

1. INTRODUCTION

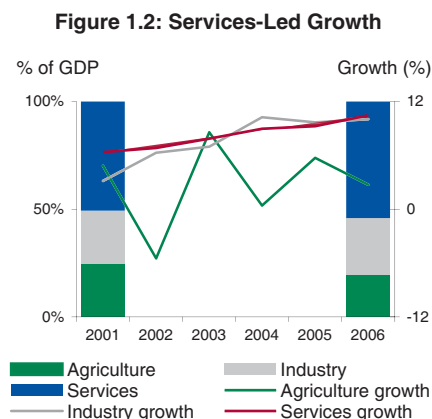
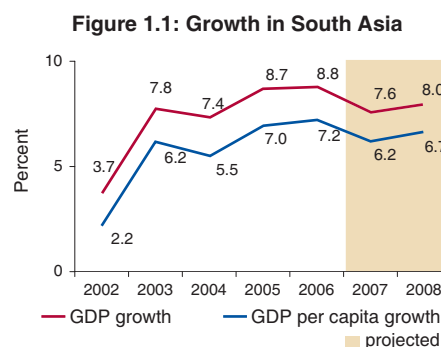
Recent Economic Performance and Prospects

South Asia continues to build on its recent record of strong economic performance. Growth of gross domestic product (GDP) reached a remarkable 8.8% (7.2% in per capita terms) in 2006, sustaining the impressive trend established since 2002, when annual growth averaged over 8%. South Asia is outperforming Asia as a whole, which grew at 8.3% in 2006, and remains one of the fastest growing regions in the world. With GDP forecast to grow at 7.6% in 2007 and 8.0% in 2008, the high growth trajectory is expected to be sustained over the medium term (figure 1.1).

All countries in the region grew at over 6% in 2006, except Nepal. The Indian economy maintains a robust rate of expansion with a high 9.4% growth in fiscal year (FY) 2006, which surpassed the previous year's rapid pace. Growth also accelerated in Bangladesh and Sri Lanka to decade-long highs of 6.6% and 7.4%, respectively, while the Maldives strongly rebounded from the previous year's tsunami-induced contraction by registering a 19.1% expansion. After expanding rapidly in the previous 2 years, growth in Pakistan, however, slowed to 6.6%.

Services continued to underpin economic growth in South Asia. In 2006, sectoral output expanded rapidly, by 10.5%, buoyed by vibrant trade, transport, and communications services across the region, as well as other vital subsectors such as information technology and information technology enabled services in India and tourism in the Maldives. As a result, the share of the services sector in total output increased further to 54.2% of GDP. Growth in the industry sector also remained high at 10.1%, as construction continues to expand with increased residential and commercial property building in India and Bhutan, and with reconstruction efforts in calamity-stricken countries in the region. The utilities subsector is also becoming more important due to rising hydropower generation in Bhutan and Sri Lanka. Agriculture only grew by 2.7% in 2006 (figure 1.2), although the post-tsunami recovery of fisheries in Sri Lanka is indeed a welcome development. Industry and services in South Asia are each forecast at over 7.5% annual growth in the next 2 years.

Rising food prices due to depressed farm production, rapid money supply growth, and high world prices of oil and commodities have resulted in a significant rise in regional inflation to 5.9% in 2006



(figure 1.3). Investment requirements from the rise of manufacturing and the construction boom in India fueled credit and liquidity growth, which, combined with high food and fuel prices, pushed inflation up to 5.4%, a full percentage point higher than the previous year. Excess liquidity, plus a sharp depreciation of the taka, also raised inflation significantly in Bangladesh to 7.2% in FY2006. However, the sharpest price increases were recorded in Nepal, where inflation almost doubled to 8.0% due to low agricultural output, reduced petroleum subsidies, and a higher value-added tax rate.

Monetary authorities in South Asia raised nominal interest rates in attempts to tighten liquidity but rising inflation kept real interest rates low. Thus, money supply growth in the region stabilized at a slightly lower although brisk pace of 20% in 2006. Inflation is expected to ease to 5.5% in 2007 and to 5.4% in 2008, as central banks continue the tight monetary policy stance, a strong supply response to high food prices is realized, and the world price of oil could be reduced.

