Philippine Review of Economics and Business
Volume XXVII, No. 2, December 1990

INFLATION IN DEVELOPING MEMBER COUNTRIES OF ADB

By Edita A. Tan*

The paper is a comparative descriptive analysis of inflation in the Asian region. It looks at the level and movement, as well as the causes, of inflation in each ADB member country. The inflation rate is found to be generally low and double digit levels occurred only intermittently due to external shocks and climatic changes that adversely affected agricultural output. Monetary variables appear not to be a cause of the inflation spurts experienced. China and Vietnam's high inflation experience is taken to be temporary and results from the structural transformation of their economies.

1. Broad Trends and Causes, 1970-90

In general, the ADB developing member countries (DMC) have followed a tradition of low inflation policy. Double-digit inflation was, in most cases, an occasional occurrence and traceable to extraordinary events such as the oil shocks in the '70s, climatic catastrophies that seriously damaged food crops in the agricultural-based DMCs, and major political developments such as the 1983-85 economic crisis that followed the assassination of Aquino in the Philippines, the 1987-88 ethnic conflicts in Sri Lanka, and the current political and economic restructuring in the centralized countries of China and Vietnam. Asian average inflation rate has been lower than that of other developing regions and even the high 1970s levels were below other regions' inflation rate and were only of the same level as those of the developed countries. In general, the rate has been on the downtrend from the '70s to 1986, averaging 10.7 percent in 1970-80 and 8.3 percent in 1981-86. (See Table 1.) It reached all-time lows in 1986 of 5 percent due largely to the recession that hit the DMCs. It was –1.4 percent in Singapore, 0.7 percent in Taiwan, 2.8 percent in Hongkong and Korea, 1.8 percent in Thailand, 0.7 percent in Malaysia, 0.8 percent in the Philippines and 3.5 percent in Pakistan. The downtrend was steep for these countries and for several others like Indonesia where the average inflation fell from 17.6 percent to 9.7 percent in the 1970s to 1981-85. As the DMCs recovered from the 1985-86 recession and moved back to their normally high growth path, inflation also rose to their longer-run level. With few exceptions, inflation is expected to stabilize in the 1990s at fairly moderate levels and the cross-country variation to lessen. The NIEs' 1990 rates are expected to range from 2.5 percent for Singapore to 9.0 percent for Hongkong. Thailand and Malaysia which have performed

---

* Professor of Economics, University of the Philippines. This paper was written for the ADB Second Workshop on Asian Economic Outlook for 1990, November 13-16, 1989.

Table 1– Inflation Rates, 1971-88, Projected 1989, 1990

	1971-80	1981-85	1986	1987	1988	1989	1990	1991
A. NIE								
1. Hongkong	8.5	9.4	2.8	5.5	7.5	10.0	9.0	
						(10.0)[a]	(7.5)[a]	
2. Korea, Rep. of	16.4	7.4	2.8	3.1	7.1	5.5	5.5	
						(5.8)[b]	(5.5)[b]	5.0[b]
3. Singapore	6.7	6.8	-1.4	0.5	1.5	2.2	2.5	
						(1.9)[c,b]	3.5-4.5[b]	3.5-4.5[b]
4. Taipei, China	11.1	4.2	0.7	0.5	1.3	2.8	3.6	
						(4.5)[c]	(3.4)[b]	4.2[b]
B. Southeast Asia								
1. Thailand	9.8	5.0	1.8	2.5	3.7	4.5	4.5	
						(7.10)[c]	(6.6)[b]	8.2[b]
2. Malaysia	6.0	5.0	0.7	0.6	2.7	3.0	4.0	
						(4.0)[c]	(5.0)[b]	6.0[b]
3. Indonesia	17.6	9.7	5.9	9.3	8.0	7.8	7.1	
						(7.0)[d,3]	(5.0)[b]	6.0[b]
4. Philippines	13.9	21.3	0.8	3.8	8.8	7.0	8.6	
						(10.0)[c,10]	(9.0)[b]	8.2[b]
C. South Asia								
1. Bangladesh	20.7	11.9	11.0	9.5	10.3	12.3	9.0	
2. India	8.3	9.3	8.7	8.8	9.8	7.7	6.7	
						(8.5)[a]	(10.0)[a]	
						(4.6)[c,8]		
3. Nepal	8.4	9.2	19.0	10.7	10.9	9.0	6.0	
						(8.1)[c]	(11.1)[b]	9.5[b]
4. Pakistan	12.0	7.2	3.5	4.7	7.8	11.0	10.0	
						(10.4)[c]	(10.7)[b]	9.9[b]
5. Sri Lanka	8.9	12.2	8.0	7.1	14.5	10.0	7.0	
						(10.2, to April)		
D. China	2.6	3.5	6.0	7.3	18.5	14.0	9.5	
						(21.0)[a]	(12.0)[a]	
E. Vietnam		74.2	487.0	301.0	308.0	175.0	75.0	

The first line are from the 1989 ADO.

