

3. COUNTRY SECTION

Afghanistan

Table 3.1: Country Macroeconomic Indicators: Afghanistan

Indicator	Actual		Forecast	
	2003-2005 Average	2006	2007	2008
GDP (annual change, %)	12.6	7.5	13.5	8.4
Inflation (annual change, %)	16.5	5.1	7.0	8.0
Overall Budgetary Balance (% of GDP)	(1.1)	(2.7)	(2.6)	(2.0)
Money Supply (annual change, %)	32.9	12.4	19.0	14.4
Exports (annual change, %)	14.2	15.7	18.3	4.7
Imports (annual change, %)	21.6	23.9	11.9	6.6
Current Account Balance (% of GDP)	1.8	(0.6)	(2.0)	(3.2)

GDP = gross domestic product.

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila; and International Monetary Fund.

Economic developments in FY2006 were generally favorable (Table 3.1). However, available information suggests that the impact of drought on agricultural production was somewhat larger than previously anticipated, with real GDP growth decelerating to about 7.5%, from 14.0% in FY2005. Rising prices of imported fuel and basic commodities (mainly food) caused the Kabul consumer price index to increase by 8.0% in the first 7 months of FY2007. Fiscal performance in FY2006 was better than expected, with preliminary data indicating that the operating budget deficit (excluding grants) was 3.6% of GDP—better than the 4.1% targeted under the International Monetary Fund's (IMF) Poverty Reduction Growth Facility (PRGF). This achievement was because of stronger-than-expected revenue collection as well as expenditure discipline. In addition, implementation of development expenditures improved significantly in FY2006 (50% higher than in FY2005), reaching over 90% of target. The overall core budget deficit (including grants) narrowed to 2.7% of GDP in FY2006, compared to 3.8% targeted under the PRGF. Despite intensified counter-narcotics efforts, opium production rose substantially in FY2006.

The macroeconomic outlook for Afghanistan in FY2007 is expected to remain favorable. Real GDP growth is projected at 13.5%, owing to a rebound in agriculture, sustained growth in the construction and services sectors, and a strengthened fiscal position due to increased contributions of funding agencies in support of the

Afghanistan National Development Strategy. This document will serve as the country-owned Poverty Reduction Strategy Paper. Inflation is expected to increase slightly compared to FY2006 to 7.0% because of rising transportation costs and higher energy prices.

Bangladesh

Table 3.2: Country Macroeconomic Indicators: Bangladesh

Indicator	Actual		Actual/	Forecast
	2003–2005 Average	2006	Estimate 2007	2008
GDP (annual change, %)	5.8	6.6	6.5	6.0
Inflation (annual change, %)	5.6	7.2	7.2	8.0
Overall Budgetary Balance (% of GDP)	(3.3)	(3.2)	(3.2)	(4.2)
Money Supply (annual change, %)	15.4	19.5	17.0	15.0
Exports (annual change, %)	13.1	21.5	15.8	13.5
Imports (annual change, %)	15.6	12.1	16.6	15.9
Current Account Balance (% of GDP)	(0.1)	1.3	1.4	1.2

GDP = gross domestic product.

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila; International Monetary Fund; and staff estimates.

GDP growth is estimated at 6.5% in FY2007, slightly lower than the 6.6% in FY2006 because of moderating growth of agriculture following the post-flood high growth of FY2006 (Table 3.2). Growth of GDP was bolstered by private investment and was underpinned by steady expansion of manufacturing and services. GDP growth is forecast to slow somewhat to 6.0% in FY2008 because of the extensive flooding during July–September 2007, a devastating cyclone in mid-November 2007, and a slowdown in external demand for garments. The major challenge facing the country is to boost business confidence. Major reforms are needed to overhaul tax administration, restructure state-owned enterprises, and augment financial sector restructuring. Economic prospects will depend on rehabilitation following the floods and the cyclone, the rebound of private sector activity, and political stability in the lead up to the general elections scheduled for the end of 2008.

Inflation accelerated compared to recent years, reaching 7.2% in FY2007, with rises in both food and nonfood prices. Rising domestic demand aided by steady GDP expansion and continued high monetary growth amplified inflationary pressures. In December 2006, broad money growth reached a record high 22.3%, but slowed in subsequent months to 17.0% in June 2007. Increases in credit to the private sector were contained by the erosion of business confidence rather than by monetary tightening. Inflation is forecast to rise further to 8.0% in

FY2008, driven by higher food and commodity prices and shortfalls in crop production following the floods and the cyclone.