The regional average fiscal deficit declined further to 5.9% of GDP in 2006, driven by a significant reduction of expenditure in India, where fiscal consolidation continues at both the federal and state levels (figure 1.4). A marginal improvement in fiscal position was also recorded in Bangladesh, while Bhutan's large budget deficit declined due to higher foreign grants and a slight reduction in capital expenditures. In general, however, fiscal deficits across South Asia remained high because of incomplete pass-through of high oil prices and higher development expenditures. Relief and reconstruction expenditures, in response to the severe effects of the tsunami in the Maldives and the earthquake in Pakistan, also contributed significantly to the high budget deficits in these countries.

South Asia's integration with the world economy through international merchandise trade proceeded at a slightly slower pace in 2006. Total trade as a proportion of GDP increased to 36.3%, from 33.9% in 2005 and 30.8% in 2004. Export growth moderated to 19.4% in 2006, as the flow of goods from Afghanistan, India, Nepal, Pakistan, and Sri Lanka lost some momentum due primarily to real currency appreciation. However, the growth of exports accelerated substantially in Bangladesh, Bhutan, and the Maldives. Although average import growth was also lower at 22.0%, it remained above export expansion. The trade deficit thus increased to about 7.3% of GDP (figure 1.5). Large foreign exchange inflows from service exports and workers' remittances, valued at \$130 billion, cushioned the current account, although the deficit still expanded to 1.4% of GDP.

These trends are projected to persist in the next 2 years. Growth of merchandise imports is again likely to outstrip that of exports because of South Asia's rapid economic growth and low GDP growth in developed countries. Merchandise exports are expected to expand by an average of almost 15% per annum during the next 2 years, slightly lagging behind the growth forecast of nearly 18% for regional

Figure 1.3: Inflation and Money Supply Growth

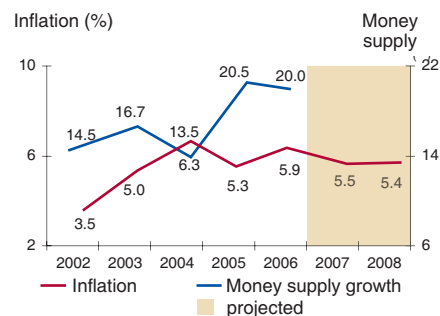
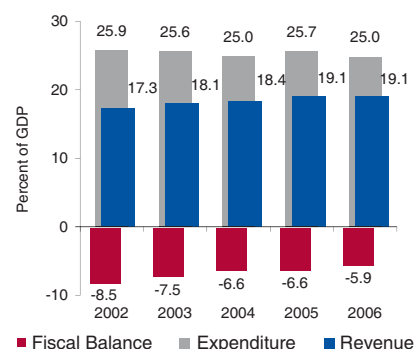


Figure 1.4: Fiscal Performance



imports. As a result, the trade deficit is projected to deteriorate further to 8.5% of GDP in 2007 and then to 9.5% in 2008. However, consistently strong performance of service exports and rising remittances should substantially compensate for the trade deficit, and help to stabilize the current account deficit at around 2.2–2.3% of GDP through 2007 and 2008.

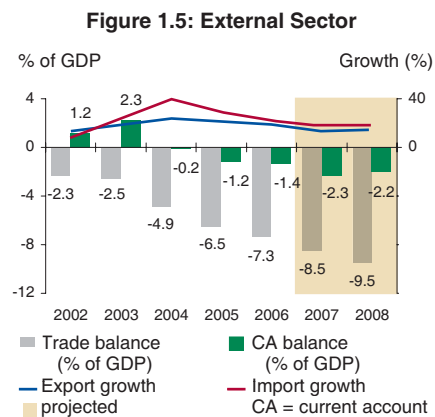
Given its impressive economic performance in recent years and solid prospects for continued high growth, South Asia is becoming one of the more attractive destinations for foreign capital. Investor confidence is rising, with foreign direct investment (FDI) reaching over \$24 billion in 2006. This builds substantially on the previous year's large inflows, which breached the \$10 billion mark for the first time. India's leading role in the region's economic surge has generated the most interest among investors. About 80% of total FDI in South Asia flowed into India in 2006, amounting to \$19.5 billion—almost \$12 billion more than the previous year. Pakistan follows a similar trend as FDI more than doubled to about \$3.5 billion in FY2006. The volume of capital inflows into South Asia has counteracted prevailing current account deficits, translating into balance-of-payments surpluses and an accumulation of gross international reserves in excess of \$220 billion across the region. Prospects for sustaining rapid economic growth will become brighter as investor confidence develops and foreign capital inflows gain momentum.

