and procedural problems that inhibit investment. Rising public investment came as the government stepped up its implementation of election pledges. Foreign direct investment remained low.

Annual average inflation accelerated to 7.4% from 6.8% in FY2013 as political unrest before the election disrupted food supplies and pushed up prices. Wage increases in both the public and the private sector, and an upward adjustment to power tariffs effective in March 2014, contributed to inflation. By June, inflation had moderated to 7.0% year on year. In the first 7 months of FY2015, to January 2015, food inflation eased and inflation for other expenditures edged up slightly to converge at 6.0% (Figure 3.15.2). Moderate demand, unchanged administered prices, a stable exchange rate, and a cautious monetary policy underpinned the outcome.

3.15.1 Supply-side contributions to growth



Note: Years are fiscal years ending on 30 June of that year.
Sources: Bangladesh Bureau of Statistics. 2014. *National Accounts Statistics.* June; ADB estimates.
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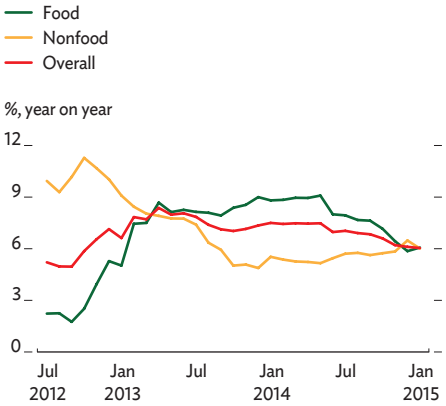
3.15.2 Monthly inflation



Source: Bangladesh Bank. 2015. *Monthly Economic Trends.* February. http://www.bangladesh-bank.org
Click here for figure data

This chapter was written by Shamsur Rahman, Md. Golam Mortaza, and Barun K. Dey of the Bangladesh Resident Mission, ADB, Dhaka.

Money supply and credit growth slowed in FY2014, reflecting the central bank's cautious monetary stance. Broad money growth was, at 16.1% in June 2014, slightly lower than the FY2014 monetary program target of 17.0% (Figure 3.15.3). Private credit growth slowed to 12.3%, well below the program target of 16.5%. Growth in net credit to the government slowed sharply because little bank financing was needed for the budget. The large surplus in the overall balance of payments expanded net foreign assets by 41.2% over the year, which accounted for nearly half of monetary expansion.

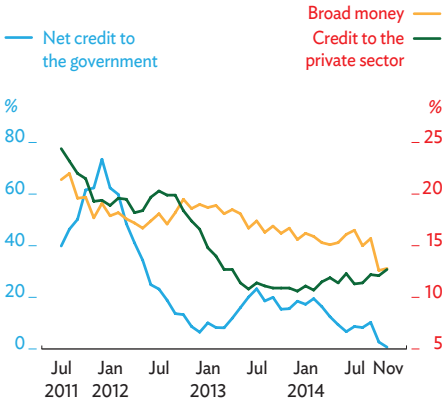
With ample liquidity in the banking system, the central bank raised the cash reserve requirement from 6.0% to 6.5%, effective in June 2014. Easy liquidity nevertheless caused the call money rate to decline. The weighted average yield on 91-day Treasury bills fell to 6.9% in June 2014 from 8.3% a year earlier, and banks' weighted average lending rate eased to 13.1% from 13.6% at the end of June 2013. The deposit rate also declined, to 7.7% from 8.4%, widening banks' interest rate spread by 0.2 percentage points to 5.4%.

Weak discipline at state-owned commercial banks (SCBs) and specialized banks have caused nonperforming loans to proliferate in banks and the larger banking system. SCBs hold about 25% of banking system assets, and specialized banks about 5%. At the end of 2014, the ratio of nonperforming loans to total loans stood at 9.7%, up from 6.1% at the end of 2011 (Figure 3.15.4). Specialized banks had the highest ratio at 32.8%, and the more financially important SCBs had an extraordinarily high ratio of 22.2%. Before 2012, the central bank's options were largely limited to tightening classification and provisioning requirements, but the Bank Company (Amendment) Act, 2013 gave the central bank much more authority to supervise SCBs. To improve their performance, the central bank has undertaken a restructuring program that sets detailed requirements in memoranda of understanding that are acknowledged and signed by the board of each SCB. The memoranda define policies dealing with credit risk management, internal control and compliance, loan review, and liquidity management. They also set specific limits on credit growth. The program aims to put the banks on a sound financial basis over time. However, it is important that nonperforming loans are accurately assessed at all banks, including privately owned banks, to appropriately assess the risk of banking system distress.

Revenue collection by the National Board of Revenue grew by 10.4% in FY2014 but underperformed the budget target because of disrupted economic activity. Total domestic indirect taxes grew by 11.8%, while income tax collection rose by 15.6%. Revenue from taxes connected with imports was weak, however, as imports of higher-duty consumer goods slackened and the bulk of imports were low-duty items such as capital goods, industrial raw materials, and food grains. As a share of GDP, revenue collection rose to 11.6% in FY2014 from 10.7% the previous year (Figure 3.15.5). Meanwhile, total spending reached 16.0%, limiting the budget deficit to 4.4% of GDP. Domestic sources financed close to 70.0% of the deficit.

As part of its periodic adjustment program, the government raised electricity tariffs for retail consumers by 6.7% in March 2014. However, it did not adjust the price of furnace oil, which is used mostly to

3.15.3 Growth of monetary indicators



Source: Bangladesh Bank. 2015. *Major Economic Indicators: Monthly Update.* January. http://www.bangladesh-bank.org

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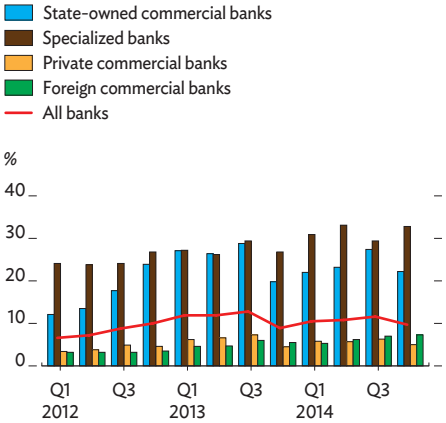
3.15.4 Gross nonperforming loan ratios

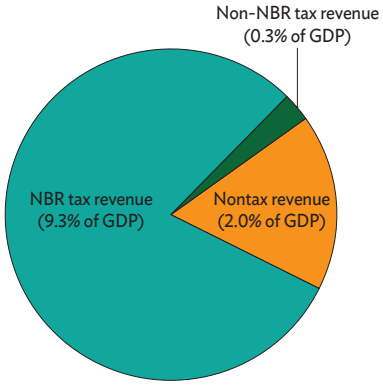


Q = quarter.

Source: Bangladesh Bank. *Bangladesh Bank Quarterly July–September 2014.* http://www.bangladesh-bank.org

Click here for figure data

3.15.5 Government revenues FY2014



NBR = National Board of Revenue.

Source: Ministry of Finance. 2014. Annual Budget 2014–15: *Budget in Brief.*

Click here for figure data

generate electricity, and it last adjusted diesel, kerosene, and gasoline prices in January 2013.

Exports grew by 12.0% in FY2014, up from 10.7% growth a year earlier. Higher demand from the large traditional buyers—the European Union and the US—and from newly developed markets pushed growth in readymade garment exports to 13.8%, outpacing the previous year's 12.7% expansion. Import payments rose by 8.9% in a marked revival from low growth of 0.8% in FY2013. The upturn reflected big increases in imports of petroleum products, machinery and other capital goods, industrial raw materials, and food grains. A stark departure from trend saw workers' remittances fall by 1.6% to $14.2 billion because of a large drop in employment abroad, especially in the Middle East.

A smaller trade deficit notwithstanding, the decline in workers' remittances and the higher services deficit narrowed the current account surplus from $2.4 billion in FY2013 to $1.3 billion, equal to 0.8% of GDP (Figure 3.15.6). With stronger inflows into capital and financial accounts, the overall balance of payments recorded another very large surplus of $5.5 billion in FY2014, slightly above the $5.1 billion recorded in FY2013. The central bank's foreign exchange reserves rose sharply by the end of June 2014 to $21.5 billion, equal to about 5.9 months of imports (Figure 3.15.7).

Active management by the central bank kept the exchange rate stable for the Bangladesh taka, which appreciated by a slight 0.2% against the US dollar in FY2014 (Figure 3.15.8). Because of the taka's nominal appreciation against other currencies and domestic inflation that was higher in Bangladesh than in its trading partners, the taka appreciated in real effective terms by 5.5% year on year as of the end of June 2014, indicating lost export competitiveness.

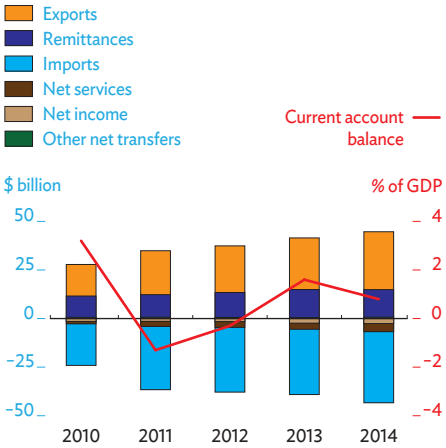
Key stock market indicators improved in FY2014. The Dhaka Stock Exchange broad index rose by 9.2% by June 2014, and market capitalization by 16.3%. The price-to-earnings ratio rose to 16.4 in June 2014 from 14.6 a year earlier, and 12 new companies were listed. Net foreign portfolio investment of $825.0 million in FY2014—more than double the $368.0 million in FY2013—also contributed to market vitality. Reforms such as demutualization and enhanced surveillance undertaken by the Bangladesh Securities and Exchange Commission have improved market discipline.

Economic prospects

Projections for FY2015 are based on a several assumptions: The central bank will maintain its cautious monetary stance to contain inflation, as envisaged in the January 2015 monetary policy statement. The government will raise electricity and natural gas prices to cut subsidies and keep current spending within the budget. It will attain targeted budget revenue and foreign financing and strengthen project implementation. Finally, the weather will be favorable.

GDP growth in FY2015 is projected at 6.1% (Figure 3.15.9). Before political unrest began in January 2015—the anniversary of national elections that the opposition boycotted—the economy had been expanding briskly for 6 months, indicating good growth prospects

3.15.6 Current account components



Note: Years are fiscal years ending on 30 June of that year.
Source: Bangladesh Bank. *Annual Report 2013–2014.* http://www.bangladesh-bank.org
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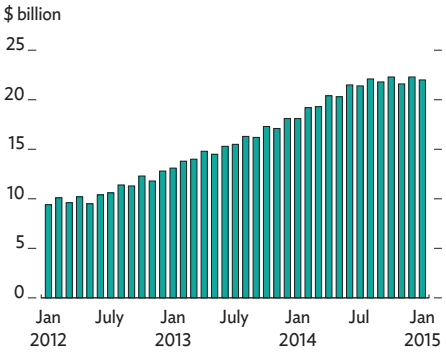
3.15.1 Selected economic indicators (%)

	2015	2016
GDP growth	6.1	6.4
Inflation	6.5	6.2
Current account balance (share of GDP)	−0.5	0.5

Source: ADB estimates.

3.15.7 Foreign exchange reserves



Source: Bangladesh Bank. http://www.bangladesh-bank.org
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for FY2015. Strong remittance inflows boosted consumption, and private investment was rising, as indicated by higher capital equipment imports. Although exports remained subdued, they were gradually improving as export orders picked up. However, political unrest and action to shut down transportation began undermining growth prospects by affecting private investment and export activity. Continued healthy remittance inflows are nevertheless expected to support consumer spending and sustain economic momentum. Notwithstanding the country's resilience under domestic and external shocks, if political unrest continues, it would further hinder economic growth.

Growth in FY2016 is projected to accelerate to 6.4%, aided by higher remittances and export growth, which is underpinned by the continued economic recovery in the US and the euro area. Consumer and investor confidence are expected to pick up as the political situation stabilizes, strengthening growth momentum. In addition, infrastructure constraints will likely ease somewhat with the completion of ongoing projects, particularly the opening of new power plants.

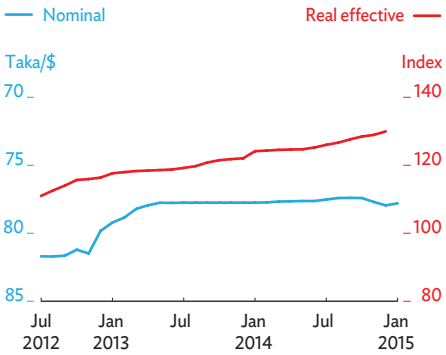
Agriculture incomes will be constrained in FY2015 by losses of perishable foodstuff caused by disrupted supply, distribution, and marketing networks. Nevertheless, growth is expected to reach 3.3%, aided by a good harvest, continued policy support, and favorable weather. With rising demand for agricultural products other than traditional crops—and a positive supply response boosted by improved infrastructure, connectivity, and marketing facilities—agriculture growth is projected to improve to 3.5% in FY2016.

At 8.5%, industry growth in FY2015 will be slower than expected earlier, as unrest affects exports, small-scale manufacturing, and construction. However, strong performance by large and medium-sized industrial firms before the onset of unrest is expected to mean good industry growth recorded for the full year. Industry growth is projected to rise to 9% in FY2016 with improved prospects for the readymade garment industry following reform that improved safety standards and compliance, along with stronger external demand as the pace of recovery strengthens in the euro area. Industry will be further boosted by better electricity supply and infrastructure, as well as improving business confidence.

Services growth is expected to moderate to 5.7% from 5.8% in FY2014 as transport, trade, and wholesale and retail business have been affected by demonstrations and attacks on vehicles. A pickup in external trade and a rise in domestic demand are projected to slightly improve services growth to 6.0% in FY2016.

Inflation is expected to slow to 6.5% in FY2015 and further to 6.2% in FY2016 (Figure 3.15.10). A slowing inflationary trend that started in June 2014 continued during the first 7 months of FY2015, with inflation decelerating to 6.0% year on year in January 2015 from 7.5% in January 2014 as food and other commodity prices fell on the international market. Although likely increases in administered prices for natural gas and electricity may exert inflationary pressure in the ensuing months, inflation is expected to soften over time with easing constraints on supply, large public stocks of food, normal weather, and a supportive

3.15.8 Exchange rates



Sources: Bangladesh Bank. 2015. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org; Monetary Policy Department.

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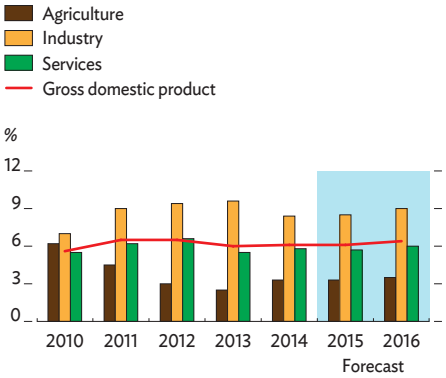
3.15.9 GDP growth by sector



Note: Years are fiscal years ending on 30 June of that year.

Sources: Bangladesh Bureau of Statistics. 2014. *National Accounts Statistics*. June; ADB estimates.

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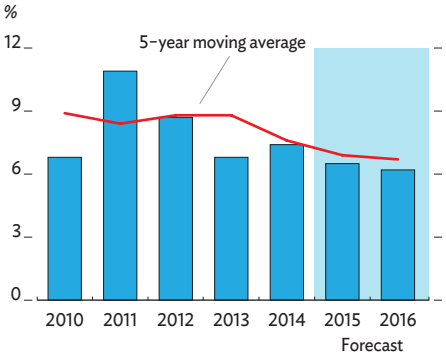
3.15.10 Annual inflation



Note: Years are fiscal years ending on 30 June of that year.

Sources: Bangladesh Bank. 2015. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org; ADB estimates.

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monetary policy that includes strong supervision by the central bank to discourage banks' extension of unproductive credit.

Exports grew by only 2.1% in the the first 7 months of FY2015, significantly down from 15.1% in the corresponding period of FY2014 (Figure 3.15.11). Exports of readymade garments grew by 1.9%, a low number that reflects in part declines in payments to exporters for weaker orders executed in FY2014 during political unrest before the parliamentary election. Even accounting for the impact of the current round of political disruption on strong order books, export growth is greater in the second half of the fiscal year, bringing export growth to 6.0% for all of FY2015. Export growth is projected to recover to 10.0% in FY2016 on the expected pickup in external demand and further progress in improving garment industry safety standards and compliance, which attracts global players that buy large volumes.

Import payments surged by 18.3% in the first half of FY2015 with higher imports of rice, petroleum, fertilizer, raw materials for garments, and capital goods (Figure 3.15.12). Import growth is expected to slacken in the second half of the fiscal year, for an increase by 11.0% in FY2015. Imports are projected to increase by 13.0% in FY2016, reflecting modest expectations for improvement in trade and the economy.

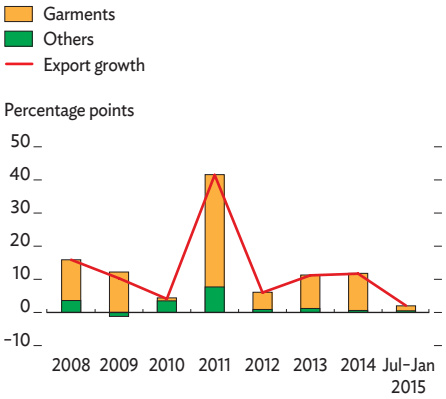
Workers' remittance inflows rose by 8.7% to $8.7 billion in the first 7 months of FY2015 as employment overseas increased, especially since early 2014. Remittances picked up notably from the Middle East, Malaysia, and the US. With jobs abroad trending higher, remittances are expected to expand by 11.0% in FY2015 and 14.0% in FY2016, in large part because of resumed recruitment by Saudi Arabia and Qatar.

Despite rising remittances, the current account balance is expected to move to a small deficit of 0.5% of GDP in FY2015 because of a larger trade deficit and growing deficits in the services and income accounts (Figure 3.15.13). However, the current account is projected to move back to a small surplus of 0.5% of GDP in FY2016 as larger remittances offset projected deficits in trade and nontrade items.

Revenue collection grew by 16.7% during the first 7 months of FY2015, with domestic indirect taxes outpacing indirect taxes connected with imports. The collection of direct taxes also remains strong. The FY2015 budget targets 19.3% growth in tax revenue, which is higher than growth in nominal GDP, to lift the ratio of tax to GDP by 0.5 percentage points to 10.1%. Reaching the target may be a challenge, especially as political unrest hinders economic activity, unless discretionary tax measures are adopted. Total expenditure was slated to rise to 16.4% of GDP in FY2015, with current spending falling to 8.4%, net capital lending level at 2.3%, and the annual development program reaching 5.2%—a significant rise, as the government intends to step up implementation to meet election pledges. The target for the budget deficit is 4.4% of GDP, about two-thirds of it set to be financed from domestic sources (Figure 3.15.14).

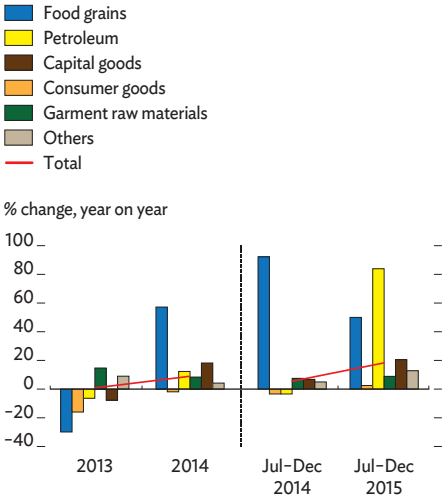
Sustained low global oil prices have two main implications: Lower spending for imports improve the trade and current account balances, and the government benefits from reduced expenditures on fuel subsidies. Though the drop in oil prices has created opportunity to review policies regarding energy prices and subsidies, market-based

3.15.11 Contributions to export growth



Notes: Years are fiscal years ending on 30 June of that year.
Sources: Export Promotion Bureau; ADB estimates.
Click here for figure data

3.15.12 Growth in imports and components



Note: Years are fiscal years ending on 30 June of that year.
Source: Bangladesh Bank. http://www.bangladesh-bank.org
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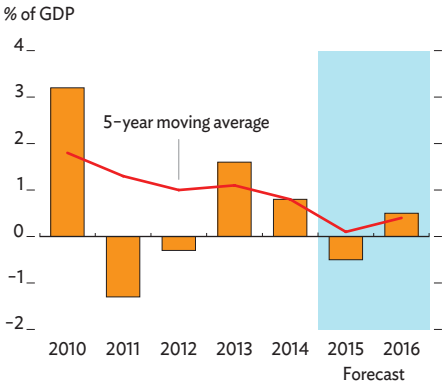
3.15.13 Current account balance



Note: Years are fiscal years ending on 30 June of that year.
Sources: Bangladesh Bank. *Annual Report 2013–2014.* http://www.bangladesh-bank.org; ADB estimates.
Click here for figure data

price adjustments are unlikely in the coming months as the authorities are expected to first recoup earlier losses of the Bangladesh Petroleum Corporation.

The outlook is subject to several downside risks: delayed economic recovery in the European Union, Bangladesh's main export destination; inability to mobilize the domestic revenue or foreign financing needed to meaningfully improve infrastructure, especially for power generation; and prolonged political unrest that would drain confidence. Finally, unfavorable weather is always a risk in Bangladesh.

Policy challenge—opening investment bottlenecks

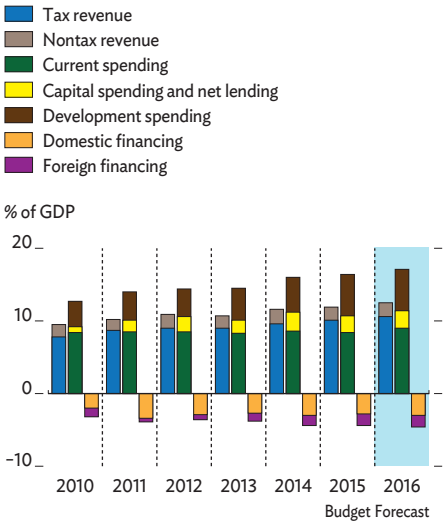
Economic and social progress notwithstanding, Bangladesh still faces formidable challenges over the medium to long term in its efforts to raise investment to a level sufficient to put it on a high growth trajectory.

Private investment needs to be greatly scaled up. This first requires reversing the falling trend over the past 2 years caused by political uncertainty, land and infrastructure shortages, a skills deficit, and a weak business climate. In terms of infrastructure quality, Bangladesh is less competitive than other Asian economies. These include the People's Republic of China, from which it stands to inherit opportunities in light manufacturing, and such competitors as Cambodia, India, and Sri Lanka (Figure 3.15.15). Bangladesh needs to improve the quality of its roads, ports, railways, electricity supply, water supply, and sanitation. Further, capacity constraints in government agencies need to be addressed.

According to *The Global Competitiveness Report 2014–2015* of the World Economic Forum, inadequate and unreliable energy and power supply appear to be the most binding constraints on the country's competitiveness. Likewise, in the World Bank's *Doing Business 2015*, Bangladesh ranks 188 among 189 countries on the ease of electricity delivery (Figure 3.15.16). The cost of power outages has been estimated to equal 0.5% of gross domestic product. Electrification rates rose from 35% in FY2003 to 62% in FY2013, and transmission and distribution losses were reduced, but supply remains irregular and overly reliant on natural gas. Power outages are still frequent, and transmission and distribution systems suffer high losses. Even though installed capacity is over 10,000 megawatts, available capacity is limited to 6,000–7,000 megawatts. The problem may get worse, as supply coming online is inadequate to meet growing demand in the coming years. In addition, higher transaction costs and excessive procedures are major regulatory hurdles to getting electricity.

Bangladesh needs to seriously cut the costs of doing business to boost private and foreign investment. *The Global Competitiveness Report* ranks Bangladesh at 109 out of 144 countries surveyed. Strong efforts are needed to reduce the burden of paying taxes, getting credit, registering property, and enforcing contracts. Bangladesh ranks 131 on the ease of getting credit, compared with India at 36. On average, contract enforcement has 41 procedures that take 1,442 days in Bangladesh, costing 66.8% of the value of the claim.

3.15.14 Fiscal indicators



Note: Years are fiscal years ending on 30 June of that year.
Source: Asian Development Outlook database.
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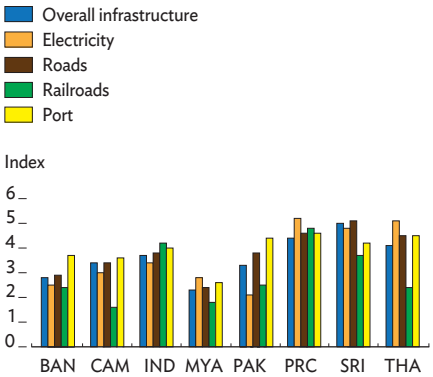
3.15.15 Comparison of infrastructure quality 2014–2015



BAN = Bangladesh, CAM = Cambodia, IND = India, MYA = Myanmar, PAK = Pakistan, PRC = People's Republic of China, SRI = Sri Lanka, THA = Thailand.

Note: Index scale runs from 1 (worst) to 7 (best).

Source: World Economic Forum. *The Global Competitiveness Report 2014–2015.*

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Land shortages have emerged as a binding constraint on investment. Unplanned urban sprawl and high population pressure complicate finding suitable locations for enterprises. The land market is inefficient because of long delays and the high cost of property registration, weak land ownership data, the lack of automation in land records, and poor zoning laws. On registering property, Bangladesh ranks 184 out of 189 countries, significantly below such subregional peers as Pakistan at 114, India at 121, and Sri Lanka at 131. Registering property in Bangladesh requires eight procedures and 244 days, costing 7.2% of the property value. Institutional reform to simplify land transactions and registration, improve land administration and record keeping, and develop more economic zones is key to attracting private investors domestically and from overseas.

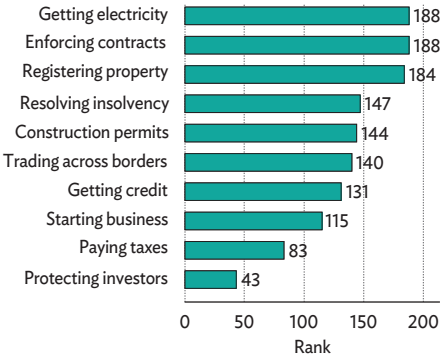
A sound financial system is vital for private and foreign investment. Banks have limited capacity to finance large projects and provide sufficient trade finance. Discipline needs to be strengthened in banks, especially SCBs, by instituting effective competition, efficient management, higher credit standards, and enhanced supervision and corporate governance. Progress has been made in strengthening prudential regulation, enhancing central bank capacity, and allowing more competition through the entry of new private banks.

To boost investment and growth, Bangladesh adopted in 2012 a broad policy framework with support from international financial institutions. The structural reform agenda aims to strengthen fiscal revenue and tax capacity (including implementing a new value-added tax) to generate greater resources for a revamped and well-prioritized public investment plan. It includes reform to operations at SCBs to improve governance, strengthen labor and safety standards and social safety nets, and streamline regulations on business, trade, and foreign exchange. Substantial progress has been made, even in the current contentious political environment.

The government is setting up five economic zones, each providing one-stop service. Measures to improve the business climate include automating the administration of the judicial system to expedite the enforcement of contracts, computerizing the processing of exports and imports to speed cross-border trade, and introducing alternative mechanisms to resolve disputes over income tax, value-added tax, and customs duties that will ease the administrative burden and cost of paying taxes.

To accelerate infrastructure development, the government has fast-tracked a number of priority projects and established a high-level technical committee to implement them. The projects are a deepwater seaport in southern Sonadia, a metro rail in Dhaka, the Padma Bridge, a terminal for imports of liquefied natural gas, the Matarbari ultra-super critical coal-fired power plant, the Payra seaport, and a coal-fired power plant at Rampal, in the southwest of the country.

3.15.16 Private investment in Bangladesh: Key regulatory constraints



Note: Ranking among 189 countries; 1 = best, 189 = worst.
Source: World Bank. *Doing Business 2015.*
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Bhutan

Growth accelerated slightly as hydropower construction and manufacturing picked up. Most temporary import and credit restrictions have been lifted, and new monetary and fiscal policy mechanisms instituted to manage excessive demand. The outlook is for rapid growth as new large projects are built to generate more hydropower for export. The current account deficit will be substantial, reflecting construction imports, but large capital inflows and cautious demand management are expected to sustain a surplus in the overall balance of payments.

Economic performance

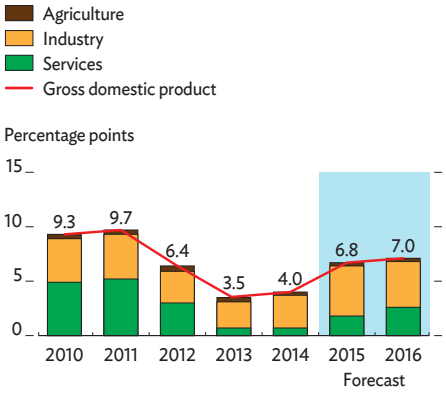
The economy expanded in FY2014 (ended 30 June 2014) at an estimated 4.0%. This is up from 3.5% a year earlier but remains below the long-term growth rate of nearly 8.0% (Figure 3.16.1). The boost came from growth in industry and construction, mainly in hydropower, which comprises about a third of economic activity. Sales of cement, one of the country's few industries, recovered from a contraction last year, reflecting stronger performance in construction as well as manufacturing. The value of electricity output grew on higher power tariffs and despite hydropower production falling slightly.

Services grew marginally more quickly than last year, notwithstanding wholesale and retail trade continuing to fall from their double-digit expansion of earlier years. Although credit restrictions on housing construction and vehicles continued, output from the finance sector picked up somewhat as lending for manufacturing, tourism, and personal use increased. Tourism, though a niche activity, recorded a nice gain. Agriculture saw a marginal pickup in growth, but its share in GDP is small.

Consumer prices are highly volatile because of heavy dependence on imports, which supply about half of goods, both food and nonfood, with most supplies coming from India. In FY2014, average annual inflation accelerated to 9.6% from 8.8% in the previous year, due mainly to high prices for food, with price pressures coming from India as well as domestic markets (Figure 3.16.2). Food inflation peaked at 14.5% in the fourth quarter of 2013, then receded to 5.9% a year later. Inflation for other expenditures was fairly stable, averaging 7.8% in FY2014.

The fiscal deficit in FY2014 equaled 4.1% of GDP, marginally lower than in the previous year but higher than the government's target of 3.0% on average over the Eleventh Five-Year Plan, FY2014–FY2018. Preliminary estimates show domestic revenue growing by only 3.7%, much more slowly than in previous years as import restrictions cut

3.16.1 Supply-side contributions to growth



Note: Years are fiscal years ending on 30 June of that year.
Source: National Statistics Bureau. *National Accounts Statistics 2014.* http://www.nsb.gov.bt
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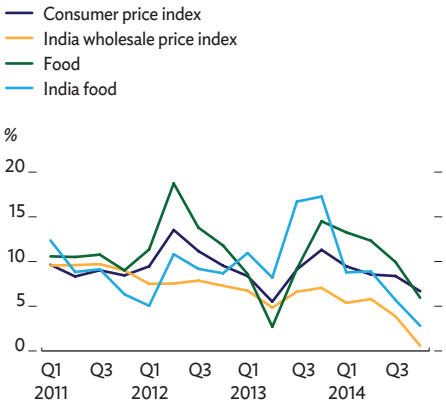
3.16.2 Inflation



Q = quarter.
Source: National Statistics Bureau. http://www.nsb.gov.bt
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This chapter was written by Sarah Carrington of the South Asia Department, ADB, Manila, and Elbe Aguba, consultant, South Asia Department, ADB, Manila.

into tax earnings. Although domestic revenue at 19.6% of GDP was able to fully cover current expenditure at 17.2%, the remaining balance fell short of financing the government's target of covering 15% of capital expenditure. Grants picked up to equal 10% of GDP but were insufficient in FY2014 to cover the remainder of capital expenditure (Figure 3.16.3).

Money supply grew by 6.6%, much less than in FY2013, reflecting slower increases in net foreign assets and bank credit (Figure 3.16.4). Growth in credit to the private sector remained tame at 6.4%, slightly less than in the previous year, as temporary credit restrictions continued in some sectors, having been imposed in 2012 to address excessive consumption and a severe shortage of Indian rupee reserves.

To strengthen financial and liquidity management, the Royal Monetary Authority adopted new monetary and macroprudential policies in the banking sector, including new risk-weighting requirements for various loans, the imposition of loan-to-value caps for housing and vehicle loans, and a loan-to-income cap of 70% for consumer loans. The fiscal authority also implemented demand-management policies such as revised taxes and import duties on vehicles and a new green tax on fuel. With these new measures in place, the monetary and fiscal authorities have begun to gradually remove temporary measures, lifting in February 2014 the import and foreign exchange restrictions on furniture and alcohol and in September the remaining restrictions on credit and imports.

The current account deficit improved slightly from 27.3% of GDP in FY2013 to 25.5% in FY2014, owing to lower deficits in the trade and primary income accounts (Figure 3.16.5). Restrictions caused imports to fall by 5%, narrowing the trade deficit. Lower interest payments in FY2014—largely reflecting the full liquidation of overdraft loans from India obtained during the rupee crises—helped reduce the primary income deficit. Financial net inflows fell but were still substantial at 13.0% of GDP. With a hefty increase in investment grants from India, the capital account rose to 14.8% of GDP, and the overall balance remained in surplus, albeit substantially lower than in the previous year.

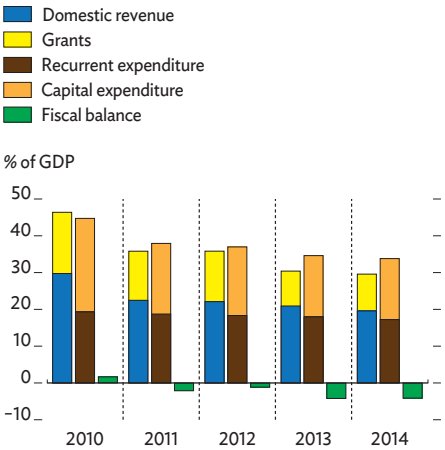
At the end of FY2014, the overall balance of payments surplus stood at $98.7 million, or 5.4% of GDP, and gross international reserves increased to $997.9 million, equivalent to 13 months of imports (Figure 3.16.6). Of total reserves, $829.3 million was in convertible currency. Indian rupee reserves, equivalent to $168.6 million, were 16.9% of total reserves, which was a marked improvement from the miniscule balance in FY2012.

Economic prospects

Economic recovery is set to continue, and high growth rates are projected over the next 2 years. The industry sector, comprising about four-tenths of GDP, will continue to drive the economy, bolstered by the construction of new hydropower projects including the Nikachhu and Kholongchhu plants and increased electricity output from the new Dagachhu plant, which opened early this year.

Growth in services is expected to accelerate as trade and finance activities gather pace with temporary restrictions being lifted.

3.16.3 Fiscal indicators



Note: Years are fiscal years ending on 30 June of that year.
Sources: Ministry of Finance. National Budget Financial Year 2014/15. http://www.mof.gov.bt; ADB estimates.
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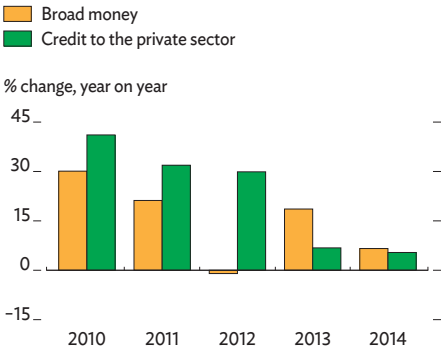
3.16.4 Monetary indicators



Note: Years are fiscal years ending on 30 June of that year.
Source: Royal Monetary Authority of Bhutan. 2015. *Monthly Statistical Bulletin January 2015.* http://www.rma.org.bt
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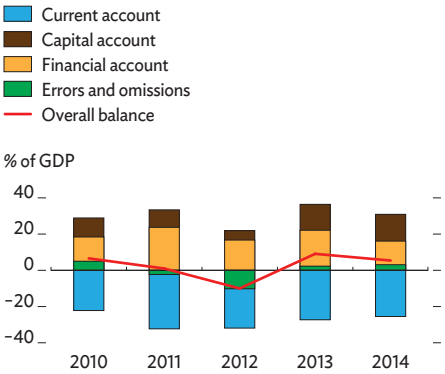
3.16.5 Balance of payments



Note: Years are fiscal years ending on 30 June of that year.
Source: Royal Monetary Authority of Bhutan. http://www.rma.org.bt
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Expansion will not be at the rates seen during the severe rupee shortages in previous years, however, as new monetary and fiscal measures and better bank regulation are expected to help rein in excessive consumption spending. Tourism is expected to be robust with the government declaring 2015 to be Visit Bhutan Year. Over the first half of FY2015, tourist arrivals grew at an astonishing 43.1% and revenue by 18.4%.

Inflation in the first half of FY2015 slowed to 7.5%, as food and other prices eased from their highs in the previous year in line with lower inflation in India. Inflation is expected to ease further to an average of 7.0% this year and 6.8% next year. The improved inflation outlook comes from price moderation in India and forecasts of declining world oil prices, which will help offset increases in domestic power tariffs.

The government plans to narrow the fiscal deficit to 2.7% of GDP in FY2015 with revenue-enhancing reforms such as new tax measures on fuel and telecommunication services, a revised tax and import duty on vehicles, and revised export tariffs. Current expenditure is expected to grow by 13.7%, mainly on planned increases in infrastructure maintenance and civil service salaries. While capital expenditure is currently set much lower than last year at Nu15.2 billion, it may be revised when grant funding is secured during the year.

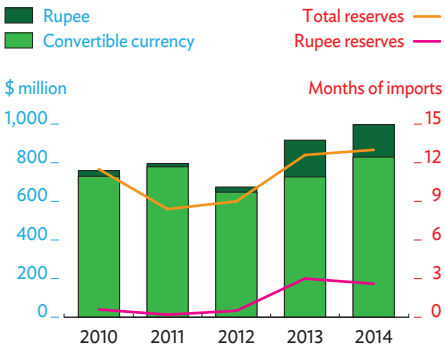
The current account deficit is projected to widen over the next 2 years to about 30% of GDP as the trade deficit expands to accommodate large imports of goods related to hydropower investments. Although exports will also strengthen as electricity exports to India increase, adequate inflows of external funding—mostly hydropower loans and budgetary investment grants from India—are projected to keep the overall balance of payments in surplus.

3.16.1 Selected economic indicators (%)

	2015	2016
GDP growth	6.8	7.0
Inflation	7.0	6.8
Current account balance (share of GDP)	–30.6	–30.6

Source: ADB estimates.

3.16.6 Gross international reserves



Note: Years are fiscal years ending on 30 June of that year.

Source: Royal Monetary Authority of Bhutan. 2014. *Annual Report FY2013/14*. http://www.rma.org.bt

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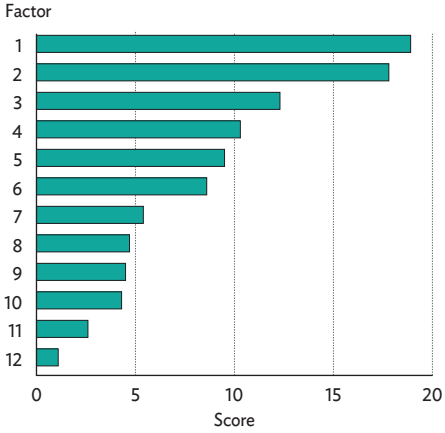
Policy challenge—enhancing agriculture for more inclusive growth

Since the hydropower subsector began its development in the 1980s, the share of agriculture in GDP has been steadily displaced, falling from over half to about 13% and contributing in the past decade only 8% of annual GDP growth. Agriculture remains crucially important, however, as it employs 56% of the workforce and is the main source of income in rural Bhutan. The challenge is to improve the sector to help achieve more balanced and inclusive growth in the economy and contribute to poverty reduction.

Growth in agricultural production in constant terms averaged 2.1% per annum in the 1980s, declined to –1.0% in the 1990s, and picked up to 3.5% over the recent decade to 2011. Similarly, growth in food product exports in constant terms improved substantially to average over the recent decade 2.8% growth per annum. Over half of Bhutan's food exports are processed fruits and vegetables, and about a quarter are spices. With respect to export destinations, most processed fruits and vegetables go to India, about a third to Bangladesh, and the balance to newer markets in Japan, Singapore, Thailand, and Hong Kong, China.

Constraints on agriculture and economic diversification in Bhutan are legion: rough topography, limited arable land, lack of infrastructure,

3.16.7 Most problematic factors for exporting



1 = identifying potential markets and buyers, 2 = difficulties in meeting quality or quantity requirements of buyers, 3 = access to imported inputs at competitive prices, 4 = inappropriate production technology and skills, 5 = access to trade finance, 6 = high cost or delays caused by domestic transportation, 7 = technical requirements and standards abroad, 8 = corruption at foreign borders, 9 = burdensome procedures at foreign borders, 10 = high cost or delays caused by international transportation, 11 = tariff barriers abroad, 12 = rules of origin requirements abroad.

Source: World Economic Forum. 2014. *The Global Enabling Trade Report 2014*. http://www3.weforum.org

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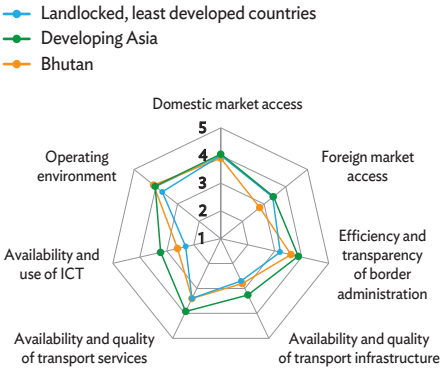
fluctuating yields, inadequate market links, and high transaction costs. In addition, export businesses cite at the top of their list of problems difficult entry into potential markets and meeting their quality requirements (Figure 3.16.7).

One advantage that Bhutan does have in relation to its neighbors is seasonal diversity, allowing it to produce a wider range of crops. And, compared with other landlocked countries, and with developing Asia as a whole, Bhutan scores well on enabling trade, and fares even better on foreign market access (Figure 3.16.8). Recent progress in improving agricultural production can be reinforced by modernizing farming technology, improving yield and productivity, and addressing market constraints and infrastructure challenges. This would help to expand food exports and boost rural incomes.

The government's current five-year plan identifies agriculture as a key entry point to address poverty and to augment economic growth by accelerating agricultural growth from the current average of 2.4% to at least 4.0% annually. The plan promotes commercial over subsistence farming and aims to engage the private sector to improve farm productivity. Bhutan plans to strategically position itself by expanding agriculture's export base and markets where it has comparative advantage, in fruit, vegetables, and spices. Product differentiation to create profitable niche products is recognized as crucial to agricultural development. Strategic diversification into new markets, particularly the emerging Asian economies, could help expand the export base. Success will depend on overcoming supply-side constraints, logistics challenges, and trade barriers.

3.16.8 Enabling trade index 2014 score



ICT = information and communication technology.

Note: Numbers correspond to scores on a 1-to-7 scale, where 7 corresponds to the best possible outcome.

Source: World Economic Forum. 2014. *The Global Enabling Trade Report 2014*. http://www3.weforum.org

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India

Economic expansion picked up in 2014, inflation markedly declined, and the external position was comfortable, helped by positive policies and lower global oil prices. The outlook is for economic strengthening through higher infrastructure spending, increased fiscal devolution to states, and continued reform to financial and monetary policy. The government underscored its intention to move steadily to tackle politically difficult structural issues that have stalled investment and limited economic performance in recent years.

Economic performance

A more robust economic performance than was earlier indicated emerges from revised data based on an updated base year, wider coverage of goods and services, and the inclusion of tax data to estimate economic activity. Real growth was previously estimated as a change in volume, but the new series estimates value added at each stage.

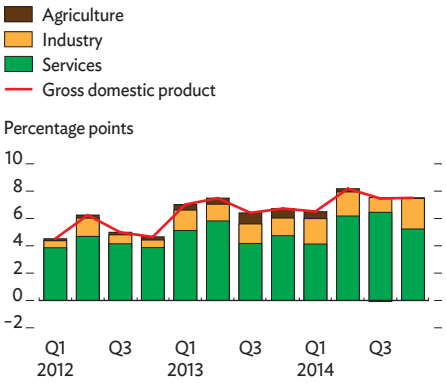
The government's initial estimates for FY2014 (ending 31 March 2015) show that economic growth accelerated to 7.4% (Figure 3.17.1). Agriculture growth slipped to 1.1% in FY2014 largely because the monsoon was erratic, particularly affecting the summer crop. The production of food grains contracted by 3.2% from FY2013.

After growing by 4.5% in FY2013, industry accelerated to 5.9% in FY2014, helped by a 6.8% expansion in manufacturing. These estimates may be a tad optimistic, however, as they assume manufacturing growth to have exceeded 10% in the final quarter of FY2014. Monthly industrial production estimates indicate a more modest upturn. The production of capital goods expanded after 3 years in the red. However, consumer durables continued to decline. Improved coal production helped double the growth of electricity generation over the previous year's rate.

Service sector growth rose to 10.6% in FY2014. Financial services received a boost from the government's new financial inclusion scheme, under which new depositors have opened 125 million accounts. An uptick in industrial activity enhanced the growth of trade and transport services.

Private consumption growth increased to 7.1% (Figure 3.17.2). Declining oil prices, weakening food inflation, improved job prospects, and a stable currency helped lift consumer confidence, though moderation in rural wage growth could have dampened rural consumption. Despite the policy momentum toward resolving issues that have constrained investment, growth in capital formation inched up only to 4.1% in FY2014. While the pace slowed as the year progressed, the initial estimates point to recovery in the last quarter of FY2014.

3.17.1 Supply-side contribution to growth



Q = quarter.

Notes: Years are fiscal years. Q1 refers to data for April–June.

Source: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in

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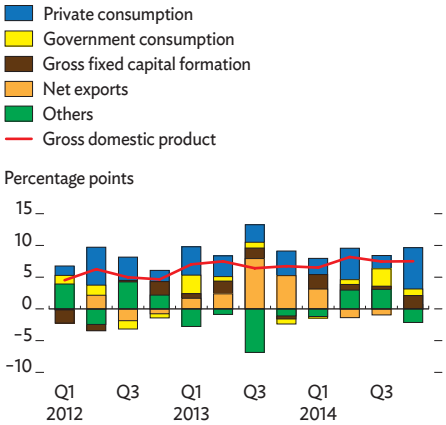
3.17.2 Demand-side contribution to growth



Q = quarter.

Notes: Years are fiscal years. Q1 refers to data for April–June.

Source: Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in

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This chapter was written by Johanna Boestel, Abhijit Sen Gupta, and Nidhi Kapoor of the India Resident Mission, ADB, New Delhi.

Consumer price inflation fell sharply over the course of the year to average below 7% in FY2014. Food inflation moderated considerably, helped by a limited increase in minimum support prices for food grains, muted rural wage growth, and the government's offloading of food stocks. A sharp drop in global oil prices helped moderate fuel inflation, though hikes in excise duty limited the pass-through of global oil prices to domestic retail prices. The central bank's strong anti-inflationary stance and the declining trend in the fiscal deficit bode well for core inflation, which dropped to below 5% (Figure 3.17.3).

After maintaining an anti-inflationary stance during most of FY2014, despite retail inflation declining by almost 400 basis points from April to December 2014, the central bank reduced key interest rates by 50 basis points in the fourth quarter of FY2014 (Figure 3.17.4). The move came after inflation had fallen significantly below the 8% target for January 2015 and because inflation was likely to continue to average less than 6% to January 2016. The central bank eased requirements on the portion of deposits that banks must invest in government bonds by 50 basis points to 21.5%, to encourage banks to onlend for productive uses.

February 2015 saw a monetary policy framework formalized under which the primary objective is to maintain price stability while remaining mindful of growth. The central bank is expected to bring consumer price inflation down to 6% by January 2016, with the target for inflation being 4% ±2% from FY2016.

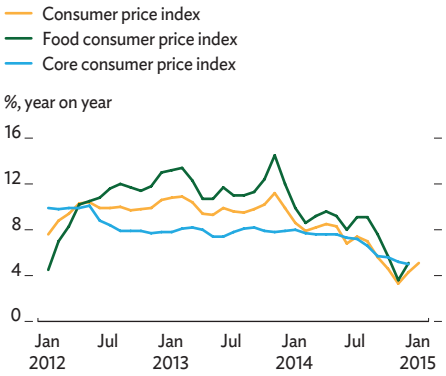
The quality of banks' assets continues to be a matter of concern. The ratio of nonperforming assets (NPAs) to total advances deteriorated from 3.4% in March 2013 to 4.5% in September 2014 (Figure 3.17.5). A major part of the NPAs are with government-owned banks, whose NPA ratio rose to 5.3% in September 2014. Much of the rise reflects a corporate sector stressed by high leverage and adverse business conditions. In addition, restructured loans have continued to proliferate, their ratio growing to 6.2% of all loans in the first half of FY2014. More than half of these loans are concentrated in infrastructure, iron and steel, textiles, and power.

The government's financial inclusion scheme to universalize banking access introduces several innovations, including insurance provided up front to subscribers, mobile banking, and the issuance of debit cards with overdraft facility.

The central government's budget deficit is estimated at 4.1% in FY2014, below the 4.4% recorded in FY2013. The reduction in the deficit came largely from curtailed expenditure, as revenue growth remained sluggish. While most major tax revenue segments underperformed their original targets, growth in corporate and service taxes was especially subdued. A sharp drop in global oil prices provided an opportunity to garner additional revenue by raising excise duty on various petroleum products. Receipts from asset sales increased in the last quarter of FY2014 but still fell well below target.

Expenditure grew by 7.8% in FY2014, less than the targeted 12.9%. However, as in previous years, much of the burden of expenditure compression fell on capital expenditure, which grew by 2.5%, only a fraction of the 20.8% growth target. In contrast, current expenditure grew by 8.5%. The drop in global oil prices, deregulation of diesel prices,

3.17.3 Inflation



Sources: CEIC data company (accessed 27 February 2015); ADB estimates.

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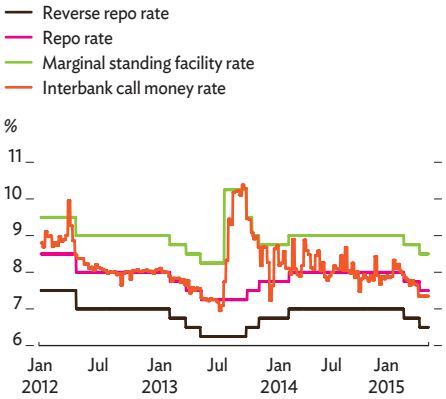
3.17.4 Policy interest rates



Source: Bloomberg (accessed 18 March 2015).

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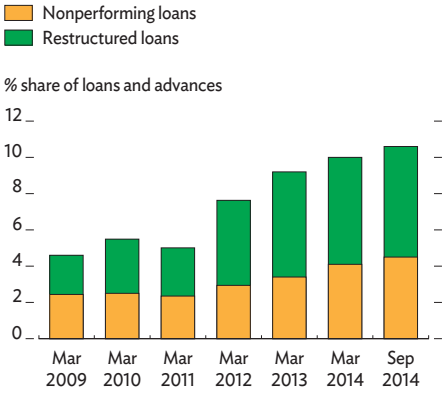
3.17.5 Nonperforming and restructured loans



Source: Reserve Bank of India. http://www.rbi.org.in

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and limited increase in minimum support prices helped contain the subsidy bill, which was 2.1% of GDP.

A commission set up by the government every 5 years to advise on revenue distribution between the center and the states, as well as among the states, has recommended increasing the share of tax devolved from the center to the states from the current 32% to 42%. It advises local bodies and states to explore municipal bonds for funding infrastructure. With a view to facilitating the introduction of the uniform goods and services tax, the commission recommended a tapering compensation package for the states for 5 years to reimburse their lost revenues.

After moderating to 1.7% of GDP in FY2013 from record highs in the previous 2 years, the current account deficit is estimated to have narrowed further to 1.5% of GDP in FY2014 (Figure 3.17.6). The improvement largely reflected a reduced trade deficit in FY2014 as imports grew by only 2.0%. Oil imports, which account for nearly one-third of all imports, declined by about 15% as global prices fell sharply. The relaxation of restrictions on gold imports imposed in FY2013 spurred gold import growth over the previous year, which was more than offset by the decline in oil imports.

Export growth moderated to 2.3% in FY2014. The double-digit growth witnessed in the first quarter slowed considerably in subsequent months, tracking slowdowns in the People's Republic of China and the European Union that cramped external demand, and declining oil prices because they affected exports of refined petroleum products. Higher services exports and a slight increase in remittances helped to narrow the current account deficit.

A decisive election result, improved fiscal and current account deficits, and some movement toward resolving structural bottlenecks buoyed investor sentiment and foreign capital inflows. Net portfolio investment inflow recovered strongly to over $35 billion in FY2014, after being unusually low in FY2013. Foreign direct investment revived on improved growth prospects, while low interest rates in advanced economies aided external commercial borrowings.

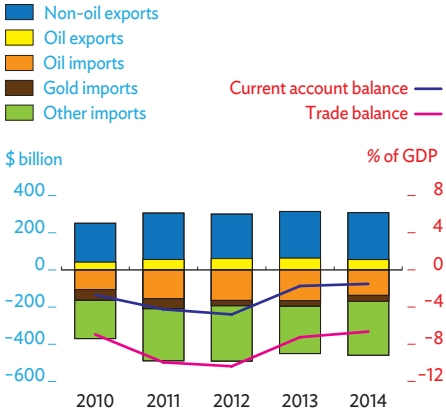
An improved current account deficit and boisterous capital flows helped reserves increase by $33 billion in FY2014 to over $337 billion (Figure 3.17.7). Despite the rise in reserves, import cover continues to be well short of historical norms.

The healthy external position was reflected in exchange rate developments. The Indian rupee remained within a narrow range against the US dollar during FY2014, compared with depreciation of 7.0% and 9.0% in the previous 2 years (Figure 3.17.8).

Economic prospects

A further pickup in economic growth would be contingent on accelerated investment. Prospects look promising at this stage, though significant challenges remain. Policy momentum toward addressing structural bottlenecks that hampered the investment climate is likely to provide a fillip to the investment cycle. Investor sentiment should improve with government measures to remove bottlenecks to investment: expediting environment and forest clearances, easing land

3.17.6 Trade and current account indicators



Source: CEIC Data Company (accessed 13 March 2015).
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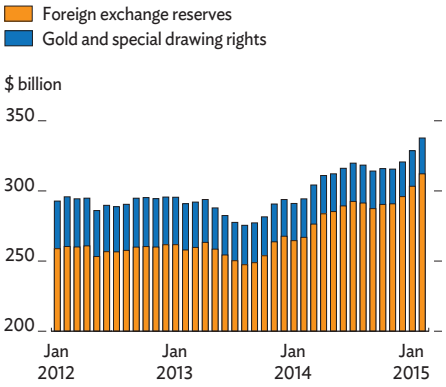
3.17.7 International reserves



Source: CEIC Data Company (accessed 12 March 2015).
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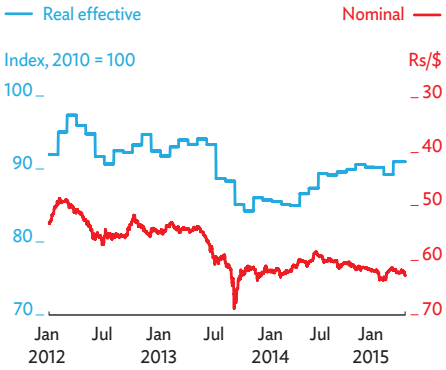
3.17.8 Exchange rate



Source: Bloomberg (accessed 12 March 2015).
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acquisition for building infrastructure and industrial corridors, allowing the auction of coal mines to the private sector, and easing the burden of compliance with labor laws for small and medium-sized enterprises. While these measures show the government's commitment to pushing through reforms, some have been introduced through executive orders and will become void without legislative ratification within the stipulated time frame. This leaves uncertainty for investors.

The Project Monitoring Group set up by the cabinet in mid-2013 to facilitate clearances for large infrastructure projects has cleared projects worth $105 billion, equal to 4.8% of GDP. This has helped to revive some stalled projects. According to the data from the Centre for Monitoring Indian Economy, announcements of new projects in the year ending in December 2014 reached their highest level since 2011 (Figure 3.17.9).

Industry is likely to record an uptick in growth. Mining clearances and auctions of coal mines will provide a fillip to mining and electricity generation. Manufacturing will receive a boost from the government's flagship Make in India program, which aims to induce businesses around the world to invest in manufacturing by providing infrastructure and streamlining regulations. A benign inflation outlook would serve to help monetary policy support growth.

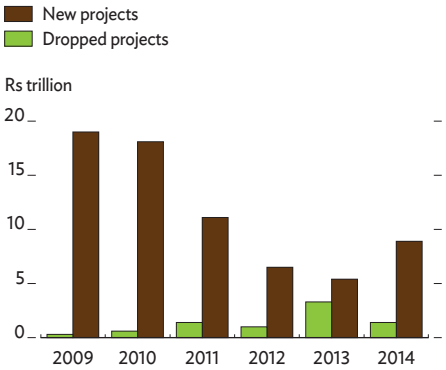
The HSBC India manufacturing purchasing managers' index rose in December 2014 to its highest in over 2 years before slipping a bit in January and February 2015 (Figure 3.17.10). Current indicators such as output, and forward indicators including domestic and export orders, have both improved over previous months. Despite some weakening in the most recent quarter ending December 2014, the central bank's business expectation index continues to be at its highest in the past 2 years, indicating improved sentiment on production and exports (Figure 3.17.11).

A pickup in growth in the advanced economies would provide a boost to tradable services like finance, software design, and business services. The HSBC India services index revealed expansion for the ninth consecutive month in January 2015, helped by sustained growth in new business.

On balance, GDP growth is expected to accelerate to 7.8% in FY2015 on improved performance in both industry and services as policy addresses structural bottlenecks and external demand improves. Growth is expected to edge up further to 8.2% in FY2016, helped by a supportive monetary policy in 2015 as inflation continues to trend lower and by a pickup in capital expenditure.

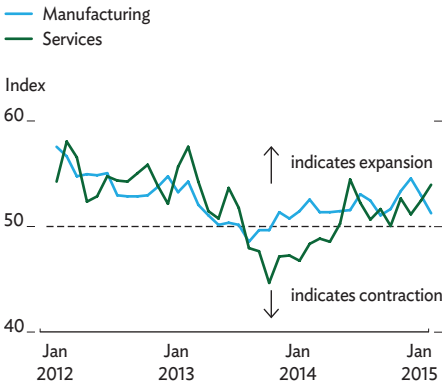
Consumer inflation is expected to decline further to 5.0% in FY2015 as inflation is restrained by muted hikes in rural wages and minimum support prices and by the government's offloading of excess stocks. With control on gas and diesel prices lifted, domestic fuel inflation will be largely determined by global oil price movements. The expectation that the price will be about $65 per barrel in 2015 bodes well for fuel inflation. After rising by double-digits for nearly 5 years, inflation expectations of households dropped to around 9% in December 2014. This would help moderate core inflation. Inflation is likely to pick up marginally to 5.5% in FY2016 as global oil prices firm and improved economic prospects lift demand.

3.17.9 New investment projects and investment projects dropped



Note: Years are fiscal years ending on 31 March of the next year.
Source: Centre for Monitoring Indian Economy.
Click here for figure data

3.17.10 Purchasing managers' indexes



Source: Bloomberg (accessed 12 March 2015).
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3.17.1 Selected economic indicators (%)

	2015	2016
GDP growth	7.8	8.2
Inflation	5.0	5.5
Current account balance (share of GDP)	–1.1	–1.5

Source: ADB estimates.

With consumer inflation likely to remain within the central bank's target band, and with a move toward fiscal consolidation outlined in the budget, policy rates are likely to be cut a bit more in FY2015. However, aggressive interest rate cuts are unlikely with a new monetary policy framework focused more on inflation and an uptick in the growth rate closing the output gap. The framework should improve coordination between monetary and fiscal policy.

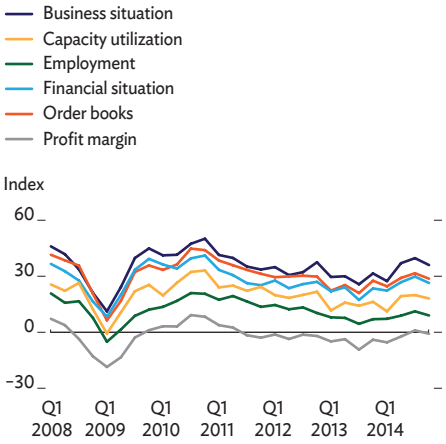
The government set a fiscal deficit equal to 3.9% of GDP for FY2015, pushing back the medium-term fiscal deficit target of 3.0% by a year to FY2017 (Figure 3.17.12). The adjustment allows additional spending that will fund larger infrastructure investment. At the same time, the limited decline in the revenue deficit from 2.9% in FY2014 to 2.8% in FY2015 continues to be a matter of concern. Tax revenue is projected to grow at 15.8%, helped by hikes in rates for customs duty and excise and service taxes. However, a larger outgo to the states will mean only marginal growth in tax revenue for the center. The disinvestment target of 0.5% of GDP could be on the ambitious side, given the failure of the government to meet the FY2014 target despite a buoyant stock market.