Although Bangladesh carried out some fiscal reform measures in recent years, revenue performance remained weak. Bangladesh's revenue (10.3% of GDP in FY2007) and its recent trend compare unfavorably with other countries. But because of underperformance in development spending, the fiscal deficit stood at 3.2% of GDP, lower than the 3.7% target for FY2007. In FY2008, although revenue is projected to rise to 10.8% of GDP, higher expenditure due to a rise in development spending is expected to push up the fiscal deficit to 4.2% of GDP. Unless revenue collection increases significantly, the higher expenditure needed for faster economic growth and rapid poverty reduction cannot be met without pushing fiscal deficits to unsustainable levels. Major reforms in the tax system and tax laws will be needed to augment tax revenues.

The losses of state-owned enterprises and associated quasi-fiscal obligations pose a significant fiscal risk for the period ahead. The fuel price adjustments of 16–21% in April 2007 cut Bangladesh Petroleum Corporation (BPC) losses, bringing domestic prices of diesel and kerosene to 79% of breakeven in July 2007. But BPC's losses in FY2007 were still estimated at \$460 million, or 0.7% of GDP. To facilitate the corporation's operations, the Government assumed BPC's overdue bank loans through a \$1.1 billion bond issue. The Government needs to introduce an automatic price adjustment mechanism to avoid re-accumulation of BPC losses and nonperforming loans (NPLs) of nationalized commercial banks (NCBs). Similarly, switching to an electricity tariff structure that reflects actual costs would be desirable.

Despite improvement, gross NPLs of the banks remain high (14.0% in June 2007). High lending rates caused by the large NPLs of state-owned banks and weak financial intermediation discourage investment and reduce the financial sector's contribution to economic growth. Bangladesh Bank has made progress, however, in adopting international best practice in prudential regulations and in improving banks' compliance with reporting and risk management. The recent increase in the capital adequacy ratio to 10% was a positive step. The Bank Company Act (Amendment) of 2007 was another step toward improved efficiency in the financial sector. Under this amended act, each bank will have to increase its capital base to taka 2 billion, among other requirements. The sale of Rupali Bank (one of four NCBs) has been concluded, although handover of the bank is experiencing difficulties, as the highest bidder remains unresponsive. The other three NCBs have been formed into corporations by the Government in preparation for their eventual privatization. The capital market remains small, with market capitalization amounting to 14% of GDP despite the recent uptrend in share prices.

Exports and imports during FY2007 grew by 15.8% and 16.6%, respectively. The rise in the trade deficit was more than offset by a

25% increase in overseas workers' remittances, leading to a current account surplus of 1.4% of GDP. Despite recent slower growth in garment exports, the strength of the external sector in FY2008 is likely to be sustained by strong growth in overseas workers' remittances. A weak US economy, aggravated by the subprime mortgage crisis, sustained higher oil prices, and increased prices of raw materials—including cotton, yarn, and dyeing chemicals—contributed to the recent slowdown in garment exports. Also, political uncertainty and labor turmoil in 2006, resulting in damaged factories and the temporary shutdown of the Dhaka Export Processing Zone, contributed to the slowdown as some buyers moved to other countries. But the industry is optimistic that orders will surge as global demand for low-cost apparel returns to normal in the upcoming winter season. However, the country still runs the risk of tough competition in its two largest markets (the EU and the US) as the safeguard quota on the PRC is due to expire in 2008. Much of Bangladesh's competitive advantage depends on its abundant low-cost labor, flexible exchange rate, and close ties with some large buyers. To deal with the intense competition, the industry needs to improve productivity. This will require a major improvement in infrastructure—including transport and power supply, and streamlining custom procedures. Cutting lead time also is critical if Bangladesh wants to produce high value-added products, which need prompt availability of quality fabrics and other materials.

Bhutan

Table 3.3: Country Macroeconomic Indicators: Bhutan

Indicator	Actual		Forecast	
	2003–2005 Average	2006	2007	2008
GDP (annual change, %)	7.6	9.1	17.0	14.4
Inflation (annual change, %)	3.5	4.9	5.2	5.0
Overall Budgetary Balance (% of GDP)	(5.1)	(0.8)	(3.4)	(1.8)
Money Supply (annual change, %)	14.5	24.8	7.6	—
Exports (annual change, %)	22.2	47.2	67.0	31.9
Imports (annual change, %)	30.7	(5.6)	17.0	17.5
Current Account Balance (% of GDP)	(17.8)	(3.3)	10.6	10.1

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

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila; and International Monetary Fund.

Bhutan's economy is experiencing structural changes, in both economic and political dimensions. The phased commissioning of the 1,020 megawatt Tala hydropower project since July 2006 will eventually double electricity export capacity to India and significantly boost government revenue. Accordingly, GDP growth is estimated

to have reached 9.1% in FY2006 and almost doubled to 17.0% in FY2007 (Table 3.3).

