South Asia

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

Islamic Republic of Afghanistan

Worsening security and the global downturn have made the socioeconomic situation even more difficult. Severe drought caused a sharp fall in agricultural output and a slump in GDP growth in the licit (non-opium) economy. Lower farm output and the escalation of global food and fuel prices pushed inflation to its highest level in 5 years, but it began to moderate toward the end of the year. The challenges are daunting, and, to name but a few, involve the need to strengthen security, rehabilitate basic infrastructure, combat narcotics production, improve the rule of law, strengthen public policy management, and foster private sector growth.

Economic performance

In FY2008 (ending 20 March 2009), drought hit agricultural production, which represents about a third of licit GDP. Although continued expansion in construction and services partly offset this decline, GDP growth is estimated to have slumped to 3.4% (Figure 3.14.1).

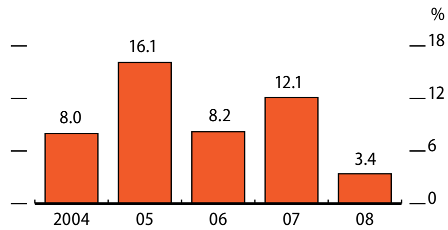
The country experienced a serious food crisis in FY2008 owing to a 40% lower wheat harvest than in FY2007 (partly because of poor rainfall that affected nonirrigated crops particularly); surging global prices of wheat and other foods (combined with a high dependence on food imports); and restrictions on wheat exports from Pakistan (the main source of supply).

As food accounts for three fifths of the consumer basket and as wheat is the staple, the consumer price index for Kabul, which began rising in late 2007, jumped by 43.2% year on year in May 2008 before falling to 22.7% in December. That month saw a 30.3% increase in food prices but an easing in nonfood prices in the basket of 10.7% (Figure 3.14.2). For FY2008, inflation averaged an estimated 28.3%, compared with 12.9% the prior year.

A combination of deteriorating security, the continued lack of basic infrastructure (mainly power), and what is seen to be rampant corruption has hampered government efforts to boost private sector investment. Nongovernment investment was essentially unchanged in FY2008 from a year earlier at 7.7% of GDP, and below the 9.6% and 8.1% shares recorded in FY2005 and FY2006. Overall investment as a share of GDP declined to about 32.0% from an estimated 36.7% in FY2007.

The opium economy, equivalent to about 20–30% of licit GDP, remains a grave challenge. Counter-narcotic efforts helped cut estimated opium production by about 6% in calendar 2008 from record production a year earlier, even as border prices fell to $70 a kilogram (Figure 3.14.3). Afghanistan still produces around 90% of the world's opium, and the opium trade remains a major source of income for nearly 80% of the rural population. Potential earnings from poppy farming are much higher than from alternative crops, and financing for the crop from drug traffickers is readily available.

3.14.1 GDP growth



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

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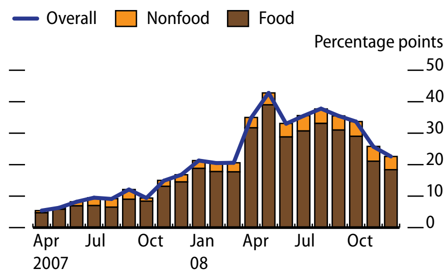
3.14.2 Contributions to inflation



Note: Data refer to Kabul only.

Source: Central Statistics Office.

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This chapter was written by Mohammad Ishaque Sarwari of the Afghanistan Resident Mission, ADB, Kabul.

As a result of poor revenue performance and unanticipated expenditure (mainly related to increased security costs), the Government's Medium-term Fiscal Framework target of being able to fully finance its operating budget through domestic revenue will be delayed by 3 years, to FY2016. Due to a lower than expected volume of taxable imports and inadequate tax collection, domestic revenue is estimated to have declined to 6.6% of GDP in FY2008 (Figure 3.14.4), and is likely to have covered only about 55% of operating spending, or 11 percentage points lower than in FY2007.

Development budget execution, which had improved to about 55% of the budgeted target in FY2007, is estimated to have reached only about 42% in FY2008 because of the Government's limited absorption capacity. Lack of staff with skills in project implementation and management continued to have a negative impact on contracting and procurement, resulting in delays affecting physical progress as well as planned budget disbursement.

The external budget—the portion of the budget that donors implement directly—continued to account for more than half total public spending. That so much of total spending is outside the government budgeting process complicates the Government's development agenda in terms both of setting priorities and of monitoring progress against desired outcomes according to the Afghanistan National Development Strategy (ANDS), which was endorsed at the Paris International Conference in June. The Government would like to see more external funding channeled through the core budget.

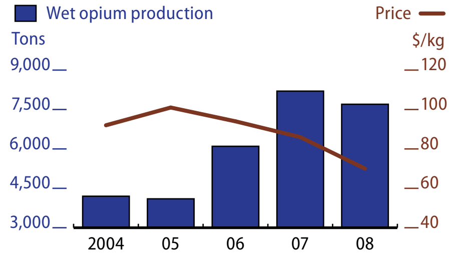
The Government has made progress in public financial management, including budgeting and accounting reforms. Some central ministries are now undertaking program budgeting, which is increasingly seen as a useful tool to align ministry strategies with the ANDS.

Monetary policy aims to support price and exchange rate stability. Inflation is expected to continue moderating from the high levels seen in early 2008 as a result both of declining global food and oil prices and of the Government's prudent monetary and fiscal policies. The nominal exchange rate remained stable at around AF50/$1 (Figure 3.14.5).

The Government's monetary policy has been adjusted to accommodate balance-of-payments pressures resulting from emergency imports of large quantities of wheat. The net international reserves target has therefore been adjusted downward to about $2.9 billion from the earlier $3.0 billion monetary program target. Targets for reserve money and currency in circulation were correspondingly adjusted to ensure that monetary policy contributes to disinflation, capitalizing on the declining prices of imported food and fuel.

The current account deficit in FY2008, excluding grants, is estimated to have widened to $7.1 billion, or about 58% of GDP, from $6.4 billion a year earlier. The increase reflected a widening of the trade deficit stemming from greater imports associated with donor-financed activities, including security and development projects. Domestic official exports (that is, exports excluding transit trade and smuggling) are estimated to have risen by about 27% to $610 million, or 5% of GDP. Including grants, the current account deficit is put at about 1.3% of GDP, financed by inflows of foreign direct investment ($300 million) and concessional loans.

3.14.3 Opium production and prices



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

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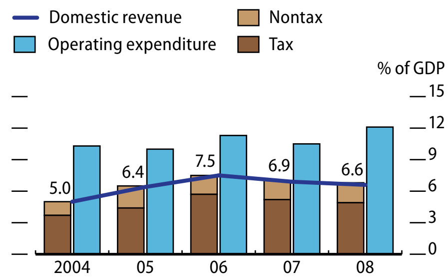
3.14.4 Domestic revenue and operating expenditure



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

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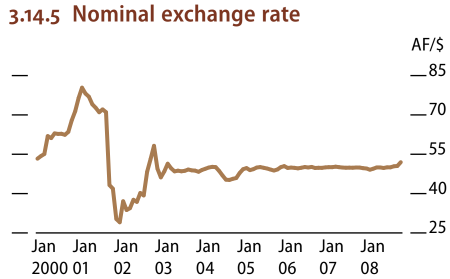
3.14.5 Nominal exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 9 March 2009.

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The International Monetary Fund's fourth review of the 3-year Poverty Reduction and Growth Facility (PRGF) ended in July 2008. The PRGF will enable Afghanistan to be eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. The Government has continued to work toward reaching its HIPC "completion point" by the end of this year, and for this purpose it is pursuing agreements to settle its bilateral debts with the Czech Republic and the Kuwait Fund so as to regularize its relations with those external creditors not included in the Paris Club. Afghanistan's loans from the OPEC Fund were restructured in September 2008, and the Government intends to recognize its debts to the Islamic Republic of Iran and to request a waiver in light of its expected HIPC status.

For the ANDS, the Government has established a coordinating committee, consisting of key ministers and senior officials, to oversee the progress of implementation. Donors have input through the Joint Coordination Monitoring Board.

Parliament approved a new Civil Servants Law in July 2008, which includes provision for a new pay and grading structure for the whole civil service. The Government originally planned to start bringing into effect the new structure for 10% of civil servants during the second half of the current fiscal year. However, since a prerequisite under the new law is the regrading of positions, any significant fiscal impact is not expected before FY2009.

Although private sector–led economic growth is a major objective of the ANDS, progress in encouraging private development has been slow. To foster such development, an Afghanistan Investment Climate Facility was established in June last year. In addition, an enabling committee for the private sector and civil society has been established as a public–private forum to play a leadership and advocacy role.

Economic prospects

Externally financed development has buttressed growth in the licit economy. On the assumption of continued large inflows of donor funding and no drought or other factors that would affect agricultural production, GDP growth is forecast to rebound to 9.0% in FY2009 and then decline to 7.5%. Average inflation is expected to fall to 6.0% and then edge up to 6.8% in this period, reflecting the decline in global prices of food, fuel, and other commodities.

The external position is seen improving on the back of sustained large inflows of official transfers. Official development assistance and foreign direct investment, as well as debt relief through the HIPC initiative, will finance the small deficits in the current account (once official transfers are included).

Medium-term prospects depend heavily on the Government's success in combating corruption, overcoming infrastructure bottlenecks, and implementing further structural reforms, all of which are needed to stimulate private sector investment. Moderate to high growth targets will be attainable only if structural reforms are put through decisively and if public investment is targeted to key areas of infrastructure, notably transport and electricity.

3.14.1 Selected economic indicators (%)

	2009	2010
GDP growth	9.0	7.5
Inflation	6.0	6.8
Current account balance (share of GDP)	-3.5	-4.7

Source: Staff estimates.

3.14.1 Development challenges

Poor security, weak governance, and a poor environment for the private sector remain critical concerns. Additionally, lack of both physical and economic infrastructure (including stable power supply), land titling, and access to finance are hobbling the private sector.

A greater focus on development management and aid effectiveness, through better prioritization, would enable the Government to tackle these problems. However, until the presidential election scheduled for later this year is held, the Government may have difficulty in getting the National Assembly to approve crucial reform measures.

Bangladesh

Growth prospects are dimmed by the global economic slowdown, but inflation has eased with falling global commodity prices. The new Government should raise infrastructure investment and improve the enabling environment for private sector activity, in order to enhance prospects for rapid growth and job creation. This in turn will require improved implementation of the development expenditure program as well as strengthened revenue mobilization. Addressing power and gas shortages will be particularly important for enhancing longer-term growth prospects, especially in terms of encouraging private investment.

Economic performance

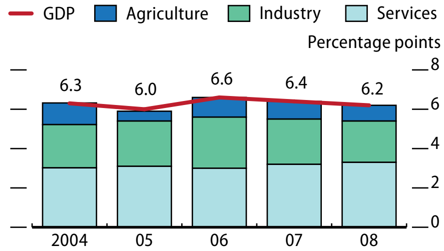
GDP growth at 6.2% was slightly lower in FY2008 (ended June 2008) than in the previous year, because of weaker growth in industry and agriculture (Figure 3.15.1). Industrial growth was pulled back by a dip in garment production in the first half of the fiscal year, as well as by higher raw material import costs and growing energy shortages. Natural disasters in the first half affected agricultural output. Growth in services was supported by expansion of transport and storage and of wholesale and retail trade.

On the demand side, growth continued to be driven by private consumption (Figure 3.15.2) aided by an ongoing surge in remittances. Total fixed investment fell to 24.2% of GDP, reflecting a cut in the Government's annual development program (ADP), and slower growth in private investment, caused partly by the uncertainty created by the Government's anticorruption drive. While private investment rose marginally to 19.2% of GDP in FY2008 from 19.0% in FY2007, public investment fell from 5.5% of GDP to 5.0%. The fall in investment over the past 2 years is manifesting itself as surpluses in the current account, signaling the need to rebalance growth by boosting investment, while keeping the current account balance at manageable levels. The deficit in net exports of goods and services widened, slowing growth more than in FY2007.

Average inflation accelerated from 7.2% to 9.9% in FY2008, on higher global food prices and shortfalls in domestic production. Higher public spending, rapid credit growth, and stronger demand boosted by remittances also contributed to inflation pressures. Inflation moderated in more recent months, declining to 6.1% year on year in January 2009 from 10.2% in September (Figure 3.15.3), as food price rises steadily eased.

Bangladesh Bank stepped up monetary expansion and private sector credit growth as the fiscal year progressed to sustain the growth momentum. The year-on-year expansion in money supply (M2) rose from 14.7% in December 2007 to 17.6% in June 2008, exceeding the central bank's annual program target of 16% (Figure 3.15.4). Private sector credit growth accelerated from 16.8% to 24.9% in the same period, also

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009.

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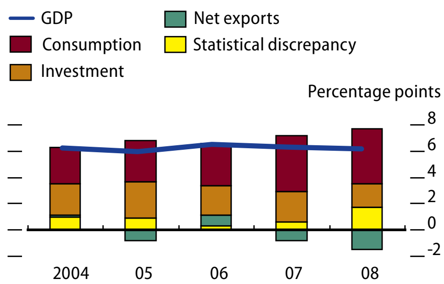
3.15.2 Contributions to growth (demand)



Source: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009.

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This chapter was written by Mohammad Zahid Hossain and Md. Golam Mortaza of the Bangladesh Resident Mission, ADB, Dhaka.

overshooting the program target. Although stoking inflation pressures, the accommodative monetary stance helped improve goods availability by boosting imports and raising domestic supply.

In conducting monetary policy, the central bank kept reserve requirements, liquidity ratios, and the main policy rate (reverse repo) unchanged in FY2008, relying more on open-market operations to constrain liquidity. The weighted average yield on 28-day Treasury bills was 7.5% in June 2008, marginally higher than the 7.3% in June 2007. The reverse repo and repo rates (1–2 day maturity) were unchanged at 6.5% and 8.5%, respectively, from December 2007 through June 2008. The weighted average lending rate declined from 12.8% in June 2007 to 12.3% in June 2008, and the weighted average deposit rate of 7.0% remained negative in real terms during this period. The spread between lending and deposit rates remained high at 5.3 percentage points, reflecting banking sector inefficiencies, particularly high administrative costs and still-sizable nonperforming loans. The sector allocation of bank advances to the private sector were broadly unchanged.

The nominal exchange rate remained stable in FY2008, with the taka appreciating only by about 0.5% against the United States (US) dollar, aided by periodic interventions in the foreign exchange market by Bangladesh Bank. The real effective exchange rate depreciated by 0.6% over the year, but appreciated by 3.6% in the first half of FY2009, implying erosion of competitiveness in the international market.

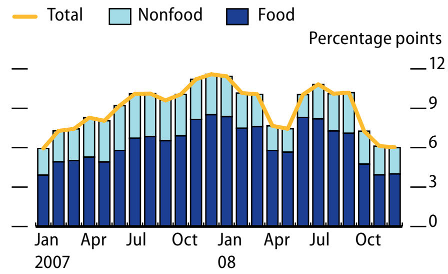
Revenue collection jumped to 11.2% of GDP in FY2008 from 10.2% in the previous year (Figure 3.15.5). Despite the cut in the ADP, public spending rose to 15.9% of GDP, from 13.4% in FY2007, because of higher spending on relief and reconstruction, expanded safety net programs to combat the rise in food prices, and higher subsidies for fuel and fertilizer. Consequently, the fiscal deficit widened to 4.7% of GDP from 3.2% in FY2007.

Measures such as expanding taxpayer registration, modernizing the National Board of Revenue along functional lines, and strengthening its audit functions need to be accelerated so as to further improve revenue performance. Lists of tax exemptions, exclusions, and incentives will also need to be reviewed by the Government and pared down, and income tax and value-added tax laws updated, in order to expand the tax base and raise tax collections.

Exports grew by 15.7% in FY2008, driven by strong performance in knitwear in the second half. The share of woven garments and knitwear, at 75.8% of total exports, was slightly higher than in the previous year. Imports rose by 25.6%, with imports of food, fuel, and fertilizer rising sharply. The higher trade deficit was offset by continued strength in workers' remittances, leading to a small current account surplus of $0.7 billion or 0.9% of GDP (Figure 3.15.6). A smaller surplus in the capital and financial account lowered the overall balance-of-payments surplus to just over $600 million in FY2008 from about $1.5 billion in the previous year. Foreign exchange reserves rose by $1.1 billion, to $6.1 billion at end-June 2008 (import cover of about 3 months), partly reflecting a rise in central bank liabilities (Figure 3.15.7).

Although the financial soundness of private banks strengthened along with their rapid growth in FY2008, the state-owned commercial banks (accounting for about 30% of assets and deposits of the banking system)

3.15.3 Contributions to inflation



Source: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009.