[a]Merrill Lynch Asian Commentary. November 1989.

[b]Country paper for the Second Workshop, ADO forecast.

[c]Actual figure, partial for 1989, country paper, Second Workshop, ADO. The figure beside the reference indicates the amount covered.

[d]Actual figure, partial for 1989, *International Financial Statistics*, July 1989. The figure beside the reference indicates the month covered.

Source: ADB, *1989 Asian Development Outlook*; various periodicals as noted above.

very well in the last decade would also have relatively low inflation rates of about 3-5 percent. The other countries would be between 5 and 11 percent excepting Vietnam which has to contend still with the inflationary impact of its economic restructuring. Its inflation rate has been declining rather rapidly from its extremely high level of 487 percent in 1986. It fell to about 300 percent in 1987 and 1988, and is forecast to continue falling to 175 percent in 1989 and 75 percent in 1990. China appears to have had a much lesser market repression than Vietnam so that its economic restructuring resulted in a much smaller upsurge in prices from 3.5 percent inflation rate in 1981-85 to 6.0 percent in 1986, 7.0 percent in 1987, and 18.5 percent in 1988. The most recent forecast this year (1989) is 19.8 percent. The rate would likely decline in 1990 as a result of the austerity program and the recentralization movement that are expected to take place following the June event.

More recent forecasts of inflation in the DMCs are only slightly off the 1989 ADO forecasts except for the Philippines, China, India and Nepal. In these DMCs the inflation rates in the first half of the year were higher than the forecast: 7.0 versus 9.6–12.5 percent for the Philippines, 7.7 versus 9.5 percent for India, 14.0 versus 19.8 percent for China and 9.0 versus 12.0 percent for Nepal.

The causes or processes of inflation differ among the DMCs. For many DMCs inflation is traceable to the monetary and fiscal policy followed. But the process of inflation, that is, the effect of an increase in money supply on price level, is complicated by the structure of the financial market, the state of transport and other infrastructure, and the way other policies are working. In a developed and competitive financial market, a given change in money supply will tend to generate a smaller inflationary pressure than in a repressed underdeveloped financial market where interest rate is distorted and access to a varied portfolio of assets is limited. In the former, a larger part of any increase in liquidity will find its way in financial asset portfolios and a smaller part will go directly to increased demand for goods. Development policies exert their own inflationary bias. A trade repressive regime leads to persistent BOP problems and currency depreciation and inflation. Unsuccessful development policies also imply slower outward shifts in goods supply. The state of transport infrastructure, the balance in development between agriculture and industry, particular constraints on input supply including labor, and other physical constraints will determine inflation parameters. A given increase in demand will generate a different rate of inflation depending on these conditions.

All the NIES have achieved full employment and are now facing labor shortages. Wage increases have exceeded labor productivity and are exerting inflationary pressures. The rest of DMCs continue to have labor surplus including Malaysia and Thailand which have had high sustained growths. Most face infrastructure constraints. All DMCs other than the NIEs and Thailand have had fairly large budget deficits exceeding 5.0 percent of GDP. South Asian DMCs have larger deficits/GDP ratio than Southeast Asian DMCs. In 1986-88 it averaged 6.3 percent for Bangladesh, 5.0 percent for India, 9.0 percent for Nepal, 8.0 percent for Pakistan and 13.4 percent for Sri Lanka. A high budget gap tends to generate current account deficits. Nepal, Pakistan and Sri Lanka have had very high current account deficits: -4.8 percent (Nepal), -2.6 percent (Pakistan) and -5.8 percent (Sri Lanka) for the same years.