The expenditure mix is expected to improve significantly, with capital expenditure growing by a robust 25.5%, well above 3.2% growth for current expenditure. This bodes well for capital expenditure, which in FY2014 fell to 1.5% of GDP, the lowest in more than a decade. Government investment in infrastructure for energy, transport, and industry is projected to rise by 25% and renew the investment cycle. While the share of subsidies as a percentage of GDP is expected to fall from 2.1% in FY2014 to 1.7% in FY2015, the decline is largely from lower fuel subsidies allowed by lower global oil prices and from leakage plugged through cash transfers. Fertilizer and food subsidies remain elevated, with no clear roadmap to prune them or improve their targeting.

With global oil prices expected to be about 35% lower in 2015 than in the previous year, oil imports are expected to significantly contract in FY2015. In contrast, gold imports are likely to increase with the removal of most of the restrictions imposed in 2013, but their extent will be limited by positive real interest rates, lower inflationary expectations, and reduced incentives to hoard gold. Moreover, higher gold imports will continue to be more than offset by the decline in oil imports. Accelerating economic activity is likely to push up imports other than commodities. On balance, imports are likely to contract by 1.1% in FY2015. Export growth is expected to be at 3.2% as global growth momentum improves and moderating inflation boosts competitiveness. However, lower oil prices will drag down exports of petroleum products. Higher growth prospects in the advanced economies will boost remittance inflows. The current account deficit in FY2015 is expected to equal 1.1% of GDP, significantly less than in FY2014 (Figure 3.17.13).

In FY2016, the current account deficit will expand to 1.5% as recovering oil prices raise oil imports. Rising industry and investment will raise demand for imports other than commodities, bringing overall import growth to 5%. Further growth recovery in the advanced economies would boost exports, and petroleum exports would benefit from higher oil prices. Overall, export growth is likely to inch up to 7%.

3.17.11 Industry outlook survey



Q = quarter.

Notes: Years are fiscal years. Q1 refers to data for April–June.

Source: Reserve Bank of India. http://www.rbi.org.in

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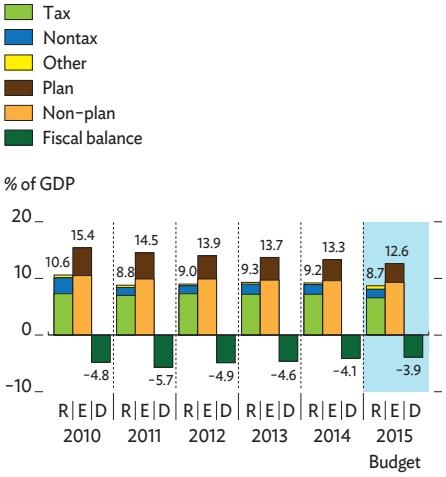
3.17.12 Federal budget indicators



R = revenue, E = expenditure, D = deficit financing.

Note: Years are fiscal years ending on 31 March of the next year.

Source: Ministry of Finance. Union Budget 2014–2015. http://indiabudget.nic.in

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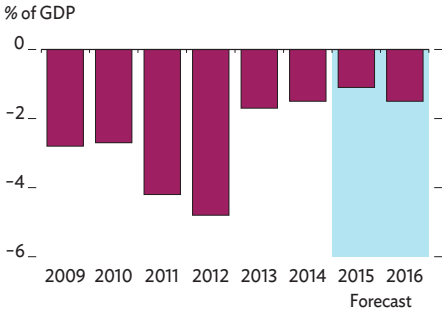
3.17.13 Current account balance



Source: Asian Development Outlook database.

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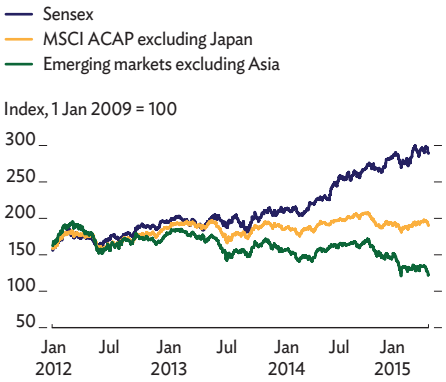
Improved growth prospects and a stable currency will continue to attract portfolio capital inflows. However, with more than 80% of the cap on foreign investment in the bond market already achieved, additional inflows to the bond market would be limited. Investors' optimism about India's growth prospects is readily seen in the increase in portfolio investment, which helped to lift stock prices on the Bombay Stock Exchange Sensex by about 29% in FY2014 (Figure 3.17.14). Net foreign direct investment inflows are likely to increase on better growth prospects, liberalized ceilings in several sectors, and the government's focus on improving the ease of doing business and other enabling policies under the Make in India program. The proportion of the current account deficit that is funded by stable foreign direct investment inflows is thus expected to increase, mitigating the vulnerability associated with volatile capital inflows.

3.17.14 Stock prices



Source: Bloomberg (accessed 12 March 2015).

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Policy challenge—turning cities into engines of growth and job creation

Economic growth, industrialization, and urbanization are intertwined. Greater economic growth enables structural transformation with increased workforce migration from agriculture into more productive industry and services. As these sectors are usually based in cities, industrialization naturally promotes urbanization. Economic growth raises per capita income, prompting people to migrate from rural areas to cities in search of a better standard of living. Thus, cities can act as engines of faster and more inclusive growth through the forward and backward linkages they create through markets, demand for raw materials, and employment.

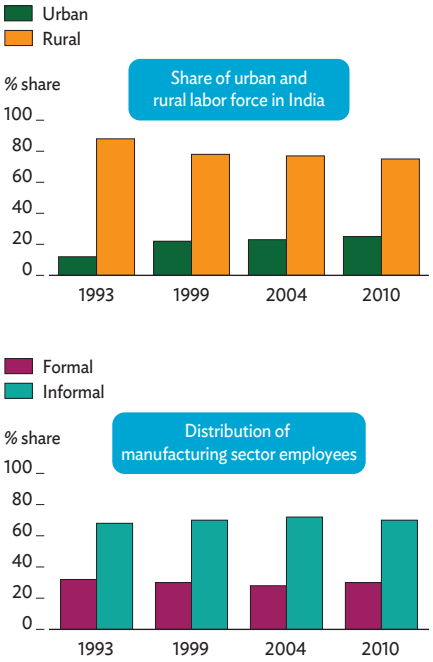
India is urbanizing. The 2011 census found 35% of the population, or about 400 million people, living in urban areas. India is expected to have by 2030 nearly 600 million living in urban areas, which will expand urban areas much faster than ever before. At this juncture, the challenge for policy makers is to prepare cities for their role as promoters of faster and more inclusive growth.

In the last 10 years, the urban share of the workforce has been stagnant at around 25%–30% (Figure 3.17.15). Further, the share of manufacturing in urban employment has been low and largely informal, and almost 75% of the urban population lives on less than $2 per day. These statistics indicate that the potential of urbanization to generate inclusive growth has not been fully realized.

While several factors are responsible for this, one of the most important is the limited synchronization of urban and industrial planning.

Policy makers in India have mostly treated urbanization and industrialization as distinct processes requiring different management systems. Urban development agencies have focused on land-use planning and service provision but not local economic development. Similarly, industrial development agencies have focused on the economics of setting up and operationalizing industrial facilities but paid less attention to urbanization. This has left urban areas with limited industrialization and industrial areas with limited urbanization.

3.17.15 Trends in urbanization and manufacturing employment



Notes: Years are fiscal years ending on 31 March of the next year. The informal sector excludes own-account manufacturing enterprises.

Source: Annual Survey of Industries and National Sample Survey Organization, Ministry of Statistics and Programme Implementation. http:// www.mospi.nic.in

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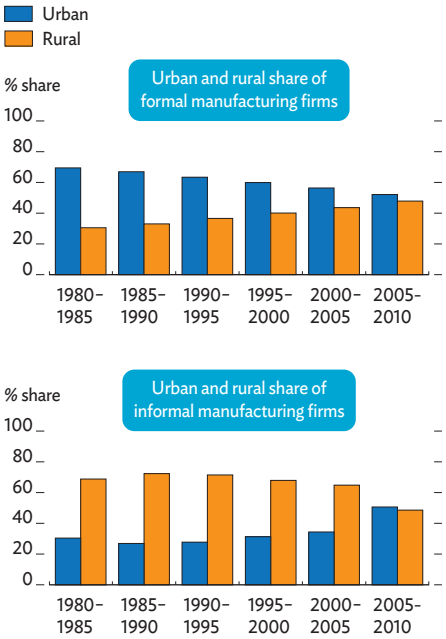
As a result, since the 1980s, industry and especially formal manufacturing have prematurely moved away from cities (Figure 3.17.16). This is because governments have provided incentives for new industries to locate in less-developed areas, polluting industries have been forced to relocate outside of cities, and land has become costly and difficult to consolidate in urban areas partly because of stringent land-use policies. Consequently, migration from rural to urban areas, which usually follows industrialization, has been held back. Much of urban population growth from the 1980s to the 2000s has been from natural increase, not migration.

Further, most of the new industrial locations, unlike existing cities, have only limited support infrastructure and inefficient delivery of urban services. Thus, while industries moved out of cities, a large part of the workforce stayed. The decline of industrial employment in cities has been associated with a rise in skill-intensive service jobs but also with low-productivity informal manufacturing jobs, limiting the scope for translating urbanization into inclusive growth.

If India is to reap the benefits of urbanization, it must synchronize urban and industrial planning to attract industries back to cities. Further, support for infrastructure is needed to realize the full potential of industry and services to create forward and backward linkages and so achieve inclusive growth.

An important step in this direction is the Make in India campaign, under which various government departments are working in close coordination to develop economic corridors. The purpose is to promote the development of industry, especially manufacturing, in and around cities that are engineered to be smart and sustainable, and along transport and freight corridors. The government has announced several measures to develop such corridors, including setting up a national institution to coordinate, integrate, and supervise their development, while improving the ease of doing business through regulatory reform and building trunk infrastructure. The successful implementation of these measures will ensure the creation of cities that are equipped with world-class infrastructure, provide affordable public services, and have a business-friendly climate to attract investments.

3.17.16 Trends in the location and organization of manufacturing firms



Notes: Years are fiscal years ending on 31 March of the next year. The informal sector excludes own-account manufacturing enterprises.

Source: Annual Survey of Industries and National Sample Survey Organization, Ministry of Statistics and Programme Implementation. http://www.mospi.nic.in

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Maldives

Growth accelerated last year on expansion in tourism and an impressive revival in construction. The outlook is for moderately slower growth on less robust gains in tourism from major tourist markets. Higher capital expenditure and the promotion of special economic zones are planned toward raising growth potential. However, high public debt requires improved efforts to reduce recurrent expenditures and keep budget deficits sustainable.

Economic performance

Government data show economic growth to have accelerated to an estimated 6.8% in 2014 from 4.7% in the previous year. Tourism and related transport and communication remained key contributors to growth, while, in contrast with the previous 2 years, construction contributed substantially to expansion (Figure 3.18.1).

Preliminary estimates show that tourism expanded strongly by 6.8%, albeit less than the 9.0% growth recorded in 2013. Growth in tourist arrivals at 7.1% in 2014 was much less robust than the 17.4% seen in the previous year as European economies were sluggish and the People's Republic of China (PRC) experienced a slowdown. Asian tourists now make up 47% of the market of 1.2 million visitors per year, most of them from the PRC. The share from Europe, which used to be the major market, has declined to 44% (Figure 3.18.2).

Transport grew robustly by 11.2% and communication by 9.6%, as reflected by the rapid increase in communication services such as mobile cellular and internet subscriptions. Government services likewise grew on increased social welfare spending and subsidies.

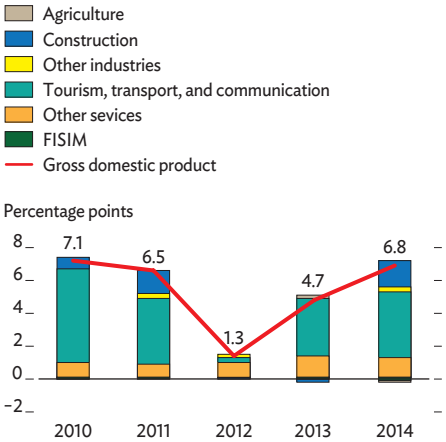
Construction rebounded substantially, by an estimated 20.6%, after a 2.5% contraction in 2013. The bulk of construction is in new resort projects and real estate development, notably on Hulhumalé to help relieve overcrowding in the nearby capital, Malé. Buoyant construction drove up imports of cement, wood, and other construction materials by nearly 30.0%. Bank lending to private construction firms rose accordingly. After growing at 5.1% in 2013, agriculture slowed to 2.1% as the fish catch declined. Fish exports, which account for essentially all domestic exports, fell by 2.8%, compared with 22.1% expansion in 2013.

Average inflation moderated to 2.4% in 2014 from 4.0% in 2013, mainly on declining world commodity and fuel prices as well as weakening domestic fish prices. Monthly inflation throughout the year was low, ranging from 1.1% to 3.5% and trending downward in a seesaw pattern (Figure 3.18.3).

Fiscal policy was expansionary, with total expenditure increasing by 20.6% from 3.5% growth last year. Current expenditure, which makes up

This chapter was written by Sarah Carrington of the South Asia Department, ADB, Manila, and Elbe Aguba, consultant, South Asia Department, ADB, Manila.

3.18.1 Supply-side contributions to growth



FISIM = Financial intermediation services indirectly measured.

Source: Maldives Monetary Authority. 2015. *Monthly Statistics.* February. http://www.mma.gov.mv

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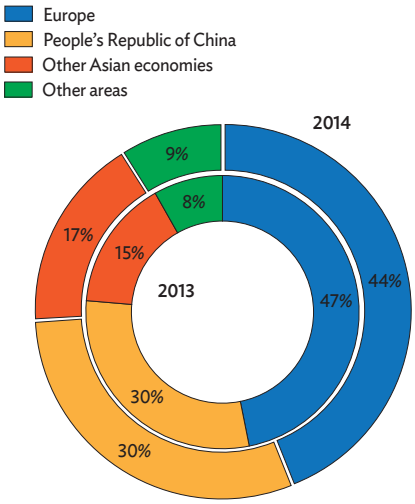
3.18.2 Tourist markets by share of arrivals



Source: Maldives Monetary Authority. 2015. *Monthly Statistics.* February. http://www.mma.gov.mv

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over 80% of total expenditure, rose by 17.1%, largely on increased social welfare benefits, pension payments, and subsidies for food, medicine, electricity. Capital expenditure increased by 40.4% but still comprised only about 18% of the fiscal budget. Revenue and grants grew rapidly by 25.3%, owing mainly to increases in the business profits tax, the tourism goods and service tax, and nontax revenues. Based on reported fiscal data, the budget deficit is estimated to have narrowed to 3.2% of GDP from 3.9% in 2013 (Figure 3.18.4). The International Monetary Fund estimates, however, that the Maldives budget deficit widened to 11.6% of GDP in 2014 from 7.8% in 2013.

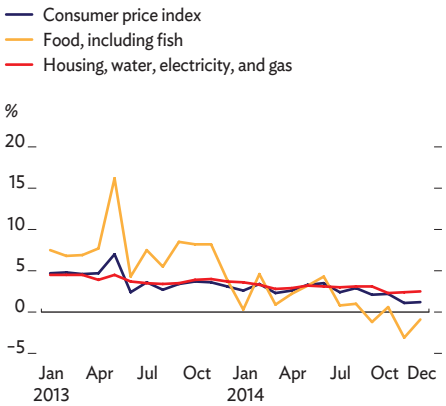
Government financing of the deficit was funded largely through Treasury bills bought primarily by domestic sources, mostly banks and other financial corporations. Total domestic claims on the central government increased from 40.7% of GDP in 2013 to 44.3% in 2014 (Figure 3.18.5). Notably, all outstanding loans granted by the Maldives Monetary Authority (MMA) to the government were retired and replaced with Treasury bonds, which nearly doubled to Rf6.4 billion. External public debt increased by 5.6% to $789.5 million in 2014, amounting to 26.1% of GDP. Total public debt was estimated at 70.4% of GDP at the end of 2014, about 2 percentage points higher than a year earlier.

Monetary stance has been accommodative because inflation is low and credit growth slowing. The MMA has moved to stimulate lending by reducing in February 2014 the minimum reserve requirements for banks from 25% to 20%, halving in September the overnight deposit facility interest rate to 1.5%, and cutting the overnight Lombard policy rate to 10% from 12% (Figure 3.18.6). Despite these efforts, bank lending rates for the private sector stayed elevated, though the rate eased somewhat for public corporations (Figure 3.18.7). The MMA reintroduced in April the fixed-rate tap system for issuing Treasury bills, and the rates were since set at 7.5% for the 28-day bill and 8.0% for the 91-day bill.

Credit to the private sector was depressed by net repayments for most of 2014 but began to pick up in the last quarter and, at year-end, was up slightly by 3.3% as lending for construction and commerce increased while lending for tourism continued to fall (Figure 3.18.8). Growth in credit to the public sector slowed from 12.9% in 2013 to 7.4% in 2014. The large overall balance of payments surplus substantially increased the MMA's net foreign assets, and with open market operations suspended from May, banks' reserves with the MMA expanded by almost half, and with them banks' ability to lend. Growth in broad money eased to 14.7% from 18.4% in 2013.

The current account deficit is estimated to have widened to 9.6% of GDP from 6.5% in 2013 as higher imports outweighed increased tourism receipts (Figure 3.18.9). Merchandise imports rose by 16.8% in 2014, much more than in the previous year, on robust imports of construction materials. This widened the trade deficit to 54.8% of GDP as exports remained small. With capital and financial inflows double those of a year earlier, the overall balance of payments moved to a large surplus estimated at nearly $250 million, and gross international reserves climbed to $614.7 million, sufficient to cover 3.7 months of merchandise imports.

3.18.3 Inflation



Source: National Bureau of Statistics. 2015. *Consumer Price Index*. January. http://www.planning.gov.mv

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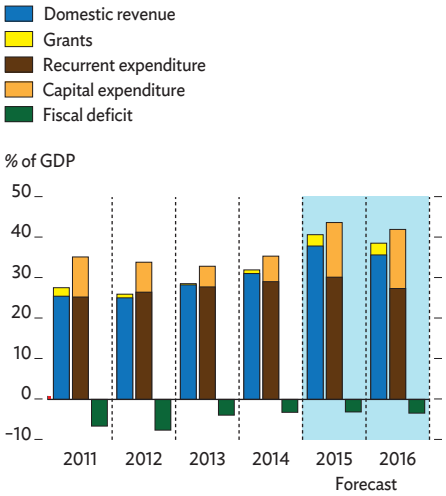
3.18.4 Fiscal indicators



Source: Maldives Monetary Authority. 2015. *Monthly Statistics*. February. http://www.mma.gov.mv

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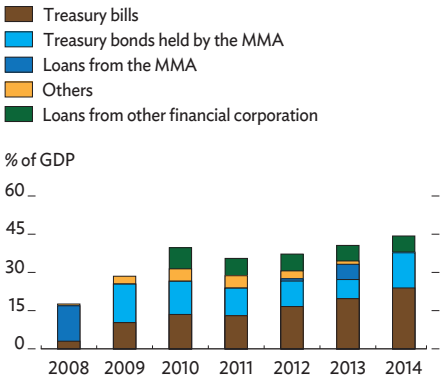
3.18.5 Government domestic debt



MMA = Maldives Monetary Authority.

Source: Maldives Monetary Authority. 2015. *Monthly Statistics*. February. http://www.mma.gov.mv

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Economic prospects

GDP growth is forecast to average 6.3% in 2015 and ease to 5.1% in 2016. Tourism is projected to see growth rebound to 8.3% in 2015 as the government forecasts 13.0% growth in tourist arrivals. The launch of three new flights to the PRC this year and a strengthened promotion campaign support this projection. Tourism expansion will moderate in 2016 in light of the low growth outlook in tourist source economies. Growth in related transport and communication is expected to follow a similar trend. Construction will continue to expand but at a moderate pace of 8.0% in 2015 off the high base in 2014. Construction is expected to grow at a similar rate in 2016 as work gathers pace on government infrastructure and private investments connected with the new special economic zones.

With increased import duties from April 2015 on about 17 goods—including tobacco, alcohol, land vehicles, and construction materials—inflation is projected to accelerate slightly to 3.0% in 2015 before easing back to 2.5% as the base effect weakens and global prices remain low. The trade deficit is expected to narrow substantially over the next 2 years on much slower growth in petroleum products, a major purchase for the Maldives, and other imports whose prices follow petroleum, as well as more moderate growth in construction. Tourism projections inform a forecast that the current account deficit will narrow to just over 6% of GDP.

The government intends to further consolidate finances, reducing the fiscal deficit over the next 2 years to average just over 3% of GDP. New revenue measures include increased import duties, the new green tax of $6 per visitor night, and new leases on 10 islands for resorts. Policy measures to consolidate spending include improved regulation of public sector employment and preparations to better target government subsidies on electricity and food.

A risk to the outlook arises from the arrest in February of the first democratically elected president, who narrowly lost the 2013 contest and became the opposition leader. This may revive violence like that experienced in 2012 as the country heads into parliamentary elections in April.

Policy challenge—developing infrastructure across a dispersed archipelago

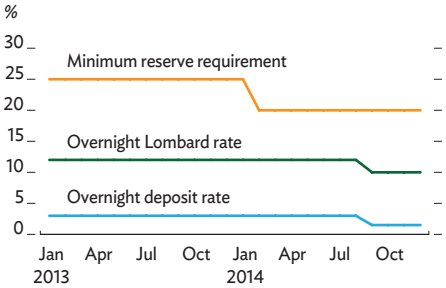
Infrastructure development is essential to diversify the economic base beyond tourism and support sustainable growth in the Maldives. The archipelago's stark vulnerability to climate change further accentuates the importance of investment in infrastructure to enhance productivity growth and the resilience necessary to mitigate the economic volatility likely to accompany climate change. However, the population in the Maldives is small at only 350,000. About a third is concentrated in the capital, Malé, and the rest is thinly dispersed over more than 180 inhabited islands (Figure 3.18.10). Infrastructure investment is costly for lack of economies of scale, raising the cost per capita of inclusive infrastructure investment.

3.18.1 Selected economic indicators (%)

	2015	2016
GDP growth	6.3	5.1
Inflation	3.0	2.5
Current account balance (share of GDP)	−6.3	−6.1

Source: ADB estimates.

3.18.6 Monetary indicators



Source: Maldives Monetary Authority. 2015. *Monthly Statistics*. February. http://www.mma.gov.mv

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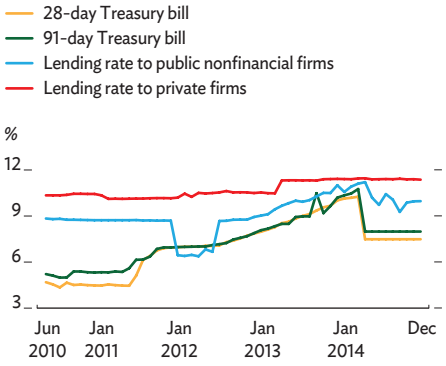
3.18.7 Interest rates



Source: Maldives Monetary Authority. 2015. *Monthly Statistics*. February. http://www.mma.gov.mv

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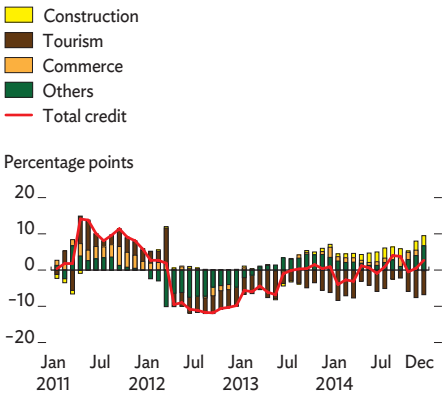
3.18.8 Contributions to credit growth



Source: Maldives Monetary Authority. 2015. *Monthly Statistics*. February. http://www.mma.gov.mv

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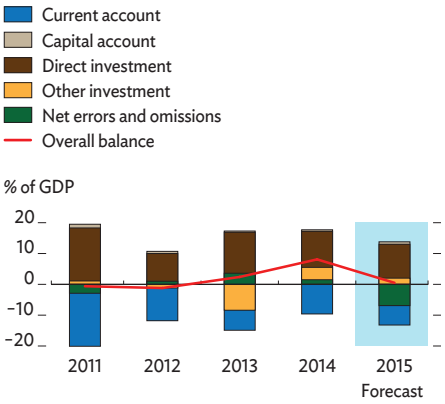
The current infrastructure gap is inequitable. Although virtually all Maldivians have electricity, diesel-fuelled generation is expensive. Diesel imports, mostly for power generation, cost around $300 million in 2013. Despite significant government subsidization of diesel at over 8%, difficult transport keeps supply unreliable, particularly in the outer islands. Renewable energy production is thus a priority of the government, which aims to become carbon neutral by 2020. To this end, local solar and wind generator projects are being developed.

Difficult fuel supply also drives up the cost of transport and freshwater. Sea transport remains the sole mode of transport between most islands. As transport uses diesel, services to outer islands are expensive and irregular. Limited access to safe water on the outer islands was exacerbated by the devastating tsunami of 2004, which damaged water-supply infrastructure and contaminated groundwater supplies. Many islands turned to diesel-operated desalination, which is effective but more costly than tapping groundwater.

Recognized the archipelago's infrastructure deficit, the government nearly doubled the budget of the Public Sector Investment Program in 2015 to Rf6.3 billion from Rf3.5 billion last year. This is to fund water supply and harbor projects, electricity generation, airport upgrading, and sewage and waste collection systems. Inevitably, however, not all desirable investments will be financially feasible, so careful cost–benefit analysis is required to select the best investments. Proposals to consolidate the Maldivian population on fewer islands aim to address the financial constraints and enable more equitable access to infrastructure and greater growth opportunities for all. However, the benefits to such consolidation need to be carefully weighed against social costs through appropriate, broad-based consultation.

3.18.9 Balance of payments



Source: Maldives Monetary Authority. 2015. *Monthly Statistics*. February. http://www.mma.gov.mv

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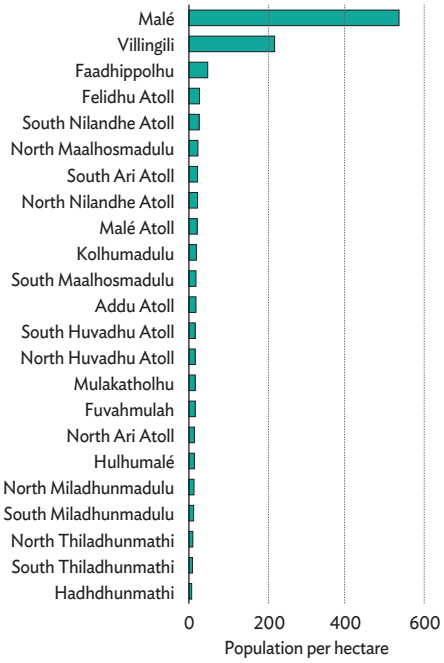
3.18.10 Population density



Source: National Bureau of Statistics. http://www.planning.gov.mv

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Nepal

Robust agriculture and remittances boosted growth and the current account surplus. Growth is expected to slow this year with an unfavorable monsoon but revive in 2016 as the weather returns to normal. Concluding the protracted negotiations over the new constitution would strengthen the outlook. Nepal can leave behind dependence on agriculture and remittances for an economy with a higher growth trajectory if it invests more in eliminating major deficiencies in infrastructure.

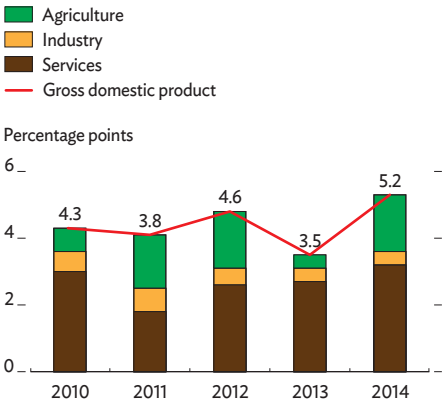
Economic performance

GDP growth accelerated to 5.2% in FY2014 (ended 15 July 2014) from 3.5% a year earlier. A favorable monsoon boosted agricultural output and a marked increase in remittance income, now amounting to 28.2% of GDP, bolstered spending on services, which accounts for over half of GDP (Figure 3.19.1). Growth in agriculture, at 4.7%, and in services, at 6.1%, was the highest in the last 6 years. Industry again advanced only marginally at 2.7%, as long hours of power outages and other supply-side constraints continued to stunt manufacturing and divert to imports consumer spending on finished goods.

Inflation stayed high at an average of 9.1% in FY2014, moderating little from 9.9% a year earlier as stubbornly rising food prices offset gains from falling prices for other expenditures (Figure 3.19.2). Despite a better harvest, food price inflation averaged 11.6%, up from 8.6% a year earlier, as transport costs rose, supply-side bottlenecks persisted, and food inflation worsened in India, an important supplier. In the first half of FY2015, year-on-year inflation fell to 6.8% by January 2015, reflecting several downward adjustments to domestic fuel prices that have helped to ease nonfood inflation, though food inflation remains elevated.

Despite the timely adoption of the FY2014 budget, actual expenditure amounted to just 82.4% of budget allocations, which held spending to 20.9% of GDP, only slightly improved from the previous year's depressed level. Budget execution shortfalls reflect long-standing procedural and procurement inefficiencies that constrain investment spending and development. Higher tax collections from a surge in imports and efficiency gains in revenue administration allowed revenue, including grants, to expand by 21.3%, pushing it to a record 20.8% of GDP. The budget balance turned to a deficit of 0.1% of GDP, much less than the target deficit of 2.4%, but an improvement on the unintended surplus in the previous year (Figure 3.19.3).

3.19.1 Supply-side contributions to growth



Note: Years are fiscal years ending on 15 July of that year.
Source: Central Bureau of Statistics. 2014. *National Accounts of Nepal 2013/14.* http://cbs.gov.np/
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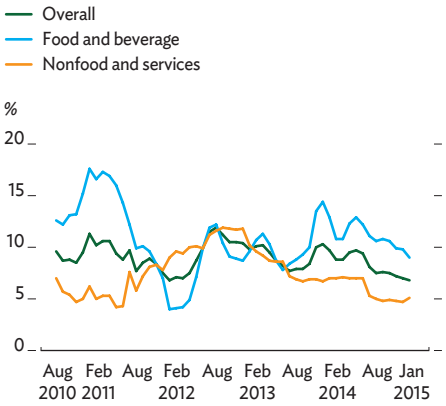
3.19.2 Monthly inflation



Source: Nepal Rastra Bank. 2015. *Recent Macroeconomic Situation.* http://www.nrb.org.np
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This chapter was written by Chandan Sapkota of the Nepal Resident Mission, ADB, Kathmandu.

Monetary conditions remained highly accommodative in FY2014. The increase in remittance inflows boosted deposits and bank liquidity, and financial institutions struggled to find bankable projects immediately ready for investment. The interbank rate hovered at close to zero, and weighted average rates for deposits and loans continued to ease, leaving real lending rates positive and deposit rates negative (Figure 3.19.4). Growth in credit to the private sector was, at 18.3%, more contained than the 20.2% expansion recorded in FY2013 (Figure 3.19.5). While the central bank has sought to channel credit to productive investment and so foster growth, monetary policy cannot compensate for inadequate infrastructure, political uncertainty, and other supply-side constraints that inhibit productive business activity.

The current account surplus expanded to 4.7% of GDP on large remittance inflows despite an ever-widening trade deficit (Figure 3.19.6). Exports reversed a decline in FY2013 to increase by 5.1% with the help of a marked deprecation of the Nepalese rupee, which is pegged to the Indian currency. Imports grew by 13.9%, mainly because imports other than oil expanded sharply as disposable income rose, though imports of petroleum products, about 20% of the total, also recorded a double-digit increase. The trade deficit widened to 30.9% of GDP. Remittance inflows grew by 11.9%, reaching a record 28.2% of GDP. The balance of payments surplus climbed to $1.3 billion, and gross foreign exchange reserves hit $6.9 billion, equivalent to 10.2 months of imports of goods and services (Figure 3.19.7).

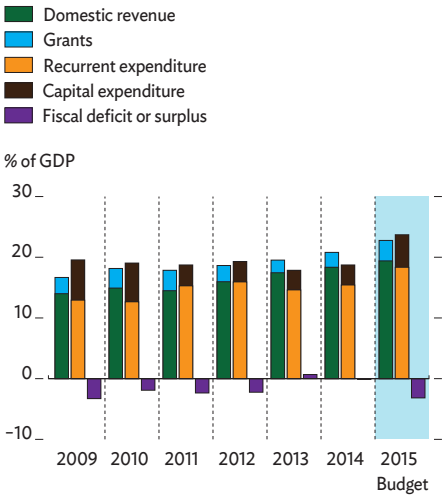
Economic prospects

The economic outlook is less favorable than in FY2014 because agricultural output is crimped by a weak monsoon and the political situation is fluid. The Constituent Assembly, the second of which was elected in November 2013, failed again to write a new constitution, this time by the 22 January 2015 deadline agreed by all political parties. There is yet no unanimity among the political parties on how to proceed. Many of the outstanding issues that the earlier Constituent Assembly failed to resolve remain contentious, leaving uncertainty over the future course of politics regarding such basic matters as the number, names, and functions of proposed federal states, as well as on the overall structure of governance.

The weak monsoon and such natural disasters as floods and landslides will affect the output of paddy, maize, and millet. Industry may see better conditions in the medium term following the government's strong commitment under the FY2015 budget to ease business regulations by introducing updated policies and legislation, though a downside risk is that the unsettled political environment will derail legislative action. Nevertheless, news from the power sector bolstered business and investor confidence. The government concluded project development agreements in the first half of FY2015 for two 900-megawatt hydroelectricity projects promoted by Indian investors.

Considering the unfavorable monsoon and the lingering political uncertainty, GDP growth is projected to slow to 4.6% in FY2015, less than the government's revised target of 5.0%. The Ministry of

3.19.3 Fiscal indicators



Note: Years are fiscal years ending on 15 July of that year.
Source: Ministry of Finance. Budget Speech 2015.
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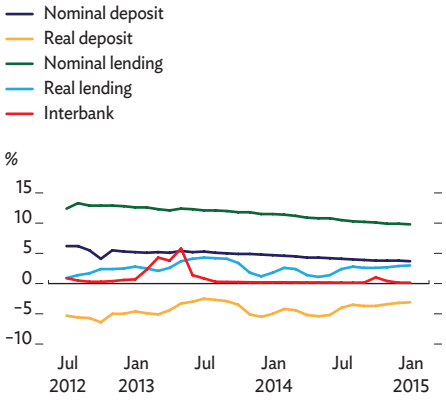
3.19.4 Commercial banks' weighted average rates



Source: Nepal Rastra Bank. 2015. *Recent Macroeconomic Situation.* http://www.nrb.org.np
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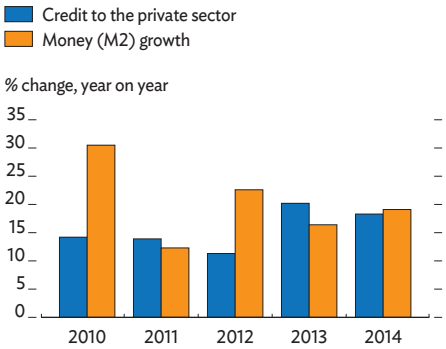
3.19.5 Credit to the private sector and money growth



Note: Years are fiscal years ending on 15 July of that year.
Source: Nepal Rastra Bank. 2015. *Recent Macroeconomic Situation.* http://www.nrb.org.np
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Agricultural Development projects paddy output to drop by 5.1%, and maize by 6.0%. Almost half of growth will come from services, particularly robust growth in wholesale and retail trade, tourism, and transport and communications. The reform-oriented budget calls for higher capital expenditure and for total planned spending to increase to 23.7% of GDP, up by 5 percentage points. This should help to underpin growth, especially in construction, even if capital spending falls modestly short. Assuming a stable political situation, a normal monsoon, a timely budget and its effective execution, and strong remittance inflows, GDP growth is expected to rebound to 5.1% in FY2016.

Despite the expected agricultural shortfall—and an increase in civil service salaries and allowances for a second consecutive year—average inflation is expected to continue to slow to 7.7%, lower than the target set by the central bank in its 2015 monetary policy, as neighboring India experiences markedly lower inflation and the drop in international oil prices passes through as lower administered fuel prices. Food inflation is expected to ease somewhat but will remain elevated owing to the smaller domestic harvest. Inflation is projected to edge lower in FY2016 to 7.3% on a better harvest, broadly stable oil and commodity prices, and central bank's progress in efforts to rein in excess bank liquidity.

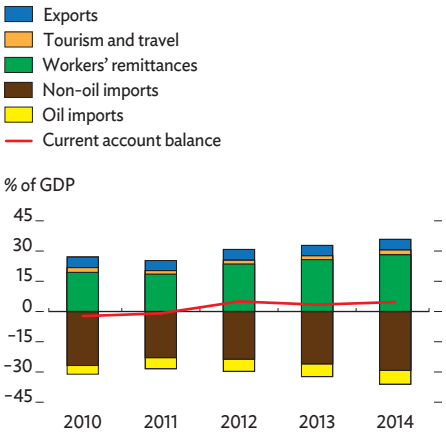
The external position is expected to weaken in FY2015 with lower surpluses in the current account and the overall balance of payments. Although export growth is expected to stay at 5.0% and import growth to slow to 10.0% on lower prices for petroleum imports, the improvement in the trade deficit will likely be offset by some slowing in remittance inflows, narrowing the current account surplus to 2.7% of GDP. A pickup in export growth, strong remittance inflows and tourism receipts, and continued low global oil prices are expected to boost the current account surplus to 3.5% of GDP in FY2016.

Policy challenge—accelerating capital expenditure

Capital spending has been persistently weak, with both planned and actual spending languishing far below what is required to close the infrastructure deficit, which has been estimated to require capital spending equal to between 8.2% and 11.8% of GDP per year until 2020 (Figure 3.19.8). Raising the amount and quality of capital expenditure is one of the country's most pressing challenges. Accelerated capital spending is needed to scale up infrastructure investments and thereby attract the private investment needed for Nepal to attain higher economic growth that is both sustainable and inclusive.

In its provision and quality of infrastructure, Nepal is rated one of the least competitive countries in the world, ranked 132 of 147 (Figure 3.19.9). Disaggregating aspects of infrastructure, Nepal's ranking on the quality of electricity supply is 136, on air transport infrastructure 129, and on roads 115. These dismal figures indicate that Nepal needs more and better investment to foster innovation, make the economy competitive, and enhance the efficiency of markets for goods, labor, and finance. Gross fixed capital investment has to be raised to at least 30% of GDP from the current 22% to support higher economic growth. Higher public capital spending is crucial, as it is the catalyst for private capital investment.

3.19.6 Current account indicators



Note: Years are fiscal years ending on 15 July of that year.

Source: Nepal Rastra Bank. 2015. *Recent Macroeconomic Situation.* http://www.nrb.org.np

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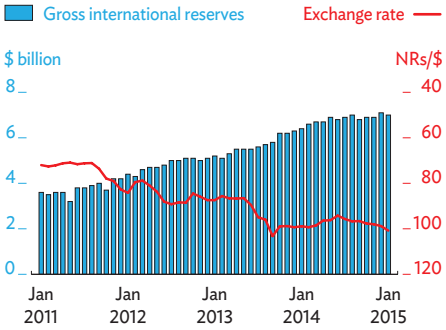
3.19.7 Gross international reserves and exchange rate



Source: Nepal Rastra Bank. 2015. *Recent Macroeconomic Situation.* http://www.nrb.org.np

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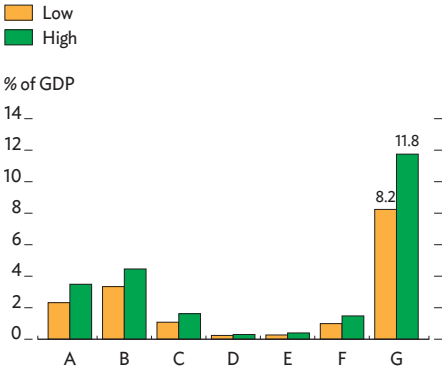
3.19.8 Investment required to close infrastructure gap
(% of GDP per year, 2011–2020)



A = transport, B = electricity, C = water supply and sanitation, D = solid waste management, E = telecom, F = irrigation, G = total.

Source: Andres, L., D. Biller, and M. Herrera Dappe. 2013. *Reducing Poverty by Closing South Asia's Infrastructure Gap.* World Bank. http://www.worldbank.org

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Capital spending comprises government spending on, among other things, land, buildings, furniture and fittings, civil works, vehicles, and plant and machinery. The average planned capital expenditure in the past 4 years was 5.6% of GDP, but actual spending averaged just 3.3% (Figure 3.19.10). Given Nepal's huge infrastructure financing needs, budgeted capital spending is insufficient in itself to bridge the infrastructure deficit in such critical sectors as energy, transport, water supply and sanitation, irrigation, and telecommunications. The government's recent commitment to meet certain infrastructure needs by developing public–private partnerships is an encouraging sign that the gap can be closed. A worrying observation, though, is that project spending has averaged only 71% of budgeted allocations in the past decade, indicating that the government is unable to fully disburse allocated funds on time.

Efficient budget execution has been hampered by bureaucratic hassles over project approval and by such structural issues as the limited capacity of line ministries to prepare a pipeline of projects ready to implement. That projects are included in the budget despite lack of readiness has left large sums of money unspent at the end of each fiscal year. A project will face many problems in execution if it is launched without detailed design, clarity about land acquisition, project offices properly established and staffed with the required personnel, and detailed procurement plans. Further, delays affecting government ministries' project approval and budget release, and inherent weaknesses in procurement processes and contractors' capacity and construction management, have hobbled implementation. Finally, the desired acceleration of capital spending has been hampered by political interference and by frequent staff turnover that weaken project planning and implementation capacity.

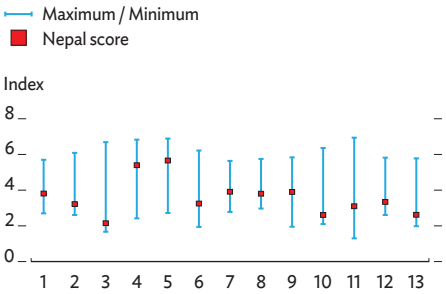
The government recently reached a number of decisions to tackle these challenges. It resolved to abolish or shorten some of the processes required for project approval at the National Planning Commission, require the advance submission of procurement plans for projects seeking approval, and provide better mechanisms for planning and monitoring projects to troubleshoot in a more effective and timely way critical issues that slow project implementation. The government is amending the existing Public Procurement Act to remove legislative hurdles for accelerated project implementation. Essential to boosting the quality and quantity of capital spending are prudent public finance management, better interministerial coordination, the elimination of political interference, better qualified staff for project offices and lower turnover, careful planning and preparation, sound construction management, and more diligent project monitoring.

3.19.1 Selected economic indicators (%)

	2015	2016
GDP growth	4.6	5.1
Inflation	7.7	7.3
Current account balance (share of GDP)	2.7	3.5

Source: ADB estimates.

3.19.9 Global Competitiveness Index 2014–2015



1 = Global Competitiveness Index 2014–2015, 2 = institutions, 3 = infrastructure, 4 = macroeconomic environment, 5 = health and primary education, 6 = higher education and training, 7 = goods market efficiency, 8 = labor market efficiency, 9 = financial market development, 10 = technological readiness, 11 = market size, 12 = business sophistication, 13 = innovation.

Source: World Economic Forum. *The Global Competitiveness Report 2014–2015.*

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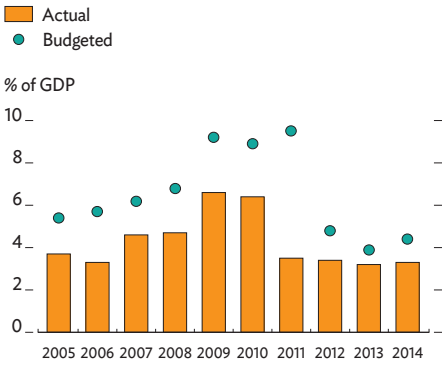
3.19.10 Budgeted and actual capital spending



Notes: Years are fiscal years ending on 15 July of that year. Changed report system to Government Finance Statistics (GFS) 2001 in FY2012. In FY2011, actual reporting was done based on GFS 2001, but budget allocation was done based on earlier GFS.

Sources: Central Bureau of Statistics. http://cbs.gov.np/; Ministry of Finance. Budget speech (various years).

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Pakistan

Government policies narrow the budget deficit, rebuild depleted exchange reserves, and raise growth modestly despite large energy deficits. The outlook is for moderate growth, lower inflation, and a stable external position underpinned by low oil prices and stronger growth in the advanced economies. These projections assume further progress in the government's extensive program of macroeconomic and structural reform, as well as manageable political and security challenges.

Economic performance

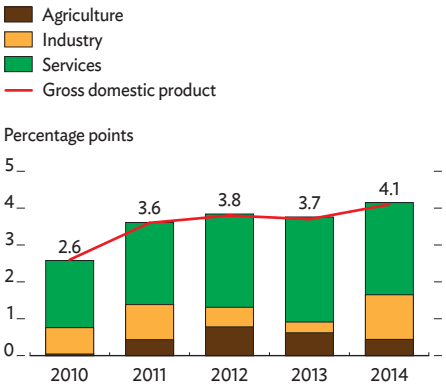
A strong revival in construction and steady expansion in manufacturing and services edged GDP growth up to a provisional estimate of 4.1% in FY2014 (ended 30 June 2014) from 3.7% in the previous year (Figure 3.20.1). Agriculture growth decelerated to 2.1% as a fall in the production of minor crops and slow growth in livestock offset rising output in most major crops.

Construction expanded in double digits on larger government development expenditure, providing most of the lift to industry. Large-scale manufacturing, which contributes 80% of manufacturing output, grew by 3.9% in FY2014, little changed from FY2013. Energy shortages continued to suppress manufacturing output despite efforts to improve energy supply and management. Textiles (21% of manufacturing), food, petroleum products, automobiles, and cement expanded at a slightly slower pace, but leather products saw strong gains, as did fertilizer with improved supply of natural gas for the sector. Expansion in services, which comprise nearly 60% of GDP, slowed to 4.3% in FY2014 from 4.9% in the previous year. Weaker growth in transport and government services offset rapid growth in wholesale and retail trade.

Increased remittances and likely growth in rural and small business income markedly boosted private consumption expenditure and, with government consumption, essentially accounted for all the rise in domestic demand (Figure 3.20.2). Investment remained stagnant and contributed only 0.2 percentage points to GDP growth despite improved credit to the private sector. Fixed investment as a share of GDP declined from 12.6% to 12.4% in FY2014. Net exports turned negative, reflecting higher import growth.

Headline inflation rose to 8.6% in FY2014 from 7.4% the year before. The surge was led by food price acceleration reflecting short supply, rising utility prices, and an increase in the general sales tax by 1 percentage point. The depreciation of the Pakistan rupee against the US dollar raised prices for imports. To control inflation, the State Bank

3.20.1 Supply-side contributions to growth



Note: Years are fiscal years ending on 30 June of that year.
Source: Ministry of Finance. *Pakistan Economic Survey 2013–2014.* http://www.finance.gov.pk
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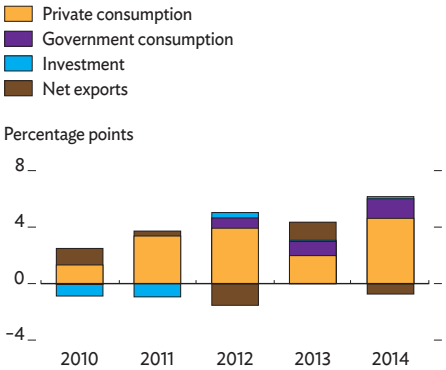
3.20.2 Demand-side contributions to growth



Note: Years are fiscal years ending on 30 June of that year.
Source: Ministry of Finance. *Pakistan Economic Survey 2013–2014.* http://www.finance.gov.pk
Click here for figure data

This chapter was written by Sharad Bhandari and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

of Pakistan, the central bank, raised its policy rate by 50 basis points in September and again in November 2013, to 10%.

The consolidated budget deficit narrowed to 5.5% from 8.2% in FY2013 (Figure 3.20.3). Revenues rose by 22% with strong growth for the second year in a row in nontax revenues, reflecting sharp increases in central bank profits, inflows under the Coalition Support Fund and the Pakistan Development Fund, proceeds from the auction of 3G/4G spectrum licenses, and the utilization of the Universal Support Fund. Despite 16.7% growth in tax collection by the Federal Board of Revenue, the target set in the budget was missed, as in previous years. Improving the low ratio of tax to GDP (10.1% in FY2014) continues to be a key policy challenge.

Total expenditure grew by 9.2% in FY2014 over the previous year as provincial expenditure fell short and subsidies declined. Subsidies contracted by 16.8% in FY2014 as those to the power sector were contained by an increase in electricity tariffs. Subsidies still remained above the budget target, totaling PRs309 billion or 1.2% of GDP. The exclusion of power sector arrears for FY2014, estimated at 0.9% of GDP, helped lower accounted expenditures. Interest payments and defense expenditures each increased by over 15%. Consolidated development spending expanded by 46.2%, reflecting an enlarged public sector development program, but spending was below target by 14.4%.

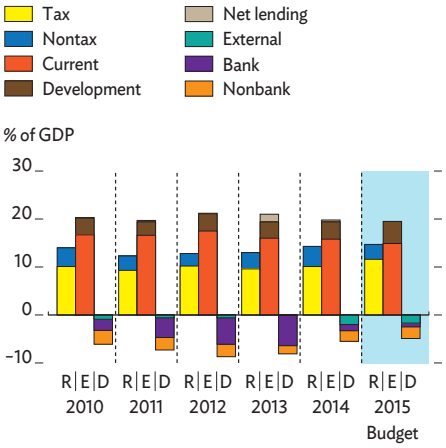
The smaller budget deficit was financed with large foreign inflows in the second half of FY2014. Government borrowing from domestic banks fell significantly to PRs323 billion from PRs1.4 trillion in the previous year (Figure 3.20.4). This left funds for better provision of credit to private firms in food, textiles, telecoms, and energy for working capital, fixed investment, and trade finance—allowing credit to the private sector to balloon to PRs298 billion from PRs17 billion in FY2013. Consumer financing doubled in FY2014 from a small base.

Public debt decreased as a share of GDP by 0.6 percentage points to 64.8% in FY2014 (Figure 2.20.5). The government's domestic debt stock increased only marginally, by 0.4 percentage points to 43.2% of GDP. The maturity profile of domestic debt improved with an increased share of long-term debt largely comprising 3-year investment bonds. Public external debt and liabilities increased to 22.1% of GDP from 21.9% in FY2013. To guide policy, the government produced the country's first medium-term debt-management strategy, which assesses different financing strategies and their associated costs and risks under alternative scenarios for interest and exchange rates.

The current account deficit widened slightly to 1.3% of GDP in FY2014 from 1.1% a year earlier as import growth picked up while exports rose only modestly. Remittances were robust, growing at 13.7%. The services deficit widened because Coalition Support Fund inflows fell to $1.0 billion from $1.8 billion in FY2013. Financing the current account deficit were strong foreign inflows through eurobond placements, the one-off receipt of a $1.5 billion external grant, the sale of 3G/4G spectrum licenses, and disbursements by multilateral agencies.

Reflecting the large external inflows, net foreign exchange reserves rose to $9.1 billion at the end of June 2014, and the Pakistan rupee, which had come under depreciating pressure during the first half of

3.20.3 Fiscal performance



R = revenue, E = expenditure, D = deficit financing.

Notes: Years are fiscal years ending on 30 June of that year. Data refer to consolidated federal and provincial governments. Net lending includes statistical discrepancy. Nonbank includes privatization proceeds.

Source: Ministry of Finance. *Pakistan Economic Survey 2013–2014.* http://www.finance.gov.pk

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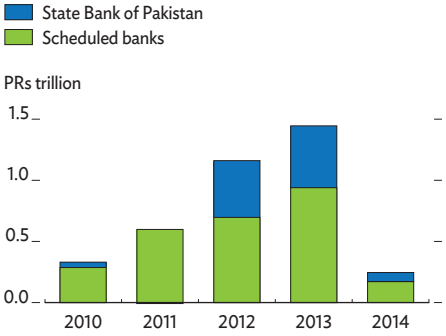
3.20.4 Budget borrowing from banks



Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 6 March 2015).

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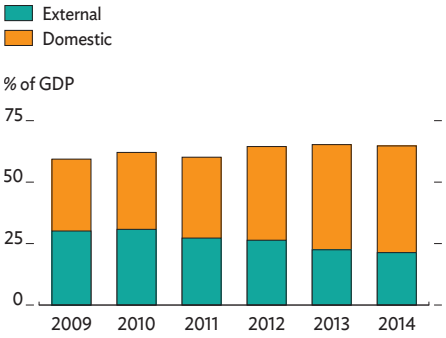
3.20.5 Public debt



Source: State Bank of Pakistan, Economic Data (accessed 9 February 2015).

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FY2014, rebounded to PRs98.9 to the US dollar in the last quarter, for overall appreciation of 0.9% in FY2014. Appreciation in real effective terms was by 5.6%, with likely adverse implications for export competitiveness.

Economic prospects

GDP growth is projected at 4.2% in FY2015 and 4.5% in FY2016, underpinned by low international oil prices and the expected uptick in economic growth in advanced economies. The projections assume steady progress in macroeconomic and structural reforms, manageable political and security challenges, and normal weather. Growth in FY2016 could be higher if economic reform proceeds at a faster pace. The government has made some progress in implementing macroeconomic and structural reforms to strengthen its fiscal position, alleviate energy shortages, and restructure and privatize loss-making public enterprises. However, progress remains slow in a challenging political and security environment.

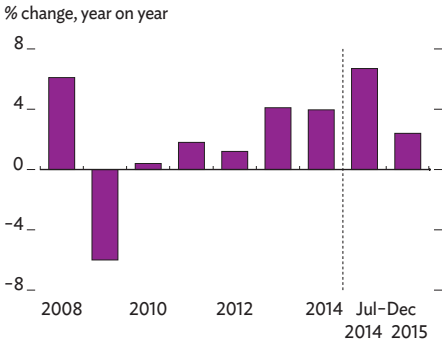
Weak preliminary results for some major crops are expected to limit any rebound in agriculture in FY2015. Lower prices will likely suppress sugarcane output, but better rains in the first half of FY2015 should have benefited rice production. The government increased procurement prices for wheat to cushion farmers from adverse prices and, if weather is favorable, perhaps bolster production.

Continued power and gas shortages, lower cotton and edible oil prices, and weak external demand for some products such as cotton yarn and cloth and cement are likely to contain growth in large-scale manufacturing, which decelerated to 2.7% during July–December 2014 from 6.6% in the same period a year earlier (Figure 3.20.6). Growth slowed in most of the components, including low-end textiles, electronics, and petroleum products. Fertilizer and food output declined. Only iron and steel, automobiles, and leather products picked up from last year. Higher credit to private cement producers and construction firms for infrastructure projects suggests strengthening activity in these sectors. Lower input costs, including easier credit conditions and borrowing costs in the second half of FY2015, should help improve the industrial outlook. Services are expected to grow in line with the performance of commodity producing sectors.

Consumer price inflation averaged 5.8% in the first 7 months of FY2015, decelerating from 8.8% in the same period of FY2014 (Figure 3.20.7). In January 2015, headline inflation slowed to 3.9% year on year largely because food inflation dropped significantly to 3.0%, reflecting lower commodity prices both globally and locally, the latter made possible by the limited impact of floods in August 2014 on supplies of perishable products. Nonfood inflation also declined, to 4.5% in January, as the government passed on to domestic consumers most of the benefit of lower international oil prices. Moreover, a significant reduction in government borrowing from the central bank in the latter part of FY2014 likely helped contain inflation expectations.

Following the marked decline in inflation, the central bank revised the policy interest rate downward in November 2014 and January 2015

3.20.6 Growth in large-scale manufacturing



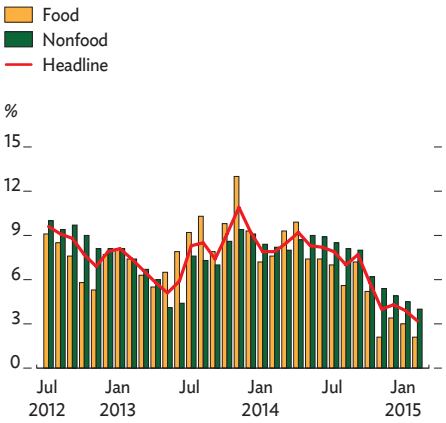
Source: State Bank of Pakistan.
Click here for figure data

3.20.1 Selected economic indicators (%)

	2015	2016
GDP growth	4.2	4.5
Inflation	5.8	5.8
Current account balance (share of GDP)	–1.0	–1.3

Source: ADB estimates.

3.20.7 Inflation



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 6 March 2015).
Click here for figure data

by a cumulative 150 basis points to 8.5% (Figure 3.20.8). It had earlier kept the policy rate unchanged from November 2013 to contain inflation. Headline inflation is expected to average 5.8% in FY2015, assuming some rise in oil prices from lows in the first half of FY2015, some hiked gas and electricity tariffs toward implementing structural policy to bring tariffs closer to cost recovery, and some impact from midyear increases in sales taxes and duties for several items to bolster budget revenue.

A lower consolidated fiscal deficit projection at 4.9% of GDP in FY2015 assumes that Federal Board of Revenue tax collection increases by 0.7% of GDP to PRs2.8 trillion. The target was revised down to PRs2.6 trillion in February 2015 because revenues disappointed expectations in the first half of the fiscal year (Figure 3.20.9). Taxable transactions fell steeply amid lower world commodity prices, reductions in administered electricity tariffs and prices for petroleum products in the first half of the fiscal year, and weak large-scale manufacturing. The general sales tax on petroleum products was raised from 17% to 27% in two steps in December 2014 and February 2015, and February also saw increases announced for taxes and regulatory duties on furnace oil and certain luxury items, which may increase tax collections in the latter part of FY2015. However, the second round sale of 3G/4G licenses, projected to provide PRs56 billion in nontax revenue for the year, has not yet taken place. Despite the implementation of a number of structural measures to improve tax compliance and broaden the tax base, reform has yet to yield a buoyant tax system able to lift the country's low tax ratio.

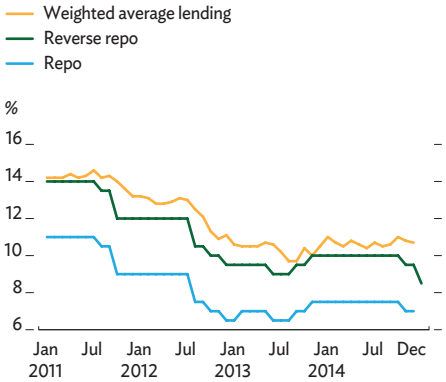
Lower expenditures are budgeted for FY2015, with current expenditures reduced by 1% of GDP from the previous year, partly reflecting a cut in subsidies to bring them down to 0.7% of GDP. As receding oil prices reduce the cost of generating electricity in thermal plants, which provide 33% of power, it may be possible to limit electricity tariffs increases further while reining in power subsidies that the government pays to cover the difference between actual costs and official tariffs for consumers.

Risks to the budget targets include elevated expenditures to enhance security, a build-up of power sector arrears, and failure to realize planned revenues. Missed targets could force down development spending, which, at 1.1% of GDP in the first half of FY2015, was already badly trailing its budget allocation equal to 4.2%.

The plan to finance the fiscal deficit in FY2015 relied largely on domestic borrowing from commercial banks and nonbank sources. Nonbank financing was 43% of the budgeted amount during the first half of FY2015. As the government targets zero borrowing from the central bank for the budget, borrowing from banks to cover the revenue shortfall in the first half climbed to over 80% of planned borrowing for the full year. To address banks' liquidity shortages in the money market, the central bank made significant injections on the open market.

The current account deficit is expected to narrow to 1.0% of GDP in FY2015 from 1.1% a year earlier, owing to lower world prices for oil and other commodities, a sustained increase in remittances, and expected Coalition Support Fund inflows (Figure 3.20.10). Import growth slowed to 0.9% in the first 7 months of FY2015 from 5.3% in the same period

3.20.8 Interest rates



Source: State Bank of Pakistan, Economic Data.

