South-East Asia

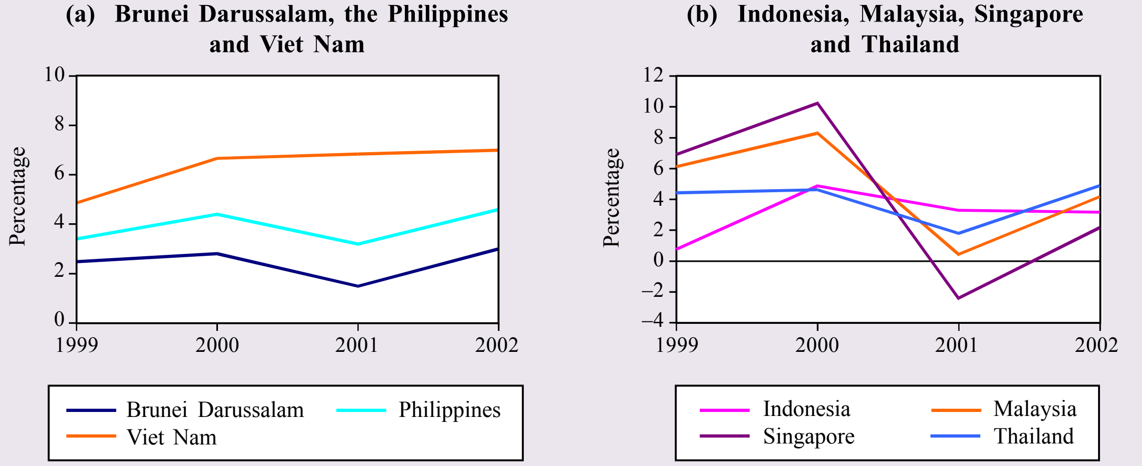
A. Developing countries in the subregion

Subregional overview and prospects

Economic recovery supported by both domestic and external demand

After the global slowdown that affected most countries in the subregion in 2001, economic growth recovered in South-East Asia in 2002, although the degree to which it was sustained through the year varied between countries (figure II.26). In Thailand and Malaysia, for example, economic activities were helped by rising consumer expenditure, accommodative fiscal and monetary policies, and a recovery in exports, mainly of electronics and electrical goods and primary commodities. In both countries, investment was also lifted to some extent in the second half of 2002. Strong domestic and external demand was also responsible for the continued vigorous growth in Viet Nam, where investment, in particular, increased strongly. However, the collapse of investment in Indonesia and reduced investment in the Philippines was a matter of concern, while weakened consumer spending and export demand offset the early gains in Singapore's growth somewhat. The return of global uncertainty, together with a slowdown in electronics, in the second half of 2002 added to doubts about future growth performance. The situation of the least developed countries of the subregion, Cambodia, the Lao People's Democratic Republic and Myanmar, is discussed later in this section.

Figure II.26. Rates of GDP growth in selected South-East Asian economies, 1999-2002



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

The outlook for 2003 is less certain

The outlook for economic growth in the subregion in the coming year depends on the prospective strength of both external and domestic demand. Global economic conditions suggest that export demand is likely to be subdued, at least until the second half of 2003, and competition is intensifying. Consumer expenditure is likely to remain strong in 2003 as long as incomes and interest rates hold steady, but is unlikely to grow as fast as in 2002, particularly as consumer debt levels are now relatively high. Firm commodity prices at least into 2003 will support rural incomes, and accommodative monetary policy can be expected to continue. However, the need for fiscal consolidation may dampen prospects for greater fiscal stimulus to offset weakness in demand. Some of the increase in private investment in 2002 reflected the revival of the property sector; how durable the increase is remains to be seen, given the relatively high margin of unutilized capacity and the weakness of FDI flows.

Faster growth forecast in Malaysia and Thailand

For 2003, Malaysia expects an increase in GDP growth to 6-6.5 per cent but the weakening global outlook and slowing exports may be a constraining factor. However, the planned expansion of oil palm acreage will lead to higher agricultural growth, supported by firm commodity prices. Although the number of applications for new investment from foreign investors increased in 2002, that of approvals of both foreign direct and domestic investment fell sharply; however, the Government has indicated that it is ready to provide additional pump-priming to sustain the growth momentum, notwithstanding its desire to initiate fiscal consolidation.

In Thailand, the Government has indicated that fiscal policy will be conditioned by the need to cap public debt at 55 per cent of GDP. Private consumption, while remaining strong, is unlikely to expand as rapidly in 2003 as previously, particularly as consumers are coping with higher levels of personal debt following major purchases of housing and vehicles in the current year. In addition, regulations on the issuance of credit cards have again been tightened after having been relaxed in 2002. However, the fiscal incentives that helped to revive the property sector in 2002 are to be extended for another year and additional incentives given for the construction of low-cost housing. The official forecast for GDP growth in 2003 is in the range of 3.5-4.5 per cent.

The external outlook for Viet Nam and Singapore in 2003 is expected to be positive

The Government expects the external environment to be better for Viet Nam in 2003, particularly in the second half of the year, along with the expected revival of the global economy and as the opportunities presented by the trade agreement reached with the United States in 2001 are exploited more fully. GDP growth is projected to accelerate to 7.5 per cent in 2003 owing to improved performance from all sectors. The export rebound expected in the second half of the year will also benefit Singapore, but private consumption expenditure is likely to remain subdued in 2003 until labour market conditions improve. Given the weakening of business confidence reported in the fourth quarter of 2002, a strong revival in private investment is still some way off. Reflecting these uncertainties, the Government expects GDP growth in 2003 to be around 2-5 per cent.

The Philippines and Indonesia have revised their growth forecasts downwards

Business confidence also turned down towards the end of 2002 in the Philippines, indicating that an early uplift in investment spending was not likely. Private consumption may remain subdued as rural incomes are likely to remain low, while public spending is constrained by the need to contain the burgeoning fiscal deficit. The Philippine Government's forecast range for GDP in 2003 was 5-5.5 per cent before the recent slowdown, but was revised marginally downwards to 4.2-5.2 per cent.

The Government of Indonesia also had to revise its forecast downwards for 2003, from 5 to 4-4.5 per cent, following the Bali bombing, but much depends on global developments as well as the state of consumer and business confidence. Although tourism employs around 10 million people in Indonesia, it accounts for a relatively small share of GDP and earns less in foreign exchange than such sectors as oil, gas and textiles. The Government announced a stimulus package of Rp 10.63 trillion after the bombing, with support from IMF and the Consultative Group for Indonesia. Donors have also pledged support for the post-conflict reconstruction of Aceh (box II.6). The agricultural sector benefits from firm commodity prices but the outlook for this sector is conditioned by the possibility of a drought following a mild El Niño event.

Box II.6. Post-conflict reconstruction in Aceh

On 9 December 2002, following two years of negotiations, the Government of Indonesia and the Free Aceh Movement signed a framework agreement in Geneva on the cessation of hostilities in the troubled oil-rich province on the island of Sumatra. The agreement, which was facilitated by the Henri Dunant Centre for Humanitarian Dialogue with an advisory role played by a committee of three "wise men",[a] brought the current rebellion, which began in 1976 and in which many thousands have lost their lives, to an end. Under the terms of the agreement, a Joint Security Committee comprising representatives of both sides as well as officials from the Philippines and Thailand will formulate the process for implementing the agreement, oversee the security situation with the assistance of international monitors and define the process of demilitarization. The Committee will also designate "peace zones" that will become the focus of initial humanitarian, reconstruction and rehabilitation efforts if peace is established successfully. The Government, which has committed itself to granting Aceh a full measure of autonomy, is to engage in an all-inclusive dialogue within the province, which will be supported by the Free Aceh Movement, with a view to holding full and fair elections in 2004.

[a] The committee was made up of former United States Marine Corps General Anthony Zinni, the former Ambassador of Yugoslavia to Indonesia, H.E. Mr. Budamir Loncar, and H.E. Dr. Surin Pitsuwan, former Minister for Foreign Affairs of Thailand.

The conflict in Aceh has long historical antecedents and several issues, such as the Movement's demand for independence and finding the best method to deal with the human rights abuses committed by both sides, remain to be resolved. Although the peace agreement has drastically reduced the level of violence, sporadic fighting between soldiers and rebels continues. However, the cautious optimism with which the agreement was greeted and the belief that, unlike its predecessors, it is likely to work derive from some unique features: (a) it is the first time that a sovereign Government has negotiated with a separatist movement under the auspices of an international non-governmental organization; (b) international monitors will have an important role to play in the implementation process; and (c) the donor community has pledged support for the agreement. In fact, in anticipation of the signing of the agreement, the European Union, Japan, the United States of America and the World Bank co-sponsored the Preparatory Conference on Peace and Reconstruction in Aceh, held at Tokyo in December 2002, at which donors met representatives of both sides to see how best they could help. Five priority areas for donors were agreed in Tokyo: support to the peace process; short-term humanitarian assistance; community reconstruction; governance and public planning; and restoration of the social and physical infrastructure.

As a follow-up to the Conference, the four Co-chairman visited Aceh early in January 2003 to meet representatives of local government and the people of Aceh. Donors have agreed on a coordinated approach to support, focusing on quick-impact, community-based programmes that affect people's welfare directly and so lessen conflict. A participatory planning process involving all segments of society in Aceh, as well as major changes in the quality of governance, to reduce corruption, increase transparency and improve the administration of justice, were also identified as being necessary to restore confidence in development.

As outlined in a World Bank document[b] presented to the Consultative Group Meeting on Indonesia, held on 21 and 22 January 2003, the process of recovery and development in Aceh has short-, medium- and long-term aspects. The focus in the short term has to be on supporting the peace process and providing humanitarian assistance in the conflict areas of the province, where poverty rates are now high. Large numbers of refugees remain to be resettled (both those displaced within Aceh and those, generally of Javanese origin, who have moved out of the province). The local administration has identified the dominant social problem that it faces as being the welfare of the estimated 47,000 widows and 50,000 orphans left as a result of the conflict. Education, in particular, has suffered as many schools were burnt. Many houses that were destroyed or damaged in the conflict also have to be replaced or rehabilitated.

In the medium term, the focus has to shift to the delivery of social services throughout the province of Aceh and rebuilding the private sector through restoration of the investment climate. Although poverty rates in Aceh, with the exception of the conflict areas, are below the national average, the conflict disrupted both the quality and the coverage of public services, which now need to be restored. To improve the business climate, infrastructure will have to be repaired and security improved. Aceh is largely an agricultural province, and plantation and estate crop and forestry activities cannot be undertaken without peace and security and a functioning transport system. Similarly, multinational corporations active in the oil and gas sector, as well as in other resource-based operations, will need to see stability in the business environment before contemplating a return to the province. Power shortages, which were a problem even before the conflict, have become acute as a result of it. Governance issues, including corruption, remain constraints on investment. Small and medium-sized businesses will also need adequate credit and technical assistance to enable them to recommence or initiate activities.

Finally, in the long term, many of the issues facing the province regarding its economic and social development are similar to those faced by the rest of Indonesia. However, Aceh is also in a position to attempt to ensure that its development is sustainable by making judicious use of the high share it receives of the oil and gas revenues generated by its endowments, as these are likely to be depleted within the next 10 years.

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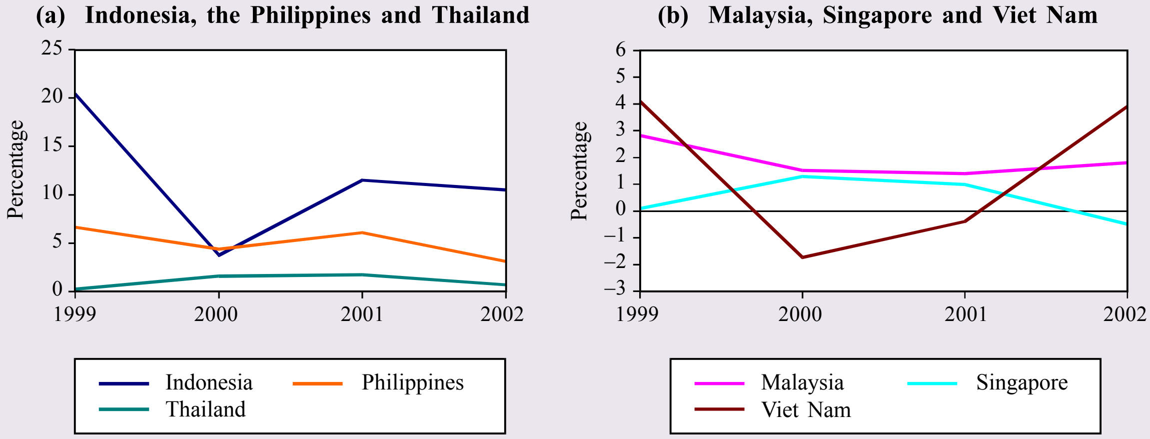
[b] "Promoting peaceful development in Aceh", available at <http://lnweb18.worldbank.org/eap/eap.nsf/Attachments/012103-12CGI-Aceh/$File/CGI_Acehupdate.pdf>, 4 February 2003.

Figure II.27. Inflation in selected South-East Asian economies, 1999-2002[a]



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.

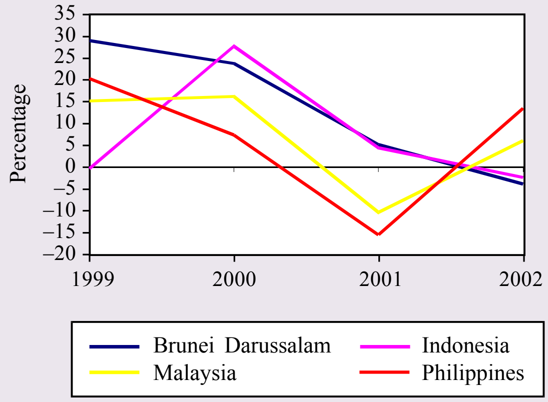
Inflation slowed as demand and cost pressures were generally absent

With the exception of Viet Nam and, to some extent, Malaysia, inflationary pressures moderated noticeably in South-East Asia in 2002 as demand pressures were not excessive and cost pressures remained manageable, the latter in part the result of currency appreciation (figure II.27). However, inflation remained in double digits in Indonesia. Although Singapore was the only country to record a small fall in prices, deflationary pressures were felt in other countries, such as Thailand, during parts of the year. Increases in administered prices, for fuel, utilities, transport and telephone charges, were responsible for some increases in inflation during the year in some countries, as were higher food prices following natural disasters. In the Philippines, concerted attempts were made to monitor and check price increases, including through liberalizing imports of food items and reducing administered prices for electricity. By and large, central banks pursued accommodative monetary policies with interest rates declining in most countries, reaching particularly low levels in Singapore and Thailand, as liquidity remained ample and loan demand generally weak.

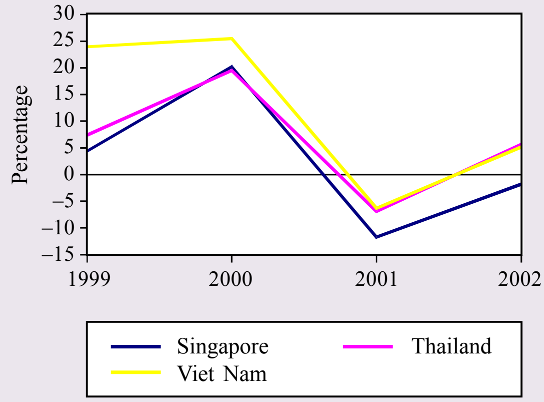
Merchandise export earnings had declined in most countries in the subregion in 2001 owing to reduced demand in major export markets, such as the United States, the EU and Japan, as well as within the region itself. By contrast, exports returned to positive growth in some countries

Figure II.28. Growth rates in merchandise export earnings of selected South-East Asian economies, 1999-2002

(a) Brunei Darussalam, Indonesia, Malaysia and the Philippines



(b) Singapore, Thailand and Viet Nam



Sources: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003; National Economic and Social Development Board of Thailand web site <http://www.nesdb.go.th>, 13 January 2003; and Bank Negara Malaysia web site <http://www.bnm.gov.my>, 27 February 2003.

Note: Figure for 2002 for Malaysia is for the whole year and for Thailand is a projection for the whole year; data for other countries refer to January-August.

