Afghanistan

After 2 years of double-digit growth, expansion slowed in 2004 as agriculture was hit by another drought. In contrast, the opium economy has grown to record levels. The Government has implemented many structural reforms, but formidable challenges remain. Long-term sustainable development will require new drivers of growth, continued commitment to the ambitious reform agenda, sustained international support, and tackling the opium economy.

Macroeconomic assessment of 2004

In 2004, another drought worked to bring down cereal production by an estimated 25%, substantially lowering GDP growth for FY2004 (ended 20 March 2005) to an estimated 7.5%, from 15.7% and 28.6%, respectively, in the 2 previous years. GDP for FY2004 is estimated at $5.4 billion, exclusive of illicit opium (poppy) production, which is estimated at $2.8 billion. (Calculations in this chapter generally refer to non-drug GDP.) Apart from agriculture, which accounts for about half of GDP, other sectors, especially services and construction, continued to show strong performance as they are mainly linked to the reconstruction effort financed by external assistance and the private spending of international personnel. Per capita GDP is estimated to have risen from $199 in FY2003 to $228 in FY2004.

According to the United Nations Office on Drugs and Crime (UNODC), opium cultivation in 2004 increased by 64% to record levels, despite falling farm gate prices (down 67%) and lower yields due to bad weather conditions and disease. Value added in the opium economy has amounted to about 50–60% of the country's (non-drug) GDP over the past 3 years. Expenditures stemming from drug-export income have generated substantial demand, production, and income in the non-drug economy, and alternative livelihood opportunities will need to be developed alongside stronger eradication efforts.

Social indicators, while improving, are still very low. Delivery of essential services still depends heavily on continued donor support and faces extreme difficulty. Particularly in remote areas and areas affected by continued unrest, even basic services are largely absent. Reliable figures for unemployment are nonexistent, but qualitative information suggests that it is significant, especially among the young, and is exacerbated by extremely low human resource capacity, a continuing influx of returning refugees, and high population growth rates. A National Risk and Vulnerability Survey conducted in 2003 estimated that per capita expenditure in rural areas amounted to $165 per year. The data also suggest that 3.5 million of the 17.5 million Afghans living in rural areas suffer from extreme poverty and another 10.5 million are vulnerable to it. In 2004 widespread crop failure, caused by localized drought and plant and animal diseases—particularly in the west, southwest, and south—led to severe food shortages.

The Government's operating budget for FY2004 was set at $609 million, with $300 million to be generated through domestic revenues and $309 million to be covered by foreign assistance. The target for domestic revenues under the IMF staff-monitored program (SMP) was set more conservatively at $256 million. It is expected that

the Government will meet or exceed the SMP targets but fall short of the budget targets. The development budget increased from $1.8 billion in FY2003 to $4.2 billion in FY2004. Following patterns similar to the previous year, operating expenditures, as well as "core" budget development spending, which includes those donor-funded projects that are administered through government accounts, were slow through the first 9 months of FY2004. The rate of spending is estimated to have picked up during the last quarter. Budget development spending has been very slow and remains hampered by the volatile security situation and capacity constraints, particularly in line ministries.

Inflation in FY2004, as measured by the CPI in Kabul, rose sharply in the first quarter, primarily due to higher housing rents and petroleum prices, but it decreased again in the second. Year-on-year inflation at end-December was 11.9% (6.6% excluding housing rents and petroleum), slightly above the 10.5% rate for FY2003.

The afghani remained relatively stable, trading in the range of AF45–49/$1 over most of 2004, reflecting widespread acceptance of the new currency, prudent macroeconomic policies, and a government commitment to keep broadly within the SMP targets for monetary growth. Currency in circulation is expected to have shown 38.0% growth by end-FY2004.

Balance-of-payments data are weak. Exports in FY2004 are estimated to have reached $2.0 billion (including reexports of $1.5 billion). Total imports are put at $3.4 billion (including items for reexport). The principal exports are carpets and dried fruits; imports consist mainly of machinery and equipment, fuel, food, clothes, and medicine. Most reexports—primarily electronic goods, cosmetics, toiletries, and auto parts—are destined for the Pakistan market. The current account deficit (excluding grants) is estimated at $1.7 billion (about one third of GDP) in FY2004. The deficit is largely covered by grants; FDI is estimated at about $100 million and net disbursements of public loans at about $141 million for the year.

Foreign reserves are expected to have increased to $1.1 billion at end-FY2004 from $814 million a year earlier. A debt management unit in the Ministry of Finance is currently identifying and reconciling outstanding obligations to bilateral creditors. Several countries have provided generous debt relief on old claims. Much of the outstanding claims are from the Russian Federation and date back to the Soviet era.

Macroeconomic policy developments

The encouraging growth performance of the last few years has been supported by the Government's commitment to an ambitious reform agenda and the achievement of several political milestones. The country's first-ever democratic presidential elections in October 2004 were met by high voter turnout without major security incidents, and confirmed the incumbent interim president as Afghanistan's first democratically elected president. These developments laid strong foundations for further political stabilization.

The Government has been implementing the SMP since March 2004. The program aims to maintain macroeconomic and financial stability, pursue essential structural reforms, and build statistical capacity. SMP performance during the first 3 quarters of FY2004 was strong and most of the targets and structural benchmarks were met. However, bottlenecks in the legal system, mainly due to a lack of capacity within the Ministry of Justice, are postponing the introduction of key laws such as those on financial management, investment, and statistics.

Budget preparation and execution have improved significantly, particularly with the introduction of a "core" budget in June 2004 that consolidated the operating budget with the development budget. Also, various government accounts have been consolidated into the Treasury Single Account.

Domestic revenue generation strengthened, from $208 million in FY2003 to an estimated $256 million in FY2004. Yet despite these improvements, donor support will remain crucial to sustaining the reform momentum and to ensuring the delivery of basic services over the medium term. Tax reform measures were enacted in early 2004, including a final wage withholding tax on higher-income employees, an improved income tax regime, and a limited range of consumption taxes on services such as telecommunications, air travel, hotels, and restaurants. However, tax administration and enforcement

remain a great challenge and require substantial improvement. Furthermore, the use of market exchange rates in customs valuation and a new streamlined tariff structure (from 25 tariff rates of 0–150% to six rates of 2.5–16%) came into effect in March 2004. Provinces have begun to regularly transfer government revenues collected in their areas to the Treasury Single Account.

Reform of the civil service is only slowly moving forward. A main pillar is the Priority Reform and Restructuring (PRR) program, which enables government departments to transfer or appoint key staff to a higher pay scale for a fixed term. This has become necessary, particularly since the heavy presence of international and nongovernment organizations distorts the local labor market, which already suffers acutely from a scarcity of qualified personnel. By end-2004, 10 ministries and two independent entities had been granted PRR status and 8,017 positions had been transferred to the PRR scales. The initial target for FY2004 was for 30,000 civil servants to have moved to these scales, including 6,000 at the provincial level. The Government's target is for domestic revenues to cover the wage bill by FY2008—a very challenging objective.

Monetary policy continues to focus on keeping inflation under control and on ensuring a relatively stable exchange rate. There is an increasingly regular regime of foreign exchange auctions. The Da Afghanistan Bank, the central bank, introduced a short-term capital note in September 2004 and a system of bank reserve requirements has been adopted. Afghanistan's financial infrastructure, including savings and investment instruments, is still largely undeveloped. Eleven national and foreign banks have been granted operating licenses by the central bank, which is gradually disengaging from its commercial banking functions. In late-2004, the Government introduced antimoney laundering legislation.

The volatile security environment, unclear and insecure property rights, inadequate and unreliable power supply, and poor communications and transport infrastructure are key deterrents for private investors. Most investments to date have focused on the hotel and restaurant businesses that cater to the large international presence, and on the rapidly growing telecommunications sector. An Afghan Investment Guarantee Facility was set up in September 2004 to provide political risk guarantees to attract further foreign investment. An industrial park has been established outside Kabul and more are to be set up in other cities. Rationalization of SOEs has started, with an audit of their financial positions. A preliminary assessment proposes that, out of a total of 71 enterprises, 41 could be privatized, 20 liquidated, and 10 kept in government hands.

The Government and its development partners consider the opium economy—with its linkages to insecurity, warlords, poverty, and poor governance—a key issue for a successful development effort. The challenge, however, is daunting, especially given the still limited capacity to deal with governance and security problems facing the Government and the opium economy's strong economic incentives.

According to UNODC estimates, the number of families involved in poppy cultivation rose by 35% to 356,000 in 2004, representing approximately 2.3 million people or 10% of the population. This is largely because opium production remains far more profitable for farmers than legitimate crops. Despite the fact that the yearly gross income of opium-growing families declined sharply by 63% from $4,600 to $1,700 in 2004 according to UNODC, mainly due to weaker prices, this income was still many times higher than the gross income from wheat cultivation ($390). Also, many poor farmers are deeply involved in opium-related debt or sharecropping arrangements, which forces them to continue cultivating poppies. There are, though, early indications that farm gate prices have been falling and that eradication measures are showing signs of progress, most likely leading to a reduction in the 2005 harvest.

Outlook for 2005–2007 and medium-term trends

At the Berlin Donor Conference in March 2004, the Government outlined its program of action in the document, Securing Afghanistan's Future: Accomplishments and the Strategic Path Forward, based on the country's National Development Framework. The document stresses the importance of the private sector as an economic driver and emphasizes investments in human

capital, physical infrastructure, security, and good governance. It argues that an average of 9% growth a year of the non-drug economy (10–15% in the short term and 7–9% in the long term) is needed to assure a visible improvement in economic and social conditions while the drug economy is gradually eliminated. Total financing of $31.8 billion is needed until 2010 to raise Afghanistan to an annual per capita GDP of about $500, including an external financing requirement of $27.6 billion over 7 years. Donors pledged $8.2 billion for March 2004–2007 at the Berlin conference, the equivalent of 69% of the $11.9 billion government target for this period.

The high growth rates seen since the end of the conflict have been fueled primarily by donor-supported assistance and construction activities as well as by some relief from the drought. Reconstruction-related activities and growth in the services sector are also likely to sustain overall growth levels of about 10% annually in FY2005–FY2007. However, to achieve the Government's own growth targets over the medium term and to gradually replace opium production, there is a need to shift to broader-based and sustainable development and to identify new drivers of growth. This is particularly important in light of the Government's counter-narcotic efforts. Abrupt efforts to eradicate opium production could well have severe social and political consequences and adversely affect the overall economy and poverty reduction. Considering the size of the opium economy, a comprehensive strategy that creates alternative livelihoods in the rural economy—combined with eradication measures and legal reform—is required, supported by broad-based economic growth and sustained donor commitment.

Substantial continued donor assistance will be required for the recurrent budget over the medium term. There are serious concerns about the fiscal sustainability of the PRR program, the government payroll, and security expenditures. Revenue measures and tax enforcement will have to improve significantly to meet ambitious targets for covering recurrent expenditures. In early 2005, the Government started to develop an interim poverty reduction strategy paper, which will update and integrate various ongoing strategies and programs for reducing poverty, sustaining rapid economic growth, and promoting social inclusion. The 15-month formulation process is to include widespread consultation with civil society and the development of a 3-year macroeconomic framework.

Any future growth scenario will depend on the continuation of political reforms, sound economic policies, and the security situation. This remains volatile and could deteriorate in the run-up to the parliamentary elections originally scheduled for April 2005 but recently postponed until September. The scenario is also highly dependent on developments in the agriculture sector. With very high growth rates in cereal production of 84% in 2002 and 50% in 2003, even accounting for the 2004 shortfall, cereal production is nearing its natural ceiling on irrigated land. The frequency and duration of drought over the past 7 years are a serious concern and are partially attributable to deforestation and soil degradation. Through the expansion of irrigation and improvements in irrigation efficiency, productivity levels and the proportion of land under cultivation can still be significantly increased.

For the private sector to be the primary engine of growth and to create employment opportunities, support mechanisms will have to be strengthened, and the legal foundations for property rights, contract enforcement, and bankruptcy legislation strengthened; in addition, a legal framework for the extractive industries needs to be introduced. Currently, the exploitation of Afghanistan's mineral resources, including coal, copper, gems, and gold, is very limited. Another potential growth area is the carpet industry—traditionally one of the main exporting industries—particularly in rural areas and for women.

Significant growth potential also lies in the exploitation of Afghanistan's geographic position between Central and South Asia. Currently there is very limited trade between Afghanistan and the Central Asian republics (CARs) as tariff and nontariff barriers remain significant. If these barriers could be substantially eliminated with trade and transit linkages established, this would create new markets for Afghan exports, while transit trade from the CARs to South Asia through Afghanistan would benefit all parties substantially.

Bangladesh

Despite widespread and destructive flooding, GDP growth in FY2005 is expected to slow only moderately, aided by flood-damage reconstruction efforts and continued expansion in export-oriented industry and services. In the policy field, initiatives are needed to mitigate the adverse impact of the termination of the MFA, including upgrading infrastructure and removing structural impediments.

Macroeconomic assessment of 2004

In FY2004 (ended June 2004), GDP expanded by 5.5%, up slightly from 5.3% a year earlier. The performance was underpinned by improvements in industrial production and services, reflecting a rebound in exports and greater private consumption. Growth in the agriculture sector slowed to 2.7% from 3.1% in FY2003, mainly due to weakness in the crops and horticulture subsector, though the fishing subsector performed well in response to greater external demand for marine fish and frozen shrimps.

Industrial output increased by 7.7% as against 7.3% in FY2003, due to somewhat greater strength in export manufacturing and construction activity. Production of garments, knitwear, pharmaceuticals, ceramics, cement, and food products registered steady upticks. Following a steep rise in international prices of construction materials, the Government provided tax concessions on their import and sale to sustain momentum in construction, where growth accelerated to 8.3%. As in the preceding year, expansion in the power, gas, and water supply subsector remained robust at over 8%. The services sector recorded a broad-based expansion of 5.7%, up from 5.4%.