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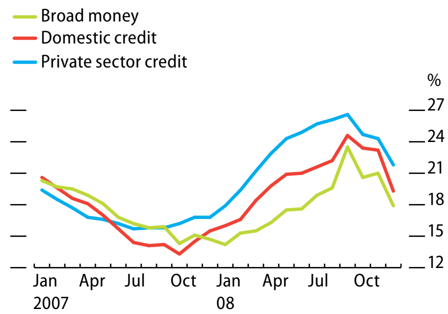
3.15.4 Growth of monetary indicators



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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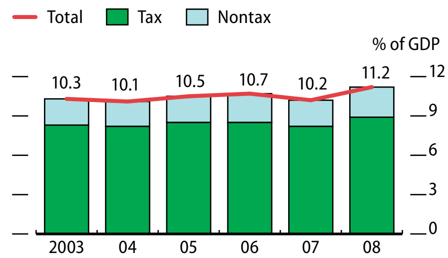
3.15.5 Government revenue



Source: Ministry of Finance, available: http://www.mof.gov.bd, downloaded 19 February 2009.

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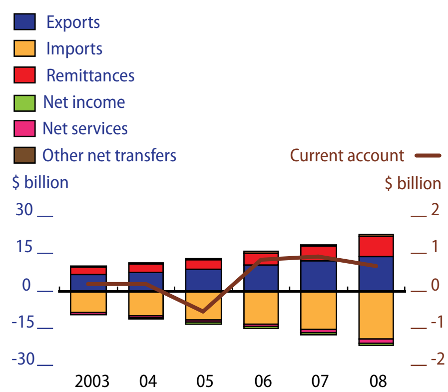
3.15.6 Components of the current account balance



Source: Bangladesh Bank, Annual Report, available: www.bangladesh-bank.org, downloaded 30 December 2008.

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remained weak, with negative capital and a nonperforming loan ratio of 33% (Figure 3.15.8), thus undermining the overall efficiency of the banking system. While operational autonomy and accountability of the state banks rose after their corporatization in 2007, greater attention to credit quality, recovery of nonperforming loans, and intensified monitoring by Bangladesh Bank are needed for improving their financial position. Bangladesh Bank is advising financial institutions to provide more credit to activities that generate domestic value added and create jobs in the country, and to more carefully assess borrowers' creditworthiness, in order to improve the credit quality of these institutions.

The Dhaka Stock Exchange price index dropped by 7.4% in the year to end-2008 (Figure 3.15.9). Since the share of foreign portfolio investment in the stock market is very small and the risk of contagion from international markets is minimal, the downward movement in share prices stems from nervous domestic investors. In the same period, market capitalization rose by 40.5%, reflecting some large initial public offerings. Inefficiencies in the pricing mechanism for such offerings, weaknesses in corporate governance and market surveillance, and the high costs of listing need to be addressed if market capitalization is to rise further in line with other South Asian markets.

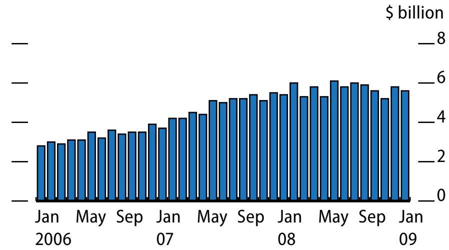
Economic prospects

Prospects for FY2009 and FY2010 will hinge critically on the way in which the democratically elected government (which assumed office in January 2009) continues and deepens the economic reforms initiated during the caretaker Government's 2-year tenure. Prudent macroeconomic management, in particular prompt action to address the downside risks to growth from the global slowdown, will also be required. The Government will need to adopt measures to accelerate ADP implementation, including addressing deficiencies in institutional capacities in key line ministries, raising revenues, and encouraging greater private participation in infrastructure investment. Economic prospects will also depend on the continued availability of adequate external assistance—despite the economic downturn—for supporting public spending on infrastructure, especially for rolling back growing power shortages.

Against this background, GDP growth is forecast to decline to 5.6% in the current fiscal year (FY2009), because of the effects of the global slowdown on exports and remittances and, as anxious consumers trim their spending, of lower domestic demand. GDP growth is forecast to slide further to 5.2% in FY2010 as the global economic slowdown persists, with continued moderation in external and domestic demand (Figure 3.15.10). Agricultural output will rise briskly in the forecast period, if normal weather conditions prevail and if farmers can access credit and inputs.

Industrial growth is expected to moderate in FY2009, as export production begins to slow in the second half of the fiscal year, reflecting cooling global demand. The export sector got off to a robust start in the first quarter, when total shipments surged by 42.4%. In the second quarter, though, they declined by 1.2%, resulting in still-robust, cumulative export growth for the first 7 months of 18.2% (Figure 3.15.11).

3.15.7 Gross foreign exchange reserves



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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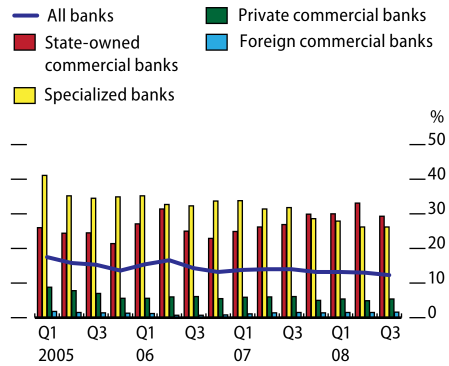
3.15.8 Gross nonperforming loan ratios by type of bank



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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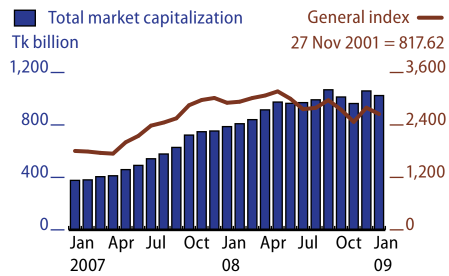
3.15.9 Dhaka Stock Exchange indicators



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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3.15.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.6	5.2
Inflation	7.0	6.5
Current account balance (share of GDP)	0.2	-0.5

Source: Staff estimates.

Deceleration in demand for low-end garment exports from the People's Republic of China (PRC) due to the appreciating yuan and the PRC's graduation from this market segment has provided opportunities for export growth for Bangladesh, where low-end products predominate. International buyers of Bangladesh products have also been encouraged by the large improvements in ports, customs, and safety and labor standards in the past couple of years. Nevertheless, slower growth in export earnings for the rest of FY2009 is foreseen because of the global slowdown and lower prices. Export vulnerability is accentuated by the lack of diversification both in terms of products and destinations—about 75% of exports are concentrated in textiles and over 90% of those exports are destined for US and European markets. Exports that are income elastic, such as frozen foods and leather products, have already shown considerable vulnerability to the global slowdown.

Slower export growth will take down that of industry to 6.6% in the current fiscal year. Next year will see 6.0% industrial expansion as the slump in external and domestic demand continues. Services sector growth will also slow to 6.0%, down from the 6.7% in FY2008, because of slower activity in the export sector and an easing in consumer spending induced by moderation in incomes and remittance growth. Services sector growth will fall to 5.5% in FY2010 due to industry's slowdown. Agricultural growth is expected to edge up to 4.0% in FY2009 and further to 4.1% in FY2010, on the basis of improved crop harvests.

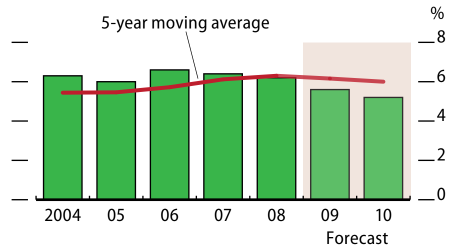
Inflation slowed during the course of the fiscal year. The decline in food inflation was steeper than that of nonfood inflation by end-January. The rapid decline in international commodity prices and good domestic crop harvests are pulling inflation lower. The cut in the domestic administered price of petroleum in October and December, after an increase in July, also eased inflation pressures, as has the modest monetary tightening in the second quarter of FY2009, and the further cut in domestic petroleum prices in January 2009. Inflation is projected at 7.0% for FY2009 and is expected to fall further to 6.5% in FY2010 (Figure 3.15.12).

The Monetary Policy Statement (MPS) announced by Bangladesh Bank in January 2009 envisages no shift in the broadly accommodative policy stance. The central bank continues to support the flow of credit to increase production of goods and services, and provide refinancing against lending in employment-intensive sectors such as agriculture and small and medium-sized enterprises, which are underserved by the market. The year-on-year growth in broad money (17.9%) in December 2008 is in line with Bangladesh Bank's end-June 2009 annual program target of 17.5%.

While the year-on-year growth in private sector credit in December 2008 was 21.8%, the adjustments in the repo and reverse repo rates are expected to guide credit growth back toward the annual program target of 18.5%. The MPS inflation projection of 8.5% for FY2009 appears overly pessimistic, considering the pace at which price pressures are dissipating. However, Bangladesh Bank cut the repo rate in March 2009 (from 8.75% to 8.5%) to encourage banks to lower their lending rates.

The external current account is expected to show a tiny surplus in FY2009 (0.2% of GDP) and a small deficit in FY2010 (0.5%) (Figure 3.15.13). Overseas workers' remittances remain a source of strength for

3.15.10 GDP growth



Sources: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009; staff estimates.

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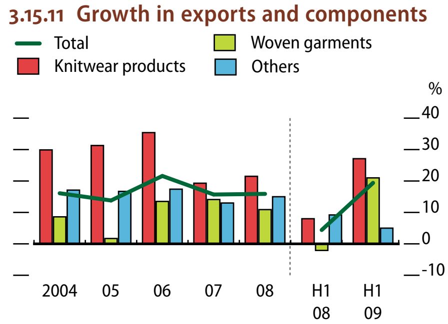
3.15.11 Growth in exports and components



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 19 February 2009.

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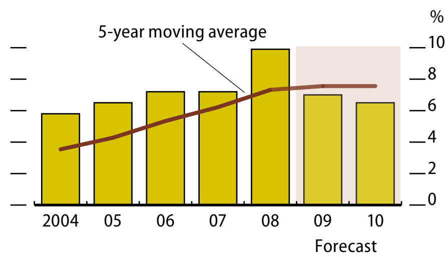
3.15.12 Inflation



Sources: Bangladesh Bank, Economic Trends, available: http://www.bangladesh-bank.org, downloaded 19 February 2009; staff estimates.

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Bangladesh, with 27.0% growth in the year to February. Nearly two thirds of remittances originate in the Middle East, with another one third from the US and Europe. A large majority of overseas workers are unskilled and involved in low-end jobs, which were relatively unaffected, especially in the Middle East, at the beginning of the economic slowdown. But a deceleration in remittance growth is inevitable as the downturn has now deepened, to 20% in FY2009 and to 15% in FY2010.

Similarly, export growth is projected to decelerate, to 14.0% and 13.0% over these two years. Import payments during the first half of FY2009 rose by 23.2% relative to the same period of FY2008. However, the opening of import letters of credit—a leading indicator for annual imports—declined by 2.2% in the first 7 months of FY2009, mainly because of the difficulties for international negotiating banks in supporting import activities in the face of liquidity shortages. With a further fall in international commodity prices, growth in import payments is expected to moderate and settle at 18.0% in FY2009 and 17.0% in FY2010.

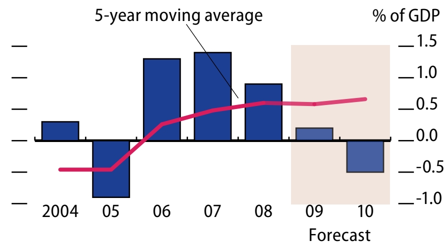
Government revenues are showing signs of deceleration, with growth falling from 20.5% in the first quarter of FY2009 to 12.4% in the first 7 months of the fiscal year, compared with the corresponding periods of FY2008. Slower private sector activity, as the impact of the global economic slowdown takes hold, could further affect revenue collections. Import-based receipts will be hit by the cuts in customs duties made in the FY2009 budget and by the erosion in import values resulting from lower international commodity prices.

Although the Government has transferred some of the benefits of lower international petroleum prices to consumers through successive cuts in domestic prices, the sharp decline in international prices also allowed it to eliminate petroleum subsidies and permitted a small profit for Bangladesh Petroleum Corporation. The lower operating costs for the Power Development Board and Petrobangla will contain their losses and reduce budgetary subsidies. A cut in non-urea fertilizer prices by about 50% in January 2009 will raise the budgetary cost of fertilizer subsidies, but the fiscal strain is likely to be minimal due to the savings on petroleum subsidies, likely ADP underutilization, and lower spending on food subsidies compared with budget targets.

Aided by the Public Resources and Budget Management Ordinance of 2008, which set a cap on domestic government borrowing, current spending is also likely to remain in check. The budget deficit in FY2009 is therefore expected to be 4.7%, within the budgeted level of 4.9% (Figure 3.15.14), despite the weaker revenue performance.

Several risks to the economic outlook could materialize from the global economic slowdown. Revenue collections may come under further pressure if economic activity declines more than expected, which would constrain the Government's ability to spend on essential infrastructure and social sector programs. ADP implementation could be delayed as the new Government takes time to address institutional capacity and personnel management issues. In addition, reversal of economic and sector reforms initiated by the caretaker Government could weaken the business environment and dent business confidence. Finally, a return to confrontational politics could also disrupt economic activity, as could natural disasters.

3.15.13 Current account balance



Sources: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009; staff estimates.

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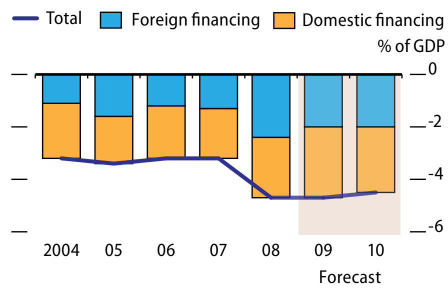
3.15.14 Fiscal balance



Sources: Ministry of Finance, available: http://www.mof.gov.bd, downloaded 19 February 2009; staff estimates.

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Development challenges

Bangladesh needs to substantially raise investment, which has followed a declining trend in recent years, in order to enhance growth and job creation and thereby reduce poverty. Public investment must be raised, primarily by accelerating ADP implementation, but efforts to raise private sector participation in infrastructure investment should also be made. The new Government needs to pay attention to improving institutional capacities in its various agencies, both to implement reforms and strengthen development administration. Over the medium term, with climate change posing a major threat to growth, tackling such concerns needs to be integrated into economic development plans and activities (Box 3.15.1).

The emerging shortages in gas and power supplies (over four fifths of power is generated from gas) need to be urgently addressed. Unless early remedial measures are adopted, power cuts and irregular electricity supplies will hamper domestic production and hold back medium-term growth prospects. In the longer term, the lack of gas supplies will severely limit power generation and, therefore, new investment in manufacturing activities. Large and rapid investments in gas and power are essential to ensure their continued availability. As foreign direct investment flows in gas and power are unlikely to materialize soon because of the global financial market turmoil, the Government must mobilize its own resources and tap external donor assistance. Investments in other infrastructure, such as roads, ports, and urban infrastructure and services, are also essential.

Food security surfaced as a major development challenge in 2008. The sharp rise in global food prices and domestic crop losses due to natural disasters led to a surge in domestic food prices. Although quick action by the Government, through higher imports and public distribution of food supplies as well as expanded social safety net programs helped mitigate the hardship on the poor before prices eased, this episode signals the need to develop a preemptive strategy to deal with similar shocks in the future.

To maintain affordable food prices while providing fiscally sustainable incentives to farmers, agricultural productivity needs to be raised. Dissemination of new technologies, improved research and extension, and investments in rural infrastructure (including roads, water, and power), will help achieve greater productivity. The sustainability of safety net programs could be enhanced by linking such programs to rural infrastructure investments and other job-creating activities, thus more directly contributing to longer-term economic growth and poverty reduction.

The caretaker Government is credited with introducing core governance reforms to combat corruption and improve access to justice, and with implementing key institutional and sector reforms. Such progress, which was helped by the apolitical nature of the caretaker administration, will have to be sustained. The new Government will need to undertake further reforms in local governance, particularly decentralization of administration and finance, and build local government capacity, both to deliver services more effectively and to improve infrastructure.

3.15.1 Addressing climate change

Climate change is a pressing development challenge in view of the country's geographic location, low deltaic floodplain, and hydrological influence of erratic monsoon rainfall. The major climate-induced disasters, such as more frequent floods, cyclones, and storm surges, as well as droughts, are causing severe loss of life and damage to property, and are seriously affecting the country's development prospects. The damage to infrastructure is particularly costly, as it erodes productive capacity. It also reduces the security of livelihood assets for the poor.

A further rise in the sea level will make more areas of the country extremely vulnerable to floods, squeezing settlements and resource-use patterns, and will have serious implications for livelihoods and the physical environment. A rising sea level may also inundate vast areas of coastal Bangladesh and force millions of people to move.

In addition, a rising sea temperature is likely to make cyclones and storm surges more frequent. Finally, higher salinity intrusion in coastal areas and riverbank erosion across the country will severely affect the lives and livelihoods of millions of poor people.

The key challenges in tackling the effects of climate change are ensuring food and water security, protecting infrastructure, and managing disaster risks. Addressing health insecurity, forced migration, and overall environmental degradation is also vital. Aggravating any response are high population pressures, lack of funds for appropriate climate change adaptation measures, inadequate policy frameworks, and limited human resources.