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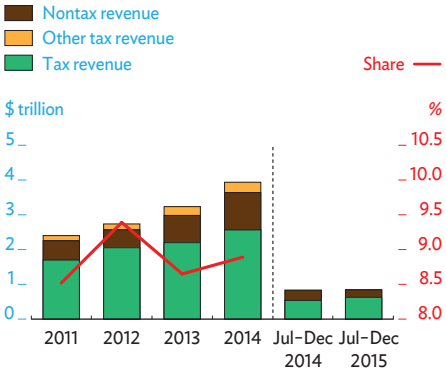
3.20.9 Federal Board revenue tax collection



Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 27 January 2015).

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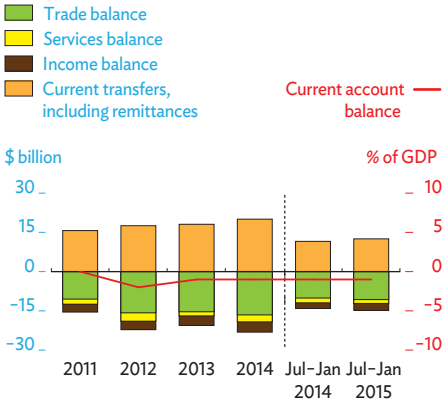
3.20.10 Components of the current account balance



Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 1 March 2015).

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a year earlier, reflecting lower oil import payments. However, non-oil imports rose by nearly 6% as higher domestic prices for wheat drove a 16% increase in food imports.

Exports contracted by 2.5% during the first 7 months of FY2015 (Figure 3.30.11), as lower prices for cotton cloth and yarn exports more than offset strong gains by readymade garments, knitwear, and bed wear that benefit under the Generalized System of Preferences Plus scheme of the European Union. Lower input costs should provide some support for exports and manufacturing growth during the second half of the fiscal year and into FY2016. Pakistan's exports may suffer as the US dollar strengthens against the currencies of Pakistan's export competitors and as the euro weakens. The rupee appreciated in real effective terms by 3.5% in the first 6 months of FY2015. Energy shortages are expected to continue, and volatility in supply remains a risk to exports and growth. The current account deficit is expected to widen slightly in FY2016 to 1.3% of GDP, assuming some pickup in oil prices and moderate expansion in non-oil imports to support higher growth.

The financial account surplus increased sharply to $2.4 billion in the first 7 months of the year from $527 million in the same period of FY2014. This came in large part from an upsurge in portfolio inflows to $1.2 billion in the period, from a mere $141 million a year earlier, as the issuance of Sukuk bonds in December 2014 brought in $1.0 billion. Increased bilateral and multilateral inflows of official development assistance provided the bulk of loan flows of $670 million, while net foreign direct investment remained low at $545 million in light of continuing security challenges and shortcomings in the business environment. Official foreign exchange reserves rose to $10.4 billion in January 2015 from $9.1 billion in June 2014 (Figure 3.20.12). In the 7 months to January 2015, the Pakistan rupee depreciated against the US dollar by only 1.8% to PRs100.75.

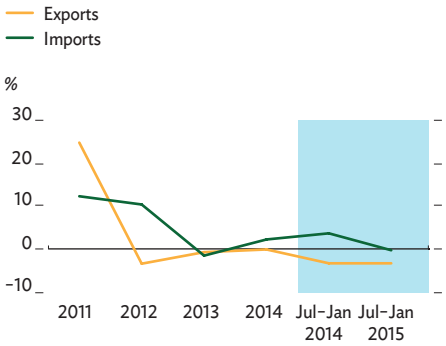
Policy challenge—boosting manufacturing

The economic transformation of Pakistan has largely bypassed manufacturing as it evolved from agriculture to services, most of the services with low productivity. The share of manufacturing in GDP increased from 13.4% in FY1995 to 18.3% in FY2005 but then subsided to 13.5% in FY2006, changing little since. Within manufacturing, large-scale manufacturing comprises 10.9% of GDP while small-scale industries amount to only 1.7%. The share of manufacturing in total employment is, at 14.1%, dwarfed by 43.0% in agriculture and 32.7% in services.

The weak performance of manufacturing reflects industry-specific issues, security challenges, and energy shortages. Historically, the sector's performance has been marred by a number of factors: poor infrastructure, cumbersome regulations, low productivity, distortions arising from industrial policy, a trade policy favoring import substitution and biased against exports, and limited access to finance, especially for small manufacturers.

Manufacturing has undergone little diversification or deepening. The sector largely produces items with little value added, such as

3.20.11 Export and imports growth

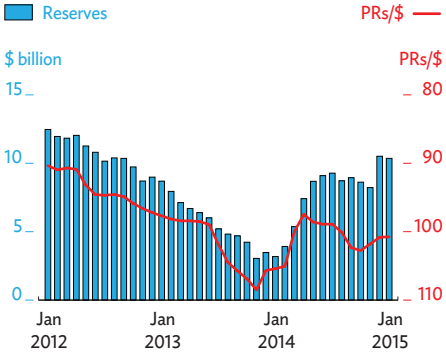


Notes: Years are fiscal years ending on 30 June of that year. The large expansion of exports in FY2011 largely reflects a surge in cotton prices.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 26 February 2015).

Click here for figure data

3.20.12 Foreign reserves and exchange rate



Source: State Bank of Pakistan, Economic Data.

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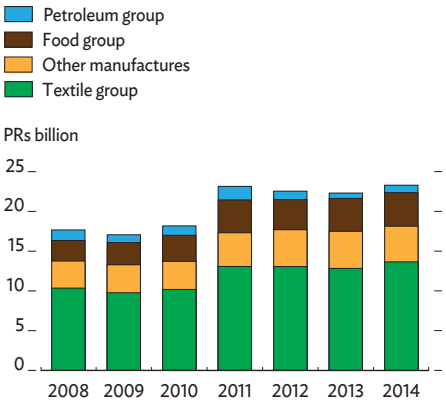
3.20.13 Merchandise exports



Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 26 January 2015).

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low-end textiles, food, and leather products, which together comprise about half of production by large-scale manufacturers. Although the share of higher-tech manufacturing increased from 17% of the total in 1970 to 25% in 2006, it lags the 53% achieved in Malaysia, 52% in Thailand, 45% in the People's Republic of China, and 38% in India—and only slightly exceeds 24% in Bangladesh. Notably, electronics occupied in FY2014 only 2.8% of large-scale manufacturing in Pakistan, and engineering goods a strikingly small 0.6%.

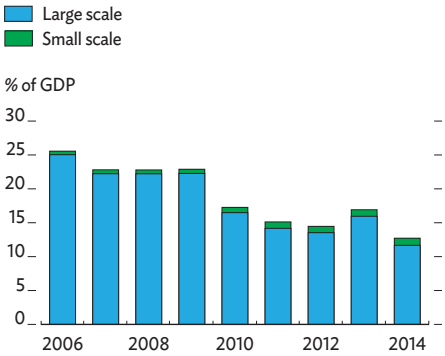
Pakistan's share of world exports remained stagnant at 0.13% from 1970 to 2013, while the shares of other regional economies increased appreciably: India's rising from 0.56% to 1.66%, Malaysia's from 0.55% to 1.21%, and Thailand's from 0.14% to 1.21%. About two-thirds of Pakistan's merchandise exports are textiles, many of which enjoy little potential for higher demand or profitability in world markets (Figure 3.20.13).

Most of the growth in manufacturing in Pakistan arises from higher inputs. Total factor productivity growth was only 1.6% in the 1990s and even slower at 0.9% from 1998 to 2007. Most firms lack both incentive and capacity to innovate. In some key sectors, firms are risk-averse, partly for lack of competition, and they often benefit from tax and tariff exemptions.

The share of manufacturing in total investment, the lowest among sectors, has declined by half since FY2006 (Figure 3.20.14). Foreign direct investment has been concentrated in oil and gas and, since sector liberalization and privatization, in finance and telecoms. The high cost of doing business, including the disproportionate burden of taxes, deters investment in manufacturing. The federal budget for FY2015 cut the corporate income tax rate from 34% to 33%, but this is still high among Pakistan's competitors. Deficient infrastructure remains a key constraint on investment, and shortages of electricity and natural gas are binding constraints that force industries to operate below capacity.

The Global Competitiveness Report 2014–2015 of the World Economic Forum ranks Pakistan at 129 of 144 countries surveyed (Figure 3.20.15). Very low ranks on most of the components of the index indicate weakness in global competitiveness and in many areas necessary for rapid economic growth. Enhancing industrial competitiveness will require that Pakistan address policy distortions, lower trade barriers, create a business-friendly environment with a stable macroeconomic framework, and improve infrastructure, access to finance, and human development.

3.20.14 Manufacturing shares in investment at current prices



Source: Ministry of Finance. *Pakistan Economic Survey 2013–2014.* http://www.finance.gov.pk

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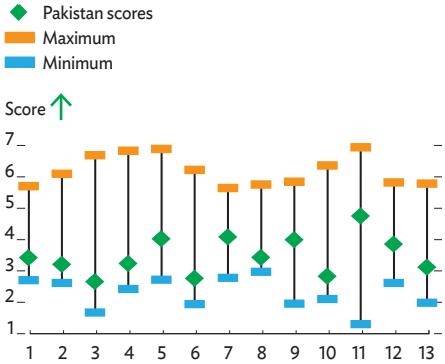
3.20.15 Pakistan scores in Global Competitiveness Index 2014–2015



1 = Global Competitiveness Index 2014–2015, 2 = institutions, 3 = infrastructure, 4 = macroeconomic environment, 5 = health and primary education, 6 = higher education and training, 7 = goods market efficiency, 8 = labor market efficiency, 9 = financial market development, 10 = technological readiness, 11 = market size, 12 = business sophistication, 13 = innovation.

Note: The index scale runs from 1 (worst) to 7 (best).

Source: World Economic Forum. *The Global Competitiveness Report, 2014–2015.*

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Sri Lanka

The economy continued to grow robustly in 2014, inflation fell markedly, and the current account deficit narrowed. The election in January 2015 brought a new president into office with a mandate for political and economic change. With parliamentary elections expected in June 2015, the year will be marked by political transition. The outlook is for a continued strong economic performance aided by generally favorable global conditions.

Economic performance

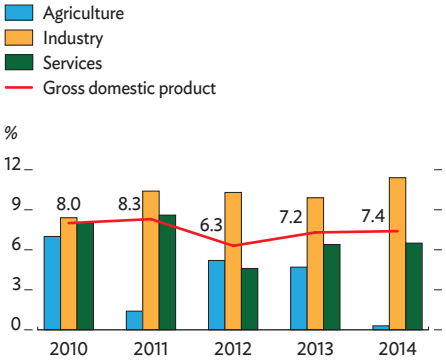
GDP grew by 7.4% during 2014, up slightly from 7.2% a year earlier (Figure 3.21.1). Continued high growth was driven by faster expansion in industry, which offset substantially weaker growth in agriculture.

Provisional estimates show that industry provided the lift to growth as it advanced by 11.4%, up from 9.9% a year earlier, reflecting fast expansion in construction and a pickup in manufacturing apparel for export. The performance would have been better if not for a temporary slowdown in garment manufacturing and exports in October and November. Services grew by 6.5%, little changed from a year earlier, driven by continued solid expansion in hotels and restaurants, wholesale and retail trade, and post and communication. The improving global economy contributed to higher tourist arrivals and better trade performance. Agriculture performance was much weaker than a year earlier, however, expanding by a mere 0.3% because of droughts and floods during some months of the year 2014.

On the demand side, investment, exports, and government consumption are estimated to have recorded higher nominal growth in 2014 than in 2013 (Figure 3.21.2). Expansion in private consumption slowed, however, to 8.5% from 9.9% in 2013. Government consumption rose by an estimated 15.4% from 11.3% in 2013, reflecting increased salaries and wages for public employees, as well as larger special allowances and cost-of-living allowance granted during the year. Fixed capital investment expanded by 15.7%, fueling robust construction performance.

Inflation continued to fall in 2014 (Figure 3.21.3). Annual average inflation was 3.3% in 2014, the lowest recorded since 1985. Nonfood inflation averaged 2.8%, dropping significantly from 6.1% in 2013 with the fading of the base effect from increased administered energy prices in 2013, as well as with decreases in fuel prices in September and December 2014. The 2015 budget was revised by the new government to further reduce fuel prices at the end of January 2015. As a result, the

3.21.1 GDP growth by sector



Sources: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk (accessed 16 March 2015); ADB estimates.

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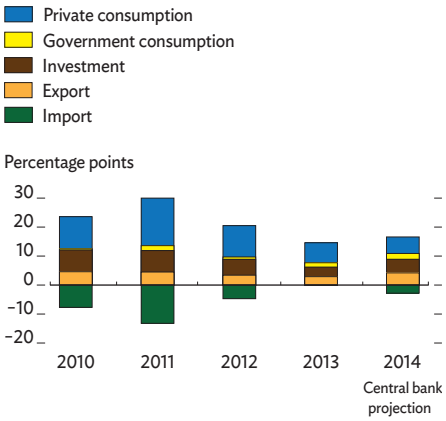
3.21.2 Demand-side contributions to growth



Source: Central Bank of Sri Lanka. *Recent Economic Developments for 2014 and Prospects for 2015.* http://www.cbsl.gov.lk

Click here for figure data

This chapter was written by Tadateru Hayashi, Nimali Hasitha Wickremasinghe, and Savindi Jayakody of the Sri Lanka Resident Mission, ADB, Colombo.

nonfood index shows deflation since October 2014. Food inflation was on the rise, however, climbing to 12.0% by January 2015 because of earlier adverse weather that reduced harvests, especially of rice, before easing to 9.5% in February.

The central bank relaxed its monetary policy in December 2012 as inflation eased. Policy rates were further reduced by 50 basis points in October 2013 and again in January 2014. In response, banks' lending rates declined from 9.7% in January 2014 to 6.4% in January 2015 (Figure 3.21.4). Credit to the private sector nevertheless decelerated until July 2014, when it turned up to reach 8.8% year on year by December 2014. This helped to support a pickup in private sector investment.

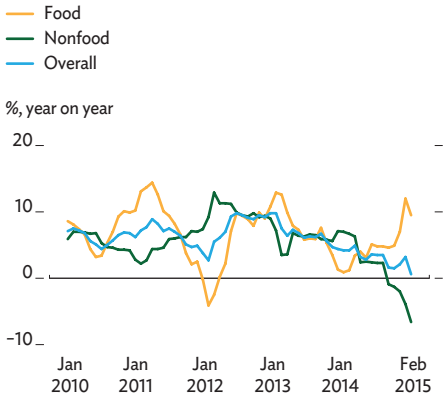
Fiscal consolidation continued in 2014. The budget deficit was estimated to drop to 5.2% of GDP in 2014, compared with 5.9% in 2013. Capital expenditure was estimated at 5.7% of GDP, broadly consistent with the government target of 6%–7%. Domestic revenue was estimated to have increased to 14.2% of GDP in 2014 from 13.9% in the previous year. In January and April 2014, the government successfully issued foreign currency denominated debt on international markets for $1 billion and $500 million, respectively. Total government debt declined to 74.4% of GDP in 2014 from 78.3% in 2013 (Figure 3.21.5). Total public debt—including government debt, Treasury guarantees, and the borrowing of state-owned enterprises from banks and foreign sources—is estimated to have been 88.9% of GDP at the end of 2014.

Exports expanded by 7.0% in 2014 and amounted to $11.1 billion, following growth recovery in the second half of 2013. However, export performance showed some weakness toward the end of 2014, when exports were down by 13.7% year on year in October and 10.7% in November. Imports grew by 7.9% to reach $19.4 billion in 2014, recovering from a 6.2% drop in the previous year. Oil imports, which account for about a quarter of total imports, started to decline in the second half of 2014 in line with the downdraft in global prices.

Service exports were boosted in 2014 as booming tourism ran up a 28.6% increase in earnings and robust remittances expanded by 9.5%. Accordingly, the current account balance is estimated to have recorded a deficit of 3.5% of GDP in 2014 that improved on the deficit of 3.9% in 2013 (Figure 3.21.6).

Notwithstanding outflows on account of foreign debt service payments amounting to $2.1 billion and payments to the International Monetary Fund amounting to $704 million, strong financial inflows maintained a surplus in the overall balance of payments for 2014. Gross official foreign currency reserves increased to $8.2 billion as of the end of December 2014, covering 5.1 months of imports (Figure 3.21.7). The Sri Lankan rupee held steady against the US dollar in 2014, depreciating marginally by less than 1%. It appreciated, however, in nominal and real effective terms by nearly 6% over the year, with most of the change occurring after midyear as the dollar strengthened markedly against other currencies, notably the euro (Figure 3.21.8).

3.21.3 Inflation



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk (accessed 4 February 2015).

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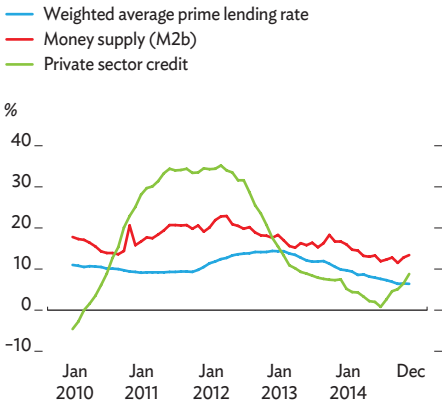
3.21.4 Interest rate, credit, and money growth



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators.* http://www.cbsl.lk

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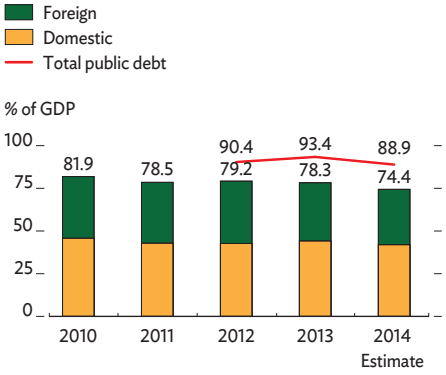
3.21.5 Government debt



Note: Total public debt is government debt, Treasury guarantees, and the borrowings of state-owned enterprises from banks and foreign sources.

Sources: Central Bank of Sri Lanka. *Recent Economic Developments for 2014 and Prospects for 2015.* http://www.cbsl.gov.lk; Budget Speech 2015. Revised January 2015. http://www.treasury gov.lk; ADB estimates.

Click here for figure data

Economic prospects

Following the election in January 2015 that ousted a powerful incumbent, and with parliamentary elections expected in June 2015, Sri Lanka is experiencing substantial political transition this year. Risks to economic growth arise from uncertainties during the transition and a wait-and-see approach adopted by investors.

The election manifesto of the new President set out the broad policies of the new government, which emphasizes good governance, inclusive growth, and private sector development. The good governance agenda includes reviewing some of the previous administration's development projects for possible corruption and waste. The government initially focused on its 100 days program toward reducing the powers of the executive president and addressing corruption. In addition, relief to low-income groups promised in the campaign was a main focus in the new government's budget, which replaced that of the previous administration. The direction of development strategy and fiscal policy is likely to be clear only after the general elections expected in June.

The revised budget for 2015, which Parliament approved on 1 February, has current expenditure higher than in the original budget and substantially lower capital expenditure, cut to 4.6% of GDP from 6.2%. While the revenue ratio was reduced, the fiscal deficit was lowered slightly to equal 4.4% of GDP, compared with 4.6% earlier (Figure 3.21.9). The revised budget plans to collect more revenue through new one-off taxes from high income groups and large commercial operations to finance the additional expenditures. Since the increase in recurrent expenditure will continue in the following years, it is crucial for the government to ensure fiscal revenue increase, so that sufficient public investment is secured to support long-term economic growth.

Recurrent expenditure increased due to higher salaries and pensions for public workers and for transfers and subsidies, which included a 200% increase from April 2015 in the *Samurdhi* ("prosperity") monthly social security payment. Capital spending was reduced by removing expenditure considered wasteful, such as allocations for poorly performing state-owned enterprises. The taxes introduced to fund the additional recurrent expenditure included heavy taxes on assets such as large houses and on large profits, as well as the one-off super gain tax, which is levied on companies and individuals that earned profits over SLRs2 billion in 2013–2014.

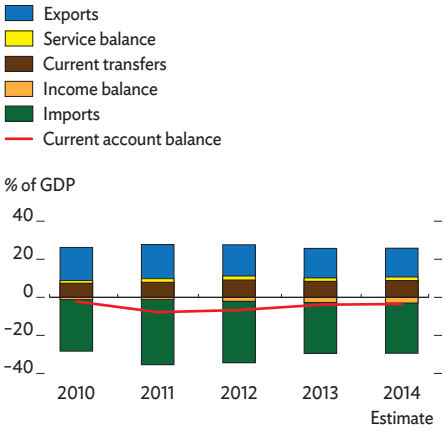
Growth in 2015 will be affected by the political transition and the revised priorities of the government. Construction will slow after leading growth in the recent years, driven by large government infrastructure projects. Political uncertainty would retard private investment. While investment is likely to lose momentum in 2015, consumption is expected to pick up. Price reductions for food and fuel will encourage private consumption, and government consumption will rise with the shift in the budget toward recurrent expenditure. Somewhat faster growth in advanced economies will benefit export industries such as apparel and tourism. How well agriculture performs after mixed fortunes over the past 5 years will depend on the weather, but increases in government-guaranteed prices for several agricultural products should boost production. Against this backdrop, assuming that

3.21.1 Selected economic indicators (%)

	2015	2016
GDP growth	7.0	7.3
Inflation	2.0	5.0
Current account balance (share of GDP)	–1.4	–1.5

Source: ADB estimates.

3.21.6 Current account components



Sources: Central Bank of Sri Lanka. 2014. *Annual Report 2013.* http://www.cbsl.lk; ADB estimates.

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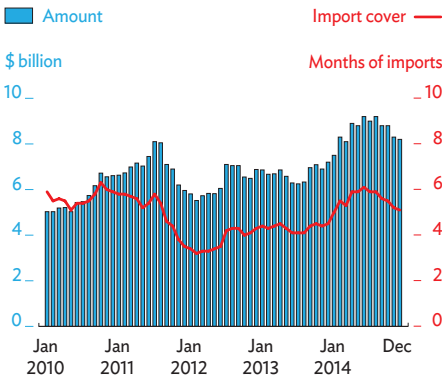
3.21.7 Gross official reserves



Source: Central Bank of Sri Lanka. Press Releases. http://www.cbsl.gov.lk

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politics settle in the second half of 2015 and that investment rebounds, growth is projected to ease to 7.0% in 2015 and then strengthen to 7.3% in 2016.

Inflation is expected to remain low in 2015, held in check by a series of reductions in fuel prices in September and December 2014 and January 2015 that are expected to restrain other prices. With international oil prices expected to remain low this year and next, inflationary pressures are eased. Moreover, the government's revised budget announced tax reductions for several essential items including flour, bread, milk powder, and sugar. Accordingly, inflation is expected to ebb to 2.0% in 2015 before rebounding to 5.0% in 2016 on account of the base effect.

With inflation remaining low, the central bank has signaled that monetary policy will maintain its current accommodative stance. Policy rates are likely to be kept low in 2015, supporting higher private sector credit.

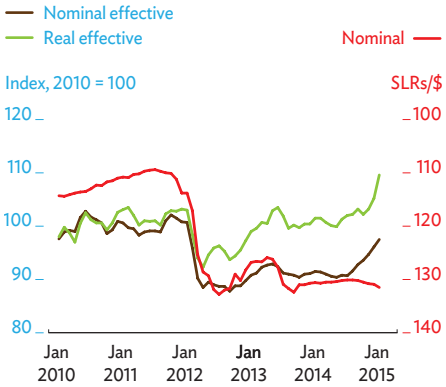
Exports will continue to improve in 2015 and 2016 as Sri Lanka's partner economies pick up pace. Imports are expected to rise, though imports of investment goods will likely slow on more moderate investment. Higher domestic consumption will exert upward pressure on imports and shift the composition of imports away from investment to consumption goods, while low international oil and food prices will help contain total value. Earnings from tourism and remittances are expected to continue current growth trends. They will contain the current account deficit at 1.4% of GDP in 2015. The deficit is projected to widen marginally to 1.5% in 2016 as the economy and domestic investment pick up.

Indications are that Sri Lanka is being viewed more favorably internationally with the change in government and its policies, which will attract higher foreign investment and cement trade ties, especially with Europe and the US. These factors will strengthen the balance of payments position in the medium term.

With GDP per capita estimated at about $3,700 in 2014, Sri Lanka is at the cusp of gaining upper-middle-income status. While the country has been focusing on infrastructure and human capital development, the time has come to adjust strategy to enable it to rise to the next stage of development. Private sector investment should take over the role of driving economic growth. A new focus on human capital development has already started, and emphasis should gradually shift to higher skills and tertiary education to meet the market requirements of the knowledge economy.

With upper-middle-income status comes the need for greater gains in efficiency, or total factor productivity, to continue climbing to high-income status. Sri Lanka should start by strengthening its technological readiness to accept technology transfer through foreign direct investment. At the same time, it should begin innovating. The development of infrastructure and human resources should be adapted to this new policy agenda.

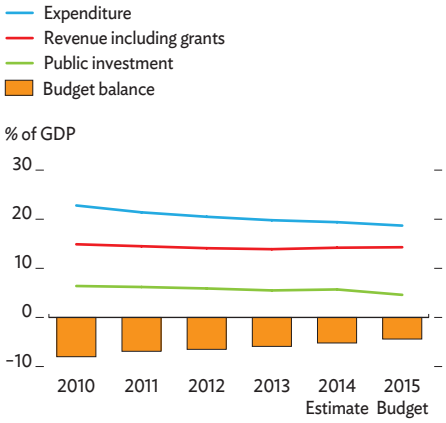
3.21.8 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk

Click here for figure data

3.21.9 Government finance



Sources: Central Bank of Sri Lanka. 2014. *Annual Report 2013.* http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. 2015. *Budget Speech 2015 Revised January 2015; Fiscal Management Report 2015.* http://www.treasury.gov.lk

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Policy challenge—promoting innovation

Innovation is becoming an important policy agenda for Sri Lanka. Nevertheless, according to the Knowledge Economy Index of the World Bank, Sri Lanka lags in innovation and technological adoption (Figure 3.21.10).

The Global Competitiveness Index of the World Economic Forum ranks Sri Lanka behind other countries in university–industry collaboration in research and development (R&D), Patent Cooperation Treaty patents and applications, corporate R&D spending, and the quality of science research institutions (Figure 3.21.11).

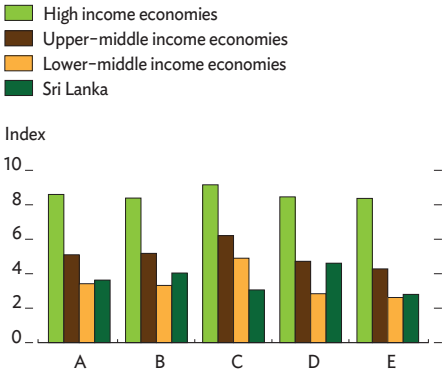
Sri Lanka's spending on R&D equaled 0.16% of GDP in 2010. This is low even compared with its South Asian neighbors, with India at 0.81% in 2011, Pakistan at 0.33% in 2011, and Nepal at 0.30% in 2010. Sri Lanka's component of high-tech products in total manufactured exports was 0.9% in 2012, far below the 6.2% average for South Asia, 8.4% for lower-middle-income economies, and 20.6% for upper-middle-income countries.

Private investment in R&D needs to be encouraged by removing institutional and regulatory bottlenecks and improving infrastructure, including those pertaining to information and communication technology. The environment for innovation could be improved by establishing proof-of-concept labs and patent-application grants, introducing innovation voucher schemes and incentives for collaboration between firms and universities, and investing in knowledge-based capital supported by copyrights, trademarks, and brand equity. These initiatives may create multiple innovation bases and hubs.

Innovation cannot depend solely on large companies within structured systems. As the important role of frugal innovation is increasingly recognized, frugal innovation for consumers in the middle of the pyramid should be encouraged. The government should aim to raise R&D expenditure to at least 1.5% of GDP and concentrate public funds on innovation in a few high-impact areas.

Sri Lanka's universities and research labs are not well linked with industry as is the case in many developed and emerging economies. Such links should be strengthened, as was done successfully with the establishment of the nanotechnology park near Colombo, which secured five patents in its first full year of operation. Sri Lanka has started to build up a pool of experts by gearing the education system to produce high-quality science and technology graduates. The proportion of students currently studying science subjects is low, as over 30% prefer the arts. Reform to secondary education to improve curricula and teaching quality should continue to be the government's focus, but the university system also needs quality improvement.

3.21.10 Knowledge economies

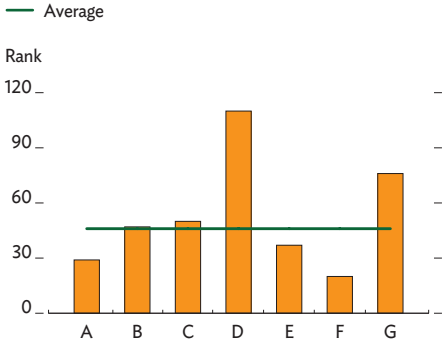


A = knowledge economy index, B = economic incentive and institutional regime, C = innovation and technological adoption, D = education and training, E = information and communication technology infrastructure.

Source: World Bank. http://www.worldbank.org

Click here for figure data

3.21.11 Global competitiveness: ranks of innovation sub-indexes



A = innovation capacity, B = science research institutions' quality, C = corporate research-and-development spending, D = university–industry collaboration in research and development, E = government procurement of advanced technology products, F = scientists and engineers availability, G = Patent Cooperation Treaty patents and applications per million of population.

Source: World Economic Forum. *The Global Competitiveness Report 2014–2015*. http://www.weforum.org

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SOUTHEAST ASIA

Brunei Darussalam
Cambodia
Indonesia
Lao People's Democratic Republic
Malaysia
Myanmar
Philippines
Singapore
Thailand
Viet Nam

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Brunei Darussalam

Declining hydrocarbon production has weighed on this economy. GDP has contracted for 2 years and is projected to contract again in 2015. Consumer prices are forecast to ease for a second straight year. Growth in sectors unconnected to energy indicates that the country is making gradual progress toward broadening its economic base.

Economic performance

GDP contracted by an estimated 1.2% in 2014, a second consecutive year of decline, as oil and gas production continued to shrink (Figure 3.22.1).

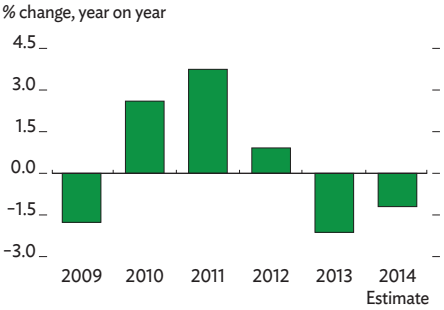
The oil and gas sector, which directly accounts for almost two-thirds of the economy, has contracted since 2012 (Figure 3.22.2). The production of crude oil and condensate fell to 135,000 barrels per day in the first half of last year from 151,000 barrels per day a year earlier (Figure 3.22.3). Since 2006, daily oil output has fallen by about 40% with the depletion of existing oilfields, protracted closures for maintenance of aging equipment, and government policy to manage oil production so that it lasts until other industries can generate a larger share of GDP. The production of natural gas declined to 1,225 million cubic feet a day in the first half of 2014 from 1,248 million in the first half of 2013.

The rest of the economy—mainly services, construction, and manufacturing—grew by an estimated 2.6% in 2014, based on data through September. Services, particularly those provided by the government, contributed most of this growth. Construction and agriculture grew, but manufacturing contracted. From the demand side, private consumption recorded a modest rise. Government consumption increased, but fixed investment decelerated and net exports fell from 2013, reflecting the weakness in oil and gas production.

The government rebased its 2010–2013 national accounts to 2010, which deepened the GDP contraction in 2013 to 2.1%. Using the new base year, GDP grew by 0.8% on average over 2011–2013.

Merchandise exports comprise mainly crude oil, liquefied natural gas, and methanol. In 2014, exports fell by 6.9% to $10.7 billion (Figure 3.22.4). Imports, which provide most of the country's food, consumer goods, and capital equipment, fell by 5.1% to $3.4 billion. That narrowed the trade surplus to a still large $7.2 billion and the current account surplus to $4.7 billion, equal to 26.4% of GDP. International reserves rose to $3.5 billion, cover for 12.1 months of imports of goods.

3.22.1 GDP growth



Source: Asian Development Outlook database.
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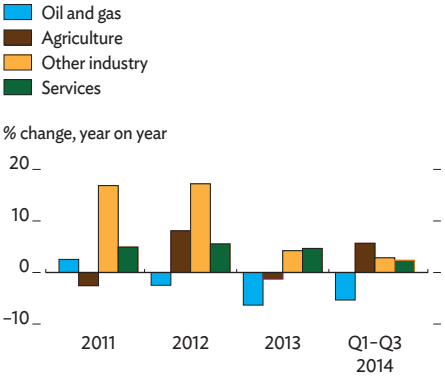
3.22.2 GDP growth by sector



Q = quarter.
Source: CEIC Data Company (accessed 6 March 2015).
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This chapter was written by Mohammed Parvez Imdad of the Southeast Asia Department, ADB, Manila.

Prices eased last year for many consumer goods and services: food and drink, clothing and footwear, housing and utilities, household furnishings, and recreation. These declines more than offset small increases in health care, transportation, communications, education, and restaurant and hotels costs, so that the consumer price index fell by 0.2% on average from 2013. Price controls and subsidies curtail inflation in the economy.

Income from hydrocarbons through taxes, dividends, and royalties provides the government almost all of its revenue to fund a relatively large public sector and to invest in infrastructure and subsidize consumer goods and services. However, declining hydrocarbon production and plunging oil prices have reduced the government's revenue. In FY2013 (ended 31 March 2014) revenue fell by 17.3% (Figure 3.22.5). Government spending was virtually flat, leaving a fiscal surplus equal to 9.3% of GDP. Revenue dropped by a further 21.5% in the first 3 quarters of FY2014, when the government reduced its spending by 8.4%.

The Brunei dollar, which is pegged at par to the Singapore dollar through a currency board arrangement, depreciated by 4.7% against the US dollar between the end of 2013 and the end of 2014. Growth in credit slowed from 8.1% in 2013 to 2.3% in the third quarter of 2014.

In February 2014, the monetary authority relaxed a cap on personal loans from 30% to 40% of all bank loans, and in October it removed a cap on interest rates on residential property loans. The launch of a real-time gross settlement system in November was part of an effort to modernize the national payment and settlement systems.

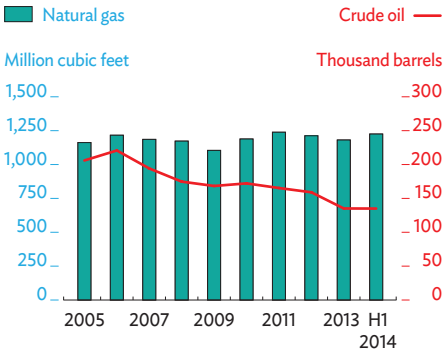
Economic prospects

Subdued production and the impact of lower global prices for hydrocarbons will likely see GDP contract in 2015 before a slight rebound in 2016, assuming some recovery in oil and gas output. Accurate forecasting is hampered by uncertainty over the timing of oil and gas production from new fields and of stoppages for maintenance of wells and pipelines.

Prospects for growth also depend on the timing of several large construction projects. The biggest is an oil refinery and aromatics cracker planned for Pulau Muara Besar with capacity to produce 160,000 barrels a day of petroleum products for domestic use and for export. Led by a company from the People's Republic of China (PRC), this project is expected to involve investment over several years of more than $2.5 billion. In January 2014, the company signed a land-lease agreement with the Brunei Economic Development Board. Completion was scheduled for 2017, but construction has been delayed.

Also last year, PRC investors signed a land-lease agreement with Brunei Darussalam to build a $50 million carbon steel pipe factory. This plant is scheduled to start operating in 2017, with capacity to produce 100,000 tons per year of welded rounding carbon steel pipes for the oil and gas and construction industries. A company from the Republic of Korea signed a nonbinding agreement to build a $107 million plant to produce 120,000 tons per year of aluminum billet casting and 48,000 tons per year of aluminum extrusions, mainly for export.

3.22.3 Average daily production



H = half.

Sources: CEIC Data Company (accessed 6 March 2015); Department of Economic Planning and Development. 2014. *Brunei Darussalam Key Indicators 2014.* http://www.depd.gov.bn

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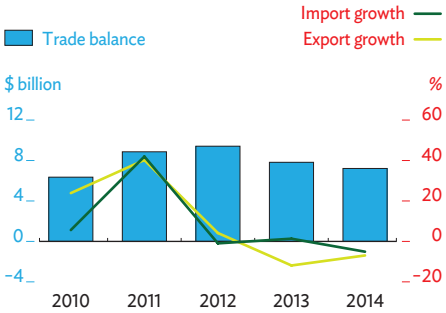
3.22.4 Merchandise trade



Source: CEIC Data Company (accessed 6 March 2015).

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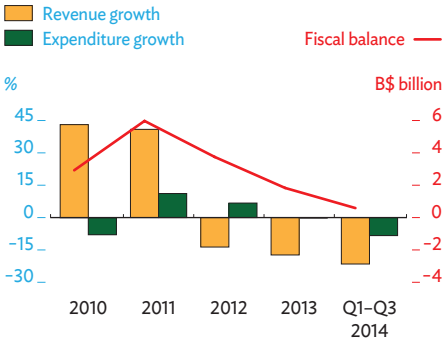
3.22.5 Fiscal indicators



Q = quarter.

Sources: Asian Development Outlook database; Department of Economic Planning and Development. 2014. *Brunei Darussalam Key Indicators 2014.* http://www.depd.gov.bn

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These projects are part of the government's strategy to diversify the economy through export-oriented manufacturing and services. The government intends to build bridges, roads, and utilities for the projects. It is investing in a high-speed broadband network and hopes to revive plans to import hydropower from neighboring Sarawak.

However, the government has also signaled that its expenditure in FY2015 will be constrained by the slide in revenue from oil and gas. The budget is expected to fall into deficit before accounting for income from investments.

Consumer prices are forecast to decline marginally again this year, despite a recent uptick in prices and the potential for further depreciation of the Brunei dollar against the US dollar (Figure 3.22.6). In 2016, prices are seen edging higher as domestic demand improves and global commodity prices turn up.

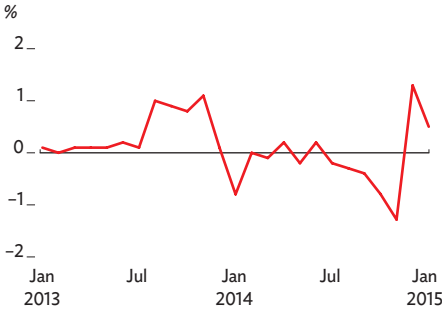
Weak global oil and gas prices are projected to lower export receipts again in 2015. Next year, rising oil prices and the anticipated pickup in oil production will see exports start to recover. Imports, too, are expected to decline in 2015 but bounce back in 2016 if substantial construction gets under way on proposed projects. Nevertheless, exports will still comfortably exceed imports to maintain substantial trade and current account surpluses. Large sovereign wealth funds and sizeable international reserves provide buffers against external and fiscal risks.

3.22.1 Selected economic indicators (%)

	2015	2016
GDP growth	–1.5	0.8
Inflation	–0.2	0.4
Current account balance (share of GDP)	25.0	26.5

Source: ADB estimates.

3.22.6 Monthly inflation



Source: CEIC Data Company (accessed 6 March 2015).
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Policy challenge—diversifying the economy

Oil and gas production generates a GDP per capita of $42,240, which is one of the highest in developing Asia. However, heavy reliance on one sector leaves the economy vulnerable to swings in global energy demand and to the gradual depletion of hydrocarbon reserves.

Aiming to diversify the economy, the government has identified certain industries and provides incentives to draw foreign investment to develop export-oriented businesses. The industries include petrochemicals, halal products, information and communications, Islamic financial services, and aviation and oilfield support services. Incentives are the provision of land and infrastructure, liberal trade and labor policies, competitively priced utilities, and tax breaks.

From 2015, the government has cut the corporate tax rate to 18.5%, abolished corporate tax for small businesses, and increased tax breaks for investment in plant, machinery, and industrial buildings.

Investments made and planned by foreign companies indicate, along with the gradual expansion of the domestic private sector, that the strategy is achieving some success. Nevertheless, more could be done. Brunei Darussalam is ranked near the middle of 189 countries in the World Bank's *Doing Business 2015*, putting it above Indonesia but well below Singapore, Malaysia, and Thailand—and also under the Philippines and Viet Nam. Improving the business environment is key to attracting new investment and diversifying the economy.

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Cambodia

The forecast is for higher growth based on a better outlook for exports and tourism, an easing of domestic political and labor tensions, and lower fuel costs. Prospects are brighter as well for agriculture, which lagged in 2014. Inflation has ebbed and is projected to remain low. A major development challenge is to diversify sources of growth.

Economic performance

Solid growth last year estimated at 7.0% slightly underperformed the 7.3% average of the previous 3 years (Figure 3.23.1). Industry and services were the drivers as agriculture lagged. Prolonged expansion has lifted Cambodia's gross national income per capita toward the $1,045 threshold for entry into lower-middle-income status.

Political tensions and, in the garment industry, labor unrest spilled from 2013 into 2014 to temporarily dampen investment and disrupt garment manufacturing and tourism. These headwinds eased as the year progressed. Exports of garments and footwear, based on customs data, reached $6.0 billion in 2014, rising by 10.7% but decelerating from the previous year. Shipments to the European Union increased by 22% to $2.4 billion, but those to the US fell by 5.4% to $2.0 billion. Construction continued to expand, funded by inflows of foreign direct investment (FDI) and a 34.3% rise in bank credit for the segment. Industry as a whole grew by an estimated 9.8%.

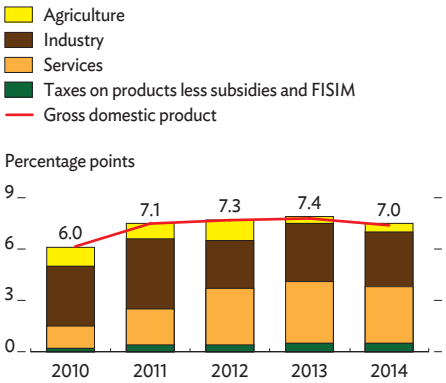
Growth in wholesale and retail trading, tourism, and real estate contributed to an estimated 7.9% expansion in services. Tourist arrivals increased by 7.0% to 4.5 million, though this was slower than in 2013 because of the political tensions early in the year and a decline in tourism to neighboring Thailand and, consequently, side trips to Cambodia.

Flooding and drought hurt agriculture, curbing its growth to an estimated 1.8%. Preliminary estimates show paddy production falling by 2% to 9.2 million tons. Output of maize and soybeans also declined, but cassava production jumped by 41%, mainly to meet rising demand from the People's Republic of China.

The political and labor uncertainties appeared to dent foreign investor sentiment, causing net FDI inflows to fall by 9.9% to $1.6 billion in 2014.

Inflation accelerated through the first half, mainly on higher meat prices, before easing in the second half. Lower global oil prices brought inflation down to 1.1% year on year in December (Figure 3.23.2). For 2014 as a whole, inflation averaged 3.9%.

3.23.1 Supply-side contributions to growth



FISIM = financial intermediation services indirectly measured.

Sources: National Institute of Statistics; ADB estimates.

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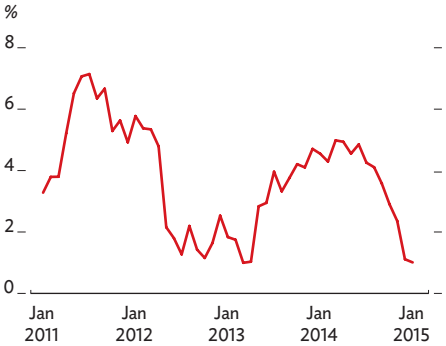
3.23.2 Monthly inflation



Source: National Institute of Statistics (accessed 6 March 2015).

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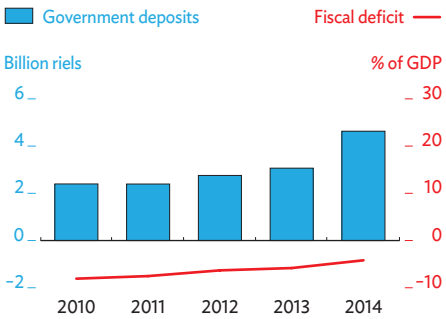
This chapter was written by Jan Hansen and Poullang Doung of the Cambodia Resident Mission, ADB, Phnom Penh.

Fiscal estimates suggest improvement last year. Robust domestic demand and stronger tax collection lifted revenue to an estimated 15.7% of GDP, while expenditure as a ratio to GDP declined slightly to 19.8%, narrowing the fiscal deficit excluding grants to an estimated 4.1% of GDP. Foreign loans and grants funded the fiscal deficit. The government replenished its deposits in the banking system to the equivalent of 7.0% of GDP, approaching the 7.8% maintained in 2008, before the global financial crisis (Figure 3.23.3).

Credit to the private sector grew by a rapid 31.3%, and M2 money supply, excluding foreign currency outside the banking system, by 29.9% (Figure 3.23.4). The Cambodian riel depreciated by a slight 0.3% against the US dollar over the year. Dollarization remained high, with foreign currency deposits accounting for more than 80% of liquidity.

External accounts strengthened in 2014. Merchandise exports—mainly garments, footwear, and milled rice—rose by an estimated 13.4% to $7.4 billion. Merchandise imports rose by 10.1% to $10.7 billion. The current account deficit excluding official transfers shrank to an estimated 12.5% of GDP. This gap was fully financed by FDI and official loans and grants. Gross international reserves rose to $4.4 billion, cover for 4.2 months of imports of goods and services.

3.23.3 Fiscal indicators



Source: National Bank of Cambodia.
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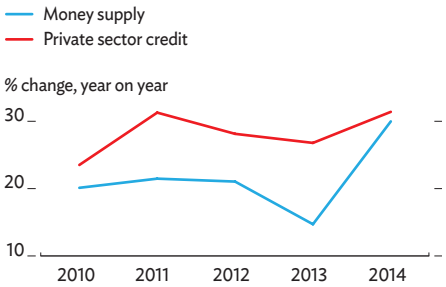
3.23.4 Money supply and private sector credit



Source: National Bank of Cambodia.
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Economic prospects

The outlook is for economic growth to pick up in light of anticipated stronger performance in trade partners—the US and Thailand and, to a lesser extent, the European Union—coupled with a calmer domestic political environment and lower fuel costs. GDP is projected to increase by 7.3% in 2015 and 7.5% in 2016 (Figure 3.23.5).

Over the medium term, growth will be stimulated by gradual diversification into light manufacturing and further integration into regional and global supply chains.

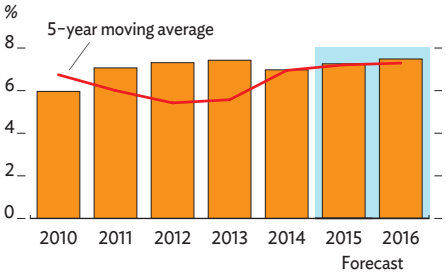
Garments and footwear will benefit this year from improved demand in major markets. Industry as a whole is seen growing by 9.7% as services growth accelerates slightly to 8.1%. Wholesale and retail trade will gain from rising incomes. The calmer political environment in both Cambodia and Thailand paves the way for tourism to pick up. Real estate is supported by FDI inflows and moderately accommodative fiscal and monetary conditions. Agriculture is expected to grow by 2.5% in 2015, assuming better weather than last year.

Inflation is seen edging up to 3.0% by the end of 2015, but the year-average rate will likely be a low 1.6% (Figure 3.23.6). Rising food and fuel prices in 2016 could prod inflation to 2.7%.

This year's budget targets a 10.1% increase in government spending and a budget deficit of 4.8% of GDP excluding grants. The target for domestic revenue is 12.1% higher than for last year's budget.

The ratio of the trade deficit to GDP is projected to narrow slightly in 2015 on rising exports and declining prices for imported food and fuel. Higher tourism receipts will keep the services account in surplus. The current account deficit, excluding official transfers, is forecast to be a little changed (Figure 3.23.7). Downside risks to growth for the

3.23.5 GDP growth



Source: Asian Development Outlook database.
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forecast period are unexpected deterioration in the prospects for major trading partners and natural disasters such as floods.

Rapid financial deepening has seen growth in credit to the private sector rise by an average of 27.3% in 2010–2013, accelerating to 31.3% in 2014, and the ratio of credit to GDP climb to 54.6% last year from 45.0% in 2013. These trends, combined with high dollarization, heighten macrofinancial risks. Strengthening bank supervision and the regulatory framework, and closely monitoring lending for real estate investment, would help ensure a stable financial sector and forestall bubbles in real estate and construction.

Analysis of debt sustainability by the International Monetary Fund last year found Cambodia at low risk of debt distress but vulnerable to shocks to growth, exports, and the budget. Further structural reforms to diversify growth and raise fiscal revenue would mitigate these risks. External debt is long term in nature and on concessional terms.

3.23.1 Selected economic indicators (%)

	2015	2016
GDP growth	7.3	7.5
Inflation	1.6	2.7
Current account balance (share of GDP)	–12.9	–12.7

Source: ADB estimates.

Policy challenge—diversifying sources of growth

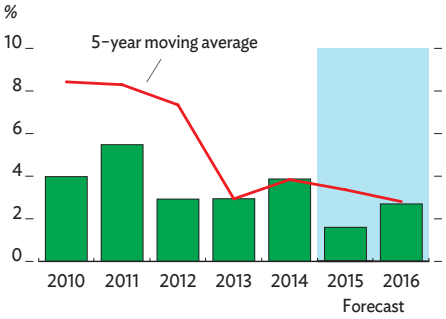
Growth over the past 2 decades has depended on garments, tourism, rice, and construction. This narrow production base and a concentration of exports to the European Union and the US, heavily facilitated by preferential trade access, leaves the economy exposed to external price and demand shocks and changes in trade policy. Also, without diversifying into products and services with higher value, the country could stay mired in low-wage, low-technology production.

Modest progress has been made toward diversification, reflected in Cambodia's widening range of agricultural products and growth in light manufacturing, mainly furniture and components for automobiles and electronics. More could be done to attract foreign investment, which is critical for the capital, technology, and management needed to diversify and upgrade the economy. The government provides some fiscal incentives, such as exemptions from corporate income tax, but a sharper focus on incentives for introducing new products and services may bring better results. Infrastructure improvements—especially for transportation, energy, and water supply—would enhance the investment climate, as would better customs and trade regulations.

Special economic zones have helped to attract foreign investors in manufacturing, as 11 of 35 approved zones are up and running. There is no strong evidence, however, that firms in these zones significantly outperform others in Cambodia or that they deliver substantial spillover to benefit the wider economy.

As higher-value industries need a skilled workforce, efforts should be redoubled to improve human capital and teach skills relevant to the workplace. Assistance in accessing technology, understanding market opportunities, and meeting standards and certifications is important to raise competitiveness. The government is finalizing an industrial development policy that will address many of these issues.

3.23.6 Inflation



Source: Asian Development Outlook database.
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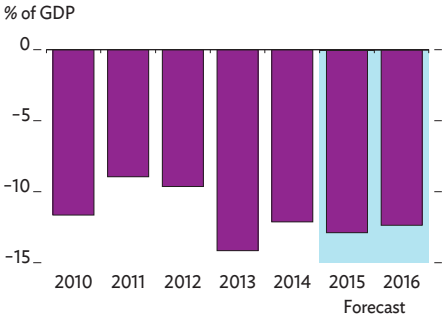
3.23.7 Current account balance



Source: Asian Development Outlook database.
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Indonesia

After 4 years of decelerating growth, policy reform to improve the investment climate is expected to spur economic recovery this year and next. Reform of fuel subsidies has already freed significant public funding for social and physical infrastructure. Inflation is seen to subside to moderate rates through the forecast period, and the current account deficit to narrow. Challenges center on maintaining reform momentum, bolstering government revenue, and developing export-oriented manufacturing.

Economic performance

Political transition to the new government in October 2014 went smoothly, and policy reform gathered momentum. Nevertheless, measures over the previous 2 years to restrain domestic demand and curb the current account deficit, coupled with sluggish exports, weighed on the economy. GDP growth slowed to 5.0% in 2014, a fourth consecutive year of deceleration (Figure 3.24.1). In 2014, personal consumption remained buoyant, but government spending and fixed investment slowed and net exports fell.

Almost 60% of GDP growth last year was generated by private consumption, which expanded by a robust 5.3%. Consumption spending benefitted from growth in employment, as new jobs created in the 12 months through August 2014 exceeded entrants into the labor market. The unemployment rate fell from 6.2% to 5.9% over that period. Poverty incidence declined from 11.5% to 11.0% over the 12 months to September.

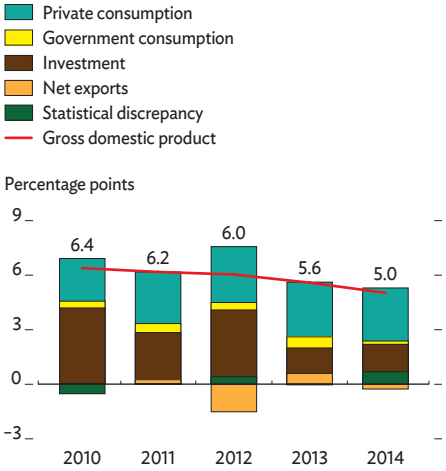
By contrast, public consumption grew by a meager 2.0% last year as the government cut nonessential spending in the second half.

Growth in fixed investment was dampened by rising interest rates, the weakness in external demand, and uncertainty ahead of elections—in April for Parliament and in July for the President. After accelerating to 9% in 2011–2012, growth in fixed investment slowed over the past 2 years to 4.1% in 2014 (Figure 3.24.2). Net external demand dragged on GDP growth as the volume of imports of goods and services increased by 2.2%, outpacing a 1.0% rise in the volume of exports.

On the supply side, growth in services moderated to 6.1%. Communications maintained double-digit growth, and wholesale and retail trading picked up from 2013, but transportation and financial services slowed. Services still contributed just over half of total GDP growth.

Manufacturing recorded slightly faster growth of 4.6% last year, after a sharp deceleration in 2013. Recovery in manufacturing was uneven, though, with better growth in food processing, machinery and

3.24.1 Demand-side contributions to growth



Sources: Asian Development Outlook database; CEIC Data Company (accessed 6 March 2015).
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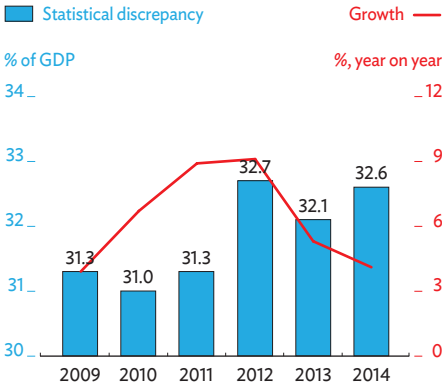
3.24.2 Fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 6 March 2015).
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This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

equipment, and paper products but slower growth in textiles, chemicals, and metals and an output decline for refined petroleum products. Construction and utilities also picked up from the previous year.

Mining was subdued, a result of declining crude oil extraction, weak global commodity prices, and a temporary ban on the export of unprocessed mineral ores. These factors combined to pull down growth in mining to 0.5%. Agriculture grew by 4.2%, the same pace as in the previous year, despite extremely dry weather from El Niño weather patterns in the final quarter of 2014.

Inflation ebbed over the first 8 months of 2014 from 8.1% year on year to 4.0%, as the impact of fuel price hikes in June 2013 faded and food price inflation slowed (Figure 3.24.3). In November, the incoming government raised subsidized prices of gasoline by 31% and diesel by 36%, which pushed inflation back to 8.4% in December. Electricity tariffs also rose during 2014. For the year, inflation averaged 6.4%.

In this context, Bank Indonesia, the central bank, raised its policy interest rate by 25 basis points to 7.75% in November, which followed rate rises of 175 basis points in 2013 to curb inflation and a widening current account deficit. Growth in credit halved to 11.4% in 2014 from 2013.

The slowing economy and lower commodity prices hurt government tax revenue, which fell 8.0% short of the target and prompted the government to reduce nonessential spending during the second half. The outcome was a fiscal deficit equal to 2.0% of GDP, narrower than planned. Disbursement of government capital expenditure undershot the target owing to impediments to budget execution compounded by delays during the election and the transition to a new government.

External accounts improved, but the current account deficit remains a concern. Merchandise exports fell by 3.7% in US dollars terms on subdued demand from Indonesia's major trading partners, particularly the People's Republic of China (PRC), and on soft prices for export commodities such as coal and natural rubber. Exports of manufactured products rose moderately, supported by depreciation of the Indonesian rupiah.

Merchandise imports fell in US dollars terms by 4.5%, more steeply than exports, to raise the trade surplus by 18.3% to $6.9 billion. Lower imports of capital equipment reflected weakness in fixed investment. Deficits in services and income put the current account deficit at $26.2 billion, equal to 3.0% of GDP, compared with 3.2% in 2013.

Net portfolio investment more than doubled to $25.8 billion, despite jittery financial markets toward the end of 2014. Foreign investors increased their holdings of Indonesian shares by $3.8 billion and holdings of government bonds by $11.0 billion. Foreign direct investment increased by $3.3 billion to $22.3 billion. These large capital inflows more than offset the current account deficit to keep the balance of payments in surplus (Figure 3.24.4). Gross international reserves increased by $12.5 billion to $111.9 billion, covering 6.4 months of imports and government debt payments (Figure 3.34.5).

With the central bank allowing greater exchange rate flexibility to help correct the current account deficit, the rupiah depreciated by 1.8% against the US dollar between the end of 2013 and the end of 2014.

3.24.3 Inflation and policy rate

Note: Inflation based on consumer price index (2012 = 100).
Source: CEIC Data Company (accessed 6 March 2015).
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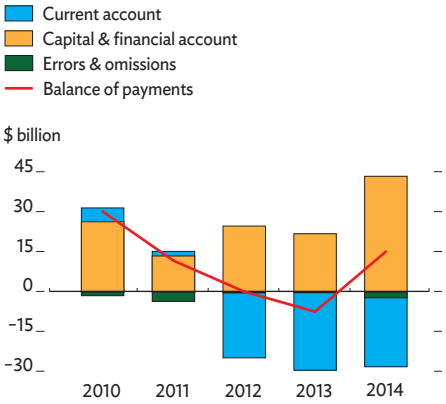
3.24.4 Balance of payments components



Source: CEIC Data Company (accessed 6 March 2015).
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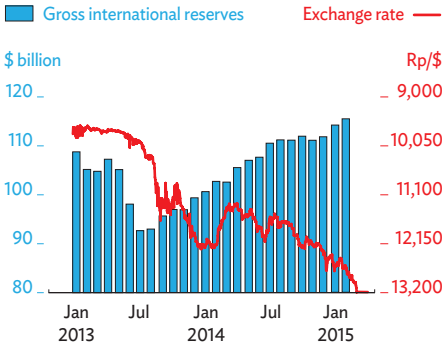
3.24.5 Gross international reserves and exchange rate



Sources: Asian Development Outlook database; CEIC Data Company; Bloomberg (both accessed 6 March 2015).
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Economic prospects

Projections for 2015 and 2016 assume that the new government's rapid reform momentum is maintained through both years and that the administration follows through on policies to accelerate infrastructure development, improve the investment climate, reduce logistic costs, and enhance budget implementation. On this basis, GDP growth is forecast to recover to 5.5% this year and 6.0% in 2016 (Figure 3.24.6).

Last November's cut in fuel subsidies greatly improved the fiscal outlook and freed up significant resources for more productive purposes. Savings of $16.9 billion in 2015 achieved by reducing the subsidies have allowed the government to more than double its capital spending allocation in 2015, increase outlays on education and health, and still lower the fiscal deficit target to 1.9% of GDP (Figure 3.24.7). Moreover, a government decision in January to link domestic fuel prices to international prices has removed risks to the fiscal accounts posed by the remaining fuel subsidies.

Fiscal resources will be further bolstered by a drive this year to raise much more tax revenue, including by stronger enforcement of personal income taxes and higher consumption taxes on the wealthy. The impact of stronger tax collection efforts will be partly offset by lower oil and gas revenue, which comprised 14% of total revenue last year. Nevertheless, the fiscal position could, if required during this year, accommodate a more expansionary stance.

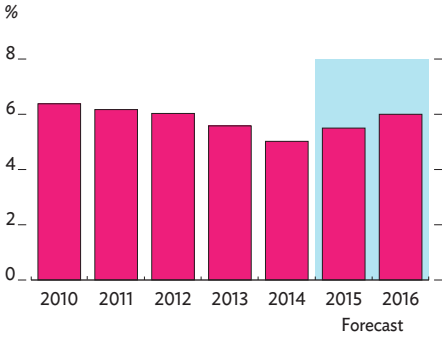
Prospects for improvements to budget execution support the outlook for public investment. The government has simplified the procurement process for infrastructure projects, including through electronic procurement, and new regulations became effective early this year to expedite the acquisition of land for infrastructure projects.

