South Asia

Afghanistan, Islamic Rep. of
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Islamic Republic of Afghanistan

In the licit economy, economic growth slowed as agriculture was hit by another drought, while reconstruction-linked construction and services continued to expand. The Government continued along its track of solid macroeconomic policy and structural reforms. Yet popular discontent with slow reconstruction, pervasive corruption, as well as sharply deteriorating security, institutional and human resource constraints, a heavy reliance on aid, and a very low domestic revenue base, all remain formidable challenges. As does the impact of opium production, which reached record levels. Since current, licit, drivers of growth cannot provide sustained growth, creating a private sector enabling environment and diversifying the economy remain crucial tasks.

Economic performance

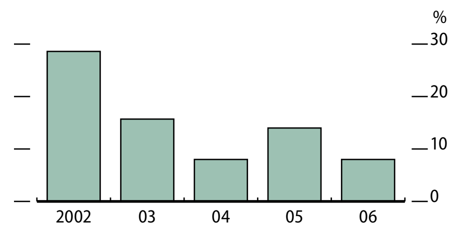
In FY2006 (ended 20 March 2007) the agricultural sector, representing about a third of licit GDP, was hit by another drought. (Box 2.13.1 on the next page discusses the non-licit economy—essentially opium.) While continued expansion in construction and services partly compensated for this decline, overall GDP growth for the year is now expected to reach only about 8% (Figure 2.13.1), or well below the 12% expected in the Poverty Reduction and Growth Facility program with the International Monetary Fund (IMF).

In December 2006, year-on-year inflation registered by the consumer price index for Kabul and five other cities declined to a little less than 4% (Figure 2.13.2), aided by a decline in energy prices and rents in the capital. Wheat imports lessened the impact of the drought on food prices.

Currency in circulation in the year to September 2006 grew less than expected with a gradual shift in money demand from cash toward deposits. Over the year, interest rates on the central bank's 30-day capital notes declined from about 8% to 5–6%. Growing competition in the banking sector is helping narrow the gap between bank deposit and lending rates. From a wider perspective though, the banking sector is still small relative to the economy, despite rapid growth in recent years, and bank assets still account for less than 9% of GDP. Commercial banks dominate the formal financial sector, with about 95% of its assets.

The Government continued to adhere to its "no overdraft" policy for bank financing of the national budget. By the end of FY2005 the execution rate of the development budget reached only 43%, reflecting low capacity, particularly in line ministries; poor prioritization of projects; unrealistic time, cost, and expenditure projections; and delays in project implementation due to a deteriorating security situation. In FY2006 the Government increased its efforts to address the poor implementation performance, such that development expenditures are likely to reach about 55–60% by the end of the fiscal year. To better reflect current spending capacities, the development budget was reduced by 5.1% at the midyear budget review.

2.13.1 GDP growth



Source: International Monetary Fund, available: www.imf.org, downloaded 9 March 2007.

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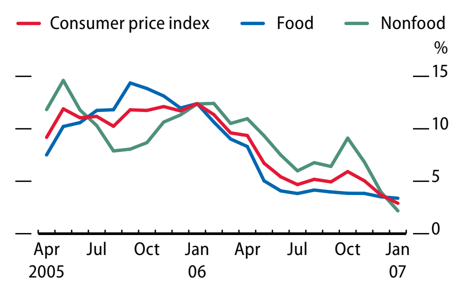
2.13.2 Monthly inflation, Kabul and five other cities



Source: Central Statistics Office, available: www.cso.gov.af, downloaded 19 February 2007.

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As spending pressures are growing, the same review increased the operating budget by 6.3% to account for expenditures that had previously been funded by donors, such as the fuel subsidy to operate several power generation plants, costs of additional teachers required, and salary arrears (mainly to teachers). The deteriorating security situation is also adding to spending pressure, and these are likely to increase in the medium term.

On the income side, domestic revenues are expected to rise by 15–20%. Since FY2003, government revenues have seen an overall increase of about 500%, yet are still very low. Customs revenues dropped in the second half of last year, most likely due to new restrictions on imports of old and right-hand vehicles, delays in the introduction of a new tariff schedule, and concessions to traders. This drop was partly offset by higher revenues from taxes on income, profits, and business receipts.

With imports of consumer and capital goods outpacing only slowly rising licit exports, the trade deficit, at $2.6 billion in FY2005, is seen rising. But with grants, the current account should remain close to balance.

The exchange rate showed continued stability, fluctuating at AF49.73–50.65/$1 over calendar year 2006. The large foreign exchange inflows have made the currency relatively strong and, given the lack of productivity improvement in the economy, has harmed external competitiveness.

Since the Paris Club rescheduling agreement of July 2006, the Government has been finalizing outstanding bilateral issues and agreements. An agreement with the United States was signed in September 2006 and agreements with the Russian Federation, the largest creditor, and Germany are expected to be signed. Afghanistan will likely benefit from the Heavily Indebted Poor Countries initiative this year.

In January 2006, the Government approved the Interim Afghanistan National Development Strategy (I-ANDS). This sets 5-year benchmarks to enhance security, governance, rule of law, human rights, economic and social development, and stimulate private trade (Box 2.13.2). The Government initiated the implementation of the I-ANDS while preparing a full strategy. The Government continues to push for more aid to be channeled through the budget (currently about three quarters of aid is off-budget) as a further impetus to better align development projects with priorities identified in the I-ANDS. It would also enhance the Government's capacity and, by demonstrating its ability to deliver services to the people, help bolster its legitimacy.

In June 2006, IMF approved a 3-year arrangement worth SDR81.0 million (about $119 million) under the Poverty Reduction and Growth Facility, building on advances made under its Staff Monitored Program. Progress under the Program and the first review of the Facility has been good, with the authorities meeting most benchmarks.

Revenue administration continued to make progress: tax receipts, particularly from large businesses, increased almost 10-fold in FY2006; a road toll was introduced in June 2006 (though revenues fell far short of initial forecasts); a draft proposal to simplify the tax system and to abolish "nuisance taxes" is expected to be submitted for parliamentary approval by end-FY2006; and reform of the mustoufiats—provincial units of the Ministry of Finance—continued. Strengthening the capacity of these units—responsible for revenue collection, payment processing, and accounting functions at the provincial and district level—is vital.

2.13.1 Opium harvest at record in 2006

According to estimates of the United Nations Office on Drugs and Crime (UNODC), total opium cultivation in 2006 increased by 59% and production by 49%. Afghanistan now produces 6,100 tons, equivalent to 92% of total global supply. Most of the production increase was from volatile, conflict-ridden southern provinces.

With the expansion of the licit economy, the share of the total export value of opium to licit GDP is gradually decreasing: from 61.7% in FY2002 to 36.3% in FY2005.

The macroeconomic effects of opium are huge: it generates large aggregate demand, boosts the balance of payments and, through customs duties on drug-financed imports, supports government revenues. However, as much of the income from opium accrues to traffickers, is invested abroad, or is used on imported goods, the overall positive macroeconomic impact is limited.

In rural areas, opium production remains one of the leading sources of employment (it is more labor intensive and more profitable than the production of other crops). In 2006, the share of households involved in opium poppy cultivation rose by nearly half to about 13% of the population.

Responding to changes in economic and enforcement situations, the opium economy has proven to be extremely flexible. Reduction in cultivation in one province often results in production shifting elsewhere.

A study by UNODC and the World Bank has highlighted that eradication efforts tend to most affect poor farmers and rural wage laborers, those who lack political support, or those who cannot pay bribes. Considering the size of the opium economy, phasing out drug production will require significant and sustained effort.

Sources: UNODC. 2006. *Afghanistan Opium Survey 2006*. September; UNODC/World Bank. 2006. *Afghanistan's Drug Industry—Structure, Functioning, Dynamics, and Implications for Counter-Narcotics Policy*.

Reforms in customs focused on the introduction of the Automated System for Customs Data, attention to compliance, training, and expansion and upgrading of customs offices. The customs tariff structure was further rationalized, customs duties for all raw materials were reduced to 1% and customs duty for all imported machinery waived.

With only about 1.3% of the total population employed by the Government, the size of the Afghan civil service is low in both Asian and global terms. The public sector continues to suffer from lack of institutional and human capacity, impacting on the delivery of basic services, causing implementation delays of development projects, and fueling corruption, though in September 2006 a higher salary structure for many "nonuniformed" civil servants, including teachers, was brought in. In 2006 progress in reforming public administration remained slow.

Economic prospects

Assuming that the agriculture sector rebounds from the most recent drought, growth for FY2007 and FY2008 is expected to reach double digits again. Inflation is forecast to stay largely unchanged.

Growth prospects for the medium term hinge on the security situation. Overall physical security has deteriorated significantly over the past year, with antigovernment and anti-Coalition forces stepping up attacks, particularly in the south and east. Suicide attacks increased many-fold. Army and police forces, government employees, and aid workers have all been targeted. Less bloody, but still important for the long-term socioeconomic development of the country, are insecurity of contract, property, and land-tenure rights.

The substantial security costs, now largely paid for by other nations, will remain outside the Government's capacity for a long while. The authorities will also have to deal with uncertainties about nonmilitary donor commitments, including the funding of development projects' operating expenditures (currently covered by donors), and salary pressures.

Development challenges

Despite impressive growth and a solid track record of macroeconomic policy and structural reforms, the country still faces substantial challenges. The current reconstruction-related drivers of growth will neither sustain growth, create employment, nor reduce poverty over the medium term.

One of the Government's main priorities, emphasized in the I-ANDS, is to improve the enabling environment for the private sector and to encourage trade (Box 2.13.2 discusses why). An estimated 80–90% of economic activity is in the informal sector because of political uncertainty, the lack of the rule of law, inefficient business registration procedures, and the tax regime. Entrepreneurs in the informal sector typically remain small, avoiding investments in productive assets or technology that would enable them to achieve economies of scale or to move into higher value-added activities.

(A fuller discussion—still relevant—of the constraints and potential drivers of growth can be found in *ADO 2006*, pp. 145–146.)

2.13.1 Selected economic indicators

	2007	2008
GDP growth	10.0	10.0
Inflation	5.0	5.0
Current account balance (% of GDP)	-4.8	-5.7

Source: Staff estimates.

2.13.2 Private sector collapse

Prior to 1979, Afghanistan had a vibrant private sector with a long tradition of entrepreneurship, engaged in the production of agricultural products, small-scale industrial activities, and trade.

During the 1980s, most industries were nationalized, traditional manufacturing industries such as carpet weaving moved to neighboring countries, and many businesses were forced to close down due to lack of inputs.

Industrial production fell by 95% between 1979 and 2002, with private output hardest hit, falling from 60% of the total to 21% in this time, recovering to a modest 26% in 2005.

Private sector activity is concentrated in construction and services, both fueled largely by the influx of international donor assistance and opium-related funds. In services, trade and transport dominate. Private sector activity has increased in relatively new services sectors such as telecommunications and banking. Manufacturing is limited to traditional products and small-scale activities such as carpet weaving and dried fruit production.

The private sector cites a lack of adequate infrastructure (especially power), and poor access to land and finance as key impediments. A recent investment climate survey identified corruption as one of the main obstacles for doing business in the country—yet government efforts to combat corruption lack the strong political leadership required for focus and coordination.

Bangladesh

At 6% over the past 4 years, strong GDP growth has been underpinned by more market-oriented economic policies, a dynamic garment sector, and substantial inflows of overseas workers' remittances. The lead-up to the parliamentary elections was generally expected to be a rough patch given the country's contentious political environment; the constitutional mechanism of a neutral caretaker government was expected to help smooth the way. Deepening political deadlock culminated with the president in January declaring a state of emergency and calling off the elections. But the new caretaker Government has continued with established economic policies and expedited structural and sector reforms. It has taken a broad agenda of activity, including an extensive anticorruption drive that it sees necessary to establish better foundations for holding the elections. GDP is forecast to maintain its recent momentum over the medium term.

Economic performance

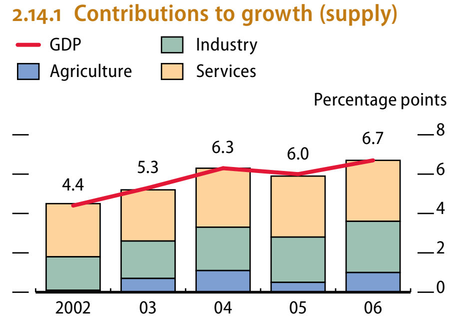
Growth in GDP has trended up in recent years, reaching 6.7% in FY2006 (ended 30 June 2006), driven by improved domestic and external demand. This performance was reflected in a steady expansion in industry, lifted by export-oriented manufacturing, and in continued services buoyancy (Figure 2.14.1). A marked reduction in poverty accompanied growth: the headcount poverty rate declined by about 1.8 percentage points a year between 2000 and 2005 to 40%, compared with a decline of only about 1 percentage point a year in the preceding decade (Figure 2.14.2). The improvement was somewhat faster in rural than urban areas. Rising access of the poor to microcredit, a rapid expansion in overseas workers' remittances, and improvements in physical and social infrastructure all contributed to the sharp drop in poverty.

In FY2006 on the expenditure side, private consumption propelled growth. Investment rose by 0.5 percentage points to 25.0% of GDP, bolstered by a rise in private investment. Gross national savings increased by 0.8 percentage points to 26.6% of GDP, lifted by a rise in workers' remittances. Net exports of goods and services remained negative.

Inflation moved up steadily to average 7.2% (Figure 2.14.3). This exceeded the 7.0% limit set by Bangladesh Bank, the central bank, in its first Monetary Policy Statement (MPS) issued in January 2006. Demand pressures generated by excess money, a sharp depreciation in the taka (Tk) against the US dollar (of 8.5% in FY2006), and a rise in global commodity prices (including oil), all heightened inflationary pressures. Rising exports of some consumer items, pulling their domestic prices to higher global levels, also added to price pressures.

Despite attempts to tighten monetary policy, both money and credit aggregates expanded rapidly in FY2006 (Figure 2.14.4). Broad money grew by 19.5%, as against the MPS program target of 14.3% and prior-year actual growth of 16.8%. Private sector credit grew sharply because of rising credit demand in support of domestic economic activity, while the public sector borrowed in excess of the credit target, mainly to

2.14.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006.

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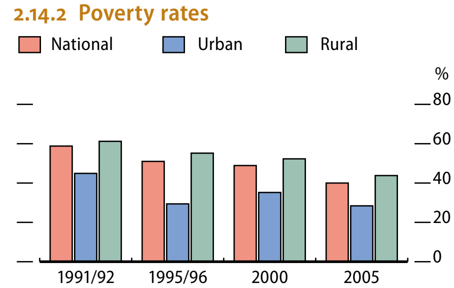
2.14.2 Poverty rates



Source: Bangladesh Bureau of Statistics, *Preliminary Report on Household Income and Expenditure Survey 2005*.

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finance the high cost of imports by state-owned Bangladesh Petroleum Corporation (BPC). To tighten credit, Bangladesh Bank raised key policy rates over the course of the year: the 28-day treasury bill rate from 6.6% in the last quarter of FY2005 to 7.1% in the last quarter of FY2006, and the reverse repo rate from 4.5% in June 2005 to 6.0% in June 2006. Yet because of excess liquidity in the system, these measures failed to fully restrain credit growth.

The second MPS, announced in mid-July 2006, again aimed to tighten monetary policy, both to control inflation and to ease pressures on the exchange rate, at the same time sustaining domestic output growth. The introduction of the MPS is a welcome development as it seeks to bring greater predictability to the policy regime and to avoid policy surprises, which should aid the private sector in making its investment decisions. However, to derive greater benefit from the MPS, the Government needs to allow Bangladesh Bank greater operational autonomy and to establish greater coordination between monetary and fiscal policies.

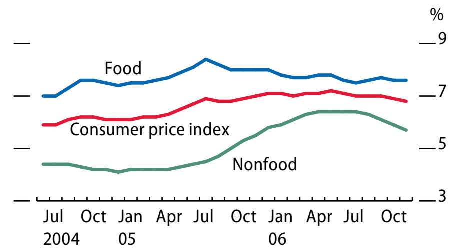
At 3.3% of GDP, the central government deficit in FY2006 came in below the budgeted 4.5%. This was because of lower than planned growth in both current and development expenditures, and in spite of underperformance in revenue collection. Current expenditures were lower as a result of tighter budgetary discipline and reductions in unproductive outlays through austerity measures. Development spending was kept at a lower than projected level by large cost reductions in nonpriority projects, fewer unproductive expenditures, and slow project implementation.

Revenues fell short of target because expected increases in collection arising from reforms and administrative improvements failed to materialize. So while tax-reform efforts yielded some gain in domestic value-added tax and income tax collection, overall targets were missed in part because of lower customs receipts stemming from tariff cuts. Domestic financing (borrowing from bank and nonbank sources) of the budget deficit amounted to 2.1% of GDP, while foreign assistance (both loans and grants) financed the remaining 1.2%.

The exchange rate came under increasing pressure during much of FY2006, because of slowing financial account inflows and higher import prices for oil and some other products. The currency stabilized in the last quarter of the fiscal year, as the tighter monetary policy started to have an effect, and the current account strengthened notably. The exchange rate stood at Tk69.7/$1 in June 2006, representing an 8.5% depreciation against the US dollar in FY2006 (Figure 2.14.5). The marked depreciation in the nominal rate offset Bangladesh's higher inflation relative to its trading partners, and the real effective exchange rate of the taka depreciated by 5.3% in FY2006, boosting the country's external competitiveness.

Import growth fell sharply to 12.1% in FY2006 from 20.6% (Figure 2.14.6) in FY2005 as administrative controls on letters of credit were imposed and unproductive imports discouraged. In addition, lower imports of foodgrains and most other edible products offset higher imports of oil, industrial raw materials, and capital machinery. Export growth surged to 21.6% from 14.0%, reflecting robust performance of knitwear and woven garments. A decline in the trade deficit and a steep rise in remittances (24.8%) turned the current account balance from a deficit of 0.9% of GDP to a surplus of 0.9%. Foreign exchange reserves

2.14.3 Inflation, 12-month moving average



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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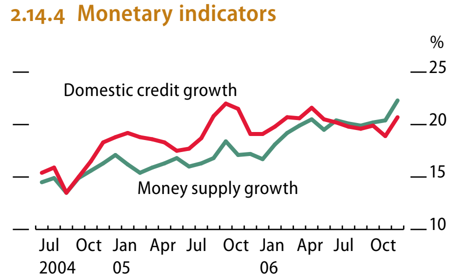
2.14.4 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 7 March 2007.

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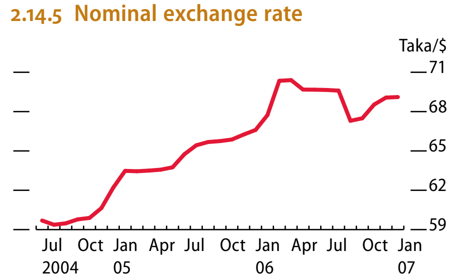
2.14.5 Nominal exchange rate



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

rose to $3.5 billion at end-June 2006 from $2.9 billion a year earlier (Figure 2.14.7).

In the FY2007 budget (announced in June 2006), the Government shaved duties on intermediate goods from 13% to 12% and on raw materials from 6% to 5%, as part of trade reforms agreed with the World Bank. It also cut supplementary duties. These measures should improve profitability and competitiveness of domestic industries, though they add to the effort needed to raise the budget's low revenue ratio.

Financial sector reforms to strengthen the regulatory and supervisory framework for banks made headway in 2006, though at a slower than expected pace. The health of the banking system has improved since 2002, as seen in the declines in gross nonperforming loans (NPLs) from 28% to 14% and in net NPLs (i.e., less provisions) from 21% to 8% (Figure 2.14.8). This led to significant rises in profitability ratios. Although the private commercial banks improved to record low NPLs of 6%, the four nationalized commercial banks (NCBs) are still weak and show very high NPLs of 25%. The NCBs have large capital shortfalls with a risk-weighted capital asset ratio of just 0.5% in June 2006 (as against the required 9%), compared with 10% for the private banks.

