

## COUNTRY SECTIONS

### Major Economies<sup>19</sup>

#### *China*

Policy measures to cool down the economy appear to have had some success, but it is too early to call the end of the investment boom that has become known as “overheating”. GDP growth eased to 9.7 percent year-on-year (y-o-y) in the first half of 2004, slightly down from the 9.9 percent recorded in the last quarter of 2004. Growth has still been mainly driven by investment, although retail sales have also remained buoyant. Looking ahead, we expect GDP growth to ease further, to 9.2 percent for 2004 as a whole, and 7.8 percent in 2005.

Debates continue on the extent and form of “overheating”, the success of the measures to slow down investment, as well as on the appropriateness of relying on administrative measures instead of more market-oriented tools. After peaking in the first quarter, investment growth slowed down following administrative measures that seemed targeted at limiting investments in specific sectors where the authorities saw excess capacity to be building up. Fiscal policy has also contributed to limiting demand pressures, but monetary policy has shown an ambiguous stance. Growth in monetary aggregates and credit has slowed down considerably, in part induced by “window guidance” of the central bank and further tightening of reserve requirements. This despite continued capital inflows, which the authorities largely sterilized. On the other hand, real interest rates have until recently continued to decline as a result of increases in inflation. Indeed, low interest rates and the strong incentives for local governments to boost growth in their region, combined with their reliance on revenues from real estate developments, continue to fuel investment. Moreover, low or negative real deposits rates have started to show their effects on households, who are increasingly seeking alternative investments for deposits in banks.

The new investment policy announced in July aims to increase the role of the market in investment decisions, but the key tool for this—the interest rate—is yet to play its proper role. Banks are not yet using the recently granted (moderate degree of) flexibility in setting interest rates. In addition, the authorities have been reluctant to increase interest rates significantly because of concerns about the impact on financial fragility in the corporate sector, banks’ balance sheets, and capital

inflows. At the same time, underlying inflation pressures remain manageable, which provides support for the authorities usage of measures that seemed targeted at preventing future over-supply in certain sectors rather than at further significantly tightening overall macroeconomic policies. Against this background, the modest increase in interest rates effective October 29 (around 25 basis points) serves mainly as a signal that the authorities would be ready to use the interest rate instrument more forcefully if required on the basis of developments on inflation or deposits.

Nonetheless, looking ahead, with underlying inflationary pressures projected to remain limited, drastic macroeconomic measures to cool down the economy are unlikely to be imminent, and if the economy lands at all, it is likely to be a soft landing this time around. The rapid deceleration in credit in recent months, if continued, could already cause a larger than expected slowdown, although it is too early to tell whether the credit growth decline is largely due to lower demand because of the impact of the administrative measures, or whether banks have become more reluctant to lend. Nonetheless, fears of a hard landing remain limited in light of continued strong demand indicators in recent months.

Growth in agricultural production has picked up and rural incomes increased significantly—due to grain price increases and, to some extent, the government’s “pro-rural” policies. Plans announced to expand the social security system more fully to rural areas may help to reduce the remaining large gap between rural and urban living standards, although the feasibility of the plans at this stage of China’s development remains to be seen.

External developments remained favorable. Production capacity has expanded significantly due to the recent investment boom, and this allowed exports (in US\$) to grow by 35 percent (y-o-y) in the first 9 months of 2004. Driven by the buoyant domestic demand, imports grew 38 percent in this period. With a small current account surplus and a significant surplus on the capital account, China continued to increase its foreign exchange reserves—by US\$ 80 billion to US\$ 483 billion in end-July 2004.

#### *Indonesia*

The successful and peaceful election and political transition represent an important step in the consolidation of Indonesia’s democracy. In the run-off election September 20<sup>th</sup>, Susilo Bambang Yudhoyono (SBY), former coordinating minister for security and political affairs, was elected as the next president, with his term extending to 2009. The next few months are crucial to Indonesia’s medium-term economic picture. A new

<sup>19</sup> More detailed individual Country Briefs for the major economies can be found at the World Bank website: <http://www.worldbank.org/eapupdate/>

economic policy package and early implementation steps by the new government would draw attention from investors and markets. Currently there are signs of investment recovery and the external economic environment is supportive. Together with high capacity utilization – serving as a proxy for investment demand - a credible economic policy package and its implementation are likely to be rewarded by an acceleration in investment. The World Bank's forecast for GDP growth is now 4.9 percent in 2004 and 5.4 percent in 2005<sup>20</sup>.

During the first half of 2004, the economy grew by 4.7 percent (yoy). The good news is that investment grew by 8.3 percent, much higher than 0.4 percent in the second half of 2003. Other indicators also signal a recovery in investment. Capital goods imports for the period January-September increased by 35.3 percent (yoy) and the number of investment approvals is also on the rise in 2004. However, these numbers start from a low base in 2003 and sustained increase in investment will require continued improvement in the investment climate. Employment also rebounded. Recent quarterly data indicate that the open unemployment rate declined from 8.5 percent in August 2003 to 7.4 percent in May 2005, although a high 65 percent of the employed are in the informal sector<sup>21</sup>. Market sentiment is strong. The bombing at the Australian embassy in September had very little impact on markets. The stock and foreign exchange markets recovered to the pre-bombing level on the following day but renewed concerns about security. Fiscal and external risk indicators continued to improve. The government debt to GDP ratio declined from 81 percent at end-2000 to 53 percent in June 2004. The external debt ratio also declined from 86 percent at end-2000 to 53 percent by June 2004. These positive political and economic developments were reflected in rating upgrades and Fitch recently upgraded their rating outlook from 'stable' to 'positive'.

Despite these signs of investment recovery, Indonesia's investment climate remains weak, especially as compared to regional competitors. The World Bank's Doing Business Survey 2005 shows, for example, that it takes 151 days in Indonesia to start a business, much higher than regional competitors such as Thailand (33 days) and Malaysia (30 days).

On the fiscal front, the revised 2004 budget (using 1993 base GDP) estimates that fuel subsidies will

increase from a budgeted Rp.15 trillion (0.7 percent of GDP) to Rp.59 trillion (3 percent of GDP) at \$36/bbl. At this level of expenditure the fuel subsidy is close to total development expenditures (Rp.72 trillion or 3.2 percent of GDP). While increased revenues will hold the overall deficit almost unchanged (up from 1.2 to 1.3 percent of GDP) from an efficiency point of view, reducing the fuel subsidy is among the most important challenges for the new government.