As Bhutan's currency is pegged to the Indian rupee, monetary developments have limited impact on prices. Inflation in Bhutan is heavily influenced by price developments in India. Consumer prices peaked at 6.2% in the second quarter of calendar year 2006, which resulted in inflation averaging 4.9% in FY2006. Inflation increased marginally to 5.2% in FY2007 as food prices jumped in the second quarter of 2007.

In March 2007, the Government revised fiscal figures for FY2005 and FY2006, and budget estimates for FY2007. The Government's fiscal position in FY2006 was better than previously expected, with the overall budget deficit narrowed to ngultrum (Nu) 0.3 billion, or 0.8% of GDP. The improved fiscal position resulted mainly from a smaller capital expenditure. The revised budget estimates for FY2007 anticipate doubled nontax revenue, which will increase total government revenue by 41.6%. The budget, however, includes plans for a larger increase in capital expenditure than the Tala project windfall—e.g., for the construction of a Supreme Court building, and preconstruction work for Punatsangchu I and Dagachhu hydropower projects—as well as an increase in current expenditure. As a result, the deficit will widen to 3.4% of GDP.

The current account improved markedly in FY2006 as the deficit narrowed to \$29 million (3.3% of GDP), from \$217 million (28.2%) in FY 2005. This was attributed mainly to rapid growth in exports as well as to larger net transfer receipts. The 47.2% expansion in export earnings in FY2006 was about equally split between exports to India (largely electricity) and other countries. Imports declined only by 5.6% in the same year from FY2005, when imports were buoyed by the purchase of two Airbus aircraft. This appears to reflect brisk demand for imported goods from India and other countries. Tourism also continued to be strong, with growth of 27.4% in tourist numbers and 29.7% in revenues. As inflows in the capital account (including grants for the Tala project) and the financial account (mainly foreign aid loans) together amounted to \$144 million and were much greater than the current account deficit, the overall balance of payments registered a large surplus. External debt outstanding as of June 2006 was 77.5% of GDP, of which around 60% was Indian rupee borrowing from the Government of India for the Tala project. The debt service ratio was only 5.8%, as almost all debt was contracted on concessional terms.

Although the Tala hydropower project should reduce dependence on foreign aid, other economic issues remain. The most pressing is the need to promote private sector activity to create employment, especially for the growing number of young entrants to the labor force. In the political sphere, Bhutan is scheduled to change from a monarchy to a two-party democratic system in 2008, though this is unlikely to have major economic impact.

India

Table 3.4: Country Macroeconomic Indicators: India

Indicator	Actual		Forecast	
	2003-2005 Average	2006	2007	2008
GDP (annual change, %)	8.3	9.4	8.5	8.5
Inflation (annual change, %)	5.4	5.4	5.0	5.0
Overall Budgetary Balance (% of GDP)	(7.8)	(6.3)	—	—
Money Supply (annual change, %)	16.7	21.3	20.0	20.0
Exports (annual change, %)	25.1	20.9	16.0	16.0
Imports (annual change, %)	34.9	22.3	24.0	22.0
Current Account Balance (% of GDP)	0.3	(1.1)	(1.6)	(1.9)

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

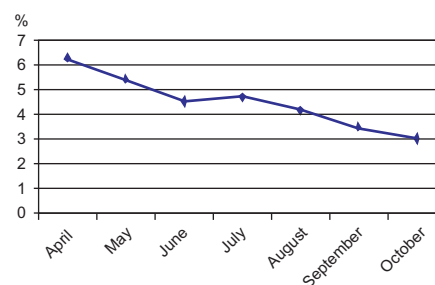
Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila.

Rapid growth continued for the fourth year in succession (Table 3.4). Riding strong growth in manufacturing output, GDP expanded 9.4% in FY2006 and 9.2% in the first quarter (April–June) of FY2007. Two important characteristics have emerged. First, the manufacturing growth rate has caught up with that of services over the past few years. Second, agricultural performance remains subdued.

The robust performance of manufacturing was not uniform across subsectors during the first two quarters of FY2007. While growth in the capital goods subsector remained impressive at 19.6%, the consumer durables subsector was adversely affected by rising interest rates. The latter registered a contraction of 3.2% in April–September 2007, compared to growth of 15.2% in the same period of 2006.