Merchandise exports made a modest recovery, while demand from traditional markets remained weak

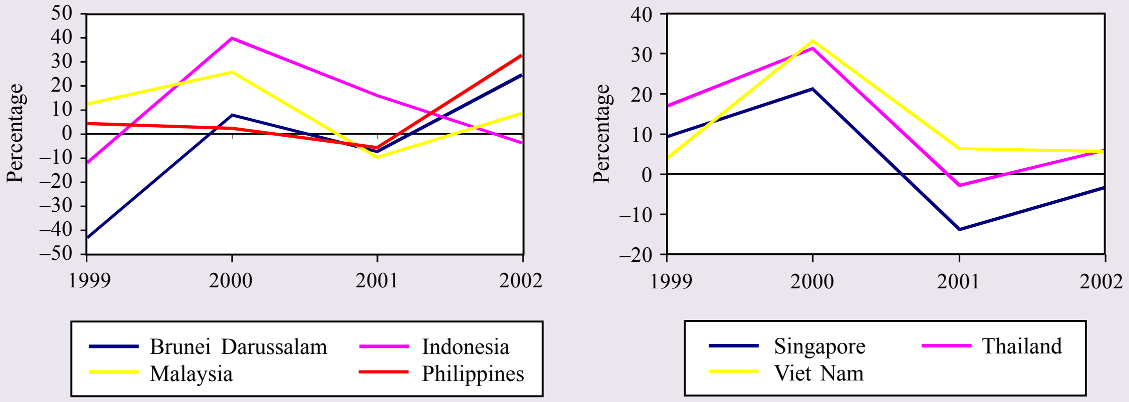
of South-East Asia in 2002, although the extent of the increase was modest in comparison with the strong increase recorded in 2000 (figure II.28). There were higher exports of primary commodities, from the energy and agricultural sectors in particular, as well as manufactured goods, such as electronics and electrical products and chemicals. Within the subregion, some countries with more favourable trade access, particularly to the United States, expanded garment and footwear exports, while others found it difficult to withstand competition in third markets from lower-cost producers such as China. Exports of services were mixed; tourism picked up in some countries at the expense of others after the shock of the Bali bombing. Traditional export markets remained soft after an initial revival in the first half of the year but demand from within the East Asian region picked up significantly, for both goods and services.

The performance of merchandise imports reflected a similar pattern and strength of economic growth in the different countries of the subregion (figure II.29). Increased imports of intermediate goods, together with consumer and capital goods in some cases, boosted imports in most countries. However, the continuing weakness in manufacturing saw imports contract in Singapore in 2002, as in 2001, and Indonesia, particularly sharply in the latter.

Figure II.29. Growth rates in merchandise import spending of selected South-East Asian economies, 1999-2002

(a) Brunei Darussalam, Indonesia, Malaysia and the Philippines

(b) Singapore, Thailand and Viet Nam



Sources: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003; National Economic and Social Development Board of Thailand web site <http://www.nesdb.go.th>, 13 January 2003; and Bank Negara Malaysia web site <http://www.bnm.gov.my>, 27 February 2003.

Note: Figure for 2002 for Malaysia is for the whole year and for Thailand is a projection for the whole year; data for other countries refer to January-August.

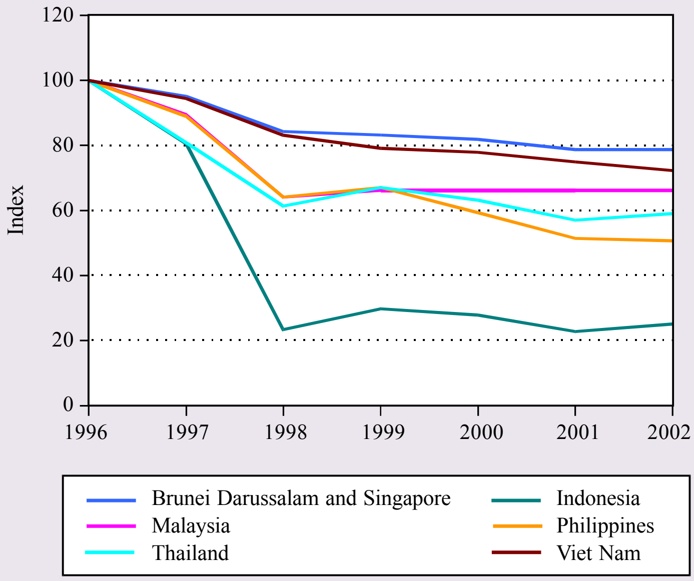
The slowdown in FDI is a worrying development for the subregion

A worrying feature of the capital account in most parts of the subregion in 2002 was the slowdown in FDI. Portfolio investment was more mixed, with some countries attracting significantly higher flows than in 2001. Official foreign exchange reserves increased in all countries, even though foreign debt was higher in several countries with external borrowing, Thailand being the notable exception. International confidence in the countries of South-East Asia has generally improved, although it remains low in Indonesia and the Philippines. The exchange rate performance was more variable (figure II.30). Malaysia and Brunei Darussalam maintain currency pegs, the former against the United States dollar and the latter against the Singapore dollar. Other countries in the subregion permitted exchange rates to move with market conditions. Most currencies appreciated against the United States dollar, although the Philippine peso and Vietnamese dong weakened.

Finally, the major policy issues confronting Governments in the subregion in 2002 were not radically different from those faced in previous years. Social concerns such as unemployment and the incidence of poverty continue to be at the top of the policy agenda. The recent lack

Figure II.30. Index of exchange rates against the United States dollar of selected South-East Asian economies, 1996-2002

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LV, No. 12 (December 2002); *Far Eastern Economic Review,* various issues; and ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002).

Notes: Data for 2002 are estimates. The currency of Brunei Darussalam is set at par with the Singapore dollar.

of investment in the subregion has focused attention on matters relating to the medium-term sustainability of growth and long-term competitiveness. Issues such as fiscal consolidation and financial restructuring, which have been on the agenda since the 1997-1998 financial crisis, have acquired greater urgency in some countries as a result of the relatively weaker economic performance in 2001-2002.

Medium-term sustainability of growth and competitiveness have joined unemployment and poverty alleviation on the policy agenda

GDP growth performance

The economy of Thailand rebounded very strongly in 2002 from the low 1.8 per cent GDP growth of 2001, with growth accelerating in each quarter to reach 4.9 per cent for the full year, compared with the annual average of 4.5 per cent in 1999-2000 (table II.31). Private consumption expenditure, a major factor in this expansion, was underpinned by fiscal stimulus and easy monetary conditions, while rising farm incomes reflected stronger world prices for rubber, cassava and oil palm. Malaysia

Expansionary policies supported consumption in Thailand and Malaysia as exports rebounded and investment revived

Table II.31. Selected South-East Asian economies: growth rates, 1999-2002

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Brunei Darussalam	1999	2.5	–0.1	3.2	1.7
	2000	2.8	..	..	..
	2001	1.5	..	..	..
	2002	3.0	..	..	..
Indonesia	1999	0.8	2.2	2.0	–1.0
	2000	4.9	1.7	6.2	2.2
	2001	3.3	0.6	4.3	2.0
	2002	3.2	3.7	3.3	1.7
Malaysia	1999	6.1	0.5	8.8	4.9
	2000	8.3	2.0	14.4	3.8
	2001	0.4	1.8	–3.2	5.7
	2002	4.2	0.3	4.0	4.5
Philippines	1999	3.4	6.5	0.9	4.0
	2000	4.4	3.4	4.9	4.4
	2001	3.2	3.7	1.3	4.4
	2002	4.6	3.5	4.1	5.4
Singapore	1999	6.9	–1.1[a]	7.1	6.8
	2000	10.3	–5.7[a]	10.8	10.0
	2001	–2.4	–4.9[a]	–9.2	2.0
	2002	2.2	–1.5[a, b]	4.0	1.5
Thailand	1999	4.4	2.1	9.6	0.3
	2000	4.6	4.8	5.2	4.0
	2001	1.8	3.3	1.3	2.3
	2002	4.9	4.4	3.3	6.6
Viet Nam	1999	4.9	5.2	7.9	2.3
	2000	6.7	4.0	9.8	5.6
	2001	6.8	2.7	10.4	6.1
	2002	7.0	5.0	14.4	6.2

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues; and national sources.

Notes: Data for 2002 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Including quarrying.
[b] Estimate.

also benefited from strong domestic demand and rising exports, principally of semiconductors and crude palm oil, in 2002. However, growth eased as export demand became more muted towards the second half of the year. GDP growth at 4.2 per cent in 2002 was nevertheless well up on the out-turn of 0.4 per cent in 2001.

Table II.32. Selected South-East Asian economies: ratios of gross domestic savings and investment to GDP, 1999-2002

(Percentage)

	1999	2000	2001	2002
Savings as a percentage of GDP				
Indonesia	..	29.5	28.0	23.0
Malaysia	47.3	46.7	42.5	41.8
Philippines	14.3	16.1	16.8	17.4
Singapore	48.8	49.3	45.8	44.5
Thailand	32.9	32.9	30.0	28.7
Viet Nam	24.6	27.0	29.0	28.7
Investment as a percentage of GDP				
Indonesia	..	29.3	24.7	18.5
Malaysia	22.3	26.8	24.0	25.0
Philippines	18.8	18.4	17.6	17.8
Singapore	31.9	31.6	24.3	23.6
Thailand	20.5	22.7	24.0	24.2
Viet Nam	27.6	29.5	31.9	33.0

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); and national sources.

Note: Data for 2002 are estimates.

In both countries, consumer credit to purchase houses and motor vehicles expanded strongly as interest rates remained low and savings as a percentage of GDP continued to decline (table II.32). Improved consumer and business confidence were also responsible for the increasing momentum of private investment in Thailand, particularly in residential and commercial construction, as the effects of tax incentives and low interest rates were felt. An encouraging sign was the sharp increase in investment in machinery in the third quarter of 2002. In Malaysia, the growth rate in investment became positive in the third quarter of 2002, after declining from the middle of 2001, and accelerated strongly in the fourth. The investment-to-GDP ratio increased to 25 per cent in 2002 from 24 per cent in 2001. Inventory accumulation also increased in both countries.

Thailand is a good case study of economic diversification

In terms of production, Thailand is an illustration of the advantages of a diversified economy. Although paddy output was affected by drought in the second quarter and widespread flooding in the third, agricultural growth was driven by the higher production of sugar cane and rubber, as well as livestock and fisheries (despite the negative effects on prawn cultivation of health concerns in major export markets). In manufacturing, the output volumes of construction materials, electronics and electrical products and vehicles expanded very strongly. Average capacity utilization in all sectors improved to around 59 per cent in 2002 from 53 per cent in 2001. Mining output was also significantly higher as crude oil production was stepped up to meet increased domestic demand and more limestone was quarried for the cement industry. Growth in services was also very strong, particularly in financial intermediation and activities related to property. Tourism was affected somewhat following the Bali bombing but there were signs of a strong recovery towards the end of the year.

Manufacturing expanded strongly in Malaysia

Malaysian growth was driven primarily by manufacturing and services in the first half of 2002, but became more broadly based later in the year as the strong revival in commodity prices stimulated agricultural production in the second half of the year. Industrial output went up by 4 per cent in 2002, reversing a decline of 3.2 per cent in 2001, as value added in mining increased in line with higher oil and gas prices. There was also strong expansion in manufacturing activities, particularly electronics, off-estate processing and chemicals and chemical products. Growth in the construction sector declined somewhat following the mid-year expulsion of illegal migrant workers, which led to labour shortages. Growth in services at an annual rate of 5.7 per cent had been crucial in sustaining the rise in GDP in 2001, but it slowed to 4.5 per cent during 2002, owing to a sharp decline in intermediate services such as transport and financial services.

Investment from new businesses is proving vital to Viet Nam

Viet Nam was the only economy in the subregion with unabated growth in 2001, largely due to strong domestic demand. The country improved on its performance in 2002 as GDP went up by 7 per cent. Strong expansion in domestic demand was again the principal driver of growth, with retail sales returning to levels prevailing before the 1997-1998 crisis. Investment, particularly in the private sector, also boomed and was equivalent to one third of GDP in 2002, one full percentage point higher than the 2001 ratio (table II.32). The number of new businesses established in 2002 increased 17 per cent to 20,000 and investment by new SMEs in the formal economy was expected to reach $2.7 billion in 2002.

As in previous years, much of the impetus for growth in Viet Nam in 2002 came from the industrial sector, where output was 14.4 per cent higher in response to stronger demand for consumption-related products such as vehicles, particularly motorcycles, television sets, ceramic tiles and other building materials. Garment production also boomed as a result of the current quota-free access to the United States market. The private and foreign-invested sectors led growth, while expansion in the State sector was more modest. Drought in the Central Highlands, combined with lower world prices, resulted in decreased coffee production and severe flooding in the South affected the rice output. Nevertheless, growth in the agricultural sector improved to 5 per cent in 2002 owing to, among other things, higher production of black pepper and cassava. As in Thailand, the fisheries output (shrimp in particular) was affected by health concerns in export markets as well as a trade dispute with the United States regarding the alleged dumping of catfish. The service sector grew at a robust 6.2 per cent in 2002; inward tourism boomed, particularly in the last quarter as tourists looked for alternatives to destinations where the perceived terrorism risks were higher.

The strong rebound in economic growth and exports proved to be short-lived in Singapore

The severe economic contraction that began in Singapore in 2001 appeared to have bottomed out in the first half of 2002 following a spurt in global economic activity that stimulated export demand, including in the IT sector. However, the economic rebound was short-lived, and a W-shaped (rather than V-shaped) recovery appeared likely with GDP growth at 2.2 per cent in 2002. While much of the early recovery was driven by increased external demand, domestic consumption expenditure was also sustained by the effects of two fiscal stimulus packages adopted by the Government in 2001 (totalling 8.5 per cent of GDP), together with an expansionary budget for 2002 and monetary easing. However, private consumption contracted in the second half of 2002 as job insecurity worsened with continuing retrenchments, and the decline in private investment resumed as export demand softened and excess capacity persisted.

Recovery in Singapore in the first half of 2002 was strongly led by manufacturing, particularly electronics and chemicals, mainly pharmaceuticals, as the production of high value added intermediaries surged and new production facilities came on-stream. However, those trends were reversed later in the year and the lower production of pharmaceuticals accounted for most of the contraction in manufacturing output. Construction had been on a decline since the third quarter of 2001; it contracted even more sharply in 2002. Growth slowed in the service sector but was by and large similar to the pattern recorded in 2001 as improved entrepôt trade and transport and communications compensated somewhat for a slower expansion in retail sales, tourism and financial services.

Strong private consumption compensated for investment weakness and restrained public spending in the Philippines

The Philippines managed to sustain GDP growth at a healthy rate of 3.2 per cent in the face of the global slowdown in 2001, and saw this accelerate to 4.6 per cent in 2002. In terms of demand, the overall resilience of the Philippine economy was due largely to sustained personal consumption expenditure and increased government expenditure in the second half of 2002. However, capital formation was very weak; inventories in particular were run down noticeably during the year.

GDP expansion in the first half of the year was initially led by the strong performance of agriculture but the declining production of coconut, rice and corn led to a subsequent slowdown in that sector. Meanwhile, a rebound in export demand, along with sustained consumer spending, saw industry, particularly manufacturing, and services taking up the slack and growing strongly. A higher level of industrial activity was maintained by substantial increases in mining and quarrying, as the output of gas, copper and gold was stepped up, and in the demand for utilities. Within the manufacturing sector, food manufacturing and electrical machinery output faltered. The service sector witnessed strong expansion in the transport, communications and storage subsectors.

Improved macroeconomic stability did not herald faster growth in Indonesia

Economic growth in Indonesia slowed slightly to 3.2 per cent in 2002. Consumer sentiment improved with growing political and economic stability and this, together with rapid increases in formal sector wages and consumer credit, served to fuel expenditure growth. The impression is that the Bali bombing has not deterred consumers so far, but it may be too early for a full evaluation of the impact of that event. Capital investment, however, remained weak and this was a major reason why economic growth did not take off despite the much-improved macroeconomic stability. The investment ratio declined to 18.5 per cent of GDP in 2002 from almost a quarter in 2001. Investment approvals were also down, thus clouding the prospects for a major turnaround in the near future. Capacity utilization in manufacturing was reported to be averaging 60 per cent in the first half of 2002, down from 70 per cent in the same period in 2001. Inventories were also run down in 2001-2002, with a dampening effect on growth.

The strengthening of commodity prices benefited the Indonesian economy, among others

On the supply side, agriculture rebounded in Indonesia in 2002 despite extensive flooding in the first two months of the year. The country benefited from improved commodity prices during the year, in particular for crude palm oil, wood pulp and cocoa. In a bid to assist domestic rice farmers, the Government announced a 15 per cent increase in the floor price of unhusked rice and the imposition of a 75 per cent import tariff, but unresolved issues concerning land ownership hindered agricultural development. Forest fires and the consequent haze continued in 2002 as the use of slash-and-burn techniques to clear land, particularly by large corporations, eluded control. Industrial growth slowed in the first half of 2002, with a marked decline in manufacturing. The downturn in investment also slowed construction activities. Mining was affected by uncertainty following decentralization, as local governments sought to play a more prominent role. More generally, the outputs of oil and gas, leather and textiles and wood and wood products were on the decline, although exports to China were sharply up. Sales of automobiles, boosted by low interest rates, had also started falling by mid-year, although the demand for motorcycles remained strong.

Revenues from the energy sector continue to sustain the economy of Brunei Darussalam

Brunei Darussalam's economy continues to depend heavily on revenue from the oil and gas sector, and the return of higher energy prices coincided with the higher growth of 3 per cent recorded in 2002. Consumer spending was the main domestic driver of growth, particularly as the Government appears to have encountered some capacity constraints in implementing its long- and short-term fiscal stimulus measures.

A reduction in automotive tariffs to a flat 20 per cent (from 20 to 200 per cent) in November 2001 was partly responsible for the surge in consumer expenditure in 2002, along with low interest rates and easy credit.

In 2001, the contraction in construction, brought about in part by fiscal stringency, contributed to weaker economic growth, but the implementation of measures to stimulate the economy in 2002 led to a revival of this sector, with important multiplier effects on the rest of the economy. The performance of the agricultural sector was mixed, while output in the industrial sector, particularly manufacturing, appeared to have decreased after an initial surge in the production of garments was subsequently dampened by weaker export demand.