On an expenditure basis, GDP expansion in FY2004 was driven by a 6.3% gain in consumption. At 23.6% of GDP, investment was marginally higher than the 23.4% of the previous year. Private investment edged up by 0.3 percentage point to 17.5% of GDP, while public investment declined by 0.1 percentage point to 6.1% of GDP, reflecting underperformance in development spending. The national savings rate, at 24.5% of GDP, was unchanged from a year earlier.

According to the preliminary report of the Poverty Monitoring Survey (PMS) of the Bangladesh Bureau of Statistics in December 2004, poverty incidence has further declined. The PMS uses the direct calorie intake and food energy intake methods to measure poverty. Based on the former method, head count poverty retreated from 46.2% in 1999 to 40.9% in 2004; the corresponding estimates under the latter method are 44.7% and 42.1%. Although not directly comparable, the PMS results are broadly in line with the latest household income and expenditure survey of the Bureau, which reported that 50% of the population was below the poverty line in 2000.

In spite of a shortfall in revenues, the budget deficit in FY2004 narrowed to 3.2% of GDP from 3.4%. Revenues remained at a low of 10.2% of GDP, and reflected continued problems in boosting tax collection, despite the various measures that have been taken. Total expenditures declined a little to 13.4% of GDP from 13.7%, reflecting restraint placed on current expenditures and underperformance in development spending. Domestic sources accounted for two thirds

(2.1% of GDP) of deficit financing; foreign assistance covered the balance.

Price pressures mounted in FY2004 with CPI inflation climbing to 5.8% from 4.4% in the previous year, due mainly to higher food prices. The food component of the CPI nearly doubled, to 6.9% from 3.5%, while the nonfood component moderated (Figure 2.14). Inflationary pressures were, in good part, due to increased international prices of major commodities. An upward revision in administered prices of some energy products also fed into inflation, although most of the rise in international oil prices was not passed on. The exchange rate was broadly stable against the US dollar in FY2004.

Broad money (M2) growth declined from 15.6% in FY2003 to 13.8% in FY2004, though still somewhat higher than the target of 12.2%. Credit growth to the private sector moved up to 14.2% from 12.7% in FY2003 on account of a pickup in manufacturing and services. Bangladesh Bank made use of newly introduced repo and reverse repo instruments to influence the level of liquidity in the banking system. Interest rates continued to decline in FY2004, aided by lower rates offered on government national savings certificates, a reduction in the statutory liquidity requirement, and improved supervision and corporate governance at commercial banks. The weighted average interest rate on bank credit slipped to 11.0% at end-June 2004 from 12.8% 12 months earlier, while that on bank deposits eased from 6.3% to 5.7%.

Exports increased by 15.9% to $7.5 billion in FY2004, up from 9.5% a year earlier. This better performance was underpinned by greater strength in woven garments, knitwear, frozen shrimps and marine fish, and leather in response to a rise in external demand. Imports rose by 13.0% to $9.8 billion, a rate similar to the previous year. Imports of textiles, industrial raw materials, capital goods, and food products increased sharply. While the trade deficit widened slightly to $2.3 billion, the current account surplus (excluding official transfers) of $115.0 million (0.2% of GDP) was essentially unchanged due to stronger current transfers of workers' remittances from a year earlier. The overall balance of payments recorded a surplus of $171.0 million, and foreign exchange reserves at end-FY2004 stood at $2.7 billion, equivalent to about 3 months of imports.

Table 2.14 Major economic indicators, Bangladesh, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	5.5	5.3	6.0	6.0
GDI/GDP	23.6	24.0	26.0	26.0
Inflation (CPI)	5.8	7.0	6.0	5.0
Money supply (M2) growth	13.8	14.0	15.0	14.0
Fiscal balance/GDP	-3.2	-4.7	-4.6	-4.5
Merchandise export growth	15.9	15.0	10.0	8.0
Merchandise import growth	13.0	20.0	16.0	13.0
Current account/GDP	0.2	-1.0	-1.0	-1.5

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1995/96 market prices.

Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 28 February 2005; Bangladesh Bureau of Statistics; Export Promotion Bureau, Ministry of Finance; staff estimates.

Macroeconomic policy developments

Bangladesh's Interim Poverty Reduction Strategy Paper (I-PRSP) was completed in March 2003. Since then, substantial progress has been achieved in moving from the I-PRSP to a full PRSP, which incorporates prioritized strategies and a medium-term macroeconomic framework for combating poverty. The draft PRSP released in January 2005 centers on eight policy priorities that pursue the goal of accelerated poverty reduction. These include maintaining macroeconomic stability, maximizing pro-poor benefits from the growth process, strengthening the social safety net, advancing human development, assuring participation of poor and disadvantaged groups in the development process and their empowerment, promoting good governance, improving service delivery in the areas of basic needs, and protecting the environment.

The FY2005 budget sets an ambitious revenue target of a 16.7% rise in revenues. The revenue-enhancing measures adopted in the budget include expanding income tax and VAT coverage and rationalizing rates of customs duty, supplementary duty, and income tax. Attaining the revenue target will require an effective revenue mobilization drive and enforcement of greater discipline in tax management, including closer monitoring and supervision of staff. The budget seeks to enhance

total spending by 15.6% year on year. The budget prioritizes projects with growth and poverty reduction potential in the infrastructure and social sectors. Fully achieving these development priorities will require improved public expenditure management and stronger institutional capacity for implementing development projects.

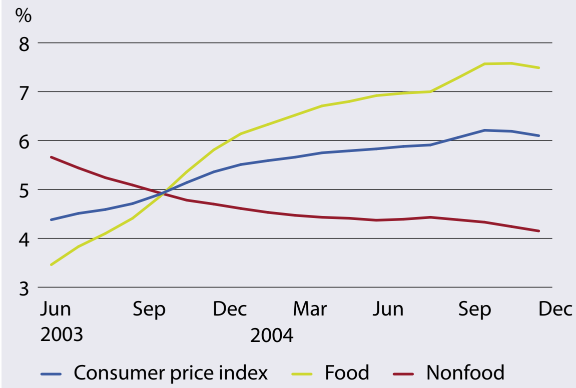
The financial sector is overwhelmingly bank-based, with 49 banks accounting for about 95% of the sector's resources. There has been progress in financial sector reforms, including bringing more discipline to the banking sector, increasing the operational autonomy and regulatory power of the central bank, and improving the governance of public financial institutions.

The Government has secured commitments from the nationalized commercial banks (NCBs) to restrict new lending, reduce NPLs, and rationalize their branch networks. Special audits of the NCBs have been undertaken in accordance with international auditing and accounting standards. The ratio of NPLs to total loans in the banking system was 20.9% in September 2004, having declined from 41.1% in 1999. However, the NCBs were still burdened with a 29.7% NPL ratio in September 2004, due mainly to loans made on noncommercial grounds that date back to the 1970s and 1980s. While local private banks as a group have a healthier financial position than the NCBs, even some of these face difficulties due to large NPL portfolios.

Under IMF's ongoing Poverty Reduction and Growth Facility, the Government has undertaken major reforms of the NCBs, including defining bank-by-bank resolution strategies. In the interim, it has also taken steps to strengthen bank management and to restrain lending so as to stanch additions to NPLs. The World Bank's Development Support Credit also supported key banking sector reforms. The implementation of the ongoing reform agenda for the NCBs and their eventual privatization will require strong political support.

Despite recent improvement, the capital market remains underdeveloped, and at end-2004 had a market capitalization of a mere $3.8 billion (6.7% of GDP). The capital market consists primarily of equity issues, while government securities and savings instruments account for almost the entire limited amount of debt securities issued in the country. Moreover, high interest rates offered on long-term government savings instruments have discouraged the development of the equities market and distorted the market for issuing private debt securities. To pave the way for the development of a secondary market in debt securities, the recently introduced government 5- and 10-year bonds were listed for trading on the Dhaka Stock Exchange. Moreover, high interest rates offered on the Government's 3- and 5-year savings certificates have been trimmed to better align them with market-determined rates.

Figure 2.14 Inflation, 12-month moving average, Bangladesh, June 2003–December 2004



Source: Bangladesh Bureau of Statistics.

Partly in response to restructuring of government interest rates, the Dhaka Stock Exchange general index moved up to 1,971.31 by 30 December 2004, for a 104% gain over the year. However, investor confidence in corporate governance of the listed companies and in execution of the rule of law remains low. In addition, the unavailability of issues with strong fundamentals and the absence of sufficient initial public offerings are major problems for sustaining the stock market's growth.

Although the MFA was phased out with effect from 1 January 2005, exporters are optimistic about continued steady growth of the garment sector in a quota-free world. The garment industry is stressing the need for the creation of a central bonded warehouse, funding facilities for development of an integrated domestic supply chain, and relaxation of the rules of origin to enable it to face the post-MFA challenge of global competition. Many garment entrepreneurs have prepared them-

selves by consolidating and restructuring their operations to improve competitiveness.

The garment industry is hampered by costly infrastructure bottlenecks. The challenge is now to lower costs and improve infrastructure to meet increasingly stiff competition. Because of poor infrastructure and high import dependence, the purchase order to delivery cycle (or lead time) of the garment industry is 1 month longer than in major competing countries. This problem has become even more critical in the post-MFA era since the industry now needs to compete with much smaller margins. Over the years, the role of FDI in the garment industry has significantly declined as the Government opted to preserve the valuable quotas for the locally owned factories. This has deprived the country of benefits from the inflow of superior technology and management as well as direct market access and links to EU and US buyers.

Outlook for 2005–2007 and medium-term trends

GDP growth in FY2005 is estimated at 5.3%, down slightly from the preceding year, mainly due to the devastating floods of July–September 2004. Affecting about 38% of the country, the floods caused extensive damage to standing crops, infrastructure, and livelihoods of 36 million people across 39 districts. According to a preliminary assessment conducted in September 2004, damage is estimated at about $2.2 billion, comprising $1.3 billion in asset loss and $0.9 billion in output loss. The impact of the flood damage, together with a steeper oil bill, is expected to be largely offset by flood rehabilitation expenditures mainly financed by aid and increased workers' remittances.

It is estimated that the flooding will bring down agricultural growth in FY2005 to 0.4%, primarily due to its adverse effects on the *aman* (wet-season rice crop). Industrial growth, however, is likely to be pushed higher, to 7.8%, by export-oriented manufacturing. During the first 4 months of FY2005, manufacturing output, boosted by garment production, rose by 8% over the same period in the previous year. The services sector in FY2005 is likely to show improved growth of 6.0%. Expansion in transport and trade services, an upturn in recruitment in public administration, and higher profitability of private sector banks are expected to lift services.

During FY2005, the fiscal deficit is projected to worsen to 4.7% of GDP, reflecting increasing expenditures in the face of weak revenue performance. In the first half of FY2005, revenues under the National Board of Revenue were only 9% higher than in the same period of the previous year, and well below the 16.7% targeted in the budget. Meanwhile, the Government in December 2004 raised prices of kerosene and diesel by 15% to Tk23 per liter, to reduce the losses of the state-owned Bangladesh Petroleum Corporation and to alleviate pressure on the government budget caused by high international oil prices. Further adjustments will be required, though the current government policy is for partial adjustments spread over time.

Inflation is expected to accelerate to 7.0% in FY2005. Overall inflation, on a 12-month moving average basis, has been on a rising trend and reached 6.1% in December 2004, with the food component at 7.5%. With the setback in rice production, food prices are unlikely to decrease significantly during the rest of the year, raising the overall index. Moreover, the December upward adjustment in petroleum prices has not been fully passed through.

Exports are estimated to grow by 15.0% in FY2005, reflecting a steady uptrend in garment exports. During the first half of the year, exports recorded a 15.2% gain over the same period of FY2004 with an especially strong performance in knitwear (up by about 38%). Imports are also projected to pick up in FY2005, by 20.0%, due to increases in industrial raw materials, capital goods, and oil.

During the first 5 months of the year, imports jumped by 22.8%. According to estimates of the central bank, the balance-of-payments impact of higher oil prices is in the order of $300 million–400 million, on an assumed oil price of $40–45 per barrel. A mitigating factor in the energy outlook is that locally produced natural gas is being substituted for petroleum products, particularly in the transport sector. Despite an increase in workers' remittances, a widening trade deficit is expected to push the current account (excluding official transfers)

into a deficit of about $600 million (1.0% of GDP) during FY2005. Additional foreign assistance has been available in FY2005 and foreign exchange reserves rose (by about $300 million) to $3.0 billion at end-January 2005.

GDP growth is expected to strengthen to 6.0% in FY2006–FY2007, with budget and external deficits remaining within manageable levels. The improvement will reflect a recovery in agricultural output to 3.0%, as well as steady performance in industry and services. Investment is projected to rise to 26.0% of GDP in FY2007, propelled by an acceleration in private investment induced by ongoing reforms.

Inflation will likely moderate to 5.0% by FY2007 as crop production returns to normal levels and as the Government continues its policy of gradually reducing petroleum subsidies. The budget deficit is forecast to decline to 4.5% of GDP by FY2007 with revenues and expenditures both growing each year, by 0.5% and by 0.4% of GDP, respectively.

Growth in exports is expected to fall to 8.0% by FY2007 as more intense global competition limits expansion in garment exports. However, the current account deficit (excluding official transfers) is forecast to remain modest at 1.0–1.5% of GDP, aided by the steady growth in remittances from workers abroad.

These forecasts face several downside risks over the medium term, including an even greater adverse impact from the phaseout of MFA quotas, an unforeseen and abrupt increase in oil prices, and the possible intensification of the country's confrontational politics, which could trigger an upsurge in general strikes and lawlessness. The Government needs to address crucial policy and institutional issues to temper some of these risks.

In line with its medium-term macroeconomic framework, macroeconomic stability needs to be maintained and the necessary structural reforms implemented. In particular, the Government will have to focus on augmenting domestic resources while rationalizing expenditures. Raising private investment levels will require major efforts to improve the investment climate, including improving governance and stepping up reforms to improve the efficiency of the banking system and capital market.

In addition, the authorities should undertake policy initiatives to mitigate the impact on the balance of payments of the elimination of MFA quotas. These include efforts to promote diversification of the export base and enhancement of competitiveness so as to encourage FDI (especially in the garment industry) and to remove structural impediments. To realize the potential for anticipated higher export-led growth, the ports, roads, railways, and waterways, as well as energy provision and ICT, all require significant infrastructure improvements.