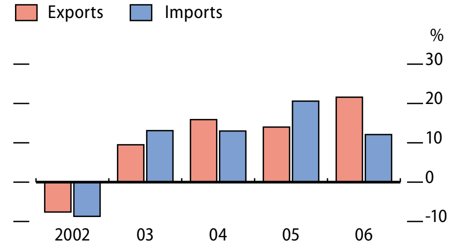
The performance of the four NCBs is monitored under memorandums of understanding signed by each of them and the central bank, in relation to tightened prudential norms and lending limits. It has been mixed, though, in part because of government-directed extensions of credit, particularly to BPC to finance its higher import costs.

The divestment of Rupali Bank, an NCB, moved forward and the sales and purchase agreements are expected to be signed. The Government has taken steps to corporatize the remaining NCBs and make them more autonomous while keeping them under the regulatory purview of the central bank, with an eye on their eventual privatization.

Other areas have shown progress. Bangladesh Bank has completed a comprehensive plan to switch over to the new international standard framework for assessing banks' capital adequacy under Basel II, which the Government intends to implement from early 2009. It established a settlement system for secondary bond trading in May 2005 and introduced mark-to-market valuation guidelines for treasury securities effective February 2006, which have improved operations of the interbank and treasury bill markets. It also introduced market-based auctions of treasury bills in September 2006 to bring greater flexibility to liquidity management.

Unlike many other bourses in Asia, the Dhaka Stock Exchange has not recorded significant gains, though January 2007 (Figure 2.14.9) saw a rise in response to prospects of an improved political situation. Still, as indicated by the low 7.5% market capitalization-to-GDP ratio, the equity market remains underdeveloped, largely because of weak corporate governance, lack of high-quality share listings, and a dearth of large institutional investors. While governance issues need to be tackled, increasing the supply of listed shares by privatizing state enterprises through public share offerings would help boost market capitalization and trading activity. Two major power sector entities—Dhaka Electric Supply Company and the Power Grid Company of Bangladesh—have already

2.14.6 Export and import growth



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.
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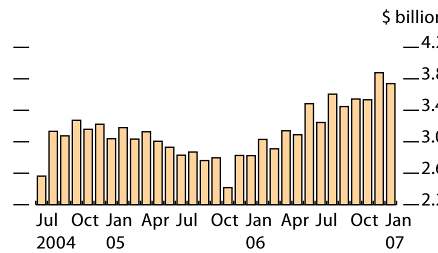
2.14.7 Gross international reserves



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.
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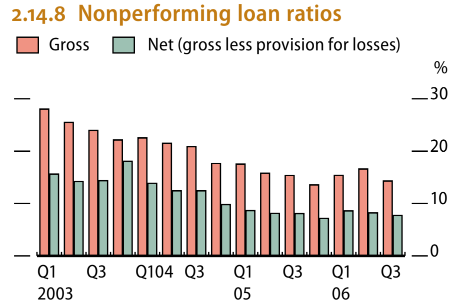
2.14.8 Nonperforming loan ratios



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.
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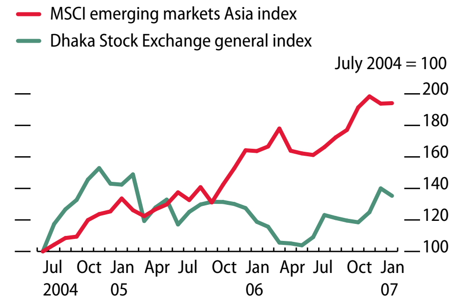
set an example by selling shares in the equity market in 2006, under the Government's broader goal of privatizing state enterprises.

Modernization of the National Board of Revenue gathered pace. Large taxpayers' units for value-added tax and income tax have already been established in Dhaka, and branches of these units are being set up in Chittagong (the second biggest city and main port). The board is being reorganized along functional lines and an audit cell has been set up. The central intelligence cell has detected several tax evasion cases and secured unpaid taxes. These actions are expected to strengthen the tax machinery and raise revenues over the medium term. In an attempt to curb corruption among tax officials and redress taxpayers' grievances, the country's first tax ombudsperson was appointed in July 2006.

The Customs House in Chittagong is being split into two entities to strengthen customs administration: one for imports and one for exports. Computerization of customs administration has improved tax assessment and appraisal functions.

2.14.9 Stock market indicators



Sources: Bloomberg, downloaded 7 March 2007; Dhaka Stock Exchange, *Monthly Review.*

Click here for figure data

Economic prospects

The economic forecasts for FY2007 and FY2008 are based on several policy assumptions. The most important is that the new caretaker Government will maintain its resolve to preserve macroeconomic stability. Continuing the reforms agreed with the International Monetary Fund under the ongoing Poverty Reduction and Growth Facility, the central bank will retain its tightened monetary policy stance to control inflationary pressures. At the same time, it will aim to support economic growth of around 7% by ensuring adequate credit to the private sector but restraining credit to the public sector.

The inflationary consequences of monetary policy will depend both on how political events unfold and on stability in labor and financial markets. At 10.7% of GDP (Figure 2.14.10), weak revenues hamper government efforts to provide resources for physical and social infrastructure development and for poverty reduction.

The second assumption is that, as agreed under the current Poverty Reduction and Growth Facility, the Government will attempt to lift revenues by 0.5 percentage points of GDP this fiscal year by adopting many tax and nontax measures, and by streamlining tax machinery, to offset reductions in customs duties. The authorities are expected to continue reorienting spending to support growth. They are also likely to strengthen institutional capacity for project formulation and administration, and to improve fund-release procedures for programs on infrastructure development and poverty reduction. In FY2007, domestic financing of the fiscal deficit will be capped at 2.5% of GDP.

A third assumption is that the Government will further rationalize energy prices to improve the financial position of state enterprises. In addition to the 5% increase in urban power tariffs of March 2007, it is likely to raise diesel and kerosene prices to bring them more into line with international prices and to reduce BPC's losses, at the same time attempting to address equity concerns.

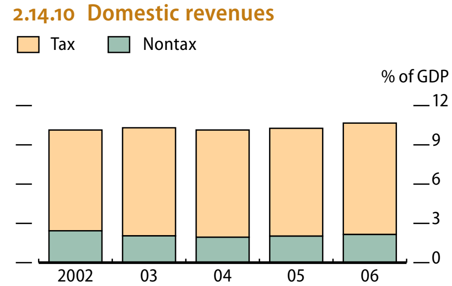
Fourth, it is assumed that the Government will continue in its efforts to shore up foreign exchange reserves. It will encourage remittances and

2.14.1 Selected economic indicators

	2007	2008
GDP growth	6.5	7.0
Inflation	7.0	6.0
Current account balance (% of GDP)	1.0	0.2

Source: Staff estimates.

2.14.10 Domestic revenues



Source: Asian Development Outlook database.

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exports by measures such as allowing the exchange rate greater flexibility and further improving banking services.

On the above basis, GDP growth is forecast at 6.5% in FY2007 and 7.0% in FY2008, driven by a robust performance in industry and services (Figure 2.14.11). Trends in the first half of FY2007 point to a significant pickup in economic activity. Although agricultural growth in FY2007 is likely to moderate from the postflood recovery in FY2006, it is still expected to be above trend. The harvest of the major summer crop—*aman*—has been good, though slightly below that of a year ago. The production of the major winter crop—*boro*—will depend on weather conditions and availability of inputs, though developments to date suggest that it—and the output of other crops including wheat, maize, pulses, and spices, as well as fisheries—is on track for an above-average outturn.

The conditions for expansion in industry (supported by new capacity in garments and textiles, chemicals, cement, and engineering) are favorable, though infrastructure constraints may pose problems. Manufacturing has shown a strong performance, as suggested by healthy growth in manufactured exports, imports of industrial raw materials, and private sector credit. Services output appears to be expanding impressively, in line with industry.

In the first quarter of FY2007, output of medium and large manufacturing, driven by export-oriented industry, rose by 14%, and that of small-scale industry by 11%, year on year (Figure 2.14.12). Uptrends were also noted in the production of nonmanufacturing items, namely gas (9.3%) and electricity (5.1%).

The garment industry grew rapidly, with 28% growth in its exports in the first half of FY2007. Successful diversification of products and markets, increased backward linkages, and a supportive policy regime are among the forces driving the industry. Yet sustaining such growth needs improved infrastructure to help producers cut the present excessive lead times, while more investment in design, equipment, training, and marketing is required if the industry wants to move from producing low- or medium-priced products to high-value-added items.

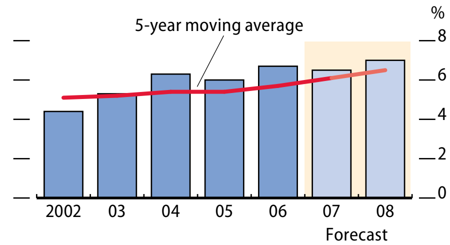
Entering and keeping its place in the market for these items, offering competitive prices and quality, and addressing social compliance issues are crucial if the garment industry is both to remain competitive internationally and to continue generating high employment and income growth for the country.

The pickup in external trade, bank advances to transport and trade, and mobile phone subscribers implies that high growth in services will continue.

In FY2007, inflation is projected to decline slightly to 7.0% and to 6.0% in FY2008 (Figure 2.14.13). After the heightened price pressures of FY2006, inflation has trended down in the early months of FY2007; on an annual point-to-point basis the national consumer price index fell from 7.5% in June 2006 to 6.1% in December 2006, with declines in both food and nonfood prices. The anticipated sustained moderation in price trends is based on a continued tight monetary policy, an easing in international oil prices, a softening of nonfuel commodity prices, and a continued buildup in foreign exchange reserves.

The authorities have announced a broad money growth target of 14.7%

2.14.11 GDP growth



Sources: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006; staff estimates.

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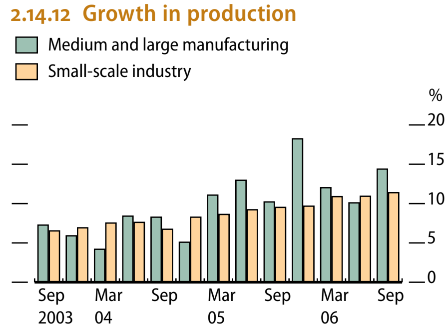
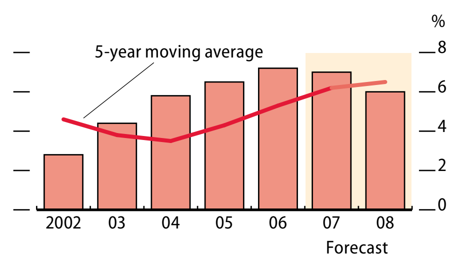
2.14.12 Growth in production



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

2.14.13 Annual inflation



Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 2 February 2007; staff estimates.

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and a domestic credit growth target of 14.1% in FY2007. Reflecting its restrained monetary policy stance, the central bank raised policy interest rates between June and December 2006: the 28-day treasury bill rate from 7.1% to 7.3%, and the reverse repo rate from 5.5% to 6.5% (Figure 2.14.14). Commercial banks' lending and deposit rates also rose over the same period, from 12.1% to 12.4% and 6.7% to 7.0%. Even with this cautious policy, a healthy flow of credit to the private sector was sustained with growth of 19.4% year on year in December 2006.

The current account balance in FY2007 is expected to record a surplus of 1.0% of GDP and moderate to 0.2% of GDP in FY2008 (Figure 2.14.15). The outcome will be aided by a continued reduction in the trade deficit and robust growth in remittances. Exports are projected to grow at 20% and 18% in FY2007 and FY2008. In the first half of FY2007 they were up by 26% from a year ago, buoyed by high growth in knitwear (32%) and woven garments (24%) (Figure 2.14.16). Import growth in FY2007 and FY2008 is forecast at 15% and 14%. In the first 6 months of FY2007, imports grew by 20%. Workers' remittances rose by 31.3% in the same period (Figure 2.14.17). Foreign exchange reserves strengthened by $0.4 billion in the same period, touching $3.9 billion at end-December 2006.

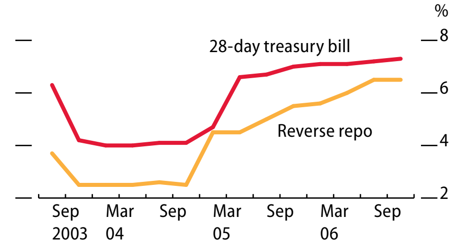
The taka/dollar exchange rate was little changed between June 2006 and February 2007. Bangladesh Bank limits its market interventions to countering disorderly movements and to building a more comfortable reserves position consistent with the macroeconomic program agreed with the International Monetary Fund. A managed floating exchange rate system in force since May 2003 has served the economy well, enabling it to adjust relatively smoothly to the changing external environment, especially in absorbing the oil price shock, supporting export growth, and protecting reserves.

BPC's large losses continue to mount. The Government has not granted any upward adjustments to domestic fuel tariffs since June 2006, when diesel and kerosene (together making up 75% of domestic consumption) were put up by 10% and gasoline by 30%. Even after the fall in prices in the international market, the prices of diesel and kerosene were about 80% of the breakeven level as of mid-January 2007, with a loss of $0.11 a liter for diesel and $0.12 a liter for kerosene (Figure 2.14.18). BPC sells other products at a profit.

Driven by growing economic activity, the demand for various fuel products is projected to rise to 4.0 million tons in FY2007, up by 5.3% from the preceding year. In FY2006, BPC incurred losses estimated at $474 million; this fiscal year losses are projected at $340 million. BPC's losses, which have been financed mainly by NCB credits, will eventually become government obligations. In a policy shift, the FY2007 budget includes an allocation equivalent of $86 million, which though inadequate, could cover part of the oil company's losses. The urgently needed policy change, however, is to implement automatic pricing formulas (on the line of those adopted in 2003 but largely ignored) to recover BPC's full costs while providing for social safety net measures to mitigate the impact on society's most vulnerable groups.

From a longer-term perspective, the economy has gently picked up its rate of growth, from 3.7% in 1981–1990, to 4.8% in 1991–2000, and to 5.7%

2.14.14 Interest rates



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 7 March 2007.

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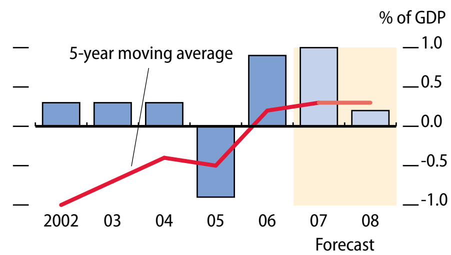
2.14.15 Current account balance



Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007; staff estimates.

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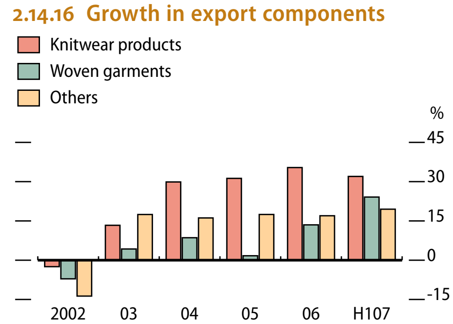
2.14.16 Growth in export components



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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in 2001–2006 (Figure 2.14.19). Savings and investment played their part, rising from 11.6% and 17.5%, respectively, in 1981–1983 to 19.9% and 24.5% in 2004–2006. Greater openness, with exports aided by the dynamic garments industry, also provided stimulus to growth. All sectors, especially industry and services, contributed. Factor productivity also increased sharply, reflecting sounder policies and a higher rate of capital accumulation. The Government stepped up policy and sector reforms to create a more market-oriented economy, paving the way for faster private sector-led growth. Significant reductions in tariff and nontariff barriers and deregulation fostered competition in the economy.

The steady growth record, despite internal and external shocks, provides a sound basis for Bangladesh's medium-term growth prospects of 8% GDP growth. However, for this to be achieved, investment needs to be augmented and economic and structural reforms accelerated to improve productivity and competitiveness in the economy.

Several downside risks to medium-term growth prospects could derail projections, implying slower growth, a weaker balance of payments, and higher inflation. An upsurge in political conflict and associated disturbances would clearly affect economic activity. Growing infrastructure constraints, particularly worsening power shortages, could deter new investments and hold back growth. Externally, stiff competition in garments and textiles in the wake of the end of the quota system poses significant risks. The competition in the world textile market will be further intensified after 2008, when temporary quotas imposed by the European Union and United States on the People's Republic of China expire.

Development challenges

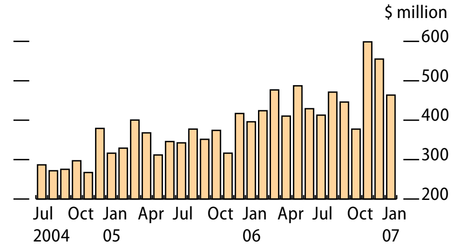
Key development challenges facing Bangladesh include upgrading the physical infrastructure, augmenting efficiency in the financial sector, stimulating greater foreign direct investment (FDI), and strengthening governance. Deficiencies in key infrastructure, such as power (Box 2.14.1), ports, railways, and roads, seriously hamper export growth, investment, and opportunities for transport integration with neighbors.

In the ports segment, Chittagong port, which handles nearly 85% of imports and 80% of exports, suffers from low productivity, labor problems, and weak management, exacerbated by the practice of stuffing and unstuffing containers in the port (because of limited off-dock facilities and costly railway services to move containers). Chittagong port is below the UNCTAD productivity standard of 230 lifts per berth a day.

Bangladesh Railway is unable to carry containers efficiently and on time because of limited locomotive and freight-car availability, congested network on major corridors such as Dhaka–Chittagong and the corridor to India, lack of operational efficiency, and infrastructure constraints. The main constraints facing the road sector are inadequate maintenance funding and weak management.

As a result of weaknesses in transport operations, the country is tardy in exporting and importing, requiring 35 and 57 days, respectively, measured from start to completion of export/import procedures and shipment. This compares ill with neighboring countries such as India

2.14.17 Workers' remittances



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

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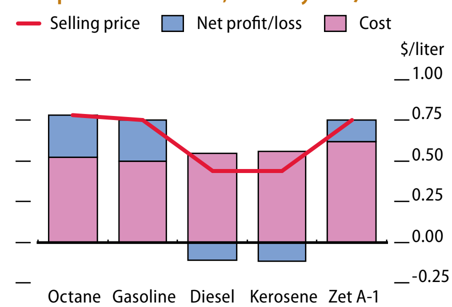
2.14.18 Bangladesh Petroleum Corporation fuel price breakdown, January 2007



Note: Figures are based on average fuel price in the international market as of 12 January 2007.

Source: Ministry of Energy and Mineral Resources.

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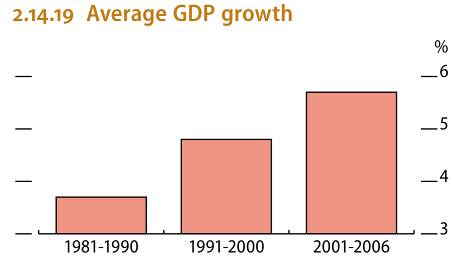
2.14.19 Average GDP growth



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, various years.

Click here for figure data

(27/41 days export/import, respectively), Pakistan (24/19 days), and Sri Lanka (25/27 days). Similarly, costs are high. For example, the cost of export for each container in Bangladesh is $902, compared with $864 in India, $797 in Sri Lanka, $481 in Malaysia, and $335 in the People's Republic of China.

For Chittagong port, the focus should remain on contracting out operations to the private sector, on allowing private operators to invest in port infrastructure, and on restructuring its management. The caretaker Government has, in fact, transferred the operations of Chittagong container terminal to the private sector, and has also signaled its intention to do the same for the new mooring container terminal.

For Bangladesh Railway, the emphasis should be on ensuring greater commercial orientation, outsourcing some business to private companies, and introducing modern management and financial systems. In roads, the priority should be on approving an integrated multimodal transport policy and creating a road maintenance fund.

Despite some progress, Bangladesh is yet to establish a healthy and efficient financial system. Ongoing banking sector restructuring must be strengthened. In the capital market, the thrust should be on improving financial reporting and corporate governance, and strengthening monitoring and enforcement by the Securities and Exchange Commission. Many government-owned enterprises, including the petroleum distribution companies and Biman Bangladesh Airlines, as well as major private companies such as mobile phone companies with huge annual turnover, could be prime candidates for selling shares, stimulating the equity market.