Policy reforms are expected to stimulate private investment. In addition to the large increase in infrastructure investment that will improve the investment climate, the government is upgrading investment regulations. A new one-stop investment licensing service that started this year will speed up and enhance the transparency of obtaining licenses, starting with priority industries. In March, the government introduced tax breaks for investment in export-oriented industries, the railway and shipping industries, and research and development. This follows some liberalization last year of investment restrictions to encourage private investment in selected infrastructure such as ports and power plants, including through public–private partnership. Finally, growth in credit is projected to increase to 15% this year, which will support investment.

Private consumption is seen remaining robust in light of growth in employment, cash payments from the government to 15.5 million low-income households through June 2015 to compensate for the fuel-price hike, and slowing inflation. The central bank's latest surveys show that consumers and businesses are optimistic about their prospects for 2015 (Figure 3.24.8).

Inflation is projected to subside to average 5.5% in 2015 and 4.0% in 2016 (Figure 3.24.9). The central bank lowered its policy rate by 25 basis points following a sharp deceleration of inflation in the first 2 months of this year. While the central bank will need to keep its focus on

3.24.6 GDP growth



Source: Asian Development Outlook database.

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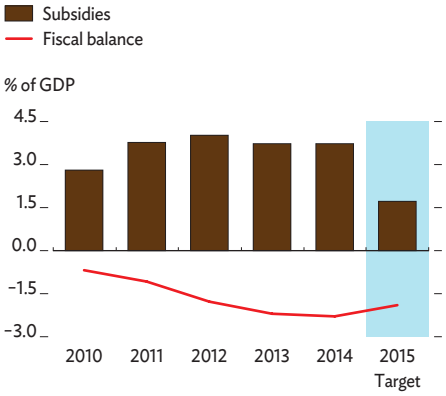
3.24.7 Fiscal indicators



Sources: Asian Development Outlook database; Indonesia Budget Statistics; Ministry of Finance, http://www.depkeu.go.id

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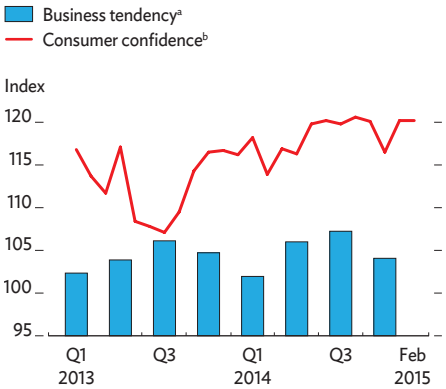
3.24.8 Consumer and business confidence



Q = quarter.

[a] From a quarterly Statistics Indonesia survey of business executives.

[b] From a monthly Bank Indonesia survey of households.

Note: A score above 100 means that respondents are optimistic and vice versa.

Source: CEIC Data Company (accessed 6 March 2015).

Click here for figure data

stability issues in the near term as it contemplates the expected rise in US interest rates, the anticipated downtrend in inflation could pave the way for further monetary easing during the forecast period.

Flexibility in the rupiah's exchange rate should help to facilitate external adjustments. The rupiah depreciated a further 6.0% against the US dollar from the start of 2015 through mid-March.

Exports are expected to rise slightly this year—by 1.2% in US dollar terms—before trending higher in 2016. Better prospects for markets including the US and India are countered to some degree by slowdown in the PRC economy. Soft global prices for energy and commodities will weigh on export receipts. Manufactured exports should improve gradually, though the industrial production index was flat in January (Figure 3.24.10).

Imports are also projected to edge up. Higher capital spending will lift imports of machinery, equipment, and construction materials. However, lower prices for imported petroleum and expected slower growth in the volumes of petroleum imports after the cuts in fuel subsidies should contain the increase in the import bill. Imports of crude oil and petroleum products together comprised 22.2% of total imports in 2014.

The trade surplus for the first two months of year 2015 rose sharply to $1.5 billion (Figure 3.24.11). This is projected to rise this year and the current account deficit to narrow gradually over the next 2 years (Figure 3.24.12). Inflows of direct and portfolio investment should keep the balance of payments in surplus.

Downside domestic risks to the outlook are shortfalls in government revenue and slowing momentum on reform. Lower-than-expected revenue in the first half could see the government decide to widen its fiscal deficit target but also cut planned investment in infrastructure, which would dent prospects for achieving growth forecasts. Any slowing in the pace of reform would hurt the recovery in private investment. This risk has been lessened somewhat by increasing political support for the government's infrastructure and reform programs.

External risks would be posed by unexpected weakness in the growth of major trading partners and disruption to capital flows to emerging markets triggered by the expected rise in US interest rates. The potential for disruption to fund flows to cover Indonesia's current account deficit is mitigated by the buildup in international reserves and policy reforms that attract investment. A more flexible exchange rate and market-driven adjustments to bond yields have improved the country's resilience under volatility in global financial markets.

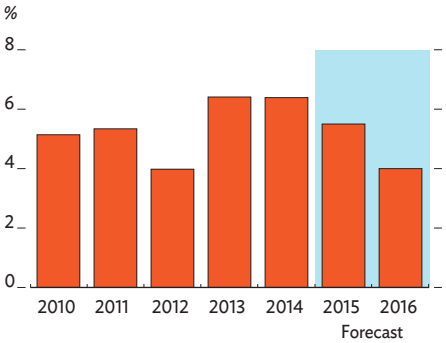
To further manage risks the government has prepared management protocols effective in the event of a financial crisis, improved coordination between relevant agencies, and been careful to maintain substantial contingent funding facilities with development partners, as well as currency swap agreements.

3.24.1 Selected economic indicators (%)

	2015	2016
GDP growth	5.5	6.0
Inflation	5.5	4.0
Current account balance (share of GDP)	–2.8	–2.4

Source: ADB estimates.

3.24.9 Inflation



Source: Asian Development Outlook database.
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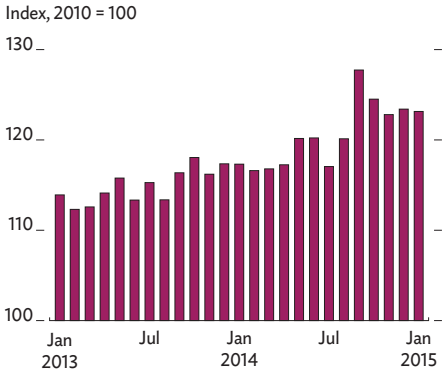
3.24.10 Industrial production



Source: CEIC Data Company (accessed 17 March 2015).
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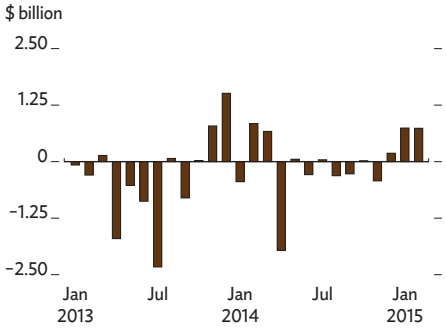
3.24.11 Merchandise trade balance



Source: CEIC Data Company (accessed 17 March 2015).
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Policy challenge—to spur manufacturing

A medium-term goal of the government is to drive GDP growth back above 6%, which was last achieved in 2010 and 2011, when the global commodity boom powered exports.

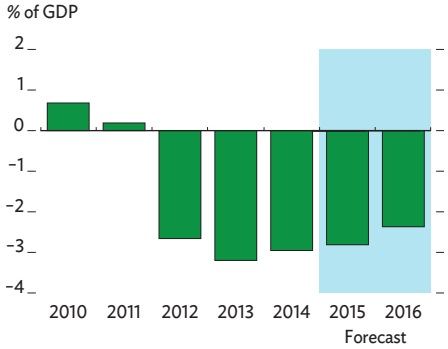
Now that the commodity boom has faded, Indonesia needs a new source of export growth to help restore 6%-plus GDP expansion. Export-oriented manufacturing would be more stable than volatile commodities and would generate more and better jobs.

Manufacturing has been constrained by factors that include inadequate infrastructure, rupiah appreciation during the commodity boom, and regulatory uncertainties. In Indonesia, manufacturing depends heavily on imports of raw materials and semi-finished products, so it needs well-functioning ports and efficient logistics to be competitive in world markets. However, logistics costs are relatively high, and ports are strained owing to underinvestment in infrastructure. In this regard, the government's efforts to boost investment in infrastructure with a focus on ports and connectivity should show significant results in the medium term. Addressing congestion and delays in ports will also require further measures to simplify export and import procedures, streamline customs clearance, and improve preclearance processes.

Foreign direct investment is particularly important to spur innovation through technology and management skills and to link Indonesia to regional and global production networks. During the commodity boom, manufacturers had to compete with the buoyant commodity industries for investment and were disadvantaged in world markets by the rupiah's appreciation. In recent years, a higher share of foreign investment has been channeled into manufacturing (Figure 3.24.13). This trend should be reinforced by the new one-stop investment licensing service, which gives export-oriented manufacturing priority treatment, and by the depreciation of the rupiah.

Longer term, manufacturing would benefit from sustained low inflation that keeps financing costs competitive, more efficient connectivity infrastructure, a more predictable process for setting wages that is based on productivity, and the acceleration of reform in education and training to upgrade labor skills.

3.24.12 Current account balance



Source: Asian Development Outlook database.
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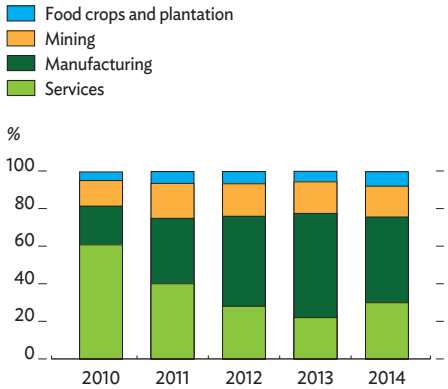
3.24.13 Realized investments by sector



Source: CEIC Data Company (accessed 6 March 2015).
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Lao People's Democratic Republic

Despite headwinds that have slowed growth, GDP is seen increasing by 7.0% this year and slightly faster in 2016 as hydropower and services expand. Inflation is expected to remain modest, and some improvement is forecast in external accounts. Renewed efforts are needed to spur the development of the domestic private sector.

Economic performance

Growth was maintained above 7% for a ninth consecutive year in 2014, though fiscal tightening and weaker global demand for minerals moderated the pace by 0.5 percentage points to 7.4% (Figure 3.25.1). Two decades of significant economic growth helped to halve the national poverty rate from 46% in 1992 to 23% in 2013.

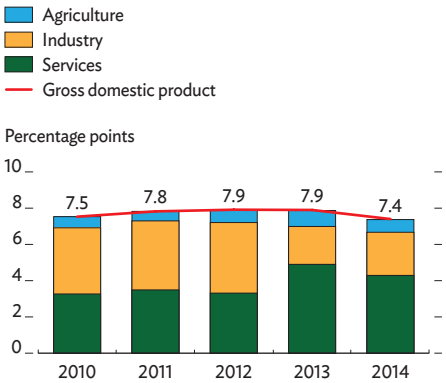
By sector, services expanded by 9.0% in 2014. Wholesale and retail trading, public services, and transport and communications recorded solid growth. A decline in tourism in neighboring Thailand, owing to political unrest and street protests there, saw fewer tourists taking side trips to the Lao People's Democratic Republic (PDR), such that growth in total tourist arrivals slowed to 10.8% in 2014 (Figure 3.25.2).

Industry grew by 8.5%, supported by foreign direct investment to construct hydropower projects, residential and commercial developments, and factories in special economic zones. Output of electricity, most of it sold to Thailand, rose by 7.7% to 15.4 billion kilowatt-hours (Figure 3.25.3). Softer global demand and prices for minerals dampened growth in mining. Copper production from the two main mines in the Lao PDR rose by 3.1% to 159,680 tons, and silver output increased, but gold production fell by 23.2% to 168,755 ounces, reflecting the end of gold production from the Sepon mine in December 2013.

Better weather for agriculture, which employs nearly 70% of the workforce but accounts for only 25% of GDP, lifted this sector's production by 2.9%.

The government tightened fiscal policy in reaction to a sharp widening of its fiscal deficit in FY2013 (ended 30 September 2013), when it had boosted wages and allowances for the civil service and then fell into arrears. In FY2014, the government cancelled a cost-of-living allowance for the civil service, curbed off-budget spending, and postponed some infrastructure projects. A second sharp hike in civil service wages went ahead, but the government cancelled a third wage hike that was to take effect in FY2015. These measures narrowed the

3.25.1 Supply-side contributions to growth



Sources: Lao Statistics Bureau; *Asian Development Outlook* database.

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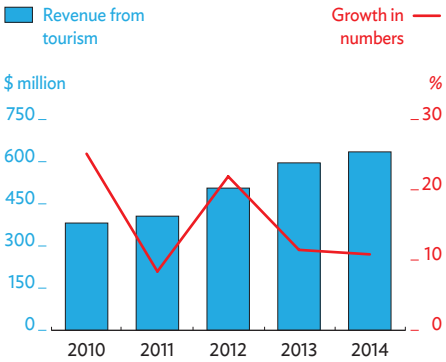
3.25.2 Tourism indicators



Source: National Tourism Administration.

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This chapter was written by Soulinthone Leuangkhamsing of the Lao PDR Resident Mission, ADB, Vientiane. The policy challenge section draws on ADB. Forthcoming. *Lao PDR Private Sector Assessment 2014*.

fiscal deficit, including grants but excluding off-budget spending, to an estimated 4.2% of GDP in FY2014 from 5.6% in FY2013.

The monetary authorities, concerned about rapid growth in credit and declining international reserves, restricted sales of foreign currency to the public and directed commercial banks to limit lending in foreign currency. The central bank also curbed its direct lending for infrastructure. Credit growth decelerated to 14.1% at the end of 2014 from 35.7% in 2013 (Figure 3.25.4).

Some businesses dealing with the public sector faced delays receiving payments that hurt their earnings and their capacity to service loans, which added to banks' nonperforming loans.

Inflationary pressures eased steadily in 2014 owing to better food supplies, lower fuel prices, and the fiscal tightening (Figure 3.25.5). Inflation abated to 2.4% year on year by December, bringing the average rate in 2014 to 4.2%, the lowest in 5 years.

Moderating domestic demand restrained growth in merchandise imports to 4.4% last year, while merchandise exports grew by 6.1%. The current account deficit narrowed to an estimated $3.2 billion, or 25.0% of GDP. Inflows of foreign direct investment contributed to a slight rebuilding of gross international reserves to an estimated $815 million, cover for only 1.3 months of imports of goods and services.

The Lao kip depreciated by 2.7% against the US dollar during 2014, though it appreciated by 2.9% against the Thai baht. In real effective terms, the kip has appreciated over recent years, hurting export competitiveness.

Economic prospects

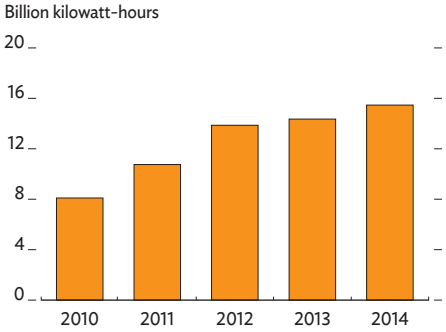
Growth is expected to moderate further in 2015 as lackluster demand for minerals weighs on mining, and as fiscal constraints curb public investment. Nevertheless, GDP growth is forecast at 7.0% in 2015, picking up to 7.2% in 2016 (Figure 3.25.6).

Investment in power projects will generate much of the growth over the forecast period. More than 20 power projects are under construction, including the $3.5 billion Xayaburi hydropower plant, scheduled for commissioning in 2019 with capacity to generate 1.3 gigawatts. Power generation will get a boost when the large Hongsa lignite power plant, able to generate 1.9 gigawatts, comes on stream later this year and is fully operational in 2016. Total electricity production is projected to rise by 6% in 2015, accelerating significantly in 2016 when six new plants come online.

Recovery in Thailand, and in particular in its tourism industry, will benefit the Lao PDR. So will lower oil prices, as the country imports all its oil, which comprises 15% of merchandise imports. Services will continue to expand at a strong pace, but agriculture is expected to record only slight growth this year.

Weaker revenue from mining suggests that the fiscal deficit could widen to about 5% of GDP. Public debt is projected to increase from 60% of GDP to 65% over the medium term. The International Monetary Fund reported that the risk of external debt distress worsened in 2014 but is still moderate.

3.25.3 Electricity output



Source: Ministry of Energy and Mines.
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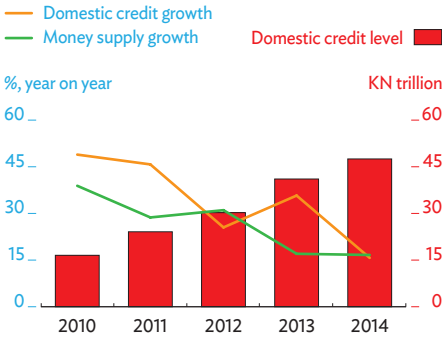
3.25.4 Monetary indicators



Source: Bank of the Lao People's Democratic Republic.
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3.25.5 Monthly inflation

Source: CEIC Data Company (accessed 8 March 2015).
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Inflation eased further to 1.4% in February 2015. Lower oil prices and slowing economic growth are forecast to trim year-average inflation to 3.5% for the year. In 2016, inflation is seen quickening to 4.0% as domestic demand picks up and the prices of imported oil and food trend higher.

Oil price declines will also benefit the current account. Electricity exports will rise though prices of metals and some other export commodities will likely stay soft. The deficit in the current account is expected to remain substantial but to narrow through the forecast period (Figure 3.25.7).

Domestic risks stem from delays in strengthening the fiscal position, low foreign reserves, and weaknesses in the banking system.

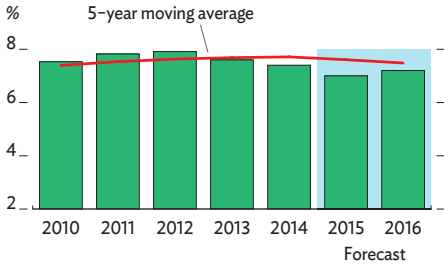
For the medium term, the government has lowered its annual GDP growth target to 7.0%–7.5% in its Eighth National Socioeconomic Development Plan, 2016–2020 from the target of 8.0% growth during the seventh plan. The private sector is expected to play a stronger role during the upcoming plan period, as foreign aid is expected to decline.

3.25.1 Selected economic indicators (%)

	2015	2016
GDP growth	7.0	7.2
Inflation	3.5	4.0
Current account balance (share of GDP)	–21.2	–17.3

Source: ADB estimates.

3.25.6 GDP growth



Source: Asian Development Outlook database.
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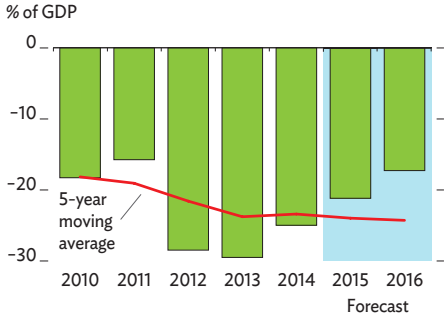
3.25.7 Current account balance



Source: Asian Development Outlook database.
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Policy challenge—developing the private sector

Outside of foreign-dominated mining and hydropower, the Lao PDR private sector consists mostly of small enterprises in agriculture, construction, manufacturing, and services. Few have links to the two main growth industries, and many operate in the informal economy and have little hope of developing into larger businesses that could help to diversify the economy and spread the benefits of growth.

According to a recent private sector assessment, informal enterprises decide to stay informal to avoid the time and costs involved in registration, regulatory compliance, and taxation. The problem is that informal status severely constrains their access to bank credit and government support programs, as well as their ability to link to global business networks. Moreover, high rates of business informality unfairly disadvantage registered competitors, who pay the costs of compliance, and narrow the government's tax base.

A survey in 2012 of formally registered businesses found that 42% faced competition from informal enterprises, which is likely one reason that very few firms achieve the scale needed to improve productivity and compete in foreign markets. In 2010, the Lao PDR had only about 1,100 registered medium-sized enterprises (those employing 20–99 people) and just 200 large enterprises (employing 100 or more).

Inducing informal enterprises to register and comply with regulations requires streamlined procedures and lower costs for compliance, coupled with more consistent and transparent tax administration. Broader constraints on businesses could be addressed by measures that include improving their access to finance and upgrading infrastructure, as well as through education and training reforms to increase the supply of skilled and semiskilled labor.

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Malaysia

Though buffeted by the slump in oil prices, the economy is projected to post growth through the forecast period that is more moderate than last year's rate but still solid. Trade and current account surpluses will narrow in 2015, but inflation is seen little changed in year-average terms. Fiscal reform will help to offset lower revenue from hydrocarbons.

Economic performance

Buoyant private consumption and strong exports powered GDP growth to a 4-year high of 6.0% in 2014, despite slowdowns in both fixed investment and government spending (Figure 3.26.1).

Private consumption grew by a robust 7.1%, near the pace in the previous year, to contribute more than half of GDP growth from the demand side. The rise was driven by job creation, low unemployment, and higher wages. Cash transfers from the government continued to supplement incomes and support consumption. Government efforts to rein in the budget deficit saw expansion in government consumption ease to 4.4%.

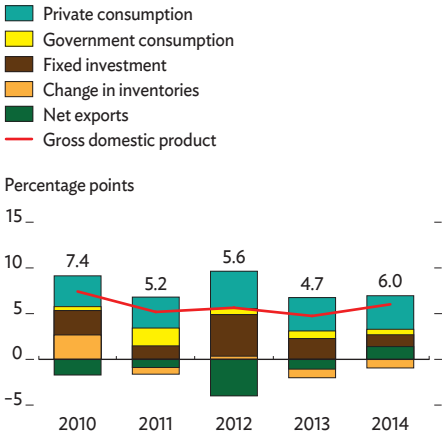
Growth in fixed investment slowed for a second straight year, to 4.7% (Figure 3.26.2). Private fixed investment decelerated, but it still grew by 11.0%, with a focus on manufacturing and services. The government's fiscal tightening and the completion of some projects contributed to a 4.9% fall in public fixed investment. A decline in inventories dragged down GDP growth. However, a rebound in net exports of goods and services substantially contributed to growth.

From the supply side, services grew by 6.3% to generate most of the GDP growth. Communications, wholesale and retail trade, and real estate and business services recorded robust growth, reflecting buoyant household spending and business expansion. Increased tourism spurred the pace of growth in accommodation and restaurants.

Manufacturing expanded by 6.2% in 2014, the strongest performance in 4 years. Faster growth was seen in export-oriented manufacturing, particularly electronics and electrical products, and in consumer products, including food and drinks. Construction maintained double-digit expansion for a third year on vigorous housing activity in the Klang Valley, Penang, and Johore and on civil engineering projects that included the Klang Valley mass rapid transport system, Janamanjung power station, and expansion of the North–South Expressway.

Though much smaller than services or manufacturing, mining made its most significant contribution to GDP growth in 7 years as crude oil production recovered by 4.3% last year from contraction in 2013, and

3.26.1 Demand-side contributions to growth



Source: CEIC Data Company (accessed 6 March 2015).
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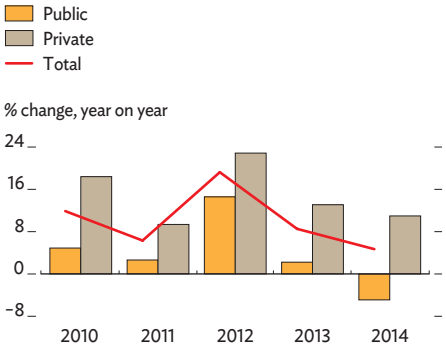
3.26.2 Fixed investment growth



Source: CEIC Data Company (accessed 6 March 2015).
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This chapter was written by Gary Krishnan of the Southeast Asia Department, ADB, Manila.

as natural gas production posted a small gain. Better food production lifted growth in agriculture to 2.6%, despite a sharp fall in natural rubber production and floods on the east side of the peninsula that hit palm oil production late in 2014. The price of palm oil weakened as plunging global oil prices undercut demand for biofuel.

Inflation picked up in 2014 to average 3.1%, the highest in 3 years (Figure 3.26.3). Upward pressure on prices stemmed from the buoyant consumer demand and government decisions to reduce subsidies, particularly on fuel, and to raise electricity tariffs. Fuel subsidies, which largely benefitted higher-income groups, were cut in 2013 and removed in 2014. Inflation started to ease in the second half.

Bank Negara Malaysia, the central bank, raised its policy interest rate by 25 basis points to 3.25% in July 2014 to dampen further inflation pressure expected from the planned introduction of a 6.0% goods and services tax in April 2015. It was also concerned about speculation in property and high household debt. Growth in lending to households moderated to 9.9% in December 2014 from 11.5% a year earlier, while lending to businesses picked up to 9.4% from 7.9%.

The Malaysian ringgit weakened against the US dollar as global oil prices fell in the second half of 2014. It depreciated by 6.1% against the US dollar in 2014 and another 2.3% in the first 11 weeks of 2015.

Government efforts to curtail the budget deficit narrowed the fiscal gap to 3.5% of GDP in 2014, mainly on higher revenue (Figure 3.26.4). Strong economic growth and rising oil and gas production generated 3.4% higher revenue. The government raised operating expenditure by 3.9% but continued to trim net development expenditure, by 5.5% in 2014.

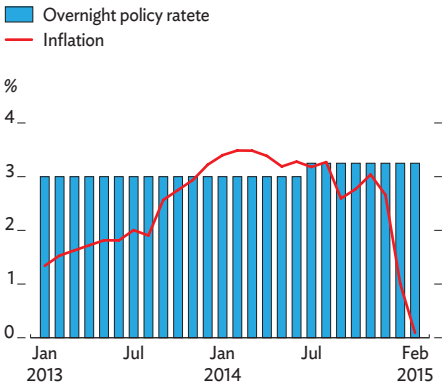
The trade surplus rose after 2 years of declines. Merchandise exports increased by 2.9% to $221.8 billion on a robust performance from manufactured goods, particularly electronics and electrical products, and higher exports of commodities, partly from rising oil production and shipments. Exports to India, the European Union, and the US grew at double-digit rates, but those to the People's Republic of China declined.

Merchandise imports lagged exports, growing by 1.3% to $183.6 billion. Imports of consumer products and intermediate goods needed by manufacturers grew, but imports of capital goods fell, reflecting slower fixed investment. These developments expanded the trade surplus by 11.2% to $38.3 billion.

After accounting for wider deficits in services and income, the current account surplus rose to $15.1 billion, equal to 4.6% of GDP (Figure 3.26.5). However, large net outflows in the financial account put the balance of payments in deficit by $11.1 billion. Net outflows of portfolio investment jumped to $11.6 billion, and foreign direct investment recorded net outflows of $5.2 billion as investment abroad by Malaysians outstripped inflows of foreign direct investment. Gross international reserves of $106.9 billion in February 2015 provided cover for more than 6 months of goods imports.

Malaysia's external debt was $213.0 billion at the end of 2014, equal to 69.6% of GDP, a marginal increase over 12 months. Slightly over half of the external debt has medium- to long-term maturity, and about half comprises nonresident holdings of ringgit-denominated debt securities and deposits.

3.26.3 Inflation and policy rate



Source: CEIC Data Company (accessed 21 March 2015).
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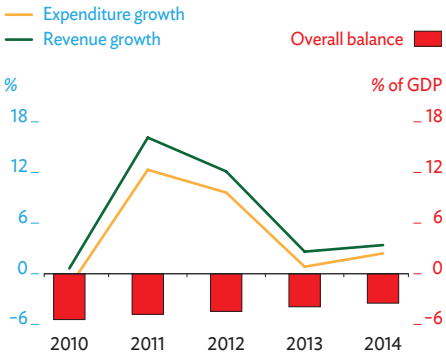
3.26.4 Fiscal performance



Source: CEIC Data Company (accessed 6 March 2015).
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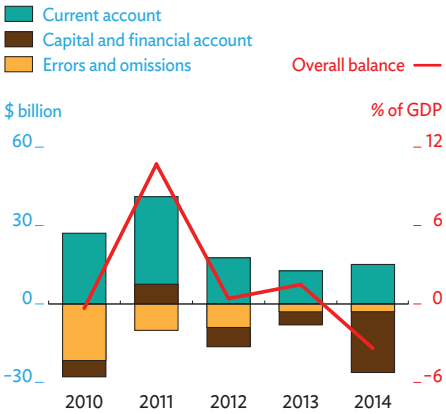
3.26.5 Balance of payments components



Source: CEIC Data Company (accessed 6 March 2015).
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Economic prospects

Economic growth is projected to slow in 2015 largely on the impact of weaker demand and the slump in prices for oil and other commodities (Figure 3.26.6). The slowdown will be tempered by expected benefits to manufacturing, which now comprises one quarter of the economy, and to services such as tourism. The benefits will flow from lower fuel costs, ringgit depreciation, and, not least, the improving economic outlook in the major industrial economies, particularly the US.

From the demand side, growth in private consumption is expected to moderate through the forecast period. Lower earnings from oil and other commodities will weigh on spending. So will the new goods and services tax, though its impact will be mitigated by the removal of the sales and services taxes it replaces and by tax cuts and government assistance to low-income groups. Lending to households is projected to decelerate further in an economy where household debt already equals a high 87.9% of GDP. A cooling housing market and recent weakness in share prices could dent confidence, as indicated by consumer and business sentiment weakening late in 2014 (Figure 3.26.7).

Nevertheless, several factors, including the firm labor market and government cash transfers, will ensure that private consumption remains a driver of GDP growth. Lower fuel prices, even with fuel subsidies gone, are expected to contribute to higher disposable incomes.

Fixed investment faces headwinds from the slump in commodities, ringgit depreciation, fiscal tightening, and possibly higher borrowing costs. The government's Economic Transformation Programme to upgrade industry and infrastructure continues to generate investment projects, though the flow from this pipeline to oil and other commodity projects may diminish this year. Fixed investment is expected to strengthen in 2016 as prospects improve for global trade.

In January 2015, the government revised its budget and reset the fiscal deficit target for 2015 at 3.2% of GDP, a modest tightening from last year's actual deficit of 3.5%. Meeting this target could be a challenge as almost one-third of government revenue derives from oil and gas. Revenue will also suffer from slowing economic growth, weak prices for commodities other than hydrocarbons, and income tax cuts for individuals and businesses. Further, reconstruction after floods late in 2014 adds budget strain. On the positive side, subsidy reform will produce substantial fiscal savings, and the goods and service tax will broaden sources of revenue.

After raising its policy interest rate once last year, the central bank has paused in light of slowing inflation and heightened risks to growth. In March 2015, the monetary authorities said the policy rate of 3.25% supported growth.

On the balance of these influences, GDP growth is forecast to decelerate to 4.7% in 2015 but to then pick up to 5.0% in 2016 as the outlook improves for investment and exports (Figure 3.26.8).

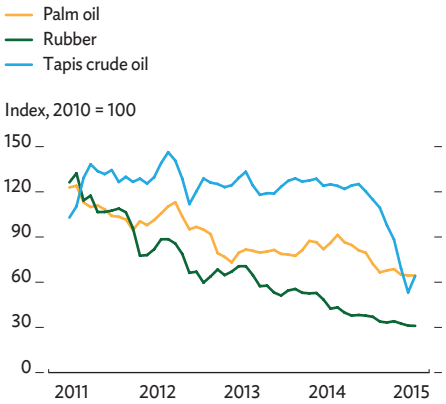
Inflation forecasts for 2015 have edged down over recent months. In January, inflation ebbed to 1.0% year on year as fuel prices fell. The introduction of the goods and services tax, and the impact of ringgit depreciation on the cost of imports, will put some upward pressure on prices during this year. In year-average terms, inflation is projected to

3.26.1 Selected economic indicators (%)

	2015	2016
GDP growth	4.7	5.0
Inflation	3.2	2.9
Current account balance (share of GDP)	3.3	4.5

Source: ADB estimates.

3.26.6 Selected commodity prices



Sources: Bloomberg; World Bank Commodity Price Data (Pink Sheet), http://econ.worldbank.org (both accessed 5 March 2015).

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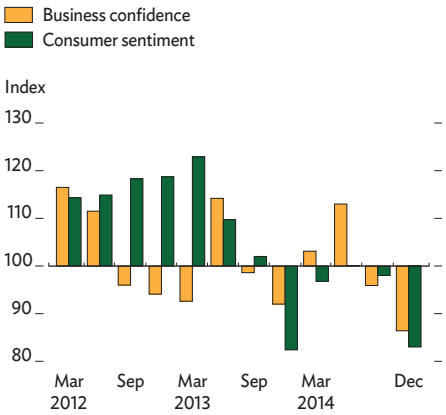
3.26.7 Business and consumer confidence



Note: Above 100 indicates improvement in business conditions and rising consumer confidence.

Source: CEIC Data Company (accessed 6 March 2015).

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be little changed in 2015 before it eases in 2016 as the temporary impact of the new tax fades (Figure 3.26.9).

Exports started 2015 on a weak note. The slide in prices for oil and some other commodities has pulled down merchandise exports in US dollar terms since last October (Figure 3.26.10). In January 2015, customs-recorded exports fell by 8.3% year on year. Exports of refined petroleum products plunged by 46.3% in January, and exports of palm oil products by 27.3%, as both volumes and prices were lower. Exports of natural rubber fell by 36.6% and of liquefied natural gas by 7.9%. Shipments of electronics and electrical products fell by 2.3% in US dollars terms but rose in ringgit terms. Imports were even weaker than exports, falling by 12.6% in January.

Merchandise exports are forecast to decline by 1.5% in 2015 before rebounding by 6.6% in 2016. Imports are seen rising modestly in 2015 and accelerating in 2016 in line with investment growth. Trade and current account surpluses are projected to narrow in 2015, then turn up next year.

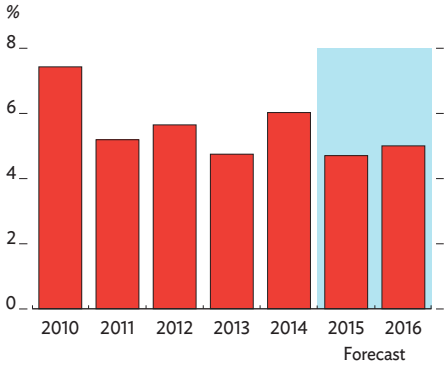
Policy challenge—defending against economic headwinds

Malaysia is well braced for this year's buffeting. Its economic structure is increasingly diversified, as services and manufacturing now account for 80% of GDP, with mining, agriculture, and construction each making significant contributions. Manufactured products provide 65% of merchandise exports, and oil, gas, and other commodities 35%. The removal of fuel subsidies and the broadening of the tax base through the goods and services tax should pave the way to a balanced budget over the medium term and a lower ratio of debt to GDP.

Foreign currency reserves have declined but are still healthy, and the current account is seen remaining in surplus. The flexible exchange rate system and substantial financial buffers provide defense against any volatile capital flows that may arise from the eventual raising of US interest rates.

Finally, Malaysia and its fellow members of the Association of Southeast Asian Nations will soon launch the ASEAN Economic Community and stand to benefit from further accelerating the pace of subregional economic and financial integration.

3.26.8 GDP growth



Source: Asian Development Outlook database.
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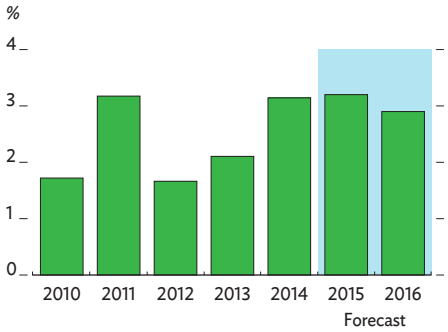
3.26.9 Inflation



Source: Asian Development Outlook database.
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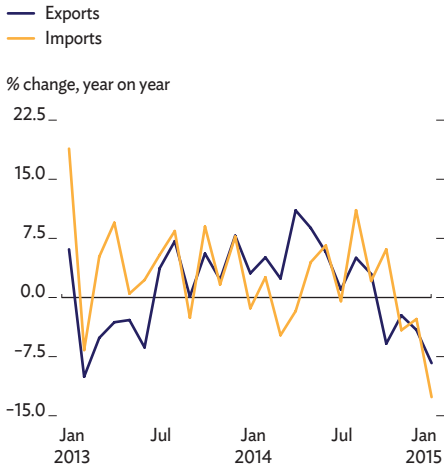
3.26.10 Merchandise trade growth



Source: CEIC Data Company (accessed 6 March 2015).
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Myanmar

Policy reform allowed rapid economic growth in the closing fiscal year and is expected to drive stronger expansion through the forecast period. Inflation will likely accelerate as well, and stresses are seen building in fiscal and external accounts. A key challenge is to develop the country's human resources, in particular by better equipping its young people for roles in a modern economy.

Economic performance

GDP growth is estimated at 7.7% in FY2014 (ending 31 March 2015), reflecting strong expansion in construction, manufacturing, and services. The government's ambitious structural reform program has underpinned the strong growth performance in recent years.

Construction was driven by government investment in infrastructure, and by property development in Yangon and Mandalay. Manufacturing benefitted from increasing flows of foreign direct investment, with more than one new garment factory opening per week on average in 2014. Growth in services was bolstered by a surge in tourist arrivals from 2.0 million in 2013 to an estimated 3.1 million in 2014 (Figure 3.27.1).

The natural gas industry continued to expand, as reflected in a $400 million increase in gas exports to $2.1 billion in the first half of FY2014. However, growth in agriculture slowed. Agriculture provides 30% of GDP and more than 60% of employment.

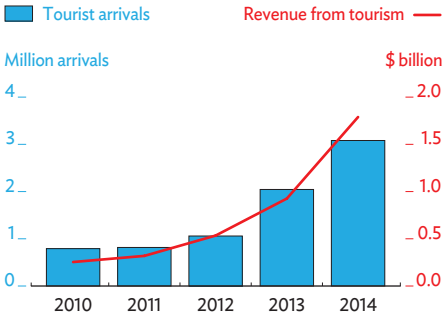
A 10% increase in business registrations in the first 9 months of FY2014 indicated that business confidence remains robust (Figure 3.27.2). The Directorate of Investment and Company Administration streamlined procedures to slash from 72 days to 3 days the time it takes to register a company. Growth in credit to the private sector continued to grow rapidly at 36% year on year in November 2014.

Approvals of foreign direct investment totaled $6.6 billion between April and December 2014, up from $4.0 billion for all of FY2013. Telecommunications attracted almost a third, followed by oil and gas at 24%, real estate at 18%, hotels at 13%, and manufacturing (primarily garments) at 8%. Less than 1% was for agriculture.

Inflation picked up toward the end of FY2014, partly because of rising food prices and higher prices for imports owing to depreciation of the Myanmar kyat. The kyat weakened from MK965 to the US dollar at the start of FY2014 to MK1,042 toward the end, largely the result of a widening current account deficit and a stronger US dollar. Inflation averaged an estimated 5.9%.

Strong demand for capital equipment and liberalized import and foreign exchange restrictions drove a surge in merchandise imports that outpaced exports, widening the current account deficit to an estimated 7.1% of GDP in FY2014. Gross official reserves look set to total

3.27.1 Tourism



Note: Years are fiscal years ending on 31 March of the next year. Tourist arrivals include border tourism.

Source: Ministry of Hotels and Tourism.

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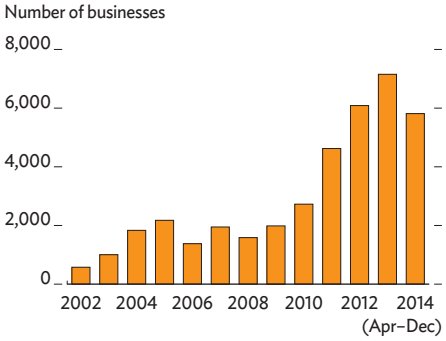
3.27.2 Domestic business registrations



Note: Years are fiscal years ending on 31 March of the next year. Data in FY2014 cover the first 9 months from April–December 2014.

Source: Directorate of Investment and Company Administration.

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This chapter was written by Peter Brimble and Yan P. Oo of the Myanmar Resident Mission, ADB, Yangon.

$4.8 billion at the end of the fiscal year, which is cover for 2.7 months of imports, down from 3.0 months in FY2013.

The government increased spending in FY2014, while revenue from sales of telecommunications licenses declined from FY2013, widening the fiscal deficit to an estimated 4.3% of GDP. Treasury bill auctions introduced in January 2015 broadened options for funding the deficit and strengthened the capacity of the Central Bank of Myanmar to follow an independent monetary policy.

Total external debt as a ratio to GDP fell slightly to 17.6%. Debt sustainability analysis by the International Monetary Fund in October 2014 found Myanmar at low risk of external debt distress after clearing arrears with Paris Club creditors in 2013.

3.27.1 Selected economic indicators (%)

	2015	2016
GDP growth	8.3	8.2
Inflation	8.4	6.6
Current account balance (share of GDP)	−6.8	−5.0

Source: ADB estimates.

Economic prospects

After moderating in FY2014, growth is forecast to accelerate to 8.3% in FY2015 and remain close to this pace in FY2016 as it is propelled by investment stimulated by structural reform, an improved business environment, and Myanmar's gradual integration into the subregion (Figure 3.27.3).

Better prospects in neighboring India and Thailand—and further afield in the major industrial economies—support the outlook for Myanmar but are partly offset by a slowdown in the People's Republic of China.

Fiscal policy is expected to provide additional stimulus in FY2015. Increases in government spending and higher civil service salaries could sharply widen the fiscal deficit to 6.3% of GDP. This raises concern because prudent fiscal policy is particularly important to macroeconomic stability when monetary policy tools are limited. It could be a challenge to maintain fiscal discipline ahead of national elections in the fourth quarter of 2015.

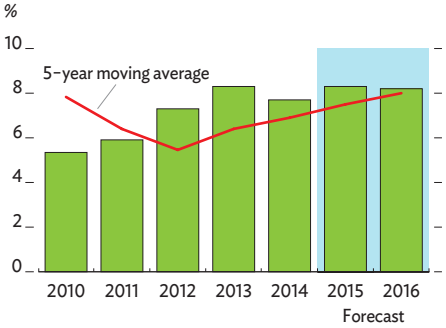
Higher fiscal spending and expected higher wages will add to domestic demand such that inflation is projected to accelerate to 8.4% in FY2015 before easing in FY2016 (Figure 3.27.4).

Strong economic growth will drive up imports, though lower global oil prices will counteract some of the impact on the trade balance. The current account deficit is seen narrowing through the forecast period (Figure 3.27.5). Eventually, though, low oil prices could drag down natural gas prices, dampening export earnings and government revenue. This vulnerability in fiscal and external accounts intensifies the need to build gross official reserves to more comfortable levels.

External debt is projected to rise to $12.5 billion in FY2015, or 18% of GDP. Myanmar's risk of debt distress is expected to remain low as significant concessional funding becomes available. In addition, a new public debt law and debt management office will strengthen the management of debt, both external and domestic.

After 4 years of significant economic reform, many development challenges remain: improving infrastructure, strengthening governance and public sector capacity, developing human capital, building a dynamic private sector, and revitalizing agriculture. Poverty reduction is imperative. The United Nations Development Programme last year ranked Myanmar 150 among 187 countries in its human development index, with 26% of the population below the poverty line.

3.27.3 GDP growth



Note: Years are fiscal years ending on 31 March of the next year.

Sources: International Monetary Fund; ADB estimates.

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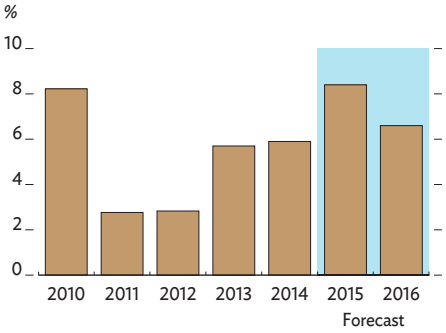
3.27.4 Inflation



Note: Years are fiscal years ending on 31 March of the next year.

Sources: International Monetary Fund; ADB estimates.

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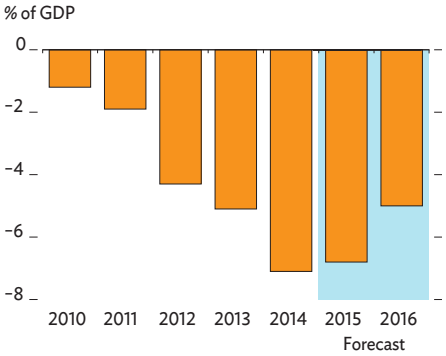
Risks to the economic outlook come from thin external and fiscal buffers, ethnic and sectarian tensions, vulnerability to bad weather, and a possible slowing of reform momentum ahead of the elections. Progress was achieved in 2014 toward improving economic data, which is badly needed to support policy formulation and planning.

3.27.5 Current account balance



Note: Years are fiscal years ending on 31 March of the next year.

Sources: International Monetary Fund; ADB estimates.

Click here for figure data

Policy challenge—equipping young people for a modern economy

Many young people entering Myanmar's workforce are poorly educated and skilled. This undercuts efforts to achieve inclusive economic growth and threatens to trap the economy in a model that adds little value and depends heavily on exploiting natural resources.

Employers cite inadequate human resources as a serious barrier to doing business. They complain that the low quality and relevance of education, compounded by low average attainment, leaves young workers ill-equipped for either work or further training because they lack basic knowledge and skills for problem-solving or teamwork.

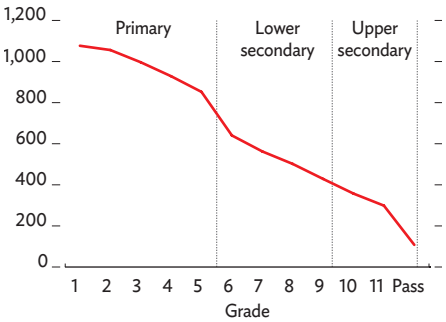
Broadening the ranks of secondary school graduates is a prerequisite to expanding and modernizing industry and services. Enhanced technical and vocational education and training (TVET) needs to play a complementary role by providing specific technical skills. However, in FY2009, 57% of males and 39% of females who were aged 18–27 and held formal jobs had left school during or immediately after secondary school, and fewer than 2% had completed post-secondary TVET.

Analysis of enrollment data suggests that secondary education is the bottleneck: of the estimated 1.1 million new enrollees in first grade in 2002, four-fifths successfully completed primary schooling 5 years later, but only one-tenth completed secondary education by passing the matriculation exam at the end of grade 11 in 2013 (Figure 3.27.6). Low pass-through from secondary school is a principal factor limiting entry into higher education and TVET. Moreover, half of all young people, and two-thirds of the poor, are unable to complete even lower-secondary education, which leaves them with virtually no access to TVET and facing bleak prospects for decent employment.

To address these challenges, the government is preparing its National Education Sector Plan, 2016–2020. The plan is expected to improve the secondary school curriculum and align it with workforce needs, boost secondary education completion rates, establish pathways linking secondary education with TVET, and expand access to new forms of demand-responsive TVET, particularly for disadvantaged youths and unskilled workers.

More broadly, the government is starting to address chronic underinvestment in education. Public investment in education was 0.8% of GDP in 2011, far below the Asian norm. From FY2011 to FY2013, the government more than tripled spending on education in nominal terms, but this brought spending to only an estimated 2.0% of GDP. Critically, the education plan will provide an evidence-based roadmap for further increases in financing.

3.27.6 Grade progression and exit from schooling



Note: "Pass" refers to grade 11 students who successfully pass the matriculation exam.

Source: ADB estimates using Myanmar Education Management Information System data for school years 2002/03–2012/13, and adjusting grade 1 enrollment for underreported repetition.

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Philippines

A recovery in government expenditure is seen driving strong economic growth, together with robust private consumption, investment, and exports. Inflation has eased and is forecast to remain moderate. Challenges are to accelerate infrastructure development and further improve the investment climate to generate more and better jobs for poverty reduction.

Economic performance

The economy expanded by 6.1% in 2014, fueled by sustained increases in private consumption, higher fixed investment, and recovery in exports. The pace of growth decelerated by almost 1 percentage point from the average of the previous 2 years, largely on a slowdown in government expenditure (Figure 3.28.1).

Private consumption generated more than 60% of the GDP growth last year. Consumer spending grew by 5.4%, benefitting from a 2.8% rise in employment, modest inflation, and higher remittances from overseas Filipinos, which reached $27.0 billion after climbing in 2014 by 6.3%, or by 10.9% in Philippine peso terms.

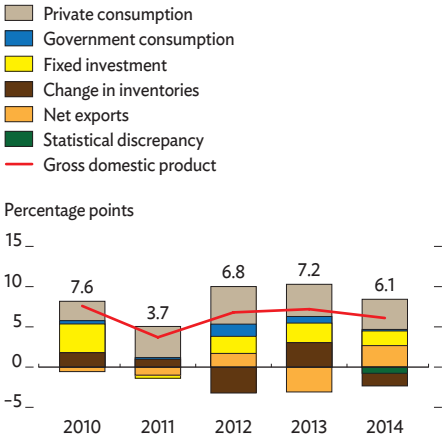
Government consumption contracted through the first 3 quarters, reflecting in part a Supreme Court ruling against certain government funds that slowed disbursements. In the fourth quarter, the government accelerated spending so that outlays for the year edged up by 1.8%, compared with a much bigger increase of 7.7% in 2013.

Fixed investment rose by 8.6%, also decelerating from the previous year largely due to the slowdown in government spending (Figure 3.28.2). Private construction rose at a double-digit pace, driven by demand for offices, retail space, and housing. Investment in machinery and transport equipment expanded as well. However, public construction fell by 1.5%, though it started to recover in the fourth quarter. Exports of goods and services rebounded in volume terms from contraction in 2013. Imports rose in volume terms at a slower pace, which generated a significant contribution to GDP growth from net external demand.

From the production side, services contributed nearly 60% of GDP growth, and manufacturing one-third. Comprising about half the economy, services grew by 6.0%, led by wholesale and retail trading, business process outsourcing, tourism, finance, and real estate.

Manufacturing grew by 8.1%, close to its recent annual average rate of increase. Buoyant domestic demand and rising export orders for manufactured products underpinned this growth. Damage inflicted by Super Typhoon Haiyan late in 2013 and other storms in 2014 hurt

3.28.1 Demand-side contributions to growth



Sources: Asian Development Outlook database; CEIC Data Company (downloaded 6 March 2015).
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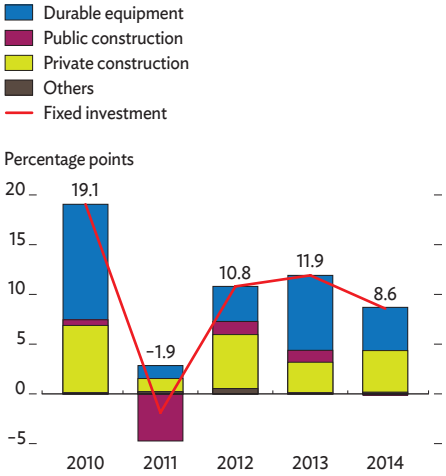
3.28.2 Contributions to fixed investment growth



Sources: Asian Development Outlook database; CEIC Data Company (downloaded 6 March 2015).
Click here for figure data

This chapter was written by Sona Shrestha and Teresa Mendoza of the Philippines Country Office, ADB, Manila.

agricultural production for much of last year, but fisheries output and crops recovered to lift full-year agricultural production by 1.9% over 2013.

Nevertheless, poor harvests and supply bottlenecks pushed inflation to 4.9% year on year in August, the highest for 3 years (Figure 3.28.3). Supply bottlenecks included a Manila city ordinance restricting cargo trucks, which disrupted deliveries. After August, better harvests, additional rice supplies from imports, and plunging global oil prices brought inflation down and put the average for 2014 at 4.1%.

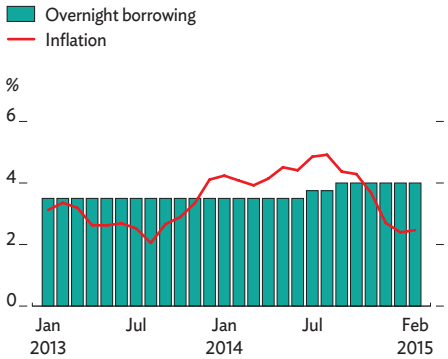
Inflation in the first 3 quarters prompted Bangko Sentral ng Pilipinas, the central bank, to raise policy interest rates by 50 basis points between July and September 2014, to 4.0% for the overnight borrowing rate and 6.0% for the overnight lending rate. The central bank raised the reserve requirement for banks by 2 percentage points to mitigate risk from the rapid expansion of domestic liquidity, and it increased the interest rate on its special deposit account. Consequently, growth in broad money (M3) decelerated to 11.3% in December.

Subdued government spending, as well as higher revenue, cut the fiscal deficit to 0.6% of GDP in 2014, well under the ceiling of 2.0% and narrower than the deficit of 1.4% recorded in 2013. Revenue rose by 11.2%, helped by more stringent tax administration, while expenditure excluding interest increased by 6.7%.

Merchandise exports rebounded to shrink the trade deficit. Exports rose in US dollar terms by an estimated 9.0% on higher shipments of machinery and transport equipment, furniture, garments, fruit and vegetables, and minerals. Exports of electronics, mainly semiconductors, recovered from a slump in 2013. A modest 2.4% increase in merchandise imports in US dollars reflected increases in capital and consumer goods tempered by falling oil prices in the second half (Figure 3.28.4).

After accounting for higher inflows of remittances and earnings from business process outsourcing, the current account surplus was estimated at 3.6% of GDP. The balance of payments was in deficit, however, on net outflows in the financial account, mainly of portfolio investment. Gross international reserves at $81.3 billion in February 2014 provided a high 10.4 months of cover for imports of goods and services and income payments. The peso depreciated by 0.5% against the US dollar between the end of 2013 and the end of 2014.

3.28.3 Inflation and policy rate



Source: CEIC Data Company (accessed 14 March 2015).
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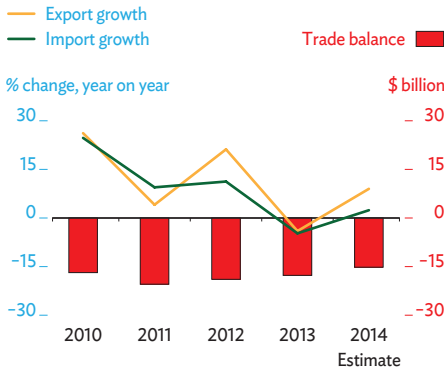
3.28.4 Merchandise trade indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 6 March 2015).
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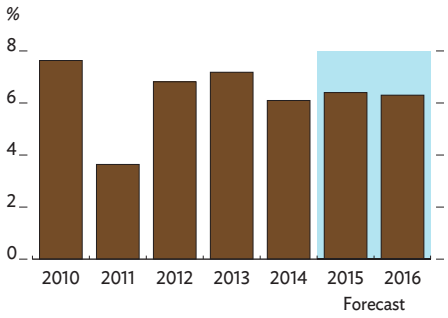
Economic prospects

Strong GDP growth is projected for 2015 and 2016 based on buoyant private consumption, a solid outlook for investment and exports, and recovery in government expenditure. GDP is projected to increase by 6.4% in 2015 and 6.3% in 2016 (Figure 3.28.5).

Factors that powered private consumption in 2014—growth in employment, modest inflation, and higher inflows of remittances—are projected to continue through the forecast period. One million new jobs were generated in the 12 months to January 2015, mostly in services, and the unemployment rate fell to 6.6% from 7.5% in January 2014. Lower fuel prices are benefiting consumers and businesses alike. Surveys conducted by the central bank show positive consumer and business sentiment (Figure 3.28.6). Upgrades to the country's credit

3.28.5 GDP growth



Source: Asian Development Outlook database.
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rating support investor sentiment. After lifting its rating for the Philippines to investment grade in 2013, Moody's upgraded it again in December 2014 by one notch to Baa2.

Prospects for construction are favorable. Building permits for houses and apartments increased by 21.5%, and nonresidential permits by 14.5%, in the fourth quarter of 2014 from the year-earlier period. Other positive indicators include brisk motor vehicle sales and growth in manufacturing output and credit. Lending to the private sector rose by 15.3% year on year in January 2015, with credit to businesses up by 16.0%. Election-related spending will provide a boost to domestic demand through May 2016, when national and subnational elections are held.

Fiscal policy is expected to become more expansionary. The government has maintained its fiscal deficit ceiling at 2.0% of GDP for 2015 and 2016, which accommodates a widening from the 0.6% deficit in 2014 if disbursements increase as planned. The government budget this year is 15.1% larger than last year and has, at the equivalent of 18.4% of GDP, the biggest ratio to GDP in at least a decade. The budget boosts allocations for social services and infrastructure and directs additional support for the development of agriculture, tourism, and manufacturing.

A master plan approved last October for rehabilitating areas damaged by Super Typhoon Haiyan will help to accelerate reconstruction spending. The plan covers 171 affected cities and municipalities and involves outlays of about $4 billion.

Inflation eased further to 2.4% in the first 2 months of 2015, mainly owing to lower fuel prices and modest increases in food prices. For the year as a whole, inflation is projected to average 2.8%. There are risks to this forecast from El Niño weather conditions that are expected to last through the first half, as well as from possible power shortages and pending petitions for higher electricity tariffs. Next year, inflation is seen quickening to 3.3% on higher global prices for oil and other commodities (Figure 3.28.7).

As inflation stays within the central bank's 2%–4% target range, the monetary authorities may maintain current policy settings for some time before resuming a gradual tightening. The policy rates were at record lows before last year's increase of 50 basis points.

Improved economic prospects for major industrial economies bode well for exports and foreign direct investment. The US is the Philippines' second biggest market after Japan, buying 14% of exports in 2014. The European Union, the market for 11% of exports, granted duty-free entry late last year to additional Philippine products. As well as stimulating exports, this concession should help to attract investment into products that enjoy duty-free access to the European Union.

Exports are forecast to rise faster than imports, pushing up the current account surplus in 2015 to 4.0% of GDP. Strong domestic demand will lift imports, but this will be countered by lower oil prices. The Philippines imports more than 90% of its oil, and crude oil comprises about 12% of total imports. In 2016, the current account surplus is projected to fall to 3.6% of GDP as oil prices rise. Sustained growth in remittances and services exports will bolster current account surpluses.

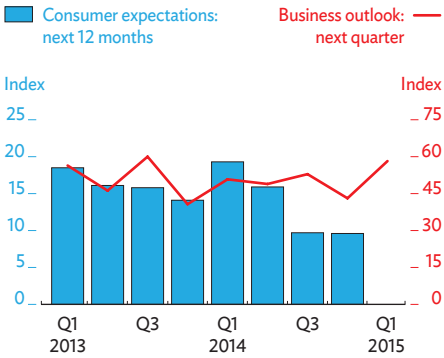
Risks to the outlook come from unexpectedly weak recovery in the industrial countries, as Japan, the US, and the euro area together

3.28.1 Selected economic indicators (%)

	2015	2016
GDP growth	6.4	6.3
Inflation	2.8	3.3
Current account balance (share of GDP)	4.0	3.6

Source: ADB estimates.

3.28.6 Consumer and business confidence



Q = quarter.
Note: A positive index indicates a favorable view.
Source: CEIC Data Company (accessed 14 March 2015).
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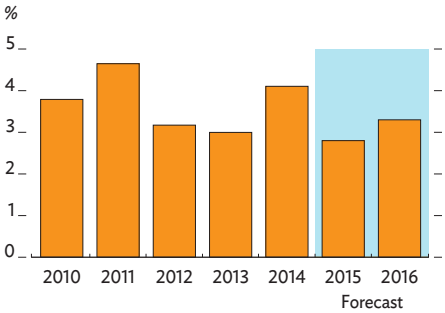
3.28.7 Inflation



Source: Asian Development Outlook database.
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take half of all Philippine exports. Luzon may suffer power shortages during the summer. To mitigate this risk, the government is providing incentives to big power users such as factories to run their own generators to ease demand on the grid. After May 2016, the new administration's priorities and policies will have an important bearing on economic prospects.

Policy challenge—stimulating investment

Higher rates of investment are needed to build on recent gains and raise employment to reduce poverty. While the Philippines has posted solid growth in recent years, unemployment and underemployment remain high. Even when the unemployment rate fell to 6.6% in January 2015, the lowest in 10 years, 2.6 million people remained jobless, nearly half of them aged 15–24 years, and a further 6.5 million were underemployed. An average of 1 million new workers join the workforce each year.

Poverty incidence declined during 2013, though a quarter of the population remained poor, reflecting the need for more and better jobs. In the first half of 2014, poverty incidence was reported at 25.8%, compared with 24.6% in the same period in 2013, rising largely due to higher food prices and damage to livelihoods caused by typhoons.