Finally, Timor-Leste is facing enormous challenges in nation building with the economy stagnating in 2002 after GDP growth averaging 16 per cent annually over 2000-2001 (see box II.7).

Inflation

Inflationary pressures were missing in most countries of South-East Asia, with the exception of administered price changes and some weather-related increases in food prices

The slight acceleration in inflation in Malaysia in 2002, to 1.8 per cent from 1.4 per cent in 2001 (table II.33), was attributable to one-off changes in administered prices for transport and communications, particularly telephone charges. Monetary policy was largely accommodative, as the Central Bank attempted to keep interest rates stable in the face of increased consumer expenditure and the fiscal stimulus, and liquidity was ample. However, demand pressures on prices remained weak.

In Viet Nam, low inventories of rice pushed food prices up in 2002, as flooding increased price pressures, and by November they were approximately 8 per cent higher than in 2001. Inflation increased to 3.9 per cent in 2002 as nearly half of the consumption weight in the calculation of the consumer price index is given to food items. Higher prices of building materials also contributed to the more rapid rate of inflation. Meanwhile, inflation is projected to be at the level of 5 per cent in 2003 as depreciation of the dong, which slowed in 2002, picks up again. The growth of credit in the economy fell sharply from 38 per cent at the end of 2000 to 21.5 per cent at the end of 2001; the target for 2002 was 20.5 per cent. The broad money supply (M2) also expanded more slowly, from 35.4 per cent in 2000 to an estimated 14.6 per cent in the first nine months of 2002. The State Bank of Viet Nam lifted caps on lending rates for dong-denominated loans from June 2002, thus giving commercial banks more freedom to manage interest rate spreads and respond to the needs of the private sector. The average deposit rate was 6.39 per cent in the second quarter of 2002, up from 4.96 per cent in the same quarter of 2001, while the average lending rate fell to 8.75 per cent from 9.35 per cent over the same period.

Box II.7. Timor-Leste: facing enormous challenges in nation-building[a]

Timor-Leste (formerly East Timor) became an independent country on 20 May 2002, making it the first new country of the new millennium. It joined the United Nations as the 191st Member State on 27 September 2002.

The United Nations played an important part in the creation of the new country. The General Assembly placed East Timor on the international agenda in 1960, when it added the territory to its list of Non-Self-Governing Territories, and had been actively involved since then by facilitating negotiations between the Indonesian and Portugese authorities on the future of East Timor. Similar to its role in the events leading up to the independence of Cambodia in 1992, the United Nations took an active part in the affairs of East Timor with the establishment of the United Nations Mission in East Timor (UNAMET) in June 1999 and the holding of the referendum on 30 August 1999 to begin a process leading towards political independence. This was followed by the establishment in October 1999 of the United Nations Transitional Administration in East Timor (UNTAET), which administered East Timor from that date up to the time of independence in May 2002.

UNTAET consisted of a governance and public administration component, a civilian police component of up to 1,640 persons and an armed United Nations peacekeeping force. In addition, humanitarian assistance and rehabilitation components were incorporated within the structure of the Transitional Administration. To finance the activities of UNTAET, the Donors' Meeting for East Timor, convened at Tokyo in December 1999, pledged more than $520 million.

UNTAET, with the assistance of multilateral and bilateral development agencies, had the enormous task of economic and social reconstruction in East Timor. Apart from the task of establishing the administrative structure for East Timor, it was also faced with the formidable task of rehabilitating essential infrastructure and transport networks, the provision of basic health care, the reopening of schools and, very importantly, the resumption of markets and economic activities which had been devastated by the civil unrest following the overwhelming vote by the Timorese for independence over autonomy within Indonesia.

The assistance from the international community has been very important in the rebuilding process of the new country. At the Tokyo Meeting in 1999, the international donor community set up the Trust Fund for East Timor (TFET) to provide assistance in rebuilding the country. ADB and the World Bank propose and manage projects financed under the Trust Fund. ADB is responsible for managing TFET-funded projects worth $52.8 million. Since 1999, ADB has also committed $8 million in technical assistance grants to help to prepare projects and capacity-building. An emerging infrastructure rehabilitation project which has been managed by ADB since April 2000 has helped to repair roads, expand port facilities and restore power supply. Up to 85 per cent of Timor-Leste's infrastructure was destroyed during the civil unrest. Some of the infrastructure damaged or destroyed has been rebuilt or upgraded under the water supply and sanitation rehabilitation project. Many development agencies have been helping the country to reopen schools, which had also been extensively destroyed. In some cases, UNICEF helped by paying for some building materials; the Government of Timor-Leste was paying teachers' salaries and providing equipment, while the school fees were paid voluntarily as most parents were unemployed. Oxfam,

TIMOR-LESTE

Facts and figures

- *Population:* 800,000
- *Capital:* Dili
- *Major languages:*
  Tetum
  Portuguese
  English
  Bahasa Indonesia
- *Major religion:*
  Christianity
  (Roman Catholic)
- *GDP growth*

1999 –34%
2000 15%
2001 18% (estimated)
2002 zero (projected)
2003 2% (projected)

- *Main economic activity:* agriculture
- *Major export:* coffee
- *Natural resources:*
  Offshore oil and gas reserves in the Timor Sea, being developed by Australia under the Timor Sea Treaty signed on 20 May 2002.
  Production is expected to begin in 2004 and gas deliveries are expected to begin late in 2005.

Some important dates

- **1999**

  23 June – Indonesia announces a plan to grant East Timor extensive autonomy

[a] This box is largely based on *ADB Review*, September-October 2002, pp. 4-11.

an international non-governmental organization, is helping to implement both the ADB and EU programmes in the country. The World Bank signed an agreement with UNTAET on 21 February 2001 for the disbursement of $21.5 million over two and a half years for community empowerment and local government projects. It also signed a $12.7 million grant on 7 June 2000 to help to revamp the country's health sector. On 23 June 2000, the donor community, at a meeting held at Lisbon, pledged its continued support for the reconstruction of Timor-Leste and for closing the financing gap of $16 million for financial year 2001.

There are many challenges facing the new country. One of the most urgent tasks of the Government is to establish not only a small, competent and transparent Government but one which is lean and cost-effective so as to keep aggregate expenditure aligned with the country's absorptive capacity. This will require, among other things, the development of the country's human resources to ensure effective public administration, transparency and accountability and, more important, better aid coordination and absorption at the national level. Domestic revenue sources are important to finance the country's recurrent budget. The maintenance of a good economic and regulatory environment conducive to efficient private sector activities is important in this context. Timor-Leste is well endowed on a per capita basis, with natural resources both onshore and offshore. The projected oil and gas revenues from the Timor Sea for the medium term are promising following the signing of the Timor Sea Treaty allowing Australia to develop Timor-Leste's offshore oil and gas reserves. Production is expected to begin in 2004 and gas deliveries late in 2005. Gas-based export income will be supplemented by earnings from marble, coffee and other agricultural produce, and tourism, since Timor-Leste has a comparative advantage in these activities.

As three quarters of the people are engaged in agriculture, Timor-Leste will need to strengthen the traditional agriculture by using appropriate technology inputs to increase crop yields. Adequate access to rural banking and microcredit facilities are also important to help to increase the sector's output growth and provide a sound basis for sustained economic growth and poverty alleviation through export-oriented primary activities. ADB is implementing a TFET-financed project, under which a microfinance institution has been established and is operating successfully in the country. With a small natural resource base and limited domestic financial resources, Timor-Leste needs to engage actively in trade if it is to achieve sustained economic growth to enable it fight unemployment and poverty effectively.

The United Nations will continue to maintain a presence in Timor-Leste in the post-independence period to ensure the security and stability of the new country. A successor mission, known as the United Nations Mission of Support in East Timor (UNMISET), will adopt a milestone-based approach to its gradual withdrawal from the country and will support the Timorese authorities in the areas of economic stability, democracy and justice, internal security and law enforcement, and external security and border control. For its part, the new Government will need to take bold initiatives, including steps towards good governance, so that it will continue to have the support and goodwill of the international community to assist it in its development efforts. Being a latecomer can also be a blessing in disguise for Timor-Leste as the authorities can learn from the mistakes made by other developing countries in their early stages of independence. In this connection, Timor-Leste could foster closer economic cooperation with countries in the ESCAP region, including those from the Pacific island subregion, and learn from their experience in development. Timor-Leste could, for example, seek the assistance of ESCAP through such modalities as economic and technical cooperation among developing countries, with the assistance of concerned member Governments.

30 August – In a referendum supervised by the United Nations, an overwhelming 78.5 per cent of voters choose independence over autonomy within Indonesia. In the violence that erupts after the vote, hundreds of people are killed, and hundreds of thousands are forced to flee their homes.

26 October – Indonesia officially yields authority over its former territory to UNTAET.

- **2001**

30 August – East Timor elects a constitutional assembly.

- **2002**

22 March – East Timor's Constituent Assembly signs into force the first constitution.

- *14 April* – East Timor elects Xanana Gusmão as the country's first president.

20 May – UNTAET hands over authority to the elected Government of independent Timor-Leste.

27 September – General Assembly admits Timor-Leste as its 191st Member State.

Table II.33. Selected South-East Asian economies: inflation and money supply growth (M2), 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Inflation[a]				
Indonesia	20.4	3.7	11.5	10.5
Malaysia	2.8	1.5	1.4	1.8
Philippines	6.7	4.4	6.1	3.1
Singapore	0.1	1.3	1.0	–0.4
Thailand	0.2	1.6	1.7	0.7
Viet Nam	4.1	–1.7	–0.4	3.9
Money supply growth (M2)				
Indonesia	11.9	15.6	13.0	6.6[b]
Malaysia	13.7	5.2	2.2	5.8
Philippines	16.9	8.1	3.6	9.1[c]
Singapore	8.5	–2.0	5.9	–0.7[b]
Thailand	5.4	3.4	2.2	0.6[c]
Viet Nam	66.4	35.4	27.3	14.6[d]

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); IMF, *International Financial Statistics,* vol. LVI, No. 2 (February 2003); Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates.

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

Inflation subsided with currency appreciation and monetary restraint in Indonesia but was still in double digits

Inflation in Indonesia had peaked at 15 per cent in the second quarter of 2002, when administered prices for petroleum products, electricity and other utilities and transport were raised and flooding led to higher prices. It then went down to an average of 10.5 per cent, slightly above the Government's target range, for the year as a whole. Appreciation of the rupiah and slower growth in the money supply helped to stabilize prices. Nevertheless, the interest rate on short-term Bank Indonesia paper was a little above 13 per cent in December 2002, down from 17.6 per cent at the end of 2001. A lower rate of inflation, in the 8.5-9.5 per cent range, is targeted for 2003; the partial clawback of the second round of increases in administered prices in January 2003, together with appreciation of the rupiah, may enable this price goal to be achieved.

Concerted action brought inflation down sharply in the Philippines

In the Philippines, food prices have a 51 per cent weight in the consumer price index and were monitored by a specially formed task force. The prices were held down by stable supply conditions, helped in part by liberalized imports that offset the effects of a weaker peso. Food prices rose by 1.8 per cent in 2002, down from 3.9 per cent a year earlier. Electricity tariffs were reduced through a series of administrative measures. At the same time, excess capacity, coupled with weakening demand, limited the ability of producers to raise prices. The overall rate of inflation decelerated significantly to just over 3 per cent in 2002, from 6.1 per cent in 2001, well below the Government's 4-4.5 per cent target for the year. Inflation was expected to increase somewhat in 2003 owing to higher oil and food prices but to remain in the 4-5 per cent range. Interest rates were lower in 2002 compared with 2001. The Central Bank continued monetary easing into the first quarter before switching to a neutral stance, which was to remain in place provided that inflation was manageable. Market interest rates rose in the second half of the year, however, owing to concerns about rising fiscal deficits as well as global economic prospects and regional security. The yield on 91-day treasury bills was 5.3 per cent in December 2002, compared with 4.3 per cent in May; bank lending rates also drifted higher.

There were worries about deflation in Thailand until inflation picked up late in the year

Inflationary pressures in 2002 were very muted in Thailand, as demand pressures during the year were not excessive, and cost pressures were contained by the low capacity utilization, the absence of wage push and the appreciation of the baht. The inflation rate of 0.7 per cent for the full year was well below the 1.7 per cent rate of 2001, and there was some concern about deflation during the year. However, inflation picked up in December 2002, with consumer prices 1.6 per cent higher than the level prevailing in the same month a year earlier, owing to increased prices of food items (attributable, in turn, to adverse weather conditions), oil and some consumer goods. Inflation is expected to remain at 1.5 per cent in 2003, largely owing to higher prices for oil.

Monetary policy in Thailand was generally accommodative in 2002 but was also conditioned by the Bank of Thailand's desire to target the level and stability of the exchange rate. The benchmark 14-day repurchase rate was cut in December 2001 and again in January 2002 by a total of 50 basis points to 2 per cent. It was left at that level for much of the year to maintain a small premium over interest rates in the United States and thus discourage domestic banks from sending excess liquidity overseas. Continued global economic weakness, together with low domestic inflation and a declining fiscal stimulus, prompted the Bank of Thailand to make a further 25 basis point cut in November 2002, bringing the repurchase rate to 1.75 per cent.

Deflation occurred in Singapore as wage growth was negligible in the slackening labour market

Singapore experienced modest deflation of around –0.4 per cent in 2002. This reflected weak demand and restrained domestic costs, following the slack labour market conditions and negligible wage growth. In 2003, inflation is expected to pick up but remain comparatively low, at between 0.5 and 1.5 per cent, as the result of modest wage growth and the phasing-in of an increase in the Goods and Services Tax from 3 to 4 per cent. However, the sluggish economic recovery is likely to limit the ability of producers to pass the tax increase on to consumers. Domestic interest rates declined in 2002, in line with global interest rates and abundant liquidity in the domestic money market. The three-month interbank lending rate went down from 2.8 per cent at the end of 2000 to 1.3 per cent at the end of 2001 and further to 0.8 per cent at the end of 2002.

Foreign trade and other external transactions

External trade

Merchandise exports and imports rebounded very strongly in the Philippines

The Philippines experienced a sharp upswing in merchandise exports in 2002, albeit from a relatively low level in 2001 (table II.34). Increased shipments of electrical machinery and semiconductors accounted for the revival, particularly to markets in developing countries in East Asia; electronics expanded by almost 23 per cent. Garment exports were also up

Table II.34. Selected South-East Asian economies: merchandise exports and their rates of growth, 1999-2002

	Value (millions of US dollars)	*Exports (f.o.b.) Annual rate of growth (percentage)*			
	2001	*1999*	*2000*	*2001*	*2002 Jan.-Aug.*
Brunei Darussalam	3 318	28.9	23.7	5.1	−3.9
Indonesia	64 840	−0.4	27.6	4.4	−2.4
Malaysia[a]	88 199	15.1	16.1	−10.4	6.0
Philippines	32 140	20.3	7.3	−15.6	13.4
Singapore	121 717	4.4	20.2	−11.8	−1.8
Thailand[b]	63 200	7.4	19.5	−6.9	5.7
Viet Nam	13 569	24.0	25.5	−6.3	5.2

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003; National Economic and Social Development Board of Thailand web site <http://www.nesdb.go.th>, 13 January 2003; and Bank Negara Malaysia web site <http://www.bnm.gov.my>, 27 February 2003.

[a] Figure for 2002 is for the whole year.
[b] Figure for 2002 is a projection for the whole year.

Table II.35. Selected South-East Asian economies: merchandise imports and their rates of growth, 1999-2002

	Value (millions of US dollars)	*Imports (c.i.f.) Annual rate of growth (percentage)*			
	2001	*1999*	*2000*	*2001*	*2002 Jan.-Aug.*
Brunei Darussalam	1 321	–43.4	7.6	–7.6	24.5
Indonesia	38 810	–12.2	39.6	15.8	–3.9
Malaysia[a]	73 857	12.3	25.5	–10.0	8.3
Philippines	29 558	4.1	2.1	–5.8	32.6
Singapore	116 018	9.3	21.2	–13.8	–3.3
Thailand[b]	60 700	16.9	31.3	–2.8	6.0
Viet Nam	16 618	3.8	33.2	6.3	5.6

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), January 2003; National Economic and Social Development Board of Thailand web site <http://www.nesdb.go.th>, 13 January 2003; and Bank Negara Malaysia web site <http://www.bnm.gov.my>, 27 February 2003.

[a] Figure for 2002 is for the whole year.
[b] Figure for 2002 is a projection for the whole year.

sharply in the second half of 2002, reversing four consecutive quarters of decline. Boosted by demand for intermediate inputs, merchandise imports also grew strongly, reducing the trade surplus (table II.35). Significant expansion was recorded in imported materials and accessories for the manufacture of electronics products, and in capital goods imports. The deficit on the service account narrowed, mainly owing to higher net receipts from travel; fewer residents travelled overseas because of the weaker peso and a government campaign to attract domestic as well as foreign tourists was a success. Helped also by robust growth in migrant workers' remittances, the surplus on the external current account increased to 6.8 per cent of GDP in 2002 from 6.3 per cent in 2001 (table II.36).

