South Asia

Islamic Republic of Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Islamic Republic of Afghanistan

The economy grew robustly on a recovery in agriculture in FY2009, and inflation declined sharply. More widely, the politico-economic environment was characterized by a significant worsening in security, as well as corruption and uncertainty. Steady economic growth and development in the medium term require continued moves toward the following: strengthening security, building critical infrastructure, substantially raising government institutional capacity while improving governance, creating a pro-growth business regulatory environment, fostering social inclusion and equity, and expanding access to social services.

Economic performance

In FY2009 (ending 20 March 2010), GDP growth is estimated to have rebounded to 15.1%, driven by a recovery in agriculture after severe drought a year earlier (Figure 3.14.1). The sector recorded the largest harvest in 32 years. The continued inflow of external assistance and increased security spending benefited other sectors.

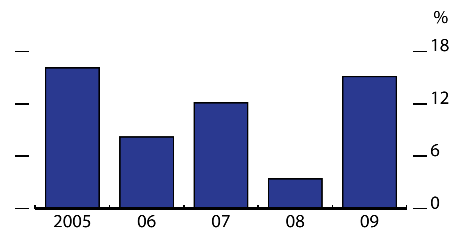
The opium economy, which is equivalent to about 20%–25% of legal GDP, saw an estimated 10% decline in FY2009 owing to increased suppression efforts, lower prices, and expanded efforts to support legal crops. Nevertheless, it remains a major source of income for many farmers and especially rewards those involved in trafficking, which in turn boosts domestic demand in the legal economy.

Inflation (in Kabul) has been on a marked downward trend (Figure 3.14.2), reflecting lower global food prices and the recovery in domestic crop production (food has a 61% weight in the consumer price index). The 12-month rate in November 2009 was minus 13%, plummeting from a peak of 43% in May 2008, as the food index moved into negative territory. For FY2009, consumer prices are expected to be 10% lower on average than a year earlier.

The Da Afghanistan Bank, the central bank, continued to focus on controlling inflation while seeking to smooth exchange rate volatility. It responded to the fall in inflation and eased monetary policy, raising its target for growth in circulation of currency in FY2009 to 22% from the original 16%. This policy is consistent with the 12-month end-March 2010 inflation target of about 6%. To attain its monetary targets, the central bank is increasing the use of its 28-day capital notes as well as purchase and sale of foreign exchange with market dealers. It continues to promote a secondary market for these notes to develop a basis for controlling reserve money and monetary policy through open-market operations.

Afghanistan maintains a managed floating exchange rate system. The rate for the afghani strengthened slightly in FY2009 to around AF50/$1 (Figure 3.14.3), and close to its 5-year average in real effective terms. Large inflows of funds from external donors, remittances, and narcotics-related

3.14.1 GDP growth



Source: International Monetary Fund. 2010. *Country Report* No. 10/22. January. http://www.imf.org

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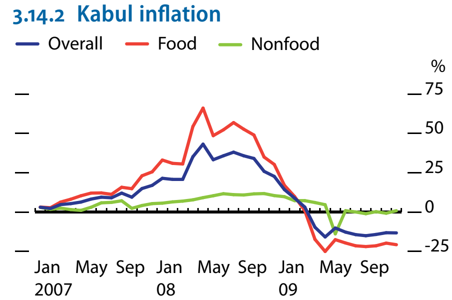
3.14.2 Kabul inflation



Source: Ministry of Agriculture, Irrigation & Livestock. *Agricultural Commodity Price Bulletin*. Various issues. http://mail.gov.af

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This chapter was written by Allan Thomas Kelly of the Afghanistan Resident Mission, ADB, Kabul.

activities continue to create upward pressure on the real exchange rate, and this could deteriorate Afghanistan's external competitiveness.

The government made further progress in terms of revenue collection, by controlling expenditure, by adopting a programmatic and sustainable medium-term fiscal framework, and by aligning the budget with the objectives of the Afghanistan National Development Strategy (ANDS) to achieve macroeconomic stability and sustainable growth. It has focused on controlling non-security spending while incorporating increases in security spending financed with additional grants.

Over the past few years, even though the government has increased collection of domestic revenue, it is insufficient to meet operating budget spending; development expenditure in the government budget is almost fully donor funded. Moreover, a large part of donor activity is undertaken outside the government budget and accounts for more than half total public spending. This reduces the effectiveness of the government's development agenda in terms of priorities, resource allocation, fiscal policy, and in monitoring progress against desired outcomes according to the ANDS.

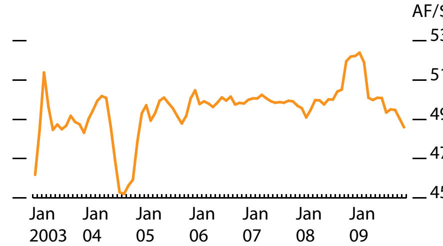
The fiscal position strengthened in FY2009 with domestic revenue estimated to have risen by almost 32%, bringing it to 8.1% of GDP after several years of little improvement (Figure 3.14.4). This increase was achieved by greater tax collection from large and medium taxpayers, stronger customs revenue via tighter controls on fuel imports, and legal amendments that subjected imports to a business tax.

With the decline in security, the government lifted operating budget spending to 14.4% of GDP in FY2009, with much of the rise due to an increase in the size of the police and army (of about 23% to 205,800). The operating budget (excluding grants) is expected to worsen by 1.6% of GDP, though including grants it will remain unchanged as nearly all the additional spending will be financed by grants (more than 80% of security expenditure is met from external sources). As the need for much higher levels of security spending has become evident, the government's target of being able to fully finance its operating budget through domestic revenue, originally slated for FY2015, will likely slip to FY2023, according to a January 2010 report from the International Monetary Fund (IMF).

The current account deficit (Figure 3.14.5), excluding grants, is estimated to have widened from $6.4 billion to $7.0 billion, or about 53.7% of GDP (but still lower as a share of GDP from 54.5% a year earlier). Including grants, the current account deficit was only $462 million (about 3.6% of GDP), and was more than fully financed by official loans ($392 million) and foreign direct investment ($185 million). Imports, the bulk of which are associated with donor-financed activities, increased by 3.5%. Domestic exports fell by 2.4%. Gross international reserves rose during the year and at an estimated $3.8 billion in March 2010 could finance about 13 months of domestic (non-donor) imports.

The IMF's sixth review of the Poverty Reduction and Growth Facility was completed in January 2010. It noted the successful implementation of the FY2009 economic program and the series of steps that qualified the country for $1.6 billion in debt relief from multilateral, bilateral, and private creditors (equivalent to a 96% reduction in the country's external debt), as it had reached the completion point under the heavily indebted

3.14.3 Nominal exchange rate



Source: International Monetary Fund. International Financial Statistics online database (accessed 16 March 2010).

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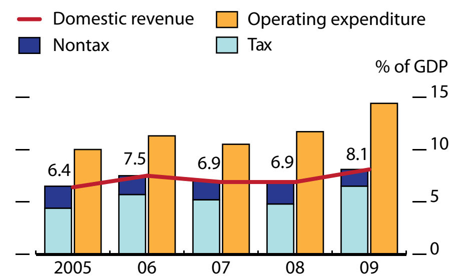
3.14.4 Domestic revenue and operating expenditure



Source: International Monetary Fund. 2010. *Country Report* No. 10/22. January. http://www.imf.org

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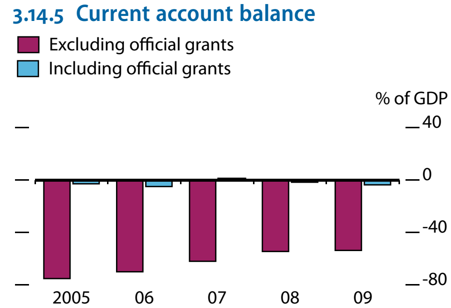
3.14.5 Current account balance



Source: International Monetary Fund. 2010. *Country Report* No. 10/22. January. http://www.imf.org

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poor country initiative. As part of this process, the Paris Club of 19 creditor countries met in March 2010 and canceled Afghanistan's debt owed to its members.

While the debt relief will reduce debt burden indicators to sustainable levels, the economy will remain at high risk. Given its reliance on foreign grants, it is vulnerable if grant support decreases. A sensitivity analysis carried out by the IMF in January emphasized that the external position is particularly exposed to slower growth and to greater reliance on debt rather than grant financing.

Economic prospects

GDP growth in FY2010 is forecast to moderate to 7.6% and to a little under 7.0% the following year. This forecast is based on a number of key assumptions: a gradual improvement in security, continuation of the large development partner funding for projects, sustained agricultural production, continued growth of business enterprises catering to growing consumer demand, improved revenue administration and public enterprise reform, financial sector development, and growing foreign direct investment, especially that aimed at development of the country's substantial mineral resources (such as copper and iron ore).

3.14.1 Selected economic indicators (%)

	2010	2011
GDP growth	7.6	6.8
Inflation	8.4	4.5
Current account balance (share of GDP)	-1.8	-2.1

Source: ADB estimates.

Monetary policy is expected to contain inflation to 8.4% and 4.5% in the forecast period, barring unexpected developments in global commodity prices or domestic crop failures. The current account deficit (including grants) is projected to improve slightly to about 2% of GDP, mainly owing to an improvement in export performance.

The medium-term growth forecast is subject to several key risks in terms of the domestic security situation; political stability; and the government's ability to combat corruption and to address the infrastructure constraints in power, transport, and irrigation. Inability to achieve steady implementation in structural reforms that will facilitate private sector investment is a further risk underscored in the World Bank's *Doing Business 2010* report.

Development challenges

It is important that the government continue with strengthening and developing its range of macroeconomic policy instruments, with advancing fiscal reform, and with increasing domestic revenue collection. It will also need to tightly manage and control budget expenditure, as well as improve the budget formulation process and capacity to execute projects among line ministries. Improved budget expenditure alignment with the ANDS priorities is also necessary.

Achieving greater aid effectiveness through stronger alignment of donor activities (done outside the government budget) with the national development priorities and the government budget is another priority. Associated with these measures are improvements in structural policies and the business and regulatory environment, the building of core government institutional capacity for efficient service delivery, and improvements in social inclusion, equity, and access to social services.

Bangladesh

The global recession's late-unfolding effects will, this year, slightly slow growth, but it will likely improve next year as the worldwide recovery strengthens. Macroeconomic stability has been maintained, but liquidity pressures in banking have emerged and will need to be dealt with decisively. Power and natural gas shortages will have to be tackled through large and quick investments, and policy and institutional reforms accelerated, to raise medium-term growth. Therefore, greater implementation capacity is needed for government development projects and infrastructure investments under the new public–private partnership scheme.

Economic performance

This economy has performed better than many others in Asia due in part to its lack of integration with global financial markets as well as the nature of its garment and labor exports, which are targeted mainly at the low end of the market (a segment that was less affected during the early stages of the crisis).

Official sources estimate that GDP growth declined slightly to 5.9% in FY2009 (ended June 2009) from 6.2% in the previous year largely because of industry's decelerating growth (Figure 3.15.1), as export production slowed during the global recession. Industry's growth was also constrained by power and natural gas shortages and by a weakening in construction activity.

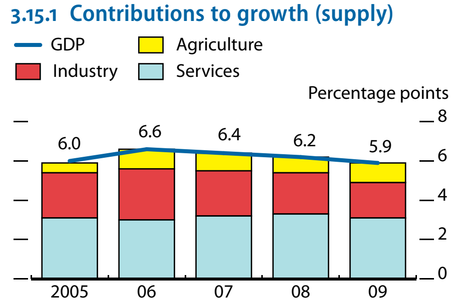
Agriculture performed well, aided by favorable weather and government support to farmers that improved their access to inputs and credit. Expansion in services decelerated as the slowdown in industry crimped trade and transport activity.

On the demand side, private consumption remained the major driver of growth (Figure 3.15.2), fueled by a healthy expansion in workers' remittances from abroad. Total fixed investment, at 24.2% of GDP in FY2009, was unchanged as the marginal rise in private investment was offset by a decline in public investment due to continued sluggish implementation of the government's annual development program (ADP). The contribution to growth of net exports of goods and services was negative.

Foreign direct investment (FDI) has stagnated at the meager level of less than $1 billion annually over the past 5 years. In an attempt to boost FDI into gas, the government invited bids for offshore gas exploration and awarded contracts for three offshore blocks. To attract potential investors into the power sector, it relaxed the cap on producers' gas sales prices to bring them close to international levels.

Average inflation dropped to 6.7% in FY2009 from 9.9% the year before, with the fall in food prices steeper than that in nonfood prices. The steep decline in petroleum and food import prices and an uptick in domestic agricultural performance were the main factors contributing to easing price pressures. However, after falling to a 90-month low of 2.3%

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics. 2009. *National Accounts Statistics.* May.
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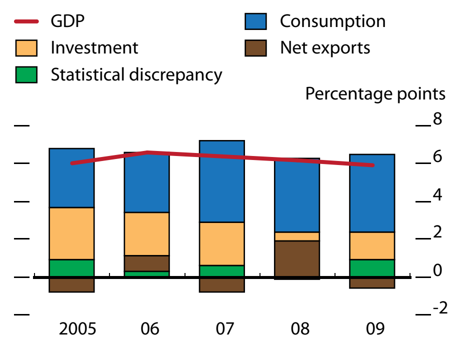
3.15.2 Contributions to growth (demand)



Source: Bangladesh Bureau of Statistics. 2009. *National Accounts Statistics.* May.
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This chapter was written by Mohammad Zahid Hossain, Md. Golam Mortaza, and Shamsur Rahman of the Bangladesh Resident Mission, ADB, Dhaka.

year on year in June 2009 (Figure 3.15.3), inflation accelerated to 9.0% in January 2010, with food and nonfood prices rising sharply. This upturn reflected the impact of unfavorable weather on domestic crop production and the strengthening of global prices of rice and other commodities.

Growth in broad money was strong throughout FY2009, advancing 19.4% year on year in June 2009, compared with the 17.5% program target of Bangladesh Bank, the central bank (Figure 3.15.4). This buoyancy largely reflected unexpected strength both in the banking system's net foreign assets and in the balance-of-payments outturn. Expansion in private sector credit fell to 14.6% year on year in June 2009 (against a target of 18.5%), as slower domestic economic activity and business uncertainty curtailed demand.

Bangladesh Bank cut its policy rates (repo and reverse repo) by 25 basis points in March 2009 in an effort to bolster economic activity. Moreover, its operations in the foreign exchange market substantially raised commercial banks' excess reserves and lending capacity. Reflecting these factors, the average interbank call money rate dropped sharply to 1.8% in June 2009, from 8.3% in March 2009. However, commercial banks' weighted average lending rate declined only marginally to 11.9% in June 2009 and credit flows did not strengthen perceptibly. In October, the central bank cut the two policy rates by 400 basis points in an effort to encourage banks to reduce lending rates and to stimulate credit demand. After that move, credit to the private sector climbed strongly.

The taka–dollar exchange rate remained stable at about Tk69/$1 in FY2009, as Bangladesh Bank intervened heavily in the interbank market, purchasing $1.5 billion during the year (up from only $0.2 billion in FY2008) to prevent that rate from appreciating. However, the real effective exchange rate appreciated by 7.2% over the year due to higher domestic inflation than in its major trading partners, implying erosion in export competitiveness.

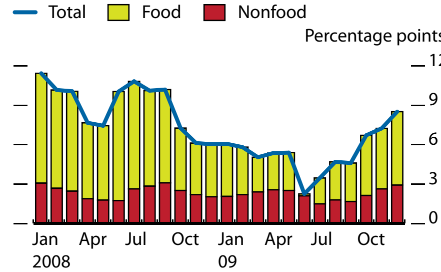
Revenue collection rose slightly to 11.2% of GDP in FY2009, but fell well short of the FY2009 budget target, mainly because of the slower growth in imports. Total spending at 15.3% of GDP was also lower than target. Lower international prices of food, fuel, and fertilizer contained current spending on subsidies, and the ADP was also substantially underspent due to continuing human resources constraints in key line agencies. The overall budget deficit was therefore only 4.1% of GDP, well below the target of 5.0%.

Export growth decelerated to 10.1% in FY2009 from 17.4% in FY2008, with essentially stagnant year-on-year export gains after the September 2008 global financial meltdown (Figure 3.15.5). Readymade garments posted a still-healthy growth of 15.4%, which helped raise their share in total exports to 79.3% from 75.8% the previous year, as other products' exports declined by 5.7% on weak demand and lower prices.

Contracting in the second half from year-earlier levels, imports plummeted to only 4.2% growth in FY2009 from 25.6% (Figure 3.15.6). A good domestic crop and a combination of falling global commodity prices and weaker imports of capital machinery and raw materials were the major factors.

The improved trade deficit, together with 22.4% growth in workers' remittances, lifted the current account surplus to $2.5 billion (2.8% of

3.15.3 Contributions to inflation



Sources: Bangladesh Bureau of Statistics. http://www.bbs.gov.bd (accessed 7 March 2010); ADB estimates.