The White Paper package of policy measures announced in September 2003 combined with an adequate implementation record and monitoring mechanism contributed to bridging the "policy credibility gap" at the end of the IMF program. As of September 2004, the government successfully completed most of its commitments under the White Paper though performance varies by area. In particular progress on 'increasing investment, exports and employment' lagged behind macroeconomic stability and financial sector restructuring. The investment, export and employment section included structural issues in legal reform and employment that have proved difficult. However there are a number of policy successes including: the enactment of the State Audit Law and the amendment of the Bankruptcy Law, Law No.22/1999 on decentralization and No.25/1999 on fiscal decentralization. The new government will need a new economic policy package that should focus on consolidating the achievements to date, and especially on improving the investment climate.

### **Korea**

Buoyed by strong export demand, Korea's economy grew 5.3 percent year-on-year in the first quarter and 5.5 percent in the second quarter of 2004. The economy is clearly on a rebound from last year's underperformance and is expected to grow 4.9 percent this year and 4.4 percent next year. Exports has been exceptionally strong, rising 23-27 percent in real terms in each of the past three quarters. High-tech and IT-related products, which now account for a third of the country's export receipts, have generated much of the trade surplus with cell phones and flat-panel displays gaining in importance ahead of semiconductors. Equally strong were shipments of steel, metals and chemicals, particularly to China, which last year outpaced the U.S. as Korea's main export market.

Domestic demand however has been relatively weak and policy-makers continue to ease macroeconomic policies with the aim of generating broader-based growth. In August, the central bank cut interest rates by 25 basis points to a historic low of 3.5 percent in an attempt to encourage domestic spending. The authorities also front-loaded fiscal expenditures into the first half of the year, enacting a supplemental budget amounting to about 0.5 percent of GDP. For next year, the authorities are reportedly targeting a deficit of 1.25 percent of GDP,

<sup>20</sup> Growth forecast is revised up from 4.5 percent to 4.9 percent for 2004 and 5 percent to 5.4 percent for 2005. In addition to favorable recent political and economic developments, change in the GDP base year affects the revision.

<sup>21</sup> Quarterly labor statistics are drawn from a much smaller sample size than the annual labor force survey and this trend will need to be confirmed from the annual numbers from the August sample.

consisting of a package of tax cuts, including a one percentage point reduction in all income tax rates and extra spending specially directed at social programs.

A recovery in domestic demand however will clearly depend on whether household spending picks up. Household spending has been depressed over the past one and a half years, following a rapid expansion of credit card lending during 2000-2002, which in turn resulted in a substantial increase in household debt and household loan delinquencies. To address the household debt problems, the authorities and financial institutions have established a number of channels that offer varying terms depending on the size of debts and whether the debts are to single or multiple creditors. The Ministry of Finance and Economy has also announced plans to step up the financial supervision of credit card issuers and to implement an early warning system in the credit card loan sector.

Korea's large corporations, which have so far used their profits to further de-leverage their balance sheets and to invest in abroad, particularly in China, now appear to also be increasing their domestic investments. Investment in machinery and equipment, which declined for four consecutive quarters, picked up in the second quarter. Overall, Korea's non-financial corporate sector remains in good health on average, having lowered leverage ratios to international norms and strengthened profit margins. The exception to the general pattern of corporate health is in the SME sector. SME finances have weakened after a period of strong credit growth, although so far, there has been little increase in the SME delinquency ratio.

Korea's banking sector remains healthy. Indeed, with the recent economic rebound banks' net income rose four-fold in the first half of this year. Potential bank losses on SME loans remain limited, both because half of the loans are collateralized and government guarantees cover one fifth of SME credits, and because most SMEs deal with only one or two creditors which facilitates any debt restructuring. Following capital infusions, the average CAR of credit card companies has also improved, from negative last year to 7 percent this year.

Based on our expectations of the external environment—including higher oil prices, a cooling of the global IT sector, and a slowdown in China's growth—we are projecting a lower growth rate of 4.4 percent for Korea next year. While lower than consensus forecast at the beginning of this year, the projected growth rate is still higher than those of most OECD countries. Over the longer-run, initiatives to place the SME sector into a more competitive footing will help sustain stronger growth, as will continuing efforts to improve corporate governance particularly in Korea's large corporations. Equally important will be the initiatives announced recently to enhance productivity of the Korean economy by opening

up segments of the services sector to increased international competition.

### **Malaysia**

The Malaysian economy continued to strengthen through the first half of 2004, and real GDP is on course to grow by 7 percent in 2004, and 6 percent in 2005. Real GDP increased by 8 percent in Q2 2004, driven by sustained expansions in manufacturing output and services, mirrored by a prolonged cyclical upswing in both domestic private and external demand, and continued prudent domestic financial management.

Domestic demand was driven by robust private consumption and a sharp pick-up in private investment, which the authorities estimate at 14¾ percent. Public consumption grew by 7.1 percent, while public investment declined by 28 percent in line with the 2½ percentage points of GDP contraction budgeted for 2004.<sup>22</sup>

Foreign direct investment inflows were sustained and channeled mainly to oil and gas, manufacturing, and services sectors. External demand was boosted by the synchronized economic recoveries in the U.S.A., Japan, and Europe, stellar growth in China, expanding intra-regional trade, and robust international commodity prices. The overall global outlook for 2004 remains favorable, but the combined effects of some moderation in China's growth, higher oil prices on the global economy, and the anticipated decline in the demand for electric and electronic (E&E) products towards the end of the year will act to moderate growth in the second half of 2004 and in 2005.

Strong export performance marks 2004. Exports of chemical, metal, and rubber products performed well following higher volume sales in the region, while sales of agricultural commodities expanded strongly from higher earnings of palm oil and natural rubber. Crude petroleum exports benefited from the rise in world prices, while sales of liquefied natural gas increased sharply from higher regional demand. Imports rose by 32 percent through end-June, reflecting higher purchases of intermediate and capital goods, and remained strong through August, boosted by higher imports of consumer goods stemming from stronger private consumption. Tourist arrivals surged by 38.4 percent in Q1, but declined slightly in Q2.

The overall balance of payments remained in surplus and net international reserves rose further, to \$56.9 billion by end-September, equivalent to 7½ months of retained imports and 5 times short-term external debt. Total external debt rose slightly to \$51 billion in Q2, equivalent to 49 percent of GNP.

<sup>22</sup> Gross development expenditure of the Federal Government.

Consumer price inflation rose by 1.4 percent in August, reflecting higher prices for beverages and tobacco, rent, fuel, and power, but the overall increase was restrained by the limited increases in Government-controlled prices. Core inflation remained subdued.

To bolster domestic private sector-led growth, the Government is combining gradual fiscal consolidation with a prudent but accommodative monetary policy. The overall budget deficit for 2004 is projected to decline to 4½ percent of GDP, from 5¼ percent of GDP the year before, and the 2005 Budget envisages a further decline to 3¾ percent of GDP. The monetary stance of Bank Negara Malaysia (BNM) remains accommodative but consistent with the exchange rate peg to the U.S. dollar. In a further move to liberalize lending rates, in April the BNM introduced a new overnight policy interest rate (OPR) to replace the three-month intervention rate. With ample liquidity, financial institutions have been able to lower their lending rates, and this has helped fuel consumer spending and business investment.

