

1. INTRODUCTION

South Asia exhibited robust macroeconomic performance in 2006. Economic growth was strong, with savings and investment rates high, inflation moderate, trade and foreign direct investment (FDI) expanding, and fiscal deficits lower. South Asian countries are expected to sustain high growth rates in 2007 and 2008.

Economic growth in South Asia was stronger in 2006, as aggregate gross domestic product (GDP) posted an 8.8% expansion (Figure 1.1). It was the second consecutive year of the highest growth rate in the region since 2003. Most economies in South Asia registered GDP growth rates exceeding 6.0% in 2006, largely the result of impressive performance by the services sector and the industrial sector. The rise of services, even prior to sustained industrialization in the region, has been a prominent feature of the development of South Asia. From 50.8% in 2001, the share of the services sector in regional GDP expanded to 54.3% in 2006 (Figure 1.2). The sector's share of GDP in Bangladesh, India, Pakistan, and Sri Lanka was likewise relatively large, at 49.1%, 54.9%, 52.8%, and 56.2%, respectively. While the services sector continues to lead economic growth in the region, expansion of industrial output has accelerated to catch up with that of the services sector. All countries in South Asia, except Nepal, are expected to continue their present momentum of robust economic performance, with GDP growth rates exceeding 6.0% in both 2007 and 2008.

Expansion of the consumption demand component of GDP was surpassed by investment growth in the region for the sixth consecutive year. This is attributed to the positive outlook of investors and expectations of continued high rates of growth. The rate of investment in South Asia reached a high of 31.9% of GDP in 2006, up from 22.2% in 2001. The expansion of regional consumption was also outpaced by that of the savings rate, which rose from 22.0% of GDP in 2001 to 28.9% in 2006. However, the domestic savings rate in South Asian countries is not as high as in many countries in East and Southeast Asia, and is not sufficient to finance the huge amount of capital required for domestic fixed capital formation. As a result, capital inflows from outside the region have played an important role in supplementing domestic savings. FDI in South Asia in 2006 amounted to \$24.3 billion, or 2.1% of GDP, a sharp increase from the 2005 level of \$10.4 billion. The surge in regional FDI inflows reflects good growth prospects, rising investor confidence, a much-improved international credit standing, and the progressive development of financial and capital markets. The strong growth of FDI can augment the efficiency of investment through enhancement of the skills of local labor and introduction of new and advanced technology.

Figure 1.1: Growth in South Asia

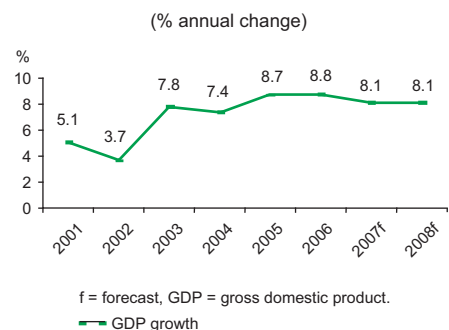
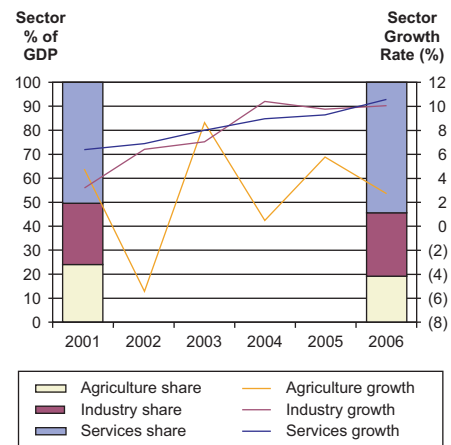


Figure 1.2: Major Sectors in the South Asian Economy—Shares of GDP and Annual Growth Rates



GDP = gross domestic product.