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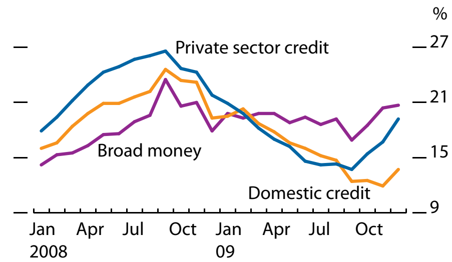
3.15.4 Growth of monetary indicators



Source: Bangladesh Bank. http://www. bangladesh-bank.org (accessed 1 February 2010).

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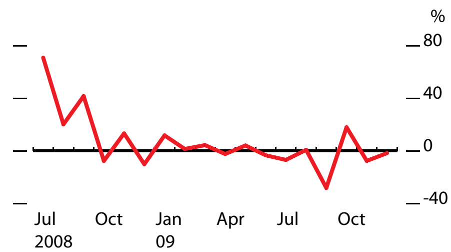
3.15.5 Monthly export growth



Source: Export Promotion Bureau. http://www.epb.gov.bd (accessed 8 March 2010).

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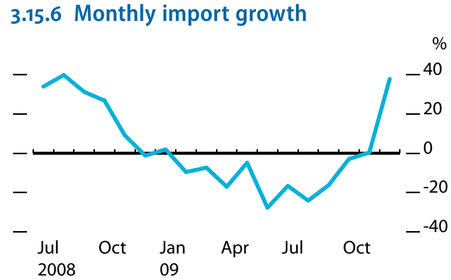
3.15.6 Monthly import growth



Source: Bangladesh Bank. http://www. bangladesh-bank.org (accessed 1 February 2010).

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GDP) from $702 million (0.9% of GDP) in FY2008 (Figure 3.15.7). A small deficit in the capital and financial account resulted in a surplus of $2.1 billion in the overall balance of payments in FY2009, dwarfing the prior-year's $331 million surplus. Foreign exchange reserves rose to $7.5 billion (3.8 months of imports) at end-June 2009, and surged to $10.6 billion at end-February 2010, nearly twice the level of a year earlier, and equivalent to over 5 months of imports (Figure 3.15.8).

Economic prospects

Economic forecasts for FY2010 and FY2011 assume continued prudence in macroeconomic management and steady progress in governance reforms. Commissioning of new power generation capacity should moderately reduce supply shortages.

GDP growth in FY2010 is forecast at 5.5%, somewhat lower than in FY2009 due in part to the lagged effects of depressed external demand on Bangladesh's mainly low-end garment exports. In FY2011, growth is expected to rise to 6.3%, underpinned by the global recovery and strengthened business confidence and investment.

Despite continued policy support, agricultural growth is seen moderating in FY2010 to a still-high 4.1% from 4.6%, as the *aus* (summer) crop has been affected by drought and the *aman* (monsoon) crop by inadequate rainfall. The high base of the previous year and less remunerative farmgate prices are also factors. Sector growth is projected to nudge up to 4.3% in FY2011 on an expected return to normal weather.

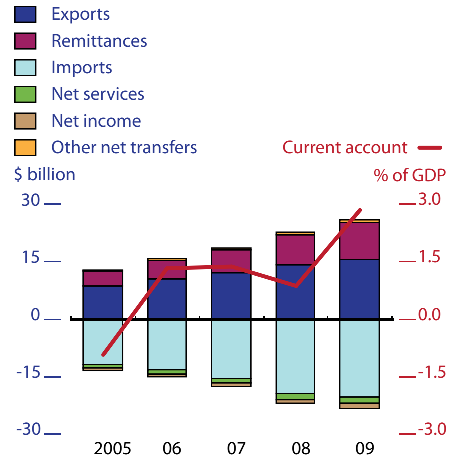
Industrial growth is seen decelerating to 5.6%, reflecting subdued domestic and external demand in the first half of FY2010. Several indicators suggest that industry will remain sluggish throughout the year. Export performance was dismal in the first half, declining by 6.2% (Figure 3.15.9), with most items (including garments) contracting due to weak retail sales in industrial countries. In addition, domestic investor sentiment has not fully revived following the initial uncertainty over the extent and depth of the impact of the global recession on Bangladesh. Moreover, decelerating remittance growth will limit growth in consumer demand. Still, industrial performance is expected to strengthen in the second half of FY2010 as exports return to a positive growth path on recovering global momentum.

In FY2011, industry is likely to grow more robustly at 7.5% with further recovery in global demand and improved domestic business confidence that will raise construction activity and investment. Other domestic factors, such as financial support to small and medium-sized enterprises spearheaded by the central bank, should also help boost industrial output.

Services growth in FY2010 is forecast to slow to 5.9% from 6.3%, reflecting weaker performance in agriculture and industry. Trade and transport activity are especially affected. Growth is projected to rebound to 6.5% in FY2011.

With the rise in year-on-year inflation, the 12-month average has also picked up. In FY2010, average inflation is forecast to climb to 7.5% and then to 7.8% the following year. The excess liquidity in banks and international commodity price pressures are expected to stoke inflation.

3.15.7 Components of the current account balance



Source: Bangladesh Bank. 2010. *Annual Report 2008–09*. http://www.bangladesh-bank.org
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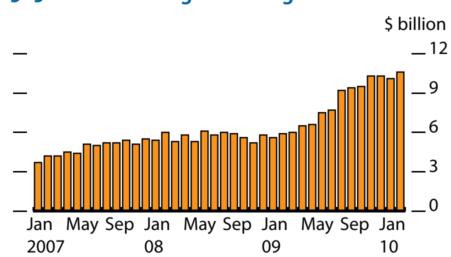
3.15.8 Gross foreign exchange reserves



Source: Bangladesh Bank. http://www. bangladesh-bank. org (accessed 8 March 2010).
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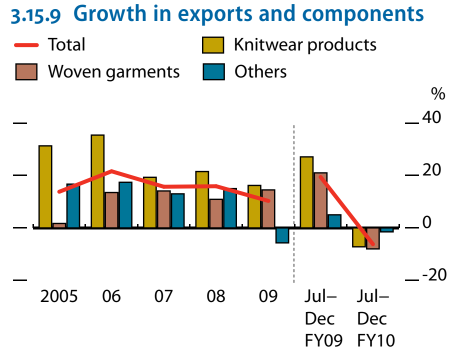
3.15.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.5	6.3
Inflation	7.5	7.8
Current account balance (share of GDP)	1.8	0.5

Source: ADB estimates.

3.15.9 Growth in exports and components



Source: Bangladesh Bank. 2010. *Annual Report 2008–09*. http://www.bangladesh-bank.org
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The Monetary Policy Statement announced in January 2010 continues the accommodative stance. The statement seeks to maintain supportive monetary conditions to help exports recover and investment pick up. It also anticipates that the boost to production from improved credit availability and the November 2009 cut in fertilizer prices will help contain FY2010 inflation. The year-on-year growth in broad money (20.7%) in December 2009 was higher than the central bank's annual program target of 15.5%, while growth in private sector credit at 19.2% was also above its program target of 16.7%.

Remittances reached a peak of $1.1 billion in November 2009, before falling to $844.1 million in February 2010. Remittance growth dropped to 19.2% in the first 8 months of FY2010 from 27.0% in the year-earlier period. Job placements abroad also tumbled (42.2%) in this period (Figure 3.15.10) and many workers came home. Reflecting a decelerating rise in the number of new migrants and an increasing number of returnees, remittance growth is expected to slow further, to 16.5% in FY2010 and to 12.5% in FY2011.

Based on orders received, exports are set to perform better in the second half but, because they declined in the first half, full-year FY2010 growth is projected at only 5.0%. The first-half decline also suggests a more pronounced impact of the global recession in FY2010 than a year earlier. The government announced a Tk10 billion ($145 million) package in November 2009 to boost exports' performance. With continued global recovery, growth is projected to rise to 11.0% in FY2011.

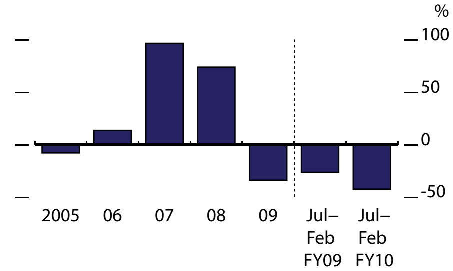
Imports declined sharply by 5.7% in the first half of FY2010 but are likely to pick up in the second half, with overall growth rising to 4.0% in FY2010 and to 14.0% in FY2011, as international fuel and nonfuel commodity prices recover and as domestic demand for imported raw materials and capital machinery grows.

The surplus in the current account is expected to decline to 1.8% of GDP in FY2010 as export and remittance growth slow, although import growth will also decelerate. The surplus will slide further to 0.5% of GDP in FY2011 (Figure 3.15.11), as the trade deficit widens due to a recovery in import growth and a further slowing in remittance growth.

In June 2009, the government set an expansionary fiscal stance in the FY2010 budget. It included sizable spending on a new public–private partnership (PPP) scheme, a much larger ADP, an expanded social safety net program, and a special stimulus package (Box 3.15.1). Although ADP utilization of 35% in the first 7 months of the fiscal year is an improvement over past years, based on its current pace, the ADP allocation is unlikely to be fully spent. The allocation for PPPs is also likely to remain largely unused, as the preparatory work for launching the scheme is taking longer than foreseen. Thus, the FY2010 budget deficit is expected to be contained within the projected level of 5.1% of GDP (Figure 3.15.12).

The government has not raised the administered prices of domestic fuels since it lowered prices of diesel and kerosene (together, close to 75% of domestic consumption) in January 2009, despite subsequent increases in international oil prices. The Bangladesh Petroleum Corporation (BPC) is suffering losses from selling these products at below cost. It is making some profit on gasoline (petrol), which accounts for about 15% of consumption; the price was reduced in December 2008. Effective 1 March

3.15.10 Growth in overseas employment



Source: Bangladesh Bank. http://www. bangladesh-bank.org (accessed 1 February 2010).

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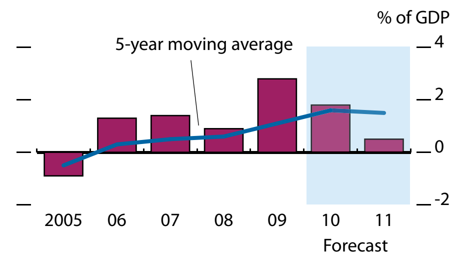
3.15.11 Current account balance



Sources: Bangladesh Bank. 2010. *Annual Report 2008–09.* http://www.bangladesh-bank.org; ADB estimates.

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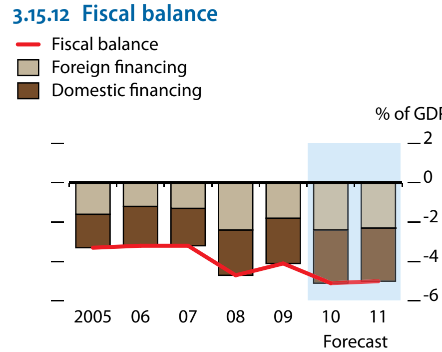
3.15.12 Fiscal balance



Sources: Ministry of Finance. 2009. *Budget at a Glance.* http://www.mof.gov.bd; ADB estimates.

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2010, the Bangladesh Power Development Board (BPDB) increased tariffs by 6%–7%. Without domestic price increases, BPC is likely to incur a sizable deficit. The FY2010 budget earmarked $370 million for subsidies to BPC and to BPDB to cover their likely losses.

Several downside risks could undermine projections. These include a weaker than expected global economic recovery, failure of planned measures to address growing power and gas shortages, business confidence weakened by a lack of progress in economic and governance reforms, and an unexpected surge in commodity prices or in bank credit pushing inflation much higher. The threat of natural disasters always looms.

Development challenges

Infrastructure investment needs to be boosted for faster economic growth and poverty reduction. Underinvestment over the years has resulted in acute deficiencies, especially in power and gas, ports, and roads, which are restricting business opportunities and access to public services. Consequently, the government has to substantially raise project implementation capacity in public sector agencies, lift ADP utilization, and carry out PPPs in infrastructure. To launch the PPP scheme, the legal framework for setting the responsibilities of stakeholders, for cost-recovery provisions, and for compensation and redress mechanisms needs to be put in place quickly.

A combination of cheap labor and a supportive policy environment helped Bangladesh emerge as a major exporter of garments over the past two decades. However, overwhelming dependence on one industry has made the country's export earnings acutely vulnerable to a global slowdown. Recent experience underscores the urgency of diversifying into other promising industries such as ceramics, pharmaceuticals, food processing, leather products, and spare parts for machinery and shipbuilding. An important requirement for such an export transformation is the necessary utility services such as power, gas, and water. Streamlining the export duty drawback system and improving customs and bonded warehouse facilities are also required.

Population pressure is a related concern. It is straining ecosystem services, such as safe water supply and habitat as well as other natural resources, and pressuring the government in terms of providing infrastructure, utilities, and other services. Although Bangladesh has made progress over the past two decades in nearly halving the total fertility rate to slightly above the population replacement rate, further progress is needed—by raising investment in family planning and reproductive health—to push the fertility rate to below the replacement rate. Job opportunities will also need to be created for the large number of youths entering the job market each year.

Climate-induced disasters are endemic in Bangladesh, ruining the lives and livelihoods of millions of people, damaging infrastructure, and harming the physical environment. Climate change multiplies these inherent risks, undermining development prospects and eroding the gains in poverty reduction. Major efforts need to be mounted for mobilizing funds for adaptation measures, putting in place the right policy frameworks, and building institutional capacity.

3.15.1 Policy responses to the global recession

The government's first response announced in April 2009 was a Tk34.2 billion ($500 million) stimulus package for exports, agriculture, power, and social safety net programs. This package provided cash incentives for the more severely affected export items such as jute and jute goods, leather and leather goods, and frozen foods. It offered no assistance to the garment industry as it was still performing reasonably well at the time.

Out of the Tk50 billion earmarked for a second fiscal stimulus package (as part of the FY2010 budget), the government initially allocated Tk18 billion for export subsidies and Tk12 billion for the power sector. From the remaining Tk20 billion, as the effects of global recession on exports became more pronounced, the government allocated Tk10 billion in November 2009 for direct export subsidies and other policy support, including assistance to the garment industry.

The central bank sought to align monetary policy to support the expansionary fiscal stance, and has continued an accommodative monetary policy stance in FY2010. In addition to lowering policy rates to improve the availability of credit, it did not sterilize the higher bank reserves (lending capacity) created by its large market purchases of foreign exchange as it kept the exchange rate stable.

Bhutan

Economic growth is dominated by the hydropower project cycle. While growth decelerated last year from very high levels as the effect of newly installed power production faded, construction of new power plants will sustain solid expansion over the next few years. Bhutan has a record of relatively strong growth that has cut poverty and advanced social development. It is based on prudent economic management and well-targeted donor support. Anchored by power, the medium-term outlook is bright, though rising unemployment, especially among young people, remains an economic and social concern.

Economic performance

Bhutan was well insulated from the global meltdown as the economy is driven largely by construction of hydropower stations and the export of electricity to power-hungry India. Electricity is the single largest sector of the economy, with a 22% share of GDP (its exports to India amount to half total exports), followed by construction at 12%, agriculture at 17%, and manufacturing at about 9%. (Services as a group account for around 37%.)

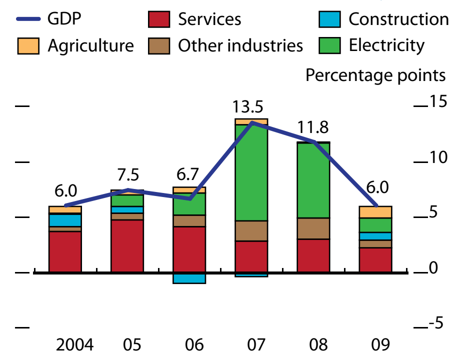
GDP growth in FY2009 (ended 30 June 2009) decelerated to an estimated 6.0% from 11.8% in FY2008 (Figure 3.16.1) reflecting the leveling-off of power output gains after the 2007 commissioning and phase-in of the huge Tala hydropower station (Figure 3.16.2). There were no stimulus measures introduced given the limited impact of the global crisis.

Though its impact was not as severe as elsewhere in the region, the global recession affected tourism and manufacturing. Tourism, though small in relation to GDP, is important for employment creation and is the largest source of hard currency earnings. While it benefited from the one-time centenary and royal coronation celebrations held in June–July 2008, arrivals dropped by 7.3% in January–June 2009, year on year (Figure 3.16.3). Major manufacturing companies, most of which produce raw materials, saw sales fall by 13.1% in FY2009, reflecting a drop in exports to India. In the labor market, unemployment is estimated to have increased to 4.0% in FY2009 from 3.7% in FY2008.