Increased revenues from exports of agricultural commodities strengthened the trade accounts of many countries in the subregion

Export growth in Thailand in 2002 was estimated at 5.7 per cent for the full year and import growth at 6 per cent. Agricultural items, electronic products, electrical appliances, plastic goods and vehicles and parts all contributed to the export growth, while there was a decline in earnings on exported fishery products and garments. Durable consumer goods, computers and intermediate goods for the electronics and vehicle industries led import growth. As a result of the positive balance on the trade and services and transfer accounts, the current account surplus rose to 4.8 per cent of GDP in 2002.

Table II.36. Selected South-East Asian economies: budget and current account balance as a percentage of GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Budget balance[a] as a percentage of GDP				
Indonesia	−2.5	−1.2	−2.7	−2.5
Malaysia	−3.2	−5.8	−5.5	−4.7
Philippines	−3.8	−4.1	−4.0	−5.6
Singapore	2.6	3.5	1.9	0.1
Thailand	−3.3	−2.2	−2.4	−2.2
Viet Nam[b]	−1.0	−3.0	−3.5	−4.0
Current account balance as a percentage of GDP				
Indonesia	4.1	5.3	4.5	2.3
Malaysia	15.9	9.4	8.0	6.8
Philippines	10.4	11.3	6.3	6.8
Singapore	20.0	17.2	20.9	21.0
Thailand	10.2	7.6	5.4	4.8
Viet Nam	4.1	3.5	2.4	−1.2

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); and Economist Intelligence Unit, *Country Forecasts* (London, 2002), various issues.

Note: Data for 2002 are estimates.

[a] Excluding grants.
[b] Excluding grants and on-lending.

Viet Nam suffered a sharp fall in export earnings in 2001. Exports continued to display a weak performance into the first half of 2002 but a significant turnaround occurred in the third quarter and export revenues were up by 5.2 per cent year on year in the first eight months of 2002. The underlying strengths were improved commodity prices and a substantial increase in sales to the United States. Exports of rubber, handicrafts and fine art products and garments and textiles went up by rates in excess of 30 per cent, while double-digit growth of exports was recorded for rice, footwear and seafood. Export earnings from vegetables and fruit, fell sharply, however, as did those from coffee and computers and other electronic products. Crude oil exports were also down, owing to capacity constraints. In the first 10 months of 2002, 55 per cent of Viet Nam's exports went to countries in Asia; about 19 per cent went to other ASEAN countries and just over 36 per cent to non-ASEAN countries, of which 14 per cent went to Japan and 9 per cent to China. However, exports to the United States more than doubled between 2001 and 2002, passing the $2 billion mark, with exports of garments alone expanding 18-fold.

The growth in the value of imports, which also declined very sharply in 2001, outpaced that in export revenues somewhat in 2002. The fastest expansion was in imported machinery and equipment, refined oil, materials for the garment and textile industries, computers and electronic components. By contrast, import spending on motorcycle assembly kits declined by nearly one half following a reduction in quotas. As a result of these developments, both the trade and current accounts were expected to be in deficit in 2002. As a percentage of GDP, the current account surplus decreased in recent years, from 4.1 per cent in 1999 to a deficit of 1.2 per cent in 2002.

China and other countries in East Asia, as well as countries in the subregion, are emerging as important markets for some countries in South-East Asia

The decline in exports from Malaysia in 2001 bottomed out in the first quarter of 2002 and export earnings staged a sharp recovery that was generally broad-based. The upsurge was particularly marked for agriculture, in response to stronger commodity prices, followed by manufacturing, mainly electronics and electrical products, chemical products and wood products, including furniture. Signs were emerging, however, of some loss of momentum in exported electronics and electrical goods following weakening demand in major markets. On a brighter note, China and other countries in ASEAN are emerging as important markets for Malaysia; exports to China went up by almost 44 per cent and to ASEAN, by just under 19 per cent year on year in the third quarter of 2002.

Meanwhile, strong growth was registered by all categories of imports, capital, intermediate and consumer goods. In fact, the rate of import expansion outpaced that of exports, causing a narrower trade surplus. However, lower deficits on the services and income accounts, which reflected payments for transport services on the one hand and investment income on the other, contributed to containing the reduction in the surplus in the current account. As a percentage of GDP, the surplus declined from 8 per cent in 2001 to 6.8 per cent in 2002.

Imports contracted sharply in Singapore for the second year in a row owing to continued weakness in manufacturing

In the first eight months of 2002, merchandise exports in Singapore contracted by 1.8 per cent, considerably less than the decline of almost 12 per cent experienced during the previous year. The improved performance was due to both non-oil domestic exports, mainly pharmaceuticals, petrochemicals and disc media products, and re-exports, principally of electronics products. Although markets in the EU and Japan remained weak, there were signs of recovery in the United States market, while China and Hong Kong, China, have emerged as major export destinations. Other economies in the region, such as the Philippines, the Republic of Korea and Thailand, have also increased in relative importance as a source of export demand for Singapore.

Meanwhile, import spending fell by 3.3 per cent in January-August 2002, following a contraction of almost 14 per cent in 2001, with intermediate electronics and pharmaceutical imports showing faster growth later in the year. As a result of the sharper contraction in imports than in exports, the trade surplus widened and there was also a significant improvement in the services balance. Nevertheless, the current account balance at 21 per cent of GDP in 2002 was substantially unchanged from the previous year's level.

Large wage increases and currency appreciation are eroding Indonesia's competitiveness

Merchandise exports from Indonesia declined in the first eight months of 2002, with earnings from non-oil and gas exports falling particularly sharply, although there were some signs of a recovery in exported machines and electrical products. Large wage increases and the appreciation of the rupiah eroded somewhat the competitiveness of the Indonesian textile industry, where exports were stagnant, particularly to traditional markets such as the United States, the EU and Singapore. China's importance as an export destination has increased rapidly; exports to that country rose by nearly two fifths in the first nine months of 2002 as compared with a year earlier. However, the competitive strength of China is being felt by Indonesia, among others, in third-country markets, where prices were increasingly coming under pressure.

Non-oil and gas imports fell sharply in Indonesia in 2002, continuing the negative trend that had started in 2001. The decline was observed across the board but was particularly marked for capital goods and raw material inputs for manufacturing. The current account balance remained higher than expected in 2000-2002, mainly owing to the reduction in imports but also because of higher commodity prices, particularly of oil.

Capital flows and exchange rates

The ringgit peg to the United States dollar has proved to be an anchor of stability

Capital flows, which had been somewhat volatile in Malaysia in recent years, stabilized from mid-2001 in response to the improved macroeconomic fundamentals and the interest rate differential in favour of Malaysia. At the same time, the decline in capital outflows enabled the Central Bank to build up international reserves to $34.6 billion at the end of 2002 (adequate to finance 5.4 months of retained imports and 5.1 times short-term external debt). Net portfolio investment turned negative from the second quarter of 2002 as stock markets softened worldwide. Net FDI, which had amounted to only $0.3 billion in 2001, picked up significantly in 2002, reaching $1.5 billion in the first half of the year as production facilities were relocated to Malaysia from neighbouring countries. The ringgit remained pegged at M$ 3.80 to the United States dollar and there was little pressure for this to change. In the view of IMF, the improved macroeconomic situation in Malaysia was supportive of the exchange rate peg as a "stability anchor", and the value of the currency did not appear to be misaligned. In line with the dollar exchange rate, the ringgit generally depreciated against most other major and regional currencies from the end of 2001 to the end of 2002, thus giving some relief to the country's exporters.

FDI slowed in Thailand, as in many other countries of the subregion

The net outflow on the capital account in Thailand of $2.6 billion in the first nine months of 2002 was appreciably lower than the $4.1 billion outflow in the same period in 2001. The causal factors for this improvement included higher net portfolio investment and a reduction in commercial banks' foreign assets. However, public debt repayments were higher, as were outflows from non-resident baht accounts. In addition, FDI appeared to have slowed considerably. The overall surplus on the balance of payments in the first nine months of 2002 amounted to $3.1 billion, up from a deficit of $0.1 billion in the same period in 2001. International reserves were estimated to have risen to $38.4 billion by December 2002. The baht appreciated against the United States dollar in the first half of the year, but the uncertain global economic outlook led to a reversal of this trend in the second half before the appreciation resumed. The currency traded in a range between 40 and 44 baht to the dollar in 2002, in line with market conditions and regional trends; it is expected to continue doing so in 2003, with Bank of Thailand intervention likely to maintain stability.

Disbursements of official capital to Indonesia revived after the Bali bombing

Lower debt repayments in 2002 served to slow private capital outflows from Indonesia, while inflows picked up as a result of asset disposals by the Indonesian Bank Restructuring Agency and the privatization programme. Portfolio investors have also been returning to Indonesia, although FDI fell 35 per cent in terms of value and 15 per cent in terms of the number of projects in 2002. Disbursements of official capital revived after the Bali bombing, conditional on the implementation of reforms and action to fight poverty, and by the end of 2002 Bank Indonesia's foreign exchange reserves had risen to $31.7 billion. The rupiah strengthened throughout the year, with the exception of a surprisingly brief period of weakness in the immediate aftermath of the Bali bombing; from Rp 10,320 to the dollar at the end of 2001, it reached Rp 8,965 at the beginning of December 2002. The currency's strength was partly a reflection of general currency strength in the region and partly of the weakness of the United States dollar, but it also reflects the greater political and macroeconomic stability achieved by the country.

Increased remittances and portfolio investment mitigated the weakness of the Philippine peso

The deficit on the capital and financial accounts increased in the Philippines in the first half of 2002 owing to higher net outflows of direct investments as well as higher outflows of "other" investments. Direct investments declined because of lower equity investments by non-residents and repayment of intercompany loans. Higher residents' investment in equity capital abroad also contributed to the increase in outflows. The net outflow of "other" investments reflected higher net deposits abroad by resident banks. Meanwhile, net portfolio investments rose sharply owing to non-residents' investment in government-issued medium-term bonds. In the first nine months of 2002, the overall surplus on the balance of payments was only $0.5 billion, which was nevertheless an improvement over the deficit of $1.3 billion recorded in the same period in 2001. Gross international reserves stood at $16 billion at the end of September 2002, a marginal improvement from $15.7 billion at the end of 2001 and enough to cover 9.3 months of imports. Increased inflows of foreign portfolio investment as well as remittances, together with the general strengthening of regional currencies against the dollar, supported the peso exchange rate in the first half of 2002. However, deteriorating market sentiment, influenced in part by the burgeoning fiscal deficit, drove the peso lower in the second half of the year and the exchange rate hovered in the range of 53-53.5 pesos to the dollar towards the end of the year.

FDI flows are increasingly directed to small and medium-sized projects in Viet Nam

Remittances are also gaining in importance in Viet Nam following the Government's adoption of measures to attract them in 1999. Remittances were estimated to have reached $1.9 billion in 2001 and to exceed $2 billion in 2002. Inward FDI was relatively stable in 2000-2002 in terms of disbursements, at around $2.1 billion a year. Although commitments were lower in 2002, they covered a larger number of projects, thus indicating a shift towards small and medium-sized projects. There have been substantial inflows of ODA to Viet Nam in recent years. Of a total of $5.82 billion committed between 2000 and 2002, some $5.25 billion was disbursed. Official reserves increased from $3.4 billion in 2000 to approximately $4 billion in 2002. The dong has been depreciating against the United States dollar since 1997, although the rate of depreciation slowed in 2002 to 2.1 per cent, or just over half of the 3.9 per cent depreciation in 2001. However, given the weakness of the United States dollar against most other currencies in 2002, the effective depreciation of the dong was much greater. The dong was trading at 15,400 to the dollar in December 2002.

Gross official reserves increased significantly in Singapore in spite of the deficit on the capital and financial accounts

The shortfall in the capital and financial accounts in Singapore widened in the third quarter of 2002, after narrowing in the first half, because of higher net outflows of portfolio and direct investment. Nevertheless, gross official reserves were expected to increase to $83.3 billion by the end of 2002. From the beginning of July 2001, the Monetary Authority of Singapore has maintained a neutral policy stance, targeting a zero appreciation in the trade-weighted nominal effective exchange rate for the Singapore dollar, which fluctuated in the upper band of its target range for much of 2002. The Singapore dollar appreciated against the United States dollar in 2002, ending the year at S$ 1.74 to the United States dollar. On the exchange markets, the Brunei dollar has followed the Singapore dollar, to which it is linked by a currency peg.

External debt

External debt was down in Indonesia but much of it remains short-term in nature

At the end of July 2002, total external debt in Indonesia amounted to just over 90 per cent of GDP, down from 91.3 in 2001, the Government's portion of foreign debt being 57 per cent of the total. Although external debt has been on the decline, and is well down from the peak of 157 per cent of GDP in 1998, much of it remains short-term. The World Bank has estimated that debt due within one year constituted 70 per cent of gross reserves in 2002, 10 per cent lower than the 2001 figure but nevertheless much higher than comparable figures for the other countries hit by the 1997-1998 financial crisis. Rescheduling agreements were reached for debt-service payments with the Paris Club in April 2002 and with the London Club in June 2002, easing considerably the burden of short-term debt obligations on the government budget and on official reserves. Indonesia's foreign currency sovereign debt ratings are currently CCC+/B3 with a stable or positive debt outlook; although these ratings have improved, they are still below those for comparable economies in the subregion.

Aggressive borrowing on international capital markets to finance the Philippine Government's fiscal deficit has eroded confidence somewhat

External debt was on a rising trend in the Philippines as the Government was financing its deficit by borrowing aggressively in international capital markets, in part to take advantage of lower interest rates. By the end of June 2002, the total government debt amounted to 67 per cent of GDP, a comparatively high value for the subregion; of this amount, 47 per cent was external debt. From just over $46 billion in 2000-2001, it had ballooned to almost $55 billion by mid-2002. External debt declined in the third quarter to $53.6 billion, of which the public sector share was 65 per cent. However, the unexpected widening of the fiscal deficit led the Government to resort to additional external borrowing. Although major ratings agencies have maintained current ratings for foreign currency sovereign debt at BB+/Ba1, the debt outlook was downgraded to negative from stable by some agencies following those developments.

The Government's external debt has also been rising in Malaysia but market sentiment remains favourable

Total external debt as a percentage of GDP has also been on a rising trend in Malaysia since 2000, when it amounted to 46.7 per cent of GDP; the ratio reached 51.8 per cent in 2001 and an estimated 53.3 per cent of GDP by September 2002. The share of the public sector external debt of a medium- and long-term nature also rose, accounting for 64.8 per cent in the third quarter of 2002 as compared with 61.3 per cent in the first quarter of 2001. While the Government was initially keen to limit borrowing overseas, its current priority is to maintain the fiscal stimulus in the face of a weakening global economy, while at the same time limiting the impact of public spending on domestic interest rates. Market sentiment as regards Malaysia appears to be favourable: credit rating agencies upgraded the country's foreign currency sovereign debt to BBB+/Baa1 in the third quarter of 2002, and new placements of sovereign bonds in April and June 2002 were oversubscribed.

The increase in official reserves has led Thailand to repay the outstanding balance of the loan from IMF two years ahead of schedule

Thailand's external solvency has improved greatly in recent years. Total external debt at the end of August 2002 was in the region of $64.4 billion, roughly 55 per cent of GDP, well below the 93 per cent of GDP prevailing at the end of 1998. Approximately 79 per cent of this debt was long-term, and the share of the public sector in total external debt was around 41.3 per cent. The high level of international reserves will permit the earlier repayment of the $4.8 billion outstanding from the IMF loan following the financial crisis of 1997-1998 within a six-month period beginning February 2003, two years ahead of schedule, thus saving $126 million in interest payments. International ratings agencies, while maintaining Thailand's ratings for sovereign foreign currency debt at BBB-/Baa3, raised the debt outlook to positive from stable.

Viet Nam's stock of external debt outstanding was expected to reach $13.3 billion by the end of 2002, up from $12.1 billion at the end of 2001. This represents 37 per cent of GDP and 84 per cent of exports. Most of this debt is on concessional terms and carries very low interest rates. The external debt-service ratio, which was just under 23 per cent of export earnings in 1997, fell very sharply to 9.4 per cent in 2001 and further to 7.9 per cent in 2002. This is judged to be a sustainable level and Viet Nam is not likely to qualify for debt relief under the Highly Indebted Poor Countries Initiative. International ratings agencies raised Viet Nam's sovereign foreign currency debt ratings in 2002 to BB-/B1, with a stable or positive debt outlook.

Key policy issues

Unemployment and poverty alleviation continue to head the policy agenda of most countries in the subregion

Issues related to poverty and unemployment continued to head the policy agenda in many countries in the subregion. Although the officially-defined poverty headcount index in Indonesia declined from the 27 per cent value it had reached in 1999 after the financial crisis to 13.2 per cent early in 2001, it has since drifted upwards as a result of modest economic growth. The index, which stood at 17 per cent at the end of 2002, was to be lowered to 15 per cent in 2003, but recent price increases for products such as kerosene, after fuel subsidies were cut as part of the IMF-mandated reform programme, and rice, following increases in the paddy support price and import tariffs, may make it more difficult to attain this goal. The latest round of fuel price increases was greeted with extensive demonstrations, prompting the Government to change its policy and cut subsidies gradually. This action may have clouded prospects for the disbursement of much-needed official aid somewhat, but the response of donors so far has been sympathetic. The Bali bombing is also likely to increase the incidence of poverty in the short to medium terms; according to World Bank estimates, another 2-3 million people will fall below the poverty line as a result of the adverse impact of the bombing on economic growth.