Bhutan

Strong economic growth, due principally to hydropower, is likely to continue in the medium term. While the country remains on track to achieve the Millennium Development Goals, the challenges of economic diversification, employment generation, private sector development, and domestic resource mobilization require continued attention.

Macroeconomic assessment of 2004

In 2004, GDP is estimated to have grown by 7.0%, moderately higher than the 6.5% achieved in 2003. The power and construction subsectors continued to be the main drivers, with the industry sector accounting for essentially all of the pickup in GDP growth. In September, 32 megawatts of additional generating capacity came on line at the Basochu hydroelectric plant. Tourist arrivals grew by about 48% to reach 9,249, a record, with the industry earning $12.5 million, or about 1.6% of GDP. Tourism was boosted during the year by the opening of a luxury hotel while other high-end projects also financed by FDI are under way. Major investments under construction include the 1-gigawatt Tala hydropower project, housing projects, and road network expansion.

Domestic revenues in FY2004 (ended 30 June 2004) were up by 10.7% from the previous year. An increase of 27.4% in nontax receipts offset an 8.1% decline in tax revenues, with the tax-to-GDP ratio declining further to 8.4% in the year. While domestic revenues remained sufficient to cover recurrent expenditures, the financing of most capital spending relies on external assistance. Total expenditures fell by 11.8% from the previous year's level, due mainly to lower capital expenditures on the Tala hydropower project, which is nearing completion. The combination of much larger inflows of grant assistance—stemming from completion of aid discussions with India—and a reduction in capital expenditures resulted in an overall budget surplus of 4.5% of GDP, a marked contrast to the previous year's deficit of 10.4%.

During FY2004, broad money (M2) expanded by 4.1%, while net foreign assets of the banking system declined by 6.1%. These developments reflected a marked drawdown in and use of private sector foreign currency deposits held at commercial banks, and were consistent with a surge in imports during the year. Credit to the private sector was buoyant, increasing by 30.0%, while the government budget surplus held total banking system credit expansion to 12.5%. Subsectors most favored for private sector lending are, in order: building and construction, manufacturing, trade and commerce, and services (including tourism). Interest rates declined over FY2004: the 1-year deposit rate subsided from 7% to 6%, while the lending rate decreased from 16–12% to 16–10%. Average inflation in FY2004 was 1.3%; however, this measurement reflects an outdated basket, and a new CPI is being introduced.

Balance-of-payments preliminary estimates for FY2004 show unusually rapid growth in exports (up by 39.7% to $157.6 million) and imports (up by 29.6% to $245.6 million) (Figure 2.15). Robust exports reflected increased sales of power as well as agricultural and manufactured products. The import expansion was due to large imports for the Tala project but also the import of two Airbus A319 aircraft. The current account remained in surplus at $48.9 million (7.1% of GDP) due to a

continued large inflow of official transfers. Apart from official aid, the capital account included $3.5 million in FDI for hotel development and the first loan from the International Finance Corporation to the private sector.

At end-FY2004, outstanding external debt was $529.2 million with convertible currency debt at $216 million and the balance in Indian rupees. The debt service ratio was only 4.1%, as most debt is on concessional terms. Gross international reserves increased to $383 million at end-FY2004, providing nearly 19 months of import cover.

Macroeconomic policy developments

Significant policy actions were undertaken in 2004. The Government published a "cover note" to the Ninth Five-Year Plan (July 2002 to June 2007) and together these two documents constitute the Government's Poverty Reduction Strategy Paper (PRSP). An extensive document, the cover note was prepared by the Government in broad consultation with IMF and the World Bank. In an effort to strengthen the budget process and the management of public expenditures, the Government has introduced a 2-year rolling budget from FY2005. A medium-term expenditure framework has been developed covering the 2 preceding and next 3 financial years.

A lower (food) poverty line and an upper (income) poverty line, using the data of the 2000 Household Income and Expenditure Survey, supplemented by the 2003 Bhutan Living Standards Survey, were established and the findings were used in the PRSP. These estimates show a national poverty incidence of 25.3%—2.9% urban and 29.0% rural—using the lower poverty line, while the upper poverty line shows national poverty at 36.3%—6.4% urban and 41.3% rural. A poverty monitoring and assessment system is being developed.

Outlook for 2005–2007 and medium-term trends

Reflecting the Government's preliminary medium-term expenditure framework, GDP growth is expected to average about 8.0% annually over FY2005–FY2007. Total budget expenditures as a share of GDP are projected to decline, while a

Figure 2.15 Trade profile, Bhutan, FY2000–FY2004

Source: Royal Monetary Authority of Bhutan, *Annual Report 2003–2004*, available: www.rma.org.bt, downloaded 7 February 2005.

projection of revenues as a share of GDP sees an improvement of 2 percentage points in domestic resource mobilization by FY2007. A 5 percentage point expected decline in external resources (grants and loans), however, points to a moderate projected fiscal financing gap averaging about 2.5% of GDP over the forecast period.

The outlook for economic growth over the medium term appears favorable, despite the continued heavy reliance on only two subsectors—power and construction. The hydropower project at Tala is expected to be commissioned by end-2005. Its export of power to India will eventually decrease the trade deficit and increase government revenues, facilitating the progressive reduction of the existing reliance on external resources. However, given the low employment elasticity of power, the task of fully absorbing the 70,000 people estimated to enter the labor market during the period of the Ninth Plan is challenging, and adds urgency to promoting private activity.

Implementation of planned financial reforms would result in increased competition and enhanced corporate governance. Tourism, which is the major source of hard currency income, has expanded rapidly and, with FDI in luxury hotels and resorts, will materially contribute to private sector development and absorb part of the incoming labor force. Expansion of subregional economic cooperation activities will aid export diversification and expansion of the economic base.

India

The economy remained buoyant, but major challenges included the devastation caused by the tsunami in December, fluctuating agricultural growth, high inflation, and reemergence of a large current account deficit. The medium-term challenges for the economy include meeting the fiscal consolidation targets, stepping up infrastructure investments, managing burgeoning foreign exchange reserves, and reinforcing the economy's competitive advantage in textiles and garments in the post-MFA world.

Macroeconomic assessment of 2004

In FY2004 (ended 31 March 2005), the economy remained buoyant. GDP grew by 7.0% during the first 2 quarters of the year (Figure 2.16), following 8.5% growth in FY2003. For the year as a whole, the best estimate for growth is 6.5%. (The Government has made a somewhat higher advance estimate of 6.9%.) This strong expansion is on account of marked improvements in investment as reflected in the leading macro indicators, such as production and imports of capital goods, production of commercial vehicles, and nonfood credit offtake. Moreover, strong growth in consumer durables in FY2004 also indicates a pickup in consumption demand.

The major challenges faced during the year include the devastation caused by the 26 December tsunami, a slowdown in agricultural expansion, a high price of oil that is fueling inflation, and the reemergence of a current account deficit. The tsunami, which affected the coastline of some mainland southern states of India besides the entire Andaman and Nicobar Islands, led to large-scale loss of life and displacement, widespread damage to property, destruction of coastal fisheries and agriculture, and temporary disruption to tourism in coastal areas. The adverse impact of the tsunami is, however, localized, and the level of national economic activity has not been significantly affected.

Agricultural expansion slowed sharply to 1.5% during April–September 2004, significantly down from the unprecedented growth of 9.6% in FY2003. This stemmed from below-normal rainfall both during and after the monsoon, which also had a highly skewed geographic distribution pattern. As a result, 2004 *kharif* (summer) foodgrain production is expected to be 102.9 million tons compared with 112.1 million tons in 2003. The area sown for most *rabi* (winter) crops has also declined, and consequently the winter crop harvest is also expected to decline. The adverse impact of the tsunami on agriculture due to devastation of standing crops, destruction of irrigation facilities, and depositing of nonfertile sediments may further lower agricultural growth. For the year as a whole, total agricultural production could, at best, rise marginally by 0.6%.

Industrial growth accelerated to a robust 7.5% in April–September 2004 from 6.2% in the same period in FY2003. Manufacturing expansion was broad based, and high growth in different segments of textiles and garments is noteworthy, as the sector needs to maintain its productive efficiency in order to remain competitive in the post-MFA world. Such broad-based manufacturing expansion was supported by strong growth in key infrastructure industries such as

energy and cement. Buoyant industrial growth reflects primarily a pickup in investment and consumption demand. The strengthening of business confidence and other leading indicators such as growth in nonfood credit, especially housing credit, as well as other commercial sectors, suggests that the high industrial growth will be sustained during the rest of the year. For the year as a whole, industrial growth is estimated at 8.0%.

The services sector continued to pick up strongly and maintained an average growth rate of 8.8% during the first 2 quarters of FY2004. This was led by accelerating growth in trade, hotels, and restaurants, as well as by transport and communications, which was in turn due to a turnaround in trading and transport services, and strong performance of telecommunications. The two subsectors of financial and business services, and real estate, and of community, social, and personal services also registered high growth during this period. The strong performance in the former is attributable to a buoyant capital market, continuing expansion in exports of IT-enabled services, and a boom in the real estate market. Services sector growth is also expected to remain at above 8.0% in FY2004.

On the fiscal front, the consolidated fiscal deficit of the federal and the state governments is estimated to improve marginally from 9.4% in FY2003 to 9.1% in FY2004. The federal fiscal outcome for FY2004 is somewhat mixed. The major effort at fiscal consolidation notwithstanding, the federal fiscal deficit situation did not show any improvement in FY2004 from the previous year, while the revenue deficit declined from 3.6% of GDP in FY2003 to 2.7% in FY2004. This is in spite of significant expenditure containment and impressive gains in tax revenue collection during the year. However, capital receipts of the federal Government generated by recoveries of loans to state governments and other receipts from disinvestment proceeds have declined. Finances of the states also remained worrisome.

Money supply (M3) growth has started declining in recent months, reaching 13.3% on 4 February 2005, which is lower than the monetary policy target of 14% for the year as a whole. Growth of reserve money remained at above 14.0% as of that date, mainly on account of large inflows of foreign capital and continued buying of dollars by the Reserve Bank of India (RBI) to prevent appreciation of the rupee. Despite high growth in the foreign exchange assets of RBI and a consequent expansion of the monetary base, the excess liquidity scenario reversed as a consequence of the increase in demand for nonfood credit, along with a rise in the cash-reserve ratio and sterilization through the Market Stabilization Scheme. As a result, interest rates started moving up, with yields on 91-day treasury bills increasing from 4.4% to 5.4% in April–December 2004. However, early indications suggest that the liquidity position has been easing since January 2005.

Wholesale price index inflation rose sharply in FY2004. The average inflation rate was 6.9% during April–December 2004. With a decline in recent months, inflation for the year as a whole is expected to be 6.0%. Given the unutilized capacity in some sectors, demand-driven inflation is not a concern at present. Instead, the sharp increase in inflation has been cost-push, mainly due to high world oil prices and rising prices of iron and steel. Inflation based on the Consumer Price Index for Industrial Workers was lower, at 3.7% in April–December 2004.

Table 2.15 Major economic indicators, India, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	6.5	6.9	6.1	7.0
GDI/GDP	26.5	26.5	27.0	27.5
Inflation (WPI)	6.0	4.2	3.0	3.5
Money supply (M3) growth[b]	14.6	14.5	12.5	13.9
Fiscal balance[c]/GDP	-9.1	-8.8	-8.5	-8.0
Merchandise export growth[d]	23.2	14.1	13.8	13.2
Merchandise import growth[d]	39.0	19.7	15.4	14.4
Current account/GDP[d]	-1.0	-1.0	-1.4	-1.9

GDI = gross domestic investment, GDP = gross domestic product, WPI = wholesale price index. [a] Based on constant 1993/94 factor cost. [b] Data for 2004 are for April 2004–January 2005. [c] Includes combined fiscal deficit of the federal Government and all state governments. [d] Data for 2004 are for April–September.

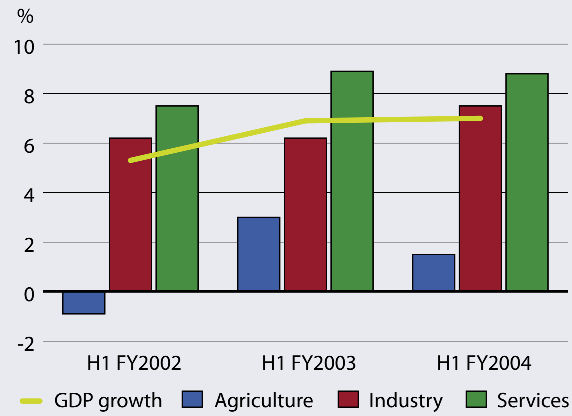
Sources: Central Statistical Organization, available: http://mospi.nic.in/cso.htm, downloaded 9 February 2005; Ministry of Finance, available: http://indiabudget.nic.in, downloaded 28 February 2005; Reserve Bank of India, available: www.rbi.org.in, downloaded 1 March 2005; staff estimates.

Bullish expectations, driven by buoyant growth and rising corporate profits, are reflected in the recent boom in stock prices. After declining quite sharply during April–May 2004 in the run-up to elections (and the formation of a new coalition Government), the market has rebounded to reach record levels of market capitalization. Despite fluctuations during the year, the Sensex market index closed at 6,752 on 15 March 2005 to record a 19.3% increase for 50 weeks of FY2004. The volatility of the index during December 2004 and January 2005 reflects the movements in portfolio investments by foreign institutional investors, primarily on account of expectations of an increase in the US Federal Funds rate.

External sector performance was also robust in FY2004. Merchandise exports grew by 23.2% and imports by 39.0% during the first half of FY2004 from the same period a year earlier. With imports outpacing exports during the period, the trade deficit increased. Despite 22.8% growth in net invisibles trade, the current account has recently switched to a deficit of $3.3 billion, having previously been in surplus from the third quarter of FY2000. Greater import growth is the result of higher oil prices and strong domestic absorption. The acceleration in merchandise exports mainly reflects strong growth of world demand, especially in ASEAN+3 countries.

