

# South Asia

*A recovery in growth in South Asia in 2003 appears on track as a return to normal weather conditions boosts agricultural production, as external demand strengthens, and as political and security conditions stabilize. A rebound in agricultural incomes and growing confidence are underpinning strengthening domestic demand. The prospect of a stronger global economy augurs well for somewhat accelerated growth in 2004, though progress in fiscal consolidation and structural reforms will be necessary in all countries to sustain rapid, broad-based growth.*

## Macroeconomic Assessment

### GDP Growth

The relatively large share of agriculture in output and employment in the economies of South Asia makes GDP growth vulnerable to the vagaries of the weather. This was amply demonstrated in 2002<sup>1</sup> when adverse weather conditions caused a decline in agricultural output in India, stagnation in Bangladesh, and low growth in Nepal; this held overall South Asian GDP growth to only 4.2%. Favorable weather conditions supported by a strengthening in external and domestic demand indicate that South Asian economic growth in 2003 will be 5.8%, marginally better than ADO 2003 forecast of 5.7%. The impact of the SARS epidemic on the subregion's economies in the first half of 2003 appears to have been negligible. Inflation remains moderate in the subregion, though an expected pickup in the subregional average rate in 2003, mainly due to agricultural and oil price pressures, is now projected to come in at 5.5% (above the 4.9% ADO 2003 forecast). Balance-of-payments developments in 2003 are generally favorable, with strong export growth and current account balances, aided by solid gains in worker remittances. International reserves have increased in all countries and there has been upward pressure on some exchange rates against the US dollar.

In Bangladesh, GDP growth for FY2003 (year ended 30 June 2003) is estimated to have increased to 5.3% from 4.4% in FY2002. This was led by the agriculture and industry sectors, aided by higher domestic and external demand. Increased agricultural output reflected a recovery in foodgrain production, with the latter increasing by 4.1% compared to a 3.2% decline in FY2002, mainly due to favorable weather. Industrial output is estimated to have increased to 7.3% growth in FY2003 from

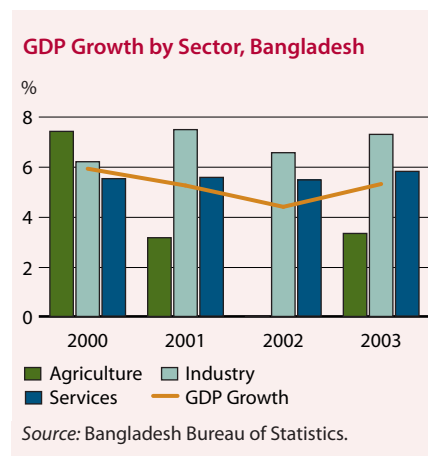


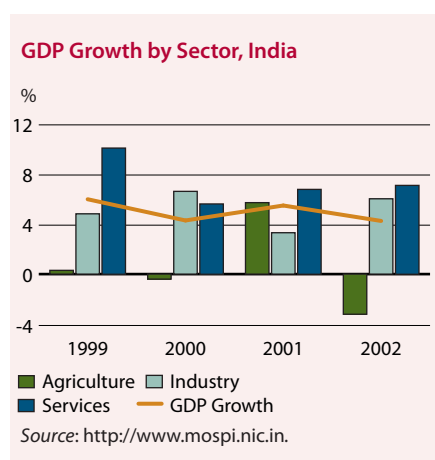
Table 2.3 Selected Economic Indicators, South Asia, 2002–2004, %

Item	2002	2003		2004	
		ADO 2003	Update	ADO 2003	Update
<b>GDP Growth</b>					
<b>Average</b>	4.2	5.7	5.8	6.1	6.1
Afghanistan	-	-	-	-	-
Bangladesh	4.4	5.2	5.3	5.8	5.7
Bhutan	7.7	-	-	-	-
India	4.3	6.0	6.0	6.3	6.3
Maldives	6.0	4.2	4.2	2.8	2.8
Nepal	-0.5	1.5	2.3	3.5	3.5
Pakistan	3.4	4.5	5.1	5.0	5.0
Sri Lanka	4.0	5.0	5.0	5.5	5.5
<b>Inflation Rate (CPI)</b>					
<b>Average</b>	3.7	4.9	5.5	5.0	4.9
Afghanistan	-	-	-	-	-
Bangladesh	2.4	3.8	5.1	4.5	4.5
Bhutan	2.7	-	-	-	-
India <sup>a</sup>	3.6	5.0	5.8	5.0	5.0
Maldives	0.9	-	-	-	-
Nepal	2.9	5.0	4.5	5.0	5.0
Pakistan	3.5	4.0	3.1	5.0	4.0
Sri Lanka	10.2	8.5	6.5	7.0	6.0
<b>Current Account Balance/GDP</b>					
<b>Average</b>	0.9	0.0	0.8	0.0	0.6
Afghanistan	-	-	-	-	-
Bangladesh	0.4	-1.3	0.6	-2.5	-1.2
Bhutan	-1.7	-	-	-	-
India	0.7	0.1	0.4	0.2	0.6
Maldives	-6.9	-	-	-	-
Nepal	-7.2	-5.0	-9.4	-5.0	-5.0
Pakistan	4.8	2.2	5.9	0.9	4.0
Sri Lanka	-1.6	-3.5	-2.5	-4.5	-3.0