Ultimately, climate change may threaten the significant gains made in poverty reduction over the past 20 years, and efforts to reduce poverty will only be sustainable over the longer term if they successfully incorporate climate change adaptation in development planning.

Bhutan

The economy is driven by hydropower project cycles. Significant new hydropower investment and output have contributed to rapid GDP growth in the past few years. For the next few years, the growth rate will slow before construction of new power plants lifts it again. Most power is exported to India under long-term contracts. Because of this, and the dominance of the power sector, the global economic slowdown is likely to have relatively little impact. However, the close trade and foreign exchange links to India, as well as a possible downturn in tourism, may still have an effect.

Economic performance

GDP growth in FY2008 (ended 30 June 2008) is estimated at 11.5%, down from 14.1% in the previous fiscal year (Figure 3.16.1). The phased commissioning of the 1,020 megawatt (MW) Tala hydropower station since July 2006 has tripled Bhutan's total power generation capacity to 1,480 MW (from 460 MW produced by three older power stations), boosting GDP growth sharply in FY2007 and slightly less in FY2008, due to the high base effect. Most hydropower is exported to India.

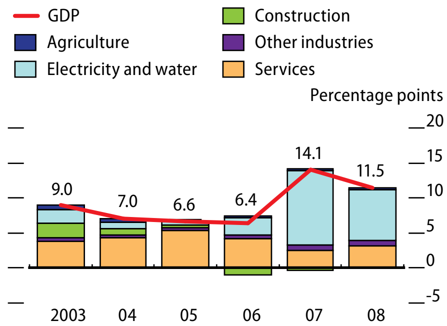
With its currency, the ngultrum, pegged to the Indian rupee (helping anchor inflation), and the country's close trade relationship with India (the source of 70% of imports), Bhutan's inflation moves along with India's. Mainly reflecting the increase in global commodity prices, the consumer price index in Bhutan escalated to 8.9% in the fourth quarter of FY2008, averaging 6.4% for all FY2008 (Figure 3.16.2). With the fall-off in global prices since mid-2008, inflation has likely peaked.

Money supply (M2) recorded modest growth of 2.3% in FY2008, compared with a 8.6% increase a year earlier. Credit to private sector, which dominates domestic credit, grew rapidly once more, at near 40%. The housing sector continued to have the highest share in bank loans (about 30%) reflecting the recent housing boom, followed by manufacturing (19%) and trade and commerce (18%).

Revised fiscal estimates for FY2008 show that nontax revenue was high, mainly from transfers of profits, tax, and dividends related to the Tala project, helping push total revenue to 37.8% of GDP (Figure 3.16.3). External borrowing (net of principal repayments) has been in a decreasing trend and turned negative in FY2008. Bhutan is taking pro-poor fiscal policy measures, according to which a third of expenditure is to be used for health and education (30% was achieved in FY2006 and FY2007). The Government has committed to maintaining its pro-poor policy in the use of additional resources.

The FY2009 budget set plans for greater expenditure (48.8% of GDP), which, however, does not include the additional costs of a 35% salary hike

3.16.1 Contributions to growth (supply)



Sources: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008; staff estimates.

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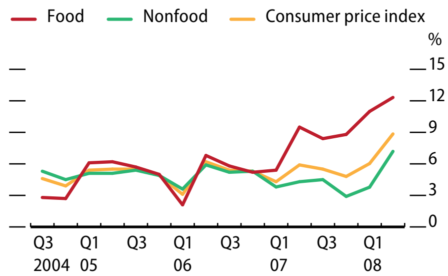
3.16.2 Inflation



Source: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008.

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

that was endorsed by the National Assembly in January 2009. With larger grants from India and increased receipts from hydropower projects, the government-budgeted deficit was projected to be 2.8% of GDP.

Total exports in the balance of payment are estimated to have decreased by 8.5% in FY2008, resulting in an unexpected trade deficit. The fall in exports appears to have resulted from a sharp drop in exports in January–June 2008. However, the latest available detailed customs data show a large increase in 2007 exports. Sales of electricity to India, which doubled in 2007, dominate Bhutan's total exports, with a share of 36% in 2007. Other major items are base metals (steel) exported to India (23% of total exports) and magnetic discs and cards sold to countries other than India (16%).

Tourism, an important source of hard currency, grew strongly up to June 2008 with visitor numbers rising by 32.4% and revenue by 29.8%. Because of the large current transfer inflow of budgetary grants from India (among others), the current account maintained a surplus, but one that declined to 3.9% of GDP (Figure 3.16.4). The overall balance of payments also stayed in surplus with a foreign direct investment inflow of $30 million (equivalent to 3.0% of GDP), including Tata Power's investment in a new hydropower project (Dagachhu). Gross international reserves stood at $646 million, equal to about 15 months of merchandise imports at end-FY2008.

Bhutan has a large external debt (relative both to other countries' and its own GDP), contracted mainly to finance hydropower projects. It stood at $780 million, or 58% of GDP, as of end-FY2008 (Figure 3.16.5). About 55% of debt is rupee-denominated borrowing from the Indian Government to support hydropower construction. The overall debt service ratio increased to 18% of total exports of goods and services in FY2008, reflecting the start of repayment for Tala. The bulk of Bhutan's external debt is self-sustaining, serviced by long-term power contracts with India, and with no foreign exchange risk. In addition, much of the remaining debt has been contracted on concessional terms. Thus the overall debt situation appears to be sustainable.

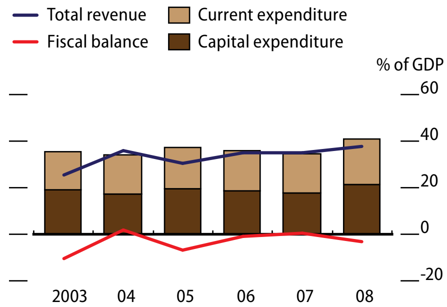
In the political sphere, Bhutan completed the transition from a monarchy to a two-party democracy. Elections were held for the National Council (the upper house) in December 2007 and for the first National Assembly (the lower house) in March 2008. The first written constitution was adopted in July 2008. The political situation under the new democratic system is expected to remain stable.

Economic prospects

Located in the Himalayas and close to India with its burgeoning demand for power, Bhutan is capitalizing on its huge untapped hydropower potential. The Government is planning four hydropower projects (Figure 3.16.6) with an aggregate generation capacity of about 2,900 MW for implementation during the 10th and 11th five-year plans (from FY2009 to FY2018).

Economic growth is therefore dominated by the hydropower project cycle. In FY2007 and FY2008, high growth was led by new electricity production from Tala. With Tala now at full output, GDP growth will

3.16.3 Fiscal indicators



Source: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008.

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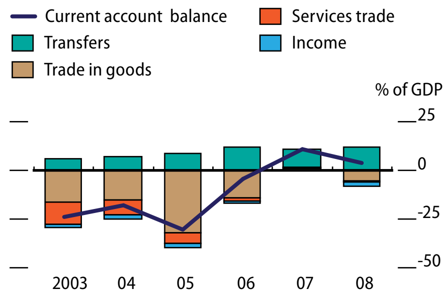
3.16.4 Current account indicators



Sources: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008; staff estimates.

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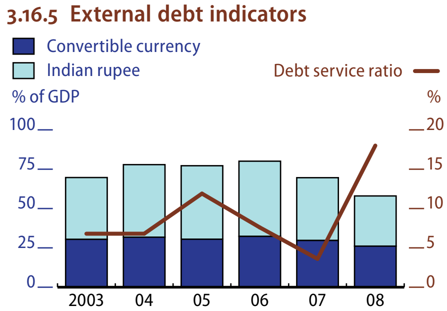
3.16.5 External debt indicators



Source: Royal Monetary Authority, *Annual Report 2007/08*, January 2009, available: http://www.rma.org.bt, downloaded 16 March 2009.

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come back to its normal path. Construction of new hydropower stations will gradually take over as drivers of growth.

Although these hydropower projects are unlikely to be directly affected by the global economic slowdown, some sectors have felt the chill wind. An early recovery cannot be expected for the steel industry, which benefits from cheap electricity, given the outlook for growth in India. Tourism is another sector that will likely suffer from the global slowdown. Moreover, some companies now face a lack of working capital because banks are reluctant to provide additional loans so as to avoid concentrating their lending among a few borrowers. Considering these factors, GDP growth is projected to be 5.5% and 6.5% in FY2009 and FY2010, respectively.

Inflation is projected at 3.5% and 4.0% for FY2009 and FY2010, respectively, similar to India's. A pay rise for Bhutan's civil servants could add to inflation pressures.

Although power exports to India will remain stable due to strong demand, exports of other products are expected to see only limited growth given the economic outlook in trade partner countries. Exports of services will also moderate as tourism weakens. The drop in international oil and other commodity prices will however help reduce imports. The current account surplus is projected at 5.5% of GDP for FY2009 and will further improve to 9.0% in FY2010.

Development challenges

The 10th five-year plan targets full employment, particularly among educated youth, and emphasizes economic diversification, since hydropower employs few people and has few backward linkages. The unemployment rate rose to 3.7% in 2007 from 1.8% in 2003, and to help counter this, labor-intensive activities would be preferred—and tourism is one area where the private sector can expand. Private sector development will be a key focus, which would also diversify economic activity. The Government also needs to tackle some bottlenecks to investment activity, such as lack of skilled labor and limited financial sector outreach.

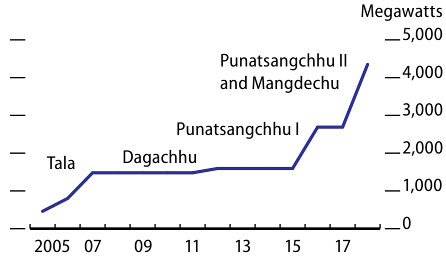
Bhutan is preparing to join the World Trade Organization this year. In the process, it has already agreed to open 54 out of 155 services. The 10th five-year plan committed to addressing the issue of skills shortages by providing vocational education and training. The Government has recently decided to approve new bank and insurance business licenses.

3.16.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.5	6.5
Inflation	3.5	4.0
Current account balance (share of GDP)	5.5	9.0

Source: Staff estimates.

3.16.6 Generation capacity



Sources: Gross National Happiness Commission, Royal Government of Bhutan, *Draft Tenth Five-Year Plan (2009–2013)*; staff estimates.

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India

The Indian economy is facing major macroeconomic management challenges stemming from the global financial crisis. Declining private investment, dwindling capital inflows, shrinking foreign exchange reserves, weakening exports, and a depreciating rupee are some of the factors constraining high growth. The consolidated government deficit has reached a high level due to subsidies and fiscal stimuli. Resurgence in growth in the short run is contingent on economic recovery in the industrial economies and revival in business sentiment at home. Raising the growth trajectory in the long run requires completion of structural reforms and substantial investment in infrastructure.

Economic performance

India went into FY2008 (ending March 2009) with strong macroeconomic fundamentals, although the authorities had serious concerns about high global prices of oil and other commodities pushing up domestic inflation. The possibility of a worsening of the international financial turmoil, which had surfaced in mid-2007 and deteriorated a year later, also posed a threat to maintaining the rapid pace of growth.

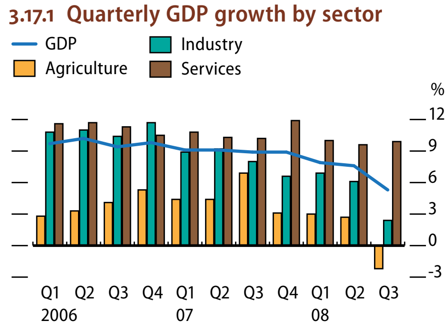
The financial crisis and global slowdown are affecting the economy through two main channels: capital flows and trade. The crisis prompted foreign institutional investors and banks to limit their exposure to emerging markets, undermining investment activity in India, while adding downward momentum to a slumping stock market. The slowdown in the global economy—with the United States (US), European Union, and Japan in recession—caused exports (including earnings from the information technology and business processing industries) to slump from October. The sum of these developments was economic growth falling sharply to 5.3% in the third quarter of FY2008 (Figure 3.17.1).

The Government's advance estimate for FY2008 put GDP growth at 7.1% as against 9.0% in FY2007 (Figure 3.17.2). (This outcome may be revised downward because of some uncertainty about end-year agricultural output.) At the sector level, industry accounted for about half the decline in growth in FY2008. Growing by only 4.8% (down from 8.1%), industry's deceleration reflected a sharp fall in growth in manufacturing (8.2% to 4.1%) and construction (10.1% to 6.5%) as private consumption and investment faltered. Expansion in the large services sector (over half of GDP) decelerated from 10.9% to 9.6%, that is, about one third of the total. Growth in agriculture slowed to 2.6% from 4.9% a year earlier, when output expanded above trend.

On the expenditure side, domestic demand is the primary growth driver (goods and services exports are about 25% of GDP). In FY2008, the pattern of domestic expenditure changed as the economy slowed (Figure 3.17.3). Growth in total consumption held pretty steady at just over

This chapter was written by Shikha Jha of the Economics and Research Department, ADB, Manila; and Hiranya Mukhopadhyay of the India Resident Mission, ADB, Delhi.

3.17.1 Quarterly GDP growth by sector



Note: Fiscal quarters.

Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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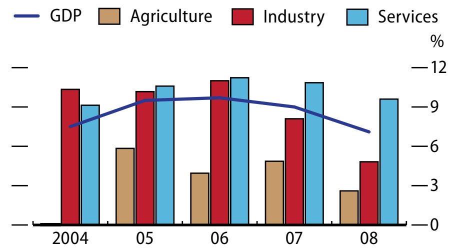
3.17.2 Annual GDP growth by sector



Source: Ministry of Statistics and Program Implementation, available: http://www.mospi.nic.in, downloaded 20 February 2009.

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8% but this masked a cooling in private consumption growth (from 8.5% to 6.8%), though government consumption expenditure growth more than doubled (from 7.4% to 16.8%) partly reflecting pay revisions of government employees.

Expansion in fixed investment, a major element of rapid growth in recent years, stepped down to 8.9% from 12.9% a year earlier. The weakness in investment, as well as an increased offset from net exports (reflecting a large expansion in import volume), were the main demand-side growth-inhibiting factors.

Wholesale price index inflation surged in the first 5 months of FY2008 to reach a high of 12.8% in August. It moderated over the following months (Figure 3.17.4), largely on weaker global prices for commodities and oil initially and later because the Government reduced the domestic prices of gasoline, diesel, and cooking gas in December 2008 and January 2009.

By February 2009 inflation was down to 3.6%, although food inflation remained stubbornly high (especially for rice, pulses, fruits and vegetables). A good spring harvest and high government food stocks are expected to add to the momentum of falling prices. Preliminary data for the first weeks in March indicate that year-on-year inflation has dropped to less than 1%, well below the authorities' target of 3%. Inflation for the whole of FY2008 is estimated at 8.7%, nearly double the previous year's 4.7%.

The concerns of the Reserve Bank of India (RBI) about inflation outweighed its anxieties over growth until September 2008, ensuring a tight monetary stance. Moreover, availability of credit was further constrained due to the knock-on effects of the global financial turmoil that resulted in reduced capital inflows. Coupled with the credit squeeze and high lending rates, increased input costs from higher commodity prices cut into manufacturing profitability and growth for much of FY2008.

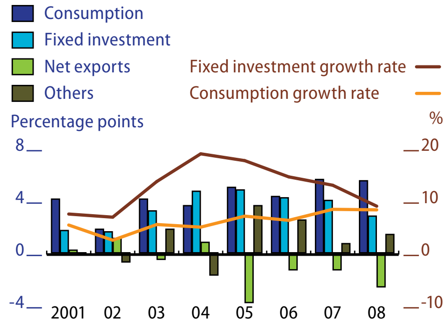
The moderating inflation provided an opportunity for RBI, from October, to reverse its stance and initiate expansionary credit policies. In phases it lowered the banks' cash-reserve ratio from 9.0% to 5.0%, the repo rate from 9.0% to 5.0%, and the reverse repo rate from 6.0% to 3.5% through early March (Figure 3.17.5).

Despite these reductions, local banks were reluctant to lower their lending rates significantly because of the high cost of the term deposits on their books; a downward floor of bank deposit rates due to interest rate paid on the Government's small-savings schemes; worries about a likely increase in nonperforming loans; and a riskier business environment for firms.

Still, with prompting from RBI, banks have lowered the prime lending rate by about 100 basis points to between 13% and 15%, but even then, tumbling inflation means that real interest rates have risen such that the stickiness of high bank lending rates has become a major concern for business. Bank lending has not expanded after the policy easing, even though banks had large excess reserves (Figure 3.17.6). General credit availability has probably tightened as capital inflows were—apparently—much lower after September.

RBI's measures to boost capital inflows included relaxation of restrictions on external commercial borrowings, abolition of interest

3.17.3 Contributions to growth (demand) and growth rates



Sources: CEIC Data Company Ltd., downloaded 16 March 2009; Press Information Bureau, Government of India, *Press Note*, 9 February 2009.