On the capital account, the country received a net capital inflow of $10.1 billion in the first half of FY2004, though net FDI was only around $2.0 billion. The surplus on the capital account was the result of external commercial borrowing and short-term loans, and other capital inflows. Data show an upsurge in foreign institutional investment inflows in later months, which pushed up foreign exchange reserves to $134.6 billion (as of 11 March 2005). The accumulation of large reserves along with the weakening of the US dollar against major international currencies caused the rupee-dollar exchange rate to appreciate on average by about 2.1% during the first 50 weeks of FY2004. This accumulation also led to the expansion of the monetary base and a consequent sharp increase in money supply growth. This latter problem becomes more acute with the limits on sterilization. Thus, for prudent foreign exchange reserves management, the central bank has to make a critical balance between arresting rupee appreciation, on the one hand, and keeping money supply growth within the stipulated target to control inflationary pressures, on the other.

Figure 2.16 Sectoral composition of growth, India, FY2002–FY2004



Source: Central Statistical Organization, available: http://mospi.nic.in/cso.htm, downloaded 9 February 2005.

Macroeconomic policy developments

At the policy level, the federal Government intends to carry forward the reform process "with a human face." Significant policy initiatives bear on the fiscal reform proposals in the FY2005 federal budget and on social and rural development programs, including the rural employment guarantee scheme. Reforms in foreign trade and investment policies, credit policy, and the existing Patents Act were also initiated.

The finance minister presented the FY2005 federal budget to Parliament in February 2005. As expected, this budget marks a major milestone in the revival of growth-promoting fiscal reforms. At the same time, it is an inclusive budget, aimed at promoting equitable growth focusing on the rural sector and social services, in line with the goals of the United Progressive Alliance Government in its Common Minimum Program. The FY2005 budget also marks a major change in federal fiscal relations vis-à-vis the states, based on the recommendations of the Twelfth Finance Commission (Box 2.3). Much of the growth-oriented fiscal reform relates to revenues. Indirect tax rates and direct tax liabilities have been significantly reduced; the tax base has been expanded,

especially in terms of the coverage of services taxation; and a slew of exemptions has been abolished. These exemptions had been earlier identified by several committees as one of the major factors accounting for India's porous tax system and a relatively low tax-to-GDP ratio of only 16%.

Equity concerns have been addressed mainly through the expenditure proposals. The budget has substantially increased the allocation of resources for agriculture and rural development, including water resources management. There is also a significant increase in social expenditures on education, health, and antipoverty programs. The expenditure budget has also addressed key growth constraints through a large increase in allocation for road transport and power infrastructure. Despite this, the total increase in federal expenditure has been contained at 1.7%. This has been possible mainly because of a sharp reduction in federal loan assistance to the states, following the recommendations of the Twelfth Finance Commission. Henceforth, states will have to access the capital market for their borrowing requirements.

This major effort at fiscal consolidation notwithstanding, the fiscal deficit of the federal Government for FY2005 remains high at 4.3% of GDP, with a revenue deficit of 2.7%. This would imply a large overall fiscal deficit of about 8.8% of GDP after the deficits of the state governments are included. The federal fiscal and revenue deficit estimates also fall short of the corresponding targets of 4.0% and 1.8% under the Fiscal Responsibility and Budget Management (FRBM) Act as envisaged in the previous year's budget. The shortfall in meeting the fiscal deficit target is largely derived from a large reduction in the federal Government's receipts from recoveries of loans to state governments, primarily due to the expiry of the Debt Swap Scheme in FY2004 in preparation for a complete rescheduling of repayment of state government debts to the federal Government, following the recommendations of the Twelfth Finance Commission. However, the finance minister has indicated that the federal Government will still meet the FRBM targets by FY2008.

Less encouragingly, the budget makes no attempt to cut down subsidies, nor has it

Box 2.3 Recommendations of the Twelfth Finance Commission

The Twelfth Finance Commission (TFC) was appointed by the president of India on 1 November 2002. The terms of reference included the following: recommend the distribution of net proceeds of taxes between the federal Government and the states and the principles that should govern the grants-in-aid of the states; recommend measures to supplement the resources of the local governments; and review the state of finances of the federal Government and the states and suggest a comprehensive fiscal consolidation plan, including specific suggestions for better tax efforts and a feasible debt-reduction plan for the states.

Specific TFC recommendations for fiscal consolidation in the states will have far-reaching implications for the federal-state fiscal relationship. TFC has correctly identified that large revenue deficits have led to large fiscal deficits and spiraling debt, resulting in the emergence of a vicious cycle of deficit, debt, and debt service payments.

Thus, every state is now required to enact fiscal responsibility legislation to eliminate its revenue deficit by FY2008. This precondition for debt relief triggers a consolidation of the federal loans to states outstanding as of 31 March 2005 for a fresh term of 20 years at an interest rate of 7.5%. TFC has also put forward a debt write-off scheme linked to the reduction of revenue deficit of the states.

TFC has suggested that the plan size of each state needs to take into account the sustainable level of debt and the capacity to borrow in the market. Thus, it has proposed a thorough overhaul of the system of providing federal assistance for state plans. The system of imposing a 70:30 ratio between loans and grants for extending plan assistance to nonspecial category states (10:90 for special category states) should be abolished. The federal Government should only extend pure grants to the states, and leave it to the states to decide how much they wish to borrow. Moreover, all external assistance will also be transferred to the states on the same terms and conditions, and the federal Government will act merely as a financial intermediary without making any gain or loss.

Source: Government of India. 2004. *Report of the Twelfth Finance Commission*. New Delhi. November.

announced any major policy initiatives with regard to disinvestment in public enterprises or liberalization of labor laws. However, the federal Government has moved forward with further dereservation and deregulation among SMEs. In addition, there was some move during the year by the Ministry of Finance and RBI with respect to liberalization of foreign equity participation in private sector banks, as well as in the construction, mining, trade, and pensions subsectors.

On the monetary policy front, RBI in its midterm review of the Annual Credit Policy 2004/05 has aimed at provision of adequate liquidity to meet credit demand and support investments, while emphasizing price stability. In this review, RBI increased the repo rate by 25 basis points to 4.75%, while leaving the bank rate unchanged at 6.0%. RBI addressed the issue of the liquidity overhang by raising the Market Stabilization Scheme limit to Rs800 billion, which is expected to mop up the increase in money supply through selling government securities and impounding these resources in a special account of the central bank. Given the prescribed limit of the scheme, RBI has raised the cash reserve ratio by half a percentage point to 5.0% to absorb surplus liquidity and control inflationary pressures.

With regard to rural employment generation, the federal Government introduced a National Rural Employment Guarantee (NREG) Bill 2004, in Parliament. This bill seeks to implement an employment guarantee scheme in 150 of the most backward districts of the country in the first phase, and then extend the coverage in stages to the entire country within 5 years. This provides a legal guarantee of 100 days of employment a year to at least one member of each rural household, and thus provides the rural poor with an effective safety net.

The NREG Bill, which has been criticized on the grounds of its limited scope, leaves room for discretionary interventions by state governments. In addition, it may also be criticized in terms of large leakages and poor delivery systems. However, the beneficial effects of such programs in terms of employment generation and poverty reduction are evident in Maharashtra and were seen in Rajasthan and Gujarat during the droughts of 1987/88. The other important benefits of such programs include expected reduction of rural-urban migration, empowerment of women, creation of useful assets in rural areas, and change of power equations in rural society to foster a more equitable social order.

The 2004 amendment to the Patent Act 1970, which is designed to comply with India's commitments under the TRIPS Agreement in WTO, marks a departure from the past regime of granting only process patents. The new amendment allows for the introduction of product patents and exclusive marketing rights under certain conditions in the area of chemicals—including agrochemicals and pharmaceuticals—and food. Certain features of the recent amendment have generated controversy: some commentators claim that the new amendment restricts affordable access to various essential drugs.

Outlook for 2005–2007 and medium-term trends

GDP is expected to expand by 6.9%, up from 6.5% in FY2004. Agriculture is projected to grow at a high rate of 4.4%, which is not unusual in a year that follows one with relatively low agricultural growth. In FY2005, industry is predicted to grow at a lower rate of 6.7%, and services sector growth is estimated at 7.7%. A slowdown in industrial growth in FY2005 can be attributed to cost-smoothing behavior of firms to tide themselves over an anticipated cost escalation as reflected in the latest business confidence survey carried out by the National Council for Applied Economic Research, New Delhi. This is corroborated by the fact that firms are very upbeat about capacity utilization but not very optimistic about demand conditions, suggesting the desire to hold larger inventories. The survey indeed shows that the proportion of firms willing to accumulate such inventory levels, especially in consumer goods, has gone up significantly. This explains the beginning of a downturn in the industrial business cycle in FY2005.

In FY2006, GDP growth is predicted to decline to 6.1%, mainly on account of a further decline in the growth of industry and services to 5.2% and 7.3%, respectively. The revival of industry and services growth in FY2007 will drive up overall expansion to 7.0%.

The medium-term challenges for the economy include meeting the fiscal consolidation targets as laid down in the FRBM Act of 2003, stepping up infrastructure investments, managing burgeoning foreign exchange reserves, and reinforcing India's competitive advantage in textiles and garments since the termination of the MFA.

Inflation is forecast to decline to 4.2% in FY2005, down from 6.0% in FY2004, and then to 3.0% and 3.5% in the following 2 years. The moderation of inflation will be largely attributed to expected stability in prices of fuels as well as prices of manufactured goods through FY2007. The downside risks that could undermine the inflation projections include a weak monsoon and a sharp rise in global oil prices.

Expansion in investment—especially in infrastructure—holds the key to sustaining high growth over the long run. The investment rate increased to 26.3% of GDP in FY2003 and is estimated to have increased to 26.5% in FY2004. However, the current rate of infrastructure investment at 3.5% of GDP is way below the 8.0% of GDP target for FY2005 made by the Expert Group on the Commercialization of Infrastructure Projects.

The current rates of both private and public infrastructure investments have been well below target. The key problem in attracting adequate private capital in infrastructure is the lack of appropriate risk allocation between creditors and investors. One such crucial risk originates in the fact that lenders are paid only from the cash flow generated by an infrastructure project, and they have limited options if investments fail to provide the expected returns because of a shift in policy parameters. Moreover, infrastructure projects usually have long gestation periods and there is usually a maturity mismatch between loans and returns. Developing a domestic market for long-term securities is therefore critical for infrastructure financing. ADB's recent issue of domestic currency long-term bonds is an important step in this direction.

Thus, in a bid to boost infrastructure investments, the federal Government has proposed financing infrastructure investment in specific areas such as roads, ports, airports, and tourism through a special-purpose vehicle in terms of additional borrowings with longer-term maturities. Therefore, with an anticipated increase in public infrastructure investment using such a vehicle over the medium term, it is expected that there will be a gradual step-up in the overall investment rate to 27.5% in FY2007.

The key factor constraining higher public investment in infrastructure is the large consolidated deficit position of the federal and state governments. Despite expected improvements in the consolidated fiscal deficit over FY2005–FY2007, reflecting tax reforms, improvements in tax administration, and containment of expenditure, the fiscal deficit is expected to remain high at above 8.0% of GDP. The consolidated revenue deficit will also stay high. Therefore, it will remain a challenge for the federal Government to increase public investment in infrastructure through additional borrowings while ensuring compliance with the FRBM targets. This will be possible only if adequate fiscal space is created by initiating effective fiscal consolidation measures.

The external sector is expected to remain buoyant. Growth of merchandise exports is forecast to be 14.1% in FY2005, 13.8% in FY2006, and 13.2% in FY2007. This is despite the strengthening of the rupee-dollar exchange rate over FY2005–FY2006. Anticipated appreciation in the real exchange rate notwithstanding, the projected large increases in merchandise exports are largely due to high growth in world trade. Strong expansion in ASEAN+3 countries in FY2005 (particularly in the PRC), which now accounts for about 23% of India's total trade, will provide a stimulus to merchandise exports.

Merchandise exports are better diversified than imports, which largely comprise bulk items. The growth in merchandise exports stems from expansion in exports of textiles and garments, automobile parts and ancillaries, and chemicals (including pharmaceuticals). Textile export composition is well diversified, and it has a competitive edge in products ranging from cotton textile items, yarns, and fabrics to knitwear.

The ending of the MFA will have a large impact on India's textile and garment exports, which account for about 20% of total exports. Even though the high growth of textile and garment exports shows the competitive strength of these products in the international market, it is still too early to assess gains, and the sector's

performance needs to be monitored closely. The benefits from the MFA phaseout will accrue only if India makes substantial improvements in efficiency, reduces unit costs, diversifies to higher value-added products, and consolidates scale economies. Also, to remain competitive, Indian textile and apparel firms need to be a part of the global value chain, and reposition themselves accordingly.

Merchandise import growth is likely to be 19.7% in FY2005 and around 15% in the following 2 years. The anticipated lowering of international oil prices in FY2006 and FY2007 largely explains the declining growth of merchandise imports during these 2 years. With import growth exceeding that of exports during the 3 years, the trade deficit is expected to remain high. Services trade, especially in software and IT-enabled business processes, will continue to rise at a robust rate over this period and expand the positive invisibles balance.

The current account will continue to post a deficit, forecast in the range of 1.0–1.9% of GDP over FY2005–FY2007. This will partly offset the surplus on the capital account. Moreover, with the expected hardening of US interest rates over the next 2 years, there may be a reduction in net portfolio investments, which will lower the capital account surplus. Hence, the rapid accretion to foreign exchange reserves observed since 2001 is likely to moderate over the medium term. Nevertheless, managing foreign exchange reserves and striking an appropriate balance between a competitive exchange rate and internally consistent money supply growth will remain a significant challenge for RBI.

Maldives

The tsunami of 26 December 2004 was the country's greatest natural disaster. While loss of life, fortunately, was low, damage on many islands was great. A loss of peak-season tourism means that growth will plummet in 2005, but should rebound in 2006 as the tourist facilities themselves are largely intact. However, substantial aid will be required for the reconstruction of infrastructure needed to sustain the past high-growth path that had reduced poverty in previous years.