- = data not available; CPI = consumer price index; GDP = gross domestic product.

<sup>a</sup> Wholesale price index.

Sources: ADO database; staff estimates.



6.5% in FY2002 with more robust manufacturing activity. The upturn in medium- and large-scale manufacturing output during the first 10 months of FY2003 (to 5.2% from 4.1% in the corresponding period of FY2002) was due to a recovery in the export-oriented chemicals, processed foods, and knitwear and garment industries; small-scale manufacturing, power generation, and gas production are estimated to have experienced even faster growth. Construction activity moderated due to an ongoing oversupply of commercial buildings and apartments, and overall investment activity increased only marginally.

The Indian economy appears poised for a strong recovery in FY2003 (year ending 31 March 2004). Growth declined to 4.3% in FY2002 from 5.6% a year earlier, though performance was mixed across sectors. A sharp 3.2% decline in the important agriculture sector caused by drought

masked a 6.0% upturn in the industry sector and continued vigorous growth in services output. With an apparent normal monsoon through September 2003, agricultural growth appears to be rebounding while manufacturing growth momentum in the early months of FY2003 remains powerful. Buoyant industrial performance continues to be supported by strong growth in merchandise exports and a construction boom.

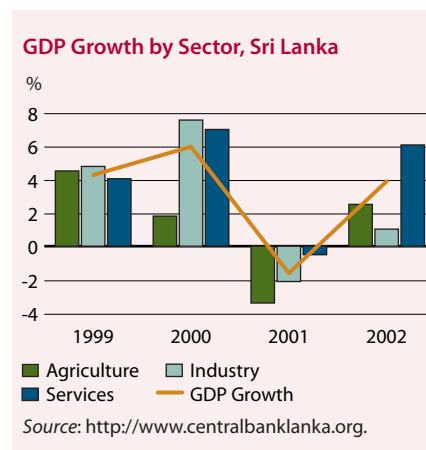
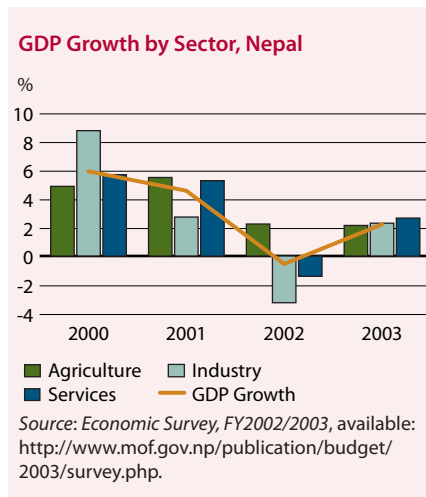
The improved security situation in Nepal following a cease-fire agreement on 23 January 2003 facilitated a moderate economic recovery in the second half of FY2003 (year ended 15 July 2003). The GDP growth rate for the year is provisionally estimated at 2.3%, based on some revival in manufacturing, export trade, and tourist arrivals. Tourist arrivals from India in January–August 2003 were up by about 33% from the same period a year earlier and may represent some diversion from other markets due to SARS. In FY2002, GDP fell by 0.5%, the worst outcome in the past two decades, as a result of the escalation in the insurgency, an irregular monsoon, and weak external demand.