With strong economic and financial ties to India, and its currency (the Ngultrum) pegged at par with the Indian rupee, Bhutan's inflation is highly influenced by that in India, and averaged 7.1% in FY2009. It decelerated to 3.0% in the fourth quarter of FY2009 from a peak of 8.8% in FY2008, as nonfood price inflation (including transport) tumbled (Figure 3.16.4).

Money supply (M2) rebounded, to 24.6% growth in FY2009 from 2.3% a year earlier, primarily due to growth in net foreign assets. Credit to the private sector grew by 31.1%, reflecting continued significant expansion in

3.16.1 Contributions to growth (supply)



Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

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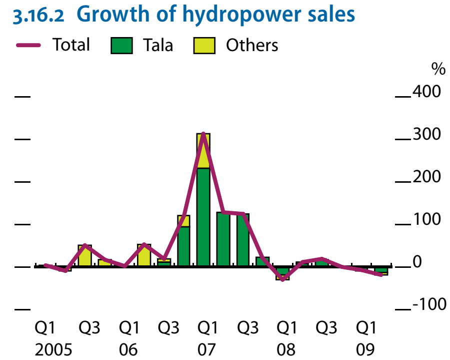
3.16.2 Growth of hydropower sales



Note: Sales based on cost in Ngultrum.

Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

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This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

personal and housing loans and lending to manufacturers. Credit to the private sector has grown rapidly by an average of 35% in the past 3 years despite efforts by the Royal Monetary Authority, the central bank, to rein in banks' excess liquidly.

Credit quality deteriorated in FY2009 as nonperforming loans increased from 13.3% to 18.3% of the total. Such loans in manufacturing more than doubled, largely owing to lower prices and export sales in metal and other processing industries, which benefit from low-cost electricity. While the outlook for manufacturing is positive (largely due to India's rapid recovery), the central bank has raised provisioning requirements of substandard and doubtful loans to 30% and 60%, respectively, to minimize any potential adverse impact on banks.

Otherwise, developments in the finance sector have generally been positive. It is expected that the entry of two commercial banks, one specialized bank, and an insurance company will stimulate greater competition in the sector.

Budget revenue for FY2009 is estimated to be up by 30.6% from FY2008, attributable to increases in personal income tax receipts, business income tax receipts, excise duty, and profit transfer from Tala. Total expenditure rose by 42.5%, reflecting a surge in capital expenditure (50.3%) due primarily to the inclusion of additional budget allocations for agriculture-related infrastructure, rural electrification, and project funds for a cement project. The estimated fiscal deficit of Nu1.6 billion is equivalent to 2.8% of GDP (Figure 3.16.5).

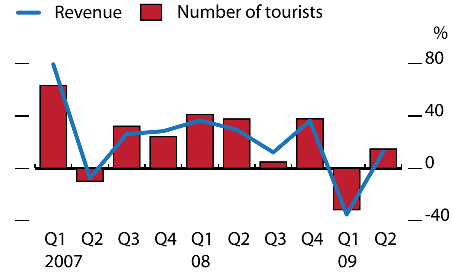
The FY2010 budget plan projects an increase in the deficit to Nu4.8 billion, or about 9.0% of projected GDP. The larger deficit reflects a 10.1% decline in budget revenue, mainly due to a fall in grant receipts, which are volatile from year to year. Domestic revenue declined slightly as weaker profit transfers from Tala are not expected to be offset by continued strong growth in domestic tax revenue. Total outlays are projected at Nu26.3 billion (up 3.1%), with current expenditure rising by about 14% (largely on a 23% increase in salaries and wages), and capital spending falling (after the large increase in FY2009).

The overall trade balance is estimated to have deteriorated to a deficit of 12.1% of GDP in 2009 from 5.5% in 2008 (Figure 3.16.6), attributable to easing commodity exports and increased imports. Manufactured exports, particularly textile- and mineral-based products, contributed to weaker export performance, but their impact was mitigated by moderate growth in hydropower exports. In the other direction, intermediate imports surged on burgeoning construction-related activity.

Despite the much higher current account deficit (9.4% of GDP), the overall balance remained in surplus due to large inflows associated with capital grants received from the Government of India. At end-September 2009, gross international reserves (convertible currency and Indian rupee combined) climbed to $849 million, equivalent to 17.1 months of import cover.

External debt as a share of GDP was high at 65.0% as of end-FY2009, with loans from India for hydropower development constituting more than half. The government recently started borrowing in rupees from the Indian government's standby credit facility and the State Bank of India's overdraft facility to meet shortfalls in rupees required for

3.16.3 Tourism growth



Note: Revenue changes calculated in US dollars.

Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

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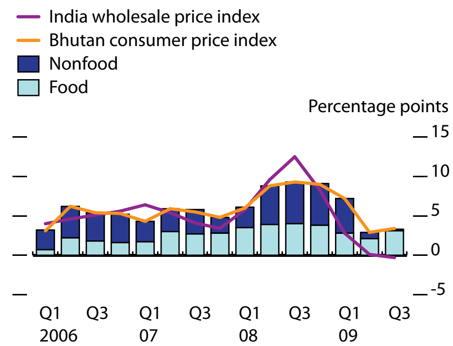
3.16.4 Contributions to inflation



Sources: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January; 2009. *Monthly Statistical Bulletin*. September. http://www.rma.org.bt

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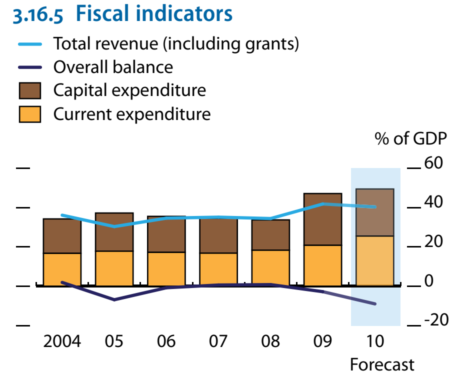
3.16.5 Fiscal indicators



Sources: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt; ADB estimates.

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import payments. Still, Bhutan's debt level is largely self-sustaining, as a steady stream of earnings from power exports to India generate the necessary service payments. Convertible currency debt is mostly on highly concessional terms involving modest debt servicing. The external debt service ratio increased to 39.6% in FY2009 from 18.5% a year earlier, reflecting repayments to the State Bank of India (Figure 3.16.7).

Economic prospects

It is expected that during the 10th five-year plan (FY2009–FY2013), growth will continue to be strong, mainly driven by new hydropower developments including 10 hydropower projects, with three of the projects expected to start this year. Construction of these new power stations will sustain high economic growth.

On these factors, GDP growth is projected to be 6.0% in FY2010 and 6.5% FY2011. With close trade links and the currency peg to the Indian rupee, inflation is projected at 5.0% for FY2010 and FY2011, largely following Indian inflation. While power exports to India will remain stable due to strong demand and long-term contracts, commodity exports will likely improve in view of that country's expected strong expansion in the forecast period.

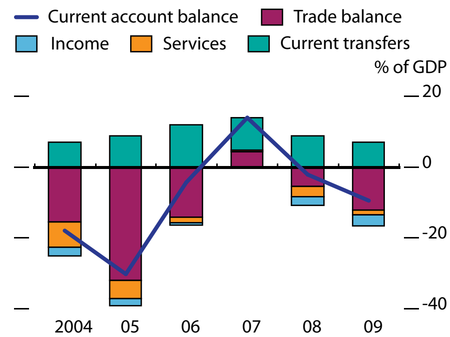
Recovery of service exports (mainly tourism) may take time, reflecting the economic recovery in industrial countries. The assumed relatively stable fuel import prices will, however, help restrain import growth. The current account is projected to be in balance in both FY2010 and FY2011.

Development challenges

Rising unemployment is a concern, as hydropower-led development employs few people and has small backward linkages. Labor-intensive activities need to be developed. Tourism is one area where the private sector can expand. Depending on the development of tourism infrastructure and new tourism products, a more steady inflow of tourists throughout the year could be better promoted.

Private sector development will be a key focus in diversifying economic activity. Bottlenecks such as lack of skilled labor, difficult access to land, inadequate infrastructure, and limited financial sector outreach need to be addressed to facilitate economic diversification and growth.

3.16.6 Current account indicators



Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

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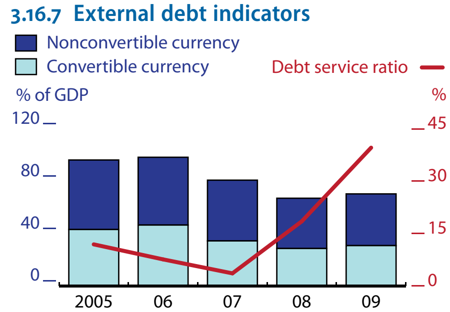
3.16.1 Selected economic indicators (%)

	2010	2011
GDP growth	6.0	6.5
Inflation	5.0	5.0
Current account balance (share of GDP)	0.0	0.0

Source: ADB estimates.

3.16.7 External debt indicators



Source: Royal Monetary Authority. 2010. *Annual Report 2008–09*. January. http://www.rma.org.bt

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India

The economy rebounded strongly over the past fiscal year and is among the leaders in exiting the global recession. Prompt and strong fiscal stimulus and monetary easing, an improving global economic environment, a return of risk appetite, and large capital inflows were instrumental in the bounceback. Rising inflation, however, is a concern. Monetary tightening and withdrawal of fiscal stimulus are under way. The outlook is for a return of high growth, though this will require continued apt handling of macroeconomic policies. To sustain long-term growth, addressing infrastructure bottlenecks and reforming agriculture are essential.

Economic performance

Starting slowly in the first quarter of FY2009 (ending March 2010), economic growth in India came back strongly over the year (Figure 3.17.1), buoyed by monetary and fiscal stimulus and by gradually strengthening consumer and private business confidence. The government's advance estimate for the year put GDP growth at 7.2%, a marked improvement over the 6.7% recorded in FY2008 (Figure 3.17.2).

At the sector level, industry fully accounted for the improvement in growth as manufacturing output spurted (Figure 3.17.3) from the very beginning of the fiscal year to be 8.9% higher than a year earlier. Manufacturing's impressive performance signals that the economy has regained the momentum lost at the onset of the global financial crisis.

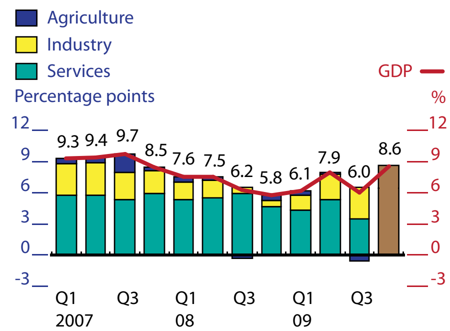
Agriculture played no role in the upturn: output is estimated to have fallen by 0.2% for the year, reflecting the poor summer monsoon. The impact of this output decline was largely felt in the third quarter, and the upward trend in growth faltered temporarily as farm production fell by nearly 3% year on year.

Expansion in services, while a healthy 8.7%, slowed from a year earlier. This reflected a more moderate pace of spending by the government on compensation to employees reflected in slower growth of social services.

On the demand side, preliminary data suggest that robust contributions by private and government consumption continued, but also that investment failed to show any signs of pickup with the fixed investment-to-GDP ratio slipping marginally to 32.3%. Restocking of inventories also added to GDP growth after a large drop a year earlier, helping boost growth in manufacturing output. Civil servants' wage hikes, low interest rates, and rising consumer confidence led to a surge in vehicle sales during the year; production data indicate sales strength of other durable items as well. Net exports also bolstered growth, reflecting a drop in imports.

Indian corporations made the most of lower commodity prices and

3.17.1 Quarterly contributions to growth (supply)



Note: Q4 2009 sector breakdown not given.

Sources: Ministry of Statistics and Program Implementation. http://www.mospi.nic.in (accessed 2 March 2010); ADB estimates.

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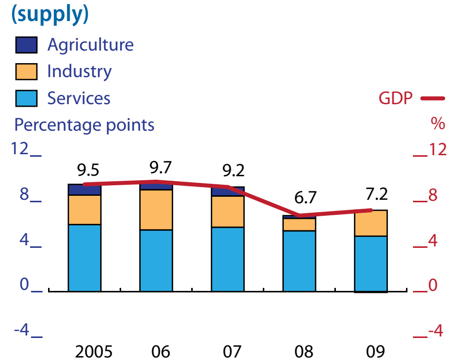
3.17.2 Annual contributions to growth (supply)



Source: Ministry of Statistics and Program Implementation. http://www.mospi.nic.in (accessed 24 March 2010).

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This chapter was written by Hiranya Mukhopadhyay of the India Resident Mission, ADB, New Delhi.

the government's cut in excise duty in response to the global crisis. Companies curtailed their expansion plans, reduced marketing expenses, and went slowly on granting pay rises to their staff. These moves, along with falling interest rates, helped them report a 28% rise in after-tax profit in the first half of FY2009.

The outline of the improving economic landscape is, however, blurred by a recent surge in inflation to 10% in January 2010, largely propelled by food inflation that reached 20% in December 2009 (Figure 3.17.4). The very weak summer monsoon in the sowing season, followed by widespread flooding later, has triggered a spurt in food prices. Importantly, escalating prices have not been confined to cereals but include pulses, vegetables, and poultry products, pointing to the government's inability to stabilize prices by the usual buffer-stock operations. With the rise in the second half, inflation is estimated to average 3.6% in FY2009.

Beyond weather, one structural reason for persistent price pressure is that the central government has raised its food procurement prices greatly (the minimum support price for paddy has gone up substantially over the past 3 years).

The government took several supply-side measures to counter the recent surge in prices, including selling wheat and rice from buffer stocks, temporarily suspending duty on sugar imports, and initiating measures against hoarding. While food prices are expected to moderate with the new harvest season, their relentless rise (given their large weight in the price index) has created concerns of spillover to nonfood prices and a ratcheting up of inflation expectations.

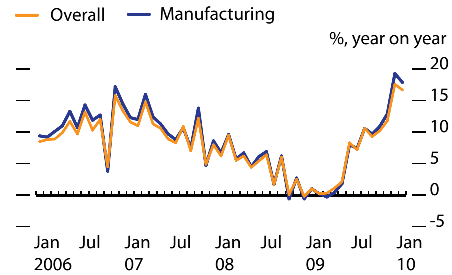
Uncertainties about domestic fuel prices (which again require heavy subsidies as global oil prices climb) are also contributing to inflation expectations. The Parikh committee, which took on the contentious issue of domestic pricing of petroleum products, recommended complete deregulation of petrol (gasoline) and diesel prices, and substantial increases in the prices of cooking gas and kerosene.

This is, indeed, a much-needed reform because of high subsidy costs and harm to the long-term health of the petroleum industry, which bears part of the subsidy costs. Implementation, however, will be challenging at the moment due to accelerating inflation and higher duties imposed on crude oil, petrol, and diesel in February 2010 that were passed on by adjustments in administered sale prices.

The Reserve Bank of India (RBI) signaled the beginning of an exit from its crisis policy stance at its January 2010 policy meeting when it raised banks' cash-reserve ratio from 5.0% to 5.75% (Figure 3.17.5). The move did not represent significant tightening in view of large excess reserves held by the banking system. In March, however, the central bank raised its key lending and borrowing rates by 25 basis points. This action, ahead of its scheduled policy meeting in April, signaled a determination to begin shifting from a crisis mode toward a more neutral stance for monetary policy.

In announcing the change, the RBI cited several developments that prompted the need for a change in policy, including the positive trend in growth (due predominately to domestic factors), a sustained increase in demand for credit, a recent escalation in prices of nonfood manufactured

3.17.3 Growth of industrial production



Source: CEIC Data Company (accessed 21 March 2010).

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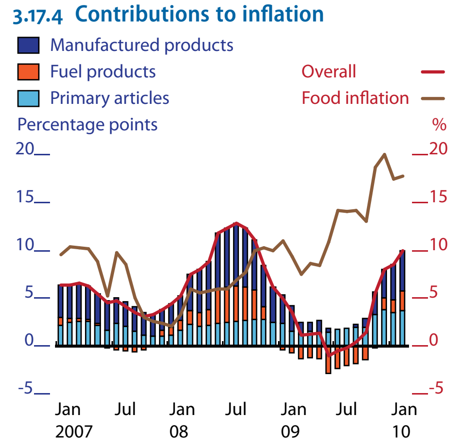
3.17.4 Contributions to inflation



Source: Ministry of Industry and Commerce. http://eaindustry.nic.in (accessed 15 March 2010).

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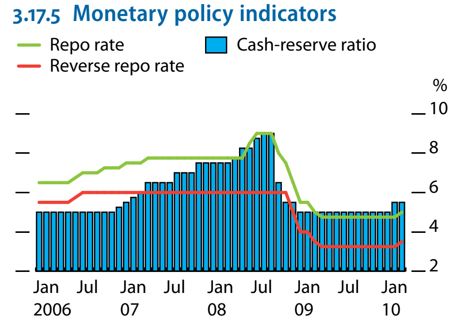
3.17.5 Monetary policy indicators



Source: CEIC Data Company (accessed 25 March 2010).