Macroeconomic assessment of 2004

In 2004 GDP grew by 8.8%, slightly faster than in 2003 (8.4%). As in the past, expansion of tourism, up by 11.4% in GDP terms, fueled growth in related sectors, including construction, transport and communications, and utilities. Tourist arrivals increased by 9.4% during the year and the average hotel occupancy rate rose to 84%, while foreign exchange earnings grew by about 19%. Tourism accounts for about one third of GDP, 70% of foreign exchange receipts, about 50% of domestic budget revenues, and almost 20% of employment. Fishing, the traditional mainstay of the economy (now about 6% of GDP), also enjoyed a good year with total exports up by about 22%.

Government expenditures grew by 7.6% during 2004, amounting to 38.3% of GDP. Although domestic revenues increased by 8.8%, a lower amount of grants caused the overall budget deficit to increase slightly to 4.4% of GDP. Nevertheless, there was no borrowing from the banking system, indeed a net repayment as in 2003, consistent with current policy intentions.

Broad money expanded rapidly in 2004, up by 32.6%, with a large buildup in net foreign assets in the banking system. Following a slow expansion in 2003, credit to the private sector surged by 57.8%, with over one half of new lending going into development of tourism facilities. CPI inflation picked up from midyear to average 6.4% for the year, compared with a 2.9% fall in 2003; however, this reflects changes in fish prices, which have a heavy weight in the CPI.

Exports and imports increased rapidly by 13.0% and 30.7% respectively, raising the traditional large trade deficit to $370 million (49.1% of GDP) in 2004. Petroleum products and intermediate and capital goods were notable in boosting imports. Despite higher tourism receipts, the current account deficit increased to $90.3 million or 12.0% of GDP from 4.6% in 2003. Sizable private capital inflows as well as larger official borrowing led to a capital account surplus of $114.8 million, bringing the overall balance to a surplus of $24.5 million. Gross international reserves rose to $205.1 million at end-2004, providing 3.8 months of import cover. The rufiyaa is pegged to the US dollar at Rf12.8/$1. External public debt increased to $289.9 million at end-2004 (Figure 2.17), equivalent to 38.5% of GDP, though the debt service ratio remains low, at 3.8%, as most debt is contracted on concessional terms.

Macroeconomic policy developments

The focus of macroeconomic policy must now be on measures to mitigate the adverse economic impact of the tsunami on the population and on the economy. Key policy measures will include: providing income support to those affected by the tsunami with special attention to the outer atolls

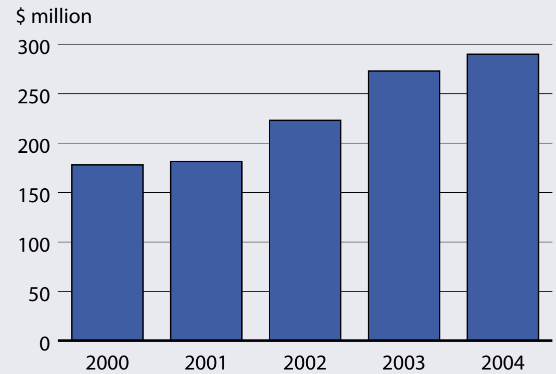
where destruction was especially severe; helping restore livelihoods in the atolls by financing assets lost and employing local labor in rebuilding infrastructure; fostering a rebound in tourism by ensuring that the world knows that facilities such as the airport are functioning normally and resorts are open for tourists, as usual; and ensuring that the reconstruction effort is carried out consistent with macroeconomic stability, i.e., through containing the fiscal deficit and keeping monetary policy on a course to preserve relative price stability and to maintain the fixed exchange rate.

Outlook for 2005–2007 and medium-term trends

The tsunami disaster was by far the greatest natural calamity experienced by the Maldives. While the loss of life was fortunately low, nonetheless it resulted in widespread damage to infrastructure facilities. About one third of the country's population of 280,000 was directly affected. According to a joint needs assessment conducted by World Bank, ADB, and United Nations, total damage is estimated at $470 million or about 60% of GDP. Of this loss, the direct loss is $298 million or about 8% of the replacement cost of the national capital stock. Severe damage was caused to houses; some resorts; harbors; boats and other fishing equipment; schools; health facilities; transport and communications equipment; and water, sanitation, and electricity infrastructure.

Overall macroeconomic developments will be affected by the pace of restoration of tourism and fishing, as well as the amount and timeliness of external assistance that becomes available. The Government has projected a 25% decline in tourism in 2005 relative to 2004 as the peak holiday season was badly hit, though the fish catch is expected to remain largely unchanged due to more intensive use of the fleet. Despite a sharp expansion in other sectors, such as construction and government services, which will offset much of the decline in tourism, overall GDP growth is expected to decelerate sharply to about 1% in 2005, well below the pre-tsunami expectation of a 7.6% GDP expansion. Most resorts were not damaged and nearly all were operating normally by March. Since the country is a unique destination with well-established source markets for tourism, it is expected that arrivals will quickly rebound to near normal levels to push GDP growth to 9% in 2006.

Figure 2.17 External public debt, Maldives, 2000–2004



Source: Maldives Monetary Authority, *Economic Statistics*, February 2005.

The impact of the disaster on the budget is expected to be substantial, as needed spending has been boosted while domestic revenue sources are expected to be under downward pressure. The 2005 budget had projected expenditures to rise by about 25%, reflecting a public service pay increase and greater capital spending. Despite efforts to contain such spending, the amounts required for relief, cleaning up, and reconstruction will cause an even more rapid growth in outlays. Reflecting these developments, the overall budget deficit, including grants, is now projected to widen to over 10% of GDP in 2005. Moreover, preliminary projections indicate that a budget financing gap of about this size is likely in 2006 as well.

The current account deficit is now expected to widen substantially to about 23% of GDP in 2005. Apart from the major loss of tourism revenues, this unusually large deficit is due to an enlarged import bill as a lower import requirement of supplies for the tourist industry is offset by large imports of material needed for reconstruction. The current account deficit should fall in 2006 but remain high. It is important to recognize that unless adequate foreign assistance is received to cover most of the 2005 financing gap—estimated at about $70 million—official foreign exchange reserves will come under severe pressure or the reconstruction effort will need to be scaled back sharply.

Nepal

The economy continued to recover from the downturn in FY2002 on the basis of improved performance in agriculture and services, though the recovery is fragile. Increased political uncertainties following the royal proclamation imposing emergency rule in February, the complex security scenario, and agriculture's continued dependence on the weather pose significant risks for higher economic growth over the short to medium term.

Macroeconomic assessment of 2004

The economy has been adversely affected by exacerbation of the insurgency and political instability since the second half of 2001. Economic growth slowed to an average of 1.2% during FY2002–FY2003, which was well below the annual average of 4.7% in the decade before FY2002. In FY2004 (ended 15 July 2004), GDP growth recovered moderately to 3.3% from 2.9% in FY2003, supported by improved performance in agriculture and services, which offset the conflict-induced weak performance in industry.

Agriculture grew by 3.9% in FY2004 from 2.5% in the previous year, contributing 1.5 percentage points to GDP growth (Figure 2.18). The improvement in output was due mainly to favorable weather, which helped increase paddy production by 7.8% year on year. The impact of lower growth in cash crop output, which suffered from declines in sugarcane, tobacco, and jute production, was thereby largely mitigated. However, the prospect of marked expansion in agriculture is limited by inadequate irrigation, an insufficient transport network, and lack of access to modern technology and credit.

Growth in industry declined to 1.0% in FY2004 from 3.0% a year earlier, reflecting sharply lower gains in the manufacturing and construction subsectors. Manufacturing grew by only 1.7%—much lower than the average rate of 7.5% in the decade before FY2001—due to conflict-related disruptions such as frequent *bandhs* (general strikes), forced closure of businesses, and restrictions on the movement of people and goods. Construction activity (about 50% of industrial output) was a particularly heavy drag on the industry sector, recording only 0.2% gain in the year. Besides suffering the effects of the conflict, the sector, especially manufacturing, remains constrained by poor infrastructure, lack of easy access to seaports, inflexible labor laws, and a weak legal and institutional framework for business.

The services sector grew by 4.3% in FY2004 from 3.3% in the previous year. The gain was driven by improved performance in the tourism, transport, and communications subsectors. Despite the conflict, tourist arrivals picked up by 35% due to competition-stimulated low prices and promotional efforts by the private sector and the Nepal Tourism Board. High growth in transport and communications services reflected investment in the stock of vehicles and a significant expansion of mobile telephone services.

On the demand side, both public and private investment was sluggish in FY2004, reflecting the weak investment climate in the country. At 19.2% of GDP, the gross fixed investment rate was below the average investment rate for FY1991–FY2001. The economic recovery in FY2004 was led by remittance-driven consumption expenditure,

which accounted for almost all of the growth in GDP. The sustainability of such an expansion, however, will depend on continued buoyancy in remittances and a pickup in other sources of personal income.

On the fiscal side, government spending was 12% below the budget target due to constraints imposed on capital spending by the conflict. The capital spending shortfall, together with an 11% improvement in revenue mobilization, held the budget deficit to 1.5% of GDP in FY2004, about half the forecast. Foreign loans financed two thirds of the deficit while domestic loans financed the remainder. Despite the conflict, Nepal's fiscal deficit has narrowed since FY2001, as the increase in security spending has been more than outweighed by underspending of the capital budget and improvement in revenue collection. However, a further worsening of the insurgency could change this outcome.

The financial sector was flush with liquidity due to continued growth of remittances and significantly higher flows of foreign loans. Broad money (M2) grew by 12.8% in FY2004, somewhat above the central bank's 11.2% target. However, domestic credit rose slowly, reflecting the weak investment demand, tighter credit control by the two large government-controlled commercial banks undergoing restructuring, and a sharp decline in the Government's domestic borrowings. Urban inflation was contained at 4.0% in FY2004, aided by higher food production and some appreciation of the local currency.

Interest rates fell for the second consecutive year in FY2004. The average weighted interest rate on the Government's 91-day treasury bills fell to 2.9% in FY2004 while commercial bank deposit rates dropped to 2.2–5.0% in July 2004 from 2.5–6.3% in July 2002—both items negative in real terms. The average lending rate of commercial banks for industry remained unchanged during the year at about 11%. The large spread between lending and deposit rates is indicative of both the inefficiency in financial intermediation and the credit risk in the present conflict environment.

On the external side, exports rebounded, rising by 12.4% to $733 million, and imports jumped by 18.4% to $1.8 billion. Export growth was based on a recovery in exports of woolen carpets and leather goods, which overcame a decline in exports of readymade garments. Import growth reflected strong demand for consumer durables, while the appreciation of the domestic currency was also a contributing factor. The larger trade deficit during the year was, however, more than offset by improvements in tourism receipts, workers' remittances, and foreign grants. In dollar terms, the current account surplus at $163 million was marginally higher than in FY2003 but was marginally lower in terms of GDP (2.4%). Apart from the current account surplus, foreign exchange reserves were buoyed by aid inflows, and stood at $1.4 billion or around 8 months of import cover at end-FY2004.

Table 2.16 Major economic indicators, Nepal, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	3.3	3.0	3.7	4.3
GDI/GDP	27.3	26.2	28.0	29.9
Inflation[b] (CPI)	4.0	4.5	4.0	4.0
Money supply (M2) growth	12.8	11.7	12.5	13.5
Fiscal balance/GDP	-1.5	-1.7	-3.0	-3.5
Merchandise export growth	12.4	10.0	10.0	10.0
Merchandise import growth	18.4	5.0	20.0	20.0
Current account/GDP	2.4	1.9	0.3	-1.1

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1994/95 factor cost. [b] Urban consumers only.

Sources: Ministry of Finance, available: www.mof.gov.np, downloaded 14 January 2005; Nepal Rastra Bank, available: www.nrb.org.np, downloaded 28 February 2005; staff estimates.

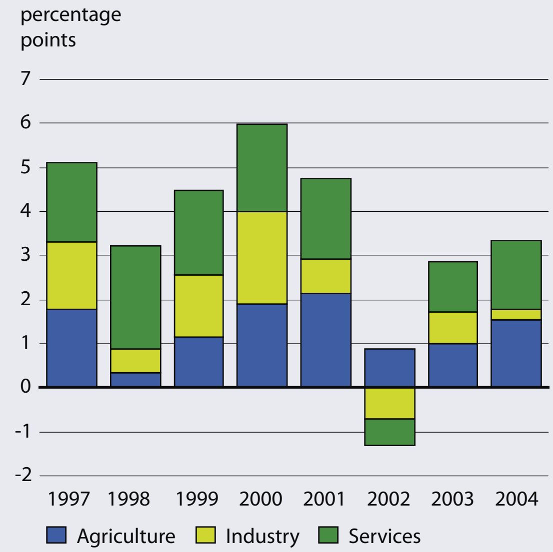
Garment exports face the threat of a sharp decline following the abolition of the MFA quota system on 1 January 2005. To cope with the threat, Nepal needs to shift its export strategy from quota utilization to one that makes use of preferential trading arrangements, such as the EU's Everything But Arms initiative and Canada's Market Access Initiative.

The economy also faces difficult challenges in reducing poverty and achieving the Millennium Development Goals. The results of the 2004 Living Standards Survey show that nominal per capita income has grown by 97% since 1996, with farm, nonfarm, and remittance incomes contributing 33%, 45%, and 19%, respectively. Remittance and nonfarm incomes have increased much faster than

farm income, revealing a structural shift in the economy. Income levels of both the poor and the rich are reported to have risen proportionately. The results show that Nepal is making some progress in reducing income poverty despite the challenges posed by the conflict and political instability.

Human development indicators remain unsatisfactory. Nepal ranked 140 out of 177 countries on the human development index in 2004—lower than all other South Asian countries except one. The country presents significant regional disparity in human development, with the conflict-affected Far-Western and Mid-Western regions faring the worst. The economy is unable to provide gainful employment to all of its rapidly growing population, though the situation has been ameliorated somewhat by migration of labor to India, Southeast Asia, and the Middle East.

Figure 2.18 Sources of growth, Nepal, FY1997–FY2004



Source: Central Bureau of Statistics.