The financial sector continues to be strengthened. Around 31 of the 119 policy recommendations of the Financial Sector Master Plan have been fully implemented, while another 24 are being implemented on a continuous basis. Recent measures include strengthening guidelines for corporate governance, improving the prudential framework by adopting new standards on asset-backed securities and incorporation of market risk, allowing intra-group mergers of commercial banks and finance companies, and improving consumer awareness and protection. The 2005 Budget also includes measures to open stock brokering activities to foreigners, and allow the entry of global fund managers and full foreign ownership of venture capital companies.

The performance of commercial banks continued to improve through mid-2004. Risk-weighted capital of banks increased to a healthy 13.8 percent of assets, while net non-performing loans of commercial banks declined to 7.7 percent of total loans. Returns on equity and assets rose steadily to 18.7 percent and 1.6 percent, respectively, while earnings per share have increased for most banks. The provision of Islamic banking services also continued to expand.

In the corporate sector, recent reforms under the Capital Markets Master Plan include the requirement that directors report on internal controls, mandatory disclosure of compliance with the Malaysian Code on Corporate Governance, and the adoption of international accounting standards and best practices on internal audit functions. Also, the Securities Commission now has more supervisory and enforcement capabilities, including greater power to impose civil penalties.

Meanwhile, leverage, cash flow, and profitability indicators of the corporate sector have improved overall. Debt-equity ratios have declined, as companies have

either restructured their debts or settled them in an environment of declining interest rates. Interest coverage ratios, and returns on equity and assets, have improved, although not to their pre-crisis levels. However, performance of the Malaysian stock exchange was disappointing. Though the exchange continued to deepen during 2004, with the number of listed companies rising to 946 by early October, the gains of composite index in 2003 and early 2004 were among the lowest in the region's top ten markets. Encouraged by the low interest rate environment, higher funding from private debt securities more than offset the decline in equity finance.

With regard to Government-linked companies (GLC), thirty of the total 40 GLC are slated for restructuring. Also, the Government has launched Key Performance Indicators (KPI) and Performance-Linked Compensation (PLC) programs, whereby management is now fully accountable for performance and remunerated accordingly. All GLC will be required to fully adopt KPI and PLC programs by 2005, and the KPI concept is being extended to public agencies. Further governance-related improvements are to be implemented at the corporate level of public agencies, including reducing the size of the individual boards, removing regulators from the boards and replacing them with independent directors, and introducing new CEOs and professional management.

To guard against external vulnerabilities, the Government is promoting domestic private sector-led growth, while encouraging FDI in selected strategic sectors. In addition to financial and corporate sector reforms, and fiscal consolidation, the Government aims to further bolster private sector development through fiscal incentives, improved governance, sequenced liberalization, and strengthening tertiary education to improve educational outcomes and the technological capacity of firms.

The Government's reform agenda is expected to include measures to further improve the investment climate for domestic and foreign investors in both manufacturing and services sectors. This will include reductions in the regulatory burden facing firms, the strengthening of professional and managerial skills of its workers, promoting innovations in firms and opening up the services sector to greater foreign investment. Greater emphasis on total factor productivity growth is sought in the rationalization and simplification of fiscal incentives.

### *Philippines*

Economic growth strengthened in the first half of 2004, but the pace of growth is likely to slow given the increase in oil prices, rising domestic interest rates and the prospect of higher international interest rates, large public sector deficits and external financing requirements amidst uncertain prospects for fiscal adjustment. Risks to the external environment add to the urgency of fiscal adjustment.

Real GDP growth increased to 6.3 percent in the first half of 2004 from 5.3 percent in calendar 2003, driven primarily by private consumption growth of 5.9 percent. Investment grew by 9.4 percent during the first half, though its relatively low share in GDP (less than 20 percent) limited its contribution to overall GDP growth. Inflation through September 2004 (y/y) jumped to 6.9 percent after averaging 3 percent in 2003 primarily reflecting rising petroleum product prices. Unemployment, while still high at 11.7 percent as of July 2004, fell by about a percentage point from July 2003 as 1.2 million net new jobs were generated over the period. Most of the new jobs created were in the farm and services sectors, whereas manufacturing jobs barely grew.

Weaknesses in public finances remain of serious concern as public debt has grown rapidly in recent years—nonfinancial public sector debt exceeds 100 percent of GDP and contingent liabilities are also significant. The fiscal program for 2004 targeted the consolidated public sector deficit (CPSD) to increase from 5.5 percent of GDP in 2003 to 6.7 percent in 2004 reflecting a rising deficit within state-owned enterprises (GOCCs), and notwithstanding the targeted decline in the national government deficit to 4.2 percent of GDP from 4.6 percent in 2003. The increased GOCC deficit in turn was expected to be driven by a sharply higher deficit within the National Power Corporation (NPC). Developments to date indicate that CPSD/GDP ratio may in fact remain relatively stable in 2004 with the national government deficit reduction on target thus far and the GOCC deficit below target as of early 2004. Nevertheless, it remains vital to move expeditiously to reduce the public sector deficit given the aforementioned risks to the external environment and the prospect of further downgrades by international ratings agencies absent a more vigorous effort to reduce the public sector deficit.

The Government of President Gloria Macapagal-Arroyo—who was reelected as President in May for a six year term beginning in July—has proposed a series of legislative measures to increase tax revenue, but the extent to which these measures will be enacted, and at what pace, remains uncertain. The Energy Regulatory Commission (ERC) recently authorized power tariffs to be raised by nearly one peso per kwh, which will reduce but not eliminate the operational losses of the NPC, whose debt and debt servicing burden remains excessive.

Philippine sovereign bond spreads have remained relatively stable in 2004 (about 470 basis points over ten year US Treasury bonds in mid-October); the \$1 billion global bond issued by the Government on September 9 was priced at nearly 500 basis points above equivalent US Treasuries. Yield curves for domestic government paper have also risen during the year—though rate increases have lagged the rise in inflation—and one-year T-bill rates as of mid-October stood at nearly 10 percent. The peso depreciated in real effective

terms, falling to a low of P56.5/USD in mid-October before recovering somewhat. Despite ongoing concerns regarding the fiscal outlook, equity prices increased by an average of about 23 percent since the beginning of the year, underpinned by robust earnings growth in the corporate sector through the first half of 2004. Growth in bank lending to the corporate sector remains weak, however—loans grew by less than 1 percent in the first half of the year.