From already low levels, FDI inflows further declined in FY2006, depriving the country of much-needed capital resources along with the associated transfer of technology, skills, and access to new export markets. Despite the seriousness of the position, the country is yet to accord political decisions on several large FDI proposals.

Corruption is an important factor that prevents Bangladesh from achieving its potential for higher economic growth and faster poverty reduction. The caretaker Government has taken an extensive anticorruption stance, and as part of this will need to address the shortcomings of the Anticorruption Commission, giving it greater independence, scope, and resources.

2.14.1 Power problems

Power is the biggest logjam in physical infrastructure. Per capita power generation is only about 158 kilowatt-hours a year, among the world's lowest.

Only a third of the population has access to electricity, and even they have a poor, unreliable service suffering from frequent power outages and low voltage.

This stems from inadequate power generation capacity and poor transmission and distribution systems. In FY2006, maximum served generation was only 3,812 megawatts (MW) as against peak demand of 4,693 MW, resulting in up to 1,312 MW load shedding on 347 days. Most industrial manufacturers have to rely on costly generators, and small enterprises that cannot afford backups have no alternative but to shut down during prolonged power outages.

Over the last decade, net energy demand has grown by 8.1% a year. Yet for an expected average annual GDP growth rate of 8% over the next two decades, the needed average annual energy growth rate is 12%.

Bangladesh faces a momentous task meeting this burgeoning energy demand, which will need substantial investment with reforms in various areas, including introducing an energy pricing policy to recover operating costs, reducing the Government's outstanding dues to power entities, further corporatizing power entities, and making the Bangladesh Energy Regulatory Commission fully operational.

Bhutan

The huge Tala hydropower project started commercial production in July 2006. In the medium term, Tala is forecast to double electricity export capacity, boosting GDP and government revenues significantly. Yet it makes Bhutan even more reliant on export of one commodity to India. Also, hydropower employment elasticity is low, and cannot cope with the many tens of thousands of young people entering the labor market or migrating to urban areas. The Government needs to stimulate greater private sector activity and to diversify the economy.

Economic performance

Economic growth is estimated to have accelerated to 9.0% in 2006 from 6.5% in 2005 (Figure 2.15.1). The pickup in growth was largely due to commissioning of the 1,020 megawatt (MW) Tala project in July, with the commercial operation of the first of six turbines in July and the second in October. Nearly all output is exported to India. Production of power from all the four power projects (Basochu, Chukha, Kurichhu, and Tala) increased by 30% year on year, and Tala was responsible for all this rise. Total export sales of power grew by 54% to Nu4.9 billion (about $109 million).

In other sectors, agriculture is estimated to have grown by 1.5% and services 10.4%. Construction, which declined by about 3% in 2005, recovered on the back of increased private residential and commercial property building.

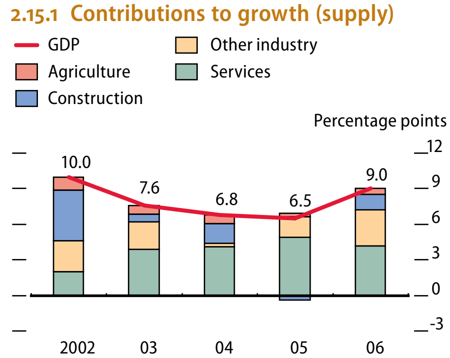
Revised budget estimates for FY2006 (ended 30 June 2006) indicate that the Government's fiscal position improved, with the overall budget deficit narrowing to Nu2.6 billion (or 7.1% of GDP) from 11.0% the previous year (Figure 2.15.2). A small decline in capital spending and an increase in foreign grants were largely responsible.

Capital spending was shaved by 2%, mostly reflecting the high FY2005 base when the Government purchased two Airbus aircraft. Current spending rose by 11%, which included outlays for draft constitution meetings and establishment costs for new institutions, such as the anticorruption and election commissions. Total expenditures, including capital spending of 24% of GDP, came to 44% of GDP.

Revenues and grants increased by 12%, with a robust increase in tax revenues and disbursement of project-tied grants as a result of faster implementation. Total budget receipts depend heavily on grants, and the tax-to-GDP ratio is low at 10.2% of GDP. Of the overall fiscal deficit, about two thirds was financed from domestic sources.

The budget for FY2007 anticipates a further reduction of the deficit to Nu1.5 billion (3.3% of estimated GDP), largely on account of much stronger domestic revenues (up 42%) associated with Tala. With grants estimated at a similar large amount as in the previous fiscal year, total receipts are projected to increase by 21%. Expenditures—both current

2.15.1 Contributions to growth (supply)



Sources: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007; staff estimates.

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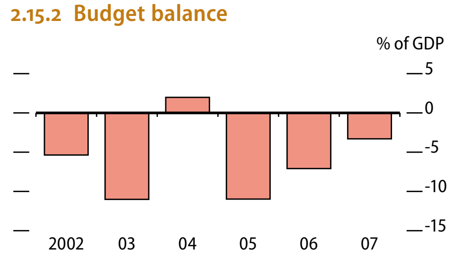
2.15.2 Budget balance



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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and capital—are each budgeted to increase by about 11%, due to a higher salaries and wages bill, preparations for the introduction of a constitution in 2008, construction of a Supreme Court building, road projects, hospital construction, and preconstruction work for Punatsangchu I and Dagachhu hydropower projects.

Broad money (M2) grew by 25% in FY2006, more than doubling from 11% in FY2005 (Figure 2.15.3). This was entirely due to an increase in the net foreign assets in the banking system. Credit to the private sector rose by 33%, but a very large build up in net deposits of the government more than offset this, and total domestic credit declined over the year. The bulk of the increase in private sector credit was for building and construction, manufacturing, and trade and commerce.

As the ngultrum is pegged to the Indian rupee, monetary developments have limited impact on prices, and inflation in Bhutan is heavily influenced by price developments in India. Consumer price inflation peaked at 6.2% in the second quarter of calendar 2006 (Figure 2.15.4). This gave an average of 4.9% for FY2006, slightly higher than India's 4.3% for the period.

The current account improved markedly, as the deficit narrowed (Figure 2.15.5) to \$30 million (3.6% of GDP) from \$211 million (29.7%). This is mainly attributable to tremendous growth in exports (up \$114 million), small reductions (of about \$15 million each) in both imports and the combined services and income accounts deficit, as well as somewhat larger net transfers receipts (up \$37 million). The 61% expansion in export earnings was about equally split between India (largely electricity) and other countries (mainly fruit and manufactured commodities).

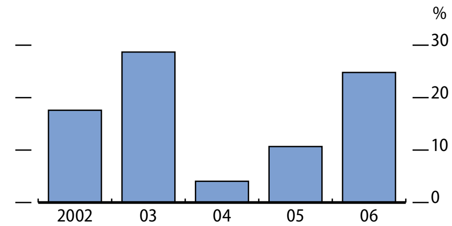
Since imports in FY2005 were buoyed by the purchase of two Airbus aircraft, the relatively small size of their drop in FY2006 of only 3.5% may be partly explained by imports for the Tala project. However, there appears to have been brisk demand for imported goods from both India and other countries. Tourism also continued strong, near-40% growth, with revenues estimated at \$21 million.

As the inflows in the capital account (including grants for Tala) and the financial account (mainly foreign aid loans) together amounted to \$144 million and were much greater than the current account deficit, the overall balance of payments registered a large surplus. Gross international reserves increased to \$479 million at end-FY2006, a very comfortable level equivalent to about 14 months of imports. External debt outstanding at end-FY2006 was \$681 million, or 82.5% of GDP. The debt service ratio for the year was only 5.3%, as almost all debt has been contracted on concessional terms.

Economic prospects

With the start of commercial operations, Tala will be the main driver of economic expansion in the next 2 years, with growth expected to accelerate further to 18% in 2007 and then moderate to 10% in 2008. Growth in other sectors together is expected to average 6–8%, while inflation should stay around 5%. Tala is expected to generate Nu40 million (approximately \$1 million) in daily revenues, and raise hydropower's share of total government revenues from 45% to about 60%.

2.15.3 Money supply growth



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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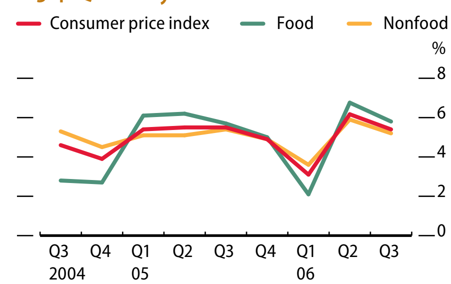
2.15.4 Quarterly inflation



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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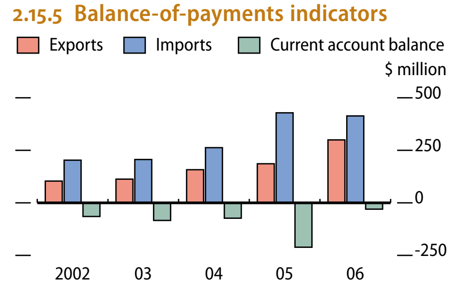
2.15.5 Balance-of-payments indicators



Source: Royal Monetary Authority of Bhutan, available: www.rma.org.bt, downloaded 12 February 2007.

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Export income from the additional power sales is expected to turn the trade balance to a surplus, and with current transfers likely maintained at about the present level, the current account balance is also projected to switch to a surplus, of 3% of GDP.

Further growth in the medium term will benefit from continued international cooperation in the hydropower sector. Memorandums of understanding have been signed between Bhutan and India for preparing detailed project reports on the 1,095 MW Punatsangchu I, the 992 MW Punatsangchu II, and the 670 MW Mangdechu hydropower projects. The full feasibility report of the Punatsangchu I project is complete and India has agreed to finance it with 60% loan and 40% grant components. Construction is expected to start this year.

2.15.1 Selected economic indicators

	2007	2008
GDP growth	18.0	10.0
Inflation	5.0	5.0
Current account balance (% of GDP)	3.0	3.0

Source: Staff estimates.

Development challenges

The main challenge is that hydropower employment elasticity is low. With more people entering the labor market each year, the Government must stimulate greater private sector activity and diversify the economy to boost employment, in line with the Government's poverty reduction strategy. The Government might aim to do this by improving transportation and communications infrastructure for better integration of the national economy, strengthening the private sector enabling environment (particularly for tourism and high-value agriculture), and enhancing the efficiency of the financial sector.

In preparation for its planned transition from a monarchy to a two-party democratic system in 2008, the Government has established institutions to ensure high standards of governance and transparency. An autonomous Anticorruption Commission has been established, and autonomous status is envisaged for the existing Auditor General's Office. The National Assembly has set up a public accounts committee, and a fiscal responsibility bill is expected to be presented for passing. The actual transformation and workings of a two-party democracy may lead to some initial uncertainty, but the transition is unlikely to result in any significant economic policy changes.

Bhutan is trying to integrate itself with regional and international economic groupings. It is currently negotiating to become a member of the World Trade Organization; the third meeting of the working party was held in October 2006.

India

Two years of above-trend growth are causing inflation. Optimism over growth prospects has brought high capital inflows and currency appreciation pressure. Manufacturing and construction growth have stimulated a voracious appetite for credit, which in turn complicates attempts to control the money supply.

Agricultural stagnation is the key structural challenge. Rising food prices contribute to inflation. Stagnation also widens inequality, as industry accelerates and services pull on robustly. It also raises pressures to transfer land out of agriculture into industry, and highlights the importance of industrial job creation for growth, labor absorption, and poverty reduction. Yet land transfer from agriculture to industry implies significant worker displacement, and has caused serious social unrest.

With inflation high, and serious structural hurdles for the economy to overcome, the Reserve Bank of India finds itself in a precarious position. It must damp expenditures in the short run, while also ensuring adequate credit supply to promote manufacturing and agricultural investments in the medium term.

However, interest rates have risen, construction growth has already tapered, and the rupee is appreciating slightly. Agricultural planting has responded to rising prices. These trends will help moderate inflation. A soft landing therefore appears likely.

Economic performance

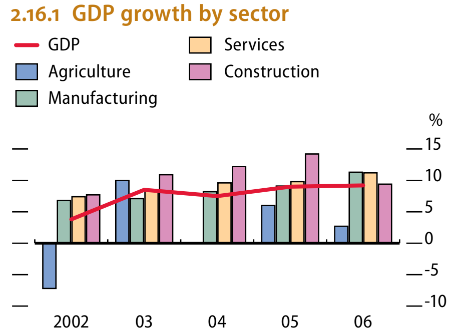
Robust growth momentum continued in FY2006 (April 2006–March 2007). After rising by 9.0% in FY2005, GDP is set to grow by 9.2% in FY2006. India's trend growth rate is estimated at 8–8.5% (see *Asian Development Outlook 2006*).

Four important characteristics emerge from the growth episode of recent years (Figure 2.16.1). First, growth is accelerating. Second, over the past few years, the manufacturing growth rate has caught up with that of services. Despite this, the services sector, given its 55% share of value added (compared to industry's 26%) continues to push up the aggregate pace. Third, construction—whose performance we report separately, given its important role in the Indian story today—has been through a boom that now appears to be ending. Indeed, construction in 2004 employed roughly 6% of the labor force, up from a more typical 3% in 1993. Fourth, agricultural performance remains subdued, with growth declining in the first half of FY2006.

Construction and home sales have soared since 2002, and demand for capital and consumer goods—especially consumer durables (Figure 2.16.2)—has followed. Demand for basic and intermediate goods has also grown with construction. Each of these developments has increased pressure to expand industrial capacity. The National Council of Applied Economic Research's October business confidence survey reveals particularly high levels of capacity utilization in the capital goods sector (Figure 2.16.3). These high levels feed back into capital goods demand.

Booming industry and construction raised gross domestic investment to 33.8% of GDP in FY2005 (Figure 2.16.4), an upward trend that appears

2.16.1 GDP growth by sector



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 2 March 2007.

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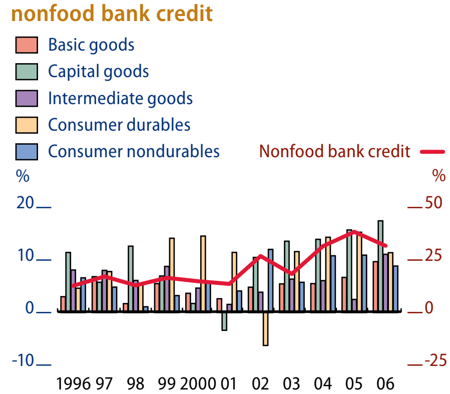
2.16.2 Growth in industrial output and nonfood bank credit



Note: 2006 data are for the first 3 quarters only.

Source: CEIC Data Company Ltd., downloaded 10 March 2007.

Click here for figure data

to be continuing despite slowing construction. This investment surge has been met by a simultaneous expansion in bank credit. Figure 2.16.2 (above) shows that India's manufacturing take-off coincided with a positive turnaround in the growth of bank credit. Table 2.16.1 demonstrates the extraordinary rate of credit expansion, which has gone into real estate (commercial and residential), infrastructure, and export industries—engineering products, textiles, and chemicals (Figure 2.16.5). An expansion in retail credit has been pushing up consumption as well.

Given the importance of high investment for continued manufacturing growth, provision of liquidity therefore remains a monetary policy priority. However, the high rate of credit growth is causing problems. First, frenetic lending by banks has, at least until recently, confounded attempts to rein in the money supply. Second, excessive lending for long-term real estate transactions appears to have led to maturity mismatches between banks' assets and liabilities. Specifically, according to some estimates, bank deposits have an average maturity of 2–3 years, while rapidly growing housing loans mature in 7–8 years. Some banks seem to feel that they are overinvested in real estate.

The impact of monetary growth and excess demand for nontradable goods and assets (especially real estate) is already being felt. Wholesale price inflation began rising in May 2006, reaching an annualized rate of 6.0% in the third week of January 2007. Consumer price inflation is higher still. While this was initially driven by booming international energy prices, and by still-ascendant food price inflation, recent figures show that burgeoning manufactured goods price inflation is now contributing as much as food and fuel prices combined (Figure 2.16.6). Given tight manufacturing and supporting infrastructure capacity, and the significant time lags involved in augmenting it to meet rising demand, manufacturing is overheating.

Prices of wheat, pulses, milk, and condiments and spices—supply has been tight for all of them—are the chief culprits of food price inflation (Figure 2.16.7). In response to these and other inflationary trends, the federal Government introduced a raft of measures including the elimination of duties on imports of wheat, pulses, edible oils, and sugar; a ban on wheat exports; modifications in the management of public food-stocks including suspension of the futures market; and reductions in regulated retail prices of gasoline and diesel charged by the government-owned oil-marketing companies.

Unfortunately, these measures have met with limited success, as some key global commodity prices have risen on adverse agro-climatic conditions. Prices in the world wheat market have risen faster than domestic prices. Nevertheless, help may be on the way, with rising prices prompting increases in the area under cultivation for wheat, pulses, and coarse cereals.

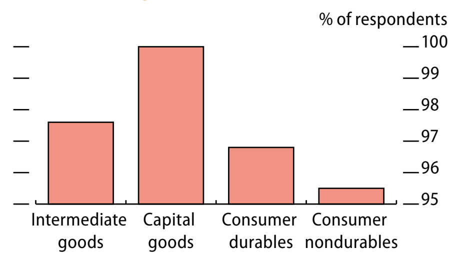
Faced with demand-led inflation, the Reserve Bank of India (RBI) needs to damp expenditures. However, in doing so, it will be important not to reduce the credit available for expanding manufacturing capacity more than is necessary to contain inflation. These capacity expansions are vital for enhancing growth potential in the medium to long term. Thus, credit provision needs to be curtailed, but also redirected away from overactive real estate markets. RBI is pursuing this redirection by

2.16.1 Credit growth rate by sector, October 2006, %, year on year

Retail	34.3
Housing	32.3
Commercial real estate	83.9
Industry, including	24.8
Infrastructure	23.2
Metals	34.6
Textiles	34.2
Engineering	15.3
Chemicals	26.9
Food processing	23.6
Construction	49.5
Agriculture	30.8

Source: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007.

2.16.3 Views on capacity utilization: close to or above optimal level, October 2006



Note: Data refer to share of respondents viewing capacity utilization as close to or above the optimal level.

Source: National Council of Applied Economic Research, *Business Expectations Survey*, October 2006.

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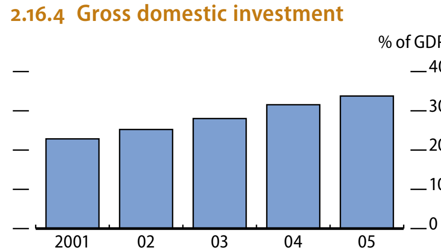
2.16.4 Gross domestic investment



Source: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 7 February 2007.

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requiring banks to hold additional reserves equal to 2% of the value of their outstanding commercial real estate loans. This figure used to be 1%. Such adjustments are an important form of prudential regulation.

Continued high growth in money supply driven by commercial credit during FY2006 prompted RBI to raise policy rates (Figure 2.16.8). However, these rate changes proved inadequate, perhaps because inflation rose faster than some nominal interest rates, leading to a fall in real interest rates. Alternatively, the failure of rate increases to quickly curb credit growth could simply reflect long lags in responses to monetary policy changes. In any event, high growth in bank credit and money supply continued unabated.

Figure 2.16.9 shows stock prices on a tear, which began in 2002 and accelerated further from 2004. Other asset classes, especially property, display similar trends. In the context of corrections in asset prices in most Asian economies in early March, and the reassessment of risk that appears to be driving it, these trends are a source of concern.

Against this background, RBI has expressed serious concerns that the economy is overheating. Consequently, and triggered by the need to sterilize exchange rate interventions in response to a further surge in foreign capital inflows in October–November 2006, the central bank raised the cash-reserve ratio by 100 basis points between December and March. Even these measures appear to have been inadequate, and money supply grew at 20.4% year on year to the first week of January. Thus RBI raised the short-term policy rate again by 25 basis points, and has not ruled out further monetary tightening in the coming months.

Robust demand for credit, higher policy rates, and a rising credit-to-deposit ratio have driven up interest rates, on both deposits and lending. Anticipating tighter liquidity conditions, commercial banks lifted deposit rates by 25–125 basis points and prime lending rates by 75–150 basis points between April 2006 and January 2007.