Macroeconomic policy developments

The Government's fiscal policy objective over the medium term is to raise the revenue-to-GDP ratio and improve efficiency of public spending. The FY2005 budget aims to boost capital spending, especially in rural areas, by improving utilization of block grants to local governments along with community-led development projects in the areas of health, education, and rural infrastructure. However, this is proving increasingly difficult in the current environment.

To raise the revenue-to-GDP ratio, the Government is improving administration of VAT, simplifying the income tax law, and implementing a 3-year customs reform and modernization program. It also announced a 3 percentage point increase in the VAT rate to 13% during the midterm review of the FY2005 budget, though much of the additional revenue will finance increases in civil service allowances and security spending.

As part of the Government's public enterprise reforms, the Bhaktapur Brick Factory was privatized in FY2004. Petroleum prices were adjusted to better reflect international prices in January 2005 and to fully offset the financial losses of Nepal Oil Corporation. The Government intends to adopt the Petroleum Products Sale and Distribution Ordinance in FY2005 to allow private sector participation in oil imports and distribution.

Nepal Rastra Bank is continuing its accommodative monetary policy to stimulate the economy. It has reduced the mandatory cash-reserve ratio from 6% to 5% for FY2005, aiming to narrow the widening differential between deposit rates and lending rates. It is targeting broad money growth of 12.5% and an inflation rate of 4% to facilitate the maintenance of the current parity peg with the Indian rupee.

Under financial sector reforms initiated by the Government, the NPLs of the two government-controlled banks being restructured under external management—Nepal Bank Limited and Rastriya Banijya Bank—have declined, respectively, from 61% and 60% in FY2003 to 52% and 56% in FY2004. The effort to improve the deteriorating financial health of these two banks has, however, substantially reduced banking services in rural areas, further concentrating them in urban locations. The Government has initiated restructuring of the Agriculture Development Bank to provide improved and affordable banking services in rural areas.

A new agriculture policy was adopted in November 2004, aimed at increasing productivity and commercialization. Based on the Government's 20-year Agriculture Perspective Plan, the new policy envisages provision of modern tech-

modern technology inputs and credit to farmers to purchase land (for productivity), and supports tariff incentives for establishing agroprocessing industries and the promotion of contract and leasehold farming (for commercialization).

Recognizing that weak governance is one of the underlying causes of the conflict, the Government has recently refocused reforms to make governance more inclusive by enhancing participation of excluded and disadvantaged groups (i.e., women, *dalits*, and *janjatis*). It has approved reservation of 45% of vacant civil service positions for these groups. It also continues to pursue reforms to rightsize the civil service, establish an automated personnel information system (for civil servants and teachers), and facilitate community participation in government projects.

To achieve its estimated growth potential of 5–6%, the Government needs to focus on several areas. First, peace and stability must be restored. Second, it must improve the investment climate by strengthening the legal, institutional, and regulatory framework for the private sector. This has become increasingly important in the liberal trade regime brought about by the expiration of the MFA and Nepal's entry into international trading arrangements such as WTO, the South Asia Free Trade Area agreement, and the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Co-operation. Third, efforts must be made to foster stronger links with the country's rapidly growing neighbors to tap the economic benefits of integration with their economies. Fourth, Nepal must accelerate the pace of ongoing governance reforms.

Outlook for 2005–2007 and medium-term trends

The royal proclamation on 1 February 2005 and the imposition of emergency rule have increased political uncertainty. Together with the complex security situation and agriculture's continued dependence on the weather, they pose significant risks for economic expansion over the medium term. Growth will likely ease in FY2005, mainly due to the anticipated weaker performance in agriculture, tourism, and transport activities, and deterioration of the conflict in the second half of the year. Beyond FY2005, it will hinge on credible progress toward a lasting resolution of the insurgency. The underlying assumptions of the *ADO 2005* projections are that: there will be no further deterioration of the insurgency situation and that progress will be made toward a lasting resolution in FY2006; stronger growth will be seen in both private and public sector investment in FY2006–FY2007; the global economic expansion will be maintained; the Indian economy will grow by about 6%; and weather conditions will be normal in FY2006–FY2007. Based on these assumptions, GDP is forecast to increase by 3.0% in FY2005, 3.7% in FY2006, and 4.3% in FY2007.

On the output side, agricultural growth is expected to moderate to 3.0% in FY2005 as the overall expansion will be limited by the weather-related decline in the production of paddy, which accounts for almost a quarter of agricultural output. Industry is forecast to grow by 2.4%, mainly on account of a remittance-driven recovery in depressed construction activity. Growth in services is projected to slow to 3.2%, reflecting an easing in tourism and transport. On the demand side, the gross fixed investment rate is projected to fall to about 18%, as a result of sluggish public and private investment in the conflict situation.

The fiscal deficit is projected at 1.7% of GDP in FY2005 compared with the Government's midterm budget target of 2.5%, signaling the difficulty in implementing development projects. Broad money is likely to increase by 11.7%, or lower than the Government's target of 12.5%. Growth in credit to both the government and private sectors will remain sluggish. The current account surplus is likely to shrink to 1.9% of GDP on account of the projected decline in tourism receipts, but foreign exchange reserves will continue to expand. Inflation is likely to rise to 4.5% due to the upward adjustment in petroleum prices, the increase in the VAT rate, and the decline in paddy production.

Agricultural growth will average about 3.5% over FY2006–FY2007; a rate higher than that is unlikely given the numerous structural weaknesses in the sector. Industry is projected to expand by 3.5% in FY2006 and 4.0% in FY2007, with improved growth in both construction and

manufacturing driving the industrial recovery. Growth in services is likely to pick up to 4.3% in FY2006 and 5.0% in FY2007. Expansion in tourism, transport, and communications services is expected to strengthen, on the assumption that the security situation improves. An improvement in the security situation would also fuel a rebound in investment over FY2006–FY2007.

The fiscal deficit is forecast to widen to 3.0% in FY2006 and 3.5% in FY2007. Government expenditures are projected to grow strongly in both years on the assumption that an improvement in the security situation will allow the Government to undertake major reconstruction work. The revenue-to-GDP ratio is forecast to improve further over FY2006–FY2007, with better revenue management, efforts to check excise leakages, stronger collection of income tax arrears, and the increase in the VAT rate. Monetary policy will stay geared to maintaining the peg with the Indian rupee and to being accommodative to aid economic recovery. Accordingly, broad money growth is likely to remain in the range of 12–14% over FY2006–FY2007. Growth in credit to the government and private sectors is forecast to pick up. The discount rates on government treasury bills are therefore expected to rise. Consumer inflation is projected to fall to 4.0% in both years, as the effects of upward adjustment in petroleum prices and VAT subside and food production returns to normal levels.

The current account surplus is projected to further narrow in FY2006 and a deficit is seen in FY2007, as imports pick up. Export growth will be limited by the loss of MFA quota access and increased external competition. Foreign exchange reserves are likely to fall slightly in FY2006–FY2007, but should remain in excess of 6 months of imports.

Actual performance of the economy will be subject to significant downside risks. In particular, an exacerbation of the conflict could further restrict development spending, undermine the growth in industry and services, and impede poverty reduction efforts. The targets set out in the current Tenth Plan/Poverty Reduction Strategy of the Government and the Millennium Development Goals could then remain unattained. However, if Nepal can resolve the conflict and make progress toward peace and political stability, there is significant potential for the economy to achieve higher growth.

The economy remains well inside its production possibilities frontier, which makes further acceleration of the growth rate perfectly feasible. With 71% of its labor force in agriculture and underemployed, Nepal can hasten its transformation from an economy based primarily on agriculture to one based primarily on services and industry. If labor-intensive services and industry grow and pull even a quarter of the rural labor force into more productive employment, the economy can be expected to grow much faster. Simultaneously, the accompanying reduction in the population pressure on farmland will help raise agricultural productivity and wages.

Pakistan

The economy picked up further in FY2004, with GDP growth coming in at over 6% for the first time in 7 years. With sound macroeconomic fundamentals achieved and key sectors strengthened by reforms implemented in the past 4–5 years, the economy is well positioned to sustain 7% or more growth in the medium term.

Macroeconomic assessment of 2004

Economic performance improved further in FY2004 (ended 30 June 2004), and GDP growth exceeded 6% for the first time in 7 years. Investment in key sectors, such as large-scale manufacturing (LSM), oil and gas, telecommunications, and construction, picked up. The fiscal position strengthened further, the current account of the balance of payments remained in surplus for the fourth consecutive year, and foreign exchange reserves touched new highs. However, the size of the current account surplus fell sharply, and inflation started to creep up.

GDP growth accelerated to 6.4% from 5.1% in FY2003, driven by investment and private consumption expenditures. With historically low interest rates, a conducive regulatory and policy environment—particularly in the oil and gas and the telecoms sectors—and most industries having reached near full capacity utilization, fixed investment went up by 14.7%, accounting for more than one third of GDP growth. As a share of GDP, total investment, including changes in inventories, climbed to 18.1% in FY2004 from 16.7%. Private consumption expenditures picked up by 5.5%, contributing almost two thirds of the GDP growth.

On the supply side, GDP's improvement was led by the industry sector, which put on 13.1%. The LSM subsector, which constitutes about half of industry, registered its fastest pace in two decades. Value added in LSM rose by 17.1%, as domestic demand strengthened on the back of a rapid rise in consumer credit, higher cash incomes of farmers, continuing strong levels of remittances, and an accelerating economy. LSM's momentum was shared by all subsectors, with more pronounced rises recorded by the electronics, automobile, fertilizer, chemical, cement, cooking oil, and cotton cloth subsectors. Although the bulk of LSM's expansion came from higher capacity utilization, capacity itself also stepped up, as indicated by a 28.4% augmentation in investment in LSM in FY2004. Electricity and gas distribution, as well as construction, also exhibited marked improvements. However, agricultural growth decelerated to 2.6% from 4.1% in FY2003, due mainly to continuing water shortages, which resulted in a slide in cotton production and slower growth among other major crops.

The services sector more or less maintained the prior year's rate, though subsector performance showed considerable variation. Value added in wholesale and retail trade grew by 8.0%, up from 5.9% in FY2003, reflecting recovery in domestic economic activity, acceleration in imports, and continuing double-digit increases in exports. Telecoms services were also very buoyant, with the number of cellular phone subscribers doubling to 5.0 million. Growth in public administration and defense, conversely, was significantly slower than in the previous year.

The improved economic performance of

the past 2 years has had a positive impact on employment in the country, with the average unemployment rate declining from 8.3% in FY2002 to 7.7% in FY2004. A particularly large fall was seen in female unemployment, which dropped from 16.5% to 12.8%, although it remains about twice as high as that for males, which receded only marginally to 6.6% in this period.

Strong growth, as well as a substantial lift to poverty-related public expenditures in the past 2 years, should also have generated a positive impact on poverty. A survey of household consumption expenditures, conducted by the Government in early 2004, showed a significant reduction in poverty since 2001. However, these numbers are only indicative of the trend, because the survey covered only about 2 weeks, and was based on one third of the sample covered in the Pakistan Integrated Household Survey 2000–01.

Inflation bottomed out in September 2003, with the annual rate, based on a 12-month moving average of the CPI, accelerating from 2.6% that month to 4.6% in June 2004. On a point-to-point basis, inflation jumped from 1.9% in June 2003 to 8.5% in June 2004. The move back up was initially triggered by supply-side factors, such as a shortage of wheat and the setback suffered by the poultry business due to avian flu. This was compounded by rises in housing rents, which reflected sharply higher real estate values. Despite the upswing, the State Bank of Pakistan (SBP) did not reverse its easy monetary stance so as not to stall the nascent economic recovery. Also, as inflation was initially confined to food prices caused by supply constraints, it did not consider appropriate a tightening of monetary policy. Money supply (M2) rose by 19.6% in FY2004 compared with 18.0% in FY2003, and the increase in credit to the private sector, at PRs325.2 billion, was almost twice as large as in FY2003.

In FY2004, the Karachi Stock Exchange's KSE-100 index leaped by 55.2%. The stable exchange rate, low interest rates, higher economic growth, improved corporate profitability, and improvement in relations with India were key factors.

The Government maintained a tight fiscal stance in FY2004 and the overall budget deficit came down further to 3.2% of GDP from 3.8% in FY2003. The sharp improvement in the fiscal position was the result of strong economic growth and good expenditure management. Revenues strengthened by 11.4% and expenditures by a slower 7.9%, despite large rises in development and defense spending. Revenues exceeded their target, whereas expenditures came in below theirs. The debt profile of the country continued to improve, with the ratio of public debt to GDP declining to 72.3% from 79.3% in the previous year.

Table 2.17 Major economic indicators, Pakistan, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	6.4	7.0	7.0	7.5
GDI/GDP	18.1	20.7	22.0	22.7
Inflation (CPI)	4.6	7.5	5.0	5.0
Money supply (M2) growth	19.6	13.0	11.0	10.0
Fiscal balance[b]/GDP	-3.2	-3.1	-3.0	-3.0
Merchandise export growth	13.5	11.0	10.0	10.0
Merchandise import growth	21.2	30.0	8.0	10.0
Current account/GDP	1.9	-1.7	-1.6	-1.9

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1999/2000 factor cost. [b] Excludes one-time expenditures.

Sources: Federal Bureau of Statistics, available: www.statpak.gov.pk/depts/index.html, downloaded 1 March 2005; Ministry of Finance, available: www.finance.gov.pk, downloaded 15 February 2005; State Bank of Pakistan, available: www.sbp.org.pk, downloaded 7 March 2005; staff estimates.

Despite a double-digit rise in exports, the trade deficit more than tripled to $1.3 billion in FY2004, as imports outpaced exports by a large margin. Imports powered forward by 21.2% to $13.7 billion, while exports rose by 13.5% to $12.5 billion. Besides a broad-based strengthening in domestic economic activity, various nonrecurring transactions, such as import of aircraft for the national airline, temporary import of dredgers on a reexport basis, and exceptionally high imports of raw cotton due to lower cotton production, also inflated the import bill. Export growth stemmed from price rises, which may partly be attributed to a shift from lower to higher value-added items. The deficit on the services account widened sharply (to $1.3 billion from only $2.0 million) due to reintegration of travel-related payments into formal channels and higher payments for shipments associated with stronger

imports. Among current transfers, workers' remittances weakened by 8.6% and the Saudi Oil Facility was discontinued effective January 2004. As a result, the current account surplus narrowed to $1.8 billion from $4.1 billion in FY2003.