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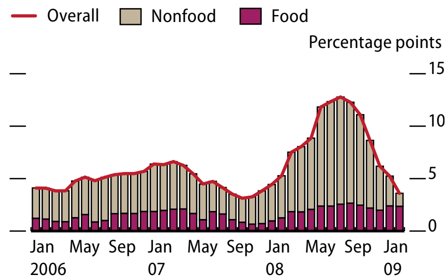
3.17.4 Contributions to wholesale price inflation



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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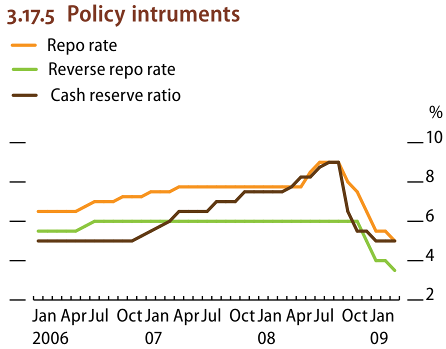
3.17.5 Policy intruments



Source: Reserve Bank of India, available: http://www.rbi.org.in, downloaded 16 March 2009.

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rate ceilings on borrowing, and increasing the annual limit on foreign institutional investment in rupee-denominated corporate bonds to $15 billion. RBI also took measures to increase the availability of credit for exporters and housing as well to small enterprises.

The current financial and economic crisis has derailed the central Government's post-FY2004 process of fiscal consolidation. The Government announced in the period December 2008 through February 2009 several fiscal stimulus measures to spur domestic demand, which amounted to about 1.5% of GDP. It made available additional funds for critical rural infrastructure and social security programs, and authorized Rs100 billion of tax-free bonds for financing public–private infrastructure projects.

It made, in December, a general 4 percentage point cut of the central value-added tax rate (excluding petroleum products). For certain goods, it cut that rate by a further 2 percentage points in late February; at the same time, it lowered the service tax by this amount. Exporters will receive full refund of service tax paid in with respect to their shipments. Moreover, the central Government raised the borrowing limit for state governments from 3.0% to 3.5% of state GDP.

The fiscal responsibility law has been put aside temporarily and the central government budget deficit is estimated at 6.0% of GDP as against 2.5% targeted for FY2008 (Figure 3.17.7). Revenue grew by only 3.7% with shortfalls from corporate taxes and import duties, well below the near 25% gain in previous years.

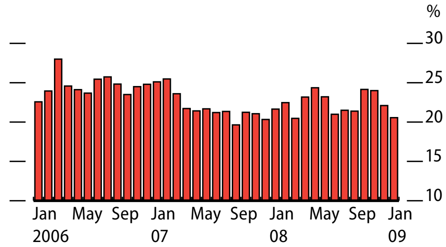
On-budget expenditure increased by about one third, because of additional social spending and subsidies, a large pay hike for civil servants stemming from the Sixth Central Pay Commission recommendations, and greater than budgeted capital expenditure. Despite falling prices toward the end of the year, off-budget subsidies for fuel and fertilizer amounted to 1.8% of GDP in FY2008. Including off-budget items, central government expenditure amounted to 18.2% of GDP, bringing the deficit to 7.8% of GDP. The high fiscal deficit has led Standard & Poor's to downgrade India's long-term sovereign debt outlook from "stable" to "negative," though the country retained a BBB- rating.

State governments have already brought down their deficits to under the target of 3.0% of state GDP set under their fiscal responsibility laws. Sustaining this pace will remain difficult though, because receipts of shared taxes from the central Government are likely to decline over the next few years. If, as expected, the consolidated states' deficit amounts to about 2.2% of GDP in FY2008, the general government deficit for the year would amount to 10% of GDP (including the off-budget items), fully reversing the fiscal adjustment of the past 6 years.

A full budget for FY2009 will be prepared after a new government is formed, subsequent to the national elections in April and May. The interim budget for FY2009 announced by the Government in February envisages an 8.4% increase in revenue and a 15.7% expansion in expenditure resulting in a fiscal deficit of 5.5% of GDP. With low global prices, the interim budget did not foresee the need for off-budget oil or fertilizer subsidies. The interim budget proposed no new tax measures as the new government will formulate fiscal policy for the year.

Better targeting of food and fertilizer subsidies and improved

3.17.6 Commercial bank lending growth



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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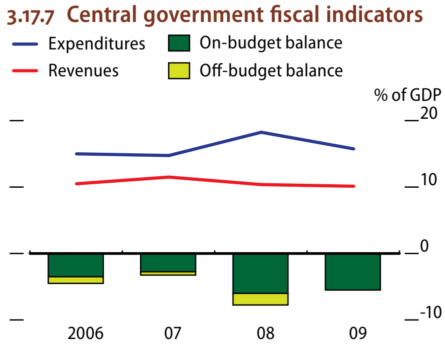
3.17.7 Central government fiscal indicators



Source: Ministry of Finance, available: http://indiabudget.nic.in/, downloaded 16 March 2009.

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cost recovery by oil-marketing companies and refineries have become imperative for sustaining fiscal deficit. At a time of falling business confidence, expansionary fiscal policies could impair the confidence of investors unless clear signals are given that the present large deficits are truly temporary. General government debt is estimated to be 80.7% of GDP at end-FY2008, indicating little room for fiscal maneuver.

The weak performance of exports—declining year on year since October 2008—have compounded the challenges of macroeconomic management (Figure 3.17.8). Exports in January 2009 amounted to $12.4 billion, or 15.9% lower than a year earlier. Items such as textiles, readymade garments, gems and jewelry, and petroleum products all saw declines. Deepening recession in industrial countries is affecting India's exports of information technology and business services, too.

Depreciation of the rupee in FY2008 does not appear to have had a favorable impact on export sales in view of external demand conditions but it has helped preserve firms' profit margins. Recently, India has been seeking to expand export sales beyond its traditional markets to the Middle East, Singapore, and other emerging markets through product diversification and quality improvement. Expansion of exports to PRC that began in earnest in the first half of FY2008 weakened in the second.

Import growth since October has dropped markedly from earlier months, reflecting a fall in oil imports and a modest increase in non-oil imports (Figure 3.17.9). At $18.5 billion in January 2009, imports were 18.2% below the level of a year earlier.

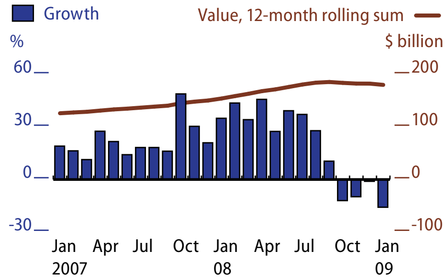
For FY2008, exports (on a balance-of-payments basis) are estimated to have reached $186 billion (a 12.1% advance over a year earlier), and imports $298 billion (15.6%). The current account deficit, put at $22.3 billion in April–September 2008 by RBI, is estimated at $35 billion (3.0% of GDP) for all FY2008, compared to a $17.0 billion deficit (1.5% of GDP) a year earlier.

The main impact of the global financial turmoil on India is the significant change in the capital account. In the first 6 months of FY2008 (March–September), central bank data showed heavy portfolio investment net outflows of $5.5 billion compared to net inflows of $18.4 billion in the year-earlier period. Similarly, commercial borrowing by the private sector slowed to $3.3 billion from $11.2 billion previously. Foreign direct investment (FDI), however, remained buoyant at $20.7 billion during the first half of FY2008 (from $12.2 billion) reflecting the continued expansion of domestic activities, a more positive investment climate, and continuing liberalization measures to attract FDI.

Net capital inflows in the first half of FY2008 came to about $20 billion, or only about 40% of the amount attracted a year earlier. The second half looks like being much weaker. Rough estimates suggest that net capital inflows tumbled in FY2008 to less than one fifth of the $108 billion recorded in FY2007.

With a weakening capital account and larger foreign exchange requirements for imports, especially for oil and fertilizer, there was downward pressure on the rupee despite central bank intervention. The rupee depreciated by about 21% against the US dollar between end-March 2008 and end-February 2009 (Figure 3.17.10). The real effective exchange rate also depreciated by about 7% during this period. Foreign currency

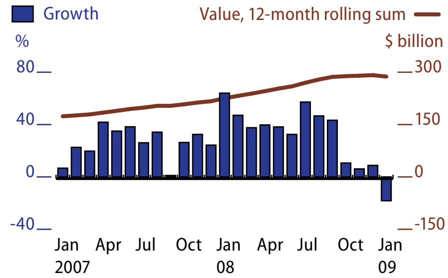
3.17.8 Export indicators



Sources: CEIC Data Company Ltd., downloaded 16 March 2009; staff estimates.

Click here for figure data

3.17.9 Import indicators



Source: CEIC Data Company Ltd., downloaded 16 March 2009; staff estimates.

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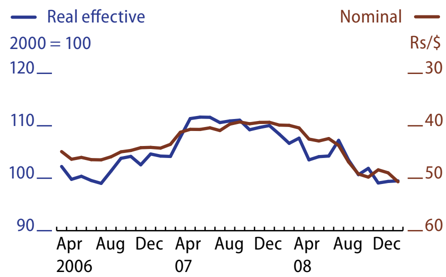
3.17.10 Exchange rates



Sources: CEIC Data Company Ltd.; Bank for International Settlements, available: www.bis.org; both downloaded 16 March 2009.

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assets of the RBI declined from about \$300 billion at end-March 2008 (Figure 3.17.11) to \$237 billion on 6 March 2009.

The Sensex, the main index of the Bombay Stock Exchange, has fallen by about 58% from its all-time high in early January 2008 through mid-March 2009. This drop follows a substantial runup in recent years. Developments in the Sensex are broadly in line with other markets in Asia (Figure 3.17.12), and generally reflect the global financial market turmoil, loss of foreign investor interest, and uncertain economic outlook both in India and in other Asian countries. Market capitalization has fallen from a peak of about 140% of GDP in December 2007 to about 50% of GDP in February 2009. Since stocks are often used as collateral by entrepreneurs for new business loans at banks, the large loss in value has had a depressing effect on new ventures.

Business confidence indicators capturing the financial position of firms, current investment climate, and capacity utilization show continued decline (Figure 3.17.13). Falling confidence has been felt across the spectrum of services and industry, largely because of uncertainties for the global economy and worries about the cost and availability of borrowing. Declining input costs have so far been unable to lift the gloomy business sentiment. Most large companies recorded a fall in net profit due to declines in sales and prices.

As companies scale back production, millions of workers have been laid off or have accepted shorter working hours and lower wages. Those particularly affected include a large number of workers in export-oriented sectors such as textiles or gems and jewelry. Job losses are also multiplying in sectors supporting domestic demand, such as motor vehicles, tourism, and transport services. New employment opportunities have dried up in urban areas and are also showing signs of falling in rural areas. The lack of a well-developed social safety net and rigid labor laws put millions of people in the informal sector at risk of falling into poverty.

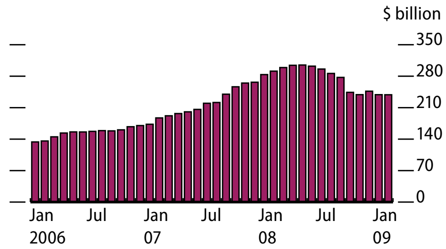
Economic prospects

The global economic outlook has turned increasingly gloomier in the last 6 months. Industrial countries have gone into recession, worldwide demand is drying up, and international oil and commodity prices have plummeted. India's growth has slowed significantly, domestic price pressures have subsided, and inflation has sunk almost out of sight. On the policy front, monetary tightening has given way to monetary easing. With little room for further fiscal maneuver and with inflation largely in abeyance, it is monetary policy that will have to revive growth in the short run.

The forecasts for FY2009 and FY2010 are based on five key assumptions: monetary conditions will continue to be accommodative; domestic food supply position will remain comfortable; global oil prices will average \$43 a barrel in 2009 and \$50 a barrel in 2010; nonfuel commodity prices will decline in 2009, but rise marginally in 2010; and a recovery in industrial economies will begin in the second quarter of FY2010.

Surplus food stocks and a normal monsoon would keep the agricultural situation comfortable. But industry and services will continue

3.17.11 Foreign currency assets



Sources: CEIC Data Company Ltd.; Reserve Bank of India, *Weekly Statistical Supplement*, available: www.rbi.org, both downloaded 12 March 2009.

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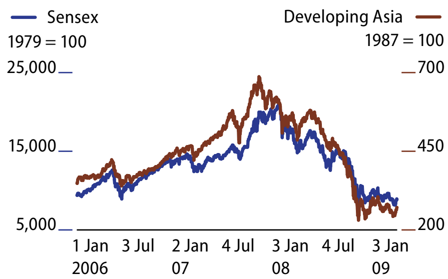
3.17.12 Stock price indexes



Note: The Developing Asia index is represented by the Morgan Stanley Capital International All Country Asia excluding Japan price index.

Source: Bloomberg, downloaded 16 March 2009.

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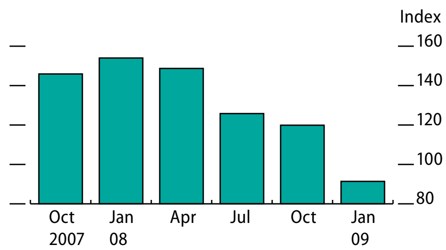
3.17.13 Business confidence index



Source: National Council of Applied Economic Research, available: www.ncaer.org, downloaded 16 March 2009.

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to suffer in the immediate uncertain environment. Consumers as well as entrepreneurs will probably be reluctant to borrow, either to spend or to invest. Prolonged recession in industrial countries will keep investor confidence low. Banks will maintain a risk-averse strategy, especially given a likely deterioration in the quality of loans. As consumer sentiment drops and job losses mount, an immediate revival in demand for consumer durables, motor vehicles, and housing is unlikely. Substantial excess capacity in domestic industry and limited export demand are damping investment prospects.

GDP growth is projected to decline to 5.0% in FY2009. Enhanced public spending, tax cuts, and increases in public sector wages are expected to buttress growth. In FY2010, a combination of a recovery in the G3 economies, improved perception of lower risks of investing in India, and lower domestic lending rates is expected to facilitate some recovery in private investment and manufacturing growth. These changes will support gradual recovery in growth to 6.5% (Figure 3.17.14).

Temporary fiscal stimulus can help prop up economic activity in the difficult period ahead, but it is imperative that the central Government bring down its deficit in the medium term to a manageable level so as to assure long-term debt sustainability. The Government therefore needs to review tax policy, the quality of public expenditure, and the effectiveness of public programs. This will allow it to create space for the infrastructure and social sector spending necessary for achieving rapid inclusive growth. Fiscal consolidation would benefit if the central Government were to set new fiscal policy rules, adopt fuel pricing and subsidy reforms, and abolish all off-budget spending.

Inflation is expected to remain low during FY2009 and FY2010 with comfortable agricultural output, especially of foodgrains, weak domestic demand, lower taxes on goods, and a decline in global commodity prices. Inflation is forecast at 3.5% in FY2009, and to rise a little to 4.0% in FY2010 as domestic markets recover and international prices of oil and non-oil commodities edge up.

Capital inflows will remain under stress throughout FY2009. A weakening capital account will put pressure on the Indian rupee to depreciate. Contraction in world trade volume will prevail over the favorable impact of the real exchange rate depreciation. In FY2009, a fall of about 10% in exports and imports, since imports are larger than exports, will improve the trade and current account deficits. An upturn in export growth in FY2010 is contingent on a recovery in world trade. A gradual rise in international oil and non-oil commodity prices will boost import growth and the trade deficit. The current account deficit is projected to narrow to 1.5% of GDP in FY2009 but then widen a little to 2.0% the following year.

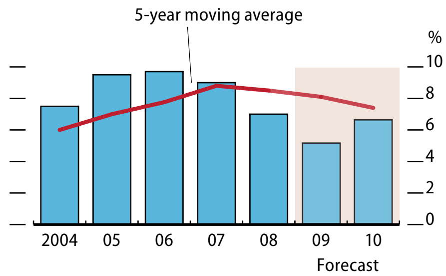
One downside risk that may jeopardize growth prospects is excessively large fiscal deficits, with domestic borrowing requirements of the Government putting pressure on interest rates and restricting the availability of private credit and investment. A further risk is continued recession in industrial countries beyond the second quarter of FY2010. In such an event growth would falter, further structural reforms would be difficult, and policy would likely look inward, which could undermine long-term growth prospects.

3.17.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.0	6.5
Inflation	3.5	4.0
Current account balance (share of GDP)	-1.5	-2.0

Source: Staff estimates.

3.17.14 GDP growth



Sources: Reserve Bank of India, available: http://www.rbi.org.in, downloaded 20 February 2009; staff estimates.

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Maldives

As a small import-dependent economy with a narrow economic base of tourism and fishing, the Maldives is particularly vulnerable to external shocks. High global commodity prices caused a spike in inflation and widened the current account deficit in 2008, and the global economic slowdown hit tourist arrivals. These developments added to the pressures induced by an overly expansive post-2004 fiscal policy. The newly elected president plans to introduce structural reforms to bring down the large domestic and external imbalances. The bleak global economic outlook presents substantial headwinds and risks.