Turning to inflation, supply constraints for primary articles, limited unutilized manufacturing capacity, and inadequate infrastructure capacity put pressure on prices. Inflation, as measured by variations in the wholesale price index, reached 6.3% in April 2007. The Reserve Bank of India (RBI) moderated excess demand through tighter monetary policy, which helped reduce the inflation rate to around 3% by October 2007 (Figure 3.1). Inflation worries, however, are not altogether over. High international oil prices remain a major cause for concern. The average price of the Indian crude basket crossed the \$90-per-barrel mark in November 2007. Gross under-recovery (the difference between the domestic selling price and unit cost) of oil marketing companies was Indian rupee (Rs) 129 billion in the first quarter of FY2007. That is expected to put pressure on the Government to raise domestic prices of petrol, diesel, and cooking gas. Such adjustments could have an adverse impact on overall inflation.

Figure 3.1: India Inflation Rate, 2007



Source: Reserve Bank of India.

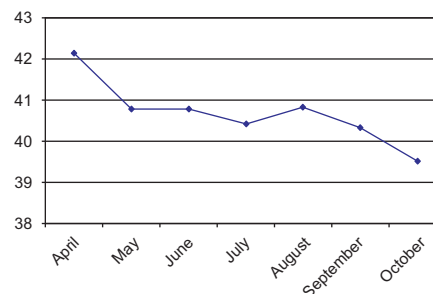
Monetary management remains a major challenge for RBI. Continuing high growth in money supply driven by commercial credit—especially during FY2006—prompted an RBI response of gradual increases in short-term interest rates and the cash reserve ratio. Strong external capital inflows further aggravated the situation, however. RBI intervened in the market by buying dollars (leading to higher money supply), which complicated RBI's endeavor to manage liquidity and strike the right balance between the exchange rate and inflation.

While exports grew by 17.8% in the first quarter of FY2007, imports grew by 21.3%, widening the merchandise trade deficit to \$21.6 billion. This deficit was significantly offset by robust inflows from invisibles, which included earnings from services such as software exports and business services, as well as private transfers from Indians working abroad. The combined current account deficit thus rose marginally to \$4.7 billion from \$4.6 billion in the first quarter of FY2006. A strong surplus in the capital account, however, helped finance the current account deficit without straining India's foreign exchange reserves position. The most striking feature of net capital inflows was a sharp rise in portfolio investment by foreign institutional investors (FII). Net FII inflows rose to \$7.5 billion in the first quarter of FY2007 from negative net inflows of \$0.5 billion in the corresponding period the previous year. Significant moderation in export growth was noticed in April–September 2007 against the corresponding period in 2006.

The Indian rupee appreciated against the US dollar from Rs42.2 in April 2007 to below Rs40 in October 2007 (Figure 3.2). The issue of Indian rupee appreciation has attracted a great deal of attention, and softening of export growth is attributed to this phenomenon. The Government announced measures aimed at compensating exporters for losses in profit resulting from the appreciating Indian rupee.

Under the framework of the Fiscal Reforms and Budget Management Act, progress was made in fiscal consolidation. The fiscal deficit to GDP ratio of the federal Government declined from 5.9% in FY2002 to 3.8% in FY2006, while the revenue deficit to GDP ratio fell from 4.4% to 2.1% over the same period. The fiscal position of the states also improved. Consequently, the combined federal-state deficit to GDP ratio declined from 9.6% in FY 2002 to 6.3% in FY2006.

Figure 3.2: Nominal Exchange Rate of Indian Rupee vs United States Dollar, 2007



Source: Reserve Bank of India.

Maldives

Table 3.5: Country Macroeconomic Indicators: Maldives

Indicator	Actual		Forecast	
	2003-2005 Average	2006	2007	2008
GDP (annual change, %)	4.5	19.1	7.3	8.0
Inflation (annual change, %)	2.3	3.5	7.0	6.0
Overall Budgetary Balance (% of GDP)	(5.3)	(7.1)	(27.6)	—
Money Supply (annual change, %)	19.7	20.6	—	—
Exports (annual change, %)	7.8	39.4	2.8	—
Imports (annual change, %)	24.2	24.4	14.8	—
Current Account Balance (% of GDP)	(18.7)	(39.8)	(45.0)	—

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

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila; Maldives Monetary Authority; and staff estimates.

The Maldives economy rebounded sharply in 2006 from its post-tsunami contraction, with GDP growth of 19.1% (Table 3.5). Expansion of GDP is projected to slow to 7.3% in 2007, as the effects of large restoration activities on the economy diminish. The tourism sector regained its pre-tsunami status in 2007 with tourist arrivals during January–September exceeding 2004 levels during the same period.

Inflation, measured by the consumer price index, recorded a moderate 3.5% rise in 2006, partly because of the pegging of the Maldives rufiyaa to the US dollar. However, inflation started to go up in 2007, reaching 10.0% in August. The increase was largely driven by higher food prices.