On the external front, the trade deficit narrowed to \$700 million and the current account surplus more than doubled to \$1.9 billion in the first half of 2004 as export growth of nearly 10 percent outpaced import growth. Philippine export growth however lagged the performance of other major economies in the region. Notwithstanding the current account surplus and substantial foreign borrowing through bond issues (primarily to service maturing debt), gross international reserves fell by nearly \$900 million in 2004 through September to \$15.9 billion in part reflecting negative net portfolio and FDI flows in the first half.

Preliminary data from the 2003 Family Income and Expenditure Survey (FIES) indicate that total real family incomes decreased by 4.4 percent between 2000 and 2003 while total real expenditure declined by 1.7 percent. Average incomes and expenditure declined by even more. These declines occurred across the span of income categories, indicating that that poverty may have risen during this period. There are, however, inconsistencies between the income and expenditure figures from the FIES and the national account data which indicate real GDP growth of about 11 percent during the same period.

### *Thailand*

The Thai economy continues to perform robustly though estimated growth of 6.4 percent this year, is lower than last year. Higher oil prices have reduced growth but not as much as the actual rise in world prices would suggest; the domestic retail price of diesel has not been raised this year. Growth of private consumption is down relative to last year due in part to higher retail prices of gasoline for cars, and in part to slower growth in rural incomes. Growth of private investment has slowed too relative to last year, especially foreign direct investment, probably due to volatile oil prices and pre-election uncertainties. Public investment, however, has risen significantly this year, in sharp contrast to the previous five years of continuous retrenchment in public capital formation. Receipts from tourism are up strongly after the slump last year due to Severe Acute Respiratory Syndrome (SARS). Export earnings are growing strongly, though growth in export volumes is down compared to 2003, and the terms of trade will improve by roughly 3.5 percent notwithstanding higher world oil prices.

GDP growth in 2005 is projected to be around 5.8 percent, slower than this year. This is in part due to deferred adjustment of retail prices of diesel and lower world demand for exports. The Government has announced its intention to float the retail price of diesel early next year, which would raise diesel price by more than a third of its current price; this will affect private consumption and private investment. Also, world demand for exports will be lower than 2004 -- including overall growth in import demand from China. Imports on the other hand, are projected to continue growing more rapidly given Government's plans for public investment generally and infrastructure investment particularly.

The macroeconomic situation remains robust, though higher oil prices and rising interest rates are likely to take their toll. Headline inflation will rise to 3 percent in 2004, compared to 1.8 percent last year, largely due to the increases in oil and electricity prices. Projections for 2005 indicate that inflation will rise further to around 4 percent as retail prices of diesel are adjusted fully to reflect world prices. Real interest rates are at their lowest level. Total investment is strong as public investment is increasing rapidly after five-years of retrenchment; private consumption growth, while slower than last year, continues to be an important driver of growth.

External vulnerability to shocks has fallen further. Total external debt has fallen to US\$ 50 billion by July this year (around 31 percent of GDP) – falling from \$52 billion in end-2003 - as the Government continue to prepay loans, including some to the international financial institutions. The current account surplus, though falling will be around 4 percent of GDP in 2004, as trade surpluses narrow further with further pick-up in import demand. External reserves now exceed US\$40 billion, around 4 times the level of short-term external debt. Next year, the current account surplus is expected to decline further given the projected increases in both public and private investment and the resulting rise in imports.

Exports earnings grew by 23 percent in the first 8 months of this year. This growth was made possible by a 16 percent increase in world prices of exports, since export volumes grew by only 6 percent, nearly half the rate in 2003. Three export categories – electrical machinery and parts, non-electrical machinery and parts, vehicles and parts – comprised 44 percent of export earnings this year. In terms of contribution to export growth, the developed country markets (US, Europe & Japan) provided most to the growth in export-earnings, followed by ASEAN; together they accounted for two-thirds of this growth, with China contributing a tenth, significantly lower than last year. Exports to ASEAN grew by 31 percent, twice the rate of last year, while exports to China grew by 24 percent, a third of last-year's rate.

However, export volumes grew slowly at only 6 percent, half the rate in 2003. Clearly negative growth in volumes of agricultural and fishery exports contributed, but most of it is accounted for by a slowdown in volume-growth of manufactured exports. Within manufactures, volume growth of resource-based products (including processed foods) and high technology products (like machinery and parts) have fallen relative to last year. With rising capacity-utilization, supply-side constraints are becoming major influences on Thailand's export performance. Future private investment in manufacturing will be a key determinant of Thailand's ability to sustain high export growth.

This performance should be viewed against the remarkable Thai export performance since 1999. Exports have grown rapidly in every year except 2001, thereby raising the export share in Thailand's GDP significantly (relative to pre-crisis years) and Thailand's export share in world market. This success has been accompanied by a significant shift in the composition of exports towards higher value-added items like electrical/non-electrical machinery and parts as well as vehicle and parts. This has been driven in part by higher foreign direct investment inflows in the post-crisis period, encouraged no doubt by the liberalization of foreign entry soon after the crisis, and by the further rationalization of the import regime.

Private investment grew by 16 percent in last 8 months, a slower rate than last year. Most of this is probably accounted for by little or no growth in foreign direct investment flows. This maybe due to the uncertainties arising from higher world oil prices, the nature of adjustment in Thai retail prices of petroleum products and of course, the impending elections. However, two positive aspects of this year's growth in private investment are worth noting. First, there is a significant increase in Board of Investment (BOI) approvals of private investment applications, including FDI, suggesting that lack of FDI growth is likely to be a 'blip' rather than a trend. Second, despite the above uncertainties, private domestic investment growth remains particularly robust, a good sign for the future.

Nevertheless, some private investment characteristics suggest fragility. First, while recovery continues, private investment as a share of GDP is still only 17 percent, significantly lower than the annual average of the 1980s. Second, residential construction investment continue is still contributing around a quarter of the annual increase in private investment; additions to manufacturing capacity supported in part by the low real interest rates. Third, given that capacity in manufacturing appears to be constraining export-volume growth, even a temporary slowdown in private investment growth is likely to slow export volumes next year.

Banks increased corporate lending is likely to sustain increasing private investment. There is a rise in banks lending to businesses this year relative to last year,

growing at an annualized rate of 14 percent over last year. These loans appear to be going mainly to tradable sectors, and relatively large firms.

Public investment will grow this year for the first time since the crisis. After retrenchment for the past 5 years, public investment grew by more than 7 percent this year. This growth has come mainly in the form of investments by local governments, and to a smaller extent by the center. With the Cabinet approval of large infrastructure projects, growth in public investment next year is likely to be much higher than 2004. This continuing rise in public investment will thus become an important driver of growth in future.

The Government is considering a large five-year program of public infrastructure investments. The financing mechanisms are still not clear. The final size of the program will depend on how the financing constraint is addressed. Nevertheless, a large investment program will have several macroeconomic implications, one of which relate to the evolution of current account balance; it is very likely that Thailand will generate a current account deficit sooner than would happen on current trends.