Economic performance

A slowdown in tourism, which generates about a third of GDP, was the main cause for the fall in growth to 5.7% in 2008 from 7.2% a year earlier (Figure 3.18.1). Value added in tourism fell to 2.9% growth from 9.4% in the previous year. Tourist arrivals edged up by only 1%, or well below the 12.3% expansion in 2007, reflecting the slowdown in the second half of the year (Figure 3.18.2). Arrivals from Europe, a market that accounts for more than 70% of arrivals, climbed marginally (0.4%). This mirrored the deteriorating economic conditions there and the euro's weakening against the United States (US) dollar (the rufiyaa is pegged to the dollar) in the last quarter of 2008.

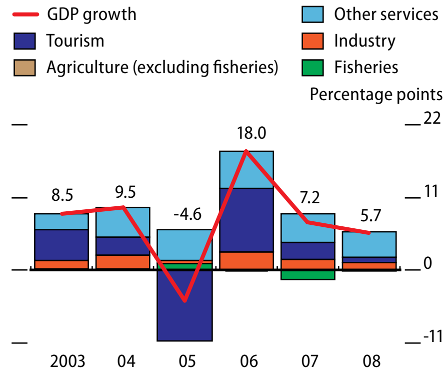
Value added in fisheries, which contributes only 4.2% of GDP but is important in terms of employment and merchandise exports, contracted by 2.7% in 2008 on a reduction in the fish catch, though fish exports grew by about 17%, on better prices. Growth in industry—manufacturing, utilities, and construction—slowed but its share in GDP increased slightly to 17.7%.

In an adverse external environment, inflation, as measured by the national consumer price index, rose to an average of 12.3% in 2008 from 7.4% a year earlier. Inflation broadly follows the movement of international prices, as the country imports the bulk of the commodities it consumes. Food, petroleum products, and construction materials are major items. Paralleling international price trends, inflation began to pick up in the second half of 2007 and peaked at 17.3% year on year in July 2008, before moderating to 9.1% in December (Figure 3.18.3).

Money supply growth gradually slowed to 23.6% year on year in December (Figure 3.18.4). The impact of expansion in domestic assets of over 40% was, however, partly offset by changes in net foreign assets of the banking system, the net liabilities of which have been growing since July 2007. This increase reflects the borrowing by foreign-owned commercial banks from their headquarters to lend to the private sector. More than half the outstanding bank credit is related to tourism.

The deteriorating fiscal balance is a concern. The Government

3.18.1 Contributions to growth (supply)



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 1, February 2009.

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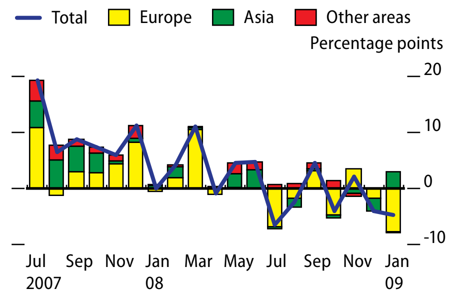
3.18.2 Contributions to growth in tourist arrivals



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

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

included large reconstruction outlays in the budget after the tsunami in December 2004, but also pushed up current spending, both to raise public sector wages and to maintain power and water subsidies in Malé. In 2008, it faced revenue and foreign exchange shortfalls, leading to the non-award of two planned major infrastructure projects totaling $190 million. The Government wanted to fill the revenue gap with leases for new resorts on 30 islands, as well as a 20% reduction in budgeted expenditure for the last few months of 2008. It did not, however, proceed with the lease tenders and instead found alternative sources from bilateral and commercial external sources. Expenditure for 2008 is estimated at 67.0% of GDP, up slightly from 66.1% in 2007. The fiscal deficit worsened to 15.7% of GDP in 2008 from 7.9% (Figure 3.18.5).

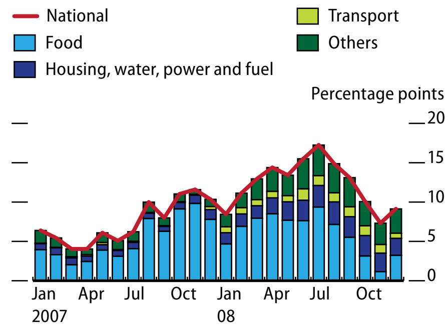
The jump in public debt from around 40% of GDP in 1999 to around 57% in 2008 raises serious sustainability concerns. About 70% of outstanding public debt is foreign currency denominated. The large deficit buildup underscores the need for fiscal prudence and for fiscal consolidation to reduce the vulnerability of the balance of payments. For example, the tax base should be expanded as it is currently reliant almost exclusively on import duties and tourism receipts. A business profit tax and a more progressive tourism tax would help secure more stable receipts.

The external sector has also experienced widening imbalances. Higher international commodity prices raised the import bill by almost one third in 2008, in large part due to the nearly 40% weight of food and petroleum products in total imports. With modest growth in domestic exports (5.5%), the trade deficit deteriorated by about 26% to $928 million, or 74% of GDP. The net surplus in services expanded by about 4% only, reflecting moderate growth in tourism receipts and larger services imports. The current account deficit widened sharply to $637 million (about 50.6% of GDP), from 39.1% in 2007 (Figure 3.18.6). Although the financial account continued to record large net inflows, the overall balance of payments moved into deficit (of $72.3 million) in 2008. At year-end, gross international reserves stood at $241 million, or 2.1 months of imports.

Short-term external debt (all owed by commercial banks) has surged since 2005 to 39.5% of GDP. Because the bulk of commercial bank lending is to develop tourism, the banks probably face a risk of asset–liability term mismatch, and as the global financial crisis deepens, they may find it hard to roll over short-term borrowing. The external imbalance thus poses significant risks for the balance of payments as well as for financial institutions' balance sheets.

The country went through an important political transition in 2008. A new constitution was adopted in August, followed by the first multiparty presidential election in November, which brought in a new president—the first for 30 years. The new Government faces hard choices to mitigate immediate risks of the country's macroeconomic imbalances. Unless it rationalizes its spending and, in particular, curtails power subsidies, public debt may not stay sustainable. More generally, the Government's ability to promptly carry out its development priorities will to a large extent depend on it success in addressing domestic and external imbalances.

3.18.3 Inflation



Source: Maldives Monetary Authority, *Monthly Statistics*, various issues.

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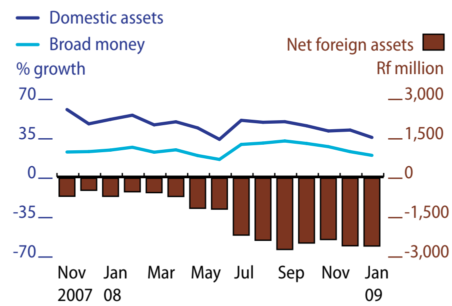
3.18.4 Monetary indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

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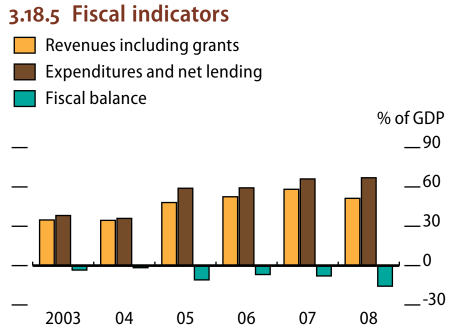
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

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Economic prospects

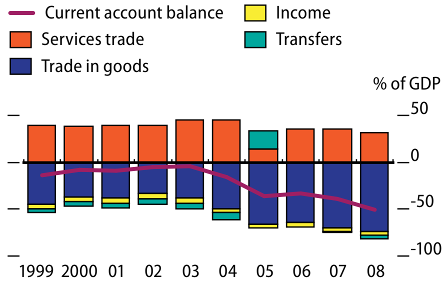
The GDP projection heavily depends on the new administration's ability to introduce meaningful economic reforms. Parliamentary elections in the first half of 2009 are expected to pave the way for measures to address the large internal and external imbalances. Growth in 2009 will also depend on the depth of the tourism tumble. Although the Government is promoting tourism from areas other than Europe, such as India, and despite likely room-rate discounts, tourist arrivals are expected to fall this year. On these assumptions, economic growth is projected to decelerate to 1.0% in 2009 and gradually recover to 1.5% in 2010.

Inflation is put at 4.5% and 5.5% in 2009 and 2010, broadly in line with global price assumptions but reflecting February 2009's pay rise for government employees of 25–30%. It is also assumed that the monetary authority will not monetize a part of the government fiscal deficit. On the external front, lower commodity prices will ease the trade deficit, but receipts from tourism will recover only after 2010. The current account deficit is forecast to be about 30.0% of GDP in both 2009 and 2010.

For the medium term, the Government will consider downsizing public employment as well as making tax reforms (such as introducing a business profit tax, an ad valorem tourism tax, and eventually a general sales tax). Amendments to the Tourism Act are expected to provide additional resources from an extension of the resort lease period.

Although the new Government's policy intentions are in the right direction, fiscal consolidation may face challenges due to the economic slowdown as fiscal receipts, especially from tourism, come under strain. Time, however, is of the essence, as the large fiscal deficit is exerting significant pressure on the balance of payments.

3.18.6 Current account



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

Click here for figure data

3.18.1 Selected economic indicators (%)

	2009	2010
GDP growth	1.0	1.5
Inflation	4.5	5.5
Current account balance (share of GDP)	-30.0	-30.0

Source: Staff estimates.

Development challenges

The country needs to address its shortage of skills and weak institutional capacity. Since vocational and skills training is underdeveloped, the education system does not provide the kind of workers that the labor market requires. High youth unemployment and heavy reliance on expatriate workers are a consequence.

The Government still plays a large role in the economy through state enterprises, indirectly limiting scope for private sector activity. Public ownership is widespread in every sector except tourism. One of the new Government's priorities is privatization, as seen in the advanced stage of turning over Malé International Airport to the private sector. The Government is also seeking expressions of interest in other entities, including state fisheries and electricity companies.

Income disparities between Malé and the atolls are large and widening. The Gini coefficient for the whole country was 0.41 in 2004, pointing to significantly higher inequality than in neighboring countries. Ensuring inclusive growth is thus vital. The Government also aims to prioritize decentralization, shifting the focus of economic development from Malé and creating economic and social infrastructure away from the capital.

Nepal

Economic growth rebounded in FY2008 from a slump in FY2007, aided by an improved security situation and emerging political stability following the end of the decade-long civil conflict, and by favorable weather. Sustaining this growth and the poverty-reduction gains of the past decade will, though, remain challenging given the protracted and complex post-conflict political transition. Additionally, the downdraft from the deepening global downturn could damage the country's growth prospects to a greater extent than earlier expected.

Economic performance

Nepal's peace process took a key step forward with the orderly conduct of the historic constituent assembly elections in April 2008, which raised hopes of economic recovery and improved living standards. Although the election results were not decisive enough to usher in a majority government, the Communist Party of Nepal, Maoist (CPNM)—an insurgent political force until April 2006—emerged as the largest party in the constituent assembly, giving it the lead role in the new coalition Government formed in August. The new administration envisages an ambitious economic recovery and development agenda in the difficult transitional political environment.

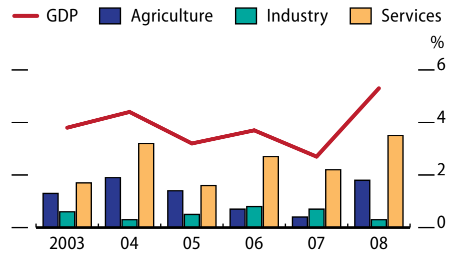
Aided by the improved security situation, overall GDP growth went back up to 5.3% in FY2008 (ended mid-July 2008) from 2.7% in FY2007 (Figure 3.19.1). This rebound, which reflected the sustained expansion of services and a weather-induced recovery in agriculture, could have been greater had it not been for the deceleration of industry due to input supply disruptions and labor agitation.

Services, with a 48% share in overall GDP (Figure 3.19.2), expanded by 7.0%, contributing 3.6 percentage points to overall growth (Figure 3.19.1 above). Growth was broad-based within the sector. In particular, hotels and restaurants as well as financial intermediation, which grew by 8.5% and 13.8%, respectively, benefited most from a sustained increase in tourist arrivals and the entry of new financial institutions. Real estate–related businesses, however, decelerated to 4.4% from 11.8% growth in FY2007, as rural households displaced by the conflict started to return from urban areas to their homes.

Agriculture, with a 36% share in overall GDP, also registered strong growth of 4.7%, underpinned by a significant increase in paddy and other crop output, which was aided by favorable monsoon rains. Agriculture's contribution to GDP growth in FY2008 improved to 1.8 percentage points, from only 0.4 percentage points in FY2007.

Industrial growth, however, slackened to 1.9% in FY2008 from 3.9% in the previous year—a combined effect of long-standing structural weaknesses, such as low productivity and the inadequate infrastructure

3.19.1 Contributions to growth (supply)



Source: Ministry of Finance, available: http://www.mof.gov.np, downloaded 9 March 2009.

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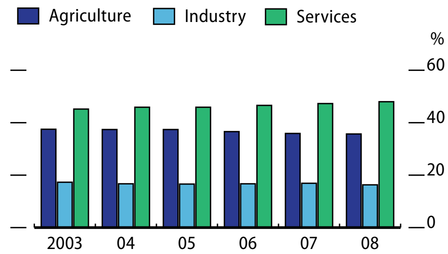
3.19.2 Sector shares of GDP



Source: Ministry of Finance, available: http://www.mof.gov.np, downloaded 9 March 2009.

Click here for figure data

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

base, as well as disruptions caused by growing labor unrest and acute power and fuel shortages. (The power shortages are due to additional peace-time demand and low water levels in reservoirs.) Although manufacturing was hard hit by these disruptions, construction activities continued to grow moderately.

On the demand side, the economy continued to be driven by private consumption, in turn fueled by workers' remittances. However, private consumption's share declined marginally to about 77% of GDP as investment picked up—gross fixed capital formation increased to 21.1% of GDP from 20.4% in the previous year—in response to the improved security situation and emerging political stability.

Average consumer inflation rose to 7.7% in FY2008 from 6.4% a year earlier, mainly reflecting rising fuel and food prices and the higher inflation in India. Nepal's inflation is closely linked to India's, given the currency peg to the Indian rupee, close trade ties, and the open border. Inflation rose to 12.1% on a 12-month basis by July and remained high through mid-January 2009 (Figure 3.19.3). Steeper transport costs that reflected fuel price adjustments, and a shortage of rice partly caused by India's temporary export ban, contributed to the increase in food prices. Given the hike in food prices (which make up 53% of the consumer price index basket), inflation has imposed a particular hardship on the poor.

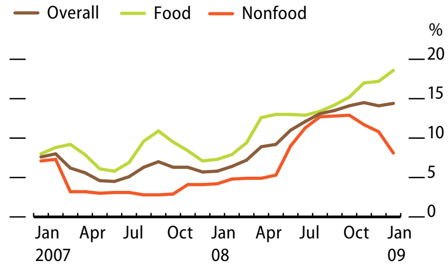
The central bank kept its main policy (bank) rate unchanged at 6.25% and the cash-reserve ratio at 5.0% in FY2008. A sharp rise in net foreign assets during the year, generated by stronger remittance inflows, expanded banking system liquidity and raised reserve money by 21.2%, compared with 7.5% in FY2007. This led to a 25.2% expansion in broad money (M2), up from 14.0% in FY2007. To rein in rising inflation, the central bank adopted a tighter monetary policy for FY2009 by lifting the bank rate to 6.5% and the cash-reserve ratio to 5.5%.

Improved revenue mobilization helped contain the budget deficit at 2.0% of GDP (1.8% a year earlier) despite a surge in expenditure (Figure 3.19.4). Recurrent spending swelled by nearly 19%, mainly on account of peace process–related expenditures such as the constituent assembly elections and operation of the temporary camps for former CPNM combatants until they are integrated into society. Capital spending also jumped, by 40.5%, in an improved project implementation environment. Total revenue (including taxes, nontax revenue, and grants) grew robustly by 24.5% in FY2008—even after sturdy growth of 21.2% a year earlier—supported by stronger tax administration. It increased to 15.6% of GDP, a gain of about 1.5 percentage points from a year earlier.

The improved security and political situation facilitated increased use of external assistance (both grants and loans), although spending still fell short of the budget target. The lower than budgeted fiscal deficit helped contain domestic financing at the budgeted level of 1.6% of GDP.