The $0.7 billion surplus in FY2003 on the capital and financial account of the balance of payments turned into a deficit of $1.3 billion in FY2004. The deterioration in the capital account was the combined effect of a $1.0 billion debt forgiven by the US in FY2003 (which shows up in the accounts as a capital inflow) and an early repayment of $1.1 billion of debt to ADB in FY2004. A 29.6% fall in disbursement of foreign assistance in FY2004 also contributed to the wider deficit. These were partly offset by a bond issue of $500 million and larger FDI in FY2004.

Reserves held by SBP moved $1.0 billion higher to $10.6 billion in FY2004. Total external debt and liabilities further declined by $216 million to $35.3 billion, and as a share of total foreign exchange earnings, external debt and liabilities fell to 164.1% from 180.5% in the preceding year.

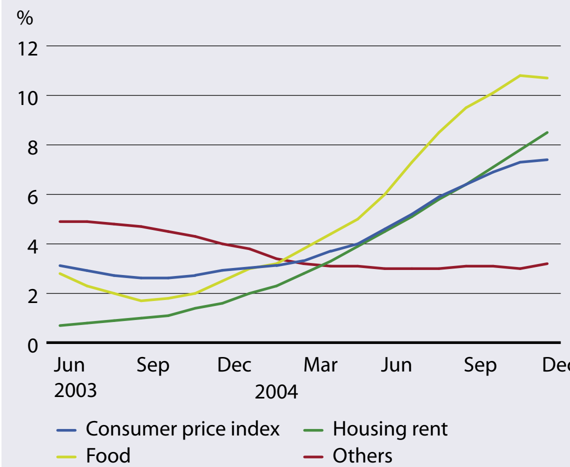
Macroeconomic policy developments

The FY2005 budget marked a break with the previous 4 years with a change in focus from fiscal stabilization to growth. The Government also continued the process of reform started in FY2002, including tax reforms, liberalization of the external trade regime, deregulation of the telecoms sector, and privatization of public sector enterprises.

The FY2005 budget took full advantage of the fiscal space created by improved revenue generation and reduced interest payments to expand development expenditures and lower business costs for the private sector. The allocation for development expenditures was increased by 25.9%, and import duties and sales tax on many raw materials and capital goods were reduced. As a result of reductions in import tariffs over the past several years, the average tariff rate has been cut to 14.9%. In addition, the FY2005 trade policy liberalized the import of used machinery to encourage the relocation of plants from abroad, mainly aimed at the textile and garment industries.

As part of the tax administration reforms, the Government plans to organize operations of the entire Central Board of Revenue on functional lines, separating the functions for collection, audit, assessment, and enforcement. It started the process in FY2003 by establishing a Large Taxpayers' Unit in Karachi, and subsequently a Medium Taxpayers' Unit in Lahore, both organized along functional lines. In these units, large and medium taxpayers can pay all their taxes in one place. Seeing the success of these experimental offices, the FY2005 budget announced the establishment of one more Large Taxpayers' Unit and five more Medium Taxpayers' Units in different cities across the country.

Figure 2.19 Inflation, 12-month moving average, Pakistan, June 2003–December 2004



Source: Federal Bureau of Statistics.

The FY2005 budget announced measures to shorten delays in payment of tax refunds, streamline general sales tax (GST) registration, rationalize the GST rate structure, and facilitate imports and exports. In the area of tax refunds, all GST refund claims are to be categorized as reliable, average, and risky based on past history, and prompt and full payment will be made in the case of claims categorized as reliable.

A new system of GST registration was introduced effective 1 July 2004, which does away with the requirement to submit a large number of documents with the registration application. The GST rate structure has been simplified, and now has one standard rate of 15% (from multiple rates ranging from 15% to 23%). Also, to make GST

a tax that genuinely accounts for value added, offsetting adjustment has now been allowed for tax on almost all intermediate payment items, including diesel used in generators for producing electric power by registered taxpayers. To facilitate exports and imports, a pilot project for an automated clearance of export and import consignments is being launched in Karachi. It will entail only selective examination of goods, based on the concept of risk management.

The telecoms deregulation policy was announced in July 2003 followed by the cellular phone policy in January 2004, to promote the availability of high-quality and cost-effective telephone services in a competitive market. Since then, the Pakistan Telecommunication Authority has issued 12 licenses to various national and international companies for long-distance international services and 73 fixed-line local loop licenses for services in 14 regions of the country. To provide telecoms services to rural areas, 106 wireless local loop licenses have been awarded to 28 companies through open bidding. Two licenses have also been issued for cellular services (in addition to those held by the four existing operators).

As a result of deregulation, telecoms is probably the fastest-expanding sector in the economy, having a significant impact on investment and employment. Cellular phone and Internet services have expanded at a phenomenal speed in recent years, with the number of cellular phone subscribers doubling almost every year since FY2000. The total number of such subscribers, at 5.0 million in June 2004, has exceeded that of fixed-line subscribers. The number of Internet users more than tripled from 0.5 million in June 2000 to 1.6 million in June 2004 and the number of cities linked to the Internet soared from 29 to 1,900. Growth in the telecoms sector is likely to accelerate further in FY2005, reflecting the impact of the recently issued new licenses.

The Government has made substantial progress in privatization in recent years, with the financial sector largely privatized and all telecoms services opened to the private sector. The focus has now shifted to the energy sector; 73% of the shares of the Karachi Electric Supply Company were sold to a Saudi group in February 2005. In addition, 20% of the shares of the Kot Addu Power Company have been divested through the stock market. The Privatization Commission has also initiated the process of privatizing the Pakistan Telecommunication Company Limited (PTCL) and has invited expressions of interest for the sale of 26% of its shares, along with management control. Expected to be the largest privatization transaction so far, the bidding for PTCL shares is planned for the third quarter of 2005.

Outlook for 2005–2007 and medium-term trends

A robust performance in the real sectors of the economy in the first half of the fiscal year, the steep rise in imports of machinery and industrial raw materials, and continuing high domestic demand all indicate that GDP growth is likely to improve to 7.0% in FY2005. An important factor is agriculture's envisaged strong performance. Output of cotton, the most important cash crop, is likely to be as much as 50% higher than in FY2004. Also, wheat, the largest crop in terms of value added, is expected to be boosted by prevailing high market prices, relatively early sowing, and timely rains. Moreover, an over 65% surge in imports of agricultural machinery and a 50% rise in gross disbursement of agricultural credit in the first half of FY2005 point to better prospects for agriculture. Accordingly, sector growth is forecast at 5.0% in FY2005.

The growth of the industry sector in FY2005 is estimated at 10.0%, given the strong recovery in investment in manufacturing seen in FY2004 and continuing high domestic demand. Reduction in import duties on machinery and liberalization of import of second-hand machinery, announced in the FY2005 budget, will further stimulate investment in manufacturing. Continuing modernization of the textile industry, as reflected in a 69.9% surge in imports of textile machinery in the first half of FY2005, and cheaper and abundant cotton, also augur well for manufacturing production. In the first 6 months of the year, the quantum index of manufacturing climbed by 16.1% compared with the corresponding period of FY2004. Of the two other important subsectors in industry, expansion will be sustained in construction, though electricity generation and distribution is likely to suffer a setback due to water shortages.

Services sector growth is also forecast to improve in FY2005. The expansion of the telecoms sector will accelerate further, as companies given licenses for various types of telephone services earlier in the year start their operations. Strengthened through reforms and privatization, the financial sector is also expected to expand robustly. Finally, wholesale and retail trade will be bolstered by a stronger performance in commodity-producing sectors and by burgeoning imports.

However, rising inflation is a major concern for FY2005. The 12-month moving average of CPI inflation pushed up further to 7.4% in December 2004 from 4.6% in June (Figure 2.19). Core inflation, which is more amenable to monetary policy, also picked up, from 3.7% to 6.5% during this period. To reduce inflationary pressure, SBP changed its stance from accommodative to a "measured tightening" of monetary policy in the first half of FY2005. Interest rates on 6-month treasury bills have risen from 2.5% in July 2004 to 5.2% in March 2005. The average interest rate on new loans disbursed by banks also increased, but at a slower pace, from 5.1% in June 2004 to 5.9% in December. However, monetary expansion in the first half of the year, at 9.8%, was somewhat larger than in the equivalent period a year earlier. Moreover, because real interest rates have remained negative, private sector credit is booming, while heavy government borrowing from SBP pushed up reserve money by 19% in the first half of FY2005. Reflecting these developments, inflation in FY2005 is put at 7.5%.

Despite an adverse effect of the increase in international oil prices, the fiscal deficit target of 3.1% of GDP should be achieved in FY2005. Tax collection by the Central Board of Revenue, which exceeded the target in the first half of FY2005, should remain above target for the year. Nontax revenues, such as dividends from the PTCL and Oil and Gas Development Corporation, as well as license fees for telephone services, are also expected to exceed the target. However, a shortfall in receipts from a surcharge on petroleum products will be seen, as the Government did not pass on the increase in oil prices to domestic consumers until very late in 2004. Still, total revenues are likely to be higher than budget estimates. As regards spending, only that on subsidies will be larger than budgeted. This is explained by additional losses from state-owned power utilities (due to higher fuel prices) and substitution of high-cost thermal power for low-cost hydropower (due to water shortages). Also, the Trading Corporation of Pakistan will require higher subsidies to cover losses in its trading operations pertaining to imports of wheat and urea, and procurement of cotton. On balance, though, the rise in expenditures due to higher subsidies is expected to be offset by the increase in revenue receipts.

In the first 6 months of FY2005, the trade deficit grew much more sharply than expected because of an unprecedented surge in imports of 47.7% compared with the same period in the previous year. Thus, despite an above-target rise in exports (14.6%), the trade deficit leaped from $159 million to $2.3 billion. This, along with an almost ninefold increase in the deficit on the services account to $1.5 billion, turned the current account into a deficit of $0.9 billion from a comfortable surplus of $1.8 billion in the first 6 months of FY2004. With high economic growth and the planned import of 1.5 million tons of wheat, imports are still expected to rise, though at a somewhat slower pace in the remaining 6 months of the year. The phaseout of textile and clothing quotas in January 2005, together with substantial investment in modernizing the textile industry in recent years, as well as the present cheaper, abundant supply of cotton, should boost the industry's exports. Nevertheless, imports will significantly outstrip exports, and the trade deficit will continue to widen. Consequently, it is estimated that the deficit on the balance-of-payments current account in FY2005 could be as high as 1.7% of GDP.

On the basis of the *ADO 2005* global outlook and continued sound macroeconomic policies, supported particularly by the low fiscal deficit and a much-improved public debt profile, the medium-term economic prospects look good. It is projected that GDP growth in FY2006 and FY2007 will remain at 7% or more, inflation will be brought down to 5% after the sharp increase in FY2005, and the fiscal deficit will be sustained at around 3% of GDP. Moreover, the current account deficit is expected to stabilize at less than 2% of GDP and, at this level, should not be difficult to finance.

The Government's active debt management policy and tax reforms are expected, respectively, to further reduce the debt service burden and to boost revenues. The resulting fiscal space will allow it to increase investment in physical infrastructure and to allocate more resources for operation and maintenance, as well as to raise allocations for basic social services, such as education, health, and safe drinking water.

The financial system, greatly strengthened by aggressively implemented reforms over the past several years, is also well positioned to support higher economic growth over the medium term. Such reforms, together with privatization, have resulted in a more resilient and efficient system that is better placed both to absorb macroeconomic shocks and to mobilize and allocate financial resources more efficiently. With four fifths of the assets of the banking system in the control of the private sector, political interference in the working of the system has been brought down to a minimum and, by and large, banks' lending decisions are based on economic considerations. As a result, the volume of NPLs has fallen significantly. Banks are extending their lending operations to new areas, such as consumer finance, which is propelling production of consumer durables such as automobiles and electronics. They are also helping growth in agriculture by sharply increasing both production and investment loans to farmers.

A significant improvement in Pakistan's relations with India in the last year has also enhanced the economic outlook, by reducing security concerns and by improving prospects of intraregional trade in South Asia.

Sri Lanka

High oil prices, growing fuel subsidies, and a drought in 2004 all impacted inflation, the budget deficit, and the balance of payments. The year ended in tragedy: more than 35,000 Sri Lankans perished in the tsunami on 26 December. Reconstruction and recovery is the first priority, but urgent economic reforms needed for long-term growth should not be forgotten.

Macroeconomic assessment of 2004

Growth in 2004 moderated slightly to 5.5% and remained driven by domestic consumption and fast-growing exports, with performance underpinned by the continuing cease-fire. Investment growth was not as high as anticipated, as two elections—both the parliamentary election in April, which resulted in a change in government, and a provincial council election in July 2004—produced economic and political uncertainty. A stalled peace process and uncertainty about how the new Government would approach negotiations with the Liberation Tigers of Tamil Eelam (LTTE) added to the prevailing atmosphere of hesitation. Privatization of parts of the retail arm of the Ceylon Petroleum Corporation with a foreign buyer was not carried through, and this brought down FDI inflows to 22.2% below the level of the previous year. Exports grew strongly, but significantly higher imports, mainly due to much larger oil payments, widened the current account deficit.

The mainstay of economic growth, the services industry, continued to thrive, growing rapidly at 8.1%. Banking sector performance, however, was not as strong as in 2003, as profit margins dipped following a reduction in interest rate differentials. Port services and shipping grew strongly, despite growing fears of increasing competition from the Indian market: 67% of cargo traffic is transshipment to or from India. Agricultural output contracted by 1.8%, due to a drought. While not affecting plantation crops, the drought caused paddy production—most of which is on small-scale farms—to fall by 24%. The industry sector's performance was mixed: generation of hydropower, always prone to wide fluctuations, fell by 2%; but both the textile and garment and the construction subsectors recorded robust growth. Construction, which now accounts for about 7% of GDP, has benefited from a cease-fire building boom, mainly in privately financed projects.