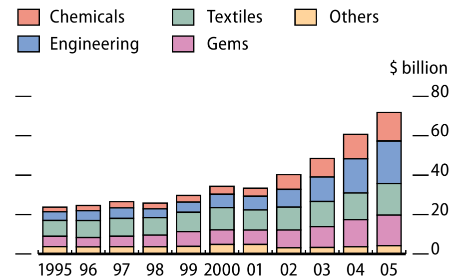
With the loanable funds market tightening, fiscal discipline matters greatly for ensuring that firms seeking to expand industrial bottlenecks are not crowded out.

In this context, it is helpful that rapid growth has boosted revenues greatly, providing ample fiscal space for large increases in expenditures while sustaining fiscal consolidation. The federal budget for FY2007 has been prepared against a background of high inflation and a comfortable foreign exchange reserves position. It also marks the beginning of the 11th Five-Year Plan.

Despite additional expenditure commitments for various social sector programs and rural infrastructure, the federal Government could sustain the momentum of fiscal consolidation. Both the current (revenue) and gross (overall) fiscal deficits as shares of GDP are marginally lower than the targets in FY2006, and the Government expects them to decline further in FY2007. The fiscal deficit is projected to fall to 3.3% of GDP, from 3.7% in FY2006.

Reviving agricultural productivity and output remains a priority area in the budget. A raft of measures has been introduced for strengthening irrigation and facilitating financial inclusion of farmers. On the revenue front, rationalization of indirect taxes continues, with the budget bringing down peak customs duties from 12.5% to 10.0%.

2.16.5 Manufactured goods exports



Source: CEIC Data Company Ltd., downloaded 1 March 2007.

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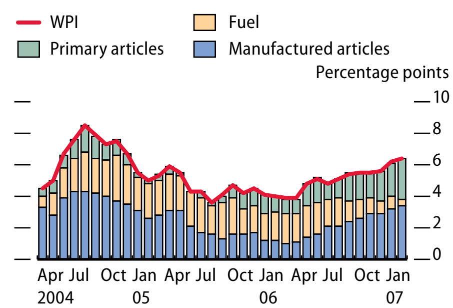
2.16.6 Contributions to wholesale price inflation



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 8 March 2007.

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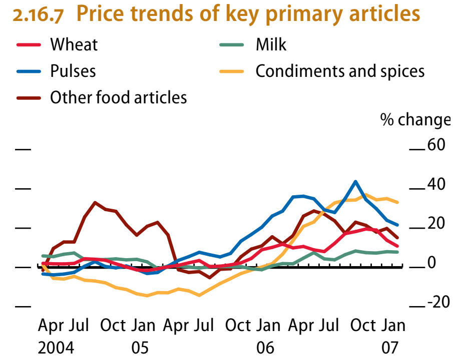
2.16.7 Price trends of key primary articles



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 8 March 2007.

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The budget also presents two sets of options for using India's growing foreign exchange reserves (Figure 2.16.10) to finance improvements in infrastructure. Whether and how to reinvest reserves has been widely debated. The immediate difficulty with actually doing so is that, in most cases, rupees would have to be released against foreign currency being returned to the country to purchase domestic inputs. So RBI, already running out of options for controlling money supply and inflation, would have even more liquidity to mop up. Further, demand for rupees by infrastructure investment firms would contribute to rupee appreciation.

The first option presented in the budget neatly sidesteps these complications by requiring foreign exchange reserves, borrowed by foreign subsidiaries of the publicly owned Indian Infrastructure Finance Corporation Limited (IIFCL), to be applied only to expenditures on *imported* inputs for infrastructure projects. Thus the reserves would never be converted into rupees or stimulate local demand. The key limitation of this approach is that most infrastructure inputs are not imported.

The second option would essentially permit foreign IIFCL subsidiaries to borrow RBI's foreign exchange reserves and use them as collateral for larger international loans. These loans could then be applied to domestic infrastructure investments denominated in rupees. Clearly, this option runs into the above monetary problems head on, as would any large foreign direct investment inflows.

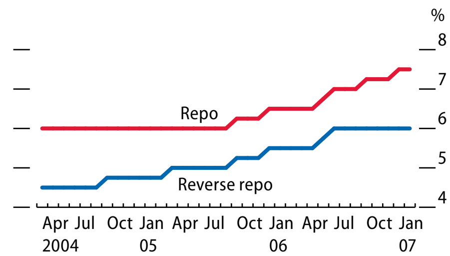
The schemes raise other concerns. IIFCL is a government-owned company, so its borrowings add to the liabilities of the Government. In the context of consolidating the budget, it must therefore be recognized that the Government is borrowing from RBI through the IIFCL. The advisability of such schemes depends on the view taken of the role of foreign exchange reserves accumulation. There are two main perspectives on this.

First, foreign exchange may be accrued for prudential reasons. If this is what reserves are for—and this is clearly RBI's position—then it is institutionally appropriate that RBI, which has been appointed to manage India's overall monetary risks, should be the arbiter of how much accumulation of reserves is "adequate." It is particularly important not to undermine RBI's autonomy as it attempts to navigate the economy toward fuller capital account convertibility.

Second, foreign exchange may be accruing as part of an effort to use exchange rates to maintain the competitiveness of exports. This is consistent with the fact that RBI has had to actively build up reserves, while remaining active in the foreign exchange market. If this is the case, then foreign exchange accumulation involves a tax on imports. Therefore this plan is tantamount to using a tax on imports to finance infrastructure. This is a policy whose relative merits the Government could debate, but it is not clear why RBI should be involved.

States' finances have improved significantly, after worsening during the second half of the 1990s (Table 2.16.2). This deterioration led to growing recognition of an urgent need to improve their finances. State governments adopted specific expenditure and revenue reform measures, and set aside funds to cover their contingent liabilities. These steps have been institutionally enshrined in fiscal responsibility legislation. The states are also undertaking measures to control rising pension liabilities.

2.16.8 Policy rates



Source: CEIC Data Company Ltd., downloaded 8 March 2007.

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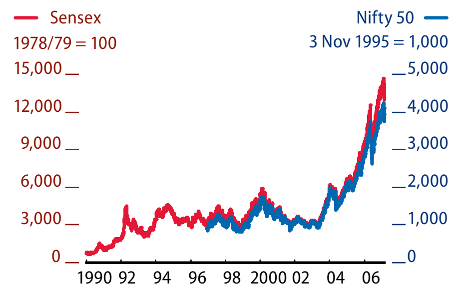
2.16.9 Stock price indexes



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 10 March 2007.

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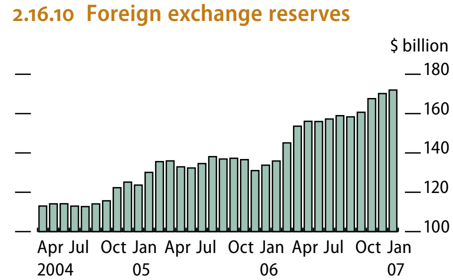
2.16.10 Foreign exchange reserves



Source: CEIC Data Company Ltd., downloaded 1 March 2007.

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2.16.2 Major indicators of state finances (% of GDP)

	1995–1997	1998–2003	2004–2006
Gross fiscal deficit	2.8	4.3	3.0
Revenue deficit	1.0	2.5	0.5
Capital outlay	1.4	1.5	3.7
Revenue expenditure	12.3	13.5	13.0
Debt	21.4	29.1	32.7

Source: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007.

Yet these improvements are threatened by several forces. The first is impending public pay increases. The federal Government has appointed a Pay Commission to review public salaries, and states are likely to follow suit. Some already have (Karnataka and Punjab). The second is that the era of easy borrowing seems to be over. Although existing debts have been restructured, bringing down the interest rates assessed on them, new debts will incur higher interest. The federal Government therefore needs to keep a strict vigil on states' borrowing programs. Finally, the pressure to generate larger resources for India's 11th Five-Year Plan, coupled with complacency facilitated by strong recent growth, is reducing the constituency for fiscal discipline.

Domestic overheating has been forcing RBI to raise interest rates. As a consequence, surges in capital inflows are leading to rupee appreciation pressure. Indeed, the real effective exchange rate has risen in recent months (Figure 2.16.11). Export growth has declined, and the current account deficit is rising. The balance-of-payments data presented below reflect these forces.

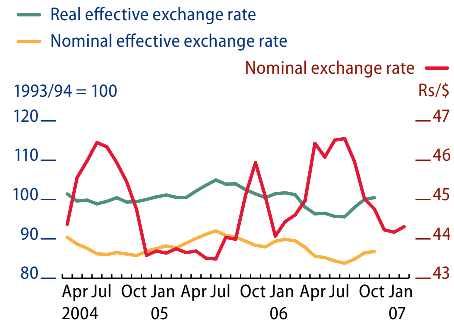
While goods exports grew 23% in the first half of FY2006, imports grew by 25%, widening the merchandise trade deficit to $35 billion (Figure 2.16.12). This deficit was significantly offset by robust inflows from invisibles, which included earnings from services such as software exports and business services (Figure 2.16.13), as well as transfers from nonresident Indians. The combined current account deficit therefore rose to $11.7 billion from $7.2 billion in the first half of FY2005. India ran a current account surplus in FY2003, when the latest growth acceleration began.

Pursuing growth opportunities, net foreign direct investment (at $4.2 billion) exceeded net portfolio capital inflows in the first half of FY2006 for the first time in several years. Net capital inflows were $19.3 billion during the same period. The surplus in the capital account is mainly attributable to foreign (direct and portfolio) investment ($5.8 billion), commercial borrowing ($5.1 billion), deposits by nonresident Indians ($2.0 billion), banking capital ($1.1 billion), and short-term credit and other capital ($4.9 billion). Thus, even with a large current account deficit, sizable capital inflows led to foreign exchange reserves accumulation of $8.6 billion.

Economic prospects

The performance described above highlights a fairly broad and overactive domestic demand base for the economy in FY2006, with public expenditures, investment, and household spending all contributing. RBI

2.16.11 Exchange rates



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 5 March 2007.

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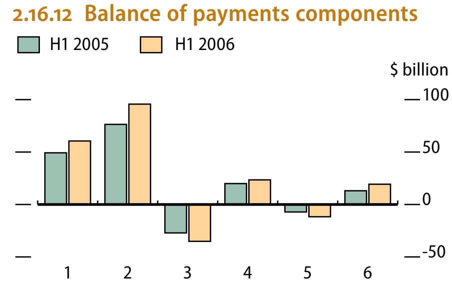
2.16.12 Balance of payments components



Note: 1 = exports; 2 = imports; 3 = trade balance; 4 = net invisibles; 5 = current account balance; 6 = capital account.

Source: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007.

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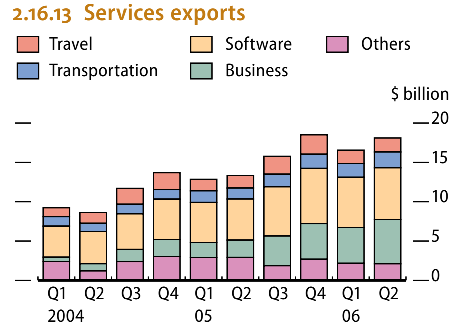
2.16.13 Services exports



Source: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 1 March 2007.

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has responded with policies intended to slow demand growth, and has indicated a willingness to tighten further.

The following forecasts rest on five major assumptions. First, there is no sudden decline in fiscal discipline. Second, monetary conditions tighten further. Third, agricultural productivity proceeds at its usual, plodding pace. Fourth, with the softening of international oil prices, the Government does not pursue further increases in diesel, kerosene, and cooking-gas prices. Fifth, RBI permits a modest appreciation of the rupee in real effective exchange rate terms.

Rising interest rates in FY2007 will have subtle and wide-ranging consequences, mediated, most importantly, through property development. As liquidity becomes scarce, banks are beginning to reexamine lending practices, which will lead to scaled-back lending for construction and housing loans to allow them to deal with the emerging maturity mismatch. Construction has already decelerated significantly in FY2006. Consumer credit should also come under pressure as banks reallocate loanable funds.

This loss of construction momentum is likely to persist through early FY2007, with knock-on effects for other components of demand. Spending on consumer durables, which has benefited from the construction and sale of new homes, will continue to slow in FY2007. Interest rate rises will also induce consumers to delay consumption, further reducing consumer durables demand. Manufacturing investment will be slightly restrained as falling demand for durables and new homes eases pressure to add industrial capacity. Rising costs of borrowing will also have a direct effect on manufacturing investment, despite good corporate earnings in the current year.

These restraints on demand growth from home buyers, manufacturing investors, and consumers will be accompanied by fiscal discipline, so domestic demand growth will be limited overall. Modest rupee appreciation will contain export growth. However, import growth will remain moderate as well, due to easing demand growth.

These forces are expected to moderate growth rates, bringing aggregate growth down to 8.0% in FY2007, closer to potential (Figure 2.16.14). The correction will not be sharp, in large measure because several drivers will continue to hold sway: industrial capacity remains tight, militating for high investment; key consumption goods markets are expanding, independent of new homes sales—including the sale of consumer durables for homes already built or construction under way; and demand for exports remains healthy, though with some deceleration. Thus despite a firm monetary position, momentum should ensure a soft landing.

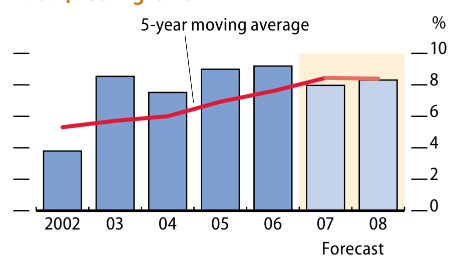
With aggregate demand back in control, interest rates are likely to stabilize and turn down slightly by FY2008. Growth that year should return to around 8.3%, as interim relief offered by the Federal Pay Commission is expected to buoy consumer spending, and as spending strengthens in the new interest rate environment. Specifically, construction is likely to pick up slightly. A large portion of the huge rise in bank lending to real estate in FY2006 was used to finance land acquisition. Future demand for commercial real estate is currently unpredictable, reflecting the uncertain future trajectory of interest rates

2.16.3 Selected economic indicators

	2007	2008
GDP growth	8.0	8.3
Wholesale price inflation	5.0	5.0
Current account balance (% of GDP)	-2.2	-2.2

Source: Staff estimates.

2.16.14 GDP growth



Sources: Central Statistical Organisation, available: http://mospi.nic.in, downloaded 2 March 2007; staff estimates.

Click here for figure data

and inflation. Therefore, while construction on some lands has been put on hold, it is likely to restart as the cost of funds becomes more conducive to long-term investments.

Against this background, wholesale price inflation is expected to soften and then remain steady at 5.0% in FY2007 and FY2008 (Figure 2.16.15). Inflationary pressures are seen weakening on four factors. First, and most important, the tighter monetary position will limit demand expansion. Second, as a result of rising agricultural prices, the acreage under cultivation has increased, and good *rabi* (spring) harvests are expected. Third, already-high agricultural prices in FY2006 will sap some of their upward momentum in FY2007. And finally, cuts in import duties on key commodities, including edible oils, will help.

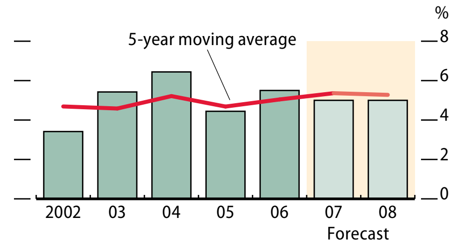
Realized performance may depart from this outlook for four key reasons. The first is the potential for an excessive contraction of credit availability. This could be due to unexpected fiscal laxity, particularly in noninvestment expenditures, or an overly severe monetary response, which would beat back investment, lowering growth.

Second, with food stocks still low, the possibility of further supply shocks in the 2007 *kharif* (autumn) harvest, or beyond, present important risks. Food supply management policies therefore need to be urgently improved to reduce price volatility. Minimum support prices are too low, buffer stock targets are not being filled, and measures to augment food stocks through imports have failed. A purely monetary solution to price increases will not work if food prices resume their acceleration.

Third, export growth has started to decline (Figure 2.16.16). This is especially true of manufactured exports, and could reflect real exchange rate appreciation. Declining exports in the short run, however, are not an economic risk—simply a potential deviation from forecast. Given excess demand in the economy, some real appreciation is expected, and a little less exuberance on the external account will help the economy to rebalance. With foreign investors confident in India's growth prospects and a solid stock of currency reserves, balance-of-payments reversals are unlikely. Active management of real exchange rates is therefore unnecessary. RBI should therefore focus on limiting short-term exchange rate volatility.

Fourth, inflated asset prices—both for real estate and equities—might fall rapidly. This would suck the air out of hot consumer spending, as wealth falls. It would also make it more difficult to raise funds for new investment on the equity market. And this would also create significant uncertainty regarding the forward path of interest rates, investment, and ultimately growth.

2.16.15 Wholesale price inflation



Sources: Reserve Bank of India Database on Indian Economy, available: https://cdbmsi.reservebank.org.in/cdbmsi/servlet/login/, downloaded 8 March 2007; staff estimates.

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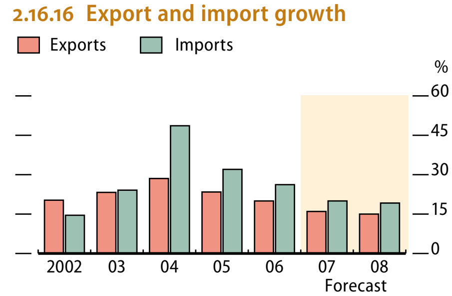
2.16.16 Export and import growth



Sources: Reserve Bank of India, available: www.rbi.org.in, downloaded 7 February 2007; staff estimates.

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Development challenges

The Government envisages growth rates of 8.5% over the next 5 years with little inflation. Agriculture provides only 18.5% of GDP, and agrarian growth has slipped to 3.0% over the last 6 years. With industry and services, which make up 81.5% of output, growing fast at anywhere between 7% and 11%, the performance of agriculture is not arithmetically important for aggregate growth. For example, if agricultural growth rates doubled, GDP growth would edge up by a mere 0.5%. It is therefore tempting to focus on industry, and less capital-intensive services, when seeking growth.

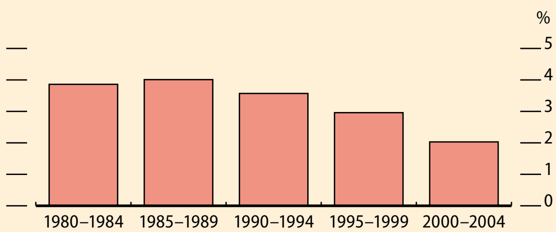
However, the arithmetic belies far more serious matters. Agriculture and related activities employ around 60% of India's labor force (or 115 million farming families), so stagnation in agricultural productivity will put poverty reduction on hold. India's food security situation is also deteriorating alongside farmers' incomes. What is to be done?

Box 2.16.1 delineates the key forces stifling agriculture, and argues that diversifying products into cash crops, improving foodgrain yields in lagging states, and scaling up agriculture a little will help. The last will probably accelerate the rate of labor displacement out of agriculture. Substantial job creation, particularly in India's infrastructure-scarce factories, is therefore urgent. But unfortunately, meager farm incomes leave little by way of profits to invest in rural industry. This helps to

2.16.1 Agriculture in transition

Agricultural performance in the past decade has been erratic, while growth in agriculture and allied activities has been slowing since the mid-1980s (box figure).

Average growth of agriculture and allied activities



Source: Mathur, A., S. Das, and S. Sircar, "Status of Agriculture in India: Trends and Prospects." *Economic and Political Weekly*, 30 December 2006–5 January 2007, pp. 5327–36.

Three primary reasons for the agricultural slowdown have been falling levels of public investment, especially in irrigation; steady deterioration of the public institutions that provide credit, inputs, and research and extension services to farmers; and environmentally unsustainable production practices (aggravated by subsidies, output pricing, and marketing policies). For example, while 39% of central Punjab enjoyed water table depths of less than 5 meters in 1973, none does today. Each of these factors adversely impacted yields of principal crops. Rice yields in 2002 were 2,915 kg/hectare compared with 3,448 in Bangladesh, 9,135 in Egypt, and 7,372 in the United States. Wheat yields, at 2,770 kg/hectare, compare poorly with 3,885 in the People's Republic of China, 7,449 in France, and 8,043 in the United Kingdom.