While large reconstruction projects are included in the government budget, government consumption also rose due to increases in public sector wages and continued power and water subsidies in Malé. Although a delay in planned capital expenditure narrowed the fiscal deficit to 7.1% of GDP in 2006, the wide gap between expenditure and revenue cannot be sustained in the medium term. The 2007 budget will result in a very high fiscal deficit of 27.6% of GDP if implemented as planned. Stronger policy measures, including a more rapid reduction in domestic expenditures, introduction of the business profit tax in 2008, and additional lease payments related to development of the tourism industry should be adopted to keep government debt at a sustainable level.

The Maldives is an import-dependent country, bringing in everything from staple foods to resort supplies, construction materials, and petroleum products. The average ratio of imports

to GDP in 2004–2006 was 82.7%, while that for merchandise exports was 23.0%. The trade balance deteriorated significantly after 2004, leading to a deficit of \$590 million in 2006 (63.6% of GDP). While exports recorded a strong increase of 39.4% in 2006 due partly to a rise in fish exports, the 24.4% rise in imports came largely from purchases of petroleum products and construction materials. Net services exports doubled, reaching \$240 million in 2006. The rufiyaa's peg to the falling US dollar contributed to tourism's sharp recovery by benefiting Europeans—about three quarters of the tourists in 2006. Earnings from tourism were up by 51.3% to \$434 million. In summary, the current account deficit widened to \$370 million (39.8% of GDP, up from 36.0% in 2005). The financial account saw the large inflow continue in 2006. The \$291 million infusion, largely from private and commercial bank borrowing, was used to finance the current account deficit. In 2007, exports expansion will slow to 2.8% because of sluggish fish exports. The current account deficit will widen further to 45.0% of GDP.

In the 2 years since the tsunami, external debt rose sharply by \$243 million, about 80% of which was short-term debt. By the end of 2006, external debt outstanding had reached \$574 million, or 62.9% of GDP. About 60% of the outstanding debt was in medium- to long-term maturities, while the balance of \$213 million was short-term debt of commercial banks. The debt service ratio was 4.5%.

Nepal

Table 3.6: Country Macroeconomic Indicators: Nepal

Indicator	Actual		Actual/ Estimate 2007	Forecast 2008
	2003–2005 Average	2006		
GDP (annual change, %)	3.9	2.8	2.5	2.8
Inflation (annual change, %)	4.4	8.0	6.4	5.0
Overall Budgetary Balance (% of GDP)	(1.0)	(1.6)	(2.0)	(2.4)
Money Supply (annual change, %)	10.3	15.4	14.0	—
Exports (annual change, %)	4.1	2.6	4.2	6.0
Imports (annual change, %)	11.8	17.8	11.3	10.0
Current Account Balance (% of GDP)	2.3	2.2	0.5	1.0

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

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila; and staff estimates.

Nepal's real GDP growth slowed to 2.5% in FY2007, from 2.8% in FY2006 (Table 3.6). Adverse weather affected the agriculture sector—which grew by only 0.7%, while renewed political turbulence

and infrastructure bottlenecks limited nonagricultural growth to 3.6%. The contribution to GDP growth by major sectors is shown in Figure 3.3.

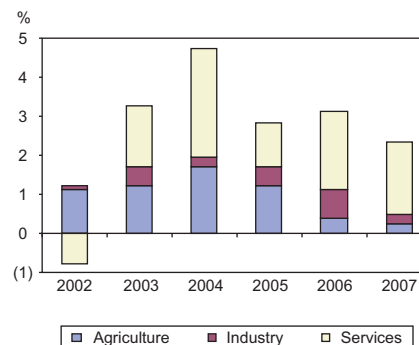
The political breakthroughs of 2006 have so far not yielded a “peace dividend,” and GDP growth is projected to remain at 2.8% in FY2008. Achieving political stability, reviving investor confidence, and overcoming low agricultural productivity are critical challenges that will have to be overcome before economic performance improves. Restoring law and order and addressing demands for greater ethnic and regional autonomy are crucial for a credible Constituent Assembly election, which has now been postponed indefinitely amid sharp differences within the ruling seven-party coalition on the preconditions for the elections.³

Inflation declined from 8.0% in FY2006 to 6.4% in FY2007. The impact of upward adjustments in petroleum prices and the increased value-added tax rate in FY2005 have subsided, but food prices rose sharply during the year as a result of the low agricultural production and intermittent supply disruptions. The Nepal Rastra Bank maintained the bank lending rate at 6.25% in FY2007—resulting in a tightening of monetary conditions, which constrained monetary growth and helped restrain inflationary pressures. Inflation is forecast to ease further to 5.0% in FY2008 on the assumption that food production normalizes and other supply disruptions ease. However, the 27% pay increase for civil servants in the FY2008 budget and pressures for upward adjustments in fuel prices could increase inflationary pressures.