But will these investments “crowd-in” private investment and promote sustained growth. This will depend on whether public infrastructure investments will enhance competitiveness of the Thai economy, thereby raising rates of return on private investment. This can happen if the Government addresses three issues. First, public infrastructure investment program should be embedded in an overarching strategy for delivering better quality and more cost-effective infrastructure services aimed at improving competitiveness. Second, these investments will have to be accompanied by policy changes that will promote inter-modal and logistics efficiency and ensure better mix of public-private investments in infrastructure and logistics. This means that current restrictions on private entry and operation will have to be relaxed. Third, public organizational arrangements – in Bangkok and in the provinces – will have to be developed in a way that increases operational efficiency of public infrastructure investments.

Addressing the existing restrictions on the services sector will be important in this context. In particular this relates to the regulatory framework for telecommunication, ports, air-travel, financial services, logistics services and so on. Modifications in these regulatory frameworks that help to increase competition and improve efficiency, but also promote growth in these sectors and enhance competitiveness of Thailand.

The 2004 Global Competitiveness Report shows that other countries are moving ahead in competitiveness. Thailand’s rank in overall “Growth Competitiveness” has slipped from 32 in 2003 to 34 in 2004. This is notwithstanding the significant improvement in ranking on macroeconomic environment. The largest declines in ranking are in respect of public institutions (by 7 places)

and in technology (by 4 places), largely because other countries have moved ahead.

Household consumption growth slowed relative to last year, but continues to be an important growth driver. Household consumption in the first half of this year grew by 5.8 percent, a slow down from 6.2 percent in the same period last year, and will likely slow down in the second half when oil prices has rises sharply and consumer confidence declines. Continued growths in consumer credits and farm incomes this year and supportive government measures, will support consumption growth, helping to cushion some of the adverse impacts of the oil price rise. Consumption of services accounts for more than half of consumption growth, at least for the first half of the year, compared to only a quarter last year. This is primarily because the rebound of tourism-related services such as hotels and restaurants and transportation services from their slump last year.

While banks’ exposure to households have risen further, household debts look manageable. Thailand’s household debt to disposable income has been rising since 2002 and is close to 60 percent this year. This has been accompanied by rising household debt for all income groups; the lowest income group and the highest have the highest debt as a share of household income, making them vulnerable to a rise in interest rates.

Positive developments are seen in the financial and corporate sector, though more remains to be done. In the financial sector, bank supervision was strengthened by the Bank of Thailand (BOT) and prudential regulation on loan classification and enforcement has been tightened. Aggressive loan expansion by a large state commercial bank has slowed down following the BOT’s intervention. In the corporate sector, the Parliament has passed partial amendments to the Bankruptcy Act, which are aimed at ameliorating the legal framework for individual bankruptcies. Nevertheless, NPLs are still in double-digits and measures to expedite NPL resolution has been delayed and still awaits the enactment of amendment to AMC law.

Implementation of reforms in 2004 continue, but at a relatively slow pace. There has been further rationalization of import tariffs and signing of FTAs that are increasing competition for producers and opening up better export opportunities. Similarly, changes in public sector governance in respect of public financial management and public administration streamlining continue. There have been fewer changes in respect of private investment regulations while the changes in legal framework formulated for the financial sector, secured transactions, collateral and so on, still remain to be enacted and implemented.

## **Vietnam**

GDP growth in the third quarter, at 8.0 percent, lifted the growth rate for the first nine months of 2004 to 7.4 percent year on year (y-o-y). Growth is expected to be maintained at 7-7.5 percent for the rest of the year. The main macroeconomic development in the last 9 months has been the sharp rise in prices, generating considerable debate among policy makers on response strategies. The high international price of oil, which on the one hand has been an important factor in the recent upsurge in inflation, has on the other hand boosted export receipts and government revenue.

The industrial sector grew by 10.6 percent in the first 9 months of 2004 with manufacturing rising by 9.3 percent. The construction sector recorded a growth of 8.1 percent in the first nine months with a pick up in the second and third quarters helped by demand injections from the government's investment program. Growth in this sector has however been dampened by the high price of steel. Agricultural growth stood at 2.3 percent in the first 9 months of 2004, representing a recovery in later months. The poultry and livestock sub-sector, which represents around 7 percent of GDP, was impacted by the avian influenza outbreak and witnessed a reduction in value added of 6.1 percent y-o-y in the first quarter, and 2.2 percent y-o-y in the first six months. This represents the net effect of a sharp reduction in poultry output being compensated to some extent by an increase in substitute livestock products. The impact on the tourism sector, other than in the month of March, has not been significant. Tourist arrivals have increased by 45 percent in 2004 compared with the first 9 months of 2003, partly a rebound from the effects of SARS. In recent months there have been some new but isolated outbreaks of avian influenza. While these have been marginal, this is an area that would require a high level of vigilance by the authorities.

Domestic consumption and investment have been strong. The retail sales index rose by 18.3 percent y-o-y in the first 9 months of 2004. Investment, in current prices, rose 19 percent in the first 9 months of 2004 representing 36.2 percent of GDP. On the external front, exports grew by 27 percent y-o-y in value terms during the first 9 months of the year. Crude oil exports, benefiting largely from high international prices, rose 43 percent in value terms. Garment exports slowed considerably to under 18 percent (compared to 53 percent in the same period of 2003) being constrained by quota limits in the US market. Exports of shrimp were adversely impacted by anti-dumping proceedings by the US. As a result, in the first nine months, exports of sea products remained flat overall, but declined by over 20 percent to the US. An emerging export this year has been wood furniture. These exports may in effect be substituting exports from China which have been slapped with anti-dumping proceedings. Faced with an uncertain market situation in the US, exporters have looked to diversify

into the EU and Japanese markets with some initial success. This trend will be aided by garment quota increases in the EU market and improved food safety standards adopted by Vietnamese exporters.

With the expiration of the MFA in 2005, Vietnam will likely face tougher competition in international markets. This is because Vietnam, not currently a WTO member, will continue to face import quotas. As a counter, the government is seeking to negotiate garment quota increases in EU and US markets while producers are starting to focus on non-quota products. Another area where the government would need to act relates to reducing the transaction costs in quota allocation as exporters face stiffer competition from quota-free countries. On the positive side, buyers appear keen to have diversified sources of supply and would retain Vietnam as an established source. A key factor would be the signals on WTO membership: if these remain strong then it will be a solid incentive for buyers to not re-source away from Vietnam.