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goods, a need to keep inflation expectations in check, and lags inherent in the impact of monetary policy. While a shift in monetary policy is unlikely to affect food prices, timely policy adjustments in the months ahead can help underpin a return to India's past high growth rates while maintaining relative price stability.

In a sign of rebound, export growth turned positive in November 2009 after 13 months of year-on-year declines (Figure 3.17.6). An outlook survey on exports that was conducted by the Confederation of Indian Industry indicated that nearly half the respondents expected further volume growth in the coming months despite the rising cost of raw materials and stiff international competition.

The central government will continue for a time with the 2% interest subsidy on bank loans to certain sectors that are labor intensive, such as textiles, leather, handicrafts, cotton yarn, jute, minerals, and fruits and vegetables, which were particularly hard hit by the fall in global demand.

Imports moved to positive growth in December after 12 months of year-on-year contraction (Figures 3.17.7 and 3.17.8). Oil and non-oil imports slumped by about 25% and 17%, respectively, from April 2009 to January 2010, relative to the same prior-year period. Non-oil imports rose sharply from $12.4 billion in March 2009 to $16.9 billion in January 2010 on the strength of the domestic economic recovery.

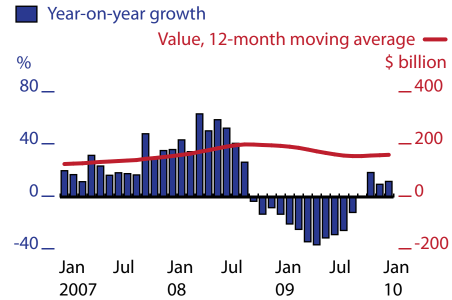
Although official balance-of-payments data for FY2009 are unavailable, various indicators suggest that the adverse effects of the global recession have largely played themselves out. Though reviving in the final months of FY2009, annual exports and imports are estimated to have declined by around 15% and 17%, respectively, yielding a moderate improvement in the trade deficit of about $24 billion (Figure 3.17.9). Net invisible receipts are estimated to have declined by $20 billion to around $70 billion, mainly due to a fall in miscellaneous business receipts. By these estimates, the current account deficit narrowed to 1.9% of GDP from 2.5% a year earlier.

A notable feature of economic revival was the resumption of large capital inflows, led by the turnaround in foreign institutional equity purchases from large net sales a year earlier, and a sustained high level of foreign direct investment. Total net capital inflows are estimated at $60 billion in FY2009 (up from $7 billion a year earlier), reflecting a return of risk appetite in global financial markets in conjunction with India's economic resilience as demonstrated over the course of the fiscal year. The capital account surplus more than covered the current account deficit.

Gross international reserves (including valuation adjustment) increased by about $25 billion to an estimated $280 billion by the end of FY2009 (Figure 3.17.10). The increase in reserves includes the allocation of SDR3.3 billion ($5.2 billion) made by the International Monetary Fund in August and September 2009. In November 2009, India purchased 200 tons of gold from that body, and this is reflected in the difference between gross international and foreign exchange reserves in the figure. Reserves are ample, amounting to about 13.1 months of imports of goods and services.

The rupee exchange rate appreciated both against the US dollar and

3.17.6 Export indicators



Source: CEIC Data Company (accessed 17 March 2010).

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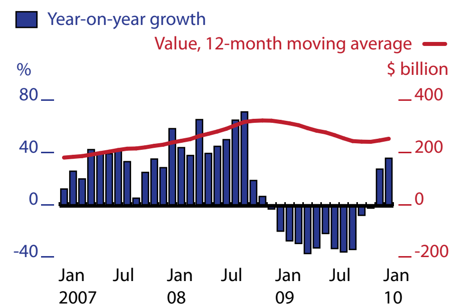
3.17.7 Import indicators



Source: CEIC Data Company (accessed 17 March 2010).

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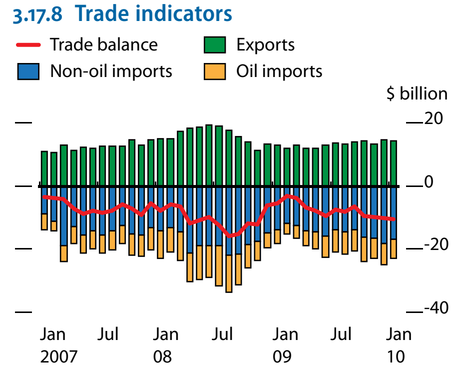
3.17.8 Trade indicators



Note: Total exports and imports based on customs data.

Source: CEIC Data Company (accessed 17 March 2010).

Click here for figure data

in real effective terms throughout FY2009 as the economy strengthened. This contrasts with a downward slide in FY2008 as the economy and balance of payments faltered. The real effective exchange rate appreciated by about 11% in FY2009, essentially reversing an equivalent depreciation in FY2008, though it remains about 6% below its mid-2007 high (Figure 3.17.11). The return of a large capital account surplus has required the RBI to resume interventions in the foreign exchange market to moderate abrupt upward pressure on the rupee and to support exports.

But given the rise in inflation and buildup of inflation expectations, the RBI may find it difficult to continue intervening. Among the first wave of economies leading the recovery phase, it may have to contend with managing even much larger capital inflows, which would put upward pressure on the exchange rate, interest rates, and growth of credit, replaying the difficult monetary policy mix of FY2007 when capital inflows surged. Thus, the central bank's effective use of sterilization and other capital control policies at the same time as it accepts some flexibility in the exchange rate will be critical in effectively managing the economy through its recovery phase.

The FY2009 budget of the central government was prepared in the midst of a marked slowdown in the domestic economy. It envisaged a substantial rise in government spending and maintenance of lower excise and service tax rates put in place in the latter part of the previous fiscal year as a main element of countercyclical policy measures. The outturn came very close to plans for both revenue and expenditure with the deficit at 6.7% of GDP (Figure 3.17.12).

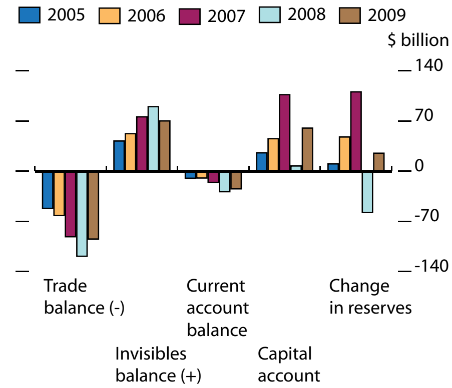
The consolidated general government deficit in FY2009, however, including off-budget liabilities for subsidies and the deficits of state governments, is expected to be about 10%. This, the second year of large deficits owing to the global crisis, had raised concerns over debt sustainability. In announcing the FY2009 budget the government pledged it would reduce the deficit to 5.5% of GDP in FY2010 and 4.0% in FY2011.

The central government budget for FY2010, introduced in February this year, was set against a somewhat more favorable background; the complex challenge of renewing the commitment for fiscal consolidation while sustaining rapid growth momentum. The central government reiterated its commitment to kick-start a well-coordinated exit strategy, and bring the budget deficit to 3.0% by FY2013.

This target was in line with the recommendations of the 13th Finance Commission fiscal road map that also called for the combined deficit of the states to fall to 2.4% of GDP in FY2013 and set a target for general government debt to be reduced to 68% of GDP by FY2014 (from 82% at end-FY2009). The introduction of a new direct tax code and a national goods and services tax effective from the start of FY2011 will underpin this fiscal effort.

The FY2010 budget deficit is set to decline to 5.5% of GDP, a 1.2 percentage point reduction. About one-half of fiscal consolidation is expected to be achieved through bigger revenue collection mainly due to faster growth, some retracement of the stimulus excise tax rate cut, a widening of the service tax net, divestment of stakes in state-run enterprises, and the sale of spectrum for third-generation telephony. On

3.17.9 Balance-of-payments indicators



Note: Change in reserves includes valuation adjustments.

Sources: CEIC Data Company (accessed 23 March 2010); ADB estimates.

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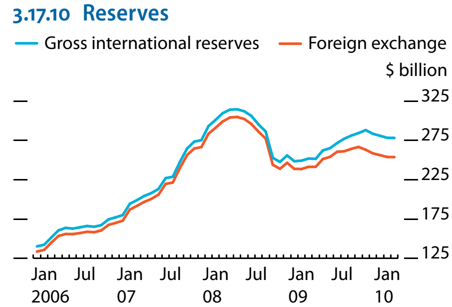
3.17.10 Reserves



Source: CEIC Data Company (accessed 17 March 2010).

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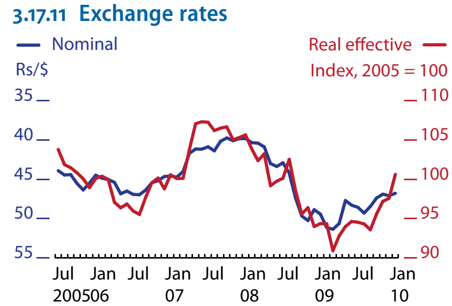
3.17.11 Exchange rates



Sources: Reserve Bank of India. http://www.rbi.org.in; Bank of International Settlements. http://www.bis.org (both accessed 17 March 2010).

Click here for figure data

the expenditure side, a reduction in the deficit of 0.6% of GDP is driven by a drop in current expenditure in relation to GDP.

The guiding principle of the budget on the expenditure side was to sustain high growth by boosting allocations for infrastructure while elsewhere ensuring that the benefits of high growth are broadly distributed. The budget took several steps in this direction. The allocation for the education and health sectors was raised by 16% and 14%, respectively, from FY2009 levels. The National Rural Employment Guarantee Scheme continued to get top priority with an allocation of Rs401 billion ($9 billion) in FY2010. The finance minister also reiterated that the government will address key issues in the areas of financial inclusion; rural and urban housing; social security for unorganized sector workers; women and child development; and micro, small, and medium-sized enterprises.

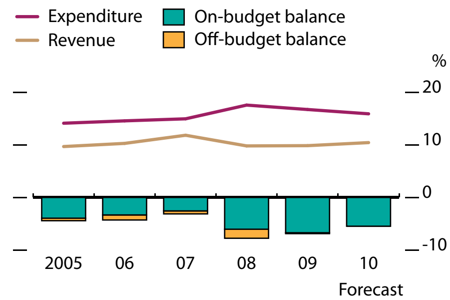
The budget began the exit from fiscal stimulus by partly rolling back the earlier rate reduction of 4 percentage points in central excise duties. It also raised the standard rate on all nonpetroleum products from 8% to 10%. Similarly, the ad valorem component of excise duty on large cars, multi-utility vehicles, and sports-utility vehicles, which was reduced as part of the stimulus package, was increased by 2 percentage points. Other tax proposals included rationalization of the income tax slabs; additional excise duty on petrol and diesel; and restoration of a 5% customs duty on petroleum products, including crude oil.

A landmark reform in the area of government subsidy is the introduction of nutrient-based subsidy for fertilizer. This policy is expected to improve agricultural productivity, contain the subsidy bill over time, and offer environmental benefits. Further, the government will no longer issue special off-budget bonds from FY2010 to finance subsidies for fuel, fertilizer and food; much-reduced programs are now to be supported on the budget.

Another major fiscal development is a revived program for disinvestment of state-owned enterprises listed on the stock exchange by reducing ownership stakes (though not majority control). In FY2009, the government raised a record Rs335 billion (about $7 billion); the FY2010 budget calls for sales of Rs400 billion.

The Sensex, the main index of the Bombay Stock Exchange, witnessed a large runup in FY2009. This recovery, which began in March, was part of the general worldwide boom in stock prices set off by depressed valuations in conjunction with early signs of recovery in the global economy. A notable feature of the rally was the degree to which the increase in the Sensex exceeded a general index of emerging Asian stock markets: in the past, they have mostly moved in tandem (Figure 3.17.13).

3.17.12 Central government fiscal indicators



Source: Ministry of Finance. http://indiabudget.nic.in (accessed 27 March 2010).

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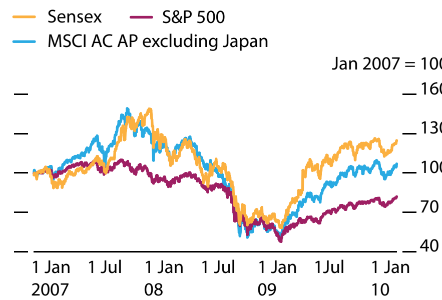
3.17.13 Stock price indexes



MSCI AC AP = Morgan Stanley Capital International All Country Asia Pacific.

Source: Bloomberg (accessed 17 March 2010).

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Economic prospects

ADO 2010 forecasts for FY2010 and FY2011 are based on six key assumptions: monetary and fiscal stimuli will be withdrawn gradually over the next 2 years; the domestic food supply position will be comfortable because of normal monsoons; international oil prices will average about $80 per barrel in 2010 and $85 in 2011; domestic fuel prices will be revised upward; a modest recovery in industrial economies is

3.17.1 Selected economic indicators (%)

	2010	2011
GDP growth	8.2	8.7
Inflation	5.0	5.5
Current account balance (share of GDP)	-1.5	-2.0

Source: ADB estimates.

expected in 2010 followed by further acceleration in 2011; and world trade will grow by 7%–8%.

Appropriate adaptations in monetary policy and the fiscal stimulus measures by the authorities and economic recovery in industrial economies will underpin the pace of growth in the forecast period. All recent surveys point to a marked improvement in business confidence. For example, the Dun & Bradstreet Composite Business Optimism Index for the first quarter of 2010 recorded an increase of 43% relative to the first quarter of 2009 (Figure 3.17.14). Moreover, six of seven "optimism subindexes" registered an increase from the previous quarter.

The HSBC Markit Purchasing Managers' Index for manufacturing for December 2009 recorded its highest level since May that year, suggesting a robust month-on-month improvement in manufacturing. The equivalent index for services also registered significant expansion, suggesting that the services sector, too, is well poised for a strong recovery.

Renewed investor and consumer confidence—the return of the exuberance that marked FY2005–FY2007, the years of 9% or more growth—is expected to fundamentally shape the outlook. Unlike FY2009, the composition of aggregate demand will be driven by strong advances in private consumption and investment in the next 2 years. Government consumption expenditure will cease to be an engine of growth.

The normalization of financial market conditions is expected to support a rebound of private investment, sustaining demand as the fiscal stimulus fades even with some hardening of lending rates. Major capacity enhancement plans in the cement, steel, aluminum, automobile, paper, tire, and electricity sectors are in the works. The return of ready access to global capital by Indian corporations will help bring these plans to fruition. The government's high priority for developing infrastructure is another factor in an investment-rich mix.

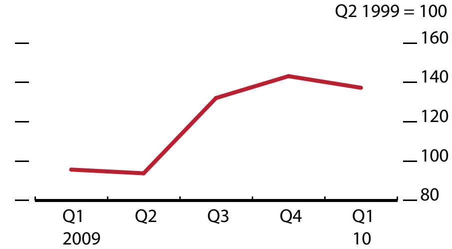
Urban consumption is expected to remain strong as the fear of large-scale job cuts has disappeared, substantial new hiring is under way, and salaries are back on a rising trend. The marked revival in the Sensex is also bolstering consumer and business attitudes. Expected normal rainfall and an enlarged National Rural Employment Guarantee Scheme will foster growth in rural consumption.

From the supply side, manufacturing and services will be the major drivers of expansion. Technology spending is expected to rebound in industrial countries, with their purchases set to post healthy growth, boosting growth in Indian high-tech services. These factors, in conjunction with recovery in the global economy, should lift GDP growth to 8.2% in FY2010 and 8.7% in FY2011 (Figure 3.17.15).

Inflation pressures are expected to ease in early FY2010 after the winter harvest. However, increases in the domestic prices of petrol, diesel, cooking gas, and kerosene are likely during the forecast period following the recommendations of the committee that rules on domestic fuel prices. While demand-pull inflation pressures in manufacturing are on the rise, the RBI has already begun an exit from monetary stimulus and is expected to keep price pressures in check. Thus inflation is forecast at 5.0% in FY2010 and 5.5% in FY2011 as international prices of oil and non-oil commodities edge up (Figure 3.17.16).

Large annual falls in exports and imports were recorded in FY2009,

3.17.14 D&B Composite Business Optimism Index

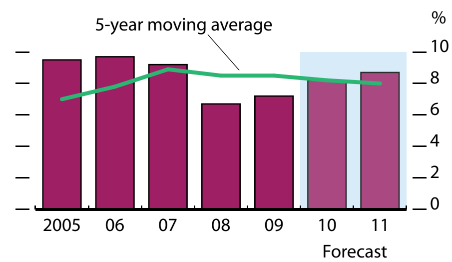


Note: The index is calculated as the ratio of the positive responses for six selected parameters (or "subindexes") for the period under review to the positive responses in the base period (Q2 1999).