The currencies of NIEs which have had large current account surplus are appreciating and dampening inflationary pressures. Malaysia also shows a fairly high CA surplus: 7.6 percent in 1987 and 3.5 percent in 1988. Thailand has had a relatively high CA deficit but this was being compensated for by large inflows of capital, especially direct investment. Their currencies have been stable. The rest experienced different rates of currency depreciation. Indonesia's fairly high CA deficits in 1986 or 5.2 percent of GDP, fell by half in 1988. Also showing a declining trend in the deficits is Bangladesh. The worrisome places are Nepal, Pakistan, Sri Lanka and Laos whose CA deficits have persisted and even increased in the last three years. External borrowing is increasing in these DMCs.

Inflation in Asia is not always traceable to money supply growth. The low inflation NIE economies, excepting Singapore, have allowed their money supply to grow with their current account surplus. In the '80s, money supply (m_1) grew on average at more than 16 percent in Korea, about 23 percent in Taiwan and 16 percent in Hongkong. With a more developed financial market, and low anticipated inflation, most of the money growth went to investment in financial assets which in turn financed real investment. Because of low inflation, the yield on financial assets including bank deposits was positive and quite high. The savings rate was notably high and consumption demand did not increase as fast as the increase in liquidity. The experience appears to also apply to Thailand where money supply was growing at an average rate of 11 percent but inflation rate at only 4.0 percent. When inflation was at its lowest levels in 1986 and 1987– 1.8 percent and 2.5 percent– money grew at 20.5 percent and 28.0 percent. In several high inflation DMCs like the Philippines, Indonesia, Bangladesh, Pakistan, Sri Lanka and Nepal, money supply growth and inflation rates were both high. Here money growth, budget deficits, current account deficits, currency depreciation and inflation appear to interact with each other in the expected direction.

Crop failure due to bad weather intermittently led to an upsurge of inflation in the agricultural-based economies especially because food was still an important component of consumption. The widespread drought in 1987 led to negative growth in agricultural output in seven nations especially Laos and Sri Lanka, and a drastic drop in its growth rate in three others. Only Malaysia, China and Indonesia did not suffer a crop failure that year. Flooding may have become a regular serious problem for Bangladesh which is at the receiving end of the flood waters from the denuded forests of the Himalayas.

The world environment will tend to have a dampening effect on inflation. There is relative price stability and moderate growth in GDP in the OECD countries. Of perennial concern, however, is the movement of petroleum prices which exerted some inflationary pressure in the later part of this year.

2. The Inflation Prospects for Individual DMCs

This section takes off from the 1989 ADO analysis. The DMCs are grouped into the NIEs, Southeast Asia, South Asia, China and Vietnam. Very little additional information is available for the other countries. Some attention is given to the possible effects of trade, monetary and fiscal policies that have prevailed or are being adopted. It is argued that these would determine both the immediate and longer–run movement of prices. External factors such as changes in petroleum prices and the vagaries of the weather are outside the control of government and are viewed as short-run causes or unexpected fluctuations around the trend. The view is that their negative impact could be mitigated by appropriate development policies as shown by the experience of the NIEs, Thailand and Malaysia.

2.1 The NIEs

All four NIEs have had similar successes in their development efforts— high income growth led by the export sector, balanced budget and high savings rate. Especially noteworthy is their high savings rate (Gross Domestic Savings/GDP) which in 1981-88 averaged 29.2 percent for Hongkong, 30.1 percent for Korea, 41.8 percent for Singapore and 33.5 percent for Taiwan. Among the other DMCs, only Malaysia has this high savings rate or 33.1 percent. These high savings rates explain much of the growth in income and reflect positive conditions in the economy especially those prevailing in the financial market. They imply a small import propensity and a small income elasticity of consumption. Except for Korea, the NIEs have incurred current account (CA) surpluses from 1970 to 1988. Korea's CA, though, has turned positive since 1986. Apparently these are not being fully sterilized as money supply has been allowed to grow at fairly high rates. The high savings tradition and the availability of financial assets and other investment alternatives helped channel the excess liquidity away from consumer demand and negated the pressure on prices.

The NIEs are reported to be "overheating" as borne out by labor shortages. Unemployment rate has fallen in 1988 to 1.4, 2.5, 3.4 and 1.7 percent for Hongkong, Korea, Singapore and Taiwan. These possibly approximate full employment levels. Nominal wage rates have risen fairly substantially. In Korea, nominal wage rose by 20 percent in 1988, in Singapore it rose by 3-10 percent after the government lifted the moratorium on wage increases in 1987. Moreover, it gave its employees a hefty 20 percent wage increase which was a belated adjustment to productivity increases over the 1987-1988 period when the wage rate was frozen in 1987. Wage rates continued to increase in 1989 and are expected to rise above the inflation rate in the 1990s.