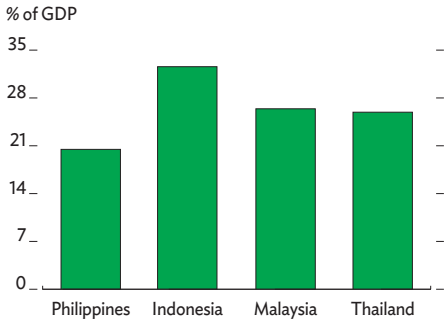
Investment has improved in the Philippines but still lags its subregional peers (Figure 3.28.8). Net foreign direct investment inflows are modest, despite a 66% increase to $6.2 billion in 2014 (Figure 3.28.9).

A key constraint on growth stems from inadequate past investment in infrastructure. The Philippines ranks 95 out of 144 countries for the quality of its infrastructure in *The Global Competitiveness Report 2014–2015* of the World Economic Forum (Figure 3.28.10). Acknowledging this, the government has prioritized infrastructure investment and aims to double outlays on infrastructure from 2% of GDP over the past decade to 4% in 2015 and further to 5% in 2016.

The government's public–private partnership program has begun to make progress. From 11 projects in 2010, the Philippines now has 61 potential projects in the pipeline, covering highways, railways, light rail mass transit, classrooms, and hospitals. Nine projects costing a total of $2.9 billion have been awarded since 2010. Meeting the country's vast infrastructure needs requires the program's continued development through the enactment of proposed legislation to improve the framework for public–private partnership, better project appraisal and monitoring, and strengthened capacity in the agencies involved.

Recent liberalization of aviation policy and lifting of restrictions on foreign ownership of banks were important milestones. Further reforms to enhance competition, improve regulatory efficiency, and reduce the administrative costs of doing business are crucial for achieving higher levels of investment.

3.28.8 Fixed investment, 2014



Source: Asian Development Outlook database.
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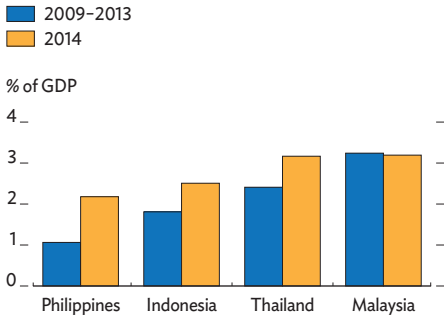
3.28.9 Foreign direct investment inflows



Source: Asian Development Outlook database.
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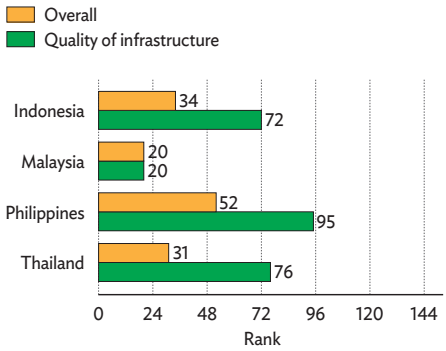
3.28.10 Global competitiveness ranking, 2014–2015



Note: Data shows ranking out of 144 countries.
Source: World Economic Forum. *The Global Competitiveness Report 2014–2015.*
Click here for figure data

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Singapore

The economy slowed in 2014, inflation remained tame, and the current account improved. An uptick in growth is forecast for 2015 and 2016, with inflation subsiding in 2015 and edging up again later, and external surpluses narrowing. The main policy challenge during the forecast period is to enhance the business environment for creating competitive export-oriented enterprises.

Economic performance

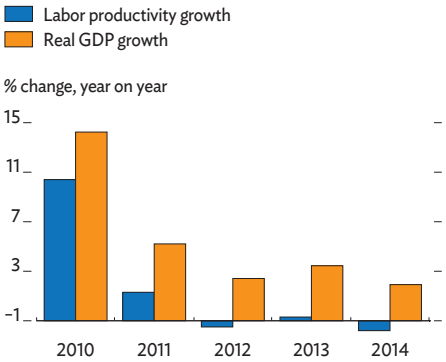
GDP growth slowed to 2.9% in 2014 from 4.4% in 2013 as productivity gains remained weak for the third straight year (Figure 3.29.1). The service sector was the main driver of growth in 2014, expanding by 3.2% and contributing 2.1 percentage points to GDP growth (Figure 3.29.2). Finance, insurance, and business services were the best performers, and their share in GDP increased to 25.6% in 2014. Industry contributed 0.7 percentage points to growth, as biomedical and chemical output rose on strong external demand. Construction growth halved to 3.0% on weak private sector activity. Quarrying rebounded, as did agriculture and fisheries as the government provided funds to farmers to increase their yield and productivity.

On the demand side, net exports expanded further in 2014, contributing 1.7 percentage points to GDP growth as exports rose by 2.1% in real terms, outpacing the 1.4% rise in imports (Figure 3.29.3). Growth in domestic demand decelerated to 0.3% because investment contracted and growth in government expenditure was weak, contributing only 0.01 percentage points to GDP growth. Investment to construct nonresidential buildings fell, and government expenditure rose by only 0.1%, a tiny fraction of the 11.5% expansion in 2013. However, private consumption rose by 2.5% and contributed 1.0 percentage point to growth as wages continued to rise, reflecting a low unemployment rate and job vacancies outnumbering job seekers.

With global commodity prices soft, inflation averaged 1.0% in 2014, down from 2.4% in 2013 (Figure 3.29.4). Increases in prices for prepared food, recreation, and health care were the main contributors to inflation, but transport and communication costs moderated as prices for automobiles and internet subscription fees declined. Core inflation, which excludes rent and private road transport, increased to 2.0% in 2014 from 1.7% in 2013.

The trade surplus expanded to equal 24.8% of GDP in 2014, though exports and imports both declined in foreign currency terms. Exports were weighed down by falling exports of refined petroleum products

3.29.1 Labor productivity and real GDP



Source: Singapore Department of Statistics and Manpower Research & Statistics Department, Ministry of Manpower (accessed 23 February 2015).

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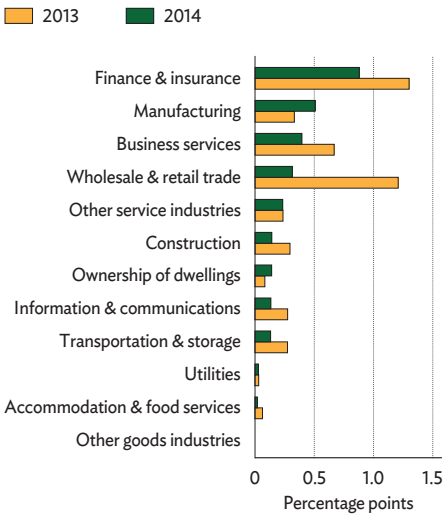
3.29.2 Contribution to growth, by industry



Source: Ministry of Trade and Industry. Economic Survey Singapore 2014 (accessed 23 February 2015).

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This chapter was written by Minsoo Lee and Mai Lin Villaruel of the Economic Research and Regional Cooperation Department, ADB, Manila.

and the continued slump in electronics, while merchandise imports shrank as oil imports fell by 1.7% with the sharp drop in oil prices in the fourth quarter. Services exports have been recording robust growth in recent years and now make up over a quarter of the country's exports. However, net services registered a deficit amounting to 0.4% of GDP in 2014 as insurance and financial payments exceeded maintenance, transport, and insurance receipts. The current account surplus widened to 19.1% of GDP, but the overall surplus in the balance of payments narrowed to 2.0% of GDP, owing to large deficits in the capital and financial accounts (Figure 3.29.5).

The budget recorded a deficit of S$126 million in FY2014 (ending 31 March 2015), or 0.03% of GDP, as government expenditure including special transfers rose by 16.1% while revenue including contributions from investment returns grew by 7.0% (Figure 3.29.6). Revenue growth reflected rising personal income tax and vehicle quota premiums paid to obtain certificates of entitlement, which are required for motor vehicle registration. The steep rise in government expenditure followed higher outlays on health care, culture, community and youth, and special transfers.

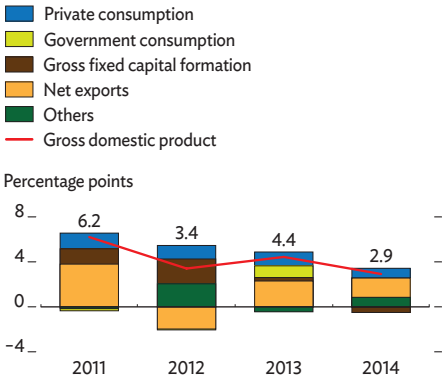
The Monetary Authority of Singapore maintained its policy of modest and gradual appreciation of the Singapore dollar in terms of its nominal effective exchange rate (NEER)—a policy that has served the country well by containing inflation both domestic and imported, and by ensuring that inflation expectations remain anchored. The appreciating trend in the NEER and the real effective exchange rate continued in 2014, but at a slower pace than in 2013, with the NEER rising by 1.3% and the real effective exchange rate by 0.1% (Figure 3.29.7). The Singapore interbank offered rate increased by 0.03 basis points in 2014, dampening the growth of credit (Figure 3.29.8), which together with a substantial narrowing of the balance of payments surplus reduced the growth of money supply (M2) to 3.3% from 4.3% in 2013

Economic prospects

Influenced by diverging global economic developments and ongoing economic restructuring, the Singapore economy is forecast to grow by 3.0% in 2015 and 3.4% in 2016, as global recovery gathers momentum and the service sector continues to strengthen. Finance, insurance, and business services will be the main drivers of growth again in 2015 and 2016, but growth in labor-intensive sectors like construction, retail, and food services could be constrained by the persistently tight labor market.

Domestic demand will expand as public investment and government spending on public transportation and health-care infrastructure is expected to rise. Benefitting from higher government subsidies for education services and the enhancement of a low-income voucher scheme, private consumption should also rise in 2015. With moderate improvement in external demand in 2015 on the expected strengthening of its partner economies, Singapore should see exports grow modestly—though they may be also tamped down by weakening exports of petroleum products, which fell by 33.3% year on year in January 2015.

3.29.3 Demand-side contributions to growth



Source: Ministry of Trade and Industry. Economic Survey Singapore 2014 (accessed 23 February 2015).
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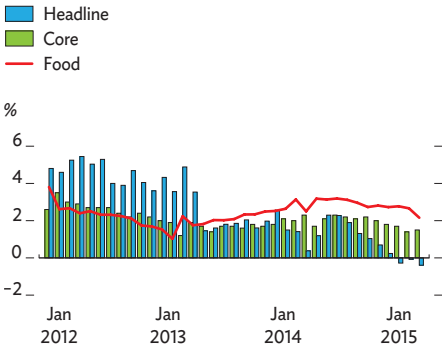
3.29.4 Inflation



Source: CEIC Data Company (accessed 23 February 2015).
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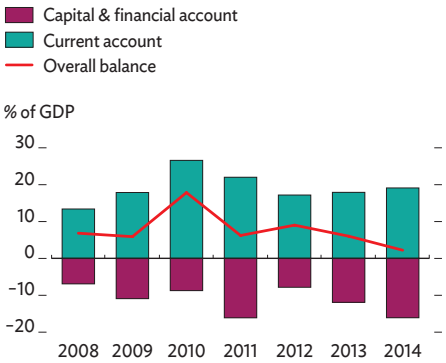
3.29.5 Balance of payments



Source: CEIC Data Company (accessed 23 February 2015).
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3.29.1 Selected economic indicators (%)

	2015	2016
GDP growth	3.0	3.4
Inflation	0.2	1.5
Current account balance (share of GDP)	18.9	19.3

Source: ADB estimates.

Imports are expected to grow even more slowly, however, generating a modest rise in net exports. The current account surplus will narrow to 18.9% of GDP in 2015 and rise to 19.3% in 2016.

The inflation rate will slow to 0.2% in 2015 as oil prices decline, domestic cost pressures recede, and the Singapore dollar continues to appreciate through a measured change in the NEER. Rental increases will likely be minimized by current macroprudential policies, and transportation costs will rise little in 2015 as lower premiums for certificates of entitlement are sustained. Wages may rise modestly owing to the tightening labor market, but the authorities do not expect the pass-through to be large. In 2016, the inflation rate may rise to 1.5% as commodity prices start to edge up.

Fiscal policy will be expansionary in 2015 with a rise in the budget deficit to 1.6% of GDP in FY2015 (ending 31 March 2016). Government expenditure is expected to increase by more than 14.0% as outlays on health-care infrastructure, public transport, and Changi Airport increase, surpassing the 4.7% growth in revenue anticipated from duties on motor vehicles in particular.

External risks to the outlook include sluggish growth in the advanced economies (particularly in the euro area and Japan), continuing structural reform in the People's Republic of China (PRC), and the impact on the Singapore interbank offered rate from eventual higher interest rates in the US. Domestically, a sharp correction in the real estate market may adversely affect construction and real estate investment, and rising labor costs and declining labor productivity could hinder the growth of labor-intensive sectors, slowing economic growth during the forecast period.

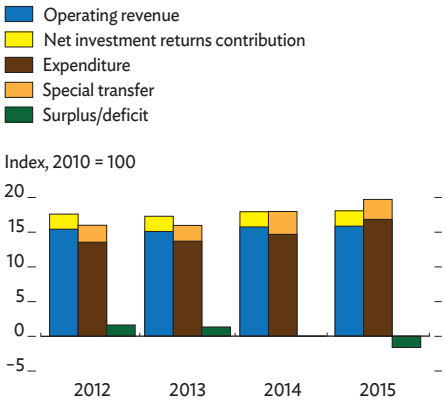
Policy challenge—building efficient companies to safeguard resilient growth

Singapore's small domestic market makes the maintenance of its current export orientation and global competitiveness essential for safeguarding resilient economic growth. To stay globally competitive, Singapore needs to position itself to take advantage of existing and prospective developments in the region. It needs to facilitate the establishment of additional world-class service companies to cater to the needs of a growing middle class in the Association of Southeast Asian Nations (ASEAN) and beyond.

ASEAN—a growing market of 620 million people with a combined GDP of $2.3 trillion in 2013—is Singapore's top investment destination and its largest trading partner, accounting for more than 26% of its trade. The urban population of ASEAN is growing fast and will account for 65% of the population by 2030, spurring demand for modern services that Singapore can provide. ASEAN's links with global value chains enhance Singapore's selling point as a hub for the region and allows Singapore-based companies to better tap opportunities both within the region and further afield.

Other developments in Singapore's international trade relations provide additional opportunities. With the implementation of the

3.29.6 Fiscal balance



Note: Years are fiscal years, ending on 31 March of the next year.

Source: Ministry of Finance.

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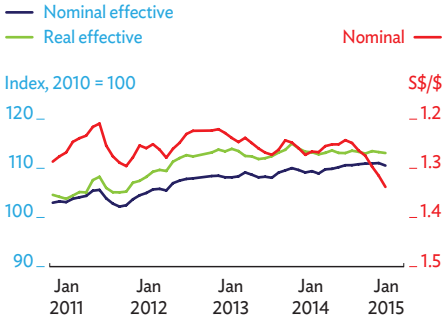
3.29.7 Exchange rates



Source: CEIC Data Company (accessed 23 January 2015).

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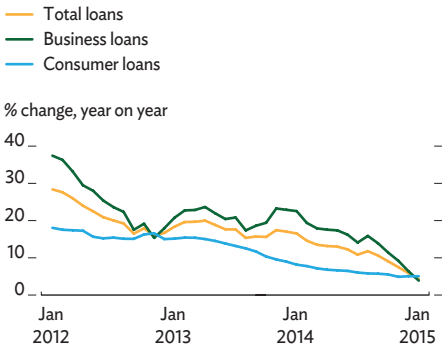
3.29.8 Bank lending



Source: Monetary Authority of Singapore. http://www.mas.gov.sg

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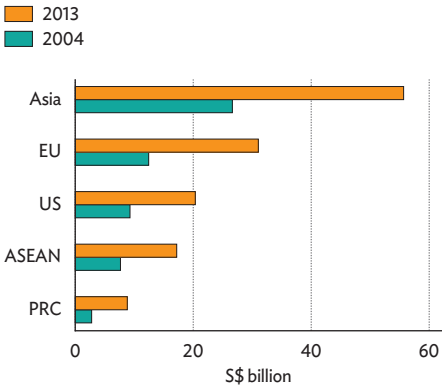
ASEAN Economic Community in 2015, Singapore will benefit from lower foreign equity limits and reduced tariff and nontariff barriers to trade in services, which is an important sector in Singapore's economy (Figure 3.29.9). In addition, the Regional Comprehensive Economic Partnership—which will link ASEAN with Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand when established—should boost intraregional trade flows to the benefit of Singapore's wholesale trade sector.

The government is already leveraging these advantages to encourage the emergence of competitive export-oriented companies that can cater to the burgeoning needs of ASEAN members and other countries. Singapore is halfway through its program of economic restructuring toward innovation and accelerated internationalization. The 2015 budget will raise grant support and introduce tax deductions and incentives for small and medium-sized enterprises to help them capture greater value from research and development. It will also catalyze enterprise financing, which is important for small businesses attempting breakthrough. In particular, improvements in tax allowances for acquisition costs and tax benefits for mergers and acquisitions should help small and medium-sized enterprises scale up, attract talent, and compete effectively overseas toward becoming strategic partners to multinational companies.

The government could also encourage investment overseas by companies that it partly or wholly owns and that have potential to lead the development of indigenous technological capabilities. Meanwhile, Singapore should strive to maintain its current position as the ASEAN hub for trade, finance, and intellectual property.

The authorities plan to enhance productivity over the next decade by encouraging businesses to upgrade their technological and capital bases, create better jobs, and raise real wages. These efforts could be undermined, however, by an aging population and a shrinking labor pool, which could inhibit the growth of established enterprises and the launch of new ones. An effective response would be for Singapore to extend to labor flows the kind of liberal external economic policy it maintains for trade in goods and services.

3.29.9 Exports of services by major trading partner



ASEAN = Association of Southeast Asian Nations members excluding the Lao People's Democratic Republic, EU = European Union members Belgium, Denmark, France, Germany, Italy, the Netherlands, Norway, Switzerland, and the United Kingdom, PRC = People's Republic of China, US = United States.

Notes: Data on major trading partners are based solely on data from the International Trade in Services Survey for which the latest year available is 2013. Asia includes ASEAN; the PRC; Hong Kong, China; India; Japan; the Republic of Korea; Saudi Arabia; Taipei,China; and the United Arab Emirates.

Source: Singapore Department Statistics, Ministry of Trade and Industry.

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Thailand

Cautious economic recovery that started in 2014 is expected to gather momentum slowly, nudged forward by higher investment and abetted by a calmer political environment, better prospects for some exports markets, and lower fuel costs. Consumer prices will barely change this year before edging up in 2016. Stronger public investment depends heavily on state-owned enterprises, which need reform.

Economic performance

A contraction in GDP in the first quarter of 2014 was followed by a cautious recovery sufficient for the economy to post marginal growth of 0.7% for the year (Figure 3.30.1). Political unrest and street protests disrupted economic activity into the first half of 2014, culminating in a military takeover of the government in May. Various disruptions since 2007 have confined average growth over this period to 2.9%.

Consumption and net exports contributed to the slight GDP increase in 2014, while investment fell sharply. Private consumption recorded meager growth of 0.3%, weighed down by depressed consumer confidence during the political strife and a decline in farm incomes caused by weaker prices for agricultural products. Government consumption also made a minor contribution to GDP growth.

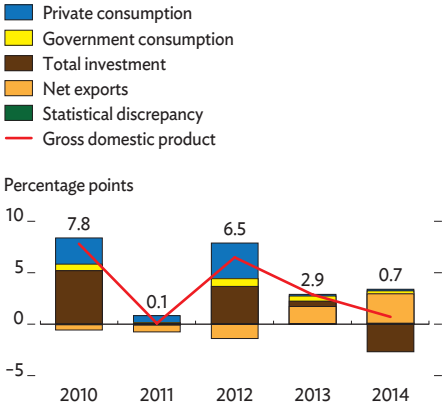
However, fixed investment fell by 2.8% in 2014, following on from a 2.0% decline in the previous year (Figure 3.30.2). Public fixed investment was hampered by political disruptions and legal challenges to the previous administration. Political uncertainty and soft domestic and external demand hurt private investment, which started to recover in the second half.

Imports of goods and services shrank in volume terms more than exports did, allowing net external demand to make the biggest contribution to GDP growth.

From the supply side, services grew by 2.2% and agriculture by a modest 1.1%, but industry contracted by 0.9%. Services benefited from growth in telecommunications and finance, partly offset by weakness in wholesale and retail trade—and in hotels and restaurants as tourist arrivals fell by 6.7% to 24.8 million, suppressed by street protests and military intervention (Figure 3.30.3). Agriculture, hampered by lower prices for rice and natural rubber and a disease in shrimp aquaculture, grew at the weakest pace in 4 years.

Contraction in industry stemmed mainly from declines in manufacturing and construction. Manufacturing, hit by slack domestic demand and declining export orders, shrank by 1.1%. Construction

3.30.1 Demand-side contributions to growth



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 17 February 2015).
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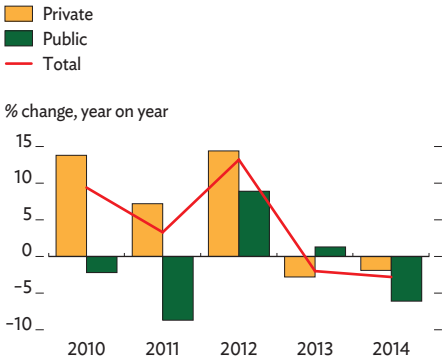
3.30.2 Fixed investment growth



Source: National Economic and Social Development Board. http://www.nesdb.go.th (accessed 17 February 2015).
Click here for figure data

This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

contracted by 3.8%, mainly the result of a political vacuum in the first part of the year that delayed construction by state-owned enterprises.

Inflation decelerated for a third straight year in 2014, to average 1.9%. Weak domestic demand and lower food and oil prices pulled inflation down to 0.6% year on year by December (Figure 3.30.4).

Responding to the first-quarter economic contraction, the Bank of Thailand, the central bank, lowered its policy interest rate in March 2014 by 25 basis points to 2.0%. Although commercial banks trimmed lending rates, growth in credit to the private sector slowed sharply to 4.5%, reflecting subdued demand for loans and banks' deepening caution toward extending credit to households and small businesses.

Government spending through the first half of FY2014 (ended 30 September 2014) was severely limited by legal and political constraints, causing the fall in public fixed investment. Total government spending and revenue fell over the fiscal year, and the fiscal deficit widened to 2.5% from 2.0% in the previous year.

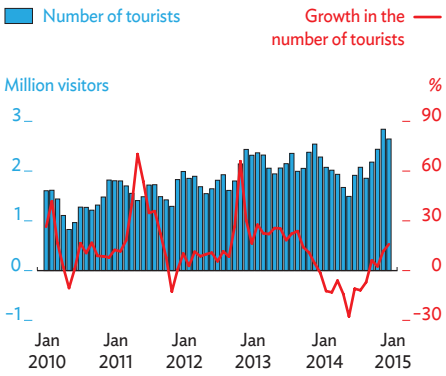
In the external accounts, sluggish demand in major markets and falling prices for export commodities, including natural rubber and sugar, nugged merchandise exports down by 0.3% to $224.8 billion in 2014. Exports to the People's Republic of China fell by a relatively sharp 7.9%.

Merchandise imports dropped by 8.5% to $200.2 billion, a result of lower exports, falling oil prices, and weak domestic demand, particularly for capital goods (Figure 3.30.5). Consequently, the trade surplus jumped to $24.6 billion, and the current account turned to a surplus of $14.2 billion, equal to 3.8% of GDP.

Capital and financial accounts registered net outflows of $15.3 billion, mainly on outflows of portfolio investment, and the balance of payments showed a small deficit. Gross international reserves of $157.1 billion at the end of 2014 covered 7.4 months of imports. The Thai baht weakened early in 2014 but ended the year little changed against the US dollar. It appreciated over the year against the euro, the Japanese yen, and most regional currencies.

The previous government's costly support program for rice farmers ended last year. After that, farmers faced not only declining rice prices but also drought in many areas. The interim administration provided support through subsidies for rice farmers' production costs, capped at B15,000 per farm. It paid B1 million to each drought-affected district for community investments and hired farmers temporarily to maintain irrigation canals. Rubber producers also received a subsidy for production cost.

3.30.3 Tourism indicators



Source: Bank of Thailand. http://www.bot.or.th (accessed 16 February 2015).

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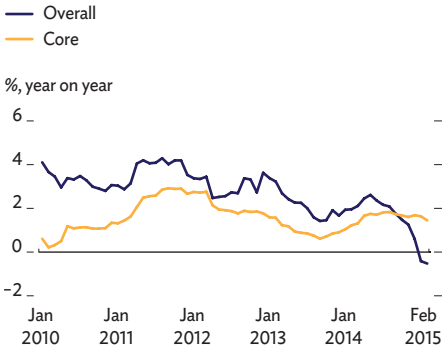
3.30.4 Monthly inflation



Source: CEIC Data Company (accessed 9 March 2015).

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Economic prospects

The economy is expected to benefit this year from a relatively calm political environment, the restoration of government investment, better prospects for exports to the major industrial economies, and lower fuel costs for businesses and consumers. These factors are forecast to lift GDP growth to 3.6% in 2015 and 4.1% next year (Figure 3.30.6).

In particular, public fixed investment will rise in 2015 after last year's decline and is expected to accelerate in 2016. The interim government

3.30.1 Selected economic indicators (%)

	2015	2016
GDP growth	3.6	4.1
Inflation	0.2	2.0
Current account balance (share of GDP)	4.0	1.5

Source: ADB estimates.

has approved an infrastructure program that includes $95 billion in investments over 8 years in railways, roads, ports, airports, and special economic zones. This year, public investment will be confined to relatively small projects, with larger-scale construction to start from next year. The government plans to offer contracts for mass transit rail lines in Bangkok and for double-tracking rail lines across the country.

Fiscal policy is expected to support economic recovery. The budget for FY2015 provides for a deficit of B250 billion, equivalent to 1.9% of projected GDP. In addition, the government is implementing stimulus measures such as a soft-loan program through state-owned financial institutions and is drawing on funds carried over from past budgets to help finance public investment. The execution of budget programs has improved as 42.6% of the budget was disbursed in the first 5 months of FY2015. Looking to FY2016, the fiscal deficit is expected to widen to B390 billion to accommodate additional spending. Public debt is manageable at 45.8% of GDP, below the 60.0% ceiling set under the fiscal sustainability framework.

Private fixed investment is recovering gradually and is expected to pick up as infrastructure projects get under way and consumption spending strengthens. After approvals for firms' investment privileges ground to a halt last year during the political disruptions, they have resumed. Lower energy costs and a further reduction in interest rates in March 2015 should support investment, though low capacity utilization hinders expansion in some industries.

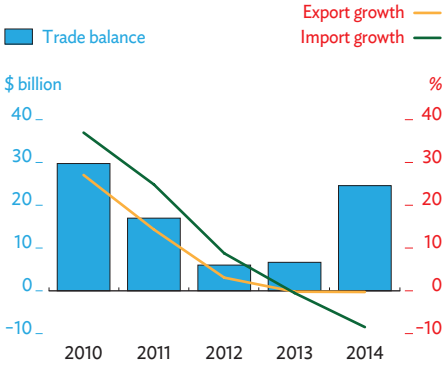
The interim government plans to develop five special economic zones along Thailand's borders to attract industries such as logistics, processing agricultural products, and labor-intensive manufacturing. Investors in the zones get several tax breaks and privileges, including permission to employ foreign experts and for foreign investors to own land. Under the plan, migrant workers from neighboring countries can work in the Thai zones and still live at home.

Consumer confidence rallied in the second half of 2014 on the calmer political environment, but confidence waned in early 2015 (Figure 3.30.7). Household spending is expected to show a modest increase this year, supported by higher civil service salaries from January, lower fuel costs, and government measures to help farmers. However, data for January showed that private consumption and private investment remained sluggish (Figure 3.30.8).

Recovery in consumer spending is muted by flagging rural incomes caused by subdued prices for agricultural products and high household debt that by last September had risen to the equivalent to 84.2% of GDP. Under a new program designed to improve access to formal finance and ease the cost of debt servicing for low-income earners, nonbank financial institutions can lend up to B200,000 to individuals at interest rates above those charged by commercial banks but far below those charged by unlicensed loan sharks.

Because lower prices for fuel and transport more than compensated for slightly higher prices for most other consumer goods and services, consumer prices eased by 0.5% in the first 2 months of 2015. For the full year, inflation is projected to average a low 0.2% (Figure 3.30.9). In March, the central bank lowered its policy interest rate by 25 basis

3.30.5 Trade indicators



Sources: Bank of Thailand. http://www.bot.or.th (accessed 6 March 2015); National Economic and Social Development Board. http://www.nesdb.go.th (accessed 17 February 2015).

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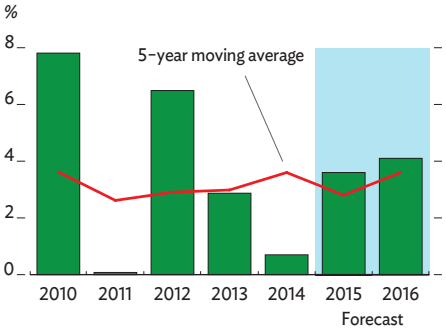
3.30.6 GDP growth



Source: Asian Development Outlook database.

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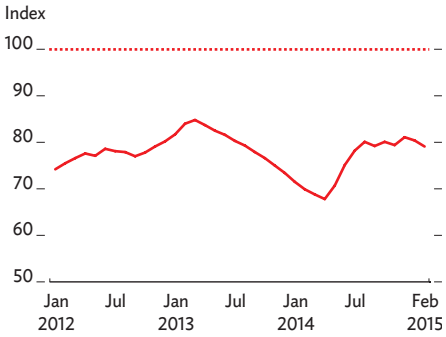
3.30.7 Consumer confidence



Note: A reading of less than 100 denotes a deterioration in consumer confidence.

Source: Bank of Thailand. http://www.bot.or.th (accessed 27 February 2015).

Click here for figure data

points to 1.75%, citing a disappointingly weak economic recovery and declining consumer prices (Figure 3.30.10).

Next year, inflation is seen quickening to 2.0% as domestic demand strengthens and global prices for food and other commodities turn up. A restructuring of domestic fuel prices has reduced subsidies on diesel and cooking gas and lowered the excise tax on benzene, bringing prices more in line with the international market.

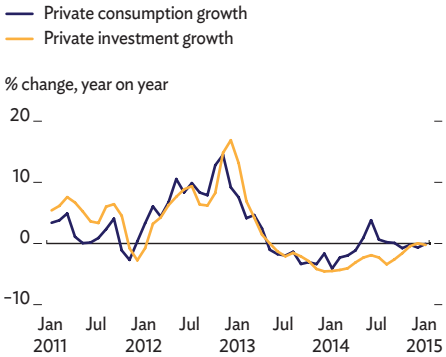
Exports are projected to improve gradually through the forecast period. In January of this year, merchandise exports declined by 3.5% in value terms. Shipments of manufactured goods rose, but export commodities remained weak. Imports will recover from last year's slump, though the increase will be contained by lower oil prices; crude oil and petroleum products comprised 21% of Thailand's total merchandise imports in 2014. Imports will accelerate from 2016 if major infrastructure projects get under way as planned.

Tourism is likely to be a bright spot this year, illustrated by a 15.9% rise in tourist arrivals in January. Further gains in tourism receipts are expected in 2016, particularly if martial law is lifted nationwide by the interim administration ahead of proposed elections.

These developments are expected to generate a significant current account surplus in 2015 and a smaller surplus in 2016 (Figure 3.30.11).

Domestic risks to the economic recovery center on how well the public infrastructure program is implemented and on political uncertainty. The interim government has set an ambitious target to disburse better than 90% of its investment budget in FY2015. A significant shortfall would dent confidence and growth. The outlook assumes that national elections proceed smoothly in 2016 and that the incoming government follows credible economic policies. External risks come from volatile global capital flows and growth in major trading partners turning out weaker than anticipated.

3.30.8 Private consumption and investment



Note: Seasonally adjusted, 3-month moving average.

Source: Bank of Thailand. http://www.bot.or.th (accessed 27 February 2015).

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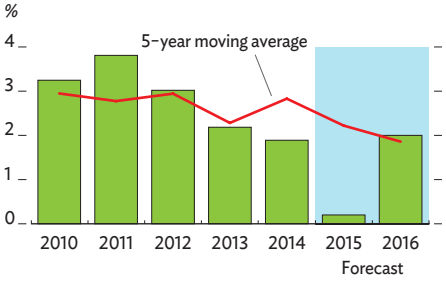
3.30.9 Inflation



Source: Asian Development Outlook database.

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Policy challenge—reforming state-owned enterprises

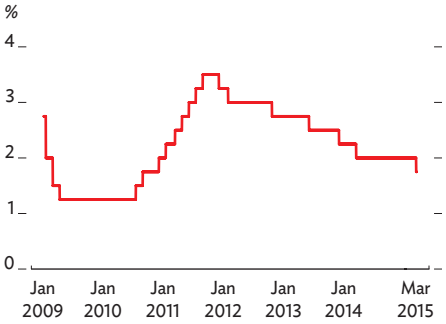
The need for stronger public sector investment to help revive Thailand's economy and to improve its infrastructure has turned a spotlight on the country's state-owned enterprises (SOEs), whose combined annual outlays are twice those of the government.

The assets of the 56 SOEs, which range from banks to airlines and energy companies, total $355 billion, and their annual investment exceeds that of the government (Figure 3.30.12).

Renewed focus on the role of SOEs has prompted proposals to improve their performance and efficiency, help shield them from political interference, and stem the drain on the national budget caused by the half of SOEs that operate at a loss.

Governments over the years have used SOEs to implement programs that, while popular with sections of the public, have imposed at times large, opaque financial burdens on the SOEs and eventually the state. The rice-pledging program launched by the previous government in 2011 to bolster rural incomes is an example. Payments to farmers to buy their

3.30.10 Policy interest rate



Source: Bloomberg (accessed 12 March 2015).

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rice at a 40%–50% premium above the market price were made through the state-owned Bank for Agriculture and Agricultural Cooperatives. But the bank's financial position was jeopardized at one stage when the previous government was unable to reimburse the rice purchases in a timely way. The program expired last year, leaving the state with huge losses.

Government lending programs and political interference that compromised lending decisions over the years contributed to financial stress at the state-owned Small and Medium Enterprise Development Bank of Thailand (SME Bank). In 2013, SME Bank was weighed down by nonperforming loans that equaled 33.7% of total lending, and by a capital-adequacy ratio less than half that of commercial banks. Early in 2015, the Ministry of Finance injected B2 billion into SME Bank to bolster its capital.

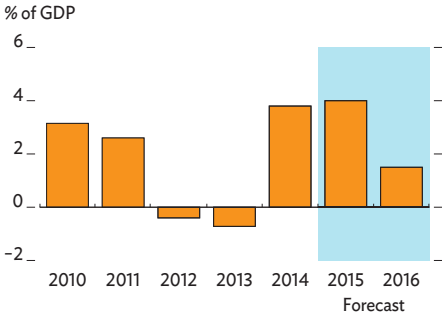
Well-designed public service programs executed through SOEs can benefit the public and effectively stimulate the economy. However, the programs and the government's funding obligations should be transparent and defined precisely, allowing the SOEs to maintain accounts that separate public service activities from regular operations.

At the State Railway of Thailand, the sole operator of railway services in the country, passenger traffic fell by 41% from 1993 to 2009, but the railway kept in operation roughly the same number of trains. Low-fare passenger traffic takes up 70% of the railway's track capacity. The railway incurs annual losses and at times lacks adequate funds for maintenance. Its freight operations have been slowly losing ground to road carriers, partly because the railway is short of suitable rolling stock and other equipment.

To address some of these issues, the interim administration appointed the State Enterprises Policy Commission, which earlier this year approved a rehabilitation program for seven SOEs, including SME Bank, the State Railway of Thailand, and Thai Airways International. The commission has approved in principle the formation of a holding company to supervise SOEs and shield them from direct political intervention. Another proposal being discussed is to bring governance standards at SOEs into line with those at companies listed on the stock exchange.

Longer term, consumers and businesses would benefit from stiffer competition with SOEs from private firms, which should spur them to improve their performance. Indirect subsidies enjoyed by SOEs, such as government guarantees on debt and exemption from certain regulations, could be reconsidered to drive higher efficiency.

3.30.11 Current account balance



Source: Asian Development Outlook database.
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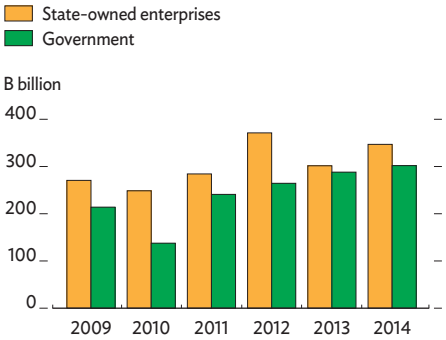
3.30.12 Capital investment budget



Source: Bureau of Budget and State Enterprise Policy Office.
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Viet Nam

Rising foreign direct investment helped to accelerate economic growth to 6.0% in 2014. Inflation abated, and robust external accounts enabled the rebuilding of foreign reserves. Growth is forecast to edge higher again this year and next, while inflation remains relatively low. Policy challenges are to reform banks and state enterprises and to integrate domestic firms into global value chains.

Economic performance

The economy grew by 6.0% in 2014, the strongest pace since 2011 (Figure 3.31.1). Industry expanded by 7.1%, against 5.4% in 2013, benefitting from foreign direct investment (FDI) that boosted growth in manufacturing to 8.5%. Recovery in demand for property lifted growth in construction to 7.1%. Agriculture picked up to grow by 3.5%, supported by higher exports of fish and shrimp.

By contrast, growth in services eased from the previous year to 6.0%, partly a result of fewer visitors from the People's Republic of China (PRC), which hurt tourism. Total visitor arrivals increased by 4.0% in 2014—a deceleration from 10.6% in 2013.

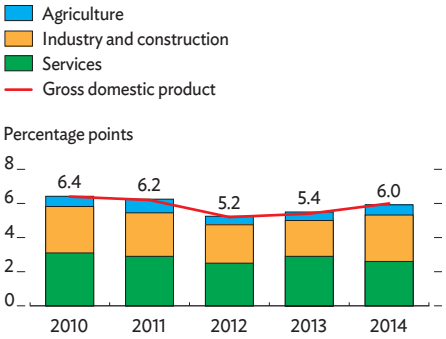
On the demand side, private consumption accelerated by almost a percentage point to 6.1%, reflecting improved consumer sentiment. Growth in public consumption eased to 7.0% as the government reduced capital expenditure and contained increases in public sector wages. Investment strengthened last year as gross capital formation rose by 8.9%, spurred by an estimated 16% increase in FDI disbursements and lower domestic interest rates. However, net external demand weighed on GDP growth because imports of goods and services rose in volume terms at a faster pace than exports.

Inflation decelerated to average 4.1% in 2014, the lowest in 10 years, owing to better food production and lower global prices for oil and commodities. By the end of 2014, inflation was just 1.8% year on year (Figure 3.31.2).

Moderating inflation paved the way for the State Bank of Viet Nam, the central bank, to reduce policy interest rates by a further 50 basis points, to 6.5% for the refinancing rate and to 4.5% for the discount rate. Commercial banks lowered lending rates, which helped to stimulate credit growth to an estimated 12.6%, meeting the central bank's 12%–14% target for 2014 (Figure 3.31.3). M2 money supply grew by an estimated 16%, also in line with the official target.

International reserves recovered by the end of 2014 to an estimated 3 months of import cover (Figure 3.31.4). Merchandise exports rose by an estimated 13.7% on a balance-of-payments basis and in US dollars, supported by further gains in shipments of manufactured products

3.31.1 Supply-side contributions to growth



Source: General Statistics Office of Viet Nam.
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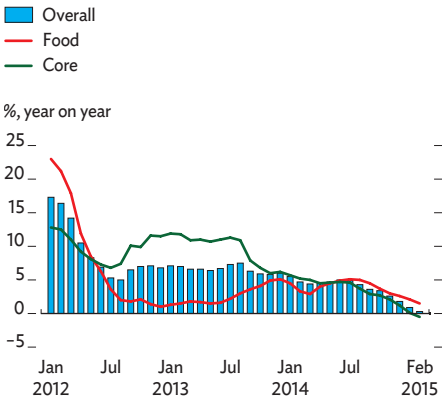
3.31.2 Inflation



Source: General Statistics Office of Viet Nam.
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This chapter was written by Dominic Mellor, Aaron Batten, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

such as mobile phones from foreign-invested factories. Measured the same way, imports rose by 12.1%, so that the trade surplus increased to an estimated $11.9 billion. Exports benefitted from a 1% devaluation of the Viet Nam dong against the US dollar in June 2014, which followed a similar devaluation in mid-2013.

The current account recorded its fourth consecutive surplus, estimated at $8.1 billion or 4.4% of GDP. On the capital account, the 16% increase in FDI disbursements to $8.1 billion more than offset a drop in portfolio inflows (Figure 3.31.5).

Fiscal policy was moderately expansionary in 2014. The fiscal deficit, excluding off-budget and onlending items, widened to 4.4% of GDP from 3.9% in 2013. Preliminary figures show that budget expenditure remained at the equivalent of 25.9% of GDP, but revenue and grants fell to 21.5% of GDP, mostly a result of weak growth in tax collection.

Moody's Investors Service raised Viet Nam's sovereign credit rating by one notch to B1, and Fitch upgraded its rating to BB–, citing improved macroeconomic stability and stronger external accounts. These actions supported the government's sale of $1 billion in 10-year bonds at an annual coupon rate of 4.8%, the lowest rate of its three issuances of offshore debt denominated in US dollars since 2005.

The Viet Nam Asset Management Company acquired from banks an estimated $5.7 billion in nonperforming loans by the end of 2014, a key part of the government's efforts to mend a banking system handicapped by impaired balance sheets and insufficient capital. However, the government has yet to outline a clear strategy to resolve the nonperforming loans. Further, the extent of bad loans remaining with the banks is unclear. Full enforcement of new guidelines on loan loss classification and provisioning was delayed until April 2015.

Cross holdings between banks, as well as between banks and nonbanks, pose risks to the financial sector. The central bank introduced new prudential regulations to address this issue that, if effectively implemented, will improve financial stability.

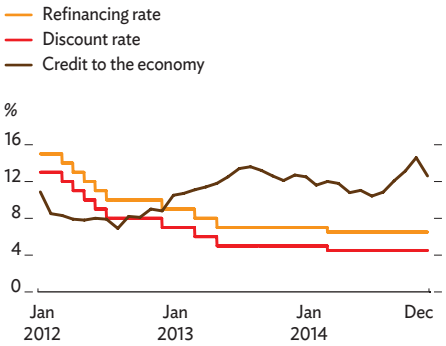
Addressing the reform of underperforming state-owned enterprises (SOEs), the government approved new laws to guide divestment of SOE assets and accelerate their commercialization. The number of SOEs equitized or partly privatized rose in 2014, though it fell short of the official target (Figure 3.31.6).

Economic prospects

GDP growth is forecast to edge up to 6.1% in 2015 and 6.2% in 2016, with FDI an important driver (Figure 3.31.7). Data from the Foreign Investment Agency show that new FDI commitments rose to $15.6 billion in 2014, while an additional $4.6 billion was committed to existing foreign-funded projects.

Better economic performance in the major industrial economies—particularly the US, Viet Nam's biggest export market—will spur exports, but this positive effect will be partly offset by slowing growth in the PRC. Exports of manufactured products will continue to expand, given that 76% of last year's disbursed FDI was directed into manufacturing.

3.31.3 Interest rates and credit



Source: State Bank of Viet Nam.

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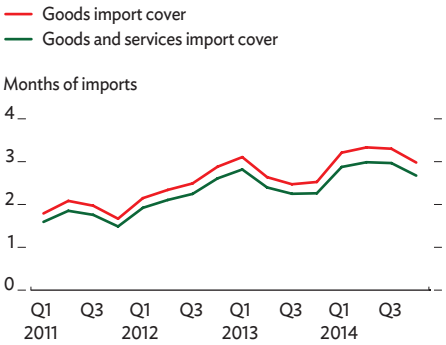
3.31.4 Gross international reserves



Q = quarter.

Note: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations. Imports are on free-on-board.

Sources: State Bank of Viet Nam; International Monetary Fund; ADB estimates.

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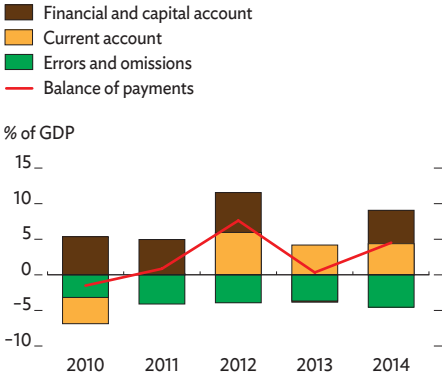
3.31.5 Balance of payments indicators



Sources: State Bank of Viet Nam; International Monetary Fund; ADB estimates.

Click here for figure data

Factors bolstering private consumption will be expanded employment, low inflation, and growth in remittances, which reached almost $10 billion last year. In January 2015, ahead of the lunar new year, retail sales jumped by 13% in nominal terms.

Lower interest rates, ratings upgrades, and brighter prospects for manufactured exports have improved the outlook for investment. The central bank targets credit growth of 13%–15% in 2015, slightly above last year's estimated outcome. Restrictions on foreign investment in real estate will be eased from July 2015, which should support other measures taken by the government to revive the property market.

The drop in global oil prices from last year is a positive development for this economy. Though Viet Nam produces about 350,000 barrels of oil per day and is a net exporter of crude oil, it is a net importer of refined petroleum products. Lower fuel prices boost household disposable income, stimulate consumption, and reduce costs for many businesses, supporting profits and investment. The National Financial Supervisory Commission estimates that savings on domestic production costs could reach 3% this year. The fall in oil prices dents government revenue, but fiscal policy is still likely to promote economic growth.

On a sector basis, industry is expected to be the major driver of growth. FDI and government investment will spur construction while recent increases in imports of manufacturing inputs—including chemicals, cotton, and plastics—signal strength in industry. The HSBC Purchasing Managers' Index showed that new orders, output, and employment in manufacturing continued to rise through February 2015 (Figure 3.31.8).

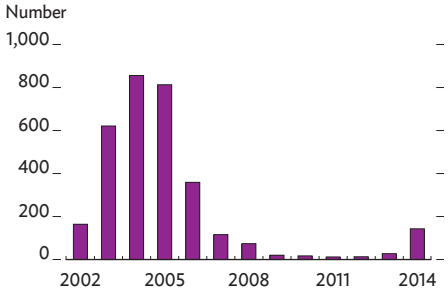
The service sector stands to gain from lower fuel and transport costs, as well as from recovery in tourism from the PRC. Stepping up progress on SOE reform would spur growth in other service industries. Agriculture, too, has been helped by the decline in fuel and transport costs, but its expansion is impeded by sluggish global food prices and bottlenecks in transport and trade infrastructure.

Fiscal policy looks set to remain expansionary in light of a planned budget deficit of 5.0% of GDP in 2015 and a similar deficit likely in 2016. Budget priorities include greater emphasis on capital expenditure, which is slated to rise by nearly 20% after 2 years of absolute declines. Current expenditure is expected to rise at a more modest rate of 10%, including increases of 11% for health care and 5% for education.

The government may struggle to meet its revenue target. Reductions in corporate income tax rates, the removal of tariffs, and exemptions for favored firms have eroded the tax base. From 2010 to 2014, central government revenue and grants fell from 27.6% of GDP to an estimated 21.5%. During the forecast period, the lower oil prices will hurt corporate and resource tax collections. The outlook assumes that, if revenue is weaker than anticipated, the authorities will opt for a moderately wider budget deficit rather than significant cuts in expenditure. Under this scenario, public debt may rise toward 60% of GDP by the end of 2016. This prospect highlights the importance of correcting fiscal imbalances over the medium term to avoid running up unsustainable debt or jeopardizing investor confidence.

Inflation ebbed further in the first 2 months of 2015 to average just 0.6% as food and transport costs declined. For the full year, inflation

3.31.6 State-owned enterprises equitized



Source: Ministry of Finance.
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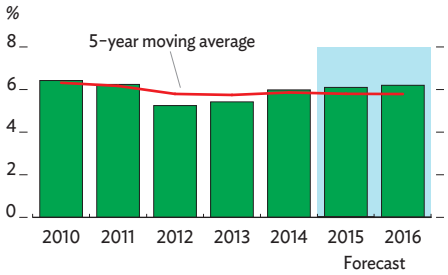
3.31.7 GDP growth



Source: Asian Development Outlook database.
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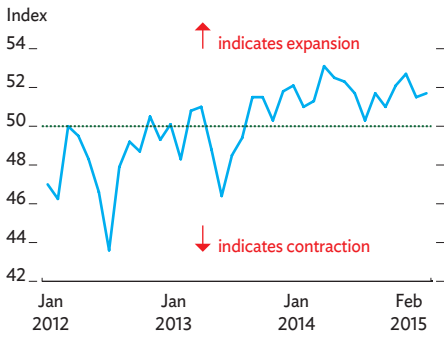
3.31.8 Purchasing managers' index



Note: HSBC-Markit Manufacturing.
Source: Bloomberg (accessed 5 March 2015).
Click here for figure data

is projected to average 2.5%. It is seen quickening to 4.0% in 2016 as domestic demand and global oil prices rise (Figure 3.31.9).

The forecasts assume the government will maintain expansionary monetary policies in a low-inflation environment. The central bank wants banks to trim deposit and lending interest rates by 1.0–1.5 percentage points in 2015, after cuts of around 2 percentage points made in 2014. In January of this year, the central bank devalued the dong by a further 1% against the US dollar and it might devalue by up to 2% in 2015.

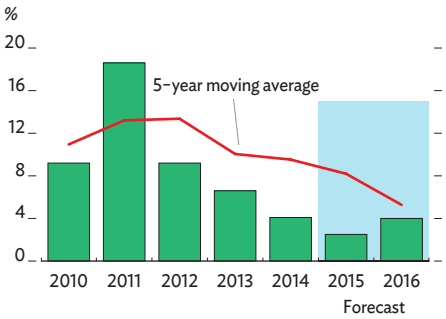
Export receipts from agricultural products and crude oil will likely decline as imports expand to meet stronger domestic demand and to supply inputs for manufacturing—albeit partly offset by lower prices for imported petroleum and commodities. Trade and current account surpluses are projected to fall through the forecast period (Figure 3.31.10).

Additional impetus for trade and investment should come in the medium term from new trade agreements, Viet Nam's integration into the Association of Southeast Asian Nations (ASEAN) Economic Community from late 2015, and the planned easing of restrictions on foreign ownership of property and companies listed on the stock exchange. Gradual progress is being achieved toward strengthening the banking system though the encouragement of mergers and the state's acquisition of bad debt held by banks. More SOEs will be partly privatized.

The banking system and SOEs nevertheless continue to pose risks to the economy. Undercapitalized banks with deficient financial transparency remain exposed to shocks. Finding sufficient investors to participate in share sales of SOEs is hampered by their complex ownership structures and opaque financial accounts.

Over the longer term, achieving higher rates of economic growth depends on Viet Nam's ability to undertake deeper structural and corporate governance reform, and to facilitate local firms' integration into global value chains.

3.31.9 Inflation



Source: Asian Development Outlook database.
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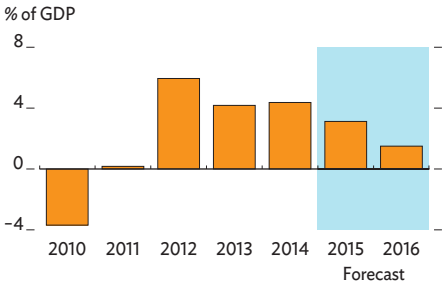
3.31.10 Current account balance



Source: Asian Development Outlook database.
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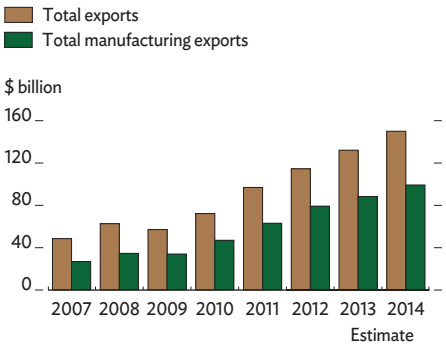
Policy challenge—linking local firms to global value chains

The gradual opening of Viet Nam's economy over the past 30 years, including through trade pacts that culminated in membership of the World Trade Organization in 2007, has spurred FDI, exports, and economic development. FDI inflows averaged $7.3 billion annually from 2007 to 2014. Rising international trade has lifted the ratio of trade to GDP to 170%. Exports of manufactures have surged in the past 5 years as multinational companies built factories to assemble products such as mobile telephones and electronics, or to fabricate parts, as part of their global production chains (Figure 3.31.11).

However, Viet Nam's main contribution to these production chains is low-skilled labor. The cost of imported materials and components is estimated to equal 90% of the value of Viet Nam's exports of manufactured goods. Future economic prosperity will depend in large part on involving more domestic firms in global value chains so they can

3.31.11 Manufacturing exports



Sources: General Statistics Office of Viet Nam; ADB estimates.
Click here for figure data

benefit from foreign funding and technology and gain access to global markets, as well as generate spillover to benefit the whole economy.

At this stage, small and medium-sized enterprises (SMEs) in Viet Nam generally lack the capacity to participate in supply chains for foreign-invested factories. Only 36% of all Vietnamese firms are integrated into export-oriented production networks, compared with nearly 60% in Malaysia and Thailand. Just 21% of Vietnamese SMEs participate in global supply chains, and SMEs' contribution to exports from Viet Nam is significantly less than in other countries (Figure 3.31.12).

While the government supports industrial deepening and the development of SMEs, insufficient interagency coordination often fragments policies and weakens implementation. A proposed new law on SMEs provides an opportunity to correct some of these shortcomings. Moreover, greater consultation with the private sector would better inform the government about constraints that inhibit links with production networks. The private sector needs to be closely involved as well in initiatives intended for its own development. For example, the success of the proposed Institute of Directors, which aims to improve corporate governance, will depend on attracting funding and support from the private sector.

Industry-specific strategies are also needed. For manufacturers, encouraging the development of more industry clusters could allow for economies of scale, shared learning, and lowered transaction and transportation costs. Agribusinesses would benefit from improved product certification standards and better regulation of aquatic resources.

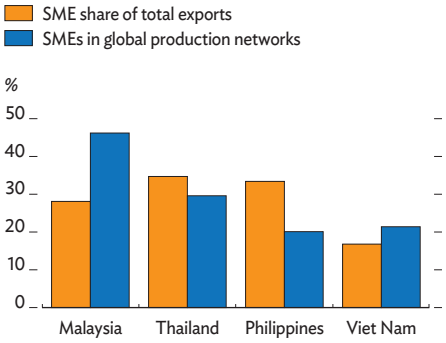
Early in 2015, the Prime Minister endorsed the selection of five industries as priorities for developing industry clusters and value-chain products: electronics, textiles, food processing, agricultural machinery, and tourism. Action plans should now be drawn up for these industries with the aim of targeting support to those supply chains with maximum potential for FDI spillover into the domestic private sector, as measured by domestic value added, job creation, and tax revenue.

3.31.1 Selected economic indicators (%)

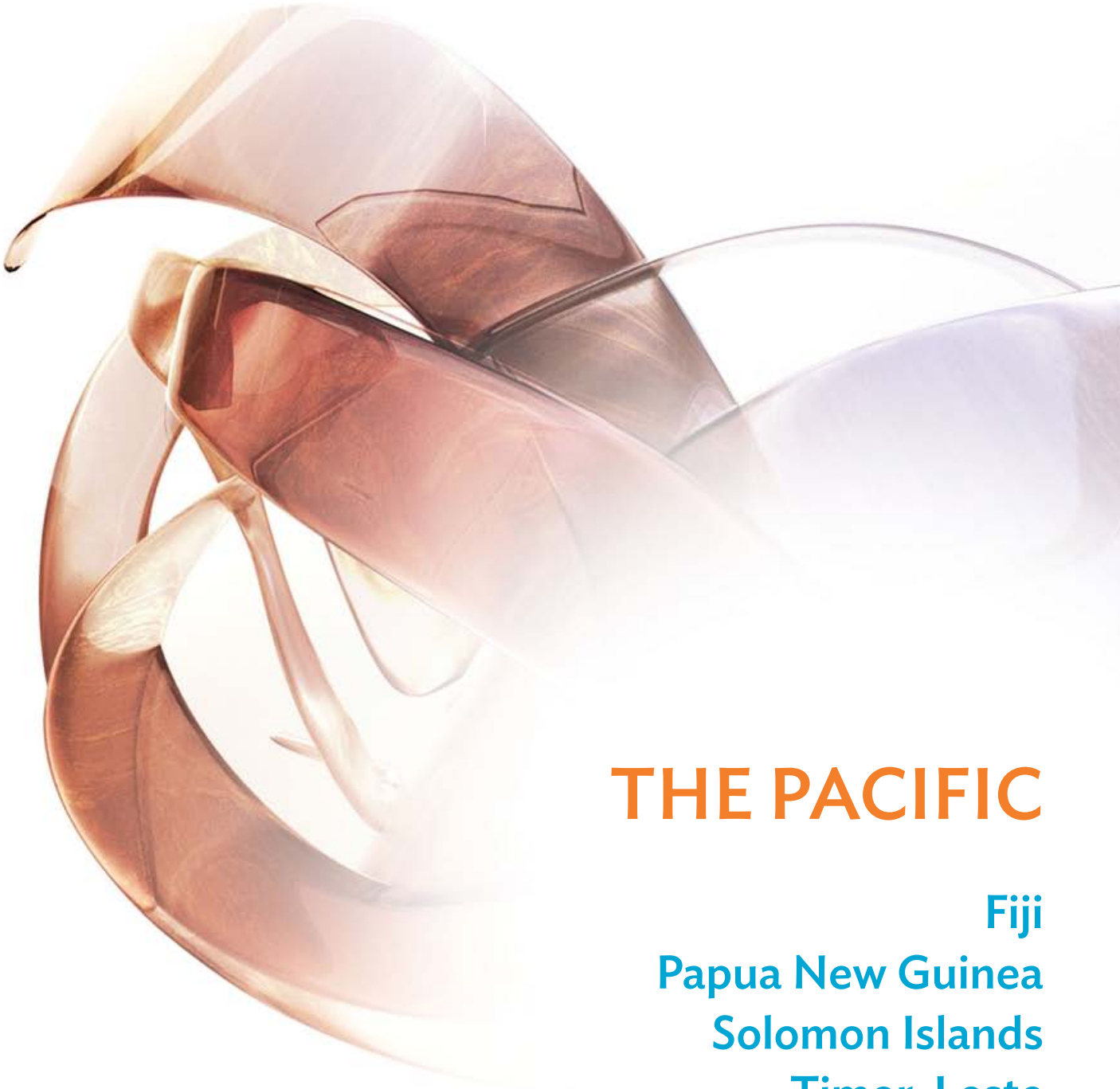
	2015	2016
GDP growth	6.1	6.2
Inflation	2.5	4.0
Current account balance (share of GDP)	3.1	1.5

Source: ADB estimates.

3.31.12 SME share of total exports



SMEs = small and medium-sized enterprises.
Source: Asian Development Bank Institute.
Click here for figure data



THE PACIFIC

Fiji
Papua New Guinea
Solomon Islands
Timor-Leste
Vanuatu
North Pacific economies
South Pacific economies
Small island economies

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Fiji

Growth was broad based in 2014, as investor confidence strengthened in the run-up to the September election and persisted thereafter. Macroeconomic policy continues to be mildly expansionary, with investment in infrastructure, particularly transport, helping to boost growth. While growth has been sustained over the past 5 years, tightening fiscal conditions will require the implementation of structural reforms announced in the 2015 budget to further encourage private investment and rebalance the economy.

Economic performance

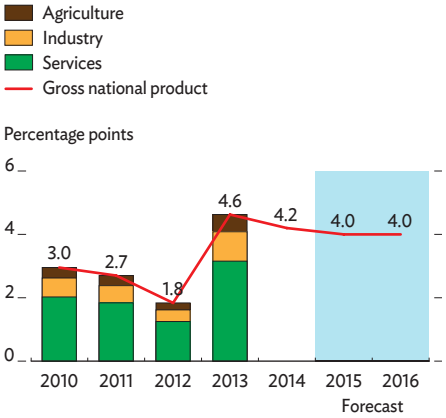
The Fiji economy is estimated to have grown by 4.6% in 2013 and 4.2% in 2014 (Figure 3.32.1). The economic expansion that began in 2010 has been one of the longest sustained periods of growth since independence in 1970. Greater government capital expenditure, higher remittance income, and improved business confidence in the run-up to the elections held in September 2014 saw new lending for consumption increase by 72.8% and for investment by 11.3%. These trends have contributed to record growth in private sector investment, which is expected to reach 13.5% of GDP in 2014.