Source: Dun & Bradstreet. 2010. *Business Optimism Index: India*. January. http://www.dnb.co.in

Click here for figure data

3.17.15 Annual GDP



Source: Asian Development Outlook database.

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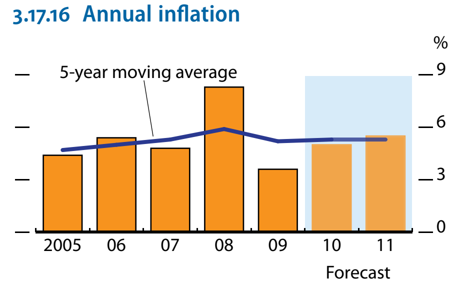
3.17.16 Annual inflation



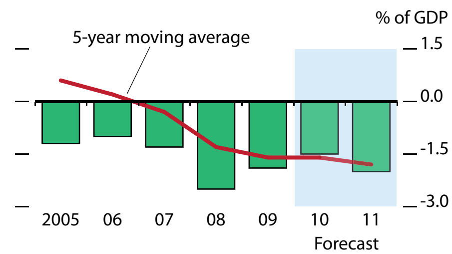
Source: Asian Development Outlook database.

Click here for figure data

though growth moved into positive territory in the closing months of the year. Trade flows in FY2010 and FY2011 will climb, though at a slower pace than in years prior to the global slowdown. Exports are projected to gain 16.0% in FY2010 and 12.0% in FY2011. This would bring exports in FY2010 to near FY2008 levels and in FY2011 to just over the $200 billion target set in the government's foreign trade policy. These rates of expansion seem achievable given the expected revival in global trade volumes of 7.1% and 8.1% in these 2 years and the demonstrated focus and depth of India's export industries, exports of which grew at an annual average of nearly 24% in the 5 years through FY2008.

As GDP growth is pushed again to high levels and international oil prices firm, imports will expand rapidly, at 20.0% in FY2010 and 18.0% in FY2011. This projected expansion takes imports to 20%–21% of GDP and is in line with experience during FY2005–FY2007. The growing trade deficit is, however, expected to be partly offset by revival of growth in net invisibles from an expansion in the services surplus and an increase in transfers from nonresident Indians. Overall, the current account deficit is expected to widen marginally to 2.0% of GDP by FY2011 (Figure 3.17.17).

3.17.17 Current account balance



Source: Asian Development Outlook database.
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Development challenges

India is currently facing both short- and medium-term policy challenges. In the current situation, with its signs of economic recovery—albeit with uncertainties of how well entrenched growth is—policy makers face a dilemma. Too slow a removal of the fiscal stimulus may lead to a quick uptake of inflation and force them to raise interest rates by more than they would otherwise choose. Alternatively, too rapid a removal of monetary accommodation may lead the economy to stall and prolong the downturn.

Given the repeated occurrence of food price inflation in recent years, one of the major medium-term challenges of the central government is to design and implement a comprehensive plan for augmenting the domestic supply of food products, including vegetables and dairy products. The policy cannot be restricted to measures that enhance agricultural productivity. It needs to encompass many related issues including pricing, distribution, trade, subsidies, infrastructure, and research.

More specifically, one aim is to increase farmgate prices to trigger effective supply-side responses while containing retail prices, in order to mitigate erosion of purchasing power and adverse impacts on the poor. Since nearly half the food produced is lost from field to table, there is ample scope for solutions.

Finally, sustained acceleration in growth requires significant infrastructure building. Although much of the necessary investment will have to be privately funded, the government is tasked with substantially raising its own contribution. This is going to require real dexterity, especially at a time when its priority is to contain the fiscal deficit. It can release additional funding for infrastructure spending by containing subsidies as part of the consolidation of current expenditure and by promoting alternative sources of investment financing, such as public–private partnerships.

Maldives

Too rapid fiscal expansion in recent years and a global recession–induced drop in tourism have taken the economy to the brink of crisis. A new government is attempting to correct structural imbalances and restore sustainable growth, including broadening the revenue base, rationalizing expenditure, and retrenching public employment. It also supports privatization as part of a wider shift of the role of government.

Economic performance

After the December 2004 tsunami disaster, the economy rebounded on the back of large tourism-related investment and substantial increases in government spending. The fiscal expansion was, however, excessive, including as it did large increases in public sector wages and employment as well as subsidies. It pushed budget expenditure to 63.1% of GDP by 2008 and the overall deficit to 16.9% of GDP.

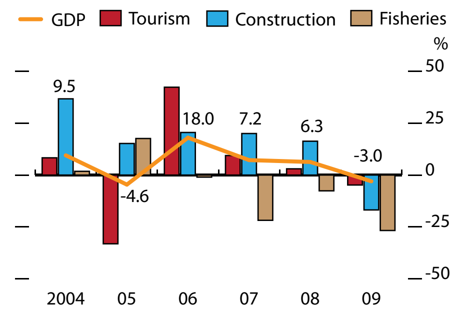
Given high import dependency, this fiscal expansion led to a marked balance-of-payments deterioration. When the country was hit by a drop in tourism after the start of the global crisis in September 2008, the heavy domestic and external imbalances threatened macroeconomic stability.

In these circumstances the economy struggled, with GDP dropping by 3.0% (a 9 percentage point tumble) in 2009, due primarily to contractions in tourism (the current economic mainstay), construction, and fisheries, by 4.8%, 16.8%, and 26.7% respectively (Figure 3.18.1). Tourist arrivals declined by 4.0% in 2009; indeed, the drop would have been even worse had it not been for a surge in arrivals from the People's Republic of China, which helped offset a 7.1% fall in European visitors, a market usually responsible for around two-thirds of visitors (Figure 3.18.2). Hotel occupancy rates declined to 70% from 78% the previous year. Fishing, the main source of employment, saw a 22% decline in the catch. Total fish and fish product exports fell by 36%, in part reflecting a drop in prices.

Since the country imports the bulk of its goods, domestic price volatility is largely attributable to price pressures in global markets. After consumer inflation peaked at 17.3% year on year in July 2008, the high price hikes quickly moderated, as evidenced by inflation declining to 4.0% by December 2009 (Figure 3.18.3). Inflation averaged 4.0% in 2009, down from 12.3% a year earlier. A drop in food prices—at one-third, the most heavily weighted component in the consumer basket—was the main factor in the decline.

Broad money grew by 12.5% in 2009 (Figure 3.18.4). This expansion was due primarily to a 14% increase in net domestic assets as net foreign liabilities were reduced. The expansion in net domestic assets was entirely due to continued large expansion in net credit to government,

3.18.1 Selected GDP growth indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv
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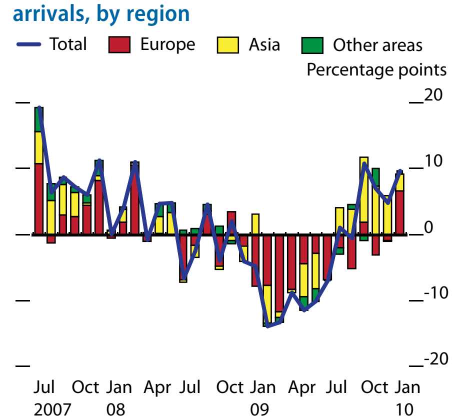
3.18.2 Contributions to growth in tourist arrivals, by region



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv
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This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

while credit to the private sector fell by 4.1% (in contrast to about a 30% expansion a year earlier) as the government bond issue, which replaced financing by the monetary authority as part of structural reform, crowded out private investment.

Total fiscal revenue, including grants, is estimated to have deteriorated by 20% in 2009 to 31.6% of GDP from 46.2% in 2008 (Figure 3.18.5). All major sources of tax revenue fell, reflecting a 30% drop in imports and the decline in tourism. Total expenditure climbed by about 7%, well below the near 23% increase in 2008, as the government tried to rein in the deficit, including wage cuts for civil servants. Still, the deficit expanded sharply to 26.1% of GDP from 16.9% a year earlier with just over three-quarters financed by the banking system.

The current account deficit surged from 15.7% of GDP in 2004 to 51.4% in 2008 owing to strong domestic demand led by new resort construction, large government expenditure, and soaring food and oil prices after 2007. As international prices stabilized and economic activity fell, the deficit is estimated to have fallen to a still-high 28.5% of GDP in 2009 (Figure 3.18.6).

Capital inflows have in large part financed the large deficit. The main items have been investment inflows for resort development, greater lending by Malé-based branches of two foreign commercial banks, and foreign borrowing by the government. Since the onset of the global crisis, foreign banks in Malé have sharply curtailed their lending, which has led to a shortage of dollars in the domestic market—a particularly acute problem in a dollarized economy. As the monetary authority intervened to maintain the fixed exchange rate with dollar, gross international reserves declined to $207 million in September 2009 before showing a slight retracement.

In an attempt to restore macroeconomic stability, the current President, who was elected in October 2008, began to implement an emergency economic reform program that includes substantial fiscal reform. On the revenue side, airport passenger service charge has been raised, a business profit tax will be introduced, and the tourism bed tax will be transformed into a tourism goods and service tax, yielding substantially higher revenue.

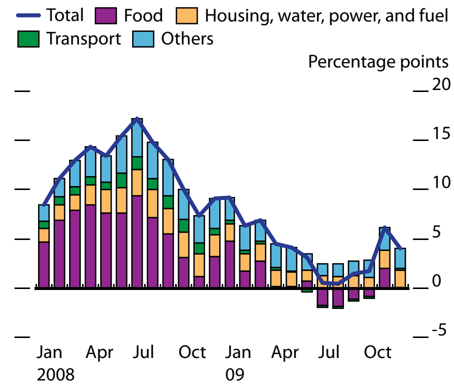
In order to align expenditures with revenues, the government is streamlining administrative machinery by downsizing the civil service, reducing electricity subsidies, and linking power tariff adjustments to cost of inputs twice a year. The government also plans to privatize parts of the extensive network of state-owned enterprises.

To support the government's reform program, the IMF approved in December 2009 a $79.3 million standby arrangement and $13.2 million under a program to deal with external shocks.

Economic prospects

The economic outlook heavily depends on performance of tourism and fisheries, as well as the government's ability to push through its reform measures. Although fisheries constitute a small fraction of GDP growth, they remain vital in the economy as they are the main provider of food and employment in many of the atolls. And, while tourist arrivals have

3.18.3 Contributions to inflation



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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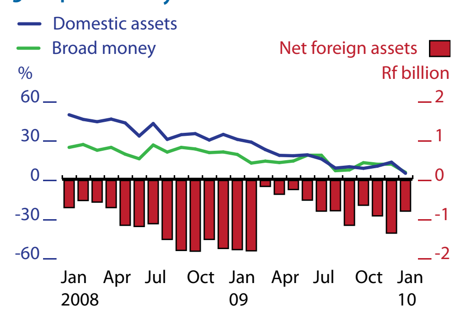
3.18.4 Monetary indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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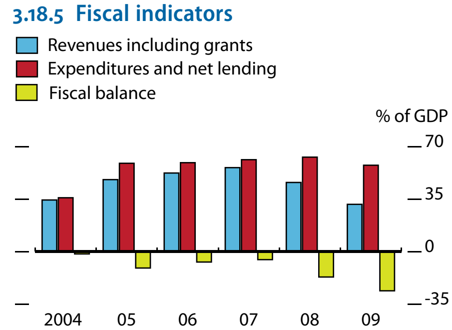
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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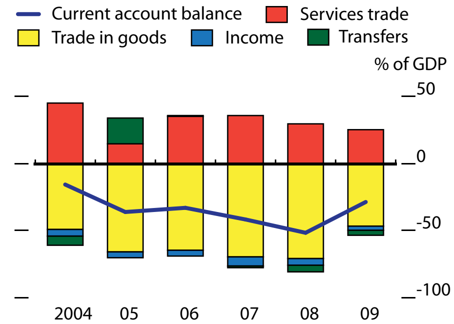
seemingly bounced off the bottom, driven by non-European arrivals, it will no doubt be some time before arrivals from Europe recover to precrisis levels.

With a better than initially expected economic outcome in 2009, the economy is projected to grow at 3.0% for 2010 and 3.5% in 2011. Inflation is put at 4.0% in 2010 and 3.0% in 2011, broadly in line with global commodity price assumptions where oil prices are expected to rise marginally and nonfuel commodity prices to remain stable. It is also assumed that the monetary authority will aim policy to support price stability and not provide financing for the fiscal deficit.

On the external front, lower commodity prices will ease the trade deficit, but receipts from tourism will recover only from next year. The current account deficit is expected to remain flat at 25.0% of GDP in the forecast period.

3.18.6 Current account indicators



Source: Maldives Monetary Authority. 2010. *Monthly Statistics*. February. http://www.mma.gov.mv

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Development challenges

As a tiny, open economy the country is vulnerable to events beyond its control—including geopolitics, global economic developments, and climate change. Within its domain, however, the government needs to correct structural economic imbalances, primarily via fiscal reform and consolidation as well as privatization of state-owned enterprises. In view of the limited role of monetary policy under the currency peg with US dollar, fiscal policy has to play the greater role in demand management and economic stabilization. In addition, weak institutions and human resource deficiencies are major constraints, including the fragmented structure of government.

As the country lacks the natural capacity to expand its economic base beyond tourism and fisheries, increasing value added in those sectors is vital. The government aims, within tourism, to ensure better training of local staff to limit the current heavy reliance on expatriates, and within fisheries, to promote exports.

The significant income disparities between Malé and the atolls are continually widening. The government has an intention to group the atolls into seven provinces and develop regional administration and economic centers. Its hope is to concentrate and thereby improve service delivery, but given that it aims to reduce the cost to itself at the same time, this is a tall order.

Recognizing the country's vulnerability to climate change (none of the islands is more than 1.8 meters above sea level), in the short term, all the government can do is attempt to minimize the disaster impact, and therefore has strengthened mitigation responses for beach erosion. By 2019, the government has committed to switching from oil to 100% renewable energy production to serve as a model for other nations.

3.18.1 Selected economic indicators (%)

	2010	2011
GDP growth	3.0	3.5
Inflation	4.0	3.0
Current account balance (share of GDP)	-25.0	-25.0

Source: ADB estimates.

Nepal

The global economic crisis had a limited impact, but despite that, political uncertainties, poor weather, and infrastructure bottlenecks restrained economic growth in FY2009. With the political uncertainties remaining and macroeconomic challenges emerging, GDP growth will be below par in FY2010. But it is likely to pick up in FY2011, on account of continued sound fiscal management, strengthening global economic recovery, and some easing of supply disruptions.

Economic performance

The continuing peace process—marked by controversies over the rehabilitation of the Maoist combatants and transformation to a federal structure from the current unitary system—led to frequent strikes and transport blockades, which acted as a break on the much anticipated postconflict economic recovery in FY2009 (ended July 2009). Coupled with unfavorable weather, these setbacks slowed GDP growth to 4.7% in FY2009, from 5.3% the year before.

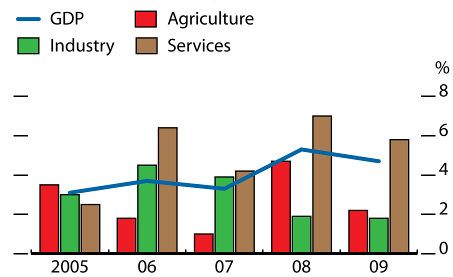
Although the deceleration was broad-based (Figure 3.19.1), services still grew by 5.8%, mainly supported by sturdy remittance-related spending. Agricultural growth fell by more than half to 2.2% due to a delayed monsoon and prolonged winter drought, which reduced both the cultivated area and productivity. Industry remained a sluggish performer, as labor unrest and persistent fuel and power shortages led to a contraction in manufacturing, which was marginally offset by increased activity in the remittance-driven construction industry.

On the demand side, rapid growth in remittances continued to fuel consumption spending and imports, further raising the share of private consumption in GDP from 77.1% in FY2008 to 79.2% in FY2009. The share of private fixed capital formation decreased modestly to 17.1% of GDP from 18.0% over the same period, reflecting uncertainty in the political landscape and limited investment opportunities other than real estate and housing.

Slower agricultural growth and disruptions to transportation produced shortages of foodgrains in several parts of the country, especially remote districts, driving up inflation to an average of 13.2% in FY2009 from 7.7% a year earlier. While food price inflation has been generally trending up in the last few years, the increment in FY2009 was more pronounced (Figure 3.19.2). Inflation was exacerbated by a strong expansion in the broad money supply in FY2008 and FY2009, which reflected larger remittance inflows and the buildup of net foreign assets.