On the external front, the current account in FY2008 moved to a surplus of 2.6% of GDP from a deficit of 0.1% a year earlier, buoyed by large workers' remittances (17.4% of GDP) and improved tourism receipts (2.3% of GDP), which more than offset a widening trade deficit (Figure 3.19.5). Export growth picked up to 12.8% (from 1.9% in FY2007), because of a significant rise in shipments to markets other than India. Still, the trade deficit widened by about 2 percentage points to 19.2%

3.19.3 Inflation



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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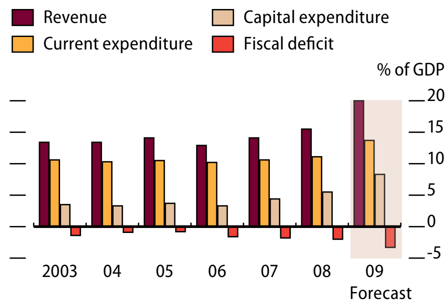
3.19.4 Fiscal indicators



Sources: Ministry of Finance, available: http://www.mof.gov.np; Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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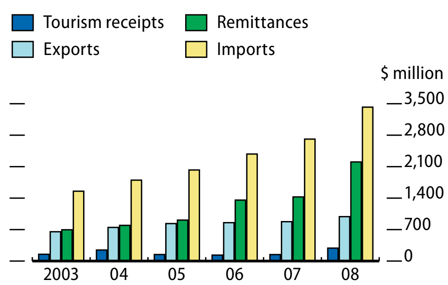
3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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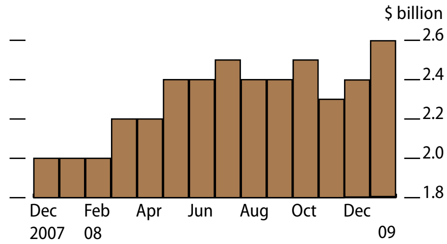
of GDP as imports surged by 26.3%, fueled mainly by large remittance spending on consumer goods and by higher oil prices.

With increased aid flows, the overall balance-of-payments surplus grew to 4.1% of GDP. Foreign exchange reserves climbed markedly to $2.5 billion at end-FY2008 (mid-July), and subsequently rose to $2.6 billion by mid-January 2009 (Figure 3.19.6). Reserves are equivalent to about 7 months of imports of goods and services.

The Nepalese rupee depreciated by 5.3% against the United States dollar over the course of FY2008 due to its peg to the Indian rupee (Figure 3.19.7). The trade-weighted real effective exchange rate also depreciated, by 3.4%.

3.19.6 Foreign exchange reserves



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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Economic prospects

Medium-term growth and development prospects rest largely on continued macroeconomic stability, a smooth and rapid political transition, and the impact of the global economic slowdown. The fragile political situation and the adverse external environment pose significant downside risks. The expansionary FY2009 budget—with an expenditure outlay of NRs218.6 billion or a 52.0% increase from the estimated expenditure in FY2008—presents a challenge for maintaining fiscal and macroeconomic stability.

The more disruptive is the post-conflict political transition, the less focus will there be on the pressing reform and development priorities. A rapid political transition, in parallel with renewed structural reform and development efforts to boost rural incomes, is therefore vital. Although the global economic slowdown has not yet affected Nepal, some impact is inevitable on exports, remittances, tourism receipts, and external assistance, especially if it is prolonged. The authorities will, therefore, need to remain vigilant and be prepared to take necessary fiscal and monetary policy measures.

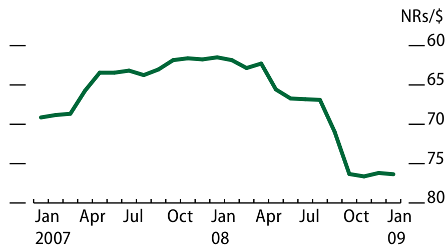
Lower international oil prices augur well, as the economy is fully dependent on imported fuel. An upswing in oil prices could, though, once more disrupt supply, which combined with power shortages would have a detrimental impact. Current low international oil prices present an opportunity to put in place an effective market-oriented pricing mechanism and import deregulation.

Against this backdrop, the baseline assumptions for Nepal's economic performance in FY2009 and FY2010 are that normal weather conditions will prevail, the political transition will progress without serious disruption, prudent macroeconomic policies will be continued, and business confidence will strengthen somewhat. It is also assumed that the exchange rate peg to the Indian rupee will be maintained and that the domestic oil supply situation will remain normal, but that power shortages will not ease significantly.

Based on these assumptions, GDP growth is forecast to slow to 3.0% in FY2009, following the high cyclical rebound in services and the exceptional gain in agriculture in FY2008, and then pick up somewhat to 3.5% in FY2010. Growth in each of these 2 years will be led by a 4.0% expansion in services.

Services growth in FY2009 will be supported by trade, financial

3.19.7 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, available: http://www.imfstatistics.org, downloaded 2 March 2009.

Click here for figure data

3.19.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	3.5
Inflation	10.0	8.0
Current account balance (share of GDP)	1.5	1.0

Source: Staff estimates.

intermediation, transport and communications, and tourism (though the likely significant shortfall in the Government's capital spending due to delayed budget approval will limit growth in certain subsectors). Financial expansion will be aided by the new Government's efforts to boost rural financial services, while the expansion of transport and communications, and of tourism, will be bolstered by improved fuel supply.

Although the growth of some subsectors such as trade and tourism will weaken in FY2010 because of the lagged impact of the global downturn, this will be offset by higher public spending and continued expansion of the financial and the transport and communications subsectors.

Agriculture is expected to expand by 3.0% in FY2009, underpinned by the good summer crop (mainly paddy), but damped by a poor winter crop (mainly wheat and barley) due to drought. Assuming normal weather conditions and smoother transport services from improved fuel supply and political stability, the sector is expected to expand by 4.0% in FY2010.

Industry's performance will likely remain sluggish, as power shortages and labor unrest continue to affect manufacturing. While utilities output will not improve (with the decline in output of major power plants and the delayed commissioning of the Middle Marsyangdi Hydroelectric Project), construction activity is expected to pick up in response to the fall in prices of construction materials. Industry is, therefore, projected to grow by a mere 1.0% in FY2009, but with some concrete steps to improve industrial relations and the overall business environment, it is expected to expand by 2.5% in FY2010.

On the demand side, consumption will stay buoyed by remittances, which are likely to continue rising as a result of new labor agreements with several host countries. However, the slowdown in the outward flow of migrant works and the increasing repatriation of some workers from certain host countries in recent months suggest that remittance inflows will likely slow, especially in FY2010.

Owing to high prices of some food items, and of fuel and transport, year-on-year inflation in mid-January 2009 remained high at 14.4%. This reflected supply constraints caused particularly by high transport costs (since domestic fuel prices have not yet been adjusted downward commensurately in response to the drop in world oil prices), increases in the minimum wage and civil service salaries, and the deepening power crisis. Domestic oil and transport price adjustments will likely be made, easing supply bottlenecks in FY2010 when average inflation should moderate to about 8%.

The wide trade deficit will persist. Import growth, though slowing, will be driven by a higher oil import bill stemming from more oil-fired power generation, continued remittance-induced consumer spending, and greater outlays on investment goods. Export growth will be sluggish due to weak external demand and long-standing structural weaknesses. Remittances and tourism receipts should continue to grow, albeit more slowly because of the global economic downturn, but they will still offset the trade deficit.

These developments suggest that the current account surplus will likely shrink to about 1.5% of GDP in FY2009 and to 1.0% in 2010. Although significant increases are unlikely, aid flows are expected to maintain the capital and financial accounts in surplus, which will ensure a continued overall balance-of-payments surplus.

3.19.1 Development challenges

Despite significant poverty reduction from 1996 to 2004 (largely due to remittances), poverty is still widespread and inequality is rising. These are key development challenges, especially in light of the increasingly difficult global and domestic economic environments.

In the complex political transition, the potential weakening of the reform and development focus, which is intended to generate employment and boost rural incomes, poses a major risk to sustaining the poverty reduction gains of the past decade. The drop in remittance inflows and any reduction in aid flows may also undermine these gains.

Generating widespread domestic employment opportunities has become crucial, especially with a burgeoning labor force and repatriation of migrant workers. Improving the business and investment environment will be important to achieve strong employment growth. To this end, various bottlenecks need to be tackled, particularly growing management–labor tensions, lack of skilled labor, inadequate (especially power-related) infrastructure, and limited access to rural finance.

The entry of a large number of financial institutions in the past couple of years poses a major challenge for the central bank with its limited institutional capacity to effectively supervise and regulate them. However, losses due to the international financial crisis do not affect local banks and the housing market is expected to remain stable.

Pakistan

A sharp deterioration in current account and fiscal balances in 2008, amid escalating inflation, led to a depletion of foreign exchange reserves. This, in turn, triggered a balance-of-payments crisis. The immediate threat to economic stability and the servicing of international debt obligations was overcome through a stabilization program backed by the International Monetary Fund. The growth model of recent years has several structural weaknesses, which result in recurring boom-bust cycles and overdependence on foreign capital. Beyond the immediate fiscal and monetary steps, the country needs a long term strategy and action plan to transform, upgrade, and diversify the economy, in particular manufacturing. The objective is to generate employment, and relax the balance-of-payments constraint to growth.

Economic performance

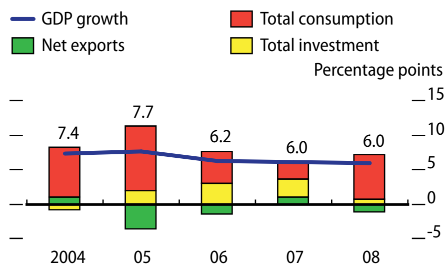
During FY2008 (ended 30 June 2008), the economic situation deteriorated significantly after 5 years of respectable growth that averaged around 7%. The growth during FY2003–FY2007 was premised on economic reforms and an expansionary policy framework that aimed to achieve high growth rates. This framework banked on the (at the time) substantial available external capital inflows. These inflows also helped build up foreign exchange reserves.

Aggravated by unprecedented oil and food price shocks in FY2008, though, the economy started having problems attracting inflows, and its economic fundamentals worsened. The resulting steep drawdown of reserves led policy makers to turn to the International Monetary Fund (IMF) for support for its stabilization program, in November 2008. The program, based on tightened fiscal and monetary policies, aims bring down the current account deficit, shore up reserves, and cut inflation, but will have a depressing impact on growth in the short to medium term.

Growth dropped to 5.8% in FY2008. Significant factors constraining growth have been the sharp decline in the growth of private investment resulting from political uncertainty, the worsening security situation, and the impact of high international oil prices and frequent power shortages. The contribution of investment to growth fell to only 0.7 percentage points in FY2008 compared to 2.7 percentage points in the preceding fiscal year (Figure 3.20.1). Yet the saving–investment gap (private sector deficit) widened, as a result of a decline in the saving-to-GDP ratio. The contribution of net exports to growth turned negative caused by the oil price hike and a continued slowdown in textile exports. Without the robust consumption growth in FY2008, GDP growth would have been even lower.

On the supply side, growth in agriculture and industry (Figure 3.20.2)

3.20.1 Contributions to growth (demand)



Source: Ministry of Finance, *Pakistan Economic Survey 2007–08.*

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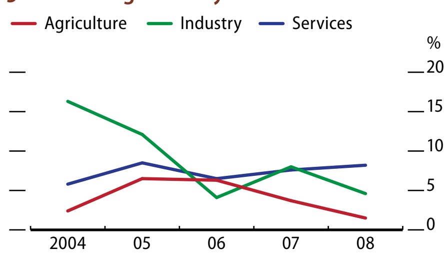
3.20.2 GDP growth by sector



Source: Ministry of Finance, *Pakistan Economic Survey 2007–08.*

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This chapter was written by Jesus Felipe of the Central and West Asia Department, ADB, Manila; and Safdar Parvez of the Pakistan Resident Mission, ADB, Islamabad.

was less than half the respective targets for FY2008. Water scarcity and the high price of fertilizers brought down growth of major crops. Industrial growth remained subdued. Therefore, most of the supply-side expansion came from services.

The oil price shock and the high wheat import price, when combined with the failure to adjust domestic prices in line with international price movements, led to a massive buildup of unbudgeted subsidies and resulted in a high fiscal deficit of 7.4% of GDP in FY2008—the highest in 9 years. Also, block payments on maturing government certificates issued in the 1990s steeply increased debt service and contributed to the larger deficit (Figure 3.20.3). In the absence of foreign inflows, the deficit had to be financed mainly through domestic borrowings from the central bank. Development expenditure planned in the budget had to be cut to accommodate the untargeted subsidies. The tax-to-GDP ratio remained at a low 10%.

Subsidies on oil, food, fertilizer, and power contributed to the budget deficit but failed to contain inflation as food prices soared and the price of fuel was adjusted upward in the last 4 months of FY2008. The steep depreciation of the Pakistan rupee stoked inflation pressures. The consumer price index on a year-on-year basis climbed to 21.5% in June 2008 and to 25.3% in August—the highest in 30 years. Core inflation also increased (Figure 3.20.4). As food prices rose sharply (to 32% in June 2008 year on year), the poorest groups in society were the hardest hit.

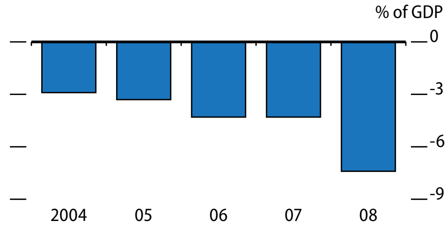
With declining international commodity prices and a slowing domestic economy, the year-on-year consumer price index fell to 20.5% and food inflation to 21.6% in January 2009. Domestic inflation would have fallen by more had the Pakistan rupee not depreciated by 15.9% against the United States dollar in the first 7 months of FY2009.

Reacting to rising inflation and the sharp increase in imports, the State Bank of Pakistan, the central bank, tightened monetary policy three times in FY2008 with a cumulative increase of 250 basis points in the discount rate (Figure 3.20.5). The interest rate climbed by another 300 basis points to 15% (the highest in South Asia) by November 2008 under the IMF program as inflation persisted, the drain on the reserves continued, and the Government sought to reduce its borrowings from the central bank by making Treasury bills more attractive to commercial banks.

This tightened monetary stance was opposite to that adopted in much of the developed world, which was grappling with a worsening global economic downturn. The rise in interest rates did not subdue inflation however, since it is largely driven by supply, not demand.

However, as banks started to face a liquidity crunch caused by a major drawdown of their net foreign assets, the central bank was forced to relax monetary policy during September and October 2008 through open-market operations and reductions in the cash-reserve and statutory liquidity requirements. These measures coincided with the above increase in the discount rate, thus implementing potentially inconsistent measures. The central bank maintained unchanged its monetary tightening policy as it was able to drain the excess liquidity thorough open-market operations in December 2008.

3.20.3 Fiscal deficit



Source: Ministry of Finance, *Pakistan Economic Survey 2007–08.*

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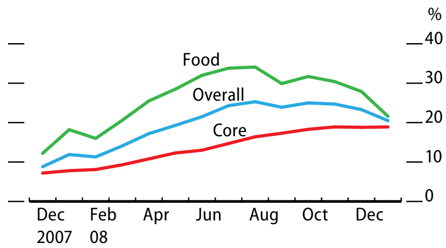
3.20.4 Inflation



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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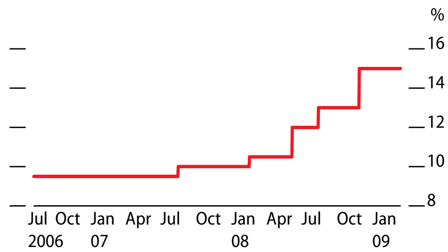
3.20.5 Policy rate



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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The central bank's liquidity management lent stability to the Karachi Interbank Offered Rate. The real lending and deposit rates, as a result, remained negative even after the increase in the policy discount rate in November 2008. The declining trend in the real rate failed, however, to help the private sector credit uptake, which plummeted by 48% during 1 July 2008–16 February 2009 relative to the corresponding period in the previous fiscal year. Weak external demand and deceleration in imports affected the appetite for credit from the demand side and a risk-averse stance of banks with their rising level of nonperforming loans squeezed the availability of credit from the supply side.

The current account deficit widened to $14.0 billion (8.4% of GDP) in FY2008 (Figure 3.20.6), from $6.9 billion (4.8%) in FY2007, as the trade balance recorded its highest-ever deficit of $15.3 billion. Imports expanded almost twice as fast as exports. The oil import bill jumped by 43% and food imports by 46% in FY2008 relative to FY2007. In exports, while rice and cement showed strong growth, textiles remained stagnant. The income and services accounts also recorded larger deficits than in the preceding fiscal year. The current account deficit would have been larger in the absence of a robust 17% growth in workers' remittances.

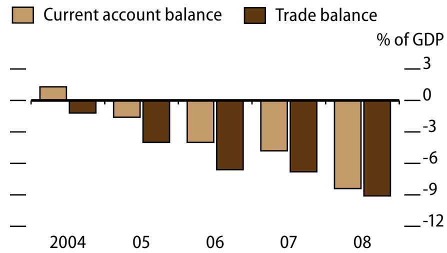
Managing the fiscal and current account deficits became a key challenge for the Government. The financial account surplus declined by $2.5 billion in FY2008 as external and domestic economic shocks led to a massive adjustment in portfolio investment, which declined to just $41 million from $3.3 billion in the prior year. Foreign direct investment in FY2008 showed no change, at $5.1 billion. The Government's privatization program stalled. Multilateral disbursements, however, recorded a 14% increase in FY2008.