While the wage cost push might be there for good, the NIE governments are addressing this problem. Singapore holds strong control over foreign labor and may use it if the shortage becomes a serious threat to the country's competitiveness and growth. Taiwan, on the other hand, attacks the labor shortage by encouraging the relocation of investment in labor-abundant countries. Taiwanese investment in Thailand, Malaysia and the Philippines has been on the upswing. Labor shortage, it appears, need not be a serious binding constraint to growth as has been shown by Japan.

The accompanying appreciation of the currency to the current account surplus is dampening inflationary pressure. The nominal exchange rate for Hongkong has remained virtually stable from 1986 to 1988 but it appreciated for the three other NIEs: 17.0 percent for Korea, 7.6 percent for Singapore and 24.4 percent for Taiwan. The latter's currency appreciated further by 9.5 percent in the first nine months of 1989.

Domestic policies are geared in different ways to inflationary pressure and declining growth. Taiwan has just adopted a financial liberalization policy aimed at a faster and healthier development of the financial market. Entry to banking is relaxed and the three large state banks are being privatized, allowing 51 percent holding of equity by the private sector. Money supply growth is to be limited to 20 percent per year. A high real rate of interest is being targetted as a means of dampening consumer demand.

Korea's stabilization measures include tariff reduction on petroleum products, lower money supply growth via the flotation of interest – attractive Monetary Stabilization and Exchange Equalization Bonds, increased reserve requirements and discount rules. Food production will be intensified as a supply-increasing anti-inflationary measure. It plans to stimulate increasing domestic demand to sustain its development.

Singapore fine-tunes its economy and it will adopt measures as the government sees fit including anti-inflation measures. Hongkong, in contrast, faces an uncertain future. Its growth target has been lowered to 6.0 percent in the 1990s but the inflation rate is projected at 10.0 in 1989 and 8.5 percent in 1990.

2.2 Southeast Asian DMCs

We find greater diversity in the economic performance and stages of development of the Southeast Asian DMCs. Thailand appears to be following the development path of the NIEs while Malaysia comfortably follows Thailand with somewhat lower growth rate and lower inflation rate. Indonesia has its own unique path and so with the Philippines. Natural endowment and policy regimes vary and together they determine the growth path and inflation of each country. Thailand and Malaysia have had moderate inflation rates from the '70s onward as compared to the Philippines and Indonesia as seen below.

Two policy elements have kept the inflation rate in Thailand and Malaysia fairly low. Fiscal and monetary policies have been conservative as shown by the slow growth of money supply. In Thailand it grew on average in the '80s at 10.0 percent and in Malaysia, 7.4 percent (Table 2). These rates exceeded GDP growth rates by 2.5 and 1.7 percentage points only. They also pursued a fairly balanced growth so that agricultural output in both DMCs grew at 4.0 percent, significantly exceeding the population rate. Thailand's budget deficit was very modest at 2.7 percent of GDP. While Malaysia incurred high budget deficits, these were not financed by money creation but by foreign loans and investment. The two countries achieved fair success

Table 2- Inflation and Correlate Variables, Growth and Ratios in Percent, 1981-88

	GDS/ GDP	CA/ GDP	BD/ GDP	GDP	VA Agric	M_1	ER[a]	CPI
A. NIE								
1. HK	29.2			7.7		18.3		7.9
2. Korea	30.1	0.8	- 1.8	9.0	5.6	16.2		6.2
3. Singapore	41.8	-2.0	1.2	5.3	-6.1	8.8		4.3
4. Taipei	33.5	11.3	0.6	7.6	1.0	22.7		2.9
B. ASEAN								
1. Thailand	23.0	-4.2	-2.7	7.5	4.0	10.0	13.8	4.1
2. Malaysia	33.1	-2.4	- 11.3	5.7	4.0	7.4	12.0	3.6
3. Indonesia	26.1	-3.9	-4.6	5.0	3.6	13.6	62.5	9.0
4. Philippines	19.4	-1.7	-3.1	1.4	2.0	13.5	62.5	15.0
C. South Asia								
1. Bangladesh	2.6	-3.1	-6.6	3.8	1.9	16.6	43.3	11.3
2. India	20.5	-1.7	-4.4	5.9	3.4	14.4	37.8	7.8
3. Nepal	10.5	-5.7	-9.1	3.6	5.0	16.7	47.0	10.8
4. Pakistan	7.6	-3.3	-7.1	6.4	3.8	14.3	45.1	5.7
5. Sri Lanka	13.2	-6.9	- 13.6	4.3	2.0	16.9	39.5	11.4

[a] Depreciation rate is computed as the 1-nominal exchange rate 1981/nominal exchange rate in 1988 in percent.