To rein in the rising inflation and to curb the remittance-driven real estate bubble in urban areas, Nepal Rastra Bank (NRB), the central bank, tightened monetary policy by raising the cash-reserve ratio from 5.0%

3.19.1 GDP growth by sector



Source: Ministry of Finance. 2009. *Economic Survey Fiscal Year 2008/09*. July. http://www.mof.gov.np

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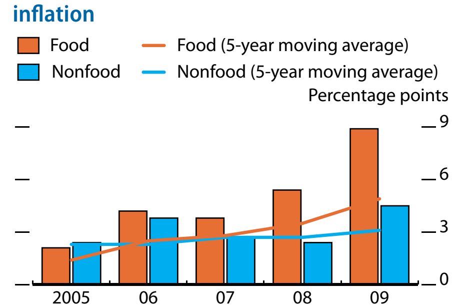
3.19.2 Contribution to consumer price inflation



Source: Nepal Rastra Bank. 2009. *Recent Macroeconomic Situation*. September. http://www.nrb.org.np

Click here for figure data

This chapter was written by Yubraj Acharya of the Nepal Resident Mission, ADB, Kathmandu.

to 5.5% (effective November 2008) and the policy rate from 6.25% to 6.5% (effective October 2008).

On the fiscal side, the government undertook several reforms on revenue mobilization, including the introduction of an income disclosure scheme and implementation of a performance-based incentive system for tax offices and officers. These reforms widened the tax base substantially and curtailed leakages, resulting in a record 32% growth in domestic revenue mobilization in FY2009 (well above the 3-year trend). For the first time, income tax collection exceeded customs revenue (Figure 3.19.3). External grants also swelled, by 70%, as donors sought to support Nepal during its political transition.

Despite the delayed approval of the budget (due to disagreements among various factions in the Constituent Assembly) and a difficult project implementation environment, capital spending picked up in the latter part of FY2009, increasing by 30% from a year earlier (Figure 3.19.4). Political pressures to raise salaries and wages of civil servants and security forces resulted in 33% growth in recurrent expenditures, contributing to the 32% growth in overall spending (excluding net lending). The resulting deficit, equivalent to 1.9% of GDP, was financed mainly through domestic borrowing.

On the external front, import growth markedly slowed to 8.3% from 24.1% in FY2008, mainly because of a decline in oil imports. (Nepal Oil Corporation, the state-owned and sole supplier of petroleum products, struggled to clear its dues with the Indian Oil Corporation.) Imports of other items continued to grow in line with the historical average. Exports contracted by 4.7% in FY2009, the first decline since FY2003, as some domestic enterprises shut their operations, both because of intense foreign competition in a weak market and domestic labor disruptions, and because of the long-standing structural bottlenecks such as poor infrastructure and skills shortages.

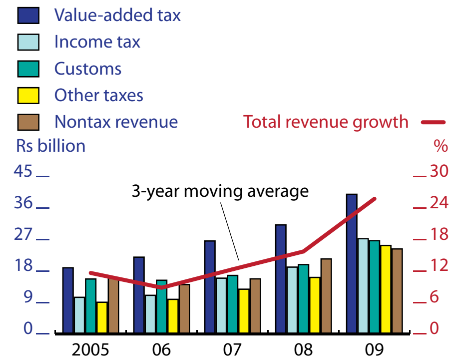
The resulting wider trade deficit (21.8% of GDP after 19.1% in FY2008) was, however, more than offset by remittance inflows, which grew by 24.2% (mainly due to the relatively inelastic demand for the unskilled Nepalese workers) and by a 26.7% increase in tourism receipts (Figure 3.19.5). With a strengthening current account surplus—from 2.9% of GDP in FY2008 to 4.3%—the overall balance-of-payments position became stronger, with over $2.8 billion in reserves (equivalent to 7.7 months of total imports).

Given the continued peg to the Indian rupee, the Nepalese rupee mirrored the former currency—depreciating rapidly against third country currencies at the onset of the global crisis and appreciating after May 2009. However, the real effective exchange rate has been appreciating since August 2008 (Figure 3.19.6), reflecting relatively high domestic inflation.

Economic prospects

Nepal's medium-term growth and development prospects hinge on progress in the political transition, macroeconomic stability, and the pace of global economic recovery. With a high share of agriculture in GDP, much of which relies on rainfed irrigation, prospects also heavily depend on weather conditions.

3.19.3 Revenue indicators



Source: Nepal Rastra Bank. 2009. *Recent Macroeconomic Situation.* September. http://www.nrb.org.np
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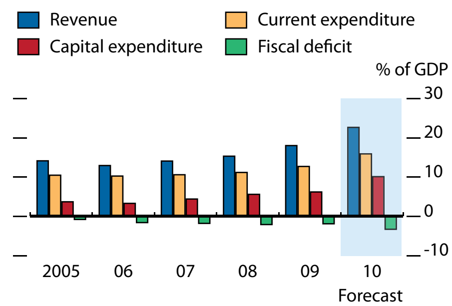
3.19.4 Fiscal indicators



Sources: Ministry of Finance. 2009. *Economic Survey Fiscal Year 2008/09.* July. http://www.mof.gov.np; ADB estimates.
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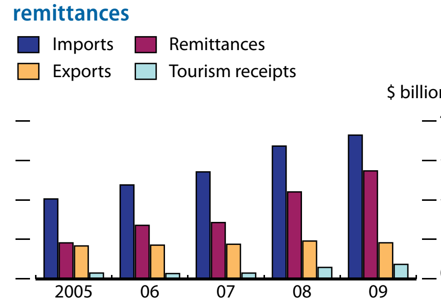
3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank. 2009. *Recent Macroeconomic Situation.* September. http://www.nrb.org.np
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A range of factors are challenging the sound macroeconomic management seen in previous years (despite the political turmoil then). Notably, the initial resilience seen in remittances and exports faded in the first half of FY2010 and reserves have declined modestly since July 2009 (Figure 3.19.7), raising concerns that a lagged effect of the crisis may still be felt.

Growth in all sectors is expected to decelerate in FY2010 from FY2009 with overall GDP expansion expected to ease to 3.5%, on the assumption that, with the emerging global recovery, remittance inflows and tourism receipts will not decelerate further. The possible delay in writing the new constitution before the 28 May deadline constitutes the key downside risk to the outlook, as political uncertainties can affect the investment climate and the project-implementation environment. Assuming continued recovery in the global economy and a domestic political landscape more conducive to economic activity, growth is expected to pick up to 4.5% in FY2011 (on a par with that in FY2009).

Agriculture is expected to grow by only 1.0% in FY2010, assuming normal winter weather, as the production of paddy and maize, two major summer crops, was severely affected by the delayed and reduced monsoon. Assuming a return to normal weather and no disruptions to the transportation of fertilizers and seeds, the sector is expected to grow by its historical average of 3.0% in FY2011.

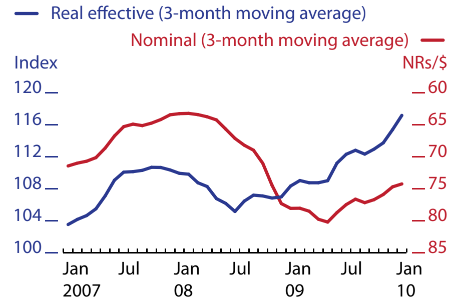
Industry's performance in FY2010 will be checked by fuel and power shortages and sporadic labor tensions, all of which will restrict recovery in manufacturing. Construction activity will also slow due to reduced credit from commercial banks. Consequently, industry is expected to grow by only 1.5% in FY2010. Growth is expected to pick up to 2.5% in FY2011 as power shortages ease somewhat (several micro-hydropower projects are slated for completion in FY2010) and as strikes lessen (the political parties have signed an agreement not to organize any *bandh*—politically inspired economic shutdowns—during Visit Nepal Year 2011).

Services are expected to continue to drive growth, although real estate renting and business activities will be hit by credit limitations that the NRB has placed on commercial banks to counter price pressures. Expansion in services is expected to moderate to 5.5% in FY2010. As performance in agriculture, industry, and tourism is expected to improve in FY2011, growth in services will be pushed up to 6.0%.

While the NRB's tighter monetary policy from FY2009 seems to be working to reduce inflation, the pass-through from the policy rate and cash-reserve ratio to inflation has been slow and small. Consumer price index inflation remained in double-digits in January 2010, suggesting that nonmonetary factors, such as reduced grain production, rising transportation costs, and delays in importing certain items like sugar, may be driving up inflation. Therefore, 10.0% inflation is expected in FY2010, with moderation to 8.0% in FY2011 as supply disruptions lessen.

The current account is expected to move into deficit in FY2010. Rising oil prices will have a significant bearing on imports as oil constitutes 17% of Nepal's total imports. Imports of other items will moderate, adjusting to decelerating remittance inflows, but this moderation is unlikely to fully offset the effect of rising oil prices on overall imports. With reduced competitiveness from the appreciating real exchange rate and domestic

3.19.6 Exchange rates



Source: International Monetary Fund.

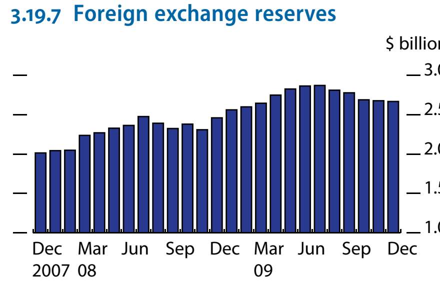
Click here for figure data

3.19.1 Selected economic indicators (%)

	2010	2011
GDP growth	3.5	4.5
Inflation	10.0	8.0
Current account balance (share of GDP)	-0.5	1.0

Source: ADB estimates.

3.19.7 Foreign exchange reserves



Source: Nepal Rastra Bank. 2010. *Recent Macroeconomic Situation.* March. http://www.nrb.org.np

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structural shortcomings that continue to plague key industries, exports will continue to decline in absolute terms. Remittances and tourism receipts, growing at their current pace, will fail to offset the trade deficit, leading to a current account deficit of approximately 0.5% of GDP.

In FY2011, remittances are expected to strengthen as the majority of Nepalese workers are employed in oil-exporting countries in the Middle East that are seeing a revival in growth. Moreover, improved industrial activity and some moderation in the appreciation of the real exchange rate are expected to support growth in exports. Aided by larger tourism receipts, the current account is expected to recover to a surplus of 1.0% of GDP.

Development challenges

The infrastructure deficit—particularly in transport infrastructure, power, and irrigation—is a major bottleneck to economic growth and to development prospects. In particular, power shortages could have adverse social and political implications if not addressed expeditiously.

Despite the large hydropower potential of around 80,000 megawatts, half of which is economically viable, Nepal is a net importer of electricity. The electrification rate, at 48% in 2006, is one of the lowest in South Asia, and means that more than 13 million mainly rural people are without access to electricity. In urban areas, current peak demand is more than 720 megawatts, of which only 40% is available, leading to up to 16 hours of daily power cuts. A range of factors have contributed to underinvestment in power generation, including the uncertain investment climate, poor road access, and lack of transmission lines.

The government is preparing a new energy strategy to promote the power sector, but its implementation is likely to remain challenging unless a political consensus is built. Two draft bills—the Nepal electricity bill and the Nepal electricity commission bill—are currently before the Constituent Assembly. In the meantime, the government is focusing on repairing and upgrading existing generation, transmission, and distribution infrastructure. It is also planning to expand existing transmission links to India, and develop new high-capacity cross border lines, to enable importation during dry periods. Recognizing the capital-intensive nature of hydropower projects, the government should develop a policy framework to encourage public–private partnerships, clearly delineating public and private sector roles. The policy should include other modes of power generation including solar, wind, and thermal.

In the restructuring of policies, the government should give to private power producers economically viable market access by clarifying and liberalizing connection and tariff policy, and should provide related infrastructure, such as access roads and distribution lines. A fast-track approval process for hydropower projects needs to established. Policy efforts should go beyond rural electrification and mitigating power shortages in urban areas, to include a focus on export of electricity to make hydropower a major source of foreign currency earnings.

To facilitate some of these changes, the capacity of the newly created Ministry of Energy should be augmented and the financial health of Nepal Electricity Authority, the key buyer and distributor of electricity, needs to be improved.

Pakistan

Continued modest growth is expected in fiscal year 2010. Macroeconomic imbalances have narrowed and economic fundamentals have improved, but the security environment and an ongoing power crisis are both burdening the fiscal situation and obstructing a growth revival. That revival will depend on faster implementation of structural reforms to strengthen revenue mobilization, eliminate electricity outages, and transform the industrial and export sectors. Rapid fiscal improvements are also needed to underpin recovery, sustain the public sector development program, and prevent crowding out of the private sector.

Economic performance

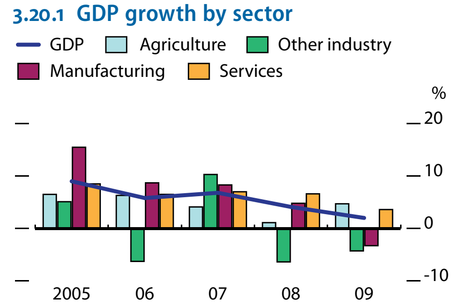
The country's recourse to an International Monetary Fund (IMF) program in November 2008 (see *ADO 2009* and *ADO 2009 Update*) and its need for fiscal and balance-of-payments stabilization coincided with the onslaught of the global recession, precluding any immediate fiscal or monetary policy response. This lack of response, together with the deteriorating security situation and electricity shortages, saw growth slow further to only 2.0% in FY2009 (ended June 2009), from 4.1% in FY2008 (and from an average of over 7% in the 4 years prior to that).

Manufacturing contracted (Figure 3.20.1), and trade and services slowed. Both public and private investment shrank. With economic growth down to near the rate of population growth, per capita incomes stagnated (Figure 3.20.2), affecting poverty rates. In this way, the difficult economic circumstances of FY2008 carried over into FY2009, and revealed how years of seemingly sustainable growth can unravel in a single year because of structural problems in the face of exogenous shocks and delayed policy response to such shocks.

The global downturn, security challenges, and energy shortages, by subduing industrial and export growth, also contributed to underachievement of tax collection targets in a year of expenditure overruns. The tax-to-GDP ratio in FY2009, for taxes collected by the Federal Board of Revenue, fell to a 10-year low of only 8.8%. This ratio indicates a lack of buoyancy in the tax system and calls for urgent reform in tax policy and administration.

The fiscal deficit was further undermined by the additional defense outlays necessitated by military action against extremists. The fiscal deficit target in FY2009 was, therefore, missed and at 5.2% of GDP, was 0.9 percentage points wider than projected. The target was overshot even though the government had started cutting subsidies and was reducing the public sector development program (PSDP) as part of its expenditure rationalization program. From 3.8% of GDP in FY2008, it cut subsidies to 1.9% of GDP in FY2009 (Figure 3.20.3), as it allowed domestic fuel prices to float with international prices.

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk

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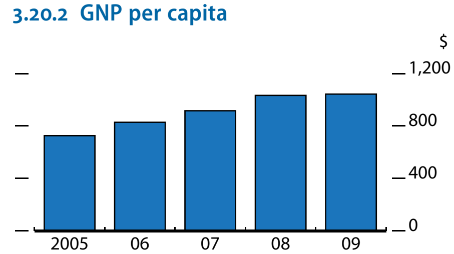
3.20.2 GNP per capita



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk; State Bank of Pakistan. *Annual Report 2008–09*. http://www.sbp.org.pk

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This chapter was written by Safdar Parvez and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

Electricity subsidies, however, stayed very high at 44% of total subsidies in FY2009 and remained a significant budget burden. The government is phasing in a power tariff increase to reduce these subsidies, but since the tariff is expected to reach cost recovery only in the first quarter of FY2011, cash subsidies will continue to be paid over the rest of FY2010.

Despite the increase in costs of production, consumers' electricity tariffs had not been increased for several years before FY2008 when the oil price hike substantially raised generation costs and the need for much higher tariff differential subsidies. The lack, however, of timely subsidy payments created an "intercorporate circular debt" problem—when distribution companies could not pay power producers, who, in turn, could not pay fuel suppliers.

This led to power plants' inability to produce at optimum capacity, thus adding to existing power shortages. Load shedding has continued, with power shortages peaking at 5,000 megawatts in the summer time. To improve operations in the power sector, the government in September 2009 paid off part of its circular debt while paying interest on its outstanding obligations. The circular debt is now being transferred to a debt-holding company for servicing and resolution.

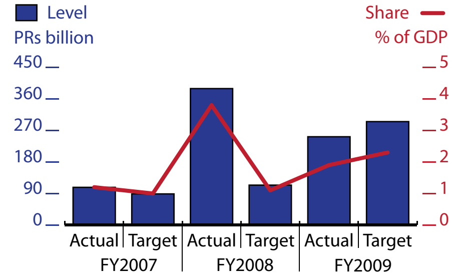
The PSDP, already slashed to 4.4% of GDP in FY2008 (from a targeted 5.1% of GDP), was cut further in FY2009 to 3.0% of GDP as part of the effort to rein in the deficit (Figure 3.20.4). As a result, expenditure on education fell further to 2.1% of GDP in FY2009 from the already low 2.5% of GDP in FY2008, and on health from 0.6% to 0.5% in the same period. Such weak social sector expenditures are difficult to justify in a country whose human development index ranking of 141 places it toward the bottom.