Growth was broad based, with investments in finance, construction, and transport leading the trend. The increase in construction saw demand for domestic cement increase by 17.6%. Despite high growth, inflation slowed to 0.5% in 2014, reflecting the steep fall in global oil prices, which led the Fiji Commerce Commission to reduce its retail price of gasoline and diesel by nearly 8%.

The Fiji Revenue and Customs Authority reports that its collections in 2014 totaled $1.12 billion, exceeding their original forecast of $1.08 billion. The rising revenues were an improvement of 13.7% over 2013 collections. This solid performance came on the back of strong growth in revenues from income tax by 12.5% and value-added tax by 5.7%. Planned asset sales fell below expectations, however, leaving a fiscal deficit in 2014 equal to 2.0% of GDP. This was larger than anticipated, even as a planned large increase in government expenditure was scaled back.

Fiji's macroeconomic policies continue to support growth. An expansionary fiscal policy has boosted growth through substantial spending on infrastructure, mainly for transport, as well as higher spending on education toward implementing a policy of providing free primary and secondary education to all school-aged children. While a moderately expansionary fiscal policy has been appropriate, new programs were expected to be financed in large part by the

3.32.1 Supply-side contributions to growth



Sources: Fiji Bureau of Statistics; ADB estimates.
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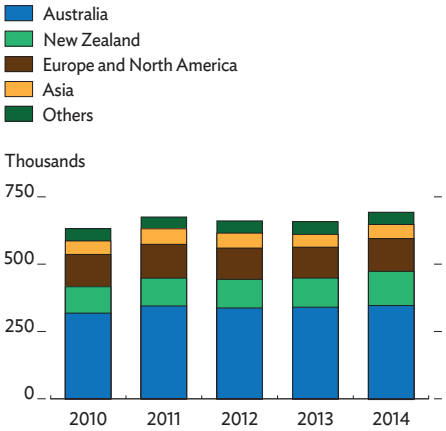
3.32.2 Visitor arrivals, by source



Source: Fiji Bureau of Statistics.
Click here for figure data

This chapter was written by Caroline Currie of the South Pacific Subregional Office, ADB, Suva, and Christopher Edmonds of the Pacific Department, ADB, Manila.

disappointing asset sales. Over the medium term, faster growth and higher revenue collection are needed to support public programs and allow the government to meet its objective of ensuring that debt, currently 49.7% of GDP, remains manageable.

Monetary policy is able to support higher economic growth by stimulating domestic demand because the outlook for inflation is soft. Bank lending rates remain low, and commercial banks enjoy comfortable liquidity. Foreign reserves at the end of 2014 were estimated at 4.7 months of import cover.

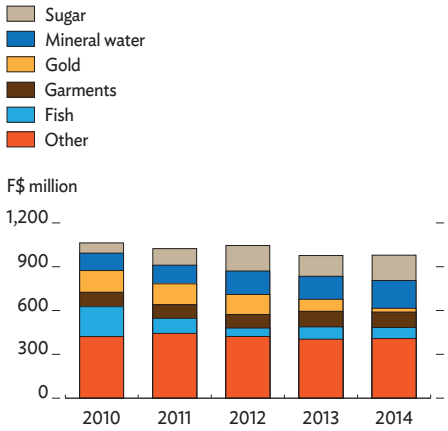
With the exception of fishing and mining, all productive sectors of the economy are estimated to have grown in 2014. Earnings from tourism continue to trend upwards, with a record-breaking 692,630 tourist arrivals in 2014, which was 5.3% higher than in the previous year (Figure 3.32.2). Tourist arrivals from Fiji's two largest markets maintained solid growth in 2014, as the number of visitors from Australia rose by 2.7% and New Zealand by 14.5%. Arrivals from the People's Republic of China were up 13.4% during the year, further boosting Fiji's strong tourism performance.

Fiji's production of sugar, its primary agricultural commodity, exceeded expectations in 2014 as output grew by 13.7% year on year. Investment to improve milling efficiency and introduce higher-yielding varieties of sugarcane contributed to higher output. Data from the Fiji Bureau of Statistics indicate that the value of sugar exports increased by about 22% in 2014. This reverses the fall in export returns seen in 2013.

Gold production fell modestly in 2014, and by year's end output was 1.8% lower year on year. The fall was partly attributed to the declining quality of the ore extracted, and partly to the sharp downtrend in the price of gold, which began in 2013. The value of gold exports continued to decline dramatically, plunging by 72.7% in the year to November 2014. Exports of fish and garments also fell in 2014, but this was offset by strong exports of sugar and mineral water to generate 0.3% growth in exports net of re-exports (Figure 3.32.3).

Fiji recorded a current account deficit equal to 8.9% of GDP in 2014, improving on the previous year's deficit of 14.9%, which included Fiji Airways' purchases of new aircraft. Excluding aircraft purchases, however, the trade deficit widened on rising imports of machinery and mechanical and electrical appliances in 2014. Tourism receipts and remittances from abroad grew by 13% year on year, which helped to narrow the current account deficit.

3.32.3 Exports net of re-exports



Note: Data for 2014 are estimates based on the year to November 2014.

Sources: Fiji Bureau of Statistics; ADB estimates.

Click here for figure data

Economic prospects

Indicators suggest that growth will moderate slightly in 2015 to 4.0% as the economy navigates a transition in its growth drivers. Tourism is expected to continue to grow at a steady pace, but current sugar and gold prices will make it hard to maintain growth in these industries in the coming year.

In an effort to maintain last year's growth momentum, the 2015 budget increases public expenditure on infrastructure for transport, energy, and water supply and sanitation. This should directly boost construction and indirectly spur growth in other sectors.

3.32.1 Selected economic indicators (%)

	2015	2016
GDP growth	4.0	4.0
Inflation	2.5	2.5
Current account balance (share of GDP)	–9.8	–8.7

Source: ADB estimates.

The government plans to fund most of the higher infrastructure spending through grants and borrowing from bilateral and multilateral development partners. A rise in grant financing will help contain public debt, which is projected to decline to 48.3% of GDP in 2015. Increased support from multilateral lenders in the medium term can ease debt service requirements, even if total debt stocks remain broadly constant. The Ministry of Finance is projecting a net fiscal deficit equivalent to 2.5% of GDP for 2015 (Figure 3.32.4).

Investments in new and existing businesses are expected to make a greater contribution to growth in 2015. The efforts of firms, particularly in the transport sector, to replace and upgrade their productive assets are evident in recent years' growth outcomes.

Prospects for growth in 2016 remain strong, fuelled by rising expenditures on social and economic infrastructure funded by development partners. Working with bilateral and multilateral partners, the government is planning much-needed poverty alleviation projects, which are expected to begin implementation toward the end of 2015. Public capital expenditure is expected to continue at present levels, with spending on infrastructure for transport, water supply, and urban sanitation as priorities. Infrastructure spending is expected to have an immediate impact on GDP in 2016 by increasing demand for labor and construction materials. Once the projects are completed, the enhanced infrastructure will underpin GDP growth over the longer term.

The government is expected to face tighter fiscal conditions in 2016 but plans to privatize selected state-owned enterprises in 2015 to defuse mounting fiscal pressure and contain the budget deficit.

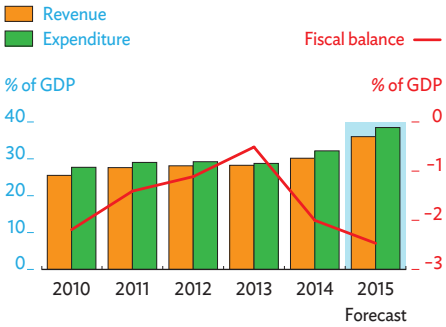
Inflation is seen to rise slightly as a result of unseasonably dry weather early in the year that is likely to affect domestic food supply. However, low international prices for food and fuel are expected to keep inflation low at 2.5% in 2015 and 2016 (Figure 3.32.5).

The current account deficit is expected to widen in 2015 to the equivalent of 9.8% of GDP as the trade deficit expands with imports of construction equipment and materials for development projects. However, foreign currency reserves are expected to remain sufficient, providing about 4.5 months of import cover. The current account deficit is projected to equal 8.7% of GDP in 2016 (Figure 3.32.6).

Policy challenge—structural reform to encourage private investment

The current year looks to be a crucial one for government efforts to guide the economy through a transition from growth driven by domestic investment and public stimulus to growth with a broader foundation. Maintaining macroeconomic stability while attracting greater investment from overseas, including investment projects funded by development partners, will be central to this effort. The economy has enjoyed sustained growth during the past 5 years, but the government's policy options for spurring future growth have been eroded by rising expenditures and relatively expansionary monetary policy in recent years. To maintain macroeconomic stability and facilitate investment,

3.32.4 Fiscal accounts



Source: Fiji Ministry of Finance. *Economic and Fiscal Update: Supplement to the Budget Address* (various years).

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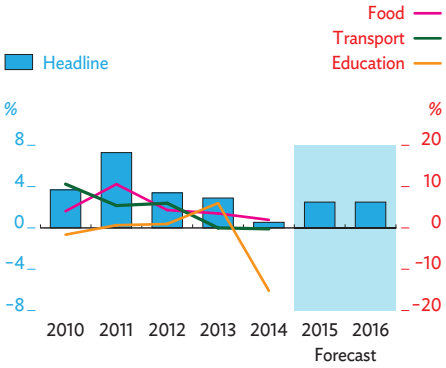
3.32.5 Inflation



Sources: Fiji Bureau of Statistics; ADB estimates.

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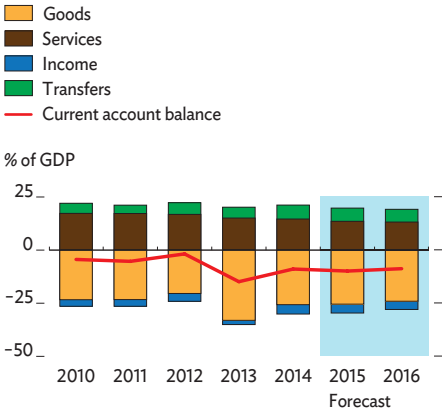
3.32.6 Current account components



Source: Fiji Ministry of Finance. *Economic and Fiscal Update: Supplement to the 2015 Budget Address* (various years).

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policy makers need to control Fiji's fiscal and trade deficits and keep the public debt burden manageable while maintaining growth during the transition. As growth accelerates, the economy may face capacity constraints, including skills gaps and shortages, until investments in infrastructure and human resources yield returns. In the interim, a risk is that higher imports could deepen the trade deficit.

To manage this transition, policy makers need to accelerate the pace of structural and financial management reform announced in the 2015 budget. An increasingly open and transparent policy-making process—as has been seen since the election last September—would help alleviate policy uncertainty and encourage domestic and foreign investment. Rapid progress on reform should make budget execution more efficient, strengthen government accountability and transparency, and improve state-owned enterprises' provision of basic public services such as electricity and other utilities. Improvements in education quality, particularly those that enhance students' capacity to innovate and adapt to changing workplace needs, can help to address emerging skills shortages and gaps. Fast-tracking efforts to strengthen implementation capacity in the public sector, as proposed in the government's civil service reform, and to improve the regulatory framework for public–private partnership will hasten the implementation of public investment programs and encourage private sector growth.

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Papua New Guinea

New gas exports are forecast to drive a growth surge to 15.0% in 2015 that will subside to 5.0% in 2016. In contrast with mining and petroleum, the rest of the economy is projected to grow by a more modest 4.0% in both years. As the economy comes to rely more heavily on resource extraction, policy needs to ensure that the benefits of growth are shared widely to reduce poverty and regional inequality.

Economic performance

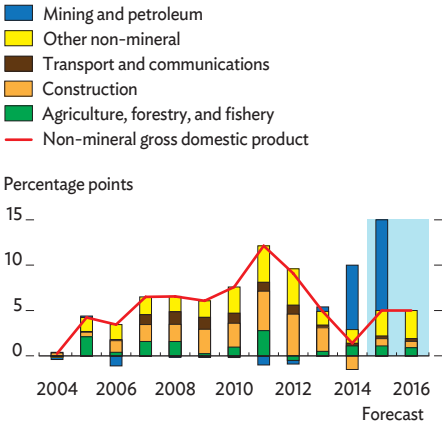
Economic growth in Papua New Guinea (PNG) rose to 8.0% in 2014 following the commencement of liquefied natural gas (LNG) exports. Growth in other sectors of the economy remained modest. Construction output fell by 6.4% in 2014, and this spilled over into the broader economy, stalling wholesale and retail trade growth at 5.5% and slowing utilities from 9.0% growth in 2013 to 6.0% in 2014. Long-term declines continued at a number of older mining operations, but rising output from a new nickel project meant mining and quarrying as a whole expanded by 5.9% (Figure 3.33.1).

Agriculture, forestry, and fishery growth picked up to 3.9% in 2014 as the weather improved, enabling greater production and exports of cocoa, coffee, and oil palm. However, much of this growth was recovery from weak growth in previous years. The sector continued to be hampered by low global commodity prices, declining yields from aging plantations, inadequate pest control, and poor transport infrastructure.

Fiscal policy remained expansionary, with the government achieving its planned budget deficit of 5.9% of GDP in 2014 (Figure 3.33.2). However, with revenue growth lower than expected and a number of unplanned expenditures, hitting the target required an expenditure slowdown toward the end of the year and K1 billion (nearly 5% of domestic revenue) reapportioned from unspent project trust funds back into the central government account. Despite the slowdown, government spending grew by 20% in 2014, continuing 4 years of rapid fiscal expansion that has seen expenditure grow by an average of 25% annually.

Rapid spending growth over the past 3 years has required a significant increase in government borrowing, some 70% from local capital markets. This has the potential to crowd out finance for local investment and has begun to push up local interest rates. Government borrowing costs for long-term domestic debt reached 14% per annum in 2014. While government debt remains modest by regional standards, the cost of servicing it is rising sharply, from 5.5% of domestic revenue in 2013 to an expected 9.2% in 2015 (Figure 3.33.3).

3.33.1 Supply-side contributions to growth



Sources: National budget documents (various years), ADB estimates.

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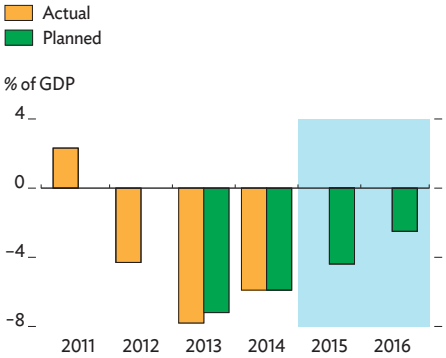
3.33.2 Budget balance



Sources: National budget documents (various years), ADB estimates.

Click here for figure data

This chapter was written by Aaron Batten, formerly of the Papua New Guinea Resident Mission, ADB, Port Moresby.

Aggregate demand eased following the completion of LNG project construction and global commodity prices declines, exerting downward pressure on inflation during 2014. However, these pressures were more than offset by government spending and price rises for imports caused by a depreciating currency. The rise in the consumer price index accelerated in 2014 and reached a high of 8.3% in December, averaging 5.9% for the whole year (Figure 3.33.4).

In June, the Bank of Papua New Guinea, the central bank, attempted to stem kina depreciation by placing a trading band on an official rate. That the official rate valued the kina 20%–30% higher than prevailing market rates triggered a shortage of foreign exchange as residents and business moved currency offshore. Although the kina was allowed to depreciate slowly in the latter half of the year, foreign currency shortages continue, with all commercial banks reporting order backlogs. The central bank's ongoing intervention in the currency market drained foreign exchange reserves during 2014. By the end of the year, they were sufficient to cover only 4.6 months of imports, down from 5.9 months at the end of 2013 and a peak of 10.5 months at the end of 2011.

The PNG current account balance strengthened significantly in 2014, recording a deficit equal to 11.4% of GDP, or half of the 22.6% deficit in 2013. This improvement reflected growing surpluses in the goods balance driven by the onset of LNG exports and strengthened agricultural exports, partly offsetting large deficits in services and income.

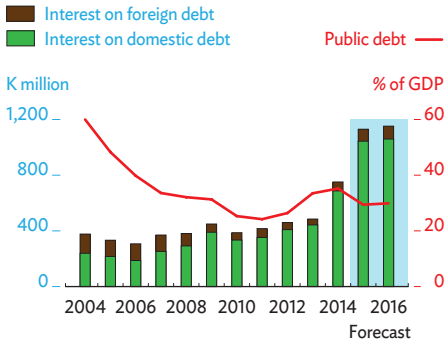
Economic prospects

GDP growth is forecast at 15.0% in 2015, slowing to 5.0% in 2016. Leading this growth is the oil and gas sector, as 2015 is the first full year of LNG production. While near a record high, current growth projections for 2015 are significantly below the 21.0% forecast in *Asian Development Outlook 2014*. This largely reflects the early commencement of LNG production in 2014, which raised the base last year, and the delay of peak production until 2016, which lowers projected production this year. A rebound in the mining and quarrying sector is expected as operations at a new nickel mine continue to expand, more than offsetting declines at a number of older operations. Real growth in the sector will reach 12.0% in 2015, falling back to 3.0% in 2016.

In contrast with mining and petroleum, activity in the rest of the economy is expected to remain modest, with non-mineral growth forecast at 4.0% in 2015 and 2016. After contracting by 6.4% in 2014, construction will grow by 3.8% in 2015, boosted by government investment in transport and energy infrastructure and new sports facilities. The transport and logistics sector is expected to grow by 5.0% in 2015 as the global oil price slump brings lower fuel prices.

During 2015 and 2016, growth in wholesale and retail trade is seen to return to a long-run average of 5.5%, and financial services to 4.5%. The agriculture, forestry, and fishery sector is expected to continue its recovery, with growth at 3.6% in 2015 and 3.7% in 2016. Although international prices remain subdued, a cheaper kina and

3.33.3 Public debt and debt servicing costs



Sources: National budget documents (various years), ADB estimates.

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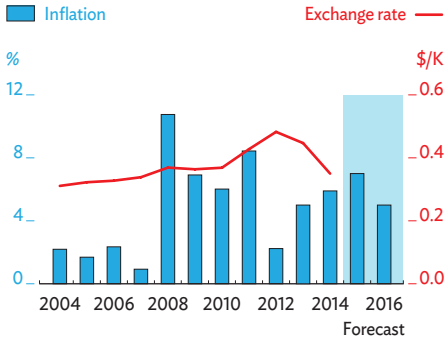
3.33.4 Inflation and exchange rates



Sources: Bank of Papua New Guinea. 2015. *Quarterly Economic Bulletin*; ADB estimates.

Click here for figure data

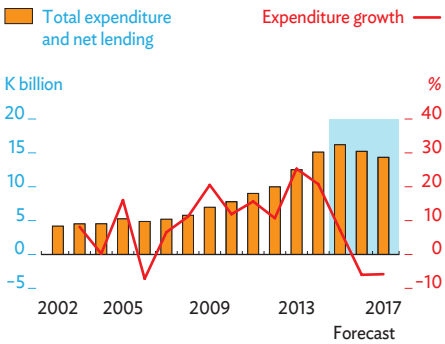
savings on transport costs generated by lower fuel prices will boost the sector strongly, as it is dominated by export commodities: logs, tuna, crustaceans, coffee, cocoa, and palm oil.

The 2015 budget aims for much-needed fiscal consolidation (Figure 3.33.5). The budget deficit target is 4.4% of GDP in 2015, and the government plans to return to a balanced budget by 2017. Achieving this will be a challenge. Corporate and personal income taxes and sales taxes, which make up roughly 80% of domestic revenue, are all expected to remain stable over the coming years, as the benefits of measures to enhance compliance fade and growth in non-mineral sectors of the economy remains weak. Further, the slump in world energy prices means revenues from the first shipments of LNG are likely to be significantly lower than expected. This will have implications for government revenue. If lower prices persist, a proposed cut of 10% to nominal government expenditure to 2017 may have to be higher to balance the budget.

Inflation is anticipated to increase to 7.0% in 2015 and moderate to 5.0% in 2016, as the pass-through of a lower kina exchange rate is offset by a slowing domestic non-mineral economy and lower commodity prices. This forecast depends heavily on the government's ability to rein in expenditure growth and on the central bank maintaining prudent monetary policies. Domestic deposit rates are seen to remain near zero for the foreseeable future unless the central bank can undertake monetary interventions sufficient to soak up liquidity in the banking system.

After several years of large deficits, the current account is expected to record a surplus of 13.5% in 2015 and 15.0% in 2016. This reflects an expected 48.6% increase in exports during 2015 from the first full calendar year of LNG exports and from expanded nickel production at the new mine. With LNG construction completed and fiscal consolidation planned, imports are expected to fall by 8.2% in 2015 and 12.9% in 2016. Meanwhile, payments from abroad are expected to increase substantially from 2015, mainly income and dividends paid to the government from LNG exports.

3.33.5 Government spending growth



Sources: National Budget documents (various years), ADB estimates.

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Policy challenge—adapting to elevated resource dependence

PNG has reached an important economic crossroad. The commencement of LNG production and export marks the end of the large inflows of foreign direct investment that fueled a period of construction-led growth. What is emerging is an economy that depends heavily on mineral resources. Over the next 12 months, the share of output generated by the resource sector will almost double from 12% of GDP to 22%, while the share of budget revenue obtained directly from mining, oil, and gas operations similarly soars from 11% to 20%. By contrast, growth in the job-intensive non-mineral sector will likely be modest. Several new resource projects in the pipeline mean this dependence may intensify over the coming decade. As the current sharp and unexpected drop in global prices for energy and other commodities demonstrates,

3.33.1 Selected economic indicators (%)

	2015	2016
GDP growth	15.0	5.0
Inflation	7.0	5.0
Current account balance (share of GDP)	13.5	15.0

Source: ADB estimates.

managing the volatility associated with resource dependence will be an increasingly important part of macroeconomic management. To ensure that growth is sustainable, a number of adjustments to economic policy are needed.

First, fiscal consolidation is required to enhance the economy's resilience under adverse economic shocks. As the economy's dependence on mining, oil, and gas exports grows, so will its vulnerability to global economic downturns, particularly those related to commodity prices. After a decade of commendable fiscal discipline, which slashed public debt from 72.4% of GDP in 2002 to 22.1% in 2011, expansionary fiscal policy over the past 4 years has seen public debt rebound to 35.5% of GDP at the end of 2014. Debt slightly exceeds the government's own ceiling of 35.0% of GDP (revised up from 30.0% in 2013). This borrowing, largely from local capital markets, has begun to create a number of macroeconomic pressures: crowding out local investment, exerting downward pressure on the kina, and spurring inflation. It has also cramped the government's fiscal space to undertake countercyclical fiscal measures. With LNG revenues expected to be modest over the medium term, lower spending growth and returning the budget to near balance will be vital for maintaining macroeconomic stability.

Second, strong institutions need to be established to ensure transparent and accountable resource revenue management. Transparency necessarily underlies accountability and is essential for informed decision making and assuring the community that resource revenues are being used appropriately.

Since 2009, the government has been working toward establishing a sovereign wealth fund to insulate the budget from commodity price volatility and provide a clear and transparent process for managing resource revenues. After several unsuccessful attempts, a policy framework has been worked out for establishing the fund; this should be done soon so that robust institutional oversight can be applied at the earliest stages of LNG exports and revenues. In addition, with current policy proposals suggesting that a portion of resource revenues will be channeled to off-budget government institutions, further efforts are needed to ensure that the design of the sovereign wealth fund is credible. In 2013, the government signaled its intention to comply with the global Extractive Industries Transparency Initiative. This was a positive step, but progress in compliance has been slow, suggesting that greater effort is needed to ensure that PNG is able to satisfy these standards in a timely manner.

Also important to PNG is to improve transparency in subnational resource revenue flows, something that the initiative is not designed to address. This includes creating a mechanism to inform communities about the flow of revenues from resource extraction to provincial governments and landowner groups who hold equity in resource projects or receive royalties from them.

Third, a greater focus is needed on enhancing the quality and impact of public expenditure. Capacity shortfalls are often seen as the major challenge facing the public sector's ability to implement ambitious budgetary plans, but other factors contribute. Sector agencies highlight frequent disconnects between sector budget submissions and the

approved budget, often forcing project staff to hurriedly design and implement unfamiliar projects. Work on feasibility and design studies is often lacking before projects are financed. This has caused unrealistic cost estimates, tendering delays, and difficulties attracting private sector participation in construction. While funding given to provincial and district governments is on the rise, they often lack the expertise and administrative skills to plan, procure, and maintain infrastructure.

In addition, new capital projects continue to trump recurrent operations in funding allocations. From 2009 to 2014, recurrent budget allocations fell from 60% of total allocations to 51%. This limits sector agencies' ability to expand human resources to meet growing investment demands and jeopardizes sustainability by underfunding routine maintenance.

Taken together, these three priorities constitute an ambitious reform agenda to ensure that PNG transitions successfully and inclusively into greater resource dependence. The moderate funding growth outlined in the budget for 2015 presents an opportunity to make progress toward all of these targets. Sector agencies will have to play catch up to work through investment backlogs, and they should focus on building the technical and institutional capacity necessary to deliver cost-effective and sustainable infrastructure and services. Meanwhile, a period of fiscal consolidation can allow central agencies to improve budget coordination and planning and to enhanced efforts to establish the institutions and policies needed to ensure that future resource revenues are managed transparently and accountably.

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Solomon Islands

The economy contracted in 2014 after disruptive flooding in April. Growth is expected to pick up in 2015 on flood-recovery spending and in 2016 on increased foreign investment, though the medium-term outlook for mining and forestry is uncertain. A new government elected in December faces a challenging budget outlook. A priority is to promote financial inclusion to generate inclusive growth and economic opportunity, particularly in rural areas.

Economic performance

Floods in April caused GDP to contract by 0.2% in 2014, with per capita GDP falling by 2.4%. Gold production ceased, and damage to businesses, houses, and public infrastructure was widespread (Figure 3.34.1). Private enterprise and public services were heavily affected. Damage was centered in and around Honiara, the capital, where dozens of people were killed, more than 10,000 were displaced, and 52,000 were affected in other ways. The government estimated damage and losses from the flooding at $108 million, or 9% of GDP.

Gold output fell by over 70% in 2014 because flooding halted production at the only mine, where operations are likely to remain suspended for some time. The government is currently in talks with the former operators to transfer the lease and management. Before the mine closed, the United Nations had expressed concern over the environmental dangers posed by its tailings reservoir.

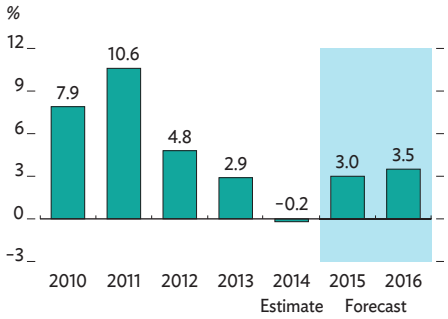
The flooding damaged transport links and disrupted log exports, but they recovered strongly and, by year's end, were close to the record achieved in 2012 (Figure 3.34.2). Logging output has essentially been flat for the past 4 years, with production sustained by secondary harvests in previously logged areas. Logging output is expected to begin to decline over the next few years as forest area dwindles.

Agricultural output grew strongly in 2014 despite disruption from flooding. Cocoa, copra, and fisheries all registered double-digit increases, but palm oil output stagnated as production was concentrated in areas affected by the flooding.

The current account deficit widened to an estimated 14.7% of GDP in 2014. This was partly because of arrested gold production, and partly because lower prices reduced the value of cash crop exports. Despite the worsening deficit, foreign exchange reserves remained high, bolstered by large inflows of grants and foreign direct investment. As of December 2014, foreign reserves exceeded cover for 10 months of imports, down only slightly from 11 months a year earlier.

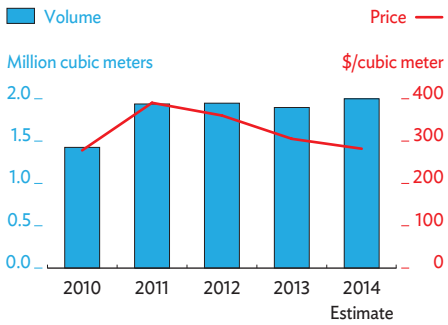
Headline inflation accelerated to 6.0% in 2014 from 5.4% in 2013. Food prices rose sharply after the April flood but moderated in the

3.34.1 GDP growth



Sources: Central Bank of Solomon Islands; ADB estimates.
Click here for figure data

3.34.2 Log exports



Sources: Central Bank of Solomon Islands; World Bank Commodity Price Data (Pink Sheet).
Click here for figure data

This chapter was written by Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney.

second half of the year as agricultural production recovered and local transport links were restored.

The Central Bank of Solomon Islands continued its efforts to tame inflation by trying to mop up liquidity through short-term instruments known as Bokolo bills (named after a former bank governor). The Solomon Islands dollar remained pegged to a basket of currencies in 2014, with the result that it appreciated strongly against the Australian dollar and Japanese yen but fell against the US dollar.

After a major Australian bank withdrew trade financing for logging exports over environmental concerns, the government offered additional banking licenses. Pan Oceanic Bank, headquartered in Sri Lanka, took a license and by year's end had gathered over 7,000 depositors in the country.

The 2014 budget increased government spending by almost 10%, to SI$3.5 billion, with investments to develop agriculture and fisheries as the main recipients of higher expenditure. The government aimed to maintain a balanced budget with an additional SI$2.8 billion in revenue and SI$665 million in grants. However, the shutdown of the gold mine and slower growth pushed tax revenues lower than expected, even as relief efforts following the flood forced unplanned spending, as did spending associated with the election and overspending on university scholarships. The result was a budget deficit estimated to equal 1.8% of GDP in 2014.

The government has controlled growth in public debt, maintaining the ratio of debt to GDP at 14% in 2013 and 2014. Its debt-management strategy provides for an annual limit on new borrowing based on a debt-sustainability analysis undertaken each year as part of the budget process. The limit on new debt in 2014 was SI$160 million, equal to 1.8% of GDP. The Debt Management Advisory Committee vets new loan proposals.

Economic prospects

Growth is expected to rebound to 3.0% in 2015, driven by spending on flood reconstruction and continued recovery in agriculture, and despite projected declines in gold and forestry output.

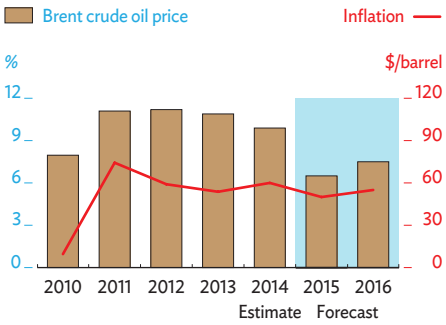
In 2016, growth is projected to pick up further to 3.5%, driven by fiscal stimulus from investment projects and their spillover into the broader economy. Increased investment in telecommunications and spending to develop large nickel deposits in Isabel Province are also expected to strengthen growth next year.

Inflation is seen to moderate in 2015 to 5.0% as price rises from flood-related spending dissipate (Figure 3.34.3). Then, in line with higher growth, inflation is expected to pick up slightly to 5.5% in 2016.

The 2015 budget has been delayed because a new government was elected only in November 2014, and it will likely present the budget to Parliament by the end of March 2015. The government has announced that it will take no new loans for recurrent expenditure in 2015 but will need to closely monitor and control major areas of government expenditure such as payroll, constituency funds, and tertiary scholarships in a challenging fiscal environment of lower logging revenues and no mining revenues.

In its most recent policy statement, the central bank noted that it would pursue a more expansionary policy, but its ability to do so is limited as monetary policy is boxed in by the currency basket and lack of capital controls.

3.34.3 Inflation



Sources: Central Bank of Solomon Islands; World Bank Commodity Price Data (Pink Sheet).

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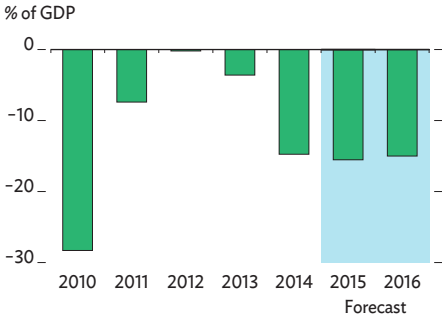
The current account deficit is expected to deepen in 2015, growing to the equivalent of 15.5% of GDP (Figure 3.34.4). A similar deficit equal to 15.0% of GDP is projected for 2016. These deficits primarily reflect low export growth and imports of equipment for flood reconstruction and investment. The government plans to fund the deficit through continued development assistance and foreign direct investment. Currency reserves are expected to shrink but remain above 8 months of import cover through 2015 and 2016.

3.34.4 Current account balance



Sources: Central Bank of Solomon Islands; ADB estimates.
Click here for figure data

Policy challenge—promoting financial inclusion

Solomon Islands has achieved strong growth outcomes since ethnic tensions eased in 2003, but growth has not generally translated into improved social indicators. Many Solomon Islanders remain outside the formal economy and its financial system. Before the global financial crisis, Solomon Islanders' access to financial services was among the most constrained in the world. In 2007, the portion of the population using financial services was estimated at 15%.

Since 2010, the government and the central bank have pursued a national strategy that actively promoted financial inclusion. The National Financial Inclusion Task Force established in 2010 committed the government, commercial banks, the private sector, and civil society to work to expand financial inclusion by 70,000 people, or 12% of the population, in 2015.

The task force has made great strides by using new technology. Commercial banks have offered mobile phone banking and branchless banking through neighborhood businesses using 3G technology. From 2011 to the third quarter of 2014, more than 129,000 new accounts opened, most of them using technology-enabled financial services. Over half of adults in the country now have bank accounts, having signed up for the low-fee no-frills accounts through streamlined processes that include eased requirements for personal identification documents. The number of access points per 10,000 adults is now 2.4, well above the government's target of 1.0.

While access to basic banking services has improved, access to credit remains constrained, particularly for small and medium-sized enterprises. The ratio of credit to GDP rose to 18% by the end of 2013, but this is still only half the average across Pacific island economies. Impediments to credit expansion include weak investor protection, unclear property rights that limit the availability of collateral, and a shortage of investable projects. The government has taken steps to improve the property rights regime, introducing a law on secured transactions and a registry for movable property. The new government has pledged to record and register land under customary ownership to facilitate its productive use.

Though Solomon Islands has yet to fully extend access to credit or generate much market activity, its financial system is sound. Banks are adequately capitalized, highly liquid, and profitable. The rate of nonperforming loans jumped to 7.2% at the end of 2013, after declining for several years, but subsequently fell to about 5% by mid-2014.

3.34.1 Selected economic indicators (%)

	2015	2016
GDP growth	3.0	3.5
Inflation	5.0	5.5
Current account balance (share of GDP)	–15.5	–15.0

Source: ADB estimates.

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Timor-Leste

Large increases in public spending accelerated economic growth in 2014. Growth is expected to be slower in 2015 but recover in 2016 if major investment projects proceed as planned. Inflation eased under favorable external conditions but is projected to rise in 2015 and 2016. Declining petroleum production and low energy prices highlight the need to diversify the economy by encouraging private investment.

Economic performance

Economic growth accelerated in 2014, with GDP excluding the offshore petroleum sector (non-oil GDP) expanding by an estimated 7.1% (Figure 3.35.1). Improvements in budget execution saw own-funded government expenditures rise by 26.5% as the proportion of planned expenditures that were actually disbursed improved from 62% in 2013 to over 90% in 2014. Total public expenditures, including activities funded by development partners, were equivalent to 110% of non-oil GDP in 2014.

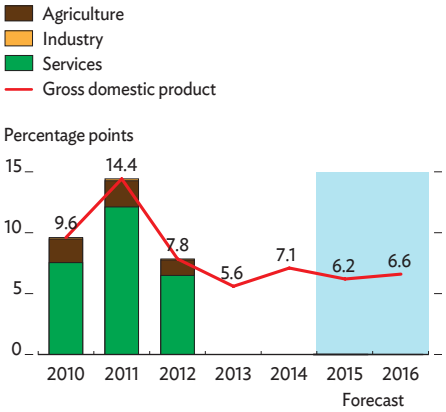
The private sector remains reliant on demand from government spending. This was highlighted by the recently published *Business Activity Survey of Timor-Leste 2013*, which provides the most recent comprehensive data on formally registered businesses. Public spending fell by 7.5% in 2013, and this contributed to an estimated 4.1% loss of formal employment in the private sector and a 3.5% drop in sector profits. The new data imply that non-oil GDP growth in 2013 was significantly lower than the most recent official estimate of 5.6%.

Fiscal stimulus in 2014 supported increased commercial activity and strong growth in private consumption. Electricity use by businesses rose by 10.9%. Motorcycle and passenger vehicle registration increased by 60.4%. The entry of a new airline restored competition on the Bali–Dili route. While total passenger numbers were flat, the number of Timorese passengers more than doubled.

Inflation continued its downward trend in 2014 as annual average inflation slowed to 0.7% despite higher demand from rising public spending (Figure 3.35.2). As the US dollar is the official currency of Timor-Leste, its continued strength against the currencies of trading partners such as Indonesia was a key factor. Lower oil prices reduced transport costs, and lower international food prices kept local prices stable in the face of rising demand.

The 2014 budget introduced new regulations to improve the quality of public spending, including limits on single-source procurement, conditions linking withdrawals from the Petroleum Fund to timely budget execution, and controls on advance payments. Several of these

3.35.1 Supply-side contributions to growth



Sources: Statistics Timor-Leste; ADB estimates.
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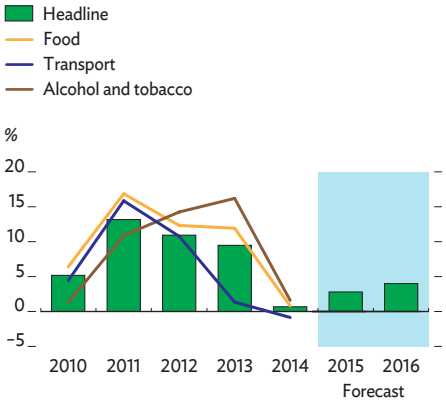
3.35.2 Inflation



Sources: Timor-Leste National Statistics Directorate; ADB estimates.
Click here for figure data

This chapter was written by David Freedman, consultant, Timor-Leste Resident Mission, ADB, Dili.

regulations were subsequently relaxed as budget execution lagged. This helped push own-funded capital expenditures up by 27.8% to $448 million in the year, with more than half of this higher spending in November and December.

The government continued to invest in the national electricity network. Expenditures of $133 million in 2014 brought investment on the network since 2008 to $1 billion. Despite excess generation capacity, additional investment and reform are needed to reduce operating subsidies of $87 million in 2014—equal to 6% of non-oil GDP.

Government revenues totaled $3.0 billion in 2014 and yielded a fiscal surplus equivalent to 1.3 times non-oil GDP. This surplus was saved in the government's Petroleum Fund, increasing its balance to $16.5 billion or $13,700 per capita. Fund investments obtained a nominal return of 3.3% in 2014. This was consistent with the benchmark yields established by the fund's investment mandate, but investment income nevertheless fell 35% short the 2014 budget forecast.

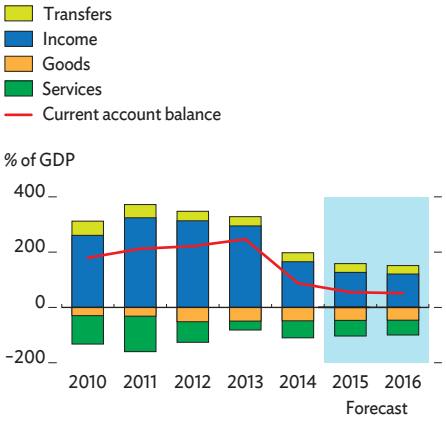
Real sector outcomes were mixed in 2014. Construction is estimated to have grown rapidly on the back of increased public capital investment and sustained demand from the private sector, though official trade statistics reported lower imports of such inputs as cement and steel. Heavy rains contributed to a 29% fall in coffee production, but coffee export revenues fell by only 12% thanks to higher international prices. The Food and Agriculture Organization estimated that rice and maize production increased by 18% with expanded planted area, the adoption of new technologies, and favorable growing conditions.

Lending to businesses and individuals was flat in 2014 but showed significant variation by sector. Lending for trade and finance accounted for 20% of all private sector credit in 2013 but fell by more than 64% in 2014, while lending for transport and communication fell by 18%. Lending to all other sectors grew. Credit to individuals rose by 11% and to construction firms by 15%. Lending for agriculture, manufacturing, and tourism accounted for 6% of all lending in 2013 but grew rapidly in 2014 to account for 13% of total private sector credit by the end of the year.

Businesses continued to accumulate bank deposits in 2014. Growth in business deposits averaged 46% year on year, such that the stock of deposits now exceeds total credit to the private sector. This growth, which started in 2013, suggests that more businesses can now use retained earnings to finance their operations.

Despite declining petroleum income, Timor-Leste once again posted a current account surplus, equal to 88% of non-oil GDP in 2014, as higher petroleum income offset a large deficit in goods and services trade (Figure 3.35.3).

3.35.3 Current account components



Sources: Banco Central de Timor-Leste; ADB estimates.
Click here for figure data

Economic prospects

Growth is expected to slow to 6.2% in 2015 as stimulus from rising public spending eases, then rise to 6.6% in 2016 as major public and private investment projects move forward. Inflation is forecast at 2.8% in 2015 and 4.0% in 2016 as the deflationary effects of the strong dollar and low international food prices dissipate and domestic demand builds.

3.35.1 Selected economic indicators (%)

	2015	2016
GDP growth	6.2	6.6
Inflation	2.8	4.0
Current account balance (share of GDP)	55.0	51.6

Source: ADB estimates.

While growth is forecast to be lower than in recent years, encouraging signs have emerged of a more active private sector. Work on a new $45 million brewery and bottling plant is set to begin in 2015, and domestic and foreign investors are considering several other major investment projects.

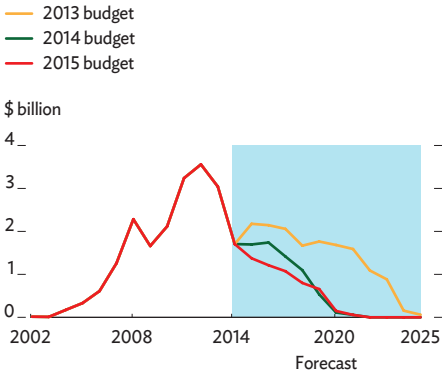
Budgeted spending for 2015 is 5% above the 2014 budget envelope and 21% above the government's own target for long-term fiscal sustainability. The share of recurrent spending in the budget has continued to rise, with social transfers and grants accounting for more than a quarter of public spending. The government has also maintained plans for large public capital projects. The 2015 public investment program includes $66 million to upgrade national roads and bridges and an additional $57 million for the electricity system. Work to develop a new international port is expected to start, and the budget anticipates investments in other transport infrastructure to be greatly scaled up in 2016.

Taxes and royalties from petroleum production provided 57% of government revenues in 2014. Production from current fields peaked in 2012 and is forecast to end in 2020, while the prospects for new development remain uncertain. The 2015 budget cut the discounted forecast of future petroleum revenues by 16% to $4.7 billion in anticipation of production downgrades, rising costs, and lower prices (Figure 3.35.4). This forecast assumes an average oil price of $89 per barrel from 2015 to 2020. As it was prepared in May 2014, it did not factor in the sharp fall in oil prices in the second half of 2014. In January, the World Bank forecast the average price of crude at $63 per barrel during 2015–2020.

Lower oil prices will likely narrow the current account. Surpluses are expected to fall to 55% of non-oil GDP in 2015 and 51.6% in 2016. The fiscal surplus will fall to 36% of non-oil GDP in 2015 and 8% in 2016 if planned spending increases go ahead (Figure 3.35.5). The 2015 budget estimated that the Petroleum Fund could sustain annual withdrawals of $638.5 million without losing value in real terms. However, lower oil prices will likely cut the estimated sustainable income to less than $600 million—significantly below planned withdrawals of $1.3 billion in 2015 and $1.7 billion in 2016.

The government of Timor-Leste decided in October to establish a special commission to negotiate maritime boundaries with Australia. Progress in resolving territorial disputes could pave the way for developing the Greater Sunrise gas field, though prospects remain uncertain. As revenues from existing fields decline, prudent fiscal policy is needed to avoid rapidly depleting savings in the Petroleum Fund. Fiscal consolidation is likely to mean a period of lower growth, but improving the quality of public spending can bring sustained improvement in living standards.

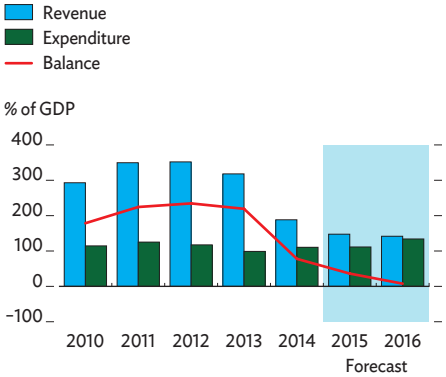
3.35.4 Adjustment to projected petroleum revenues



Sources: Timor-Leste 2013, 2014, and 2015 State Budget; ADB estimates.

Click here for figure data

3.35.5 Government revenues and expenditures



Sources: Timor-Leste State Budget (various years); ADB estimates.

Click here for figure data

Policy challenge—encouraging private investment

Growth and job creation increasingly depend on the private sector, which has expanded rapidly in recent years but remains at an early stage of development. Limited domestic capacity means that foreign investors

can play important roles by providing access to capital, technology, and new markets.

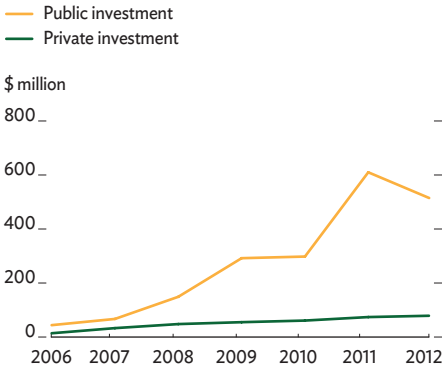
Successive governments have implemented policies and laws to encourage foreign investment. The 2005 Foreign Investment Law established a framework for investment by foreign citizens and nonresident Timorese. The law guaranteed foreign investors equal treatment and established an investment certification process with modest tax incentives and few restrictions on the sectors open for investment. To encourage investment, tax reform in 2008 slashed corporate tax from 30% to 10%, which compares favorably with the average corporate tax rate of 23% among members of the Association of Southeast Asian Nations. Further incentives were provided in the 2011 Investment Law to encourage investment by foreign nationals and resident Timorese citizens. Investors who meet legal requirements can receive tax exemptions for up to 10 years.

Despite these incentives, private investment has increased only moderately. National accounts data show that private capital formation has grown modestly since 2007 when compared with the rapid increases in public investment (Figure 3.35.6). Growth in the number of registered foreign investments has also been slow. The government has registered an average of six foreign investments per year since 2006, with an average of $2.9 million per investment equal to 0.2% of non-oil GDP (Figure 3.35.7).

Investors from Australia, the People's Republic of China, Indonesia, Portugal, and Viet Nam have been most active in the country since 2006, and there is clear potential to attract greater foreign investment. However, current low investment reflects the country's challenging business environment and the failure of incentives to overcome these challenges.

To attract greater investment from overseas, the government has established a new agency to promote Timor-Leste as an investment destination and facilitate the entry of new investors. This could significantly improve investment flows if supported by a credible program to improve the business environment. Planned reviews of the investment law and tax code offer opportunities to ensure that tax incentives are clearly defined and well targeted. Legal reform to ensure clear and straightforward access to land is another priority, and there is scope to streamline business licensing and improve access to foreign skilled labor where needed.

3.35.6 Capital formation by the government and the private sector



Source: Timor-Leste National Accounts. 2012.
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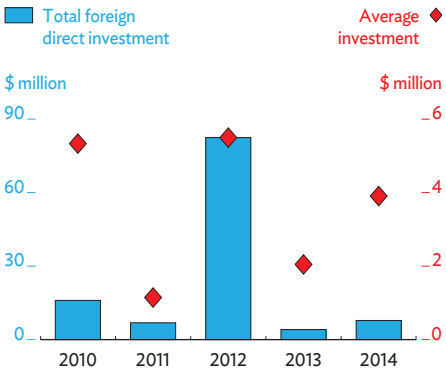
3.35.7 Foreign direct investment



Source: Timor-Leste Specialized Investment Agency.
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Vanuatu

The economy grew in 2014 at its fastest rate in several years but will likely contract in 2015 following a severe tropical cyclone in March. A rebound is expected in 2016 on reconstruction spending and recovery in agriculture and tourism. Medium-term development challenges are to find new revenue sources and to control growth in government spending. These efforts can free up fiscal resources to fund for infrastructure projects and maintain fiscal sustainability.

Economic performance

Vanuatu has enjoyed over a decade of uninterrupted growth, though the economy slowed in the years after the global financial crisis. Growth accelerated in 2014 to 3.6%, the fastest rate since 2008. Government estimates show, however, that economic growth and output have languished below potential for the past 5 years.

Growth in 2014 was driven by commercial construction and projects funded by development partners. Expenditure on major projects is projected to quadruple from 2014 to 2016. Although visitor arrivals by air declined in 2014, the number of arrivals by cruise ship grew strongly. This contributed to growth related to tourism, notably in hotels and restaurants, transport, retail trade, and telecommunications.

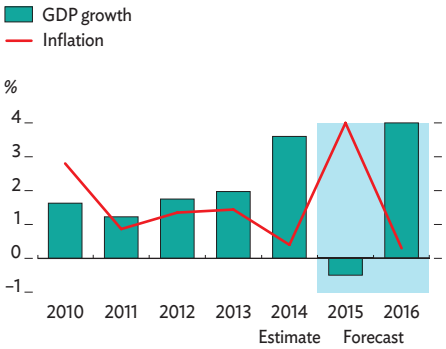
Real estate investment from abroad has slowed in recent years, reflecting developments in neighboring markets such as Australia. Meanwhile, government land sales have caused concern in affected communities.

Output stagnated in the agriculture, fisheries, and forestry sector in 2014, as growth in fisheries output was offset by declining livestock and crop production. Smallholder agriculture has been in long-term decline as rural populations have migrated to cities and coconut plantations have aged.

The current account deficit widened to an estimated 5.7% of GDP in 2014 from 3.3% in 2013. This reflected a deteriorating trade deficit as imports of goods for construction rose while total exports expanded only slightly on small gains in agricultural exports. Despite a widening current account deficit, foreign reserves remain high, bolstered by inflows of foreign direct investment and funding from development partners. In December 2014, reserves exceeded 6 months of cover for imports.

Inflation averaged 0.4% in 2014, down from 1.4% in 2013 (Figure 3.36.1). The deceleration was caused by excess productive capacity and lower commodity prices, particularly for fuel. The Reserve Bank of Vanuatu, the central bank, has cut the policy rate only once

3.36.1 GDP growth and inflation



Sources: Reserve Bank of Vanuatu; ADB estimates.
Click here for figure data

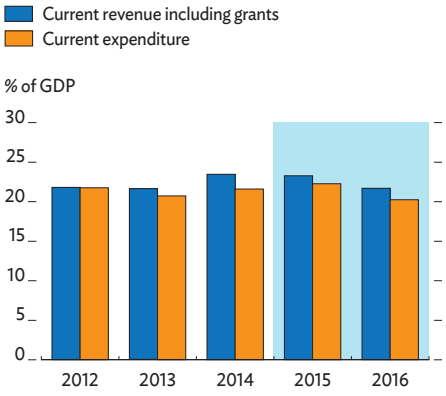
This chapter was written by Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney.

since 2008, from 6.0% to 5.5% in March 2013. The steady rate reflects continued low inflation despite a recovery in growth.

The government targeted a small surplus of current revenue over current expenditure for 2014, in line with a legal requirement that the budget not show a deficit. Unbudgeted expenses, such as additional funding for health care, necessitated a supplementary budget in mid-2014. Spending restraint on other budget items and improved compliance with revenue collection generated an overall fiscal surplus equal to 1.2% of GDP for the year as a whole (Figure 3.36.2).

Government debt has trended higher since 2010, the year it dipped below 20% of GDP. The government has increased its borrowing to fund a number of large infrastructure investments and now estimates that debt will equal 26% of GDP in 2015 and 30% in 2016. The debt position would be considerably worse if the government had gone ahead with a controversial airport infrastructure project that would have required the issuance of promissory notes equivalent to more than 40% of GDP.

3.36.2 Current budget outcomes and projections



Source: Vanuatu 2015 budget.

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Economic prospects

A category 5 cyclone struck Vanuatu in mid-March. Tropical Cyclone Pam reportedly destroyed or damaged 90% of the buildings on Efate Island, which includes the capital, Port Vila. Damage is expected to severely disrupt economic activity and hinder growth in 2015. Early assessments suggest that agriculture output and tourism will suffer large declines.

Vanuatu's economy is among the most dependent on tourism in the Pacific. Tourism accounts for roughly 25% of GDP and is the principal source of foreign exchange and formal sector employment. Tourism is concentrated around the capital Port Vila, and only 10%–18% of tourists travel to the other islands. Over the past decade, Vanuatu has seen strong growth in tourist arrivals, particularly cruise ship arrivals (mainly from Australia), which have grown at the rate of 15% per year. In 2014, there were about 230 port calls by cruise ships in the country, with diminished numbers during Australia's summer in December–March.

3.36.1 Selected economic indicators (%)

	2015	2016
GDP growth	–0.5	4.0
Inflation	4.0	2.0
Current account balance (share of GDP)	–10.0	–7.0

Source: ADB estimates.

Travel advisories, the indefinite suspension of cruise ship visits, and extensive damage to infrastructure around Port Vila are expected to dramatically reduce the number of tourists in the second quarter of this year, with recovery likely in the third quarter at the earliest. Recent experience suggests that tourism generally takes 1–2 years to fully recover following a major natural disaster, depending on the time required to repair the infrastructure that underpins tourism and to salvage the country's reputation as a safe destination.

Agriculture accounts for a quarter of GDP but engages some 80% of the population in subsistence farming or smallholder production of coconuts and other cash crops. Disruption to agriculture is expected from damage to crops and transport links. No detailed estimates were available in mid-March, but early indications were that agricultural output in 2015 would be steeply down from 2014.

Increased spending on construction for cyclone recovery and the planned implementation of a number of major infrastructure projects later in the year are expected to offset the shocks to agriculture and tourism. The economy is now expected to contract in 2015—reversing

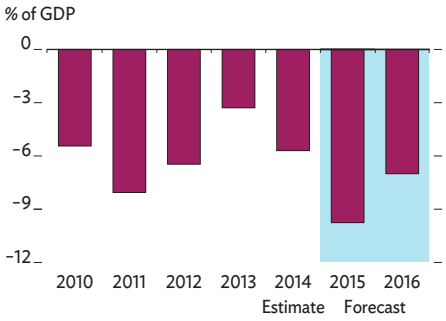
a forecast of growth at about 4.0% made before the cyclone—but a detailed forecast will depend on firmer information about cyclone damage and disaster response. If the economy does contract this year, it will be Vanuatu's first annual GDP contraction since 2002. Growth is expected to rebound to 4.0% in 2016 as infrastructure works and recovery in tourism and agriculture continue.

Inflation is expected to accelerate to 4% in 2015, with higher local food prices caused by cyclone-related supply disruption offsetting low fuel prices. In 2016, inflation is expected to return to its long–run trend at about 2%.

The government had planned to run small fiscal surpluses, in line with legal requirements, for current revenue and expenditure in 2015 and 2016. However, the need to increase expenditure for cyclone recovery will likely make these targets impossible to achieve without significantly higher assistance flows from development partners.

The current account deficit is expected to widen significantly in 2015 as lost tourism revenue combines with higher imports for reconstruction and major infrastructure projects. This will likely narrow in 2016 as agriculture and tourism receipts recover (Figure 3.36.3). The deficit is expected to be financed through foreign direct investment and increased assistance from development partners. Foreign exchange reserves are expected to decline but still provide 5 months of cover for imports in 2015 and 2016, exceeding the central bank's target of 4 months.

3.36.3 Current account balance



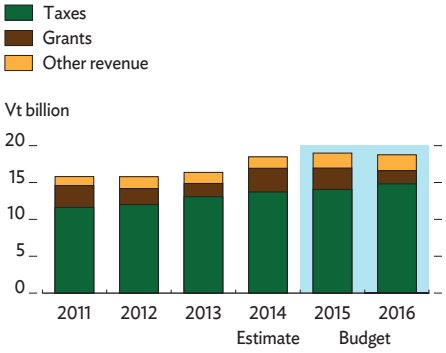
Sources: Reserve Bank of Vanuatu; ADB estimates.
Click here for figure data

Policy challenge—sustainably funding development investment

While recovery from Tropical Cyclone Pam is the priority in the short term, the government's medium-term challenge is to sustainably fund development investment. Government revenue growth has been constrained by falls in external grants, which trended down from 2009 to 2013 (Figure 3.36.4). Revenue growth over the period came from higher tax collections, mainly of the value-added tax. However, Vanuatu's narrow tax base constrains the government's ability to further increase revenues. As a percentage of GDP, revenue has declined from 27.0% in 2008 to 21.6% in 2013. Revenue is estimated to have bounced back to 23.4% in 2014, mainly from higher grant receipts, which are counted as government revenue. Uncertainty over assistance inflows for cyclone recovery makes it difficult to project revenue as a share of GDP in 2015, but before the cyclone it was expected to slide to 23.2%.

Meanwhile, demand for government spending has expanded with rapid population growth. Capital expenditure growth is expected to outpace that of current expenditure as major construction projects are implemented. Recent developments in health care have highlighted the need for the government to adequately budget and plan for additional expenditure associated with major projects. The Vila Central Hospital, for example, exhausted its annual budget in the first 6 months of 2014, forcing the temporary closure of the country's only intensive care unit and rendering largely unusable $14.6 million worth of newly modernized

3.36.4 Revenue components



Source: Vanuatu Department of Finance and Treasury.
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facilities. The facility reopened when additional funds were allocated for health care in a supplementary budget.

The government plans a large pipeline of major infrastructure projects for the next 5 years, and construction on some projects is already under way. The success of these projects will depend on having adequate resources set aside for both construction and maintenance.

Vanuatu's fiscal law requires the government to avoid a budget deficit. This requirement is likely to become increasingly difficult to satisfy if the government does not control expenditure growth and develop alternative revenue sources over the medium term.

Vanuatu has limited options for increasing revenue as it does not levy taxes on individual or corporate income. Its domestic revenue is low relative to its Pacific island peers, suggesting scope for increase. The International Monetary Fund estimates that an income tax levied at modest rates on employees and employers alike could yield revenues equal to 3%–4% of GDP and raise revenues more equitably than through indirect taxes.

As well as exploring additional revenue-raising opportunities, the government needs to control and prioritize government expenditure more effectively. One area that warrants careful monitoring is scholarships for study at universities overseas. In addition to scholarships funded by Australia and New Zealand, the government finances scholarships for study at universities in Fiji and the Philippines. In 2014, a supplemental appropriation was needed to increase spending on government-funded scholarships to more than Vt345 million, more than double the initial budget of Vt163 million. More modest expenditure of Vt154 million is proposed in the 2015 budget, but these expenditures must be carefully monitored to keep spending in line.

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North Pacific economies

Palau's economy recovered strongly last year on record tourist arrivals, but the Republic of the Marshall Islands and the Federated States of Micronesia registered weak economic performance. Growth in the North Pacific is seen to accelerate in the near term because of favorable external conditions and stimulus from infrastructure projects, along with continued tourism growth in Palau. Rationalizing air links to the North Pacific would boost prospects for sustainable growth.

Economic performance

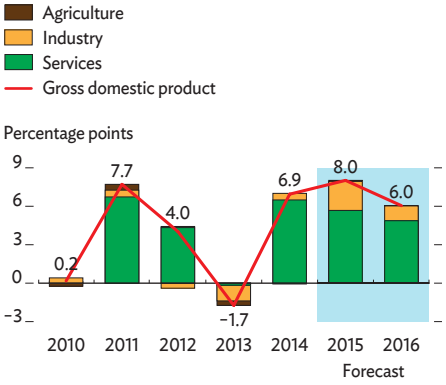
While economic growth in the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM) was subdued amid problems implementing capital projects under their compacts of free association with the US, Palau grew strongly by 6.9% in FY2014 (ended 30 September 2014).

A surge in tourism and increased construction, particularly late in the fiscal year, drove growth in Palau, which reversed economic contraction in the previous year (Figure 3.37.1). Following a 9.5% decline in FY2013, visitor arrivals rebounded by 13.2% to reach a record high of nearly 123,000. Particularly strong was growth in arrivals from the People's Republic of China, which made it the largest tourist source in the last quarter of FY2014. Arrivals from two other major markets, Japan and Taipei,China, also improved. New air links with Hong Kong, China and expanded accommodation capacity boosted recovery in tourism arrivals.

In the RMI and the FSM, the release of FY2014 sector grants was delayed because both countries had failed to update their plans to accommodate anticipated decreases in compact funding. After growing by 3.0% in FY2013, the RMI economy grew by a mere 0.5% in FY2014 for lack of new infrastructure projects (Figure 3.37.2). This followed the completion in FY2013 of airport road realignment funded by the US Federal Aviation Authority and reflected unforeseen delays affecting other scheduled capital projects. Growth in FY2014 was driven mainly by strong fishery performance as domestic purse seiners landed larger catches. Weak construction, and lower compact grant disbursements for education and health care, suppressed demand for associated services such as transport, storage, and communications.