With the large current account deficit and the deterioration in the financial account, the rise in interest rates in FY2008, besides being unable to stem inflation, was insufficient to arrest the depreciation of the Pakistan rupee and to stop the depletion of foreign reserves. The nominal exchange rate sank by 11.3% and the real effective exchange rate depreciated by 2.3% despite high domestic inflation (Figure 3.20.7). Foreign exchange reserves dropped by almost one third, to end FY2008 at $11.0 billion (Figure 3.20.8).

Following the slowdown in non-debt-creating inflows, the financing burden of the fiscal and current accounts led to a large accumulation of debt, both domestic and foreign. The debt-to-GDP ratio increased for the first time in 3 years to 58.8% (Figure 3.20.9). This went counter to the Fiscal Responsibility and Debt Limitation Law of 2005, which requires a 2.5% annual reduction in that ratio. Debt as a share of public revenue also increased and the share of short-term floating debt rose as the Government's borrowings from the central bank rose.

The ratio of external debt to GDP, however, declined moderately (by 0.6 percentage points), although the absolute level of external debt rose by $5.46 billion with an increase in multilateral borrowings. The depreciation of the Pakistan rupee also caused the local currency–denominated value of external debt to increase. At the same time, the adequacy of reserves to back foreign debt diminished.

3.20.6 Current account indicators



Source: State Bank of Pakistan, *Annual Report 2007/08*.

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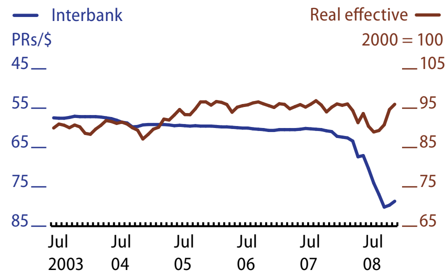
3.20.7 Exchange rates



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009; International Monetary Fund, *International Financial Statistics* online database, downloaded 16 March 2009.

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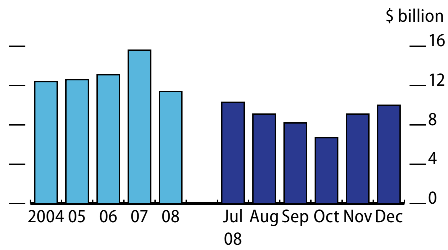
3.20.8 Total foreign exchange reserves



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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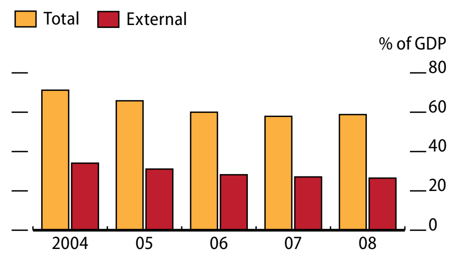
3.20.9 Debt indicators



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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Economic prospects

To stop the steep deterioration in macroeconomic fundamentals in FY2008, the Government prepared a plan to stabilize the economy. IMF endorsed the plan under a standby arrangement (Box 3.20.1).

The measures agreed with IMF aim at stabilizing the economy. In the short run, they will depress the investment and unemployment outlook, and increase the vulnerability of the poor if social assistance fails to reach the targeted groups. While failure to reduce imbalances may hurt future growth, the stabilization policies will hit growth and will lower the potential of the economy. Indeed, as the experience of the Asian crisis of 1997–98 shows, stabilization policy cannot be separated from growth policy. Growth in the Asian crisis–affected countries is significantly lower than during the precrisis period. Moreover, an important lesson of that crisis is that cutting core development spending, such as for infrastructure, during a crisis can have significant long-run costs, as rehabilitation later will be costly and hold back economic recovery.

Fiscal discipline will lead to low inflation, but it will also become a deflationary force, since it creates excess capacity and unemployment. This is an important issue because the ultimate goals have to be job creation and wage and price stability. A key question, therefore, is that in addition to reducing imbalances, the Government needs to implement other policy actions to revive the economy in the medium and long term. These are discussed in the final section on development challenges (Box 3.20.2).

These considerations are relevant because growth in FY2009 is estimated to slow to 2.8% due to the impact of the global slowdown, tight demand management policies, and the power deficit (Figure 3.20.10). Growth in agriculture will improve with respect to that in the last fiscal year, but will remain moderate on account of high input costs (including electricity, fertilizers, and pesticides) and pest attacks. The sugarcane crop has been disappointing, and the cotton crop has been short of target. However, the wheat crop is projected to be very good on account of improved water availability and a 52% increase in the support price for farmers, announced in September 2008.

Energy shortages, the law and order situation, and capacity and input constraints caused by higher import prices from the large depreciation of the Pakistan rupee, will lower industrial performance. Large-scale manufacturing shrank by 5.6% in the first 5 months of FY2009 as textiles, automobiles, metals, food and beverages, and petroleum products all registered declines. Growth in services, too, in FY2009 will moderate as a result of the knock-on effect of the lower growth momentum in the commodity-producing sectors on wholesale and retail trade, as well as of the ongoing consolidation in the telecommunications subsector. The performance of the financial subsector could be affected by the increase in nonperforming loans this year.

GDP growth is expected to improve to 4.0% in FY2010. The expansion will come from greater stability in economic fundamentals, improved financial inflows resulting from gradual easing of global credit conditions that will help revive investment, and the expected improvement in electricity availability as the Government rationalizes the tariff structure

3.20.1 The stabilization program

In November 2008, the Government and the International Monetary Fund reached an agreement according to which a 23-month standby arrangement amounting to $7.6 billion was made available to Pakistan to support its economic stabilization program. The arrangement released $3.1 billion immediately; subsequently quarterly reviews will determine the availability of the remaining tranches.

The two key objectives of the support are: to restore macroeconomic stability and confidence through a tightening of macroeconomic policies; and to ensure social stability and adequate support for the poor and vulnerable in Pakistan.

The specific areas that are being targeted to meet these key objectives are:

- External balance—to be targeted via fiscal tightening.
- Fiscal balance—the program requires a fiscal deficit tightening from 7.4% of GDP in FY2008 to 4.2% in FY2009 and then 3.3% in FY2010. The tightening will come principally through phasing out energy subsidies, better prioritizing development spending, and implementing strong tax policy and administration measures.
- Monetary tightening—through increases in the policy discount rate, to contain inflation, offload government borrowing from the central bank, and build reserves.
- Financial institution reform—structural changes to deal with risk contingencies, insolvent banks and to strengthen the SBP's resolution capacity.
- Foreign exchange intervention by the central bank—geared only toward achieving the program's reserve targets and smoothing excessive exchange rate volatility.
- Social assistance—to be strengthened but better targeted, such that spending on the social safety net will be increased to 0.9% of GDP in FY2009, an increase of 0.6 percentage points of GDP.

and moves to eliminate the intercorporate circular debt problem in the energy sector to reduce the fiscal constraints that now limit production.

The fiscal deficit is expected to decline in FY2009, as the Government removes or reduces subsidies, and rationalizes development expenditure. With the fiscal deficit targeted to fall to 4.3% of GDP, the Government has already fully eliminated the subsidy on petroleum products, and is undertaking a phased reduction in the electricity subsidy, with the target to remove this subsidy too by the end of FY2009. A reprioritization of projects is expected to lead to a slashing of the development budget by over PRs100 billion for FY2009. The fiscal deficit in the first half of the fiscal year of 1.9% of GDP suggests that the authorities are on course on meeting the fiscal deficit target for the full year.

The deficit has been reined in despite a shortfall in tax revenue collected by the Federal Board of Revenue. But this is being offset to a large extent by petroleum development levy receipts because the domestic oil price has not been adjusted downward by as much as the fall in the international price. The Board's tax collection target has been accordingly reduced for the full year. In the event that the revised target also cannot be met, for example, because of the slowdown in economic activity and declining inflation, then further expenditure cutting, mainly on development, might be the only way to meet the fiscal deficit target.

In FY2010, the fiscal deficit is projected to go down further to 3.4% of GDP as ongoing tax administration and policy reforms start to make themselves felt in greater generation of revenue and as expenditure is streamlined. Although fiscal deficits are programmed and although they are projected to decline as a share of GDP, deficits complement private spending and generate adequate and sustainable economic growth by providing the income and growing net financial wealth that meets the private and external sectors' demand at full employment. The fiscal stance plays a very important role in providing "balance" to the economy; it fills the demand gap that is opened up when the operations of the nongovernment sectors (domestic plus rest of the world) are deficient. The economy needs to develop infrastructure and invest in health and education. Deficit spending can be carried out judiciously, and it need not be inflationary because the economy is very far from full employment.

Although global food and oil prices are on the decline, the increase in the wheat support price and the reduction in subsidies, along with currency depreciation, will together keep up the inflationary pressure in FY2009, resulting in an average consumer price inflation of around 20.0%. Despite the fact that inflation pressure declined from November 2008 to January 2009, the consumer price index, food inflation, and core inflation, were still all over 20% on a year-on-year basis. As global commodity prices fall to stabilize at a lower level, and as the base effect of FY2009 manifests itself, inflation is projected to fall to an average of 6.0% in FY2010.

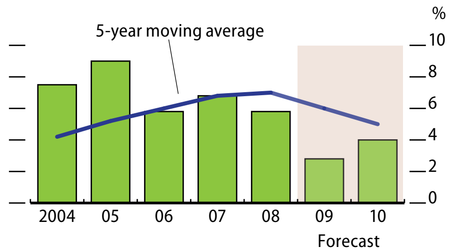
Despite growth in exports, the current account deficit jumped to $7.3 billion during the first half of FY2009, and came in at 20% higher than in the same period in the previous fiscal year. However, the petroleum bill, having doubled in the first 4 months of the fiscal year, then started to show a contraction as the impact of lower international oil prices was felt. Consequently, even with slowing exports, the

3.21.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.8	4.0
Inflation	20.0	6.0
Current account balance (share of GDP)	-6.0	-4.5

Source: Staff estimates.

3.20.10 GDP growth



Sources: Ministry of Finance, *Pakistan Economic Survey 2007–08*; staff estimates.

Click here for figure data

3.20.2 Development challenges

Medium- and long-term prospects depend on the evolution of a model of sustainable growth, in the sense that growth is not confronted with a balance-of-payments constraint every time it attempts to move above 5%. To accomplish this, the economy must develop a growth model of the kind that transformed East Asia over three decades. This must be the objective for the next two decades.

Five interrelated challenges need to be overcome to meet this objective. First, the deterioration in macroeconomic conditions has to be stopped and reversed. Over the past few years, the economy has achieved high growth rates but has remained overly dependent on volatile external inflows. The Government must now focus on increasing the productive capacity of the economy and on generating exports with a higher world income elasticity of demand. Developing countries like Pakistan have to build a robust virtuous circle between increased productive investment and exports.

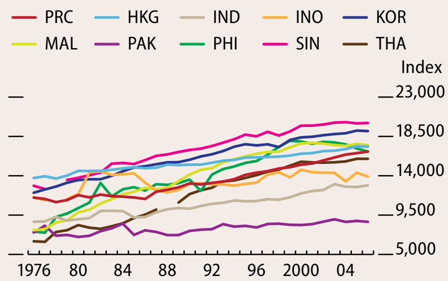
Second, to progress toward a model of sustainable growth, the authorities have to address structural challenges. Although services are the largest sector, the economy is, to all intents and purposes, agrarian. However, agricultural output growth is low and the reallocation of labor from agriculture into industry and services contributes little to overall labor productivity growth. More than 40% of the labor force is employed in agriculture and at very low wages. Development will occur only when agriculture becomes more efficient and when industry and services can absorb the huge surplus of agricultural labor by offering productive and decent jobs.

Moreover, manufacturing, which is concentrated in textiles, shows little sign of quality-upgrading and diversifying. Box figure 1 graphs an index of the sophistication of exports for a selected group of Asian countries. The index reflects the degree to which a country's export basket is similar to that of industrial countries, and shows that Pakistan ranks at the bottom. The reason that this has happened is that the country specializes in the production and export of products at the lower end of the textile range. These are unsophisticated goods with low elasticity of demand, and it is this that underlies the recurrent balance-of-payments problems.

The third challenge is the infrastructure deficit, and in particular the power crisis and prolonged hours of daily load-shedding that choke growth, investment, and private sector development. The Government's efforts to improve governance and financing in the electricity industry through unbundling power entities and privatization, along with tariff reforms and measures to address the circular debt issue, will improve the situation, but only if the reforms are fully implemented. Also needed are new generation capacity and systemic improvements in transmission and distribution systems, immediately and in the coming years. Interventions in these areas have, in fact, begun with the support of development partners.

The fourth challenge is social and relates to the country's poor human development indicators,

1 Export sophistication



PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PAK = Pakistan; PHI = Philippines; SIN = Singapore; THA = Thailand.

Note: The index was constructed using GDP per capita in constant 2005 international dollars.

Source: Staff estimates.

Click here for figure data

deterioration in the current account deficit was contained—a comparison of the first 7 months reveals that the current account deficit in FY2009 was only 1.5% above the level in FY2008. At the same time, with the release of the first tranche of IMF's standby assistance, foreign reserves went up to $6,477 million in November 2008, having fallen to $4,064 million the previous month. The exchange rate has subsequently stabilized, at about PRs79/$1.

Imports would need to continue to compress significantly in the second half of FY2009 to improve the current account balance, especially as exports will be hit harder by recession in the main importing economies. On these assumptions, the current account deficit is projected to go down to 6.0% of GDP in FY2009. Workers' remittances

3.20.2 Development challenges *(continued)*

particularly in health and education. The Millennium Development Goals will not be achieved unless the pace of progress in this sphere is accelerated significantly.

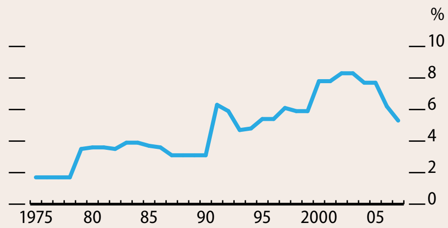
These four challenges contribute to and result in the overarching challenge of high and persistent poverty, unemployment, and underemployment. Having declined to 22.3% in FY2006, poverty has likely risen once again following the slowdown in growth, dismantling of subsidies, and the sharp buildup of inflation in FY2008. Unemployment (Box figure 2) decreased in the preceding years of higher growth but the quality of employment worsened, as there was an increase in the share in total employment of unpaid family workers; today this group represents more than a quarter of all those employed.

The lack of access to productive and decent employment for large segments of the population remains the main cause of poverty. The low level of structural transformation is adding to the problem. Industry does not create employment and, therefore, workers shift from agriculture into low-productivity services jobs. However, services are not creating enough employment to absorb both those moving from other sectors and new entrants to the labor force.

In view of the five challenges, the country needs a carefully thought out medium-term strategy and action plan for industrialization, as well as upgrading and structural change to sustain economic growth. Such a well-developed industrial strategy, understood as a plan for strategic collaboration between public and private sectors, will be an important tool for change—and this change will not come about otherwise. Industrial strategy is not about "picking winners" (favored sectors) but about public and private sectors jointly identifying new activities where the economy can excel. It is also a process of identifying market failures that impede structural transformation, and of removing constraints. This requires strategic collaboration between public and private sectors, as well as the development of the appropriate institutions for change.

Exports are vital to relaxing the balance-of-payments constraint on growth and must be at the center of this development strategy. While textiles and clothing will remain a vital export sector, they cannot be the engine of growth and have to outgrow their current state of low sophistication. Diversification needs to be given the highest priority. A strategy that significantly diversifies and upgrades exports is the only way for Pakistan to achieve sustained high growth and create productive and decent employment.

2 Unemployment



Source: Asian Development Bank, Statistical Database System, downloaded 17 March 2009.

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would need to be sustained to achieve the projected reduction in the current account imbalance—remittances have held up in the first 7 months of the fiscal year. In FY2010, the current account deficit will fall to 4.5% as the trade account improves with stability in oil prices and as export volumes become stronger, reflecting an improvement in meeting demand for electricity.

The current account gap remains a major challenge that was exacerbated by the deterioration in the financial account in the 7 months of FY2009. IMF will provide much-needed balance-of-payments support over the next 2 years but such support cannot indefinitely sustain a large external imbalance. This imbalance imposes a balance-of-payments constraint to sustainable growth in Pakistan: ADB staff estimates indicate that whenever GDP growth exceeds 5% for a number of years—such as the current episode—the country tends to fall prey to a balance-of-payments crisis. This is triggered by imports rising much faster than exports, because Pakistan's exports have a low world income elasticity of demand.

Sri Lanka

Bolstered by agriculture, the economy maintained healthy growth in 2008, though high global food and oil prices boosted inflation and widened the trade deficit. Growth will slow on depressed export demand in 2009, with the worst effects of the global downturn felt in the balance of payments, creating pressures on reserves and the exchange rate. Meeting fiscal targets for 2009 will be a challenge due to tight financial markets and a fiscal stimulus package. With major military operations expected to end in early 2009, rehabilitation and reconstruction in the north might start this year.