Import growth at 21 percent in the first nine months equaled the pace in the same period last year. The trade deficit in the first nine months is estimated at 4.3 percent of GDP compared with 6.6 percent in the same period of 2003. With a continuation of recent trends, the current account deficit which stood at 4.7 of GDP in 2003 will likely narrow this year as remittances have remained strong. On the financing side ODA disbursements will continue to be the main source. FDI disbursements, according to official data which employ a definition different from the balance-of-payments one, have risen 16 percent y-o-y in the first half of 2004. Gross foreign exchange reserves stood at \$6.3 billion (2.6 months of imports of goods and services). During 2003 reserves were boosted as commercial banks moved funds from off-shore deposits on-shore. This trend has slowed in 2004.

Budgetary revenues remained robust in the first 9 months of 2004 fulfilling 79 percent of the annual plan and expenditures remained on target. Government revenues have benefited from higher non-tax sources such as the profits of oil-producing state owned enterprises. However, import-export revenues are reported to have been lower than targeted. The lower than expected collections from trade taxes can be explained in terms of removal of tariffs on items such as oil products and steel in order to cushion the price impact on consumers; sharply lower imports of high tariff items such as motorcars and their component parts; and only in part due to the ongoing tariff reductions under the ASEAN Free Trade Area (AFTA). The government's target deficit of 2.2 percent of GDP for 2004 remains attainable.

By September, 2004 the CPI had increased by 10 percent y-o-y, a significant rise compared with the January, 2004 figure of 3.4 percent. The price of food, which accounts for nearly half the consumption basket had risen by 19 percent y-o-y. The rise in the price of

non-food items was lower, at 4 percent. This rise in prices has been mainly supply-driven stemming from the avian influenza outbreak, and higher international prices of key commodities such as oil, fertilizer and steel. The avian influenza outbreak resulted in a rise in prices of poultry products, with knock-on effects on prices of substitute meat products. Meanwhile, the price of fertilizer, a major input, has risen 46 percent. However, there are signs that a deceleration in inflation is already underway. The average month-on-month rise in CPI during June-September was 0.6 percent compared with over 1.5 percent in earlier months.

Credit growth rose sharply from 25 percent in 2003 to around 35 percent y-o-y in June 2004, but this should not be seen as the factor behind inflation as the major rise in credit occurred after inflation had shown signs of abating. The State Bank of Vietnam (SBV) expects credit growth to slow in the coming months and anticipates meeting its target of 25 percent for 2004. In order to control credit growth SBV has increased the reserve requirement for banks from 2 to 5 percent (effective from July 1, 2004). Slowing credit growth at this stage is better viewed as an attempt to control the quality of lending rather than reducing aggregate demand. The credit growth from commercial banks has been somewhat offset by slower disbursements by the Development Assistance Fund (DAF) which, in the first six months, is reported to have met only 20 percent of its disbursement target for 2004. This is likely related to the new government decree regulating policy lending which introduced stricter criteria for loan approvals.

GDP growth is expected to remain around 7-7.5 percent in 2005, with domestic demand playing a more important role than in 2004. Export growth is likely to slow as oil prices are expected to soften, and quota limits constrain garment exports. Export growth would thus depend on Vietnam's success in negotiating quota increases for garment exports. Investment from all sources, state, non-state, and the foreign invested sector is expected to remain strong. The current account deficit is anticipated to be around 4.6 percent of GDP. Inflation is expected to decline to 5-6 percent by the middle of next year.

## Smaller Economies

### *Cambodia*

Cambodia's economic growth has been slowing starting last year. Real GDP grew by 5.2 percent in 2003, compared to the annual average of around 7 percent in the 1999-2002 period, largely due to a jump in agricultural growth resulting from favorable weather conditions. Real GDP growth is projected to slow to 4.3 percent in 2004 as agricultural slows relative to 2003 and structural

weaknesses constrain non-agricultural growth. Next year, the termination of the Multi-Fiber Agreement (MFA) is expected to lead to negative growth in the garments sector; given the importance of garments to the manufacturing sector, this decline will reduce real GDP growth to around 2.4 percent in 2005. Growth in services and construction are also expected to slow, but the impact will likely be somewhat offset by the tourism sector, which is expected to grow by 15 percent. Reductions in overall incidence of poverty remain limited.

Inflation is expected to rise somewhat relative to the low rate of 0.5 percent in 2003, but it is projected to remain well below 5 percent in 2004 and 2005 if current monetary and fiscal policies are maintained. Monetary and fiscal policies have been broadly stable. Prudent fiscal policy has been key to ensuring price stability in Cambodia's highly dollarized economy. Fiscal revenue is expected to recover in 2004 after falling in 2003. The revenue-to-GDP ratio is expected to rise to 11.9 percent in 2004 from 10.4 percent in 2003, reflecting increases in both tax and non-tax revenues. However, Cambodia's revenue effort is one of the lowest in the region and compares quite unfavorably to other low income agricultural economies. With implementation of tax policy and administration reform in the Tax and Customs and Excise Departments, Cambodia's medium term fiscal position looks to be favorable. Expenditure will be limited to 18.0 percent of GDP in 2004, and is projected to rise very slowly thereafter. The projected overall budget deficit of 6.1 percent of GDP in 2004 is expected to decline steadily over the medium term, with the deficit continuing to be offset by external financing. External developments have been on track with continued expansion of trade, a stable exchange rate, and rising gross official reserves (equivalent to 3.0 months of imports in 2004).

The ratification of membership to the World Trade Organization (WTO) membership was a major achievement for Cambodia, though overall progress on structural reform—in particular governance reform—remained lackluster in 2003 and in 2004, in part because of the elections and the difficulty of forming a government. The new government – formed in July 2004 – has announced a “Rectangular Strategy,” which puts governance at the core and highlights the need for creating a more favorable private sector environment. This promising announcement has also been accompanied by a process for formulating a comprehensive public financial management reform program and a private sector action plan. It is hoped that these will translate into the implementation of reform measures soon, that will help to increase economic confidence and begin reversing the decline in economic growth.

### *Fiji*

Political tensions have persisted in Fiji with ongoing discussions between the government and

opposition about the composition of the Cabinet. In mid-2003 the Fiji Supreme Court ordered the Prime Minister to include the Fiji Labour Party (FLP) in his Cabinet under the power sharing provisions of the Constitution. In response, the Prime Minister announced that Cabinet would simply be expanded to accommodate the required number of FLP representatives. However, disputes have arisen as to the precise number of FLP representatives required under the Constitution, whether the leader of the FLP is entitled to a position in Cabinet, and whether there is any restriction on the significance of Cabinet posts offered to members of the FLP. This issue may not be fully resolved until the next election due in September 2006.

Court cases in 2004 relating to the 2000 coup resulted in Fiji's Vice President, Ratu Jope Seniloli, along with four other prominent Fijians, being found guilty of taking an unlawful oath at the height of the May 2000 political uprising and sentenced to four years jail. Agitation for pardons began almost immediately.