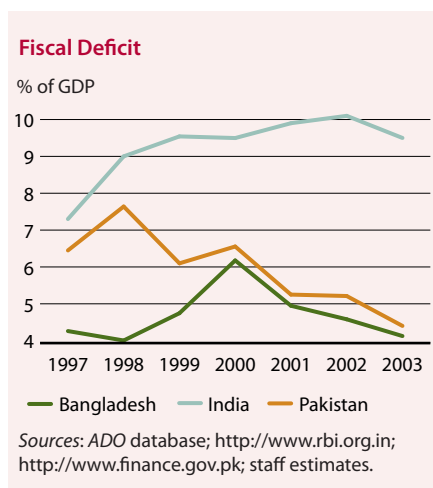
Pakistan’s economic performance showed a sharp, broad-based improvement in FY2003 (year ended 30 June 2003) with GDP growing by 5.1% (3.4% in FY2002), the fastest pace in the last 6 years. This reflected an accelerated expansion in large-scale manufacturing, a revival of growth in major crops (output had fallen in the previous 2 years), and strengthening in the services sector. The broad advance was built on favorable weather conditions, strong export performance (especially in textiles), and the payoff from programs of macroeconomic and structural reforms undertaken in recent years. Gross fixed investment, however, remained stagnant at 13.1% of GDP, an all-time low. This stagnation appears explained in part by excess industrial capacity and perhaps also by the political uncertainty generated by the confrontation between the Government and the opposition over constitutional amendments.

Sri Lanka’s economic performance in 2003 made a promising start with GDP up by 5.5% in the first quarter. The SARS outbreak in East Asia and the conflict in Iraq had little impact on the economy. Services output grew by 7.6% in the first quarter accounting for more than 70% of growth as tourism and shipping continued their resurgence from the impact of the 2001 bombing of the international airport. Notably, industrial production grew by 5.4% in the first quarter; electricity output was up by 20% and with none of the load shedding that had adversely affected the economy in 2002. Agriculture, which had largely recovered from the 2000–01 drought in 2002, grew by about 1% in the quarter but turned in a mixed performance: paddy production was solid but plantation crops showed poor results. A positive leading indicator was the 7.6% increase in the construction industry, ending five quarters of decline.

**Fiscal Situation**

Fiscal consolidation remains a major area of concern in South Asia as wide deficits and high debt levels are commonplace. However, Bangladesh improved its budgetary performance in FY2003. Revenue fell short of the original target but is estimated to have risen by 12.4% to 10.4% of GDP; the gain reflected revenue measures adopted in the budget and improved tax administration in a growing economy. Despite higher than planned current expenditure caused mainly by higher interest payments,





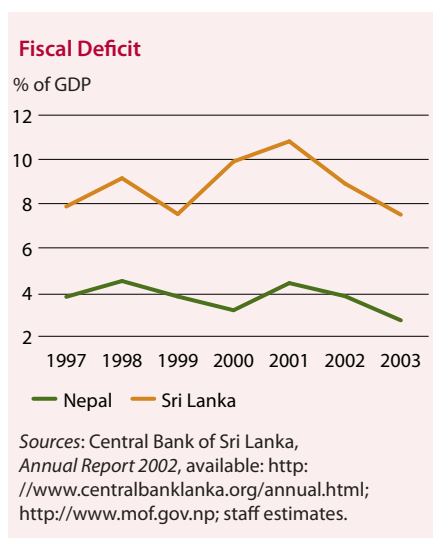
overall expenditure was held slightly below the budget target, as low-priority development projects were pruned. As a result, the overall deficit for FY2003 is estimated at 4.2% of GDP, lower than the 4.6% of GDP outturn in FY2002.

India's fiscal deficits in FY2002 (year ended March 2003) remained large. The central government deficit (including privatization funds) is provisionally estimated at 5.9% of GDP, against an original target of 5.3%. The deficit of the state governments is estimated at 4.7% of GDP, indicating that the consolidated general government deficit was 10.1% of GDP for the year. Total government debt (center and states combined) was 75.5% of GDP at end-FY2002. The central government budget for FY2003 envisages only a small improvement in the central government deficit to 5.6% of GDP. Data for the first quarter of FY2003 (April–June 2003) indicate a 16% decline in total revenue from a year earlier but also lower spending that offset the impact on the deficit. A major reform, namely the introduction of VAT in FY2003 to replace the states' general sales taxes, was postponed. In view of the low prevailing interest rates, various programs are under way to refinance the outstanding debts of central and state governments to reduce interest costs.

In Nepal, the Government revised the FY2003 (year ended 15 July 2003) budget at midyear to account for lower economic activity in the first half of the fiscal year: tax revenue, external aid, expenditure, and the overall deficit were all revised downward. After the announcement of the cease-fire, economic activity and tax collection improved. Revised estimates indicate that revenue collection exceeded the revised budget target of 11.9% of GDP and domestic financing was contained within the planned level of 2% of GDP. Capital spending, however, was under budget, reflecting continued implementation constraints at the local level.

The Government in Pakistan tightened fiscal policy in FY2003, resulting in a decline in the overall fiscal deficit to 4.4% of GDP, compared to 5.2% of GDP in FY2002. Tax revenues, which met the budget target, increased to 13.7% of GDP with broad-based gains resulting from recovery in domestic economic activity and a sharp increase in imports as well as reforms of tax administration. Development expenditure was lower than planned and reflected continued problems with the implementation capacity of the Government.