Economic performance

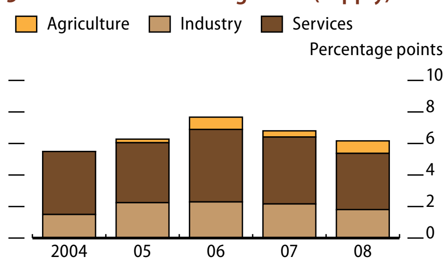
Performance in 2008 was resilient to adverse global financial and economic developments and the intensified civil conflict in the north of the country. As recession battered the United States (US) and European economies, production of export industries slowed somewhat, but overall growth slid only a little, to 6.0% from 6.8% in 2007 (Figure 3.21.1).

Agriculture recorded strong growth of 7.5%; services and industry, moderate growth. Although the Government already had a policy of maximizing agricultural production and minimizing food imports, the shortage of rice early 2008, together with sharp increases in global food prices, spurred its efforts. It launched a major drive to cultivate abandoned paddy lands, which lifted paddy production by half. Tea production was 4% higher than the previous year, though the sector underwent significant price reductions from the third quarter of the year, with the December average price dropping by 36% relative to December 2007 at Colombo auctions.

In services, at over 20% expansion the communications subsector continued to drive sector growth, of 5.6% (down from 7.1% a year earlier). Tourist arrivals and earnings from tourism both fell by 11% year on year, resulting in contraction in the hotel subsector for the fourth consecutive year. Transport and banking services turned in slower growth than in the previous 2 years. Global conditions affected clothing, which slowed to around 2% annual growth and was the main factor reducing industrial growth to 5.9% from 7.6% a year earlier.

Annual average inflation in 2008 was high at 22.6%, well above the prior-year's 15.8%. Year-on-year inflation peaked in June at 28.2%, and stepped down gradually to 14.4% by December (Figure 3.21.2). In fact, the economy had experienced a persistent rise in inflation since 2006, a phenomenon linked primarily to bank-financed government deficits. However, June's spike stemmed from higher fuel and food prices, originating in the lifting of subsidies on fuel in 2006 and on electricity in 2008, which allowed global oil prices to be fully reflected in price developments.

3.21.1 Contributions to growth (supply)



Source: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 9 March 2009.

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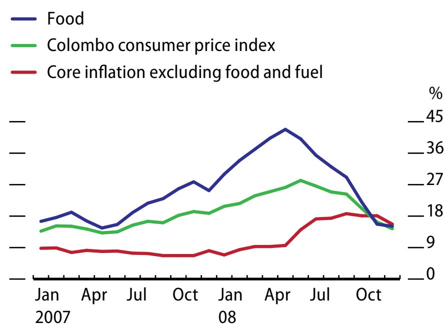
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka, available: http://www.statistics.gov.lk, downloaded 20 February 2009.

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

To help deal with escalating oil prices, the Ceylon Petroleum Corporation had made hedging agreements with commercial banks from 2006, but with tumbling oil prices in the second half of 2008 it incurred heavy losses. An order by the Supreme Court, which had earlier suspended the agreements on account of wrong procedure, was removed in January 2009, compelling the Corporation to honor its payments to the banks. It is unclear whether these payments will be made, as the central bank has since issued a directive to stop the payments.

The central bank tightened its monetary policy in 2008. It lowered its reserve money growth targets on three occasions during the year from 14.7% to 9.7%, in a bid to restrain rising inflation pressures. As a result of tight liquidity and the resulting high interest rates, growth in credit to the private sector decelerated to around 9% toward the end of the year from the 20–26% seen in 2007 (Figure 3.21.3). Real interest rates were negative for most of the year, becoming positive only in the last 2 months, as inflation dropped below 20%.

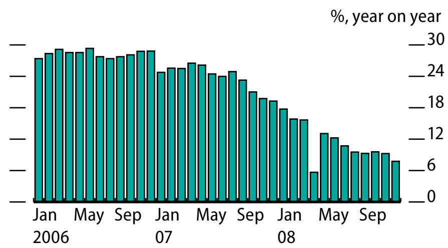
Late 2008 saw a liquidity shortfall in the market precipitated by the global financial crisis, which caused an outflow of dollars from the system. The central bank reduced the statutory reserve requirement of commercial banks by 225 basis points in two steps in 2008 to inject liquidity into the market. It further reduced this requirement by 75 basis points in February 2009, releasing SLRs9 billion into the system. The central bank has also been injecting additional liquidity by providing repo facilities to commercial banks and primary dealers.

The high global food and fuel prices prompted the Government to take certain fiscal measures that resulted in revenue losses in 2008. These steps included reducing import tariffs on food and cutting value-added tax on gasoline from 15% to 5%. However in May 2008, it removed an import duty waiver that had been in effect on gasoline imports to cross-subsidize the price of diesel, and imposed a duty of SLRs20 per liter. The Government has resorted to ad hoc cesses to raise additional revenue, and cess revenue now accounts for 4.3% of the total tax take, up from 1.4% in 2006. This development has made the tax system increasingly complex, and the 2009 budget called for a presidential task force to plan a rationalization.

Revenue and capital expenditure continued to underperform relative to budgeted levels. Although the deficit continued its narrowing trend of 2006 and 2007, it stayed high at nearly 7% of GDP in 2008 (Figure 3.21.4). On the expenditure side, fertilizer subsidies exerted heavy pressure on the budget, because of the increase in international prices in the first half. Full-year expenditure was driven mainly by these subsidies and defense, at the expense of the ambitious public investment program, which, due to a shortage of counterpart funds, is estimated to have spent 17% less than the budgeted amount

The 2009 budget was presented in a deteriorating global scenario, which poses specific challenges to the Sri Lankan economy in terms of raising funds in the international market, risks to exports, falling reserves, and pressure on the rupee. This year the Government was also facing difficulties in meeting counterpart funding commitments. However, while some support was provided to foreign exchange–earning industries (such as tea, garments, hotels, and rubber), there are no specific

3.21.3 Private credit growth



Source: CEIC Data Company, Ltd., downloaded 11 March 2009.

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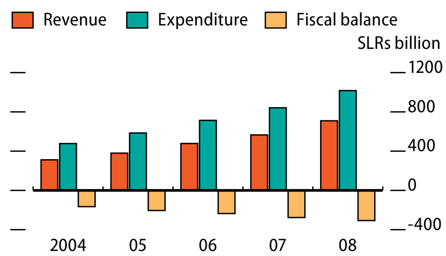
3.21.4 Fiscal indicators



Source: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 20 February 2009.

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measures in the budget proposals to address these challenges. After debt repayments and interest payments, defense makes up the largest single cost category, accounting for 10% of total expenditure.

In the revenue proposals, income tax brackets have been expanded resulting in lower tax payments for all levels of income. Value-added tax has been brought down from 15% to 12%. Cesses have been imposed and rates increased on items already covered, to encourage domestic industries. The budget deficit is expected to come down to 6.5% in 2009, from an estimated 7% of GDP in 2008.

The Government's total external foreign currency commercial debt declined from $485 million at end-2007 to $460 million a year later. The authorities have been increasingly turning to foreign commercial borrowing in recent years, the share of which, in total foreign debt, rose from 5% in 2003 to 13% in 2007. As the maturities are relatively short, the roll-over risk of this debt is high in the current environment. The central bank had proposed to borrow $300 million in the international capital market in the latter part of 2008, but failed to push through with this because of the prevailing global conditions. For example, the sovereign spread for Sri Lanka rose to about 1,300 basis points in October. The debt-to-GDP ratio, at 85% at end-2007, was down to 78% 12 months later, aided by high nominal GDP growth.

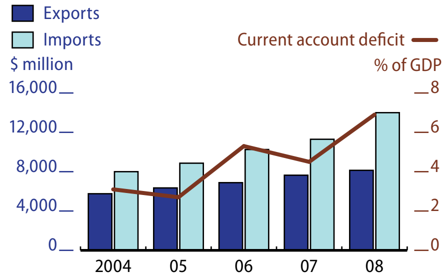
The most direct effect of the global economic turmoil in the current account was on the trade deficit: slowing export demand and high global prices widened it by 61% to $5.9 billion; the import bill rose by 24.0%, mainly on high oil prices. Clothing exports were affected by recession in the main markets and grew by only 5% during the year.

On a positive note, the Generalized System of Preferences, plus concessions available from the European Union, was conditionally extended for 3 more years. This was a relief to a clothing industry already affected by worsening global conditions. Despite healthy growth of remittances (of around 16% to $2.9 billion), the current account deficit is projected at $2.9 billion, or about 7.1% of 2008 GDP (Figure 3.21.5). The capital and financial account was in surplus owing to large inflows, including Sri Lanka Development Bonds of $250 million, a syndicated loan of $150 million, foreign direct investment, and a credit line from the Islamic Republic of Iran for oil.

The central bank has intervened in the foreign exchange market since 2007 to keep the Sri Lanka rupee stable against the US dollar. With the eruption of the global financial crisis, foreign exchange drained from the country, occasioned by a fall in nonresident holdings of Sri Lankan Treasury paper and the settlement of large petroleum bills in the last quarter of 2008. This, with high inflation, exerted depreciation pressure on the local currency (Figure 3.21.6). In response, the central bank intervened, seeking to maintain the rupee at about SLRs107/$1, but this intervention entailed a large drop in official international reserves from $3.4 billion at end-August (Figure 3.21.7) to $1.8 billion at end-December 2008 (equivalent to 3 months and 1.5 months of imports, respectively).

During the fourth quarter, the central bank relaxed its stance somewhat and allowed greater flexibility in exchange rate movements, primarily because of a sharp decline in export prices, lower export demand due to the slowing global economy, and the sharp appreciation

3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 9 March 2009; staff estimates.

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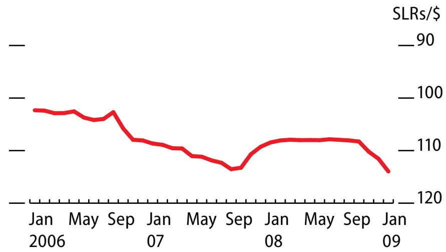
3.21.6 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 10 March 2009.

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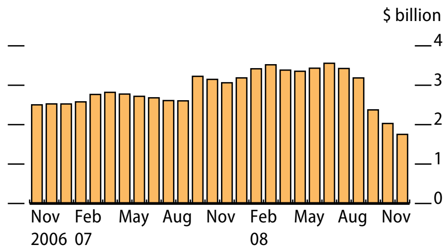
3.21.7 Gross official reserves



Source: Central Bank of Sri Lanka.

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of the US dollar against most major currencies. To contain imports, the central bank also imposed a 100% margin (deposit) when traders opened letters of credit for selected imports in November. The imports covered under this include electrical items, liquor, confectionery, and household items. This created great difficulties for small and medium-sized importers who generally rely on an advance against imports credit scheme, and find it hard to pay upfront.

Economic prospects

The main concerns for 2009 and 2010 are slowing growth, a deteriorating balance of payments, and meeting fiscal targets. Although the domestic financial system has reported no direct losses from foreign securities, the global financial crisis and economic slowdown mean that Sri Lanka faces tighter access to capital markets and weaker demand for its exports.

Growth is expected to fall to 4.5% this year as the global slowdown deepens, affecting export industries. In addition, last year's exceptional agricultural performance is unlikely to be repeated. On the positive side, there are signs that the civil conflict could end this year, paving the way for reconstruction, which should give a stimulus to the economy if financing is available. Growth is forecast to rebound to 6.0% in 2010, reflecting a measure of global economic recovery (Figure 3.21.8).

Inflation dropped to 7.6% in February 2009, reaching single digit levels for the first time since July 2006. It will continue its downward trend, following global prices lower, and is expected to average 8.0% this year. However, inflation has historically been high and has been affected by government borrowings from the domestic banking sector. Keeping inflation low will therefore depend on the Government's borrowing program as well.

The Government expects to ease the monetary policy stance a little this year, according to the Financial Road Map for 2009 released by the central bank. That document also states that the growth of broad money is targeted at around 14% this year, which is expected to facilitate the Government's projected growth rate of 5–6%. The targets have been set with annual inflation in mind of 9% this year. With inflation falling, the central bank cut its policy rates by 25 basis points in February, the first change in 2 years. Market interest rates can also be expected to fall. Easing of monetary policy is intended to stimulate the economy and help counter the negative impact of the global slowdown.

Since Sri Lanka's financial system was not exposed to the toxic assets of the US and European systems, it should remain largely unscathed. However, nonperforming loans seem to be rising, because industries such as clothing, tea, and construction are facing difficulties. These problems will persist during 2009 when borrowing sources stay limited.

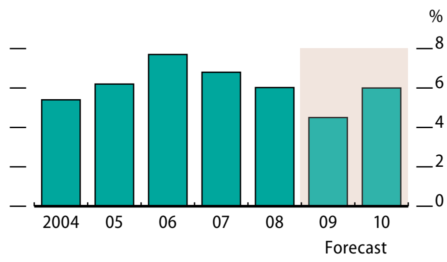
Maintaining fiscal discipline in 2009 will remain a major challenge. The budget for 2009 expects the deficit to fall to 6.5% of GDP, a view underpinned by assumptions of discipline in current spending and strong revenue performance. Historically, both these targets have been hard to meet, leading to cuts in the capital budget to maintain the deficit at a manageable level. The public investment program will also depend on the Government's ability to raise funds in international capital markets,

3.21.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.5	6.0
Inflation	8.0	6.0
Current account balance (share of GDP)	-7.5	-7.0

Source: Staff estimates.

3.21.8 GDP growth



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 9 March 2009; staff estimates.

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which will remain problematic this year: Sri Lanka's sovereign rating was downgraded in 2008 both by Fitch (to B+ from BB-) and Standard & Poor's (to B from B+). The rating was further downgraded by Fitch to B in February this year.

With revenue measures focusing on protecting the poor and tax collection increasingly depending on trade-related taxes, the implications for revenue collection may be significant in the current global context. The Government announced a stimulus package of SLRs16 billion with cuts in energy prices and incentives for exporters in 2008. The package includes the removal of a 15% surcharge on electricity for the tourism, garments, leather, and rubber industries, lifting the cess tax on manufactured rubber exports and giving tea producers price support through state purchases.

The sources for funding the package and its implications for the budget deficit are still unclear. The interventions, which the Government sees as necessary to maintain growth, would make it harder to meet fiscal targets in 2009; the fiscal space for such interventions is also limited on account of the high deficit.

In terms of the trade balance, the global downturn's impact on exports will be softened by a lower import bill (largely reflecting lower fuel prices). The current account deficit will remain high at around 7.5% of GDP in 2009, given lower exports and slowing remittances. Exports will fall due to lower external demand and lower prices, which have already affected the tea industry. With exports and GDP growth expected to pick up during the second half of 2010, the current account will start to improve that year.

As international financial markets remain tight, financial inflows will be substantially lower than in 2008. This, coupled with falling reserves, will pose serious risks to the economy. The Sri Lanka rupee is expected to depreciate further in the first half of this year. Given the relatively low foreign exchange reserves, the Government's decision to allow more depreciation in the exchange rate in late 2008 was correct. The overvalued currency is hurting exports, and exporters have been lobbying for a larger depreciation. However, any depreciation of the rupee will increase debt repayments in rupee terms and add to the fiscal burden. Considering all these factors, the Government needs to follow a more active exchange rate policy, which should be supported by greater fiscal restraint to minimize risks and maintain export competitiveness.

The Government announced strategies to boost reserves in January 2009, such as currency swaps with some central banks, promotion of investments in Treasury bills and bonds among the Sri Lankan diaspora, bonus interest on nonresident and resident foreign currency deposits, and a concessional final income tax for new foreign exchange inflows. With markets tight and investors cautious and risk averse, the effectiveness of these measures remains to be seen.

On the positive side, the Government is negotiating with the International Monetary Fund a Standby Facility of $1.9 billion. An agreement would provide support to reserves and have other positive effects such as of improving investor confidence and support for the exchange rate.

3.21.1 Development challenges

The contribution of manufacturing to GDP has expanded only marginally since the 1970s. The economy has moved from agriculture to services, but the manufacturing base has remained concentrated on garments, processed food, and chemical and plastic products. Since the opening of the economy in the late 1970s, export processing zones have been set up and wide-ranging incentives offered to attract foreign direct investment for industrial development.

With the 2008 budget, the Government started rationalizing tax exemptions provided to foreign companies, which have been costly in revenue terms. In the 2009 budget, it raised the issue of broadening manufacturing's base. But doing this and attracting investment may be difficult during the global recession, and the success of both will depend on improving the investment climate.

The 2009 budget proposed to set up a presidential task force to prepare a national tax policy. The current tax system is complicated and has been subject to ad hoc changes, and although progress has been achieved over the last few years to broaden the tax base, the changes in the 2009 budget do not support this trend.

It is a positive development that the Government has recognized the importance of simplifying the tax system and has proposed to set up a task force for this. However, such initiatives have fallen far short of expected outcomes in the past on numerous occasions. The challenge is to ensure that the proposed task force will not meet a similar fate.