Reviving the performance of agriculture is therefore the major challenge of the 11th Five-Year Plan. The strategy rests on two pillars: increased public investment in rural infrastructure, and reforms and incentives facilitating diversification into high-value crops.

However, agricultural diversification is held back by structural rigidities.

- Marketing arrangements need to be revamped to deal with monopsony, rent seeking, and waste. Private sector competition can help in this regard. Private investment is also crucial for stimulating downstream food processing and extension research to support horticultural growth.
- The absence or poor condition of supporting infrastructure, such as cold storage, hampers the process of diversification. Moreover, the shift to animal husbandry and dairy is constrained by, for example, lack of green fodder, grazing land, and proper supply-chain facilities.
- Better extension and research services are required to adapt new agricultural activities to regional conditions, and help farmers connect to domestic and foreign markets.

Corporate contract farming is often an effective facilitator of agricultural diversification. However, land consolidation is inexorable under contract farming, and distressed farmers, many of whom are heavily indebted, may sell out despite having no alternative livelihood. Notwithstanding the obvious merits of freedom of choice, landlessness in the context of high underemployment can put serious strains on the social fabric.

Agricultural diversification carries significant productivity benefits, but it may have implications for food security. The Government faces a choice: either procure food for national buffer stocks on international markets while providing farmers with decent income alternatives; or, in the name of food security, do not assist farmers in diversifying into higher value-added cash crops when profitable. The latter, through neglect, would implicitly require farmers, among India's poorest people, to bear the burden of providing national food security.

Certainly, interventions that would increase productivity in both cash crops and foodgrains, and enhance farmers' ability to choose between the two in response to market conditions, would be the preferred outcome.

explain why large orchestrated industrialization is being attempted, with state involvement, in rural areas through the development of special economic zones (SEZs).

Such industrial developments demand more agricultural land and even greater labor displacement. Unsurprisingly, these prospects are raising tensions, particularly among landless agricultural laborers who fear a loss of livelihood and expect little by way of compensation. The challenge, therefore, is to simultaneously boost agricultural productivity, while creating enough manufacturing and other nonagricultural employment opportunities that are suited to those pushed out of agriculture.

While India's agrarian crisis has unfolded slowly but relentlessly, the dynamics of employment have shifted recently. Table 2.16.4 shows that employment growth has quickened over the last 5 years. It has done so among both men and women, and those living in rural and urban areas. Further, the data show that casual labor, with its attendant risks (food insecurity for one) is stagnant. Rather, the new jobs have gone to the self-employed and regular employees.

Moreover, employment growth has picked up in most activities. The only two activities identified in Table 2.16.4 where it has slowed ("Trade, hotels, and restaurants," and "Transport, storage, and communications"), have nevertheless grown robustly. The data appear to reveal a rebalancing of employment growth, with industrial employment growing faster, and growth rates in services regressing toward the mean. Indeed, in the last 5 years, industry overtook services in terms of employment growth.

However, those aggregate calculations neglect important details regarding the types of jobs, the locations of those jobs, and the education levels of prospective employees. A large proportion of Indians are illiterate (24.7% of men and 46.3% of women, according to the 2001 census), and many of them are older and supporting families, so educating them belatedly may be difficult. Therefore, a particularly serious concern is whether the economy can generate the types of jobs that would hire the educationally disadvantaged.

The following analysis uses numbers calculated from the National Sample Survey's employment datasets drawn in 1993/94 and a somewhat thinner sample drawn in 2004. At least in so far as the *quantity* of jobs created is concerned, the analysis indicates that these concerns regarding the less educated are somewhat misplaced.

Table 2.16.5 presents the estimated number of new employees in manufacturing and services, by education level. It shows that manufacturing has created more employment for the less educated than has services. Of new manufacturing jobs, 69.6% went to workers without secondary degrees, compared with only 45.6% in services. The four most prolific job creators, which account for 74% of new manufacturing jobs created between 1999 and 2004 are textile products (including apparel);

2.16.4 Overall employment growth rates, %

	1993/94–1999/2000	1999/2000–2004
Rural male	1.0	1.9
Rural female	0.2	3.2
Rural persons	0.7	2.4
Urban male	2.6	3.7
Urban female	1.0	6.2
Urban persons	2.3	4.2
Total male	1.4	2.4
Total female	0.3	3.7
Total persons	1.0	2.8
Nature of employment		
Self employed	0.4	4.3
Regular employed	2.3	3.6
Casual labor	1.5	-0.1
All	1.0	2.8
Sector employment		
Agriculture	0.1	1.5
Mining and quarrying	-2.8	2.4
Manufacturing	1.6	5.0
Electricity, water, etc.	-4.7	3.1
Construction	6.4	8.2
Industry	2.4	5.8
Trade, hotels, and restaurants	6.3	3.9
Transport, storage, and communications	5.3	4.9
Other services	-0.7	3.5
Services	2.9	3.9
All sectors	1.0	2.8

Source: National Sample Survey reports of 1993/94, 1999/2000, and 2004.

2.16.5 Net new job creation in manufacturing and services, 1993/94–2004

	Manufacturing		Services		All new employment	
Education level of new employees	Total new jobs	% of new jobs	Total new jobs	% of new jobs	Total new jobs	% of new jobs
Less than primary	826,767	6.15	1,301,377	4.52	-7,225,836	-10.32
Primary	3,003,227	22.34	3,716,948	12.90	18,020,414	25.74
Middle	5,523,520	41.08	8,103,174	28.13	29,331,773	41.90
Secondary	1,750,110	13.02	4,019,009	13.95	11,042,178	15.77
Higher secondary	718,377	5.34	3,384,852	11.75	6,668,285	9.52
Postsecondary	1,624,252	12.08	8,277,945	28.74	12,171,631	17.39
Total	13,446,253	100	28,803,305	100	70,008,445	100

Note: Figures were calculated from National Sample Survey raw data, which were scaled to accurately reflect the size of the Indian population, per the central statistical organization. Scaling factors were 14.6% in 1993/94 and 14.0% in 2004.

Source of raw data: National Sample Surveys 1993/94 and 2004 employment rounds.

nonmetallic mineral products; wood, wood products, furniture, and fixtures; and beverages, tobacco, and related products. Fewer than 20% of workers in each of these sectors have completed secondary school.

The upshot is that as the less educated are squeezed out of agriculture, generating jobs for them will be significantly easier if these education-unintensive manufacturing subsectors continue to grow well.

The analysis so far does not reveal whether the low-skill jobs are being generated in the formal or informal sector. It is likely that much of the manufacturing in the four subsectors identified above is carried out by small enterprises in the informal sector. It follows that the new less-educated manufacturing workers might not enjoy the high levels of labor productivity that come with organizational scale. This is consistent with a study by IMF researchers, who have noted low rates of less-educated job creation in the *formal* manufacturing sector, which implies that these jobs must be predominantly in the informal sector.

In this environment, where farm incomes are falling; where the bulk of job creation is in self-employment and traditional services; and where those low-skill workers able to find manufacturing jobs are in the informal sector, provision of social safety nets becomes a major challenge. Workers without medical insurance, reliable savings mechanisms, and limited access to credit to finance investments and smooth consumption are particularly vulnerable to adverse economic shocks.

This challenge is magnified by the large disparities between agricultural and industrial land productivity, which are creating pressure in land markets. Governments have begun promoting the redevelopment of farmland with the aim of creating SEZs which are intended to assist industrial developers seeking to bypass infrastructure and administrative bottlenecks. As detailed in Box 2.16.2, the creation of SEZs involves a series of measures that are fiscally costly, potentially diverting industry away from other areas, and bring states' land-acquisition powers to bear in markets where land ownership is either poorly defined, or carries significant external effects. Given that large numbers of agricultural laborers who have no title to these lands nevertheless depend upon them for sustenance, the issue is exceptionally emotive.

However, manufacturing is not the only activity placing demands on land. As argued in Box 2.16.1 above, farmers face strong incentives to move land into the production of cash crops. However, agricultural diversification has obvious implications, as diversification may exacerbate India's deteriorating food self-sufficiency situation, as well as inflation.

Well-targeted interventions are required that seek to identify and remove the very distinct barriers to agricultural productivity growth in different states. Foodgrain yields can be increased significantly in agriculturally lagging states, whereas diversification is required to enhance farm income in more agriculturally advanced regions. As the Government has chosen to pursue self-sufficiency in foodgrains as a way of ensuring food security, it must strive to ensure that farmers receive adequate support for their role in making the policy work. While the budget has set aside funds for this, improving systems for delivering services to farmers remains the bottleneck.

Each of these trends shows clearly that as India's modern sectors steam ahead of the traditional sectors, social tensions are brewing,

2.16.2 Special economic zones

A special economic zone (SEZ) permits a set of units to operate in a well-defined area where policy measures (which are not generally applicable to the rest of India) promote certain economic activities.

These zones offer high-quality infrastructure facilities and support services, and allow duty-free imports of capital goods and raw materials. In addition, they offer attractive fiscal incentives and investor-friendly institutional services such as simpler customs, banking, and other procedures.

The SEZ Act of 2005 provides a raft of incentives to attract firms. These include: fiscal incentives; tax concessions; establishment of free trade and warehousing zones; reliable infrastructure services, including power, warehousing, and transport; establishment of a single-window authority for each SEZ to impart greater administrative autonomy and reduce bureaucratic costs; and designation of special courts and a single enforcement agency to ensure speedy trials.

Fifteen SEZs were already operational prior to the SEZ Act. The central Government had given formal or in principle approval to 403 applications for setting up new SEZs as of 20 October 2006. Investments of about Rs1 trillon with an employment potential of over 500,000 are expected from the new SEZs over the next 3 years. The central Government has, however, put all new SEZ approvals on hold until the following issues are resolved.

The pros and cons of SEZs are very difficult to weigh. Nothing of this scale and with this particular set of administrative arrangements and subsidies has been attempted before in India. Clearly, SEZs present an opportunity to provide potential investors with better infrastructure and greater bureaucratic efficiency. Nevertheless, valid criticisms of subsidies to SEZs deserve consideration.

First, with firms already eager to invest (but for the infrastructure and bureaucratic problems), providing enclaves that meet these needs might be enough to stimulate investment. Tax breaks may therefore be unnecessary. Second, SEZ tax inducements are expensive, and come at a time when government is struggling to provide adequate infrastructure in the wider economy.

Third, special tax exemptions always risk opening up loopholes for tax evasion. And fourth, subsidies can undermine both investment and existing firms located outside the SEZs. These firms suffer two disadvantages—worse infrastructure and higher taxes.

Serious concerns have also been expressed with regard to the people displaced by land acquisition. Important issues include: the kind of land to acquire for SEZs; the extent of state involvement in selecting and taking land; how to provide land losers with financial stakes in SEZs; and how to retrain economically displaced people, especially landless agricultural workers for jobs in SEZs.

Indeed, some of the loudest political opposition to SEZ projects comes from the landless, who may not receive lasting compensation for land conversion and who lack the capital to become self-employed.

mediated as ever through tight markets for land and food, and slack markets for labor.

The Government is in a position to play a crucial role in alleviating these tensions. It can do so by assuring appropriate compensation packages for displaced workers; retraining schemes to permit displaced workers to qualify for jobs on SEZs; and most important, infrastructure support for creating and locating manufacturing jobs more organically. More directly, it can help tackle the tensions through well-targeted investments to improve agricultural productivity.

This pursuit of geographically distributed industrialization and agricultural productivity growth requires significant resources to expand infrastructure. For this reason, some economists have urged the Government to suspend its fiscal discipline targets. Yet the historical data suggest that fiscal laxity is at least weakly associated with slower growth in India. Given high capacity utilization and the rising costs of borrowing today, it would be unfortunate if government borrowing crowded out private investment. Therefore, the Government must continue its fiscal consolidation efforts to create fiscal space for infrastructure financing, and continue to explore alternative mechanisms for such financing.

Maldives

The economy strongly rebounded in 2006, after the downturn in 2005 that stemmed from the impact of the December 2004 tsunami. The Government's expansionary fiscal policy adopted in response to the disaster, building on long-standing structural issues, such as expansion of the civil service and continued heavy subsidies for some social services, worsened the fiscal indicators. This deterioration presents a potentially serious threat to prospects of further recovery.

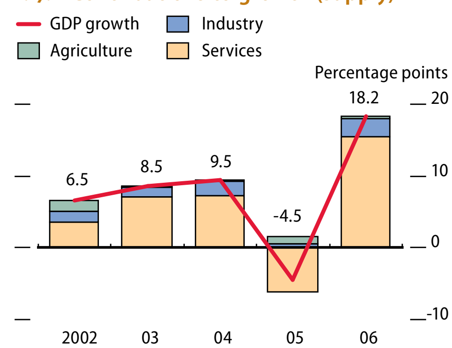
Economic performance

After 2005's contraction—essentially caused by the December 2004 tsunami—2006 saw an economic upswing, with GDP growth estimated at 18.2% (Figure 2.17.1). Tourism, traditionally accounting for about one third of GDP, grew by nearly half and its contribution to GDP rebounded to its former share as tourist arrivals recovered to close to pre-tsunami levels (Figure 2.17.2). Transport and communications recorded 12% growth. Growth in fisheries (accounting for 7% of GDP, though more important in terms of exports and employment) increased by 3.7% from its robust expansion of 17% in 2005.

Inflation measured by the consumer price index is volatile, as the heavily weighted food component fluctuates significantly. In 2006, inflation picked up slightly to 3.7% from 3.3% a year earlier. This was largely driven by price rises in transport and communications, and in housing, water, fuel, and power, in the main reflecting global oil price rises. The Maldives Monetary Authority tightened monetary policy in 2006 to address inflationary pressures, raising the interest rate on certificate of deposits from 4% to 5% in January. Broad money, however, accelerated to 21% growth from 12% in 2005, driven by a large expansion (50%) in private sector credit, mainly to the tourism and wholesale/retail trade sectors.

The 2006 budget planned for the deficit to widen to 18.1% of GDP from 12.5% in 2005 (Figure 2.17.3). Expenditures were set to grow by 51% (74.5% of GDP) mainly due to a more than doubling in capital expenditures, including those for tsunami reconstruction projects, while current spending was slated to rise by around 18%. Total revenues, including a large increase in grants, were to grow by 44% (to 56.4% of GDP). Preliminary fiscal data through the third quarter of 2006 show strong increases in both tax and nontax revenues. Import duties (about 70% of tax revenues) rose by around 40% from the previous year, reflecting a higher level of imports (as well as the Government's decision to withdraw the 2005 duty exemption granted for tsunami-related reconstruction) and a recovery in tourism taxes (about 20% of tax revenues) from the previous year's lower base. Large nontax revenues of advance payments from newly leased resorts were also collected. However, expenditures through the third quarter of 2006 have risen

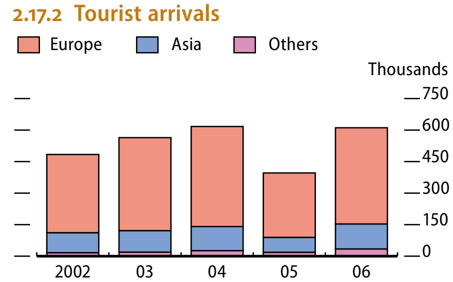
2.17.1 Contributions to growth (supply)



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

2.17.2 Tourist arrivals



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

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less than revenues, on account of lower utilization of the development (capital) budget. This result is likely to hold for full-year 2006, as monetary data show that net credit to government decreased (by 22%) and balance-of-payments estimates no substantial increase in grants.

The Maldives is an import-dependent country, bringing in everything from staple foods to resort supplies, construction materials and petroleum products. The average ratio of imports to GDP in 2000–2004 was about 60%, while that for merchandise exports was about 20%. The trade balance deteriorated significantly after 2004, leading to a deficit of $604 million in 2006 (preliminary estimate, about 67% of GDP; (Figure 2.17.4). Imports increased by 27% in 2006 as both private sector and public sector imports grew. The increase largely came from petroleum products and from construction materials and related products. Exports (domestic and reexports) recorded a strong increase of 40%, mainly due to a pick up in marine exports, which now account for nearly all domestic exports. Garment production and exports virtually disappeared in 2005 with the termination of the quota system at end-2004.

Net services and income receipts about doubled and reached $185 million in 2006. Earnings from tourism were up by 51% to $434 million for the year but still were 8% lower than the 2004 pre-tsunami level. Grant transfer receipts estimated at $122 million were somewhat less than the $152 million of grants in 2005. Taking into account payments (mainly workers' remittances), net transfers amounted to $42 million. In sum, the current account deficit widened to $376 million (42% of GDP, from 36% in 2005).

In terms of financing the current account deficit, the financial account saw an estimated large inflow of $318 million in 2006, largely private and commercial bank borrowing. Taking account of a large positive errors and omissions, the overall balance was estimated to post a surplus of $45 million in 2006 (switching from the $17.3 million deficit of the previous year). At $232 million as of end-2006, gross reserves offer 3.0 months of import cover.

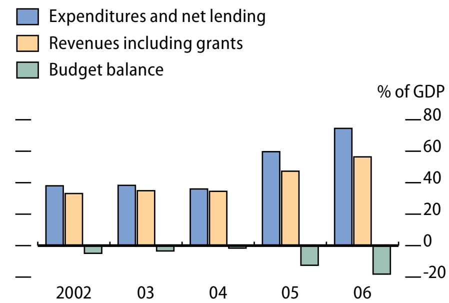
The rufiyaa's peg to the falling US dollar (Rf12.8/$1 since 2001) has contributed to tourism's sharp recovery. About three quarters of tourists in 2006 were Europeans, benefiting from a strong euro.

External debt statistics of the country cover only government and government-guaranteed borrowings, and the external debt of the banking sector. In the 2 years since the tsunami, external debt sharply increased by $250 million to reach an estimated $582 million at end-2006 (64% of GDP), about three quarters the expansion in debt was accounted for by sector short-term external borrowing of commercial banks for onlending to the private sector. At end-2006, about 63% of the outstanding debt was in medium- to long-term maturities (the bulk of which is concessional lending by official creditors), while the balance of $213 million was short debt of commercial banks. The debt service ratio at the end of 2006 was 4.6%.

Economic prospects

The Government estimates that GDP will continue its rapid growth in 2007, at 12.1%. This would appear realistic given that tsunami-related damage is being restored, tourism is rebounding strongly, and inflation

2.17.3 Fiscal indicators

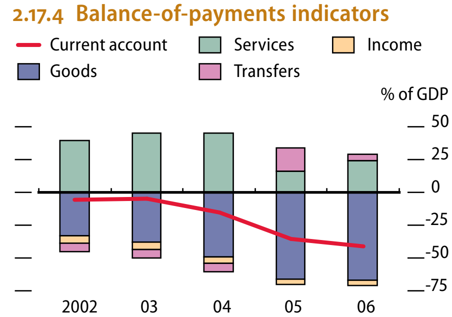


Note: 2006 is budget estimate for the year.

Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

Click here for figure data

2.17.4 Balance-of-payments indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 8, No. 2, February 2007.

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and the balance of payments are under control. Growth would likely slow in 2008, perhaps to about 8%. The Government estimates that the current account deficit could even exceed 60% in 2007 if development plans are fully put through. Inflation should stay at around 4%.

However, the deteriorating fiscal indicators are worrying. The large budgeted deficit stems not only from reconstruction, but also from long-standing structural issues such as expansion of the civil service (and large pay rises) and subsidized social services. Unless the Government addresses these issues before its debt reaches unsustainable levels, high economic growth cannot be maintained. Increases in commercial banks' short-term external debt also need careful monitoring.

The downside risks are grounded in the narrow economic base, shallow financial sector, structural issues that have been masked by tourism-led growth, and severe human resources deficiencies. On average, some 40% of the labor force is expatriate—both at the lower and higher skills end—and a large number of secondary school graduates are absorbed by the public sector, not on account of their skills, but as a social policy objective of keeping youth unemployment down. While absolute poverty has declined and the Maldives is in compliance with the Millennium Development Goal of poverty reduction, inequities and inequalities have increased between Male' and the outer atolls.

2.17.3 Selected economic indicators

	2007	2008
GDP growth	12.1	8.0
Inflation	4.0	4.0
Current account balance (% of GDP)	-60.9	-15.0

Sources: Government projections for 2007; staff estimates for 2008.