Growth remains insufficient to absorb the unemployed in Indonesia

Per capita incomes in urban areas of Indonesia appear to have returned to pre-financial crisis levels as a result of the steep rise in minimum wages across the country, by 30 per cent on average in 2002, and in government wages, by 15-20 per cent in the same year. Real wages in agriculture and in the informal sector and among SMEs, however, remain well below pre-crisis levels because of increased competition for the available jobs from the large number of displaced formal sector workers. The volume of unemployment is thought to be considerably larger than the official estimate of 8.4 million in 2002 and is likely to rise further as a result of higher minimum wages. A large number of illegal migrant workers have also been repatriated from Malaysia; a much faster rate of economic growth, around 6-7 per cent annually, is thought to be necessary to absorb these workers along with the 2.5 million new entrants to the labour force each year.

The lack of new jobs in industry is largely responsible for the slow growth of employment in the Philippines

The unemployment rate in the Philippines rose to 10.2 per cent in October 2002 (up from 9.8 per cent in October 2001). Based on a labour force survey in July 2002, the number of employed persons increased by 2.8 per cent, while the labour force expanded by 4.1 per cent year on year. Jobs generated in services and agriculture were the main cause of the expansion in employment, as the number of jobs in industry shrank. Meanwhile, the number of workers seeking employment overseas went up by 2.2 per cent in the same period. In addition, the volume of underemployment amounted to 15.3 per cent of those currently in employment. Nominal wages in the agricultural and non-agricultural sectors went up by just over 14 and 12 per cent respectively in the second quarter of 2002, compared with the same quarter a year earlier; real wages gained 10 and 8 per cent respectively in the same period.

Early gains in poverty reduction in the Philippines have been reversed recently and vulnerability remains high

Poverty in the Philippines fell very substantially from 34 per cent in 1991 to a little over 25 per cent in 1997, based on the officially-defined poverty headcount index. The latest index value available shows that in 2000 poverty had increased to 27.5 per cent nationally. The rural poverty rate, at slightly over 41 per cent, was more than three times the urban rate of 13.2 per cent. There are also many near-poor: the World Bank estimates that while the percentage of the population living on less than $1 per day was 12.7 in 2000, the percentage living on less than $2 per day was 45.7. Poverty is likely to have decreased in 2001 but the recent increase in unemployment suggests that it may have risen again in 2002. The Medium-term Philippine Development Plan, 1999-2004, targets a decrease in poverty incidence to 18.8 per cent in 2004 and 11.6 per cent in 2010 in order to meet the millennium development goal on poverty reduction, but more robust economic growth will be needed if these targets are to be met.

Thailand has made considerable progress in reducing unemployment and the incidence of poverty, but poverty levels remain above those prevailing before the 1997-1998 crisis

The labour market has improved noticeably in Thailand, with the official unemployment rate falling to its lowest level in five years, to 1.8 per cent in August 2002 compared with 2.1 per cent in August 2001. Employment increased markedly in construction and manufacturing; it increased less sharply in services and remained essentially stable in agriculture. The estimated volume of underemployment also declined, from 1.8 per cent in August 2001 to 1.4 per cent in the same month in 2002. Indications are that by the end of 2002, GDP per capita had returned to the level prevailing in 1996.

Progress has also been made in poverty reduction: the percentage of the population living on less than $2 per day fell to 32.3 per cent in 2002 from 35.6 per cent in 2000. According to World Bank estimates, however, the incidence of poverty remains above pre-crisis levels. In addition, while it appears to have declined faster in rural areas, it remains much higher there than in urban areas. The Government has implemented a number of measures to target low-income groups for further poverty reduction as well as to generate more employment opportunities, such as the village fund and debt suspension for farmers. There are, moreover, other schemes to raise the amount of credit available for SMEs as well as the universal health-care scheme of 30 baht per health-care visit. More recently, measures were also announced to encourage the construction of one million units of low-cost housing for low-income groups.

Poverty remains largely a rural phenomenon in Viet Nam, where income inequality is also rising

An employment survey conducted in Viet Nam in July 2002 found that the labour force had expanded by 2.9 per cent from the previous year, faster than the current growth rate of 1.5 per cent in the population but reflecting the more rapid rates of population growth of some years before. At the same time, the urban unemployment rate declined to 6 per cent from 6.3 per cent in 2001. In rural areas, open unemployment, estimated at 1 per cent of the labour force, was low but seasonal underemployment could be considerably higher. The survey found that in rural areas the amount of time spent working increased to 75 per cent of potential working hours in 2002 from 74 per cent in 2001.

Viet Nam has also made good progress in poverty reduction. According to World Bank estimates, the percentage of the population living on less than $1 per day declined from 15.2 per cent in 2000 to 10.4 per cent in 2002. However, vulnerability remains high as the percentage of the population living on less than $2 per day in 2002 was high, at 57.6 per cent (down from 64.7 per cent in 2000). Ninety per cent of the poor live in rural areas, where the poverty gap is wider and natural disasters are more frequent. Furthermore, there have been some signs that inequality may be widening in recent years after a decade of rapid growth and reform. Incomes of people in the top 10 per cent of the income scale were 10.6 times the incomes of those in the bottom 10 per cent in 1996. This figure rose to 12 times in 1999 and further to 12.5 times in 2002. In May 2002, Viet Nam embarked on a Comprehensive Poverty Reduction and Growth Strategy, which was strongly endorsed by international donors and multilateral agencies. The programme is due to last three years, at a total cost of $70 billion, with the bulk of the funds coming from the State budget.

Pockets of poverty persist in Brunei Darussalam in communities of migrants

In Brunei Darussalam, the official unemployment rate (based on those registered with the Government as seeking jobs) was 4.7 per cent in 2001, but the true figure is likely to be considerably higher. It has been estimated, for example, that one quarter of school-leavers might be unable to find work straight away. Close family networks and some welfare organizations provide a safety net for the unemployed, and the Government is looking for ways to ease youth unemployment in particular. Some pockets of absolute as well as relative poverty persist, particularly among communities of migrants who have been settled in the country for many generations. There is scope for enhanced intersectoral and inter-agency collaboration for more effective poverty alleviation.

Lack of investment is primarily responsible for limited employment opportunities in Indonesia, where many businesses are closing

Investment to generate job opportunities and maintain competitiveness was another important policy issue in 2002. The lack of adequate investment in the Indonesian economy is of concern. In particular, foreign investment approvals fell 40 per cent and domestic investment over 70 per cent in the first half of 2002, as compared with the same period in 2001. Four causal factors were cited: the weak legal system, increasing labour unrest, new regional autonomy laws and security concerns. In a recent UNCTAD study,[4] the country was ranked 138th out of 140 in its ability to attract FDI, relative to its size. Many large and medium-sized firms have been closed down and several others downsized or merged (a total of 1,323 in 2001, up from 1,149 in 2000). Labour-intensive sectors such as textiles and garments, leather and footwear seem to be the most affected, although Sony announced the closure of its audio equipment plant in March 2003, affecting approximately 1,000 employees. A number of multinationals such as Nike and Reebok have shifted purchase contracts to China and Viet Nam. Many companies in which firms from Japan and the Republic of Korea have invested have also threatened to close some factories and relocate others in response to labour unrest and high wage demands. In 2002, Indonesian manufacturers were actively seeking postponement of the full implementation of the ASEAN Free Trade Area for the textile and shoe industries as well as for chemicals and sugar.

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[4] UNCTAD, *World Investment Report 2002: Transnational Corporations and Export Competitiveness* (United Nations publication, Sales No. E.02.II.D.4).

Weak investment in Philippine industry is also a reflection of low savings and investment ratios and limited FDI

The slow rate of job creation in Philippine industry is also a reflection of insufficient investment in that sector. Unfortunately, both the savings and investment rates of the Philippines are low by subregional standards, and FDI inflows have also been less buoyant. In addition, business confidence on the part of both domestic and foreign investors was seriously affected by the Government's perceived lack of credibility in tackling the rising fiscal deficit.

To reduce reliance on foreign trade and investment, the Malaysian Government is looking to SMEs, particularly in services and agriculture

Malaysia is also faced with the challenge of sustaining medium-term growth through a return of private sector investment to the levels prevailing prior to the 1997-1998 crisis, given in particular the Government's declared aim of lowering dependence on foreign investment and trade. To this end, the 2003 budget introduced targeted tax cuts and tax incentives aimed at SMEs and at bolstering investment in services and agriculture. New initiatives were launched in 2002 to enable SMEs to adopt information and communication technologies to improve the management of resources, enhance design capabilities and integrate more closely with international supply chains.

Improving total factor productivity will require a sustained effort to raise educational quality in Malaysia

Malaysia is also seeking to transform itself into a knowledge- and service-based economy as it faces intensifying competition in third markets. Science and mathematics are to be taught in English in all schools to improve the competitiveness of the labour force and university admissions are to be based on merit and not race. In the Seventh Malaysia Plan, 1996-2000, total factor productivity contributed just under a quarter to economic growth, as compared with the relative shares of labour and capital, which were 25 per cent and just over 50 per cent respectively. In the Eighth Malaysia Plan, 2001-2005, total factor productivity is expected to contribute over 37 per cent to growth, while the relative shares of labour and capital are 21.5 and 41.3 per cent. Over the decade of 2001-2010, it is expected that the contribution of total factor productivity to overall growth will be raised to 42.5 per cent, a share much larger than the individual contributions of both labour (20.9 per cent) and capital (36.6 per cent). Much remains to be done, however, to upgrade educational quality and improve total factor productivity if Malaysia is to achieve its goal of developed country status by 2020. Education and vocational training continued to be accorded priority in the 2003 budget, as in the previous year.

Singapore is also faced with the challenge of intensifying ...

In Singapore, unemployment has been on a rising trend for some years, from an average of 1.8 per cent of the labour force in 1997 to a 15-year peak of 4.8 per cent (seasonally adjusted) in the third quarter of 2002. Although job losses have been concentrated in manufacturing and construction, there was also a contraction of employment in services.

... international competition and the need to reduce vulnerability to external shocks

While some of the increase in unemployment is no doubt cyclical, it is clear that Singapore is faced with the need to restructure and develop new industries as competitive pressures from other economies in the region intensify and global consolidation continues in such key sectors as financial services. Nevertheless, the country has maintained its ranking as the fourth most competitive economy in the world according to the World Economic Forum.

Singapore is also highly vulnerable to swings in external demand, given its significant reliance on trade. Since 1995, the country has experienced several external shocks: a downturn in the electronics industry in 1996-1997, the Asian financial crisis of 1997-1998 and another downturn in electronics in 2001. In response, the Government has maintained its medium-term focus by using fiscal measures not only to offset decreases in demand but also to influence supply-side variables, such as corporate taxation, so as to lower business costs. It has also adopted policies to promote labour market flexibility and reduce the burden of pension contributions on wages.

Attracting highly qualified individuals and SMEs to relocate to Singapore is an important aspect of the Government's strategy

Singapore has sought to diversify its economic activities by promoting services and chemicals, particularly pharmaceuticals, and high-end, niche products such as biomedicines. Education and training have received considerable investment. Encouraging entrepreneurship remains problematic in an economy with such a large government-linked sector, but the Government is now seeking to attract both highly qualified individuals and SMEs, particularly high-tech start-ups, to relocate to Singapore. An International SME Business Centre has been established to enable foreign SMEs to find inexpensive facilities, and the PartnerSingapore programme has also been designed to enable those firms to form partnerships with local SMEs. Attracting multinational corporations continues to be an important aim, but by broadening the focus to include SMEs the Government hopes to reduce some of the "footloose" nature of multinational investment.

Free trade agreements are another important aspect of Singapore's strategy

Singapore, which is a member of AFTA, has also moved aggressively to sign FTAs with other countries, not only as a means of stimulating Singaporean firms to be more competitive but also to improve the country's attractiveness as a business location. FTAs have been concluded with Australia, the European Free Trade Association, Japan and New Zealand, and the agreement with the United States is on the verge of conclusion. Singapore is also discussing FTAs with Canada, Mexico and the Republic of Korea. In 2002, ASEAN agreed to work towards establishing an FTA with China and tariffs will be eliminated for the more developed members of the grouping by 2010 (box II.8).

Box II.8. Closer economic cooperation between ASEAN and China

At the Fourth ASEAN Informal Summit, held in Singapore in November 2000, the leaders of ASEAN and China agreed to look at measures to enhance economic cooperation and integration between them, with a view to establishing a free trade area. The imminent accession of China to the WTO and the rapid growth in trade and investment between both sides provided the spur to those discussions. ASEAN had additional reasons to search for major partners for its free trade area (AFTA). Its “flying geese” model of development, with Japan providing demand traction as well as enhanced supply potential through its FDI in ASEAN, had lost momentum with the slowdown in the Japanese economy that began in the early 1990s. The United States and the EU had provided alternative markets until the 1997-1998 financial crisis shook the confidence of their investors in the subregion. China’s adoption of market-oriented development and its subsequent formidable growth have placed it in a position to play an important locomotive role for the subregion. The potential for this was demonstrated in 2002 when China was an important source of demand for the exports of goods and services from members of ASEAN.

The slow progress of multilateral negotiations on trade liberalization under WTO and the proliferation of regional and bilateral trading agreements have provided additional incentives for East Asian nations to move towards similar agreements among themselves. However, the strong commitment of Japan and the Republic of Korea to multilateral trade liberalization, as well as other issues such as trade in agriculture, have tended to slow their participation in regional trading arrangements.

Total trade between China and ASEAN grew at an average annual rate of 20.4 per cent from 1991, when total trade amounted to only $7.9 billion, to reach $39.5 billion in 2000, when ASEAN became China’s fifth-largest trading partner.[a] This does not take into account the important but largely undocumented border trade between China and the new ASEAN-4, Cambodia, the Lao People’s Democratic Republic, Myanmar and Viet Nam. While ASEAN’s imports from China have tended to concentrate on machinery and electrical equipment, China’s imports from ASEAN are moving away from resource-based products towards manufactures. In fact, the strongest rate of growth in trade between both sides is in manufactured products, with trade in machinery and electrical equipment, including electronics, growing the fastest. This suggests considerable potential for intra-industry trade between ASEAN and China, with its attendant benefits through greater product differentiation and economies of scale. Trade in services is also likely to increase sharply, including through the potentially large market in two-way tourism. Finally, the volume of direct FDI flows between China and ASEAN is still relatively small. Nevertheless, the importance of foreign-invested enterprises in exports from both sides suggests that increasing trade between them is likely to generate more investment, including from multinational corporations.

Against this background, the leaders of China and ASEAN took a decision at the summit held at Bandar Seri Begawan in November 2001 to launch negotiations for the creation of a free trade arrangement (FTA) within 10 years, and a Framework Agreement on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and the People’s Republic of China was signed at the summit held at Phnom Penh in November 2002.[b] The objectives of the Agreement, which will come into force on 1 July 2003, are to strengthen and enhance economic, trade and investment cooperation, progressively liberalize trade in goods and services as well as facilitate investment, explore closer economic cooperation and facilitate the economic integration of the newer member States of ASEAN. To this end, an ASEAN-China FTA will be created, with tariffs being eliminated or reduced by China and the ASEAN-6, Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand, by 2010, when AFTA will be fully implemented, and by the new ASEAN-4 countries by 2015. A particular feature of the Agreement is the Early Harvest Programme of accelerated tariff reductions mainly on agricultural products. China has also committed itself to according most-favoured-nation treatment consistent with WTO rules and disciplines to all members of ASEAN that are not members of WTO. Negotiations are to begin early in 2003 on the agreement for

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[a] After Japan, the United States, the EU and Hong Kong, China. See “Forging closer ASEAN-China economic relations in the twenty-first century”, report submitted by the ASEAN-China Expert Group on Economic Cooperation, pp. 7-10, <http://www.aseansec.org/newdata/asean_chi.pdf>, 15 February 2003.

[b] See <http://www.aseansec.org/13196.htm>, 15 February 2003.

tariff reduction or elimination in order to implement the FTA by the agreed dates, and on trade in services and investments. The parties to the Framework Agreement have also agreed to strengthen cooperation in five priority areas, agriculture, ICT, human resources development, investment and development of the Mekong River basin. Particular regard will be given to capacity-building programmes and technical assistance for the newer members of ASEAN. Within a year of the entry into force of the Agreement, appropriate formal dispute settlement mechanisms and procedures will be established.

The ASEAN-China FTA will create a market of 1.7 billion consumers with a combined GDP estimated at over \$2 trillion. For ASEAN, this is a major initiative, enabling it to leverage its privileged access to the Chinese market to position itself as a "hub" for future FTA "spokes", with Japan, the Republic of Korea, the United States and India, and possibly Australia and New Zealand.[c] It can also hope to retain its attractiveness as a destination for multinational FDI for the same reason. Furthermore, as Chinese companies are becoming major investors in foreign markets, ASEAN will be first in line for consideration as an investment location. The competitive pressure exerted on ASEAN by China, in terms of both exports of light manufactures, such as textiles, garments, footwear and leather products, to third-country markets, and attracting FDI flows, intensified during the 1990s. However, an examination of more recent data suggests that changing trade and FDI patterns in China, with a rising trend in the electronics sector, point to the emergence of a more complementary relationship between China and ASEAN.[d] Unlike light manufactures, where the scope for intra-industry and intra-firm trade is limited, trade in electronics is driven by multinational corporations that split the value added chain among several production locations in search of greater efficiency, lower costs and higher profitability. Thus, ASEAN can hope that greater integration with China will help it to stay in the picture if the subregion can maintain and enhance its own competitiveness.[e]

A potential problem exists, however, in the emergence of a "two-speed" ASEAN.[f] While more developed countries in ASEAN could benefit from China's growth through greater linkages with its high-tech industries, the less developed member countries (such as the new ASEAN-4 and possibly some "older" members as well) could find themselves being squeezed out of light manufacturing without the possibility of becoming part of the emerging regional production networks. Thus, there is a clear need to ensure that the development gap does not become insuperable in the process of promoting regional cooperation and enhancing regional integration.