GDS = gross domestic saving
CA = current account balance
BD = budget deficit/surplus
VA = value added
M_1 = demand deposits + currency
ER = currency depreciation = .1 - (1981 nominal exchange rate 1988 nominal exchange rate)

Source: ADB, *1989 Asian Development Outlook.*

Table 2-(continued)

	GDP	VA Agric	BD/ GDP	CA/ GDP	GDS/ GDP	M_1	ER	CPI
D. China								
1981	4.9	7.1	-9.3	2.2	28.4	35.9	1.71	3.4
1982	8.3	11.7	-8.4	1.6	31.7	11.0	1.89	2.0
1983	9.8	8.5	-9.0	0.9	32.1	17.8	1.98	1.4
1984	13.5	13.0	-9.0	-4.0	32.9	41.8	2.32	2.8
1985	13.1	1.7	-6.8	-2.6	34.5	33.8	2.94	8.8
1986	8.3	3.4	0.7	0.1	33.4	25.3	3.45	6.0
1987	10.6	5.8	-0.7	-0.4	36.6	25.2	3.72	7.3
1988	11.2	3.2			36.4	13.0	3.72	18.5
E. Vietnam								
1981							10.5	69.6
1982							10.5	95.4
1983	7.1	7.2	-6.7				10.5	49.5
1984	8.4	4.2	-4.2	-21.5		53.3	10.5	64.9
1985	5.6	4.7	-4.8	-14.6		282.6	15.0	91.6
1986	3.4	1.9	-5.1	-3.8		215.9	15.0	487.0
1987	2.1	-3.4	-4.9	1.1		472.5	18.0	301.0
1988	5.8	4.2					225.0	308.0

Source: ADB, *1989 Asian Development Outlook*.

with their export promotion industrialization policy which helped prevent a drastic depreciation of their currencies. The Malaysian ringgit depreciated by about 12 percent and the Thai baht by about 14 percent against the U.S. dollar for the period 1981 to 1988. Both currencies appreciated slightly in 1989. In turn, their low inflation rates contributed to the strong performance of their external sector. Double-digit growth is creating infrastructure constraint in Thailand. Infrastructure constraints are considered to generate inflationary pressure as the economy attempts to maintain high growth. Its labor market has tightened since 1986 when employment growth exceeded labor growth for the first time. The preliminary inflation figure for 1989 is 7.1 percent, the projected level for 1990 is 6.6 percent —much higher than initial projections of 3.7 and 4.5 percent. The real wage rate has began to rise. In Malaysia, in contrast, unemployment rate has remained at 8.0

percent. The inflation rate in 1989 is estimated at 4.0 percent, the projection for 1990 about the same. These compare to initial projections of 2.5 and 4.0 percent.

Indonesia has shown a decidedly downward inflation trend from17.6 percent in 1971-80 to 9.7 percent in 1981-85 to 7.7 percent inflation rate. The rate for the first quarter of 1989 is lower than the ADO projection, 7.0 versus 7.8. The trend is expected to continue with the rate falling to 6.0 percent in 1990, with Indonesia moving toward a more conservative and competitive environment. The relaxation of bank regulations, especially the widening of entry of foreign bank branches in and outside Jakarta, and the encouragement of private banking will help stimulate financial development and savings mobilization. Interest rates on bank deposits have been set by state banks at fairly high levels exceeding the inflation rate. Under a more competitive setup, the financial system may be expected to diversify its portfolio offering and attract savers to invest more in financial assets. Real savings itself might increase because of these measures. The rules on private investments including foreign investment are being rationalized. The currency has been depreciated to market levels and transactions in foreign exchange are unrestrained. All these bode well for a higher growth rate including that of exports, and a stable currency. Money supply growth shows a downward trend over the whole 1980 decade starting at 29.8 percent in 1981, down to 17.7 percent in 1985 and further to 7.9 percent in 1988. Budget deficits, while higher in 1986 to 1988, have stabilized at around 5.6 percent of GDP. Agricultural output has been growing at an average rate of 4.0 per year in the '80s and there are no expected untoward climatic or world price changes to reduce agricultural output in 1989 to 1990. Private universities and colleges have been allowed to expand and the increasing college enrollment is likely to meet expected increases in higher level skills.