Development challenges

In the absence of any meaningful structural revenue-enhancement measures, there is a possibility that development expenditures will bear the brunt of the necessary fiscal adjustment. This is also evident from the Government's preliminary medium-term fiscal projections, which show development expenditures progressively declining to 9.6% of GDP by 2010, the final year of the Seventh National Development Plan.

The economy remains overdependent on a narrow and concentrated economic base with excessive reliance on tourism. Given its natural endowments, the Maldives will continue to rely on tourism to fuel its growth. However, the feasibility of expanding into business tourism (conference tourism) should be examined.

Other structural issues, such as the presence of many state-owned enterprises, coupled with the absence of a clear strategy for privatization, have flowed into the economic undercurrents that are now beginning to surface ominously in the fiscally constrained post-tsunami era. The process of political liberalization needs to be continued and higher standards of governance adopted to facilitate inclusive development.

In addition, given that the country now has middle-income country status with an average per capita income projected to increase to over $2,500 in 2006, the Government should decide whether to keep its role to providing and sustaining an enabling environment with a well-defined regulatory mechanism, including enforcement of contracts; or whether to become a more expansive provider of social goods and services.

Nepal

Economic growth remained hobbled by the long-running insurgency, political instability, and poor weather. Yet there is now guarded optimism on the political, and thus economic, front, due to major political breakthroughs starting in April 2006. These brought a comprehensive peace agreement that officially ended the 11-year armed insurgency and started a political process that holds promise of peace and a transition to a more productive economy. Nevertheless, the challenges are huge, and include widespread poverty, pervasive social inequality, low economic growth, and the legacy of a quasi-feudal political structure.

Economic performance

Political developments were the main event of the year, and moved rapidly from late-April 2006 when parliamentary government was restored following nationwide demonstrations. A few days later a cease-fire was declared by the Maoist insurgents. Subsequently in November, a comprehensive peace agreement was signed that officially ended the 11-year insurgency. Then in January this year the parliament approved an interim constitution that will be effective until a constituent assembly, scheduled to be elected by June 2007, approves a new constitution. Also in January, the Communist Party of Nepal (Maoist) joined the interim legislature.

Many difficult issues of course remain, but the current peace process holds the best promise yet of a new beginning for the country.

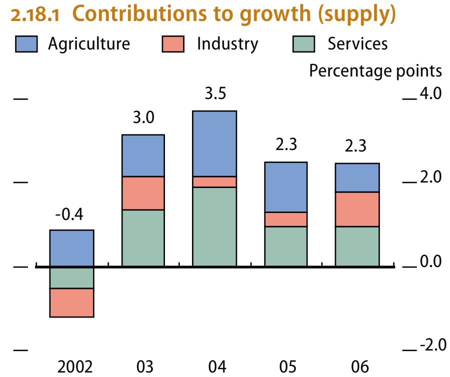
The economy continued its passage through the doldrums in FY2006 (which ended mid-July 2006), undermined by the continuing insecurity and political turmoil (the restoration of parliamentary rule and the cease-fire came late in the fiscal year). GDP grew at 2.3% (Figure 2.18.1), a rate unchanged from a year earlier. Weak conditions in agriculture largely offset industry's slight improvement.

Inclement weather hampered agriculture, damaging the production of the main food and cash crops. Agriculture, which accounts for about 40% of GDP and the livelihoods of 80% of the population, grew by 1.7% in FY2006 (contributing 0.7 percentage points of GDP growth), down from about 3.0% the previous year. Production of key agricultural crops declined by 2%, with paddy output, which accounts for one fifth of the value of food crops, falling by 1.8%.

Industry grew by 3.5% (contributing 0.8 percentage points), primarily due to a 4.2% expansion in construction after 2 years of stagnation. Utilities output was also well above the previous year's level. However, manufacturing remained weak, slipping to 2.2% growth, largely on tumbling garment production (exports slid 35%), continued supply and transport bottlenecks, and more frequent work stoppages and disruptions.

Services growth stayed at 2.4% (making a 1.0 percentage point contribution to growth). Performance was mixed as a recovery in trade, restaurants, and hotels was offset by slower growth in transport,

2.18.1 Contributions to growth (supply)



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

Click here for figure data

communications, and storage; finance and real estate; and social services. Tourist arrivals were little changed.

In terms of aggregate demand, both public and private investment stayed sluggish, reflecting the weak investment climate and security-related limitations to making development expenditures in much of the countryside. At 18.5% of GDP, the gross fixed investment rate continued its decline of recent years, moving by about 0.5 percentage points below the level of FY2005 (Figure 2.18.2). As for that year, growth in GDP was mostly driven by expansion in private consumption, which was made possible by the continued large, rapidly expanding inflows of remittances.

The budget deficit widened slightly to 1.8% of GDP, from 0.8%, indicative both of weakness in attempts to expand total revenues and of a decline in grants. Receipts (including current revenues, capital receipts, and grants) increased by 4% (compared with 16% in FY2005) due to low economic activity, poor export growth, and a shortfall in aid flows. Government spending, growing by 11%, fell substantially short (about 15%) of initial budget targets, thereby limiting the deterioration in the deficit.

Both current and capital expenditures missed budget plans, reflecting the difficulties in undertaking spending because of conflict-related disruptions. With foreign aid financing falling below both the budgeted and FY2005 levels, domestic financing of the deficit amounted to 1.4% of GDP (up from 0.2%).

Continued strong growth in remittances boosted liquidity in the banking sector. Broad money (M2) rose by 15.6%, with about two thirds of that coming from a rise in net foreign assets. Private sector credit picked up by 8.9%, in good part reflecting higher import credit, while credit to government rose by 14.5%.

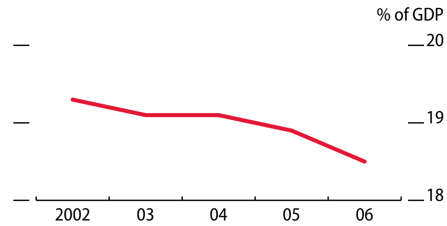
Over the year, bank lending rates rose to about 11.6%, while deposit rates declined marginally to 2.3%. Little progress was made in the effort to accelerate loan recoveries from large, willful defaulters, yet this is essential to bring down high levels of nonperforming loans and improve banks' operations.

Inflationary pressures grew in FY2006 with the consumer price index averaging 8.0%, nearly double the prior-year rate (Figure 2.18.3) and marking the largest rise in 6 years. Lower farm output drove up agricultural prices while upward adjustments to petroleum-product prices in February pushed up fuel and transport costs. The impact of the upward revision in value-added tax in May 2006 was a factor in commodity price rises.

Nepal Rastra Bank sought to tighten monetary policy through raising the discount rate by 25 basis points to 6.25% in February 2006, though this has a weak impact and reserve money still increased by 14% over the year. As the central bank has only limited means to engage in market operations to offset large inflows of remittances, monetary aggregates such as reserve money and money supply are very difficult to control. Still, given that the Nepalese rupee is pegged to the Indian currency, domestic inflation is broadly kept to India's. This link was evident in the rapid growth of imports in FY2006, which muted price pressures. In view of the rise in foreign exchange reserves and the very comfortable level of reserve holdings, this safety valve on price pressures remains securely in place.

Lackluster export growth, higher imports, and a trade deficit widening to $1.5 billion characterized the external sector. Merchandise

2.18.2 Gross fixed investment



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

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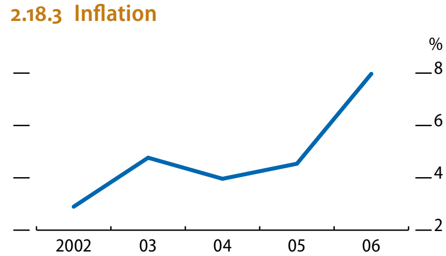
2.18.3 Inflation



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 12 December 2006.

Click here for figure data

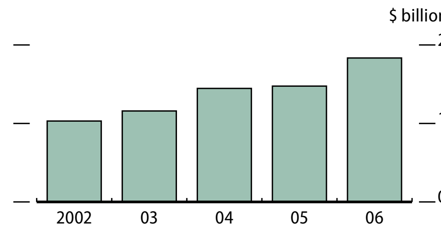
exports climbed by only 4.2%, reflecting slower growth in exports to India (accounting for nearly 70% of the total). They decelerated to 5.4% from 28.2% a year earlier. Stimulated by preferential trade arrangements, exports to India have grown rapidly in recent years, and the growth slowdown bore witness to a sharp drop in shipments of vegetable ghee, a major export that was affected by countervailing duties.

Exports to other countries improved by 1.8%, following a steep 14.5% decline in FY2005, when a sharp fall in garment sales was recorded. Performance in FY2006 underlined the facts that the country's export base is not well diversified and that traditionally large earners such as garments, as well as carpets and pashmina shawls, face stiffer competition, which has eroded sales both to India and to the rest of the world. Imports rose by 18.4%; oil-product imports accounted for about one quarter of the increase and remittance-financed consumption expenditure most of the rest.

Tourism receipts are estimated to have declined by about 10% to $132 million from a year earlier, but total net services and income receipts are small and were little changed. Nepal is increasingly dependent on remittances as a source of income and foreign exchange: they reached $1.3 billion in FY2006, an almost 50% year-on-year jump.

The remittance surge more than offset the wider trade deficit and kept the current account in surplus for the seventh consecutive year (at $191 million or 2.4% of GDP). Taking account of developments in the capital account and valuation changes, gross foreign exchange reserves rose by 24.3% to reach $1.8 billion (Figure 2.18.4)—equivalent to about 8 months of imports.

2.18.4 International reserves



Source: Nepal Rastra Bank, available: http://www.nrb.org.np/, downloaded 1 February 2007.

Click here for figure data

Economic prospects

The peace process has rekindled hopes of economic revival in Nepal (Box 2.18.1). Whether the 2.1% average growth of the past 5 years can be substantially lifted to bring the country nearer to its real potential depends crucially on sustaining peace, including timely (and nonviolent) constituent assembly elections scheduled for June this year. The transition to higher growth will also require political stability (including law and order) and better labor relations, the latter to restore business confidence and allow normal economic activities to resume.

Besides political stability and the weather, the populace's ability to cope with price rises for petroleum products (to eliminate the large operating losses sustained by the Nepal Oil Corporation) will substantially influence growth and economic developments. Renewing the bilateral trade treaty with India, which is scheduled to expire in March 2007, could provide a fillip to exports if Nepal can again achieve beneficial terms from its dominant trading partner.

Over the medium term, the economic outlook will depend on how fast the new Government can both step up the pace of structural and governance reforms, and maintain macroeconomic stability. It will concurrently need to boost investment in infrastructure and basic services, education, and health. Reviving conflict-hit industries is also important.

Major donors have already pledged to boost aid to facilitate economic recovery. Moreover, in November 2006, the Government and the International Monetary Fund agreed on a resumption of the poverty

2.18.1 Selected economic indicators

	2007	2008
GDP growth	2.8	2.8
Inflation	5.3	5.4
Current account balance (% of GDP)	1.0	1.0

Source: Staff estimates.

reduction and growth facility arrangement that defined comprehensive economic and financial policies for FY2007. To help get the economy back on track, the Government will soon unveil a 3-year interim development plan, which aims at reconstruction of infrastructure, rehabilitation for displaced people, basic service delivery, and reforms to boost investment.

GDP is seen picking up to about 2.8% in FY2007 and FY2008. Agriculture is likely to grow by the same amount, but this will depend on the weather, since irrigation is patchy. Weather conditions in the early months of FY2007 have not been the best, but expansion penciled in for the year still seems achievable. Better rural security should bring some areas back into cultivation, improve distribution of inputs and services, and generally raise farm productivity, especially after FY2008.

Industry is forecast to grow by 2.2–2.5% in the next 2 years. Increased construction expenditures and better operating conditions in manufacturing, along with continued strong, remittance-based, consumer spending, are expected to provide the stimulus. However, reviving many "sick industries" will prove difficult since this requires overcoming long-standing weaknesses, such as low labor productivity, high transport costs, and keen competition for external markets. Moreover, power outages have become a grim reality: the wider problem is that energy demand is rising by 10% annually, but supply constraints remain unaddressed.

Expansion in consumption will continue to be the main driver of aggregate demand and this, with some expansion in tourist arrivals, is expected to generate services growth of 3.3%. Investment spending is also likely to rise substantially. At first, this would largely stem from greater budget allocations for rehabilitation and investment and from the more secure countrywide conditions. Private investment in construction and equipment is expected to expand. However, for investor confidence to return, labor relations will have to improve (and the number of work stoppages fall), and the authorities will need to ensure a supportive climate for entrepreneurship.

Inflation is expected to trim to about 5.3–5.4% in the next 2 years, as supply bottlenecks ease, but two factors will have a heavy impact on this forecast: agricultural output and prices may be less than assumed because the weather in early FY2007 was unfavorable, and the magnitude and timing of upward adjustments of Nepal Oil Corporation's fuel prices cannot be predicted with certainty.

The external sector is set to remain manageable, though reflect a widening trade deficit. Merchandise exports are projected to grow by 4.7% and 6.0%, respectively, in FY2007 and FY2008. Exports to India are likely to be relatively brisk on account of the expected renewal of the existing bilateral trade treaty, but exports to other countries will be attenuated until new strategies to compete in the garment trade, as well as new products, are developed.

Imports are likely to continue growing at relatively high levels of 6.5% and 10.0% in the forecast period, in view of expected double-digit expansion in remittances from abroad as well as fiscal and monetary polices that focus on fostering economic revival. Tourism should see steady improvement, but the overall services and income net balances are unlikely to record major gains. The current account surplus is set to decline moderately to 1% of GDP.

2.18.1 A peace dividend?

Nepalis are upbeat following the formal cessation of armed hostilities and, it is hoped, an end to the devastating human cost. Economically, the insurgency has relegated Nepal to being one of the world's poorest countries. Growth in the medium term, however, clearly depends on how political events unfold in the next couple of years.

On the assumption that peace becomes embedded, a higher growth trajectory requires increased resource mobilization and productivity gains. An investor-friendly climate would create more employment, generate technological spillovers, and contribute to overall economic competitiveness, while a skilled labor force would contribute to raising domestic productivity.

As regards infrastructure—largely neglected in recent years—despite Nepal's huge reserve of water resources, the country faces scarcity in meeting its irrigation, energy, and drinking-water needs.

Agroprocessing industries and light manufacturing provide much further scope for widening the industrial base, and tourism and remittances also represent lucrative sources of income. With its unique location between the two fast-growing Asian giants, Nepal could benefit from the spillovers of their rapid growth.

But benefits will only fully materialize if peace is consolidated.

Pakistan

Buoyant growth, improved macroeconomic fundamentals, and strengthened international credit ratings have been the economy's hallmarks in recent years. In fiscal year (FY) 2006, high oil prices, a weak agricultural performance, as well as the effect of the October 2005 earthquake, trimmed the expansion, while strong demand-side pressures have exposed macroeconomic stresses. The economy is expected to pick up slightly in FY2007, reflecting some strengthening in agriculture and manufacturing. Inflation is set to moderate, after a further tightening of monetary policy, but still come in above the central bank's target. Spurred by an expansionary, pro-growth fiscal policy, the budget deficit will widen slightly, as will the current account deficit. The medium-term outlook remains positive, but macroeconomic stability has to be maintained and structural issues addressed.

Economic performance

The economy has grown strongly over the past 3 years, at an average pace of 7.5%. After expanding at high rates in the preceding 2 years, the economy slowed in FY2006 (ended 30 June 2006), but still maintained a robust outturn of 6.6% (Figure 2.19.1). On the demand side, private consumption, boosted by continued rapid expansion in consumer credit and higher workers' remittances, continued to be a lead contributor to GDP growth for the third year running (Figure 2.19.2). Private sector credit expanded by about 24%. Total investment spending (fixed and inventories) rose to 20.0% of GDP in nominal terms, mainly because of a sharp increase in private investment.

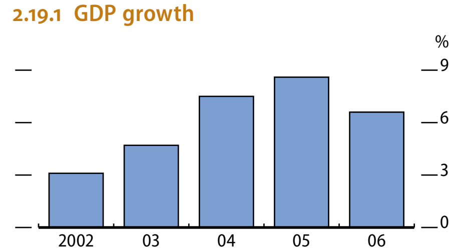
Over the last 3 years, improved business confidence and rising inflows of foreign direct investment (FDI) have buoyed private investment, but negative real interest rates on bank deposits and rising consumer demand have helped push down national savings, further widening the investment–savings gap. With a sharp rise in the current account deficit, the contribution of net exports of goods and nonfactor services became negative for the first time in 6 years.

On the supply side, GDP's deceleration in FY2006 was due to a sharp decline in agricultural growth and slower year-on-year growth in manufacturing, attributable to capacity constraints and the high-base effect. Services, in contrast, accounting for slightly more than half of GDP, gained further steam and recorded their fastest-ever growth rate of 8.8%.

In recent years, the Government's strong macroeconomic policies, high growth rates, increases in pro-poor spending, and burgeoning workers' remittances have all contributed to a steep decline in the incidence of poverty and the unemployment rate. According to official statistics, the proportion of the population living below the poverty line fell sharply from 34.5% in FY2001 to 23.9% in FY2005; in absolute terms, the number of poor people fell from 49 million to 37 million. The unemployment rate declined from 7.7% in FY2004 to 6.2% in FY2006.

Based on recent years' macroeconomic improvements and the strong

2.19.1 GDP growth



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007.

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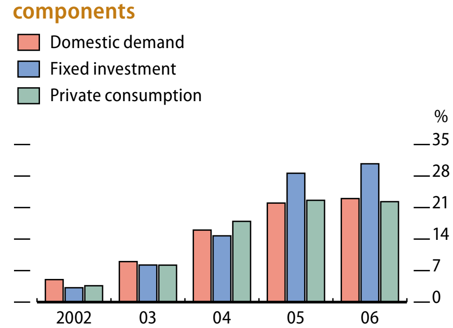
2.19.2 Growth of nominal demand components



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 6 February 2007.

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growth potential of the economy, Standard and Poor's in December 2006 announced upgrades for credit ratings to B+ for foreign currency, BB for local currency long-term ratings, and B for short-term sovereign ratings.

Strong demand, catalyzed by increased investment and consumption expenditure, as well as the rise in workers' remittances, has outstripped supply and helped stoke inflationary pressures. Inflation, after peaking at 9.3% in FY2005, remained high at 7.9% in FY2006. The first half of FY2007 witnessed no change in inflation, as rising food prices offset easing oil and nonfood commodity prices. Food inflation rose to 12.7% at end-December 2006 from 7.8% at end-June (Figure 2.19.3), lifted by higher prices of milk as well as by edible oil and wheat, pulled by rising international levels.

In the context of a continuing expansionary fiscal policy, the onus of demand management rests on monetary policy. The State Bank of Pakistan, the central bank, started tightening monetary policy in the second half of FY2005 by raising the discount rate by 150 basis points to 9.0%. In FY2006, it focused on draining liquidity from the market to push up the interest rate structure and contain credit expansion.

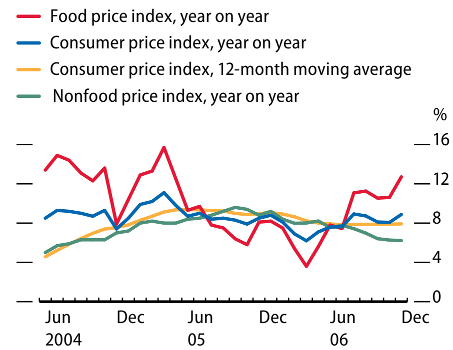
This policy succeeded in reducing growth in private sector credit and resulted in monetary growth that was below the increase in nominal GDP for the first time in 5 years. But, as high inflation persisted, the central bank further tightened monetary policy in July 2006 by raising the discount rate (by 50 basis points to 9.5%), the reserve requirement (on demand deposits by 200 basis points to 7.0%), and the liquidity requirement (by 300 basis points to 18.0% of demand and time deposits). Consequently, the average interest rate on new bank loans rose from 10.1% in June 2006 to 11.3% in December. Monetary growth declined (Figure 2.19.4) because of the decrease in domestic credit and the Government's reduced bank borrowing.