Fiscal performance in Sri Lanka in the first 5 months of 2003 shows certain weakness, particularly in terms of the revenue targets. VAT did not perform up to expectations but other revenue sources were compensatory. Less than budgeted spending on the capital side underlines the need for addressing long-standing aid utilization issues, but this was offset by some current account overspending. Keeping spending on track and improving VAT performance are issues if the targeted improvement in the overall deficit to 7.5% of GDP from 8.9% of GDP in 2002 is to be achieved.



### Money and Prices

Monetary policy has continued to be generally accommodative in South Asia in 2003 to foster economic growth. This has been facilitated by sustained low world interest rates, the general absence of price pressures, and underutilized domestic production capacity.

In Bangladesh, broad money (M2) growth increased to 15.6% in

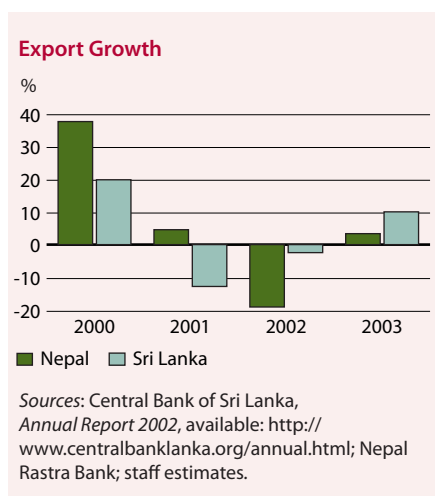
FY2003 (up from 13.1% in FY2002), mainly due to a sharp rise in the net foreign assets of the banking system, buoyed by gains in overseas worker remittances. Growth in domestic credit in this period moderated due to reduced budgetary financing and a more cautious attitude toward private sector lending by commercial banks. The banks' commercial lending rate remained steady at about 12%. Monetary policy restraint by Bangladesh Bank was achieved by sterilization of international reserve accumulations through the sale of treasury bills; these rates were allowed to rise from 5% to 7% to reflect market conditions.

Money supply (M3) growth in India moderated to 12.2% in the year to June 2003, after growing by 15.1% in the year to March 2003. Monetary policy has continued to be aimed at maintaining easy liquidity conditions to foster economic growth but high real interest rates and risk-averse banks restrained private credit growth. The continuation of a large overall payments surplus has meant that the Reserve Bank of India (RBI) continues to intervene in the foreign exchange market, accompanied by sterilization operations, to contain rate volatility and limit the appreciation of the Indian rupee. Reflecting signs of Nepal's economic recovery, broad money (M2) growth increased to 8.1% in FY2003 (up from 4.4% in FY2002) mainly due to increased private sector credit. However, broad money growth was still much lower than the 12.0% target rate. To support the economic recovery, the Nepal Rastra Bank lowered cash reserve requirements by 1 percentage point in August 2002.

In an environment of stable prices, the State Bank of Pakistan (SBP) continued to pursue an easy monetary stance in FY2003 to stimulate investment and growth. Interest rates maintained a steep downward trend and the average lending rate charged by banks on overall advances declined by 554 basis points (bps) to 7.6% over FY2003; the lending-deposit rate spread fell by 327 bps. Despite SBP's policy of partial sterilization of foreign exchange purchases in the interbank market, broad money supply increased by 17.6% in FY2003, compared to 15.4% in FY2002, an uptick triggered exclusively by a larger expansion in the banking system's net foreign assets.

In Sri Lanka, a core objective of the central bank is further progress toward price stability, though bank policy rates have been adjusted downward as inflation moderates to foster investment and growth. Over the first 7 months of 2003, the money supply (M2) increased by 6.1%, in line with the central bank's program target of about 13.5% expansion in M2 for the entire year, which aims to slow inflation to about 6.5%. Domestic credit to the private sector was the source of most of the money supply expansion in this period, while commercial banks' average prime lending rate fell by about 390 bps to 10.4%.

Price developments have varied throughout the subregion, though inflation is generally moderate and is not a major policy issue except in Sri Lanka. In Bangladesh, annual average inflation moved up to 5.1% in FY2003 from 2.4% in FY2002. Food prices were the main driving force. Inflation has also picked up in India where the wholesale price index was 5.4% higher than a year earlier in the first quarter of FY2003. Higher global oil prices and effects from the past drought on certain agricultural products were the main causes of the rise. Average inflation in Pakistan moderated to 3.1% in FY2003 from 3.5% in FY2002, as comfortable



supplies of both food and manufactured goods, as well as exchange rate appreciation, offset oil price pressures. In Sri Lanka, the 12-month moving average of CPI inflation fell to 6.1% by June 2003 from over 12% a year earlier. The slowing of food price increases was a major factor, but the Government also intervened to smooth local oil prices during the weeks preceding the conflict in Iraq.