The budget deficit (after grants) was 2.0% of GDP in FY2007 compared to 1.6% in FY2006. The widening deficit was largely due to a shortfall in foreign grants, despite the achievement of domestic revenue targets and development expenditures below budgetary targets. During the year, government revenues grew by 19.2%, while expenditures rose by 21.4%. Actual realization of capital and recurrent expenditures during FY2007 is estimated at 77% and 96% of budgetary estimates, respectively. Capital spending continued to be below target as many positions in local government bodies remained vacant, hampering implementation of development programs at the grassroots level.

The FY2008 budget (presented on 12 July 2007) coincides with the start of the Government’s 3-year Interim Development Plan (FY2008–2010). The plan focuses on reconstruction, reintegration, rehabilitation, economic recovery, and social inclusion. The plan aims to achieve an average annual GDP growth rate of 5.5%, with targets for agricultural growth and nonagricultural growth placed at 3.6% and 6.5%, respectively. This outlook assumes that gains in the

Figure 3.3: Sector Contribution to GDP Growth in Nepal, 2002–2007



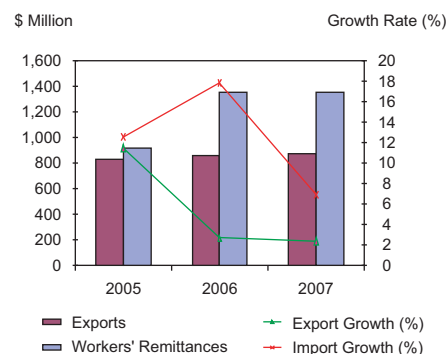
GDP = gross domestic product.
Source: Nepal Ministry of Finance. Available:
<http://www.mof.gov.np/publication/budget/2006/surveyeng.php>

³ The date of the Constituent Assembly election, which had been scheduled for 22 November 2007, was postponed indefinitely in early October after the Communist Party of Nepal/Maoists left the Government in mid-September.

peace process will be consolidated, investor confidence restored, and foreign aid inflows increased.

Exports rose by only 4.2% in FY2007 (Figure 3.4) as a result of frequent economic disruptions—such as *bandhs* (strikes), labor-management disputes, and chronic energy shortages—and a sharp appreciation of the domestic currency. FY2007 imports rose by 11.3%, compared to 17.8% growth in FY2006. Remittances in FY2007 increased by only 4.5%, down from a 49.1% jump the previous year, because of a slowdown in labor outflows and the rising Nepalese rupee. Consequently, the current account surplus fell from 2.2% of GDP in FY2006 to 0.5% of GDP in FY2007. Foreign exchange reserves rose from \$1.8 billion in FY2006 to \$1.9 billion in FY2007, providing import cover of about 8.3 months. The Nepalese rupee appreciated 14.2% in 2007 by mid-July, although the trade-weighted, real effective exchange rate appreciated by only 6.9%.

Figure 3.4: Value of Nepal Exports and Workers' Remittances, and Growth Rates of Exports and Imports, 2005–2007



Source: Nepal Rastra Bank. 2007. *Current Macroeconomic Situation*. September. Kathmandu.

Pakistan

Table 3.7: Country Macroeconomic Indicators: Pakistan

Indicator	Actual		Actual 2007	Forecast 2008
	2003–2005 Average	2006		
GDP (annual change, %)	7.1	6.6	7.0	6.5
Inflation (annual change, %)	5.6	7.9	7.8	6.5
Overall Budgetary Balance (% of GDP)	(3.1)	(3.1)	(4.3)	(4.2)
Money Supply (annual change, %)	19.0	15.2	19.3	—
Exports (annual change, %)	16.4	14.9	3.3	7.0
Imports (annual change, %)	26.0	33.3	7.9	10.1
Current Account Balance (% of GDP)	1.2	(4.5)	(5.2)	(5.5)

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

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila

After a slight reduction in the pace of expansion in FY2006, Pakistan's economy posted robust and broad-based growth in FY2007, expanding 7.0% (Table 3.7). Growth was fueled by the strong recovery of agriculture, the continued momentum of manufacturing sector development, and sustained expansion of services. The momentum of growth is expected to continue into FY2008 in the wake of budgetary measures aimed at supporting productivity in the agriculture sector and boosting investment in the manufacturing sector. However, continuation of tight monetary policy, high international oil prices, and slow export growth is expected to curb GDP growth somewhat in FY2008, to 6.5%.