The development of China is likely to open up unprecedented market opportunities for ASEAN. According to a recent study,[g] China will become East Asia's largest trading nation in 2020, its largest exporter in 2010 and its largest importer in 2005. It is projected to develop a structural trade surplus with Western economies but a structural trade deficit of the same magnitude with East Asia. Trade liberalization will ensure that the ASEAN economies will be in a position to take advantage of the net benefits of China's export success, even though there will be an inevitable process of adjustment as countries seek to strengthen and develop areas of comparative advantage.[h]

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[c] Robert Scollay, "Economic impact of RTAs in Asia and the Pacific region", paper presented at the Expert Group Meeting on Regional Trade Arrangements in Asia and the Pacific, held at Bangkok on 30 and 31 January 2003.

[d] Kong-Yam Tan, "Comments on PRC's WTO entry: impact on rest of the region", paper presented at the ADB Fourth Asia Development Forum: Trade and Poverty Reduction, held at Seoul from 3 to 5 November 2002, <http://www.adb.org/Documents/Events/2002/ADF/tan_paper.pdf>, 15 February 2003.

[e] Simulations presented in Scollay, op.cit., suggest that ASEAN will be the principal beneficiary in terms of welfare of the ASEAN-China FTA, with the gain to China being negligible. An FTA that included Japan and the Republic of Korea, however, would provide greater welfare gains to both China and ASEAN.

[f] Kong-Yam Tan, op.cit., and Thitapha Wattanapruttipaisan, "ASEAN-China FTA: advantages, challenges and implications for the newer ASEAN member countries", forthcoming in *ASEAN Economic Bulletin*, April 2003.

[g] David Roland-Holst, "An overview of PRC's emergence and East Asian trade patterns to 2020", ADB Institute Research Paper 44 (Manila, October 2002), <http://www.adbi.org/PDF/wp/rp44.pdf>.

[h] The study points out, however, that although the ASEAN-China FTA will benefit most member countries, it will do so to a lesser extent than global trade liberalization. Furthermore, it will entail significant trade diversion from Japan, the Republic of Korea and Taiwan Province of China. See Roland-Holst, op. cit., and also Scollay, op. cit..

The structural problems of the labour market in Brunei Darussalam also remain to be resolved and may impinge on its ability to attract foreign investors; in the UNCTAD study referred to earlier, the country was ranked 128th out of 140 in its ability to attract FDI relative to its economic size. Many businesses are hard-pressed to find skilled workers and obtain manual labour to work on construction projects. There have also been delays in securing labour permits for migrant workers. However, many professionals are reported to be seeking jobs overseas owing to the lack of opportunities at home and government training programmes seem to attract limited interest.

Progress in market-oriented reforms has been uneven in Viet Nam

Viet Nam has embarked on a number of market-oriented reforms, including in the area of trade policy, where progress has been very rapid. Quantitative restrictions are being removed, tariffs reduced and other trade barriers lifted in accordance with a five-year timetable that was announced in April 2001. However, some recent backtracking has occurred with regard to motorcycles and passenger vehicles as protection continues for the domestic motorcycle and vehicle assembly and parts industries. At the same time, Viet Nam is moving ahead with commitments made under AFTA and the bilateral trade agreement with the United States. Viet Nam is also proceeding with a series of bilateral negotiations with a number of countries as it is seeking membership in WTO. Reform of State-owned enterprises has been viewed as a necessary complement to trade and banking reforms, but progress has not been as fast as expected, largely because of management and employee resistance and the heavy debt burden of those enterprises; the debt consists mainly of loans from State-owned commercial banks. The Government is seeking to revitalize the process by setting annual targets for the reform of State-owned enterprises, and 1,400 of these firms are to be equitized by mid-2004.

The limited economic recovery in 2002 opened up the possibility of initiating fiscal consolidation in some countries in the subregion

Fiscal consolidation has been a major preoccupation in some countries, such as Indonesia, which has little discretion on either the fiscal or monetary policy fronts. Economic policy is being formulated under an IMF progrmme due to expire in December 2003. Considerable progress has been made in reducing the Government's deficit through cuts in fuel subsidies, falling interest rates and some increases in tax revenue (table II.36). The actual deficit in 2001 was 2.7 per cent of GDP, below the planned 3.7 per cent, as the inability to meet reform commitments delayed disbursement of foreign financing. For 2002, the deficit target of 2.5 per cent of GDP is likely to be met. A more substantial reduction in the deficit, to 1.3 per cent of GDP, was planned for 2003 but this was revised upwards to 1.8 per cent after the Bali bombing. The Government-debt-to GDP ratio declined more rapidly than expected, from 98 per cent in 2000 to 80 per cent in mid-2002, but around 40 per cent of the State budget is currently allotted to servicing both foreign and domestic debts. Legislation adopted on 24 September 2002 established treasury bills as a new asset class, allowing the Government to issue those bills with maturities of 6-12 months to refinance bank recapitalization bonds as they come due. Previously, the bond market consisted of only short-term Bank Indonesia certificates and long-term recapitalization bonds, and the addition of these bills will increase liquidity and permit greater flexibility in financing.

The fiscal deficit target was overshot by a very wide margin in the Philippines, where tax administration is in need of urgent reform

In the Philippines, the fiscal balance went from a surplus of 0.1 per cent of GDP in 1997 to a deficit of 4 per cent in 2001, and a lower shortfall of 3.3 per cent of GDP was targeted in 2002. It now appears that the deficit for 2002 will be 5.6 per cent of GDP and targeted shortfalls for 2003 and following years will have to be reviewed. Interest payments consumed around one third of government revenues in 2002. A reduction in the fiscal shortfall appears to be mainly dependent on raising more revenue, as there is little room for further expenditure cuts if essential spending on the social sectors is not to be jeopardized. While there may be some room for increasing tax effort, tax administration appears to be the area most in need of reform, and the Government has introduced several measures to improve tax collection. A bill was also introduced in Congress to create an Internal Revenue Management Authority to strengthen the performance and accountability of the Bureau of Internal Revenue.

The concern on the part of investors is that, as the sovereign ratings of the Philippines slip, the cost of loans in foreign currency on which the Government has been relying will rise, forcing it to turn to domestic sources of funds. Capital markets are underdeveloped in the Philippines, as in other countries in the subregion, the principal type of financing for companies being short-term lending from domestic banks. While loan demand has been subdued, the banks have been more than willing to purchase government paper, but if demand from private investors were to rise, they could find themselves being “crowded out” by the public sector. Since companies in the Philippines tend to rely on retained earnings to finance investment much more than do other countries of the region, this effect could be mitigated somewhat but heavy public sector borrowing could still stand in the way of capital market development.

In Viet Nam, the 2001 fiscal deficit, widened to 3.5 per cent of GDP, from 3 per cent in 2000, as the Government had to incur additional capital expenditure to repair infrastructure damaged by flooding. For 2002, a further widening of the deficit, to 4 per cent of GDP, is expected as more resources are needed for poverty reduction and reforms.

Fiscal consolidation in Viet Nam will require a major effort to develop non-oil sources of government revenue

The Government is also hoping to stabilize the level of public debt in the medium term and the deficit is set to decline gradually to 2 per cent of GDP by 2007. However, the augmented deficit, including on-lending and the capital cost of reforms, will peak at 10 per cent of GDP in 2003. Total public sector debt, including the portion pertaining to State-owned enterprises, was approximately 70 per cent of GDP in 2001; it is expected to peak at 76 per cent in 2004 before a subsequent gradual decline. Achieving fiscal consolidation will require a major effort to increase non-oil revenue, apart from containing the public sector wage bill and the expenditure of State-owned enterprises. It is estimated that almost one third of government revenue came from oil in 2002, but this figure is likely to drop in the future because of capacity constraints and possibly softer international prices. Rapid economic growth and measures to improve tax administration and combat tax fraud, particularly in VAT, may help to raise tax collections. However, a further strain on the budget can be expected from lower import tariffs resulting from commitments made under AFTA and the bilateral trade agreement with the United States, as well as from the provision of such tax incentives as the agricultural tax exemption for poor farmers.

Malaysia and Thailand have initiated the process of deficit reduction but much will depend on their economic performance in the immediate future

With the 2002 budget, Malaysia aimed to initiate the process of fiscal consolidation while at the same time attempting to support growth. The target for the shortfall was 5.1 per cent, down from 5.5 per cent in 2001, and strong revenue performance during the year led to a downward revision of the deficit to approximately 4.7 per cent. The 2003 budget seeks a further reduction to 3.9 per cent of GDP, but it was formulated when growth prospects appeared brighter and the deficit target may have to be reconsidered if the global economy weakens significantly. Strong revenue performance also led to a downward revision of Thailand's actual budget deficit in 2002 to 2.2 per cent, below the programmed 3.7 per cent as well as the actual shortfall of 2.4 per cent in 2001. Government debt, however, increased from 14.5 per cent of GDP in 1996 to approximately 59 per cent of GDP in 2001, with two thirds of the increase related to the costs of financial restructuring. The government focus is increasingly on fiscal consolidation, and the deficit programmed for 2003 is 3.1 per cent of GDP; it is hoped to return to a balanced budget by 2007. The target ratio of government debt to GDP was lowered from 60 to 55 per cent of GDP.

Indonesia has made reasonable progress in financial restructuring

Financial restructuring continues to be an important preoccupation in some South-East Asian countries. In Indonesia, the Indonesian Bank Restructuring Agency is likely to achieve its revenue target for 2002, having disposed of NPLs worth Rp 81.6 trillion at an average recovery rate of 28.3 per cent. The revenue target for 2003 was raised following revision of the State budget after the Bali bombing, but the Agency is still confident of meeting the higher target level. NPLs in the banking system amounted to 12.1 per cent in July 2002, as against 15.8 per cent in July 2001. After the Bali incident, Bank Indonesia postponed the requirement for banks to reduce NPLs to 5 per cent of outstanding loans by the end of 2003. It has also indicated that it will not be rigid about enforcing a 12 per cent capital adequacy ratio in line with Basel requirements. Although the average capital adequacy ratio in mid-2002 was quite high, at 23.4 per cent, this could reflect continuing bank reluctance to lend and weak loan demand. Blanket government guarantees on bank deposits, introduced at the height of the financial crisis of 1997-1998, are to be phased out in 2003. The Jakarta Initiative Task Force, which was founded in 1998, has finalized debt-restructuring deals for about 60 per cent of its $29 billion portfolio. Its mandate was extended from 2001 to expire at the end of 2003, and companies are still seeking its assistance. However, its work has been hampered by continuing weak economic growth and inadequate bankruptcy legislation.

The financial sector remains strong in Malaysia, where considerable progress has also been made in corporate governance

Financial and corporate restructuring has been largely completed in Malaysia. The banking sector remains sound, with the risk-weighted capital adequacy ratio reaching 13.3 per cent and the net NPL ratio declining to 7.7 per cent in the third quarter of 2002. Danaharta has restructured all its NPL holdings, with an average expected recovery rate of 57 per cent. The Corporate Debt Restructuring Committee closed down its operations as scheduled in August 2002, completing all but one of its 48 debt-restructuring cases; the remaining case was resolved in September. Considerable progress has also been made in corporate governance: minority shareholders' rights were strengthened; a new accounting standard was issued so as to improve the timeliness and reliability of financial disclosures; code of conduct guidelines were developed; and laws governing listing on the Kuala Lumpur Stock Exchange were amended.

The health of banks in Thailand has improved but private banks still need help with NPLs

The Thai Asset Management Corporation, which was established to clear up the NPLs of financial institutions, expects to meet its restructuring target of B 500 billion for 2002 and to complete restructuring of the remaining B 280 billion in its portfolio by the end of 2003. By mid-December 2002, it had restructured B 482 billion in NPLs, with an average recovery rate of 45 per cent. In 2003, the Corporation will focus on smaller NPLs (below 20 million baht) of State-owned financial institutions and will take over the debts of the Industrial Finance Corporation of Thailand. Most of the loans in the Corporation's portfolio came from State-owned banks, where the NPL ratio was 5.3 per cent at the end of November 2002. Private banks continue to be burdened with bad loans and the NPL ratio for those banks was around 13.7 per cent at the end of November 2002. Banks are still reluctant to lend to businesses, preferring to expand credit card operations and home mortgages. This may be one factor holding back private investment, in addition to the opportunity to buy assets cheaply during restructuring. The Bank of Thailand has announced that it intends to assist commercial banks by acting as a mediator between banks and their debtors to clear up around B 840 billion in bad loans by the end of 2004. In other respects, the financial health of banks remains good and the risk-weighted capital adequacy ratio of all commercial banks was around 14.3 per cent in October 2002, well above the 8 per cent Basel minimum requirement.

The NPL ratio in the Philippines is now higher than in the countries directly affected by the 1997-1998 financial crisis

The Philippines was not as severely affected by the 1997-1998 financial crisis as other countries in the region, but the number of NPLs has been increasing in recent years. The NPL ratio went up from 4.7 per cent at the end of 1997 to 16.5 per cent in September 2002. At this level, the ratio is now higher than that prevailing in the countries most severely hit by the financial crisis (Indonesia, Malaysia, the Republic of Korea and Thailand). No centralized asset management corporation has been set up so far, but the Government is working on legislation (the Special Purpose Asset Vehicle bill) that will permit banks to sell non-performing assets to specially designed asset management corporations. However, progress in the passage of this bill has been slow.

The Philippines is working to be removed from the Financial Action Task Force's list of non-cooperative countries

The country is moving ahead to strengthen its banking system and introduced a new risk-based capital adequacy ratio for banks effective July 2001. At the end of March 2002, the ratio reached 16.7 per cent, well above the Basel minimum. Following the passage of the Anti-Money Laundering Act in September 2001, the Central Bank issued a manual for banks and other financial institutions to promote compliance. However, the Philippines remains on the Financial Action Task Force on Money Laundering's list of non-cooperative countries and the central banking authorities are working with other government agencies on drafting a bill to amend the Act to address outstanding concerns.

Viet Nam has a long way to go before its banking sector can meet the challenge of multinational financial services corporations

The opening of the service sector in Viet Nam, as envisaged in the bilateral agreement with the United States, will have a major impact on the banking industry, where reforms have also been progressing. The ratio of NPLs to the total loans of the banking system dropped from 12.7 per cent at the end of 2000 to 4.8 per cent at the end of 2002, and banks have had to absorb losses amounting to 57 per cent of the face value of NPLs. At the beginning of 2002, the four major State-owned banks had a capital adequacy ratio of 2.8 per cent, well below the Basel minimum. The first phase of recapitalization took place in 2002, and by 2004 the ratio will have reached 5 per cent.

B. Least developed countries in the subregion

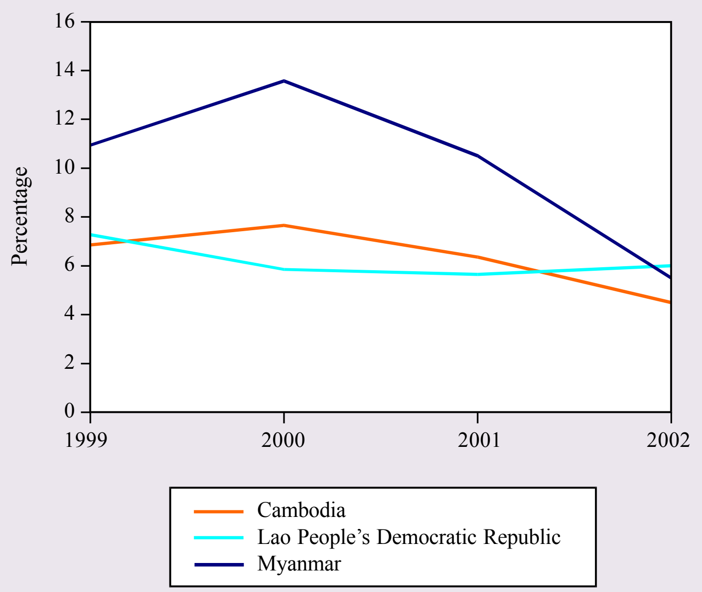
Overview and prospects

The fall in overall economic growth in Cambodia and the Lao People's Democratic Republic in 2002 was expected to be reversed in 2003

The three least developed countries in South-East Asia, Cambodia, the Lao People's Democratic Republic and Myanmar, showed a varied economic performance in 2001-2002 (figure II.31). Notwithstanding the global and regional slowdown, the Lao People's Democratic Republic managed to sustain growth in all sectors; construction and the garment industry were the stimuli for the expansion in industrial output. By contrast, economic growth in Cambodia was softened by the decrease in garment exports and hence manufacturing output. However, with the opening of direct air routes to Siem Reap, tourism has become an important source of foreign exchange earnings. Following the double-digit growth officially recorded in recent years, GDP growth in Myanmar slowed considerably, despite the promise shown in agricultural output, oil and gas production and inward tourism. Adverse weather conditions in 2002 affected agricultural output in all three least developed countries in the subregion.