### External Sector Developments

South Asian export growth for 2003 is estimated to be 14.7%. Solid export gains were recorded by most countries in the subregion, whereas in 2002 strong performance in India essentially accounted for the subregion's marked 11.5% export expansion. In Bangladesh, preliminary data show that exports increased by 9.4% in FY2003. Exports showed a marked pickup after February and were broad based, with garment exports recording a modest increase in value since April as strong volume growth offset low unit values. India's exports staged a vigorous revival and grew by 18.0% in FY2002. Customs data indicate that export growth moderated to about 11% year on year during April–June 2003 (first quarter FY2003). Capacity expansion and competitive pricing have boosted traditional exports, such as textiles, light manufactures, and jewelry. Preliminary estimates indicate that Nepal's exports increased by 3.3% in FY2003 (year ended 15 July 2003) after their sharp 19% fall in the previous year. The improved performance was mainly due to an upsurge in readymade garment exports that overcame declines in woollen carpet and pashmina exports. Exports to India fell by about 5% as quantitative restrictions on some major exports (set in the renewed Nepal-India trade treaty) took hold. Pakistan's exports grew by 19.1% in FY2003, substantially exceeding the target and representing a strong recovery from the small 2.3% increase in the previous year. Export gains were broad based and reflected increases in both volume and the dollar price. Movement to higher-value textile items and elimination of under-invoicing as the currency appreciated appear to have aided the strong performance. Sri Lanka's exports increased by 18% in the first 7 months of 2003 compared to the same period a year earlier. Export performance was boosted by a major recovery in industrial exports, including garments and machinery, but agricultural exports contracted, due mainly to a drop in tea exports.

Imports to South Asia in 2003 are now expected to grow by about 12.5%, a somewhat larger increase, as with exports, than envisaged in *ADO 2003*. In Bangladesh, imports are estimated to have risen by 10.3% in FY2003 with the entire expansion taking place in the second half of the year. There were large rises in imports of rice, edible oils, sugar, and petroleum products that offset a decline in capital goods imports. Imports to India grew by 13.6% in FY2002 (year ended March 2003). Higher capital goods and food imports helped raise non-oil imports by about 8%, while oil imports (about one fourth of the total) were up by about 27%. Preliminary customs data for April–June 2003 indicate quite rapid import growth, with oil imports up by nearly 18% and non-oil imports up by about 31% from a year earlier. Nepal's imports are estimated to have grown by 15.2% in FY2003 after a 10.9% drop in the previous year. The revival appears to largely reflect increased imports of machinery and raw materials used in export production and higher oil prices. Imports to Pakistan are estimated

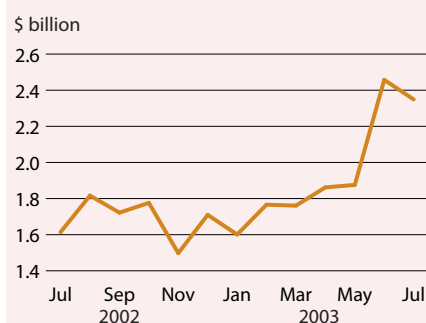
to have increased by 21.1% in FY2003, largely due to increased oil prices and a marked expansion in raw materials imports. Sri Lanka's imports rose by 8% in the first 7 months of 2003. Most of the increase was due to greater imports of intermediate goods used in export production, though imports of consumer durable goods have also risen.

Current account balances are expected to remain relatively healthy in 2003 for South Asia, averaging about 0.8% of GDP. In Bangladesh, despite an estimated increase in the trade deficit to \$1.9 billion and a continued services deficit, strong growth in worker remittances maintained the FY2003 current account balance (excluding grants) in surplus estimated at \$310 million or 0.6% of GDP. India's current account surplus substantially strengthened to \$3.7 billion or 0.7% of GDP in FY2002, almost entirely due to a widening of the invisibles surplus resulting from robust growth in information and communications technology earnings and worker remittances. Based on high growth expected in merchandise exports and a considerable surplus on the invisibles account, it is expected that the current account surplus will be 0.4% of GDP in FY2003. Preliminary estimates show Nepal's current account deficit to be 9.4% of GDP in FY2003, despite some revival in tourism and continued large worker remittances. The deficit was well above that recorded a year earlier and the *ADO 2003* projection, due to increased imports and only a marginal improvement in exports. Pakistan's current account surplus markedly strengthened to \$4.0 billion or 5.9% of GDP in FY2003. Much of the improvement was due to higher worker remittances, though lower interest payments were also important. In Sri Lanka, the trade deficit narrowed by about 16% to \$824 million in the first 7 months of 2003. The projected current account deficit has been reduced by a percentage point to 2.5% of GDP.