Strong aggregate demand in recent years has catalyzed growth in Pakistan, but it has also generated inflationary pressures. Inflation

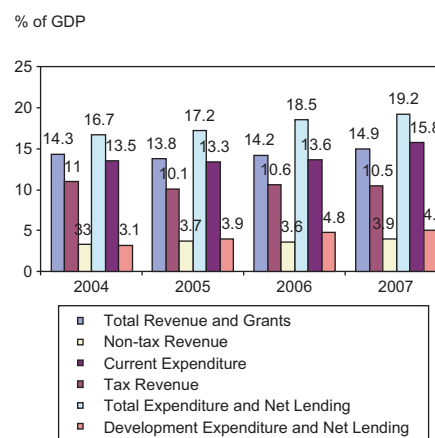
peaked at 9.3% during FY2005, but declined only marginally to 7.8% in FY2007 from 7.9% in FY2006. Measures taken by the Central Bank during the first half of FY2007 tightening monetary conditions led to control of overall core inflation. However, shortages of some essential food items, such as rice, edible oil, meat, pulses, milk, and fresh vegetables—notwithstanding the overall strong recovery of the agriculture sector—boosted inflation of food to 10.3% in FY2007. Food prices increased further to 10.7% in October 2007. Overall inflation, however, continued a gradual decline to 7.5%, due mainly to reduced inflation for nonfood items and maintenance of tight monetary conditions.

Notwithstanding the tight monetary policy, fiscal policy continued to be expansionary. Total public expenditure in FY2007, at Pakistan rupee (Rs) 1,675 billion, was 19.5% higher than the previous year. Actual development expenditure in FY2007, at Rs434 billion, also was higher (18.9%) than development expenditure the previous year. Despite strong revenue performance, the fiscal deficit as a percentage of GDP rose to 4.3% in FY2007. The remarkable increase (around 20%) in revenue collection the same year did not prevent tax revenue as percentage of GDP from falling slightly to 10.5% in FY2007 from 10.6% in FY2006 (Figure 3.5).

Expansionary fiscal policy is expected to continue during FY2008, with a large increase in spending on development and relief measures announced in the federal budget. Public sector development expenditures, including expenditure on rehabilitation of earthquake-affected areas, are projected to increase by 19.9% from the FY2007 level. In addition, expenditure on relief and rehabilitation in areas affected by recent rains and floods will also boost public spending. As the Government expects revenue performance to continue to be robust, the revenue collection target for FY2008 has been increased by around 20% over FY2007. Accordingly, the fiscal deficit—including earthquake-related expenditure—is expected to remain at 4.2% of GDP in FY2008.

On the external front, import growth decelerated sharply to 7.9% in FY2007 from 33.3% the preceding year, a result of the reduced demand for consumer goods and industrial inputs, as well as the softening of international oil prices during the first half of the fiscal year. Export growth also declined to only 3.3% against the target of 12.9% in FY2007. While the overall decline in export growth can be attributed to the sluggish performance of the textile sector—which accounts for almost two thirds of total exports, non-textile export growth also slowed. The continued lack of diversification of Pakistan's export base, the concentration of exports in a few markets, and poor compliance with quality standards are major factors in the country's poor export performance, and contributed to the widening trade deficit. As a result, the FY2007 current account deficit as a percentage of GDP widened to 5.2%, from 4.5% in FY2006.

Figure 3.5: Pakistan Government Revenues and Expenditures, 2004–2007



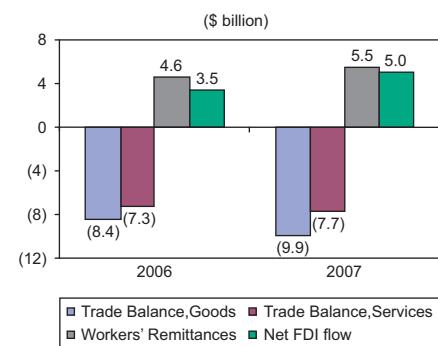
GDP = gross domestic product.
Source: State Bank of Pakistan. 2007. *Economic Survey 2006–2007*. Islamabad.

A substantial increase in capital inflows, spearheaded by a high level of workers' remittances, at \$5.5 billion (Figure 3.6), and foreign private investment, at a record \$5.0 billion, boosted official foreign exchange reserves to over \$15.0 billion in FY2007. The State Bank of Pakistan held \$13.3 billion of the total. Imports are expected to increase in FY2008 because of higher international oil prices and rising demand for raw materials for industrial use, if investment continues to grow as fast as it did in FY2007. With expectations of a moderate expansion in global trade and a slowdown in the US economy, export growth is expected to remain contained in the face of increased competition in global textile markets and a continued lack of diversification of both export commodities and markets. FY2008 is thus likely to see the trade deficit deteriorate to 7.1% of GDP, and the current account deficit remain high at 5.5% of GDP.