Poverty levels, as measured by the head count poverty ratio, have overall declined only slowly, from 26.1% in 1990 to 22.7% in 2002, according to a survey carried out in each of those years. Given variations in the surveys' approach, which make direct comparisons difficult, income inequality seems to have increased, with the share of the lowest quintile declining from 5.2% to 4.8% over this period. Across a wide range of social indicators, Uva (the central province covering most tea plantation lands) and the east remain among the most disadvantaged in terms of access to economic opportunities, education, and general infrastructure. Following the availability of new preliminary data for the north and east in 2005 (except for those districts under LTTE control), the devastation as well as inequality in terms of basic services has been documented. For example, in the north, only 3% and 64% have access to water piped into the house and electricity, respec-

tively, compared with 52% and 93% in the relatively wealthy western province.

The hoped-for fiscal consolidation was not achieved and the budget deficit was virtually unchanged at 7.6% of GDP in 2004, owing to weaker than expected expenditure and revenue outturns in equal measure. High levels of fuel, wheat, and fertilizer subsidies to cushion the impact on consumers of sharp global price increases were the primary issue with respect to expenditure pressures, while weak tax administration and leakages continued on the revenue side. Moreover, lower inflows of foreign concessional loans resulted in a much larger than expected rise in domestic borrowing (SLRs65 billion planned as against SLRs119 billion actual) adding steam to an already rapid private sector credit expansion. Central government debt jumped to SLRs2,127 billion or 106.9% of GDP, from SLRs1,864 billion or 105.5%, though the impact of exchange rate changes on the external debt explains some of the increase.

Inflation accelerated sharply during the second half of 2004, reaching 16.8% on a December-to-December basis (Figure 2.20), and up by 7.9% on an annual average basis. Cost-push factors stoked inflationary pressures, especially higher global oil prices (which were slowly and not completely passed on to the consumer in the form of 38% and 23% price rises for diesel and gasoline, respectively) and drought-related food shortages (rice prices alone surged by over 40% in 2004).

Broad money (M2b) increased by 19.6% in 2004. Domestic credit accelerated to 22.4% from 7.6% in 2003, with private sector and net government credit advancing by over 20%. This put pressure on the balance of payments, which deteriorated markedly over the year. Policy lending rates are negative, even though the central bank put up its two key lending rates by 50 basis points in November 2004 to 7.5% and 9.0%, respectively. The average weighted prime lending rates of commercial banks rose to 10.23% at end-2004 from 9.26% 12 months earlier, while 91-day treasury bill rates stayed virtually unchanged (7.25% at end-2004). The stock market performed strongly in 2004: the All Share Price Index rose by 26.6% to end the year at 1,506.9, reflecting a capitalization of SLRs382.1 billion. The index continued its advance in the first quarter of 2005.

Table 2.18 Major economic indicators, Sri Lanka, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth[a]	5.5	5.2	5.8	5.9
GDI/GDP	25.9	27.0	27.0	27.0
Inflation (CPI)	7.9	12.0	9.0	7.5
Money supply (M2b)[b] growth	19.6	16.5	13.0	10.0
Fiscal balance[c]/GDP	-7.6	-8.0	-8.0	-7.0
Merchandise export growth	12.7	9.0	11.0	12.0
Merchandise import growth	19.3	17.2	8.5	6.0
Current account/GDP	-3.2	-5.8	-5.2	-3.0

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product. [a] Based on constant 1996 factor cost. [b] Includes time and savings deposits held by commercial banks' foreign currency banking units. [c] Excludes privatization proceeds.

Sources: Central Bank of Sri Lanka, available: www.centralbanklanka.org, downloaded 7 March 2005; Ministry of Finance; staff estimates.

Swollen by both oil and non-oil products, imports are estimated to have risen by 19.3% in 2004. This led to a significant worsening of the current account deficit from $101 million to $626 million, equivalent to 3.2% of GDP. Exports grew solidly at 12.7%, buoyed as in the past by textiles and garments, but also this year by an impressive performance in rubber and tea, which were underpinned by significant global price increases. Workers' remittances, traditionally a major source of foreign currency, also continued to grow strongly, to $1.3 billion.

The depreciation of the Sri Lanka rupee against major currencies helped retain market shares in highly competitive textile and garment markets. The exchange rate relative to the dollar at end-2004 (SLRs104.5/$1) was 7.7% lower than a year earlier. Foreign exchange reserves fell sharply by about $0.5 billion to $1.8 billion by the end of the year, offering about 2.4 months of import cover. The reserve position was bolstered during the year by the issue of $250 million of Sri Lanka Development Bonds and by central bank negotiation of credit lines.

Macroeconomic policy developments

The approach of the new Government differs from that of the previous one: it has ruled out

zation of SOEs, but has announced that it is keen on restructuring them. It has also rejected the poverty reduction strategy paper developed by its predecessor, stating that it ignored the worsening regional inequality and failed to tackle poverty at its roots. The Government plans greater emphasis on direct poverty interventions and programs, and a greater role for itself in addressing increasing income inequality. However, it is not yet clear how it plans to tackle the difficult questions of reforming public utilities or of dealing with intractable land and labor issues. Discussions with IMF on a new Poverty Reduction and Growth Facility (PRGF) program are planned to take place during the first half of 2005. Finalization of a World Bank Poverty Reduction Credit was delayed because of a lack of structural reforms.

Previous governments grappled, largely unsuccessfully, with persistently weak performance of the revenue collection agencies, and the new Government also sees an improvement in revenue collection as its main priority. It has rejected the earlier administration's plans for creating a new autonomous revenue agency to improve revenue collection (a plan that faced significant labor union opposition). Instead, the Government aims to achieve change from within, and a revenue board, comprising members of all revenue collection agencies, is to be set up.

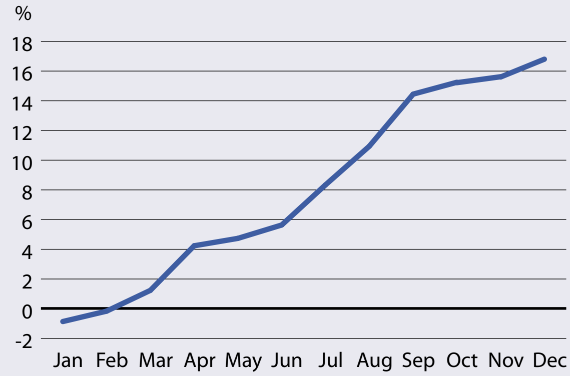
Weak revenue performance has important implications for both the size and efficiency of capital expenditures. This situation arises because new project starts are not sufficiently restricted, such that available revenues become spread too thinly over ongoing projects for them to be completed on time. Weak revenue performance slows donor-financed projects as well, since they generally require counterpart funding from the Government.

The first year's budget of the new Government presented in November 2004 envisaged further fiscal consolidation to bring down the deficit to 7.5% of GDP in 2005. At the same time, it incorporated much higher capital spending and a substantial real wage increase for civil servants. Fiscal consolidation was to be achieved almost exclusively through stronger revenue collection, primarily by a sharply higher tax on imports, but also by the elimination of most fuel and wheat subsidies in 2005. In addition to the standard 15% VAT rate and zero rate for exports, the budget announced two new rates—a 5% VAT on basic commodities and an 18% VAT on luxury goods. Capital expenditures will be ramped up by a nominal 50% to 5.8% of GDP. In addition, a 31% nominal wage rise in the civil service salary scale was made. The budget also planned a further civil service hiring drive for 30,000 trainees. The immediate impact of this latter effort on the wage bill is, though, relatively small, as the base salary is low, at SLRs3,000–5,000 a month for graduates. Since the new Government assumed office, it has created 70,000 additional government positions.

The end of the MFA on 1 January 2005 has not yet had an identifiable adverse impact on the country's textile and garment industry. According to industry reports, the order books of the largest exporters are full through the first half of 2005. The Government had pinned hopes on reaching a free trade agreement with the US to reduce the impact of the loss of quotas by giving Sri Lanka's exports special tariff treatment and thus more preferable access to US markets. These hopes were not realized because national elections in both countries put negotiation of the agreement in abeyance. However, as a result of the tsunami, the EU is likely to include a larger number of textile and garment items in its preferential trade system. Consequently, 90% of textile and garment exports to the EU would then have zero-rated access.

While there is a backlog of important

Figure 2.20 Inflation, year on year, Sri Lanka, January–December 2004



Source: Department of Census and Statistics, available: www.statistics.gov.lk/price/slcpi_monthly.htm, downloaded 28 February 2005.

economic legislation that has built up since the February 2004 election, the Government took action in July to create a Strategic Enterprise Management Agency. It is tasked with putting the 13 largest SOEs on a more commercial footing, without privatizing them. All enterprises, including the People's Bank and Ceylon Electricity Board (CEB), submitted business plans in October. The key issue for most enterprises under the agency's purview is to delink them from the political process, and allow tariff setting regulated by a fully functional public utility commission, to fully reflect enterprise costs, including an adequate return on invested capital.

In December 2004, the Government announced a phased approach to restructure the People's Bank, the largest state-owned commercial bank. The bank is burdened with heavy NPLs (over 17% of total loans) and excessive exposure (24% of total loans) in the form of advances to SOEs. The restructuring is tied to specific performance targets, reached in agreement with the People's Bank's labor union and management, on achieving levels of profitability and bringing down the NPL ratio to 9.7% by 2008.

The financial position of the CEB, the state-owned energy utility, has deteriorated substantially. Tariff increases of well over 40% would now be necessary to prevent it from incurring a loss. An attempt to raise the average tariff by 3% in November 2004 failed and the matter is now under consideration in the courts. Reform of the power sector was started in 1996 with the ultimate goal of unbundling CEB to improve efficiency, linked with a least-cost power generation expansion plan. This reform has not been seen through and no major additional power generation capacity (above 300 megawatts) is likely to come on line before 2009, a prospect that risks holding back economic growth.

Despite the mixed performance in 2004, the economy has proved remarkably resilient in the past, and continued to grow despite two decades of civil war. Its educated workforce, geographic location (next to a booming India), and its openness to international trade are important strengths. However, key policy issues—restrictive land regulations, expensive and unreliable power supplies, low agricultural productivity, rigid and nontransparent labor laws, as well as an overstaffed bureaucracy and inefficient public services—need to be tackled for the country to fulfill its substantial long-term growth potential.

Outlook for 2005–2007 and medium-term trends

The 26 December tsunami struck more than 1,000 kilometers, or two thirds, of Sri Lanka's coastline. Coastal infrastructure—as well as a large number of houses—was destroyed or significantly damaged, with an overall asset loss estimated at $1.0 billion, or 4.5% of GDP. Reconstruction costs, including upgrades, are estimated at $1.5 billion–1.6 billion. While the human loss was staggering, the impact on GDP growth might be relatively small, perhaps shaving less than 0.5 percentage point off expected growth in 2005 for an outturn of 5.2%. This is because neither the port of Colombo—through which most of the country's exports are channeled—nor the main production and exporting industries were affected. Only the fishing, tourism, and tourism-related subsectors, which together account for only about 3% of GDP, suffered extensive damage. Moreover, reconstruction activities, which are expected to be funded mainly by aid, and the easier access to EU markets should have an important offsetting impact.

Assuming reconstruction plans are implemented speedily, economic growth is likely to be 5.8% in 2006 and then rise to 5.9% in 2007. This expansion will be underpinned by strong growth in construction, the key sector in post-tsunami reconstruction activities. But tourism—which was in fact less damaged than fishing—should recover quickly, assuming that rebuilding and cleaning-up activities along the coast are not delayed.

In 2005 imports are estimated to increase by 17.2%, with much of the expansion attributable to reconstruction needs, but also by a higher oil bill. This suggests that the current account deficit for the year will nearly double to almost 6% of GDP, or about $1.3 billion. After the first year of tsunami-related imports, import growth is projected to fall to about 6.0–8.5% in 2006–2007. Export growth is projected at 9.0% in 2005 growing at 11.0–12.0% in the 2 subsequent years. The export performance assumes a solid performance of the textile and garment industry that

will benefit both from government programs to enhance productivity and preferential EU access.

The fiscal impact of the tsunami will be reflected in the budget over time. On 9 March 2005, a meeting of the Paris Club decided to grant a 1-year debt repayment moratorium for Sri Lanka. Interest rates, to be negotiated on a bilateral basis, will be capitalized. The precise details still have to be worked out, but the Government was due to pay some $500 million for debt amortization and service in 2005, including amounts due to international institutions. This will give it considerable fiscal breathing space.

With this relief and larger aid, the fiscal deficit is projected to increase only moderately from the original budgeted 7.5% of GDP to 8.0% in 2005 and 2006, and decline to 7.0% in 2007. Given the large pledging of donor funds, both from bilateral and multilateral sources, the Government should be able to finance reconstruction costs without resorting to domestic borrowing to the extent that it did in 2004. A framework to meet annual requirements and monitor assistance over the medium term is being established.

During the forecast period, numerous factors will put upward pressure on prices. These include the Government's commitment to reducing subsidies, especially for fuel; rises in utility tariffs; the substantial civil service wage increase in the 2005 budget; and the influx of donor funds that will work to raise salaries. Already, anecdotal evidence suggests that high demand for skilled labor from international agencies is leading to labor shortages; prices of construction materials are also reported to have increased. Inflation is projected at about 2 percentage points above earlier expectations at 12.0% in 2005. It will then likely moderate to 9.0% and to 7.5% over the next 2 years.

The greatest risks to growth stem, as in the past, from uncertainty in the peace process. Official peace talks between the LTTE and the Government have not taken place since April 2003, although both sides remain committed to maintaining the cease-fire, and to finding a peaceful solution. This uncertainty continues to stymie domestic and foreign investment. A wide-ranging investment climate survey conducted by ADB and the World Bank in 2004 identified the key impediments to private sector growth as weak infrastructure (e.g., lack of reliable power and reasonable roads), uncertainty over macroeconomic policies, and red tape. But following the tsunami, there is now an elevated risk that key economic reforms and investment in infrastructure will receive less attention than before, as more resources of both the Government and other stakeholders are focused on reconstruction.