Despite these tensions, the economy is estimated to have grown by 4.8 per cent in 2003; the 2004 forecast of 4.7 per cent growth is due to continuing strength in building and construction, wholesale and retail trade, restaurant and hotel sectors. However, the severe floods in April and June will have reduced output of sugar cane and food crops. Inflation has risen marginally to 2.9 per cent in the year to August 2004, and the year-end 2004 forecast for inflation is 3.5 per cent.

Tourism, Fiji's main foreign exchange earner, continues to grow. Visitor arrivals rose by 17 per cent in the year to August 2004. The garment industry, the second biggest foreign-exchange earner, has seen a marginal decline in the past five months, although on a positive note Australia has extended its preferential trade agreement for another seven years. Sugar production through August increased by 7 per cent in 2004 over the comparable period last season. However, problems of expiring land leases, poor mill performance, incidences of cane burning and cane transportation problems will need to be resolved to prevent expected declines in future years. Moreover, the government-owned Fiji Sugar Corporation is alarmed about the possible ramifications of a WTO ruling in August on the preferential treatment given by the EU to Fiji and some other sugarcane producing countries, but as yet it is unclear whether this will affect Fiji's preferential access to the EU sugar market.

The fiscal deficit is estimated to be 6.4 per cent of GDP for 2003, almost 1 percentage point higher than budgeted, partly as a result of unanticipated spending pressures that arose during the year from Cyclone Ami. The failure of privatization receipts to materialize added to the budgetary pressures. As a result of recent budget deficits, total public sector debt increased to almost 50 per cent of

GDP in 2003, higher than the government's medium-term target of 40 per cent by 2005.

### **Lao PDR**

Real GDP grew by 5.3 percent in 2003, slightly lower than in 2001 and 2002, but is expected to reach nearly 6 percent in 2004. This strengthening of growth performance is due to higher private and public investment, some recovery in tourism, and robust export performance fuelled by growth in China, Thailand and Vietnam. Though world growth and regional growth is projected to slow down in 2005 relative to 2004, GDP growth in Lao PDR is likely to exceed that of 2004, mainly due to a projected jump in foreign investments in mining and hydro-power, with continued good export performance and stable agricultural and manufacturing growth. Poverty reduction is projected to continue. Inflation is expected to fall from the high of 12.6 percent at end-2003 to below 10 percent in 2004 and 2005, as long as fiscal consolidation is continued.

The fiscal situation, though improving, remains fragile. This is largely because the share of government revenue in GDP has been stagnating for several years, while the pressure for increased spending continues. These are manifest in the pressures to increase the modest salaries and benefits of public servants, as well as to raise non-wage recurrent expenditures. The Government has held the line on spending increases for the last three quarters and achieved the higher tax-collection targets. As a result inflation has continued to fall in 2004. The challenge is to sustain fiscal prudence and maintain inflation at single-digit levels.

Since 2001, the Government has been implementing a program of structural reform, together with relatively successful macro-stabilization. The latter has focused mainly in the areas of public expenditures, state owned enterprises (SOEs), the financial sector, private sector development and regional trade. These efforts were sustained in 2004, though at an uneven pace. On trade, annual reductions in AFTA tariffs and in expansion of inclusion list have also continued. On SOE reform, detailed time-bound programs of restructuring-actions for Lao Airlines, Nam Papa Lao, Pharmaceutical Factory No. 3 and Phudoi were adopted by the Prime Minister in April 2004, and their implementation is underway, albeit at a slower pace than planned. On financial sector reform, amendments to the commercial banking law and issuance of new regulations in respect of concentration and foreign exchange exposure are in process. The restructuring efforts for BCEL (the Foreign Trade Bank) and the Lao Development Bank (latter formed from merger of two state commercial banks) have also been continuing in 2004 with the help of international banking advisors, but non-performing loans in these two banks are coming down more slowly than envisaged, largely due to provincial government's

continuing arrears to private contractors working on government projects. On private sector development, incentives were recently rationalized and the process for integrating the laws on foreign and on domestic investment is being discussed.

### **Mongolia**

In 2003, GDP growth in Mongolia was 5.6 percent, an increase of 1.7 percent from the 3.9 percent growth rate in 2002. This good record resulted partly from the strong expansion in the mining sector, and a favorable external environment. For the first half year of 2004, the real gross industrial output grew at 5.8 percent. This robust growth originates mainly from the mining sector expansion (8.8 percent growth over the first semester) following the increase in copper and gold world market prices and the start of mining exploitation by new foreign investors. Given this favorable environment, GDP is projected to reach 6 percent this year.

During the first semester, signs of inflationary pressure were perceived. As of June 2004, CPI increased by 5.3 percent from the corresponding period of previous year, and by 7 percent from the beginning of the year, respectively. This significant increase in inflation is mainly caused by the increase in the domestic oil price (by 23 percent since the beginning of July) which in turn is due to the increase of prices on the world market and to the Yukos oil company financial crisis, Mongolia's main oil supplier. In addition, an accommodating monetary policy has accompanied the increase in prices. As of June 2004, M1 and M2 increased respectively by 21.9 percent and 45.6 percent, a marked acceleration from the June 2003 figures (11.3 percent and 39 percent respectively). At the end of 2003, public sector debt had reached 118.7 percent of GDP while external public debt was 103 percent of GDP. Most foreign loans (more than 98 percent) are concessional lending, implying a low risk and cost on these liabilities for the Government. Overall, Mongolia's public debt remains manageable, despite a significant increase following the settlement of the Transferable Rubble Russian debt at the end of 2003.

During the first semester, export earnings increased by 40 percent and imports by 33 percent, led by a sustained external demand for copper, gold and textile. Mongolia signed a trade and investment framework agreement with the United States earlier this year, as a first step toward a free-trade agreement. This reflects the concern among countries that have built thriving textile export trade regimes upon a U.S. quota system that will expire at the end of this year. The U.S. is Mongolia's third biggest export market, the bulk of that trade being textiles, and textile exports contribute to 10 percent of annual Mongolia's GDP. Private remittances have increased significantly over the last three years reaching in 2003 10.8 percent of GDP. On the capital account side, FDI and foreign aid and loan remained sustained. Overall, net international reserves in the end of 2003 were US\$

129 millions, a drop from the 2002 figure of US\$ 225.8 millions, reflecting the use of part of the reserves for the settlement of the Russian debt. The floating exchange rate remained stable at the end of June 2004, at 1174 togrog per US dollar.