Even with the cuts in subsidies and the PSDP, financing the deficit in FY2009 posed major problems at a time when few foreign resources were available: only 22% of the deficit was financed with external resources compared with 53% in FY2007. More than half the domestic financing was arranged through banks. The higher cut-off yields encouraged banks to invest in Treasury bills when their eagerness to lend to the private sector was dented by a higher concentration of nonperforming loans and a risky business environment.

The government's preemption of banking sector funds in this way resulted in lower availability of credit for the private sector. The private sector's demand for credit had also diminished on account of higher interest rates and other constraining structural factors, such as electricity shortages. As a result, private sector credit nosedived to a negligible net level in FY2009 (Figure 3.20.5).

In the high inflation environment of late FY2008 and the first half of FY2009—spawned by higher food and nonfood prices and reduction of oil and energy subsidies—the State Bank of Pakistan (SBP) sharply tightened monetary policy through hikes in the policy discount rate. The policy rate peaked at 15% in October 2008 as year-on-year inflation surged (Figure 3.20.6). The rate was then gradually brought down by 250 basis points from April to November 2009, as there was a trend decline in year-on-year inflation that receded to less than 9% by October 2009. Both food and nonfood consumer price indexes had fallen sharply by then. Despite the private sector's demand for a sharper cut in interest rates, the

3.20.3 Subsidies



Source: Ministry of Finance. *Annual Budget Statements*. http://www.finance.gov.pk
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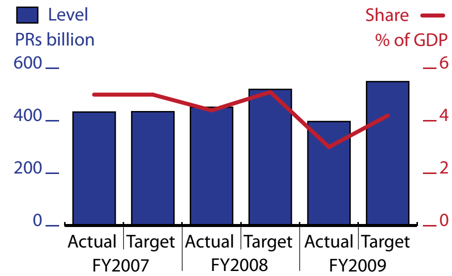
3.20.4 Public sector development program



Source: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk
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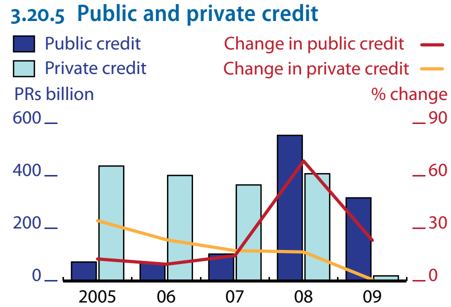
3.20.5 Public and private credit



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2010).
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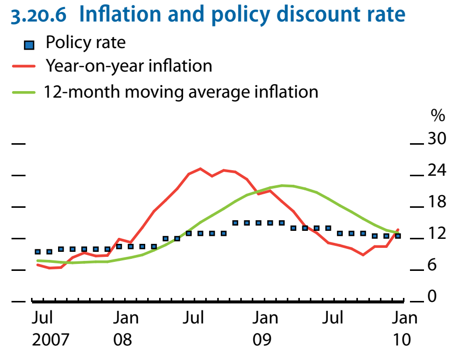
3.20.6 Inflation and policy discount rate



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2010).
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SBP's measured response at that time, mindful of the downside risks to inflation, was nonetheless appropriate. (The sharp resurgence in year-on-year inflation in January 2010 was to prove this later.)

The economic slowdown in FY2009, combined with tighter demand management policies, the fall in international oil prices, and a depreciated currency, led to a sharp fall in imports of over 10% in FY2009 (Figure 3.20.7). As exports fell by more than 6%, because of lower international demand, domestic security challenges, and electricity shortages, the trade deficit narrowed. High double-digit inflation diminished any competitiveness advantage exports might have gained due to a 16.4% depreciation in the average nominal effective exchange rate in FY2009 (Figure 3.20.8). The average real effective exchange rate depreciated by only 0.9%, while the competitiveness of exports remained blocked by structural bottlenecks.

The contraction in the trade deficit was complemented by a steep 48% shrinkage in the services account deficit. That account improved mainly due to receipts for logistical support to the United States in Afghanistan and to a decline in outflows from foreign exchange companies following administrative measures taken by the SBP. The current account deficit in FY2009 fell by a third to 5.6% of GDP (Figure 3.20.9), helped by remittances that continued to defy the global recession, growing by 21%.

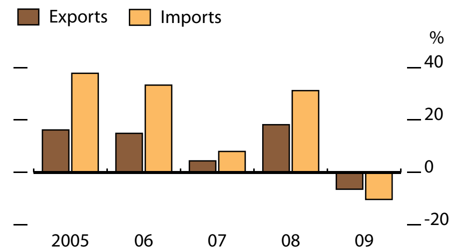
Foreign direct investment (FDI) and net portfolio investment together fell to half the level of the preceding year, on account of the global economic slowdown and the domestic situation (Figure 3.20.10). Approximately 55% of the $9.3 billion current account deficit was financed by disbursements from multilateral institutions and aid agencies. This implies a high dependence on official borrowings that not only makes current account financing vulnerable but also has adverse implications for the country's external debt profile.

Foreign reserves recovered strongly by end-FY2009 (Figure 3.20.11) with the IMF's support for the balance of payments totaling $12.4 billion (and further to $15.1 billion by end-December 2009). But the ratio of reserves to external debt still declined, as higher reserves were offset by new external debt, which shot up by $6.3 billion in FY2009. This buildup of debt reversed, for the first time in 6 years, the trend decline in the ratio of external debt to GDP, which increased to 30.4% in FY2009 from 27.0% in FY2008. External debt grew by 14.1% in dollar terms, but jumped by 36% in Pakistan rupee terms, over the same period (Figure 3.20.12).

Domestic debt rose by PRs587 billion to PRs3.9 trillion in FY2009 (or 29.4% of GDP); almost half the increase was short term. Overall public debt continued to hover around 61% of GDP. Debt-servicing ratios therefore deteriorated, and debt servicing consumed more than half the total tax revenue in FY2009, representing a major drain on fiscal resources.

Although the IMF's third review in January 2010 of the ongoing standby arrangement projects that Pakistan's debt-to-GDP ratios will begin to decline from FY2012, it also shows that the external and public debt trajectories from the baseline are vulnerable to shocks, such as those arising from lower growth, higher imbalances, lower FDI, and larger local currency depreciation. Consequently, the fiscal and current account deficits need to be contained and higher non-debt-creating

3.20.7 Trade growth



Source: State Bank of Pakistan, *Annual Report 2008–09*. http://www.sbp.org.pk (accessed 11 March 2010).

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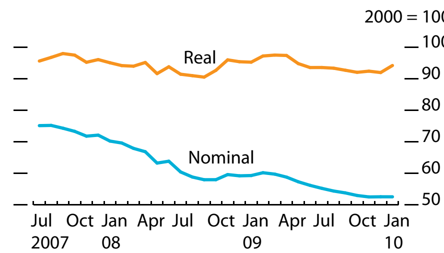
3.20.8 Effective exchange rates



Source: State Bank of Pakistan. 2010. *Statistical Bulletin*. March. http://www.sbp.org.pk

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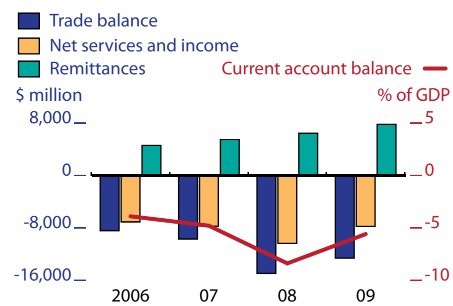
3.20.9 Current account indicators



Source: State Bank of Pakistan. *Annual Report 2008–09*. http://www.sbp.org.pk (accessed 11 March 2010).

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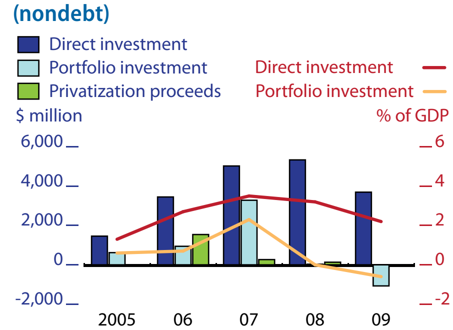
3.20.10 Financial account indicators (nondebt)



Source: State Bank of Pakistan. *Annual Report 2008–09*. http://www.sbp.org.pk (accessed 11 March 2010).

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inflows have to be resumed for debt sustainability to be maintained in the near and medium term.

Economic prospects

Pakistan's economic prospects over the next 2 years are predicated on a successful completion of the current IMF program by end-2010; a gradual improvement in the security situation; a phased reduction in electricity shortages as tariffs are rationalized and new power plants are commissioned; sustained implementation of fiscal reforms, particularly for tax and administration; a gradual economic recovery in the main trading partners; and political stability.

Growth in FY2010 is expected to modestly improve to 3.0%, backed by a slight recovery in manufacturing. This recovery, apparent in the first half of FY2010, reflects (among other factors) higher production for cement products for the local market and stronger domestic demand for automobiles. Textiles manufacturing, however, has continued to contract on account of lower cotton availability, electricity and gas shortages, and poorer relative product competitiveness in international markets.

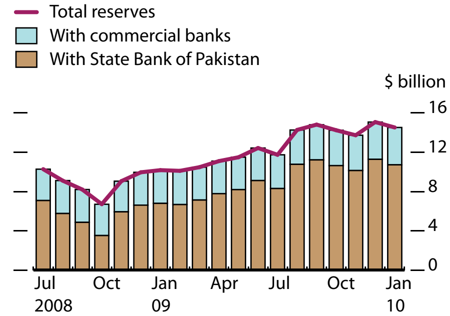
Agricultural growth in FY2010 is set to remain below the government's target owing to lower than targeted production of most major crops, such as sugarcane and cotton. Production of wheat, a winter crop, will be less than the target of 25 million tons due to water and seed shortages, delayed sowing, and higher input costs.

Slower growth in agriculture, only a modest recovery in manufacturing, and continued contraction in imports will all continue to drag down wholesale and retail trade. Following years of strong growth, telecommunications service providers, too, will need to consolidate operations (because of stronger competition and lower margins). Financial services could, however, perform better than in FY2009, as seen in slower growth in nonperforming loans in the first half of FY2010, improving profitability of banks following higher spreads, and banks' good capitalization. The services sector overall will grow only moderately.

GDP growth is expected to reach about 4.0% in FY2011 as private sector investment picks up following gradual improvement in the security situation and fewer electricity shortages, and as public investment accelerates, supported by an improved fiscal situation with value-added tax (VAT) and other administrative tax reforms kicking in from 1 July 2010. Manufacturing growth is also expected to be stronger, as is agriculture's (to a lesser degree) on the back of higher commodity prices. Higher real sector expansion with larger international trade volumes and an improving financial sector should catalyze further growth in services.

The modest growth projected for FY2010 will make it hard for the Federal Board of Revenue to achieve its revenue target. However, higher oil and electricity prices (by way of larger customs revenues and sales tax receipts) will compensate somewhat for lower direct tax collections. Yet with higher than budgeted defense spending, the fiscal deficit target of 4.9% of GDP for FY2010 will be missed, and the government is now

3.20.11 Foreign exchange reserves



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 3 March 2010).

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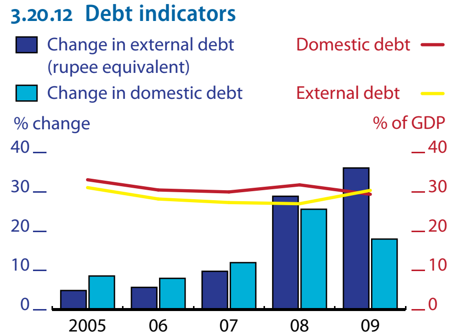
3.20.12 Debt indicators



Source: State Bank of Pakistan. *Annual Report 2008–09.* http://www.sbp.org.pk (accessed 3 March 2010).

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3.20.1 Selected economic indicators (%)

	2010	2011
GDP growth	3.0	4.0
Inflation	12.0	8.0
Current account balance (share of GDP)	-3.6	-4.2

Source: ADB estimates.

targeting a deficit of 5.1%. But this too could be overshot in case of further shortfalls in tax and nontax revenues.

Even with this larger fiscal deficit target, PSDP spending, although higher in the first half of FY2010 than in the same period in FY2009, will need to be reduced to accommodate higher defense spending, and will end up being lower than planned under the budget for FY2010. To contain current expenditure, the government in December 2009 announced austerity measures including reducing the number of federal ministries and slashing administrative expenses related to the offices of the President and the Prime Minister. It also set up a cabinet committee to restructure loss-making state-owned enterprises. For 2011, resource pressures will continue to weigh on the central government, owing to restructuring of shared taxes and responsibilities between the central and state governments (Box 3.20.1).

The key issue with the fiscal deficit remains its financing. A much larger than planned recourse to the domestic credit market to finance the deficit was required in FY2009 as external sources of financing dried up. The trend continued in the first half of FY2010. To this end, in the first 8 months of FY2010, the government borrowed PRs191 billion from commercial banks, although it kept borrowings from the central bank in check.

In addition to bank financing, nonbank domestic financing of the deficit mainly through the National Saving Schemes jumped sharply. Such borrowings at end-2009 relative to end-2008 were PRs300 billion higher. Continued high levels of domestic financing from bank and nonbank sources is unsustainable from the standpoint of fiscal stability and not desirable from the perspective of mobilization of deposits by commercial banks, credit availability for the private sector, and growth.

Continued recourse to such sources is partly due to the delays in foreign disbursements projected under the Friends of Democratic Pakistan (FODP) aid group—a part of these unrealized disbursements is being temporarily made up by the IMF's bridge-financing under the standby arrangement. The fiscal framework for FY2010 had relied heavily on such external resources for financing. The fiscal deficit target for the year might yet need to be scaled back if the projected FODP disbursements are not realized.

Inflation in FY2010 is expected to fall from its peak of the previous fiscal year due to the base effect, a sharp year-on-year decline in both food and nonfood prices between July and October 2009, and a continued relatively tight monetary policy. But at a forecast 12.0%, it is still high. Looking ahead, domestic oil prices will increase in line with international prices with an automatic pass-through mechanism in place. Phased increases in electricity tariffs will also contribute to maintaining momentum in inflation during the fiscal year. In FY2011, improvement in domestic food supplies and continued fiscal and monetary discipline will help moderate inflation to 8.0%.

With projected double-digit inflation this fiscal year, the SBP will need to carefully calibrate monetary policy to maintain price stability amid strong pressure to cut interest rates further to revive growth. Control of monetary aggregates will be complicated by the government's continued large borrowing requirements from commercial banks.

3.20.1 Strengthening fiscal federalism

An agreement in December 2009 on a new National Finance Commission award that distributes resources between the federal and the provincial governments and among provincial governments is important from the point of view of strengthening fiscal federalism.

Under the award, the share of provinces in the total divisible pool of federal taxes has been increased from 47.5% currently to 56% from the next fiscal year (FY2011) and further to 57.5% for the subsequent 4 years.

Consequently, the federal government would need to meet its fiscal obligations (interest payments, defense, large development projects, etc.) with a smaller share of the divisible pool, though the size of the pool is to be boosted by the new value-added tax and other revenue-generating measures.

This will require the federal government to rationalize and restructure its expenditure obligations over time and devolve greater expenditure responsibilities to the provinces. Provinces, in turn, will need to upgrade their capacity to effectively spend the additional resources.

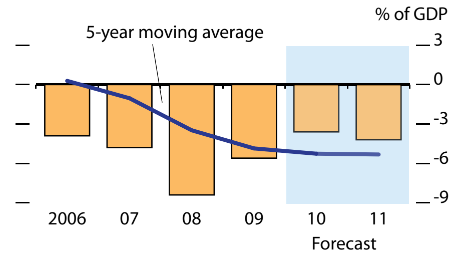
The provincial and federal governments will also need to coordinate more closely to maintain fiscal stability and meet the deficit targets.

Exports are predicted to contract once more in FY2010, although only by 1.4%. Inflation will limit depreciation of the real effective exchange rate and block increased export price competitiveness. Imports, too, will decline in FY2010 by about 2.4% from their level in FY2009 because of continued suppressed investment and economic activity. Backed by the still robust remittance inflows (up by 17.7% in the first 8 months), the current account deficit in FY2010 is projected to fall to 3.6% of GDP from 5.6% of GDP a year earlier.

The current account deficit (Figure 3.20.13) is expected to rise in FY2011 to 4.2% of GDP as imports grow by about 7.1% owing to recovery in non-oil imports, on account of stronger economic activity. Higher imports in FY2011 will, however, be offset to an extent by projected 4.2% growth in exports.