However, faster economic growth is expected in these countries in 2003. The Government of Cambodia is aiming at an increase of more than 6 per cent in aggregate output, although the civil unrest targeted at foreign interests late in January 2003 could have a dampening ripple effect. GDP is projected to rise by 6 per cent in the Lao People's Democratic Republic in 2003, industry and the service sector being the main stimuli; these two sectors account for just under half of domestic production. The Government of Myanmar is also aiming at an annual 6 per cent rate of expansion in GDP in the period 2003-2005, slightly higher than in 2002.

Figure II.31. Rates of GDP growth in the least developed countries in South-East Asia, 1999-2002



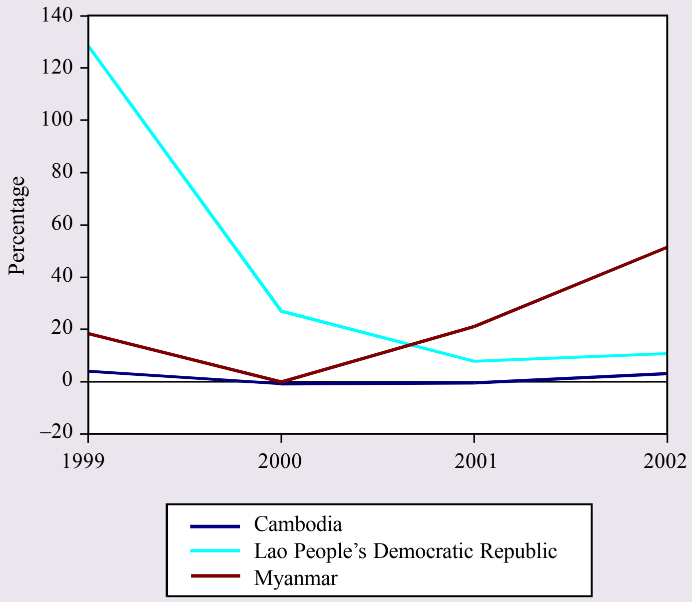
Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); Economist Intelligence Unit, *Country Reports* (London, 2002); and national sources.

Note: Data for 2002 are estimates.

There was a mixed picture in consumer price movements

Both Cambodia and the Lao People's Democratic Republic managed to retain single-digit inflation rates in 2002 as they curtailed Central Bank financing of the fiscal deficit (figure II.32). Those countries were also able to sustain exchange rate stability while reaffirming their commitment to flexible exchange rate regimes, as evidenced by the narrow margin between official and market exchange rates. Central Bank financing of public expenditure in Myanmar, however, has led to spiralling inflation and depreciation of the kyat.

Figure II.32. Inflation in the least developed countries in South-East Asia, 1999-2002[a]



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit *Country Reports* (London, 2002); and national sources.

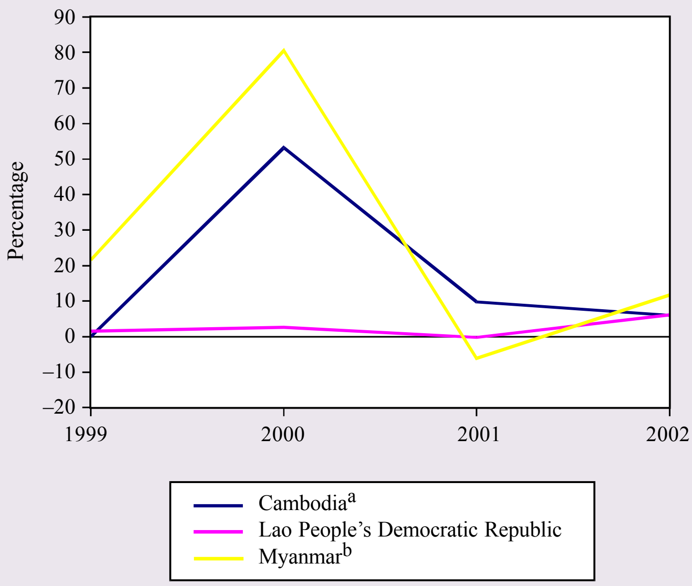
Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.

Improved outcome in the external accounts

Although export earnings continued to rise in all three countries, growth in a number of key sectors, such as garments in Cambodia and gas in Myanmar, was expected to slow in the coming year as demand from importing countries stabilized (figure II.33). Import spending was expected to grow more slowly than exports in the Lao People's Democratic Republic and to decline in Myanmar, leading to a slight

Figure II.33. Growth rates in merchandise export earnings of the least developed countries in South-East Asia, 1999-2002



Sources: IMF, *Country Reports,* various issues; and national sources.

[a] Domestic export value.
[b] Fiscal year.

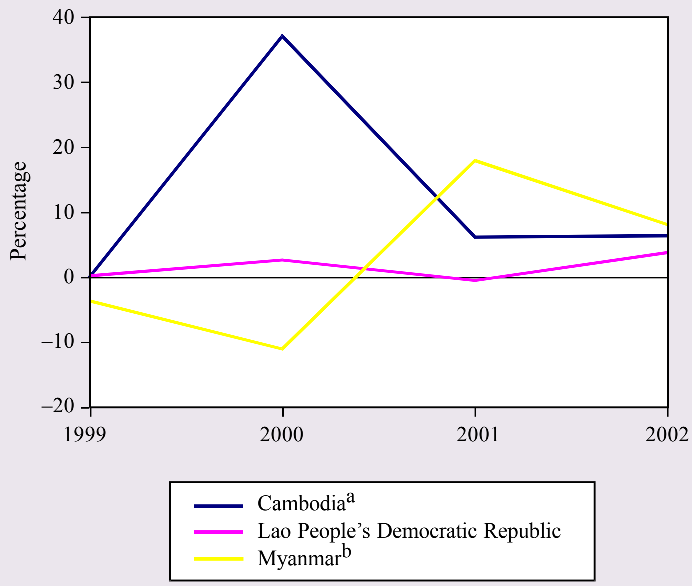
improvement in their external current accounts in 2002 (figure II.34). All three countries experienced an increase in official reserves in 2002, although the rise was rather small in Myanmar. The exchange rate performance was much improved in Cambodia, where the riel was essentially stable, and in the Lao People's Democratic Republic, where the depreciation of the kip slowed considerably (figure II.35).

GDP growth performance

Real GDP growth in Cambodia was adversely affected by reduced garment exports and tourism receipts

Cambodia recorded a marginal decline in GDP growth, from 5.5 per cent in 2001 to an estimated 4.5 per cent in 2002, owing mainly to the declining growth in garment exports and tourism receipts (table II.37). A drought in 2002, followed by flooding in some areas, also depressed agricultural production, which comprises almost two fifths of current-price GDP, with knock-on effects on consumer demand Although garment export volumes were maintained, the prices of new orders were reported to have fallen by more than 10 per cent. Restructured concession agreements for forestry were not completed on schedule in 2001,

Figure II.34. Growth rates in merchandise import spending of the least developed countries in South-East Asia, 1999-2002



Sources: IMF, *Country Reports,* various issues; and national sources.

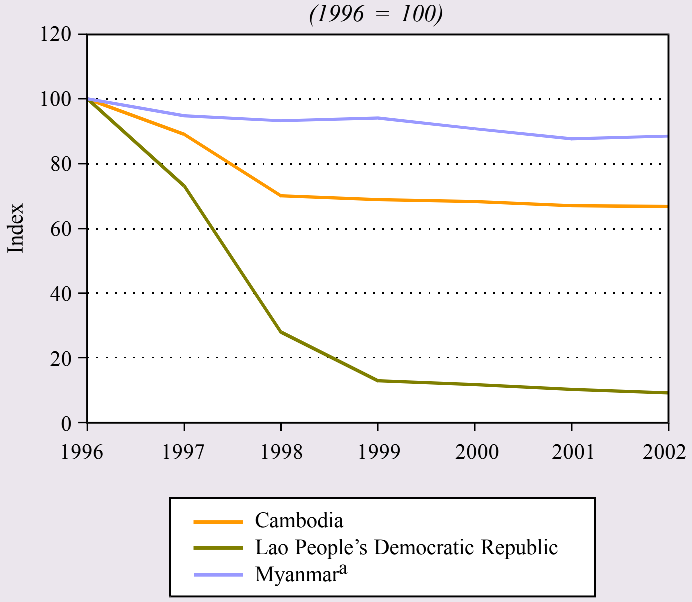
[a] Retained import value f.o.b.
[b] Fiscal year.

thereby affecting logging operations. However, foreign airlines were allowed to fly directly to Siem Reap, which is located near the Angkor Wat temple complex; as a result, visitor arrivals by air went up by over 70 per cent year on year in 2001 and by another 12 per cent year on year in 2002. Tourist arrivals from within the Asian region offset the decline in arrivals from outside Asia, particularly after the Bali bombing, but the decline at the higher end of the market affected overall tourism receipts.

A rise in regional economic activity, new construction and other investments sustained growth in the Lao People's Democratic Republic in 2002

A rise in regional economic activity, new construction and a number of large and medium-sized investments sustained a strong growth rate of 5.8 per cent in the Lao People's Democratic Republic in 2002. Progress in reforms, including streamlined approval procedures, has stimulated investment in the second mobile telephone network, manufacturing, mining and aviation. Investment in telecommunication and transport infrastructure was expected to further stimulate the tourism sector. Flooding in several provinces in 2002, however, could lead to lower output in the agricultural sector and affect overall economic growth in 2003 adversely.

Figure II.35. Index of exchange rates against the United States dollar in the least developed countries in South-East Asia, 1996-2002



Sources: IMF, *International Financial Statistics,* vol. LV, No. 12 (December 2002); and *Far Eastern Economic Review,* various issues.

Note: Data for 2002 are estimates.

[a] Data for 2002 refer to January-October.

Agriculture, oil and gas, as well as tourism, hold promise for future economic growth in Myanmar

According to official figures, GDP in Myanmar went up by 10.5 per cent in 2001; economic growth was driven primarily by the agricultural sector, which performed well owing to the absence of flooding and drought. The expansion of primary production contributed, in turn, to growth in agro-processing, services and trade. A glut in the domestic rice market led to low rice prices, affecting farmers adversely. Other economic indicators, however, showed less positive signs. Domestic production and imports of fertilizer declined by more than half in 2001. Yields of rice crops also declined in 2001 owing to such factors as the current rice procurement system and a shortage of fertilizer as a result of foreign exchange constraints. Although cement production declined by almost 10 per cent over the period, power generation was reported to have increased by 10 per cent. GDP growth in Myanmar in 2002 slowed noticeably to 5.5 per cent, as floods affected agricultural output and industrial production remained sluggish. Weak domestic and international demand, reduced foreign investment and continuing power shortages constrained growth, although construction showed signs of recovery.

Table II.37. Least developed countries in South-East Asia: growth rates, 1999-2002

(Percentage)

		Rates of growth			
		Gross domestic product	*Agriculture*	*Industry*	*Services*
Cambodia	1999	6.9	0.0	13.2	7.1
	2000	7.7	–0.3	34.6	5.8
	2001	5.5	3.9	15.5	2.9
	2002	4.5	0.9	11.8	3.9
Lao People's Democratic Republic	1999	7.3	8.2	8.0	6.7
	2000	5.8	4.1	9.4	5.5
	2001	5.7	4.0	7.0	7.7
	2002	5.8	4.0	9.8	5.8
Myanmar	1999	10.9	11.5	13.8	9.2
	2000	13.7	12.4	18.0	13.4
	2001	10.5	7.2	17.2	14.0
	2002	5.5	..	..	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); Economist Intelligence Unit, *Country Reports* (London, 2002), various issues; and national sources.

Note: Data for 2002 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

An examination of the savings and investment ratios of the least developed countries of South-East Asia indicates that these ratios are low and have declined in many cases (table II.38). In Cambodia, the sharp rise in the investment ratio in 2001 was not sustained, and the ratio fell by 1.7 percentage points in 2002; the savings ratio has declined moderately every year since 2000. By contrast, in the Lao People's Democratic Republic the investment ratio has improved gradually since 2000 but the fall in the savings ratio has been quite marked.

Inflation

After experiencing deflation through most of 2001, consumer prices were on the rise in Cambodia in 2002

In Cambodia, there was slight deflation over 2000-2001 but inflation of around 3 per cent in 2002 (table II.39). Among the causal factors were drought-induced damage to the rice crop, which contributed to higher rice prices, and increased prices for housing and utilities. Inflationary pressures from higher food prices are likely to continue in 2003, and the Government has set an annual consumer price inflation target of 3.5 to 4 per cent for the period 2001-2005; this represents an upward revision of an earlier target of "close to zero".

Table II.38. Least developed countries in South-East Asia: ratios of gross domestic savings and investment to GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Savings as a percentage of GDP				
Cambodia	..	10.7	10.2	10.0
Lao People's Democratic Republic	16.4	15.1	15.4	13.7
Myanmar	13.1	12.3	..	..
Investment as a percentage of GDP				
Cambodia	15.9	13.5	17.9	16.2
Lao People's Democratic Republic	22.7	20.5	21.0	21.2
Myanmar	13.4	12.4	11.3	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); and national sources.

Note: Data for 2002 are estimates.

Cambodia has a highly dollarized economy, and it has been estimated that foreign currency deposits accounted for just under 70 per cent of broad money supply (M2) in 2002. This, together with the weakness of the financial system, makes monetary policy largely ineffectual. Money supply growth accelerated sharply in 2000 to an annual rate of almost 27 per cent, but slowed subsequently as the National Bank of Cambodia has been avoiding bank financing of fiscal deficits; the growth rate was 22 per cent in 2002, slightly up on the previous year (table II.39). Meanwhile, more room has been created for the expansion of credit to the domestic private sector.

Inflation in the Lao People's Democratic Republic remained stabilized, although at the double-digit level

Macroeconomic stability has improved remarkably in the Lao People's Democratic Republic as a result of a variety of factors. Expenditure restraint and an increase in the number of auctions of government securities have eliminated the need for Central Bank financing of the budget. Consequently, money supply (M2) growth of 20 per cent in 2002 was largely unchanged from the previous year but significantly below the very high rates prevailing in 1999-2000. The rate of inflation, which had been in triple digits in 1999, has slowed substantially since then, reaching 7.8 per cent in 2001 before picking up somewhat to 10.6 per cent in 2002. This upturn was largely due to seasonal pressures and the introduction of large-denomination bank notes, which led to higher prices in the last quarter of the fiscal year. However, ongoing stabilization policies are expected to reduce inflation to 5 per cent by 2004.

Table II.39. Least developed countries in South-East Asia: inflation and money supply growth (M2), 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Inflation[a]				
Cambodia	4.0	–0.8	–0.5	3.0
Lao People's Democratic Republic	128.5	27.1	7.8	10.6
Myanmar	18.4	–0.1	21.1	51.3
Money supply growth (M2)				
Cambodia	17.3	26.9	20.4	22.0
Lao People's Democratic Republic	78.4	45.5	20.2	20.0
Myanmar	29.7	42.4	43.9	40.6[b]

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* (London, 2002); and national sources.

Note: Data for 2002 are estimates.

a Changes in the consumer price index.
b January-April.

Central Bank financing of public expenditure in Myanmar led to higher inflation and depreciation of the kyat

In Myanmar, the annual growth rate in the money supply (M2) was over 40 per cent in the period 2000-2002. The financing requirements of the public sector and the continued low interest policy led to domestic credit growth of almost 37 per cent in 2001; private sector credit, primarily to the manufacturing and trade sectors, was also up by 57 per cent year on year over the same period. Consumer prices went up sharply, from virtually no inflation in 2000 to 21 per cent in the following year, with steep rises in the prices of essential commodities. In 2002, inflation went up further to a rate in excess of 50 per cent. Much of this acceleration could be traced to an increase in public sector wages that was financed by Central Bank lending to the Government. In addition, the rise in food prices, particularly of rice, in the wake of heavy flooding, was compounded by higher prices for imported goods following a steep depreciation of the free-market exchange rate and periods of border closure. Although the Government is expected to act to restrain prices in the near future, accommodative monetary policy and higher prices for imported goods are likely to generate domestic inflationary pressures.

Foreign trade and other external transactions

External trade

In Cambodia, domestic exports (excluding re-exports), at $1.3 billion in 2001, were expected to increase by only 6 per cent in 2002, compared with almost 10 per cent in 2001 (table II.40). Much of the slowdown reflected difficult market conditions in the United States for garment exports, which accounted for approximately 70 per cent of the value of merchandise exports in 2000. Although garment export quotas to the United States for Cambodia were raised by 15 per cent in 2002, non-quota exports slowed as demand remained weak and competition intensified. Cambodia benefited from firmer international rubber prices, but the volatile international prices of other commodities, such as black pepper and chillies, affected export earnings as traders switched sourcing.

A marginal rise in Cambodia's external current account deficit resulted as a low rate of import spending did not offset slower export growth entirely

Table II.40. Least developed countries in South-East Asia: merchandise exports and their rates of growth, 1999-2002

	Value (millions of US dollars)	*Exports (f.o.b.) Annual rate of growth (percentage)*			
	2001	*1999*	*2000*	*2001*	*2002*
Cambodia[a]	1 288	..	53.2	9.8	6.0
Lao People's Democratic Republic	350	1.5	2.6	−0.3	6.2
Myanmar[b]	2 293	21.6	80.6	−6.1	11.6

Sources: IMF, *Country Reports,* various issues; and national sources.