In 2003, total budget revenue amounted 40.7 percent of GDP, a 4.8 percent increase from 2002, partly due to strong increase in corporate income tax collection (5.1 percent in 2003 versus 3.7 percent of GDP in 2002). In 2003, total budget expenditure and net lending increased to 45.4 percent of GDP from 44.2 percent of GDP in 2002. Government overall deficit decreased in 2003 to 4.7 percent of GDP from 6 percent in 2002 and is projected to be 4 percent in 2004. In end June 2004, total budget revenue collection reported an increase of 43.4 percent compared to June 2003, as a result of a good tax effort. The corporate income tax rate was reduced by 25 percent (from 40 percent in 2003 to 30 percent in 2004) as a step to reduce the tax burden on private sector activities and toward a single income tax system. As of June, government expenditure had increased by an extra 20.1 percent compared to the corresponding period of previous year. Overall, there are indications of a loosening of policies in the run-up of the 2004 elections, including a sharp increase in wages (up to 25 percent) and pensions (up to 30 percent). The implementation of the public expenditure management reform program has shown progress this year, with for instance the adoption in March 2004 of a resolution on the budget planning process in order to make it more explicit and enforceable. However, the impact of the settlement of Russian debt were incorporated in the Medium-Term Budget Framework in Spring 2004, but remains to be reflected in an amended budget for 2004 in the Fall. Finally, the June 2004 elections led to the unexpected result of no clear parliamentary majority, opening the stage to a prolonged period of uncertainty regarding the continuity of the reform program, in particular in the domain of social policies and the overall macroeconomic framework.

### **Papua New Guinea**

*Political Developments.* The government continued to face challenges in the first half of 2004, through opposition efforts to bring about a motion of no-confidence. In apparent response and to ward off further challenges there have been a number of Cabinet reshuffles. At mid-year, Parliament was adjourned until early November 2004.

Implementation of the Enhanced Cooperation Program between Papua New Guinea and Australia commenced in the second half of 2004, following Parliamentary ratification of the underlying treaty. Under this package Australia will support PNG to respond to the long term deterioration in the law and order situation and to strengthen economic management through deployment of about three dozen Australian public servants mainly into line positions in the PNG public service and over 200

police and other legal/judicial personnel to underpin improvements in law and order as well as in areas such as border control. Australia will provide new financing for the police related portion of the program while the other components will be financed out of the existing bilateral aid program.

*Economic Developments.* The nascent economic recovery of 2003, when real GDP expanded an estimated 2.7 percent, is continuing in 2004 and GDP growth is expected to be around 3 percent. A key factor which has contributed to the continued improvement is a tight fiscal stance which has underpinned the restoration of macroeconomic stability. Buoyant global commodity prices, particularly for a number of PNG's key exports—including oil, gold and some agricultural commodities—have also contributed to increases in production as has an improvement in business confidence. The coffee season has commenced early but it is expected that the bumper harvest of 2003 will not be matched in 2004. The economic recovery remains fragile not the least because of supply constraints and resource depletion in the mineral sector.

Expenditure control efforts have been intensified in 2004, while an agenda for improved budget management is being rolled out. As a result a budgetary surplus estimated at 1.5 percent of GDP was achieved over the first half of 2004. While the tight controls are expected to be maintained it is expected that the overall outcome for the year will be a deficit of around 1.5 percent of GDP, in line with the budget plan. This is on account of seasonality in the PNG economy. In addition to the improved expenditure controls, the budget position has also been supported by sharply higher revenues from the mineral sector—principally oil and gold—combined with a sharp reduction in debt servicing costs. Government has taken advantage of the opportunity offered by improved macroeconomic conditions to restructure its domestic debt obligations.

In line with these developments the current account is expected to shift to surplus by year end. The currency has remained stable in 2004, appreciating slightly relative to the U.S. dollar over the first nine months of the year.

The easing of the monetary stance which commenced during the third quarter of 2003, has continued through 2004 and has facilitated a reduction in Treasury bill yields from 16 percent in January 2004 to a little under 5 percent in September 2004. These developments have facilitated an easing of inflation, which was running at an annualized rate of 2 percent at mid year. External reserves have continued to accumulate during 2003, with gross external reserves increasing by about US\$200 million during the year to September when they stood at just over US\$600 million, equivalent to more than 6 months of non-mineral imports.

## **Solomon Islands**

The restoration of law and order, underpinned by the intervention of the Regional Assistance Mission to Solomon Islands in July 2003 has been effectively maintained and permitted the scaling back of the military component. Technical support continues, however, through advisors and placement in-line positions, in economic and central agencies and the legal and judicial system. Improvements in security have boosted public confidence and reinvigorated formal business activity, particularly in Honiara.

The government is considering adoption of a new constitution based on a federal system of government, with a significant number of political, financial and legal powers transferred to state governments. Although a bill may be ready to be tabled in Parliament by end-2004 or early 2005, there are concerns regarding the high costs of establishing such a structure, even as central government finances remain fragile. As well, effective systems to monitor the fiscal and economic performance of provinces are absent, risking the sought after improvement in public service delivery.

After four years of contraction, which saw a cumulative decline in real GDP of 16.5 percent, the economy expanded in the second half of 2003 due to growth in primary production, construction and services. Consequently GDP increased by an estimated 5.1 percent in 2003, and is projected to expand by 4 percent in 2004. Inflation declined substantially in 2003, to 3.8 percent on a year-end basis compared to 15.4 percent in 2002, although it has picked up slightly to almost 7 percent in the year to July 2004.

The restoration of fiscal discipline was reflected in the budget deficit of 1.4 percent of GDP in 2003, and a surplus of 4 percent of GDP is projected for 2004. Despite the recommencement of debt service payments, total government debt, both domestic and external, has only fallen marginally reflecting the large build up of arrears. Significantly, the Government reached an important settlement with its major domestic bondholders—mainly the commercial banks and the National Provident Fund—in the first half of 2004. Under the terms of this, 60 percent of interest arrears due to the bondholders were written-off, and the restructured bonds were replaced with a 14 year amortizing bond, carrying an interest rate of 2<sup>1</sup>/<sub>4</sub> percent, compared to about 9 percent on the previous bonds. Overall the Government saved about SI\$11.8 million on the interest arrears and an estimated SI\$130 million in interest costs through the reduction in interest rates.

The balance of payments strengthened in 2003 as a current account surplus of almost 1.5 percent of GDP was recorded fuelled in part by timber exports with reserves continuing to be rebuilt, buoyed by inflows of foreign assistance. The level of reserves has almost

doubled in the past year, reaching SI\$538.1 million in September 2004. As a result the Central Bank of the Solomon Islands lifted the foreign exchange controls that had been in place since 2000.

Although the economic recovery is encouraging, the structural reform agenda remains critical to sustaining that recovery. This includes the cost, efficiency, reliability and coverage of telecommunications and power service to underpin private sector development and business activities, as well as the resumption in inter-island shipping services which are so important to rural agricultural production.