Prospects for Philippine inflation are not good. The ADO forecasts for 1989 and 1990 are 7.0 percent and 8.6 percent. The National Economic and Development Authority adjusted upward the expected rates for these years to 11.0 percent and 10 percent. Both the civil servants' pay and the minimum wage were raised in the second half of 1989. While these raises barely adjust for the past two years' inflation, the wage increase still adds to the inflationary pressure. In December, petroleum prices were adjusted to the world price level. The longer-run rate is likely to be about 8.0 percent. Policies do not favor a low inflation scenario. The currency has been allowed to depreciate slowly, thus raising import prices. The depreciation is expected to continue in the coming months and even in the longer run. The exchange rate is being repressed by implicit quantitative import controls and high interest rate policy. Some economists think that the currency is overvalued by 20 to 25 percent, basing their argument on the gradual diminution of international reserves and the negative effects of the above measures on investment, exports, savings mobilization, and growth. The repression of currency depreciation tends to produce speculative attacks against the currency and capital flight, exacerbating trade deficit–caused depreciation.

Food production has been damaged by a series of typhoons that hit wide areas of the country. Food prices have in fact risen very substantially. In addition, serious infrastructure bottlenecks, especially roads and energy source, are being encountered. The implementation of public works projects is slow and the reported completion rate is only about 60 to 75 percent of the plan and budget for 1987 to 1989.

Monetary and fiscal policies on the other hand are fairly conservative, judging from the relalatively slow growth of money supply and small budget deficits. A large part of the budget or as much as 40 percent, goes to external debt service. This implies a reduced supply of public services. Debt servicing adds to inflationary pressure in health, infrastructure and other government services.

Financial saving and borrowing from the formal sector have been discouraged by the Central Bank policy of imposing high intermediation taxes and barriers to bank entry. These measures widen the intermediation margin by lowering the yield on deposit and raising the loan rate. Possibly real savings rate is also discouraged. The Philippine savings rate is much lower than that of Malaysia, and below that of Thailand.

2.3 South Asia

The South Asian DMCs have had higher inflation rates than the first two groups of DMCs discussed above, ranging from 6.2 percent average annual rates for Pakistan to 11.3 for Bangladesh. The inflation movement showed no definite trend but varying degrees of fluctuation across countries. Pakistan and Nepal experienced wider price swings than the other neighboring DMCs. The forecast for 1989 is downward only for Sri Lanka with the rest likely to have the same level as in the past few years. Inflation in these countries is highly sensitive to the supply of food, and the various forecasts placed emphasis on the likely effect of the preceding year's weather and how it was to affect the 1989 harvest.

The 1987-88 floods in Bangladesh have prevented some rice replanting in 1989 and have also destroyed some rural transport infrastructure. A negligible increase in agricultural production is therefore forecast for 1989. However, the flooding enriched the soil and barring another flood, food output is expected to grow above normal rates in 1990. Like Bangladesh, India experienced negative growth in agricultural production in 1986 and 1987 due to a bad drought. It recovered in 1988, achieving 17 percent growth but the observed growth in 1989 is 2-3 percent only. Serious shortages in tea, cooking oil and sugar are being experienced with consequent inflation in these commodities at more than 20 percent in some areas. Sri Lanka was as seriously affected by the 1986-87 drought. Its agricultural production dropped by 5.9 percent in 1987 following a minimal growth of 0.7 percent in 1986. Production recovered in 1988. Pakistan and Nepal also suffered from climatic changes but not to the same extent as the three other countries. The forecast for 1989-1990 of average yield appears warranted as the weather has so far been fairly good. Their agricultural sector is projected to grow at 3.0 for Pakistan and 3.5 for Nepal.

Excepting India, all have incurred persistent current account deficits ranging from -1.7 percent for India to -6.9 percent of GDP for Sri Lanka. Their currencies depreciated quite substantially from 1981-1988 at 38 to 47 percent. Budget deficits as a percent of GDP were even higher, ranging from 4.4 for India to 13.6 percent for Sri Lanka. Monetary expansion financed much of the budget deficits; consequently money supply growth was higher.