[a] Domestic exports.
[b] Fiscal year.

Retained imports, which amounted to $1.6 billion in 2001, grew by 6.5 per cent in 2002, a rate marginally faster than that of exports but largely similar to that of import spending in the previous year (table II.41). As a result, the merchandise trade deficit widened in Cambodia in 2002. The slower growth in imports of the inputs needed for export-oriented industries was offset to some extent by higher import prices for oil. Inward tourism, which had expanded strongly in 2001, notwithstanding the events of 11 September 2001, did not grow as quickly in 2002 as the global economy weakened; the Bali incident also contributed to the slowdown in the number of visitors from outside the region. Consequently, the service balance weakened, and Cambodia's external current account deficit worsened, from 6.3 per cent of GDP in 2001 to

Table II.41. Least developed countries in South-East Asia: merchandise imports and their rates of growth, 1999-2002

	Value (millions of US dollars)	Imports (c.i.f.) Annual rate of growth (percentage)			
	2001	1999	2000	2001	2002
Cambodia[a]	1 647	..	37.1	6.2	6.5
Lao People's Democratic Republic	567	0.3	2.7	–0.4	3.9
Myanmar[b]	2 736	–3.6	–11.0	18.0	8.1

Sources: IMF, *Country Reports,* various issues; and national sources.

[a] Retained imports f.o.b.
[b] Fiscal year.

over 8 per cent in 2002 (table II.42). As one of the three pilot countries in the Integrated Framework for Trade-related Technical Assistance to Least Developed Countries, Cambodia has designated trade policy and facilitation as one of the pillars of its National Poverty Reduction Strategy and has expressed its commitment to the WTO accession process.

Table II.42. Least developed countries in South-East Asia: budget and current account balance as a percentage of GDP, 1999-2002

(Percentage)

	1999	2000	2001	2002
Budget balance as a percentage of GDP				
Cambodia[a]	–4.0	–5.3	–6.0	–5.9
Lao People's Democratic Republic[a]	–10.5	–8.3	–7.5	–8.3
Myanmar[b]	–4.5	–8.3	–4.6	–4.9
Current account balance as a percentage of GDP				
Cambodia[c]	–8.4	–7.6	–6.3	–8.1
Lao People's Democratic Republic[c]	..	–8.3	–6.9	–8.0
Myanmar[a,d]	–0.2	0.0	–0.1	..

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); Economist Intelligence Unit, *Country Reports* (London, 2002); and national sources.

Note: Data for 2002 are estimates.

[a] Excluding grants.
[b] Refers to the consolidated public sector, including the Government and non-financial State enterprises.
[c] Excluding transfers.
[d] At official exchange rates.

The removal of structural impediments is necessary to improve the long-term export competitiveness of the Lao People's Democratic Republic

After contracting in 2001, both merchandise exports and imports returned to positive growth in the Lao People's Democratic Republic in 2002; export earnings went up by 6.2 per cent easily outpacing the import growth of just under 4 per cent. However, the deficit on the trade account rose from $217 million in 2001 to $285 million in 2002. Exports were dominated by electricity from hydropower plants, garments and wood products. The sluggish growth in imports reflected weak demand for the inputs needed for the export industries as well as slower domestic demand, although these compressing factors on import expenditure were somewhat offset by a higher bill for imported fuel. The deficit on the external current account, which had narrowed to 6.9 per cent of GDP in 2001, widened again to 8 per cent in 2002.

In August 2002, following the conclusion of an agreement to facilitate trade, Viet Nam lowered tariffs by around 50 per cent on 27 items commonly imported from the Lao People's Democratic Republic, among which were agricultural and wood products, industrial goods and handicrafts. Given the level of dollarization in the economy of the Lao People's Democratic Republic, the removal of structural impediments would be necessary in order to improve export competitiveness. Lack of access to the United States market in the absence of normal trading relations status is another problem limiting export potential. Import controls have been partially liberalized in line with international practices and commitments made under AFTA, with the lifting of quantitative restrictions on two out of six product groups before the end of 2002. However, in October 2002, customs officials began imposing a 20 per cent tariff on a wide range of imports from Thailand (with a value of B500 and above per item) brought in through the main border-crossing between the two countries.

Priority import lists to maintain foreign exchange control in Myanmar have constrained the implementation of tariff reforms

In Myanmar, the external current account (measured at the official exchange rate) deteriorated slightly, from an approximate balance in 2000 to a deficit of 0.1 per cent of GDP in 2001, as the merchandise trade balance declined. However, a better outcome was likely in 2002 as exports, led by gas and agricultural commodities, increased sharply by almost 12 per cent. Natural gas was the largest single export item and rice exports also showed notable gains following a series of good harvests. Exports of pulses and beans, mainly to Bangladesh and India, accounted for 18 per cent of non-gas exports in 2001. The suspension of the issuance of export licences to foreign traders in 2002, however, was expected to reduce such exports. Exports of seafood and hardwoods also performed well, but tourism receipts and private remittances were lower. State-owned enterprises, which accounted for 21 per cent of the aggregate output in Myanmar in 2000, handled the export of rice, petroleum, natural gas, precious stones and metals. The public sector's share of total exports rose to 47 per cent in 2001 from 30 per cent in the previous year.

Receipts from gas exports in 2000 financed public sector imports, contributing to a higher share of imports going to that sector: 35 per cent in 2001 compared with 28 per cent in previous years.

Imports into Myanmar expanded very sharply in 2001, by approximately 18 per cent, before slowing to a growth rate of 8 per cent in the following year. Imports of both capital and consumer goods fell, as investment remained depressed and the sharp depreciation in the free market exchange rate limited consumer demand. Although the country has implemented tariff reforms in line with the AFTA Common Effective Preferential Tariff Scheme, the continuation of priority import lists to maintain foreign exchange control exerted a restraining influence on external trade.

Capital flows and exchange rates

International reserves increased in Cambodia, while external debt declined

Cambodia's international reserves, which had amounted to $548 million (equivalent to three months of imports) by the end of 2001, reached $754 million in September 2002. Official transfers of $280 million and concessional lending of $131 million were expected in 2002. FDI inflows, however, were much lower, at an estimated $60 million for 2002. External debt had reached $2.1 billion (or 66.3 per cent of GDP) in 2001 but was expected to decline sharply to $1.5 billion in 2002; in consequence, the debt-service burden was expected to fall from 3.3 per cent of domestic exports in 2001 to just under 2 per cent in 2002. Debt-rescheduling was discussed with the Russian Federation and the United States, while the Paris Club of creditors expressed willingness to give assurances on a concessional basis (Naples terms) to cover the financing gap in 2002. The riel was essentially stable in 2002. At present, Cambodia has no restrictions on current international transactions and does not engage in discriminatory exchange rate practices. The difference between the official and market exchange rates remained stable at below 1 per cent in 2002.

Official reserves were also up in the Lao People's Democratic Republic but debt service remained high

The improved investment climate in the Lao People's Democratic Republic attracted considerable interest from foreign investors and the number of new projects involving FDI increased in 2001. Reflecting higher inflows of foreign exchange, gross international reserves in the country, at $178 million by the end of August 2002, were sufficient to cover just under four months of imports. Given the limited capacity to service debt, ODA flows were expected to cover the Government's projected financing gap in 2003 and 2004. However, there was a notable shift in favour of concessional loans (instead of grants); ODA inflows were expected to rise from $378.3 million (with about two thirds in grants) to $438.7 million (with just under one half in grants) in 2002-2003.

The Lao People's Democratic Republic, classified as a heavily indebted poor country (HIPC), has chosen not to take part in the HIPC initiative. Total debt service, including commercial borrowing by private hydroelectricity exporters, was equivalent to 15.5 per cent of merchandise export earnings in 2001. Public debt service was roughly one half of this amount but was expected to rise to almost 10 per cent of exports in 2003 because of the repayment of public commercial debt in the near term. In 2001, bank financing of the budget deficit in the Lao People's Democratic Republic contributed to a 10 per cent depreciation of the kip in the second quarter of 2001. The rate of depreciation slowed in 2002 and the margin between the official exchange rate and the parallel exchange rate remained at less than 2 per cent, in line with the Government's commitment to maintaining a flexible exchange rate regime.

Private and public capital inflows into Myanmar virtually ceased but official reserves were somewhat higher

International sanctions and the lack of private sector confidence contributed to a virtual stoppage of private and public capital flows into Myanmar. However, gross international reserves went up slightly, adequate to cover 2.5 months of imports, as a result of the $200 million swap arrangement with Malaysia. In 2001, total external debt amounted to more than $6 billion, almost four fifths of GDP, and external debt arrears exceeded $2.5 billion. The annual budget deficit was estimated at around 5 per cent of GDP in 2001-2002, and measures to enhance the budgetary control processes and reduce the shortfall could include replacing implicit taxes and subsidies with more explicit fiscal instruments. Meanwhile, the officially sanctioned foreign exchange certificate rate in the parallel market depreciated sharply to reach K 906 to the United States dollar in August 2002 (compared with the official exchange rate pegged at K 6.16 to the dollar). As a result of inflation and exchange rate depreciation, kyat-denominated financial assets were converted into gold and hard currency and into physical assets such as land and property. In response, the Government prohibited the acceptance of gold by banks as collateral for personal loans and suspended the issuance of export licences to foreign traders in 2002.

Key policy issues

Higher fiscal revenue was expected in Cambodia and the Lao People's Democratic Republic in 2002

Sound macroeconomic management is a major challenge to the least developed countries of South-East Asia, particularly in the area of public finance. Cambodia's revenues were budgeted to increase from 12.5 per cent of GDP in 2001 to 13.5 per cent in 2002. Although tax revenues from domestic sources were in line with projections for 2001, customs revenues fell short as import volumes declined, leading to a slight shortfall in the overall amount of fiscal receipts. Since total expenditure was also held below target, the overall deficit, excluding grants, of 6.0 per cent of

GDP was fully financed from external concessional sources in 2001 (table II.42). The Government has committed itself to maintaining fiscal stability in the coming years, with a cap on the fiscal shortfall of around 6 per cent of GDP. Government revenues in the first quarter of 2002 reached $107 million, an increase in nominal terms of 16 per cent year on year following the launch of the fiscal reform programme and the introduction of new tax collection measures.

As in previous years, Cambodia has been focusing on improving revenue mobilization and redirecting expenditure from defence and security to the social sectors. The lowering of tariffs in compliance with AFTA commitments will present the country with further challenges. A unit focusing on large taxpayers and work plans for improving tax administration were introduced in 2001, while the capabilities of the Customs and Excise Department and the pre-shipment inspection services for imports were expected to be strengthened in 2002. In addition, the military was demobilized by 11.5 per cent and the civil service workforce reduced by 6 per cent through the computerization of the civil service payroll late in 2001.

The Lao People's Democratic Republic experienced difficulty in reaching its revenue targets

As a result of poor collections from large taxpayers, optimistic revenue targets for some provinces following fiscal decentralization and the continued weak performance of State-owned enterprises, government revenues in the Lao People's Democratic Republic reached only 37 per cent of the annual programme target during the first half of 2002; however, revenue collections were expected to pick up in the second half of the year. Domestically financed capital spending was consequently curtailed to 27 per cent of the programme target over the same period, while current expenditure was in line with the target. The overall fiscal deficit was 8.3 per cent of GDP in 2002, up from 7.5 per cent in 2001. Over the medium term, the Government intends to keep the budget deficit, including grants, to less than 5 per cent of GDP, with bank financing of the shortfall limited to 0.5 per cent of GDP. In view of the weak central tax administration, the Tax Department was reorganized to focus on revenue collection, monitoring and auditing, and progress was also made in developing a national customs service.

Defence spending and weak performance by State-owned enterprises contributed to Myanmar's fiscal deficit

Owing to declines in both capital and current expenditure, Myanmar's fiscal deficit has fallen significantly from the peak of 8.3 per cent of GDP reached in 2000. Nevertheless, it still amounted to almost 5 per cent of GDP in 2002, or more than twice the original target of 2 per cent in 2001. Revenues also declined from 7.8 per cent of GDP in fiscal 1997 to 4.2 per cent in 2001. However, total expenditure exhibited a sharp decrease, from 13.6 per cent of GDP in 2000 to 9.1 per cent in 2001. Meanwhile, the fiscal balance continued to be adversely affected by defence spending, which absorbed about a quarter of the government budget, a fivefold increase in public sector wages since 2000, persistent weak performance by State-owned enterprises and capital expenditure overruns. Total public sector debt is estimated to have reached 95 per cent of GDP by the end of 2001.

Banking reform continued in Cambodia

Strengthening the financial sector and improving monetary control is another area of policy concern in the least developed countries of the subregion. Cambodia embarked on the reform of its banking sector in the early 1990s and the process was given added impetus with the adoption of the law on Banking and Financial Institutions in 1999. Under a relicensing programme undertaken in 2001 and 2002, 12 private commercial banks that failed to meet the provisions of the Law were closed, while 13 others were operating under conditional licences. In preparation for the privatization of the State-owned Foreign Trade Bank, external management assistance to implement a reorganization plan, the issuance of bonds by the Ministry of Economy and Finance to replace the National Bank of Cambodia as the major shareholder and an unqualified external audit were expected to be completed in 2002. To improve bank supervision, all banks were required to use a new set of accounts starting in 2003.

Financial sector reform is a priority of the Government of the Lao People's Democratic Republic

The cessation by the Central Bank in the Lao People's Democratic Republic of its financing of the fiscal deficit has permitted it to focus on controlling inflation and stabilizing the exchange rate. As in Cambodia, the country is engaged in ongoing reform of the banking sector. Although there are some privately owned banks, the financial system is dominated by three State-owned commercial banks and a bank focusing on the agricultural sector. Much of the lending of the State-owned banks is to State-owned enterprises, and these loans often become non-performing. Two State-owned commercial banks are to be merged, and measures have been implemented to lower the volume of NPLs. At the same time, the Central Bank is expected to strengthen the enforcement of prudential regulations. It also initiated a review of the operations and credit decisions of the State-owned commercial banks in view of the excessive growth in their net domestic assets, which reflected, in turn, defaults on letters of credit and irregular lending, among other factors.

NPL ratios were relatively modest in Myanmar's private sector banks

In Myanmar, the NPL ratio for private banks fluctuated between 3 and 5 per cent; the ratio for the banking sector as a whole remained at 14 per cent, reflecting the weak position of the State-owned banks. The Control of Money Laundering Law was adopted in 2002.

The least developed countries of South-East Asia are under severe constraints with regard to institutional capacity and financing resources, which often serve to limit the extent of reforms or delay the adjustments

Cambodia, the Lao People's Democratic Republic and Myanmar have recognized the need for economic growth led by the private sector

necessary for long-term macroeconomic stability. However, a number of incremental measures, which take into consideration the constraints faced by these countries, could be taken over the medium term. In the Lao People's Democratic Republic, the implementation of streamlined regulations under the Foreign and Domestic Investment Promotion Laws seems to have spurred recent private sector investment in medium-scale projects. As noted earlier, the country has also initiated the restructuring of State-owned commercial banks. Tariffs for electricity, domestic airfares and water were adjusted in 2002 as the first step toward restructuring the State-owned enterprises concerned. As part of the National Poverty Eradication Programme, such reforms were expected to improve efficiency, attract domestic and foreign investment and develop both infrastructure and human resources. In Myanmar, a more stable macroeconomic environment could emerge from the gradual shift in the operations of the State-owned enterprises to the parallel foreign exchange market, the removal of restrictions on private exports of higher-quality rice, enhanced efforts towards revenue collection within the existing tax structure and the replacement of implicit taxes and subsidies with more explicit fiscal measures.

The incidence of poverty remained high in the least developed countries of South-East Asia

In Cambodia, an estimated 36 per cent of the population was living below the poverty line in 1997, nine tenths of these in rural areas. The Government embarked on a National Poverty Reduction Strategy in 2002 and hopes to eradicate poverty by 2015. In the Lao People's Democratic Republic, the incidence of such poverty was approximately 39 per cent in 1998 and again, poverty is widespread in rural areas, where 90 per cent of the poor live. In both countries, the lack of food security, particularly of the main staple, rice, is an important dimension of poverty. Although economic growth has helped to reduce poverty, there are some indications of growing income inequality. The Lao People's Democratic Republic is in the process of formulating a National Poverty Eradication Programme which is due to be completed in 2003.

The negative impact of reform measures on low-income households needs to be addressed

The restructuring processes being conducted in these least developed countries have generated some negative ripple effects on low-income households. In the Lao People's Democratic Republic, for example, tariffs on electricity and water were adjusted so that the increases were lower for small users. A social safety net was included in banking and enterprise reforms and a social fund will support community-based projects. To address poverty over the long term, both Cambodia and the Lao People's Democratic Republic are channelling a greater share of government expenditure to education and health. As a result, spending on education and health in Cambodia rose from 1 and 0.4 per cent of GDP respectively, in 1998 to 2.1 and 1.2 per cent of GDP in 2002. This compares with the continuing fall in spending on basic education to 0.3 per cent of GDP and on public health to 0.2 per cent of GDP in Myanmar in 1999.