The general strengthening in balance-of-payments developments in South Asia has been reflected in reserve holdings and exchange rates. In Bangladesh, a strengthened current account more than offset a deficit on the financial account and raised the estimated FY2003 overall surplus above the \$365 million level recorded a year ago. Official reserves increased by \$305 million over the first 11 months of the year, i.e., to end-May, and were buoyed in June by the release of a large (\$308 million) World Bank development credit. At end-June 2003, official reserves were nearly \$2.5 billion (bringing import cover temporarily to about 3 months). At end-May 2003, the Bangladesh Government stopped setting an official band for the taka, effectively adopting a floating exchange rate. Subsequent market rates through July were little changed.

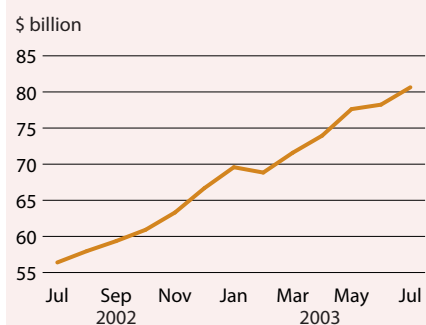
India's overall payments surplus was estimated at \$17 billion in FY2002. Official foreign currency reserves increased by \$20.8 billion in the year, following an \$11.5 billion gain a year earlier, and amounted to \$71.9 billion at end-March 2003. Subsequently, foreign currency reserves went up by \$10.7 billion through 29 August 2003, pointing to continued balance-of-payments strength in FY2003. Capital account developments, including very large inflows from nonresident Indians, have underpinned these historic large increases in reserves. However, valuation gains on foreign currency assets added about \$4 billion to reserves in FY2002. A favorable interest rate differential and the expectations of an Indian rupee appreciation appear to be the main driving forces behind the accretion in foreign reserves. The Indian rupee/US dollar rate appreciated by

Foreign Exchange Reserves, Bangladesh



Source: <http://www.bangladesh-bank.org>.

Foreign Exchange Reserves, India



Source: <http://www.rbi.org.in>.



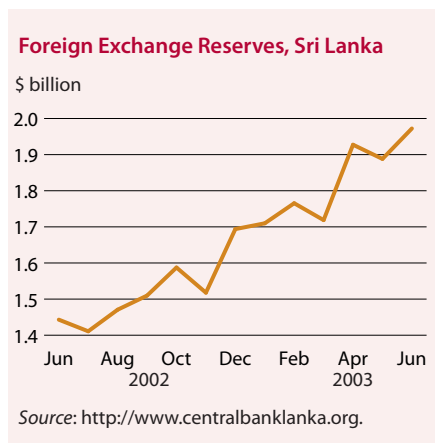
about 2.3% in FY2002, and by about 3.4% in the first 5 months of FY2003 through August 2003.

In Nepal, despite the weakening in the current account balance, the overall balance of payments in FY2003 is estimated to have been in surplus equal to about 1.5% of GDP, due to higher foreign aid and unrecorded inflows. Official foreign exchange reserves increased to over \$1 billion, equivalent to about 8 months of imports of goods and services. In Pakistan, due mainly to the large current account surplus and an increase in FDI, partly boosted by privatization proceeds, SBP's official foreign exchange reserves increased by \$5.2 billion in FY2003 to \$9.5 billion at fiscal year-end. The Pakistan rupee appreciated by about 4% against the US dollar in FY2003, but the real effective exchange rate remained essentially unchanged. Sri Lanka's gross official reserves went up by \$278 million over the first 6 months of 2003 to nearly \$2.0 billion at end-June. While the average exchange rate against the US dollar was largely stable in this period, it depreciated markedly against the euro, pound sterling, and yen.

### Policy Developments

The main policy issues in South Asia relate to the fiscal consolidation needed to address high budget deficits and large government debt to GDP ratios, as well as strengthening the revenue base and improving expenditure efficiency to create space for undertaking expanded poverty-reducing expenditure policies. Maintaining sound macroeconomic policies and continuing structural and governance reforms are also at issue.