Bangladesh's savings rate is the lowest in the region. The government is adopting a more restricted monetary policy with the growth rate of money supply (M_1) reduced in 1986 to 1988: 14.7 percent down from 20.7 percent in the preceding three years. The deficits also showed a slow decline from 1984. New exports– shrimps, fish, and garments– are growing though they are as yet of small volume. The prospects are for a modest decline in the inflation rate from 10-12 percent in 1988-1989 to 9.0 percent in 1990.

India's inflation is on a slight downtrend from 1983 to 1988. This is partly explained by tighter fiscal and monetary measures that have been adopted and are being reflected in a drastic reduction of money supply growth from 24.9 percent in 1988 to 13.6 percent in 1989. Part of the fall in budget deficits/GDP ratio was funded from domestic sources. Budget deficits/ratios have slightly declined from their peak of GDP 12.0 percent in 1983 to 8.8 percent in 1988. Deficits are projected to fall further to 7.0 percent in 1989-90. Currency depreciation was also a contributing factor. From 1981 to 1988, currency depreciated by 47.0 percent and in 1987 to 1988 by 6.3 percent. Current account deficits have remained high and for this reason continuous depreciation of the currency may be expected.

Pakistan has achieved the highest growth rate in the area averaging 6.4 percent in the 80s. Up to 1988 it had the lowest inflation rate. Growth has been financed by foreign sources as its savings rate is next to the lowest in the area, 7.6 percent on the average. The savings rate, however shows an upward trend: in 1989 it was 12.8 percent. Current account deficits to GDP ratio averaged 3.3 percent over the period and were financed by foreign borrowing. Its external debt doubled from US$ 10.5 billion to US$ 22 billion from 1981 to 1988. Government deficits to GDP ratio has been high at 7.1 percent on average, and shows an upward trend from 6.1 percent in 1981 to 8.3 percent in 1988. The IMF is pushing for a lower budget deficit and the targets for 1989 to 1991 are at about 7.0 percent. Tight monetary/fiscal policy has been announced. Money supply growth, while high on the average of 14.3 percent, declined from 18.5 percent in 1986-1987 to 11.2 percent in 1988. There is less flexibility in the spending side since more than half of current expenditures goes to defense and debt service. Tax revenue, which is 85 percent from indirect tax sources, is 13 percent of GDP. There is a good potential from direct taxes for raising the tax revenue share in public finance.

These moves may explain the slightly lower inflation rate in the first four months of 1989 than was originally forecast, 11.0 percent versus 10.6 percent (IFS). In the longer-run, the likely trends in inflation and the other variables to which it interacts will depend on the success of its reforms especially the measures to liberalize imports, to encourage private sector investments via deregulation of production, pricing and trading, and to collect direct taxes. The change in political climate might make these planned changes feasible.

In Sri Lanka like in its neighbors, price fluctuations are very much dependent on the weather. Inflation in the longer run will likely persist at the same rate as in past or about 10.0 percent. Inflation over the last four months averaged 10.2, virtually the same as the ADO forecast. The country has a low average savings rate of 13.2 percent, the highest current account deficit/GDP ratio of –6.9 percent, the highest budget deficits/GDP ratio of 13.6 percent, and also a relatively high money supply growth of 16.9 percent over the 1981-88 period. Agricultural production grew at only 2.0 percent per year. The currency has been gradually depreciating at 4.0 percent per year over the 1981-88 period. The depreciation trend may continue in the near future as there is no likely let-up on the current account deficits. The signs for the future inflation are mixed. The positive factors are as follows. Current account deficits/GDP ratio has been declining since 1985. GDP growth has drastically slowed down mainly because of the bad harvest. This slowdown has both a dampening and stimulating inflationary effect. Demand for non-agriculture falls as agricultural income drops while food prices rise because of food shortages. The budget deficits have been allowed to increase from 11.9 percent to 15.7 percent of GDP from 1985 to 1988. Most of the deficits are financed by monetary expansion, thus the rapid rise in money supply growth from 11.5 percent to 29.1 percent in the same years. The prospects for closing the budget gap by tax may not be so feasible given that the tax rate is already quite high by LDC standard, 19 percent.