The FSM economy contracted by 3.4% in FY2014, extending the 4.0% contraction in the previous year (Figure 3.37.3). Domestic fisheries recovered, but the absence of demand connected with new construction kept industry and services in decline. Capital expenditure shrank by 57.9% in FY2014, while US Compact capital grants plunged by 80.5%.

3.37.1 Supply-side contributions to growth in Palau



Note: Years are fiscal years ending on 30 September of that year.

Source: ADB estimates using data from the *Republic of Palau FY2014 Economic Review.*

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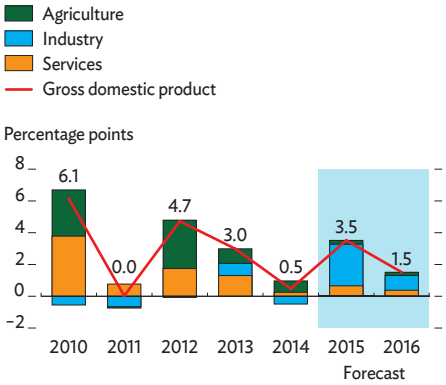
3.37.2 Supply-side contributions to growth in the Marshall Islands



Note: Years are fiscal years ending on 30 September of that year.

Source: ADB estimates using data from the *Republic of the Marshall Islands FY2013 Economic Review.*

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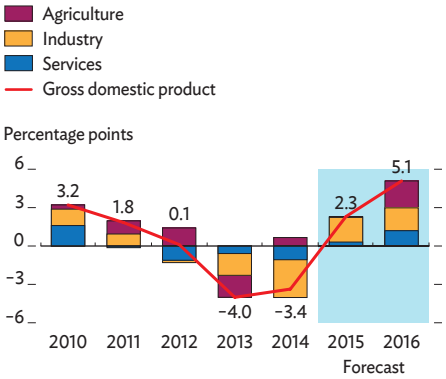
This chapter was written by Christopher Edmonds, Rommel Rabanal, and Cara Tinio of the Pacific Department, ADB, Manila, and Prince Cruz, consultant, Pacific Department, ADB, Manila.

Inflation slowed in the RMI and the FSM with lower import prices, which were in line with declining international commodity prices, and with the appreciating US dollar (the currency used by all three North Pacific economies). In the RMI, inflation eased to 1.3% from 1.9% in FY2013, and in the FSM to 0.7% from 2.1%, reflecting weak demand and low import costs. Conversely, inflation accelerated to 4.0% from 2.8% in Palau, where increases in tobacco taxes and medical and educational fees, and a strong growth environment, more than offset lower import prices.

The North Pacific economies all recorded fiscal surpluses in FY2014. In the RMI, a decline in grants was offset by higher fishing license revenues and lower expenditure, generating a surplus equivalent to 3.2% of GDP. The FSM recorded its third consecutive year of rising surpluses. In FY2014, revisions to corporate tax regulations for foreign insurance companies brought a windfall of $20 million and a fiscal surplus equal to 11.1% of GDP. Without the windfall, the surplus would have been 4.4% of GDP, which is still higher than the FY2013 surplus of 2.9%. The windfall tax revenue was invested equally in FSM Social Security and the FSM Trust Fund. The large surplus also reflected higher fishing license revenues and capital grants left unspent because of inability to comply with compact requirements. Palau's small surplus, equal to 1.2% of GDP, made FY2014 the fourth consecutive year with a positive fiscal balance. Reductions in grant receipts and higher expenditure were more than offset by higher collections from the gross revenue tax, hotel taxes, and a higher tobacco tax rate.

Current account positions in the North Pacific—which are heavily affected by large merchandise trade deficits—were generally helped by low international commodity prices and continued strong fishing license collections. In the FSM, smaller deficits in goods and services trade, together with the windfall from the corporate income tax paid by nonresidents, reversed the current account position from a deficit equivalent to 10.1% of GDP in FY2013 to a surplus of 14.2% in FY2014. Although Palau's strong economic recovery translated into a larger merchandise trade deficit as demand for imports rose, this was partly offset by large tourism receipts arising from record visitor arrivals. Thus, Palau's current account deficit narrowed to the equivalent of 5.1% of GDP in FY2014 from 8.8% in FY2013. In the RMI, lower imports of goods following the completion of airport road realignment offset lower grant inflows, leaving a current account deficit equal to 9.4% of GDP and improved from 12.4% in FY2013. All three economies have seen large swings in their current account positions caused by volatility in key foreign exchange receipts such as budget support grants, remittances, and fishing license revenues, as well as from periodic imports of costly durable machinery and equipment.

3.37.3 Supply-side contributions to growth in the Federated States of Micronesia



Note: Years are fiscal years ending on 30 September of that year.

Source: ADB estimates using data from the *Federated States of Micronesia FY2013 Economic Review.*

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Economic prospects

The outlook for growth in the near term is bright because of favorable external conditions and progress expected in infrastructure development across North Pacific economies. Lower international prices should ease governments' substantial expenditures on imported diesel

for generating electricity. Transport savings, declining food prices, and a stronger US dollar are expected to further reduce expenditures on imports. Recovery in the US economy and sustained subregional efforts to raise fishery access fees bode well for higher external income flows.

GDP growth in Palau is projected to accelerate to 8.0% in FY2015 on increased tourism, hotel construction, stimulus from higher public infrastructure spending, and improvements in the external economic environment. Tourism stands to benefit from lower air transport costs as visitor arrivals continue to climb at double-digit rates. Tourist numbers from the People's Republic of China in particular are seen to rise further after a second airline began offering chartered flights from Hong Kong, China in September 2014. Concerns are growing, however, about how many new visitors can be accommodated in the current stock of hotel rooms and about the carrying capacity of tourist sites and public infrastructure. Growth in visitor arrivals is expected to taper off slightly in FY2016, but GDP growth is seen to remain strong at 6.0%, supported by ramped up public infrastructure construction.

Progress in infrastructure project implementation is expected to stimulate the economies of the RMI and the FSM. Accelerated work on delayed projects and the commencement of new initiatives are projected to push RMI GDP growth to 3.5% in FY2015. Growth is then seen to slow again to 1.5% in FY2016 as projects near completion and construction winds down. Similarly, in the FSM the resumption of the Airport Improvement Program with the renovation of the runway at Chuuk should help reverse the economic downturn and support growth at 2.3% in FY2015. Growth is projected to accelerate to 5.1% in FY2016 with scaled-up implementation of projects.

Low inflation will likely continue as international commodity prices remain subdued. In the RMI, inflation is projected to stay steady at 1.4% in FY2015 and 1.3% in FY2016. Economic recovery in the FSM is expected to push inflation to 2.4% in FY2015 and 2.6% in FY2016. Inflation in Palau is seen to ease in FY2015 as the one-off impact of increased medical and school fees passes but will remain relatively high at 3.4% with the second phase of the tobacco tax hike taking effect in January 2015. Sustained strong economic growth is expected to keep inflation steady in FY2016 (Figure 3.37.4).

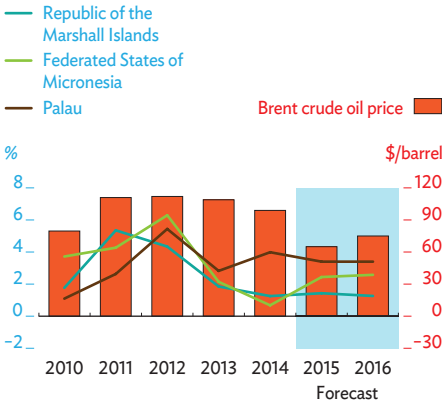
The RMI current account deficit is projected to expand to the equivalent of 9.9% of GDP in FY2015 and 11.4% in FY2016 because construction projects will bolster demand for imports (Figure 3.37.5). With the one-off corporate tax windfall gone, the FSM current account surplus is seen to narrow to 11.2% of GDP in FY2015 and 6.4% in FY2016, as rising fishing license revenues are offset by higher imports of goods and services related to airport upgrades. Palau's current account deficit is projected to widen to the equivalent of 6.4% of GDP in 2015 and 8.1% in 2016, partly because the country's declaration turning its entire exclusive economic zone into a marine sanctuary will eliminate fishing license revenues by FY2019.

3.37.1 Selected economic indicators (%)

Marshall Islands	2015	2016
GDP growth	3.5	1.5
Inflation	1.4	1.3
Current account balance (share of GDP)	–9.9	–11.4
Federated States of Micronesia		
GDP growth	2.3	5.1
Inflation	2.4	2.6
Current account balance (share of GDP)	11.2	6.4
Palau		
GDP growth	8.0	6.0
Inflation	3.4	3.4
Current account balance (share of GDP)	–6.4	–8.1

Source: ADB estimates.

3.37.4 Inflation



Note: Years are fiscal years ending on 30 September of that year.

Sources: Federated States of Micronesia FY2013 Economic Review; Republic of the Marshall Islands FY2013 Economic Review; Republic of Palau FY2014 Economic Review; World Bank Commodity Price Data (Pink Sheet); ADB estimates.

Click here for figure data

Policy challenge—air links to the North Pacific

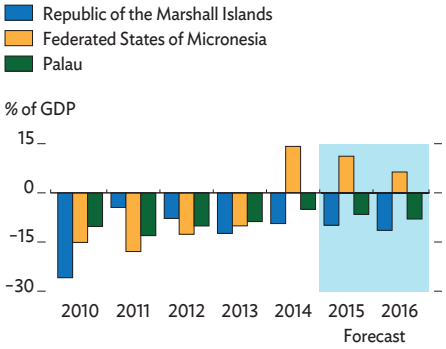
Tourism is important in many Pacific countries. In Palau, the sector has expanded rapidly, with a record number of visitors arriving in FY2014. Tourism receipts have amounted to more than half of GDP in recent years, and tourism development has been facilitated by direct air links between Palau and several major Asian markets that have reduced travel time. However, recent growth in visitor arrivals, pushed by rapid expansion in the number of charter flights from Hong Kong, China, is leading the Government of Palau to consider policy options to reduce the number of charter flights in light of congestion and strain on infrastructure during peak periods.

In contrast, tourism in the RMI and the FSM remains underdeveloped. From 2004 to 2013, annual visitor arrivals to the RMI averaged only about 5,000, and to the FSM 15,000. Most visitors came from the US, with Japan being the largest Asian market for both countries and accounting for 20% of arrivals. It is clear that the RMI and the FSM could benefit, as Palau has, from expanded international air links. More frequent and less costly connections to international markets, particularly the fast-growing economies of East and Southeast Asia, would enhance the longer-term prospects for tourism, investment, and trade. At present, the FSM is accessed primarily through Guam or Hawaii, requiring clearance through US customs and immigration. The RMI also has twice-weekly flights through Nauru. Flight services to the RMI and the FSM are among the lowest capacity in the Pacific (Figure 3.37.6). While limited air links inhibit the flow of tourists and businesspeople alike, they also reflect lack of demand for flights because tourist facilities are relatively undeveloped, and business and investment activity weak. Stimulating demand for greater air links therefore requires complementary efforts to improve domestic infrastructure and the enabling environment for sustainable tourism.

The governments of the three North Pacific economies recently considered establishing a new airline that would offer direct connections to Asia, possibly using Singapore as a hub. Previous experience shows, however, that airlines owned and operated by governments are generally inefficient and unsustainable. Air Marshall Islands, established in 1980 to fly between the main and outer islands, has become a significant fiscal drain. In the early 1970s, seven Pacific island governments held shares in the Air Pacific effort to develop a regional airline. However, the Government of Fiji came to own more of the company while investments from other countries faded, and the airline was rebranded as Fiji Airways in 2012.

The Government of the FSM is now seeking to expand links through bilateral air service agreements to allow existing airlines to assess demand and better respond to potential market opportunities. It is currently discussing air service agreements to connect member states with large markets in Asia such as the People's Republic of China, the Philippines, and Singapore. FSM policy makers are also pursuing opportunities for arranging stopovers in the FSM on Fiji Airways' Nadi–Honolulu flight (as well as direct flights between the FSM and Fiji) and Air Niugini's Port Moresby–Narita flight, to improve air links with South Pacific air transport hubs. Discussions are also under way for Nauru Airlines' Nauru–Majuro flight to include stops in the FSM.

3.37.5 Current account balance

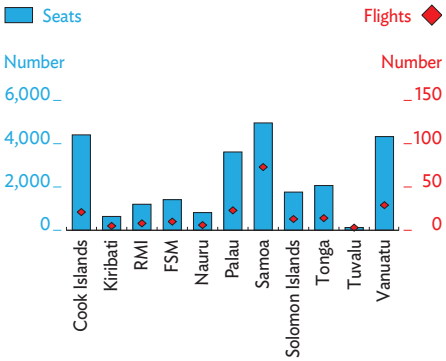


Note: Years are fiscal years, ending on 30 September of that year.

Sources: Federated States of Micronesia FY2013 Economic Review; *Republic of the Marshall Islands FY2013 Economic Review*; *Republic of Palau FY2014 Economic Review*; ADB estimates.

Click here for figure data

3.37.6 Weekly international air departures



FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Source: IOS Partners and APA Airport Planning Associates. 2015. *Baseline data and forecasting report: options for regional aviation supply & long-term sustainability of regional aviation infrastructure.* January.

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South Pacific economies

These small and fragile economies still depend on tourism earnings and public infrastructure funded by development partners. Delays in implementing projects slowed economic expansion in the Cook Islands, while increased construction and steady tourism performance reversed downturns in Samoa and Tonga. Growth is expected to accelerate this year before slowing somewhat next year. To make growth sustainable, South Pacific governments should continue to improve the environment for private sector development.

Economic performance

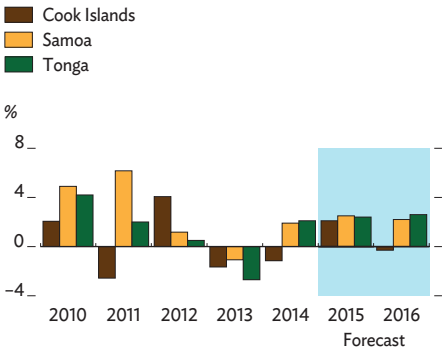
Growth generally improved in FY2014 (ended 30 June 2014) in the South Pacific (Figure 3.38.1). Samoa's economy grew by 1.9% on spending to prepare for the 2014 United Nations Small Island Developing States Conference and continued reconstruction following Cyclone Evan in December 2012. Tonga—recovering from 2.7% contraction in FY2013 caused by a sharp decline in reconstruction after the end of loan-financed projects—recorded growth at 2.1% in FY2014. Growth came from higher agricultural output in the first half, before the arrival of Cyclone Ian in January 2014, and recovery in construction in the wake of that cyclone.

In the Cook Islands, GDP declined by 1.2%, a slight improvement from 1.7% contraction in FY2013. Delays in implementing projects supported by development partners outweighed growth in visitor arrivals. Updated official figures have caused the latest growth estimates to differ significantly from those reported in previous editions of *Asian Development Outlook*.

Tourism remains a key income source for these South Pacific economies, and sector performance has stayed generally positive (Figure 3.38.2). In FY2014, Samoa welcomed about 127,000 visitors, close to the number received in FY2013. Visitor arrivals in Tonga are also estimated to have been stable, at about 59,000 visitors in FY2014, following slight declines in the previous 2 years. Visitors to the Cook Islands increased to about 123,000 in FY2014, up by 1.6% over FY2013. Although visitor arrivals to the Cook Islands continue to increase, growth has slowed over the past few years.

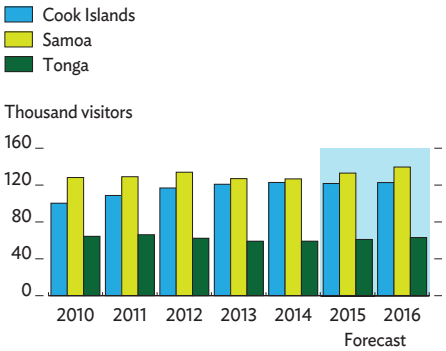
Inflation stayed moderate across the South Pacific in FY2014 as international food and fuel prices continued to decline (Figure 3.38.3). Inflation in the Cook Islands averaged 1.6%, down from 2.6% in FY2013, because the economic slowdown reinforced the effects of international price movements. Prices in Samoa contracted further by 1.2% in FY2014, following marginal deflation at 0.2% in FY2013. The continued decline

3.38.1 GDP growth in the South Pacific



Note: Years are fiscal years ending on 30 June of that year.
Sources: Cook Islands Statistics Office; Samoa Bureau of Statistics; Tonga Department of Statistics; ADB estimates.
Click here for figure data

3.38.2 Tourist arrivals to the South Pacific



Note: Years are fiscal years ending on 30 June of that year.
Sources: Cook Islands Statistics Office; Samoa Bureau of Statistics; National Reserve Bank of Tonga; ADB estimates.
Click here for figure data

This chapter was written by Malie Lototele and Shiu Raj Singh of the South Pacific Subregional Office, ADB, Suva, and Cara Tinio, Laisiasa Tora, and Johannes Wolff of the Pacific Department, ADB, Manila.

in international food and fuel prices offset a slight increase in prices for locally produced goods to keep domestic prices subdued. Only Tonga experienced higher inflation in FY2014, which accelerated to 2.3% from 0.7% in the previous fiscal year because of improved domestic demand and the disruption to local supply networks caused by the cyclone.

The Cook Islands and Samoa continue to run budget deficits (Figure 3.38.4). The Cook Islands recorded a fiscal deficit equal to 3.0% of GDP in FY2014, slightly narrower than the 3.8% deficit incurred in FY2013. During the same period, Samoa's fiscal deficit expanded to 5.3% of GDP as the government financed preparations to host the United Nations conference. This deficit was financed largely by soft loans from traditional development partners.

Tonga recorded a budget surplus equal to 1.1% of GDP in FY2014 as fiscal consolidation reversed relatively high deficits in recent years. Tonga and the Cook Islands need to further consolidate their public sector operating costs. Expenditures on public sector wages, for example, are reportedly much lower in Samoa (Figure 3.38.5).

Monetary policy generally remained expansionary in Samoa and Tonga. The central banks of both have kept policy interest rates low to encourage lending to the private sector and promote economic activity. After years of decline, lending to the private sector in Samoa, and lending to households in Tonga, began to increase toward the end of FY2014. The Cook Islands does not have a central bank and uses the New Zealand dollar as its official currency.

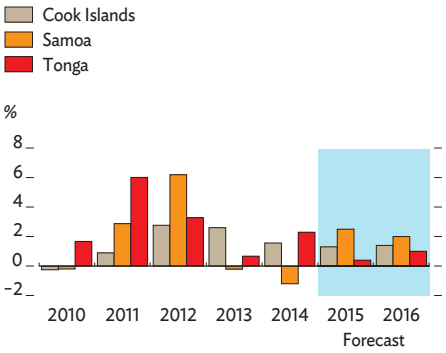
Samoa and Tonga ran current account deficits (Figure 3.38.6). Large imbalances in merchandise trade were partly offset by remittance inflows and capital grants from development partners, yet Samoa's current account deficit doubled to the equivalent of 12.2% of GDP in FY2014 from 5.9% in FY2013, mainly on higher goods imports. The country has implemented stronger exchange controls after seeing foreign reserves drained in recent months. Tonga's current account deficit narrowed to an estimated 1.4% of GDP from 1.9% in FY2013. The Cook Islands does not report balance of payments estimates.

Remittances continue to be an important source of income for many dependents of Samoans and Tongans working abroad—mostly in Australia, New Zealand, and the US—but inflows to Samoa and Tonga declined in FY2014 (Figure 3.38.7). Remittances to Tonga decreased by 4.5%. Samoa's remittances declined by 8.1% in FY2014, reversing the 12.0% increase in FY2013, as high unemployment, especially among Pacific laborers, continued in New Zealand—the main host for Samoan workers overseas. Unlike the other two South Pacific economies, the Cook Islands is a net remitter because it employs more than 3,000 foreign workers, mostly from the Philippines and Fiji.

Economic prospects

Growth in the South Pacific is expected to accelerate in FY2015 before slowing slightly in FY2016. Tourism and public infrastructure development will continue to drive growth, but contributions from agriculture should increase as projects implemented with development partners boost the sector in Samoa and Tonga.

3.38.3 Inflation



Note: Years are fiscal years ending on 30 June of that year.
Sources: Cook Islands Statistics Office; Central Bank of Samoa; National Reserve Bank of Tonga; Tonga Department of Statistics; ADB estimates.
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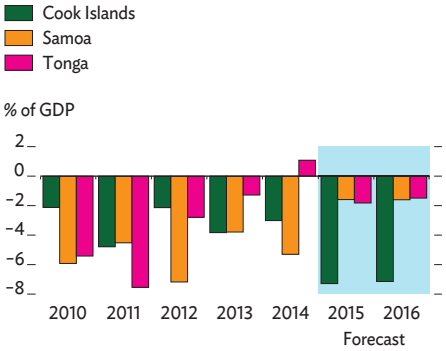
3.38.4 Fiscal balance



Note: Years are fiscal years ending on 30 June of that year.
Sources: Cook Islands Statistics Office; Samoa Bureau of Statistics; International Monetary Fund staff report on Tonga, 2014; ADB estimates.
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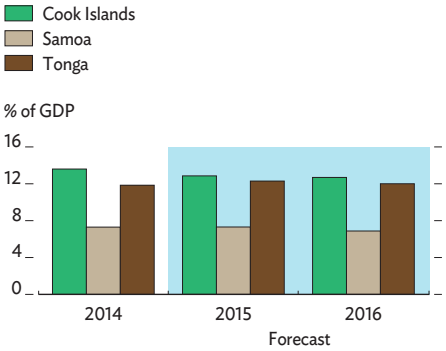
3.38.5 Public sector wages



Note: Years are fiscal years ending on 30 June of that year.
Sources: Cook Islands Ministry of Finance and Economic Management; Samoa Bureau of Statistics; Samoa Ministry of Finance; Tonga Ministry of Finance and National Planning.
Click here for figure data

In the Cook Islands, growth in FY2015 is forecast to improve but remain slow at 2.1%, driven largely by capital projects funded by development partners. A slight contraction of 0.3% is expected in FY2016 as large public investment projects end. Visitor arrivals in the Cook Islands are expected to stabilize in FY2015 and FY2016 after years of steady increase. Arrivals from New Zealand and Australia, the key source markets, began to soften in late FY2014. Capacity constraints loom in Rarotonga, the capital island, as the accommodation occupancy rate reached 74% in FY2014.

The Samoan economy is expected to expand by 2.5% in FY2015 as tourism continues to recover. It is expected that visitor arrivals in FY2015 will be 5.0% higher than in the previous year largely because of the United Nations conference in September 2014. Samoa is expecting record visitor arrivals in FY2016 as it hosts the Commonwealth Youth Games in September 2015 and adds new accommodation capacity. Record visitor arrivals should propel growth, which is expected to reach 2.2% in FY2016.

Tonga is expected to grow by 2.4% in FY2015 as the airport runway upgrade financed by development partners proceeds, along with preparations for the July 2015 coronation, and as major cyclone reconstruction carries over from 2014 into 2015. Following 2 years of decline, visitor arrivals in Tonga are seen to increase gradually in FY2015 and FY2016. Economic growth is forecast to accelerate to 2.6% with the expected ramping up of preparations for the 2019 South Pacific Games, executed with continuing support from development partners, and with improved agricultural production and tourism performance.

Inflation is forecast to stay low in the South Pacific on expectations of lower international food and energy prices. Inflation in the Cook Islands is projected at 1.3% in FY2015 and 1.4% in FY2016, and in Tonga at 0.4% and 1.0%. Samoa will likely emerge from price contraction and record inflation at 2.5% in FY2015 and 2.0% in FY2016, reflecting higher growth and prices for local agricultural produce.

Samoa and the Cook Islands are expected to maintain expansionary fiscal policies in the medium term, as evidenced by the relatively large capital expenditures planned for FY2015 and FY2016. The Cook Islands' budget deficit is forecast to jump to the equivalent of 7.3% of GDP in FY2015 before easing to 7.1% in the following fiscal year, while Samoa is expected to maintain a deficit equal to 1.6% of GDP throughout the forecast period. Tonga intends to continue consolidation efforts to narrow the gap between domestic revenues and recurrent expenditures and improve its debt position. However, planned spending on post-cyclone reconstruction and the upcoming coronation is seen to fuel a fiscal deficit equal to 1.8% of GDP in FY2015. The deficit is projected to narrow to 1.5% in FY2016. Fiscal consolidation remains a key development challenge in the South Pacific, but slow economic growth in the subregion requires that efforts to create fiscal buffers be balanced with their anticipated drag on economic growth.

Monetary policy in Samoa and Tonga will likely remain accommodative to further promote domestic economic activity, taking into account expectations that inflation will remain below central bank targets. Low private sector lending remains a concern in both countries.

3.38.1 Selected economic indicators (%)

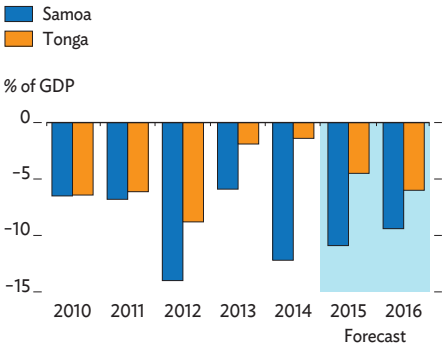
Cook Islands	2015	2016
GDP growth	2.1	–0.3
Inflation	1.3	1.4
Current account balance (share of GDP)	...	...
Samoa		
GDP growth	2.5	2.2
Inflation	2.5	2.0
Current account balance (share of GDP)	–10.9	–9.4
Tonga		
GDP growth	2.4	2.6
Inflation	0.4	1.0
Current account balance (share of GDP)	–4.5	–6.0

... = data not available.

Source: ADB estimates.

Samoa's current account deficit is projected to widen to the equivalent of 10.9% of GDP in FY2015 despite expectations of lower prices for imports in the second half. Imports for the planned comprehensive upgrade of Samoa's airport will keep the current account deficit above 9.0% of GDP in FY2016. Without augmented support from development partners, Samoa will likely need macroeconomic policy adjustments to address growing external imbalances. Tonga's current account deficit is expected to widen to the equivalent of 4.5% of GDP in FY2015 and 6.0% in FY2016, driven by high imports for reconstruction, public investment projects, and preparations for the coronation and the 2019 South Pacific Games.

3.38.6 Current account balance



Sources: National Reserve Bank of Tonga; Central Bank of Samoa; International Monetary Fund.

Click here for figure data

Policy challenge—pursuing structural and fiscal reforms

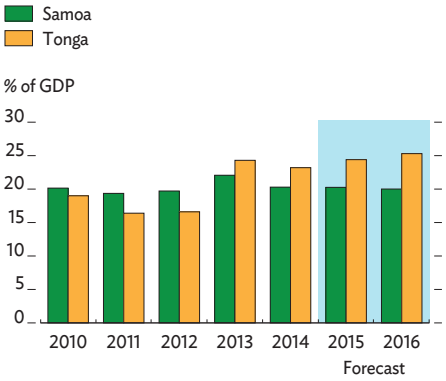
The domestic private sector needs to play a greater role in the economies of the South Pacific to quell high economic volatility stemming from the outsized influence of such external factors as tourism, remittances, and development partners' spending on infrastructure. Entrepreneurship, private investment, and private sector jobs are integral to achieving sustainable economic growth and reducing poverty. South Pacific economies need to offset the disadvantages posed by their remote locations and small domestic markets through laws and policies that can stimulate business. Financial sector development to bring down the cost of capital, and public infrastructure investments to tame transaction costs, are required if the private sector is to drive growth in the medium term.

The Government of the Cook Islands is seeking to develop a deeper understanding of issues affecting broad-based private sector investment and sustainable growth. Some of the issues it is considering are the size of the public sector, the role of state-owned enterprises (SOEs), and issues affecting business entry and access to land and finance.

Samoa is taking steps, albeit slowly, to improve and formalize its existing leasing framework that allows land under customary ownership to be used for productive purposes while continuing to protect it from alienation.

With the launch of a new online business registry in 2014, Tonga improved its business environment relative to many of its Pacific neighbors. In the World Bank's *Doing Business 2015* report, Tonga ranks as the second most business-friendly economy in the Pacific, after Samoa. However, despite the high ranking and ongoing reform, inflows of foreign investment remain meager. To overcome natural constraints on growth, Tonga needs additional reform to improve its business environment and mitigate existing constraints on private sector development. A foreign investment regime—with unambiguous regulatory frameworks for taxation and business incentives—is among the innovations necessary to take full advantage of the country's natural assets through sustainable tourism, fishing, agriculture, and possibly seabed mining. Access to land and capital—key factors of production—needs to improve to attract investment. Formal credit markets still

3.38.7 Remittances



Note: Years are fiscal years ending on 30 June of that year.

Sources: Central Bank of Samoa; International Monetary Fund; ADB estimates.

Click here for figure data

lack foundational legislation, including appropriate receivership and bankruptcy frameworks. This hinders businesses' access to finance.

On the fiscal side, further reform to public financial management, public administration, and SOEs is required to put finances on a more sustainable footing. Public wages remain high relative to GDP, contributing to deficits in recurrent budgets and crowding out other government expenditure, especially in Tonga, where public service reform is urgently needed to prevent further hikes in salaries and cost-of-living allowances that would be unsustainable. Additional SOE reform to improve governance and rationalization—or privatization—can reduce public subsidies, level the playing field between SOEs and the private sector, and generate new business opportunities for the private sector. Continued reform to public financial management will help make tax administration, expenditure management, and eventually public service delivery more effective. This is necessary to better allocate limited public resources and maximize their benefits.

To move this agenda forward, fiscal and structural reforms have been incorporated in joint policy action matrices agreed by South Pacific governments with their development partners. However, much work remains to ensure actual progress.

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Small island economies

For a third consecutive year, high fishing license revenues have spurred economic growth and improved fiscal balances in the small Pacific island economies of Kiribati, Nauru, and Tuvalu. Externally funded infrastructure projects have contributed to higher growth. Inflation has risen with currency depreciation. With higher revenues, all three economies have approved expansionary budgets for 2015. Access to finance remains a key challenge.

Economic performance

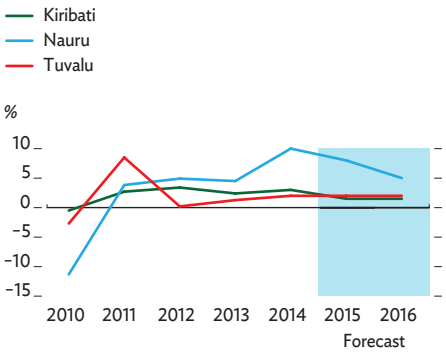
The economy of Nauru grew by 10.0% in 2014, outpacing more moderate growth at 3.0% in Kiribati and 2.0% in Tuvalu (Figure 3.39.1). Nauru's growth was driven by construction following the recommencement of operations at the Regional Processing Centre for those seeking asylum in Australia and by the liquidation and payout of the Nauru Phosphate Royalties Trust, which boosted private consumption of goods and services—both local and imported. In Kiribati and Tuvalu, growth was sustained by construction projects funded by development partners and continuing high revenue from fishing license fees. As parties to the Nauru Agreement, all three small island economies have benefitted from rising rates under the vessel day scheme.

Revenues from fishing licenses outperformed budget expectations for the third year running as they soared by 110% in Nauru over the previous year's actual earnings and by 34% in Kiribati (Figure 3.39.2). Revenue collections have been boosted as well by improved tax collection in Kiribati and higher dividends paid out by a joint venture of the National Fishing Corporation of Tuvalu and overseas investors.

With a weaker Australian dollar, which is the currency used in all three economies, inflation rose on higher import costs. In 2014, prices increased by 2.6% in Kiribati, driven by higher spending connected with projects, and by 3.3% in Tuvalu, where wage increases were large. Nauru experienced higher price inflation at 5.0% in FY2014 (ended 30 June 2014) driven by a large increase in household income.

Kiribati recorded a large current account deficit in 2014 as the trade balance deteriorated because of high demand for imports associated with projects funded by development partners. Another large current account surplus is estimated for Tuvalu, reflecting inflows of official development assistance to support the budget and continuing high income from fish exports and fishing licenses (Figure 3.39.3). Nauru does not compile current account statistics.

3.39.1 GDP growth

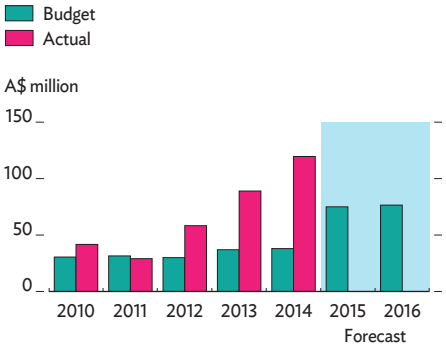


Note: Years are fiscal years ending on 30 June of the same year for Nauru and coinciding with the calendar year for Kiribati and Tuvalu.

Sources: Kiribati National Statistics Office; Nauru budget documents; Tuvalu Central Statistics Division; ADB estimates.

Click here for figure data

3.39.2 Kiribati fishing license revenue



Sources: Ministry of Finance and Economic Development. *Kiribati Government Budget* (various years); Ministry of Finance and Economic Development and Ministry of Fisheries and Marine Resources Development. 2014. *Fishing License Revenues in Kiribati*. September.

Click here for figure data

This chapter was written by Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney, and Malie Lototele of the South Pacific Subregional Office, ADB, Suva.

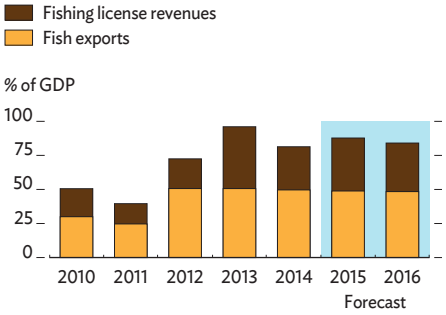
Economic prospects

Growth is expected to slow in Kiribati, moderate in Nauru, and remain the same in Tuvalu. Tropical Cyclone Pam caused tidal surges that damaged infrastructure and private property in Kiribati and Tuvalu in mid-March. About 45% of Tuvalu's population was reportedly displaced, and the Betio–Tarawa causeway in Kiribati—a key transport link—was extensively damaged. Growth in Kiribati's economy is projected to halve to 1.5% in both 2015 and 2016 as projects funded by development partners are completed. In Tuvalu, the airport upgrade funded by development partners and continued retail expansion are expected to maintain economic growth at around 2.0% in 2015 and 2016. In Nauru, growth will come off its high, falling to 8.0% as household consumption is boosted by government debt repayments and the liquidation of the Nauru Phosphate Royalties Trust. Growth in Nauru is seen to moderate further in FY2016 to around 5.0% as the boost to household incomes wanes.

Inflation in Nauru is expected to accelerate in FY2015 to 8.0% on strong underlying demand and to moderate to 3.0% in FY2016 as economic growth slows (Figure 3.39.4). Inflation is projected to slow to 1.0% in Kiribati in 2015, edging up to 1.5% in 2016. In Tuvalu, inflation will likely ease to 1.0% in 2015 and 2016.

With improved revenue performance over recent years, all three island governments plan to adopt expansionary fiscal policies to help support economic growth in the near term. In Nauru, the FY2015 budget provides for an increase in expenditure that triples expenditure from the level 3 years ago. This will be used largely to repay debt, including salary arrears, and place $5 million in the new Nauru Trust Fund. The government forecasts a surplus of A$400,000 from visa fees and customs duties generated by the Regional Processing Centre and high fishing revenues (Figure 3.39.5). Fiscal expansion in Kiribati and Tuvalu will see expenditure rise by 13% in Kiribati and 38% in Tuvalu. This is driven by planned increases in recurrent expenditures and capital spending.

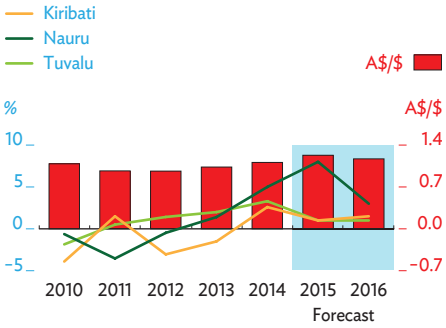
3.39.3 Tuvalu income from fisheries



Sources: International Monetary Fund. 2014. *Tuvalu: 2014 Article IV Consultation—Staff Report*. August; Ministry of Finance and Economic Development. *Government of Tuvalu 2015 National Budget*; ADB estimates.

Click here for figure data

3.39.4 Inflation and exchange rate



Note: Years are fiscal years ending on 30 June of that year for Nauru and coinciding with the calendar year for Kiribati and Tuvalu.

Sources: Kiribati National Statistics Office; Nauru budget documents; Tuvalu Central Statistics Division; Reserve Bank of Australia; Economist Intelligence Unit; ADB estimates.

Click here for figure data

Policy challenges—managing windfall gains, and restoring bank services to Nauru

The value of national trust funds in Kiribati and Tuvalu has fallen in the years following the global financial crisis. The Nauru Phosphate Royalties Trust, which was almost completely depleted in the 1970s and 1980s, has been liquidated, and the remaining capital is being distributed to landowners. The recent windfall gains from fishing license revenues have provided opportunities to rebuild the fiscal buffers in Tuvalu and Kiribati (Figure 3.39.6). Nauru is pursuing the establishment of a new trust fund with international standards of governance.

In Kiribati, higher revenue from fishing licenses in 2012, 2013, and 2014 enabled the government to contribute A$10 million to the Revenue Equalization Reserve Fund. However, it needs to enhance revenue collection and keep current expenditure in check to improve reserve fund dynamics over the long run. The real value of the fund per capita

3.39.1 Selected economic indicators (%)

Kiribati	2015	2016
GDP growth	1.5	1.5
Inflation	1.0	1.5
Current account balance (share of GDP)	−53.0	−48.4
Nauru		
GDP growth	8.0	5.0
Inflation	8.0	3.0
Current account balance (share of GDP)	...	...
Tuvalu		
GDP growth	2.0	2.0
Inflation	1.0	1.0
Current account balance (share of GDP)	−37.2	−21.4

... = data not available.

Source: ADB estimates.

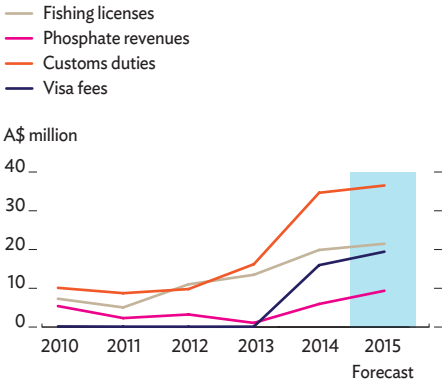
has been trending downward in recent years, falling well below the benchmark of A$4,500.

For the first time since 2008, the Government of Tuvalu received a distribution of A$6.5 million from the Tuvalu Trust Fund (TTF) to the Consolidated Investment Fund (CIF). When the market value of the TTF exceeds its maintained value (which is indexed to the Australian consumer price index), the difference becomes an automatic distribution to the CIF, through which the government finances its budget deficits. Because there were no distributions for a number of years, the CIF became nearly exhausted in 2012. With assistance from development partners, the government has since restored the fund, the value of which rose from A$4.8 million in 2008 to $26.7 million at the end of 2014. While the current CIF balance is above the government's target of 16% of the TTF (equivalent to A$22.4 million), prudence in the face of revenue volatility requires the government to continue to save windfall gains. As part of its commitment to build the value of the TTF, the government has included a $3 million contribution to it in its 2015 budget.

Nauru has been without a financial institution able to provide banking services since the collapse of the state-owned Bank of Nauru. The bank's reserves were drawn down to the point that it could no longer meet its obligations to depositors, and it effectively ceased operating in 1998. Its facilities are now used for storing government cash. No formal system currently exists through which consumers and businesses can hold deposits or access credit. A cash economy is facilitated by an office for payments and receipts under the direction of the Ministry of Finance. International transactions are limited to a Western Union franchise and automatic teller machines operating at Menen Hotel and Eigigu Supermarket. The lack of a formal financial system impedes the development of the private sector. Individuals have only limited incentive to save or avenues for investing surplus income.

Fortunately, the government recently formalized an agreement with Bendigo and Adelaide Bank to establish a banking agency in Nauru, and government has recruited a manager to act as its agent. Over 1,500 Nauruans already have accounts with the bank.

3.39.5 Nauru major sources of domestic revenues



Sources: Nauru Deparment of Finance and Economic Planning; ADB estimates.

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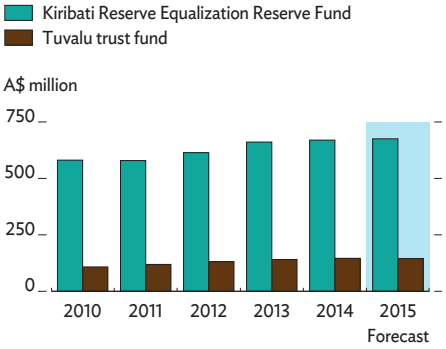
3.39.6 Fiscal buffers in Kiribati and Tuvalu



Sources: International Monetary Fund. 2014. *Tuvalu: 2014 Article IV Consultation—Staff Report*. August; Ministry of Finance and Economic Development. *Kiribati Government 2015 Budget*.

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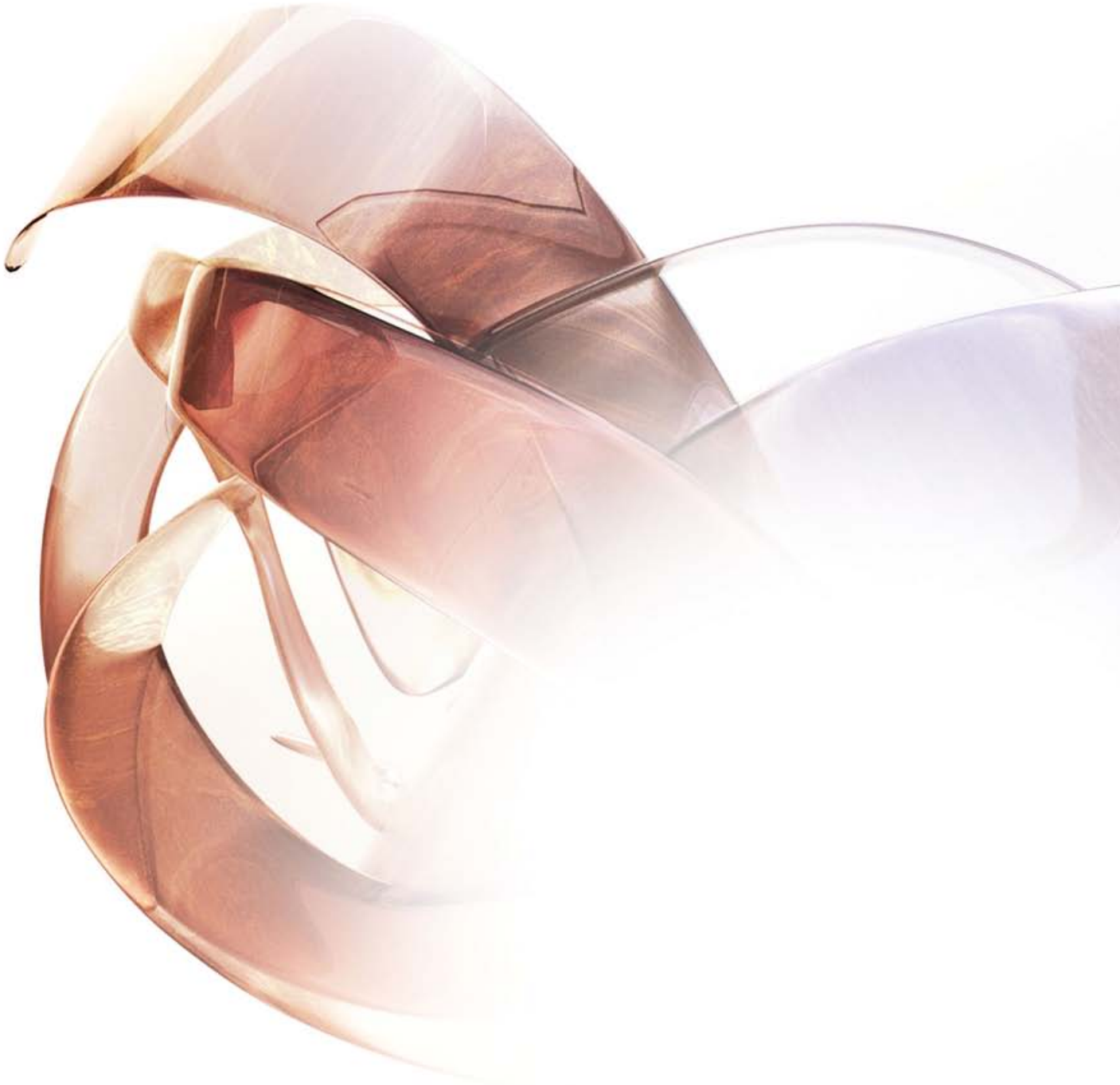

STATISTICAL APPENDIX

Statistical notes and tables

The statistical appendix presents selected economic indicators for 45 developing member economies of the Asian Development Bank (ADB) in 18 tables. The economies are grouped into five subregions: Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. Most of the tables contain historical data from 2010 to 2014; some have forecasts for 2015 and 2016.

The data were standardized to the degree possible to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. The national income accounts section is based on the United Nations System of National Accounts, while the data on balance of payments are based on International Monetary Fund (IMF) accounting standards. Historical data were obtained from official sources, statistical publications and databases, and documents of ADB, the IMF, and the World Bank. Projections for 2015 and 2016 are generally ADB estimates made on the bases of available quarterly or monthly data, though some projections are from governments.

Most economies report by calendar year. The following record their government finance data by fiscal year: Armenia; Azerbaijan; Brunei Darussalam; the Cook Islands; Hong Kong, China; Kazakhstan; the Kyrgyz Republic; the Lao People's Democratic Republic (Lao PDR); Samoa; Singapore; Taipei,China; Tajikistan; Thailand; and Uzbekistan. The Federated States of Micronesia, Nauru, the Republic of Marshall Islands, and Palau report government finance and balance-of-payments data by fiscal year. South Asian countries (except for the Maldives and Sri Lanka), Myanmar, Samoa, and Tonga report all variables by fiscal year.

Regional and subregional averages or totals are provided for seven tables (A1, A2, A6, A11, A12, A13, and A14). For tables A1, A2, A6, and A14, the averages are computed using weights derived from gross national income (GNI) in current US dollars following the World Bank Atlas method. The GNI data for 2009–2013 were obtained from the World Bank's World Development Indicators online. Weights for 2013 were carried over through 2016. The GNI data for the Cook Islands were estimated using the Atlas conversion factor. Myanmar and Nauru have no GNI data. For tables A11 and A12, the regional and subregional averages were computed on the basis of a consistent sum, which means that if there are missing country data for a given year, the sum

of the prior year used for computing the growth rate excludes the corresponding country data. Data for Myanmar and Nauru are excluded from the computation of all subregional averages and totals.

Tables A1, A2, A3, A4, and A5. These tables show related data on output growth, production, and demand. Changes to the national income accounts series for some countries have been made to accommodate a change in source, methodology, and/or base year. The series for Afghanistan, Bhutan, India, Myanmar, and Pakistan reflect fiscal year data, rather than calendar year data, while those for Timor-Leste reflect the GDP excluding oil and United Nations inputs.

Table A1: Growth rate of GDP (% per year). The table shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value-added or similar taxes. Constant factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. Most economies use constant market price valuation. Fiji, Pakistan, and Sri Lanka use constant factor costs, while the Maldives and Nepal use basic prices. The series for Taipei,China has been changed to accommodate its adoption of the chain-linking method.

Table A2: Growth rate of per capita GDP (% per year). The table provides the growth rates of real per capita GDP, which is defined as GDP at constant prices divided by the population. The series for most of the Pacific countries were revised to accommodate a change of source for population data. Data on per capita gross national product in US dollar terms for 2013 are also shown, sourced from the World Bank's World Development Indicators online.

Table A3: Growth rate of value added in agriculture (% per year). The table shows the growth rates of value added in agriculture and its corresponding share in 2013. The agriculture sector comprises agricultural crops, livestock, poultry, fisheries, and forestry. The series for Georgia refers to only the first 9 months of the year.

Table A4: Growth rate of value added in industry (% per year). The table provides the growth rates of value added in industry and its corresponding share in 2013. This sector comprises manufacturing, mining and quarrying, construction, and utilities. The series for Georgia refers to only the first 9 months of the year.

Table A5: Growth rate of value added in services (% per year). The table gives the growth rates of value added in services and its corresponding share in 2013. Subsectors generally include trade, banking, finance, real estate, public administration, and other services. The series for Georgia refers to only the first 9 months of the year.

Table A6: Inflation (% per year). Data on inflation rates represent period averages. The inflation rates presented are based on consumer price indexes. The consumer price indexes of the following economies are for a given city or group of consumers only: Afghanistan is for Kabul (until 2011), Cambodia is for Phnom Penh, the Marshall Islands

is for Majuro, Solomon Islands is for Honiara, and Nepal is for urban consumers.

Table A7: Growth in money supply (% per year). This table tracks the annual percentage change in the end-of-period supply of broad money as represented by M2 for most countries. M2 is defined as the sum of M1 and quasi-money, where M1 denotes currency in circulation plus demand deposits, and quasi-money consists of time and savings deposits including foreign currency deposits.

Tables A8, A9, and A10: Government finance. These tables give the revenue and expenditure transactions and the fiscal balance of the central government expressed as a percentage of GDP in nominal terms. For Cambodia (since 2006), the People's Republic of China, India, Kazakhstan, the Kyrgyz Republic, Mongolia, and Tajikistan, transactions are those reported by the general government.

Table A8: Central government revenues (% of GDP). Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a percentage of GDP at current prices. For the Republic of Korea, revenues exclude social security contributions. For Singapore, revenues include the net investment returns contribution. For Kazakhstan, revenues include transfers from the national fund. Grants are excluded in Cambodia, the Lao PDR, Malaysia, Singapore, and Thailand; revenues from disinvestment are included for India; and only current revenues are included for Bangladesh.

Table A9: Central government expenditures (% of GDP). Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a share of GDP at current prices. For Thailand, expenditures refer to budgetary expenditures excluding externally financed expenditures and corresponding borrowing. Those for Tajikistan include externally financed public investment programs. One-time expenditures are excluded for Pakistan.

Table A10: Fiscal balance of central government (% of GDP). Fiscal balance is the difference between central government revenues and expenditures. The difference is also computed as a share of GDP at current prices. Data variations may arise from statistical discrepancies, e.g., balancing items for both central and local governments, and from differences in the concept used in the individual computations of revenues and expenditures as compared with the calculation of the fiscal balance. For Fiji, the fiscal balance excludes total loan repayments. For Thailand, the fiscal balance is a cash balance composed of the budgetary and nonbudgetary balances. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan.

Tables A11, A12, A13, and A14: Balance of payments. These tables show selected international economic transactions of countries as recorded in the balance of payments. These items cover annual flows.

Tables A11 and A12: Growth rates of merchandise exports and imports (% per year). These tables show the annual growth rates of exports and imports of goods. Data are in million US dollars, primarily obtained from the balance-of-payments accounts of each economy. Exports are reported a free-on-board. Import data are

reported free on board, except for the following economies, which value them on the basis of cost, insurance, and freight: Afghanistan; Bhutan; Cambodia; Hong Kong, China; India; the Lao PDR; Myanmar; the Philippines; Samoa; Singapore; Solomon Islands; and Thailand.

Table A13: Trade balance ($ million). The trade balance is the difference between merchandise exports and merchandise imports. Figures in this table are based on the exports and imports amounts used to generate tables A11 and A12.

Table A14: Current account balance (% of GDP). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. The values reported are divided by GDP at current prices in US dollars. In the case of Cambodia, the Lao PDR, and Viet Nam, official transfers are excluded from the current account balance.

Table A15: Exchange rates to the US dollar (annual average). Annual average exchange rates are quoted as the local currencies per US dollar.

Table A16: Gross international reserves ($ million). Gross international reserves are defined as the US dollar value of holdings of foreign exchange, special drawing rights, reserve position in the IMF, and gold at the end of a given period. For the Marshall Islands and Taipei,China, this heading refers to foreign exchange reserves only. In some economies, the rubric is foreign assets and reserves of national monetary authorities and national oil funds, i.e., foreign assets of the Maldives Monetary Authority, net foreign reserves of the State Bank of Pakistan, assets of the National Oil Fund of Azerbaijan, and official external assets of Kiribati. The data for India are as of 6 February 2015.

Table A17: External debt outstanding ($ million). For most economies, external debt outstanding, public and private, includes medium- and long-term debt, short-term debt, and IMF credit. For Cambodia, Georgia, and the Lao PDR, only public external debt is reported. For Armenia, Azerbaijan, India, Kazakhstan, the Kyrgyz Republic, Malaysia, the Philippines, and Singapore, the figures for 2014 are as of the end of September.

Table A18: Debt service ratio (% of exports of goods and services). This table generally presents the total debt service payments of each economy, which comprise principal repayments (excluding on short-term debt) and interest payments on outstanding external debt, as a percentage of exports of goods and services. For Cambodia and the Lao PDR, debt service refers to external public debt only. For Papua New Guinea, Samoa, and Viet Nam, exports of goods are used as the denominator in the calculation of the ratio; for the Philippines, exports of goods, services, and income are used as the denominator. For Bangladesh, the ratio represents debt service payments on medium- and long-term loans as a percentage of exports of goods, nonfactor services, and workers' remittances; and for Azerbaijan, the ratio represents public and publicly guaranteed external debt service payments as a percentage of exports of goods and nonfactor services.

Table A1 Growth rate of GDP (% per year)

	2010	2011	2012	2013	2014	2015	2016
Central Asia	6.8	6.8	5.6	6.6	5.1	3.5	4.5
Armenia	2.2	4.7	7.2	3.5	3.4	1.6	2.3
Azerbaijan	5.0	0.1	2.2	5.8	2.8	3.0	2.8
Georgia	6.3	7.2	6.4	3.3	4.7	2.0	2.5
Kazakhstan	7.3	7.5	5.0	6.0	4.3	1.9	3.8
Kyrgyz Republic	–0.5	6.0	–0.1	10.9	3.6	1.7	2.0
Tajikistan	6.5	7.4	7.5	7.4	6.7	4.0	4.8
Turkmenistan	9.2	14.7	11.1	10.2	10.3	9.7	9.2
Uzbekistan	8.5	8.3	8.2	8.0	8.1	7.0	7.2
East Asia	9.8	8.1	6.6	6.8	6.6	6.5	6.3
China, People's Rep. of	10.4	9.3	7.7	7.7	7.4	7.2	7.0
Hong Kong, China	6.8	4.8	1.7	2.9	2.3	2.8	2.9
Korea, Rep. of	6.5	3.7	2.3	3.0	3.3	3.5	3.7
Mongolia	6.4	17.3	12.3	11.6	7.8	3.0	5.0
Taipei,China	10.6	3.8	2.1	2.2	3.7	3.7	3.6
South Asia	9.1	6.4	5.1	6.5	6.9	7.2	7.6
Afghanistan	8.4	7.2	11.9	3.4	1.7	2.5	3.5
Bangladesh	5.6	6.5	6.5	6.0	6.1	6.1	6.4
Bhutan	9.3	9.7	6.4	3.5	4.0	6.8	7.0
India	10.3	6.7	5.1	6.9	7.4	7.8	8.2
Maldives	7.1	6.5	1.3	4.7	6.8	6.3	5.1
Nepal	4.3	3.8	4.6	3.5	5.2	4.6	5.1
Pakistan	2.6	3.6	3.8	3.7	4.1	4.2	4.5
Sri Lanka	8.0	8.3	6.3	7.2	7.4	7.0	7.3
Southeast Asia	8.1	4.7	5.8	5.1	4.4	4.9	5.3
Brunei Darussalam	2.6	3.7	0.9	–2.1	–1.2	–1.5	0.8
Cambodia	6.0	7.1	7.3	7.4	7.0	7.3	7.5
Indonesia	6.4	6.2	6.0	5.6	5.0	5.5	6.0
Lao People's Dem. Rep.	7.5	7.8	7.9	7.9	7.4	7.0	7.2
Malaysia	7.4	5.2	5.6	4.7	6.0	4.7	5.0
Myanmar	5.3	5.9	7.1	8.3	7.7	8.3	8.2
Philippines	7.6	3.7	6.8	7.2	6.1	6.4	6.3
Singapore	15.2	6.2	3.4	4.4	2.9	3.0	3.4
Thailand	7.8	0.1	6.5	2.9	0.7	3.6	4.1
Viet Nam	6.4	6.2	5.2	5.4	6.0	6.1	6.2
The Pacific	6.4	9.5	6.0	4.4	6.3	9.9	4.8
Cook Islands	2.1	–2.6	4.1	–1.7	–1.2	2.1	–0.3
Fiji	3.0	2.7	1.8	4.6	4.2	4.0	4.0
Kiribati	–0.5	2.7	3.4	2.4	3.0	1.5	1.5
Marshall Islands	6.1	0.0	4.7	3.0	0.5	3.5	1.5
Micronesia, Fed. States of	3.2	1.8	0.1	–4.0	–3.4	2.3	5.1
Nauru	–11.3	3.8	4.9	4.5	10.0	8.0	5.0
Palau	0.2	7.7	4.0	–1.7	6.9	8.0	6.0
Papua New Guinea	7.6	11.3	7.7	5.1	8.0	15.0	5.0
Samoa	4.9	6.2	1.2	–1.1	1.9	2.5	2.2
Solomon Islands	7.9	10.6	4.8	2.9	–0.2	3.0	3.5
Timor-Leste	9.6	14.4	7.8	5.6	7.1	6.2	6.6
Tonga	4.2	2.0	0.5	–2.7	2.1	2.4	2.6
Tuvalu	–2.7	8.5	0.2	1.3	2.0	2.0	2.0
Vanuatu	1.6	1.2	1.8	2.0	3.6	–0.5	4.0
Average	9.3	7.3	6.2	6.5	6.3	6.3	6.3

Table A2 Growth rate of per capita GDP (% per year)

	2010	2011	2012	2013	2014	2015	2016	Per capita GNI, $, 2013
Central Asia	5.2	5.2	4.0	5.1	3.7	2.2	3.2	
Armenia	1.9	4.2	6.8	3.2	3.1	1.3	2.3	3,800
Azerbaijan	3.8	–1.1	0.9	4.4	1.5	2.0	1.8	7,350
Georgia	5.0	6.4	6.3	3.6	4.5	1.8	2.5	3,570
Kazakhstan	5.5	5.9	3.5	4.5	2.8	0.4	2.3	11,550
Kyrgyz Republic	–1.8	4.8	–1.4	8.7	1.6	–0.3	0.0	1,210
Tajikistan	5.5	7.4	4.7	5.8	5.1	2.4	2.3	990
Turkmenistan	7.4	12.9	9.3	8.5	8.6	8.0	7.5	6,880
Uzbekistan	6.8	5.3	5.6	6.3	6.3	5.3	5.5	1,880
East Asia	9.3	7.6	6.0	6.3	6.1	6.0	5.7	
China, People's Rep. of	9.9	8.8	7.2	7.2	6.8	6.6	6.2	6,560
Hong Kong, China	6.0	4.1	0.5	2.4	1.6	2.0	2.1	38,420
Korea, Rep. of	6.0	2.9	1.8	2.5	2.9	3.1	3.3	25,920
Mongolia	4.5	15.3	10.2	9.3	5.5	1.3	3.3	3,770
Taipei,China	10.4	3.5	1.7	2.0	3.6	3.5	3.5	21,620
South Asia	7.2	4.9	3.9	5.0	5.5	7.1	6.4	
Afghanistan	6.3	5.2	9.7	1.4	–0.3	0.5	1.5	690
Bangladesh	4.1	5.1	5.2	4.6	4.7	4.7	5.0	1,010
Bhutan	7.3	7.8	4.6	1.8	2.3	5.1	5.4	2,330
India	8.8	5.3	3.8	5.5	6.1	8.0	6.9	1,570
Maldives	5.3	4.7	–0.4	2.9	5.3	4.6	3.4	5,600
Nepal	2.7	3.1	3.1	2.0	3.7	3.1	3.7	730
Pakistan	–3.2	1.5	1.8	1.6	2.1	2.2	4.5	1,360
Sri Lanka	6.9	7.1	9.2	6.4	6.2	6.0	6.8	3,170
Southeast Asia	6.1	3.1	4.4	3.7	3.4	3.2	4.0	
Brunei Darussalam	0.8	2.0	–0.7	–3.7	–5.2	–2.7	–0.4	43,923
Cambodia	4.8	5.2	5.1	6.6	5.6	5.9	6.1	950
Indonesia	3.6	4.3	4.5	4.1	3.6	4.0	4.8	3,580
Lao People's Dem. Rep.	5.3	5.7	6.5	5.7	5.3	2.8	4.2	1,450
Malaysia	5.5	3.7	4.6	2.6	4.6	3.5	3.5	10,430
Myanmar	4.2	4.9	6.0	..	..	..	..	..
Philippines	5.8	1.2	5.7	5.4	6.1	1.7	4.5	3,270
Singapore	13.2	4.0	0.9	2.8	1.6	1.5	1.9	54,040
Thailand	7.2	–0.4	6.0	2.3	0.2	3.1	3.6	5,340
Viet Nam	5.3	5.1	4.1	4.3	4.9	5.0	5.1	1,740
The Pacific	4.1	7.1	5.7	2.4	4.4	8.0	2.9	
Cook Islands	14.1	–21.1	7.0	0.4	2.5	5.9	3.4	23,026
Fiji	–0.6	1.4	12.4	4.3	3.7	3.3	2.5	4,370
Kiribati	–3.7	0.6	0.7	0.8	0.9	–0.6	–0.6	2,620
Marshall Islands	5.4	2.3	3.8	2.2	–0.2	2.9	1.0	4,310
Micronesia, Fed. States of	3.9	2.4	–0.5	–4.0	–3.3	2.4	5.2	3,280
Nauru	–10.9	–0.9	4.9	1.4	8.5	6.5	3.0	..
Palau	–0.4	7.1	3.4	–2.4	6.3	7.3	5.4	10,970
Papua New Guinea	5.3	8.9	5.4	2.7	5.7	12.6	2.8	2,010
Samoa	4.6	3.8	1.1	–1.1	1.9	2.6	2.3	3,970
Solomon Islands	3.5	7.8	5.2	0.7	–2.5	0.7	1.3	1,600
Timor-Leste	6.7	11.4	5.0	3.1	4.6	3.7	4.1	3,940
Tonga	3.9	2.3	0.4	–2.8	2.1	2.4	2.7	4,490
Tuvalu	–3.2	7.9	–0.3	4.7	0.2	0.2	0.5	5,840
Vanuatu	–0.8	–0.9	–0.7	–0.3	1.3	–2.7	1.7	3,130
Average	8.3	6.4	5.4	5.7	5.5	5.6	5.5	

... = data not available, GNI = gross national income.