The State Bank of Pakistan continued a managed float policy and the nominal rupee/dollar parity rate remained stable in FY2006. With relatively high domestic inflation, the real effective exchange rate appreciated, which with strong domestic demand, contributed to the deterioration in the current account.

With advances in hand in structural reforms and macroeconomic fundamentals of recent years, the Government since FY2005 has pursued a pro-growth fiscal policy. Development outlays have sharply risen. Spending in the various pro-poor sectors defined in the poverty reduction strategy paper, in particular, increased from 4.8% of GDP in FY2005 to 5.6% the following year. Alongside this, unplanned spending on relief and reconstruction in areas affected by the October 2005 earthquake also contributed to a sharp increase in public expenditures in FY2006, raising the fiscal deficit to 4.2% of GDP (Figure 2.19.5). Excluding earthquake-related spending, the fiscal deficit was 3.4% of GDP, little changed from FY2005. The primary balance, however, which is a more accurate reflection of the Government's discretionary fiscal stance because it excludes the impact of interest payments, turned into a deficit in FY2006 after being in surplus the preceding 4 years.

The current account of the balance of payments has recorded increasingly wide deficits in the last 2 years, after posting large surpluses in the preceding 3 years). In FY2006, the current account deficit,

2.19.3 Inflation



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 20 January 2007.

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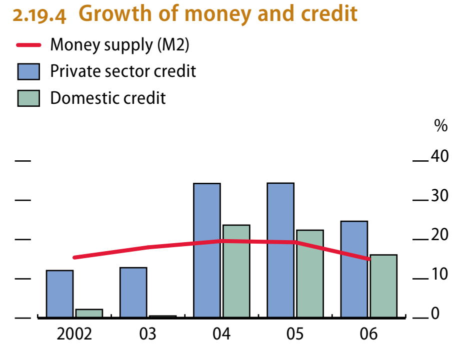
2.19.4 Growth of money and credit



Sources: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 12 March 2007; State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 29 August 2006.

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excluding official transfers, more than tripled to $5.7 billion, or 4.4% of GDP, from 1.6% of GDP in FY2005, as import growth outstripped export growth (reflecting higher oil prices and strong domestic demand; Figure 2.19.6). The deficit would have been larger still but for the very robust increase in workers' remittances to $4.6 billion.

The current account deficit was easily financed through non-debt-creating inflows and concessional loans from multilateral agencies. In fact, the overall balance of payments posted a substantial improvement in FY2006. Official foreign exchange reserves rose, and the external debt-to-GDP ratio remained on a downward trajectory, declining further to 28% in FY2006 from 31% in FY2005. However, ever-greater reliance on privatization proceeds, official grants, and portfolio investment, which together financed 45.3% of the current account deficit, raises issues of sustainability of financing large deficits over the medium and long term.

The improved policy environment has stimulated a multifold increase in FDI in recent years, which has risen from $483 million in FY2002 to $3,451 million in FY2006. The first half of FY2007 saw an inflow of $1,873 million. About 70% of total FDI is concentrated in just four sectors: telecommunications, oil and gas exploration, petroleum refineries, and financial businesses.

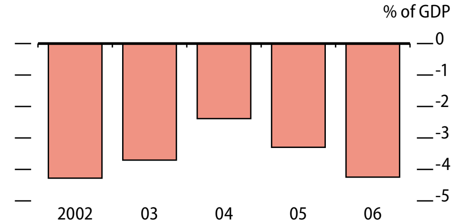
Privatization picked up further in FY2006 when two large entities—the Pakistan Telecommunication Company Limited and the Karachi Electric Supply Company—were privatized. A sum of $1.5 billion was raised in privatization proceeds, which represented 43% of total FDI in FY2006. In the last few years, the Government has also used the domestic stock market for selling the shares of public sector enterprises to the general public to broaden the base of share holdings. In December 2006, it ventured into the international equity market for the first time in several years, raising $731 million in global depository receipts issued by the Oil and Gas Development Corporation on the London Stock Exchange.

Economic prospects

The prognosis for FY2007 and FY2008 is based on the assumptions that the authorities will continue, or perhaps strengthen, the economic reforms of recent years, and that they will press on with relieving the macroeconomic stresses that have emerged in the last couple of years. It is assumed that the central bank will continue its tight monetary policy and pursue a flexible exchange rate policy. Globally, economic growth in the United States (US) and the European Union (EU), the country's two largest trading partners, is assumed to slow somewhat, as is the growth of world trade volume.

The sharp rise in investment last year and moderation in oil prices are expected to boost growth in FY2007. However, shortages of natural gas and suspension of its supply to a number of industrial units to meet the rising demand for household consumption (because of exceptionally cold weather) will likely depress industrial growth, which along with the ongoing slowdown in exports, will dampen the expansion. Agriculture and manufacturing have improved in the first half of FY2007, and services appear to be growing robustly, but somewhat less quickly than last year.

2.19.5 Budget balance



Source: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 9 March 2007.
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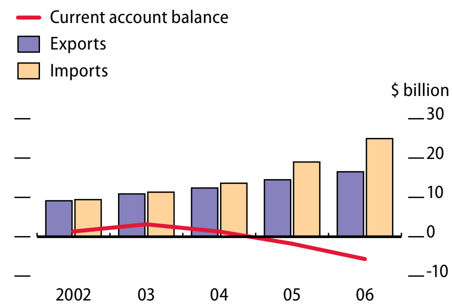
2.19.6 Balance-of-payments indicators



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 12 March 2007.
Click here for figure data

2.19.1 Selected economic indicators

	2007	2008
GDP growth	6.8	6.5
Inflation	7.0	6.5
Current account balance (% of GDP)	-4.5	-3.9

Source: Staff estimates.

With developments to date, the economy is projected to grow by 6.8% in FY2007, a solid expansion but essentially unchanged from a year ago (Figure 2.19.7).

In agriculture, production of the major summer crops in FY2007 has shown improvement. The higher offtake of fertilizers and a substantial increase in production loans for agriculture, as well as greater availability of water, all augur well for winter crops. The new package of incentives for livestock, announced in the FY2007 budget, and high prices of livestock products throughout last year, will also boost livestock production. Agriculture is projected to grow by 4.0% in FY2007.

Large-scale manufacturing, which constitutes almost half of the value added in industry, is expected to grow by 8.6%, supported by incentives provided in this year's budget. Growth in textiles and clothing, however, is expected to soften, on lower than targeted output of cotton and weakening export demand. The significantly larger public sector development program, reconstruction of earthquake-affected areas, and greater supply of cement will all boost construction output in FY2007. Hydropower generation will be bolstered by greater rainfall and availability of water in the two main water reservoirs. In all, industrial growth should pick up to 8.6%.

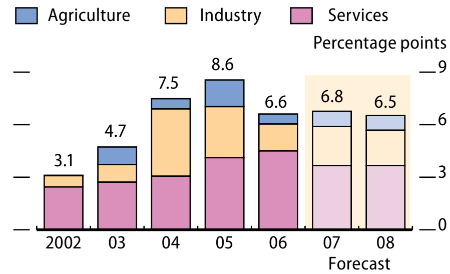
In services, rising foreign investment in telecoms and privatization of the Pakistan Telecommunication Company last year will help sustain vigorous growth. Strengthened by reforms, privatization, and ongoing mergers and acquisitions, the financial sector is expected to stay lively. It will be further spurred by the planned flotation of new global depository receipts for some financial institutions. However, the growth of wholesale and retail trade will slow because of decelerating exports and imports. Services as a whole is projected to grow by more than 7% in FY2007, somewhat off last year's fast pace.

In FY2008, on the back of the expected continuing strength in services and stable growth in manufacturing, GDP is projected to slow slightly to 6.5%. This is still solid performance but less than the projected 7.6% in the Government's Medium-Term Development Framework. The buildup of macroeconomic imbalances and the consequent tight monetary conditions, emerging capacity constraints, infrastructure bottlenecks, and issues of competitiveness in exports of textiles and clothing—on which the economy is overdependent (Box 2.19.1)—are some of the key constraints to reaching the Framework's target.

Inflation is expected to decline further in FY2007, under the weight of continued tight monetary conditions. After resisting demands for cutting domestic prices of petroleum products for 9 months, the Government finally lowered these prices in January 2007. This will have a damping effect on prices throughout the economy in the coming months, as will the slower monetary growth last year. But, because of the upsurge in food prices and higher prices of raw materials, inflation is projected at 7.0%, above the central bank's target of 6.5%. Sustained tight money is likely to take inflation down to 6.5% in FY2008 (Figure 2.19.8).

With projected strong GDP growth, ongoing tax reforms, extension of the tax net to real estate transactions, and higher tax rates on some financial services in the FY2007 budget, tax receipts are expected to maintain double-digit growth and be above the budget target. Despite a

2.19.7 Contributions to growth (supply)



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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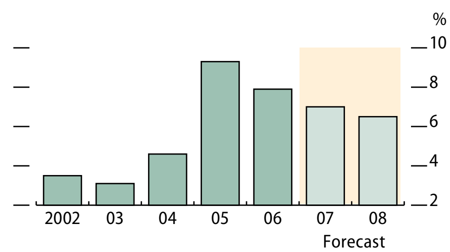
2.19.8 Inflation



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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2.19.1 Export performance

Over the past 5 years, merchandise exports have delivered over 12% average annual growth, as they have benefited from an enabling policy environment, low inflation, the low cost of credit, and general upturn in economic activity. In FY2005 and FY2006, they grew by 16.6% and 15.4%, respectively, but started decelerating in the second half of FY2006, to just over 6.5%, and to 5.0% in the first half of FY2007. Some of the deceleration stems from the high-base effect, but the underlying causes appear structural.

The main issue is exports' heavy reliance on textiles as well as limited geographic diversification. Between them, textiles and clothing, cotton, leather, rice, and sports goods account for over three quarters of total exports—textiles and clothing alone for three fifths. Thus a downturn in these segments has a significant overall impact.

Conversely, immediately after the ending of quotas, textile exports accelerated strongly, to 16.8% in FY2006 from 6.6% the year before. Increasingly, however, textile exports have come under competitive pressure from Bangladesh, People's Republic of China, and India, specifically in the higher value-added categories that have traditionally not been a strength of the Pakistani textile sector. This pressure, in turn, has led to a fall in international export prices. Consequently, Pakistani textile exports increased by only 4.3% by value in the first half of FY2007 (box table). The low expected cotton production in 2007 will further hit textile exports, as will the removal of restrictions on textile exports from the People's Republic of China in 2008.

Another issue is that the bulk of Pakistan's trade is with a handful of countries, particularly in Europe and North America. It is expected that the growth in trading volumes in those regions will decline in 2007, hitting Pakistan's exports there.

Export growth of major commodities

Commodity	FY2005	FY2006	July–Dec 2005	July–Dec 2006
Textiles and clothing	6.6	16.8	32.5	4.3
Rice	47.1	19.3	46.4	1.2
Leather and leather products	18.7	16.1	31.3	-26.3
Sports goods	-3.0	13.4	6.9	-14.4

Thus, lack of export diversification—for products and markets—is the main reason for recent sluggish performance. Trade policy should therefore focus on developing strategies for diversification and enhancing export competitiveness.

decrease in the domestic oil price, the petroleum levy will likely continue to yield significant income, as will receipts from the US for logistics support operations for Afghanistan. Current expenditures, though, are expected to exceed the budget estimate, because of expected overruns in the interest payment on domestic debt. On balance, the fiscal deficit is likely to rise to 4.5% of GDP in FY2007, coming in at the planned level.

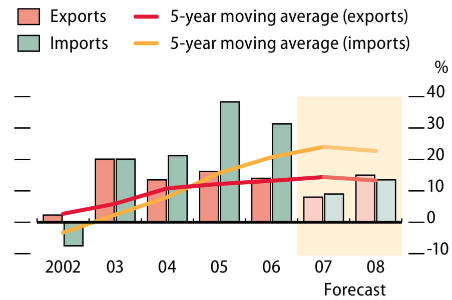
Import growth is set to decelerate in FY2007, on account of moderation in the oil import bill, weaker demand for consumer durables, and some rundown from an apparent buildup of inventories in FY2006 (Figure 2.19.9). Nevertheless, sustained growth and the forecast rise in investment are projected to keep import growth at about 9%. Exports too will rise, but the high domestic cost of production in the textile and garment sector as well as stiff competition from the People's Republic of China (PRC) and India are likely to restrict total export growth to about 8.0%. The current account deficit is projected to edge up to $6.5 billion, or 4.5% of GDP in FY2007. With the expected stabilization in GDP growth, cooling demand for consumer durables (on higher interest rates), and softening in oil prices, import growth is likely to be moderate in FY2008. As a result, the current account deficit could decline to $6.0 billion, or 3.9% of GDP (Figure 2.19.10).

In an environment of pro-growth government policies, a continuous increase in the public sector development program, and the projected rise in investment, the medium-term outlook for the economy is positive. Greater trade volumes with countries in the region, including the PRC, will also help. The boom in banking and telecoms is likely

to continue, as the policy environment for these sectors is favorable. Foreign hydrocarbons investments in recent years will have an output payoff. Finally, significantly strengthened through reforms and mergers and acquisitions, the banking system is well positioned to better channel savings to productive uses.

The growing current account deficit, continuing high inflation, and the emerging power and gas shortages are potential risks to the country's medium-term economic prospects. Any deterioration in the security environment would be another. In addition, the ending in 2008 of PRC-specific safeguards imposed by the US and EU against textile and clothing imports could further weaken Pakistan's textile export prospects.

2.19.9 Export and import growth



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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Development challenges

After the so-called lost decade of the 1990s, the strong performance in the new decade so far is attributable to sound macroeconomic management policies and pursuit of structural reforms in key areas.

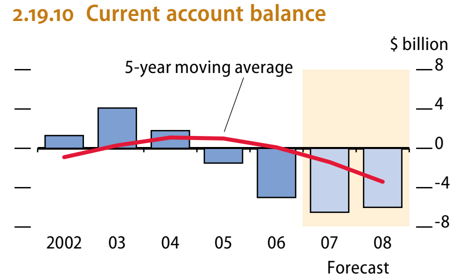
Still, important structural challenges remain and have to be tackled promptly to sustain the present growth trend. Despite healthier investment, the investment-to-GDP ratio is still low relative to countries that have experienced sustained strong growth. Even if investment in the country is underestimated, gross capital formation in 2004 was less than half of that in the PRC and about 60% of that in India or Thailand. Total factor productivity has improved, but insufficiently either to compensate for low investment or to sustain high growth.

Similarly, gross savings as a share of GDP needs to pick up substantially. In recent years, the demand-driven growth and negative real interest rates on bank deposits have contributed to low savings. Another issue is the narrow industrial base, which is linked to the lack of a diversified export base, which in turn must cope with rising international competition.

Human capital development remains a major structural challenge. Despite the recent rise in pro-poor spending, historical underinvestment in human capital has critical implications for growth and competitiveness. Public spending on education was only 2.0% of GDP in 2004, compared with 6.0% in Malaysia, 4.0% in Thailand, and 3.0% in the PRC and India. Unsurprisingly, the human development index rating was the lowest among these countries as well. The Government has, however, announced its commitment to increasing education expenditures to 4.0% of GDP. Finally, critical physical infrastructure bottlenecks impede high growth.

The Government is tackling these structural challenges over the medium term by committing to reform, by strengthening the enabling environment for investment, and by prioritizing resource allocation for infrastructure development and the social sectors.

2.19.10 Current account balance



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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Sri Lanka

Despite resurgence of the civil conflict, impact of the Asian tsunami, and doubling of oil prices since 2004, the economy grew at its fastest rate since 1978 last year. This strength was fueled by buoyant private activity and expansionary macroeconomic policies that have, though, accelerated inflation. Growth is forecast to moderate over the next 2 years, given the conflict, slow pace of structural reform, and need to cool the economy. Further out, if the fiscal consolidation and increased investment envisaged in the new 10-year development framework are achieved, growth is expected to pick up substantially.

Economic performance

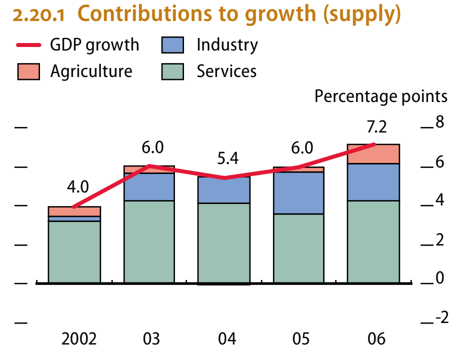
The impressive 7.2% growth in 2006 reflected continued strong performance of services of 7.7% and an unexpectedly high outturn in agriculture of 5.9% (Figure 2.20.1). (The peaceful west and south were responsible for most of the good news, since the two north and eastern provinces embroiled in the conflict contribute only about 9% of total GDP.) Aiding agriculture was fisheries' recovery from the December 2004 tsunami, as it surged by 55%. In fact, had agriculture continued its past 10-year trend of 1% growth, total GDP would have expanded by only 6.4%.

Aggregate domestic demand—buttressed by workers' remittances and rapid credit expansion—stayed high. The population continues to release its pent-up demand for consumer goods and services, especially mobile phones. Mobile and landline phone penetration has grown dramatically since 2003; as a result, mobile phone companies are thriving, with the major operators reporting revenue growth in the first half of 2006 of over 40%. These growth rates have induced many companies to reinvest their earnings to expand their networks, leading to an estimated doubling of total foreign direct investment inflows from $234 million to $480 million in 2006. Port services, cargo storage, and warehousing as well as other trade-related services also continued to boom, in line with growing international trade.

Tourism, in contrast, failed to do well in 2006 (Figure 2.20.2), with profit margins falling by up to 50% as hoteliers dropped prices to attract tourists. The subsector had picked up strongly after the signing of the cease-fire agreement between the Government and the Liberation Tigers of Tamil Eelam (LTTE) in 2002. However, it suffered in the aftermath of the tsunami and more recently has been hit by blanket travel warnings from key European markets following the sharp escalation of hostilities between the Government and the LTTE. Tourism industry sources put occupancy rates at 30–50% in January 2007, down from the 90% usually seen at that time of year. While tourism accounts for little more than 2% of GDP, the impact on employment, with about 120,000 directly and indirectly employed, is likely to have been significant.

Industry's performance was decidedly mixed. On the one hand, garments, which dominate the export and industrial base (contributing

2.20.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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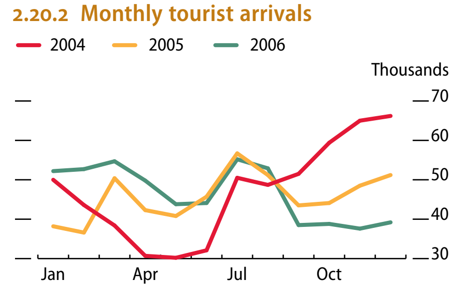
2.20.2 Monthly tourist arrivals



Source: Ministry of Finance, *Weekly Economic Position Report*, 2nd week, February 2007.

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about 40% of export earnings; Figure 2.20.3), continued to struggle following the end of the quota system on 1 January 2005, growing by little more than 5% in 2006. Structural weaknesses in garments, such as high staff turnover and levels of absenteeism, difficulties in attracting staff (over 30,000 vacancies left unfilled), problems with transport, high electricity prices, as well as the loss of price competitiveness vis-à-vis Bangladesh, People's Republic of China, and Viet Nam, caused in part by an appreciating real exchange rate, all added to the garment industry's woes. Small-scale manufacturing, too, was weak.

On the other hand, favorable weather conditions boosted hydropower generation, helping the utilities subsector expand by about 15%.

As expected, construction continued to grow, in part because of tsunami reconstruction, but also because of major housing developments in big cities, bolstered by a surge in property prices and demand for high-quality housing by Sri Lankan expatriates, and by returnees to the country.

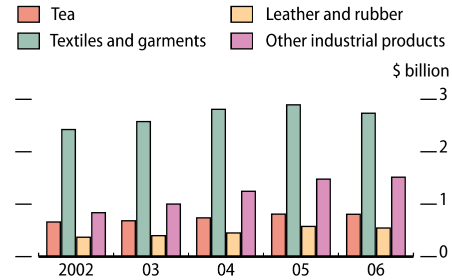
Government spending, up by 26% in 2006, imparted a strong stimulus to the economy but also drove up inflation. While the 2006 budget planned no borrowing from the banking sector, the Government ultimately borrowed 30 billion Sri Lanka rupees (SLRs), or about 1% of GDP. Fiscal consolidation has been a policy objective in recent years, though the Government has repeatedly announced that it would not cut expenditures to contain the deficit, focusing rather on improving revenue collection.