The inflation outlook for Nepal is worse than was originally projected in the 1989 ADO. An important reason which preoccupies the government and the people, is the rather surprise closing of the major access roads between India and Nepal. The blockage has been wreaking havoc to the export sector and to the economy, as a whole, as critical imports like petroleum products, machinery spare parts and food are drastically reduced. High inflation in these products and in other goods using imported inputs has resulted.

2.4 China and Vietnam

An upsurge of inflation is to be expected when a very major restructuring of an economic system is implemented. In the case of centrally-planned systems which had relied on non-market means of resource allocation and pricing, a move towards private decisions and market-type adjustments would generally result in substantial adjustments in both relative and absolute prices. The extent of adjustments will depend on the deviation of the centrally-determined structure and levels of prices and those to which the new market-oriented system will determine. Fiscal and monetary policies are intervening factors in the process of adjustment. The adjustments will be facilitated by an accommodating money supply growth in the case where prices have been repressed to very low levels. The budget will necessarily be affected by the deregulation of business enterprises as both subsidies to and revenue from state corporations are reduced, possibly at unequal rates.

China had many factors favoring an easier transition to a mixed market system. Its savings rate has been very high and compares well with those of the NIES, 31 percent. Prior to and during the implementation of reform, its agricultural production was growing very rapidly at 10.0 percent per annum, and it had a small surplus in its current account, 0.3 percent. The high growth of agricultural products in the past likely weakened the degree of price distortion or repression in food prices explaining in part the slow rise in CPI when prices were relaxed and wages were allowed to increase. In fact, the World Bank Study (1989) argued that the industrial reforms were timed when food output was at especially high levels. There were, however, substantial price increases in some food items. The degree of price repression and their income elasticities differed across consumption items. Luxury items like meat faced larger increases in demand. Supply elasticities tended to be lower for these items, exacerbating their inflation tendencies. There were also big differences in inflation across regions, reflecting distribution bottlenecks and costs.

The big jump in prices began in 1988, three years after the initiation of the reforms. Demand pull and cost-push factors have increasingly become important in the inflation process. The newly-created Central Bank had not yet exercised effective control over the widely-located cooperative and other banks. These banks were allowed to extend 'temporary' credit to local enterprises. The local banks were pressed to accommodate the exuberance of investment demand in the provinces. The newly deregulated enterprises were also allowed to increase wages and bonuses within limits of central guidelines. Without having established market disciplines local enterprises readily went into haphazard investment and labor spending. In turn business expansion throughout was creating infrastructure and input constraints.

Credit is an important loose end in the reforms in China. On the fiscal side, the government will have to institute an effective tax system to allow it to step up infrastructure investment. The June events are expected to result in a return to a more conservative monetary policy and a more effective control by the Central Bank of the supply of credit at the local level. More cautious business decisions are likewise to be expected from local entrepreneurs. Inflation rate is most likely to decline to 12.0 percent in 1990 from 21.0 percent in the first eight months of 1989.

Reforms in Vietnam did not start as auspiciously as in China. Its agriculture was growing at a much lower rate prior to the reform, or 5.4 percent in 1983-85; it then dropped to 1.9 and -3.4 percent in 1986 to 1987 due to bad weather. Traditionally, it has had a very high inflation rate, averaging 71.5 percent in 1983-85. Its current account deficits were much higher than China's, -21.5 percent in 1984. Money supply was allowed to grow at more than 200 percent during the period of reform. A drastic depreciation of currency from Dong 10:5 to Dong 15 per US dollar in 1986 to 1987, then to Dong 225 in 1988 was an important correction of distortion in the economy. It however exacerbated the inflationary pressure.

References

Asian Wall Street Journal (1989), Jan. 9; June 2, 3, 12, 13, 15; July 20, 27; October 19, 23, 26, 27 and November 2.

Asian Development Bank (1989), *Asian Development Outlook*

Merrill Lynch (1989) *Asian Commentary, A Monthly Review,* (November) *Daily Digest* (1989), May 4, 12, 15 and June 2.

Far Western Economic Review (1989), May 4, 18; July 6, 13, 20.

The World Bank (1989), *World Development Report.*

International Monetary Fund (1989), *International Financial Statistics* (July).

Asian Development Bank (1989), *Key Indicators of Developing Member Countries.*

ADB Second Workshop (1989) Country paper, *Asian Development Outlook Forecast.*