Table A3 Growth rate of value added in agriculture (% per year)

	2010	2011	2012	2013	2014	Sector share, 2013, %
Central Asia						
Armenia	–16.1	14.0	9.5	7.2	7.8	21.2
Azerbaijan	–2.2	–8.0	5.8	4.9	–2.6	5.7
Georgia	–4.8	8.0	–3.7	13.0	1.3	9.4
Kazakhstan	–11.6	26.5	–17.4	11.2	0.8	4.9
Kyrgyz Republic	–2.6	1.9	1.2	2.6	–0.6	17.0
Tajikistan	6.8	7.9	10.4	7.6	4.5	...
Turkmenistan	7.8	0.1	8.1	10.0	4.2	10.0
Uzbekistan	6.8	6.6	7.0	6.8	6.9	19.1
East Asia						
China, People's Rep. of	4.3	4.3	4.5	4.0	4.1	9.4
Hong Kong, China	3.8	0.8	–3.2	1.5	2.5	0.1
Korea, Rep. of	–4.3	–2.0	–0.9	5.8	3.0	2.3
Mongolia	–16.6	–0.3	21.1	19.3	14.4	15.4
Taipei,China	2.2	4.5	–3.2	3.4	3.5	1.8
South Asia						
Afghanistan	–6.4	–7.9	31.5	0.9	1.0	...
Bangladesh	6.2	4.5	3.0	2.5	3.3	16.8
Bhutan	1.7	1.6	2.3	2.6	2.8	14.1
India	8.6	5.0	1.7	3.8	1.1	18.7
Maldives	–0.9	1.1	0.0	5.1	–2.1	3.3
Nepal	2.0	4.5	4.6	1.1	4.7	34.3
Pakistan	0.2	2.0	3.6	2.9	2.1	25.1
Sri Lanka	7.0	1.4	5.2	4.7	0.3	10.8
Southeast Asia						
Brunei Darussalam	–5.8	–2.6	8.1	–1.2	..	0.7
Cambodia	4.0	3.1	4.3	1.6	1.8	33.5
Indonesia	...	3.9	4.6	4.2	4.2	13.7
Lao People's Dem. Rep.	2.0	1.8	2.5	3.5	2.9	25.6
Malaysia	2.4	5.8	1.3	2.1	2.6	9.4
Myanmar	–0.1	–2.0	1.5	..	..	29.9
Philippines	–0.2	2.6	2.8	1.1	1.9	11.2
Singapore	2.4	2.1	3.8	–1.0	1.6	0.0
Thailand	–2.3	4.1	3.8	1.4	1.1	12.0
Viet Nam	3.3	4.0	2.7	2.6	3.5	18.4
The Pacific						
Cook Islands	12.0	–7.3	7.7	2.3	18.0	5.5
Fiji	–2.6	8.1	3.5	2.6	...	12.5
Kiribati	–2.5	5.7	...	...	...	...
Marshall Islands	26.0	–0.4	23.6	6.2	4.2	22.0
Micronesia, Fed. States of	1.1	4.2	5.9	–6.2	2.3	28.1
Nauru	...	...	...	...	...	...
Palau	–5.1	9.6	1.6	–8.0	–1.8	4.3
Papua New Guinea	2.9	8.6	–2.7	1.6	3.9	27.4
Samoa	2.2	2.5	–7.1	–2.4	9.6	9.6
Solomon Islands	...	...	...	...	...	...
Timor-Leste	–2.6	–18.3	14.7	...	...	...
Tonga	0.5	2.0	0.5	...	...	...
Tuvalu	2.2	0.5	...	...	...	...
Vanuatu	4.8	6.1	2.2	4.8	...	26.7

... = data not available.

Table A4 Growth rate of value added in industry (% per year)

	2010	2011	2012	2013	2014	Sector share, 2013, %
Central Asia						
Armenia	6.1	0.0	5.7	–1.5	–1.3	30.5
Azerbaijan	4.4	3.4	–0.6	4.9	0.5	61.1
Georgia	9.1	9.4	9.5	1.9	8.5	24.0
Kazakhstan	7.2	3.4	2.0	3.1	1.4	36.9
Kyrgyz Republic	2.5	7.0	–11.7	30.5	5.1	28.9
Tajikistan	9.7	5.9	10.4	3.9	5.1	...
Turkmenistan	8.7	26.5	8.6	7.3	11.4	49.6
Uzbekistan	8.2	7.5	8.0	9.0	8.5	32.8
East Asia						
China, People's Rep. of	12.3	10.3	7.9	7.8	7.3	43.7
Hong Kong, China	7.6	8.9	4.4	0.4	1.4	7.1
Korea, Rep. of	10.4	4.5	1.9	3.2	3.4	38.6
Mongolia	4.3	8.8	14.8	15.3	16.1	35.5
Taipei,China	20.3	6.0	3.3	1.6	5.7	34.2
South Asia						
Afghanistan	6.3	9.8	7.2	2.5	1.3	...
Bangladesh	7.0	9.0	9.4	9.6	8.4	29.0
Bhutan	8.0	8.0	5.4	5.1	7.3	46.2
India	7.6	7.8	2.3	4.4	5.9	31.7
Maldives	4.3	12.1	0.8	–1.5	13.2	14.1
Nepal	4.0	4.3	3.0	2.5	2.7	15.2
Pakistan	3.4	4.5	2.5	1.4	5.8	21.1
Sri Lanka	8.4	10.4	10.3	9.9	11.4	31.1
Southeast Asia						
Brunei Darussalam	1.7	3.2	–1.4	–5.6	..	68.7
Cambodia	13.6	14.5	9.3	11.0	9.8	25.6
Indonesia	...	6.3	5.3	4.2	4.2	43.6
Lao People's Dem. Rep.	14.5	14.2	13.7	9.7	8.5	31.6
Malaysia	8.5	2.1	5.1	3.6	6.1	38.6
Myanmar	13.2	17.5	8.1	..	..	33.8
Philippines	11.6	1.9	7.3	9.3	7.5	31.1
Singapore	23.9	7.1	2.2	2.5	2.7	24.8
Thailand	12.8	–3.9	7.2	0.3	–0.9	42.5
Viet Nam	7.2	6.7	5.7	5.4	7.1	38.3
The Pacific						
Cook Islands	6.0	–8.1	21.8	–16.4	–14.8	7.5
Fiji	6.5	2.0	1.1	5.1	...	21.2
Kiribati	–9.9	11.8	...	...	...	...
Marshall Islands	–5.9	–6.1	–1.2	8.4	–5.5	10.3
Micronesia, Fed. States of	18.0	11.8	–1.6	–19.6	–40.9	7.9
Nauru	...	...	...	...	...	...
Palau	3.6	5.3	–5.0	–15.8	7.4	9.0
Papua New Guinea	10.8	13.0	14.7	9.2	15.6	45.2
Samoa	10.9	8.0	0.3	–3.0	4.5	25.4
Solomon Islands	...	...	...	...	...	...
Timor-Leste	–15.4	0.0	0.0	...	...	...
Tonga	11.6	5.5	1.2	...	...	...
Tuvalu	–6.9	–28.7	...	...	...	...
Vanuatu	12.6	–19.4	–22.2	9.8	...	8.4

... = data not available.

Table A5 Growth rate of value added in services (% per year)

	2010	2011	2012	2013	2014	Sector share, 2013, %
Central Asia						
Armenia	4.5	6.1	6.9	6.2	5.2	48.3
Azerbaijan	7.2	–2.1	6.9	7.2	7.4	33.1
Georgia	7.8	5.7	6.2	3.9	5.4	66.6
Kazakhstan	7.1	9.0	10.4	6.8	6.0	58.2
Kyrgyz Republic	–1.1	6.9	6.5	4.7	4.1	54.1
Tajikistan	4.6	13.5	14.5	9.7	1.0	...
Turkmenistan	9.9	8.3	14.7	12.7	10.6	40.4
Uzbekistan	11.7	11.8	10.4	13.7	15.4	48.0
East Asia						
China, People's Rep. of	9.8	9.4	8.1	8.3	8.1	46.9
Hong Kong, China	6.9	5.2	1.8	3.0	4.0	92.9
Korea, Rep. of	4.4	3.1	2.8	2.9	3.2	59.1
Mongolia	9.8	17.8	10.3	6.8	4.8	49.1
Taipei,China	5.1	3.1	1.5	2.0	2.2	64.0
South Asia						
Afghanistan	18.1	12.7	7.3	3.7	1.8	...
Bangladesh	5.5	6.2	6.6	5.5	5.8	54.2
Bhutan	12.7	12.7	6.6	1.2	2.3	39.8
India	9.7	6.6	8.0	9.1	10.6	49.6
Maldives	8.0	5.8	1.5	5.9	6.2	82.6
Nepal	5.8	3.4	5.0	5.2	6.1	50.5
Pakistan	3.2	3.9	4.4	4.9	4.3	53.8
Sri Lanka	8.0	8.6	4.6	6.4	6.5	58.1
Southeast Asia						
Brunei Darussalam	3.8	4.9	5.5	4.7	..	30.6
Cambodia	3.3	5.0	8.1	8.7	7.9	40.8
Indonesia	...	8.4	6.8	6.5	6.1	42.6
Lao People's Dem. Rep.	8.0	8.5	8.0	9.7	9.0	42.9
Malaysia	7.4	7.1	6.4	5.9	6.3	52.0
Myanmar	6.4	6.4	12.1	..	..	36.3
Philippines	7.2	4.9	7.4	7.2	6.0	57.7
Singapore	11.2	6.6	4.0	6.0	3.2	75.1
Thailand	4.6	3.8	6.2	5.9	2.2	45.5
Viet Nam	7.2	6.8	5.9	6.6	6.0	43.3
The Pacific						
Cook Islands	1.7	–1.7	1.6	–0.3	–2.4	87.0
Fiji	2.9	2.0	1.8	4.9	...	66.4
Kiribati	1.4	–1.2	...	...	...	...
Marshall Islands	3.6	1.3	1.8	1.8	–0.1	67.7
Micronesia, Fed. States of	2.2	–0.1	–1.3	–0.8	–1.8	63.9
Nauru	...	...	...	...	...	...
Palau	0.2	7.0	4.6	–0.3	7.0	86.7
Papua New Guinea	8.5	11.5	9.7	3.0	3.7	27.4
Samoa	3.5	5.7	2.7	0.1	–0.2	65.1
Solomon Islands	...	...	...	...	...	...
Timor-Leste	10.1	18.5	4.1	...	...	...
Tonga	1.0	1.8	0.5	...	...	...
Tuvalu	2.5	6.4	...	...	...	...
Vanuatu	3.0	3.2	4.4	0.1	...	64.9

... = data not available.

Table A6 Inflation (% per year)

	2010	2011	2012	2013	2014	2015	2016
Central Asia	7.0	8.9	5.1	5.8	5.7	6.7	6.6
Armenia	8.2	7.7	2.6	5.8	3.0	4.6	4.1
Azerbaijan	5.7	7.9	1.1	2.4	1.4	6.0	5.5
Georgia	7.1	8.5	–0.9	–0.5	3.1	5.0	5.0
Kazakhstan	7.1	8.3	5.1	5.8	6.7	6.0	6.2
Kyrgyz Republic	7.8	16.6	2.8	6.6	7.5	10.5	10.0
Tajikistan	6.5	12.5	5.8	5.1	6.1	10.0	6.5
Turkmenistan	4.4	5.3	5.3	6.8	6.0	7.0	6.5
Uzbekistan	9.4	12.8	12.1	11.2	8.4	9.5	10.0
East Asia	3.1	5.0	2.6	2.4	1.9	1.7	2.2
China, People's Rep. of	3.3	5.4	2.6	2.6	2.0	1.8	2.3
Hong Kong, China	2.3	5.3	4.1	4.3	4.4	3.3	3.4
Korea, Rep. of	3.0	4.0	2.2	1.3	1.3	1.3	2.1
Mongolia	10.1	9.2	14.3	9.9	12.8	8.9	7.7
Taipei,China	1.0	1.4	1.9	0.8	1.2	0.5	1.0
South Asia	9.3	9.9	10.1	9.0	7.1	5.1	5.6
Afghanistan	7.7	11.8	6.2	7.4	5.0	5.0	5.0
Bangladesh	6.8	10.9	8.7	6.8	7.4	6.5	6.2
Bhutan	4.8	8.6	10.2	8.8	9.6	7.0	6.8
India	9.5	9.5	10.2	9.5	7.0	5.0	5.5
Maldives	6.1	11.3	10.9	4.0	2.4	3.0	2.5
Nepal	9.6	9.6	8.3	9.9	9.1	7.7	7.3
Pakistan	10.1	13.7	11.0	7.4	8.6	5.8	5.8
Sri Lanka	6.2	6.7	7.9	6.9	3.3	2.0	5.0
Southeast Asia	4.1	5.5	3.8	4.2	4.1	3.1	3.1
Brunei Darussalam	0.4	0.1	0.1	0.4	–0.2	–0.2	0.4
Cambodia	4.0	5.5	2.9	2.9	3.9	1.6	2.7
Indonesia	5.1	5.3	4.0	6.4	6.4	5.5	4.0
Lao People's Dem. Rep.	6.0	7.6	4.3	6.4	4.2	3.5	4.0
Malaysia	1.7	3.2	1.7	2.1	3.1	3.2	2.9
Myanmar	8.2	2.8	2.8	5.7	5.9	8.4	6.6
Philippines	3.8	4.6	3.2	3.0	4.1	2.8	3.3
Singapore	2.8	5.2	4.6	2.4	1.0	0.2	1.5
Thailand	3.2	3.8	3.0	2.2	1.9	0.2	2.0
Viet Nam	9.2	18.7	9.1	6.6	4.1	2.5	4.0
The Pacific	4.6	8.5	4.3	5.0	3.6	5.0	4.1
Cook Islands	–0.3	0.9	2.8	2.6	1.6	1.3	1.4
Fiji	3.7	7.3	3.4	2.9	0.5	2.5	2.5
Kiribati	–3.9	1.5	–3.0	–1.5	2.6	1.0	1.5
Marshall Islands	1.8	5.4	4.3	1.9	1.3	1.4	1.3
Micronesia, Fed. States of	3.7	4.3	6.3	2.1	0.7	2.4	2.6
Nauru	–0.6	–3.5	–0.5	1.4	5.0	8.0	3.0
Palau	1.1	2.6	5.4	2.8	4.0	3.4	3.4
Papua New Guinea	6.0	8.4	2.2	5.0	5.9	7.0	5.0
Samoa	–0.2	2.9	6.2	–0.2	–1.2	2.5	2.0
Solomon Islands	1.0	7.4	5.9	5.4	6.0	5.0	5.5
Timor-Leste	5.2	13.2	10.9	9.5	0.7	2.8	4.0
Tonga	1.7	6.0	3.3	0.7	2.3	0.4	1.0
Tuvalu	–1.9	0.5	1.4	2.0	3.3	1.0	1.0
Vanuatu	2.8	0.9	1.4	1.4	0.4	4.0	2.0
Average	4.4	6.0	4.1	3.8	3.1	2.6	3.0

Table A7 Change in money supply (% per year)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	11.8	23.7	19.5	14.8	8.3
Azerbaijan	24.3	32.1	20.7	15.4	11.4
Georgia	33.1	14.5	11.4	24.5	13.8
Kazakhstan	13.3	15.0	7.9	10.2	10.5
Kyrgyz Republic	21.1	14.9	23.8	22.8	3.0
Tajikistan	18.6	33.1	20.1	20.1	7.0
Turkmenistan	43.4	36.3	35.6	31.1	22.6
Uzbekistan	52.4	32.3	27.5	26.4	25.7
East Asia					
China, People's Rep. of	19.7	17.3	14.4	13.6	11.0
Hong Kong, China	8.1	12.9	11.1	12.4	9.5
Korea, Rep. of	6.0	5.5	4.8	4.6	8.1
Mongolia	62.5	37.0	18.7	24.2	12.5
Taipei,China	5.4	4.8	3.5	5.8	6.1
South Asia					
Afghanistan	26.9	21.3	8.8	9.4	8.3
Bangladesh	22.4	21.3	17.4	16.7	16.1
Bhutan	30.1	21.2	–1.0	18.6	6.6
India	16.0	13.2	13.9	13.3	7.9
Maldives	14.6	20.0	5.0	18.4	14.7
Nepal	30.5	12.3	22.6	16.4	19.1
Pakistan	23.6	15.9	14.1	15.9	12.5
Sri Lanka	15.8	19.1	17.6	16.7	11.0
Southeast Asia					
Brunei Darussalam	4.8	10.1	0.9	1.5	3.2
Cambodia	20.0	21.4	20.9	14.6	29.9
Indonesia	15.4	16.4	15.0	12.8	11.8
Lao People's Dem. Rep.	39.5	28.7	31.0	22.7	23.7
Malaysia	9.8	14.3	9.0	7.3	7.0
Myanmar	36.3	26.3	46.6	32.7	30.6
Philippines	10.0	7.1	9.4	31.8	11.3
Singapore	8.6	10.0	7.2	4.3	3.3
Thailand	10.9	15.1	10.4	7.3	4.7
Viet Nam	33.3	12.1	18.5	18.8	16.0
The Pacific					
Cook Islands	–2.3	–13.4	19.2	–25.6	3.0
Fiji	4.2	14.8	6.3	21.2	5.2
Kiribati	...	...	...	...	...
Marshall Islands	...	...	...	...	...
Micronesia, Fed. States of	...	...	...	...	...
Nauru	...	...	...	...	...
Palau	...	...	...	...	...
Papua New Guinea	12.0	15.5	11.0	6.7	0.6
Samoa	10.9	–0.8	–4.0	–0.8	6.7
Solomon Islands	13.3	25.8	17.4	12.4	3.2
Timor-Leste	18.2	9.3	26.2	22.9	...
Tonga	5.6	3.3	7.2	6.1	7.2
Tuvalu	...	...	...	...	...
Vanuatu	–6.0	1.3	–0.6	–5.5	1.5

... = data not available.

Table A8 Central government revenues (% of GDP)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	22.6	23.3	23.7	25.1	25.1
Azerbaijan	26.9	30.1	31.6	32.9	31.2
Georgia	28.3	28.2	28.9	27.7	28.0
Kazakhstan	19.7	19.5	19.2	18.1	19.2
Kyrgyz Republic	30.5	31.8	34.2	29.0	31.4
Tajikistan	23.2	24.9	25.1	28.5	29.3
Turkmenistan	16.1	18.3	21.0	17.6	16.4
Uzbekistan	32.4	32.0	32.8	32.2	32.5
East Asia					
China, People's Rep. of	20.7	22.0	22.0	22.0	22.1
Hong Kong, China	21.2	22.6	21.7	21.5	20.5
Korea, Rep. of	19.0	19.4	19.9	19.5	20.2
Mongolia	32.0	33.9	29.7	31.3	28.1
Taipei,China	10.6	11.7	11.4	11.4	10.6
South Asia					
Afghanistan	22.0	21.4	25.4	26.3	23.3
Bangladesh	9.5	10.2	10.9	10.7	11.6
Bhutan	46.4	35.8	35.8	30.4	29.7
India	20.7	19.7	20.0	21.0	21.2
Maldives	21.9	27.6	26.0	28.6	32.0
Nepal	18.2	17.9	18.6	19.5	20.8
Pakistan	14.0	12.3	12.8	13.3	14.0
Sri Lanka	14.9	14.5	14.1	13.9	14.2
Southeast Asia					
Brunei Darussalam	51.8	60.4	52.6	46.7	..
Cambodia	13.2	13.2	15.2	15.0	15.7
Indonesia	14.5	15.5	15.5	15.0	15.5
Lao People's Dem. Rep.	15.7	16.4	17.7	18.1	17.2
Malaysia	20.0	20.9	22.1	21.6	20.6
Myanmar	11.4	12.0	23.3	23.2	24.2
Philippines	13.4	14.0	14.5	14.9	15.1
Singapore	14.3	14.7	15.4	15.1	15.7
Thailand	17.3	18.0	18.3	18.1	17.1
Viet Nam	27.6	26.1	22.7	22.1	21.5
The Pacific					
Cook Islands	33.0	32.4	41.2	43.0	41.8
Fiji	25.5	27.6	28.1	28.2	30.2
Kiribati	72.5	62.1	90.4	112.8	83.8
Marshall Islands	60.3	57.1	50.1	52.6	50.3
Micronesia, Fed. States of	68.2	65.0	66.0	62.9	65.3
Nauru	49.5	62.1	85.4	110.9	141.4
Palau	47.4	44.1	44.7	41.0	41.2
Papua New Guinea	31.4	30.4	29.8	29.8	31.8
Samoa	32.4	32.1	25.3	26.8	29.9
Solomon Islands	57.5	63.8	51.8	49.1	40.4
Timor-Leste	293.1	349.7	352.0	318.1	188.3
Tonga	27.3	26.8	27.8	25.5	29.0
Tuvalu	71.8	69.1	84.6	109.3	121.4
Vanuatu	24.6	22.3	21.8	21.6	23.4

... = data not available.

Table A9 Central government expenditures (% of GDP)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	27.6	26.1	25.1	26.7	27.2
Azerbaijan	27.7	29.6	31.8	34.1	31.7
Georgia	34.9	31.8	31.7	30.3	31.0
Kazakhstan	22.1	21.5	22.1	20.1	22.2
Kyrgyz Republic	36.6	36.4	39.6	33.0	35.7
Tajikistan	26.1	27.0	24.7	28.2	29.0
Turkmenistan	14.1	14.6	14.7	16.1	15.6
Uzbekistan	32.0	31.9	32.7	32.0	32.3
East Asia					
China, People's Rep. of	22.4	23.1	23.6	23.8	23.8
Hong Kong, China	17.0	18.8	18.5	20.4	17.7
Korea, Rep. of	20.1	20.5	21.3	21.0	22.0
Mongolia	31.6	37.9	35.9	32.2	32.2
Taipei,China	13.5	13.4	12.9	12.2	11.9
South Asia					
Afghanistan	21.1	22.0	24.9	24.3	25.1
Bangladesh	12.7	14.0	14.4	14.5	16.0
Bhutan	44.7	37.9	37.0	34.6	33.8
India	27.6	27.4	26.9	28.0	27.1
Maldives	36.2	34.1	33.7	32.5	35.1
Nepal	20.1	20.2	20.9	18.9	20.9
Pakistan	20.2	18.9	19.6	21.4	20.4
Sri Lanka	22.8	21.4	20.5	19.8	19.4
Southeast Asia					
Brunei Darussalam	35.3	32.4	34.9	37.4	..
Cambodia	21.3	20.7	21.6	20.8	19.8
Indonesia	15.2	16.5	17.3	17.2	17.8
Lao People's Dem. Rep.	24.6	24.4	24.6	29.4	27.6
Malaysia	25.5	25.7	26.5	25.5	24.1
Myanmar	16.9	16.6	25.0	25.2	28.7
Philippines	16.9	16.0	16.8	16.3	15.7
Singapore	14.1	13.4	13.5	13.7	14.7
Thailand	16.6	16.4	19.6	18.2	17.3
Viet Nam	27.2	25.4	28.2	26.0	25.9
The Pacific					
Cook Islands	35.1	37.2	43.4	46.8	44.8
Fiji	27.7	29.0	29.2	28.8	32.2
Kiribati	85.2	83.3	97.2	102.6	109.7
Marshall Islands	58.2	55.7	52.2	53.2	47.1
Micronesia, Fed. States of	67.7	65.6	65.1	60.1	54.2
Nauru	43.5	61.4	86.5	110.5	141.3
Palau	48.3	42.9	43.7	39.7	40.0
Papua New Guinea	30.7	28.1	34.1	38.5	37.7
Samoa	38.3	36.7	32.5	30.6	35.2
Solomon Islands	51.8	54.2	46.6	42.3	42.5
Timor-Leste	114.5	125.2	117.4	98.8	110.5
Tonga	32.7	34.4	30.6	26.8	28.0
Tuvalu	95.7	78.0	76.2	81.8	86.4
Vanuatu	22.2	24.5	23.3	21.7	22.3

... = data not available.

Table A10 Fiscal balance of central government (% of GDP)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	–5.0	–2.8	–1.5	–1.7	–2.0
Azerbaijan	–0.9	0.6	–0.2	–1.2	–0.5
Georgia	–6.6	–3.6	–2.8	–2.6	–3.0
Kazakhstan	–2.4	–2.1	–2.9	–2.0	–3.0
Kyrgyz Republic	–6.3	–4.6	–5.4	–4.0	–4.3
Tajikistan	–3.7	–2.5	0.4	0.3	0.3
Turkmenistan	2.0	3.6	6.4	1.5	0.8
Uzbekistan	2.0	2.0	0.1	0.2	0.2
East Asia					
China, People's Rep. of	–1.7	–1.1	–1.6	–1.9	–1.8
Hong Kong, China	4.2	3.8	3.2	1.0	2.8
Korea, Rep. of	–1.1	–1.1	–1.4	–1.5	–1.8
Mongolia	0.4	–4.0	–6.2	–0.9	–4.1
Taipei,China	–2.9	–1.7	–1.6	–0.9	–1.3
South Asia					
Afghanistan	0.9	–0.6	1.1	2.0	–1.8
Bangladesh	–3.2	–3.9	–3.6	–3.8	–4.4
Bhutan	1.6	–2.1	–1.1	–4.2	–4.1
India	–6.9	–7.8	–6.8	–7.1	–5.9
Maldives	–14.3	–6.6	–7.6	–3.9	–3.2
Nepal	–1.9	–2.4	–2.2	0.7	–0.1
Pakistan	–6.2	–6.5	–6.8	–8.2	–6.3
Sri Lanka	–8.0	–6.9	–6.5	–5.9	–5.2
Southeast Asia					
Brunei Darussalam	16.5	28.0	17.7	9.3	..
Cambodia	–8.1	–7.5	–6.3	–5.8	–4.1
Indonesia	–0.7	–1.1	–1.8	–2.2	–2.3
Lao People's Dem. Rep.	–8.9	–7.9	–6.9	–5.6	–4.2
Malaysia	–5.4	–4.8	–4.5	–3.9	–3.5
Myanmar	–5.5	–4.6	–3.9	–4.9	–4.3
Philippines	–3.5	–2.0	–2.3	–1.4	–0.6
Singapore	0.3	1.2	1.6	1.3	0.0
Thailand	–2.6	–0.9	–4.1	–2.0	–2.5
Viet Nam	0.5	0.7	–5.5	–3.9	–4.4
The Pacific					
Cook Islands	–2.1	–4.8	–2.1	–3.8	–3.0
Fiji	–2.2	–1.4	–1.1	–0.5	–2.0
Kiribati	–12.7	–21.2	–6.8	10.3	–25.8
Marshall Islands	2.1	1.4	–2.0	–0.5	3.2
Micronesia, Fed. States of	0.5	–0.6	0.9	2.9	11.1
Nauru	6.0	0.6	–1.2	0.4	0.1
Palau	–1.0	1.2	1.0	1.2	1.2
Papua New Guinea	0.7	2.3	–4.3	–8.7	–5.8
Samoa	–5.9	–4.5	–7.2	–3.8	–5.3
Solomon Islands	5.7	9.6	5.1	6.8	–2.1
Timor-Leste	178.5	224.5	234.6	219.3	77.8
Tonga	–5.4	–7.5	–2.8	–1.3	1.1
Tuvalu	–23.9	–8.9	8.4	27.5	35.0
Vanuatu	2.4	–2.2	–1.5	–0.1	1.2

... = data not available.

Table A11 Growth rate of merchandise exports (% per year)

	2010	2011	2012	2013	2014	2015	2016
Central Asia	28.4	37.1	1.5	–0.9	–5.4	–21.6	4.6
Armenia	54.8	19.5	5.9	7.9	2.7	3.6	2.3
Azerbaijan	25.5	30.3	–6.1	–1.8	–4.7	–15.0	6.0
Georgia	30.0	32.2	7.6	21.3	–1.6	–15.0	5.0
Kazakhstan	39.8	38.8	2.0	–1.5	–8.6	–32.0	3.1
Kyrgyz Republic	5.0	27.7	–13.1	3.8	–6.3	10.0	10.0
Tajikistan	18.3	5.2	41.0	–14.4	3.6	14.0	13.0
Turkmenistan	8.0	73.0	18.9	–4.7	3.3	–13.2	7.3
Uzbekistan	6.0	20.3	–7.6	6.5	–2.0	1.3	3.0
East Asia	29.7	19.5	6.0	6.4	4.6	5.1	6.6
China, People's Rep. of	31.4	20.4	8.0	7.9	6.1	5.5	7.0
Hong Kong, China	22.8	12.5	7.0	8.1	4.3	6.5	6.7
Korea, Rep. of	27.4	26.6	2.8	2.4	0.5	2.0	5.0
Mongolia	54.3	65.6	–9.0	–2.6	35.3	5.0	0.0
Taipei,China	34.6	11.7	–2.3	1.4	2.7	6.7	6.7
South Asia	31.1	24.6	–0.9	2.9	3.0	3.4	7.3
Afghanistan	12.3	–5.1	2.7	–5.2	3.0	3.0	3.5
Bangladesh	4.2	39.2	6.2	10.7	12.0	6.0	10.0
Bhutan	3.0	26.8	–7.3	–11.5	–2.0	13.8	9.6
India	37.3	23.7	–1.0	2.6	2.3	3.2	7.0
Maldives	16.8	75.4	–9.2	5.3	–1.7	6.7	4.0
Nepal	–6.3	11.7	5.7	–2.9	5.1	5.0	6.0
Pakistan	2.9	28.9	–2.6	0.3	1.1	–0.3	5.0
Sri Lanka	21.0	23.2	–7.4	6.3	7.0	11.0	15.0
Southeast Asia	28.5	16.4	2.2	0.4	1.4	1.4	5.4
Brunei Darussalam	30.3	33.2	3.5	–11.2	–6.7	–6.8	6.2
Cambodia	24.4	29.0	11.8	16.0	13.4	16.0	15.3
Indonesia	25.3	27.4	–2.0	–2.8	–3.7	1.2	3.5
Lao People's Dem. Rep.	57.5	43.2	6.1	9.5	10.0	9.5	13.0
Malaysia	26.9	14.9	–2.9	–3.0	2.9	–1.5	6.6
Myanmar	16.5	16.0	1.0	18.0	22.6	11.4	..
Philippines	26.2	4.1	21.2	–4.0	9.0	6.3	6.8
Singapore	31.7	11.1	0.8	0.5	–1.0	–1.8	3.0
Thailand	27.1	14.3	3.1	–0.2	–0.3	3.0	5.5
Viet Nam	26.5	34.2	18.2	15.3	13.7	11.0	11.2
The Pacific	31.3	24.7	–4.4	–7.1	–58.7	289.0	10.1
Cook Islands	8.5	–3.5	–21.6	139.9	141.3	–0.4	...
Fiji	34.3	29.0	12.0	–12.1	9.4	0.7	2.1
Kiribati	–38.1	121.8	–17.8	–1.1	–0.5	–1.6	13.9
Marshall Islands	54.4	58.6	14.8	–7.6	5.7	–18.6	4.6
Micronesia, Fed. States of	19.5	27.7	42.4	–16.9	4.0	3.2	2.9
Nauru	...	...	...	...	...	...	...
Palau	48.7	5.9	18.8	–8.1	33.8	–30.9	18.2
Papua New Guinea	30.9	21.8	–9.1	–6.5	–76.8	667.9	10.7
Samoa	53.7	25.8	38.9	97.4	–9.7	–42.0	...
Solomon Islands	35.6	85.6	18.7	–10.7	–20.1	15.2	18.5
Timor-Leste	93.3	–13.8	32.0	30.3	25.6	25.9	13.2
Tonga	9.7	36.7	65.7	–22.9	8.7	0.0	15.3
Tuvalu	...	5.2	95.1	–3.0	–4.5	–6.3	8.5
Vanuatu	–8.4	24.9	–13.9	–18.1	–30.3	72.7	1.0
Average	29.5	19.6	4.4	4.5	3.4	3.6	6.4

... = data not available.

Table A12 Growth rate of merchandise imports (% per year)

	2010	2011	2012	2013	2014	2015	2016
Central Asia	7.1	27.9	16.8	6.4	–9.4	–5.6	4.4
Armenia	14.0	8.5	2.4	2.8	1.4	0.0	1.9
Azerbaijan	3.6	50.7	0.3	9.4	–17.6	–16.7	–7.1
Georgia	17.7	33.6	14.3	0.3	7.1	–3.0	3.0
Kazakhstan	13.7	22.7	20.9	4.1	–18.9	–10.0	5.0
Kyrgyz Republic	5.9	32.0	26.2	13.0	–4.3	10.0	10.0
Tajikistan	3.5	19.9	16.8	9.1	7.3	–16.0	6.0
Turkmenistan	–8.0	40.6	27.6	11.7	1.8	–6.0	8.0
Uzbekistan	–4.8	23.4	8.2	9.0	3.0	2.0	4.0
East Asia	36.1	24.0	3.5	4.6	1.5	4.1	10.2
China, People's Rep. of	39.1	25.1	4.5	7.1	1.2	4.2	12.3
Hong Kong, China	27.1	15.4	9.5	7.7	5.7	8.1	7.5
Korea, Rep. of	31.6	34.2	–0.7	–3.4	–1.3	–1.5	7.0
Mongolia	49.7	106.2	2.1	–17.0	–14.4	–20.0	25.0
Taipei,China	43.1	13.0	–3.7	–0.5	0.9	7.1	6.5
South Asia	23.1	30.7	1.3	–8.6	2.8	0.2	6.1
Afghanistan	11.6	3.3	11.2	–4.1	–1.8	–0.5	0.5
Bangladesh	5.4	52.1	2.4	0.8	8.9	11.0	13.0
Bhutan	36.1	41.7	–10.0	–6.4	–5.0	17.2	14.1
India	26.7	31.1	0.5	–10.4	2.0	–1.1	5.0
Maldives	16.2	36.6	–8.2	8.1	16.8	9.7	8.0
Nepal	35.5	8.9	4.7	10.9	13.9	10.0	10.0
Pakistan	–1.7	15.0	12.8	–0.5	3.7	1.2	8.0
Sri Lanka	31.8	50.7	–5.3	–6.2	7.9	3.0	15.0
Southeast Asia	31.0	18.8	6.4	0.7	–1.1	3.5	6.3
Brunei Darussalam	2.0	9.8	61.1	–12.3	–5.1	–3.4	3.9
Cambodia	18.0	24.7	13.4	19.7	10.1	13.0	13.0
Indonesia	34.1	32.2	13.6	–1.3	–4.5	1.0	3.1
Lao People's Dem. Rep.	21.2	31.7	34.5	17.4	5.0	2.0	5.0
Malaysia	33.8	14.4	1.4	–0.2	1.3	2.5	6.0
Myanmar	15.8	27.5	19.4	19.4	17.2	13.9	..
Philippines	24.7	9.5	11.3	–4.7	2.4	4.0	7.2
Singapore	30.5	12.7	2.1	–1.3	–1.7	–0.5	2.8
Thailand	37.0	24.9	8.8	–0.5	–8.5	6.0	8.5
Viet Nam	19.6	25.8	8.7	16.5	12.1	14.0	14.3
The Pacific	19.8	19.1	12.2	12.1	–47.5	64.7	–2.9
Cook Islands	1.3	17.2	11.3	–2.8	6.1	–1.7	...
Fiji	25.6	23.0	3.2	20.5	–6.8	2.3	1.0
Kiribati	5.7	25.2	18.3	–2.6	–0.6	–8.1	1.4
Marshall Islands	40.5	–11.6	3.4	10.6	–5.7	–6.4	3.4
Micronesia, Fed. States of	4.3	9.0	5.0	–2.3	–11.8	–7.0	7.8
Nauru	...	...	...	...	...	...	...
Palau	10.9	19.5	6.8	4.2	4.6	–1.2	10.3
Papua New Guinea	23.0	21.5	11.5	13.4	–87.4	493.5	–10.7
Samoa	10.8	1.7	19.8	0.7	11.3	3.2	...
Solomon Islands	50.8	16.9	5.8	3.9	5.0	6.6	9.0
Timor-Leste	–8.7	22.2	79.7	6.3	6.2	6.3	7.9
Tonga	–0.1	17.0	17.5	–2.1	0.1	11.6	8.8
Tuvalu	...	14.3	–5.1	7.7	8.3	44.9	–16.3
Vanuatu	–2.7	1.7	2.8	5.7	–56.0	122.7	3.5
Average	32.5	23.6	4.1	2.1	0.7	3.4	8.7

... = data not available.

Table A13 Trade balance ($ million)

	2010	2011	2012	2013	2014	2015	2016
Central Asia	46,147	69,613	57,146	49,150	50,844	24,061	25,373
Armenia	–2,066	–2,110	–2,112	–2,092	–2,100	–2,040	–2,070
Azerbaijan	19,730	24,328	22,182	20,621	21,088	18,083	20,167
Georgia	–2,590	–3,494	–4,214	–3,493	–4,108	–4,486	–4,549
Kazakhstan	28,500	44,844	38,145	34,792	37,025	16,087	15,883
Kyrgyz Republic	–1,202	–1,665	–2,993	–3,565	–3,453	–3,798	–4,178
Tajikistan	–1,463	–1,930	–1,949	–2,543	–2,785	–3,200	–3,280
Turkmenistan	2,232	6,272	6,527	4,030	4,385	2,704	2,790
Uzbekistan	3,005	3,367	1,561	1,400	792	710	610
East Asia	331,607	289,926	379,646	458,001	579,781	642,095	564,791
China, People's Rep. of	254,180	243,549	321,595	359,890	471,900	521,614	453,788
Hong Kong, China	3,291	–7,477	–18,917	–18,801	–27,288	–37,987	–45,219
Korea, Rep. of	47,915	29,090	49,406	82,781	92,688	113,043	108,281
Mongolia	–292	–1,781	–2,354	–1,321	993	2,238	1,282
Taipei,China	26,513	26,545	29,916	35,452	41,488	43,187	46,659
South Asia	–164,564	–233,622	–244,932	–181,088	–185,345	–172,974	–178,004
Afghanistan	–7,070	–7,539	–8,609	–8,281	–8,008	–7,877	–7,830
Bangladesh	–5,155	–9,935	–9,320	–7,009	–6,806	–9,043	–11,165
Bhutan	–269	–460	–396	–402	–365	–446	–536
India	–130,593	–189,759	–195,656	–135,798	–137,571	–122,227	–121,699
Maldives	–1,059	–1,370	–1,261	–1,372	–1,663	–1,835	–1,995
Nepal	–4,084	–4,422	–4,623	–5,263	–6,079	–6,738	–7,455
Pakistan	–11,452	–10,427	–15,652	–15,355	–16,555	–17,150	–18,516
Sri Lanka	–4,881	–9,710	–9,416	–7,609	–8,299	–7,659	–8,808
Southeast Asia	154,499	157,570	116,189	113,670	143,441	122,201	118,571
Brunei Darussalam	7,014	9,884	8,762	7,823	7,242	7,264	7,264
Cambodia	–1,851	–2,142	–2,506	–3,210	–3,321	–3,530	–3,791
Indonesia	31,003	33,825	8,680	5,833	6,902	7,322	8,258
Lao People's Dem. Rep.	–1,109	–1,185	–2,567	–3,299	–3,265	–3,002	–2,768
Malaysia	42,455	49,531	40,530	34,349	38,213	30,295	33,423
Myanmar	645	–195	–2,120	–2,677	–2,473	–3,197	..
Philippines	–16,859	–20,429	–18,926	–17,702	–15,189	–14,701	–15,987
Singapore	69,232	71,547	67,487	74,501	76,365	70,165	72,958
Thailand	29,751	16,989	6,015	6,661	24,582	19,313	14,009
Viet Nam	–5,136	–450	8,714	8,713	11,913	9,075	5,205
The Pacific	21	419	–982	–2,705	–2,292	3,411	5,273
Cook Islands	–84	–99	–111	–104	–100	...	...
Fiji	–732	–851	–786	–1,334	–1,075	–1,119	–1,117
Kiribati	–69	–83	–102	–99	–98	–90	–90
Marshall Islands	–100	–66	–63	–80	–69	–72	–74
Micronesia, Fed. States of	–128	–134	–126	–131	–108	–96	–106
Nauru	...	...	...	...	...	...	...
Palau	–93	–113	–119	–126	–128	–132	–144
Papua New Guinea	2,221	2,712	1,578	523	694	6,529	8,100
Samoa	–260	–260	–306	–277	–322	–358	...
Solomon Islands	–137	–6	47	–23	–134	–113	–85
Timor-Leste	–277	–349	–639	–671	–704	–738	–793
Tonga	–123	–142	–161	–162	–161	–181	–196
Tuvalu	–6	–8	3	1	–1	–11	–5
Vanuatu	–191	–183	–198	–223	–87	–208	–217
Total	367,709	283,905	307,067	437,027	586,429	618,795	536,003

... = data not available.

Table A14 Current account balance (% of GDP)

	2010	2011	2012	2013	2014	2015	2016
Central Asia	4.6	7.0	3.2	2.0	2.4	–0.2	0.2
Armenia	–14.2	–11.1	–11.1	–8.0	–8.5	–9.2	–8.3
Azerbaijan	28.4	25.7	21.4	16.6	16.0	12.0	13.4
Georgia	–10.2	–12.7	–11.4	–5.7	–9.5	–12.0	–10.5
Kazakhstan	0.9	5.4	0.5	0.5	1.8	–1.0	–1.3
Kyrgyz Republic	–7.2	–6.1	–15.1	–14.1	–15.0	–16.0	–15.0
Tajikistan	–1.2	–4.7	–2.4	–2.6	–7.9	–5.9	–4.8
Turkmenistan	–10.6	2.0	0.0	–6.3	–4.4	–8.4	–6.2
Uzbekistan	6.1	5.8	1.2	1.6	1.2	0.9	1.1
East Asia	4.2	2.3	3.1	2.8	3.0	3.3	3.0
China, People's Rep. of	4.0	1.9	2.5	1.9	2.1	2.3	2.0
Hong Kong, China	7.0	5.6	1.6	1.5	0.2	2.6	2.5
Korea, Rep. of	2.6	1.6	4.2	6.2	6.3	7.0	6.3
Mongolia	–12.2	–26.5	–27.4	–25.4	–12.5	–8.0	–15.0
Taipei,China	8.9	8.2	9.9	10.8	12.3	12.5	13.0
South Asia	–2.2	–3.7	–4.2	–1.4	–1.3	–1.0	–1.3
Afghanistan	3.9	3.2	3.9	3.6	3.8	1.4	–1.0
Bangladesh	3.2	–1.3	–0.3	1.6	0.8	–0.5	0.5
Bhutan	–22.2	–30.0	–21.7	–27.3	–25.5	–30.6	–30.6
India	–2.7	–4.2	–4.8	–1.7	–1.5	–1.1	–1.5
Maldives	–15.3	–17.2	–10.6	–6.5	–9.6	–6.3	–6.1
Nepal	–2.3	–0.9	5.0	3.4	4.7	2.7	3.5
Pakistan	–2.2	0.1	–2.1	–1.1	–1.3	–1.0	–1.3
Sri Lanka	–2.2	–7.8	–6.7	–3.9	–3.5	–1.4	–1.5
Southeast Asia	6.2	5.5	2.6	2.2	3.2	3.1	2.9
Brunei Darussalam	43.8	47.2	29.8	28.2	26.4	25.0	26.5
Cambodia	–11.6	–8.9	–9.6	–14.2	–12.5	–12.9	–12.7
Indonesia	0.7	0.2	–2.7	–3.2	–3.0	–2.8	–2.4
Lao People's Dem. Rep.	–18.3	–15.8	–28.5	–30.6	–25.0	–21.2	–17.3
Malaysia	10.9	11.6	5.8	4.0	4.6	3.3	4.5
Myanmar	–1.2	–1.9	–4.3	–5.1	–7.1	–6.8	–5.0
Philippines	3.6	2.5	2.8	3.8	3.6	4.0	3.6
Singapore	26.6	22.0	17.2	17.9	19.1	18.9	19.3
Thailand	3.1	2.6	–0.4	–0.7	3.8	4.0	1.5
Viet Nam	–3.7	0.2	5.9	4.2	4.4	3.1	1.5
The Pacific	25.3	42.1	31.4	29.0	7.0	13.9	14.4
Cook Islands	...	...	...	...	...	...	...
Fiji	–4.4	–5.3	–1.8	–14.9	–8.9	–9.8	–8.7
Kiribati	–16.7	–32.3	–26.3	–27.3	–53.2	–53.0	–48.4
Marshall Islands	–25.9	–4.5	–7.8	–12.4	–9.4	–9.9	–11.4
Micronesia, Fed. States of	–15.1	–17.9	–12.6	–10.1	14.2	11.2	6.4
Nauru	...	...	...	...	...	...	...
Palau	–10.2	–13.1	–10.1	–8.8	–5.1	–6.4	–8.1
Papua New Guinea	–6.5	–1.3	–14.9	–22.6	–11.4	13.5	15.0
Samoa	–6.5	–6.8	–14.0	–5.9	–12.2	–10.9	–9.4
Solomon Islands	–28.3	–7.4	–0.2	–3.6	–14.7	–15.5	–15.0
Timor-Leste	179.6	212.1	221.5	246.7	87.9	55.0	51.6
Tonga	–6.4	–6.1	–8.8	–1.9	–1.4	–4.5	–6.0
Tuvalu	–11.8	–36.5	25.5	26.2	27.3	–37.2	–21.4
Vanuatu	–5.4	–8.1	–6.5	–3.3	–5.7	–10.0	–7.0
Average	3.4	1.9	1.9	2.1	2.4	2.5	2.3

... = data not available.

Table A15 Exchange rates to the United States dollar (annual average)

	Currency	Symbol	2010	2011	2012	2013	2014
Central Asia							
Armenia	dram	AMD	373.7	372.5	401.8	409.6	415.9
Azerbaijan	Azerbaijan new manat	AZN	0.8	0.8	0.8	0.8	0.8
Georgia	lari	GEL	1.8	1.7	1.7	1.7	1.8
Kazakhstan	tenge	T	147.4	146.6	149.1	152.1	179.2
Kyrgyz Republic	som	Som	46.0	46.1	47.0	48.4	53.7
Tajikistan	somoni	TJS	4.4	4.6	4.8	4.8	4.9
Turkmenistan	Turkmen manat	TMM	2.9	2.9	2.9	2.9	2.9
Uzbekistan	sum	SUM	1,576.8	1,710.9	1,885.4	2,095.0	2,311.2
East Asia							
China, People's Rep. of	yuan	CNY	6.8	6.5	6.3	6.2	6.1
Hong Kong, China	Hong Kong dollar	HK$	7.8	7.8	7.8	7.7	7.7
Korea, Rep. of	won	W	1,155.4	1,107.4	1,125.7	1,094.2	1,053.1
Mongolia	togrog	MNT	1,347.2	1,265.2	1,359.2	1,523.9	1,817.3
Taipei,China	NT dollar	NT$	31.6	29.5	29.6	29.8	30.4
South Asia							
Afghanistan	afghani	AF	45.8	47.7	50.9	55.5	57.1
Bangladesh	taka	Tk	69.2	71.2	79.1	79.9	77.7
Bhutan	ngultrum	Nu	46.7	45.3	50.3	54.9	61.5
India	Indian rupee/s	Re/Rs	45.6	47.9	54.4	60.5	61.0
Maldives	rufiyaa	Rf	12.8	14.6	15.4	15.4	15.4
Nepal	Nepalese rupee/s	NRe/NRs	74.2	72.1	80.7	87.7	98.0
Pakistan	Pakistan rupee/s	PRe/PRs	83.8	85.5	89.2	96.7	102.0
Sri Lanka	Sri Lanka rupee/s	SLRe/SLRs	113.1	110.6	127.6	129.1	130.6
Southeast Asia							
Brunei Darussalam	Brunei dollar	B$	1.4	1.3	1.2	1.3	1.3
Cambodia	riel	KR	4,188.5	4,065.9	4,033.0	4,027.0	4,038.0
Indonesia	rupiah	Rp	9,086.9	8,776.0	9,384.2	10,460.5	11,868.7
Lao People's Dem. Rep.	kip	KN	8,248.6	8,011.4	7,994.0	7,818.0	8,150.0
Malaysia	ringgit	RM	3.2	3.1	3.1	3.2	3.3
Myanmar	kyat	MK	5.6	5.6	855.2	964.6	994.3
Philippines	peso	P	45.1	43.3	42.2	42.4	44.4
Singapore	Singapore dollar	S$	1.4	1.3	1.2	1.3	1.3
Thailand	baht	B	31.7	30.5	31.1	30.7	32.5
Viet Nam	dong	D	18,621.3	20,489.6	20,828.0	20,934.6	21,148.8
The Pacific							
Cook Islands	New Zealand dollar	NZ$	1.4	1.3	1.2	1.2	1.2
Fiji	Fiji dollar	F$	1.9	1.8	1.8	1.8	1.9
Kiribati	Australian dollar	A$	1.1	1.0	1.0	1.0	1.1
Marshall Islands	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Micronesia, Fed. States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	1.1	1.0	1.0	1.0	1.1
Palau	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Papua New Guinea	kina	K	2.7	2.3	2.1	2.2	2.5
Samoa	tala	ST	2.5	2.4	2.3	2.3	2.3
Solomon Islands	Sol. Islands dollar	SI$	8.1	7.6	7.4	7.3	7.3
Timor-Leste	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Tonga	pa'anga	T$	1.9	1.9	1.7	1.7	1.8
Tuvalu	Australian dollar	A$	1.1	1.0	1.0	1.0	1.1
Vanuatu	vatu	Vt	97.2	94.6	92.6	94.5	97.2

Table A16 Gross international reserves ($ million)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	1,866	1,933	1,799	2,252	1,489
Azerbaijan	6,409	10,274	11,277	14,401	14,646
Georgia	2,264	2,818	2,873	2,823	2,699
Kazakhstan	28,275	29,328	28,269	24,715	28,919
Kyrgyz Republic	1,719	1,835	2,067	..	..
Tajikistan	476	572	650	500	400
Turkmenistan	18,800	22,400	26,400	29,300	32,400
Uzbekistan	14,579	18,049	22,100	22,500	23,900
East Asia					
China, People's Rep. of	2,914,184	3,255,786	3,387,863	3,880,383	3,952,130
Hong Kong, China	268,731	285,408	317,336	311,185	328,510
Korea, Rep. of	291,571	306,402	326,968	346,460	363,593
Mongolia	2,197	2,457	4,126	2,248	1,650
Taipei,China	382,005	385,547	403,169	416,811	418,980
South Asia					
Afghanistan	5,403	6,208	7,150	7,100	7,370
Bangladesh	10,750	10,912	10,364	15,315	21,508
Bhutan	759	796	674	917	998
India	304,818	294,397	292,046	304,223	330,213
Maldives	350	335	305	368	615
Nepal	2,759	3,836	4,960	5,614	6,939
Pakistan	13,953	16,614	11,905	7,198	10,509
Sri Lanka	6,610	5,958	6,877	7,200	8,200
Southeast Asia					
Brunei Darussalam	1,563	2,487	3,285	3,399	3,471
Cambodia	2,653	3,032	3,463	3,643	4,391
Indonesia	96,207	110,123	112,781	99,387	111,862
Lao People's Dem. Rep.	727	679	740	666	816
Malaysia	106,590	133,257	139,698	134,658	116,035
Myanmar	850	922	3,062	4,546	4,751
Philippines	62,373	75,302	83,831	83,187	79,541
Singapore	225,754	237,737	259,307	273,065	256,860
Thailand	172,129	175,124	181,608	167,289	157,108
Viet Nam	12,382	13,531	25,399	25,745	34,125
The Pacific					
Cook Islands	...	...	...	...	...
Fiji	716	831	915	755	750
Kiribati	...	...	...	...	...
Marshall Islands	...	...	...	...	...
Micronesia, Fed. States of	..	..	..	..	..
Nauru	...	...	...	...	...
Palau	..	..	..	..	..
Papua New Guinea	3,092	4,323	4,001	2,814	2,624
Samoa	176	158	158	163	161
Solomon Islands	266	412	500	528	484
Timor-Leste	406	462	884	687	1,124
Tonga	88	121	141	145	153
Tuvalu	27	24	28	37	49
Vanuatu	155	172	180	184	183

... = data not available.

Table A17 External debt outstanding ($ million)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	3,299	3,568	3,739	3,899	3,785
Azerbaijan	3,734	4,841	5,470	6,059	6,478
Georgia	4,219	4,507	4,829	4,523	4,420
Kazakhstan	118,223	125,321	136,918	149,895	157,656
Kyrgyz Republic	4,381	4,872	5,403	5,929	6,371
Tajikistan	1,911	2,093	2,260	2,149	...
Turkmenistan	908	2,923	6,365	8,654	8,053
Uzbekistan	5,804	6,090	6,660	7,383	8,084
East Asia					
China, People's Rep. of	548,938	694,997	736,986	863,167	890,000
Hong Kong, China	879,034	985,042	1,030,583	1,160,738	1,264,065
Korea, Rep. of	355,911	400,034	408,928	423,505	425,449
Mongolia	5,928	9,628	15,386	15,387	15,388
Taipei,China	101,581	122,528	130,821	170,134	177,945
South Asia					
Afghanistan	1,303	1,242	1,320	1,260	1,290
Bangladesh	20,336	22,086	22,095	22,381	23,626
Bhutan	874	1,289	1,334	1,607	1,759
India	317,891	360,766	409,484	442,261	455,900
Maldives	962	913	815	793	836
Nepal	3,442	3,658	3,491	3,510	3,617
Pakistan	61,567	66,366	65,478	60,899	65,533
Sri Lanka	21,438	32,748	37,098	39,741	...
Southeast Asia					
Brunei Darussalam	...	...	...	...	...
Cambodia	3,152	3,645	4,274	4,828	5,264
Indonesia	202,413	225,375	252,364	266,120	292,579
Lao People's Dem. Rep.	2,809	2,990	3,037	4,611	..
Malaysia	140,839	169,171	196,195	212,281	213,076
Myanmar	14,400	15,300	13,700	10,600	11,000
Philippines	60,048	60,442	60,337	58,506	57,730
Singapore	1,343,053	1,415,335	1,437,268	1,527,241	1,708,393
Thailand	100,561	104,334	130,747	141,933	140,900
Viet Nam	32,741	37,644	42,158	45,243	..
The Pacific					
Cook Islands	...	...	67	79	82
Fiji	286	465	523	588	618
Kiribati	18	14	14	14	19
Marshall Islands	103	100	97	98	108
Micronesia, Fed. States of	84	87	87	87	...
Nauru	63	...	...	...	...
Palau	66	63	69	65	67
Papua New Guinea	922	979	1,142	1,355	1,525
Samoa	280	294	341	427	449
Solomon Islands	147	125	141	...	...
Timor-Leste	0	0	0	44	60
Tonga	118	153	201	205	192
Tuvalu	11	10	10	9	8
Vanuatu	101	111	108	105	103

... = data not available.

Table A18 Debt service ratio (% of exports of goods and services)

	2010	2011	2012	2013	2014
Central Asia					
Armenia	4.6	4.1	9.4	31.5	9.1
Azerbaijan	...	...	...	...	...
Georgia	4.9	7.5	4.6	5.1	6.5
Kazakhstan	38.8	33.1	34.8	35.1	10.2
Kyrgyz Republic	25.9	11.5	..	..	..
Tajikistan	7.5	5.1	...	...	...
Turkmenistan	2.3	1.6	1.8	2.3	..
Uzbekistan	4.1	3.6	6.4	3.5	4.6
East Asia					
China, People's Rep. of	1.6	1.7	1.6	1.6	2.1
Hong Kong, China	48.9	50.5	49.1	48.9	..
Korea, Rep. of	2.9	7.9	7.5	7.1	7.3
Mongolia	11.0	29.4	24.7	46.4	43.9
Taipei,China	0.7	3.5	0.5	2.2	1.9
South Asia					
Afghanistan	1.1	1.3	1.1	1.9	2.5
Bangladesh	2.9	2.5	2.4	2.5	2.6
Bhutan	30.7	51.7	127.1	229.2	26.8
India	4.3	6.0	5.9	5.9	7.5
Maldives	2.7	2.7	3.3	2.1	2.7
Nepal	11.5	11.1	10.6	9.5	8.6
Pakistan	18.5	12.7	15.2	20.6	27.9
Sri Lanka	16.7	13.2	19.7	25.3	...
Southeast Asia					
Brunei Darussalam	...	...	...	...	...
Cambodia	1.1	1.0	1.0	1.1	1.2
Indonesia	19.8	21.7	34.9	42.7	46.2
Lao People's Dem. Rep.	4.4	4.4	4.3	5.0	...
Malaysia	7.5	10.4	10.3	10.4	10.8
Myanmar	5.6	9.1	2.2	2.2	..
Philippines	9.9	9.9	7.3	7.6	..
Singapore	..	..	..	..	..
Thailand	4.7	3.5	4.2	4.0	4.4
Viet Nam	3.4	3.5	3.5	4.3	..
The Pacific					
Cook Islands	...	...	...	...	...
Fiji	1.2	8.4	1.5	1.7	1.7
Kiribati	3.7	2.8	3.3	2.8	2.8
Marshall Islands	18.6	23.2	9.6	8.8	9.1
Micronesia, Fed. States of	6.3	6.7	5.3	6.7	...
Nauru	...	...	...	...	...
Palau	7.0	5.7	5.1	4.9	4.4
Papua New Guinea	0.3	0.4	0.3	0.3	4.3
Samoa	50.3	0.8	5.3	0.0	0.0
Solomon Islands	3.0	1.3	0.7	...	...
Timor-Leste	0.0	0.0	0.0	0.0	0.1
Tonga	10.1	7.0	7.3	8.4	10.1
Tuvalu	3.9	3.5	0.8	2.4	2.3
Vanuatu	1.4	1.4	−0.6	1.9	1.8

... = data not available.

Asian Development Outlook 2015

Financing Asia's Future Growth

The annual *Asian Development Outlook* provides a comprehensive analysis of economic performance in the past year and offers forecasts for the next 2 years for the 45 economies in Asia and the Pacific that make up developing Asia.

Steady growth in the region is sustained by economic reform at home, soft commodity prices, and reviving demand from the advanced economies. Moderation in the People's Republic of China as it pursues higher-quality growth is balanced by acceleration in Southeast Asia and India, the region's other reforming giant. Risks to the growth outlook include possible capital outflows under higher interest rates expected this year in the United States, an oil price reversal, and deepening recession in the Russian Federation.

This edition makes the case for further developing Asia's financial sector to broaden access for households and firms to affordable finance that can spur investment, innovation, and inclusive growth. The challenge for policy makers is to strengthen the governance of financial institutions to protect stability while exploring the benefits of flexible regulation that promotes inclusive growth.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to the majority of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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