External debt indicators improved further in FY2007, with external debt as a percentage of GDP declining to 26.9% from 28.0% at end FY2006. Standard & Poor's improved Pakistan's credit rating in December 2006 to B+ for foreign currency debt, and to BB for local currency debt. This aided the country's efforts to raise funds in international capital markets through global depository receipts offerings, and the issuance of a 10-year sovereign bond. However, following the declaration of emergency, Standard & Poor's lowered the country's rating outlook from "stable" to "negative" in November 2007.

Sri Lanka

Figure 3.6: External Sector of Pakistan, 2006–2007



FDI = foreign direct investment.
Source: State Bank of Pakistan. 2007. *Annual Report 2006–2007*. Islamabad.

Table 3.8: Country Macroeconomic Indicators: Sri Lanka

Indicator	Actual		Forecast	
	2003–2005 Average	2006	2007	2008
GDP (annual change, %)	5.8	7.4	6.1	6.0
Inflation (annual change, %)	7.1	9.5	14.5	10.0
Overall Budgetary Balance (% of GDP)	(8.3)	(9.0)	—	—
Money Supply (annual change, %)	18.0	17.8	—	—
Exports (annual change, %)	10.5	8.5	10.0	8.0
Imports (annual change, %)	13.3	15.7	8.0	9.0
Current Account Balance (% of GDP)	(2.1)	(4.9)	(3.7)	(3.5)

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

Source: Asian Development Bank. 2007a. *Asian Development Outlook 2007 Update*. Manila; and staff estimates.

Sri Lanka's economy continues to do remarkably well despite the renewed outbreak of fighting in the civil conflict in August 2006 (Table 3.8). However, GDP growth is beginning to slow—to 6.2% in the first half of 2007 from a peak of 7.4% in 2006. This is due mainly to a stagnating agriculture sector that has been unable to repeat its impressive post-tsunami recovery performance of 2006, and a shrinking tourism sector because of conflict-related travel warnings issued by governments.

The main economic concerns continue to be the impact of the ongoing hostilities on the fiscal deficit and business confidence, high inflation, and low foreign exchange reserves. After the Central Bank reduced its net lending to the Government during the early months of 2007, the Government returned to Central Bank borrowing to finance its deficit in June 2007—a move likely to increase inflationary pressures. In addition, frequent adjustments to administered prices have increased the level of the consumer price index. These adjustments have included a one-off increase in previously heavily subsidized kerosene (the price of which increased by Sri Lanka rupee [SLRs]16 per liter in May 2007), as well as frequent changes to diesel and gas prices. Year-on-year inflation rose again to 16.6% in June 2007, and ADB's *ADO 2007 Update* predicts that inflation will average at least 14.5% in 2007. The Government is trying to combat the rising cost of living by exempting 15 basic goods from import duties. The Government has estimated that this resulted in a revenue shortfall of SLRs9 billion for the first half of 2007. Interest rates on government securities increased sharply from 12.0% in January to 18.0% in September 2007.

The Government revised its macroeconomic framework twice in 2007—once in July and again in November. The original 2007 budget—approved in November 2006—almost doubled the allocation for capital expenditure. This has now been scaled back substantially, with capital spending plans revised from 9.2% to 6.6% of GDP. Because of the relatively slow implementation of capital projects and difficulties in securing financing, the projected budget deficit is still in line with the revised Government forecast of July 2007, despite some shortfalls in revenue collection in the first half of 2007. Available data show that salary costs increased from January to May 2007 by over 30% compared with the same period in 2006, to SLRs85 billion. This was primarily because of increases in the recruitment of civil servants and military staff. Resettlement of people recently displaced by the conflict and rehabilitation have so far cost the Government SLRs288 million in the first half of 2007.

In the first half of 2007, Sri Lanka's trade deficit shrank because of a reduction of 7.8% in the oil import bill when the temporary closure of one refinery and high stocks of oil temporarily reduced demand for imports. As a result, Sri Lanka's total imports in the first half of 2007 grew by only 3.9%, while exports did better than projected, growing by 13.0%. The primary reason for this success was Sri Lanka's resilient and high-end garment export sector, which continued to make substantial inroads into European markets. Exports to Europe increased, while those to the US, the country's other key market, shrank in value terms. As in previous years, the current account was supported by remittances from overseas workers, which grew by 17.0% in dollar terms in January–June 2007 from the corresponding period in 2006. The balance of payments was in surplus as capital inflows (mostly borrowing by the Government and by state-owned banks) increased sharply. The Government partially liberalized its capital account with the gradual opening of the T-bond market to external investors, a move that attracted \$490 million in the first half of 2007.