During the second half of FY2003, the Government of Bangladesh further strengthened macroeconomic management with renewed emphasis on structural reforms. In particular, fiscal policy was tightened through enhanced revenue measures and expenditure restraint, while monetary policy was restrained through the greater use of market-based instruments to manage liquidity. On the structural front, utility tariffs and energy prices were revised upward, while Bangladesh Bank was granted greater autonomy and authority to conduct monetary and exchange rate policy and to supervise the banking sector. Having improved the institutional capacity of Bangladesh Bank and developed a more market-based monetary framework to control inflation, the Government floated the taka at the end of May 2003 with a view to enhancing competitiveness and strengthening resilience to external shocks. Also in the second half of FY2003, the Government formulated its interim poverty reduction and development strategy—the National Strategy for Economic Growth, Poverty Reduction and Social Development—after broad public consultations. The key strategic elements include pro-poor economic growth, human development, women's advancement, social safety nets, and participatory governance. The Strategy facilitated the Government agreeing to new lending programs with the World Bank and IMF. Accordingly, the budget for FY2004 seeks to boost revenue and increase spending on infrastructure and human capital, buttressed by the greater availability of concessional aid. Notwithstanding these advances, progress has been slow on much-needed governance reforms and structural reforms in the state-owned enterprise and banking sectors.



The Indian Parliament passed the Fiscal Responsibility and Budget Management Bill (FRB) in August 2003. The FRB spells out the responsibility of the central Government for ensuring fiscal sustainability, intergenerational equity in fiscal management, and long-term macroeconomic stability. It also seeks to remove fiscal impediments to the effective conduct of monetary policy and prudential debt management and to enhance transparency in fiscal operations of the central Government. These goals are to be achieved mainly through rule-based fiscal discipline, including required annual limits on central government deficits, borrowings, and debt with an objective of eliminating the revenue deficit by FY2008. For implementation of the targets, the FRB assigns to the finance minister the responsibility for reviewing quarterly fiscal trends in relation to the budget; allows the Government to take appropriate measures for increasing revenue or reducing the expenditure in response to deviations from targets; and makes it binding on the finance minister to seek prior approval and explain to Parliament any deviation, spelling out budgetary implications and remedial measures.

In the monetary and credit policy announced for FY2003, RBI has reduced the cash reserve ratio from 4.75% to 4.5% and the bank rate from 6.25% to 6.0%. Despite these measures, the existing prime lending rate remains high at 10.5–11%, given an inflation rate of around 5.0%. Although monetary policy aims at expanding the flow of credit and boosting domestic investment, credit availability remains an issue, partly due to high real interest rates and partly due to credit rationing for non-prime borrowers by risk-averse commercial banks. In the area of structural reform, the Electricity Act of 2003 sought to promote competition, efficiency, and commercial viability in the power sector. The Act includes de-licensing of thermal power generation, removal of control on captive power generation, introduction of open access in transmission and distribution networks, recognition of electricity trading as a legitimate economic activity, transparency in subsidy management, and creation of an Appellate Tribunal. The Electricity Act requires the Government to prepare (and periodically update) a National Electricity Policy and a Tariff Policy.

Nepal's FY2004 budget announced on 17 July 2003 focuses on the implementation of the recently approved Tenth Five-Year Plan and introduces a strategic theme of public-private partnership. Other key elements of the FY2004 budget include revision of customs and excise duties, tax concessions for the export sector, and divestiture of some major public enterprises. To improve prioritization of development expenditure, a Medium-Term Expenditure Framework was introduced. The Immediate Action Plan for 2003, a concept introduced in 2002 to prioritize and expedite reform programs, seeks to expand further efforts to devolve management of schools and subhealth posts, expand rural electrification through transfer of distribution management to local communities, allocate more resources to less developed regions, and establish a Poverty Alleviation Fund. Privatization and liquidation of several public enterprises have been initiated. Key financial reforms have also begun, including introduction of external management teams in the two large government-controlled banks, operational review and preparation of restructuring plans for the Agricultural Development Bank and the Nepal Industrial Development

Corporation, and establishment of a debt recovery tribunal, although not yet operational.

In Pakistan, the FY2004 budget, announced on 7 June 2003, is the first budget of the elected Government that came into power in November 2002. The budget reflects the Government's commitment to continue structural reforms initiated in 2002 by the previous administration. This commitment was demonstrated by a further reduction in corporate tax rates for private and banking companies by 2 and 3 percentage points, respectively, as announced last year; and further progress in phasing out excise duties and eliminating tax exemptions, particularly in the area of income tax. The budget also envisages a reduction in the overall fiscal deficit to 4.0% of GDP in FY2004 (from 4.4% in FY2003). Moreover, the budget provides incentives for private investment, particularly in housing and construction. Although the Government has more or less stayed on course in implementing structural reforms, there has been some slow-down. For instance, the general sales tax (GST) has not been extended to services and some amendments have been made in the Income Tax Ordinance 2001, partially reversing the process of reducing the discretionary powers of tax officials. However, the greatest concern is that the losses of public sector enterprises are not being adequately tackled, particularly those of the two state-owned power utilities that are huge drains on government resources.