Preliminary data indicate that the 2006 budget deficit (including 0.8% of GDP for foreign-funded tsunami-related project expenditure) was 8.9% of GDP, essentially unchanged from the 2005 outturn and in line with official budget projections (Figure 2.20.4). Three elements contained the deficit: the Government lifted revenue collection substantially for the second year running (up 27.5%); it removed almost all fuel subsidies that had cost it SLRs26 billion, or about 1% of GDP, in 2005; and it offset an SLRs38 billion cost overrun on recurrent spending by means of reallocating funds previously earmarked for capital expenditures. The bulk of the revenue improvement stemmed from changes to income tax (raised tax rates and lowered taxable thresholds), improved value-added tax (VAT) collection, and increased import tariffs.

Recurrent spending rose by 22%, fueled mainly by larger defense expenditures (up by 27%); new recruits to the civil service (continued regularization of 40,000 trainees taken on earlier); additional home guards (35,000 recruits); a greater number of pensioners; and higher civil service wages (the second installment to bring the base salary to SLRs11,650) and cost-of-living allowances.

Looser fiscal policy and increased central bank financing of the budget deficit led to an escalation of demand pressures over the year. Inflation, which had subsided toward the end of 2005, reversed course and accelerated sharply after July 2006, peaking at 20.5% in January 2007 (Figure 2.20.5). This should be seen in the context of annual average inflation in 2006 of 13.6% (based on the Colombo consumer price index). While the one-time impact of rises in administered prices for fuel and electricity and in vegetable prices (due to supply shortages) were factors, the sustained large price upswing primarily reflects rapid increases in

2.20.3 Major exports



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007; Economist Intelligence Unit, *Sri Lanka Country Report*, February 2007.

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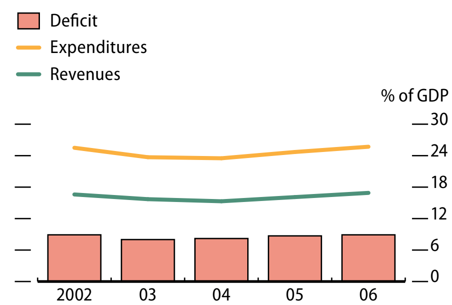
2.20.4 Fiscal indicators



Sources: Central Bank of Sri Lanka, avaliable: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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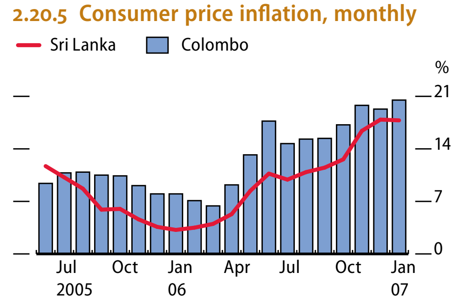
2.20.5 Consumer price inflation, monthly



Source: Department of Census and Statistics, available: http://www.statistics.gov.lk, downloaded 10 March 2007.

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money (Figure 2.20.6) and credit powered by low and at times negative real interest rates. Consumer credit jumped by 43% (October 2005–September 2006), and overall private sector credit leaped by 24% (both substantially above their respective 10-year averages of 25% and 15%); and credit to the government expanded by 20%.

From September 2006, the central bank took steps to reduce liquidity in the market by increasing its policy rates, bringing the repurchase (repo) rate to 9.625%, and reverse repo or lending rate to 11.5%, and the 91-day treasury bill rate to 12.7% by year-end (Figure 2.20.7). Since the start of this year, the central bank has restricted access to the reverse repo facility at times when the commercial banking system shows a liquidity surplus. Some commercial banks previously used this facility as their main source of credit expansion, taking advantage of the interest differential between the interbank market and (lower) policy rates. But on 30 January, the central bank acted to narrow the interest rate differential between market and policy rates.

Despite improvements in key debt indicators, the Government's debt policy has increased its exposure to foreign exchange rate fluctuations. While public debt rose in 2006 in absolute terms, it declined as a proportion of GDP because of the rapid expansion of *nominal* GDP, but it still remained quite high at about 92%. Since 2004, the Government has pursued a policy of taking on domestic short-term foreign-denominated debt to reduce interest rate costs and to retire more expensive local currency debt, increasing its exposure to foreign exchange risk.

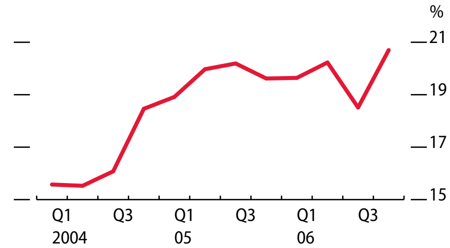
The stock of such debt increased by $520 million in 2006 to $1.65 billion at year-end, or 6% of GDP. Overall debt service (principal and interest) of the Government fell from 92% of total revenues in 2004 to 82% in 2006, but still amounted to 15.7% of GDP in 2006, edging up with the end of the tsunami-related debt moratorium in December 2006.

The balance of payments has weathered the oil price shock relatively well, even as the oil import bill (consonant with doubling oil prices) almost tripled in only 2 years to $2 billion in 2006. Nevertheless, strains are apparent, with the trade deficit remaining in double digits for the third year in a row, reaching 13% of GDP, a deficit not seen since 1994 (Figure 2.20.8). The current account deficit stabilized at 2.8% of GDP, substantially lower than projected in the Government's medium-term economic framework.

A major factor keeping the current account deficit largely in check and helping ease pressure on the balance of payments has been soaring workers' remittances, unexpectedly increasing by $400 million (or over 1% of GDP) to $2.3 billion in 2006: after the tsunami, they jumped by almost 30% a year (against 9% annual growth in the 5 years preceding the disaster).

An International Monetary Fund study finds that this jump is probably less a result of altruism than of high global oil prices, since they increased the chances of employment and higher wages for Sri Lankan migrants, over 85% of whom live in net oil-exporting countries. Even though foreign exchange reserves have been maintained at approximately $2.5 billion (Figure 2.20.9), last year's 15.7% expansion in imports reduced the import cover ratio to 2.6 months by year-end from 2.9 months at end-

2.20.6 Money supply (M2) growth



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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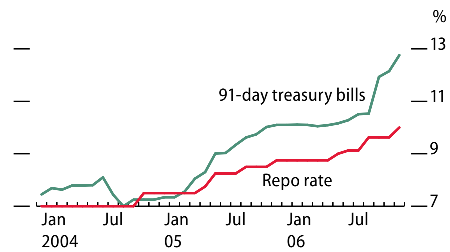
2.20.7 Interest rates



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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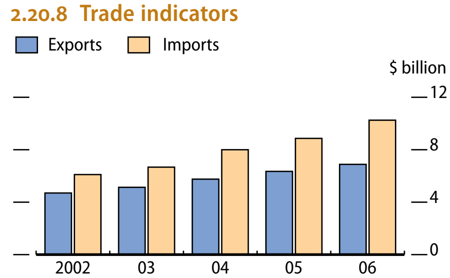
2.20.8 Trade indicators



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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2005. To safeguard reserves, the central bank imposed restrictions in late September 2006 on current payments, imposing deposit requirements of 50% on the import value of certain goods. The International Monetary Fund subsequently approved these restrictions as a temporary measure.

The nominal exchange rate has increasingly come under pressure and has depreciated substantially, especially vis-à-vis the euro and the British pound, even despite initial central bank intervention to defend the currency. Tsunami-related foreign inflows, which in 2005 led to real and nominal currency appreciation, are now moving out of the country to fund capital imports for reconstruction. These outflows, in combination with higher external debt service and oil import bills, all contributed to the substantial drop in the nominal exchange rate. The real effective exchange rate however, is trending upward because of accelerating domestic inflation (Figure 2.20.10).

Since the Government took office in November 2005, structural reform has been limited. Although the private sector accounts for over 85% of GDP, the Government owns institutions that manage about 60% of all financial assets as well as all public utilities and some smaller enterprises. In key policy statements, it has announced that it would seek alternatives to privatization for bringing greater efficiency into the state-owned sector.

Restructuring, rather than privatization, of the People's Bank, which accounts for about 20% of financial assets in the country, has made some progress. One major reform was the removal of fuel subsidies in 2006, relieving a heavy drain on the budget and moving Ceypetco, the state oil and petroleum company, to operate more on a commercial basis. However, the market for retail fuel and lubricants was liberalized in September 2006 without the regulator, the Public Utility Commission, yet receiving authority to regulate applicable retail prices, safeguard consumers' interests, and ensure fair competition.

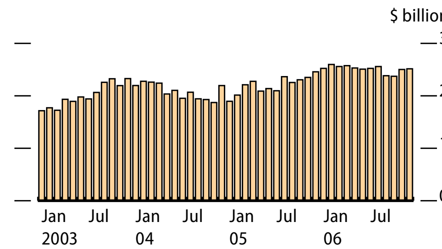
Strong opposition by labor unions has been one of the major factors holding back reforms. The long-awaited unbundling of the Ceylon Electricity Board, in the planning stage since 1997, has been put on hold. The Government is now seeking to manage the utility more efficiently by other means, and to bring more transparency into rate setting and procurement.

The power sector remains a major troublespot for the economy because its least-cost generation plans have not been implemented for the last 20 years. This has pushed electricity tariffs to among the highest in the region, despite the fact that the sector does not charge cost-recovery tariffs, leading to daily losses of SLRs50 million and an accumulation of large debts. Operational problems are exacerbated by rising power demand and high capacity utilization in the transmission and distribution system. Many lines and transformers are becoming overloaded and this will result in rising maintenance costs, deteriorating performance, and higher technical losses.

Economic prospects

Growth prospects have become, if anything, more complex: opportunities for, and risks to, economic growth have risen since last year. Factors that could potentially lay the foundation for strong economic growth

2.20.9 Gross official reserves



Source: Central Bak of Sri Lanka, available: http://www.cbsl.lk, downloaded 14 March 2007.

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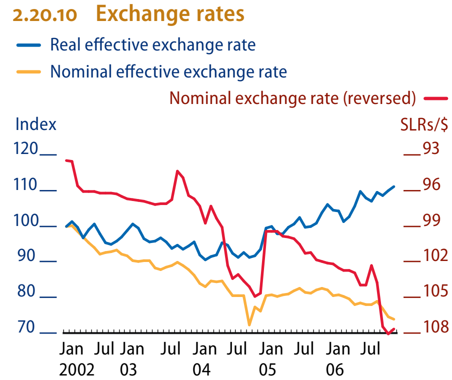
2.20.10 Exchange rates



Source: CEIC Data Company Ltd., downloaded 12 March 2007.

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and that show a marked departure from previous approaches are, first, a powerful president whose first term will end in 2011, and who has now also succeeded in forging a parliamentary majority with crossovers of Members of Parliament from the typically more private sector-oriented United National Party. This could make implementing legislative changes easier than before, and could also be the beginning of a "southern consensus," the lack of which has been partially blamed for the slow resolution of the ethnic conflict in the country. Second, public investment is considerably higher.

Factors that have increased the risks are the falling import cover in terms of foreign exchange reserves, accelerating inflation, and the rapid buildup of domestic dollar-denominated, short-term, commercial debt, now amounting to 6% of GDP. Despite the fact that the private sector continues to be resilient, these developments are a concern, and need to be addressed through policy actions to reduce the fiscal deficit (and hence the need to borrow commercially), and to gradually tighten monetary policy so as to control inflation. There is also the risk of prolonged power cuts in 2007, a result of the delay in commissioning a new power plant, unless the government quickly introduces contingency plans.

The underlying assumptions of the following projections are: the conflict will not escalate further; the LTTE will not succeed in destroying key economic infrastructure; and 2007 will see gradual monetary tightening and a determined effort to slow inflation (as the central bank at least partially succeeds in implementing its ambitious financial and monetary policies for the year). In this it will need to be supported by the Government and the newly established National Economic Council.

The outlook for 2007–2008 is for growth of 6.1% and 6.0%, respectively (Figure 2.20.11), which is somewhat below government forecasts. It assumes that tighter fiscal and monetary policies gradually curtail aggregate demand by 2008, and that the conflict will continue to curtail tourism growth. In addition, agriculture will expand much less quickly than in 2006, in line with long-term trends, as its post-tsunami recovery is largely completed. However, except for the lackluster performance of tourism, the private sector will once again prove to be resilient, and services will remain the engine of growth. Finance, trade-related services, telecommunications, and information technology (IT) will perform robustly, buoyed by continued consumer demand and public sector expansion.

Assuming a gradual deceleration in inflation to 9% by 2008 (as the impact of tighter policy is felt with a time lag of up to 2 years), industry consolidation, and facilities upgrading, the garment sector is projected to regain some of its competitiveness by 2008, just when the People's Republic of China moves out of restraints imposed by the European Union and United States. The Government expects a breakthrough in the negotiations with the European Union on lowering the threshold of country-of-origin requirements under the "GSP Plus" scheme from 50% to 35% this year. However, hopes to conclude a free trade agreement with the United States are unlikely to be realized.

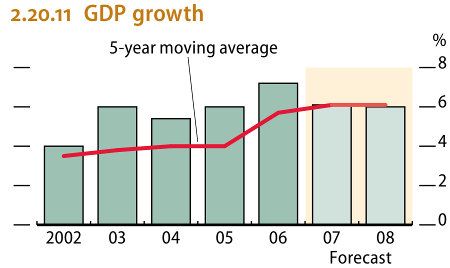
The government-projected deficit of 9.2% of GDP for 2007, including fully foreign funded projects, is likely to be met. A gradual reduction of spending as fiscal policies slowly tighten will bring the deficit—including

2.20.1 Selected economic indicators

	2007	2008
GDP growth	6.1	6.0
Inflation	10.0	9.0
Current account balance (% of GDP)	-2.5	-2.4

Source: Staff estimates.

2.20.11 GDP growth



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

Click here for figure data

fully foreign funded investment projects—to 7.7% of GDP in 2008. However, the expenditure composition is likely to change, with recurrent expenditure (such as defense, subsidies, and wages and pensions) likely to surpass budgeted estimates. The implementation of key cost-cutting exercises outlined in the budget speech, such as cutting SLRs16 billion by avoiding duplication of expenditure, would have to be tackled quickly to show results.

Revenue collection, though, is projected once again to increase substantially, despite the growing complexity of the tax regime that introduces more exemptions: higher CIF mark-up values on imports, the cascading nature of the tax regime, falling tax thresholds, and tax implementation changes that would convert VAT to a quasi-withholding tax (whereby one third of VAT payments to government contractors are withheld), will all help boost revenue collection.

The first steps taken in January 2007 to rein in growth of monetary aggregates suggest that the central bank is determined to fight inflation more aggressively than last year. Its financial and monetary policy plans of January 2007 indicate its intention to reduce growth of broad money supply to 13.2% by December 2007 (relative to estimated actual levels of 12 months earlier), a sharp drop from the 17.8% growth seen in 2006.

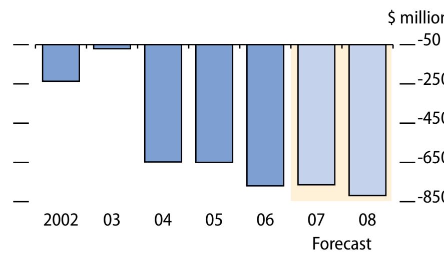
Achieving the central bank target depends crucially on the volume of government net domestic borrowing, which has to keep in line with the budget target of SLRs156 billion (out of which commercial bank borrowing should not exceed SLRs16.7 billion).

Given the Government's expenditure plans, and past delays in firming up foreign financing, it is not yet clear whether the central bank will succeed in controlling expansion of the money supply (and thereby inflationary pressure). Neither is it clear whether moves to control prices of 11 essential consumer items for 3 months from 1 March 2007, are temporary, or whether these measures will remain more permanent.

The current account deficit in 2007 will narrow slightly to $764 million (or 2.5% of GDP; Figure 2.20.12), due to substantially lower import growth following a projected stabilization of oil prices at about $57 a barrel. Export performance will stay muted, despite several expected positive developments for the garment sector. Concessional financing, tsunami-related grants (largely phased out by 2008), and commercial borrowing appear sufficient to finance this deficit. However, should oil prices be as high on average as in 2006 (about $65 per barrel), the current account deficit would increase sharply by 1.2% of GDP ($320 million) to 3.7% of GDP.

In the long term, the significantly higher public investment planned by the Government will increase economic growth. Three major investment projects, some in the pipeline for 20 years, are now finally going ahead: the Kerawalapitya Combined Cycle Power Plant ($310 million), the Norrachchalai coal power plant ($510 million), and the extension and development of the Colombo Port ($300 million, with total project costs including planned private sector investment for the terminals eventually estimated at $1.2 billion). These investments are crucial to safeguard economic growth, act as a catalyst to private sector investment, and expand the country's role as a logistics hub.

2.20.12 Current account balance



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 7 March 2007; staff estimates.

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Development challenges

The country's civil conflict is undoubtedly the main long-term challenge to development, shaving off an estimated 2% of GDP growth each year. Civil conflicts of such complexity can take decades, if not generations, to resolve. However, despite the opportunity costs of the conflict, the economy has grown at an annual average of 4.6% since the conflict started in 1983, and is a testimony to its resilience.

The current policy focus of the Government is on infrastructure development to improve electricity supply and roads. This is crucially important, but would need to go hand in hand with preparing the ground for higher productivity gains. To achieve this—and at the same time increase income equality—Sri Lanka needs a well-educated labor force and better access by the underprivileged to high-quality education (Box 2.20.1).

2.20.1 Education

Literacy indicators are high, and do not point to an immediate crisis. However, representatives of those segments that can propel the country on to a higher growth path (e.g., IT and high-value manufacturing) have repeatedly stated that they suffer from a shortage of suitably skilled labor.

Spending on private tuition among all families, including the poorest, has shot up, pointing to deficiencies in the quality of public education. In turn, sustained high economic growth has to create jobs attractive enough to retain highly skilled people who are usually among the most mobile and too often leave the country. The country reportedly has one of the highest "brain drain" ratios in the world. (This may reinforce the lack of skilled staff, identified by entrepreneurs as slowing growth in business outsourcing and IT development.)

In addition to the need to improve the skills of its students, the school and education system seems to increasingly fail the poorest. School leavers who, due to poor conditions in rural schools, often fail one or more of their O levels, stand little chance of being employed in the private sector; with very high pressure emanating from their families that hope to have at least their offspring move away from the agriculture sector, the public service (clerical jobs) or the army is often the only source of employment.

In addition, the lack of mathematical skills precludes even those who go to university from studying a non-arts degree, thereby again relegating them to arts subjects for which employers usually pay less well. The quality of schooling is highly skewed between rural and urban regions and educational outcomes between the provinces differ sharply (box table).

The quality of English language teaching and the lack of English language proficiency are other serious obstacles to social mobility. Overall, the poor see few chances of upward mobility, due to the lack of good education and—according to anecdotal evidence—a social and political network. As a result, their children drop out more often, and intergenerational education mobility is low internationally.

In contrast to Sri Lanka's earlier impressive record, education's share of GDP and expenditure started decreasing in the 1970s and is now equivalent to about 2.5% of GDP—lower than in most comparable countries.

The Government now sees education as a priority, embarking in 2006 on a reform program that includes improving English at all levels and that introduces English as a medium of instruction in state schools. This 5-year program should show some results within a few years. It is hoped that it will be able to address some of the needs of a modernizing society, of the knowledge economy, and of the poor.

Provincial education outcomes

Province	Percentage of students achieving mastery of: their first language (Sinhalese or Tamil)	mathematics	the English language
Western	51	52	20
Central	34	33	8
Southern	43	44	13
North-Eastern	23	25	5
North-Western	42	43	9
North-Central	36	41	8
Uva	34	35	8
Sabaragamuva	40	43	10
Sri Lanka	37	38	10

Source: World Bank, *Treasures of the Education System*, 2004.