The regional trade deficit widened further in 2006, to 7.4% of GDP from 6.5% the previous year. The growth of merchandise imports accelerated to 22.4% in 2006, boosted by domestic demand and the appreciation of local currencies. The pace of merchandise export growth the same year slowed somewhat from the previous year, to 19.6%, as some countries lost export momentum because of currency appreciation. The trade deficit is partly counterbalanced by exports of services, in the case of India, and workers' remittances, particularly for Bangladesh, India, Nepal, Pakistan, and Sri Lanka. For the region, however, the current account deficit is projected to widen from 1.4% of GDP in 2006 to 1.9% in 2007 and 2.1% in 2008. The widening gap is being fueled by increases in merchandise imports exceeding those of merchandise exports because of strong domestic demand bolstered by high GDP growth rates. FDI has become increasingly important for the financing of current account deficits in South Asia in recent years. FDI devoted to export-oriented industries that raise export earnings can contribute to diminishing the current account gap in the future (Table 1.1).

Table 1.1: Major Items in Balance of Payments for South Asian Countries, 2006

(% of GDP)

	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	South Asia
Trade Balance	(39.6)	(4.7)	(14.0)	(7.1)	(63.7)	(17.0)	(6.7)	(12.5)	(7.4)
Service Exports	—	2.2	6.9	8.9	45.1	4.1	3.7	6.0	7.9
Workers' Remittances	—	7.7	—	3.1	—	15.8	3.6	8.6	3.6
Current Account	(0.6)	1.3	(3.3)	(1.1)	(39.8)	2.2	(4.5)	(4.9)	(1.4)
Foreign Direct Investment	2.8	1.2	0.6	2.1	1.5	(0.1)	2.7	1.7	2.1

— = data not available, GDP = gross domestic product.

Source: Bhutan data is based on the Bhutan Article IV Consultation, International Monetary Fund.

The inflow of foreign capital into South Asia is one of the reasons for inflationary pressures resulting from monetary expansion. The inflation rate in South Asia reached 5.9% in 2006, higher than the average rate of inflation of developing Asia the same year, and above the region's inflation rate in 2005. Higher food prices due to weak regional agricultural production, higher global prices, and strong domestic demand also contributed to rising inflation. However, regional inflation is expected to moderate to 5.7% in 2007 and 5.5% in 2008. Monetary authorities are likely to maintain tight monetary policies given the strong demand pressures generated by high economic growth.

While growth prospects for South Asia are favorable, the region faces formidable challenges to sustained development and growth in the longer term. These challenges include the need to develop physical and social infrastructure, accelerate inclusive growth and human development, promote FDI, diversify domestic industries, revive agriculture, institute structural policy reforms, and secure political stability and security.

Against this backdrop, the first issue of the *South Asia Economic Report (SAER)* highlighted the need for institutional reforms and well-targeted public investment to sustain and accelerate growth. The first *Report* recommended that public investment be aimed at areas where infrastructure bottlenecks are emerging, particularly power, roads, urban infrastructure, and ports. The second *SAER* focused on education and health, and argued that sustaining and enhancing the inclusiveness of growth are crucial. It recommended six actions for governments in the region: (i) focus on the poor, (ii) respond effectively to new global opportunities and challenges, (iii) enhance the responsiveness and agility of the social sectors, (iv) proactively address the potential inequality of the transition, (v) leverage information and communication technology (ICT) to address current and transitional challenges, and (vi) prepare the social sectors for a “borderless world.”

This third issue of *SAER* provides an in-depth examination of the main factors influencing FDI in South Asia, and recommendations for governments to strengthen incentives for FDI. Section 2 deals with FDI in selected South Asian countries, including a discussion of its potential benefits to the region’s economies. Section 2 also assesses the latest trends of factors governing inter and intra-regional FDI flows, as well as the major constraints to those flows. Economic reforms and policies that will help attract FDI into South Asian countries are identified. The section concludes with specific recommendations for economic reforms that will help invigorate the region’s FDI inflow. As mentioned above, however, the challenges to sustained development and growth in the longer term also should be addressed for effective promotion of FDI and sustainable growth in South Asia.

Section 3 supplements analyses provided in Section 2 with an in-depth look at the latest information on economic performance, outlook, and risks in each of the eight countries of South Asia, namely, Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