Sri Lanka's policy efforts are based on a comprehensive framework for economic growth and poverty reduction that is supported by new lending agreed in 2003 with international finance institutions. Key elements of the framework, which will be implemented over 3 years, are fiscal consolidation; strengthening macroeconomic policy and institutions; and reforms in public enterprises, labor regulations, and the trade regime. Consistent with the framework and the Fiscal Management and Responsibility Act of December 2002, the budget deficit for 2003 was targeted at 7.5% of GDP. Postponement of the extension of VAT to the retail and wholesale sectors in the year, however, added pressure to achieving this objective. In March, the central bank strengthened its ability to regulate the money supply by introducing open-market operations. Structural reforms have been continued in several areas including several amendments to labor laws that were passed in January 2003 and the privatization of the Sri Lanka Insurance Corporation that was completed in April.

### Outlook for 2003–2004

The present forecast for South Asian economic performance is marginally improved from that made in *ADO 2003*. That forecast assumed normal weather conditions, improved political stability and security in subregional countries, and some improvement in global economic growth; those assumptions have held true to date and remain necessary in the medium term. Projected growth in subregional GDP for 2003 has been slightly revised from 5.7% to 5.8%. No change is made to the *ADO 2003* projection of a pickup in subregional growth to 6.1% in 2004. Balance-of-payments outcomes are now generally seen to be somewhat healthier than forecast in *ADO 2003*.

The outlook for FY2004 in Bangladesh is for GDP growth to accelerate

to 5.7%, with a further upturn in both domestic and external demand. The current account of the balance of payments is likely to move to a deficit of 1.2% of GDP from the surplus of 0.6% of GDP in 2003, as import growth outstrips export growth and growth in worker remittances is more subdued due to a slowing in the number of registered workers leaving for abroad. The rate of inflation is likely to moderate from 5.1% in 2003 to 4.5% in 2004, mostly due to the greater availability of foodgrains and more favorable oil prices, which will offset an expected slight depreciation of the exchange rate on account of the likely deterioration in the trade balance.

The projected outlook for the Indian economy remains essentially that given in *ADO 2003*. A revision was made in the inflation forecast to 5.8% for FY2003. With an expected recovery in agricultural production, GDP was—and is—projected to grow by 6.0% in FY2003. The *ADO 2003* projection of slightly higher GDP growth of 6.3% for FY2004, reflecting the upswing in the Indian business cycle and further strengthening in the world economy, is maintained, as is the inflation forecast at 5.0%. The current account surplus is now projected to be 0.6% of GDP in FY2004, up from 0.4% of GDP now estimated for FY2003.

Economic prospects in Nepal crucially depend on progress in peace talks and the security situation as well as developments in political relations between the Government and its parliamentary opposition. On the assumption of no serious deterioration in the security situation and normal weather conditions, the economy is projected to grow by about 3.5% in FY2004. In the same year, export growth is expected to strengthen and import growth to slow. The projected improvement in the current account deficit to 5.0% of GDP mainly depends on further recovery in tourism and continued increase in worker remittances. Higher aid and other capital inflows should result in a small overall balance of payments surplus. With the exchange rate peg, inflation follows price developments in India and is expected to be about 5%.

Given recent trends, Pakistan's economy should be able to maintain GDP growth of at least 5.0% in FY2004, with a pickup in investment activity. Continued sound macroeconomic policies and favorable supply-side conditions indicate that the 4.0% inflation target should be achieved. Export and import growth are likely to moderate but remain relatively strong at about 12% and 10%, respectively. The surplus on the current account in FY2004 is expected to decline but remain sizable at about 4% of GDP because worker remittances are likely to be sustained at about FY2003 levels (the shift to banking system channels is now completed) and because external grants and payments for support operations in Afghanistan are likely to decline but remain significant.

Economic developments in Sri Lanka indicate that the *ADO 2003* projection of 5.0% GDP growth in 2003 will be achieved, and no change has been made in the 5.5% projection for 2004. Recovery in export performance, however, has been appreciably stronger than was anticipated (2003 exports are now expected to be up by 10.0% rather than the 6.5% in *ADO 2003*) and projected growth in 2004 is now raised from 9.0% to 11.0%. This development has lowered the projected current account deficit to 2.5% of GDP in 2003 and to 3.0% in 2004. Moreover, tight financial policies combined with increased domestic food production have slowed price