With FDI down sharply in the first 8 months of FY2010, financing the current account deficit will continue to depend heavily on debt-creating inflows from multilateral agencies, including FODP commitments. From FY2011, non-debt-creating inflows, such as foreign direct investment and privatization proceeds, could assume a greater share of such financing, but the outlook remains uncertain and debt sustainability remains a major concern.

3.20.13 Current account balance



Source: Asian Development Outlook database.

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Development challenges

Pakistan faces three interconnected development challenges. The first is its weak fiscal situation, marked by underperformance in government revenue over the years. The second is low growth and the challenge to revive it so as to create jobs and reduce poverty. The third is to improve the competitiveness of the economy so as to expand exports, sustain growth, and avoid balance-of-payments problems in the future.

Pakistan's economic crisis that erupted in FY2008 was essentially fiscal. To strengthen public finances, the government has embarked on an ambitious track of revenue reforms centering on institutionalizing the new VAT, which it estimates will yield an increase in the tax-to-GDP ratio of several percentage points. Tax administration reforms to strengthen compliance, reduce exemptions, and harmonize tax collection and monitoring systems are also under way. These reforms are critical to generate the fiscal space necessary to reinstate public investment and free up banking and nonbanking finance to support private investment.

Likewise, reforms toward a technically and financially sustainable power sector will release fiscal space and reduce the sector's strain on the budget, and, crucially, create an enabling environment for growth, investment, and business development. Medium- and long-term growth depends on sustained political commitment to these structural tax and power reforms.

Part of the competitiveness challenge is to generate a diversified, vibrant, and higher value-adding export base. Such a base will not only lead to a smaller current account deficit and improved debt profile, but will also result in higher growth and greater generation of jobs to absorb the country's growing labor force.

Sri Lanka

Chronic large budget deficits and reliance on short-term external borrowing in recent years made the economy vulnerable to a global financial crisis and recession. Heavy losses of foreign exchange reserves and a domestic downturn early in 2009 threatened an economic crisis and required a recovery program supported by financing from the International Monetary Fund. The end of the 30-year internal conflict in May, however, marked a major turning point, and an immediate revival of confidence coinciding with global economic improvement sparked an economic rebound. The outlook is positive, despite large budget deficits weighed down by reconstruction costs.

Economic performance

The economy grew by an estimated 3.5% in 2009 (Figure 3.21.1). Growth declined to 1.5% in the first quarter, but picked up rapidly after the second quarter supported by optimism over the end of 3 decades of civil war. With a revival of agriculture in Eastern province (which came under government control in 2008), the sector performed well in the first half before shrinking marginally due to drought in the third quarter.

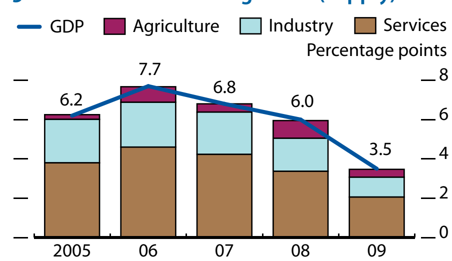
During the second half of 2009, services and manufacturing picked up sharply, driven by an upturn in domestic demand. External trade–related sectors stayed depressed throughout the year. Tourism saw a rebound after May.

Inflation had peaked at 28.2% in June 2008, driven by high global prices for food and fuel, but declines in these prices saw inflation subside to about 1% by mid-2009 (Figure 3.21.2). Prices picked up in the final quarter of the year on short supply of certain agricultural products including rice, vegetables, and coconuts, which have significant weights in the Colombo consumer price index. The annual average rate was 3.5%, down from 22.6% in 2008.

As inflation fell, the central bank eased monetary policy and cut the policy interest rates five times during the year. It also lowered the statutory reserve requirement. But despite the repeated rate cuts, commercial bank lending rates failed to come down significantly, especially in relation to indicative market rates, such as the 3-month Treasury bill rate (Figure 3.21.3). The government, in an attempt to speed up the process, directed the public sector commercial banks to bring down interest rates by 700 basis points (to 8%–12%) in October 2009.

Credit to the private sector remained in the doldrums throughout 2009, due to weak demand and banks' cautious approach to lending (Figure 3.21.4). Nonperforming loans increased, but the banking system as a whole remains well capitalized.

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*. http://www.cbsl.gov.lk; ADB estimates.

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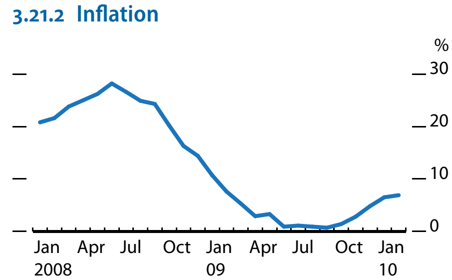
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 11 March 2010).

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This chapter was written by Nimali Hasitha Wickremasinghe of the Sri Lanka Resident Mission, ADB, Colombo.

Growth in broad money supply was subdued during the first half as the economy faltered, but accelerated in the second half, supported by a significant buildup of net foreign assets at both the central bank and commercial banks, and by an expansion of credit to the public sector. Broad money supply grew by about 19% in 2009 and was within the central bank's target.

An economic stimulus package was introduced in December 2008. It reduced prices of gasoline (petrol), diesel, kerosene, and liquefied petroleum gas; and brought in a subsidy for fertilizer for tea smallholders, and a subsidy for rubber manufacturers. In May 2009, Parliament passed a supplementary SLRs8 billion (about $70 million) package to support exporters. It included a reward scheme to grant a 5% incentive for exporters that maintained export earnings at levels similar to the year before, kept their current employment levels, and met specific domestic value-added criteria for various sectors.

Weak revenue performance and expenditure pressures pushed the 2009 budget deficit to 10.2% of GDP (excluding grants) according to the government's provisional estimates (Figure 3.21.5), substantially exceeding the planned deficit target under an International Monetary Fund (IMF) $2.6 billion standby arrangement of July 2009. Due to the slowdown in external trade and domestic economic activity, total revenue in 2009 was SLRs702 billion, well below target; and at 14.6% of GDP, revenue performance was marginally worse than a year earlier.

Expenditure increased to 24.7% of GDP in 2009 (a rise of 2.1 percentage points), accounting for the bulk of the deficit's increase from a year earlier. Expenditure pressures came from larger national security spending, provision of basic needs for internally displaced persons, greater public investment, and double-digit increases in wages and pensions and in interest payments.

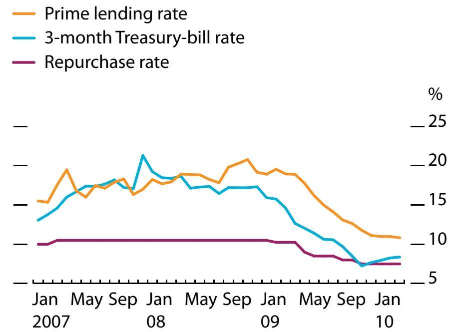
Total government debt increased by 16% in 2009 and the debt-to-GDP ratio rose from 82% to 86%. While this ratio had decreased in recent years through 2008, the structure of the debt became less favorable, with the mix shifting from concessional external borrowing to higher-cost domestic and nonconcessional external borrowing. This has increased rollover risk, while the rise in dollar-denominated domestic debt has added to the exchange rate risk.

The central objective of the IMF standby program is to reduce the fiscal deficit to a sustainable 5.0% of GDP by 2011. The government is expected to introduce reforms to broaden the tax base and reduce tax exemptions in the 2010 budget, which should assist in moving toward this target.

One of the most difficult targets of the fiscal reform effort under the standby arrangement is hitting breakeven in operations at the two loss-making state utilities, the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

As an initial step, the government established an independent regulator for the power sector in March 2009. It is also moving toward lower-cost electricity generation and has appointed a Joint Review Mechanism Committee to monitor the operations of the two enterprises and to recommend improvements. In July 2009, the government raised retail prices of gasoline and diesel by 5%–10%,

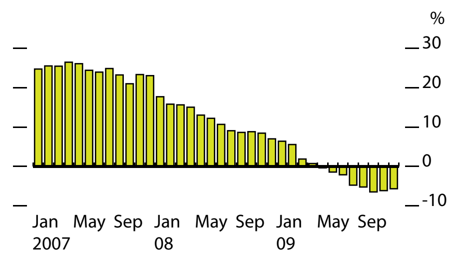
3.21.3 Interest rates



Source: Central Bank of Sri Lanka. http://www.cbsl.gov.lk (accessed 12 March 2010).

Click here for figure data

3.21.4 Private credit growth



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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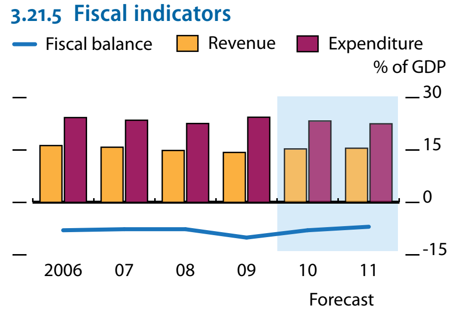
3.21.5 Fiscal indicators



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*. http://www.cbsl.gov.lk; Ministry of Finance and Planning. 2010. *Pre-Election Budgetary Position Report*. http://www.treasury.gov.lk; ADB estimates.

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moving toward full pass-through of increases in international oil prices. However, it cut gasoline prices by 11% in December 2009, prior to the presidential election in late January.

Falling global demand and prices hit both exports and imports heavily. The largest factor in the 12.9% export drop was a 15.4% decline in industrial products, due mainly to lower exports of textiles and garments, food, beverages and tobacco, machinery, and equipment. The even larger import fall of 29.4% reflected lower demand across all categories.

Remittances held up well, growing by about 14%. The shrinking trade deficit and growth in remittances took the current account into surplus at about 0.3% of GDP in 2009 (Figure 3.21.6).

Tourist arrivals, which fell heavily during the first 5 months, recovered strongly over the rest of the year. Although they grew by only 2.1% for the whole year, it was the largest gain since 2004. The outlook for the industry is for marked upturn in the coming years.

Gross official reserves rebounded from a low of $1.3 billion (only 1.2 months of imports) in early 2009 (Figure 3.21.7) to $5.1 billion by end-December 2009 (6.2 months of imports). This gain was underpinned by $1.2 billion from sales of government short-term securities and by IMF disbursements. The central bank intervened in the foreign exchange market in this period to prevent a substantial appreciation of the Sri Lanka rupee.

The authorities made several policy changes at the beginning of 2010 with the intention of gradually relaxing restrictions on capital account transactions. The changes include allowing Sri Lankans to open accounts with banks abroad and to invest in foreign company shares; and permitting foreigners on tour to open domestic currency accounts in Sri Lanka and to invest in local corporate bonds.

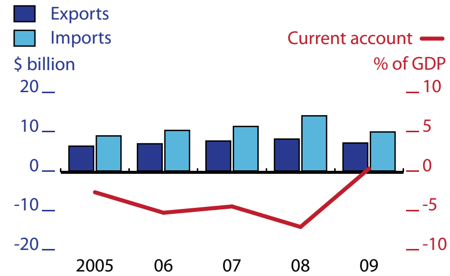
Economic prospects

The ending of the military conflict in May last year is likely to boost growth and development in the coming years. Investor confidence in Sri Lanka's markets has already shown signs of improvement, as evidenced by a sharp runup in the stock market (Figure 3.21.8) and the country's standing in global capital markets. Substantial government investment in social and economic infrastructure will still be needed, though.

With growth picking up in the second half of 2009, the economy is poised to recover in 2010. The sectors that performed poorly in 2009 were mainly industries and services related to the external sector, such as textiles and garments, import and export trade, and cargo handling. With the global economy in recovery mode and with higher domestic and foreign investment, growth momentum is likely to strengthen and reach 6.0% in 2010 and 7.0% in 2011. These projections assume that the tax reforms and fiscal consolidation will achieve fiscal deficit targets, sustaining investor confidence.

The authorities aim to control inflation through monetary targets, while ensuring adequate credit to the private sector. The central bank plans the growth of both reserve money and broad money supply to accelerate by 14.5% in 2010. Given international price pressures, inflation is expected to remain at around 6.5% in 2010.

3.21.6 Current account indicators



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*; *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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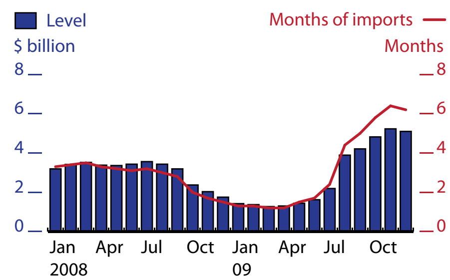
3.21.7 Gross official reserves and import cover



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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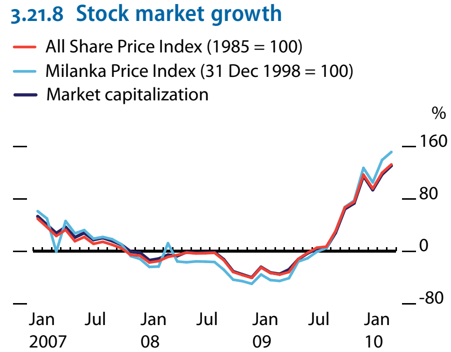
3.21.8 Stock market growth



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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3.21.1 Selected economic indicators (%)

	2010	2011
GDP growth	6.0	7.0
Inflation	6.5	8.0
Current account balance (share of GDP)	-2.0	-3.0

Source: ADB estimates.

In February 2010, the European Commission withdrew preferential tariffs under the Generalized System of Preferences Plus (GSP Plus) to Sri Lanka's exports on account of weak implementation of human rights conventions. The suspension will take effect in August. The two sides, however, are working on measures that could allow for the preference to be reinstated. The garment sector, which receives about 7% in tariff concessions under the scheme, will be the most affected by the loss of concessions.

External trade is expected to continue gathering momentum as the global economy recovers. At about 5.0% growth, exports will be below potential in 2010 owing to the impending withdrawal of GSP Plus concessions (as well as only a modest improvement in demand for garments).

Imports will advance from their current low base, growing by about 20.0%, reflecting a marked increase in domestic demand and higher oil prices. The trade deficit will widen significantly, but continued improvement in workers' remittances should hold the current account to a deficit of 2.0% of GDP in 2010 (Figure 3.21.9). It is likely to reach 3.0% of GDP in 2011.

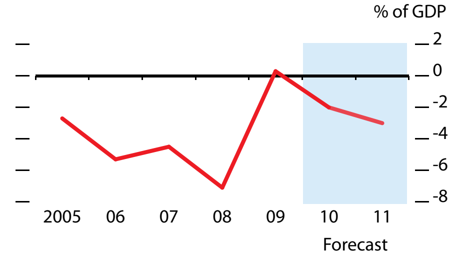
External capital inflows have improved since May and are likely to strengthen further in the forecast period. Sri Lanka floated a $500 million, 5-year international sovereign bond issue in October 2009, and the offer was oversubscribed, receiving $6.8 billion and reflecting the increased international confidence in the economy. Moreover, during the second half of 2009, rating agencies raised Sri Lanka's outlook to "stable" from "'negative."

Budget expenditure is projected to come down to 23.3% of GDP in 2010 and reach 22.5% in 2011 (Figure 3.21.5 above). Since the 2009 targets were not achieved and some of the additional expenditure items such as humanitarian assistance to Northern province (the locus of the conflict) and expenses relating to stimulus measures introduced in 2009 will spill over to 2010, greater adjustment than this would likely be difficult.

As the economy picks up, revenue collection should improve. However, revenue-enhancement measures that were expected to be implemented in 2010 under the IMF program have been delayed due to the scheduling of the parliamentary election in April and the consequent postponement of the 2010 budget. The latest government estimates envisage revenue to be 15% of GDP this year. A Presidential Tax Commission, set up in 2009, is expected to recommend measures to broaden the tax base. With these recommendations implemented, revenue could reach 15.5% of GDP in 2011.

The government aims to bring down the fiscal deficit to 8.0% this year. In 2011, the deficit should come down to 7.0%, if revenue and expenditure adjustments are made. How the government will actually address fiscal issues this year and beyond will become clear only once the budget is approved by Parliament (likely by midyear).

3.21.9 Current account balance



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*; *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk; ADB estimates.

Click here for figure data

3.21.1 Development challenges

The 2010–2012 development plan for Northern province aims to spend SLRs295 billion (about $2.7 billion). While it gives no estimate on how much donors will fund, the government likely needs to raise a significant amount from them. GDP growth of the province is expected to average 13% during the 3 years.

There are manifold challenges in reviving the economy of Northern province (and to a lesser extent, Eastern province). A substantial infrastructure gap with the rest of the country has opened during 30 years of destruction and virtually no investment. The investment that the two provinces need to bridge this gap is enormous.

Yet developing the former conflict regions and normalizing living conditions are key factors in establishing lasting peace and placing Sri Lanka on a higher growth path. Consequently, there is no alternative but to make this investment.