Overall, South Asia is expected to experience high growth with strong domestic demand and rising investment, although economic performance may moderate somewhat in line with global trends. India will continue to set the pace with GDP growth forecast at about 8% per annum over the next 2 years. Bangladesh, Pakistan, and Sri Lanka are projected to grow at 6–7% during this period, providing strong support for the encouraging rate of progress in South Asia.

Challenges and Opportunities

South Asia is on a track of high growth. However, growth has only been strong during the past few years, and the region has yet to prove that rapid growth is sustainable in the longer term. In addition, there is growing concern that the growth is not sufficiently inclusive and truly poverty-reducing (Felipe and Hasan 2006, 2007). Successfully tackling these challenges requires strategic choices in crucial policy areas.

In this respect, the previous *South Asia Economic Report (SAER)* highlighted the need for institutional reforms and targeted public investments required to sustain and accelerate growth. Institutional reforms need to focus on improving regulatory quality and government effectiveness. The first *SAER* also recommended that public investments be targeted at areas where infrastructure



bottlenecks are emerging. In particular, power, roads, urban infrastructure, and ports form a serious constraint to sustaining growth in the medium to long term.

This issue of the *SAER* focuses on a different, but equally important, set of challenges and opportunities for South Asia in the areas of education and health.¹ We argue that the social sectors in South Asia are increasingly confronted with a number of global and regional trends, which present both opportunities and challenges. Understanding and strategically capitalizing on these trends in order to improve social sector performance—and ultimately to sustain and enhance the inclusiveness of growth—is crucial, since South Asia continues to perform weakly in key dimensions of education and health. In section 3, the *SAER* describes six broad trends and their impact on the education and health sectors.

- First, accelerated economic growth and integration into the global economy have created new and unprecedented economic opportunities that have provided increased income for many.
- Second, rapid technological changes have redefined the nature of the services sector, resulting in unbundling and outsourcing (Friedman 2005). Among the factors that have made “offshoring” (the wholesale movement of factories to other countries) possible are advances in computer and communications technology. Technology is also redefining the way social services are provided with a potential to enhance the effectiveness and efficiency of public and private social service delivery.
- Third, labor markets in the region are in constant motion. Workers have become increasingly mobile and have generated both domestic and international migration streams. Worker remittances doubled in the region as a whole between 2001 and 2006.
- Fourth, the private sector has rapidly increased its participation in education and health. Effectively structured public-private partnerships have opened new vistas for the efficient delivery of education and health services.
- Fifth, South Asia is undergoing the demographic transition with reduced fertility rates and improved life expectancy. This will lead to a 30- to 40-year window of opportunity called the “demographic dividend.”

¹ A balance between economic growth and social development cannot be found without addressing inequality issues such as income, gender, labor productivity, persistent underemployment, and growth of the informal sector. The continued existence of such inequities raises fundamental questions about the stability and sustainability of development. We acknowledge that policy and program response to the challenges posed by the broad global and regional trends, among other factors, will involve social protection, which we touch upon while referring to risk pooling and health insurance. However, a more comprehensive discussion of social protection and other aspects of improving labor productivity in agriculture and the manufacturing sectors (measures beyond health and education) for employment generation is beyond the scope of this report.

- Sixth, disease patterns are undergoing an epidemiological transition, with a lower burden of communicable diseases and an increase in noncommunicable diseases.

A thorough understanding of these trends and appropriate government responses is crucial. Ignoring the trends threatens to steer governments off course in their efforts to achieve the Millennium Development Goals (MDGs) and to improve the social sectors in general. As section 2 demonstrates, South Asia has little margin for error in this respect. South Asia continues to lag behind the rest of Asia and the world (except for Sub-Saharan Africa) in education and health outcomes. The region is progressing only slowly toward meeting the nonincome MDGs (primary education, gender equity, child and maternal health, and communicable diseases such as HIV/AIDS, tuberculosis, and malaria).

Ignoring the challenges and opportunities posed by these trends will entail substantial economic costs in terms of foregone growth and development in the region. Human development and economic growth are closely interlinked. The right investments in human development improve the likelihood of sustainable economic growth, increase labor productivity, and increase the likelihood that backward regions can catch up with better-endowed regions. For South Asia to successfully benefit from the opportunities, human resources are a key factor. A healthy and appropriately skilled workforce is crucial in attracting economic activity that will contribute to sustainable and inclusive growth (Devarajan and Nabi 2006).

Based on section 3's analysis of the crucial trends and their impact on the health and education sectors, section 4 proposes a set of key actions for governments in the region to shape the social sectors in dealing with the challenges and opportunities. Section 5 concludes the report by summarizing the strategic actions needed.